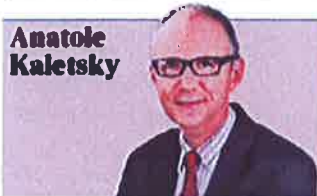


Exit Trichet with euro blood on his hands

By being more German than the Germans, the ECB chief has played a key part in the single currency's problems

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The European tragicomedy that will reach its latest, but certainly not its last, climax at today's Brussels summit, has been dominated by two conflicting, yet complementary, characters: Angela Merkel, the German Chancellor, and Jean-Claude Trichet, the French President of the European Central Bank.

All the other dramatic personae — George Papandreou, Silvio Berlusconi, David Cameron — merely provide sub-plots and light relief. Even Nicolas Sarkozy has been nothing more than a bit player, "who struts and frets his hour upon the stage and then is heard no more", as Macbeth said.

Ms Merkel and Mr Trichet, by contrast, are the larger-than-life couple driving this modern version of the Scottish tragedy. But whatever the outcome of their battle to transform European monetary union into a fully fledged political federation, their personal fates will diverge this week.

Ms Merkel will continue to fight for her vision of a penny-wise Germanic Europe until she meets her fate at the hands of the German voters. Mr Trichet, by contrast, will simply be

written out with nothing more than a muffled off-stage groan when he retires on Monday after six years at the helm of the ECB, having failed to achieve the ambitions to which he has dedicated his entire career.

Mr Trichet's challenges when he became the first full-term president of the ECB in 2004 were to turn the single currency into a truly irrevocable bond, to create a unified European economy not dominated by the German export powerhouse and to leave a legacy of institutional stability for his successors at the ECB.

When he retires he will be respected for his success at maintaining low inflation and a strong currency throughout his six-year term. But this will pale in comparison with his legacy

They'll do whatever it takes – apart from things that will work

of nationalist tensions, banking chaos, ECB infighting and public debate in the parliaments of Europe about a euro break-up and sovereign defaults.

Unfortunately for Europe and Mr Trichet, his desire to be remembered as an ultra-conservative central banker and his efforts to turn the French-run ECB into an institution that was more Germanic than the old Bundesbank are directly related to the near-collapse of the single currency project in the past two years. For the

actions required to stabilise the euro — large-scale purchases of government bonds and radical monetary easing, as practised by the US Federal Reserve Board and the Bank of England right from the beginning of the crisis — were exactly contrary to the Bundesbank traditions that he tried so hard to emulate.

To make matters worse, Ms Merkel has been motivated by similar contradictions. Her self-image as a prudent German housewife, scourge of the profligate, spendthrift Latins, is directly at odds with her oft-repeated assertion that she would defend the euro "whatever it takes".

The consequences of all these contradictions have been clearly visible in the political and financial chaos leading up to this week's summit. While everybody consistently repeats the mantra that "we will do whatever it takes" to save the euro, Ms Merkel and Mr Trichet have consistently added a modest caveat: "We will do whatever it takes, apart from the things that would actually work."

For Mr Trichet, this has meant refusing to provide an unlimited central bank safety net for the Italian and Spanish bond markets. This is the one action that could prevent financial panic spreading across Europe once Greece reneges on a large part of its government debts, as it inevitably will, perhaps this week. Without such support from the ECB there can be no hope of a lasting resolution to the crisis.

Why is it possible to make such an unequivocal statement, regardless of

what is announced tomorrow in the way of new insurance mechanisms or sub-prime-style special purpose investment vehicles (already nicknamed by the market as Spivs)?

The answer is because nothing in Europe apart from the ECB is capable of mustering the financial firepower needed to defend countries as large as Spain or Italy against runs on their government debt markets or their banks. And because none of the cunning plans to avoid ECB borrowing

Only the ECB has the firepower needed to defend Spain or Italy

will be convincing without twenty changes and complex negotiations that will take an age to complete. Only the ECB can bridge this gap between the day-to-day demands of financial markets and bank depositors and the political and legal timetable, which is measured in months, if not years.

To make matters worse, Ms Merkel has confounded hopes of a long-term solution to the eurozone's debt problems by excluding the crucial action that Germany will have to take sooner or later if it wants the single currency to survive. That is to accept in principle pan-European bond issues, jointly guaranteed by all eurozone governments, to replace a substantial part of the sovereign and bank debts of all the eurozone nations.

The quid pro quo for Germany accepting a degree of collective responsibility for the debts of weaker countries would be the Mediterranean governments accepting a degree of German control over their decisions on tax, spending and social welfare. The need to combine joint responsibility for public borrowing with central control of tax and spending is the essence of fiscal federalism and explains why it goes hand in hand with political union.

But Ms Merkel seems to have a different understanding of the federalist idea. In her vision, Germany would dictate economic policies to debtor countries without sacrificing any of its own national sovereignty by guaranteeing other countries' debts.

When we combine this refusal to accept genuine fiscal federalism in the long term with Mr Trichet's refusal to support banks and governments in the short term, it is hardly surprising that resolving the eurozone crisis has proved impossible. In time their successors in the ECB and the German Government will almost certainly reverse these positions. The question is whether the euro can survive that long.

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