

FINANCIAL TIMES

September 23, 2012 7:22 pm

Draghi is the devil in Weidmann's eurozone drama



By Wolfgang Münchau

“Such paper, in the place of actual gold, is practical: we know just what we hold ... But wise men will, when they have studied it, place infinite trust in what is infinite.” **Mephistopheles, from *Faust Part Two*, by Johann Wolfgang von Goethe**

Whatever you need to know about Germany, you will probably find it somewhere in Goethe's *Faust*. But it is rare that wisdom is found in part two of the tragedy, one of the most revered and least read books in all of German literature. Someone who managed to dig up something truly remarkable from it was Jens Weidmann. The president of the Bundesbank cited Mephisto's advice to the Emperor, quoted above, that the simple solution to a lack of money is to print it.

Mephisto's speech encapsulates Germany's ultimate nightmare about fiat money and about monetary union. It was clear from the context and the timing of the speech that Mr Weidmann would cast Mario Draghi in the role of modern-day Mephisto, though, obviously, he did not say so explicitly. Mr Weidmann's remarks concluded one of the most extraordinary two-week periods in the history of central banking. We are on the cusp of an important new development, one the Bundesbank abhors. The US Federal Reserve has adopted a new programme of quantitative easing and has become much more determined in guiding future expectations. The European Central Bank, which Mr Draghi heads, has announced an unlimited – though conditional – programme of bond purchases; a programme that jars with everything the Bundesbank stands for and believes in.

Beyond these concrete actions, there is now a debate in the academic community about what could take us beyond hell – at least from the perspective of Faust and Mr Weidmann.

This is a debate about nominal income targeting, where a central bank no longer stabilises the inflation rate directly but focuses instead on stabilising nominal gross domestic product. You can think of nominal GDP as the sum of real GDP and inflation. If real growth falls, the central bank would thus have to drive up inflation. Conversely, if

real growth rises, the central bank would have to bear down on inflation much harder than it would do under the pure inflation targeting regime used by central banks such as the ECB.

Now look at this from the perspective of a newspaper-reading German conservative, who for decades has been fed misinformation about the functioning of a modern economy. He has been told as a fact that a rise in the supply of money and the purchase of government debt both give rise to inflation in the medium term. Newspapers even give readers advice on how to protect themselves against the now certain debasement of the euro. By quoting Mephisto, Mr Weidmann is turning fear into hysteria.

The German economic community and Mr Weidmann have never accepted the theories underlying the policies of modern central banks. This is one of the reasons the ECB ended up with an analytical approach that has "two pillars": one that looks at economic dynamics and shocks, the other at "monetary trends". The former pillar was designed to be relevant for policy; the latter to pretend the ECB stood in the tradition of the Bundesbank. I shudder to think how a debate on nominal income targeting would play in Germany.

It should be clear by now what game Mr Weidmann is playing. He is sabotaging the euro through the most effective means he has at his disposal – by reinforcing people's innate fears about the common currency. He cannot outvote the governing council of the ECB. He is in a minority of one. He also knows that he cannot overturn the ECB's policy through the legal route. Anybody who decided to drag Mario Draghi in front of the European Court of Justice would lose. Mr Weidmann no longer has any pull over Angela Merkel, the German chancellor he once advised.

But make no mistake: he is very effective in encouraging a creeping euroscepticism among Germans. In doing so, he may well succeed in undermining the chance of the euro's survival because euroscepticism limits the German government's political room for manoeuvre. The situation reminds me very much of the way the political debate in Britain turned anti-EU in the early to mid-1990s.

It was probably inevitable that this long-lingering clash of economic cultures has finally come out into the open. As Europe's recession gets worse, the ECB will soon have to adopt similar measures to those used by the Fed. It may even end up adopting a nominal income target, explicitly or implicitly, for the simple reason that the crisis in the eurozone is ultimately insoluble without annual nominal growth of at least 5 per cent. And I cannot see the Bundesbank support for any of it.

Despite its many design flaws, the ECB has reluctantly become a modern central bank. The Bundesbank is still obsessed with Mephistopheles. I do not have the foggiest how

this conflict will end. You will certainly not find the answer in part two of *Faust*.

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