

European Central Bank faces threat to euro and unity



Tourists wait at the Piraeus Port, near Athens, where striking workers prevented hundreds of passengers from boarding ferries. (Petros Giannakouris/associated Press)

By Neil Irwin
Thursday, June 24, 2010

FRANKFURT, GERMANY -- For an entire generation of European leaders, the euro coins jangling in their pockets are more than just a currency. They are a powerful driver of political unity on a continent where people speak more than two dozen languages and spent much of the 20th century fighting each other.

Now, as the euro faces a challenge like none before, the question is whether it will last.

The debt crisis that began in Greece and menaces half a dozen other European nations has caused the euro to lose 15 percent of its value relative to the dollar since January. Some economists consider it obvious that the currency union will not survive in its present form, that one or more southern European nations will end up reverting to liras, pesetas and drachmas.

That leaves the future of European unity to be decided not merely by politicians in Paris, Berlin and other capitals, but in a glass skyscraper in this banking hub, by a French banker named Jean-Claude Trichet and his 1,600 employees. Less than a decade after cash machines across the continent started spitting out the same currency -- and less than a month after it laid the cornerstone for a new permanent headquarters -- the European Central Bank is facing extraordinary pressure to keep the euro, and Europe, together.

The bank has crossed into virgin territory in response to the crisis, buying billions of euros' worth of government bonds to try to stabilize markets. But those actions have unleashed new tensions at the heart of the ECB as its largest member, Germany, recoils from what it sees as a violation of the most deeply held principles of central banking.

The challenge

The ECB's challenge is to craft one policy that will work for in 16 member countries from Finland to Portugal, which have different economic conditions -- and views about inflation and employment.

Trichet testified Monday that a broad new strategy of cooperation -- perhaps involving stronger restrictions on government deficits and new means of helping troubled states -- is the key to Europe's economic future. He told the European Parliament that he envisions "the equivalent of a fiscal federation," which would "require a quantum leap in terms of progress" toward a stronger economic union.

In their effort to hold Europe together, Trichet and his colleagues have upended the traditional rules under which they operate, taking a page from the playbook that Chairman Ben S. Bernanke used at the U.S. Federal Reserve during the financial crisis. But these efforts have exposed new strains within the organization, complicating their efforts.

Early last month, the European debt crisis spiked and markets turned hard against Spain, Portugal, Italy and Ireland, significantly increasing their cost for financing government spending. One solution would be for the ECB to intervene in the market, buy some of those countries' bonds and thus force down the price of borrowing money.

But the ECB has no authority to buy government debt, a power that other central banks, such as the Federal Reserve and Bank of England, have. That restriction reflects deep German opposition to any policies that carry a risk of fueling inflation, borne of the hyperinflation in that country in the 1920s. The rules are meant to prevent the ECB, which is modeled after the German national bank, from essentially printing money to lend to national governments. German politicians and economists were aghast at the idea of compromising that core principle because of, in their view, the fiscal profligacy of a few euro member states.

As the situation grew dire, however, Trichet and his colleagues decided that the goal of European unity was more important.

The compromise: They would buy bonds on the open market, not directly from governments, getting around the prohibition on funding government debt. At the same time, they would take other steps to avoid increasing the money supply, thus easing any inflationary pressures.

Announced in conjunction with a \$1 trillion European Union program to backstop governments' debts, the actions worked to stop the free fall in debt markets, and European financial markets have been more stable since the announcement.

But speculation remained rampant, especially in Germany, that the program was a backdoor way to print money for free-spending Greek, Portuguese and Spanish governments. The blowback from Germany has been immense.

German blowback

Axel Weber, the head of the German national bank and a member of the ECB governing council, said in a newspaper interview that he sees the decision "in a critical way" because of the risks that it could undermine long-term economic stability.

After fighting back one threat to the euro, Trichet and his eventual successor now must deal with another: German frustration.

"Euro area governments have effectively thrown away the rulebook," said Volker Wieland, an economist at Goethe University Frankfurt and a leading ECB-watcher. "It's a complete regime change. No-bailouts and individual fiscal responsibility have been replaced with mutual guarantees" for government debt.

These tensions, in part, reflect decisions made by European leaders almost two decades ago. Instead of waiting to adopt the euro until European countries had grown more integrated with each other, making a currency zone easier to administer, the leaders decided to move ahead. They calculated that having a single currency would bring the countries closer together, leading to better collaboration on everything from the environment to defense policy.

This mission gives the ECB a political importance that is in some ways greater than that of its counterparts overseas, such as the Fed. The ECB is designed from the ground up to achieve that unity. The bank keeps minutes of policy meetings secret for 30 years, in contrast with the Fed, which releases minutes three weeks later. The ECB's aim is to allow policymakers to advocate what they think is best for the euro area as a whole, freeing them from public pressure to represent their nations' interests.

With Trichet's eight-year term expiring late next year, followers of the ECB see Weber as the most likely successor because he is the most powerful central banker in the largest eurozone country. Other European leaders might worry, though, whether he will be flexible enough to keep the euro together.

But even as the debt crisis has cast Europe's fissures into high relief, it has reminded European leaders of how much they stand to lose if these divisions are left unaddressed.

"The stakes are so high, I think the incentives are high to sort it out," said Michael Dicks, chief economist of Barclays Wealth. "That's the biggest silver lining. That's why you are seeing huge pressure to do what Europe has never done before, which is work together."