Sunday Wrap

Happy Sunday,

Today commemorates the 7/7 London bombings 14 years ago in which 56 people were killed and more than 700 wounded. It seems a good occasion to reflect on how we think of each other in this globalised world – and which leaders we (who are lucky enough to live in liberal democracies) elect to run our societies.

And, quite fittingly, the big news this past week was Tuesday's decisions by the European Council on the four key European appointments. They decided "to elect" Belgian PM Charles Michel as the next President of the European Council, "to propose" German defence minister Ursula von der Leyen as the next Commission President, "to consider [Spanish foreign minister] Josep Borrell Fontelles to be the appropriate candidate for High Representative of the Union for Foreign Affairs and Security Policy" (i.e. EU foreign minister) and to "consider Christine Lagarde to be the appropriate candidate for President of the European Central Bank".

The following day, Wednesday, the newly elected European Parliament completed the line-up of new EU leaders by electing David Sassoli, Italian member of the Socialist Group, President of the Parliament, but only for 2 ½ years after which he'll step down and hand over the presidency to someone to be elected from the centre-right EPP group.

As you'll have noted from the carefully selected verbs in the press release, the heads of state "elect" their President, but can only "propose" the Commission President, who, along with the rest of the Commission, will need to be approved by the European Parliament. The Commission President will, in turn, "decide" on the foreign minister. And the ECB President will also need to be approved by the Parliament.

The European Parliament's confirmation processes will get under way the week after next, and while they are all likely to come through, the sign-off of von der Leyen will not be straight-forward. Most of the parliamentarians are smarting from the defeat of their treasured Spitzenkandidat system (more on that below), and the German faction of the Socialist Group is upset because they regard the agreement on von der Leyen as a violation of Berlin's coalition agreement (in spite of Merkel abstaining in the actual vote). But whether they'll actually join the Greens and others and oppose her confirmation remains to be seen. Not surprisingly, von der Leyen is already hard at work in Brussels and Strasbourg to smooth the way, which will include a number of promises to the parliamentary leaders in return for their support.

While the smart money is on von der Leyen being confirmed, if that were not to be the case (small risk), there would be a measurable probability that the entire – finely calibrated and balanced – group of nominations could unravel as well.

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I'll discuss three issues below:

- **What the selection of this new European leadership team illustrates in terms of the shifting powers within Europe.**
- **Christine Lagarde at the ECB: The challenges ahead, Part I.**
- **Ursula von der Leyen at the Commission: What to look out for.**

1. What the selection of this new European leadership team illustrates in terms of the shifting powers within Europe.

If you have read my previous musings about the likely picks for these key European positions, you'll know that I was surprised by the final outcome. I guess there were more ways than I had envisaged to shake the preferences with respect to gender balance, composition of nationalities, geographical distribution, and political party affiliation. In the end, the relative priorities within those preferences turned out somewhat differently than I had thought.

So, what did we learn from the outcome in terms of the shifting powers within Europe. I'll suggest the following four key lessons:

First, politics won over diplomacy, and power was returned from Brussels (and particularly from the European Parliament) to the national capitals, and – by a mile – to Paris and Berlin. Not only was the European Parliament's grab of power five years ago (via the Spitzenkandidat system) killed off, the Parliament ended up following the recommendation from the European Council, in terms of party affiliation, when picking their new president (although defied the recommendation of the specific candidate, Bulgarian Sergei Stanishev.) The fragmentation of the political groups in this new Parliament (largely the outcome of the rise in nationalism) clearly weakened its power which was then elegantly exploited by the heads of state, chiefly by Macron.

Second, the French-German political motor is back in charge of Europe. Germany (finally) got the Commission presidency, but only after Macron came to Merkel's rescue when her EPP group rose against her. And France retook the ECB, while the Council Presidency went to one of Macron's closest European allies. By any stretch of the imagination, through these marathon negotiations, Macron has established himself as clearly the most influential European leader, while Merkel uncharacteristically wobbled.

Third, as "shamelessly pro-European" (meant as a compliment) Macron was the winner, the Euro-sceptic Central European, Italian and Danish governments were the losers to various degrees. Most strikingly, the CEE countries have been side-lined. In spite of the clear commitment to geographical distribution of positions, the entire CEE region came away with nothing – unless you count their torpedoing of Frans Timmermans' candidacy as a victory (a victory that might well turn out to be rather Pyrrhic, as I'll discuss in Section 3 below). Italy's influence has also been diminished, but that was inevitable since no less than three of the outgoing five top-jobs were filled by Italians (ECB's Draghi, "Foreign Minister" Mogherini, and President of the European Parliament Tajani). But even taking that into consideration, despite all the rhetoric from Salvini and some of the CEE leaders of "changing the EU from within", I haven't found a single credible account of the negotiations which suggested that Italy - or CEE - played any measurable role in the selection process beyond the opposition to Timmermans. Euro-scepticism (in a more institutional way by having exercised all the optouts) also contributed to Denmark's inability to bring one of the most high-profile and qualified candidates – and a woman – over the line to the presidency of the Commission. If there was any doubt that Europe is run by the leaders of the fully-signed-up core countries who are determined to move the European integration process forward, then that's now been put to bed.

Fourth, the shifting political winds across Europe is throwing up more political vacuum than new power structures: The hard-line "euro-sceptics" were nowhere to be seen in the negotiations and their club got nothing. And the softer version, the CEE-brand of the EPP, managed at best to be spoilers for Merkel which, if anything, strengthened Macron's hand. As I have discussed before, nationalists are inherently bad at coordinating and cooperating, and it showed – again. Maybe more surprisingly, in spite of their strong showing in the election and their commitment to Europe, the Greens did not come away with anything.

2. Christine Lagarde at the ECB: The challenges ahead; Part I.

If all goes to plan, on November 1, Christine Lagarde will take her impressive experience and communication skills from eight years as head of the IMF and four years as French economics and finance minister (as well as two other ministerial positions and a law practice) to the top office at the Eurotower in Frankfurt.

The three key questions raised by market participants so far are (i) will she change the course laid out by Draghi? (ii) how will she operate, given her lack of central bank experience and/or high level academic economics training? And (iii) Will she be committed to "whatever it takes"?

I'll take them – briefly – in turn in this "Part I of the challenges ahead" (spoiler: The answers are "no, unclear, and yes"). In Part II (topics for the next couple of Sundays), I'll discuss Lagarde's likely approach to the fundamental questions for the ECB (and Europe) on the low inflation/low rates environment, the risk of bleeding the financial sector to death, the monetary-fiscal interaction, and the completion of the currency union.

So, here we go:

(i) Will Lagarde change the course laid out by Draghi?

No! The overwhelming probability is that Lagarde will implement policy changes very closely in line with what Draghi has already communicated, namely a rate cut in late summer, probably September (with some mitigating measures for banks), and - rather likely - another dose of QE late in the year. My strong feeling is that the combination of economic developments and Draghi's persuasiveness in the Governing Council means that by the time Lagarde arrives on November 1, there'll already be a decent majority in the Governing Council for such further easing. Therefore, it's virtually inconceivable that she would try (even if she wanted to) to turn the governors around again. The more interesting question will be how she'll handle the (very likely) remaining dissenting minority in the Governing Council.

And to be clear, I think the market is right to perceive Lagarde as dovish at this time. She surely doesn't see herself as an independent monetary policy thinker, but rather (rightly) as someone exceptionally good at reading the tealeaves and taking advice from those she trusts - and with the vast majority of the world's central bankers and monetary policy experts being worried about the world these days, she is surely dovish now – potentially very dovish.

(ii) How will Lagarde operate, given her lack of central bank experience and/or high level academic economics training?

Beyond "the task" of implementing Draghi's forward guidance during the next 6-12 months, how Lagarde operates, who she'll rely on etc., will be a key question – and there isn't really an answer yet. Lagarde's arrival at the ECB will mean that both the President and Vice President of the ECB are former finance ministers with great standings and respect at the highest political level, but without high level economics or monetary policy training to guide their day-to-day life. And Benoit Coeure's departure at the end of the year may imply further erosion of the Executive Board's detailed knowledge and experience. Depending on Coeure's replacement, the Executive Board could be left next year with chief economist Philip Lane as the only member with deep technical understanding of economics and central banking. (Of course, right below the Board sits an extremely experienced and talented senior staff at their disposal.)

So, while it's still early days, it seems reasonable to contemplate the possibility that the power structure at the ECB may revert back to what we saw in its earlier days with a "generalist president" and an immensely powerful chief economist role under Otmar Issing. Of course, monetary policy today is considerably more complex than it was back then and the need to communicate it now is so much higher, but this incoming "generalist president" is by any measure a master communicator, in a class of her own. Whether that's enough, remains to be seen, of course.

If this hypothesis is right, Philip Lane is the man to watch. So far, Lane has given only one monetary policy speech since joining the ECB, namely in Helsinki this past Monday, and if there were any doubt before, he used his maiden speech to tell the world that he is fully aligned with Draghi. In a very good speech, Lane provided a strong defence of the monetary policy tools, and their effectiveness, used so far, with several illustrations of what the counterfactuals would have looked like (something Draghi's opponents have been painfully short on). Philip Lane also echoed Draghi's policy message from Sintra to a tee. His very read-worthy speech is here: Monetary Policy and Below-Target Inflation

(iii) Will Lagarde do "whatever it takes", if needed?

Yes, without a doubt – and I say that for two reasons. First, to be willing to trigger the OMT, the ECB president will have to be a committed European in the true sense of being willing "to do whatever it takes" – and make sure that "it'll be enough" to save the euro. Without a shade of doubt, Lagarde fulfils this condition. In addition to her "political level", making IMF resources available in huge sums to several of the peripheral countries during the sovereign crisis provides amble evidence of this commitment.

Second, since the decision to trigger the OMT would always have to be taken with incomplete knowledge, and therefore based on a number of assumptions, including trust in the political commitments of the recipient governments, and accepting the imperfection of the world, the ECB president would have to be willing to take risks – to have "guts" in the face of inevitable opposition from some corners, potentially including powerful constituencies. In my assessment, Lagarde has showed the necessary guts and tough side on several occasions at the IMF, but particularly when she drove through the huge rescue packages to the European periphery, dispending long established rules, to save Europe – and the world – despite pretty pronounced scepticism, if not outright opposition, from other shareholders, including some very powerful ones.

In other words, I have no doubt that Lagarde will run the ECB just fine in the present environment, overseeing continued supportive policies – and I have no doubt that if the ECB is again called upon to save Europe, she'll make sure it's there and will do “whatever it takes”.

Where I am less clear is with respect to the other big questions on how she thinks about the impact of long periods of negative rates and a flat curve, on the (no longer trivial) risk of bleeding the European financial sector to death, how strongly she'll engage herself to bring governments to respond with fiscal policy, and how she views the need to complete the currency union. These are big questions, but who will she turn to to get advice on these profound issues? I'll return to these issues in “Part II of the challenges” in the next couple of Sundays.

3. Ursula von der Leyen at the Commission: What to look out for.

Ursula von der Leyen's nomination to head the next Commission is clearly the last-minute outcome of a complicated party-political compromise, reportedly engineered by Macron after Merkel was defeated inside the EPP.

Having her first choice (if that's the right word) of CSU politician Manfred Weber blocked, Merkel had signed off, in agreement with her SPD partner back in Berlin, on Dutchman Frans Timmermans (from the Socialist group) for the Commission job, but she underestimated the determination of several CEE leaders to block Timmermans, who had spearheaded the EU's opposition to the attempts to erode liberal democracy in parts of the CEE.

Officially, the EPP group insisted that as Europe's biggest political family they should have one of theirs at the head of the Commission, but the CEE-EPPs were unable to agree on a candidate – so as names were kicked around, von der Leyen suddenly seemed a good compromise. I wonder, however, if the CEE leaders, with their successful derailing of Timmermans' candidacy on account of his commitment to European liberal democracy, may have won a Pyrrhic victory with the nomination of von der Leyen.

Ursula von der Leyen is first and foremost a political survivor with great ambitions. Coming late into politics, she climbed quickly under Merkel – to the extent that Merkel, reportedly, began to feel threatened. So, when von der Leyen was moved to the defence ministry six years ago, it was widely interpreted as Merkel cutting her off by placing her in this “graveyard for politicians”. But yet, six years on and in spite of her share of scandals at the defence ministry, von der Leyen has survived it all to stand on the doorstep of a major promotion.

If she'll be effective as Commission president is too early to tell, but she surely is a European federalist. And she is not afraid of pushing that agenda. In 2011, during the eurozone crisis, she said that her long-term vision is a United States of Europe, comparable to the US, Germany and Switzerland. Besides having a common currency, she was in favour of political union and a de facto joint European military – a view not particularly popular in the CDU/CSU in 2011, if I may say.

But, again, she is not an economist by training and that sometimes comes with statements, and hence positions, we economists struggle to understand. For example, also in 2011, as Labour Minister, she was a member of the CDU party committee formed to elaborate on how to structure future financial aid to other eurozone countries. In this capacity, she proposed that any German financial underwriting of fellow eurozone countries be collateralized with gold and/or public sector companies! To their credit, both Schäuble and Merkel shot that one down …

But hey, we all live and learn. As the FT's Martin Wolf so elegantly said this past week in his acceptance speech for his (well deserved) Gerald Loeb Lifetime Achievement Award: “My opinions have altered as the world has unfolded. I make no apologies for this. Those who have not changed their opinions over a lifetime do not think. But my values have not altered."

Finally, returning to my opening note on my dismal forecast of these four key appointments, I'll try to redeem myself by forecasting that Lagarde's replacement as head of the IMF will be Mark Carney. Of course, in Berlin you hear the idea that Jens Weidmann should be put forward for the IMF job to both secure a "hard money man" at the helm of the IMF, and to give SPD a compensation prize (namely the right to appoint the next Bundesbank president) for having been side-lined during the big European appointment game. But I struggle to see this one happening.

And on that note, I'll pack up my stuff, settle the bill, and head out of this lovely coffee shop.

Best

Erik

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