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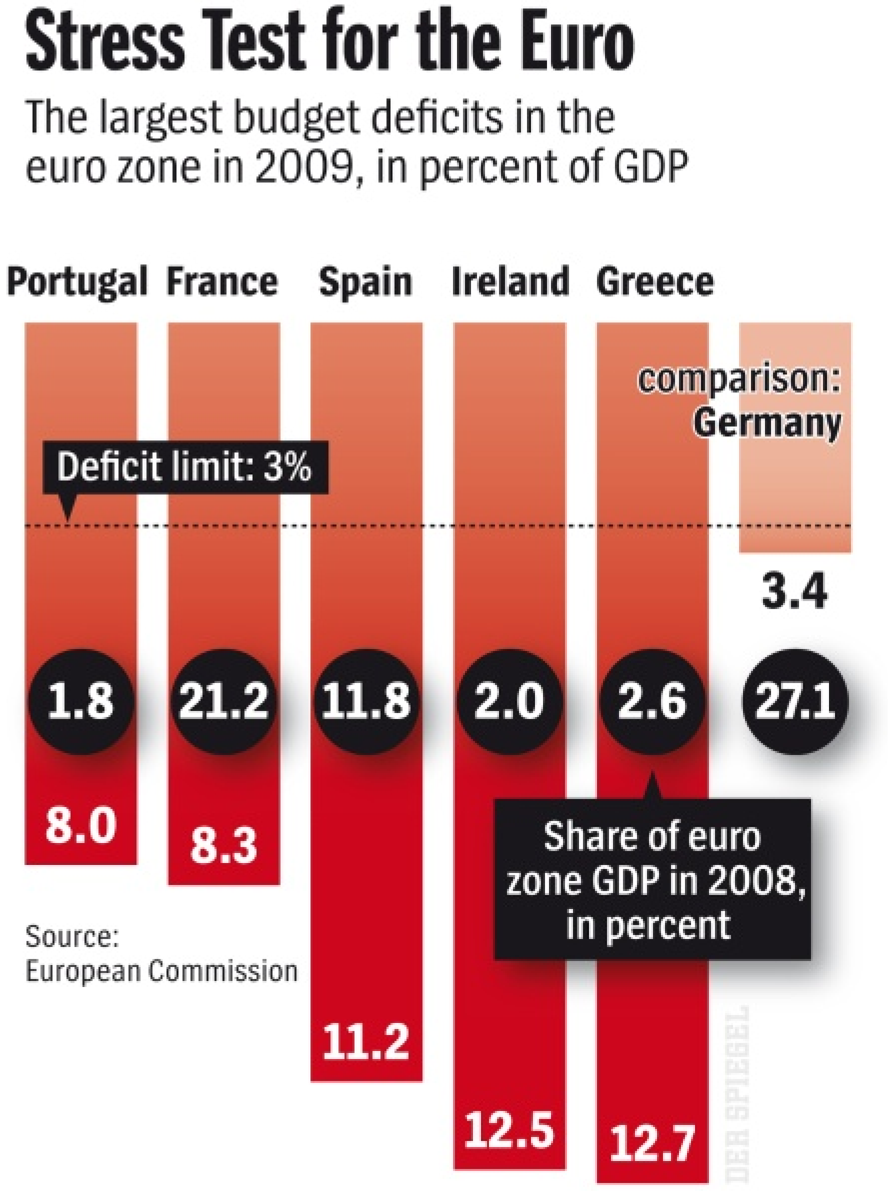
How Brussels Is Trying to Prevent a Collapse of the Euro

by Armin Mahler, Christian Reiermann, Wolfgang Reuter and Hans-Jürgen Schlamp

The problems facing Greece are just the beginning. The countries belonging to Europe's common currency zone are drifting further and further apart, and national bankruptcies are a distinct possibility. Brussels is faced with a number of choices, none of them good.

Men like Wilhelm Nölling, former member of the German Central Bank Council, and Wilhelm Hankel, an economics professor critical of the euro, have been out of the spotlight for years. In the 1990s, they fought against the introduction of the common currency, even calling on Germany's high court to prevent the creation of the euro zone. But none of it worked.

Now both men are in demand again, and the old euro critics' beliefs are more relevant than ever. Were the skeptics right back then, when they said Europe wasn't ready for the euro zone? Were the differences too great and the politicians too weak to ensure a strict and stable course?



"The euro should really be called the Icarus," Hankel suggested back then. He predicted the currency would meet the same end as the hero of Greek legend, who paid for his dream of flight with his life.

Is the euro's high flight over now too? The news these days is alarming. It's causing a commotion on financial markets and intense discussion in capitals across Europe, as well as in Frankfurt, seat of the European Central Bank (ECB).

Brussels took a hard line with Athens last week. Greece must cut costs drastically under close European Union supervision, a sacrifice of a share of its sovereignty. Risk premiums for Greek government bonds have risen drastically, and the country has to pay higher and higher charges.

The Possibility of State Bankruptcies

Accruing debt is becoming increasingly expensive for other countries in the euro zone as well, among them Portugal and Spain. The southern members of the euro zone are especially being eyed with mistrust. Speculators are betting that bonds will continue to fall and that, eventually, the countries won't be able to borrow any more money at all. State bankruptcies are seen as a possibility.

"We've reached a point where it's possible to deal individual countries a lethal blow by downgrading their credit and boycotting their government bonds," Nölling warns.

Many are now wondering how the stronger euro-zone countries should react -- whether it's possible to help the weaker ones without jeopardizing themselves and the common currency. Furthermore, there is a risk that euro-zone members will continue to grow apart economically, a trend that could cause the monetary union to eventually collapse.

Doing nothing is not an option. In light of the national debt in Greece, Portugal, Spain and Ireland, the euro zone is in danger of transforming from a "common destiny to a common liability," Nölling says.

And so it won't be any ordinary meeting when finance ministers from the 16-euro zone countries meet for a regularly scheduled get-together in Brussels next Monday. The European Commission plans to assign each country homework to be completed in the coming years.

Cohesion and Stability

The Commission doesn't hold Greece solely responsible for the current euro woes. Experts close to Economic and Monetary Affairs Commissioner Joaquín Almunia say nearly every participating country is compromising the cohesion and stability of the common currency.

"The combination of decreasing competitiveness and excessive accumulation of national debt is alarming," the experts wrote in a recent report, adding that if the member countries don't get their problems under control, it will "jeopardize the cohesion of the monetary union."

Differing economic development within the euro zone and a lack of political coordination are to blame, they say. In the more than 10 years since the euro was introduced, the Commission states, it has become clear that simply controlling the development of member states' budgets is not enough. What that means, more concretely, is that the stability provisions stipulated in the Maastricht Treaty to regulate the common currency aren't working, and member states need to better coordinate their financial and economic policy measures.

That is precisely what euro skeptics have said from the beginning -- that a common currency can't work in the long run without a common economic and financial policy. The member countries' governments ignored these objections, unready to give up a further aspect of their national sovereignty.

Now politicians are facing a difficult decision: Should they continue as they have, thus potentially undermining the euro's ability to function? Or should they yield a portion of their national sovereignty to Brussels?

Without common policies, the individual countries drift further and further apart. Before the euro was introduced, exchange rate adjustments served to dispel tensions. Now the common currency zone lacks the option of adapting by revaluing currencies.

Watching with Alarm

EU officials are watching with alarm as the various euro-zone countries' competitiveness diverges sharply. The differences are especially large between countries like Germany, the Netherlands and Finland, which are characterized by current account surpluses, and countries with high budget deficits. Along with Greece, this second category includes especially Spain, Portugal and Ireland.

These countries' competitiveness has dropped steadily since the euro was introduced. They lived on credit for years, seduced by the unusually low interest rates within the euro zone, and imported far more than they exported.

When demand collapsed in the wake of the global financial crisis, governments jumped in to fill the gap, with serious consequences -- debt skyrocketed. Spain's budget deficit was at 11 percent last year, while Greece's was nearly 13 percent. Such high debt is simply not sustainable in the long term.

In the past, the solution for these countries would have been to devalue their currency, which in turn would make imports more expensive and exports cheaper. Such a move would stimulate their national economies and strengthen their competitiveness.

Now, however, these countries must submit to a drastic therapy regime at the hands of the European Commission. They need to balance their budgets, while simultaneously creating more competition on the labor and goods markets.

The directives from Brussels translate into difficult sacrifices for the citizens of the affected countries. Employees will have to scale back wage demands for years, and civil servants will see their salaries cut. Ireland has already embarked on this path; Greece and Spain will follow.

Part 2: Is Germany to Blame?

The Commission has recommended that Spain, booming until recently, radically restructure its economy. Spain must significantly shrink its bloated construction sector and focus on economic sectors with higher productivity.

France and Italy have been given homework assignments of their own. Both countries are being asked to apply austerity packages and increase labor-market flexibility. France must also get its significant welfare and unemployment expenses under control.

Resentment is growing in the countries most directly affected. But that frustration is not directed, as might be expected, toward the Commission. Instead, it is increasingly surplus countries coming under fire -- with Germany at the forefront.

Representatives from Spain and Portugal especially -- but also from France -- hold Germany accountable for their current woes. They aren't alone in that opinion either. "The Greek crisis has German roots," says Heiner Flassbeck, chief economist at the United Nations Conference on Trade and Development (UNCTAD), in Geneva. It was German wage dumping that got the country's European neighbors in trouble, he says.

At Its Neighbors' Expense

EU officials don't phrase it quite so strongly, but they still accuse Germany more than any other country of gaining advantages for itself at its neighbors' expense, using its policy of low wages to make German products increasingly attractive relative to those from other countries.

As a precautionary measure, officials at Berlin's Finance Ministry have gathered arguments that Finance Minister Wolfgang Schäuble can put forward in the country's defense. Germany's position is that the countries now in crisis are themselves at fault for their situation. They lived beyond their means for years, the German government says, financing their economic boom on credit. Now the financial crisis has revealed their weaknesses.

Germany didn't have it easy with the euro in the beginning either, continues the argument, because the country wasn't competitive compared to other member countries -- but it regained its strength with a great deal of trouble and effort, through reforms.

German officials point to the fact that the country made its labor market more flexible through the Hartz package of welfare reforms and say that state finances are more stable than before, despite the crisis. They add that taking this same path would lead the currently troubled countries out of the crisis. And, they continue, the federal government is not responsible for lagging wage growth because, in Germany, salaries and wages are negotiated between employers and unions rather than being imposed by the government.

The German government also claims no responsibility for the country's export surplus. German firms are competitive not because of government policy, it says, but because of entrepreneurial decisions and the preferences of customers around the world.

Create More Competition

When this debate flared up recently within the euro-zone countries, Schäuble received support from the top for his position. The southern members of the euro zone shouldn't be ungrateful, warned ECB President Jean-Claude Trichet. After all, he reasons, Germany funded the deficits with its surpluses. Nonetheless, the Commission called on Germany to make further changes as well. The country should boost domestic demand, increase investment in infrastructure and create more competition in the service sector.

The Commission believes the currency union can exist in the long term only if member countries' governments implement reforms and coordinate their economic policies. Schäuble's experts agree. They are proposing -- partly with an eye toward mollifying France -- a common German-French initiative.

Both countries' governments should work toward better coordination, the German financial experts say. Merely monitoring deficits has turned out to be inadequate. In the future, they suggest, euro-zone governments should also focus on combating differing inflation rates and step in early when capital bubbles develop.

France, no doubt, would gladly accept such a proposal. Paris, after all, has long called for Europe-wide financial governance. Until now it was Germany that opposed the idea.

The euro-zone governments have started to rethink their positions, but will action necessarily follow? The past never lacked in good intentions either, but political calculation always won out in the end. How else would Greece have managed to become a member of the common currency zone? Why else would Brussels stand by for so long without taking action? It was far from secret that Greece had been cooking its books for years.

Financial Trickery

Back in the fall of 2004, Eurostat, the EU body in charge of statistics, calculated that Greece's officially announced debts of between 1.4 percent and 2.0 percent of gross domestic product between 2000 and 2003 were incorrect. In reality, the amount was nearly three times as high, falling between 3.7 percent and 4.6 percent. The statisticians surmised that Athens had whitewashed its finances in previous years, too. Greece, in fact, would never have met the conditions for membership in the common currency without such trickery.

But the country was not immediately banned from the euro zone, nor were other sanctions imposed. Instead, member countries discussed how the statistics could be improved and made more accurate. Not much emerged from all the talk.

Outgoing European Commissioner for Enterprise and Industry Günter Verheugen remembers all too well that, for a long time, the problem with Greece was simply not something that was talked about. He finds it hard to believe that this "disproportionate regard" for Greece had nothing to do with that fact that conservative allies of European Commission President José Manuel Barroso governed in Athens for five years.

Not until last fall's elections brought Greece's socialist opposition to power did new data arrive from Athens -- and new questions and accusations from Brussels.

The Greek parliament and government are now virtually stripped of power. They're not allowed to decide on any new expenditures without EU approval. Finance Minister Giorgos Papakonstantinou is required to report every four weeks on progress made in budget restructuring.

An EU Protectorate

Brussels, not Athens, now controls whether and how the austerity program takes effect. If "detailed and ongoing inspection" shows that the actual results fall short of those predicted, Almunia says, then Brussels' watchdogs will demand additional measures. There were even calls at the European

Parliament last week to send a special EU representative with extensive authority to Greece. The small country has become little more than an EU protectorate.

The EU Commission and the euro-zone leaders hope these compulsory measures will steady markets. They also hope Greek unions and associations, from farmers to taxi drivers, won't mobilize against the reduction in the country's standard of living that will accompany these new measures.

German Finance Minister Schäuble and German Federal Bank President Axel Weber rule out giving aid to the struggling country. Indeed, EU treaties strictly forbid any such aid. The message is that Greece must help itself.

As a precautionary measure, though, both German officials, along with their colleagues in other EU countries, are keeping open the possibility of lending a hand anyway. The EU can't afford for a member state to go bankrupt, either politically or economically.

Out of the Question

The experts always debate the same possibilities. The first would be a common euro-zone bond, which would be placed at Greece's disposal. The advantages for Greece are obvious -- the country would receive funds more cheaply than it currently does because the euro zone as a whole wouldn't have to pay as high a risk premium as Greece alone does. The disadvantage is that countries with good credit, like Germany, would have to pay higher interest rates. Consequently, the German government insists that such a loan is out of the question.

An alternative would be bilateral financial aid. Solvent countries, such as Germany, would take out loans on the financial market at good rates and pass these on to Greece. But euro-zone governments are also reluctant to take this path.

The last option is the International Monetary Fund (IMF), which could use its resources to help Greece out of its credit crunch. It would likely impose much stricter conditions on its aid money than the EU would. But the IMF's involvement would also mean a loss of face for the entire euro zone and a triumph for the Washington-based institution, which was always skeptical of the euro.

If Greece doesn't stabilize in the coming weeks, the euro-zone's leaders will be left facing a choice between a rock and a hard place, with the third option being even worse.

Translated from the German by Ella Ornstein