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Editorial note: Roland Vaubel provided a contribution to the January 2010 EJW symposium on economists and the Euro, and he was the guest on the November 2012 edition of **EJW Audio**. *In that interview he addressed a major current topic with clear statements, so we thought transcription would be especially useful in this case. Professor Vaubel has touched up the transcript for clarity and factual accuracy, but it is essentially verbatim. Brackets indicate an insertion, but some very small changes have been made without indication.*

Euro Politics: An Interview with Roland Vaubel

Roland Vaubel[1]
Interviewed by Lawrence H. White[2]

LINK TO ABSTRACT

Lawrence H. White: This is Lawrence H. White of the George Mason University Economics Department with the November 2012 *Econ Journal Watch* audio podcast. Today we're privileged to be speaking with Professor Roland Vaubel from the University of Mannheim in Germany. He holds the chair of political economy there. Welcome to our podcast, professor.

Roland Vaubel: Yes, hello. Good morning.

White: In January 2010, *Econ Journal Watch* had a symposium about the Euro. The lead article was by Lars Jonung and Eoin Drea, entitled "It Can't Happen, It's a Bad Idea, It Won't Last: U.S. Economists on the EMU and the Euro, 1989-2002." This article had the distinction of being published just about the time the Greek sovereign debt crisis was erupting. Greek debt was being downgraded; just a couple months later borrowing costs spiked, and it's been crisis in the Eurozone since then. But Jonung and Drea didn't anticipate that. They were, you might say, con-

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gratulating the Euro on its success and asking why had so many people been so skeptical. And then we had a number of commentaries on their article, and yours was probably the most skeptical about the future of the Euro going forward. So maybe we should start at the beginning about why people were skeptical about the Euro happening or succeeding going forward. Germany had a very strong currency in the deutsche mark, so why did the German government agree to join the European Central Bank project when it seemed to have so little to gain?

Vaubel: That's a long story. Initially, the German minister of foreign affairs and the chancellor, [Helmut] Kohl, envisaged a deal giving away monetary leadership and getting in exchange a European foreign and defense policy in which Germany would have full say, including, as some said, a nuclear component. This was the initial idea of [Hans-Dietrich] Genscher in 1988. Then there was a report by a committee, the Delors committee, on how it could be done if the leaders would agree to do it. And then the Wall fell in Berlin in fall '89, and the German government almost immediately aimed at unification, and for that unification the German government needed the assent of the Western allies: United States, UK, and France. The idea of German unification was welcomed by the American president, George Bush Sr. It was not welcomed by Margaret Thatcher and [François] Mitterrand. In fact, they had a meeting on how they could stop it. And then Mitterrand made his separate peace with the German government, promising his assent to German unification and getting in exchange the Euro. So, the deal changed. The original deal envisioned by the German government didn't come about, and instead this bait of monetary leadership was used to get German unification in time. In a TV interview, Mitterrand said that he had believed that he could not really stop German unification, but of course he could make difficulties, and the German government didn't really know how long [Mikhail] Gorbachev would be in power, so…how long the window of opportunity would be open. I think that's the explanation.

White: So, Germany was willing to join as a cost of getting something else.

Vaubel: Yes.

White: Why was France so eager to create a monetary union?

Vaubel: France had been fairly dependent on the monetary policy of the Bundesbank since 1983. This was two years after Mitterrand had been elected. In March 1983, the French economy was really in shambles because he had conducted a very expansionary monetary and fiscal policy, devaluing vis-à-vis the D-mark each year by about ten percent. And then there was a capital flight from France, and Mitterrand wanted to leave the European Monetary System, which was a sort of adjustable peg system, established in 1979, but his minister of finance Jacques Delors, and also the prime minister, [Pierre] Mauroy, did not want to leave the European monetary system, and they persuaded Mitterrand to stay. So in the following years, French monetary policy closely followed German monetary policy. I believe that Mitterrand did this because there was an election, a parliamentary election in '86, and he knew that he had to get inflation down by that time, and he would have a stabilization recession on the way, and he wanted to do that very quickly so that it would be out of the way by the time of the election, and he could use the monetary policy of the Bundesbank as a scapegoat. But then by the late '80s inflation was very low in France, and French politicians became very dissatisfied with the situation. Also, we got the Single European Act, the internal market, which meant the abolition of capital controls. So, when capital controls were abolished between France and Germany in '89, French monetary policy was bound even more closely to the policies of the Bundesbank. So, the French politicians considered that humiliating, and I think that's why they were willing to pay a price.

White: So, all you've discussed are political rationales: saving face, having more of a say in monetary policy. This was not discussed or thought of by the politicians in terms of optimal currency areas, is that right?

Vaubel: [Right], not at all. There was no economics behind the decision in December 1989 to start with a European monetary union. In fact, I did an analysis along the lines of optimum currency area theory, looking at the long-term real exchange rate changes between the member states, and they had been larger in the late '80s than they had been in the early '80s. So, from an economic point of view, '89 was less advantageous than maybe '85 or '81.

White: Now in your piece in *EJW* you talk a bit about the conditions that the German government was able to impose on the parameters of the ECB constitution. Tell us what those were.

Vaubel: Well, first of all we got the so-called Stability and Growth Pact. That was agreed to in 1996, before the final decision to start with eleven countries. Then, the German government really had veto power over who would be on the European Central Bank board, and they managed to get a solidly hard-money, hardliner board, even though in the majority of member states there were socialist or social democrat-led governments. The board of six people had only one socialist, that was [Wim] Duisenberg from the Netherlands, and he was really a hard-money man, so the initial board was extremely hawkish. And the German government also made sure that the director in charge of economics and research would be a German, Otmar Issing, who really is a monetarist.

White: You mention in your piece that once the ECB was up and running, Germany no longer had this kind of veto power.

Vaubel: Yes.

White: So has the character of the board changed?

Vaubel: Yes, very much so. Issing has disappeared, and his successor, the German successor, is in fact a member of the Social Democratic Party, and he has completely different views. In the meantime, the Greek vice president [of the ECB board], [Lucas] Papademos, was in charge of [research] at the board. He is a former student of [Franco] Modigliani at MIT, and the first thing he did after getting in charge of research…was to organize a conference against monetarism. The chief witness was Michael Woodford from Columbia University, who argues that you don't have to look at the money supply at all and you just do it by adjusting interest rates. There were some further changes. The initial inflation target had been, implicitly at least, 1.5 percent. This was raised to below two percent but as close as possible to two percent, which is 1.9999…[percent], really a joke. Then in 2003, the Stability Pact was violated by France and Germany, and in 2005 the Stability Pact was changed completely so that it had no teeth at all anymore. And the monetary reference rate, which had been introduced by Issing, of 4.5 percent per annum for M3, was delegated to lower rank, whereas initially it had been one of the two pillars of inflation targeting.

White: Now the Stability and Growth Pact that you've mentioned had fiscal rules, is that right?

Vaubel: Yes.

White: To try to restrain the membership to countries that would not want money printed to cover their deficits, is that a fair way to put it?

Vaubel: It was a limit on the deficit, and it was a limit of three percent. Three percent of GDP, government deficit relative to GDP.

White: And there was also a debt-to-GDP ratio?

Vaubel: Yes, but that was not really mandatory. That was indicative—recommended.

White: So, you mention in your piece that American economists were surprised that the Eurozone started with as many as eleven member states because they didn't think that these criteria could be met.

Vaubel: Yes. They were not met.

White: So, some countries fudged their numbers?

Vaubel: Yes, quite a few. I mean, Greece is the most obvious case, but this was later, this was in 2001. But apart from that, Italy fudged the criteria, violated the criteria, and Portugal and Spain, and some others I don't remember really. I did an analysis in February 1998, and I found that only three countries unambiguously fulfilled the criteria, and those were the three Benelux countries.

White: And so, it went ahead because nobody wanted to admit that they were not meeting the criteria?

Vaubel: Yes. At the summit in Maastricht in 1991, two important changes were introduced into the agreement, which had not been foreseen by the Bundesbank and not by the German minister of finance [Theodor] Waigel. This agreement was changed in two important respects, and the first was that a time, a date was introduced when the monetary union would start at the latest, and this date was 1999. I don't think that Kohl had anticipated this, because it was proposed by [Giulio] Andreotti and Mitterrand. Kohl then agreed to it without asking his minister of finance and the Bundesbank, and 1999 was a very inconvenient date for him because he knew that there would be an election in 1998. … The decisions about the Euro and who would take part would be taken before the election. And that is exactly what happened, and that explains to a large extent why there was really a landslide defeat for Kohl and his party. So the date was one of the changes, and the other change was that a decision about who would join would be taken by qualified majority, whereas the initial agreement, which the German minister of finance and the Bundesbank had worked out with the other central banks and so on, was that the decision would be taken unanimously, because that was the normal decision rule in these cases. It was not explicitly mentioned, but by not mentioning it, it was clear it would be unanimous. And this [change to qualified majority] was [made] at the initiative of the French minister of economics, [Pierre] Bérégovoy, and this meant that the German government could be outvoted. So, technically it would have been possible to start in 1999 with Germany and also some other countries, against the wishes of the German government. I think it was absolutely clear, since the Treaty of Maastricht, that a qualified majority of the member states would join, in 1999, because it would have been impossible to get a qualified majority in favor of [only] a minority starting with the Euro. The member governments would not agree to the start of the Euro unless their own country would be among the joiners. So this was quite predictable, and that's what happened.

White: So it would have been an embarrassment to have been left out of the initial joining group?

Vaubel: Yes. They all wanted to join.

White: So, the EMU has happened. How has it performed since its beginning?

Vaubel: The inflation target was [usually missed] except in 1999 [and 2009-10]. But the inflation rate in [1999] was not due to the monetary policies of the European Central Bank but to the previous monetary policies, which had been dominated by the Bundesbank. From [2000 to 2008], the inflation rate was always above two percent—not very much so, but they never managed to get it below their limit. And the inflation rate of the Euro, even though it was fairly low by historical standards, even compared with the D-mark, was higher than the inflation rates in the other…West European countries, where monetary policy was run by independent central banks. The inflation rate of the Euro was higher than the inflation rate in Switzerland, in Norway, in Sweden, in Denmark, and even the UK. So if you really compare it with the performance of competing central banks, the same period of time, the European Central Bank was not particularly successful. And then of course, in 2007 the inflation rate was above three percent, and without this great recession it might have stayed there for longer. And now, over the last year and this year, it [is] far above two percent.

White: And of course they're fighting a fire now with the fiscal situation, which means they're unlikely to put much emphasis on bringing inflation down, in fact…

Vaubel: Yes, I think so.

White: [Mario] Draghi has pretty much said he'll keep interest rates as low as necessary.

Vaubel: Yes, yes. And the monetary base has increased very much over the last one and a half years, by more than 50 percent. The money supply, M1, is already getting speed. It used to be absolutely stagnant—since the outbreak of the great recession M1 was stagnant, and over the last twelve months it has increased by five percent, and I would not be surprised if this increase went on, if it accelerated. The German member of the ECB board, [Jörg] Asmussen, has said that the so-called "exit" from this hyper-expansionary monetary policy would take several years, and I believe that even though we are in a mild recession now and may stay there for the next year, it will be necessary to re-collect this excess monetary base very quickly, in 2014 at the latest. And if, as I expect, it will take several years, we'll get really high inflation rates. And this is already anticipated in the housing market. In Germany we have a booming housing market, which is really not in line with the business outlook in general; growth is not very high, it's about one percent. So there are already strong inflation expectations, and also the share index, the stock market index, is quite strong, which is not at all in line with the weak economic growth. So, expectations are for high inflation I think.

White: People are buying houses and shares to get rid of…to lower their money balances.

Vaubel: Yes, that's one reason. Yes. Too much money is chasing too few goods, but in addition I think there are inflation expectations.

White: So they're buying houses as a hedge.

Vaubel: Yes.

White: In the last sentence of your *EJW* piece you have a kind of pregnant statement, that we're seeing a "shift from initial conditions to the long-run politico-economic equilibrium of the game" of the Eurozone. So, what do you mean by that? What's the long-run equilibrium look like?

Vaubel: The long-run equilibrium is that—we have it now—it's that the president of the German Central Bank is systematically outvoted, and we have that for now one and a half years. Sometimes he's joined by some others, but since he was appointed he's completely isolated in the European Central Bank council. And, I predicted that. So, the monetary policy is now run by the median decisionmaker in the council, and that is essentially France. You may remember that the previous [president] of the Bundesbank, Axel Weber, had some ambitions to become president of the European Central Bank. And in January last year, the French president [Nicolas] Sarkozy sent a letter to the German chancellor saying that he was really not opposed to having a German as the next president of the ECB, but he made some suggestions. He suggested three names, and Axel Weber was not on the list. So, Axel Weber heard about that, and he resigned as [president] of the Bundesbank immediately, in February [2011]. And that is how we got this new [president], who used to be the economic advisor of the chancellor, in the chancellor's office. Sarkozy had a very strong position. He could really veto any ECB presidential appointment, because the appointment has to be made by qualified majority, and France and Italy together have a blocking minority. So if France and Italy together had openly vetoed Axel Weber he could not have become president of the ECB. And, well, they knew this, so Weber dropped out of the race, and Draghi, who was the main contender, became president of the ECB. That's the politics behind it.

White: There was one other important sign of Germany being on the outs, which was the resignation of Jürgen Stark.

Vaubel: Yes.

White: What was that about?

Vaubel: The same, exactly the same. He and Weber had voted against the bond purchases in May 2010. In 2010, the ECB decided under [Jean-Claude] Trichet to buy Greek bonds in the secondary market, and Weber and Stark voted against that, and also the president of the Greek Central Bank, who was a conservative and opposed to the socialist government which was in power [at the time], so these three voted against it, against the bond purchases. And, well, Stark delayed his decision, I don't know why. He has said quite frankly in the meantime that the bond purchases were the reason for his resignation.

White: Where do you see the bond purchases and the current policy of the ECB leading? Where will the fiscal crisis go?

Vaubel: Yeah, that's very difficult. I think things will go on as they have until the German…federal election in September [2013], because the German minister of finance, [Wolfgang] Schäuble—who is really the strong man of government, it's not the chancellor—he has promised to the Germans that they will not lose money in giving these credits to Greece. So, he does not wish to have another haircut in Greece before the election, because that haircut would also reduce the value of the assets of the European Stability Mechanism, of which Germany is the most important shareholder, and it would also reduce the value of the assets of the European Central Bank. So, the Germans would lose money. And since the Greek government can stop debt service at any time, the German minister of finance is now really in the hands of the Greek government, and he will give any money they want, regardless of whether they fulfill the policy conditions or not, until the next election. After that we are likely to have a completely different government, and it's very difficult to predict what will happen. Many strange things can happen.

White: Is there a plausible scenario under which Germany, and perhaps Finland or the Netherlands, decide that it's not worth the cost of staying in the Eurozone?

Vaubel: It's conceivable after the election. There's now a minor party which has the program of, well, not really leaving the Euro, but they are Euroskeptical. They are saying 'no more money to Greece, and we want to have referenda on all these questions.' And in the polls, the opinion surveys, they are quite strong, so they may get into parliament. They are a right-wing party—not *particularly* right-wing, but certainly not left-wing—and it is conceivable, but not terribly likely, that chancellor [Angela] Merkel and the Christian Democrats may need the support of that party in order to continue to govern without the Social Democrats. It's conceivable; it's not very likely.

White: So the most likely scenario is just higher inflation but the Eurozone stays together?

Vaubel: Yes. Of course, this higher inflation will have further effects on German public opinion. The opinion polls show that this whole policy is deeply unpopular. Two-thirds of the Germans are opposed to these bond purchases, and this may affect the next election in four years' time. But I don't believe that, before that, the German government would want to leave the Euro.

White: Okay. Well, this will be very interesting to see. Your predictions have proven depressingly right over the years.

Vaubel: Unfortunately.

White: Thank you very much for talking to us, and we'll see how it plays out from here.

Vaubel: Yes. Thank you for your interest.

Roland Vaubel is Professor of Economics at the University of Mannheim. He is a member of the Advisory Council to the German Federal Ministry of Economics and Technology. His books include *Strategies for Currency Unification* (1977) and *The European Institutions as an Interest Group* (2009).

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