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The Lies that Europe's Politicians Tell Themselves

Delusions of the Euro Zone

A Commentary by Armin Mahler

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Since its inception, the euro zone has been built on lies, the most grievous of which is the idea that the common currency could work without political union. But Europe's politicians are currently suffering under a different but equally fatal delusion -- that they have all the time in the world to fix the crisis.

How much does time cost? That depends what you need it for. The time that Europe's leaders want to buy to tackle the euro crisis is a precious commodity. And its price keeps going up and up.

Initially, it was supposed to cost €110 billion ($130 billion). That's how expensive the first EU bailout package for Greece was. Soon, it was expanded via a comprehensive rescue fund that helped out Portugal and Ireland. Then came a second bailout package for Greece, followed by an even more comprehensive rescue fund for the rest.

In late September 2011, representatives in Germany's parliament, the Bundestag, had not yet voted on this expanded package -- which would put Germany alone on the hook for €211 billion

-- but it was already clear to them that even that wouldn't be enough. But nobody could say that out loud, and especially not Finance Minister Wolfgang Schäuble, because they obviously didn't want to endanger the government's majority in parliament -- and, thereby, its own ability to govern.

On top of that, the European Central Bank (ECB) is buying up sovereign bonds of debt-ridden euro-zone countries. At first, it was Greece, Portugal and Ireland. Then, beginning in the summer of 2011, it bought bonds from Italy and Spain. It now has a grand total of over €195 billion of bonds on its books. If things should go south, Germany will also ultimately be responsible for 27 percent of that figure, corresponding to Germany's share of the ECB's capital.

Winning Time

The argument is always that it's all about winning time. Time that would allow the financial markets to settle down. Time that would let the debt-ridden PIIGS states (Portugal, Ireland, Italy, Greece and Spain) implement stringent cost-cutting measures. Time that would make it possible for the euro zone to reform its institutions and rules -- and perhaps even let Greece default without having the entire euro immediately implode.

But is all that money really well invested? And will the time it has bought also be put to sensible use?

Anyone who believes that the European currency union doesn't have a future anyway will think that every euro devoted to the rescue effort is a euro too many. On the other hand, anyone who thinks that the European Union is no longer imaginable without the euro -- as Chancellor Merkel does -- will believe that no price is too high.

But whoever wants to save the euro must first be clear about the ultimate goal he or she wants to achieve. Do they want a currency union like the one constructed in the 1990s, with states that are solely responsible for their own finances, or a so-called transfer union with shared liabilities? Do they want a currency union in its current configuration or a smaller but stable euro zone of the core countries? And, whatever the answer, they also have to ask themselves which of these possibilities can realistically be implemented politically.

The Mistakes of the Past

In answering these questions, the very first thing one has to do is conduct an honest analysis of what went wrong with the ambitious project of giving the old continent a unified currency, and why it is stuck in such a deep crisis today. Indeed, if one is going to be able to draw the correct conclusions for the future, one can only do so by first identifying the mistakes and errors of the past.

But, already at this point, one runs into problems. Almost all of the major political figures in Europe -- whether it's Helmut Schmidt, Germany's chancellor from 1974 to 1982, who sees himself as the grandfather of the common currency, current Chancellor Merkel, Jean-Claude Juncker, the head of the Euro Group, or Jean-Claude Trichet, the president of the ECB until Oct. 31 -- have been unanimous in stressing that there isn't any euro crisis at all. Rather, in their eyes, what we have is simply a debt crisis in some euro-zone countries.

If it were only that simple. Unfortunately, it isn't. Simply put, without a common currency, Greece's problems wouldn't have spilled over into Spain and Italy. And, without this risk of contagion, politicians and central bankers wouldn't be staggering from one crisis summit to the next, ever driven by the fear that the currency union might break apart.

Without the euro, Greece could recover more easily. It could devalue its currency and thereby make its national economy competitive once again.

Indeed, without the euro, Greece wouldn't have ever gotten into this calamitous situation in the first place. The fact that it was a member of the currency union was the only thing that allowed the country to borrow money at such favorable rates and get itself up to the neck in debt.

The Principle of Hope

Nevertheless, not one of the currency union's founding fathers will admit that it was poorly designed. The currency union brought together countries that weren't compatible economically simply because it was opportune politically. It replaced the currency exchange rate, the standard mechanism for balancing out differences between national economies, with the principle of hope. Now, the common currency was supposed to make the economies align themselves with each other, practically automatically.

In reality, however, the differences between the economies of the euro-zone countries became larger rather than smaller. The so-called "Club Med" countries benefited from the low common interest rate. They lived beyond their means and they consumed more than they could afford -- to the detriment of their already weak ability to compete.

A country with a flagging economy normally devalues its currency. Doing so makes its goods cheaper on the global market, allowing it to increase exports and cut back on its deficit. But, in a currency union, there isn't an exchange rate that can serve as a compensatory mechanism. If a country doesn't have a sound economy, the tensions only increase.

For these reasons, it has always been clear that the currency union cannot function without shared economic and financial policies. Indeed, that's exactly how politicians imagined things in

the beginning. For example, in November 1991, then-German Chancellor Helmut Kohl told the Bundestag that a currency union without a political union would be absurd.

Political Delusions

At the time, Europe's governments couldn't agree on steps toward greater political integration -- but they still kept pursuing the currency-union project anyway. The vague expectation was that the political union would follow the economic one of its own accord.

This hope was never fulfilled, and so the euro rushed headlong into crisis. Things started off slowly. But, once the criteria of the Stability and Growth Pact were no longer adhered to, they started picking up speed -- until even the key promise that pro-euro politicians had made was broken. According to the so-called "no-bailout clause" of the Maastricht Treaty, no country was supposed to be liable for the debts of another.

As the former SPD Finance Minister Peer Steinbrück told SPIEGEL in an interview published in September, that was an "error that became evident during the crisis." As he sees it, this "political delusion should have already been acknowledged and explained a year and a half ago."

Instead, Germans were repeatedly told that saving the euro might not even cost them anything, that no money had changed hands yet, that only guarantees had been given. But nobody can believe that anymore.

A Bailout Based on an Illusion

Just as the euro's introduction was based on a mistake, the effort to rescue the euro began with another instance of "political delusion," to use Steinbrück's phrase.

With debts amounting to 150 percent of GNP, Greece is de facto bankrupt. Over the course of 2011, even the leading representatives of the euro zone finally accepted this fact -- after having claimed its opposite a year previously.

This explains why the first bailout package for Greece was, to put it mildly, based on an illusion. Possibly against their better judgment, countries putting money into the package assumed that Greece would be able to solve its debt problems by implementing a stringent belt-tightening regime.

The so-called troika, made up of representatives of the International Monetary Fund (IMF), the ECB and the European Commission, was tasked with evaluating the success of these measures.

But they were not successful. Instead of getting better, things only got worse for the country. The austerity measures caused the economy to stall, hoped-for increases in state revenues never materialized, and the country started sinking deeper into debt rather than climbing out of it. But the financial assistance kept coming nevertheless.

Learning a Bitter Lesson

This year, the would-be euro saviors have had to learn a bitter lesson: If they assume that the collapse of a single euro-zone country would bring with it incalculable risks, comparable to the 2008 collapse of the American investment bank Lehman Brothers, then they have no credible power to exert pressure on deficit offenders. Instead, they just have to keep paying. And then the euro zone will have to subsidize countries like Greece for the long term -- just like the rest of Germany has been supporting the chronically cash-strapped northern city-state of Bremen for decades under the country's federal financial equalization system.

The only question is whether ordinary people will play along -- both in the donor countries, who are meant to keep paying, as well as those in the recipient countries, who will have to suffer mightily under stringent austerity measures.

In September, the Bundestag voted to approve the expansion of the euro bailout fund, the European Financial Stability Facility (EFSF). But there is growing resistance to additional maneuvers of this sort -- and not only in Germany.

The currency union has already started subtly transforming itself into a debt union. If the ECB -- and soon the EFSF too -- purchase sovereign bonds that might never be paid back, or at least not in full, the stronger countries will be liable for the weaker ones.

Of course, politicians don't like to use phrases like liability union or transfer union. But what these phrases describe became reality long ago -- which also numbers among the truths they prefer not to mention.

Bottomless Pit

Yet another inconvenient truth is that not all countries will be able to reduce their debt levels by themselves and boost their competitiveness. The currency union can only survive as a transfer union, and if it doesn't want to become a bottomless pit, it also needs to become a fiscal union -- one with strict rules and independent institutions capable of enforcing them.

For these reasons, the euro states have to cede a major part of their sovereignty to Brussels. Whether or not one wants to call the result the United States of Europe is a matter of taste.

Proponents of this kind of union fantasize that the crisis will give rise to an opportunity. They believe that now, in the hour of need, the pressure to act is big enough to push through the integration of Europe that has previously always failed because of national self-interest.

But they might be deceiving themselves once again. The parliaments of the EU member states would have to approve any far-reaching amendments to the union's treaties. What's more, in many cases, this would also involve changing national constitutions and holding referendums. Such a process is protracted, and its outcome is anyone's guess.

The alternative would be returning to how things were originally, meaning at the birth of the currency union. As happened then, euro-zone members would pledge to maintain stability (which admittedly already failed once before, because the rules were overridden when push came to shove). In this case, there would be no permanent transfers and also no collectivization of debts.

Inevitable Shrinkage

In the end, the currency union will shrink. Greece and possibly even other countries will have to abandon the euro in order to be able to get back on their feet with the help of their own, significantly devalued, currency.

The euro saviors and their citizens must finally face the uncomfortable truth. Under current conditions, the euro will fail economically because the differences between euro-zone countries are too great.

But new conditions that would give the euro a firm economic foundation are almost impossible to implement due to political factors. In any case, they can definitely not be put in place quickly enough to combat the current crisis.

Indeed, the would-be euro saviors are suffering from yet another delusion: that they are able to buy all the time they need, without any limits.