

## EMU prepares for years of hope and pain

10 points to watch on Europe's grand monetary experiment

Not so much the end-game, more the never-ending game

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The member countries of economic and monetary union (EMU) have elected for years of hope and pain rather than a 'big bang' solution that could have allowed Greece to leave the euro in the near future in a (relatively) orderly way.

Incontestably, Europe's grand monetary experiment is continuing. This is not so much the end-game, more the never-ending game. To help you prepare, here are 10 misleading statements that require further analysis about the further progress of EMU.

- 'Greece is a small country.' Of course, everyone knows, it's only 2.5% of total EMU GDP (and getting smaller all the time). Many, however, find it surprising that it's the eighth biggest economy in the 17-member monetary union, accounting for about two-thirds of the Belgian economy. Nine EMU members – Cyprus, Estonia, Finland, Ireland, Luxembourg, Malta, Portugal, Slovakia and Slovenia – have smaller economies. In a way, this explains why EMU leaders have not chosen a 'big bang'. Greece is 'too big to fail' (at least for the moment).
- 'Angela Merkel is campaigning for Nicolas Sarkozy in the French election campaign because she thinks this will help him win.' In fact, this is largely irrelevant. Merkel has never been too keen on Sarkozy or his style, but she figures that, whoever is in charge in Paris, and even if it's the Socialist François Hollande, France and Germany will come to some kind of an arrangement. The main reason why Merkel has decided to step openly into the fight for the Elysée Palace is because she wants the domestic German electorate to know that she cares about Europe. Stressing overriding continuity in Germany's pro-European policies wins votes at home and also puts the Opposition Social Democrats in the shade.
- 'If Sarkozy does win, France and Germany will at last be united in crisis-fighting efforts.' That can't be true, since Sarkozy (now closing Hollande's lead in the opinion polls) will call a referendum on Europe's fiscal pact if he gets home. For 60 years, France has rejected giving up sovereignty over budgetary matters to European institutions – above all, those following German-style precepts. If Sarkozy wins against the odds, he will be cock-a-hoop, flush with victory. He will be more rather than less likely to resist German-style demands on giving up budgetary freedom.
- 'Higher German inflation combined with internal devaluations in the periphery will help solve Europe's competitiveness problems.' That seems to be working in Ireland, where Patrick Honohan, the central bank governor, has taken a pay cut of 40% to symbolise the sacrifices his compatriots are making to adjust national competitiveness. However, nothing like this has been seen in the rest of the euro area. Despite unit labour costs slowly creeping up by comparison with other EMU members, Germany seems wholly unlikely to generate enough inflation any time soon to offset the competitiveness problems of the southern euro countries.
- 'The German Opposition German Social Democratic Party would bring in Eurobonds if it wins the German election in 2013.' Unlikely. Up to now, Angela Merkel can count herself lucky to receive the SPD's support on euro assistance. The SPD has been berating Merkel for doing 'too little, too late' and has suggested that mutualised Eurobonds, in which Germany pools its low borrowing costs with other EMU members, might be the answer. However, leading SPD politicians recently have been emphasising that such generosity would only come with 'conditions' which are likely to be sufficiently onerous to rule out the exercise unless it is limited solely to the Triple A Countries in EMU, which would defeat the object. The closer we get to the German elections, the less likely the SPD will be in favour of putting taxpayers' money at risk.
- 'A longer-term technocratic government in Athens could be the answer to the euro area's prayers.' Wolfgang Schäuble, the German finance minister, has suggested that Lucas Papademos, the Greek prime minister, might stay on in his job and carry on the good work, dispensing with democracy in the meantime. However, after the storm of indignation that greeted the remark, Schäuble knows it cannot possibly fly. Germany is the Continent's democratic standard-bearer. After the experiences of the last

century – especially in Greece during the Second World War – Germany cannot possibly call for democratic systems to be put into abeyance.

- 'The Greek bail-out deal and debt restructuring means the periphery has turned the corner.' Not so. In fact, domestic pressure is rising to turn up the heat on creditors to achieve softer terms than the austerity being heaped on Greece.
- 'Automatic central bank funding for EMU countries suffering capital outflows, provided through the ECB's Target-2 system, spelling potentially large losses for German taxpayers, makes Germany less likely to bow to Greek demands for more cash.' In fact, the opposite is true. The Target-2 balances – potential losses which have to be shared out by central banks throughout the Eurosystem - would trigger payments from taxpayers only if EMU fragments into constituent parts. So the pressure on Germany is to keep the balances growing, in order to avoid crystallisation of losses that would be hugely damaging not just to Berlin but also to central banks and governments in Paris and Rome.
- 'German exports to the peripheral countries of Europe are now set to resume as a potent factor shoring up the German economy.' In fact, the periphery is becoming increasingly irrelevant to Germany's exporting companies. In the first nine months of 2011, German exports to Greece were €3.9bn, to Ireland €3.2bn, to Portugal €5.4bn, to Spain €26.5bn. When you look at the fastest-growing buyers of German goods, the figures are much larger: to Poland over the same period €33.1bn, Russia €25.7bn, Turkey €15.4bn, China €47.8bn. Whatever happens to EMU, this trend will continue.
- 'Now they're getting the money, the Greeks will become quiescent.' Hardly likely. The view put in October 2011 by Jürgen Stark, the now-departed former ECB board member – 'The Greeks think that, whatever they do, they will get the money' – no longer holds. For one thing, they're not getting the money: it's going to pay back part of what creditors are owed. For another thing, the nations sending more funds to Athens have become a lot tougher, as indicated by the latest call by Hans-Peter Friedrich, the German interior minister, for Greece to leave the euro. A lot of conditions placed on Greece by EMU governments will probably be unfulfillable. Everyone is said to have won time, but in reality they are still playing for it. Many thrills and spills are still to come.