Lecture by George Soros

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Giving a speech in Berlin, I feel obliged to speak about the euro because the euro is in crisis and Germany is the main protagonist. Unfortunately I didn't get the timing right because the crisis has a fiscal component and a banking component and the latter is just now approaching a climax. A comprehensive analysis will have to await the publication of stress test results. The best I can do at this moment is to put matters into a historical perspective. It is my contention that misconceptions play a large role in shaping history and the euro crisis is a case in point.

Let me start my analysis with the previous crisis, the bankruptcy of Lehman Brothers. In the week following September 15, 2008 global financial markets actually broke down and by the end of the week they had to be put on artificial life support. The life support consisted of substituting sovereign credit for the credit of financial institutions which ceased to be acceptable to counter parties.

As Mervyn King of the Bank of England explained, the authorities had to do in the short-term the exact opposite of what was needed in the long-term: they had to pump in a lot of credit, to replace the credit that had disappeared, and thereby reinforce the excess credit and leverage that had caused the crisis in the first place. Only in the longer term, when the crisis had subsided, could they drain the credit and reestablish macro-economic balance. This required a delicate two phase maneuver – just as when a car is skidding, first you have to turn the car into the direction of the skid and only when you have regained control can you correct course.

The first phase of the maneuver has been successfully accomplished – a collapse has been averted. But the underlying causes have not been removed and they have surfaced again when the financial markets have started losing confidence in the credibility of sovereign debt. That is when the euro took center stage because of a structural weakness in the constitution of the euro but we are dealing with a worldwide phenomenon. So the current situation is the direct consequence of the crash of 2008.

The situation is eerily reminiscent of the 1930's. Doubts about sovereign credit are forcing reductions in budget deficits at a time when the banking system and the economy may not be strong enough to do without fiscal and monetary stimulus. Keynes has taught us that budget deficits are essential for counter-cyclical policies, yet many governments have to reduce them under pressure from the financial markets. Coming at a time when the Chinese authorities have also put on the brakes, this is liable to push the global economy into a slowdown or possibly a double dip. Europe, which weathered the first phase of the financial crisis relatively well, is now in the forefront of the downward pressure because of the problems connected with the common currency.

The euro was an incomplete currency to start with and it was incomplete by design. The Maastricht Treaty established a monetary union without a political union. The euro boasted a common central bank but it lacked a common treasury. It was exactly that sovereign backing that financial markets have started to question that was missing from the design. That is why the euro became the focal point of the current crisis.

Member countries share a common currency, but when it comes to sovereign credit they are on their own. This fact was obscured until recently by the willingness of the ECB to accept the sovereign debt of all member countries on equal terms at its discount window. This allowed the member countries to borrow at practically the same interest rate as Germany and the banks were happy to earn a few extra pennies on supposedly risk-free assets by loading up their balance sheets with the government debt of the weaker countries. These positions now endanger the creditworthiness of the European banking system. For instance, European banks, hold nearly a trillion euros of Spanish debt of which half is held by German and French banks. It can be seen that the euro crisis is intricately interconnected with the situation of the banks.

How did this connection arise?

The introduction of the euro brought about a radical narrowing of interest rate differentials. This in turn generated real estate bubbles in countries like Spain, Greece, and Ireland. Instead of the convergence prescribed by the Maastricht Treaty, these countries grew faster and developed trade deficits within the eurozone, while Germany reigned in its labor costs, became more competitive and developed a chronic trade surplus. To make matters worse some of these countries, most notably Greece, ran budget deficits that exceeded the limits set by the Maastricht Treaty. But the discount facility of the ECB allowed them to continue borrowing at practically the same rates as Germany, relieving them of any pressure to correct their excesses.

The first clear reminder that the euro does not have a common treasury came after the bankruptcy of Lehman Brothers when the finance ministers of the European Union decided, at an emergency meeting in Paris in October 2008, to practically guarantee that no other financial institution whose failure could endanger the system would be allowed to default. But Angela Merkel opposed a joint Europe-wide guarantee; each country had to take care of its own banks.

At first, the financial markets were so impressed by the guarantee that they hardly noticed the difference. Capital fled from the countries which were not in a position to offer similar guarantees, but the interest differentials within the Euro zone remained minimal. That was when the countries of Eastern Europe, notably Hungary and the Baltic States, got into difficulties and had to be rescued.

It was only this year when financial markets started to worry about the accumulation of sovereign debt within the eurozone. Greece became the center of attention when the newly elected government revealed that the previous government had lied and the deficit for 2009 was much larger than previously indicated.

Interest rate differentials started to widen but the European authorities were slow to react because the member countries held radically different views. Germany, which had been traumatized by two episodes of runaway inflation, was allergic to any buildup of inflationary pressures; France and other countries were more willing to show their solidarity. Since Germany was heading for elections, it was unwilling to act and nothing could be done without Germany. So the Greek crisis festered and spread without resolution. When finally the authorities pulled their act together they had to offer a much larger rescue package than would have been necessary had they acted earlier.

In the meantime, the crisis spread to the other deficit countries and, in order to reassure the markets, the authorities felt obliged to put together a €750 billion European Stabilization Initiative Fund, €500 billion from the member states and €250 billion from the IMF.

But the markets are not reassured, because the term sheet of the Fund was dictated by Germany. The Fund is guaranteed not jointly but only severally so that the weaker countries will in fact be guaranteeing a portion of their own debt. The Fund will be raised by selling bonds to the market and charging a fee on top. It is difficult to see how it will merit a triple A rating.

Even more troubling is the fact that Germany is not only insisting on strict fiscal discipline for weaker countries but is also reducing its own fiscal deficit. When all countries are reducing deficits at a time of high unemployment they set in motion a downward spiral. Reductions in employment, tax receipts, and exports reinforce each other, ensuring that the targets will not be met and further reductions will be required. And even if budgetary targets were met, it is difficult to see how the weaker countries could regain their competitiveness and start growing again because, in the absence of exchange rate depreciation, the adjustment process would require reductions in wages and prices, producing deflation.

To some extent a continued decline in the value of the Euro may mitigate the deflation but as long as there is no growth, the relative weight of the debt will continue to grow. This is true not only for the national debt but also for the commercial loans held by banks. This will make the banks even more reluctant to lend, compounding the downward pressures.

The euro is a patently flawed construct and its architects knew it at the time of its creation, but they expected the defects to be corrected, if and when they became acute, by the same political process by which the European Union was brought into existence.

The European Union was built by a process of piecemeal social engineering, indeed it is probably the greatest achievement that method has produced. The architects recognized that perfection is unattainable. They set limited objectives and firm deadlines and then mobilized the political will for small steps forward, knowing full well that when they are accomplished their inadequacy will become apparent and require further steps. That is how the coal and steel community was gradually developed into the European Union, step by step.

Germany used to be at the heart of the process. German statesmen used to assert that Germany has no independent foreign policy, only a European policy. After the fall of the Berlin Wall, Germany's leaders realized that unification was possible only in the context of a united Europe and they were willing to make considerable sacrifices to secure European acceptance. When it came to bargaining they were willing to contribute a little more and take a little less than the others, thereby facilitating agreement. But those days are over. Germany doesn't feel so rich anymore and doesn't want to continue serving as the deep pocket for the rest of Europe. This change in attitudes is understandable but it did bring the process of integration to a screeching halt.

Germany now wants to treat the Maastricht Treaty as the scripture which has to be obeyed without any modifications and this is not understandable, because it is in conflict with the incremental method by which the European Union was built. Something has gone fundamentally wrong in Germany's attitude towards the European Union.

Let me first analyze the structural defects of the euro and then examine Germany's attitude. The biggest deficiency in the euro, the absence of a common fiscal policy, is well known. But there is another defect that has received less recognition: a false belief in the stability of financial markets. As I tried to explain in my writings, the Crash of 2008 has demonstrated that financial markets do not necessarily tend towards equilibrium; they are just as likely to produce bubbles. I don't want to repeat my arguments here because you can find them in my lectures which have just been published in German. All I need to do is remind you that the introduction of the euro created its own bubble in the countries whose borrowing costs were greatly reduced. Greece abused the privilege by cheating, but Spain didn't. It followed sound macro-economic policies, maintained its sovereign debt level below the European average, and exercised exemplary supervision over its banking system. Yet it enjoyed a tremendous real estate boom which has turned into a bust resulting in 20% unemployment. Now it has to rescue the savings banks called cajas and the municipalities. And the entire European banking system is weighed down by bad debts and needs to be recapitalized. The design of the Euro did not take this possibility into account.

Another structural flaw in the euro is that it guards only against the danger of inflation and ignores the possibility of deflation. In this respect the task assigned to the ECB is asymmetric. This is due to the fact that Germany has been traumatized by two episodes of runaway inflation. When Germany agreed to substitute the euro for Deutschmark it insisted on strong safeguards to maintain the value of the currency. The Maastricht Treaty the contained a clause that expressly prohibited bailouts and the ban has been reaffirmed by the German Constitutional Court. It is this clause that has made the current situation so difficult to deal with.

And this brings me to the gravest defect in the euro's design; it does not allow for error. It expects member states to abide by the Maastricht criteria without establishing an adequate enforcement mechanism. And now that several countries are far away from the Maastricht criteria, there is neither an adjustment mechanism nor an exit mechanism. Now these countries are expected to return to the Maastricht criteria even if such a move sets in motion a deflationary spiral. This is in direct conflict with the lessons learnt from the Great Depression of the 1930s and is liable to push Europe into a period of prolonged stagnation or worse. That will, in turn, generate discontent and social unrest. It is difficult to predict how the anger and frustration will express itself.

The wide range of possibilities will weigh heavily on the financial markets. They will have to discount the prospects of deflation and inflation, default and disintegration. Financial markets dislike uncertainty.

Xenophobic and nationalistic extremism is already on the rise in countries such as

Belgium, Netherlands and Italy. In a worst case scenario that could undermine democracy and paralyze or even destroy the European Union.

If that were to happen, Germany would have to bear a major share of the responsibility because as the strongest and most creditworthy country it calls the shots. By insisting on pro-cyclical policies, Germany is endangering the European Union. I realize that this is a grave accusation but I am afraid it is justified.

To be sure, Germany cannot be blamed for wanting a strong currency and a balanced budget but it can be blamed for imposing its predilection on other countries that have different needs and preferences – like Procrustes, who forced other people to lie in his bed and stretched them or cut off their legs to make them fit. The Procrustes bed inflicted on the eurozone is called deflation.

Unfortunately Germany does not realize what it is doing. It has no desire to impose its will on Europe; all it wants to do is to maintain its competitiveness and avoid becoming the deep pocket to the rest of Europe. But as the strongest and most creditworthy country it is in the driver seat. As a result Germany objectively determines the financial and macroeconomic policies of the Eurozone without being subjectively aware of it. When all the member countries try to be like Germany they are bound to send the eurozone into a deflationary spiral. That is the effect of the policy pursued by Germany and – since Germany is in the driver's seat – these are the policies imposed on the eurozone.

The Germany public does not understand why it should be blamed for the troubles of eurozone. After all, it is the most successful economy in Europe, fully capable of competing in world markets. The troubles of the eurozone feel like a burden weighing Germany down. It is difficult to see what would change this perception because the troubles of the eurozone are depressing the euro and being the most competitive Germany benefits the most. As a result Germany is likely to feel the least pain of all the member states.

The error in the German attitude can best be brought home by engaging in a thought experiment. The most ardent instigators of that attitude would prefer that Germany leave the euro rather than modify its position. Let us consider where that would lead.

The Deutschmark would go thru the roof and the euro would fall thru the floor. This would indeed help the adjustment process but Germany would find out how painful it can be to have an overvalued currency. Its trade balance would turn negative and there would be widespread unemployment. German banks would suffer severe exchange rate losses and require large injections of public funds. But the government would find it politically more acceptable to rescue German banks than Greece or Spain. And there would be other compensations: pensioners could retire to Spain and live like kings helping Spanish real estate to recover. On the positive side, the rest of Europe could grow its way out of its difficulties. But Germany leaving the euro would be highly disruptive. The initial wild swing in exchange rates would be followed by other fluctuations and the common market may not survive them.

It should be emphasized that this scenario is totally hypothetical because it is unlikely that Germany would be allowed to leave the euro and to do so in a friendly manner. Germany's exit would be destabilizing financially, economically and above all politically. The collapse of the single market would be difficult to avoid. The purpose of this thought experiment is to convince Germany to change its ways without going thru the actual experience that its current policies hold in store.

What would be the right policy for Germany to pursue? It cannot be expected to underwrite other countries' deficits indefinitely. So some tightening of fiscal policies is inevitable. But some way has to be found to allow the countries in crisis to grow their way out of their difficulties. The countries concerned have to do most of the heavy lifting by introducing structural reforms but they do need some outside help to allow them to stimulate their economies. By cutting its budget deficit and resisting a rise in wages to compensate for the decline in the purchasing power of the euro Germany is actually making it more difficult for the other countries to regain competitiveness.

Generally speaking, this is the time to put idle resources to work by investing in education and infrastructure. For instance, Europe needs a better gas pipeline system and the connection between Spain and France is one of the bottlenecks. The European Investment Bank ought to be able to find other investment opportunities as well.

Before any actual policy steps can be discussed, two theoretical points need to be made. One is that a tightening of fiscal policy can be offset by a loosening of monetary policy. For instance, the ECB could buy treasury bills directly from countries that cannot borrow from the market at reasonable rates, significantly reducing their financing costs below the punitive rate charged by the German inspired European Financial Stabilization Fund. But that is not possible without a change of heart by Germany.

The other theoretical point is that the current crisis is more a banking crisis than a fiscal one. The Continental European banking system has not been properly cleansed after the crash of 2008. Bad assets have not been marked-to-market but are being held to maturity. When markets started to doubt the creditworthiness of sovereign debt it was really the solvency of the banking system that was brought into question because the banks were loaded with the bonds of the weaker countries and these are now selling below par. The banks have difficulties in obtaining short-term financing. The interbank market and the commercial paper market have dried up and banks have turned to the ECB both for short-term financing and for depositing their excess cash. They are in no position to buy government bonds. That is the main reason why risk premiums on government bonds have widened, setting up a vicious circle.

The crisis has now culminated in forcing the authorities to disclose the results of their stress tests. We cannot judge how serious the situation is until the results are published – indeed, we shall not be able to judge even then because the report will deal only with the twenty five largest banks and the biggest problems are in the smaller banks, notably the Cajas in Spain and the Landesbanken in Germany. It is clear however that the banks need to be recapitalized on a compulsory basis. They are way over-leveraged. That ought to be the first task of the European Financial Stabilization Fund. That will go a long way to clear the air. It may be seen, for instance, that Spain does not have a fiscal crisis at all. Recent market moves point in that direction. Germany's role may also be seen in a very different light if it becomes a bigger user than contributor of the Stabilization Fund.

It is impossible to be more precise at the moment but there are grounds for believing that the situation is far from hopeless. When the solvency situation of the banks has been clarified and they have been properly recapitalized it should be possible to devise a growth strategy for Europe. And when the European economy has regained its balance the time will be ripe to correct the structural deficiencies of the euro. Make no mistake about it; the fact that the Maastricht criteria were so massively violated shows that the euro does have deficiencies that need to be corrected.

What is needed is a delicate, two-phase maneuver, similar to the one the authorities undertook after the failure of Lehman Brothers. First help Europe to grow its way out of its difficulties and then revise and strengthen the structure of the euro. This cannot be done without German leadership. I hope Germany will once again live up to the responsibilities that go with a leadership position. After all, it had done so until now.

Thank you.