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In the early ages of the march towards the monetary union, Axel Weber asserted that Germany herself had not been immune to influences in the opposite direction, i.e. from other currencies towards the German mark during exchange rate realignments. Other economies, especially France, were able to influence the course of monetary policy in non-German countries. Weber's thesis was that the EMS had functioned as a bi-polar system with a *hard currency option* supplied by the Banque de France (Weber, 1991, 1992). Whereas from the beginning the Netherlands had chosen the hard currency option, at least in the first stage the remaining economies of Belgium, Denmark and Ireland adopted the soft currency alternative. As France too chose the "hard" option, this system disintegrated later. To put it bluntly, "DM-zone hypothesis is invalidated by the fact that the hard currency strategy, pegging to the German mark, has not been a feature of the EMS from its start; it emerged in a later phase and at previous points in time as the result of deliberate policy switches in the EMS economies" (Weber, 1991, p. 61). It has been conjectured that bi-polarity in the EMS undermines the "Borrowing Reputation" hypothesis because such a bi-polarity does not imply a disinflationary bias in the system. The "bias" depends on whether the hard or the soft centre country is chosen for counter-inflation reputation. "The bipolarity hypothesis,... pretty well accounts for the fact that disinflation has been slower but longer lasting in the EMS." (Weber, 1991, p. 85) Based on a game-theoretic model of Backus & Driffill (Backus & Driffill, 1985 a, 1985 b), Weber sought to derive an empirical model of government reputation for fighting inflation and reached the conclusion that only the smaller EMS participants have gained counter-inflation reputation during the EMS period (Weber, 1992). The success of the EMS resulted from the shift of France to the hard option while Germany mellowed its hard stance. The result was a more stable system with a less inflationary discipline. It is due to this ambiguity that monetary institutions (ESCB-European System of Central Banks or Eurofed) will not necessarily inherit the Bundesbank's counter-inflation reputation. Such an institution must establish its own reputation *independently* –after having started its operations- by setting binding international rules for its members. So was the gist of the "Weber thesis" in the early 90s. Weber was among the influential scholars who were closely monitoring the evolution of the European monetary system.

Now Axel Weber gained more of a stature as the current Bundesbank President and the likely future Governor of the ECB. In two recent statements, Weber commented on the Greek incidence and emphasized possibly "grave contagion effects". The issue is whether Germany would ratify the bail-out package, which means Germany should contribute EUR 22.4 billion. He also said a Greek default would "pose a significant risk to the stability of the monetary union and the financial system". He also said the gravity of the situation does not justify every means, and buying government bonds on the secondary market is not an option. However, at least the withdrawal of liquidity-enhancing measures of yesteryear could be postponed, and collateral requirements be weakened. It looks increasingly likely though that the ECB is already behind the curve.

Investors ask for the highest extra yield to hold Spanish and Portuguese debt since 1999, the year when the euro was incepted. The premium on Spain's 10-year government bonds over German bunds surpassed 165 basis points. Yet there are only statements that virtually aim at appeasing the investor community to believe an orderly rescue will happen after Greece steps up and implements the program, and get the money of course. The important point in all these statements is the position taken by Weber. Already before the last turning point that drove markets wild, Spanish and Portuguese CDSs were moving in almost perfect correlation with Greece. Should the possibility of contagion turns into a likelihood, it would be very difficult to restore confidence, and monetary rules and protocols that define the Euro Zone could be wiped away.

Despite his early remarks against setting the EMU as a de facto Deutsche Mark zone, and his criticisms against the “borrowing reputation” hypothesis, Weber has been heavily criticized recently for having too close ties with Angela Merkel and German political authorities in general, and for having slept at the wheel when Deutsche Bank was allowed to pile up huge risks through extreme leverage. There are also hints to the effect that he did not object to the cover-up of heavy losses in the German public banks (Landesbanken). In Germany, the Bundesbank is supposed to act as the supreme banking sector regulator in an oversighting capacity. Axel Weber and Mario Draghi from Italy are said to be in pole positions as fight for ECB succession starts, and as no dark horses have emerged yet.

European finance chiefs acted switly over the weekend, and even Sarkozy, who cancelled a trip to Moscow, utterde that by Monday’s opening a mechanism that should support the European bond market would be in place. Whether the measures would appease European bond vigilantes is to be seen today. Working out a mechanism whereby deficit-stricken European countries would be helped out automatically is not an easy task though.

Help to Greece has not been too little perhaps, because EUR110 billion is not a small sum, but it was certainly a bit late if not too late. Fiscal measures are bound to lead to a GDP contraction in Greece, and that should further fuel concerns about public debt sustainability. Now, either Greece should be let to devalue, which means a temporary or permanent fallback from the Eurozone, or a huge primary surplus should be needed. Otherwise the euro has to depreciate by a very large percentage in order to let Greece to reduce the real rate of interest –in euro terms- to be paid ex post. None of these mechanisms are readily available right now. This dim outlook could further push up the spread of sovereign Greek debt over the Germand bund, whicjh in turn would aggravate the debt sustainability problem. Although both Trichet and Weber openly stated time and again that resorting to buy sovereign bonds is not an option, the possibility that the ECB could be forced to do so eventually is not discarded. In this case, the ECB’s asset quality could visibly deteriorate, which in fact is what the ECB already does implicitely by accepting Greek sovereigns as collateral. This outlook adds to other fundamentals yet another reason for the view that dollar is set to strengthen further against the euro, barring shocks and fluctuations.

At this point Europe intervened with a huge package, i.e. EUR750 billion. Not only the size of the package is large, but Fed’s renewed swap lines to Europe amount to USD1 trillion and this is also sizeable. Obviously, the new swap lines could temporarily reverse the Fed’s balance sheet downsizing trend. We gather that Europe was indeed behind the curve, and the German elections must have played a role here. Had a similar package been announced last week, Trichet and Weber’s statements as to the possible course of action may not have been contradicted that soon. A rescue package that amounts to c. 30% of the ECB’s balance sheet is no ordinary move, and implies that Greece is not the main issue anymore. Admittedly, Spain was in danger and Europe’s leaders finally acknowledged that. In the short and medium run we expecet the euro to stabilize, but in the longer raun we still favour the dollar.