German leadership faces test

CHANCELLOR ANGELA MERKEL TRYING TO WALK A TIGHTROPE BETWEEN THE NEEDS OF EUROPE AND NATIONAL INTERESTS

Berlin *(AP)* German Chancellor Angela Merkel says that "if the euro fails, Europe fails".

But as the debt crisis intensifies, the leader of Europe's biggest economy is sticking to a course of gradual action that markets are losing faith in and refuses to take the radical measures some say are needed to keep the currency afloat.

Top officials, even in the European Central Bank, have called for a "quantum leap" in tackling the crisis. One option often mentioned by economists is issuing eurobonds, debt backed jointly by all Eurozone nations.

But Merkel faces intense pressure at home to not expose her nation any more to the shaky finances of countries like Greece, leaving Germany — and Europe — in an uncertain position.

Merkel has so far justified the high cost of bailouts by noting that Germany's interests as a leading exporter are bound to the wider Eurozone. Its banks also are exposed to the fates of the countries.

The strategy she has led Europe to take has been to provide struggling nations with loans, in exchange for tough austerity measures. The powers of the Eurozone bailout fund will also be increased to help stabilise debt markets.

But after multiple bailouts — Greece, Ireland, Portugal and then Greece a second time — taxpayers in Germany and other northern European countries are losing confidence in the current crisis management.

And so are markets. Prices in Greek debt markets show investors are all but resigned to the fact the country will default on its debts.

Bloomberg

Shaky ground

French President Nicolas Sarkozy speaks with German Chancellor Angela Merkel at the recent European Union summit in Brussels. Merkel has so far justified the high cost of bailouts by noting that Germany's interests as a leading exporter are bound to the wider Eurozone.

But Merkel has rejected suggestions that more drastic measures might solve the situation. She has brushed away the notion of abandoning Greece to default or creating a full-scale fiscal union, in which German funds would directly plug funding gaps in other countries.

'Slow, hard road'

Many people feel the need to believe it "could evaporate with one buzzword — be it eurobonds or insolvency or other words", Merkel says. But "that won't happen".

She says resolving the crisis will be "a slow, hard road", involving deficit cuts and economic reform to make stragglers more competitive.

Merkel pointed out that even if she were for the introduction of eurobonds, they could be unconstitutional in Germany and require years of renegotiations to European treaties.

Merkel "is between a rock and a hard place", Louise Cooper, an analyst at BGC Markets, said. "Clearly Merkel does not want to be the... chancellor in Germany who was in power when the euro project blew up. But quite what she can do to prevent it, I am not at all sure," Cooper said.

Prominent authorities, however, have warned Germany and Europe need to make up their minds on what they want the Eurozone to be. Jens Weidmann, the head of Germany's hawkish central bank and once Merkel's economic adviser, said there was a choice. On the one hand Europe could have a system under which countries are largely barred from taking responsibility for others' debts and the markets discipline governments that spend too much. On the other, the region could take "a major leap" towards deeper integration.

"The decision for one of the two paths needs to be taken soon," Weidmann argued. The current situation, in which government finances are separate but get rescued in times of need, risks failing, he said.

The European Central Bank president, Jean-Claude Trichet, said the Eurozone should eventually create a common finance ministry to bind together the nations' budgets.

Germany, whose political class views itself as a driver of European unity, could hardly countenance the idea of the European project failing — quite apart from the steep financial costs.

'Absolute fiasco'

Michael Meister, a leading lawmaker in Merkel's party, argued against speculating about even a partial Eurozone break-up. "It would be an absolute fiasco for an export nation like Germany," he said. "We have to consider that we're discussing not just Greece, but our own economic prospects."

But Merkel's conservatives oppose eurobonds, and their junior coalition partner, the Free Democratic Party, is vehemently against them. They argue eurobonds would merely push up financially solid Germany's lending costs and encourage others to run up more debts, as well as facing legal barriers.

Germany's main opposition parties — who currently have a majority in polls — have advocated at least their limited introduction, arguing that other avenues could be more costly.

But that would likely cause trouble with Germany's Federal Constitutional Court.

'Not allowed'

One implication of its recent ruling upholding Berlin's participation in the bailouts so far was that "participation in an automatic and unmanageable guarantee mechanism, which might include the issuance of eurobonds, is not allowed", UniCredit analyst Alexander Koch said.

While eurobonds remain off the menu of options to alleviate the crisis, Merkel can expect the main opposition parties' support, at least for now, in pushing through the steps Eurozone leaders have so far agreed on.

Markets will take some comfort in the notion that Germany, while unable to propose a lasting solution, is willing to keep supporting the Eurozone's system of bailouts.

"Germany is the lead actor in this film," Cem Ozdemir, a leader of the opposition Greens, said. "If the lead actor in a film stops playing, then the film's over."

COMMENTARY

Does the currency have a future?

Political cohesion within bloc has deteriorated

By George Soros

The euro crisis is a direct consequence of the crash of 2008. When Lehman Brothers failed, the entire financial system started to collapse and had to be put on artificial life support.

This took the form of substituting the sovereign credit of governments for the bank and other credit that had collapsed. At a meeting of European finance ministers in November 2008, they guaranteed that no other financial institutions that are important to the workings of the financial system would be allowed to fail.

Angela Merkel then declared that the guarantee should be exercised by each European state individually, not by the European Union or the Eurozone. This sowed the seeds of the euro crisis because it revealed and activated a hidden weakness in the construction of the euro: the lack of a common treasury.

There is some similarity between the euro crisis and the subprime crisis that caused the crash of 2008. In each case a supposedly riskless asset — collateralised debt obligations based largely on mortgages, in 2008, and European government bonds now — lost some or all of their value.

Intractable

Unfortunately the euro crisis is more intractable. In 2008 the US financial authorities that were needed to respond to the crisis were in place; at present in the Eurozone one of these authorities, the common treasury, has yet to be brought into existence. This requires a political process involving a number of sovereign states. That is what has made the problem so severe. The political will to create a common European treasury was absent in the first place; and since the time when the euro was created the political cohesion of the European Union has greatly deteriorated. As a result there is no clearly visible solution to the euro crisis. In its absence the authorities have been trying to buy time.

In an ordinary financial crisis this tactic works: with the passage of time the panic subsides and confidence returns. It takes a crisis to make the politically impossible possible. Under the pressure of a financial crisis the authorities take whatever steps are necessary to hold the system together, but they only do the minimum and that is soon perceived by the financial markets as inadequate. That is how one crisis leads to another.

Where are we now in this process? The outlines of the missing ingredient, namely a common treasury, are beginning to emerge. They are to be found in the European Financial Stability Facility agreed on by 27 member states of the EU in May 2010 and its successor, after 2013, the European Stability Mechanism. While the EFSF is supposed to provide a safety net for the Eurozone as a whole, in practice it has been tailored to finance the rescue packages for Greece, Portugal and Ireland.

Legendary investor George Soros is Chairman of Soros Fund Management.

— Reuters

If the euro fails, then Europe fails

Political support to European monetary union may be undone by Greek default

By Chris Giles

Berlin Angela Merkel's staunch defence of the single currency, made in the Bundestag this month, is widely shared by other European leaders. The German chancellor's sentiment demonstrates the political will not to let Europe's sovereign debt crisis undermine the single currency.

So long as this level of political capital is invested in the euro, monetary union is highly likely to survive. However, the talk among investors and some European politicians last week has been of Greek default. The likely consequences of a default by Greece includes the possibility of the break-up of the Eurozone, though even in the event of Greek default that outcome is far from inevitable.

Plan A, as far as European authorities are concerned, is to implement the agreement struck on July 21. Under the deal, Greece was offered a second programme of loans, worth €109 billion (Dh553.33 billion), including the guarantee that Athens would not need to return to financial markets for years, borrowing instead from other European countries and the International Monetary Fund at low interest rates. The private sector would take a writedown of its debt to help ease the burden facing Greece. And the European financial stability facility — the temporary bailout fund — would become more flexible in order to limit contagion from one eurozone country's bonds to others.

Unpredictability

By 2013, the replacement permanent European stability mechanism should be in place to provide greater economic governance in the Eurozone, and as a fund to ensure that countries with difficulties borrowing in the markets had rapid access to loans alongside adjustment programmes until they were again able to roll over their debt in the markets.

That is the plan. But in the meantime, something might give — such is the unpredictability of events in a crisis. In those circumstances, Greece could default. A momentous decision not to service its debts — owed to other European countries, banks and the private sector — would start an alternative, and potentially dangerous, sequence of events.

Because Athens still does not raise sufficient tax revenues to fund its public services, it would fail to pay all of its domestic bills. Public sector workers might not be paid, some social security benefits might fall short. The shock of default and the lack of money would send the economy reeling.

At the same time as the Greek state ran out of money, the country's banks would face collapse because their holdings of domestic sovereign bonds would be heavily written down. The European Central Bank could not accept defaulted bonds as collateral to lend to banks, since they would be worth little.

The closure, even temporarily, of payment systems and cash machines would amplify the problems. To restart normal economic life, Greece would need to recapitalise its banks and balance its books on a day-to-day basis. If creditors were willing to lend fresh money to Athens, the direct consequences could stop there. But finding new lenders after default is not easy.

The alternative would be to restore Greece's ability to create money to pay its bills — and that would require exit from the euro, to re-establish the central bank's ability to create money.

The effects of any default would not be limited to Greece, however, since the investors would then question who was next. In a bid to avoid big losses, euros would flow from countries deemed at risk to those deemed safe. The sums are potentially huge, and the flows would reduce the value of sovereign debt of "at risk" nations. Plunging bond prices would further undermine many European banks and confidence in Eurozone economies.

A further slowdown would amplify this contagion. More countries could decide to default.

None of these events is inevitable. But such are the vicious feedback loops in the system that everyone should be aware of the considerable risks. Should Athens default, the risks are real that both the euro and Europe would fail.

— Financial Times

Bloomberg

Crisis management

From left: French Finance Minister Francois Baroin, ECB President Jean-Claude Trichet and US Treasury Secretary Timothy Geithner at the G7 finance ministers and central bank governors meeting in Marseille last week.

DANGER

RISK OF LEAVING THE BLOC

If one country were to leave the euro, the fear would rise that others would follow, creating exchange rate risk across the zone — smart euros would fly out of, say, Tuscany and into Bavaria in case Italy also left the euro. Even so, the ECB could act as a circuit breaker, offering to buy unlimited sovereign bonds of countries under pressure — but that would require agreement across the zone that such purchases were acceptable.

If such unity were lacking — as it has been to date — other countries could find themselves with little option but to follow Greece out of the single currency, which could then break apart.

— F.T

Analysis

Klaus F. Zimmermann

Eurobonds need some careful consideration

Special to Gulf News

It seems like 1997 all over again. The big difference is that, this time, it's Europe, along with the United States, but not Asia, that is teetering.

At a time when the entire financial world looks at developments in Europe with baited breath, it is pivotal that we Europeans resist the temptation to put the cart before the horse yet again — and jump headlong into new economic realities largely based on either wishful or overly optimistic thinking.

That, after all, is precisely what we did in the run-up to the euro, when all of official Europe put its collective hopes into the promising-sounding "Growth and Stability Pact". At the time, the switch to a common European currency was sold, in part, with the argument to put an end to American dominance of foreign exchange markets in general — and to the dollar's status as the reserve currency in particular.

This time, the case for launching eurobonds is made along similarly tantalising lines in the global power game. The creation of eurobonds is intended to have European debt capital markets compete head on with the US Treasury market. By making European markets equally deep and liquid, the hope is for lower interest rates on that debt.

Such grand designs aside, in a debt-infested world, all that ultimately matters is fiscal stability. That is why, in my view, before we get too excited and eurobonds, seen as some kind of panacea, we would do well to acknowledge that we have already failed in the mission of obtaining fiscal stability once. We cannot afford to do so again.

That certainly is the unequivocal view of the financial markets. There are two other, equally powerful reasons speaking in favour of consolidating our finances: first, fiscal stability is needed in order to have any hope of bring about sustainable economic growth, and it is needed, second, to stop burdening future generations with ever more debt.

Eurobonds can be a useful instrument over the longer term, as the end point of a process of fiscal consolidation, once the hard labour required in that regard has been done. In other words, their introduction should be a reward for past performance, not an illusory incentive for better fiscal behaviour in the future. The latter approach is precisely what we embraced at the launch of the euro, with known results (ie, near failure).

Recipe for euro demise

Europe's credit hinges on the fiscal performance of countries such as Germany, the Netherlands, Denmark, Finland and Poland. Making these countries, in effect, fiscally liable for the debt of other nations, as the premature introduction of eurobonds would do, is a recipe for the euro's demise.

Moreover, notions such as a "fiscal union" are not to be taken lightly. Even those who argue that it is in the logic of the European integration project to move in that direction — and who say that the process of the formation of the United States of America historically shows the way forward for Europe — forget one crucial thing. Most US states have a balanced budget requirement to meet each and every year. In addition, in the US there is no federal bailout clause for the debts incurred by individual states.

The writer is Director, IZA (Institute for the Study of Labour), Germany.