Not benign but malign neglect

Europeans know they are alone over the euro

by David Marsh in London

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Over the past eight years, whenever Europe got into monetary trouble, the continent could at least be sure that the administration of Barack Obama would show some interest – alloyed, admittedly, with growing frustration as his two terms in office unfolded. With Donald Trump, Europe will well and truly know where it is: on its own.

The next 12 months will see an uncomfortable combination for the 19 members of economic and monetary union. Elections and the rise of populist anti-European parties coincide with tension over German wishes to tighten European Central Bank policy and increased German risks through the Target-2 intra-ECB balances. This is all in addition to unresolved problems in EMU's perennial weak links, Italy and Greece.

Britain's European Union exit negotiations, and the possibility that the UK will continue to do better than expected economically, will provide fresh material for inflaming political discourse. In Berlin, there is plenty of foreboding about the strains likely to befall EMU this year.

In the past, the world found out about US presidents' scorn for European monetary shenanigans though oblique briefings or, in the case of Richard Nixon, the Watergate tapes. In June 1972, the recording registers him saying him 'I don't care – nothing we can do about it' on Britain's departure from the European currency 'snake', topped by the immortal epithet, 'I don't give a shit about the [Italian] lira.' Trump's intemperate unilateralism, spiced with misplaced grandeur, easily wounded pride and hyperactive communication, potentially represents a still more damaging mix. The dollar is set for fluctuations that, whatever else happens, will undermine the Europeans.

I do not agree with more optimistic German commentators that a continuously strong dollar will come to the rescue. This was the case with Ronald Reagan in the early 1980s, helping the European Monetary System, and with Bill Clinton in his second four-year term in the 1990s, aiding the birth of the euro. After 2003, following EMU's bumpy start, it was a weaker dollar that assisted the euro's revived fortunes.

The dollar has been strong for the past four years. I cannot see this continuing for too long. An unashamedly protectionist US president is promulgating a 'buy American' mantra. In his 20 January inauguration speech, Trump peddled a chilling slogan recalling 1930s-style trade autarky: 'Protection will lead to prosperity and strength.'

A stronger currency is out of kilter with this line. We can expect overt or direct calls for its weakening. Trump's approach on the greenback may be not 'benign' (as in the Reagan era) but 'malign neglect'.

Among the drawbacks of initial continued dollar appreciation are a fresh rise in Germany's current account surplus (9% of GDP) and intensified German worries about inflation as the economy accelerates. The former could lead to Trump lashing out at Germany and other Europeans as 'currency manipulators'. The latter will fuel German orthodox opinion railing against ECB quantitative easing.

Jens Weidmann, the Bundesbank president, maintains a low public profile on continued QE. This masks considerable anxiety about German criticism of the mounting risks on the Bundesbank's balance sheet as it acquires loss-making bonds at negative interest rates, yet is forced to pay progressively higher interest rates on its liabilities.

If the dollar falls in the short term – as happened under Reagan after 1983 – the outcome could be still more explosive. A weak euro, promoting higher inflation and exports, is the one state of affairs that could help the debt-encumbered southern Europeans regain a semblance of the economic ground lost since 2009.

A turnaround towards euro strength would please the Bundesbank but would exacerbate the north-south euro area divide. Especially if ECB QE continues, a stronger euro would almost certainly drive more euro area funds into 'safe haven' investments in northern Europe, offset by ballooning Bundesbank lending to peripheral countries via the ECB through the Target-2 balances. German assets under this scheme amounted to a record €754bn at end-December, up from the previous high of €751bn in August 2012.

The understanding in the 1990s was that any credits and debts built up within Target-2 would be settled within a very short time. Two decades later it has become a gigantic overdraft system under which Germany, through its central bank, extends unlimited interest-free credit without a repayment date and without economic conditions to the central banks of some of the world's most heavily indebted nations.

If Trump ever finds out about Target-2, we may expect some off the cuff US communications about how the Germans ever allowed themselves to get into this imbroglio from which there is no easy escape.

David Marsh is Managing Director of OMFIF.