Mario Draghi's efforts to save EMU have hit the Berlin Wall

If the ECB tries to press ahead with QE, Germany's central bank chief will resign. If it does not do so, the eurozone will remain stuck in a lowflation trap and Mario Draghi will resign

Mario Draghi seems to have hit the limits of European power politics Photo: AP

By Ambrose Evans-Pritchard

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Mario Draghi has finally overplayed his hand. He tried to bounce the European Central Bank into €1 trillion of stimulus without the acquiescence of Europe's creditor bloc or the political assent of Germany.

The counter-attack is in full swing. The Frankfurter Allgemeine talks of a "palace coup", the German boulevard press of a "Putsch". I write before knowing the outcome of the ECB's pre-meeting dinner on Wednesday night, but a blizzard of leaks points to an ugly showdown between Mr Draghi and Bundesbank chief Jens Weidmann.

They are at daggers drawn. Mr Draghi is accused of withholding key documents from the ECB's two German members, lest they use them in their guerrilla campaign to head off quantitative easing. This includes Sabine Lautenschlager, Germany's enforcer on the six-man executive board, and an open foe of QE.

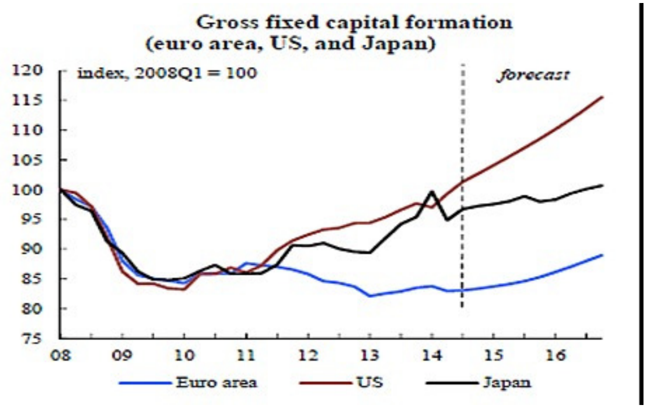
The chemistry is unrecognisable from July 2012, when Mr Draghi was working hand-in-glove with Ms Lautenschlager's predecessor, Jorg Asmussen, an Italian speaker and Left-leaning Social Democrat. Together they cooked up the "do-whatever-it-takes" rescue plan for Italy and Spain (OMT). That is why it worked.

We now learn from a Reuters report that Mr Draghi defied an explicit order from the governing council when he seemingly promised to boost the ECB's balance sheet by €1 trillion. He also jumped the gun with a speech in Jackson Hole, giving the very strong impression that the ECB was alarmed by the collapse of the so-called five-year/five-year swap rate and would therefore respond with overpowering force. He had no clearance for this.

The governors of all northern and central EMU states - except Finland and Belgium - lean towards the Bundesbank view, foolishly in my view but that is irrelevant. The North-South split is out in the open, and it reflects the raw conflict of interest between the two halves.

The North is competitive. The South is 20pc overvalued, caught in a debt-deflation vice. Data from the IMF show that Germany’s net foreign credit position (NIIP) has risen from 34pc to 48pc of GDP since 2009, Holland's from 17pc to 46pc. The net debtors are sinking into deeper trouble, France from -9pc to -17pc, Italy from -27pc to -30pc and Spain from -94pc to -98pc. Claims that Spain is safely out of the woods ignore this festering problem.

David Marsh, author of a book on the Bundesbank and now chairman of the Official Monetary and Financial Institutions Forum, says the Bundesbank has been quietly seeking legal advice on whether it can block full-scale QE. It is looking at Articles 10.3 and 32 of the ECB statutes, arguably relevant given the scale of liabilities.



The let-out clauses would make QE the sole decision of the 18 national governors - shutting out Mr Draghi - based on the shareholder weightings. Germany would have 26pc of the votes, easily enough to mount a one-third blocking minority. Mr Draghi would not even have a say.

Mr Marsh said this has echoes of the "Emminger Letter" invoked in September 1992 to justify the Bundesbank's refusal to uphold its obligation to defend the Italian lira in the Exchange Rate Mechanism. The lira crashed. The Italians were stunned. One of them was the director of the Italian Treasury, a young Mario Draghi.

Lena Komileva, from G+ Economics, says the ECB is heading for a crisis of legitimacy whatever happens. If the bank tries to press ahead with a QE-blitz, Mr Weidmann will resign. If it does not do so, the eurozone will remain stuck in a lowflation trap and the ECB will go the way of the Bank of Japan in the late 1990s, in which case Mr Draghi will resign.

Mr Draghi's balance sheet pledge was muddled and oversold from the start. Much of it was predicated on banks taking out super-cheap loans (TLTROs) from the ECB, but they have so far spurned it. You cannot make a horse drink. These loans are not the same as QE money creation in any case. They are an exchange for collateral.

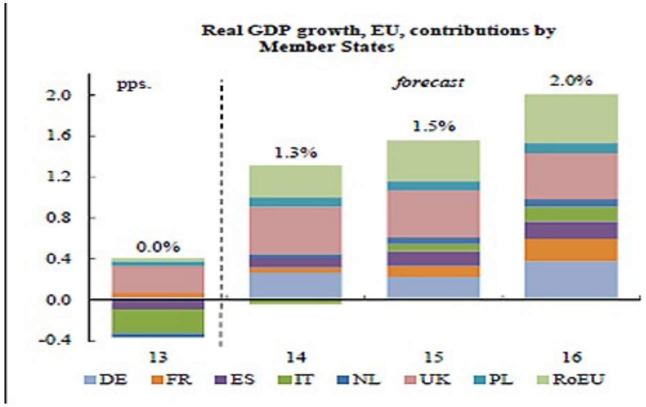
The asset purchases are what matter and the package announced so far is modest, bordering on trivial. It is unlikely to exceed €10bn a month as currently designed. The "buyable" market for covered bonds and asset-backed securities is too small to move the macro-economic dial. If the ECB wanted to match the Bank of Japan in its latest effort to drive down the yen and export deflation, it would have to launch €130bn of asset purchases every month (1.4pc of GDP).

Hawks claim that QE would make no difference because interest rates are already near zero, and the German 10-year Bund is already the lowest in history. This is eyewash. Central banks can print money to buy gold, land, oil for strategic reserves (why not?) or Charollais cattle. Or they can print to build roads or windmills. They can hand the money out as cash envelopes. If they did this, even the dimmest wits would see that QE is a monetary device and can always defeat deflation as a mathematical principle. It does not have to work through interest rates, nor should it.

The ECB's North-South clash mirrors the political breakdown of monetary union after six years of depression and mass unemployment. France's Front National now has twice as many Euro-MPs as the ruling Socialists. Euro defenders invariably insist that the triumph of Marine Le Pen - currently leading presidential polls at 30pc - has nothing to do with her pledge to restore the franc and take back French economic sovereignty.

Whether or not this is true - and that smacks of presumption - she is snatching enough votes from the Socialists to threaten their survival as a political movement. If they let perma-slump drift on until 2017, they will meet the fate of Greece's PASOK, and deserve it.

Italy is also edging closer to an inflexion point. The Five Star movement of Beppe Grillo - which won a quarter of the vote in 2013 - has grasped the elemental point that zero inflation and falling nominal GDP is pushing Italy into a debt-compound trap. For a long time Mr Grillo wrestled with the EMU issue. There is no longer any doubt. "We must leave the euro as soon as possible,” he says.



Spain's insurgent Podemos party has come from nowhere to top the polls at 28pc. It is not anti-euro. Its wrath is directed against a corrupt "Casta". Yet the party's reflation drive and furious critique of Spain's "internal devaluation" is entirely at odds with EMU imperatives, as is its €145bn plan for a universal basic income, which would lift Spain's fiscal deficit to 20pc of GDP. Podemos reminds one of France's Front Populaire in 1936. Leon Blum did not perhaps intend to leave the Gold Standard, but he knew his policies would bring it about in short order.

Mr Draghi is of course right to force the issue. The ECB is missing its 2pc inflation target by a mile, with crippling effects on the crisis states. This itself is a violation of the ECB's legal mandate. The refusal of the German-led hawks to do anything serious about this is indefensible, and remarkably stupid unless their intention is to break up EMU, a possibility one can no longer exclude.

The European Commission's Autumn forecast this week is a cri de coeur. It warns of a "snowball effect" as deflationary forces causes debt trajectories to accelerate upwards by mechanical effect.

Brussels admits that something has gone horribly wrong, obliquely blaming stagnation on the "policy response to the crisis". It halved the growth estimate for France to 0.7pc next year, and for Italy to 0.6pc, a ritual with each report.

It says the eurozone faces a "home-grown" malaise, left behind as the US and Britain pull away. "It is becoming harder to see the dent in recovery as the result of temporary factors only. Trend growth has fallen even lower due to low investment and higher structural unemployment," it said. Now they tell us.

The collapse of investment is not some form of witchcraft. It is entirely due to the folly of deep cuts in public investment - pushed by the Commission itself - at a time of private sector deleveraging, all made much worse by monetary paralysis. Italy's rate of investment fell by 7.4pc in 2012 and 5.4pc in 2013. Even Germany's fell 0.7pc in each year.

Tucked away in the report is a nugget that Britain alone accounted for almost all the EU's growth in 2013, half in 2014, and will still be the biggest contributor by far in 2015. This implies that the UK's net payments to the EU budget - already up fourfold since 2008 - will become ever more skewed. Or put another way, the more EMU makes a mess of its affairs, the more Britain must pay to prop it up.

Europe's leaders and officials have run monetary union into the ground. Mr Draghi has bravely tried to bring them to their senses and contain the damage. He seems to have hit the limits of European power politics.

There is another job waiting for him in Rome as Italian president, should he wish to take it. The offer must be tempting, if only for sweet revenge.

His departure would shatter market confidence in the euro overnight. He could then lead his country to recovery, with a correctly-valued lira, and inflict a massive trade shock on his tormentors in the North for good measure.