The Tragedy of the European Union and How to Resolve It

George Soros

In a fast-moving situation, significant changes have occurred since this article went to press. On August 1, as I write below, Bundesbank President Jens Weidmann objected to the assertion by Mario Draghi, the president of the European Central Bank, that the ECB will "do whatever it takes to preserve the euro as a stable currency." Weidmann emphasized the statutory limitation on the powers of the ECB. Since this article was published, however, it has become clear that Chancellor Merkel has sided with Draghi, leaving Weidmann isolated on the board of the ECB.

This was a game-changing event. It committed Germany to the preservation of the euro. President Draghi has taken full advantage of this opportunity. He promised unlimited purchases of the government bonds of debtor countries up to three years in maturity provided they reached an agreement with the European Financial Stability Facility and put themselves under the supervision of the Troika—the executive committee of the European Union, the European Central Bank, and the International Monetary Fund.

The euro crisis has entered a new phase. The continued survival of the euro is assured but the future shape of the European Union will be determined by the political decisions the member states will have to take during the next year or so. The alternatives are extensively analyzed in the article that follows.

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Markus Schreiber/AP Images

German Chancellor Angela Merkel and French President François Hollande during their first meeting after his election, Berlin, May 15, 2012

I have been a fervent supporter of the European Union as the embodiment of an open society—a voluntary association of equal states that surrendered part of their sovereignty for the common good. The euro crisis is now turning the European Union into something fundamentally different. The member countries are divided into two classes—creditors and debtors—with the creditors in charge, Germany foremost among them. Under current policies debtor countries pay substantial risk premiums for financing their government debt, and this is reflected in the cost of financing in general. This has pushed the debtor countries into depression and put them at a substantial competitive disadvantage that threatens to become permanent.

This is the result not of a deliberate plan but of a series of policy mistakes that started when the euro was introduced. It was general knowledge that the euro was an incomplete currency—it had a central bank but did not have a treasury. But member countries did not realize that by giving up the right to print their own money they exposed themselves to the risk of default. Financial markets realized it only at the onset of the Greek crisis. The financial authorities did not understand the problem, let alone see a solution. So they tried to buy time. But instead of improving, the situation deteriorated. This was entirely due to the lack of understanding and the lack of unity.

The course of events could have been arrested and reversed at almost any time but that would have required an agreed-upon plan and ample financial resources to implement it. Germany, as the largest creditor country, was in charge but was reluctant to take on any additional liabilities; as a result every opportunity to resolve the crisis was missed. The crisis spread from Greece to other deficit countries and eventually the very survival of the euro came into question. Since breakup of the euro would cause immense damage to all member countries and particularly to Germany, Germany will continue to do the *minimum* necessary to hold the euro together.

The policies pursued under German leadership will likely hold the euro together for an indefinite period, but not forever. The permanent division of the European Union into creditor and debtor countries with the creditors dictating terms is politically unacceptable for many Europeans. If and when the euro eventually breaks up it will destroy the common market and the European Union. Europe will be worse off than it was when the effort to unite it began, because the breakup will leave a legacy of mutual mistrust and hostility. The later it happens, the worse the ultimate outcome. That is such a dismal prospect that it is time to consider alternatives that would have been inconceivable until recently.

In my judgment the best course of action is to persuade Germany to choose between becoming a more benevolent hegemon, or leading nation, or leaving the euro. In other words, Germany must lead or leave.

Since all the accumulated debt is denominated in euros it makes all the difference who remains in charge of the euro.[1] If Germany left, the euro would depreciate. The debt burden would remain the same in nominal terms but diminish in real terms. The debtor countries would regain their competitiveness because their exports would become cheaper and their imports more expensive. The value of their real estate would also appreciate in nominal terms, i.e., it would be worth more in depreciated euros.
The creditor countries, by contrast, would incur losses on their investments in the euro area and also on their accumulated claims within the euro clearing system. The extent of these losses would depend on the extent of the depreciation; therefore creditor countries would have an interest in keeping the depreciation within bounds.

The eventual outcome would fulfill John Maynard Keynes's dream of an international currency system in which both creditors and debtors share responsibility for maintaining stability. And Europe would escape from the looming depression. The same result would be achieved, with less cost to Germany, if Germany chose to behave as a benevolent hegemon. That would mean (1) establishing a more or less level playing field between debtor and creditor countries and (2) aiming at nominal growth of up to 5 percent, in other words allowing Europe to grow its way out of excessive indebtedness. This would entail a greater degree of inflation than the Bundesbank is likely to approve.

Whether Germany decides to lead or leave, either alternative would be better than to persist on the current course. The difficulty is in convincing Germany that its current policies are leading to a prolonged depression, political and social conflicts, and an eventual breakup not only of the euro but also of the European Union. How to persuade Germany to choose between either accepting the responsibilities and liabilities that a benevolent hegemon should be willing to incur or leaving the euro in the hands of debtor countries that would be much better off on their own? That is the question I shall try to answer.

How We Got Here

When it was only an aspiration, the European Union was what psychologists call a "phantastic object," a desirable goal that captured many people's imagination, including mine. I regarded it as the embodiment of an open society. There were five large states and a number of small ones and they all subscribed to the principles of democracy, individual freedom, human rights, and the rule of law. No nation or nationality was dominant. Although the Brussels bureaucracy was often accused of a "democratic deficit," elected parliaments had to give approval of the major steps.

The process of integration was spearheaded by a small group of farsighted statesmen who practiced what Karl Popper called piecemeal social engineering. They recognized that perfection is unattainable; so they set limited objectives and firm timelines and then mobilized the political will for a small step forward knowing full well that when they achieved it, its inadequacy would become apparent and require a further step. The process fed on its own success, very much like a financial bubble. That is how the Coal and Steel Community was gradually transformed into the European Union, step by step.

France and Germany used to be in the forefront of the effort. When the Soviet empire started to disintegrate, Germany's leaders realized that reunification was possible only in the context of a more united Europe and they were prepared to make considerable sacrifices to achieve it. When it came to bargaining, they were willing to contribute a little more and take a little less than the others, thereby facilitating agreement. At that time, German statesmen used to assert that Germany has no independent foreign policy, only a European one. This led to a dramatic acceleration of the process. It culminated with the signing of the Maastricht Treaty in 1992 and the introduction of the euro in 2002.

The Maastricht Treaty was fundamentally flawed. The architects of the euro recognized that it was an incomplete construct: it had a common central bank but it lacked a common treasury that could issue bonds that would be obligations of all the member states. Eurobonds are still resisted in Germany and other creditor countries. The architects believed, however, that when the need arose, the political will could be generated to take the necessary steps toward a political union. After all, that is how the European Union was brought into existence. Unfortunately, the euro had many other defects, of which neither the architects nor the member states were fully aware. These were revealed by the financial crisis of 2007–2008, which set in motion a process of disintegration.

In the week following the bankruptcy of Lehman Brothers the global financial markets broke down and had to be put on artificial life support. This involved substituting sovereign credit (in the form of central bank guarantees and budget deficits) for the credit of the financial institutions that was no longer accepted by the markets. The central role that sovereign credit was called upon to play revealed a flaw in the euro that had remained hidden until then and that has still not been properly recognized. By transferring what had previously been their right to print money to the European Central Bank, the member states exposed their sovereign credit to the risk of default. Developed countries that control their own currency have no reason to default; they can always print money. Their currency may depreciate in value, but the risk of default is practically nonexistent. By contrast, less developed countries that borrow in a foreign currency have to pay premiums that reflect the risk of default. To make matters worse, financial markets can actually drive such countries toward default through "bear raids"—-short-selling the bonds of these countries, driving their cost of borrowing higher, and reinforcing the fear of impending default.

When the euro was introduced, government bonds were treated as riskless. The regulators in the various countries allowed banks to buy unlimited amounts of government bonds without setting aside any equity capital, and the European Central Bank accepted all government bonds at its discount window on equal terms. This made it advantageous for commercial banks to accumulate the bonds of the *weaker* member countries, which paid slightly higher rates, in order to earn a few extra basis points.

In the aftermath of the Lehman Brothers crisis, Angela Merkel declared that the guarantee that no other systemically important financial institution would be allowed to fail should be given by each country acting separately, not by the European Union acting jointly. That was the first step in a process of disintegration that is now threatening to destroy the European Union.