The Euro Debate Gets Philosophical

John Mauldin | Dec. 5, 2011

Europe is rapidly approaching the dénouement, the Endgame, of its currency experiment. The outcome is not clear, at least to your humble analyst, as the debates rage and there are huge pluses and minuses the 17 nations must decide upon. But the proverbial road down which the can is tumbling and clattering, kicked along haphazardly, is coming to its end, and soon a rather sharp turn, either to the left or to the right, will be required. Let us hope they choose wisely.

Today's Outside the Box is a rather philosophical debate between my friends at GaveKal, which they have graciously shared with us. It is important to note that Charles Gave, Louis-Vincent Gave and Francois-Xavier Chauchat are French. Louis served in the French army, studied at Duke, and has lived in Hong Kong for over a decade. Charles (his father) is the quintessential French patriot and patrician right from central casting, whose voice has the authority of God. Anatole Kaletsky is supremely British and one of the most influential economic thinkers in Europe. He is Editor-at-Large and Principal Economic Commentator of *The Times*, for which he writes a thrice-fortnightly column on economics, politics, and financial markets. These are Europeans vigorously debating the European future as only good friends can.

What we have is an email exchange among them on the future of the euro and the inherent philosophical tensions that are faced by European leaders. I have read it three times and will read it several times more. (Do not feel bad if you need Google to keep up with some of the references. When Anatole refers to Sedan, for instance, he is not talking about cars but a major battle the French lost to the Germans in 1870. Interesting Wikipedia page for you history buffs.)

Let me give you a taste, from so many great lines. Here's Louis (who I will see Monday in Dallas – more below):

"Above, Charles focuses on the philosophical hurdles to any mass intervention. And while I subscribe to Charles' reading of the German institutional framework, my concerns are far less intellectual and far more practical. Basically, we have to remember that the average sovereign debt buyer is not a hazardous investor. The guy who buys a government bond is looking for a very specific outcome: he gives the government 100 only so he can get back 102.5 a year later. That's all the typical sovereign debt investor is looking for. Nothing more, nothing less.

"But now, the problem for all EMU debt is that the range of possible outcomes is growing daily: possible restructurings, possible changes in currencies, possible assumption of other people's debt, possible mass monetization by the central bank etc. Given this wider range of possible outcomes, and the consequent surge of uncertainty, the natural buyer of EMU debt disappears. Again, the typical sovereign investor is not in the game of handicapping possible outcomes; he is in the game of getting capital back!

"… Even if the Bundesbank did agree to monetization (which is hardly a foregone conclusion), the window for this to work may now have closed."

I will be with Louis and Anatole this coming Monday morning in Dallas at a seminar for money managers and accredited investors. If you would like to attend, drop me a note and I will get you an invitation.

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What fascinating times. What an interesting period in which to live. And don't we all want to get through this and have more certainty, in place of the roller-coaster ride we are now on? I will be glad to get back to long-term investing, but in the meantime we should appreciate the fascinating spectacles. It will make for interesting stories to tell our grandkids. Have a great week, and in the midst of spectacle enjoy the holiday season.

Your amazed to finally see it all happening analyst,

John Mauldin, Editor
Outside the Box

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GaveKal
Nov. 29, 2011

Anatole: Clausewitz, the Prussian military theorist, said in his reflections on the Napoleonic period that *"war is the continuation of policy by other means"*. If so, then it would seem that Germany is again at war with Europe; at least in the sense that German policy is trying to achieve in Europe the characteristic objectives of war: the redrawing of international boundaries and the subjugation of foreign people.

Likening German policy to warfare is a controversial argument, to put it mildly, so let me begin by briefly reviewing how events in Europe have unfolded in the past few months. Angela Merkel has consistently claimed that Germany would *"do whatever it takes"* to save the Euro. But what has she actually done? She consistently refused to take any of the actions that could actually work to save the Euro and has prevented European institutions from taking such actions, even when the German veto had no legal or moral justification.

As the Euro crisis has intensified and spread from clearly bankrupt countries such as Greece to Spain, Italy and now France, it has been universally acknowledged, at least outside Germany, that three actions are absolutely essential to resolve the Euro crisis and put the European economy back on its feet.

1. The first step would be to restore financial stability through massive purchases of government bonds by the European Central Bank. To succeed, these would have to be on a scale at least comparable to the "quantitative easing" undertaken in the past two years by the US Federal Reserve, the Bank of England, the Bank of Japan and the Swiss National Bank.
2. The second step would be to restore long-term solvency to all the nations of Europe by issuing new bonds, jointly guaranteed by the entire Euro-zone, which would replace part of the government debts run up in nations such as Greece and Portugal which are clearly insolvent.
3. The third step would be to improve and coordinate economic policies in all Euro-nations to restore economic growth, ensure that the restructured debts can be serviced and that another crisis does not occur.

By blocking the first two of these actions—large-scale ECB intervention and the issue of joint European bonds—Germany has guaranteed the failure of the third step, the restoration of economic growth and national credit. Why then has Merkel so blatantly contradicted her own stated policy of "doing whatever it takes" to save the Euro?

The initial judgment was that Merkel did not understand economics, or was too beholden to longstanding monetary traditions, or was simply incompetent. But while the crisis has intensified, Merkel has become ever more stubborn in her refusal to do what was obviously needed to save the Euro, as David Cameron discovered last week. So a different interpretation of her inconsistencies must now be considered. **Is it possible that Germany, far from trying to save the Euro, actually wants to break it up?** A clear historical precedent is the sabotage of the European exchange-rate mechanism (ERM) in 1992. And the institution that now seems to be working to destroy the Euro is the same one that organised the ERM breakup—the Bundesbank.

The Bundesbank, as an institution, has always opposed European monetary unification, except insofar as it meant the imposition of German economic philosophy on other countries. This attitude of monetary imperialism was summarised by a remark in nt Times obituary published for Richard Medley (the legendary hedge-fund consultant who was at the centre of the ERM breakup as George Soros's political consultant). Helmut Schlesinger, the Bundesbank president in 1992, was asked why he disliked the precursor of the Euro, which was called the Ecu. He replied, *"I have nothing against the Ecu apart from its name—I think it should be called the Deutschemark"*.

Back in 1992, the Bundesbank encouraged Soros and other speculators to sell Sterling and the Italian Lira in order to break up the ERM. But the Bundesbank also discretely hinted that the French Franc should be supported because France was in a different category as a German ally from Italy, Britain and Spain. As Soros later said in an interview, also quoted in last week's obituary for Medley: *"I felt safe betting with the Bundesbank. The Bundesbank clearly wanted the Pound and Lira devalued, but it was prepared to defend the French Franc. I did better than some others by sticking to the Bundesbank's side."*

Today, the role of the Bundesbank in destabilising the European financial system is much more open than it was 19 years ago. Axel Weber, the former Bundesbank president, and Juergen Stark, the former vice-president, both voted against ECB support for Greece back in May 2010 and then publicly denounced these measures to the German media, in an almost unprecedented breach of central banking protocol. Last summer, when the ECB decided to extend its half-hearted support to Spain and Italy, Weber and Stark both resigned in protest—and launched openly political attacks on their own government's European policies. A few weeks later a story emerged in *The Financial Times* reporting that Siemens had become nervous about the French banking system and withdrawn its cash balances from Societe Generale to deposit them "for safety" at the ECB. It is hard to imagine who could have leaked this story other than the Bundesbank?

Today, the Bundesbank is in the forefront of a campaign to persuade the German public and the German government that ECB bond purchases and quantitative easing are illegal under European law. In truth, the EU treaties specifically allow the ECB to buy bonds, as long as it does not do this directly from governments. And EU laws say nothing at all about the effects of quantitative easing—which is not surprising since QE is a complex issue of economic theory that could not possibly be subject to determination by the courts. What the Bundesbank believes, however, is that European law should have made bond purchases and expansionary monetary policy illegal—and if other European countries refused to write these laws into EU treaties they will just have to be imposed by Germany through financial main force.

In short, the Bundesbank policy on the Euro crisis is to present the other countries of Europe with a stark ultimatum: either they accept German economic directives, German monetary theories, German financial practices and even governments imposed by Germany, as part of a draconian new regime for national insolvency and administration. Or they must face financial chaos and expulsion from the Eurozone, under a new exclusion procedure now demanded for nations that refuse to submit to German rules. In short, Germany is trying to achieve through monetary diplomacy what were previously the objectives of warfare: redrawing the boundaries of Europe and imposing German ideas on those nations that remain within. That, surely, is a continuation of war by other means.

Charles: Dear Anatole, my first answer to the above is that there is nothing new here. I have argued incessantly in every single one of our debates since Axel Weber's resignation that the Bundesbank was now in an open war with the concept of the Euro. I have also pointed out that, in my career, I have seldom made money when betting against the Bundesbank.

Now there are of course many reasons behind the hostility of the Bundesbank to the Euro. The first is obvious enough: the Euro was thrust on an unwilling Bundesbank by Mitterrand and Delors as a compromise to France accepting German re-unification. So the Euro's very birth was an unhappy one to start with.

Beyond that, the hostility rests, I believe, on important philosophical differences. Indeed, Max Weber suggested two sets of ethical virtues that a proper political education should teach: **the ethic of conviction (Gesinnungsethik) and the ethic of responsibility (Verantwortungsethik)**. According to the ethic of responsibility, an action is given meaning only as a cause of an effect; i.e., what matters is the consequences. According to the ethic of conviction, on the other hand, a free agent should be able to choose autonomously not only the means, but also the end; *"this concept of personality finds its „essence" in the constancy of its inner relation to certain ultimate „values" and „meanings" of life".* Weber recognized a gulf between his "Two Ethics," one which is concerned with consequences and one which is duty– and rules-bound. His problem arises from the recognition that the kind of rationality applied in choosing a means cannot be used in choosing an end. **Increasingly, the current debate on the Euro is nothing but a conflict between these two forms of ethics.**

In one camp, are those who, like François and yourself, say that nothing is more important than preventing a collapse of the Euro. In the other camp, the Germans say that nothing is more important than upholding the international treaties, and maintaining the supremacy of the law over the pressure of short-term solutions.

Now because of its unfortunate history, this debate can get emotional very quickly in Germany. Indeed, more than any other people, the Germans have suffered from adopting the second view, with huge negative consequences for Europe and the world. As a nation, it is thus my impression that Germany has come to the conclusion that, at the end of the day, one should never tamper with the law, whatever short-term benefits such tampering might bring.

If we apply this distinction to what money is, those who believe that money is a tool which belongs to the political sphere and can be manipulated to meet political goals, justify their destruction of money by an ethic of responsibility (fighting unemployment, creating economic growth, etc). For what it is worth, let's call them "Keynesians". On the ethic of conviction, we have the Bundesbank and the German population (but not so much the German political system) who say that money is a common good which does not belong to the state, and that the economy has to adapt to this reality, and not the other way around. Let us call them the "Austrians". As our readers know, Anatole, you are intellectually very much in the first camp, while I plant my flag in the second. With that in mind, the current debate on the Euro can be framed as such:

· On the one hand, there are those who believe that the end justifies the means. If saving the Euro requires the destruction of the notion of money as a common good, so be it. The fact that the Euro is slowly destroying Europe (as was entirely predictable—and predicted in our pages), thus leads our "Keynesians" to recommend measures and actions which have been specifically forbidden in the treaties, the German constitution, or the bylaws of the ECB.

· On the other hand, there are those who remember that Hitler said that treaties and constitutions were nothing but pieces of paper. For such Germans, it is simply inconceivable that the law could be made subservient to a political or economic goal. They believe that destroying the law is far more dangerous than destroying the Euro, and they say to the others that the solution is simple: they signed the Treaties, they now have to respect them.

I respect the German vision. The treaties creating the ECB and the Euro were built around the German notion of money and everybody knew it. So when Merkel says that the others have to become Germans, she is perfectly entitled to do so, since it was exactly what the treaties said (and why the British, Swedes and Swiss rightly refused to join). In my view, on this point, the Germans are right. **Frankly, one does not sign a treaty with Germans in the hope that the Germans will be flexible**. They never were, and given their own history, are now less so than ever.

I also have a lot of sympathy for the German view of questioning why we should sacrifice every rule, and treaty, to uphold a currency that is clearly not working for a number of countries? Must the survival of the Euro in Southern Europe really only occupy every waking hour, of every European policymaker (and investor)? Must it really take precedence over every other institutional framework? **In short, is the Euro really the end-all, be-all of European civilization; the altar on which everything else can be sacrificed**? Is this really as good as we get? Or are European policymakers only trying to save the Euro (and sacrificing the youth of a number of countries) to avoid having to admit that they made a colossal mistake?

Louis-Vincent: In all our previous debates, and in *The Divergence in European Spreads—Why Now?*, I argued that there were four possible resolutions to the European crisis:

1. The first was for troubled countries to leave and redenominate their debt in their local currencies, thereby avoiding a default but imposing massive foreign exchange losses on foreign bondholders.

2. The second was for Germany to leave—though this seemed highly unlikely as this would in essence bankrupt every German bank, insurance company and pension fund (whose liabilities would be redenominated in DM and whose assets would remain in Euros).

3. The third was for the weaker links to default and restructure their debt.

4. The fourth was for the ECB to become far more aggressive in its purchases of troubled-country bonds and swell its balance sheet.

Now up to just a few months ago, the Europtimists kept arguing that all these events were just not going to happen. Instead, the more likely scenario was one of deep structural reforms combined with some fiscal transfers and a little bit of help from the ECB. Such a combination, I was told in many meetings and even in some of our internal debates, would help to keep the Euro-show on the road.

Fast forward to today, and every Europtimist (see the latest *The Economist*) is now arguing that solution 4 has to be the answer. Obviously, this is also what Anatole is arguing for by equating the German resistance to such an outcome to an "act of war." So already we have witnessed quite a paradigm shift. **But is it now too late for this? In other words, have Europe's debt crisis and deflationary-bust moved beyond the powers of an ECB's magic wand?** Not that I don't believe in Santa Claus, or in the ability of central banks to cure every ill, but it seems to me that, should the ECB decide (a day late and a Euro short?) to now intervene in size to prevent the European bond markets from deteriorating further, it would face some very significant hurdles.

Above, Charles focuses on the philosophical hurdles to any mass intervention. And while I subscribe to Charles' reading of the German institutional framework, my concerns are far less intellectual and far more practical. Basically, we have to remember that the average sovereign debt buyer is not a hazardous investor. The guy who buys a government bond is looking for a very specific outcome: he gives the government 100 only so he can get back 102.5 a year later. That's all the typical sovereign debt investor is looking for. Nothing more, nothing less.

But now, the problem for all EMU debt is that the range of possible outcomes is growing daily: possible restructurings, possible changes in currencies, possible assumption of other people's debt, possible mass monetization by the central bank etc. Given this wider range of possible outcomes, and the consequent surge of uncertainty, the natural buyer of EMU debt disappears. **Again, the typical sovereign investor is not in the game of handicapping possible outcomes; he is in the game of getting capital back**!

This is very problematic because once uncertainty creeps in, bonds will tend to gradually drift towards what I have come to call the bonds "no-man's-land". Basically, once sovereign bonds reach 90c to par, they tend to have a much higher volatility and much greater uncertainty**. As a result, they are no longer attractive to the typical bond manager or asset allocator looking to buy bonds to diversify equity risk** (think how Italian bond yields are now correlated to European equities. If you want to be bullish Italian bonds, you may now just as well spend a fifth of the money and buy European banks for the same portfolio impact…). And once a bond enters into no-man's-land, it has to fall a lot before attracting the attention of distressed debt and vulture investors (usually yields of 15%+). **So the first obvious problem is that more and more European debt markets are entering this "no man's land" bereft of "normal" investors**.

Of course, this invites the conclusion that the ECB should thus do everything in its power to bring the bonds out of this no-man's land. But what are those magical powers the market keeps referring to? After all, the various European institutions (ECB, EFSF…) and the IMF have mopped up almost a third of the Greek debt and yet it is now trading at 25c on the Euro! Perhaps this goes back to the way a typical sovereign debt holder thinks? Indeed, let us imagine that, tomorrow, the ECB follows every editorialists' advice and comes in to mop up a third of Spanish and Italian debt in a bid to get yields fixed at, say 5%. Will our Spanish and Italian bondholders a) jump at the chance to get out of their positions with a smaller loss than forecast? Or b) sit tight and allow themselves to be transformed into junior bond holders?

Indeed, the Greek precedent (where basically the ECB insisted on being made whole while the private sector shared in the losses of lending money to the spendthrift Greek government) means that the default assumption of sovereign debt holders should be that a mass intervention of the ECB into their markets will relegate them to the "junior ranks." And needless to say, most institutions who invest in sovereign bonds are not looking to be junior bond holders. They are looking for absolute safety. So in a perverse way, massive purchases by the ECB may actually highlight that the asset one owns is anything but safe; implying that for an ECB intervention to work, the amounts would likely have to be staggering. This is why I tend to believe that even if the Bundesbank did agree to monetization (which as Charles highlights is hardly a foregone conclusion), the window for this to work may now have closed. Instead we should brace ourselves for either defaults, or countries leaving and re-denominating debt in local currencies.

Anatole: Charles, your Weberian response to my article on Germany's war against Europe is thought-provoking. But it leaves out two crucial points:

Firstly, It is not at all clear that asking the ECB to buy bonds in the secondary market conflicts with any law. This is Merkel's *interpretation* of the EU treaty. But all that the treaty actually says (Article 123) is that the ECB will not finance governments by providing "overdraft facilities" and buying their debt *directly in* the primary market. The legislative history of this article is interesting. The Germans wanted a tougher prohibition about monetary financing written into the Maasrticht Treaty, but the other countries refused. The compromise was Article 123. Merkel is now trying to *interpret* this article *as if* it enshrined the laws that they *wanted*. It is therefore the Germans who are trying to twist the law in their favor, not the French, Italians, etc.

Secondly, laws need to be changed with the passage of time. That is what government, and especially democracy, is for. Therefore **a dogma of upholding the law as it is, regardless of circumstances, and refusing to change it is not justifiable even for Weber's "ethic of conviction".** Your response to this objection would presumably be that **some** laws are so important that they should never be changed even by a democratic decision—for example, laws on human rights, racial equality and religious freedom, constitution arrangements and other fundamental laws (which is actually what Germany calls its constitution). I fully agree with this, although even constitutions always contain an amendment process—at least if they are properly drafted, which of course the treaty on European Union never was! Still, it is clear that your ethical argument (and Merkel's) only applies to tampering with fundamental laws, not the much larger number of everyday regulations that are needed for society to function, e.g.: driving speed limits, postal charges...

The question, therefore, is whether monetary laws should be treated as ethically fundamental in the same way as laws on free speech, political association, religious freedom, property rights, capital punishment, etc. I personally do not think so. To me economics is a pragmatic activity with no clear answers. The "right" of a central bank to operate independently of government is not, in my view, an ethical question, comparable to capital punishment or even the right of the citizens to adequate healthcare. This is, I think, the fundamental point on which you and I disagree.

Which leads to my third objection: even if we accept that the "right" of central bank independence is a fundamental right comparable to other constitutional requirements, Merkel is not upholding this right. In fact she is doing the opposite. She is issuing political *instructions* to the ECB on what it cannot do. If the Germans genuinely believed in the rule of law and in central bank independence, they would not try to prevent the ECB from doing whatever it thought was necessary and desirable. If the ECB board, as properly constituted under the EU Treaties, voted to buy the entire

Italian, Spanish and French secondary bond market and to engage in QE to the tune of €10trn, then Germans would have to calmly accept this as a lawful consequence of the treaties their government had freely signed. In fact, therefore, Merkel is not exemplifying the respect for law and ethics of conviction as you describe. She is reinterpreting laws and tampering with treaties in whatever ways happen to suit her.

Charles: Anatole, since we are treading on philosophical grounds, could I say that we must both have studied casuistry in our youth for this is increasingly looking like a debate between a Jesuit and a rabbi.

On your first point, if a French commercial bank subscribes to a French bond and sells it in the following second to the ECB, what do you call this? Moreover, doesn't the treaty specifically forbid joint responsibility of the debt and the mutualisation of said debt? What the ECB is doing in buying in the secondary markets in amounts higher than those needed for its open market operations is not compatible with these parts of the treaty (even if it is compatible with article 123), since Germany could be on the hook if a country failed (through the participation of the Bundesbank in the ECB). So it seems to me that Merkel is perfectly entitled to her legal views: the ECB's recent actions are de jure and de facto against both the letter (no mutualisation of the debt) and the spirit (no financing of budget deficits by the central bank) of the treaty.

On your second point, I most definitely do believe that money is far too important to be left under the control of politicians (especially French ones!) and let me explain why. The purpose of economics is to understand why things have a value and why those values change over time. To do so requires a measurement in "money". But no economist has ever been able to explain why money has any value since it has a marginal cost of production of zero. For me, money is a kind of social contract which binds a "demos" (Plato called it a "convention") where citizens accept to use it in their transactions or for their savings. But this convention is a very fragile thing.

Renan used to say that a nation is defined by the willingness of its citizens to live together, and this willingness was what created a "demos." There is no European demos, so there is no possibility of a European currency. **To make it simple: to each demos its currency.** There is no European Nation, there is a European Civilization, which is not at all the same thing (see *Was the Demise of the Soviet Union a Negative Event?*). Money thus does not belong to the government, but is a common good of the demos.

If I have learnt something after the debacle of the so-called "financial revolution of the last twenty years" it is that one should never put the monetary policy under the control of the politicians, and that money should never be "privatized," or put under the control of the market, since it has a marginal cost of production of zero. The privatization of money which started under Clinton, and was continued under Bush and Greenspan, led to the current disaster. **In my view, money is a common, (and more importantly—perhaps as I am getting older) trans-generational good that no generation should be able to manipulate for its benefit.** The only role of the government should thus be to regulate the credit system without which an economy cannot work. The attempt to regulate this credit system internationally rather than at the national level is the root cause of the current problems, the governments having failed miserably in their regulatory role. Since they have failed, like any bad trader, they are now busy doubling and tripling down. This never works.

On your third point, I have read a thousand times that if the board of the ECB decides on monetization of the debt, the Germans should just accept that decision. Except of course that the board is bound by the bylaws or the treaties which specifically forbid such a decision. What Merkel is saying is thus very simple: if the board gives in to the French or the Italians because they have the majority, then this decision will not be legally binding for Germany. In other words, she is telling the board members to respect the treaties, which guarantee the ECB independence against French or Italian politicians looking for an easy exit, as they always do, or else…

This seems to me perfectly fair and leads me back to my original point, which our latest exchange of emails amply proves: you believe that the end justifies the means (ethic of responsibility). I (like the Germans) do not (ethic of conviction). To conclude on a historical note, I believe that Chamberlain practiced the ethic of responsibility and

Churchill the ethic of conviction. And reviewing Chamberlain's actions, Churchill said "*they accepted dishonor to avoid war. They will have the war and will have lost their honor*". Looking at your proposed remedies, your solution is to destroy money to avoid ruin. We will have the ruin; it is too late and will lose our "money" anyway. Destroying money does not create wealth any more than deregulating it.

Anatole: As you have raised the issue of casuistry I must return the compliment and say that your casuistic education must have been even better than mine.

You are right that the ECB has been funding EU governments via the banking system, but the Germans never objected to this—and still do not—for the simple reason that this form of government funding is considered acceptable in Bundesbank theology. Why this is so has never been clear to me, but it must originate in some theorem of Austrian economics which I never studied. Last year, I had the chance to put this question to Axel Weber himself and he confirmed in the clearest terms that ECB lending to banks which then on-lend to governments is a perfectly acceptable way to conduct monetary policy.

Incidentally, some of the people I met in Frankfurt last week were as baffled as I was by the Buba doctrine that financing the Greek government directly is unacceptable, whereas funding insolvent Greek banks so that they can finance their government is perfectly OK. In any case, this issue of financing governments was thoroughly debated and negotiated in the Maasrticht Treaty talks. The result, as I said in my earlier email, was that the other countries refused to go as far as the Germans wanted in forbidding monetary financing under Article 123. Moreover, the German demand for a prohibition on mutualisaing debt, which you mention, was also rejected by the other countries at Maastricht. I know the Germans are always quoting the so-called "no bailout clause", but like the monetary financing clause this part of the treaty does not say what the Germans now claim. The no bailout clause (Article 125 of the new Lisbon Treaty) says this: *"A Member State shall not be liable for or assume the commitments of central governments...or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."*

This leaves plenty of scope for EU member governments to agree on mutual guarantees for institutions such as the EFSF and ESM to execute a specific project like the rescue of the Euro. Again, this is a case where the Germans, having failed to achieve their objectives in the original treaty negotiations, signed up anyway and are now trying to reinterpret the laws retrospectively to get what they want. Far from showing respect for Laws and Treaties, this is uncomfortably reminiscent of the German attitude to the Treaty of Versailles.

Now you may be right that money is a public good which should not be subject to political manipulation, but the precise mechanisms for issuing and managing money have always been subject to change—and rightly so, in my view. We both agree that returning to the gold or silver standard would not be a good idea even though money was "always" managed like that until the 1930s. Of course, others have different ideas about the gold standard and these are quite legitimate. And there are a multitude of different views about whether it is best to control money by using interest rates or inflation targets or monetary targets and which ones - eg monetary base, M1 or M3 or the exchange rate. These different views about monetary management are not about moral or philosophical issues. They are empirical judgments about what works best in the real world. Thus the German idea that monetary financing of government deficits will always and everywhere generate inflation and destroy confidence in the public good money (which you seem to share) is not a moral principle. It is a particular view about how the economy works which can only be judged by whether it turns out empirically to be right or wrong.

As it happens, an important experiment is now being conducted in monetary financing all over the world. If the US, Britain, Japan and Switzerland, all of which are now engaged in monetary financing, suffer serious inflation and a loss of confidence in the value of money, then the Germans (and you) will be proved right. Thus far, however, most of the evidence points in the other direction. (By the way I am not claiming in the last sentence that monetary financing has been successful in managing the US, British, Japanese and Swiss economies—that is another issue—but merely that it has not undermined the public's desire to hold money, as the Germans and you seem to believe).

Finally, I have already responded to your point about what the laws actually say above. So let me comment on your claims about unprincipled pragmatism.

It seems to me that "The End justifies the Means" is actually a good description of your approach to this whole single currency disaster. For you, 'the End' is the breakup of the Euro and you are willing to endorse all kinds of dishonest and economically destructive behavior from Germany to achieve this end. I believe, on the contrary, that Merkel should be judged on the effects on the world of what she is doing as well as on her party's motivations, which are politically self-serving and short-sighted. Like you, I would prefer to see the Euro break up, but I am not going to pretend that Merkel and Axel Weber are morally right, simply because their behavior happens to be advancing my side of the argument.

So in conclusion, I would return to a point that I have made before; namely that if Germany continues to want to play by its rules, rather than the rules of the community, then France should invite Germany to leave the Euro.

François: Anatole, even if your scenario of Germany leaving the Euro made economic sense for France (on which I am not convinced), I am sure that you have already noticed that French politicians are not that interested in economics. Instead, plans that are economically consistent but that threaten the French political influence in large parts of Europe remain a non-starter for our dear énarques. And you will never convince the French that they might eventually regain this influence thanks to the indirect, magical effects of a devalued currency. They won't believe in it (I don't either, by the way), and even if they did believe in it, they would never have the guts to bet on it anyway. Maintaining the status quo remains the default option for any French politician.

In *Capitalism 4.0*, you wrote how many UK economists and politicians had been surprised by the good performance of the economy in the years after the Pound left the ERM. You explained that many in the UK initially feared that this "loss of monetary anchor" would lead Britain to nowhere. On the contrary, it provoked renewed internal confidence. Could this benefit happen to France and Italy? Implicitly, this is your bet, and I find it very interesting. But as you know the UK Pound did not stay in the ERM for long, while France and Italy have anchored their monetary destiny upon Germany for more than 30 years. It is in this respect very telling that Italy did not stay long outside the ERM after it was forced to leave in 1992 (it joined back in 1996). Similarly, France did not leave the ERM in 1983. For sure, these successive political choices might be seen as meaningful of countries that lack self-confidence, and these different episodes might well have represented lost opportunities to pursue more sensible economic policies. But for both historical and economic reasons, France and Italy have felt that they needed to keep up with Germany in order to participate to the elaboration of a soft-power of global dimension, which is what the European project is about. Whatever opinion we may have about how this project is being conducted, it is a very respectable project. And after so many years and so much capital invested in it, its possible dismantling would leave much deeper scars and provoke a much larger chaos than when the UK Pound left the ERM.

Anatole: François, you have hit the nail on the head. I agree with you completely that the French enarques would not want to break with Germany even if it could be demonstrated with 99% probability that such a policy would make France stronger and more prosperous. Such is the power of what I believe you call the "pensée unique". But the problem is not a political one but is now an economic one. In other words, French politicians may decide to ignore economics but the rules of economics are not ignoring France and France may well not be able to cling to Germany much longer. This is especially true if the Germans now realise that France has become completely subservient and that, therefore, Germany no longer needs to compromise in any significant way to accommodate French demands. In short, France is currently living through yet another "Sedan"!

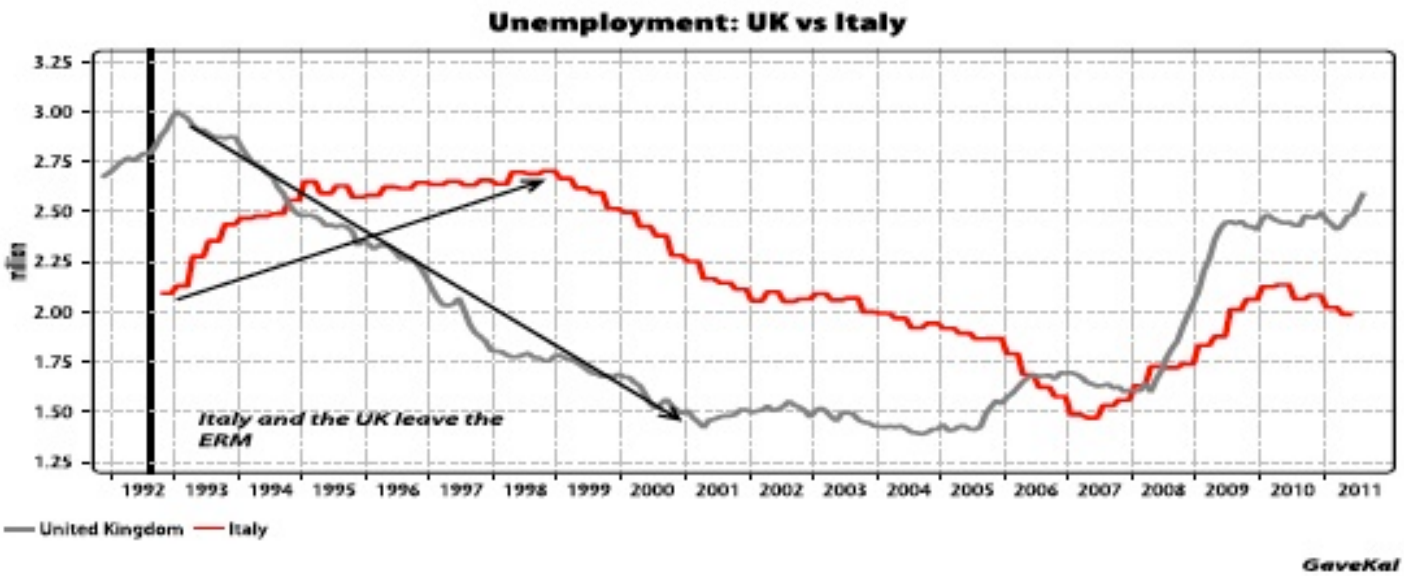
Louis: Speaking of Sedan, once it becomes apparent that the enarques are turning France into a German colony isn't it possible that the public will rebel? In other words, could we not see another "Paris Communes"? At the very least, we will likely see Marine Le Pen make new gains for the National Front in May, and likely make it to the second round. And who is to say that, as the French economic situation deteriorates further, she doesn't face off against another fringe candidate, perhaps from the far left? Let us not forget that the combined far left (communists, various

Trotskyites parties…) have typically polled a combined 15-25% in French elections. Fortunately, they were always scattered amongst many parties (in a scene reminiscent of "*The Life of Brian"* with the "Judean People's Front," the "Popular Front of Judea," etc…). But now that they are gathered under the Melenchon roof...

Francois: Since 1983, French voters have indeed voted more and more against the traditional parties (2007 was an exception to this rule). It is however not that easy to assess why. Many countries with independent economic policies are seeing the rise of the extreme right or left, while in a suffering Euro country like Spain, the traditional parties continue to attract 95% of the votes. I would thus not be able to demonstrate that the rise of political tensions and dissatisfaction in France or Italy has been due to the anchoring of economic policy on Germany, contrary to what the you suggest.

Moreover, in France, the return of the German constraint upon economic policy is for now leading the country more towards introspection (the realization of the huge costs of our so-called social model) rather than towards resentment against Germany. In fact it is even possible that, contrary to what you suggest, the centrist parties attract more, rather than less, votes in the next elections as more and more people realize that the country needs to be more seriously managed. We will see.

Finally, what exactly are the real benefits of a rebuttal of the German constraints? I suspect that Anatole is too much influenced by the success of the devaluation of the Pound in 1992. But in Italy, which left the ERM at the same time, the following years were far less fun, as the chart below illustrates:



Indeed, the UK could enjoy the benefit of the 1992 devaluation because its economy had been re-vitalized by the reforms of the Thatcher era (meanwhile, today, after more than a decade of creeping Blair-Brown health and nanny-statism, it is a very different story!). Anyway, I do not think that anyone in France would suggest that if Germany left the Euro, or if France simply refused the German constraint, the French economic situation would improve. Our problems are of our own making and are not so much related to having the wrong currency, as to having a welfare, and regulatory, state on steroids.