BROWN BROTHERS HARRIMAN

DECEMBER 4, 2011

SPECIAL FX

www.bbh.com/fx

The March to Folly: Underestimating Germany and the ECB

The House of Finance is accustomed to a cacophony of opinions and voices. Rarely out of the free market place of ideas has such a strong consensus emerged: **Germany and the ECB must capitulate.**

The ECB must act as a backstop and support the bond markets ofthe heavily indebted euro zone members. Germany must relent and permit the issuance of Eurobonds, jointly backed by European countries. At the end of the week European heads of state will be meeting in the 5th summit since the middle of last year billed to offer a comprehensive solution. **If the summit does not resolve to execute these actions, many think the euro zone will not survive.**

The consensus risks underestimating Germany and the ECB. The consensus is well-versed in economics and a few Nobel-winning economists have added their intellectual weight to the arguments. However, what is ultimately at stake here is not economics, but politics.

European monetary union was an economic solution to the eminently political problem posed by the unification of Germany. **What is required now is a political solution to the economic problem posed by debt crisis.**

II

The original architects of the European integration, like Jean Monnet, understood that the political will and institutional capability can only be built between sovereign European nations through crisis. Merkel understands this. She and the ECB are interested in the long game. The consensus, which in Europe includes many French officials, is playing for 2012 or 2013 growth.

Yet to appreciate the political dimension of the issue requires the consensus to think about Germany differently. Since the end of WWII, partly self-induced and partly demanded by others, Germany did not project the kind of political power than emanated from its economic prowess. **At the risk of over-simplifying, the House of Europe was built in many ways by French architects and German money.**

This may have also been a product of the Cold War, but whatever the conditions were, may no longer be as strong. The widely quoted statement of the Polish foreign minister expressing more concern over German inaction rather than action captures the moment.

The financial crisis exposes Germany's superior position in an undeniable and unequivocal way. But the consensus does not want Germany to pursue and project its self-interest as other countries. They want Germany's balance sheet and credit, but do not see the need to make concessions to it.

While the consensus has focused on the debt crisis, they have hardly noticed a political crisis within Germany**. Part of Germany appears to be throwing off the post-war guilt and wants to assert its political interests.** Another part does not seem ready yet.

Although Merkel is clearly in the former camp, and in this way is the first post-modern German Chancellor, the ascendancy is not complete as its refusal to participate in the NATO activity over Libya reflects**.** **Merkel wants Germany to be allowed to act like any other nation-state, but the consensus prefers a more subservient Germany.**

The consensus does not seem to accept that Germany has national interests. Instead it attributes Germany's position to idiosyncratic characteristics, such as "Merkel's fetish for stability" or her "arrogance" and "myopia".

The consensus does not realize that their arguments favor the national interest of other countries, the heavily indebted periphery, but also France, who is clearly less equipped to cope with the crisis than Germany. Indeed, the gap that has opened between Germany and France is causing a bit of political anxiety in France and also remains a key fissure within Europe.

III

Monetary union was born incomplete. The resolution of the crisis requires addressing the birth defect. The consensus wants the European Central Bank to backstop the sovereigns in the euro zone through unlimited non-sterilized bond purchases.

The quantitative easing by the central banks in the US, Japan, Switzerland, and the UK were not aimed at backstopping their sovereigns, but had other economic macro objectives. **No other major central bank has been asked to do what the consensus wants the ECB to do.**

Often the consensus asserts that the ECB needs to backstop sovereign bonds, but rarely does it address Germany and ECB's opposition (and it is not just Germany and the ECB, but several other countries side seem to agree). Their arguments are essentially three-fold. First, **the ECB is constrained by law.** Two Germans have already resigned in protest to the limited and sterilized purchases the ECB intended (Weber) and expanded (Stark).

Second, **unlimited sovereign bond purchases undermine the ECB's independence.** This is important. The ECB is a relatively new institution. The way it relates to other institutions has not been fully established. Repeatedly during the crisis, former ECB President Trichet capitulated to the political pressure (e.g. collateral rules, bond purchases, role of the IMF, etc).

In the US, it took the better part of half a century for the Treasury Dept and the Federal Reserve to work out their division of labor. The ECB has existed less than a quarter of the time. Perhaps a more appropriate historical parallel is the US Supreme Court. Constitutionally it was the weakest branch, but in Marbury vs Madison, it secured its independence and ability to review the actions of the other branches.

Third, **unlimited bond buying by the ECB blurs the distinction between monetary and fiscal policy.** In effect it would allow countries to run large deficits and not provide incentives for corrective action. Do not some in the consensus argue that one of the reasons that Japan has been able to live with 200% debt to GDP and has not been forced to restructure is that its interest rates are so low?

The higher market interest rates have forced countries to adopt long resisted reforms. The consensus cries uncle and says enough, but until countries are on a sustainable path, that point has arguably not been reached.

IV

The moral hazard arguments also are a source of objection to European bonds. The consensus sees European bonds as a solution to the financing difficulty several European countries are having and more may have next year. They risk putting the cart before the horse.

In the late 1980s, Germany was asked to share its uber-mark and Bundesbank reputation with the rest of Europe as the condition for unification. Now **Europe wants Germany to share is balance sheet and credit to an unprecedented extent. Germany appears willing, but with conditions.** The consensus does not respect the conditions and insist that Germany go forward first.

What Germany is asking its partners for does not appear materially different than what a prudent business person would do. Before making a substantial investment one conducts due diligence and makes certain agreements on how that money should be used and repayment terms. Germany is being asked for a fairly open ended commitment, it is only realpolitik to seek action that will minimize its risk.

This includes a constitutionally enshrined principle of prudent fiscal policy. It is the establishment of an independent agency to forecast and monitor budget issues. It requires pre-approval for deficits that are in excess. It requires that there is surveillance of the implementation. There needs to be some mechanism for redress if commitments are violated.

Who would ask for less with their own money? **Is it really reasonable to ask Germany (and several other countries) to write in essence a blank check with no questions or conditions? The consensus seems to reject the entire issue of pre-conditions.**

Some pundits argue that Germany is the main driver here and is using the crisis as an excuse to tighten its regional hegemony in Europe. The real push seems to be coming from the debtors for action and Germany and other creditors are stating their terms.

The consensus misunderstands Germany and risks underestimating its resolve. **It is not clear how the consensus imagines the unsustainable debt and lack of competitiveness throughout much of the euro zone will be addressed if Germany and the ECB capitulate to their demand for a backstop and Eurobond, which they argue is long overdue.**

V

There is no disagreement with the consensus claim that the regime of austerity that Germany is insisting upon (and that voters most recently in Spain gave overwhelming support for) condemns Europe to a cruel and severe adjustment that will be measured in years.

This was the case in Germany as it adjusted to the leveraged takeover of the east. It may be similar but more powerful than the substantial measures taken to prepare for monetary union in the 1990s. Italy, for example, barely grew. It confiscated 0.6% of savings deposits and reduced its budget deficit.

For the consensus this is simply not acceptable. They seem to think that the consequences of tight fiscal and monetary policy alone should be sufficient to convince Merkel, the ECB and others to capitulate.

The neo-liberalism of the consensus seems too ready to judge others by its ideological values. **There is no one true capitalism that countries "naturally" evolve into.** Germany (and Sweden and Switzerland) exports roughly the same percentage of GDP that China does in their modern evolved state.

Germany and several other countries in northern Europe embrace not neo-liberalism but what is often referred to as ordo-liberalism. It is the ideological basis for the social market. It combines markets with strong government. It embraces a robust regulatory regime as necessary for the functioning of markets. It is predicated on sound money.
It stands in opposition to neo liberalism in its stimulative Keynesianism and laissez faire libertarianism forms. It is also an alternative to right or left wing socialism. **It is really a third way, if you will.**

Modern globalization as it has emerged in the 19th and 20th centuries has been a liberal project. Its main challenge has come from land-based Eurasian power seeking hegemony over what the British military strategist MacKinder called the World Island.

VI

The analysis presented here suggests the probability of a German-led fiscal union in Europe is greater than the consensus suspects given its arguments that only an ECB backstop and a European bond will prevent the end of the greater experiment. In addition, the argument is that such actions will not resolve the underlying problem of fiscal sustainability and restoring competitiveness.

Recognizing that Germany is pursuing its self-interests which is perfectly understandable under a rational actor and realist framework, **this argument warns that the consensus may be exaggerating the likelihood of German and ECB capitulation.**

At the same time, a dialectic woven through history of last few millenniums is the struggle between Athens and Sparta: a maritime, trade-oriented power against a land-based, more egalitarian power. Pax Americana and Pax Britannia before it were modern reiterations of Athens, which is associated with liberalism.

On the other hand, the ordo-liberalism does not seem sufficiently liberal. It may be the ideology of a modern Sparta. In the terms of the long-strategy, it reveals what is at risk**. The German-led fiscal union, for which the odds, it is argued here, are greater than the consensus believes, and the rise of a non-liberal China, may offer an alternative and challenge to the liberal world order.**

Marc Chandler

BBH Global Currency Strategy Team

Marc Chandler | Global Head of Currency Strategy | 1.212.493.8800 | marc.chandler@bbh.com

G10 Currency Strategy

Mark McCormick | Currency Strategist | 1.212.493.8744 | mark.mccormick@bbh.com

Jonathan Wetreich | Currency Strategist | 1.212.493.8543 | jonathan.wetreich@bbh.com

Emerging Market Currency Strategy

Win Thin | Global Head of Emerging Market Currency Strategy | 1.212.493.8867 | win.thin@bbh.com

Ilan Solot | Currency Strategist | 44.20.7614.8747 | ilan.solot@bbh.com

Masashi Murata | Currency Strategist | 011.813.6361.6328 | masashi.murata@bbh.com

.