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Merkel, mistrust and the markets

By Richard Milne in Berlin

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As Angela Merkel prepares for this week's European Union summit on the euro, a visitor to Berlin is struck by how the German chancellor is struggling to reconcile two powerful forces: her commitment to 50 years of European integration and a deep mistrust of financial markets.

With one eye on the fallout from the global financial crisis, she believes that markets are not always right. Ms Merkel does not believe that markets are necessarily the enemy and she is also acutely aware of the pressure of financial expectations: without a credible deal this week many analysts predict a further decline in eurozone bond markets, or even the break-up of the single currency.

The fraught relationship between Ms Merkel and the financial markets can be explained partly by mutual miscomprehension. A Lutheran brought up in communist East Germany, Ms Merkel shares the view of Nicolas Sarkozy, the French president, that political legitimacy should trump the unelected power of Wall Street and the City of London. Yet France, Germany and other eurozone governments manifestly depend on market confidence to fund the sovereign borrowing required to sustain their economies.

As one senior figure who has long played a role in the euro negotiations says, politicians hate being pushed around by markets but "Trotskyists in London understand markets better than conservatives in Europe."

Ms Merkel's scepticism also stems from bitter experience. She followed investors' advice and called for private holders of Greek bonds to share the burden of a second bail-out for Greece.

Those who have spoken to the chancellor say she feels duped by those investors, who urged her to agree to a restructuring of Greece's massive debt burden but then told the chancellor that she had also made all other eurozone bonds suspect. The European Central Bank and Mr Sarkozy had warned that such contagion would happen.

The Greek bond debacle explains, in part, Ms Merkel's opposition to massive ECB bond-buying, the solution that markets would most like to see to restore confidence in sovereigns and therefore Europe's shaky banking system.

Ms Merkel does not appear to be against quantitative easing *per se*. But with the ECB barely 12 years old and still fighting to establish its credibility and backed by 17 national governments with diverging public finances, Berlin is unwilling to sanction action.

Moreover, according to the thinking in the Chancellery, an investor unwilling to buy Italian bonds today would still be unwilling after several years of ECB purchases. Setting targets for eurozone bond yields or spreads – that, say, Italy's interest rates should not be more than two percentage points higher than Germany's – is similarly given short shrift, despite being debated at the ECB.

Such targets could well calm markets but, in Berlin's eyes, would raise the risk of a political crisis. Conversely, if Mario Draghi, the ECB's newly appointed president, does open the door to bigger purchases, as he hinted last week, Germany might disapprove but would never try to block the bank.

In the last resort, there remains a tension between the accelerated pace of financial markets and the painstaking slog toward political and economic integration followed by Ms Merkel and her European colleagues.

This is what David Mackie of JPMorgan calls the "intertemporal dimension" of the two-year-old crisis. Investors and elected government work on different timescales, according to different incentives.

Berlin believes that more money on the table now means fewer reforms in the eurozone's periphery later. A precedent came in August when the ECB started buying Italian bonds only to see the government of Silvio Berlusconi begin backtrack on reforms as yields fell.

Similarly Ms Merkel's efforts to find a long-term solution runs counter to the markets' desire for clarity in the short-term. She rules out eurobonds today – another favourite of the markets which like the idea of common debt issuance for all 17 member states – and insists closer fiscal integration over time is the answer.

That scarcely helps traders seeking to make decisions today, however.

Ms Merkel's faith in the eurozone's current and future bail-out funds, the European Financial Stability Facility and European Stability Mechanism, to provide firepower alongside the International Monetary Fund seem less likely to calm markets' fears of a break-up of the single currency than an ECB intervention.

Markets are sceptical of the latest claims of an impending breakthrough after numerous false dawns. Mr Mackie's intertemporal argument suggests that markets sometimes only seem

interested in an urgent outcome. The time for the markets and Ms Merkel to discover a mutual comprehension of one another is rapidly running out.

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