German vs. German

A strange new personal war has broken out between IMF head Horst Köhler and German Finance Minister Hans Eichel. But beneath the surface, even larger issues—including perceived American heavy-handedness—are at stake.

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Observing the start of Horst Köhler's tenure as new managing director of the International Monetary Fund (IMF) about three years ago (*The International Economy*, September/October 2000), we asked a pertinent question: Did the United States—by successfully blocking former World Bank executive Caio Koch-Weser, the first-ever German candidate to head the IMF—eventually get what it deserved? Namely, a strong, independent-minded, highly qualified, new managing director of the Fund from Germany, who will probably stand his ground against even the almighty U.S. Treasury? When taking over the helm of the IMF, Köhler was living up to the qualifications that former U.S. Treasury Secretary Larry Summers listed as benchmark: "Stature, expertise, ability to command global support, and commitment to a process of ongoing reform." From what we have learned recently, things have been turned upside down in such a way that we should rephrase that three-year-old question: Did Germany get an IMF managing director it never expected? Is the new IMF head one who hits hard at his home country but wouldn't dare test America's new assertiveness? Is he an individual who had to table—from one day to the other—the major IMF project of the last two years, the Sovereign Debt Restructuring Mechanism (SDRM), because new U.S. Treasury Secretary John Snow wants to appease the private sector?

In any event, it doesn't come as a surprise that relations these days are not good between Horst Köhler and the top officials of the battered German government of Gerhard Schröder. When G8 finance ministers met ahead of the Evian Economic Summit in Deauville, France, on May 16–17, 2003, official German anger at the most visible German at the top of a powerful multilateral institution broke out into the open. When Köhler presented the findings of the recent deflation study of IMF economists, he hit especially hard at the policy failures and deflation risks in Germany, Europe's largest economy. In particular, he blasted Berlin's inability to tackle the structural rigidities in the German economy and its labor markets.

Schröder's finance minister Hans Eichel reacted angrily in the round of finance ministers. Eichel accused Köhler and the IMF of being too

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Immediately after the meeting, a visibly irritated Köhler took Eichel to task, asserting his independence from any member government in the IMF surveillance process. He defended the harsh criticism of Germany and the Eurozone and rejected the notion that the IMF was not also pointing out the deflation risks and policy failures in the U.S. economy. As managing director of the IMF, argued Köhler, he had to see things from the perspective of the whole world.

This episode says a lot about the strains and stresses in today's high policy circles.

When the press asked the Berlin ministry to comment on reports of an open rift between Köhler and Eichel, a spokesman stated that, as a matter of principle, the ministry "would not comment on G7 finance ministers sessions," but "that in the German government there are no reservations toward Horst Köhler," and "that the cooperation with the IMF is functioning very well as in the past." Looking back at the relentless broadsides against Germany, originating from the IMF and its German "MD," the ministry statement was not without a cynical touch. At the IMF headquarters in Washington, Köhler opted for openness, confirming that he had had some disagreements with Eichel.

IMF's **Köhler:** *Is he the scapegoat for European frustration with American dominance?*

German finance chief **Eichel:** *deeply resents Köhler's critical policy lectures.*

The tensions between Eichel and Köhler that burst into the open during the Deauville G8 finance ministers meeting didn't come overnight. Tensions have been building up in the course of the last year. Indeed, the dueling in Deauville must be seen in the context of the deteriorating German economy with below-zero growth, close to five million unemployed, and public sector deficits above the European Stability Pact limit of 3 percent. It has to be seen also in the context of Schröder's vehemently contested reform plan, Agenda 2010, that just got the backing of about 80 percent of the governing SPD party delegates. Insiders in German government and high finance circles point to several developments that have soured a once close and cordial relationship. They also have something to do with Köhler's important domestic role advising former Chancellor Helmut Kohl on financing German unity and as a protector for an important segment of Germany's public banking sector.

First, the governing Social Democrats have not forgotten that Köhler took sides in last year's national election. His frequent appearances during last year's national election campaign with leading opposition contenders such as Edmund Stoiber from the Christian Social Union (CSU) and Angela Merkel from the Christian Democratic Union (CDU) have irritated the German chancellor

Are U.S. Officials Manipulating the Process?

THERE ARE increasingly alarming signals from inside major multilateral institutions that issues sensitive to U.S. economic or financial interests are removed from the research agenda. Experts at the IMF, the Bank for International Settlements, and the OECD offer examples: Studies of the risks of U.S. "government-sponsored agencies" such as Fanny Mae and Freddie Mac or the concentration of derivative risks at a few big U.S. financial institutions have been blocked—under American pressure. "There is growing evidence that the IMF is very reluctant these days to explore the more problematic aspects of American economic and financial policies and developments," argues Professor Michael Frenkel from the WHU University in Koblenz, an expert on the reform of the international financial architecture.

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and his entourage. After aiding the opposition, Köhler should not be surprised that the governing Social Democrats remind him that—as key advisor to chancellor Kohl—he belongs to the decision makers in the 1990s who also are responsible for the economic and financial mess that Germany finds itself in.

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Three years ago, Schröder had put forward the former high finance official to the head the IMF as the only credible alternative to Caio Koch-Weser, who had been rejected as the first German candidate to lead the IMF by the U.S. government. That Köhler didn't even pay courtesy visits to the chancellor and the finance minister was seen as a signal that the IMF chief was sure that his CDU/CSU party friends would get back into government.

Second, some of Köhler's interviews blasting the economic policy failures of the Schröder government were seen as highly partisan and—considering Köhler's past role as defender of the status quo and as a master of political expediency—lacking a good measure of credibility.

After all, it was Köhler who—as key economic policy aid to Kohl—played a key role in the disastrous economic and financial policy failures of financing the German unification. There was a huge build-up of national debt that put national, state, and local budgets into ever-larger deficits. There was a disastrous failure to finance the extension of social protection to the East Germans by increasing taxes. Instead, the Kohl government used the contribution-financed funds of West German workers and employers for social security, unemployment, and health insurance to extend social protection toward East Germans. This way, the Kohl government instituted ever-higher supplemental charges to labor costs which increased unemployment and put a brake on economic growth.

Third, since leaving his key post in the Kohl government, Köhler became president of the Association of German Savings Banks, thus looking after the interests of a large segment of the country's public-sector banks. In this position, Köhler played a critical role in defending the system of public guarantees, at the same time as the IMF and the EU Commission were criticizing it for not giving private-sector banks a level playing field. As it turned out, it was the failed IMF candidate Koch-Weser who—as Eichel's deputy—was forced by EU Commissioner Mario Monti into a multi-year agreement under which Germany's Landesbanken are phasing out their state guaranty structures.

All this explains why the governing Social Democrats get upset at being lectured these days by Köhler and his conservative and liberal party opposition friends about getting rid of structural rigidities and making Germany's economy more flexible and competitive.

Fourth, there is a growing realization among finance and central bank officials as well as experts all over continental Europe that the terrorist attacks on the United States and the divisive Iraq war have led to an alarming American assertiveness in international financial institutions and an all-out effort to bring the international agenda under the control of the "Bush Warriors" and their willing friends. "As never before in recent decades, multilateral institutions—in particular the IMF and the World Bank—are instrumentalized for geopolitical U.S. interests," complains Professor Gerhard Fels, a member of the prestigious Group of Thirty and president of the Institute of the German Economy in Cologne. There are increasingly alarming signals from inside major multilateral institutions that issues sensitive to U.S. economic or financial interests are removed from the research agenda. Experts at the IMF, the Bank for International Settlements, and the OECD offer examples: Studies of the risks of U.S. "government-sponsored agencies" such as Fanny Mae and Freddie Mac or the concentration of derivative risks at a few big U.S. financial institutions have been blocked—under American pressure. "There is growing evidence that the IMF is very reluctant these days to explore the more problematic aspects of American economic and financial policies and developments," argues Professor Michael Frenkel from the WHU University in Koblenz, an expert on the reform of the international financial architecture. But Jürgen Michels, economist at Citigroup in London, cautions: "I don't think that ever more louder calls from international financial institutions for speedier reforms in Germany and other countries of Old Europe are the result of Washington pressures. Also the Paris OECD and the EU Commission came up with studies claiming the urgent need for far-reaching reforms in Europe. On the other side, those considerable risks in the economic development of the U.S. should not be overlooked."

So we have to put things into perspective. Seasoned IMF observers point out that Köhler is trying hard to defend the principles of multilateralism against a new American assertiveness. "By being especially tough on Germany and the Old Europe" while softpeddling the much larger risks and failures of U.S. policy, notes a veteran IMF observer at the Bundesbank, "Köhler gets a breather from those Bush warriors looking over his shoulders."

Since September 11, 2001, and even more since the divisive Iraq war, the international financial institutions have en-

SELLING A BITTER DEFEAT AS A BIG VICTORY

When it comes to selling a bitter defeat as a great victory from one day to another—and sailing smoothly with shifting political winds—Horst Köhler has few rivals. As soon as President Bush put John Snow at the helm of the U.S.Treasury, Köhler quickly realized that the most ambitious and divisive reform project of the Fund, the Sovereign Debt Restructuring Mechanism (SDRM), was out and that the big private-sector players could claim victory. They keep the freedom to self-regulate the financing of emerging markets by introducing collective action clauses or adopting a voluntary Code of Good Conduct. This is how Köhler—addressing about 450 senior executives of banks across the world—left behind two years of hard work at the IMF that was supported by the G7 finance ministers and a large part of the IMF membership. “The debate the IMF triggered with its proposal for a SDRM over the past 1½ years to deal with unsustainable debt has, on the whole, been extremely productive. Not only has it been helpful in creating better awareness of the need to pay more attention to preventing the build-up of unsustainable debt. It has also helped to clarify and move forward a number of critical issues such as tackling collective action problems, inter-creditor equity, and better rules of engagement between debtors and creditors.” Some of Köhler’s former friends in official and central bank circles reacted quite cynically to his Berlin speech. Considering that Köhler and IMF Deputy Managing Director Anne Krueger had been mobilizing the organization for SDRM the last several years, his speech had a “quality of overnight revisionism that used to characterize official speeches that were held in Moscow or East-Berlin and are still held in Peking.”

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tered a phase where lending again is driven by the political and geopolitical considerations of their major shareholder: the United States. In a world where more than one billion people—around 20 percent of the population of this planet—live on less than one dollar a day, this new development could be bad news for many poor countries and regions at a time when the global economy is slowing down.

In particular the Bretton Woods institutions have been increasingly instrumental in the global effort to root out terrorism. They find themselves as the United States’ arsenal in the antiterrorist war. They are faced with drastic changes in lending priorities: overnight some countries have gained new geopolitical importance with human resources limited; the financial institutions are running the risk that many countries and regions of lesser strategic importance are neglected. As Professor Nouriel Rubini of New York University’s Stern School of Business, a former aide to U.S. Treasury Secretary Larry Summers, admits, “[A]gainst the background of the official rhetoric of ‘no more bail-outs’ and not having the taxes of American ‘carpenters and plumbers’ pay for the bail-out of poorly performing emerging market economies, the reality of the new political and strategic interest of the United States and the other G7 countries has emerged. Even before the September 11 events, but more so afterwards, the U.S. tendency to support financial aid to countries that are considered friends, allies, or otherwise strategically or systematically important (Turkey, Pakistan, Indonesia, and possibly Brazil) has clearly emerged more strongly than during the previous administration. … And political considerations are likely to become even more important in decisions about official lending in the new geo-strategic security climate.”

Heads of international financial institutions such as Köhler are facing another challenge. The U.S.-led “coalition of the willing” is also using their power levers in multilateral institutions to wage a diplomatic war against what they call “old Europe” and its “coalition of the unwilling.” Traditional creditor countries in the Fund such as Germany and France are facing a new U.S.-led strategy of containment in international institutions with the British and the Poles as willing supporters. French and German influence at the Fund has fallen to levels never seen before.

With respect to Köhler’s row with Eichel, John Llewellyn, global chief economist of Lehman Brothers, also takes a sanguine view: “This latest spat is nothing new, and poor Mr. Köhler is caught in the middle.” There is a long history of tensions between the United States and Europe over growth, and the aggregate demand policies needed to achieve it, says the former OECD chief economist now working from London. “The U.S. Treasury has for over a decade considered that its current account deficit arises not so much because its imports are growing too fast, but because its exports are growing too slowly. And that they blame importantly on Europe, and its reliance on tight policies (with resulting slow growth) to control inflation, rather than better structural policies.” And he warns: “But the noise level in the debate is set to rise, as U.S. exports benefit at the expense of Europe’s, and the ECB is forced to cut and cut and cut.” But Jonathan Hoffman, chief economist of Royal Bank of Scotland (RBS), sees the quarrel between IMF chief Köhler and the German finance minister as further proof that “since the Plaza Agreement eighteen years ago, the risk has never been so great that G7 policies, in both the exchange rate and the multilateral surveillance sphere, become a “continuation of politics with other means.” And Hoffman warns: “But that way lies protectionism, exchange rate overshooting and misallocation of resources. If the G7 cooperation seen since 1985 turns to confrontation, everyone will lose.” ◆