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Why Germany Should Lead the Euro or Leave It

By George Soros

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Europe has been in a financial crisis since 2007. When the bankruptcy of Lehman Brothers endangered the credit of financial institutions, private credit was replaced by the credit of the state, revealing an unrecognized flaw in the euro. By transferring their right to print money to the European Central Bank, member countries exposed themselves to the risk of default, like third world countries heavily indebted in a foreign currency. Commercial banks loaded with weaker countries' government bonds became potentially insolvent.

There is a parallel between the ongoing euro crisis and the international banking crisis of 1982. Back then, the International Monetary Fund saved the global banking system by lending just enough money to heavily indebted countries; default was avoided, but at the cost of a lasting depression. Latin America suffered a lost decade.

Germany is playing the same role today as the International Monetary Fund did then. The setting differs, but the effect is the same. Creditors are shifting the entire burden

of adjustment on to the debtor countries and avoiding their own responsibility.

The euro crisis is a complex mixture of banking and sovereign-debt problems, as well as divergences in economic performance that have given rise to balance-of-payments imbalances within the euro zone. The authorities did not understand the complexity of the crisis, let alone see a solution. So they tried to buy time.

Usually, that works. Financial panics subside, and the authorities realize a profit on their intervention. But not this time, because the financial problems were combined with a process of political disintegration.

When the European Union was created, it was 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 EU into something fundamentally different, dividing member countries into two classes —creditors and debtors – with the creditors in charge.

As the strongest creditor country, Germany has emerged as the hegemon. Debtor countries pay substantial risk premiums for financing their government debt. This is reflected in their cost of financing in general. To make matters worse, the Bundesbank remains committed to an outmoded monetary doctrine rooted in Germany's traumatic experience with inflation. As a result, it recognizes only inflation as a threat to stability and ignores deflation, which is the real threat today. Moreover, Germany's insistence on austerity for debtor countries can easily become counterproductive by increasing the debt ratio as gross domestic product falls.

There is a real danger that a two-tier Europe will become permanent. Both human and financial resources will be attracted to the center, leaving the periphery permanently depressed. But the periphery is seething with discontent.

Europe's tragedy is not the result of an evil plot, but rather stems from a lack of coherent policies. As in ancient Greek tragedies, misconceptions and a sheer lack of understanding have had unintended but fateful consequences.

As the largest creditor country, Germany is in charge but refuses to take on additional liabilities. As a result, every opportunity to resolve the crisis has been missed. The crisis spread from Greece to other deficit countries, eventually calling into question the euro's very survival. Since a breakup of the euro would cause immense damage, Germany always does the minimum necessary to hold it together.

Most recently, German Chancellor Angela Merkel has backed European Central Bank President Mario Draghi, leaving Bundesbank President Jens Weidmann isolated. This will enable the European Central Bank to put a lid on the borrowing costs of countries that submit to an austerity program under the supervision of the troika formed by the International Monetary Fund, the European Central Bank and the European Commission. That will save the euro, but it is also a step toward the permanent division of Europe into debtors and creditors.

The debtors are bound to reject a two-tier Europe sooner or later. If the euro breaks up in disarray, the common market and the EU will be destroyed, leaving Europe worse off than it

was when the effort to unite it began, owing to a legacy of mutual mistrust and hostility. The later the breakup, the worse the ultimate outcome. So it is time to consider alternatives that until recently would have been inconceivable.

In my judgment, the best course of action is to persuade Germany to choose between either leading the creation of a political union with genuine burden-sharing or leaving the euro.

Since all of the accumulated debt is denominated in euros, it makes all the difference who remains in charge of the monetary union. If Germany left, the euro would depreciate. Debtor countries would regain their competitiveness, their debt would diminish in real terms, and with the European Central Bank under their control, the threat of default would disappear and their borrowing costs would fall to levels comparable to that in Britain.

The creditor countries, by contrast, would incur losses on their claims and investments denominated in euros and encounter stiffer competition at home from other euro-zone members. The extent of creditor countries' losses would depend on the extent of the depreciation, giving them an interest in keeping the depreciation within bounds.

After initial dislocations, the eventual outcome would fulfill British economist John Maynard Keynes' dream of an international currency system in which both creditors and debtors share responsibility for maintaining stability. And Europe would avert the looming depression.

The same result could be achieved, with less cost to Germany, if Germany chose to behave as a benevolent hegemon. That would mean implementing the proposed European banking union and establishing a more or less level playing field between debtor and creditor countries by establishing a Debt Reduction Fund, eventually converting all debt into eurobonds. It would also mean aiming for nominal GDP growth of up to 5 percent so that Europe could grow its way out of excessive indebtedness.

Whether Germany decides to lead or leave, either alternative would be better than creating an unsustainable two-tier Europe.

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