Marcello de Cecco
Presented at the INET Conference @ King's College, April 8-11, 2010

The crisis of the export led model in the EMU countries and its monetary and financial consequences on European integration

Considerable agreement exists in Continental Europe on the fact that it was the US authorities' thoughtless financial liberalization policy over the last two decades at least, and therefore bipartisan**,** to have brought about the subprime disaster and, furthermore, that it was the US authorities' decision to sink Lehman to start the chain reaction that brought the international financial system to paralysis from Sept.15th, 2008 to the spring of 2009. Why did they do it? Some Europeans suggested at the time that they did it to scare Congress into agreeing to TARP. Others have argued they did it because domestic political support for additional bailouts had vanished with the takeover of Fannie Mae and Freddie Mac.Whatever the motivations, the fact is that the Lehman bankruptcy precipitated the international financial system into a gigantic repeat of the Herstatt counterparty risk crisis. Banks started moving money into central banks deposits, while they took it away from the markets. The reason is that central banks do not fail.

This drying up of money in international short term markets transmitted the financial crisis to the real economy, via the dislocation of world export and import activity. Foreign trade needs short term finance to operate, and letters of credit and of comfort – for instance- for several months just were not to be had, Exports are vitally important to the GDP of countries like Germany, Italy and Japan, or to the regional GDP of countries like China (the whole southern provinces which export to developed countries experienced a huge fall in activity and employment).

Mexico is another country, hugely influenced by the US crisis in its sectors and provinces producing for the US market. Eastern Europe, as well as Northern Italy, felt the fall in German exports, for which they produce parts and components.
For a country like Italy, which has a banking system that is only lightly in high value added activities like most of those performed by investment banks, and whose financial institutions had not bought many CDOs or other innovative instruments of that sort, the crisis therefore arrived when their industrial customers were hit by the export stoppage.

After charging the US with responsibility for starting the crisis, Europeans do not proceed to

analyse with equal severity their own mistakes which were, in the same period, just as numerous and serious as those of the Americans, although rather different in kind.

What is worse, Europeans do not seem to have changed their ways because of the crisis any more than Americans have. Several of their policy reactions to the crisis show it rather clearly.

In what follows, I will concentrate on the European mistakes in policy making and institution building in the financial field, especially at EU and EMU level .

A necessary starting point in this analysis must be a reflection on the central bank Europeans built and placed at the center of their Monetary Union.
The ECB is the only case in history of a central bak deprived by its charter of all monetary sovereignty. Historically minded people recall that according to the Statute dictated by Napoleon's experts for the Banque de France, the new institution could not buy public bonds from the government. This in contrast with what the Bank of England could do and did exactly because of its charter. Perhaps the French experience with the Assignat motivated this complete "divorce" between Treasury and Central Bank. But, as Henry Thornton was quick to notice, this just meant that the Government sold the debt to

syndicates of bankers, which resold it to the Banque de France. Form sometimes, however, is sometimes as important as substance.

As in the case of the original statute of the Napoleonic Banque de France,
the ECB Statute prevents it from buying European public bonds in the primary market. It also places it completely outside the control of politicians. The rationale of this prohibition is very eloquently expressed by the Bundesverfassunggericht in a famous ruling rendered in 1993. Asked whether the ratification by the German Parliament of the Maastricht Treaty constituted a diminution of the principle of democracy which is at the basis of the Deutsche Grundgesetz**,** the German constitutional Court ruled that this had actually happened because the second added paragraph of art. 88 of the Grundgesetz (which was added after Maastricht to make it consistent with the Treaty of European Union) " has excluded an essential political area, where the maintenance of the value of money supports individual liberty and where money supply determines public finances and the political areas which depend on them, from the regulatory power of sovereign authorities and, barring amendements to the Treaties, from parliamentary control of areas of responsibility and means of action". "If monetary policy decisions," states the Court, "are placed in the hands of independent

central banks on a basis of complete autonomy, the use of the sovereign powers of the state is taken away from the direct responsibility of the national or of the supernational Parliament, with the aim of taking monetary matters away from the influence of interest groups and of those who wield political power and may be worried about their own re-election".

This was the philosophy which presided over the creation of the European central bank. It is the same philosophy according to which the State is a predatory institution, made up of people interested about their own re-election above everything else. Its influence must be therefore exorcised even if this means disposing of the principle of democracy, which is the Grundbegriff of many constitutions, including the German.

German constitutional judges obvioulsy believe in the Pareto-Mosca theory of the political class, if they justify the sacrifice of the principle of liberty. They represent very well the opinions of the founding fathers of the ECB, the European technocrats who thought Central bank autonomy ought to become a constitutional principle, and the ECB a constitutionally relevant institution.
This had been the Bundesbank's dream since its inception, but as long as it remained the central bank of the Federal republic it was not achieved

because the Bundebank was established by ordinary law, not by a constitutional one. Buba thus pushed to realise its dream when the ECB was founded, and it succeeded.

Hence, the ECB sole preoccupation with price stability, which prevented it from directly addressing the problems the European financial system experienced especially after the piercing of the US subprime bubble and the Lehman bankruptcy.

Since price stability was, however, not threatened, quite the opposite being the worry in 2008 and 2009, the ECB was able to use its extremely modern network of links with large European banks to give them short term support much more promptly and effectively than the Fed could, and without any need for special legislation or for actions on the Fed's part that, according to Paul Volcker, bordered on plain illegality especially since the Fed gave it dollars via swaps.

Any other form of support, however, to financial institutions based in European jurisdictions, had to come from national authorities, as Maastricht rules stood in the way of the ECB acting as lender of last resort, a function which is glaringly missing from its Statute.

Much to the surprise of most observers, including the present writer, among the large countries of Continental Europe, the one where there was the highest concentration of banks in need of help turned out to be Germany. Germany, whose housing market had been dormant since the early nineties (after the end of the reunification boom) managed to exhibit several large Hypobanks in need of urgent and very expensive rescue. This was the real surprise, because they had used their resources to play the US mortgage market, obviously not knowing what they were playng with, and lost massively in doing so.

As to the other category in need of rescue, the Landesbanken, they had got into trouble because of the interplay of diverse European Union institutions, especially the Competition Directorate of the Commission: egged on by German private banks (Deutsche being prominent among them) the erstwhile Commissioner for competition, professor Mario Monti, had instituted a case against the Landesbanken, which were accused of unfair competition because they used the German government guarantee to borrow at very low rates and then used the very large proceeds of their issuing in the international bond market to undercut the private banks in some of their most lucrative businesses.

Monti's ruling was that the Landesbanken had to lose the government guarantee, but it was a compromise ruling in that it allowed them to maintain the government guarantee for five years. The result was that the Landesbanken tried to borrow as much as they could while they still enjoyed their privilege, and then invested the very large proceeds in assets which they had very scant expertise of. When crisis broke out, they found themselves holding very inferior paper, often repackaged subprime US mortgages.

After the Lehman bankruptcy, therefore, the German government was surprised to learn that it had on its hands a problem equivalent to the one the UK government had to face, though it had prematurely boasted about Continental financial systems, and chiefly the German, being altogether bank centered and therefore much less fragile than the market based anglo-saxon ones. The German government had started by being extremely scathing about the possibility of joint European action to rescue the EMU financial institutions, as they had thought that German money would be sought to rescue other countries' banks. When they learned about their own banks' disgrace, they had to act unilaterally, because by that time other large countries like France Italy and Spain had already put their financial houses in order. France had some institutions which had participated in the US

financial euphoria, but the French government acted promptly and effectively and so managed to put the worst hit banks on sounder footings before other governments even began to act. Spanish large banks were less involved, because of their focus on Latin America, which was partly spared by crisis because of the continuing export boom fuelled by Asian (especially Chinese) demand for raw materials and agricultural products. The Spanish central bank, moreover, had very early on enforced on its banks a rule of pro-cyclical reserve accumulation, which proved very effective in sheltering them from the storm. There remained the savings banks hit by the crash of the Spanish building boom, but they were out of the control of the central bank and there the Spanish government intervened directly.

Italian banks got into some trouble only as far as some of them had expanded in Central and Eastern Europe, but most of them had kept clear of complex financial instruments and could rely on the financial soundness of Italian firms and families (though they would bear the consequences of the crisis when it hit the real economy).

Even in the present Greek predicament, the German authorities seem to be playing the same part and making the same mistakes they made with their banks. They began by deprecating Greek

deviousness and data fabrication, and by making extremely bellicose statements about the need that culprits be punished in an exemplary way, and that every creditor country had to look after its own problems with the Greek, as Germans could not be expected to pay for other lenders' mistakes.
They then discovered that German banks
had a combined $43 billion outstanding with Greek borrowers, behind only French and Swiss lenders with $75 billion and $64 billion, respectively (BIS data).

Greece owed $302 billion to all foreign lenders, half the debt Wall Street investment bank Lehman Brothers had when it collapsed. Of all the listed banks in Germany, Commerzbank had, according to press information, the biggest exposure to Greece**.**

The German disconcert at this discovery was evident and it put them in the hands of purveyors of easy solutions, like the now famous version of the European Monetary Fund, to be created with the money of the most indebted countries in Europe. That, of course, means Italy, which has now a public debt/GDP ratio of over 115%. The others being small countries like Belgium and Greece itself. But Italian banks have a trifling amount of Greek debt on their books, so this plan concocted by the chief economist of Deutsche Bank, Thomas

Mayer and CEPS economist Daniel Gros and directly presented by Josef Ackerman to his great friend Angela Merkel, has been glacially received by Giulio Tremonti, the Italian finance minister, whose full time occupation is to convince the international markets that Italy's financial position is much sounder than that of the other PIGS (earlier called Le Club de la Mediterranee, but now Ireland is one of them, hence the new acronym).

In the Greek saga, the German government's behaviour appears, at least superficially, as disconnected and verging on the absurd, with very pompous statements of severity being followed by embarassed 180 degree turns. In the EMF proposal, both Schäuble and Merkel made very fiery pronuncements about the need to amend the European treaties to include an explicit possibility that a country be expelled from the EMU for bad financial behaviour, but they had to retract them and openly contemplate the possbility of including the IMF in a syndicate of lenders to Greece, after Papandreou showed every intention of going directly to the IMF and seeking the US government's help, as a country that hosts an important US military base, strategic for the US Middle East strategy.

A solution for Greece, with the participation of the IMF, seems finally to have been found by the

countries of the EMU . We shall now see how it unfolds in practice. The central point seems to be that markets are asking a very high interest rate to lend to Greece, and the Greek government thinks that it will not have the means to service such a high yielding debt. Hence their request that an off-market solution be found. Which is exactly what seems to have been agreed on, if the agreement sticks.

If the solution to the Greek debt problem sticks, markets might welcome it, the Euro might go up again and the Italian election results may not worsen the financial climate in Europe. A temporary respite will be achieved. However, the fact remains that the Greek episode has only confirmed that the absence of a European coordinating authority for financial matters becomes painfully felt on occasions such as the Greek debt crisis. The open and vocal dissent from the solution which Governor Trichet expressed confirms the present EMU disarray and the general state of confusion in the EU.

This brings us back to the philosophy which inspired the coming into life of the ECB and the Stability and Growth Pact. The Zeitgeist prevailing in Europe in the 1990s, when they were created, was that of “reinforced” monetarism, which was thought to be not only the “natural” theory on

which to base the conduct of the ECB monetary policy, but also a very useful theoretical underpinning for a central bank that had to be kept completely separate from government finance, so that German citizens, who had to sacrifice their very successful currency, would agree to replace it with the Euro, once they were reassured that the ECB could never be used to pay for the public finance debaucheries of Mediterranean spendthrifts.

In the intervening decade, a common fiscal policy ought to have been added to the common monetary policy, but no innovative fiscal instrument or procedure was found for the EMU. This meant that individual countries' public debts could have no monetary backing whatsoever and that a possibly large spread between their yields could arise. This spread remained very low as long as Greenspan's monetary largesse lasted. Bernanke's reiteration of his predecessor's money supply excesses, forced by the crisis of US finance, helped it stay low.
As soon as Bernanke started making utterances about the imminence of an exit from the super expansionary phase of US monetary policy, the spread between the EMU countries' public debt yields started widening and the Greek crisis broke out, especially when it became probable that the ECB would trail the Fed in the exit strategy.

An act of God, like a double dip in the US cycle, would compel Bernanke and Geithner to reverse course and help the spread between European public debt yields to close again.

If this happens , however, it will be a further confirmation of the accusation which people like this writer have levelled at the European integration process for at least a couple of decades (my first article on the subject dates back to 1980) : that it is an integration area centered around a country like Germany, whose economic structure was rebuilt after the second world war to achieve a perpetually positive trade balance, through an export led growth fuelled by oversize exporting sectors, like mechanical and electrical engineering, machine tools, automobiles, chemicals. This means that the area cannot generate a level of aggregate demand sufficient to achieve full employment but depends of the demand generating policies of exogenous countries like the US or, now, China.

It also means that, since the inception of the EMU, all other members of the Union have lost the ability to reduce productivity deficits vis a vis Germany by devaluation. Germany, because of a very determined policy to maintain a large flow of funds destined to increase fixed investment in plant and machinery and research, and to relocate large chunks of labour intensive productive phases to

Mitteleuropa countries, thus creating high unemployment in Germany, has managed to keep productivity growth much higher than that its partners have been capable to extract from their economies. Its fast ageing population has kept total consumption low. Imports from Asian countries, especially China, have also contributed to maintaining consumer goods prices low. As a result, for the last decade, Germany constantly generated a very large surplus (almost 60% of her total export surplus) on her trade with the rest of the EMU, which accounts for 38% of its total trade. As reference, it is useful to remember that German trade with the whole EU (27) accounts for 75% of its total trade and almost 90% of its total surplus. Germany is now the workshop of Europe, having recreated what in the years before the first world war used to be called Mitteleuropa, a production complex based on extensive sub-contracting to central European producers (but also French, Belgian, Dutch, and Northern Italian suppliers) of parts and components that are finally assembled into German made products and sold all over Europe and the world.

German GDP is now composed of exports for no less than 48% in 2008 and 40% in 2009. And most of them, as I said above, go to other European countries. This makes German industry very

powerful in Europe but also potentially exposed to retaliation by disgruntled importers.

A return to protectionism has never so far been seriously contemplated in Europe, but it may be forced by a persistence and even by the intensification of what Europeans now openly call German mercantilism.

This danger can be exorcised only by a decrease of the German trade surplus with other European countries. Is this to be brought about by increasing other European countries' productivity or by slowing down German productivity?

Unfortunately, the rate of productivity growth is the result of the whole political economy of a country, and it is therefore not amenable to easy manipulation by policy makers.

German advice is that other countries in the EMU and in the EU change their ways and manage to speed up productivity and exports. The rest of Europe, in particular large countries, reply that the European public infrastructure , including that of Germany, is rapidly becoming obsolete because of the excessive reduction in public expenditure enforced in the last decade to face the deterioration of public accounts. A coordinated effort to achieve a revamping of "virtuous" public expenditure by

increasing funds going to education, infrastructure modernization, large European public works projects, would probably do the trick. Something, in other words, not like TARP, which has filled the pockets of financial firms, but like the Chinese stimulus, which has mainly gone into the real economy, ought to be agreed upon and tried in Europe, to stem the already abundant signs of decline that appear all all over our continent.

The floating of Euro-public debt, perhaps by the European Investment Bank, has been indicated as a means to finance these projects. Needless to say, this is anathema to the German government and to a German public which has been inundated of rather ugly anti-European messages by the German media. It is often said that all this is going to subside once the important regional elections in Rhineland Westfalia are out of the way. But they are in May and this gives us another two months of heated campaigning, with the Christian Democrats having to fend off the uninhibited attacks of their ally, Guido Westerwelle, who comes out rather badly in recent polls and tries to convince the electors that, had it not been for Greece and other spendthrifts like her, his electoral promise to reduce taxes would have already been kept.

In a Community like the European, with twenty seven equally sovereign states in it, or like the

EMU, with sixteen states, there are bound to be elections somewhere all the time. We have the US example in front of us and we know what that means for policy making even in one country with one flag and (so far at least) one language.