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SPECIAL ISSUE: THE CRISIS OF THE EURO

Way out of the European impasse

Parallel currency solution could resolve problems

Michael Butler, former UK Permanent Representative, European Community

The way out of the impasse over Economic and Monetary Union (EMU) is to create a parallel currency system in Europe. Uncompetitive countries would retain the euro for appropriate transactions at home and abroad, but they would also recreate national currencies, which would take part in a managed float against the euro.

We would effectively have the best of both worlds. We would maintain the euro as an important factor of integration in Europe and the second world currency after the dollar. And we would allow the weaker countries of Europe to regain some measure of competitiveness by establishing units of account in the old national currencies, bank accounts denominated in national currency to be used for trading purposes.

A solution along these lines is needed because EMU is beset by numerous problems including excessive debts and budget deficits, lack of confidence in some countries' ability to avoid default, some weak banks, and the need for support packages which may be too onerous for the taxpayers of Germany and other creditor countries. At the root of the difficulties is the lack of competitiveness of southern and western peripheral economies. Over the first decade of the euro, Germany has virtuously succeeded in holding down its costs and improving its productivity, while other member countries have not followed such rigorous policies and have progressively faced losses of competitiveness by up to 20%.

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Issing warns on 'basic design flaw' over euro and says crisis is no surprise

Otmar Issing, former chief economist of the European Central Bank, is warning that European politicians are endangering the euro's survival. He says the euro crisis 'does not come as a surprise'. He terms as a 'basic design flaw' that member countries could not be relied upon to enact appropriate economic policies. 'The present seemingly unstoppable process towards further financial transfers will generate tensions… The longer this process is characterised by unsound conduct of individual member countries, the more these tensions will endanger the existence of EMU.' **FOR FULL ARTICLE BY OTMAR ISSING SEE P.8-13**

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The mechanism within EMU generating higher interest rate spreads for troubled countries such as Ireland and Greece has shown 'fundamental merit', according to Wolfgang Schäuble, the German finance minister.

Schäuble writes, 'As a result of investors' perceptions of the risks caused in Greece by excessively high public debt and in Ireland by negative developments in the banking sector, interest rates on these two countries' debt rose significantly. Neither country could cope with the increases in borrowing costs and ensuing loss of confidence without assistance from abroad, which was forthcoming as a result of European solidarity. This assistance was made conditional on the adoption of far-reaching economic restructuring… Because the existing mechanism … has basically worked well, there is no reason for replacing it with a Community-wide pooling of interest rate risk, as the proposal to create Eurobonds would entail.'

FOR FULL ARTICLE BY WOLFGANG SCHÄUBLE SEE P.3

Official Monetary and Financial Institutions Forum

One Lyric Square
London W6 0NB
United Kingdom
t: +44 (0)20 3008 8415
f: +44 (0)20 3008 8426

David Marsh
Co-chairman
david.marsh@omfif.org
+44 (0)20 3008 5207

Michael Lafferty
Co-chairman
michael.lafferty@omfif.org
+44 (0)20 3008 8415

Evelyn Hunter-Jordan
Managing Director
evelyn.hunter-jordan@omfif.org
+44 (0)20 3008 5283

Edward Longhurst-Pierce
Kevin Molloy
Freddie Leclercq
OMFIF Secretariat
edward.longhurst-pierce@omfif.org
kevin.molloy@omfif.org
freddie.leclercq@omfif.org
+44 (0)20 3008 5262

Neil Courtis
Development Director
neil.courtis@omfif.org
+44 (0)79 4747 5044

Malan Rietveld
Head of OMFIF Education
Chief Economist
malan.rietveld@omfif.org
+1 (0)416 818 4566

Sanjay Ujoodia
Chief Financial Officer
sanjay.ujoodia@omfif.org
+44 (0)20 3008 8421

Darrell Delamaide
Newswire Editor
darrell.delamaide@omfif.org
+1 (0)202 248 1561

Tom Brown
Production Editor
tom.brown@omfif.org
+44 (0)20 3008 5284

Company Number: 7032533

The heart of the matter

Euro crisis overshadows everything

David Marsh, Co-chairman

Michael Stürmer, one of the new 2011 recruits to the now 54-strong OMFIF Advisory Board, is one of Germany's best-known contemporary historians and political scientists. He terms the European sovereign debt crisis and the trials over economic and monetary union (EMU) a challenge to European integration similar to the upheavals caused by the Cold War and the fall of the Berlin Wall. This time, though, he wrote in an editorial in Die Welt newspaper on 7 January, the US will not be engaged to help the Europeans overcome their difficulties; Europe is on its own.

John Kornblum, a former US ambassador to Germany and another new member of the board (a complete list is on p.28) sees the turbulence in a similar historical light. Kornblum is well aware of the political and economic significance of the EMU project for trans-Atlantic ties. As a long-time State Department official, shortly before the introduction of the euro in 1999, Kornblum visited European capitals on a mission aimed at toning down the instinctively anti-euro feelings of the administration of President Bill Clinton and the then chairman of the Federal Reserve, Alan Greenspan.

Geopolitics explains only part of the reasoning why, in the first OMFIF Monthly Bulletin of 2011, we are unashamedly placing emphasis on the euro. The outcome of the long struggle over the stability of the European single currency is one of the biggest questions overshadowing international asset management. It plays a crucial role in the international performance of the dollar – which has been a lot stronger than it would have been if Europe had been in perfect working order – and thus in the relationship between the American and Asian currencies, led by the renminbi. European money has become a potent factor on the international bond markets, not only because of the dramatic widening of European spreads on government debt but also on account of the new European borrowings launched as part of the bail-outs sanctioned by European governments.

These articles provide a snapshot of the state of play. Otmar Issing, former chief economist of the European Central Bank, doubts whether Europe will profit from the crisis. Wolfgang Schäuble, the German finance minister, takes comfort from the effect of the rise in peripheral country yields in promoting more European discipline. Former French prime minister Laurent Fabius says Germany would face a 100% revaluation if the euro were to end. Long-time Dutch central banker André Szász reminds us that France and Germany have never agreed on what EMU is really trying to achieve. Euro solutions are put forward by veteran civil servants from two non-member countries, Sir Michael Butler from the UK and Erik Holm from Denmark.

Jonathan Fenby outlines China's stakes in the euro turbulence. Frank Scheidig, from one of OMFIF's major partners, Germany's DZ Bank, points out that the Germans have been economic beneficiaries of the European currency strains and tells us that the long-term goal of completing European integration has not been lost. Meghnad Desai underlines the differences between US and European policies but says that, ultimately, performance in Asia will provide the key. William Keegan asks what Denis Healey, the former UK chancellor of the exchequer who provided one of the main reasons why the UK did not enter the European Monetary System in 1978-79, would have made of it all. We will have a chance to find out when Queen Mary College and OMFIF stage a special evening for Healey on 25 January.

With best wishes for a Happy New Year.

David Marsh

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Mechanism basically working well

Interest rate spreads bring incentives and discipline

Wolfgang Schäuble, German Finance Minister

The euro crisis has exposed the interconnectedness of European economies and the financial markets in a manner previously thought impossible. The debt problems in Greece, which makes up a mere 2.4% of the euro area economy, unleashed practically overnight a crisis of confidence that threatened our common currency and thus the foundation of our economic success. This is why the international community had to come to Greece's assistance with additional credits and a protective shield for the euro as a whole.

For a lasting solution we require stronger compliance mechanisms to enforce the common framework for national fiscal and budgetary policies.

With the decisions of the European Council in October and December, we have now done more than simply accomplish short-term crisis management; we have laid the groundwork for lasting stabilisation well beyond 2011. However, we must keep some key principles in mind. Nobody wants a European super-state that would take over all the responsibilities of nation states. So a solution for Europe's debt problems has to involve a balance of national and European powers, under decisions made with due democratic process.

When European monetary union was founded, monetary policy was communitised by making it the responsibility of the European Central Bank. Financial, budgetary and economic policies remained in the hands of member states. To provide a framework for these policies, we created the Stability and Growth Pact which commits each member state to a financial and budget policy in line with its overall responsibility for the euro's stability.

In the spreads between the capital market interest rates for more and less stable euro members, we have in place a mechanism that uses higher interest rates to create incentives as well as discipline. This system has shown its fundamental merit during the last few months. As a result of investors' perceptions of the risks caused in Greece by excessively high public debt and in Ireland by negative developments in the banking sector, interest rates on these two countries' debt rose significantly. Neither country could cope with the increases in borrowing costs and ensuing loss of confidence without assistance from abroad, which was forthcoming as a result of European solidarity. This assistance was made conditional on the adoption of far-reaching economic restructuring measures by the governments of these two countries.

Because the existing mechanism linking incentives and discipline has basically worked well, there is no reason for replacing it with a Community-wide pooling of interest rate risk, as the proposal to create Eurobonds would entail. However, the existing mechanism does not provide protection against the risk of infection for other EMU members. For a lasting solution we require stronger compliance mechanisms to enforce the common framework for national fiscal and budgetary policies.

In the reinforced cooperation now proposed for EMU, we must still clarify the details of how to carry out decision-making in both an efficient and democratically legitimate fashion. The same applies to the question of whether and how other EU members not yet part of the euro may participate voluntarily in such cooperation. Permanent crisis management requires not only the solidarity of all euro members, but also, when debt restructuring is necessary, the participation of private sector creditors. Such a condition serves a dual purpose since it helps, too, to combat speculative excesses on the financial markets. This second objective also requires more stringent rules for financial market participants and products, as well as improved national and European financial market supervision.

The whole of Europe needs better coordination of national financial, budgetary, economic and social policies geared to stabilising the euro. The more such efforts succeed, the more the European Central Bank will be able to concentrate on its mandate of monetary stability as an independent central bank. I am confident that, by proceeding on this basis, EMU policy-makers can convince the international financial community that the euro will remain a long-term stable currency, to the benefit of the entire world economy.

A way out of the euro impasse *(continued from page 1 ...)*

In a single currency there is no way that this can be cured except by relatively high inflation in Germany and the other lower cost countries, or depression in the uncompetitive countries (broadly Portugal, Ireland, Italy, Greece and Spain). Neither outcome is desirable or likely to be generally acceptable. The third option – breaking up the euro – would be highly unpalatable from a political and economic point of view, as well as technically difficult to achieve.

My solution, although it would contain some technical difficulties, would resolve the key challenge of uncompetitive economies – in a way that would preserve the euro as an intact currency.

Crucially, this proposal would not involve the physical recreation of notes and coins, at least at the outset; the euro would continue to circulate as legal tender in all members of the euro area. At the same time, a managed depreciation of the national currencies of the uncompetitive states would be brought about, after fixing the initial parities against the euro by agreement between the European Central Bank and the authorities of the country concerned.

Readers with knowledge of the period leading up to the single currency may see the parallels between this proposed solution and the so-called 'Hard ECU' plan put forward by the British government in June 1990 during the run-up to the Maastricht treaty in December 1991. Under this plan, launched by John Major, then Chancellor of the Exchequer and later Prime Minister, European countries would have formed the 'Hard ECU' alongside national currencies as part of an evolutionary process towards EMU. The plan originated with the City European Committee, which I chaired. The proposal was worked out with the full participation of the Treasury and the Bank of England.

In the 1990s, we would have been creating a new common currency which would gradually have grown in importance versus the national currencies. Two decades later, the single euro currency exists and we would now be creating new national currencies which could float versus the euro in different degrees. The transition would be more difficult than the one postulated in 1990. But the costs of the parallel currency system might be smaller than the costs of proceeding with the present set-up. A series of ad hoc solutions put together by politicians in 2010 did not succeed in damping the fundamental tensions at the centre of the system – and these seem likely, if anything, to get still worse in 2011.

The new system would be devised in a way likely to minimise shocks. The ECB, in consultation with euro area central banks, would manage the euro in such a way that none of the new national currencies would be allowed to appreciate against it. If and when a country with its own currency reached a sufficient degree of convergence with those that remained full members of the single currency, it could apply to return to full membership and the ECB would recommend either acceptance or a further period with a parallel national currency. Companies from weaker economies would be free to price exports and internal sales in euros or in national currencies, which would allow de facto exchange rates to adjust to the competitive pressures impinging on foreign trade.

At least for an initial period of one year, the euro would remain the budgetary currency in which all governments would be obliged to tax and spend. Existing euro debts to foreign creditors would have to be honoured in euros and this would provide a strong disincentive against loose economic policies. The expectation would be that, with trade able to be factored in the newly created national currencies, exports and economic activity would pick up faster than otherwise would be the case, stimulating the incomes needed for debt repayment by both private and public sector borrowers. New foreign debts could be contracted in either euros or in national currencies.

This outline of a plan would be elaborated in discussion among governments and central banks. The detailed work and papers completed in 1990 by the British Treasury and the Bank of England could be helpful. The plan would not be pain-free and some of the countries issuing national currencies could still have to restructure some of their debt. However, the plan would reduce the bail-out amounts required from taxpayers in the stronger European economies for the weaker countries; both creditors and debtors would thus have a strong incentive to make it work. The plan would preserve the euro, correct current extreme market dislocations, and create a re-adjustment process for the re-integration of weaker economies: all essential ingredients for restoring trust and confidence in Europe.

The man behind Britain's EMS compromise and 1990 proposal on the 'Hard ECU'

Sir Michael Butler was Deputy Under Secretary in the Foreign Office from 1974-76, Under Secretary 1976-79 and Permanent Representative to the European Community in Brussels 1979-85. He was responsible for the Economic Community in the Foreign Office when the EMS was under discussion and was the architect of the idea that Britain should be part of the EMS but not of the Exchange Rate Mechanism. From 1988-1993 at the request of the Governor of the Bank of England, he was Chairman of the City of London European Committee which met in the Bank of England with representation from the Bank and HM Treasury. During this period, in 1990, he was responsible for the 'Hard ECU' proposal put forward by John Major, then Chancellor of the Exchequer, as a parallel currency alternative to the single currency plan. He is currently Chairman of the Senior European Experts Group consisting of former high-ranking British diplomats and civil servants. See www.euromove.org.uk

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The euro's best friend

Escape route from dollar trap explains China policy

Jonathan Fenby, Advisory Board

China has emerged as the euro area's best friend. The relationship is no longer simply one of exports and imports. It is taking on a strategic dimension. Beijing wants to do what it can to head off any threat of a collapse of the single currency and the implosion of weaker members.

On visits to Portugal and Greece, President Hu Jintao and Premier Wen Jiabao offered these countries support in their economic travails. China is in the market for euro area bonds and is likely to ramp up investments in economies where asset prices are low. It is already a big investor in Greek port facilities which it sees as an important hub for its shipping to and from Europe.

In early January, Vice Premier Li Keqiang, who is expected to succeed Wen in 2013, assured European financial markets of China's confidence in Spain ahead of a visit there. (He was also due to travel to Germany and the UK). This support, he added in a newspaper article, had 'meant the purchase of its public debt, something which we will continue to do in the future'.

There is clear Chinese self-interest behind all this. The EU is now China's biggest trading partner. Beijing wants to help underpin European economic reform programmes that will provide demand for its exports. Exchange rates are another factor. As I have repeatedly pointed out, China is unlikely to acquiesce in a rapid and significant appreciation of the renminbi, despite American pressure. Slower expansion of manufacturing on the mainland bolsters the case for slow, incremental appreciation. The watchword is given by Governor Zhou Xiaochuan of the People's Bank, comparing currency policy with the gradual healing effects of Chinese medicine.

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In that context, it is only logical for China to do what it can to prevent any slump in the euro. When he visits Washington this month, Hu Jintao will no doubt be urged once again to allow currency appreciation. But the official language in Beijing remains firmly in favour of prioritising domestic growth and blaming the US for global problems which China sees as being exacerbated by fresh quantative easing.

Europe's monetary health is of concern to China in the wider context of the triangular relationship between the euro, the dollar and the renminbi. Chinese policy-makers almost certainly never planned to build $2.5tn in foreign exchange reserves. But the reserve mountain has been the inevitable result of Beijing's combined trade and monetary policies. It will not disappear for a long time. So China finds itself caught in a dollar trap. Its efforts at diversification, while quite clear, are still only chipping away at the ever-increasing mountain of greenback holdings over whose value it has little if any influence.

China has every interest in a euro which can play its full role as an alternative reserve currency, given that the prospect of the renminbi assuming such a role looks quite distant. The more it invests in euros, the greater Beijing's interest in the strength of the single currency.

China's experience with the dollar is not exactly conducive to increasing exposure in another major currency that is subject to pressures about which Beijing can do nothing. The PBoC is unlikely to want to take on an implicit role as the lender of last resort to the euro area even if that was acceptable to Germany and other stronger member states. How to dispose of those $2.5tn of reserves remains a core problem for China that may have no solution. The Five Year Plan that goes into operation this year aims at rebalancing the economy. Rebalancing the reserves is an equally tricky issue.

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Profiting from monetary uncertainty

Integrated Europe remains final destination

Frank Scheidig, Deputy Chairman, Advisory Board

There is no question about it. Germany is one of the biggest winners of the sovereign debt crisis. There is a high correlation between the euro/dollar exchange rate and German exports. If the euro rises by 10 cents against the dollar, German exports fall by more than 1%. Starting from a level of $1.35, a 10% rise in the exchange rate would point to a roughly 2% fall in German exports with a corresponding impact on German growth.

As a rule of thumb, a permanent appreciation of the euro to $1.50 would result in a German growth decline of roughly 0.5%. Every time the market's attention focuses on European problems, the euro exchange rate shifts in favour of German exports. As worries about European debt have grown, the euro has fallen by roughly 10% compared with last year's highs, having earlier suffered a fall as much as 20%.

Germany (along with other major European countries) reaps another clear advantage in terms of lower yields and better borrowing conditions. Over the last two years the German debt agency (Finanzagentur) in charge of the official borrowing programme has been able to promote a significant shift from short-dated debt to longer maturities. Without the government debt crisis, Germany would probably have faced an interest rate environment comparable to 2008. This indicates that the current interest rate advantage is over 300 basis points (at the short end) and 100 bp (at the long end). Alone for 2010, this development can be estimated to have saved the government €7.5bn in interest payments. Over the life of all bonds issued in 2010, lower interest payments amount to about €25bn.

Although the crisis has some positive aspects for Germany, the overall priority for the Berlin government is, of course, to seek a resolution.

In the end Germany (alongside France, the UK and other big countries) has no option but to support euro members in trouble, since they are often the biggest creditors. Chancellor Angela Merkel is gearing her overall strategy towards tough terms for borrowing from the European Financial Stability Facility (EFSF). Facing a number of sensitive regional German elections in 2011, the Chancellor wants to avoid the impression that Germany is footing the bill for the rest of Europe.

Being regarded as over-generous towards Greece, Ireland or Portugal would not play well with voters. With regard to the question of issuance of a common euro area bond, from Germany's point of view, this could only be a last resort. It would definitely boost refinancing costs for Germany and it would mark a very important step towards a debt union. This would bring political pressures not only within the countries in financial trouble but especially in the 'richer' countries. The long term implications of such a move might be the beginning of the end of the euro and even for the European Union.

A more palatable way out is for the countries in trouble to accept the difficulty of their present position and tighten belts so that current rescue plans can be successful – a conclusion that Ireland has now accepted. Austerity measures are in order for nearly all euro countries. As long as Europe does not have a single budget with one government and fully integrated finance, I believe a common euro bond would be a risky move.

However, Europe as a whole is heading down an ever more integrated route in politics, finance and industry. The euro is only one step towards this admittedly somewhat distant goal. In the shorter term it will be necessary to increase the €750bn EFSF. My view is that an amount well above €1tn might be required. This does not imply that Spain will need support; crucially, policy-makers need an increase to convince markets that there is enough fire power. Other recent announcements, such as Chinese indications on purchases of Portuguese and Spanish debt in 2011, may help too.

Rather than the issue of Eurobonds, a more palatable way out is for the countries in trouble to accept the difficulty of their present position and tighten belts so that current rescue plans can be successful – a conclusion that Ireland has now accepted.

Moment of truth postponed

Survival of euro is at stake

Otmar Issing, former Chief Economist, European Central Bank

The news from Athens came as a shock to the political and financial market community. When the new Greek government announced in autumn 2009 that the public sector budget deficit had risen to 13% of GDP (a figure subsequently revised to 15%), compared with the previously estimated 3%, the correction did much more than simply amplify scepticism about Greek statistics. The scale of the fiscal disaster sparked concerns about whether the country could remain a permanent member of economic and monetary union (EMU).

These worries spread, too, to other EMU members. A highly inappropriate terminology came into play, speaking of 'contagion', as if the other 'patients' had not long ago displayed similar, though weaker, symptoms of the same disease. Greece has certainly been an exceptional case. But it also demonstrated – as if we needed fresh evidence – some of the general shortcomings that have grown up since EMU started, which have contributed in large measure to the threatening circumstances we have now at the beginning of the 13th year of the single currency. Sadly, I cannot say that the scenario we face now has come in any way as a surprise. Among the past setbacks, we have to list violations of the Stability and Growth Pact as well as persistent differences in member countries' unit labour costs, resulting in serious loss of competitiveness in different member states. This was a crisis that in many ways had been pre-announced; the seeds were sown some time ago.

The present scenario does not come as a surprise. … At the outset, and also after the start, politics failed to create the right conditions for EMU to work optimally.

EMU started out as an exceptional construct. In contrast with what we might term a 'normal' historical development, in EMU the borders of money and states did not coincide. The 11 founder members, now 17 with the entry of Estonia on 1 January, in no way represent a politically unified entirety. But they form a single currency, the euro, run by one central bank, the European Central Bank (ECB), entrusted with ensuring price stability in the euro area, with a one-size-fits-all monetary policy. At the outset, and also after the start, politics failed to create the right conditions for it to work optimally.

With entry into monetary union, conditions for individual countries changed significantly. Countries that had registered higher inflation in the past were suddenly able, under the umbrella of a common stable currency, to enjoy lower interest rates – a luxury they could previously experience only through hearsay. Among other things, this created a construction boom in some countries. This development, though initially desirable in some cases, soon gave way to unsustainable overheating.

Monetary policy could not compensate for failings in individual countries, since policy had to be set for the euro area as a whole. To correct inappropriate developments in individual countries, economic policies should have been adjusted at a national level, for example though fiscal policies, which after all were still a national responsibility. Such measures could have been activated at an earlier stage to mitigate the boom.

Competitive positions: relative unit labour costs

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
France	100.0	95.2	94.0	95.9	98.7	101.4	100.2	101.4	103.6	104.3	106.9	101.6
Germany	100.0	93.4	92.1	94.4	98.8	98.9	94.1	90.1	89.3	91.4	94.4	91.1
Italy	100.0	95.8	97.3	101.3	110.8	115.3	116.7	117.7	120.6	124.5	126.6	122.8
Spain	100.0	90.0	91.0	93.5	99.2	103.0	105.3	107.9	111.8	114.0	113.0	111.1
UK	100.0	102.3	99.6	103.3	100.2	104.9	103.7	106.1	109.4	95.3	91.1	96.7

Note: Competitiveness-weighted relative unit labour costs in the manufactoring sector in dollar terms. Competitiveness weights take into account the structure of competition in both export and import markets of the manufacturing sector of 42 countries. An increase in the index indicates a real effective appreciation and a corresponding deterioration of the competitive position.

Source: OECD Economic Outlook 88 database.

However, despite multiple repeated warnings, not least from the ECB, national governments failed to take such steps. The reasons for this are evident, but they are in no way excusable. The same goes for the divergence in unit labour costs.

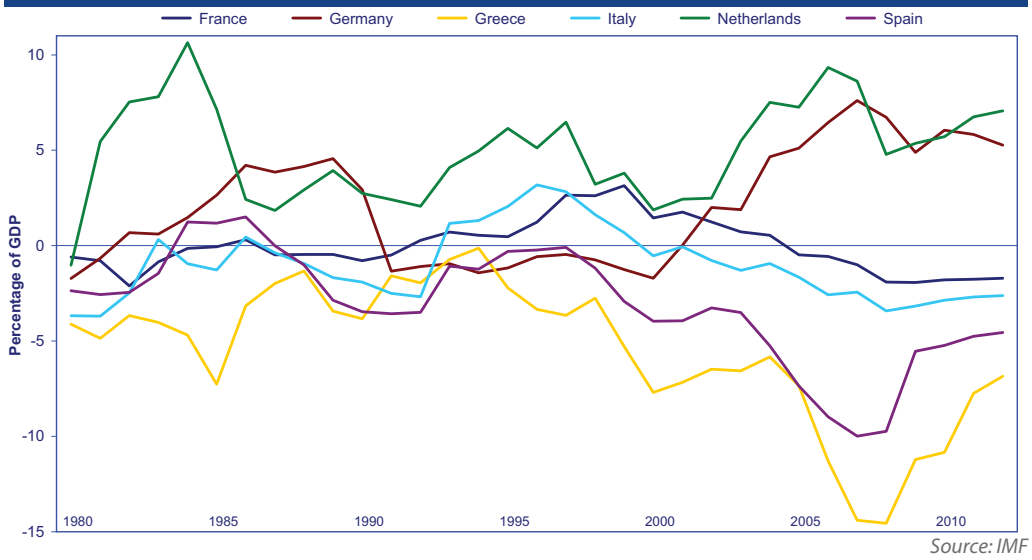
The crisis demonstrated a basic design flaw of monetary union, namely that we could not rely for its sound working on member countries to carry out appropriate economic policies.

The crisis brought further evidence of a basic design flaw of monetary union, namely that we could not rely for its sound working on member countries to carry out appropriate economic policies. Persistent errors in national policies not only damaged a country's own economy and people; they also caused serious problems for the community as a whole. The Stability and Growth was established to satisfy the overall requirements of monetary union in an important field, namely fiscal policy. The principle was not to interfere with national sovereignty on tax policy, but to define limits for fiscal deficits and public borrowing that would produce fiscal policies compatible with the goal of stable money. At the heart of the pact was an attempt to reconcile national sovereignty with European oversight. However, the failure of the pact's ambitions became evident at the latest by 2003, when the two largest countries, Germany and France, organised a political majority in the council of finance ministers to prevent sanctions against them for breaching the deficit limits. Could we, in truth, really have expected anything else from a jury in which potential and actual sinners are called upon to pass judgment on each other? It must be stressed, however, that the Stability Pact is not a mere declaration of goodwill; it is an internationally binding governmental agreement. If we can put so little faith in accords that have been ratified by parliaments, what hope for there for future improvement?

Governments have agreed that the European Financial Stabilisation facility set up last summer with a three-year life will be turned into a permanent relief fund as an apparently indispensable element for stabilising monetary union and expressing European solidarity. At stake is not simply a great deal of money from taxpayers in the more solid countries; the issue goes to the heart of the entire constitution of EMU. The no-bail-out principle in the Maastricht treaty, ruling out any liability by member states for other countries' debts, is far more than a clause governing the use of financial resources. It reflects the fact that EMU is not a state in itself, but is a composite or collective association of sovereign states that have agreed initially to assign 'merely' their monetary sovereignty to a European institution.

The treaty allows for community assistance to other members in cases of exceptional exogenous shocks such as natural disasters. For all 'home-made' mistakes, however, each country is liable. All theoretical considerations and practical experience tell us that undermining the no-bail-out principle in any way, let alone setting it aside completely, will, as part of normal 'moral hazard', provide governments and financial markets with an incentive to do the wrong things.

Current account balances of EMU members



Source: IMF

Wide-ranging divergance of current account positions in later 2000s as higher-inflation countries live beyond their means. Divergence has reduced since 2009.

Individual states would then have a clear interest in following inappropriate fiscal and economic policies, relying on outside financial support to help them withstand the inevitable consequences. Restricting or ending the no-bail-out principle thus adds up to an open invitation to states to live beyond their means at the expense of others.

Proposals that we should expand monetary union in the direction of a transfer union amount to the same thing. This would wholly change EMU's character. Suggestions that there have always been elements of a transfer union in EMU miss the point, for current transfers between member states for agricultural payments or other such matters are limited and linked to specific purposes. By contrast, transfers caused by fiscal shortfalls or other macroeconomic divergences are subject to an uncontrollable momentum and would reach dimensions that could seriously affect public finances and living standards in the contributing countries. It is, admittedly, true that assistance under the EFSF or a future permanent bail-out fund would take the form of loans, not transfers. But this would inevitably end up as transfers if the loans did not carry an appropriate rate of interest or if they were not fully repaid. There is little to suggest that this is unlikely to happen.

Expanding monetary union towards a transfer union would wholly change EMU's character. Transfers caused by fiscal shortfalls or other macroeconomic divergences are subject to an uncontrollable momentum that could seriously affect public finances and living standards in contributing countries.

Some supporters argue that a relief fund is needed to protect member states from 'unreasonable attacks' from the financial markets, with 'speculators' normally seen as the guilty party. If we take such arguments literally, we should agree that states should do everything to prevent 'reasonable' attacks against them – but no such measures are of course being discussed. The requirement that payouts from such funds should be forthcoming only if strict conditions are met by the recipients is also not entirely credible. After all, such a need would arise only after individual states had already violated 'strict' provisions of the Stability and Growth Pact or failed to heed other similar warnings. If such strict conditionality had not worked in the past, why should we believe that it would do so in future?

Analysis of the causes of the current crisis leads us to two fundamental questions. First, what conditions must member states fulfil to make a monetary union a lasting success? Second, can monetary union survive without political union? Regarding the second question, Chancellor Helmut Kohl met unanimous acclaim when he told the Bundestag on 6 November 1991: 'It cannot be said often enough. Political Union is the essential counterpart to economic and monetary union. Recent history, not only in Germany, teaches us that it is absurd to expect in the long run that you can maintain economic and monetary union without political union.' We can argue about the definition of 'political union', but it is clear that the condition set down by Mr Kohl was not anywhere near fulfilled when EMU was launched on 1 January 1999.

On that date, we embarked on a real test of whether the Chancellor's judgment was inconclusive or whether monetary union would indeed usher in a process towards political union. The current debates at all levels – from politics through to the economic community – reflect different responses to this question. As an association of states subject to international agreements and a system of rules, EMU members bear some resemblance to a club, which carries out its statutory purpose of forming 'an area of stability' on two separate levels.

On one level, the stability of the euro is guaranteed by an independent central bank, the ECB, free from any influence by politicians from member states. The euro was constructed as 'non-political money.' Moreover, in its Maastricht verdict, the Federal Constitutional Court in Germany laid down that joining a currency union can be deemed constitutional only if it follows the priority of price stability. At the second level, that of public finances, we have to accept that there is no body with state-like competence in this domain in Europe.

This makes necessary a Europe-wide system of oversight – a depoliticised process of control over public finance and budgets. In theory, one could think of an automatic mechanism, triggered when states exceed certain macro-economic limits (for example, a 3% deficit). This would probably place too much weight on the political power and perceived objectivity of sheer statistics. At the least one could construct an independent statistical agency with a clear hierarchical priority over national offices, which would produce fully objective and depoliticised data. An important contribution could come from a panel of independent experts delivering a public opinion on whether rules had been fulfilled or violated.

If we look at the need for reforming the Stability and Growth Pact, present discussions and policy statements do not bode well. Germany is the country that earlier insisted on an effective pact as a condition for entering EMU. So it is highly significant and somewhat disconcerting that Germany itself now supports continuation of a system for policing the pact through political decision-making based on majority voting. There is little hope that the community will show that it has really learned from the crisis. In the past, there was no consensus on the importance of and the need to comply with the pact's provisions. Now, we see something that is maybe still worse: progressive resignation, perhaps already a consensus, on the issue of whether such rules are enforceable or even necessary.

However, unless we set up a Europe-wide system for monitoring and control of fiscal policy, how can we possibly make access to financial assistance from any kind of crisis relief fund subject to strict economic conditions? There is an evident contradiction between lax, politically-influenced application of the pact's provisions in normal times, and implementation of tough conditions on assistance in the event of crisis.

With the failure to make sovereign states' fiscal policies consistent with the conditions for the single currency area, policy-makers not only have weakened the functioning of monetary union, but have also called into question its very survival. Whatever happens, it is incontestable that, over the longer term, sound public finances go hand in hand with stable money. If this is true for a nation state, then it applies all the more for an association of sovereign states as in EMU. Serious differences in macroeconomic policy, especially relating to public debt, create stresses in the system and increase pressure for financial transfers to prevent its disintegration. This in turn gives countries with high debt the potential to blackmail more solid member states – posing an even greater threat than the false incentive system of moral hazard described earlier.

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The demand that the stronger countries should, in pursuit of the common interest, support the weaker ones is a perversion of the oft-quoted notion of 'financial solidarity.' In fact, this is the opposite of solidarity. It would establish a revenue-sharing system under which imbalances generated by macroeconomic divergence would be financed by forced transfers from less well-off countries that play by the rules to countries with higher living standards following unsound fiscal policies. Transfer payments that are neither economically nor socially justified almost inevitably become necessary in a misaligned monetary union with an inadequate framework of rules that tends to reward rather than punish violators.

It is hardly likely that such a process can give rise to viable political structures in the direction of a fully-fledged state. Even before EMU started, we could see this idea was really nothing but a mirage. Now, however, this objective has become a much-talked about project, as if to confirm the oft-postulated role of the single currency as pacemaker towards political union. Jacques Rueff's celebrated saying in 1950, 'L'Europe se fera par la monnaie ou ne se fera pas' – ' Europe shall be made by the currency, or it shall not be made' – has always had many adherents, but – as someone who supported monetary stability – Rueff is unlikely to have thought up this particular interpretation. I can only warn against the objective of trying to create political union through the back door of the common currency. We would be setting up a system under which bad policies would be subsidised on a quasi-automatic basis. This would send member states' democratic processes in the wrong direction of unsound policies, a significant distortion if not a corruption of the political process – a thoroughly bad platform for the objective that we all share of a Europe founded on stability and proximity to citizens.

So how should a stable political union actually be accomplished? And above all: how can we give this process democratic legitimacy?

Western democracy has its origins and its roots in control of public finances through parliaments. When the Bundestag and Bundesrat, the lower and upper houses of parliament in Germany, agreed the euro rescue package last year, this was done under high pressure of events; the consequences of a No would have been incalculable. The deputies were however aware that the decision was very unpopular with the electorate – to put it very mildly. This process cannot be repeated.

Furthermore, if a creeping expansion of intra-community transfers were to be set in motion, resistance inside and outside parliament would soon become manifest. Appeals for further 'financial solidarity' of any kind, and certainly in the perverted form of which we have already seen evidence, are a long way from being supported by public opinion – at least in the countries eligible to become contributors, which sometimes have lower living standards than potential beneficiaries. The refusal to tighten substantially the rules for compliance on sound financial policy increases the likelihood of transfers. But at the same time this also makes potential contributor countries significantly less likely to accept liability for others' misconduct.

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For all these reasons, supporters of political union – and I do not deny there are good reasons for it – should take care to put the project and all its consequences fully and openly on the table. A European government, under the control of a democratically elected European Parliament, would be the clearest manifestation of such a goal. But all kinds of mixed or transitional forms of government would also need democratic legitimacy. A political union worthy of the name cannot be set up by stealth under the guise of fiscal transfers in the cause of common money.

Those who still wish to go down this route face the highest possible risk in the European community of today – rejection by the citizens. If this occurs on a broad front, it will not be long before opposition to monetary union, and possibly other policies as well, appears on the agenda not just of extremist groupings but also of established political parties, in Germany and elsewhere. The failed referenda of the past in countries as diverse as France, the Netherlands, Ireland and Denmark should suffice as a warning.

There are, of course, some positive aspects to the present state of affairs. Every crisis creates opportunities. Greece's realisation that it was staring into the abyss has opened the way to reforms of a kind earlier thought unimaginable. The EMU crisis, although anything but unexpected, revealed the weaknesses of the existing arrangements and therefore offered the opportunity decisively to improve the underlying rules. Yet based on the current position, I fear this opportunity may at best be used only marginally, and essentially will be wasted.

Living standards of EMU members measured by GDP per capita ($)

Country	1989	1999	2009	2010
Luxembourg	29,245 (1)	50,589 (1)	78,409 (1)	80,304 (1)
Netherlands	17,776 (2)	28,293 (2)	39,877 (2)	40,777 (2)
Austria	17,704 (3)	27,168 (3)	38,567 (4)	39,454 (3)
Ireland	11,650 (12)	26,193 (4)	38,685 (3)	38,816 (4)
Belgium	16,726 (6)	25,576 (5)	35,534 (5)	36,275 (5)
Germany	16,863 (5)	25,030 (6)	34,388 (6)	35,930 (6)
Finland	16,202 (7)	22,754 (9)	33,445 (7)	34,402 (7)
France	17,091 (4)	24,607 (7)	33,434 (8)	34,092 (8)
Spain	13,183 (9)	20,999 (10)	29,625 (10)	29,652 (9)
Italy	16,191 (8)	23,172 (8)	29,068 (11)	29,418 (10)
Greece	12,673 (10)	17,664 (13)	29,839 (9)	28,834 (11)
Cyprus	11,651 (11)	19,221 (11)	28,504 (12)	28,045 (12)
Slovenia	N/A	16,400 (15)	27,470 (13)	27,900 (13)
Malta	9,755 (14)	18,332 (12)	23,667 (14)	24,081 (14)
Portugal	10,043 (13)	17,342 (14)	22,671 (15)	23,114 (15)
Slovak Republic	N/A	10,844 (16)	21,245 (16)	22,267 (16)

Source: IMF

Statistical base: purchasing power parity. Figures in brackets refer to ranking in monetary union. 2010 figures are estimates

From 1989 to 2010, Ireland has advanced from 8th to 4th position in GDP per capita. Germany, France and Italy, the three largest members of EMU, have all fallen back.

A look back at history suggests that we should keep a calm head. As we all know, Europe has faced repeated crises in the past and each time has emerged on the whole in stronger shape. There is certainly no guarantee for the successful continuation of this syndrome – but at the same time there is no reason to insist that doomsday is inevitably approaching.

However, I must point out that the nature of Europe's crises has changed with each subsequent institutional development of the community. EMU members may indeed this time back away from substantially reinforcing the rules. In this case, the experience of the first 12 years of EMU teaches us that a new crisis will break out in the not too distant future. Will the community then be under even greater pressure to decide fundamental reform? The present seemingly unstoppable process towards further financial transfers will generate tensions of an economic and especially political kind. The longer this process is characterised by unsound conduct of individual member countries, the more these tensions will endanger the existence of EMU. My conclusion at the start of 2011 is a sombre one. We have not yet reached the moment of truth for EMU. It has merely been postponed.

The present seemingly unstoppable process towards further financial transfers will generate tensions of an economic and especially political kind. The longer this process is characterised by unsound conduct of individual member countries, the more these tensions will endanger the existence of EMU.

This essay is an updated version of an article that first appeared in the Frankfurter Allgemeine Zeitung on 11 November 2010.

Genial economist is a bellwether for German views on EMU

OMFIF commentary

Otmar Issing, the former chief economist of the European Central Bank and the German Bundesbank, is a genial number-cruncher who believes in the overall benefits of European integration but is genuinely is open to others' views. He is a key bellwether for Germany's stance on the euro.

In his 75th year, nearly five years after he retired from the ECB, he is still someone to watch, particularly now he has turned virulently pessimistic over the European single currency. In the period before he was appointed in spring 1998 to become the ECB's first board member in charge of economics, Issing won his spurs as a steadfast sceptic on European monetary integration. Chancellor Helmut Kohl grumbled about his finance minister's recommendation to appoint Issing to the ECB board, pointing out: 'He has never said a good word about the euro.' Theo Waigel, Kohl's wily finance minister, convinced the chancellor that Issing's well-known euro doubts would help convince ordinary Germans that the future of the single currency lay in safe hands.

During his eight years at the ECB before he retired in summer 2006, Issing never went over to the side of die-hard pro-euro enthusiasts, insisting that the single currency remained an 'experiment'. And he pointed out the dangers that imbalances could lead to a constant flow of funds from better- to worse-off EMU states that could disastrously undermine political and economic confidence. But he suspended his previous disbelief. In a speech in March 2006, shortly before he retired (and took a part time job with Goldman Sachs), Issing said monetary union could succeed without political union, stressing that 'Euro area countries already share important elements of state formation which are also key to the functioning of monetary union.' He was confident that the euro's rules-based system would produce stability. 'Member States will keep deficits low enough to ensure government solvency while providing governments with the necessary room to smoothen economic fluctuations through the operation of automatic fiscal stabilisers. This will also generate an appropriate fiscal environment for monetary policy-making at the euro area level.'

Even after leaving office, when he wrote a book on EMU (published in English in 2008), Issing's scenarios remained largely benign. Although he warned of the danger of a 'transfer union', he regarded the build-up of current account imbalances among euro members as a relative source of strength, on the grounds that financial integration among disparate member states allowed worse-off countries to put aside previous constraints on growth. 'The irreversible fixing of parities eliminates the exchange rate risk and hence removes major uncertainty in cross-border investments.'

Germany faces Doppelmark danger

Greece, Ireland 'in impossible position' from high rates

Laurent Fabius, former French Prime Minister

Laurent Fabius, the foremost French Socialist politician who has served as prime minister and finance minister, says high interest rates for peripheral euro members fundamentally disturbs the equilibrium of monetary union. In an interview with David Marsh, he sounds a sobering warning: if the euro came to an end, Germany would suffer massive revaluation pressure with a new D-Mark double its present level

Marsh: Has the unrest in economic and monetary union come as a surprise?

Fabius: Unfortunately not. These are all issues which I and others discussed several years ago. I was one of those who expressed my point of view at the time of the debate on the [European] constitution [in 2005]. I said then that Europe was at a crossroads, that the single currency was a very good thing, but that would not be easily sustainable unless there was an advance on the budgetary, economic and fiscal fronts, something that the treaty texts that were being proposed did not permit. So latest events, although disagreeable, have not been a surprise. What is the problem? We have introduced the euro for both economic and political reasons; the countries that are part of it have made a sacrifice in that they can no longer devalue if they have a problem of competitiveness. That is the limitation that we have all accepted, in exchange for the monetary and financial stability given by a larger monetary area. So, apart from the political design, there is one disadvantage and one advantage, but all this presupposes that different countries within the euro could finance their debt at moderate rates of interest on the bond markets. Now, as a result of what happened with Greece, we have experienced for the first time a very important divergence of interest rates, for the creditors have seen that buying Greek and German debt is not the same thing.

Marsh: And the Germans have profited from this, because their own rates of interest have fallen...

Fabius: Countries like Greece and Ireland are in an impossible position if the interest rate remains high. That obliges them to bring in adjustment programmes that kill their growth and with the rate of interest very high, they cannot repay their debt. The advantage given by the euro disappears if you do not have stability of interest rates. That's the root of the problem.

What we have to construct now is a situation where countries in difficulty have to make efforts but can borrow on the financial markets at reasonable rates of interest. Monetary union now faces considerable risks. If a country is under intense pressure, and is close to being throttled, people can have the best of resolutions, but they will get to a point where they will say: 'I can no longer go on.' This would be detrimental to Europe and to all European countries.

Marsh: Do you favour the issue of so-called euro bonds, under which the entire EMU membership guarantees the debt – similar to the idea that has been put forward by [Italian finance minister] Guilio Tremonti and [Luxembourg prime minister] Jean-Claude Juncker?

If a country is under intense pressure, and is close to being throttled, people can have the best of resolutions, but they will get to a point where they will say: 'I can no longer go on.'

Laurent Fabius, a member of the French National Assembly, served as Prime Minister in 1984-86, taking office at the age of 37, making him the youngest person to hold this office in the Fifth Republic. He led the rebel faction of the Socialist party advocating a No vote in the 2005 referendum on the European Constitution – a move that probably tilted the balance towards French voters' rejection of the planned treaty. He has been Budget Minister (1981-83), Research and Industry Minister (1983-84), and Economics, Finance and Industry Minister (2000-02).

Fabius: It's slightly more complicated than that. I would set a fluctuation band of 1 to 1.5 percentage points for the interest rate on a large part of the bonds issued by countries within EMU, by comparison with the best available interest rate, which would presumably be on the German bonds.

This is where there is a link with the proposition of Tremonti and Juncker. For an amount of up to 40% or 50% of their GDP, countries that have signed some sort of a political accord with the [European] Commission on the running of their economies should be able to issue these bonds at a moderate interest rate, within the defined bands. The bonds would be guaranteed by all member countries and the European Central Bank would stand ready to purchase them if necessary.

That would not cover all of these countries' debt, but a certain amount – and such a mechanism would give the countries in question the feeling that they can escape from the position they are in. If this is not the case, then the system will be in danger.

Marsh: What are the precedents for this?

Fabius: Take Japan, it has a public debt of 200% of GDP. If Japan was in the euro area, it would be in default! Why does this not happen? Because the Japanese have interest rates around zero. And 200 times zero is zero! In the euro area, by contrast, after the Greek case, interest rates have risen to levels that are too high. They must and can be lowered.

Marsh: Do you think the Germans want to have it both ways? They are profiting from their own low interest rates – and, in respect of the other countries that have to pay much more, they say: 'It's your fault, it not our responsibility.'

Fabius: I understand the German approach. But let us assume just for a moment that the euro would explode, and we would go back to the D-Mark. I'm not accepting, of course, that this would happen – it would be disastrous. But if such an occurrence did take place, then the new German currency – the Euro-Mark, if you will – would multiply in value by two compared with the present level. What would happen to German exports in such an eventuality? And how could Germany prosper if the rest of Europe was in fundamental economic difficulty?

It is largely the European market that assures the Germans their prosperity. Germany's interest – and here I appreciate the [OMFIF] interview with Helmut Schmidt [OMFIF Bulletin, December 2010, p. 8-12] – is to see Europe prosper. That is what solidarity is about. Germany should not be playing against the others; it should be with the rest of Europe. Of course the Germans are right to say that they don't want to be the sole ones to pay for others. It is right that everyone has to make an effort. But it should not be that this effort becomes impossible.

Of course the Germans are right to say that they don't want to be the sole ones to pay for others. It is right that everyone has to make an effort. But it should not be that this effort becomes impossible.

Marsh: Yes, it's difficult to see light at the end of the tunnel. And if you look at the forecasts from the OECD, there is not enough adjustment going on in Europe – by 2012, the German current account surplus will be up to 7% of GDP.

Fabius: Indeed, that is unfortunately the case. One of the areas where I would criticise both French and German authorities is that the Franco-German 'couple' – and I know that telling you this is hardly a scoop – is not working. Or, at least, not well enough. And sometimes when it does indeed function, it takes debatable decisions, for instance the agreement at Deauville [in October on opening up the European treaty to allow the possibility of sovereign debt restructuring]. Even though it might have made sense economically, this decision caused anxieties for other reasons. Because the markets drew the conclusion that some countries would not be able to pay their debts – so they added a further risk premium to interest rates.

Marsh: Do you think that [Helmut] Schmidt and [Valery] Giscard [d'Estaing] would have come up with something more intelligent?

Fabius: What I know is that we need the Franco-German partnership; this is decisive. But we need a mutual conviction – we need a mutual understanding. We need the French to understand that the Germans are not simply French people who speak German, and the Germans must see that the French are not just Germans who speak French... This is more than simply a question of personalities. We need a fundamental discussion with the Germans. It's normal that different countries in Europe should make an effort to moderate their financial position, but it is also true that countries understand they need to have neighbours with a perspective of growth and Europe a perspective of financial and trade regulation and of industrial strategy.

Marsh: In the past you have criticised the leadership of the European Central Bank for being mere technicians who don't understand strategy. Do you have an opinion about whether the future president of the ECB should be a German?

Fabius: Concerning the leadership, in the recent past the President and other members at the ECB have had a more positive attitude. They have taken a pragmatic approach that has not necessarily always been in line with [the orthodox reading of] the texts... They were right to start purchasing the bonds of the weaker countries in May. I don't want to talk about personalities at the ECB. I believe that if one wishes to resolve the crisis of different countries and of the euro, it is necessary that the ECB and its leaders avoid short sightedness.

Marsh: And a German at the top? They seem to think it's their turn.

Fabius: It is not a question of nationality, but one of orientation. If you take an exaggeratedly narrow view of the room for action at the ECB, that will increase the difficulties.

Marsh: Is there a real danger of an explosion in EMU? One has the feeling that the governments are constantly moving to the edge of an abyss. So far they have done the right things at the last moment and stopped going over the edge. Is the risk of an explosion real?

Fabius: Unfortunately no country is fully protected from the danger. All countries needed to be vigilant. It is in Germany's interest that the euro should develop and prosper. Europe cannot become prosperous through a series of defaults. It is in France's and other countries' interest too. The Germans and the others need to have a friendly and deep discussion about the longer term structure of EMU. So far, during the recent unrest, EMU members have generally reacted to each setback too little and too late. We need to change that and have a calm, considered view about the longer term.

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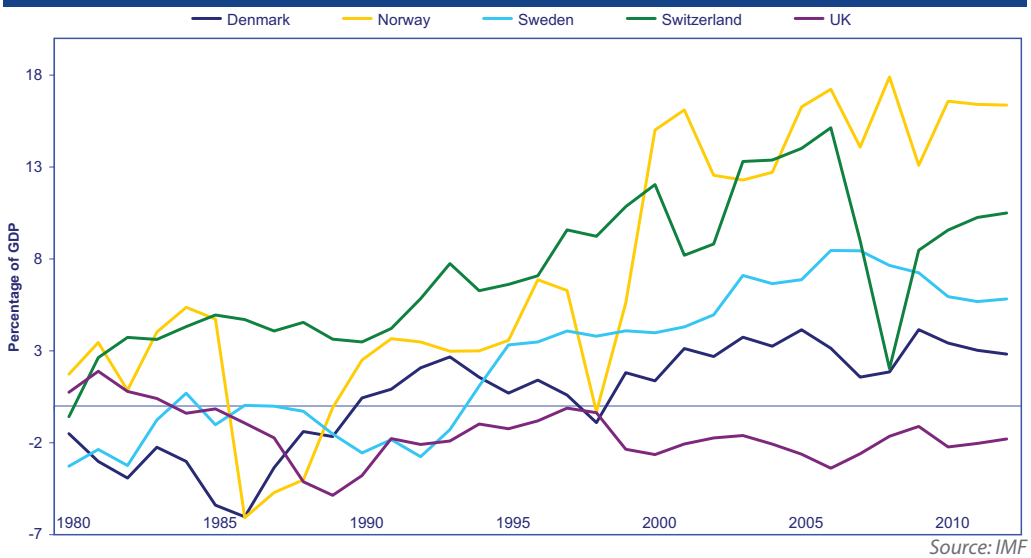
Current account balances of non-EMU members



Source: IMF

Non-EMU members have had somewhat less extreme current account positions than those in the euro bloc. Among five European non-members, only the UK runs a deficit.

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An error of understanding

France and Germany wanted two different EMUs

André Szász, former Executive Director, Nederlandsche Bank

André Szász, long-time board member of the Dutch central bank responsible for international monetary affairs, has witnessed all the major ups and downs of European money during a career that started in 1960. An acute observer of his interlocutors and a master of sardonic phraseology, Szász is the closest that the European central banking community has to a psychoanalyst of French and German thinking on EMU. His reflections on the abiding gulf between Berlin and Paris do not make for comforting reading.

The French wanted to influence monetary policy in order to promote higher growth. They didn't want to get an independent central bank and strong constraints on budgetary policies.

Marsh: My impression is that the politicians who are supervising economic and monetary union [EMU] started up a machine which they didn't understand – and where they now have lost control. Is it true that you once said that not one of the politicians who agreed the Maastricht treaty in 1991 understood what they were doing? I believe you said also: 'And least of all our own prime minister.'

Szász: I may not have said exactly that, but I certainly believed it. The fundamental problem was that the two main countries concerned – France and Germany – wanted two different monetary unions. The French wanted to influence monetary policy in order to promote higher growth. They didn't want to get an independent central bank and strong constraints on budgetary policies, but they had to accept that – because that was what was on offer: it had to be that sort of monetary union, or else there would be nothing at all.

The French accepted these conditions, instinctively thinking that once that happened and once the Germans could be overruled [through the governing council of the European Central Bank where the Bundesbank had just one seat], then the constraints that the French had to accept at the beginning of monetary union would automatically diminish. The Germans, for their part, through the personality of Chancellor Helmut Kohl, were convinced that EMU could start without political union, but once that got under way this would give rise to a dynamic that would force integration in other fields.

Marsh: Many people, including myself, were sceptical about the 'one size fits all' monetary policy but have been surprised how problems in a very small country, Greece, making up just 2.5% of euro area GDP, could touch off such a large impact. Have you been surprised by the way the crisis has arisen?

Szász: I have been surprised at the technical mechanism that brought this about, as a result of the huge exposure that banks and other financial institutions have accepted towards countries like Greece, Ireland and Portugal. Looking back, perhaps this build-up of lending was understandable on the grounds that financial market operators believed that currency risk had disappeared, that country risk had disappeared and maybe even banking risk had disappeared because there was a feeling that, if countries got into difficulty, there would be a bail-out if necessary. This conviction appeared to be justified since the financial markets came round to the belief that, if the [Maastricht] treaty provisions got in the way, then most countries would ignore them. The conviction on the financial markets was that once the exposure became large, then the authorities would bail out the countries in difficulty.

André Szász joined the Nederlandsche Bank (the Dutch Central Bank) as an economist in 1960. From 1973 until July 1994 he was a member of the Executive Board, responsible in particular for international affairs. During this period he was a member of the Monetary Committee of the European Community, as well as the Deputy for the Dutch Central Bank Governor in the Committee of Governors of the EC. From 1990 until 2000 Szász was a Professor of European Studies at the University of Amsterdam. His book published in 1999, The Road to European Monetary Union, is one of the seminal works on European monetary integration

Marsh: France and Germany's different approaches towards economic and monetary policy have been evident for 30 or 40 years. They have become somewhat stereotypical. It seems that nothing has really changed during this long period. Is this not a bit depressing?

Szász: The problem has been this: Whenever compromises were struck over this time between France and Germany over the right policy to follow, these compromises simply represented the latest stage in a process of constant discussion and negotiation. The compromises never represented a permanent position that the countries would stick with; they were always simply a platform for further compromise.

Marsh: People like [former Bundesbank president] Hans Tietmeyer were pointing out in the late 1990s that countries could suffer competitive problems because they would have lower interest rates than were warranted by their domestic economic situations, which would lead to higher growth and inflation. They would no longer be able to devalue and would have to adjust. But politicians and central bankers were comforted by the financial markets' ability over a long period to take the strain of funding these economies' deficits at rather low interest rates. And the Germans failed to see that the weaker countries' increasing payments deficits and debts would end up as claims by the Germans as creditors – and therefore that, eventually, Germany would itself be affected.

Szász: Some countries have not really adapted to the reality of a common currency. The Germans have tended to say to the weaker countries: 'You see you are now in trouble, you have to do something to get out of it.' The Germans have not always seemed to realise that it's their currency too…

Marsh: It's as if the celebrated saying by John Connally in 1971, 'It's our currency but it's your problem', has been turned on its head. Chancellor Merkel could now say to the Greeks: 'It's your problems, but it's our currency.'

Szász: The financial markets and the politicians alike underestimated the cumulative effects of the [Maastricht] treaty violations in the early stages of EMU. The lack of strictness in allowing Italy to join in 1999 acted as a precedent for Greece in 2001. It was there that the problems started. The politicians effectively ignored not just the entry criteria into EMU in 1999 but also the budgetary infringements. And the result was the huge credits built up by Greece to finance its payments deficits and then the infringement of the no-bail-out clause. This was like a chain reaction – each new treaty violation led successively to the next one.

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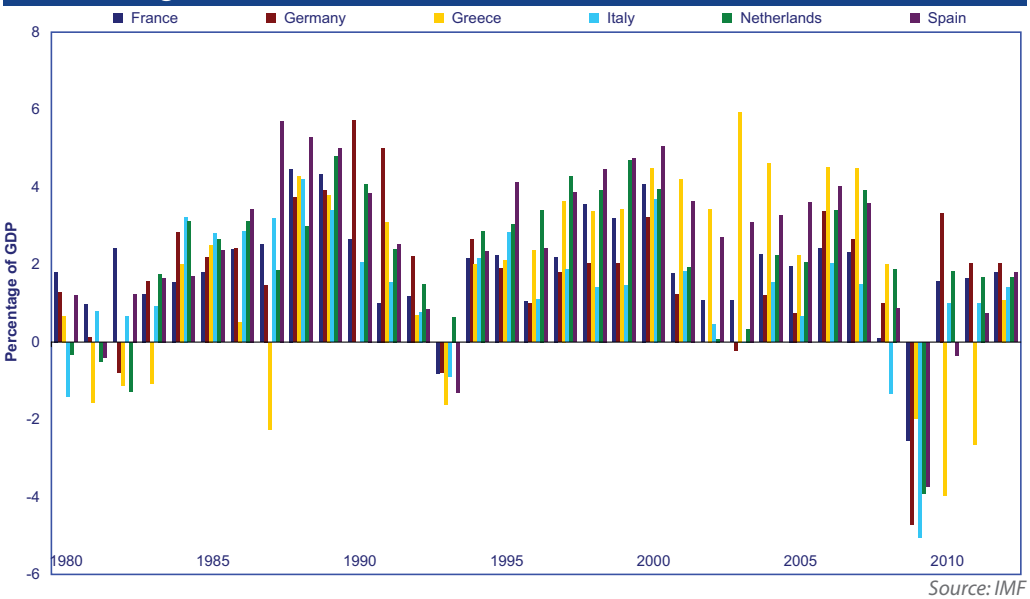
Real GDP growth rate of EMU members since 1980



Source: IMF

After strong convergence of growth rates in the late 1990s, dispersion increased sizeably from the start of EMU in 1999 under the one-size-fits-all interest rate policy.

Marsh: If interest rates were too low for the higher-inflation countries in the early EMU years, then they were too high for Germany – one of the reasons for the sluggish early 2000s German economy and the budget overshooting.

Szász: Exactly. Once you have a monetary policy of one-size-fits-all, interest rates inevitably will not be the right level for everyone. Monetary policy will be in certain cases be too loose and interest rates will be too low; you have to compensate for that with budgetary policy. In Germany at the beginning of EMU, it was the other way around, their interest rates were arguably too high for the German economic situation of the time. The Germans reacted to this by making appropriate adjustments which led then to the revitalisation of their economy. The Greeks on the other hand welcomed low interest rates and this encouraged them to borrow more than ever before – without making the appropriate budget adjustments. The bubbles in Spain and Ireland also emerged because interest rates were too low. It was a huge failure of monetary union that budgetary policies were not adjusted to take account of the looseness of monetary policy in such countries.

The bubbles in Spain and Ireland emerged because interest rates were too low. It was a huge failure of monetary union that budgetary policies were not adjusted to take account of the looseness of monetary policy in such countries.

Marsh: Isn't there an asymmetry here? The Germans are now going through a higher growth phase – one of the few periods since the 1950s where the Germans are growing faster than the European average. The Germans will not however lose competitiveness at anything like the same pace at which the weaker countries have lost theirs in recent years. So the hoped-for adjustment between the higher- and lower-growing countries will not take place quickly enough to make any difference.

Szász: I'm not so sure how sustainable the German growth phase will be. As you say, now it is Germany that has a monetary policy that is too loose. It will be the Germans who will suffer the consequences. We will see this in a few years with higher inflation.

Marsh: But that is not the case at present …

Szász: Once inflation starts to appear manifest in Germany, that will be the moment where the resentment in Germany over the euro will become really strong. At present the resentment in Germany over the euro is over the bail-out process. Even though the Germans see that one of the reasons for this is because it is an alternative to bailing out their own banks, there has been resentment at the way that the ECB has been buying bonds from the peripheral countries that are little more than junk. However, higher inflation would be, for the Germans, a still more important reason for worry.

Marsh: One sign of greater risks is the recent decision for the ECB to double its capital. Was this a surprise to you? This is not something that central banks do lightly. The ECB's balance sheet has not expanded to the same extent as at the Fed or the Bank of England. But clearly the ECB is worried about the risky nature of the bonds that it is taking on.

Szász: This was a surprise. But it is logical to see the need to double capital in the light of the bond purchases.

Marsh: Was not one of the major problems in the early years a kind of positive feedback loop between the financial markets and the politicians? The financial markets suspended disbelief, they seemed to believe that Greek bonds should have the same rating as German bonds. The politicians, regarding financial markets as the supreme arbiters, interpreted this apparent convergence as a sign that monetary union was working. That was the reasons why the politicians ignored the warning signals of mounting imbalances within Europe and also failed to see, early on, that some kind of crisis mechanism might be needed.

Szász: Politicians in Germany and elsewhere were predisposed to see interest rate convergence as a sign that EMU was a success. The harmonisation of interest rates in their view showed that Europe was becoming more integrated. Not surprisingly, they chose to represent developments in this way. In comparison, the fact that countries were ignoring obligations of membership under the Maastricht treaty was seen as not so important. As an example, the Commission a few years ago said that EMU was an 'historic success'.

Marsh: Wasn't another factor that the politicians, the Commission and the ECB knew that the strong Anglo-Saxon community in the financial markets was inclined to be hostile to EMU. Therefore they deliberately damped down any scepticism they may have felt.

Szász: I think they believed what they were saying; there's always an inclination to declare victory too early. I see it with some of my European friends who see a glimmer of hope in every disaster.

Marsh: The Netherlands has had an even bigger current account surplus that Germany over the past 10 years. As big creditors, the Dutch should be allies of the Germans in EMU policy. Shouldn't the Netherlands be doing more to find solutions, so the Germans don't appear to be driving policies alone?

Szász: I do not have the impression that the Dutch are very active in this. They are critical of Europe. It's not just that we have a minority government; in addition, because of the referendum in 2005, politicians are afraid of mentioning Europe in a positive way. When I listened to the recent parliamentary debate in Germany before the European Council meeting, I was struck at the pro-European tone of the speeches of both Chancellor Merkel and also the Opposition parties. You wouldn't get this in the Netherlands. For all these reasons, you can't expect too much from the Dutch.

Marsh: In past years, when would have been the right time for the politicians to decide remedial measures for latent euro area tensions?

Szász: Given that they had fundamental disagreements about what they wanted the union to achieve, it was always going to be difficult to find a solution. Any attempts to forestall the tensions would expose the lack of a political consensus on what the euro should be achieving. The fact that there was no mechanism for the eventuality that things went wrong reflected the view of both Germany and France that, in a crisis, events would move in the directions that they individually supported. The Germans believed that EMU needed more generalised policy coordination based on financial discipline; the French wanted more direction of policy decisions by the political authorities.

Given that the politicians had fundamental disagreements about what they wanted the union to achieve, it was always going to be difficult to find a solution. Any attempts to forestall the tensions would expose the lack of a political consensus on what the euro should be achieving.

Marsh: Wasn't it obvious soon after Jean-Claude Trichet became president of the ECB [in 2003] that the political authorities were not going to be able to tell the ECB what to do?

Szász: Not necessarily. You remember that soon after he become president of France [Nicolas] Sarkozy visited the Eurogroup of finance ministers to press his point of view, saying that France would eventually respect its obligation to lower its budget deficit, but not at that particular time. Even at that stage – before the collapse of Lehman Bros – Sarkozy did not seem to bother about the Maastricht obligations.

Marsh: This led to a rebuke by [German finance Minister Peer] Steinbrück.

Szász: Yes, but after Lehman the global financial crisis was used to justify what President Sarkozy had been doing all along. The ECB was quick to cut interest rates, and this could be seen as a belated justification for Sarkozy's visit to the Eurogroup. The ECB has now kept interest rates low for a long time. It is purchasing bonds for the weaker counties, lending large sums to banks in the problem countries and has postponed its exit from the liquidity injection policies. This could be interpreted beneficially by France. You could say that the ECB has been moving more to the French point of view.

Marsh: One of the reasons for EMU was to mitigate the perceived dominance of the Germans. It doesn't appear to be working out that way.

Szász: I always thought that monetary union cannot exist by itself. It has to be based on a genuine economic union, and there is no clear-cut boundary between economic union and political union, because economic union deals with issues like public spending, and this goes to the heart of sovereignty. European countries need a form of common foreign policy – and this would have a favourable impact on monetary union.

Marsh: How would this influence the power of Germany?

Szász: If there is not a gradual development of a common foreign policy, the alternative will not be a bigger role for Paris and London, but a bigger role for Berlin. Germany has a tradition of Ostpolitik. You only have to look at how often [Dmitry] Medvedev and [Vladimir] Putin are in Berlin. And this will continue unless Paris and London see the need for a common foreign policy.

If there is not a gradual development of a common foreign policy, the alternative will not be a bigger role for Paris and London, but a bigger role for Berlin.

Marsh: So you're saying there's the risk of a German Europe rather than a European Germany. I thought that EMU was supposed to put a stop to that…

Szász: The monetary union as it has developed is not one where the Germans are happy. My greatest worry is that, when inflation starts to rise in Germany, they will become even less so.

Marsh: Are the Germans more threatening inside a monetary union, which is what Margaret Thatcher believed, or outside, which was President Mitterrand's view?

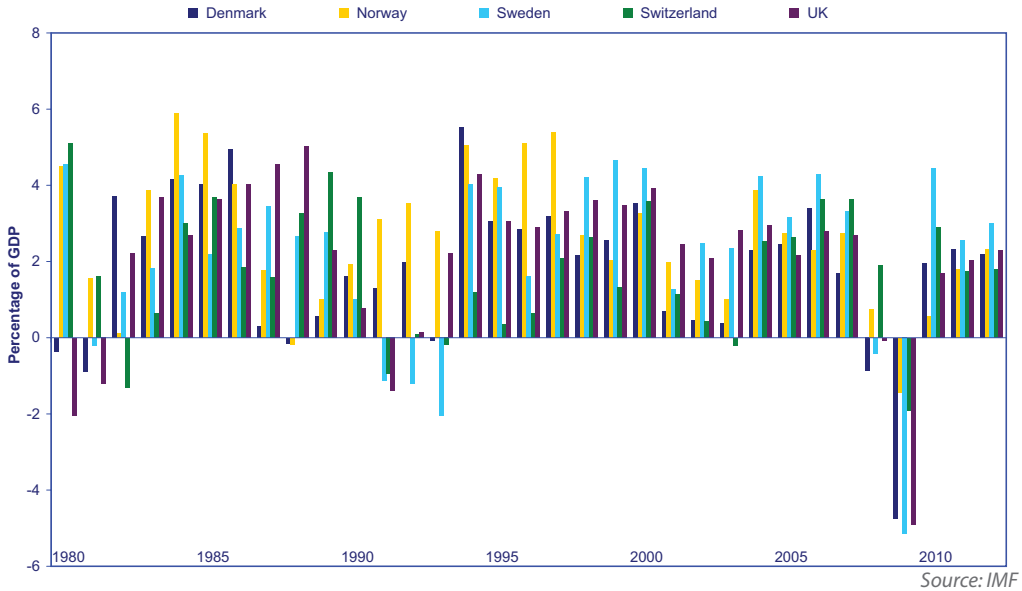
Szász: Obviously, Germany is the most powerful country in Europe. But so far the Germans have not misused their power. For the time being, the Germans want to be inside a common European home, with a common foreign policy. But that will not necessarily last; if there's a lack of cooperation, then the Germans may slide back into the natural way of doing things.

Marsh: So what will be the outcome in the next two years?

Szász: I do not know. The situation is very worrying. The politicians will do what they can to prevent a serious splitting up, so there's no real danger right now, because no-one thinks that they can afford such an outcome.

However, this is clearly not a long term solution. The problems arose due to a lack of real political consensus on what kind of monetary union we wanted to establish. A real solution can only come as a political answer from the political authorities on the basis of existing treaty obligations.

Real GDP growth rate of non-EMU members since 1980



Source: IMF

There has been far more convergence of growth rates among non-EMU members in the 2000s compared with EMU members. This reflects the way countries outside the euro bloc carried out economic restructuring in previous years and could use some economic policy flexibility after the euro started.

Keynes' Clearing Union in Europe

Towards a new EMS to replace monetary union

Erik Holm, former Advisor to Danish Prime Minister

The strains in economic and monetary union (EMU) heighten the danger of full-scale disintegration in the next few years. Europe would be well advised to abandon the idea of a full monetary union and try to manage a system of fixed but adjustable exchange rates between national currencies.

In essence, we need to return to the original plan for the European Monetary System (EMS) as suggested in 1978 by Chancellor Helmut Schmidt and President Valéry Giscard d'Estaing, before it was distorted by the Bundesbank. Resurrecting the original components of the EMS plan would mark considerable continuity with John Maynard Keynes' idea of a Clearing Union put forward during the Second World War.

My proposal, indeed, owes much to Keynes' draft plan dating back to 1942. EMU as presently constituted would vanish and develop into a clearing union. (I do not rule out, however, that a hard core of the strongest economies in north-west Europe may have the courage to continue as a smaller monetary union).

The 'shadow' of the ECB would take shape as a European Monetary Fund (EMF), a hard version of the newly created European Financial Stability Facility, a lender of last resort for European states that get into balance of payments difficulties. It would become a European version of the Federal Reserve System. Its board would consist of governors of the national central banks, acting as a European monetary council, with due reference to the European (political) council of government leaders.

The euro would remain as a reserve currency and a reference currency at the centre of the EMS. It would be a basket currency like the Special Drawings Right, composed of three to five of the leading national European currencies. The principal task of the monetary council would be to administer an orderly method of timely adjustments of relative exchange rates keeping the adjustments within a narrow band, perhaps 2.25% if not 1% as under Bretton Woods. There would be a symmetrical internal stabilising mechanism encouraging deficit and surplus countries to achieve balance of payments equilibrium.

The principle of symmetry in a Clearing Union would have to be accepted by the strong economies, which then have an obligation to bring down a structural balance of payments surplus by increasing internal demand or by making funds available at favourable terms for long-term investments and structural reforms in the weaker economies.

There would also be an internal stabilising mechanism requiring unlimited intervention in the financial markets to combat speculative pressures. It would result in very short-term credits and debits among the central banks, which would eventually cancel out after speculative attacks had been seen off.

Luckily the Exchange Rate Mechanism (ERM) set up as part of the EMS has not been completely scrapped. It was cursed in the early 1990s, particularly by the British, but it carries on as a sleeping beauty and must be woken and sustained by an obligation to unlimited intervention where the European Monetary Fund, backed by the monetary council, would play a crucial role. The great advantage is that it would be possible to include all EU member countries in a new European Monetary System – although that would require excessive political skills.

In this way all the needs for an international monetary system that Keynes outlined in 1942 would be met. He proposed a system that would include an instrument of international currency (later named bancor); an orderly, agreed method of determining relative exchange values; a quantum of international currency; a symmetric internal stabilising mechanism; and a central institution, purely technical and non-political.

The principle of symmetry in a Clearing Union would have to be accepted by the strong economies, which then have an obligation to bring down a structural balance of payments surplus by increasing internal demand or by making funds available for long-term investments.

These needs were far from met in 1946 when the Bretton Woods system was instituted because the US gained effective control. The dollar became the international currency and the quantum of international money therefore became determined primarily by national American interests. The system was not symmetrical, but heavily biased by the US.

When Schmidt and Giscard presented the European council with the EMS plan in April 1978, it was a regional version of Keynes' 1942 draft, not a precursor of monetary union. It included as key components an instrument of European currency (later named Ecu); an orderly method of timely adjustment of relative exchange rates; a proposal for pooling of reserves (in a future European monetary fund); a symmetric internal stabilising mechanism; and a purely technical, non-political ERM.

When Schmidt and Giscard presented the European council with the EMS plan in April 1978, it was a regional version of Keynes' 1942 draft, not a precursor of monetary union.

However, when the EMS was eventually launched in March 1979, the most essential elements of it had been comprehensively amended, primarily as a result of Bundesbank demands. The Ecu was not to be at the centre of the system and the idea of a fund was watered down and later abandoned.

The symmetrical stabilising mechanism was scrapped and the Bundesbank – under a secret side-agreement with Schmidt – was released from the obligation of unlimited intervention in the exchange rate mechanism.

The system became subject to a lot less discipline than was originally intended in April 1978. In the following years a number of exchange rate adjustments were made in a rather disorderly way until the narrow band exchange rate mechanism was effectively suspended in 1993.

The EMS was succeeded by a monetary union. But the fruit of this union, the euro, was a bastard child. It had a 'motherbank', the ECB, but no fatherland, since it had two fathers, Helmut Kohl and François Mitterrand.

The EMS was succeeded by a monetary union. But the fruit of this union, the euro, was a bastard child. It had a 'motherbank', the ECB, but no fatherland, since it had two fathers, Helmut Kohl and François Mitterrand. An experienced scholar of international monetary affairs, Richard Cooper, said in 1993, 'It is my luxury as an outsider to support the objective [monetary union] but to suggest that Maastricht is an undesirable – indeed, I believe unacceptable – instrument to achieve it.' He had several years before 'formed the view … that the easiest and most direct way to get a European currency was to europeanise an existing national currency … (and) for reasons of credibility, the leading candidate would be the German mark.'

In fact, it now seems that this is about to happen, but through the mechanism of the euro. It has become increasingly evident that The euro in the hands of the ECB has developed into a means to impose German Stabilitätskultur on the other countries. Statements by the German government indicate that the price for more fiscal transfers to shore up EMU necessarily – and understandably, from the German point of view – will include more German-style discipline.

If, as I propose, EMU disappears and is replaced by a new form of the EMS respecting the principle of symmetry, then we would have the D-Mark back again as the leading currency in Europe. But even if EMU struggles on in its present form, it would be based on the strong economic culture of the German nation – the finalité of the Treaty of Rome. More than two decades after the fall of the Berlin Wall we see a German Europe – and not a European Germany – rising out of the dust. This is definitely not what the fathers of the European project had intended 60 years ago.

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本书对我国金融工作者和爱好者系统认知欧元这一国际货币的来龙去脉，具有独特的参考作用。

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Mirage of Keynesian advantage

The world in the long run is Classical

Meghnad Desai, Chairman, Advisory Board

The euro crisis has demonstrated that there are no risk-free sovereign debt issuers. Governments can default, will default and indeed in case of Greece and Ireland ought to default if they do not want to sentence their people to untold misery. Debt holders' sentiments always command respect in financial markets but sovereign debt issuers have other responsibilities, namely to their citizens. In a globalised world, sovereigns are just players like everyone else in the financial markets.

The US is different. The dollar is the prime reserve currency. The euro began to be a substitute in many central banks but now it is taking a back seat. The renminbi is not yet available for these purposes though the Chinese are experimenting with renminbi bonds in the Hong Kong market. The US financial markets are deep and highly liquid. This is a strong reason for people to hold US debt. They can always sell it.

The dollar is the prime reserve currency. The US financial markets are deep and highly liquid. This is a strong reason for people to hold US debt. They can always sell it.

American seigniorage advantage promotes looser US fiscal discipline. Americans have the wherewithal to follow Keynesian expansionism. Europeans are stuck with seemingly masochistic Classical economics. We saw this with the recent American tax stimulus. President Barack Obama made his truce with the changed mood in the Congress and decided to extend the tax cuts of George W. Bush for two more years. Democrats wanted him to extend all tax cuts except the top income brackets above $250,000. The Republicans threatened a meltdown since after January they would have a majority in the House and Democrats would not be able to break a filibuster in the Senate. Obama saw the beauty of expediency and extracted a payroll tax in exchange – a boon to middle-income earners.

Purists like Paul Krugman wanted Obama to stand firm and threaten that if the Republicans did not give him the tax cut except for the top slice he would let the tax cuts expire. That would have meant higher taxes for everyone and would have unleashed a double-dip recession. What is more, the voters would not blame Congress; they would blame Obama. So the President secured a fiscal boost without having to pass a Bill. This means the US deficit debt/GDP ratio will rise. Yields on US bonds have risen. A solution for the debt burden is left for another term or another President or both.

In Europe there is little of this fiscal manouvering – and no taste for extra spending or tax cuts. Europe has signed up for debt reduction. First Greece and then Ireland have faced serious attack from the financial markets. The same plight may afflict Portugal and Spain. These two governments have already cut their budgets drastically. UK has also embarked on a strict programme for reducing the deficit to zero over five years from the current level of 11 % of GDP.

At first sight, the Classicist Europeans appear to have made an excruciating choice compared with the Keynesian Americans. Euro members can neither devalue nor pursue quantitative easing individually. Their freedom is severely constrained; and, for the weaker members, the euro now costs them extra instead of offering them protection. Governments have now belatedly established a Stabilisation Facility. But to apply for funds from it appears to be an admission of failure and alarms the markets still further.

Yet the contrast between Keynesianism and Classicism is really a mirage. The US and other OECD members are losing their growth momentum. The emerging countries of Asia, Latin America and Africa are speeding up. To generate growth, capitalism over the longer haul demands high savings and high investments, innovation and rising productivity. Financial manipulation and fiscal opportunism offer short-run gains. But Keynesian ditch-digging can only be a temporary palliative. The world in the long run is Classical. Even sovereign debt has to be paid back one day – in real resources, not in debased money.

Healey's EMS view vindicated

Former Labour Chancellor's lessons from history

William Keegan, Chairman, Board of Contributing Editors

Until recently the veteran British politician Denis Healey had the dubious distinction of having been the last finance minister of a major industrial country to have had to resort to assistance from the International Monetary Fund. After that famous episode in 1976, the IMF was a source of emergency balance of payments funding principally for developing, or 'emerging' nations during the 1980s and 1990s.

All that has changed with the recent recourse to the Fund by what have become known as 'peripheral' euro members such as Greece and Ireland.

'An Evening with Denis Healey' has been arranged this month by Queen Mary University of London and OMFIF, as a tribute to the great man. The impression grows that the modern generation of politicians in Britain are not quite in the same league as the generation of Healey and his colleagues. Moreover, as time goes on, there is probably more historical understanding of the difficult circumstances in which ministers like Healey had to operate.

The impression grows that the modern generation of politicians in Britain are not quite in the same league as the generation of Healey and his colleagues.

The 1974-79 Labour government's need for assistance from the IMF was an embarrassment that was thrown back in Labour's face many times in subsequent decades. It was not until the Black Wednesday disaster of 16 September 1992 – when Britain's short-lived membership of the Exchange Rate Mechanism became unsustainable – that the Conservatives, too, had such egg on their faces that they made less use of the IMF gibe.

Healey was Chancellor of the Exchequer under Harold Wilson from 1974-76, then under the premiership of James Callaghan. There were inevitably some difficult moments for the Callaghan-Healey relationship during the IMF negotiations of autumn 1976, and there were powerful opponents of the IMF's lending terms within the Cabinet. But in the end the Cabinet held together – a tribute to Prime Minister and Chancellor.

In the heat of the crisis Healey had to 'turn back at the airport' and cancel a trip to the annual meetings of the World Bank and IMF in Manila. He returned to face the music with IMF officials descending on London and to explain himself to the annual Labour Party Conference in Blackpool. Later he said in his memoirs: 'In a sense, the whole affair was unnecessary. The Treasury has grossly overestimated the PSBR [Public Sector Borrowing Requirement], which would have fallen within the IMF's limit without any of the [deflationary] measures they prescribed.'

Healey was proud of the fact that in the end he only had to draw half the IMF loan. All was repaid before his Chancellorship came to an end in spring 1979.

Although a great classical scholar, and an intellectual who is visibly proud of his cultural 'hinterland', Healey has remained a blunt Yorkshireman, with a demotic turn of phrase. He used to amuse Treasury officials during what he admits was 'the long agony of the IMF negotiations' by talking longingly of 'Sod Off Day' when obeisance to the Fund would no longer be required.

Healey conceded in his memoirs that: 'In practice we could have done without the IMF loan only if we – and the world – had known the real facts at the time. But…we were still describing our public expenditure in a way which was immensely damaging to our standing in the financial markets.' In his own punctiliously detailed memoir of the 1976 crisis, the Treasury's senior civil servant at the time, Sir Douglas Wass, terms as 'doubtful' Healey's belief that there was no need for the Fund's assistance. 'There was a huge external financing requirement revealed in the appraisal made in September 1976 and in any case market confidence still remained a problem.' Wass, a lifelong public servant and well-known Keynesian, would not have wished to borrow from the IMF just for the sake of it, but reluctantly recognised the power of the markets.

And it is the power of the markets that euro members have had to recognise. There is no guarantee that the financial markets have finished seeking their pound of flesh. In which context Denis, now Lord Healey must look back with some satisfaction to the day when he decided it was not in Britain's interest to join the Exchange Rate Mechanism.

The negotiations surrounding the setting up of the European Monetary System dominated the international side of the last year of Healey's Chancellorship.

Healey describes himself as having been 'fairly agnostic at first'. But once he learnt from German State Secretary Manfred Lahnstein that the true motive of the German finance ministry and Bundesbank was to create a mechanism that limited D-mark revaluations, he turned against UK membership. As he sees the troubles that the subsequent move to a single currency have inflicted on certain non-German economies, he must be doubly pleased about the view he took all those years ago.

As Healey sees the troubles that the subsequent move to a single currency have inflicted on certain non-German economies, he must be doubly pleased about the view he took all those years ago.

Looking ahead – 2011 diary dates

OMFIF Meeting with
Dr. Joachim Nagel
Deutsche Bundesbank
17 Feb 2011, London
The Outlook for Financial Markets

OMFIF Lecture with
Dr Jürgen Stark
European Central Bank
11 May 2011, London
Lessons from the ECB

OMFIF Meeting with
De Nederlandsche Bank
23-25 March 2011, Amsterdam
Europe's Place in the World Economy

OMFIF Seminar with
Dr. Lorenzo Bini Smaghi
European Central Bank
26 May 2011, London
The Outlook for the ECB

OMFIF Seminar with
Philipp Hildebrand
Swiss National Bank
4 July 2011, London/Edinburgh
Switzerland's Role in World Money

OMFIF Meeting with
Banque centrale du Luxembourg
15 September 2011, Luxembourg
The New Forces in World Banking

Note on contributors to January Bulletin

Sir Michael Butler is a former UK Permanent Representative to the European Community

Lord Meghnad Desai is Emeritus Professor of Economics at London School of Economics and Chairman of the OMFIF Advisory Board

Laurent Fabius is a former French Prime Minister

Jonathan Fenby is China Director of the research service Trusted Sources www.trustedsources.co.uk

Erik Holm is a political economist, served as economist with the IMF in the 1960s and was European adviser to the Danish Prime Minister in the 1970s

Otmar Issing is former Chief Economist of the European Central Bank and the Deutsche Bundesbank

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Frank Scheidig is Global Head of Capital Markets, DZ Bank, and a Deputy Chairman of the OMFIF Advisory Board

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