



Letter from Bali: Merkel setbacks hurt EMU reform chances

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Chancellor Angela Merkel's domestic political weakness – exemplified in a string of election setbacks and her now-signalled departure from the Berlin political scene – will toughen her already difficult task of winning consensus for reforming and strengthening the structure of economic and monetary union. That was the widespread view of well-informed participants at the International Monetary Fund-World Bank Group annual meetings in Bali in mid-October.

A background discussion issue throughout the Bali meetings was disquiet over the dispute between the Italian and German governments over the way forward for EMU. Leading politicians

in the Rome administration – notably Matteo Salvini, deputy prime minister, home affairs minister and head of the populist League party – have been criticising Berlin's strictures on public deficits and calling on the European Central Bank to do more to lower Italy's borrowing costs.

Rome has clashed with the European Commission over the Italian government's backtracking on plans to tighten the budget during the next three years. European officials in Bali said Salvini would have to tone down criticism of the ECB in any compromise over the budget, which could open up leeway on Italian debt and funding costs.

Complaints from Brussels of Rome's medium-term budgetary plans have strengthened Salvini's

anti-Berlin and anti-Brussels rhetoric. This has probably increased his domestic popularity and chances of becoming prime minister when Italy's next elections are held at a yet-to-be-determined date in coming months.

Merkel and the unsteady Berlin coalition of her conservative Christian Democratic Union and the centre-left Social Democrats (SPD) have been badly shaken by setbacks in state elections in Bavaria and Hesse, culminating in her decision to stand down from the CDU leadership. One of the reasons for Merkel's weakness, along with deep-seated conservative misgivings over her immigration policy, has been disquiet over her stance on monetary union. The electoral rebuffs will narrow further Merkel's room for policy manoeuvre both over budgetary squabbles with Italy and over the wider issue of strengthening the euro area's institutional architecture to help withstand the next financial crisis.

One leading German financial figure in Bali warned that the world was likely to enter a new downturn in around 15 months, and euro area countries were painfully ill-prepared for the next wave of turbulence.

The erosion of conservative support, accompanied by the ascent of the anti-euro, anti-immigration Alternative for Germany (AfD), raises doubts over whether Merkel will remain CDU chairman at the end of the year.

Domestic election campaigns have been dominated by the immigration debate, signalling the long-lived repercussions of Merkel's decision to allow more than 1m refugees to enter Germany in 2015. According to conservative monetary officials in Bali, an important contributor to her overall weakness has been unease among core voters over a slackening of monetary orthodoxy within EMU, epitomised by the shift to negative interest rates and massive quantitative easing since 2014 – both highly unpopular in Germany. The Bundesbank has led criticism of the ECB's policies – so much so that some mainstream politicians blame the German central bank for indirectly supporting the AfD.

Italy's ruling politicians have had discreet contact in recent weeks with senior officials in the SPD-led Berlin finance ministry, as well as with the higher echelons of the ECB. However, this has failed to calm Rome's criticisms of central features of euro area policies. German officials have been anxious, in their public comments, not to inflame passions in Rome. But their private comments have been highly critical of Italy's departure from

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pre-set European budgetary rules. 'With Socialists [in the Berlin finance ministry] like these as friends, we don't need enemies,' commented ruefully one high-level Italian financial figure in Bali.

In addition to these challenges, the ECB faces a thorny dilemma and possible charges of discrimination from Italy over maintaining its quantitative easing programme next year.

Important technical changes in allocating reinvestment of national central banks' maturing bond holdings in 2019 could exacerbate Italy's budgetary dispute with the European Commission.

Potential squabbles centre on the quinquennial recalculation of the ECB's 'capital key', scheduled to come into force on 1 January, which governs the relative weights of individual countries in 19-member EMU. These changes reflect – and may in future aggravate – long-running differences over different countries' benefits and disadvantages from euro membership.

ECB President Mario Draghi pointed to deep-seated tension as long ago as November 2014, when he warned, 'If there are parts of the euro area that are worse off inside the Union, doubts may grow about whether they might ultimately have to leave.' That was a prescient reminder of the problems building up in his native Italy. According to the European parliament's latest opinion poll on different countries' perceptions of the European Union, only 43% of Italians say EU membership has brought advantages, while 45% say that is not the case. |

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