THE EURO – CURRENCY FOR EUROPE

STRIKING A BALANCE OF THE SINGLE CURRENCY

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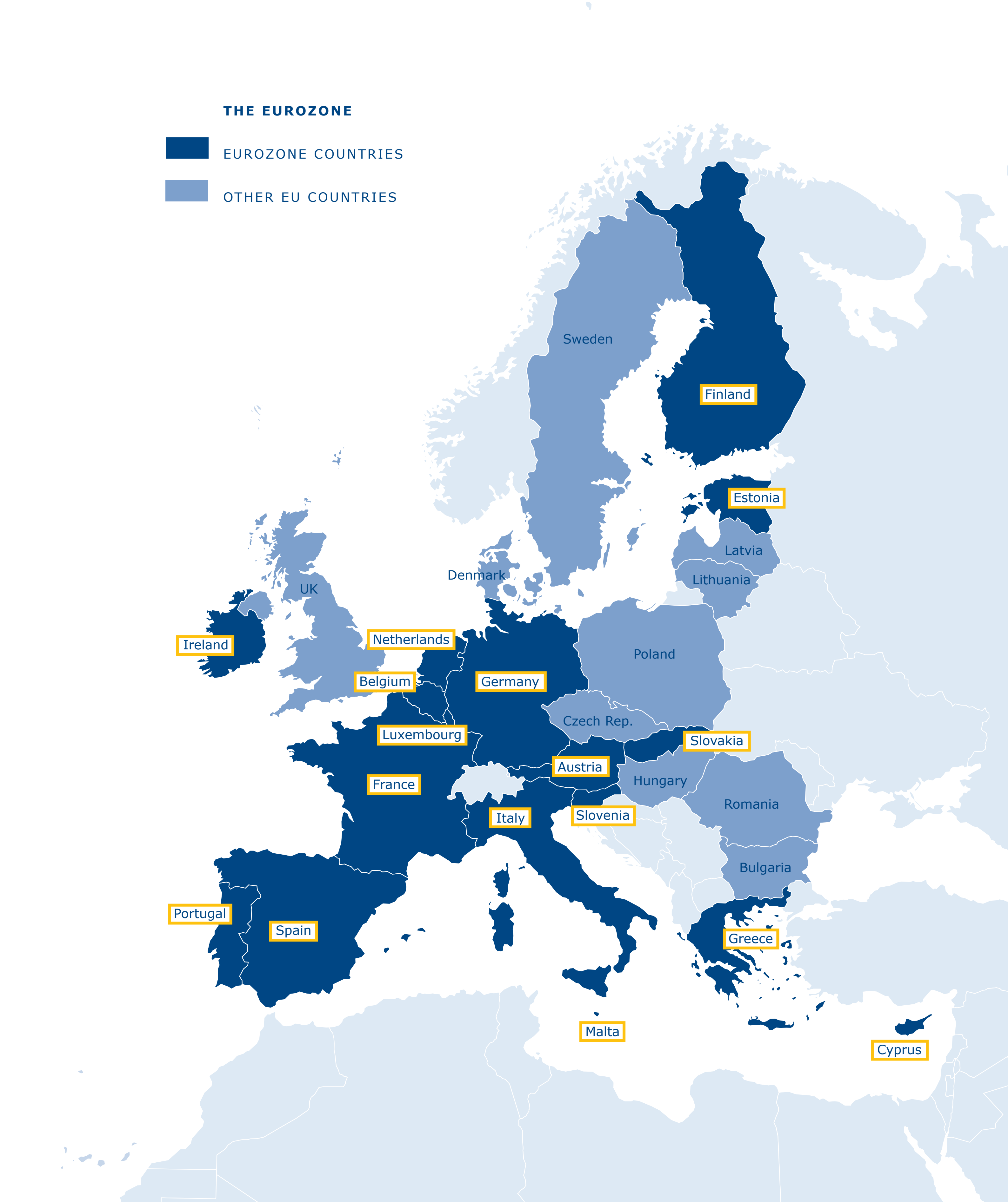
THE EUROZONE
EUROZONE COUNTRIES
OTHER EU COUNTRIES
Sweden
Finland
Estonia
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Luxembourg
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Bulgaria
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Cyprus

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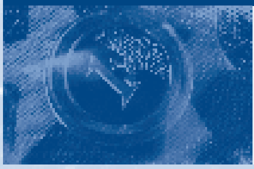


The euro – two sides of the coin: after ten years of plain sailing, in 2009 the storm clouds began to gather, bringing with them serious risks and an uncertain future.

But after thirteen years, the European Economic and Monetary Union (EMU) is still a real success story. The euro ensures price stability and low interest rates, allows companies to feel more confident in their planning and reduces risk in the business cycle. It has proven itself to be a catalyst for integration and a way of binding Europe together. It was and remains the right approach to face the challenges of globalisation with a single currency.

It was the weak spots of the EMU – the lack of budgetary discipline and dwindling competitiveness found in many eurozone countries – that triggered the sovereign debt crisis. Rescue packages for Greece and ever-expanding bailout funds have failed to calm the markets in a lasting way, nor have they created confidence.

But the debt crisis is not a currency crisis, because neither the euro exchange rate nor the eurozone inflation rate indicates that it is a currency problem. It is rather that certain eurozone countries are undergoing a sovereign debt crisis. This brings with it the serious risk that the economy and confidence in the value of the currency will also be affected.

In 2011, the governments of the member states **set out to introduce forward-thinking reforms in the way the EMU operates:** the new Stability and Growth Pact, fiscal union as a means of improving budgetary discipline, the Euro Plus Pact to increase competitiveness, new procedures for monitoring macroeconomic imbalances and a permanent European Stability Mechanism (ESM), due to be launched in July 2012. As a rescue fund for financial crises, the ESM needs to avoid false incentives.

Dealing with the crisis is an expensive business and requires real staying power. The 332 million inhabitants of the eurozone countries all benefit – to a greater or lesser extent – from the euro. This also justifies why the stronger players are being expected to bear the brunt of the crisis. If the advantages of the euro are to be maintained in the future, then confidence has to be re-built and applied to the EMU's weak spots: the unsound budgetary policies and deteriorating competitiveness of many eurozone countries, the role of the financial markets and Greece's huge levels of debt.

Re-establishing sound state finances requires a strong political will and a convincing consolidation strategy. But restoring confidence will provide new impetus for growth and investment.

The crisis-ridden eurozone countries need a sustainable model for growth. The best solution would be if they could find their way out of their debt crises through growth. Germany's role as the driver of growth is not enough; it is essential that they focus on ways of improving their own export situation. The starting point must be to rectify previous mistakes made in the utilisation of capital. Sustainable reform of public finances and structures are essential for lasting growth.

The financial markets need stability for planning and orientation purposes. And even then, they tend to over-react. The high interest rate convergence of eurozone nations' government bonds with German federal bonds until 2009 was an expression of the market's view that the no-bailout clause would not be upheld, which turned out to be the case. The sharp rise in the interest rate differential that followed tended in the right direction, but implied also an overreaction.

■ **An orderly process of debt restructuring with all creditors should be a last resort as a way of dealing with the crisis.** With a debt ratio of 160 % of GDP, Greece is the only eurozone nation with unsustainable levels of sovereign debt. And this debt ratio is continuing to grow substantially due to higher deficits and shrinking GDP. A haircut aimed at reducing Greece's debt ratio to around 60% would be sufficient to solve the problem.

■ An unruly sovereign default must be avoided, but an orderly restructuring would be possible, based on the structures provided by the Paris and London Clubs and on experiences such as those of Mexico from 1989 onwards (Brady bonds). These structures would have to be adapted for eurozone countries, which would necessitate adequate bank capitalisation.

The advantage for Greece would be significant interest rate and debt relief. The main reason for the ongoing uncertainty – unsustainable levels of sovereign debt – would in this way be removed. Companies and investors would than feel more confident to invest and Greece would gain fresh economic prospects.

The rest of the eurozone countries would have the chance to win back confidence and initiatives with the message "Greece is a special case and there will be no more debt restructuring". Complementary consolidation programmes for the other struggling eurozone countries would then serve to keep the risk of contagion to a minimum. This would limit the risk of the rescue fund collapsing and relieve the burden on the donor nations.

■ The ECB's crisis management showed that price stability alone is not enough to guarantee financial stability. Financial stability has become one of the ECB's secondary goals. **With the need to undertake crisis management, there is an increased risk that the ECB will be given too many responsibilities (e.g. purchase of government bonds).** So in the medium-term it is important that it sticks to its original mandate.

■ The debt crisis caused concerns that very expansionary monetary policies could trigger inflation. **In the short term, the sluggish economy means that there is little danger of this.** In 2012, the rate of inflation is likely to decline from 3 % to just below 2 % in line with ECB targets. Persistent low interest rates could, however, lead to investors turning to tangible assets such as property, thus creating fresh instability. The ECB has to take this seriously. In the short-term it is going to have to spread itself thinly in light of the current challenges in monetary policy.

■ **The EMU finds itself at a crossroads** and faces a choice of three possible routes.

Firstly, the worst-case scenario that the EMU will collapse as a result of sovereign debt remaining at an excessively high level seems unlikely in the current political climate.

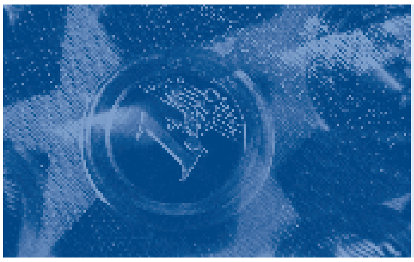
The second path leads towards a modified version of the Maastricht Treaty with fiscal union. The summit decisions on EMU reform mean that sound positions on budgets and competitiveness can be restored. Basic concepts such as the no-bailout principle and the independence of the ECB should should continue to apply.

The third route would be a European political union. Closer political cooperation based on sound national finances and growing economies should be a long-term goal. A less worthwhile goal in the current crisis would be to collectivize sovereign debt in the guise of a "political union". The goal of a European political union must be worked towards from a position of strength, with the full involvement of the peoples of Europe and the enhancement of European institutions. There are inherent dangers in the practice of giving Europe more powers as a result of the crisis. At present, it remains to be seen whether it is more likely to go down the second or the third route.

PREFACE

The Euro – Two Sides of the Coin

The Economic and Monetary Union (EMU) lies at the heart of European integration. The EMU, with the euro as the single currency for 11 EU nations, was launched in 1999. The introduction of the euro then followed on in two stages. First of all, the new European currency was established within the financial markets and monetary policy in non-physical form, so Europe can celebrate the euro's 13th birthday at the start of 2012. However, if we trace the birth of the euro back to 2002, when it was first introduced in physical form, then we have only reached its 10th anniversary. The euro only became a tangible part of the lives of European citizens once the coins and notes were introduced. For politics and business, on the other hand, the start date of 1999 was critical in making the right preparations for the major project of European integration. The establishment of the EMU as a union for monetary stability is based on three pillars:



1. An independent ECB with a consistent and centralised monetary policy aimed at achieving price stability;
2. A sound, decentralised fiscal policy based on the Stability and Growth Pact (SGP) and the "no-bailout clause"[1];
3. A strongly-performing, closely-knit economy based on a single European market that is open to foreign trade.

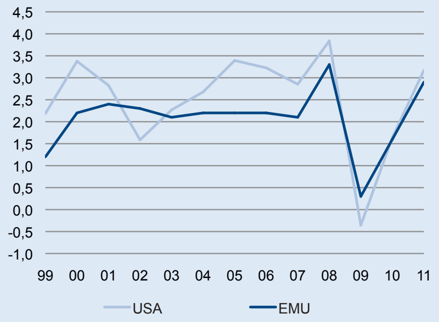
The euro's short history can be broken down into two stages: a ten-year period of plain sailing up to 2009, followed by a stormy period when it faced great challenges and dangers and an uncertain future. At the time of its 10th birthday at the beginning of 2009, the euro was widely acclaimed a success[2], but since the eruption of the sovereign debt crisis in early 2010, the dark clouds have been gathering over many eurozone countries. When assessing the state of the still-youthful euro, it is necessary to take into account not only the positive developments but also its disappointments and serious shortcomings. Firstly, the previous situation of the euro will be analysed using certain criteria. Then the debt crisis situation will be investigated and the policy decisions made to deal with it in 2011 will be evaluated, along with the future structure of the EMU. Finally, future opportunities and risks will be examined in light of the debt crisis.

What Have Been the Successes of the EMU?

THE PRIMARY GOAL OF PRICE STABILITY HAS BEEN ACHIEVED

1 | Rate of Inflation

compared to previous year (in %)



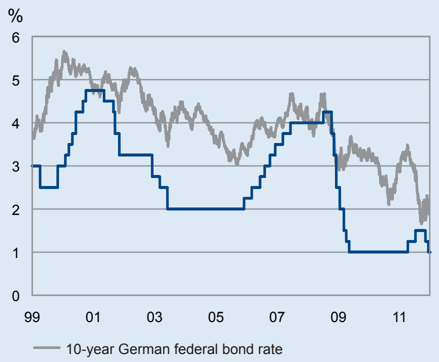
Source: Eurostat

It is clear that, after thirteen years, the EMU has been successful in a wide range of areas.[3] This is particularly the case when it comes to evaluating the ECB's performance on price stability[4], which can be demonstrated by means of historical and international comparisons. At 2.2 % (and 1.5 %), the inflation rates of the EMU (and Germany) from 1999 to 2011 were much lower than during the fifty-year period of the deutschmark (2.8 %) or in the USA (2.7 %). Here, strong non-monetary inflation factors should be taken into account.[5] Therefore, the ECB was able to achieve price stability, silencing many of its sceptics along the way. The ECB's independence and its clear mandate to make price stability its primary goal have contributed significantly to this good level of stability. As a result, despite being a new institution, the ECB was able to achieve a high degree of credibility in the financial markets and across broad swathes of the population (fig. 1).

The ECB's monetary policy was also characterised by its flexibility and pragmatism. One example of this is the way it set a medium-term goal of price stability, meaning that it did not automatically react to temporary price spikes by tightening its monetary policy. This only occurred as a result of second-round effects, such as using higher inflation rates as the yardstick for wage agreements.

Since the start of the financial and economic crisis in August 2007, the ECB has also taken over important crisis management functions. It was called upon on the very first day of the crisis in its capacity of "lender of last liquidity". So after the collapse of confidence in the interbank market in August 2007, the collapse of investment bankers Lehman Brothers in September 2008 and again following the European sovereign debt and banking crisis in 2010/11, the ECB ensured there was adequate liquidity. It helped stabilise the financial markets by repeatedly lowering interest rates and using its instruments of monetary policy in a flexible way[6]. Overall, the ECB has done a good job during these times of crisis.

2 | Low Nominal Interest Rates



Source: EZB

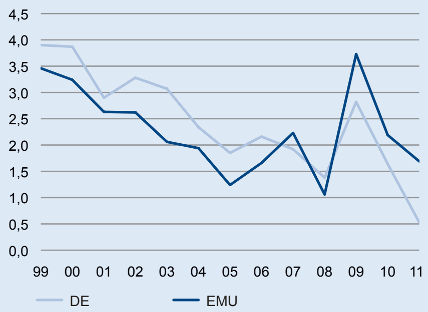
LOW INTEREST RATES – THE REWARD FOR PRICE STABILITY

The fact that the ECB was able to gain credibility on the markets relatively quickly contributed significantly to the low euro interest rates seen on the money and capital markets since 1999. The establishment of larger, more liquid EMU financial markets – such as for government bonds – and an increasing commitment to the euro on the part of international investors served to drive down interest rates. The interest rate risk premium was also dispensed with, something which the markets had demanded before the introduction of the euro in order to protect the exchange rate (fig. 2).

Since 1999, the euro's nominal interest rate has remained much lower than the deutschmark interest rate over the previous thirty years. These relatively low rates of interest have created favourable financial conditions for companies, consumers and governments, which has served to shore up growth and investment in Europe since

3 | Drop in Long-Term Real Interest Rates

10-year German federal bonds
in relation to harmonised inflation rate (%)



Source: Eurostat

1999. Therefore, low interest rates represent one of the main benefits of the euro. This also applies to government bonds, where interest rate and yield differentials remained low until 2008[7], but which subsequently diverged strongly because of the reassessment of country risk. The countries in Europe that now have the most problems piled up excessive levels of sovereign debt because of low interest rates, but this cannot be laid at the door of the euro as a currency (fig. 3).

THE MONETARY UNION STIMULATES TRADE AND INVESTMENT

The introduction of the euro removed currency-related exchange costs and risks in the euro area, giving companies operating in this area greater confidence when planning their trade and investment strategies. For example, the Federation of German Industry (BDI) estimates that German companies made average cost savings amounting to around 0.5 % of their annual foreign trade turnover.

Trade within the euro area is of vital importance, with about fifty percent of the imports and exports of most eurozone countries being with other eurozone countries. However, Germany's global focus means that its percentage of euro area trade is lower, at 37.6 % for imports and 41 % for exports.

Expectations that the euro would stimulate internal trade within the EU have largely been met. The contribution of euro area trade to the GDP of eurozone states rose from 26 % in 1998 to 33 % in 2008. However, the strong growth being experienced in Asia means that exports to the rest of the world between 1999 and 2011 were even stronger than to eurozone countries.

THE EURO BOOSTS INTEGRATION OF THE FINANCIAL MARKETS

Another benefit, and one that is often overlooked in the discussions about the debt crisis, is the strong effect of the euro as a catalyst for the integration of Europe's financial markets. However, the euro is just one of several major factors, alongside the progressive liberalisation of EU financial market regulations, globalisation and the revolution in information and communication technology.

The creation of efficient financial markets is a key component in finally achieving the Single Market. Integration of the financial markets was a political goal, but was primarily market-driven. In parallel, a common legal framework had to be drawn up within the EU, in order to create a level playing field on the financial markets. The Financial Services Action Plan (FSAP), drawn up in 1999, was a milestone along the way. Most of the FSAP's proposals were implemented by 2005.

Efficient financial markets have the function of transferring the benefits of the euro, such as low interest rates, into the real economy. In general, the whole economy benefits from financial markets that are operating efficiently, in the form of a wider range of financial services with favourable conditions.

Growth stimuli are assessed up to one percentage point of annual GDP. However, the interconnectedness of the financial markets has also meant that the individual euro area countries are now more than ever dependent on each other. The financial and sovereign debt crisis has also seriously affected the integration of the financial markets, with trade and issuing activities on the euro bond markets at times being very subdued. The debt crisis has had a negative impact on the money and government bond market in particular.

A LARGE CURRENCY AREA REDUCES ECONOMIC RISKS

One positive aspect of the EMU is the creation of a large currency area with buoyant financial markets. This has greatly reduced economic risks in Europe. Until the mid-1990s, Europe weathered several periods where exchange rate tensions in the EMS threatened the economy, such as occurred in 1992/93 and 1995. Periods when the US dollar was particularly weak against the deutschmark, the second most important investment and reserve currency, were also linked to simultaneous tensions in the internal European currency structure and revaluations of the deutschmark which were also carried out against the currencies of its main European trading partners. Thanks to the euro, since 1999 Germany and Europe have been spared these kinds of economic slowdowns due to the dollar exchange rate. An example of this is the dollar's slide to 1.60 USD/EUR in the summer of 2008.

THE EURO BECOMES A GLOBAL CURRENCY

The growing importance of the euro as an international trading, investment and reserve, or anchor, currency, is also part of its success story. Until 1998, the international monetary system was tripolar, dominated by the US dollar, the deutschmark and the yen. Since the launch of the euro, it has become a bipolar system, with the dollar as the key currency and the euro as the undisputed second global currency, while the yen has lost out.

The fact that the euro has almost universally caught up with the dollar is a result of developments in the markets[8]. So, for example, the euro has distinguished itself as an investment currency. At the end of 2010 it was used for 27.4% of international bond issues (dollar: 49%; yen: 6.3%). Since 1999, the euro's share of global foreign exchange reserves has grown from 18% to 26%, while the dollar fell from 71.5% in 2001 to 61% at the end of 2010. Despite the debt crisis, the euro has established itself as the second most important global currency and hence is carrying on the legacy of the deutschmark. However, the dollar will remain the world's number one currency for the foreseeable future.

Areas Where the Euro Has Had Mixed Results

SLUGGISH EXPANSION OF THE EMU

From the very beginning, it was intended that the EMU should, if possible, include all EU member states, as long as they could fulfil the necessary conditions of entry. The fact that in 1999 the EMU began not as "core union" but as a "large currency union" that included 11 of the 15 EU member states was seen as a sign that the non-participants would be rapidly integrated. Four out of today's five problem countries – Italy, Spain, Portugal and Ireland – were original members, along with the "core" countries, and the acceptance into the union of Greece in 2001 was considered to be more of a political decision.

However, since 1999, only a few countries have joined the union, with the total increasing by just 6 to 17, while the EU has expanded from 15 to 27 member states. The new EU members have, however, agreed to join the euro within the framework of the "acquis communautaire" as soon as they can meet the entry criteria. Since 2007, only 5 of the 12 new EU member states have introduced the euro. The UK, Denmark and Sweden are still not interested in joining, and further EMU entries are not expected in the near future because of the debt crisis. It is not envisaged that Poland and Lithuania will join the single currency before 2015.

MEDIOCRE ECONOMIC GROWTH

4 | Moderate Growth in the EMU

Compared to previous year (%)

	→ 1999-2009	2010	2011
EMU	1.5	0.7	1.5
Germany	1.0	3.7	3.0
France	1.5	1.5	1.6
Italy	0.7	1.5	0.5
Spain	2.8	-0.1	0.7
Ireland	4.0	-0.4	1.1
Greece	2.9	-3.5	-5.5
Portugal	1.2	1.4	-1.9
USA	2.0	3.0	1.6
UK	2.1	1.8	0.7

Source: Eurostat

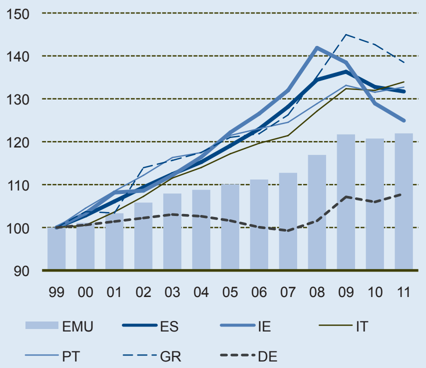
The launch of the euro was bound up with the belief that it would stimulate growth in a variety of ways: lower interest rates; savings due to the removal of exchange rate risks and currency-related transaction costs; and greater transparency and competition. However, between 1999 and 2011, GDP growth rates averaging 1.5% p.a. lagged behind the USA's economic performance (2.1%). Indeed, Germany only managed to achieve 1.3%. It was also disappointing that the eurozone, with its huge single market, was unable to detach itself from the US economy. This was also the case during the sharp global recession of 2009 – whereas the eurozone saw its GDP shrink by 4.2%, and in Germany by as much as 5.1%, the corresponding drop in the USA was only 3.5%, despite the fact that this was where the sub-prime debacle began. In 2010, the German economy was surprisingly strong and experienced growth of 3.7%, thanks to the Asian export boom, but in 2011 it once again lost momentum (fig. 4).

Growth rates within the EMU have varied greatly. At times, the difference in growth rates between the three most dynamic EMU states (Ireland, Spain and Greece) and the three weakest countries (Germany, Italy and Portugal) was more than 4 percentage points. Whereas growth in most eurozone countries was aided by low interest rates, Germany's weak levels of growth up until 2005 were mainly due to structural causes.

Weak Areas of the Monetary Union

5 | Soaring Unit Labour Costs

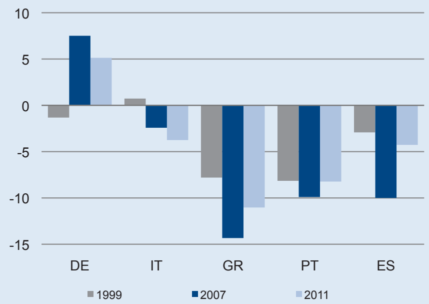
Nominal unit labour costs, base year 1999



Sources: OECD, European Commission, DB Research

6 | Balance of Payments Imbalances Increase

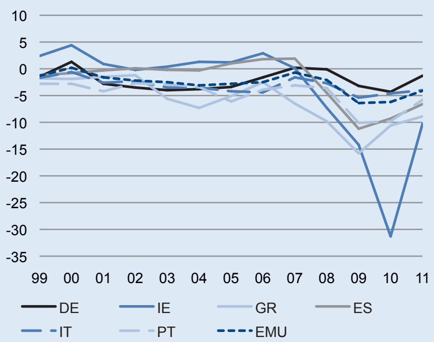
Surpluses and deficits as % of GDP



Source: OECD

7 | Budget Deficits

as % of GDP



Source: European Commission

DECLINING COMPETITIVENESS OF SEVERAL EUROZONE COUNTRIES

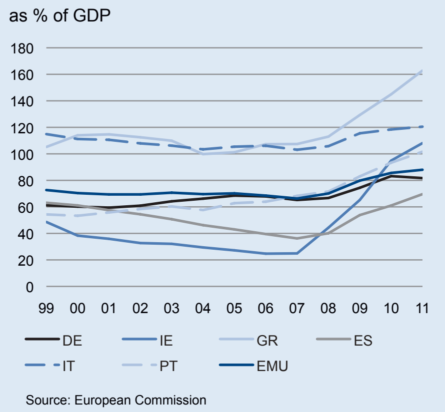
Since 1999, the five problem countries previously mentioned have found it more and more difficult to compete. One reason for this is the lack of structural reforms, such as in the labour market. The need to adapt collective bargaining policies to meet the requirements of the monetary union has also not been seriously addressed. Nominal wage levels far exceeded productivity. As a result, in 2010 unit labour costs in the five problem countries were up to 30 % higher than in 2000, whereas they had only grown by 7 % in Germany[9]. This meant that the competitiveness of these countries deteriorated significantly compared to Germany, somewhere in the order of 20 % (fig. 5), and led to major current account imbalances for some EMU countries. In contrast, Germany joined the EMU in 1999 with a deficit, but in 2009 it reported a current account surplus of 5 % of GDP, despite the collapse in the export market. The five problem countries found that their current account surplus deficits grew as a result of the price and cost increases. From a monetary policy point of view, these kinds of national imbalances are not a problem for the euro, as the EMU current account has been roughly in balance for some years. But in terms of the real economy, high national deficits are accompanied by soaring levels of foreign debt that have to be serviced (fig. 6).

LACK OF BUDGETARY DISCIPLINE TRIGGERS SOVEREIGN DEBT CRISIS

Since 1999, the EMU's main weakness has been its lack of budgetary discipline, which culminated in the massive increase in budget deficits from 2001 onwards and again after 2008. The SGP was supposed to ensure regular coordination and monitoring of budgetary discipline, but it failed to work properly because the rules were largely ignored. Despite the fact that it was Germany that had instigated the creation of the SGP in 1997, in 2003 it joined with France to overturn the rules. This created a precedent, and after that the pact was never really taken seriously. The reforms carried out in 2005[10] had little effect. Despite frequent and serious breaches of the rules, sanctions were not applied in a single case. The critics were right when they denounced the poor decision-making procedures where governments of potential "sinners" had the power to pass judgement on actual "sinners". Those countries which failed to keep control of their budgets bear the main responsibility for the damage done to the SGP, but those who simply looked the other way are also guilty because they condoned undesirable developments (fig. 7).

The global financial and economic crisis which began in the USA in 2008/09 was the trigger for the sovereign debt crisis in the eurozone. The governments of European countries tried to counter it with programmes to boost the economy and banking sector. As a result, budget deficits and sovereign debt rocketed. Since 2009, many eurozone nations have reported excessive budget deficits, many of them in excess of 3 % of GDP. In early 2010 the financial and economic crisis turned into the European sovereign debt crisis, after the debt dynamics

8 | Sovereign Debt



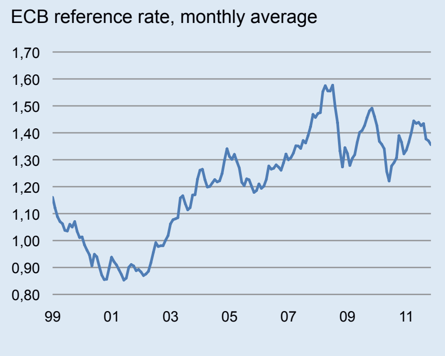
Source: European Commission

threw doubt on the ability of many eurozone countries to service their debt and their sovereign risk was reassessed (fig. 8).

The catalyst for the crisis was then Greece, a country that had been flouting the EMU's budget rules for years. With the bailout package for Greece[11] agreed on May 2, 2010, the no-bailout principle was breached for the first time. This rapidly caused contagion to spread in the financial markets of the other eurozone countries that were in a weakened budgetary position. The markets speculated that they would also need assistance. The governments once again had to act decisively, and by May 9, 2010 they had already agreed with the IMF to create a huge bailout fund in the amount of €750 billion[12]. For the first time, the ECB also allowed itself to be "roped in" to this action by buying the government bonds of affected EMU countries, in order to stabilise the markets.[13] These actions had become inevitable as a means of countering the first serious crisis the EMU had faced. The governments and the ECB proved that they were capable of acting under duress. However, up to early 2012, the anti-crisis strategy of creating ever-larger bailout funds was not enough to reassure the markets in a lasting way[14].

To What Extent is the Debt Crisis also a Euro Crisis?

9 | EUR/USD Exchange Rate



Source: European Central Bank

The sovereign debt crisis that has been raging since 2010 has generally been equated with a euro crisis. One of the arguments for this is the weakening of the euro against the US dollar. However, since 2004, the exchange rate has fluctuated between 1.20 and 1.45 USD/EUR (with the exception of a peak of 1.60 USD/EUR in summer 2008) and in terms of spending power it is, if anything, overvalued. This degree of fluctuation certainly does not indicate a currency problem (fig. 9).

This also applies to the EMU inflation rate which stood at around 2% from 2009 to 2011. Rather, it is that individual member states are struggling with sovereign debt and bank problems. The debt crisis that began in Greece gradually turned into a crisis of confidence for Europe. Ireland and Portugal had to turn to the rescue fund for help, and Spain and Italy also found themselves under serious pressure. Once again, bank confidence faded away and there was a danger of spiralling into a sovereign debt and banking crisis. However, at the time there was no serious danger of the monetary union collapsing. The idea that individual countries should withdraw from the union is not a helpful option, even though it is frequently mooted. What counts is the political will to stabilise and maintain the EMU as the key element at the heart of Europe.

However, there is a grave danger that the loss of confidence caused by the crisis could have a serious effect on other areas of the economy. At the moment, the main concern is that the real economy will fall into deep recession, similar to that of 2009. It is also a question of maintaining the confidence of savers and international investors, who are increasingly worried about the intrinsic value and security of holding their financial assets in euros.

CHRONOLOGY OF THE EURO

December 31, 1998
The exchange rates for the euro against the national currencies of the member states are irrevocably set.

January 1, 1999
The euro becomes the common currency for eleven countries: Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Spain. The national notes and coins remain in circulation as legal tender for the transitional period of 1.1.1999 to 31.12.2011, and as a non-decimal sub-unit of the euro. The euro can, however, be used to pay by cheque, credit card or debit card.

"Germany's future is inextricably bound up with the future of Europe", Dr Angela Merkel, during the general debate on the 2012 national budget in the German Bundestag

A String of Resolutions on Reforms to the EMU's Rules

The debt crisis has mercilessly laid bare the weaknesses inherent in the monetary union's rules and standards. As previously mentioned, the SGP has failed to deal with the budget deficits. The existing oversight and coordination of economic policy has failed to get to grips with the reforms needed to improve competitiveness. There is also no mechanism for supporting the adjustment process of EMU countries with weak budgetary positions.

Amongst the many summit decisions made during the turbulent year of 2011[15], many of them with a very short shelf life, particular attention should be drawn to those reform projects that make a lasting contribution to restructuring the EMU rules and that have the potential to stem the debt crisis and prevent future crises. These include (1) reform of the Stability and Growth Pact (SGP) and a fiscal union, (2) the Euro Plus Pact to enhance competitiveness, (3) a mechanism to oversee macroeconomic imbalances and (4) a permanent stability mechanism (ESM), brought forward by a year, to be launched in July 2012.

Firstly, reforms to the SGP are intended to flag up and counter any undesirable budget trends in good time. This reform means that countries with high sovereign debt must annually pay off one-twentieth of their debts that exceed the limit of 60 % of GDP. The imposition of sanctions in the event of excessive budget deficits can now only be prevented by a qualified majority of eurozone countries, so they will happen virtually automatically. This of course means that countries that have run up deficits will have to cede some of their budgetary sovereignty, but it also gives them the impetus to focus more on budgetary discipline.

The resolutions passed in December 2011 represent a strong declaration of political will in favour of a fiscal union[16] with greater budgetary discipline. The coordination of fiscal policy and the rules for imposing sanctions on budgetary sinners have been defined and tightened up. The member states have agreed to introduce a 'debt brake', (a balanced budget provision) and to either balance their national budgets or even aim to achieve a surplus. Structural deficits may not exceed 0.5 % of GDP.

The second reform project, the Euro Plus Pact, obliges its members to introduce a package of concrete measures each year in order to strengthen their international competitiveness. These measures are based on specific indicators, such as unit labour costs, and must be implemented within a 12-month period. The main focus is on reforms to social security structures and the labour market. For example, one of its aims is to stimulate the necessary structural changes by making the labour market more flexible. However, it remains to be seen whether the Euro Plus Pact's coordination of economic policy will achieve the expected improvements, as there are no plans to impose sanctions.

Thirdly, a new procedure has been launched for the surveillance of macroeconomic imbalances. This involves the Commission using a scoreboard of macroeconomic imbalances, such as excessive current account deficits, to diagnose and recommend ways of correcting them. Non-compliance may lead to sanctions. As excessive current account deficits are part of the debt problem, this is an appropriate response. However, the proposal that there should also be a penalty for surpluses is problematic, as this could mean Germany would have to accept penalties for being competitive.

But a permanent European Stability Mechanism [17] will be set up from July 2012, and the temporary EFSF safety net will continue to operate in parallel for a transitional period, the length of which is yet to be determined. In order to ensure the legal basis of the ESM, a two-line amendment is to be inserted into the existing EU Treaty in order to simplify the ratification procedure. [18] The ESM may only be activated during financial crises. Loans from the ESM should in future allow struggling eurozone countries to buy time in order to carry out the necessary budget overhauls. However, there is an inherent moral hazard in allowing budgetary sinners to know they can always fall back on a permanent mechanism to rescue them. As a result, loans are bound by strict conditions, with the involvement of the IMF in both an advisory and funding capacity. This is essential in order to avoid giving false incentives.

Dubious Instruments Proliferate in Times of Crisis

At the many summits held in 2011, a series of common debt and intervention instruments were discussed, all of them with a problematic background. In particular, these included the compulsory purchase of government bonds by the ECB and EFSF, the issuing of Eurobonds in favour of the problem countries and the awarding of a bank licence to the EFSF with ECB access. The first of these has already come into play several times, whereas in the past the EFSF only had the option. Large-scale purchases of government bonds by the ECB fall within the grey area between monetary and fiscal policy and bring with them a serious disadvantage, in that they undermine the motivation of the struggling nations to push through the necessary measures for budget consolidation and structural reform. This disadvantage also affects the EFSF's option to buy the government bonds of problem countries, if necessary on the primary and secondary markets, as well as the joint issuing of Eurobonds. Finally, a joint and several liability would involve all member states in the eurozone. [19] This would jeopardise their ratings and run the risk of higher future interest costs, along with placing excessive economic and political demands on the donor countries. Finally, a banking licence for the EFSF with ECB access was rightly thrown out, as this could allow state financing via quantitative easing.

CHRONOLOGY OF THE EURO

January 4, 1999
Global securities markets begin trading in euros.

July 1999
Minting of the new coins and notes begins.

January 2001
Greece fulfils the entry criteria – at least according to its national statistics – and becomes the twelfth country in the eurozone. It later transpires that the budget figures have been fudged.

September 1, 2001
Issuing of notes and coins begins, first of all to banks and retailers. From December, euro starter kits worth 20 deutschmarks (around 10.23 euros) are issued.

January 1, 2002
Euro coins and notes become legal tender for all members of the monetary union. For a two-month period, the national currency and the euro run in parallel. In Germany; cash payments can be made in euros or deutschmarks during this transitional period. All the banks and the German Federal Bank exchange deutschmarks for euros.

What Needs to be Done to Meet the Challenges Facing the EMU?

It is in the interests of Europe and, of course, also in Germany's own interest, to ensure the continued existence of the EMU. And it has become clear that conquering the debt crisis will be bound up with high levels of cost and uncertainty [20] which will have to be borne by many broad shoulders. Dealing with the crisis will take time and persistence. Permanent treatment for the debt crisis has to focus on the EMU's weak areas: unsound budgetary policies, the deteriorating competitiveness of some eurozone countries, the role of the financial markets and Greece's excessive indebtedness.

POLITICAL WILL IS NEEDED FOR A RETURN TO BUDGETARY DISCIPLINE

Clearly, the financial markets set the bar high for budgetary discipline within the EMU. This has been made obvious by the fact that, since 2010, the eurozone has been the focus of the markets, despite the fact that debt problems are actually even worse in other parts of Europe and the world. So, for example, the rating agencies have downgraded the eurozone countries because they no longer have the option of reducing their debt burden through inflating the economy.

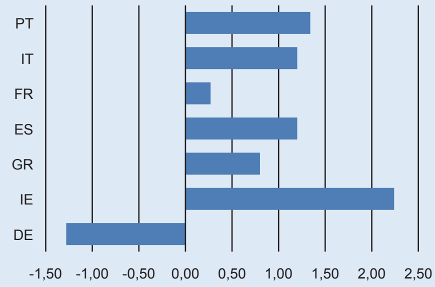
If the markets are to regain their confidence in the viability of national budgets, then all EMU countries with excessive budget deficits will have to set off down a credible path of consolidation. According to the summit resolution, excessive budget deficits must be kept below 3 % of GDP until 2013. [21] It remains to be seen whether this will be enough to regain market confidence. After the disappointments of the past, the governments of the problem countries have to make sure the reformed SGP has teeth. Their political will is being put to the test. Renewed confidence requires consolidation, which requires the acceptance of a temporary slowdown in domestic demand in the problem countries. Once confidence has been restored, there is the prospect of new impetus for investment and growth, particularly if consolidation and structural reform go hand-in-hand.

ECONOMIC POLICY: PROMOTING COMPETITIVENESS AND GROWTH

High current account deficits that are not conducive to the import of productive investment goods are a sign of a lack of competitiveness. The Euro Plus Pact meets the need for action in the area of economic policy. As the previous growth models which involved financing domestic demand through government loans have become obsolete in the problem countries of the eurozone, the question now arises of how to find new, sustainable growth models. The best solution would be if the struggling eurozone countries could grow their way out of their debts in order to lower their debt ratio. And of course it would also help if Germany could continue on from 2011 as the area's growth driver. But this will fall far short of what is required. It is essential for each country to increase its own export efforts.

10 | Germany's Real Devaluation

Real effective exchange rate, annual average 1999-2009 (%)



Source: European Commission

The classic option of correcting loss of competitiveness through devaluing the currency is no longer a possibility in the EMU. Withdrawing from the EMU and reintroducing the national currency is also not a valid option[22].

Instead, it is a case of letting the real exchange rate channel take effect, with increased competitiveness being achieved via inflation differentials over a longer period of time. Of course this adjustment mechanism takes time, but it is worthwhile, as was demonstrated by Germany in the second half of the 1990s, when it strengthened its competitiveness in a lasting way thanks to a combination of massive business restructuring, pay restraint and structural reforms. As inflation in Germany was between one half and one percentage point below the EMU average until 2006, there was a real devaluation in Germany's favour. This model may serve to provide a direction for the problem countries of the eurozone, but it cannot be directly transferred, as Germany suffered from low domestic demand for many years (fig. 10).

The real interest rate channel, which in the past has fostered growth thanks to low real interest rates, is only of limited use to debtors from the problem countries because of their restricted access to the credit and capital markets. It remains to be seen whether very expansionary monetary policies will boost a weak economy. Whatever happens, the starting point for the problem countries' future growth policies must be the correction of previous mistakes in their use of capital. The influx of capital in places such as Greece was used to fund huge national deficits, while in Ireland and Spain the property market was booming until the bubble burst and caused problems in the banking sector. Restoring sound state finances and structural reforms are essential for sustainable future growth.

OVERSIGHT FUNCTION OF THE FINANCIAL MARKETS SHOULD NOT BE QUESTIONED

The financial crisis has created a paradigm shift in relation to the dominant role that the financial markets have played for so long. Market malfunctioning and the rescue operations using tax-payers' money have led to intensive debate about the role of the financial markets and whether their power should be reined in. This debate included criticism of the financial markets' oversight function in assessing the soundness of financial investments[23]. At times people have the impression that it is not Greece with its lax financial policies over so many years that has triggered the debt crisis, but rather the speculators who make up a just a small minority within the financial markets. Here it is easy to overlook the fact that large numbers of reputable institutional and private investors are operating on the financial markets day in, day out. They are looking for sound investments (e.g. for pensions) and have to evaluate the risks. So, in the interests of financial investment, it is important that country risk in the eurozone is constantly being reassessed. The financial markets need this in order to plan with confidence and set their orientation.

However, experience also tells us that the financial markets have a tendency to overreact. The pronounced interest rate convergence in the ten years leading up to 2009 was not appropriate, but was rather an expression of the market's opinion that the no-bailout clause would not be observed. This then became true in the cases of Greece, Ireland and Portugal. The fact that the five problem countries in the eurozone have experienced soaring interest rates on borrowings and growing interest differentials with German federal bonds is again evidence of a total over-reaction. The strong interest rate spread for Italy[24] indicates that the markets believe that it is not feasible to bail out the country.

CHRONOLOGY OF THE EURO

Since March 1, 2002
German Federal Bank (Deutsche Bundesbank) branches continue to exchange deutschmark notes and coins – with no deadline, in unlimited amounts and free of charge. According to the German Federal Bank, in 2011 there were still 13 billion marks' worth of deutschmark notes and coins in circulation.

January 1, 2007
Slovenia becomes the 13th country to join the eurozone. Lithuania's application for entry is rejected by the European Commission because its inflation figures are too high.

January 1, 2008
Malta and the Republic of Cyprus introduce the euro.

January 1, 2009
Slovakia introduces the euro.

January 1, 2011
Estonia introduces the euro, kicking off a year when the euro debt crisis comes to a head. With the entry of Estonia, the euro becomes the currency used by around 332 million people across 17 member states.

ORDERLY DEBT RESCHEDULING BY ALL CREDITORS SHOULD BE AN OPTION

At first, the idea of debt restructuring in a eurozone country was considered something of a taboo because of Europe's tight integration, and then in the case of Greece, it was restricted to voluntary debt reduction by a few groups of private creditors (banks and insurance companies). But as a last resort, an orderly debt rescheduling procedure should be considered an option for all creditors. If we take a look at the debt stocks of the eurozone problem countries, we see that with a debt-to-GDP ratio of 160%, Greece's debt is no longer sustainable, whereas the other problem countries are in a more manageable position[25]. And Greece's debt ratio is continuing to grow apace, with the national debt still increasing thanks to an ongoing budget deficit (in 2011, around 9½% of GDP) in proportion to a shrinking GDP. A haircut would be an appropriate solution to the problem. The voluntary write-off of 50% of the face value of Greek sovereign debt that was agreed by the banks in October 2011 is a step in the right direction. The declared aim of the summit held in October 2011 that Greece's debt should be reduced to 120% by 2020 will, however, still not make it sustainable. In view of Greece's current lack of competitiveness, a minimum figure close to the Maastricht mark of 60% of GDP would be necessary.

There is, of course, no international bankruptcy code for countries. Traditionally, countries with excessive debt go to the Paris Club to negotiate with their state creditors and to the London Club to negotiate with their private creditors, mainly banks. During both sets of negotiations, the IMF usually intervenes with a restructuring programme linked to conditions[26]. An unruly state default must be avoided at all costs, but an orderly default, requiring rules and structures, is a possibility, for example based on the successful experiences with Mexico at the end of the 1980s[27] and Poland in 1994[28]. However, these would need to be adapted in the case of a eurozone country[29].

A prerequisite for a potential Greek debt restructuring is to ensure that the banks in Europe are adequately capitalised, so that they can absorb a write-down of Greek loans. To this end, the October 2011 summit resolution called for the banks to be recapitalised by mid-2012 and stated that debt restructuring must continue to be accompanied by a programme of reforms. Additionally, fresh money should be contributed by the EMU members in order to recapitalise Greek banks with high stocks of government bonds and thus provide funds for Greece's future growth.

First of all, the advantage for Greece would be that in future it would have to service a much lower debt burden in terms of repayments and interest. Debt restructuring would mean that the necessary process of reform would then be in a better position to get under way, because there would be more resources available for investing in the country. At the same time the main reason for the high levels of uncertainty would be removed, namely the Damocles sword of the fact that the markets believe a debt restructuring is inevitable. It is hard to find a businessman or investor who wants to commit to a country that is threatening to default and whose taxation turns any investment into an incalculable risk. Domestic and international businesses and investors need to feel confident in order to plan new investments. Only then are there better prospects of "reform dividends" and the chance of a new economic outlook for Greece.

The advantage for the EMU member states is that there is a good chance of regaining confidence and the political initiative. But the clear message that "Greece is a special case and there will be no more debt restructuring" must be accompanied by positive consolidation and reform programmes in the other problem countries of the eurozone, in order to satisfy the markets and keep the risk of contagion low. The media frenzy and potential for unrest caused by the quarterly audits and payments made to Greece by European and international bailout funds would be mitigated. The rescue fund's default risks could be more limited in future and the donor countries' ratings would be less at risk. It would be desirable for the interest rate differential for country risks in the eurozone to be permanently stronger, and indeed this is likely to happen, as it would provide an incentive to qualify for lower interest rates by carrying out sustainable policies.

After carrying out a haircut, the advantage to investors would be that they would receive guaranteed securities in exchange for unsafe Greek government bonds. So investors would be fully guaranteed the residual nominal amount after the haircut. At one time, this made Mexico's Brady bonds a relatively attractive proposition and helped the country to return to the international capital market. This could also be a possibility for Greece. Finally, there should be a classic debtor warrant, i.e. the creditor would receive higher repayments if developments in Greece turn out better than expected.

However, the potential risks and costs of an orderly debt restructuring should not be ignored. It will not be possible to remove all risk of contagion, even if steps for consolidation and reform are carried out in tandem in the rest of the problematic eurozone countries. If all creditor groups are involved in a debt restructuring, then public creditors (including the ECB[30] and the state-owned banks) will also be affected, which will add to the burden on the tax-payer. However, when compared to the current situation, the tax-payer will at least have the prospect of relief when it comes to the potential safety net obligations.

Even if the debt restructuring is successful, this does not automatically guarantee long-lasting success when it comes to the adjustment process. The reward for returning to competitiveness can only be earned through export success if there is an upswing in the European and global economy. Any debt restructuring entails moral hazard problems for the country in question, such as the expectation that the restructuring will solve all the problems so that it can ease up on its own efforts. In order to keep these risks as low as possible, the current payment of bailouts must remain bound up with consolidation and reform programmes lasting many years in order to foster competitiveness.

The somewhat sluggish reform process in Greece demonstrates that a variety of methods of "technical assistance" can also make a useful contribution to improving structures[31]. At the end of the day, the success of the adjustment process depends on whether and when Greece will be once again able to operate on the capital markets[32].

Part of any orderly debt restructuring process in the future will also comprise the summit decision to include collective action clauses (CACs) from 2013 in all new contracts for eurozone country government bonds. Whereas CACs can be introduced without problems under normal market conditions, in times of crisis they would probably entail increased risk premiums for the struggling eurozone nations, although the risk would be exaggerated.

CHRONOLOGY OF

May 2010

First rescue package for Greece approved with the help of bilateral loan guarantees from the EU and assistance from the IMF (€110 billion). The bailout is linked to certain conditions. At the same time, a temporary stability mechanism (EFSF) is created with an effective lending capacity of 440 billion euros. The EU and the IMF also contribute other funds. The eurozone countries start restructuring their national finances and set the first structural reforms in motion. At European level, gradual changes are begun to the architecture of the monetary union. Over the next few months, the ECB finds itself playing the role of crisis manager and tries to stabilise the situation on the financial markets by means of interest rate policy decisions and interventions in the secondary market (purchase of government bonds).

End 2010/early 2011

Ireland (November 2010) and Portugal (April 2011) are given bailouts by the EFSF after it becomes increasingly difficult to raise finances on the bond markets. In March 2011, the heads of state and government agree an overall package to stabilise the EMU, including steps to foster competitiveness and budgetary discipline. On top of this, it is agreed to set up a permanent stability mechanism (ESM) to take the place of the EFSF. The eurozone countries provide the ESM with guarantees of over 620 billion and pay in 80 billion euros in cash. Of the 700 billion, the fund can only use 500 billion because of the need to set aside necessary contingency funds. It can also buy government bonds directly from eurozone countries.

■ **July 2011**
Potential lending capacity of the EFSF is increased to 780 billion euros, so that it can actually pay out via guarantees 440 billion euros in emergency loans and make its instruments more flexible. Additionally, private creditors (banks and insurance companies) can now take part in the Greek restructuring, and a second rescue package is proposed for Greece. The attention of the financial markets falls on Italy and Spain. After changes of government in autumn 2011, these countries also introduce restructuring measures.

■ **October 2011**
In the case of Greece, the creditors come to an agreement on the partial cancellation of old debt. Additionally, the commitments to a second bailout for Greece (€130 billion) are strengthened and it is decided to increase the banks' capitalisation by mid-2012. The capacity of the EFSF is to be expanded through leveraging.

■ **December 2011**
The eurozone countries make efforts to create a new culture of stability and tougher deficit rules. This is to be achieved by amending the EU treaties, but without the support of the UK. The use of national debt brakes is to underline the political will to create sound fiscal policies. The permanent ESM rescue fund is to come into effect in mid-2012.

■ **January 2012**
The International Monetary Fund indicates that Greece is having major difficulties in pushing through the necessary reforms and says further steps must be taken. These include further austerity measures on the part of Greece, private creditors writing down much more of their investments and the eurozone countries' commitment to the second bailout package.

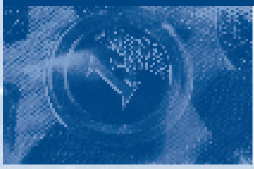
The ECB: A Long, Hard Road towards Normality

The ECB's crisis management since 2007 has been bound up with the realisation that price stability alone is not enough to achieve financial stability, but that the ECB above all has to beware of creating asset bubbles, for example in the property market[33]. Therefore, financial stability has become recognised as one of the secondary objectives of monetary policy. In view of the debt crisis, the ECB has not only revoked the pull-out from its expansion strategy introduced in 2009, but under new ECB president, Mario Draghi, in November/December 2011 it actually strongly reinforced its expansionary line in order to counter the renewed crisis of confidence in the banking system[34]. When it comes to crisis management, there is now the danger that the ECB will find itself totally overwhelmed with the task of trying to deal with price stability, financial stability and the massive purchase of government bonds from the problematic eurozone countries[35]. The purchase of government bonds was widely seens as a breach of independence and raised concerns over inflation. However, this should not be overestimated, even if the volumes purchased mean that there is a risk of value adjustments. So far any damage to confidence has been kept within limits, as the purchases are transparent and the resulting liquidity has been sterilised.

Above all, Europe's debt crisis has fuelled concerns that the high levels of sovereign debt could trigger inflation due to very expansionary monetary policies. But short or medium-term inflation is not really to be expected in view of the present weak economy. The rate of inflation in the eurozone grew to 3% in 2011, partly as a result of rising raw materials prices, but is likely to drop back to around 2% in 2012, within the ECB target area. In the long-term, however, Nobel prizewinner Milton Friedman was right when he said "Inflation is always and everywhere a monetary phenomenon". A permanently loose monetary policy has underlying risks, as very low interest rates fuel fears of inflation and can encourage flight into tangible assets and the possible creation of more asset bubbles.

Some governments might think the option of a debt reduction through devaluation caused by a "a few percentage points" more annual inflation is advantageous. However, the effectiveness of a policy that is based on money illusion is limited because of the reaction of the trade unions. The ECB will continue to stick to its clear mandate. A return to normality in terms of monetary policy is, however, not on the cards. Once the crisis has finally receded, the ECB will have to revoke its emergency measures, in the same way as a good doctor is no longer needed once a serious illness has been successfully treated.

Outlook



Despite the debt crisis, after thirteen years the euro can still be viewed as a successful core element of European integration. Most of the advantages of the euro, such as price stability, low interest rates and greater certainty for businesses continue to be the single currency’s key strengths.

However, the serious lack of sound financial policies and competitiveness led the EMU into stormy seas during 2010. The debt crisis is primarily a sovereign debt crisis affecting certain European countries, whereas the structures of the “core states” that have the economic power to provide the safety net are generally sound[36]. Everyone benefits to a greater or lesser extent from the euro. This justifies why the strongest are expected to bear the main burden of financial support.

The advantages of the euro can only be permanently preserved if confidence is restored. Here the starting point has to be the realisation that the main pillar of the EMU has been seriously damaged since May 2010 by the management of the crisis. The strategy of solving the debt crisis by creating ever-larger bailout funds has so far done little to assuage the markets. This is basically inherent in the system, because there is a major risk that larger and larger bailouts will just create dwindling confidence in the will of the problem countries to consolidate and carry out reforms and that the stronger countries will be overstretched.

A single currency has to be stable. Therefore, if confidence is to be created and the EMU preserved for good, it is necessary to look back at the basic pillars mentioned at the outset. Important steps towards have been taken to restructure the rules and regulations of the EMU, and the necessary process of consolidation and reform has begun. But the outcome is still open. The EMU is standing at a crossroads with a choice of three possible routes.

Firstly, the attempt to return to sustainable levels of national debt fails and the excessive demands made on the donor countries as a result of ever-larger rescue funds rapidly heighten the risk of the EMU collapsing. This would be a worst-case scenario, but it seems unlikely at present because of the strong political determination to hold the EMU together.

The second path leads towards a modified version of the Maastricht Treaty with increased inter-governmental coordination of budgetary policy within a fiscal union and a new SGP. It is characterised by the laborious rebuilding of sustainable budget positions and restoring competitiveness. Basic cornerstones of the EMU pillars such as the no-bailout principle and the national control of budgets should continue to apply. It is possible to carry on with the EMU with the previous summit resolutions in a Maastricht version. The option of limiting debt restructuring to Greece offers the opportunity to approach the crisis in a way that treats the cause rather than just the symptoms.

The third route would be a European political union[37]. The goal should be closer political cooperation based on sound national finances and growing economies within a competitive single market, and its form should be made concrete in the political process. However, a political union with the end objective of a European union should not be pushed through in times of crisis. The debt crisis brings with it the danger that the reestablishment of sound national finances in the problematic eurozone countries will only be partially successful and there will be a trend towards the increased collectivization of sovereign debt. In the event of this kind of European debt union being formed, Europe could find itself being involuntarily dragged towards political union. It would of course be preferable for the goal of a European political union to be worked towards from a position of strength after the debt crisis has been conquered. By following this path, the vision expressed by French economist Jacques Rueff in 1950 could be fulfilled: “Europe will be created by means of a single currency or not at all.”

Whatever happens, creating a political union has to be seen as a long-term project. Project Europe needs good policies and communication if it is to generate credibility and persuade the majority of EU citizens to get on board. The time for this is not yet ripe, as long as all governments and most citizens of the member states feel their own interests are best served at a national level. And based on current public opinion in the member states[38], this is unlikely to change in the near future. This is another reason why it still remains to be seen whether the EMU ends up taking the second or the third route.

1 | This non-liability clause in Art. 125 of the Treaty on the Functioning of the European Union serves to strengthen budget discipline. Pursuant to this, neither the Union nor the Member States may assume liability for the commitments of other Member States. However, Article 122 allows emergency financial assistance to be granted for occurrences beyond its control.

2 | European Commission (2008), EMU@10, Successes and Challenges after Ten Years of European Monetary Union; Werner Becker (2008), The euro turns ten, growing up, Deutsche Bank Research, EU Monitor 57, Reports on European integration.

3 | Werner Becker, Der Euro – eine europäische Erfolgsgeschichte, Article in: Norbert Walter (2011), Europa, Warum unser Kontinent es wert ist, dass wir um ihn kämpfen, Campus, Frankfurt/New York.

4 | The ECB defines price stability as a rate of inflation that in the medium-term is below but close to 2% p.a.

5 | So, for example, the oil price has increased more than threefold since 1999. Administrative price increases and tax increases can also drive up prices at times. The introduction of euro notes and coins in 2002 triggered a controversial debate about whether the harmonised consumer price index (HCPI) measured the rate of inflation correctly, as at times the inflation rate perceived by the public was well in excess of the actual rate. However, the official statistics are based on reliable, proven methods. The discrepancy between the "felt" and measured inflation rate was due to other reasons. For example, the obvious price increases in some frequently-used services (such as restaurant visits) were more noticeable than price decreases in less-frequently bought products such as computers.

6 | It has adapted its instruments to suit changing circumstances, e.g. with respect to the term of repurchase agreements and direct open market transactions with mortgages and government bonds.

7 | As an example, the returns on ten-year eurozone government bonds were generally less then 50 basis points above those of German federal bonds, which are used as a benchmark within the EMU.

8 | European Central Bank (2011), The International Role of the Euro.

9 | German Council of Economic Experts, annual report 2010/11, Chances for a Stable Upturn, chapter 3, Euro Area in Crisis, p. 66 ff.

10 | This reform provided budgetary sinners with more leeway for developing financial policy in periods of slow growth and allowed for more flexibility when correcting excessive budget deficits. Werner Becker (2005), Reform of the stability pact – A license to run up debt, EU Monitor No. 23, Deutsche Bank Research.

11 | The eurozone's first conditional bailout for Greece (€110 billion) consisted of bilateral loans up to €80 billion and an IMF loan in the sum of €30 billion.

12 | The rescue package agreed on May 9, 2010 comprises the emergency fund (European Financial Stabilisation Mechanism) in the sum of up to €60 billion (funded by EU guarantees), a European Financial Stability Facility (EFSF) which is (initially) limited to three years in the sum of up to €440 billion and up to €250 billion of funding from the International Monetary Fund. Bailouts are tied in to a long-term adjustment programme. Ireland also received a bailout in November 2010, followed by Portugal in April 2011.

13 | As a result, the improbable happened, in that a relatively small member of the eurozone such as Greece – whose GDP made up 2.7% of the EMU – brought about a crisis that engulfed the whole eurozone.

14 | In summer 2011, another large bailout had to be put together for Greece, which was then amended at the summit meeting in October. It has longer repayment terms and lower interest rates. The latter was also granted to Ireland and Portugal. European Council, statement by the heads of state and government of the euro area and the EU institutions, July 21, 2011.

15 | Conclusions of the European Council dated March 24/25, 2011; conclusions of the European Council dated June 23/24, 2011, Euro Summit statement of October 2011, Brussels, November 9, 2011; statement of the heads of state and government of the euro area dated December 9, 2011.

16 | The new architecture of the EMU is to be based on an inter-governmental agreement and be specifically defined by March 2012. Whereas nine of the ten non-EMU countries want to take part in the inter-governmental agreement, the UK has rejected all treaty amendments to improve the architecture of the EMU. This could handicap the inter-governmental agreement, as if there are any doubts it will be less legally binding than the EU Treaty.

17 | The ESM's effective lending capacity is to be set at €500 billion, based on guarantees (€620 billion) and capital contributions (€80 billion) by the eurozone countries.

18 | Article 136 of the Lisbon Treaty: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

19 | European League for Economic Cooperation (2010), CAHIER COMTE BOËL N°14, The creation of a common European bond market

20 | German Council of Economic Experts, Annual Report 2011/12, chapter 1: Taking Responsibility for Europe, p. 1 ff.

21 | The exception is the three problem countries, Greece, Ireland and Portugal, which have had varying degrees of success in reorganising their national finances within the framework of aid and adjustment programmes. Whereas Ireland has been making good progress, the adjustment process in Greece and Portugal still needs many years to take effect because of structural problems. It was only at the summit in October 2011 that Italy and Spain committed to enacting austerity measures and structural reforms.

22 | A significant nominal devaluation of the new currency could provide temporary relief, but because of its tight integration it would bring with it major economic and political drawbacks. The inflation that would result from a significant devaluation would have to be contained by restrictive monetary and fiscal policies, leading to a steep rise in interest rates that would put pressure on the national budget, businesses and private households. Devaluation can only change relative prices if a country manufactures products with good export potential. The achievements of the Single Market, such as the free movement of trade and capital, would have to be limited *in order to secure the new currency. It should also not be forgotten that banks, businesses and the public sector have spent large sums of money on adapting their activities (prices, accounting, IT, taxation, etc.) to the euro. The introduction of a new national currency would once again incur high adjustment costs.*

23 | An example of this is the often excessive criticism directed at the rating agencies, which play an important role in the decisions of the financial markets, in spite of previous mistakes (such as seriously overrating US mortgage-backed securities before the outbreak of the financial crisis). However, for the markets, the ratings agencies represent only one factor in their decision-making, albeit an important one.

24 | In 2011, the interest differential between German and Italian ten-year government bonds at times was as high as 5 percentage points. Such levels had not been seen since the early 1990s.

25 | Italy comes next, with a debt-to-GDP ratio of 120%. Unlike Greece it has a powerful economy, a high savings ratio and high levels of private assets. Next is Ireland (112%), then Portugal (102%) and Spain (68%). European Commission (2011), Public Finance in EMU, p. 26.

26 | An estimated one-third of private sector investment is from private investors, the rest from institutional investors such as banks and insurance companies. In view of this creditor base in Greece, a lobbying group should be set up for private investors, e.g. a "Berlin Club".

27 | The key term is Brady bonds. These were bonds designed to assist debt reduction and debt relief (debt deferrals, suspension of interest payments, interest rate reduction, etc.) and which provided debtor countries with more scope for growth via new money from creditor banks and reforms to economic policy, thus allowing the countries to find a way of conquering their debt problems through their own efforts. The Brady bonds were 100% guaranteed by the US government. This was the key to building confidence and success and providing a way for the debtor countries to return to the international capital markets. The Brady Plan produced clear successes, but also some disappointments. For instance, Mexico was able to return to the capital markets very quickly after the Brady bonds were launched in 1989, and between 1990 and 2006 its growth averaged 3% p.a. In contrast, oil-producers Venezuela and Nigeria were unable to create any impetus until 1995, and Ecuador defaulted on its Brady Bonds in 1999.

28 | In Europe, Poland accompanied its successful growth strategy with a rescheduling of foreign debts in 1994. Christoph Sowada (1995), Haushaltspolitische Konsequenzen steigender Staatsverschuldung in Polen, University of Potsdam, discussion article No. 3.

29 | If, for example, we were to take Brady bonds as a model for solving the debt crisis, the other EMU countries would have to provide complete guarantees for potential Greek Brady bonds, perhaps with the assistance of the EFSF or the ESM.

30 | Up to now, the ECB has refused a Greek debt rescheduling with all creditors. One reason for this is probably the fact that the ECB took large amounts of Greek government bonds as collateral for Central Bank loans and since May 2010 has been buying Greek government bonds on the markets. In the event of debt rescheduling, it is likely that the ECB would have to write down its high stocks of Greek government bonds, which could have a serious impact on its balance sheet. This would have to be borne in mind in the event of a debt rescheduling. Strengthening the ECB's capital base via national central banks would also burden the taxpayer, for example in the form of lower or non-existent distribution of profits by the central banks to the respective treasuries.

31 | Greece has requested practical assistance in areas such as strengthening its legal and taxation systems, improving local government and healthcare, and in the privatisation of state-owned companies. The EU has set up a task force to assist in this. It remains to be seen in practice whether it will be a handicap that this kind of assistance can only be offered on a voluntary basis.

32 | History tells us that the financial markets do not have memories like elephants. When the conditions are right, it will be possible to return to the capital market within just a few years. A necessary precondition is that Greece successfully restructures its public sector and develops a competitive economy. A second condition is that the EMU countries fully guarantee the remaining debt after the debt rescheduling.

33 | The bursting of the property bubble heightened the sovereign debt problems in Spain and Ireland, and in 2007 it triggered the financial crisis in the USA. Here the central banks have the problem that they have very few suitable means at their disposal to have a direct influence on property bubbles.

34 | The key interest rate was once again reduced to 1% (from 1.5% since July 2011). A new development was the introduction of longer-term refinancing deals with terms up to 36 months, lower credit rating requirements by the ECB on collateral for loans to banks and the halving of the reserve requirement ratio to 1%.

35 | Purchases made between May 2010 and March 2011 as a result of the debt crisis, in order to stabilise the market, and again from August 2011 onwards in favour of Italy and Spain, amounted to around €210 billion by the end of 2011.

36 | Therefore it is not accurate for the media to constantly refer to the debt crisis as the euro crisis and hence cause anxiety amongst the 332 million citizens of the eurozone.

37 | This refers to the establishment of political structures for the "United States of Europe", consisting of a European government, a fully-fledged European parliament and a large EU budget. A unique political format would need to be developed. The initiative in favour of political union that was launched by former German Chancellor Helmut Kohl in 1990 at the time of the decision on the EMU fizzled out.

38 | Standard Eurobarometer 76 (December 2011): when asked whether or not they trusted the European Union, 55% of those surveyed in all 27 EU countries replied with a resounding "No".

The Author

Werner Becker (born 1950) graduated in Economics from the Johannes-Gutenberg University in Mainz in 1974 and continued his studies there until 1979, when he gained a Ph.D (Dr. rer pol.) with his thesis on financing trends for small and medium-sized businesses. After a spell working as a Research Associate in economic and banking policy at Mainz University, from 1979 to 1991 he was a member of the Economics division of Deutsche Bank and then, until 2008, he worked at Deutsche Bank Research. His work mainly revolved around issues relating to currencies, financial markets and Europe. From 1993 to 2001, he was actively involved in preparing Deutsche Bank for the introduction of the euro. Over the last decades, Werner Becker has written many articles and given numerous talks about the problems of European integration. Since March 2009 he has been a lecturer at the Frankfurt School of Finance and Management.

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