As Predicted Here: The Rothschild Greek 'Solution'

The Euro Will Face Bigger Tests Than Greece

By George Soros
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Otmar Issing, one of the fathers of the euro, correctly states the principle on which the single currency was founded. As he wrote in the FT last week, the euro was meant to be a monetary union but not a political one. Participating states established a common central bank but refused to surrender the right to tax their citizens to a common authority. This principle was enshrined in the Maastricht treaty and has since been rigorously interpreted by the German constitutional court. The euro was a unique and unusual construction whose viability is now being tested.

The construction is patently flawed. A fully fledged currency requires both a central bank and a Treasury. The Treasury need not be used to tax citizens on an everyday basis but it needs to be available in times of crisis. When the financial system is in danger of collapsing, the central bank can provide liquidity, but only a Treasury can deal with problems of solvency. This is a well-known fact that should have been clear to everyone involved in the creation of the euro. Mr Issing admits that he was among those who believed that "starting monetary union without having established a political union was putting the cart before the horse".

The European Union was brought into existence by putting the cart before the horse: setting limited but politically attainable targets and timetables, knowing full well that they would not be sufficient and require further steps in due course. But for various reasons the process gradually ground to a halt. The EU is now largely frozen in its present shape.

The same applies to the euro. The crash of 2008 revealed the flaw in its construction when members had to rescue their banking systems independently. The Greek debt crisis brought matters to a climax. If member countries cannot take the next steps forward, the euro may fall apart.

The original construction of the euro postulated that members would abide by the limits set by Maastricht. But previous Greek governments egregiously violated those limits. The government of George Papandreou, elected last October with a mandate to clean house, revealed that the budget deficit reached 12.7 per cent in 2009, shocking both the European authorities and the markets.

The European authorities accepted a plan that would reduce the deficit gradually with a first instalment of 4 per cent, but markets were not reassured. The risk premium on Greek government bonds continues to hover around 3 per cent, depriving Greece of much of the benefit of euro membership. If this continues, there is a real danger that Greece may not be able to extricate itself from its predicament whatever it does. Further budget cuts would further depress economic activity, reducing tax revenues and worsening the debt-to-GNP ratio. Given that danger, the risk premium will not revert to its previous level in the absence of outside assistance.

The situation is aggravated by the market in credit default swaps, which is biased in favour of those who speculate on failure. Being long CDS, the risk automatically declines if they are wrong. This is the opposite of selling short stocks, where being wrong the risk automatically increases. Speculation in CDS may drive the risk premium higher.

Recognising the need, the last Ecofin meeting of EU finance ministers for the first time committed itself "to safeguard financial stability in the euro area as a whole". But they have not yet found a mechanism for doing it because the present institutional arrangements do not provide one - although Article 123 of the Lisbon treaty establishes a legal basis for it.

The most effective solution would be to issue jointly and severally guaranteed eurobonds to refinance, say, 75 per cent of the maturing debt as long as Greece meets its targets, leaving Athens to finance the rest of its needs as best it can. This would significantly reduce the cost of financing and it would be the equivalent of the International Monetary Fund disbursing conditional loans in tranches.

But this is politically impossible at present because Germany is adamantly opposed to serving as the deep pocket for its profligate partners. Therefore makeshift arrangements will have to be found.

The Papandreou government is determined to correct the abuses of the past and it enjoys remarkable public support. There have been mass protests and resistance from the old guard of the governing party, but the public seems ready to accept austerity as long as it sees progress in correcting budgetary abuses - and there are plenty of abuses to allow progress.

So makeshift assistance should be enough for Greece, but that leaves Spain, Italy, Portugal and Ireland. Together they constitute too large a portion of euroland to be helped in this way. The survival of Greece would still leave the future of the euro in question. Even if it handles the current crisis, what about the next one? It is clear what is needed: more intrusive monitoring and institutional arrangements for conditional assistance. A well-organised eurobond market would be desirable. The question is whether the political will for these steps can be generated.

The writer is chairman of Soros Fund Management and author of the Soros Lectures, published by PublicAffairs this month