



## HOW CAN WE SAVE THE EURO?

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*The views expressed in this article are the sole responsibility of the author.*

It will soon be a year since the crisis concerning the euro flared up. At the end of last year, the newly-installed Greek government announced that its budget deficit would not be 3.7% but 13.7%. At around the same time the European Central Bank (ECB) announced its intention, in the context of its so-called exit strategy, no longer to accept BBB+ as security for providing liquidity to the banks. Shortly before this, Standard & Poor's had lowered the rating of Greek government bonds to BBB+. Banks and other financial institutions then began to dump Greek government bonds in huge quantities, and since that time there has hardly been a quiet day on the financial markets.

The questions that must be asked are: Why is this happening? What is going wrong? What is not as it should be? After all, most Eurozone countries have by now announced extremely tough economy measures. What is more, since mid-2010 – admittedly only after five months of talking about it – a rescue mechanism, the “European Financial Stability Facility” (EFSF), has been set up. The EFSF, together with the “European Financial Stability Mechanism” (EFSM) and the IMF, have some 750 billion euros at their disposal to support Eurozone countries that are themselves no longer able to use the financial markets to refinance their debts. On top of this, Greece was given 110 billion euros and Ireland was the first Eurozone Member State to receive 45 billion euros from the EFSF and 22.5 billion euros from the IMF. Meanwhile, not a week goes by without the ECB buying government bonds from the most severely affected countries in an attempt to put a lid on their continuously rising interest rates. Finally, an agreement was reached to tighten up the Stability Pact, with tougher sanctions being introduced for budgetary sinners. For the first time it was also agreed to identify and to tackle so-called macroeconomic imbalances. It is thus difficult to claim that the European institutions and their leaders are remaining passive, sitting on their hands and watching the crisis unfold – on the contrary. And yet the crisis continues and spreads.

Why is this? It appears that the markets consider it all to be “too little, too late”. Measures are being taken and reforms announced under the pressure of circumstances, and these measures and reforms frequently lead in the right direction, but the markets feel that they have come too late or consider them to be too limited in time and scope to be able to turn the tide in any real sense. This impression is further intensified by the cacophony that has taken hold since the crisis first broke, a cacophony caused by an avalanche of statements from European political leaders, who at best do not contradict one another. Such statements are mainly aimed at placating the politicians' own voters, without said politicians realising that their comments are listened to throughout Europe and frequently have an undesirable effect on the world's financial markets.

### **An economic support alongside the monetary one**

The *real* reason for the continuing crisis is the unwillingness of our political leaders to recognise and to tackle the structural problem with which the euro has been struggling since its introduction. Let us be crystal clear about this: nowhere in the world is there a single currency without one single government – a government that can boast a large and credible budget and an array of its own financial resources, a government that derives its power from, amongst other things, a bond market that is as liquid as possible, and all this in order to conduct one single economic policy and to develop one single economic strategy that looks to the future. In other words, the euro cannot survive if it continues to be faced with 16 governments, and from 1 January next there will be 17 of them, 17 different economic strategies, and 17 separate bond markets. Coordinating all these governments with their own individual policy strategies can certainly be called a praiseworthy endeavour but it is in itself nowhere near enough. “Coordination” alone cannot overcome the economic and budgetary discrepancies that currently exist in the Eurozone and that are weighing on the single currency. The past 10 years have shown that “peer review” and gentle pressure are not

enough to achieve this aim. The miserable failure of the Lisbon strategy is ample proof of this. Furthermore, since the launch of the euro, the discrepancies in the Eurozone, in particular between north and south, have only increased. What we thus need is not an informal coordination of national policy strategies but rather compulsory convergence and harmonisation of policy in the Eurozone, directed from one single point, by a single body. In short, there must be a strong economic and political support alongside the existing monetary one as without it no single currency can expect to survive for long.

And there's the rub. Such a strong economic and political support, such real economic management for the Eurozone presupposes an additional transfer of power and authority from the Member States to the Union. Economic reforms, the modernisation of the labour market, pension reform, and the future of the tax system are all urgent tasks which would then be defined by the combined authorities of the Eurozone and of the European Union. And that is exactly what many countries, first and foremost Germany, absolutely do not want. Blinded by the economic success that it is currently notching up, Germany trembles at the thought of transferring more tasks to Brussels and thus handing over more of Berlin's decision-making power.

This is the reason for the rush forward on the part of Germany to reach an agreement as quickly as possible on the introduction of a lasting rescue mechanism, which, it is hoped, will succeed in restoring calm around the euro. In this way it is possible to avoid tackling the fundamental cause of the problem, which could only lead to an additional transfer of sovereignty. This move also puts an immediate end to the temporary rescue mechanism, which was presented from the very beginning – completely wrongly – as an absolute bloodletting for the (German) taxpayer. Be that as it may, in order that the lasting rescue mechanism restore the euro to calmer waters, it must be a very robust mechanism. This is the reason for the increasingly rash measures and mechanisms for sanctions that are

being proposed, such as sanctions against guilty Member States in the form of removing their right to vote, and also sanctions against the bondholders who will have to help foot the bill in the future. Much of the turmoil that is breaking out on the financial markets thus does not so much have to do with the objective situation in which many Eurozone countries find themselves, but rather with the stubborn pressure from Germany not to deal with the euro crisis structurally but to tackle it only by way of stricter sanctions, thereby excluding neither debt realignment nor even bankruptcy. Please note that it is not that stronger sanctions are unnecessary. On the contrary, they are absolutely essential. However, they must be intelligent sanctions and not sanctions that make matters even worse than the condition that they are supposed to treat.

### **Setting up a permanent crisis mechanism**

And that is exactly what is now happening. Since a leaked German government working document of 11 November this year clearly revealed the outlines of how the permanent crisis mechanism would work, the crisis surrounding the euro has been sucked into an accelerating downward spiral. This should not come as a surprise as, in contrast to the 750 billion euro temporary rescue package, the German version of the permanent crisis mechanism calls for the Eurozone countries to intervene only in a second phase of a rescue. The broad outlines of this version are now also subscribed to by the finance ministers of the other Eurozone countries. In the case of a near-bankruptcy of a Eurozone country, the holders of state bonds of that country (banks, funds and investors) would themselves first have to take steps towards debt restructuring. The German proposal suggests that this could be done by means of an automatic extension of the maturity of the bonds or by a negotiated “haircut”, i.e. a partial debt cancellation, both of which mean an actual loss for the holders of the bonds in question. Whatever the situation, the other Eurozone countries would only intervene

as a last resort by providing security and liquidity support, but only if it were absolutely necessary and if all the countries agreed.

It is clear that Germany's political leaders have been inspired by the way in which the IMF operates. Just as there is the "Paris Club", which regulates the debt cancellation of developing countries, another club – let's call it the "Berlin Club" – would be established, which would do the same sort of thing, but exclusively for the countries belonging to the Eurozone. There is just one major difference: whereas the IMF is an international organisation that embraces all currency zones, the EMF, or whatever the new permanent crisis mechanism is called – will be restricted to the European single currency. In other words, whereas a debt cancellation by the IMF is an isolated intervention in a single country with its own currency, with little danger of contaminating other countries and other currencies, the EMF will carry out similar operations in one or possibly more countries that no longer have their own currency but which belong to one currency zone. It goes without saying that such an intervention would undermine the credibility of the entire zone and that the risk of other countries in the zone being contaminated would be very great. Every time that such an operation was launched, it would send two extremely clear signals to the financial markets. The first would be that there was insufficient unity and, especially, discipline within the zone. The second would be that the other countries in the zone were not prepared to show the necessary solidarity, which is still assumed to be present in a single currency zone. In short, the message to the outside world will be that the zone does not work, does not function, or in any case does not rest on solid foundations.

However logical and rational the German proposal appears to be, it is in reality an extremely dangerous mechanism, which threatens to undermine the whole currency union. In any case it will send interest rate levels in many Eurozone countries soaring even higher, as there is no doubt that funds, banks and investors will demand a substantial additional risk

premium once the new rescue mechanism comes into force. After all, from that moment on there is a real chance that they and not the Member States will be saddled with the difficulties of one Eurozone country or another. The result of the whole operation could possibly be continuing large yield spreads. There is no doubt that, with the exception of Germany, all Eurozone countries will be faced with rising yields on their government debt, although it is already clear that we do not have to wait for the implementation of the permanent crisis mechanism for that to happen. Since German Chancellor Angela Merkel launched the idea of a contribution by bondholders, there is no stopping it. The Irish at any rate can tell us about this.

Is there then no need for any lasting crisis mechanism in addition to the tightening of the Stability Pact? Yes, there is such a need. However, we must ensure that it is an intelligent mechanism, a mechanism that strengthens the Eurozone instead of weakening it further. In other words, it should be a system that both reinforces discipline in the diverse participating countries and increases solidarity within the zone itself. In other words, more "discipline" and at the same time more "solidarity". The question is whether such a mechanism is conceivable. The answer is yes, but we must then be prepared, in addition to setting up a permanent crisis mechanism<sup>1</sup>, to think about another weakness of the Eurozone, and that is the lack of a single bond market in euros. Linking the two ideas may possibly lead to a satisfactory solution.

### **The bond market in euros**

Every Eurozone country still has its own government bond market. It uses this market to finance its government debt against an interest rate that is

<sup>1</sup> In setting up the permanent crisis mechanism, it is best to look to the establishment of a European Monetary Fund on the basis of the proposal by Gros/Mayer. This proposal not only lays down strict conditions for obtaining loans, but such loans would also be financed through fines paid by the member states for failing to meet the Maastricht criteria in relation to their budget deficits or government debts.

determined by myriad factors, such as the health of public finances and the country's economic clout and competitiveness. However, the liquidity, that is to say the size of the market, is also an important factor. The greater the liquidity, i.e. the larger the size of the market, the lower the interest rate that will have to be paid. This is called the liquidity premium, an advantage that all Eurozone countries could enjoy. Moreover, the creation of a single bond market in euros could put an end to the increase of yield spreads, i.e. the growing difference between the (low) interest rate that Germany pays on its "Bunds" and the (higher) interest rate that the other Member States have to pay. These spreads have increased to such an extent for many countries in the Eurozone that they have become a threat not only to the euro countries themselves but also to the cohesion of the euro itself. The yield spreads with Spain, Portugal, Ireland and Greece respectively have now increased to more than 200, more than 400, more than 500 and, in the case of Greece, more than 900 base points.

On the other hand there is a fear that the creation of a single bond market for all the public debts of the euro countries might remove the pressure on a particular country to put its house in order. Such a fear is of course not unjustified. This has led to the proposal to place the first 60 per cent of government debt of all Eurozone countries on the single bond market. This "senior debt" would then be guaranteed by the entire Eurozone. Governments would have to continue issuing bonds for the so-called "junior debt", i.e. the remaining debt beyond the 60 per cent limit. It goes without saying that these bonds would be more expensive. In this way there would still be a clear incentive for countries to continue reducing their deficits to below 60 per cent.

Strict rules must of course be agreed regarding the repayment of this combined Eurozone debt. They must provide for a legally enforceable right, which guarantees that such repayments take precedence over all other debt liabilities incurred in any Eurozone country. In addition, the joint

Eurozone guarantee can only be effective over the long term if there are strict conditions governing participation by Member States. These conditions must be based on the Treaty requirements in relation to government debt and budget deficits. It is then up to the joint European bodies, such as the European Commission, the EMF or a new EU debt agency, to decide which countries may take part. In concrete terms, a country that has a debt of more than 60 per cent cannot take part. But we must take account of the current crisis and therefore also allow those countries to join that will relatively quickly fulfil the conditions of the Stability and Growth Pact. In any case, each country's participation must be evaluated on a regular basis and there will be countries that will be brought into the single bond market step by step, while other countries will be pushed out bit by bit because they do not meet the conditions of the Stability and Growth Pact and are not putting their government finances in order. In short, in addition to a stricter and broader Stability Pact and the establishment of a new, permanent crisis mechanism, such a single bond market in euros would provide the European institutions with an effective weapon for monitoring discipline and stability in the Eurozone, and this without the necessary solidarity being thrown overboard.

### **Strengthening the Stability Pact**

But let us not be naïve. As has already been indicated above, in addition to introducing real economic management of the Eurozone and setting up a single bond market and a permanent crisis mechanism (EMF), it is also essential to strengthen the Stability Pact itself. In this context it is clear that the current inter-governmental method is not working. The fact that it is government leaders who have to decide which colleague should be scolded or even punished, as well as when and how this should be done, guarantees that this will never happen, just as it has never happened in the past. This is also the defect in the system that is part of the sanctions mechanism approved by the European Council. There must be a majority

in the Council in order to start proceedings against a country. The decision-making power must therefore be moved from the Council to the Commission. This is the only way to guarantee that pressure can be put on Member States and that conditions will thus be met. In concrete terms, sanctions against those countries that fail to meet the tightened conditions of the Growth and Stability Pact must be automatic and thus not dependent on a Council decision. Sanctions must be intelligent, in the sense that they improve the situation rather than making it worse. They must not so much punish those who do not completely fulfil the criteria but rather those who are not willing to work seriously towards fulfilling them. The nature of the sanctions must change. It is not the removal of voting rights but the progressive expulsion of so-called “sinners” from the single bond market that will increase the pressure. This can all be achieved very simply by amending Article 136 of the Treaty, which is in any case necessary in order to introduce the permanent crisis mechanism.

In addition to this permanent strengthening of the Stability Pact, a solution is also urgently needed for the problem of the European banks. If at the outset of the financial crisis we had immediately opted for a European rescue plan for the banks, with sound stress tests, the Irish crisis would never have happened. It is cynical to note that in the recent European stress test, the national governments could themselves choose which banks should be subjected to the test and that the bank that was eventually at the root of Ireland’s current problems, the Anglo-Irish, was not one of them. Only a European plan for the banks can ensure that such a mistake is not repeated and that there is not the threat of another bankruptcy in the Eurozone. It is, in short, high time that we now do what we failed to do in October 2008 when the financial crisis broke, and that is to isolate and solve the financial problems of the banks separately from the efforts to fill the yawning chasms of government finances in various European countries.

Whatever we do, the choice facing us is crystal clear. Either government leaders continue to muddle through as they are currently doing, or they make a leap forward in the direction of a strongly enforced economic management system that includes the creation of a joint bond market in euros. In the first scenario it looks likely that the euro will collapse under the effects of internal tensions. In the latter scenario there is a good chance that the euro will, in coming decades, grow into one of the most dependable currencies. The choice that we make will be followed with eagle eyes by the rest of the world, simply because it affects every other country in the world. If we in our Eurozone do not appear to be capable of pulling together and showing solidarity with the countries that are in difficulties, this could signal the end of the much-praised European model. In order to avoid that, there is only one possibility: next to the monetary pillar, the Eurozone needs an economic and political pillar. This is the only way to give the euro and Europe a real future.