

# **The state of economic and monetary union “Will the Greeks kill the euro?”**

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## I

It is a great pleasure and honour to be here in Amsterdam today to give this talk to the Duisenberg Institute. I feel a certain bond to Wim Duisenberg, whom I got to know moderately well both during my time as a journalist on the Financial Times and also after I left journalism to enter the City. He was always a very warm-hearted down-to-earth man and I felt that it was unfair that his reputation became somewhat tarnished during some of the difficult times in the early years of the European Central Bank when the euro was under pressure on the foreign exchanges.

I remember visiting him once when he was President at the Nederlandsche Bank in the early 1990s during the time when I was on the FT. I had come to Amsterdam not only to research a story about economic and monetary union but also to look into various cross-border European initiatives to counter trade in illegal drugs. After I had finished my conversation with Mr Duisenberg, I mentioned that my next appointment was at the Amsterdam police station and he very kindly drove me there in his car afterwards.

On another occasion I visited him in his offices at the European Monetary Institute, the forerunner of the ECB, in what is now the ECB's headquarters in Frankfurt, with a party of clients while I

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<sup>1</sup> Yale University Press. Published in German as *Der Euro: Die geheime Geschichte der neuen Weltwährung* (Murrmann Verlag). [http://www.londonandoxford.com/The\\_Euro/The\\_Euro.htm](http://www.londonandoxford.com/The_Euro/The_Euro.htm)

was working in the stockbroking subsidiary of Robert Fleming. His countenance was very sunny until the conversation turned to President Jacques Chirac and then his brow became furrowed. This was the person whom he labelled darkly “that man” on account of the latter’s opposition to his becoming the first president of the ECB.

## II

Another reason why I’m delighted to be here is because the Dutch have played a very important part in the construction of economic and monetary union. Smaller countries such as the Netherlands, very open to foreign trade, often more Atlanticist than continental in demeanour, and in touch with many other nations, are in a pivotal position for influencing matters in areas like monetary union. You, the Dutch, have your own very strong policies. But you also speak all the languages, you understand the different mentalities, you can put yourselves in different people’s shoes, and you are not arrogant enough to think that you will always be the centre of attention – so you pay more heed than others to events and influences around you.

The Dutch and the British have had much intermingling in the field of financial history. There was an unfortunate episode in the 1930s when one of your former central bank governors, Vissering was his name, was forced into a very difficult situation over maintaining stocks of sterling at the Bank of England. He took a rather complacent, one might say naive, approach to the sanctity of the Bank, in spite of strong rumours that Britain was about to go off gold, a course that was eventually taken and resulted in large losses and much embarrassment to the Dutch. A little ditty was composed in London banking parlours which went as follows:

*In matters of sterling  
The fault of the Dutch  
Is caring too little  
And trusting too much*

Britain of course got its come-uppance over the takeover of ABN Amro when certainly our banks showed too much faith in the quality of the Dutch bank's balance sheet, a course of action that eventually cost British taxpayers dear.

My subject today is an even much larger adventure – the euro. I was very pleased to come to the Netherlands on several occasions to interview leading players in this drama, including people like Wim Kok and Ruud Lubbers and my old friend Andre Szász of the Nederlandsche Bank who was a pillar of strength and a fountain of wisdom and good ideas.

Economic and monetary union is a very long and complex piece of theatre which, as I have often said, is a mixture of a Shakespearean historical masterpiece and a “whodunit” by Agatha Christie. We do not know how the play will end but we suspect it will be bloody. What we can say even at this relatively early stage is that Europe has failed to cope so far with some of the travails of the euro, even though many of these problems were entirely predictable and indeed were predicted. This has been a monumental failure not only of imagination but also of logic, including by the key people in the midst of the continent, the Germans, who one might otherwise suppose would be excellent at analysing this sort of development and whose currency was the centrepiece of this adventure.

### III

At this stage, I believe it is appropriate to remind ourselves of the four principal reasons for the formation of the European single currency.

First was the desire to found an instrument of currency stability that would promote cross-border trade and thus to complete the single European market for free movement in goods and services, in capital and labour, promulgated under the Treaty of Rome and advanced with Jacques Delors' programme as European Commission president in the 1980s.

Second came the long-held ambition to rival the US dollar as the world's prime reserve asset and transaction currency. This objective was put forward with most intensity by the French, but the Germans also had a point of view that had to be taken seriously. Watching the weakening dollar in the 1970s, they wished to avoid that too much of the burden of reserve currency status would be shouldered by the D-Mark, which they believed – no doubt correctly – would over-stretch the capacity of the German economy.

The third objective, put forward from the beginning by the founding fathers of the European Community, was to pursue political union in Europe. Monetary union was seen as a catalyst for political union – although of course there was also the equal and opposite view, which we shall develop further, that creating monetary union first and then waiting for political union to come along later was putting the cart before the horse; and that monetary union without political union would not work.

Fourth, we need to see the desire to keep Germany under control after the adventure of reunification in 1990. Helmut Kohl acquiesced in Francois Mitterrand's desire to ensure that the greater Germany born in 1990 would be as fully and reliably *communaautaire* as the old West Germany that had been a founding member of the European Common Market and Nato. Subsuming the Bundesbank and the D-Mark into a new European currency scheme – although under certain German-inspired conditions which were reasonably onerous for those who wished to join – was a vital part of securing this bargain. Indeed, Jacques Attali, the famously febrile foreign policy adviser to President Mitterrand, once told me that the Maastricht treaty was a long and highly complicated document just one essential aim – “to get rid of the D-Mark.”

Some of these motivations and desires were contradictory. At the end of the 1990s, the helter-skelter rush of most of the then 12 members of the European Community to join the single currency was itself inherently destabilising. As the view gained ground that a greater number of countries would join, yields on the outlying countries' government bonds fell across Europe, lowering debt

servicing costs and allowing countries to move within reach of attaining the celebrated Maastricht criteria for budget deficits and economic convergence. This was a monumental re-assessment of risk by the financial markets that became a self-fulfilling prophecy. And it proved to be storing up trouble for the future, because the view that all countries were converging toward the same credit rating as Germany turned out to be an illusion.

Yet countries were driven towards EMU membership, on the widest basis possible, because those that remained outside would have been automatically punished with higher borrowing costs and much more unstable economic positions than those inside. The move towards a wider rather than a narrower monetary union became inexorable – even though a wider union was arguably a great deal less sustainable than a narrow one.

What would have been the point, indeed, of a narrow EMU that would have brought together in a *de jure* monetary union only those currencies that had already existed in a *de facto* single currency bloc for many years? I formed the view in the 1990s that what was feasible over a longer period of time – a narrow EMU – was not desirable, whereas what was desirable - a wider union – was essentially unfeasible.

#### IV

As I have said, when we look at the outcome so far of economic and monetary union, there have been many failures of logic and of imagination. Let me list some of the things that were generally not foreseen during the past decade.

- By far the most crass was the inability to see that the economic failures of the southern states would be transposed into increased economic risks in the northern states. Onlookers did not predict how economic risks of one set of countries became the financial risks of others.
- The widening and deepening of the European capital markets that was a principal motivation behind the birth of the euro had the effect of attracting capital into the euro from around

the world – bringing down general levels of European interest rates below what they would otherwise have been. This had the deleterious effect of encouraging the borrow-and-spend practices (by the public and private sector) of the southern and western states whose consequences we now see. By the way, I have a less pejorative word for these nations – “PIGS”, in my parlance, stands for the “peripheral indebted go-getting states.”

- Higher exchange rates and lower interest rates in the peripheral states supplied the basic reasons for the fall in their competitiveness, a build-up of their current account deficits, a rapid rise in cross-border borrowing to finance these debts and a consequent increase in foreign debt levels. This general chain of events was not only foreseeable but was also explicitly foreseen under the preparations for monetary union. Indeed, the activation of the so-called “financial channel” for financing cross-border deficits was an essential accompaniment to the fixing of exchange rates. Jean-Claude Trichet, president of the European Central Bank, has emphasised in the past that, because the euro area lacks the instruments for adjustment seen in other more classical single currency areas – such as high labour market flexibility, or a self-equilibrating mechanism for redistributing tax revenues - the “financial channel” for cross-border lending was of vital macro-economic importance.
- As the peripheral countries’ debts rose, the pressure for the “no bail out clause” to become a “no default clause” increased accordingly. It was predicted by people such as Otmar Issing, the former Bundesbank directorate member and ECB board member responsible for economics, that the combination of the no-bail-out clause and the Stability and Growth Pact of the 1990s would effectively insulate the stronger states from negative repercussions of fiscal or balance of payments disequilibrium in weaker states. This expectation voiced by Prof. Issing in 1999 ran counter to what actually happened in the last few weeks. One of the reasons for the shortcomings in such predictions was that the

Germans themselves proved to be the principal transgressors in the Stability and Growth Pact – a bad example by a large country that left a very poor legacy that persists to this day.

- The overall effect of these developments was to leave German banks holding an estimated €700bn in claims on the five most indebted peripheral nations in Europe – debts that may prove to be very unlikely to be repaid in their entirety. These are not banks that are too big to fail. Rather, the debts that they are owed are too big for the debtors not to be bailed out.

## V

Some of these issues have now burst out fully into the public eye. For the first time, problems in the periphery of Europe are striking home in the centre of the euro area. Germany's reaction to what Chancellor Angela Merkel calls an "existential challenge" for the euro is gradually becoming clearer. And it is not something that its neighbours and allies will be very keen to hear.

The irrefutable message being relayed at home and abroad is that Germany is seeking gradually to take control of the European economy – in a last-ditch response to what Berlin sees as other countries' widespread failure to put their house in order. In no other way can we explain her statement in the Bundestag last week that the rules will in future be geared to the strong countries and not to the weak ones.

During repeated currency crises over the past half a century, Europe's difficulties never hit home directly in Germany itself. If the going got rough, the Germans could withdraw to the impregnable fastness of the D-Mark. That protection is no longer intact, because the currency intrinsically affected by the failures of Europe's periphery has become Germany's own money. John Connally, President Nixon's Treasury Secretary when the Americans severed the dollar's links to gold in 1971, was able to say laconically to European finance ministers: "It may be our currency, but it's your problem". The German message vis-à-vis

the European periphery is now: “It’s your problem – but it’s our currency.”

Let me list the following developments that have taken place in recent weeks, and some issues that arise from them:

- France and Germany are indulging in a form of political and economic brinkmanship over governance of the euro area which is highly reminiscent of past Franco-German crises over European monetary affairs. It is a somewhat sad but also strangely reassuring aspect of European financial history that national stereotypes with regard to monetary and fiscal policy do not in general change very much over time.
- The ECB has experienced its first-ever public split over monetary policy on the Governing Council. The issue has been the decision on ECB purchases of government bonds announced on 10 May, shortly after EU governments and the International Monetary Fund reached agreement on a package of €750bn in loans and guarantees for weaker states. Axel Weber, president of the Bundesbank, made clear his opposition to the move in a German newspaper interview immediately afterwards, saying that the decision involved “considerable risks to stability” – one of the strongest statements a German central bank governor can make.
- We do not know exactly how the ECB came to its decision; we do not know the extent of its prior deliberations on the matter; we do not know if there was a proper vote; we do not know to what extent others on the ECB Council agreed with Mr Weber’s point of view. We do know that the decision was taken in the heat of the moment at a time of a rapid sell-off of Greek government bonds, in particular, and that the ECB sees the step not as a move of “quantitative easing” similar to those enacted last year by the Federal Reserve and the Bank of England, but as a means of ensuring that the bond markets function properly and “to restore an appropriate monetary policy

transmission mechanism” (in the words of the ECB press release).

- One of the main factors impelling EU governments towards the aid package was the phone call by President Obama to Chancellor Merkel on the eve of the decisive European summit a fortnight ago. President Obama forcefully relayed the message that Europe needed to shore up the peripheral states to prevent a sovereign debt crisis from disrupting financial markets in a similar way to the effect of the sub-prime mortgage crisis or the Lehman bankruptcy. It is a great irony that the governments behind a European monetary scheme designed to lower dependence on the US should require the American president to galvanise them into action.
- In the eyes of the financial markets and of many commentators both within and outside Germany, the government bond purchase decision has had an extremely important effect: the ECB has lost its reputation of being a reincarnation of the independent-minded Bundesbank. The shift was summed up by the former Bundesbank president Helmut Schlesinger who said the ECB had “crossed the Rubicon”. The result has been seen in the weakening of confidence in the euro on foreign exchange markets and the marking down against key currencies, in particular the dollar and leading Asian units. It will be interesting to see to what degree the ECB’s balance sheet does indeed deteriorate as a result of the government bond purchases and whether or not this really does amount to a monetisation of EU governments’ debts, to the extent that the sterilisation procedures operated by the ECB are seen as being ineffective.
- As a number of authorities led by Chancellor Merkel have opined, the joint European-IMF package does nothing more than buy time for the weaker states. And there is still considerable uncertainty whether it will produce the desired effect. The package applies a liquidity solution to what is a solvency problem. A deflationary economic

policy as well as further increased debt is being ordained for states that have already lost considerable amounts of competitiveness and cannot devalue within the euro area. The result will be that their debt ratios become still worse in the next two to three years, since indebtedness will rise while GDP is expected to decline precipitously over that time.

- The overall depreciation of the euro against other world currencies will have a far more beneficial effect on the trade account of the one country that does not need it – Germany – since this is the country with the most globalised companies that conduct far more of their business outside the euro area than those from the peripheral states.
- The threat of default by countries such as Greece, or in a more optimistic sense that of an orderly debt restructuring, has certainly not been lifted. Josef Ackermann, the head of the Deutsche Bank, speaking on a German television chat show, has said that he does not believe that Greece will be able to repay its debts. Indeed, from a cynical point of view, the best time for Greece to default on its debt would be 2012 when it has returned to a primary surplus and can withstand the forced disruption to its borrowing programme.
- It is theoretically possible that Greece could remain within EMU after rescheduling its debts. However, by then Greece would have made copious drawings on the €750bn debt package and it is a matter of conjecture how Germany, in particular, would react to the prospect of rescheduling of large-scale public sector loans made under the debt package. There would be large-scale irritation, to put it mildly, among the creditor nations – and this would extend, too, to the less-well-off peripheral states which of course are also being asked to put up loans and guarantees for Greece.

## VI

The greater controls over public borrowing around the euro area now being considered, along with general improvements in economic coordination, add up to a further attempt to bring in some form of greater political authority over individual countries' economic programmes. Many people – including Chancellor Kohl as well as representatives of the Bundesbank – said in 1990-91 that political union was required to make monetary union work. However it was not implemented because most countries – not just the UK but also Germany and France – did not actually want it. The question is whether a form of political union worthy of its name can now come in through the back door, as the result of a crisis, when it has proven so manifestly difficult to bring it in through the front door.

One thing that we can say is that the manifold risks of monetary union have now been spread and are being borne not just by German taxpayers but also by taxpayers from countries as far afield as China and Brazil, as the result of the IMF's involvement in the rescue package.

The surplus states of northern Europe, principally Germany and the Netherlands, are of course showing solidarity with the weaker countries through the mechanism of the aid package. Given that considerable sums of public money are at risk, they will have to decide how important monetary union is to them. At present the answer is: "Very important". But on a two to three year time horizon, when much money and hope will have been expended, they may not give quite the same response.

An enterprise of the scale and scope of EMU has to bind together its member states in some form of equilibrium where there is a balance between risk and reward, between costs and benefits, and between pain and gain. At present, such equilibrium exists and on the whole this has had a stabilising effect on markets and on economies. But will that be so in three years? The rich countries may have paid a great deal over this time in aid and loans to the weaker states – but everyone may

appear to be worse off, and the threat of debt restructuring, rather than being lifted, may have become worse. There could be an unsavoury cocktail of resentment on all sides. In these circumstances, it will be difficult to avoid the prospect of some countries leaving the euro area. Whether it would be the stronger or weaker ones is hard to say.

We need to think of military analogies sometimes when dealing with monetary affairs. During the Cold War, when the power of the Americans and the Soviets was balanced by the threat of mutually-assured destruction, the big question for political strategists and military thinkers was whether the Americans would sacrifice Washington to save Bonn. The post-Cold War question for the Germans, in the existential tussle for the euro that is now unfolding, is whether they are ready, financially speaking, to sacrifice, say, Augsburg to save Athens. And, even if it were possible to isolate Greece (perhaps through the country leaving the euro), what should happen to the much larger and potentially more disruptive economy of Spain? Are the Germans ready to sacrifice Munich to save Madrid?

All these questions will be coming to the surface, demanding answers. But I am afraid I cannot say this evening whether it will be the Germans killing off the euro, or whether it will be the Greeks. The jury is still out on that. To return to my analogy of EMU being a mixture of William Shakespeare and Agatha Christie, we have seen only the first few acts of the drama. There is a long way left to run. When the curtain falls, we can be sure there will be bodies on the stage. But we do not yet know who they will be.