The Disrobing *of* Angela Merkel

In the great struggle over the eurozone's future, Club Med wins.

BY KLAUS C. ENGELEN

The surprising visit of U.S. Treasury Secretary Timothy Geithner on July 30, 2012, to Germany—flying into the North Sea island of Sylt to talk to German Finance Minister Wolfgang Schäuble and stopping over in Frankfurt to meet with ECB President Mario Draghi—dramatizes how Germany is key to keeping European monetary union from breaking up. Both policymakers, in statements to the press, aimed at calming unsettled bond markets, saying they welcomed Ireland's sale of bonds and Portugal's "continued success in meeting program commitments," and had discussed the "considerable efforts" made by Spain and Italy to "pursue far-reaching fiscal and structural reforms."

What was surprising to insiders was that Greece wasn't mentioned, since it was probably the hot potato Geithner wanted to raise with Schäuble and Draghi. In Greece, international creditors are reviewing the government's progress, and the Obama Administration wants no negative news until the November presidential elections. As by far the biggest shareholder of the International Monetary Fund, the U.S. Treasury is deeply involved in the IMF's large lending exposure to Greece and wants to make sure that eurozone governments assume any future financing burden by writing down official loans and mak-

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ing use of their rescue funds, the European Financial Stability Facility and the European Stability Mechanism. So far, Schäuble has firmly rejected any further write-downs of official exposures to Greece, pointing to the billions German taxpayers already lost when nationalized financial institutions such as Hypo Real Estate took part in the Greek debt forgiveness exercise.

In a joint statement issued after the talks on Sylt, Geithner and Schäuble "took note" of statements made last week by European leaders to "take whatever steps are necessary to safeguard financial stability" in the seventeen-nation currency area, according to *Bloomberg News.* The bilateral meeting also signaled U.S. endorsement for ECB President Mario Draghi as he seeks a game changer in the battle against Europe's sovereign debt crisis almost three years after it surfaced in Greece.

It was revealing that on the day of Geithner's meetings with Schäuble and Draghi, Italian and French government officials pressured the European Central Bank to give the European rescue funds a banking license so that they could use—without limit—government bonds of euro countries as collateral and thus relieve interest rate pressures.

It was also revealing that on the same day, Michael Kemmer, managing director of the Association of German Banks (BdB), announced an about-face by his members on the issue of the European Central Bank buying the bonds of debt-laden eurozone countries. In light of the "extreme market situation," Germany's private sector is now accepting bond purchases by the European Central Bank of countries such as Italy or Spain in order to lower these countries' interest costs when rolling over existing government debt.

On the preceding weekend Luxembourg's Prime Minister Jean-Claude Juncker, who heads the group of euro-area finance ministers, didn't mince words in addressing the real threat of a eurozone breakup. In an interview with the *Süddeutsche Zeitung,* he vented his anger at how German politicians from the ruling coalition parties—such as economic minister Philipp Rösler of the Free Democrats and Bavarian governor Horst Seehofer of the Christian Social Union—are using the "Grexit" issue to play to their electorate. These politicians were treating the European Union as a "German subsidiary." Said Juncker, "We have reached a decisive point where the world is talking about whether there will still be a eurozone in the next few months. We have to make abundantly clear with all available resources that we're completely determined to guarantee the financial stability of the currency." In the interview, Juncker confirmed that the temporary bailout fund, the European Financial Stability Facility, is working with the European Central Bank on a plan to reduce borrowing costs, adding, "We have no time to lose."

ANGELA MERKEL AGAINST THE WORLD

The July 16, 2012, cover of *Time* magazine captioned "Why everybody loves to hate Angela Merkel—and why everybody is wrong" sums up pretty well what Germany's chancellor is confronting this summer.

According to researchers at UBS focusing on market expectations, no respite is likely to be forthcoming. The next two months contain a number of flashpoints with potential for disrupting markets. Using the UBS checklist—politicians speaking in public; Greece, the Troika and the IMF; the "Greece will exit" story; Portugal, the Troika and the IMF; European bank supervisor proposals; Spain's banking system audit; the Dutch general election; the German constitutional court ruling on the European Stability Mechanism; the European Central Bank—on all those issues Germany plays a critical role.

And with Angela Merkel at the helm, so far this has meant looking first to keep her political base secure and use domestic political constraints to avoid turning the rescue of the euro into a huge transfer union with debt mutualization through eurobonds.

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A WATERLOO IN BRUSSELS

Merkel went to the EU summit—as the *Berliner Zeitung* commented—"in full confrontational mode." It continued, "She is admittedly bringing a small gesture of reconciliation with her to Brussels: She will make the proceeds of a financial transaction tax available as a sign of solidarity. But no one knows when that tax will come into effect or how much it will bring in. That's simply not enough. It's Germany against Europe and the world. That may sound polemical, but unfortunately it's reality."

Addressing Berlin lawmakers on the eve of the Brussels summit, she not only made her famous statement rejecting eurobonds "as long as she lives," but also asserted again that the euro rescue funds will only lend to governments and not directly to banks that need recapitalization.

Returning from Brussels after she was blackmailed into opening the door to using the euro rescue funds for a €100 billion Spanish bank recapitalization program, supervised under EFSF/ESM guidelines and an EU surveillance union, observers saw it as a stunning—for some an unbelievable—reversal of a long-held German position. "In agreeing to help bail out Spanish banks and enter into a virtual banking union, albeit with strings attached, Angela Merkel lost an important battle," writes Hans-Olaf Henkel, a former president of the Federation of German Industries (BDI), in the *Financial Times.* "The more Germans see her being tough with politicians from the south, the less they realize that it is they who are to pay for her euromantic policies."

A European banking union—part of which would be a common deposit insurance scheme with collective backing by all countries—is already raising the specter of a new lever for transferring the hard-earned savings deposits of German bank clients to make up for huge bank losses in Spain and other Club Med countries. A centralized bank resolution agency with common financing, designed to help more efficient bank

Italy's Prime Minister
Mario Monti

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restructuring without threatening sovereign balance sheets, is also perceived as part of a new dimension of intra-eurozone redistribution of private wealth—in particular in favor of those Club Med member states in which tax evasion and transferring private wealth abroad is the rule.

This defeat at the Brussels negotiating table in the waning hours of the first summit night was somewhat mitigated. In order to establish new controls and surveillance for direct bank lending of the euro rescue funds, Berlin agreed to give the European Central Bank a mandate as the lead bank supervisor in the eurozone *en route* to a wider European banking union. All these were reversals of long-held German positions.

Agreeing to the establishment of a single authority, with a single set of rules for the region's banks, is seen by Merkel and Schäuble as an essential condition before they will consider sharing resources with other eurozone countries. The outline they brought back to Berlin would create an overarching bank supervisor for the seventeen-nation currency bloc, instituting a new agency reporting to the European Central Bank to police the largest banks in the currency union.

After Merkel's Waterloo at the Brussels summit, Germany's capability to defend the vital national interests of its eighty million citizens and generations to come is in doubt. In the words of *Spiegel Online:* "German dominance in doubt after summit defeat. Chancellor Merkel suffered a bruising defeat at last week's summit after the leaders of Italy, Spain, and France ganged up on her. Europe's power relations have shifted as a result. It looks like Germany will no longer be calling the shots in the EU."

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More and more Germans see the European Central Bank under former Italian central bank governor Draghi as being hijacked by Club Med interests to facilitate the transfer of wealth from German and other northern Eurozone countries into the debt-laden euro member states. When Draghi promised that "within our mandate, the ECB is willing to do whatever it takes to preserve the euro and, believe me, it will be enough," and when he added, "To the extent that the size of the sovereign premia hamper the functioning of the monetary policy transmission channels, they come within our mandate," this sounded the alarm for those in Germany who are fighting still more monetizing of government debt in the eurozone.

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The ECB's **Mario Draghi.**

WEF SWISS-IMAGE.CH/PHOTO BY MONIKA FLUECKIGER

At the G-20 summit in Los Cabos, Monti played foul, trying to break German resistance to further bailout loans in order to bring down the rising interest rates that core eurozone countries such as Italy and Spain are having to pay when rolling over government debt. To Merkel's surprise, Monti and U.S. President Barack Obama handed out a document that advocated direct purchases of sovereign debt by the euro bailout fund, without special conditions. French President François Hollande and Spanish Prime Minister Mariano Rajoy supported what turned out to be a totally unexpected Italian-American coup, putting the Germans in the defensive. But Merkel stood her ground.

A few days later, at the Brussels summit, Monti organized what some in the French press later called "a Versailles without going to war" with respect to Germany. With backing from France and Spain, "Super Mario" threatened to block the €120 billion ($150 billion) "Compact for Growth and Jobs," knowing that Merkel could not return to Berlin without the pact. In order to secure the needed two-thirds majority to ratify the ESM

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treaty in both houses of the German parliament and accept her "Fiscal Pact" for all eurozone member states, Merkel had assured the opposition SPD and Greens that she would get the EU leaders to sign off on the growth and jobs pact. Although Merkel succeeded—without her own ruling coalition majority—in getting the ESM treaty ratified by both houses, the turning of the Iron Lady of the euro will linger on. It already has fired up "angst and anger" among ordinary Germans fearing for their savings and old age pensions and seeing inflation rising in the future for them and their children.

A TROJAN HORSE CALLED ECB

When, from her summer retreat, German Chancellor Merkel lines up by telephone colleagues such as French President Hollande or Italy's Monti to support ECB President Mario Draghi's earlier commitment "to do everything necessary to secure the euro," domestically this is received by a deeply unsettled German electorate.

Is the German coalition government under Merkel—waiting for the constitutional court decision on the legality of the ESM treaty and coming under increasing pressure from all sides—again shifting fiscal responsibility for saving and stabilizing the euro to the printing presses of the European Central Bank?

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For the first time Draghi attempted to offer a justification for ECB intervention to bring down borrowing costs in the eurozone. But it is unknown whether the Berlin government actually welcomes this ECB move since it could bridge the difficult waiting period until Karlsruhe (Germany's Constitutional Court) decides on the European Stability Mechanism on September 12, 2012. Again, the biggest hurdle for Draghi's new rescue moves may be the Bundesbank, which reiterated its opposition to ECB bond buying, saying it blurs the line between monetary and fiscal policy. There, the jubilation from Brussels, Rome, and Paris over the way German influence in the European Central Bank has been marginalized on key issues such as bond buying, lowering collateral requirements, and supplying the national central banks of debt-laden member countries with adequate liquidity is felt as adding insult to injury.

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Writing in *Die Welt,* economic correspondent Jörg Eigendorf argued that "The ECB thus emerges as a Trojan horse. It no longer stands for stability and the adherence to principles, but for a Europe in which the South has the final say. The result will be a gigantic redistribution at the expense of the North—without any of the underlying problems being solved."

GERMAN ECONOMISTS AGAINST BANKING UNION

Rarely has an open letter by economists in Germany caused such a virulent debate and even open and undercover retaliation from government officials as the "open letter" of 172 economists published first on the web site of *Frankfurter Allgemeine Zeitung*. In their "Aufruf gegen die Vergemeinschaftung der Bankenschulden [appeal against the pooling of bank debt]," the economists reacted to the EU summit decisions and warned that the planned European banking union would lead to a "socialization of debt" should funds from the European Stability Mechanism be used to directly bail out euro area banks with less stringent conditions as intended. If debt-laden euro area countries are able to let failing banks be recapitalized by the collectively financed EFSF or ESM without the respective government having to give any guarantee, this would reduce the pressures for economic and structural reforms that are the causes of most of the banking and sovereign debt problems.

Banks must be allowed to fail, say the economists, who point out that deposits of banks in euro area crisis countries—part of bank liabilities—amount to €3.6 billion. They also draw attention to the fact that the coming permanent European Stability Mechanism's maximum lending volume—presently €500 billion—can be raised by the ESM according to changing circumstances. What might have especially provoked the politicians' anger was that

the protesting economists drew attention to the "structural majority" in the euro area making implicit transfer decisions at the expense of future German generations.

One of the initiators was Hans-Werner Sinn, president of the influential Ifo Institute for Economic Research, and he became the target of much of the ire of colleagues and politicians. Some of the university professors signing the protest letter, the economic and financial daily *Handelsblatt* reported, received calls from Berlin politicians and highly placed officials with threats that their signature might have negative consequences. As no other German economists have put forward as many facts and figures on the euro crisis, Sinn and the Ifo have raised feathers. As Sinn argued in his "Sohmen Lecture" (in honor of economist Egon Sohmen) in April: "If the U.S. system were transplanted on Europe, the Bundesbank would be entitled to demand about €700 billion in marketable securities from other national central banks of the Eurosystem."

As was to be expected, several groupings of German economists retorted with "open letters" of their own, calling the "Aufruf" supporters wrong and irresponsible. Most sided with the official Berlin euro rescue line. Some joined the opposition Social Democrats and Greens in calling for a European Redemption Fund, first proposed by the German Council of Economic Experts last November, also hotly debated among German economists.

The basic concept of the European Redemption Fund is to pool the present debt overhang exceeding 60 percent of GDP. The fund would be backed by a joint guarantee of its members, by a partial collateralization of up to 20 percent of the transferred debt, and by earmarking specific government revenue directly for ERF debt service (debt amortization and interest payments). The fund probably could accrue a size of around €2.5 trillion over a period of several years, as Morgan Stanley estimates, compared to a total volume of triple-A sovereign assets of €2.8 trillion in the eurozone at the moment.

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WHERE DO WE GO FROM HERE?

From a German perspective, recent developments—above all Merkel's bruising defeat in Brussels—have increased uncertainties. However, there is the expectation that Germany's Constitutional Court in Karlsruhe will accept the ESM treaty with only minor additional legal safeguards that would have to be annexed to the ratified treaty before the German president signs it. Moody's recent rating decision putting the German sovereign and some German states on negative outlook is a reminder that Germany's triple-A credit rating is threatened by ever-larger euro rescue commitments and a weaker economic environment.

To get a view from the outside of the present state of the eurozone, one can turn to the new IMF staff report for the Article IV consultation on "Euro Area Policies."

The euro area crisis, says the report, "has reached a new and critical stage. Despite major policy actions, financial markets in parts of the region remain under acute stress, raising questions about the viability of the monetary union itself. The adverse links between sovereigns, banks, and the real economy are stronger than ever. As a consequence, financial markets are increasingly fragmenting along national borders, demand is weakening, inflation pressures are subsiding, and unemployment is increasing. A further intensification of the crisis would have a substantial impact on neighboring European countries and the rest of the world."

But what about possible future European scenarios? In May, Morgan Stanley's seasoned researchers Joachim Fels and Elga Barsch came out with an analysis of "Euro area scenarios: The Good, the Bad and the Ugly." They believe their four scenarios can be classed as a good one, an ugly one, and two intermediate ones (bad to some degree but not ugly).

"European Renaissance" is the good scenario. It assumes that eventually there will be significant progress on both crucial fronts: economic rebalancing and fiscal federalism. "European Divorce" is the ugly scenario. It assumes that economic divergence increases and that euro area politics become more fragmented. The ugly consequence would be a break-up of the euro.

"Italian Marriage" is one of the two possible intermediate scenarios. Here, the countries move to a fiscal and political union of sorts, but the economic divergences and imbalances remain or deepen. This is the history of Italy since it became a national state 150 years ago, combining a strong northern with a weak southern economy.

"Staggering on" seems to be the most likely scenario in the next couple of years. Here, governments fail to move towards fiscal integration but the euro area staggers on—with help of the European Central Bank—as economic reforms and fiscal belt-tightening ultimately pay off and the euro area economy rebalances.

Morgan Stanley's eurozone experts have some encouraging final words. "As financial markets will continue to challenge sovereigns in the absence of an 'end-game solution,' we believe that staying on course will require a lot of heavy lifting from governments, both in the periphery and the core, who will need to push on with balancing their books, reducing the debt overhang, and implementing supply-side reforms. In addition, governments will also likely need the help of the European Central Bank—to keep monetary policy loose, to provide funding to the banking system, and to intervene in the bond market in times of crisis."

How any such scenario plays out remains to be seen. The analysis of political economists such as Ulrich van Suntum may help to answer a key question: Who are the winners and losers of all the euro rescue billions? For van Suntum, who teaches at the University of Münster, the debt-laden countries in the euro area, the banks, and other parts of finance sectors around the world, along with some major international institutions, can be considered winners of the euro rescue operations that are largely paid for by the taxpayers and pensioners in the northern parts of the eurozone. Those taxpayers and pensioners are the main losers.

As the latest opinion polls show, 84 percent of Germans expect a worsening of the euro crisis and fear future wealth losses due to the eurozone turbulence. At the top of their worry list sits Greece, where the pollsters—Infratest dimap—found that 65 percent of Germans think that Greece should leave the euro. While Merkel is being attacked from all sides, especially among eurozone residents, Germans are lining up to support their leader. More than two-thirds of Germans polled back her handling of the crisis, and she continues to top the personal ranking of politicians with a score of 68 percent, followed closely by Wolfgang Schäuble, her finance minister, with 64 percent. ◆