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The euro: Dinner on the edge of the abyss

Print

By Tony Barber
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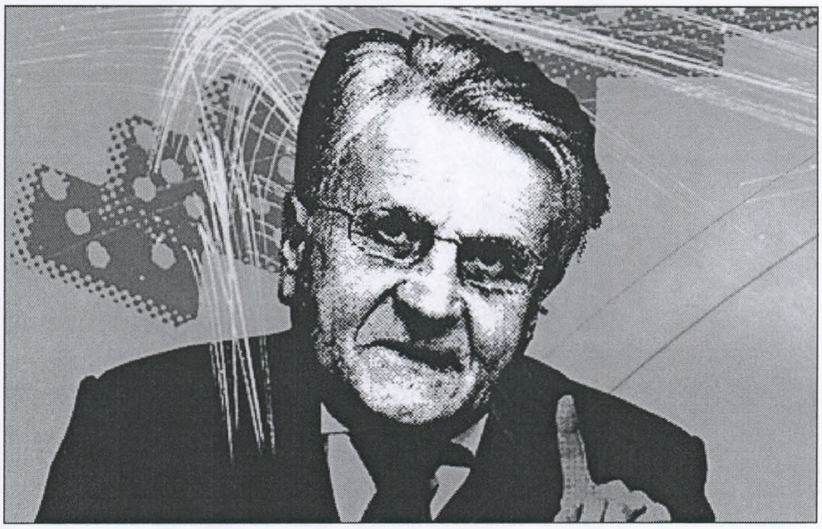

Jean-Claude Trichet, president of the European Central Bank, refused to be told what to do by politicians

Thursday April 22 2010

Canadian embassy, Washington

On a spring evening, a group of the world's most powerful policymakers sat down to dinner at 501 Pennsylvania Avenue. The building, in the heart of the US government district, is a blend of modernist and neo-classical styles termed playful by some architecture critics. But the subject under discussion was deadly earnest: how to save Europe's monetary union. On the minds of the finance ministers and central bankers from the Group of Seven advanced industrial countries around the table was the risk that **Greece's sovereign debt troubles** would explode into a wider European crisis and destabilise the global financial system.

"You can't overstate the fact that America, with increasing incredulity and anxiety, was watching Europe's inability to act," recalls Alistair Darling, the former UK chancellor, present that night. "The message was, 'Why can't you take action? You know you've got to do something.'"

Eleven days earlier, European leaders and the International Monetary Fund had promised Greece a €45bn ($62bn) bail-out. But the discussions at 501 Pennsylvania Avenue, hosted by Jim Flaherty, Canada's finance minister, established that this was likely to be far too little.

"Very serious concerns were expressed about the danger of global contagion. There was very straight talk," remembers Olli Rehn, European Union monetary affairs commissioner. "It was clear that the US and IMF would lend support. There was no American *schadenfreude*. They were supportive and ready to help with their experience of crisis management."

By the time he and his dining companions, including the heads of the US Federal Reserve and European Central Bank and the chiefs of the IMF and the World Bank, left the embassy that night they had agreed on the need for urgent and collective action.

Almost six months on, it is clear that they acted in the nick of time. Numerous and extensive interviews with those at the heart of the emergency reveal how close the single currency came to collapse – and the extent to which the rescue of the ultimate expression of European integration depended on outsiders in international institutions and the US administration.

And with bond markets displaying persistent concern about the economic and fiscal outlook for eurozone members such as **Ireland** and Portugal, not to mention Greece, the lessons of April and May are more pertinent than ever. They suggest that, though Europe's decision-making procedures can appear painfully slow, its leaders will do whatever it takes to keep the euro alive.

For the euro, unlike other currencies, is more than a means of payment and a store of value. It is a symbol of Europe's aspirations to be respected as a community of sovereign nations engaged in a unique experiment to unite in peace and prosperity. But, as analysis of this year's events shows, policymakers have

How banks gained from eurozone defence

The emergency measures announced in May to rescue Greece and defend the eurozone did not merely ensure the survival of European monetary union. They prevented an upheaval at some of Europe's biggest banks, notably in France and Germany, *writes Tony Barber*.

These banks were among the most eager suppliers of credit between 1999 and 2009 as Greece, Ireland, Portugal and Spain indulged to varying degrees in a private and public sector debt binge. By the end of last year, the combined exposure of French and German banks to these four countries amounted to $958bn, of which their work cut out to fix the design flaws and economic weaknesses that have impaired the project from the start.

Saturday April 24

IMF headquarters, Washington

At 7am, two days after the embassy dinner, Jean-Claude Trichet, ECB president, Mr Rehn and George Papaconstantinou, Greek finance minister, assembled at the spacious, sunlit office of Dominique Strauss-Kahn, IMF managing director. There they struck an agreement on the Greek rescue: the IMF would contribute half the eurozone's share. For the first time since the euro's launch in 1999, a country was to be saved from the abyss in the name of European unity and global financial stability.

By Sunday May 2, the **bill for rescuing Greece had risen to €110bn**, with €80bn to come from the eurozone, €30bn from the IMF. But as panic spread across world financial markets over the next five days, threatening to engulf Ireland, Portugal and Spain, EU leaders were forced to produce a second plan of once unimaginable size: a **€750bn backstop fund** for the entire 16-nation eurozone, backed by an unprecedented ECB initiative to buy government bonds.

Friday May 7

EU headquarters, Brussels

The story of how this second plan came to fruition starts with another dinner: asparagus and turbot served to a summit of Europe's presidents and prime ministers. Most were accustomed to reprimands from EU authorities for mismanaging their public finances. But that night's language was more apocalyptic than any they had yet heard. By the time Mr Trichet had delivered his uncompromising message, no leader doubted that the euro's fate hung in the balance.

Using a chart that illustrated how financial markets were driving interest rates on the bonds of weaker eurozone governments to unsustainably high levels, Mr Trichet announced that **the crisis was no longer limited to Greece**. One participant recalls: "Trichet said: 'This isn't only a problem for one country. It's several countries. It's Europe. It's global. It's a situation that is deteriorating with extreme rapidity and intensity.'"

His remarks had the desired impact. Leaders of smaller eurozone countries not fully plugged into world financial markets had, until this moment, not appreciated the gravity of the crisis. But even more experienced leaders appeared stunned. One EU ambassador remembers looking at the French president after the dangers had been spelled out. "[Nicolas] Sarkozy was white with shock. I've never seen him so pale," he says.

Mr Trichet told the leaders that the crisis was partly their own fault because they had too often turned a deaf ear to ECB appeals for fiscal discipline after the euro's launch. The ECB, he said, had repeatedly warned of the need for strict control of public borrowing and spending. It was the only way to hold together a group of states that shared one currency but were not joined in a US-style political or fiscal union. But governments had failed in their duties and were now paying the price. It was time for them to rise to their responsibilities, Mr Trichet concluded solemnly.

The discussions were heated and tense. Mr Sarkozy urged the ECB to follow the example of the Fed and the Bank of England, both of which had taken the drastic step during the world financial crisis of buying government bonds to unfreeze credit markets. "Sarkozy was screaming: 'Come on, come on, stop hesitating!'" recalls one EU policymaker. The French leader won support from Italy's Silvio Berlusconi, Portugal's José Sócrates and other southern European prime ministers.

However Angela Merkel, Germany's chancellor, leapt to the ECB's defence, insisting that it was not for EU leaders to give instructions to the central bank, whose independence is enshrined in EU treaty law. All present paid close attention. Not only is Germany Europe's most powerful economy but, earlier that day, parliament in Berlin had approved the country's €22.4bn share of the Greek rescue – the largest of any country. Ms Merkel was warmly supported by Jan Peter Balkenende and Matti Vanhanen, the Dutch and Finnish premiers.

$784bn was private debt and $174bn sovereign debt. A Greek default, and the ensuing contagion across Ireland and the Mediterranean, might have triggered a catastrophe at the most exposed French and German banks – and in the global financial system as a whole.

What made matters worse was that Europe's banks had not recovered from the shock of near meltdown after Lehman Brothers, the US investment bank, collapsed in September 2008. European banks received billions of euros in state aid, but they remained fearful of lending to each other because they suspected the balance sheets of their counterparts contained lethal quantities of opaque "toxic assets". In retrospect, bank analysts say, Europe's leaders missed a good opportunity in 2009 to come clean about this problem.

Two factors explain their reluctance. The first is the web of personal, business and political relationships, largely obscured from public view, that link Europe's banking establishments with the political classes at national, regional and even local level. A common instinct of self-preservation inhibited vigorous steps.

The second factor was the strident rhetoric with which EU leaders blamed the sovereign debt crisis on financial market speculators – "packs of wolves", in the words of Anders Borg, Sweden's finance minister. By identifying financial actors as the villains of the piece, EU leaders found it difficult to explain to voters why the banks might deserve yet more state funds to return to health.

By June 2010, however, market pressures compelled European authorities to subject 91 banks to stress tests. Only seven relatively small banks – five in Spain and one each in Germany and Greece – failed the tests.

As a result, questions persist about the true condition of the banks. The focus is on southern as much as northern Europe. Banks in Greece, Italy, Portugal and Spain face debt repayments totalling €190bn next year and €200bn in 2012. Many still depend heavily on the European Central Bank for liquidity. Recapitalisation of banks with state aid would pile even more debt on governments.

No wonder Miguel Ángel Fernández Ordóñez, Spain's representative on the European Central Bank's executive board, said last month: "We still can't completely rule out potential new episodes of international financial instability which prevent the normalisation of markets."

As for Mr Trichet, he knew full well that ECB purchases of government bonds were an option – highly controversial, because of the potential inflationary risks, but necessary in extremis. After a meeting of the ECB's governing council in Lisbon on Thursday, however, he told a news conference that he and his colleagues had not even discussed the matter – which was technically true, since it had not been on the agenda. Now, at Friday's summit, he could not backtrack without appearing to cave in to pressure from Mr Sarkozy and his allies. Any damage to the ECB's reputation for independence might prove irreparable.

Mr Trichet therefore went on the offensive against his critics. He reminded them that, from August 2007, the ECB had injected liquidity worth hundreds of billions of euros into Europe's banking system to protect it from collapse but had never asked eurozone leaders to take specific measures as a quid pro quo. "Trichet spoke very sharply on this point," a participant recalls. "He told them, 'Don't ask me to do anything. We will do what we ourselves judge appropriate.'"

The summit threatened to turn into an unproductive showdown between two philosophies of monetary union at odds long before and long after the euro's birth: a German vision of fiscal rectitude and central bank independence; and a French vision of an "economic government" for Europe, guided by elected politicians.

In practical terms, however, the need was to find a solution before Asian markets opened on Monday. The 16 leaders directed the European Commission to design a "stabilisation mechanism" to protect the eurozone, and ordered EU finance ministers to meet in emergency session on Sunday May 9 to approve the plan.

Weekend May 8/9

Brussels

"I'd been supposed to fly to Finland and appear on a television show, but I realised I'd have to stay in Brussels," says Mr Rehn. "We gathered the troops early on Saturday morning and worked on our proposals for 24 hours, so that they were ready by 1pm on Sunday."

By a twist of fate, the ministerial meeting got off to a slow start. Wolfgang Schäuble, Germany's finance minister, had no sooner arrived in Brussels than he fell ill and was rushed to hospital. "Wolfgang's absence came as a shock," recalls Christine Lagarde, his French counterpart. "I said, 'We can't carry on without Germany, let's wait.' But it was an issue, because time was passing. We knew we had to close the discussions before the Asian markets opened, because the euro was on the line at this moment."

Mr Schäuble's replacement was Thomas de Maizière, Germany's interior minister. He was summoned from a Sunday walk in the woods outside Dresden and flown on a government plane to Brussels. Even before his arrival, however, it was plain that Germany found the Commission's proposals unacceptable.

The Commission's plan foresaw a multibillion eurozone rescue fund, operating under EU authority and selling bonds backed by government guarantees. But Germany did not want the fund under EU auspices and insisted any country requiring financial assistance should receive it, as Greece had done, in the form of bilateral loans from other governments.

Meanwhile, EU legal experts advised the Commission that its plan was incompatible with EU law. Mr Rehn counters: "If Germany had endorsed the Commission's proposals, they would have flown. But the Germans made the point that there might be problems getting the proposals past their constitutional court."

After Ms Merkel and Mr Sarkozy conferred by telephone, agreement was reached that, however the aid money was to be raised, it would consist of the astounding sum of €500bn – €60bn in EU funds, guaranteed by the bloc's budget, and €440bn in eurozone government guarantees. Moreover, Mr Strauss-Kahn had already assured EU leaders that the IMF would contribute half of whatever figure the Europeans agreed. That meant €250bn, and therefore a grand total of €750bn for saving the eurozone.

Calls from **Barack Obama**, US president, to Ms Merkel and other European leaders had concentrated the minds of the negotiators, as had a conference call involving ministers from the world's seven leading economies, four of them European. "There were several parallel processes – the EU27's talks in Brussels, the G7 and the phone calls between Sarkozy and Merkel," says Ms Lagarde. "I was the liaison between the G7 call and the EU27 because Elena [Salgado, Spain's finance minister] was chairing the EU meeting and Schäuble was in hospital. I sometimes had two phones on the go, the G7 in one ear and the 27 in the other."

It took time to finalise the deal. Other governments dreaded going to their parliaments so soon after the Greek rescue with another request for billions in aid for struggling neighbours. They wanted a different mechanism, but no one could imagine what form it should take. It was now past midnight, and Ms Lagarde proposed a short break. "I did sense the pressure. I was looking at my watch," she says.

Video: Cyberwarfare and the economic toolbox

Analysis Review, a fortnightly debate by a panel of FT experts

According to Mr Rehn, the compromise that produced the breakthrough came from Maarten Verwey, director of foreign relations at the Dutch finance ministry. He proposed a "special purpose vehicle" with the right to raise funds backed by the €440bn in government guarantees. Germany, pleased that the SPV would not be under Commission control and that the spectre of common eurozone bonds was banished, signalled its approval.

The deal allowed the ECB to announce that it would start a government bond purchase programme to stabilise the markets. This decision caused huge controversy in Germany, where it was interpreted as a cave-in to French political pressure. It soon emerged that Axel Weber, the German central bank president, had broken ranks with his ECB colleagues and opposed the move.

However, the initiative won high praise from EU finance ministers, even if it was tempered by some. "The ECB's decision to intervene was a good one, and like any good decision it should have been made sooner," Jacek Rostowski of Poland commented wryly.

Throughout the night of May 9, the finance ministers felt sure the ECB would not let them down. But neither Mr Trichet in Basel nor Lucas Papademos of Greece, the bank's representative at the Brussels meeting, dropped any hint of their plans. "We were confident of ECB support, but Trichet was standing on his dignity – 'No politician is going to tell me what to do', and so on," recalls Mr Darling.

"One or two ministers said, 'What if he doesn't do it?' And someone said, 'We're finished if he doesn't.' So it was absolutely clear that we needed the two sides – ministers and the ECB – on board. But the ECB was adamant that it wouldn't move until the ministers moved first."

Other difficulties surfaced that day. One was the need to get Spain and Portugal to commit themselves to new austerity measures so as to relieve the bond market pressures. Another was the UK's refusal to pledge any money to the SPV fund, on the grounds that a euro bail-out was a matter for eurozone countries alone.

"The British position was not very constructive," says Anders Borg, Sweden's finance minister. "The British could pay a price for this for some time to come. At such a sensitive time, to make such a drastic statement was not very wise, and it will not be easily forgotten."

Nevertheless, EU leaders had succeeded – at the last possible moment – in buying themselves some time to restore order to the eurozone.

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How Washington pushed Europe to save the euro

Print

By Tony Barber in London
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This year's rescue plans for Greece and the eurozone were driven partly by rising US anxiety about the risks to global financial stability stemming from Europe's slowness to take action, according to those involved in the emergency.

In a three-part series which starts today, the Financial Times reveals that European, US and International Monetary Fund policymakers at the highest levels held two key meetings in Washington in late April that set the framework for the rescue operations.

"The Americans became more and more frantic," Alistair Darling, then the UK chancellor, told the FT in an interview. "In simple terms, they started saying, 'What the hell's going on over there? You guys are being incredibly complacent.'"

His recollections were confirmed by George Papaconstantinou, Greece's finance minister, who told the FT: "It's a fair assessment that the US agitation did help to bring things along."

Eurozone countries and the IMF created a three-year, €110bn support plan for Greece on May 2. One week later, in the early hours of May 10, European Union finance ministers announced a backstop facility for any eurozone countries that might find themselves in severe difficulties worth as much as €750bn, including up to €250bn from the IMF.

These measures not only pulled the eurozone from the abyss but averted the danger that contagion would spread to the rest of the international financial system, not least through private sector banks exposed to hundreds of billions of euros in European sovereign debt.

The first of the two Washington events was a dinner held at the Canadian embassy on April 22, two days before the IMF's annual spring meetings in the US capital. It brought together several finance ministers and central bankers from the G7 group of advanced industrial countries as well as Dominique Strauss-Kahn, the IMF's managing director.

"Very serious concerns were expressed about the danger of global contagion," Olli Rehn, the EU's monetary affairs commissioner, who attended the dinner, told the FT. "It was clear that the US and IMF would lend support. There was no American Schadenfreude. They were supportive and ready to help with their experience of crisis management."

Mr Darling, who was also present, said: "The Americans were saying, 'You have to sort this out and reassure the markets, or else contagion will spread like wildfire.'"

The second meeting took place at Mr Strauss-Kahn's offices on April 24, when he agreed with Mr Rehn and Mr Papaconstantinou that eurozone countries should contribute two-thirds and the IMF one-third of Greece's rescue package.

More US encouragement for European action came from a series of telephone calls that Barack Obama, the US president, made to Angela Merkel, Germany's chancellor, and other EU leaders over the weekend of May 7-9.

Ms Merkel and her chancellery advisers had always supported IMF involvement in the eurozone rescue. But prompt European action in the crisis was hampered by the initial reluctance of other German policymakers, as well as other eurozone governments, to call in the IMF.

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Saving the euro: Tall ambition, flawed foundations

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By Tony Barber
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In Europe's capitals they still talk of the evening when George Papandreou, Greek prime minister, **confessed to his fellow leaders that his nation was corrupt.** "He was very impressive and very honest. He basically said: 'My country is a corrupt country from A to Z,'" recalls one European Union policymaker present at the dinner in Brussels on December 10 2009 where Mr Papandreou bared Athens' economic soul.

His admissions at the start of an EU summit were an essential step in the process by which his nation's partners – persuaded that the prime minister was sincere about his determination to introduce fundamental reforms – came to announce in May a **€110bn rescue** of the eurozone's most financially rotten state. Yet contrary to the impression they gave at the time, EU policymakers had known months before he took office in October 2009 that **Greek public finances were in the direst of straits**.

More FT video

In early July last year, Joaquín Almunia, the Spanish socialist who was then the EU's monetary affairs commissioner, circulated a memorandum to European finance ministers expressing strong doubts about the reliability of the data that the conservative Greek government was supplying to Brussels. The document even predicted that the budget deficit was likely to soar above 10 per cent of gross domestic product – a forecast Mr Papandreou's socialists confirmed soon after they came to power. Yet EU governments took no action before October, perhaps because, in time-honoured fashion, they deemed it inappropriate to embarrass a fellow government – especially one facing a hard re-election campaign.

If this episode reveals much about the manner in which political considerations interfere with efficient management of Europe's monetary union, so too does the sorry tale of the stability and growth pact. These fiscal rules, agreed in 1997 after many bruising discussions between Germany and France, set a ceiling for countries aspiring to adopt the euro of 60 per cent of GDP for public debt and 3 per cent for budget deficits.

All along, German policymakers suspected that once countries had qualified for membership, their commitment to budgetary discipline would falter. So it proved – though few would have anticipated that Germany itself would be among the first offenders.

"The Germans were worried that the culture of fiscal laxity in other countries wouldn't change overnight. They thought that what was needed was a sort of straitjacket. It turned out to be not very straight and not much of a jacket," jokes Pascal Lamy, the French director-general of the World Trade Organisation who served as *chef de cabinet* to Jacques Delors, the European Commission's powerful president from 1985 to 1995.

An alarm bell rang in 2002 when the Commission proposed that Germany and Portugal be sent an "early warning" by fellow governments that their deficits were fast approaching the 3 per cent limit. Governments ignored the Commission's suggestion.

The Commission tried again in 2003, requesting France and Germany to take stiffer deficit-cutting measures. But at a momentous meeting on November 25, finance ministers suspended the excessive deficit procedure against Paris and Berlin, a decision that let the eurozone's biggest countries off the hook though they had broken the rules for three consecutive years. It was notable that, while Italy and the UK sided with France and Germany, most smaller states supported the Commission. The split suggested the big fish thought there was one rule for them and another for the minnows.

By March 2005, EU policymakers had substantially rewritten the stability pact, loosening its rules and making it even less likely that any country would be punished for excessive deficits. The reaction of financial markets was mild, which allowed governments to comfort themselves with the thought that they had got away with it. In the eyes of some, this set a disastrous precedent.

"This was the first serious mistake in the euro area, because it opened the door for other countries to make excuses and point at Germany and say: 'Look, they did it so leave us alone!'" recalls Jürgen Thumann, president of BusinessEurope, the pan-European employers' association.

Mr Lamy concurs. "It was a real mistake. The instrument of credibility was destroyed. The Germans would have liked a stronger stability pact. But it's not only a question of what such a pact says, it's about how the rules are implemented."

The chances that governments would obey the rules did not exactly brighten when Romano Prodi, Commission president from 1999 to 2004, asserted in October 2002 that the stability pact was "stupid" because it provided for sanctions on countries already in financial difficulties. "He's an honest man, dedicated to European integration. His heart is in the right place. But we felt straightaway that he shouldn't have said that," says one former commissioner.

In the light of this year's Greek rescue, some eminent Europeans – such as John Bruton, the former Irish premier, and Karl Otto Pöhl, former German central bank president – say it is surprising, if not outright shocking, that the country was allowed to join the eurozone in the first place. Their argument is buttressed by the fact that, less than four years after Greece's entry in 2001, the authorities in Athens acknowledged that they had **misreported the public finances data** they had supplied to ensure qualification. Contrary to what they had claimed, the budget deficit had been consistently above 3 per cent in the run-up to entry. Indeed, the deficit has fallen below 3 per cent in only one year since 1990.

Former commissioners say the data were widely known at the time to be unreliable. "Back then, I don't know if you could even count on an accurate Greek statistic about the number of kilometres from Marathon to Athens," recalls Lord Patten, the UK Conservative who served as Mr Prodi's external relations commissioner. "It was a case of: 'We all pretend to believe them, and they all pretend to be doing enough for us to believe them'."

...

However, few if any EU governments objected to the country joining the single currency. One reason was that, to present monetary union as an authentically European project, policymakers needed it to extend beyond a "hard-core" D-Mark zone of Germany and its nearest five or six neighbours. A proposal for a "hard-core" monetary union had in fact been put forward in 1994 by two German Christian Democrats – one of them, Wolfgang Schäuble, now finance minister in Angela Merkel's government. But the idea never left the ground. Countries geographically distant from Germany such as Greece, **Ireland** and **Portugal** – the very nations now most at risk in the **eurozone debt crisis** – were allowed in. Once again, political requirements trumped economic realities.

Mr Lamy describes how the debate evolved. "The Greek numbers may not have been totally straight, and there had also been rumours before about the Italian numbers. But this was about politics, not just numbers. It was about addressing

Ageing Europe

Now for the next big problem...

The financial crisis and recession of 2008-2009 threw European Union public finances into disarray, forcing governments to spend hundreds of billions of euros on recapitalising financial sectors and on fiscal stimuli to protect jobs and demand. But even these costs are dwarfed by the potential impact of state support for Europe's ageing societies.

The continent faces "unbearable increases in debt interest and pension expenditure as well as in healthcare and long-term care during the coming decades" unless "ambitious" efforts are made to consolidate government accounts and enact structural reforms, a European Commission report warned last November. Otherwise public debt for the 27-nation EU as a whole could soar by 2014 to 100 per cent of gross domestic product – equivalent to a year's economic output – and continue to rise thereafter.

The essence of the problem is that the ratio of elderly to the working population is set to increase sharply because birth rates are low and people are living longer. The rise is expected to be especially pronounced in countries such as Greece and Italy, already burdened with public debts in excess of 100 per cent of GDP. But the budget projections of most EU governments do not reflect the full cost of ever higher pensions and healthcare bills.

In a report for the Bank for International Settlements, economists Stephen Cecchetti, M.S. Mohanty and Fabrizio Zampolli observe: "The aftermath of the financial crisis is poised to bring a simmering fiscal problem in industrial economies to boiling point." The challenge will look more daunting once interest rates, exceptionally low because of the financial crisis, begin to rise again.

Small wonder, then, that Germany, Greece, Ireland, Portugal and other eurozone states have embarked on the arduous task of pension reform. The country to watch, though, is France. Nicolas Sarkozy, the centre-right president, is battling public sector protesters to lift the minimum retirement age from 60 to 62. It may seem unambitious but the context is all important: ever since the leftist Popular Front government of 1936, France has prided itself on reducing the amount of time people work. This tradition may the Club Med complex and challenging the notion that these guys around the south and in the Mediterranean are not really serious."

Both Mr Prodi and José Manuel Barroso, his successor as Commission president, say EU governments bear much of the blame for the failure to crack down on Greece's legerdemain because they refused to grant Eurostat, the union's statistics agency, the right to audit national accounts. Governments belatedly strengthened Eurostat's powers in July.

The tensions that built up between 1999 and 2009 were not, however, simply the result of structural flaws in the design of monetary union or of economic mismanagement on the part of eurozone governments. They reflected misjudgments in financial markets, too. With the advent of the euro, markets all but eliminated interest rate differentials between German government bonds and those of other eurozone countries, notably Greece, with far less respectable economic records.

In one sense, this should have pleased European policymakers. It appeared to demonstrate the faith of investors in financial centres such as London and New York – occasionally scolded by continental European policymakers for questioning the single currency's viability – that the eurozone really was an indissoluble unit. Once the scale of Greece's troubles became clear in 2009, however, the markets rushed in the other direction and bond yield spreads for Greece and other "peripheral" eurozone countries, especially Ireland, Portugal and Spain, soared to record levels.

soon be at an end.

Zone milestones

1991 European leaders sign Maastricht treaty, setting out path to economic and monetary union by 1999

1997 Governments conclude stability and growth pact, fiscal rule book for the eurozone

1999 Eleven countries adopt euro, rising to 16 by the time of the 2010 debt crisis

2001 Greece joins eurozone

2003 France and Germany join forces to avoid punishment under stability pact

May 2010 Greece receives €110bn EU/IMF rescue

For Lorenzo Bini Smaghi, the Italian member of the European Central Bank's executive board, this offers an important lesson for the eurozone's future: markets are not always right. They "were wrong in the past in underpricing risk, are probably wrong at present in overpricing it, and will again be wrong in the future", he told the European parliament last month.

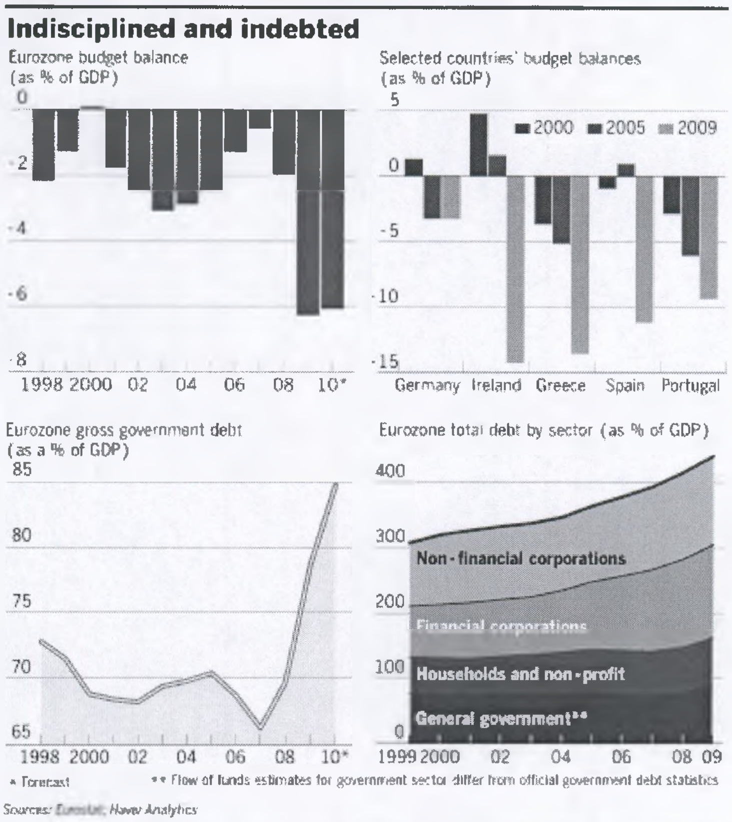
Markets can hardly be blamed, however, for the increasingly dangerous imbalances that arose in the first 10 years of monetary union between highly competitive countries with large current account surpluses, principally Germany, and the likes of Greece, Portugal and Spain that lost competitiveness, ran up large deficits and borrowed too much. Some economists doubt that the eurozone can survive in its present form unless Germany helps to correct these imbalances, for example by raising domestic demand to boost growth in southern Europe and by accepting a certain degree of fiscal union.

...

Such arguments – particularly fashionable in Paris – are hotly disputed in Berlin, where policymakers point out that Germany answered its critics by launching a big fiscal stimulus package in response to the financial crisis and recession. Moreover, Germany, with its ageing population and generous welfare state, regards its trade surpluses as a sensible means of strengthening its financial defences against an uncertain future. In any case, it is asked in Berlin, if the ruling centre-right coalition were to take the extraordinary step of making the country's businesses less internationally competitive, would Germans really buy more goods from France and its southern European allies?

Germany has supporters in this debate – Austria, Finland, the Netherlands, Slovakia and Slovenia, to name but five. But Germans fret that the eurozone – whose membership rises to 17 when **Estonia joins in January** – contains a structural majority sympathetic to France's views. This explains Berlin's determination not to fall for a siren song of European unity that disguises the more cunning proposition that it should pick up the bill for its less efficient partners.

Katinka Barysch, deputy director of the Centre for European Reform think-tank, contends that the Germans are in no mood to compromise. "Perhaps for the first time since the second world war, they are allowing themselves to be defiant and proud. Their export-oriented, stability-obsessed economic model is not up for discussion."



On October 13: two things are needed for the single currency to succeed – more convincing rules for eurozone economic governance and higher long-term European economic growth

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Saving the euro: Bound towards a tense future

Print

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"Europe will be forged in crises, and will be the sum of the solutions adopted for those crises."

Penned more than three decades ago, Jean Monnet's insight on the European Union, which the French statesman was so instrumental in founding, has certainly stood the test of time.

Today, with **the crisis of April and May** still reverberating around the eurozone, the future of Europe's economic and monetary union will be shaped by the extent to which policymakers embrace, or shrink from, closer integration in response. Few know this better than **Dominique Strauss-Kahn**, the International Monetary Fund's managing director and former French finance minister, who laid out the alternatives in a speech last month in Brussels.

"My main message is that the centre must be given a greater role in national fiscal policies if Emu is to become a more effective, and more resilient, monetary union," he said. "But of course I recognise that such a delegation of fiscal powers to the centre could meet political resistance in some countries, where the appetite for ceding further control to Brussels is already weak."

Such waning appetite is found in unexpected places. In few countries is resistance to setting up a US-style central fiscal authority stronger than in Germany. The experience of leading, and underwriting, this year's eurozone rescue embittered public opinion. It also reinforced Berlin's insistence on stricter rules, backed if necessary by financial penalties, political sanctions such as a suspension of voting rights and even – the ultimate "nuclear option" – expulsion.

Twitter discussion

Tony Barber will be on Twitter between 1pm and 2pm on Wednesday to discuss this series. To join in, **follow this link**

Some countries, such as Finland and the Netherlands, sympathise; others – mainly in central and southern Europe – do not. "Is it enough simply to say we'll have more sanctions? To my mind, no," says one eurozone finance minister. "Then there are very difficult issues, such as an orderly exit from the eurozone, which to my mind is a very misguided idea. It's more about Germany trying to show how serious we all must be about **fiscal consolidation**. There's a huge legal question mark over whether it could be done."

Reconciling these clashing views on economic governance is a task today's eurozone leaders can no longer postpone. The need to maintain credibility in the eyes of the US, China and other global partners, not to mention financial markets, demands action. However, politicians, central bankers and EU strategists say it is far-fetched to speculate that the euro's existence is at risk. As Alistair Darling, former UK chancellor, puts it: "The political penalty, never mind the economic penalty, would be so immense that I can't see the big countries abandoning it."

The real question is how to equip the eurozone with the revised rules and reinforced institutions needed to prevent upheavals and provide a long-term framework for prosperity and financial stability. A task force led by Herman Van Rompuy, the bloc's full-time president, is leading the effort. The European Central Bank as well as the European Commission have also provided significant input.

Default remains a danger

The €110bn Greek rescue plan, arranged in May by fellow eurozone governments and the International Monetary Fund, bought Athens time to stabilise public finances. But it has not removed the possibility of a Greek debt default.

Although the IMF, Greece and its eurozone partners categorically rule out this option, the persistently high interest rates demanded for government debt indicate that financial markets

Mr Van Rompuy's task force is due to present its recommendations in late October but it is questionable how ambitious they will be. In May it appeared there was general agreement on the need to strengthen budgetary discipline; address divergences in competitiveness and macroeconomic imbalances; and establish a permanent crisis management and resolution regime. But for some the launch in August of the eurozone's three-year, **€440bn European Financial Stability Facility** to help countries in severe difficulties has diminished the sense of urgency about setting up longer-term arrangements for handling **Greek-style emergencies**.

This is not true in Berlin, where policymakers **want to replace the EFSF** with a mechanism that would oblige private creditors to bear some costs of a sovereign debt rescheduling. But with the EFSF not due to wrap up its work until June 2013, a permanent solution remains some way off – and much may happen to throw the eurozone off course, including even a Greek debt restructuring.

Doubts also persist about the effectiveness of the latest proposals, expected to take effect next year, for enhancing budgetary surveillance. They start with earlier submission of national budgets for Commission and peer review. Policy recommendations would follow, aimed at ensuring each government adheres to eurozone rules and overall European economic objectives. Governments would adjust their budgets accordingly. However, France and Germany say the system must avoid "encroaching on the budgetary prerogatives of national parliaments" – a potentially crippling reservation.

As during the fierce arguments in the 1990s over the stability and growth pact, the eurozone's fiscal rule book, today's disputes centre on the question of whether governments will ever submit to rules that foresee automatic punishments – or even "quasi-automatic sanctions", as the ECB proposes – for fiscal indiscipline. The lesson of the first 11 years of monetary union, most European politicians concede, is that peer pressure is an insufficient deterrent. "The problem is that you have potential sinners sitting in judgment on current sinners. That is why we must have more automaticity," says Jörg Asmussen, state secretary at Germany's finance ministry.

But sanctions such as a suspension of voting rights appear impermissible under the EU's Lisbon treaty – and after the arduous experience of negotiating and approving that charter, few outside Germany are eager for prompt reform. "It would be a recipe for a series of political dramas that would certainly not be desirable," says one high-level policymaker who helped construct May's eurozone rescue plan.

Largely for this reason, France and Germany have proposed a compromise under which a majority of eurozone countries could make a "political agreement" to exclude offending member states from specific votes. In February 2000 EU countries froze diplomatic relations with Austria after the far-right Freedom party joined the ruling coalition. Seven months later, the EU concluded that the sanctions had been politically counterproductive and lifted them.

Another weakness is "the 'Brussels-talking-to-Brussels' syndrome" identified by Alessandro Leipold, a former senior IMF economist. The annual economic guidelines (known as stability and convergence programmes) that every EU government must send to Brussels may mean something to the Commission and other governments, but they "are virtually unknown in member states, are not part of the national public debate, and are ultimately removed from day-to-day policymaking".

Similar criticisms are levelled at the EU's latest 10-year programme – **Europe 2020** – for boosting growth, jobs and competitiveness. This sets out targets on employment, research and development, energy use, education and poverty reduction. But Fredrik Erixon, of the European Centre for International Political Economy think-tank, says: "The belief that one central strategy can fit the entire European Union – 27 economies with different reform needs and priorities – borders on a central planning mentality that can only do damage to economic growth."

are not convinced.

"Greece is in a uniquely difficult position," Willem Buiter and Ebrahim Rahbari, specialists on the crisis, wrote last month in a report for Citigroup Global Markets. "Its fiscal troubles are, in the EU, in a league of their own. There is clear daylight between the severity of Greece's fiscal predicament and that of the next most troubled euro area member states: Ireland, Portugal, Spain and Italy."

Perhaps the biggest danger attached to a Greek default is the possibility that it would tip other countries over the edge. Ireland, facing the enormous cost of saving its financial sector, and Portugal, with its overloaded public finances and lack of competitiveness, are seen as most at risk.

But if Greece is to avoid default, it will take a superhuman effort. Under the government's austerity programme, its public debt is set to soar to 149 per cent of gross domestic product by 2012-13. In the following two years, Greece will be asked to run a primary budget surplus – excluding interest payments on debt – of 6 per cent of GDP. Since 70 per cent of government debt is held abroad, there will be a temptation to default once a primary surplus is achieved. Foreign bondholders would bear the brunt of the losses.

Social discontent and instability in the financial sector pose further risks. "Fierce resistance from entrenched vested interests has stalled reforms in the past, and the burden of adjustment will test the cohesiveness of Greek society," the IMF said in May.

"Lossmaking public enterprises could yet present additional pressures on the budget, and risks to banks are also acute until confidence in a strong downward path for the fiscal deficit takes firmer hold."

Especially important to watch will be the mood in the ruling Pasok socialist party as the 2012 general election draws close. "There are people in the party who keep telling us that what we're doing is non-socialist," says George Papaconstantinou, finance minister. "But we say, 'Bankruptcy isn't socialist, either.'"

Whether at EU or national level or both, however, action is essential. Relative economic and geopolitical decline appears a distinct likelihood unless Europe improves growth rates. The region's real domestic product growth averaged 2.25 per cent a year between 1981 and 1993; slipped to 2 per cent from 1993 to 2003; and now stands at a meagre 1 per cent.

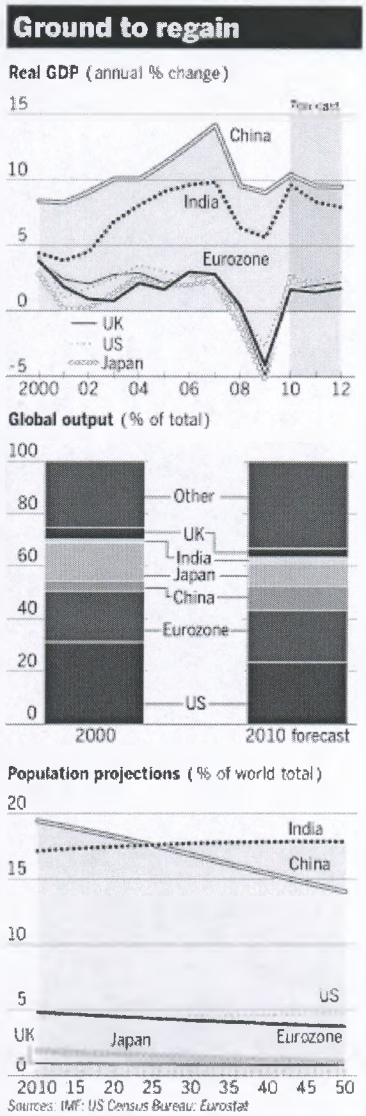
Small wonder that business leaders emphasise Europe's need for more open markets, more entrepreneurial dynamism, better education systems and an overhaul of public sectors. "Sometimes I have the sense that the future is in the Asia-Pacific region, and you have quick growth in the US and Canada, but here in Europe we are sort of standing still, not really willing to accept the fast changes taking place in the world," says German industrialist Jürgen Thumann, president of the BusinessEurope employers' lobby. He bemoans the lack of a US-style risk-taking culture. "There are some sectors where Europe is not participating at all, such as information technology and pharmaceuticals. There is no European iPhone, is there?"

European politicians say that the western world's financial crisis, originating in **high-risk US mortgage loans** and morphing into a European sovereign debt emergency, is accelerating a redistribution of global economic weight from west to east and north to south. "I'm not sure that Europe will ever have the exactly the same voice that it had five or six years ago. The world is changing massively under our eyes," says Christine Lagarde, France's finance minister. She adds hopefully: "But the wheel turns."

Miguel Angel Moratinos, Spain's foreign minister, dismisses the threat of irrelevance. "I don't want Europe to be a museum. I want my people to be first in high technology, first in higher education. Surely we can do that, if we introduce some reforms and combine our political willpower?" he asks. "Everybody now considers that we're in decline. But I'm telling you that the contrary is true, because we're taking action at the right moment to be ready to maintain our capacity, influence and competitiveness in the 21st century."

In its search for economic rejuvenation, Europe is not short of ideas. Expanding the single market must be the starting point, says Laurence Parisot, head of French employers' federation Medef. "The average British, French or German guy doesn't really understand the single market but businesspeople do understand." Without the single market, Europe would have been much harder hit by the crisis, she adds.

"American companies grow fast because their first home is their domestic market, which is so huge. It's the same for China. So Europe absolutely needs to keep and develop its single market. Among intellectuals and some politicians it might be different," Ms Parisot concedes. "We might be in danger of a return of nationalism and protectionism. But leaders of the French business community are not among those who like to criticise Europe."



Extending the single market into areas such as services and the digital economy is a cause dear to many policymakers, from France's Jean-Claude Trichet, ECB president, to Italy's Mario Monti, former EU internal market and competition commissioner, who presented a report on the subject in May. However, the single market binds together not just the eurozone but the entire 27-nation EU. For each group of nations, debate over the single market's extension raises the same hard choice – whether to go for closer integration.

With **Croatia**, several other south-eastern European countries and possibly **Iceland** likely to expand the bloc's membership to more than 30 over the next decade, EU institutions will require yet another redesign. In principle, the purpose should be to drive Europe's efforts to act and speak with one voice, with a view to maximising its influence in a world marked by rivalry as much as co-operation among seven or eight great powers. But politicians and high-level EU officials caution that it would be rash to assume that the next wave of expansion will bring closer integration. If anything, the financial crisis has exposed and accelerated a trend towards the partial renationalisation of decision-making powers.

One recently retired Brussels-based policymaker, witness to every EU crisis since the late 1980s, says that the Lisbon treaty, which required eight years of negotiations before it came into force last December, is anything but a leap towards ever closer union. The lesson, he says, is that Europe may have passed the high-water mark of post-1945 integration.

The EU isn't stabilised. It's fragile," he says. "We haven't gone beyond the point of no return. Of course, it won't disappear. But decline is possible."

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Making eurozone safe from failure

Print

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In a **three-part series concluding today**, the FT has explained how the eurozone's sovereign debt crisis earlier this year could come to pass, and the choices that now face its leaders. As they make the decisions that will shape the future of the common currency, they should bear in mind the successes of the euro as well as its challenges.

Europe must distance itself from the hysterical notion that the euro skirted disintegration. That was never a great risk. No country can be forced off the euro against its will, and no country would voluntarily abandon it – for the simple reason that the shock of leaving would outweigh any advantage of life on the outside. As **Estonia's imminent accession** proves, the monetary union is a club that is still attracting members.

The real danger was and remains a collapse of Europe's financial system and the slump this would trigger. A sovereign default could easily have repercussions exceeding even those of the Lehman bankruptcy two years ago. The losses would be taken in no small part by banks and other financial institutions in the eurozone's core. The fact that the aid to Greece was a surreptitious rescue of German banks was an important, if unmentioned, reason for Berlin's willingness to play along.

Even though financial entanglements between different eurozone countries brought the bloc into trouble, they are what a common currency is meant to achieve. In a single financial market, savings should flow to the most productive investments regardless of national borders. The eurozone's problem was not macroeconomic asymmetries *per se*, but that surpluses funded consumption binges (in Greece) and wasteful construction booms (in Spain and Ireland). The task is to ensure that net cross-border financial flows reflect true economic opportunities – not to eliminate such flows altogether.

Achieving this hinges on the economic governance reforms now being discussed. Some proposals – such as better information-sharing on national budgets and measures to ensure that statistics reflect reality – have obvious merit and must be accepted without delay.

The harder question is how countries' macroeconomic policies should be constrained. Success depends on getting the rules right: giving the extant, misguided, stability and growth pact more teeth is not helpful. It is promising, then, that the European Commission has proposed to supplement the current myopic obsession with fiscal policy by taking into account countries' overall macroeconomic balance, including private flows.

This wider net would have been able to raise alarm about dangerous private sector bubbles in fiscally exemplary states such as Ireland and Spain. As the crisis demonstrates, excessive private debt ends up turning into public debt: something neither market discipline (by definition lax in a bubble) nor a simplistic focus on present fiscal discipline take into account.

A focus on the current account may also make it easier to point a finger at surplus nations. To be sure, this is not what Berlin has in mind; nor is it politically likely. But at least it will become harder to pretend a nation bent on saving does not fund other countries' deficits. Surplus nations are not without responsibility if their savings destabilise their neighbours.

That responsibility is more likely to be honoured if lenders face the true risk of their actions. This is why restructuring mechanisms for sovereigns and those who lend to them are necessary. The new **European Financial Stability Facility** is beneficial. But to confine it to its proper use – temporary liquidity crises – Europe needs a procedure for restructuring the debt of countries proved to be insolvent.

Fear of disaster scared eurozone leaders into resolute action. They must not now let fear of defaults stop them from making the system safe from a future failure.

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