Euro crisis divides European Central Bank

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The sudden resignation of the chief economist at the European Central Bank (ECB), Jürgen Stark, has revealed deep differences over how to proceed in the euro crisis.

News broke on Friday of the resignation of the German official, a member of the ECB governing body, during a meeting of finance ministers of leading industrial nations in Marseilles, sending stock markets into a tailspin. Germany's DAX index was down more than four percent. It has lost one third of its value since August. The euro fell to its lowest level against the dollar in six months, and the gold price climbed higher still.

Stark's resignation undermined "the confidence of some investors in the ability of the ECB to resolve the financial crisis and reverse the economic downturn," one broker told the press.

Stark is one of the ECB's so-called hawks, favouring a strict policy of monetary stability and an uncompromising course of austerity. He opposes ECB purchases of the government bonds of highly indebted countries such as Greece, Portugal, Spain and Italy. His resignation is a rebuke directed at ECB President Jean-Claude Trichet, who approved the purchase of such bonds, as well as German Chancellor Angela Merkel and French President Nicolas Sarkozy, who have encouraged this course of action.

Although "personal reasons" are being cited for Stark's resignation, his rejection of the expansionary monetary policy of the ECB has long been known. That Stark regards his action as a public protest is shown by a contribution he sent just prior to his resignation to the editor of the financial daily *Handelsblatt*, which the newspaper describes as his "legacy."

In the statement, Stark categorically opposes the policy of "fiscal stimulus," i.e., expanding the money supply, to combat the economic crisis. "Fiscal stimulus would only further increase debt levels," he writes. This would heighten the risks to the public purse and undermine growth and stability. On the other hand, a "solid financial policy" would evoke "positive confidence," Stark writes. "Ambitious adaptive programmes would be associated with positive growth effects, after a short time."

Summarizing the views of the economist, *Handelsblatt* writes, "By this Stark means 'savings' and nothing else."

Stark's position has significant support, especially in Germany and several other “affluent” European countries. After the resignation of Bundesbank President Axel Weber in April, Stark becomes the second top German official to leave the ECB because of policy disagreements. Weber's successor as the head of the Bundesbank, Jens Weidmann, shares Stark's reservations about the purchase of government bonds.

The 63-year-old Jürgen Stark had been employed since 1978 in the German Economics and Finance ministries as well as the chancellery before moving to the Bundesbank in 2002 and the ECB in 2006. As state secretary for finance in the 1990s, he was involved in the drafting of the euro stability pact.

At that time, Germany tried to make the ECB follow the model of the German Bundesbank, which is exclusively committed to the maintenance of monetary stability.

The German government is not permitted to give the Bundesbank instructions or use monetary policy for economic stimulus. A major reason for this focus on fighting inflation is the experience of 1923, when a wave of hyper-inflation rendered the German mark virtually worthless within a few months, pushing the Weimar Republic to the verge of revolution.

In the post-war period, the rapid recovery of the German economy enabled the Bundesbank to preserve the relative stability of the mark, while other countries such as France and Italy experienced high inflation rates. Since the introduction of the euro, conservative financial officials and politicians have above all feared Germany being drawn into an inflationary maelstrom as a result of highly indebted countries setting the tone for the ECB.

Stark speaks for these circles, which reject any measures that aim to solve the budgetary problems of the euro countries by means of ECB monetary policy. Stark explicitly includes the course being followed by the US Federal Reserve in his criticism.

"Majority opinion in the US, both among politicians and economists, appears to go in the direction of an expansion of monetary and fiscal policy stimulus," he writes ruefully.

While Stark rejects helping the highly indebted countries with ECB funds, he is in favour of forcing through stricter austerity measures, strengthening European institutions to this end. He calls for a "quantum leap" to ensure "the necessary strengthening of the institutional rules at a European level" and a "far-reaching reform of the decision-making and sanction mechanisms." In his view, it is essential "to transfer national budgetary powers to the overall European level to a greater extent than previously foreseen."

Stark's position enjoys much support within Germany's ruling coalition. Representatives of the German federal government are likewise calling for the highly indebted countries to carry out even deeper budget cuts. In the budget debate in the Bundestag (federal parliament) last week, Finance Minister Wolfgang Schäuble threatened to block payment of the next credit tranche from the euro rescue fund for Greece if the country does not fully satisfy its deficit-reduction commitments.

For its part, Greece is warning that it cannot keep these commitments because the deep recession caused by the already imposed cuts has drastically slashed state revenues.

According to a report by *Spiegel Online*, the German Finance Ministry is already preparing for the possibility of a Greek default on its debts. Schäuble has had his officials run through all the scenarios that could arise in the event of a Greek state bankruptcy, reports the magazine.

According to *Spiegel Online*, the German government believes that precautionary lines of credit to countries like Spain and Italy should protect them from being drawn into the vortex of bankruptcy. Banks forced to write off their Greek government bonds would be supported with billions from the euro rescue mechanism.

However, Schäuble and Chancellor Merkel do not go as far as Stark and reject the purchase of government bonds by the ECB. This policy has so far prevented interest rates for Spanish and Italian government bonds rising to a level that would force these countries to access the euro rescue mechanism.

Above all, representatives of German export industries fear that too hard a line against the indebted countries could lead to failure of the euro, with devastating consequences for German exports, 62 percent of which goes to the European Union and 43 percent to the euro zone. The president of the Federation of German Industry (BDI), Hans-Peter Keitel, recently described the euro as "indispensable."

"We do not want an adventure with unpredictable risks. We want to go forward and invest in Europe, in the euro--even if it hurts us," he said.

Keitel has the support of the Social Democratic Party (SPD) and the Greens, which want to save the euro. Like the German government, both of these opposition parties advocate a course of strict fiscal consolidation.

The Merkel government has thus far pursued a zigzag course on the euro issue. It has manoeuvred between supporters and opponents of funding for the highly indebted countries. The “no” camp includes the junior parties in Merkel’s ruling coalition-- the Free Democratic party (FDP) and the Christian Social Union (CSU)—as well as a minority faction within her own Christian Democratic Union (CDU). Merkel herself has repeatedly argued within the EU against granting such financial support, only to back down and agree to emergency measures to prevent a collapse of the euro.

This policy conflict now threatens to tear apart the government. After Stark's demonstrative resignation, opponents of European-wide support measures feel their star is again rising. It is not certain whether the Merkel government will still have a majority when the vote is held at the end of September on the establishment of a permanent euro rescue mechanism. Although the SPD has already pledged to vote for the mechanism, without its own clear majority on such a fundamental issue the government could not long remain in office.

There is also speculation that the FDP could withdraw from the coalition if it suffers a major defeat in next weekend's Berlin legislature election. It might then try to win influence again by means of a nationalist-populist campaign against euro bonds and other measures of support for the highly indebted countries. Opinion polls currently indicate a high level of opposition to such aid.

The profound differences within the ECB, the EU and the German government will fuel further speculation on the stock exchanges and financial markets, threatening an outright global depression.