

Will the financial crisis strengthen or weaken the Euro?
An overview from a European and transatlantic perspective
Institute for Monetary and Financial Stability (IMFS)

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It is a great pleasure to be here in Frankfurt this evening to give this lecture. I came to Frankfurt first in the 1970s when I became acquainted with the Bundesbank. In fact I lived here for several years and even the civil ceremony of my marriage was carried out in the rebuilt Römer, during a lunch break from my work with Reuters in 1974. As the focal point of medieval Frankfurt - the place for coronation banquets of the Holy Roman Empire – and also for the first meeting of the council of the European Monetary Institute as the forerunner of the European Central Bank, the Römer reminds us of the need to keep a historical perspective about the issues connected with Economic and Monetary Union - because this is a project that has been under development for many decades. The Euro's prowess and resilience, too, have to be judged over the long term. And this is the question at the root of my lecture here tonight.

My view is that the financial and economic crisis has revealed both strengths and weaknesses in the EMU construct. Strengths – because there have indeed been signs of increased cohesion, both at a government policy-making level and within the 16-nation European Central Bank. Weaknesses – because some of the wrong policy-making actions over the past 10 years have now been laid bare by the depth of the recession and by the impossibility of devaluing one's way out of trouble within EMU. In giving judgment on the Euro, I must echo the words of Chou Enlai, the Chinese premier, when asked by Richard Nixon in the early 1970s to sum up the effect of the French revolution: "It is too early to say."

One thing is clear, though: then extraordinary pressures of the past two years are raising the stakes on whether EMU can survive as a long-term entity without some form of fiscal union to accompany the establishment of a single interest and currency rate. To hold together a still very disparate band of countries which are

both united and divided by a single currency, Europe must show more solidarity – or else there will be chaos.

I

One is reminded constantly of the very long-term nature of the undertaking. We all know that monetary unions of different types set up during the 19th century did not last because they did not, over time, receive requisite political and economic support. Latin Monetary Union started in 1865 and ended in 1927. Scandinavian Monetary Union lasted from 1873 until 1920. The Gold Standard was a form of monetary union that proved astonishingly fragile when war and civil disorder dislodged the fabric of society. In December 1991 shortly before the Maastricht summit that set the path to the Euro, Chancellor Kohl reminded us that a monetary union without a political union would remain “a castle in the air”.

During the years before the Euro was established in 1999, the Bundesbank was consistently reminding us of the need for long-running sustainability in the underpinning of the new currency. Words such as “*Auf Gedeih und Verderb*” and “*Solidaritätsgemeinschaft*” (coined by Hans Tietmeyer, a veteran of the deliberations on the Werner report in the early 1970s) were hammered into our minds. It is worth pointing out that the Werner report specifically lays down the need for political union to accompany monetary union – allowing key policy responsibilities in monetary and budgetary affairs to be transferred away from national governments and central banks towards Community institutions, under the control of a reformed European parliament.

Last month in Hamburg I took part in a debate with the long-time European MEP Klaus Hänsch on whether or not the Euro was irreversible. I was backing the notion that it would be reversible, Mr Hänsch said it would not be, i.e. the Euro is for ever. Using some of the same words as Mr Tietmeyer had coined for the Bundesbank’s 1990s phraseology, I said that, for Mr Hänsch’s point to be true, I would relax my normal strict criteria on the nature of infinity and hold that the single currency would have to last for 500 to 1,000 years.

My overall point was that, if the German wanted EMU to be irreversible, the Germans would have to pay for it.

Partly because of my insistence on this issue, during the course of the debate - although the majority of the audience still voted against the proposition - I managed to increase my share of the vote from 20% to 40%, while Mr Hänsch’s tally fell from 80% to 60%. One is reminded of Goethe’s axiom: “*Geld lenkt*”. And also of the still more telling saying: “*Beim Geld hört die Freundschaft auf.*”

The lengthy time-frame needed for an appreciation of these matters was brought home to me some years ago, in 1993, when I listened to a lecture by Mervyn King,

then the chief economist and now Governor of the Bank of England. He pointed out that the Bundesbank had been able to hold down inflation below 3-1/2 % over its lifetime that started in 1957 – the best record in the OECD – while the Bank of England’s record was a sorry 7% over that period. But Mervyn King added: “The Bank of England of course, goes back not 30 but 300 years. And I would draw your attention to the fact that, although prices in the UK have increased seventy-fold since our inception, this is less than the increase in prices in a single month in Germany in 1923!”¹

It has to be said that Governor King, although much more circumspect in public these days, is not an enormous fan of the Euro and I would say he is on the whole content that the UK has stayed outside and will continue to do so. From him stems the perhaps apocryphal remark that it would take 300 years of data to gauge whether Britain’s economy had achieved sufficient convergence with the rest of Europe to join the single currency. You can judge from all these remarks, and from the present disarray of the political parties and also of the state finances in Britain, that it will take rather a long time for us to join the Euro. I said in my book that the UK would stay out at least until 2025 and I’m beginning to think that forecast looks a little conservative.

II

I have stressed that I would like to look at this issue from a European and trans-Atlantic perspective, to try to achieve a semblance of neutrality in this debate. But of course one really cannot achieve this goal. The reality is that I am British. However much one tries – and believe me I am trying - one cannot avoid the emotional overlay that comes from the vantage point of the beholder or the analyst, and the environment that has shaped his or her experience.

Even in the best of all possible companies, such as this highly international and sophisticated audience tonight, one has to recognise the high degree of almost pathological mistrust, scepticism, bitterness and what can only be described as two-way *Schadenfreude*, real, anticipated and suppressed, that colours this debate. Plainly, whatever Goethe had to say about the all-encompassing and all-ordering role of “*Geld*”, the Euro is about far more than mere money.

Rivalry and jealousy among the different money centres of Europe is nothing new. Amazing although it might appear so soon after the Great Inflation in 1923, the following year, in 1924, Montagu Norman, the Governor of the Bank of England, feared that then newly stabilised Mark might become the strongest currency in Europe and would supplant the pound; this was one of the reasons why Britain (disastrously as it turned out) returned to the gold standard in 1925. It is fairly well documented how in the 1930s (under Emile Moreau as governor of the Banque de

France), in the 1960s (under President de Gaulle) in the 1970s (under President Giscard d'Estaing), and in the early 1990s (under President Mitterrand), France tried to use the power of money as a strategic lever against the economic interests of the UK.

The position in the UK with regards to the Euro is particularly antagonistic. This is perhaps not very surprising, but still faintly shocking, given the fact that Britain is by far the most important trading partner of the Euro area, well ahead of the US and China. In the recent European elections, the UK Independence Party, which wants Britain to withdraw altogether from the European Union, won the second largest share of the votes.

The depths of the emotional divide over the single currency are apparent when one reads transcripts of the conversations between Chancellor Kohl and President Mitterrand during the high-point of the exchange rate crisis in September 1992, when Mitterrand spoke of his belief that “billion in drugs money” was feeding the speculation. A few months later he blamed “a large-scale offensive by the Americans or British” and Kohl mentioned the Mafia as a possible source of the unrest. The two men resolved to ask their respective secret service organisations to analyse what was going on.

George Soros, who played a role in the unravelling of the EMS in 1992, said later that the trend towards disintegration on financial markets is reinforced by “the emotional amplifier – when things are going wrong, especially when mistakes are being made, there is an impulse to blame someone else.” Mr Soros asked “Who would have thought that respected officials like Jacques Delors and the Finance Minister of Belgium and the newly appointed head of the Banque de France really believed in an Anglo-Saxon conspiracy to destroy the Franco-German alliance?”² The answer, of course, is that – especially after one has read the transcripts of their conversations - one can believe this only too well.

The person at the Banque de France to whom Mr Soros was referring was Jean-Claude Trichet. His role in the events of 1992-93 – and also his endorsement of President Mitterrand’s strong-arm tactics to persuade Helmut Kohl to intervene in the row that looked likely to scupper the franc around the time of the Maastricht referendum on 20 September 1992 has been well documented.

III

National emotions - often linked to national stereotypes that, sadly, can be true - can influence events in many complex ways, for example, by leading various protagonists not to reveal their hand at an early stage for fear of provoking an undue reaction based on suspicions on their motives. We are talking about all kinds

of examples of “negative feedback”, where an already existing national trend is reinforced and often exaggerated by additional information feeding into the debate - which then takes on greater power as it criss-crosses national boundaries.

A good example of the phenomenon of organisations or personalities suppressing information for fear of inflaming a stereotypical debate came in 1995, during the build-up to the enactment of the Euro. A well-known public body in the UK produced an analysis of 29 monetary unions since the Act of Union between England and Scotland in 1707.

It is worthwhile, in parentheses, pointing out that in the Act of Union itself, money plays only a subordinate role. The Act states unambiguously in Article 1 that the two Kingdoms are to be politically united and – after much detailed discourse about trade and ownership of ships, salt, coal, parchment, vellum and herring and all sorts of other matters – comes to speak about money only in Article 16.

“From and after [my emphasis] the Union, the Coin shall be of the same Standard and Value throughout the United Kingdom, as now in England, and a Mint shall be continued in Scotland; under the same Rules as the Mint in England, and the present Officers of the Mint continued, subject to such Regulations and Alterations as Her Majesty, her Heirs or Successors, or the Parliament of Great Britain shall think fit.”

In other words, the Act tells us clearly that the monetary cart should not go before the political horse.

The UK study revealed that these 29 monetary unions fell neatly into three categories. The first was where a smaller currency effectively borrowed that of a larger neighbour – the monetary linkages between Liechtenstein and Switzerland, or between Luxembourg and Belgium, are examples of this. The second is where monetary union breaks down in the absence of political union, examples of which I have already mentioned. The third is where monetary unions prove durable because they are thoroughly embedded in political union: Germany and the UK are examples of this, but so is France.

The analysis was not given wide circulation. I am sure this was a wise decision. In view of the widespread scepticism about the European Union in UK public opinion and politics, I am sure that a mere whiff of this report – just three years after Black Wednesday - would have extensively flavoured the debate in the UK and the rest of Europe about Britain’s willingness to join the single currency. And this “negative feedback” would have had a negative influence on various other British policy ambitions in relation to our always-volatile links to the European Union.

IV

EMU is not simply a short-term means of getting out of a tight economic situation and introducing a few years of recovery fuelled by low interest rates and stable currencies. It is a strategy that is supposed to last for the rest of history. Initial developments that appear positive may turn out to be negative. Over time, as all the facts are revealed, one may be reminded of the beguiling but also terrifying French slogan at railway stations: “*Un train peut en cacher un autre.*” We have to bear this in mind when asking whether the Euro has been strengthened or weakened by the financial crisis.

The convenience and advantages of EMU are apparent early on, the drawbacks only later. There is nothing magical or unexpected about this. The Bundesbank was tireless in pointing out, before EMU started, a certain asymmetry between the immediate pluses and the potential minuses of the single currency. Bundesbank officials made repeated speeches pointing out how member countries needed full flexibility in areas like wage setting to compensate for the loss of flexibility through the exchange rate. Many of these speeches were made in German, for consumption by a home audience – and one wonders whether anyone else was listening.

In making up our minds on the Euro, we have to look at the single currency from many different perspectives, since they all provided different motivations for setting it up: as a means of securing the European single market, as Europe’s method of standing up to American monetary domination, as a way of curbing the perceived renewed power of Germany after unification in 1990, and as an instrument for political unity. There are elements of rivalry, enmity and intrigue. One must not forget that the clarion call for a United States of Europe by Victor Hugo in 1871 was driven not by pan-European altruism but by a desire to recover Alsace and Lorraine lost in the Franco-Prussian war.

This history has provided many reasons why Europe has embarked on the journey. The long experience of Germany’s partially successful attempts to dominate its neighbours explains, for instance, why the status quo that emerged during the 1970s and 1980s, where Germany took *de facto* command of European monetary policies, was not a sustainable long-term solution to Europe’s economic challenges. The history of rivalry, intrigue and resentment has also provided many reasons the journey has been unusually complicated.

There are no easy answers to the question of whether Europe as a whole has gained or lost as a result of EMU. We cannot know what would have happened if the single currency had not come about.

Certainly EMU has simplified some aspects of Europe's attempts to deal with the financial and economic crisis. I would certainly agree that EMU has afforded member countries some measure of shield from the financial storms that have ravaged the world. But I am not altogether sure whether that was overwhelmingly a good thing. Some countries have used EMU since the start as a form of insurance for protection against the harsh realities of the world outside. Not only is the protection now failing to work so well, but the cost of the premium is rising rapidly.

I am suspicious of the easy answer that everything would have been disastrous if we had not had the single currency. The sharp D-Mark revaluation that many were predicting for the early years of the 2000s if the Euro had not come about was, I am convinced, a figment of imagination. It would not have happened. I have a track record in this as I publicly took the view in 1999 that the Euro would be "as weak as the D-Mark" and would also become "the world's favourite borrowing currency" – a prediction that became true.

Since then, the European economic record has been patchy. Some countries outside the Euro have followed appropriate policies and have fared relatively well. Others within the Euro have plainly not followed the right policies – particularly in matching fiscal and monetary policies – and are now reaping unpleasant consequences.

The financial and economic crisis through which we have been living throws into sharp relief both the achievements and the drawbacks of the European single currency.

Certainly there have been benefits – for trade and investment, ease of moving money, security of transactions and so on – but there are also shortcomings, because foreign exchange crises in the past often acted as a useful thermometer to tell patients that they were unwell and forced them into remedial action. Just because the patient has discarded the thermometer does not mean that he or she is not unwell, and it may make both a diagnosis and a cure that much more difficult.

V

At the heart of EMU lies a Faustian bargain sealed among European countries in the long-running aftermath of the Maastricht treaty. After the exchange rate upheavals of the early 1990s, European countries undoubtedly made huge strides during the decade in reducing economic disparities, lowering budget deficits and stabilising their economies around low inflation growth.

They then - upon entering EMU - gave up the opportunity of using changes in interest rates and in nominal exchange rates to adjust their economies. Such adjustments could, in future, take place only through variations in prices, wages and productivity. As part of the bargain, the members of the single currency roped themselves to the mast of what had been the strongest currency, that of Germany, took the initial benefits of lower interest rates (bequeathed to them by the Bundesbank) and pledged to make further efforts at convergence to seal the stability of the new currency system that they entered.

That worked for a while as long as Germany was relatively weak. It entered EMU at an over-valued rate of the D-Mark against the other European currencies (a long-running legacy of Black Wednesday). This, together with the left-over effect of uncompetitive wage rises and other negative developments on the labour markets in the decade after unification, depressed German growth in the first years of EMU and made life easier for everyone else.

From about 2003 onwards, however, two things started to happen, both of which had negative repercussions. First, Germany, having brought down its labour costs and restored its economic house to order, started to exert greater pressure on the other members by chalking up ever-greater trade surpluses against countries whose goods had (through the combination of higher production costs and fixed exchange rates) become uncompetitive. Thus was started a build-up of credit pressures within EMU, with the largest country, Germany, rapidly increasing its financial claims on the others.

Second, enormous balance of payments disequilibria started to build up, too, in the rest of the world, principally caused by a series of Asian countries led by China (as well as other emerging economies) keeping their currencies artificially low against the dollar through concerted intervention (under which they acquired huge stockpiles of dollar reserves). This increase in international liquidity was a main reason for the development of asset bubbles which eventually burst in summer 2007.

Central banks, principally the Federal Reserve, but also the ECB, kept interest rates reasonably low during the period, lulled into a false sense of security by the apparent success of maintaining inflation at around 2 %, and fearing (rightly) that action to prick the bubbles would have had deleterious effect on the economy.

The upsurge in world liquidity accompanied by low interest rates spurred an ever-growing appetite for complex debt instruments invented by the investment bankers in New York and London. Issuance of such instruments with all sounds of harmless-sounding names rose 12-fold between 2000 and 2006 – part of the

carousel of abandonment of sound banking principles that led to the financial breakdown of August 2007 and the near-meltdown that we saw last autumn.

VI

I would now like to address some questions for the future. The imbalances within EMU have been just part of the increased disequilibrium around the world. Some of this is now easing as a result of the rapid fall-off of exports from the world's most important surplus nations, China, Japan and Germany, whose exports fell off a cliff at the beginning of the year. Latest IMF estimates show a much more balanced set of current account figures emerging for the developed and the emerging countries in 2009-10.

I foresee that the world economy will slowly improve and we will be revising upwards some of the extremely gloom-laden forecasts later this summer. For EMU, though, the worst may be yet to come. The present phase of deep economic downturn has been difficult enough but – following the European Central Bank's initial indecision about its credit policies in summer 2008 – the Europe-wide policy response has been relatively straightforward: cutting interest rates aggressively (in line with action in the US and UK) and allowing a major short-term deterioration in budget deficits to prevent the recession from turning into a still more disastrous slump.

The true test of the Euro's mettle will come when European economies start to recover, possibly as early as the second half of this year. Recent European Commission statistics on Euro area competitiveness paint an extremely bleak picture of EMU imbalances – in spite of an expected upturn – possibly intensifying the debt trap hitting especially the weaker southern and western Euro members running current account deficits (the so-called CAD nations).

The most disastrous scenario for EMU would come if, driven by export-led recovery in Germany and other traditionally stability-minded countries in northern Europe, the European Central Bank was to increase interest rates fairly aggressively, starting around the turn of the year.

The ECB will be influenced by worries about the potential inflationary impact of high government borrowing and massive injections of liquidity into financial markets. Germany has kept government borrowing relatively under control this year, with the general government deficit expected at 4.5 % of GDP this year, against 5.4 % for the Euro area. However, as the full impact of the downturn works

through, German borrowing is expected to rise to 7 % of GDP in 2010, the same as the overall Euro area.

If borrowing costs start to rise, that will disproportionately hit the CADs. On this scenario, interest rates on government bonds issued by the weaker EMU members can be expected to rise appreciably, especially if the yield “spreads” (which have recently fallen back) over German government paper start to widen again. The borrowing problems would be compounded if in these countries, growth remains very low, unemployment rises (adding further to public sector deficits) and inflation stays around 1 % – for then the real debt burden would rise very rapidly.

VII

All this would coincide with persistent financial strains. The Commission report on Euro members’ competitiveness, to which I referred earlier, says widely varying price and productivity developments throughout the Euro area, combined with the pegging of exchange rates since 1999, have produced a 10 to 15 percent overvaluation of the effective exchange rate for the CADs and an undervaluation of 5 to 15 % for the current account surplus countries, principally Germany and the Netherlands.

In particular, this has led to a sharp rise in net external liabilities for Greece, Portugal and Spain, rising close to 100 % of GDP in 2007 against near-balance in 1995. The Commission says adjustment to Euro area imbalances is taking place “only partially and at a high cost... in terms of unemployment and underutilisation of capital”. In 2007-10, “most countries with overvalued real exchange rates are expected to lose further competitiveness while undervalued economies will continue to gain competitiveness.”

The Commission sounds the alarm bells on the financing of the CADs’ liabilities. Greece and Portugal have financed more than half their increases in net external liabilities since 1998 by currency and deposits, rather than longer term sources of finance such as bonds, while for Spain currency and deposits have accounted for 25 % of the increase. The Commission notes that “cross-border deposits are easy to withdraw and can be considered a more volatile source of finance”.

Concern about financing these imbalances forms one of the reasons why the ECB has declared it is very unlikely to adopt large-scale purchases of government bonds as decided by the Federal Reserve and Bank of England. The ECB is plainly worried about the scale of financing needed to offset some of the remarkably large

imbalances building up within the Euro area as a result of differences in prices and productivity within the fixed currency system.

Because EMU is composed of 16 sovereign countries with individual government debt-issuing departments, quantitative easing would have to be applied in a GDP-weighted manner to bonds of 16 countries.

However, it would have a disproportionately large and positive impact on the bond markets of the most heavily indebted countries – and could be seen as granting privileged access to better borrowing conditions for the worse-off members.

This is precisely the effect that the weaker southern and western Euro members wish to bring about. But the idea that the ECB could act as a government bond purchaser of last resort for hard-pressed nations is also something that the ECB wishes at all costs to avoid.

VIII

The European Union has been unable to overcome a principal conundrum that has dogged it ever since the first stirrings of life behind the single currency. Without political union, monetary union will remain a headless torso that will possibly become unstable and topple. Especially as a result of widening of the European Union to 27 states, the idea of a genuine political union across Europe must now seem as remote as any time over the past 50 years.

Looking at some of the shorter-term questions, warning bells of the political strains building up have been sounded by Chancellor Merkel, who in June launched an attack on the European Central Bank for allegedly “bowing to international pressure”. Her somewhat unusual comments – she was speaking without a prepared text and managed, in the space of less than 30 seconds, to criticise not only the ECB but also the Federal Reserve and the Bank of England in a highly exceptional way - reveal a great deal about Germany’s vulnerability over the central bank’s policies.

The fundamental point about monetary union is that the Germans have given up the right to run European monetary policy by themselves. By voicing her worries about this reality, Ms Merkel is raising the likelihood of tensions with France when the central bank eventually reverses its monetary easing. There is potential for a clash between Germany’s legendary hard-headedness and the equally legendary desire of other governments, notably in Paris, to get their hands on the levers of power in Frankfurt.

For all the vaunted independence of the Bundesbank, one must remember that the German central bank periodically came under rate cut pressure in the past, and

occasionally showed itself susceptible to such action. During the ECB's short history, as Jean-Claude Trichet has frequently pointed out, the Frankfurt bank has frequently faced calls from politicians to cut rates.

French President Nicolas Sarkozy has made no secret of his irritation of the ECB's exceptional degree of independence. He may well be gleeful that France's discreet yet long-running efforts to influence the ECB appear to be stoking unease in Berlin.

These political strains form just part of the pressures facing the Euro area. The EMU is unquestionably a success in many ways; indeed, it could be said to be the only important part of the European Union that is working effectively. Precisely, however, because the internal and external environment remains so fraught, as long as acute economic uncertainties overhang Europe and the world, we must be ready for further bumps on the road ahead.

¹ Prof. Mervyn King, address to German Chamber of Industry and Commerce seminar, London, 25 March 1993.

² George Soros speech, Aspen Institute, Berlin, abridged version in *Treasury Management International*, July/August 1994.