Gunfight at the ECB Corral

The question of who succeeds Jean-Claude Trichet.

BY KLAUS C. ENGELEN

Europe's eleven-year-old monetary union is still being tested by skeptical investors and markets. It was barely saved by a €750 ($955) billion rescue plan that European Union leaders put together in May of this year.

Although the immediate danger of Greece—or other eurozone member countries like Portugal or Spain—defaulting seems to have been averted, the pressure from markets to cut public deficits, stabilize banks, and reform economies remains. A look at the interest rates and insurance premia that financially weak eurozone countries have to pay on their new sovereign debt issues makes it clear that the crisis is not over. A year of major challenges for the sixteen-member eurozone is in store, with an uncertain outcome.

For Europe's central bankers and policymakers, one of those challenges is to rebuild confidence in the euro and its guardian, the European Central Bank.

Since the ECB joined the international rescue of Greece and other financially weak nations on Europe's southern periphery and announced that it would indefinitely accept those countries' debt as collateral regardless of credit rating, the ECB, its President Jean-Claude Trichet, and its governing council have been confronted with a credibility crisis.

"Trust in the ECB, as measured by the standard Eurobarometer (and other) surveys, has fallen to an unprecedented low—especially in the larger euro area countries," concludes a major empirical study by Daniel Gros and Felix Roth of the Centre for European Policy Studies. They found that up until the start of the recession in 2008, trust in the ECB was little affected by business cycle variables such as growth and inflation. This changed radically with the recession, with trust in the ECB becoming correlated quite closely with growth. For the first time, more euro area citizens tended to mistrust the ECB than trust it. Their findings imply that

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For the first time since giving up their trusted deutschemark, the German public has woken up to the rude fact that the Bundesbank was overruled, and thus Germany lost control over its monetary destiny.

"European citizens appear to hold the ECB responsible not only for price stability in the narrow sense in which the ECB has interpreted its mandate, but also for financial stability in a wider sense. In this latter respect the ECB did not succeed."

For the German public, increasing pressure from European politicians—in particular French President Nicolas Sarkozy—on the ECB to expand its crisis financing role for the financially weak southern eurozone periphery is raising the haunting specter of scrapping the "no bailout" clause of the Maastricht Treaties. This would change the European monetary union into a European transfer union, under which German taxpayers—in the form of a common liability union—would have to foot the bill if countries such as Greece go bankrupt through a combination of poor public finances, an overburdened state sector, and uncompetitive industries.

But look at the complete the picture. The fact that some capital market experts see the rescue of Greece and other southern eurozone countries essentially as a bailout operation for highly exposed French, German, and other eurozone banks and bond investors is largely ignored. In these creditor countries, banks and governments have a common interest in avoiding a debt rescheduling with sizable discounts on nonperforming government bonds.

In the previous issue of *TIE*, Howard Davies, former Chairman of Britain's Financial Services Authority and a former Deputy Governor of the Bank of England, drew attention to another disturbing development, the "unresolved questions about the structure of the [ECB] and how it makes its decision to buy Greek bonds directly." He warns that "some issues that Europe's decision makers have wanted to keep under the carpet have now been rudely exposed. The decision to buy Greek bonds directly was not unanimous. The world now knows that Axel Weber, the president of the Bundesbank, voted against it. His was one vote out of twenty-two, but he represents 27 percent of eurozone GDP, so he cannot be dismissed as an insignificant outlier. It was the first time that the president of the ECB has had to reveal that a decision was not unanimous."

Davies quotes Nout Wellink, the governor of the Dutch central bank, that "more disclosure would one day be needed as the ECB reaches maturity," and concludes: "Weber's dissenting voice on Greek bond purchases brings that day dramatically closer." But Davies goes much further in stating that "the voting structure of the ECB is flawed" since "there is a massive imbalance between the voting weight and the GDP weight of individual countries," giving "Germany the same weight as Malta" and making it theoretically possible that the "six Executive Board members plus France, Germany, and Italy, representing 65 percent of the eurozone GDP, could be outvoted by a coalition of small countries."

Former Bundesbank President Karl Otto Pöhl, an architect of European monetary union, draws the same lesson from the euro crisis as Davies—that the ECB governing council needs a new voting structure. "It cannot be that the central banks of Malta and Cyprus have the same vote as the Bundesbank," Pöhl told the German business magazine *Wirtschaftswoche*. "This dilutes decisions of the European Central Bank. Monetary union has become bigger than expected. Therefore the principle of one country, one vote, has become outdated," says Pöhl. "One should change the ECB statutes so that a weighted vote structure is introduced in the ECB governing council. This would help the ECB to cope with future crises with more credibility."

For the first time since giving up their trusted deutschemark, the German public has woken up to the rude fact that the Bundesbank—its guardian of monetary stability—was overruled, and thus Germany lost control over its monetary destiny.

With Germany's highest court, the Federal Constitutional Court, examining several complaints about whether the country's contribution to the Greek and euro bailouts is legal, the issue of Germany losing control over the stability of its currency might be an important factor.

For many Germans who believed that the European Central Bank was modeled after the Bundesbank, the ECB's policy shift towards full-blown monetization of member countries' public deficits as part of the eurozone rescue has severely eroded confidence both in the ECB and in the cohesion of European monetary union.

Therefore, from a German perspective, the coming ECB leadership battle is shaping up as a politically explosive fight to regain more control over the central bank to secure the tradition of stability remembered from the Bundesbank.

Why Merkel Politically Needs Weber

Will Axel Weber succeed Jean-Claude Trichet at the ECB? While the Bundesbank president faces headwinds in European capitals at the moment, his chances are still better than those of his competitor, Mario Draghi, who heads the Italian central bank.

Regarding Trichet's successor, it is in the interest of all eurozone members be sensitive to markets and investors. Germans are not the only ones concerned with euro stability. The international investment community is increasingly skeptical about the euro's viability. Some even predict the death of the euro and the collapse of monetary union. The question of who becomes the next ECB president is, therefore, not primarily a question of national interests nor of the conflict between Club North and Club Med. Neither is it an issue of Germany *vs.* France. Paris, too, has a decided interest in a stable currency—and the resulting low interest rates that make bearable the burden of public debt.

In a crisis, **Axel Weber** *is the candidate willing to fight for the stability of the euro, regardless of political pressure.*

Thus, the eurozone needs a central bank president who is prepared to fight for the stability of the euro in the political arena. This is more apparent in the German Weber than in the refined Italian diplomat Draghi, who barely comments on monetary issues and avoids conflict with politicians.

The Greek crisis has made Germans aware of how much crippling pressure Europe can place on German politics in a time of crisis. The Chancellor needs the political achievement of having pushed through Weber as the next head of the ECB.

—Klaus Engelen writing in Handelsblatt, *November 1, 2010*

Officially, there is no candidate yet to replace Trichet as ECB president when his term expires in October 2011. But for some time, the leading candidates to succeed Trichet, as rumored in official corridors, are Axel Weber, president of the German Bundesbank, and Mario Draghi, governor of Bank of Italy. Other members of the ECB governing council were also named as possible compromise choices.

Berlin's behind-the-scenes diplomatic offensive to secure the presidency of the European Central Bank came into the open in February of this year when eurozone member states had to decide on the replacement for ECB Vice President Lucas Papademos. (Although central bank governor when Greece joined the eurozone, Papademos claims to have had no knowledge of his country's pervasive cheating on public deficit and debt statistics when joining the euro.)

Since Berlin supported Portugal's central banker Vitor Constancio to replace Papademos against two other central bank candidates, Peter Praet from Belgium and Yves Mersch from Luxembourg, this was taken in eurozone capitals as a strategic Berlin ploy. It was seen as a move to use the replacement as an opportunity to strengthen southern European representation on the six-person ECB executive board. By giving the ECB vice presidency to a "Club Med" member country, this could possibly exclude Italy's Draghi from the presidency and clear the way to Weber's appointment. Berlin could argue that the southern eurozone member counties—based on the ECB's geographical balance—would be adequately represented.

Even before the Greek liquidity crisis escalated into an unprecedented solvency crisis for the whole eurozone, the ECB leadership battle had reached the German mass media.

On March 11, 2010, the German mass-circulation tabloid *Bild* opened the public succession race for ECB presidency in a disturbingly nationalistic tone. Pitting against each other the profiles of the two leading contenders, Weber and Draghi, the tabloid ran the provocative headline: "Fight over the Euro-Bank: Why this German must become chief and this Italian under no circumstances."

As the editors of *Bild* told its several million German readers, "At a time when the euro is shaky, the European Central Bank has to stand firm like a German oak—with someone like Axel Weber as president." This president "grew up with a hard currency—the deutschemark." And they argue: For a country like Germany where twice in a lifetime people lost everything to inflation, a strong central bank that secures stable money is at the core of national identity. And alluding to Germany's paymaster role in Greece's financial crisis, they required that "the new ECB chief has to come from the country that pays if things are going wrong."

The *Bild* editors bluntly attacked Draghi for having worked as investment banker for Goldman Sachs in London, the Wall Street firm that in 2001 helped Greece manipulate its sovereign debt level when the Athens government struggled to meet the eurozone entrance criteria.

They noted that Draghi had made clear that he had nothing to do with Goldman's dealings with the Greek government's efforts to reduce its sovereign debt statistics. But *Bild* also reminded its readers in a somewhat contemptuous manner that Italy's lira was "that currency with the endless number of zeros" before joining the euro. And alluding to Portugal's Constancio, *Bild* lamented: "Another country whose debt has brought it to the brink of collapse. Experts call such big euro debtors PIIGS, which stands for Portugal, Italy, Ireland, Greece, and Spain. How wonderfully trustworthy the ECB would be with two representatives from the worst debtor countries at the top."

What was omitted in the piece is that Draghi is playing a key role in reforming financial market regulation as chairman of the Financial Stability Board, the Basel-based international forum of bank supervisors, central bankers, and finance officials. At the outset of the financial crisis, the FSB was mandated by the G-20 leading industrial and emerging economies to coordinate the global effort to repair the financial regulatory framework on a global scale.

When European leaders had to put together a three-year €110 billion support package for Greece—soon followed by a much larger eurozone rescue program for other financially weak member countries—the coming ECB leadership battle moved closer to center stage.

On May 12, 2010, Germany's economic and financial daily *Handelsblatt* appeared with a front page showing a beaming Chancellor Angela Merkel with the Bundesbank's Axel Weber at her side under the headline, "Merkel's Man." The story was that the (German) government's consent to the euro rescue plan was accompanied by an informal side agreement with other key eurozone partners: Bundesbank head Weber would become ECB president. As *Handelsblatt* reported, a deal was struck with several eurozone governments, in particular France, that a monetary heavyweight such as Weber should succeed Jean-Claude Trichet. "The ECB has to get back to its role as protector of monetary stability," argued a member of the German delegation in Brussels. And he continued, "Several eurozone countries went along with Berlin's plea." The Brussels summit negotiating team included, apart from Chancellor Merkel, Thomas de Maizière (standing in for Finance Minister Wolfgang Schäuble, who was hospitalized) and Finance Deputy Secretary Jörg Asmussen. Such understandings, concedes *Handelsblatt,* are not legally binding and are informal in nature.

From the heat of the May crisis until now, both leading contenders for the top ECB post are sending diverging policy signals in line with their contrasting personalities, professional backgrounds, and presumed convictions.

Weber, considered a monetary "hawk" by his colleagues at the ECB governing council, was a highly regarded monetary economist and member of the German Council of Economic Experts before he was called in April 2004 by the government of Gerhard Schröder to preside over the Bundesbank. His predecessor, Ernst Welteke, left under a cloud of taking favors from the private sector. Weber was a professor at the University of Bonn, Johann Wolfgang Goethe University Frankfurt am Main, and the University of Cologne before he became a member of the German Council of Economic Experts in 2002. He was fortunate that some of his economics students moved into the top circles of government. (See *TIE*, Summer 2009, "War of the Worlds.")

Although an academic without major international government experience or private sector responsibilities, Weber turned out to be a quick learner of power politics, assuming a key role in the financial crisis. He became a close advisor to Merkel, since the Bundesbank shares bank supervision with the Federal Financial Supervisory Authority (BaFin). Although he had been working closely with Jochen Sanio, BaFin's veteran president, Weber came forward with stunning proposals to put BaFin under the Bundesbank supervision using the election victory of the conservative-liberal parties in the last federal elections. So far, this takeover move has bogged down in political infights among the governing parties.

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In the ECB governing council and in the world of central banking, Weber has been polishing his image as a sound monetary economist in the tradition of German stability. When it comes to fighting inflation, Weber is never afraid to speak his mind and express his strong convictions.

Draghi, who is considered a centrist in the ECB governing council, operates more like a diplomat. He would come to the ECB presidency from a cosmopolitan career that includes a doctorate from the Massachusetts Institute of Technology (with Nobel Laureates Franco Modigliani and Robert Solow as professors), a stint as economics professor at the University of Florence, high-level posts at the World Bank, the Italian Treasury Department, and Goldman Sachs, and most recently governorship of the Bank of Italy and chairmanship of the Financial Stability Board.

By promoting their respective candidacies, both Weber and Draghi—about a decade apart in age—are in a long-distance race and eager to secure more influence on the present and future role of the ECB.

By making public his dissent from the crucial ECB governing council's May decision to buy eurozone government bonds as an emergency measure to stabilize the bond market, Weber has shaken the perception of the ECB as a collegiate institution and signaled German dissatisfaction with being overruled on the core issue of monetary stability. Weber's public dissent riled governments and caused tensions with his colleagues on the ECB governing council that linger still and will overshadow the public succession debate well into

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next year. It has further damaged President Trichet, whose wavering on the issue was seen by some market actors as bowing to political pressures.

"Bundesbank President Axel Weber was right to express his opinion," says Thomas Mayer, Deutsche Bank's chief economist. And Marco Annunziata, UniCredit's chief economist, is highly critical, arguing that "this was a signal that the ECB is no longer speaking with one voice." But ECB watcher Jacques Cailloux of the Royal Bank of Scotland sees things very differently. "The ECB should be praised for its bold action, not vilified. What a difference a year makes. There was a time when central bank proactivity was praised. At that time, bond purchase programs were quite fashionable and seen as the panacea. The ECB decided otherwise and opted out on the basis that the deflationary risks in the euro area were less pronounced than in the United States and the United Kingdom. At that time, the ECB was heavily criticized for its lack of proactivity, for being behind the curve or too rigid."

Weber has continued making waves. In August in a Bloomberg TV interview, he argued publicly in favor of extending emergency help for eurozone banks (unlimited liquidity on a weekly, monthly, and quarterly basis) at least until the first quarter of 2011, preempting discussions at the twenty-two-member ECB governing council. Not all reaction was friendly. The *Financial Times* speculated that "he wanted to assert his authority ahead of a decision next year on a successor to Jean-Claude Trichet as ECB president." Bloomberg quoted Julian Callow, ECB watcher for Barclays Capital, as saying, "His comments might perhaps be an irritation for Trichet, who always stresses his prerogative as ECB president to be the *porte-parole* of the council." As for the need for diplomacy, Weber remarked in the interview, "It's important to be a diplomat for the diplomatic corps. It's not so important for a central bank. One of the central bankers I've always admired was [former U.S. Federal Reserve Chairman] Paul Volcker. You can call him anything, but not a diplomat."

Draghi is pitching the ball much lower. Using his international platform as chairman of the Financial Stability Board and his G-20 mandate to coordinate global regulatory reform, Draghi first went against the powerful banking lobby, dismissing their apocalyptic impact forecasts for Basel's higher capital and liquidity standards. After the Basel III decisions, he is now pushing for systemically important financial institutions to have loss-absorbing capacity by "a combination of equity capital surcharges, contingent convertible capital, and mechanisms to 'bail in' the creditors of these institutions," as he wrote in a recent *Financial Times* op-ed. In this context, he is focusing on such issues as tools that enable authorities to resolve financial firms without systemic disruptions or taxpayer losses, improving cross-border capability when dealing with global banks, and making international supervision more effective.

As long-term director general of Italy's Treasury Department, Draghi had to deal with a powerful independent Bundesbank during the turbulent 1990s when the "BuBa" still led the "DM-bloc." Before it joined the euro, Italy never had a central bank with a tradition of monetary stability. But as banking supervisor, the Banca d'Italia can claim an impressive record during the recent global banking meltdown. On Draghi's watch as governor and in the years before, Italy's banking supervisors did not allow, as German banking supervisors did, high-leverage vehicles like SIVs and conduits outside bank balance sheets. That explains why Italy did not need a huge emergency operation like Germany's bank rescue fund.

Looking at the current coverage of the ECB succession race in the media, the public discussion is dominated by the question of whether and how much the Sarrazin affair damaged Weber's chances. A recent Reuters headline, "Weber down but not out after dissent, Sarrazin," was typical. The prevailing view among domestic and international observers is that the coalition government of Chancellor Merkel will make an effort to win support from France and other eurozone governments for Weber to succeed Trichet as ECB president next year. Whether Jürgen Stark, now a member of the ECB executive board and chief economist, would assume Weber's position at the Bundesbank is still a question.

Some ECB watchers, including commercial and central bankers, government officials, and euro diplomats, who were sounded out on the condition of anonymity, make the following observations:

■ Since the German government under Merkel has not recently opted to push Germans for top EU and international positions, observers assume that Merkel has been saving political capital for Weber. To get him at the head of the ECB after this year's eurocrisis may help her politically.

■ The future of the euro is not just a German issue. Euroland is confronted with increasingly skeptical international investors. A number of editorialists, economists, and professors are already writing euro obituaries. The question of who will be the next ECB president is not only, or not even primarily, an issue of securing national interests or an issue of the conflicting fault lines between Club North and Club Med. The eurozone needs a new president who can best represent the stability of the euro and who will not be afraid of conflict with politicians. These are personal qualities that Weber can point to when it comes to fighting inflation. Draghi, on the other hand, has not spoken up much on monetary policy issues. And not much is known about Draghi's comfort level for getting in fights with politicians. Where Weber is less convincing is in standing his ground and expressing his own strategy when it comes to spending taxpayers' billions to support banks, their creditors, and whole financial markets.

■ Trichet is leaving a legacy that is felt to be a heavy burden on the euro. Loosening key stability rules by accepting large purchases of government bonds will haunt the ECB for a long time to come. Stability-oriented governments and central banks in the eurozone have not forgotten that Italy was among the first countries to ask the ECB to bail out Greece and support rescue facilities for the PIIGS countries. Large segments of the German population feel sold out by the ECB. It is difficult to see how an Italian ECB president could win over an angry and mistrusting German public.

■ On the issue of selecting a successor to Trichet, most still see a common German-French ground, since it will be in France's interest to be counted among the stability-oriented eurozone countries. Even a weaker and ever more unpredictable Sarkozy could opt for a role as mediator between the Club Med and northern euro countries. Merkel has disputed reports in the media, however, that in exchange for Germany's support for the Luxembourg-based European Financial Stability Facility, Berlin was able to secure a firm commitment for Weber as president of the ECB from France and other major eurozone governments.

■ On the other hand, Draghi gets high marks from financial market experts for entering the reform debate on EU financial markets. He has been speaking out against misusing massive ECB refinancing to recapitalize the banking systems of the southern eurozone periphery. But neither Draghi nor Weber, so the argument goes, are addressing the problem that ever-larger imbalances in intra-eurozone trade and capital flows are still leading to risky investments and may cause the banking crises of tomorrow.

Nobody has a crystal ball. Much can happen before the early or middle part of next year when a deal on the ECB presidency must be struck. Some insiders speculate, for example, that Dominique Strauss-Kahn, currently managing director of the International Monetary Fund, might return to France's political battlefield. If this happens, another top position could open on the roster for European leaders to fight about. Perhaps France and Germany could support Draghi to succeed Strauss-Kahn at the International Monetary Fund, and thus both leading candidates for the ECB could move up. But the possibility remains that due to backroom political deals or unforeseen circumstances, the third president of the European Central Bank and steward of the second most important reserve currency in the world could end up being neither Weber nor Draghi, but someone else entirely. ◆