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Comment

HOWARD McWILLIAM

THE GREAT EU CONJURING TRICK

By talking to the original players behind the single currency, **Allan Little** and **Jane Beresford** reveal the astonishing sleights of hand that have brought the euro to its knees

In the Nineties, the economist Miranda Xafa was at Salomon Brothers in London, watching from a distance as her native Greece prepared to enter the euro. She knew – and advised her clients – that Greece's economy was not ready, that the statistics its government was publishing did not reflect reality.

"I'd come to Athens from London with clients," she told me. "We always saw the head of the statistical agency of Greece who compiled statistics on the debt, the deficit and so on. We'd call him the magician because he could make everything disappear. He made inflation disappear. And he made the deficit disappear."

Take, she says, the Greek state railway. "There were more employees than passengers. A former minister, Stefanos Manos, said publicly at the time that it would be cheaper to send everyone by taxi. How did they cover this deficit? The company issued shares that the government would buy. So it was counted not as expenditure, but as a financial transaction" – and did not appear on the budget balance sheet.

In 2004, with Greece a member of the euro, the conjuring trick was becoming transparent. A new, centre-right government was elected, with Peter Doukas appointed Budget Minister.

"I asked the senior staff of the ministry to give me details of the budget that had been passed the previous December," says Doukas. "I said don't worry about persecution or anything, just tell me the true story."

The difference between the published deficit and the real one was huge. "[It] was about 7 per cent of GDP. The budget said the deficit was 1.5 per cent. The real shortfall was 8.3 per cent." Under the Maastricht treaty, member states must keep their budget deficits below 3 per cent of GDP.

So what did he do? "I said we should start chopping down the budget. But the answer I got at the time was: 'We have the Olympic Games in a few months and we cannot upset the whole population and have strikes and everything just before the Olympic Games.'"

To meet the deficit, Greece borrowed and borrowed. Banks queued up to lend. The markets did not believe there was a risk of default because Greece's currency was locked into that of Germany.

Germany drove monetary union in the Nineties. Berlin had come to see exchange-rate instability as a form of back-door protectionism. Exports account for a third of Germany's economic output and most of its exports go to the EU.

"We wanted Italy to stop devaluing the lira," says Dietrich Von Kyaw, then Germany's ambassador to the EU. "This has to do with things like Bavaria needing to continue selling surplus milk to Italy, or Volkswagen wishing to keep competition from Fiat within certain limits."

Admitting Italy into the euro in the first wave looks, in retrospect, to be the key mistake. "Think back 20 years when we were working all this out," says John (now Lord) Kerr, former British ambassador to the EU. "My view was that it would be five, possibly six countries that would start. It never occurred to me that Italy or Spain, let alone Greece, would qualify."

Italy's failure to meet the Maastricht criteria meant it was the only one of the six founder states of the old European Community that looked likely to be left behind. Italy's national debt was around 120 per cent of GDP. Maastricht required it to be below 60 per cent.

"But it was a very unusual kind of debt," says Joachim Bitterlich, then a senior foreign policy adviser to Chancellor Kohl and one of the architects of monetary union. "It was atypical because 80 per cent of what Italy owed was to its own people. It was internal, not external. So people said that under these circumstances, we can accept the Italians."

Did you bend the rules to let Italy in? I ask him. "Yes. To some extent. We interpreted the rules at that time in favour of the Italians."

It was part of a pattern. At key moments, political imperatives trumped economic better judgement. Italian membership opened the door to Portugal, Spain, Greece and others.

But it wasn't the behaviour of the eurozone's southern members that first plunged the euro into crisis. There was, from the start, a way for the EU to police the economies of member states. It was called the Stability and Growth Pact, and it wasn't Italy or Greece that torpedoed it; it was Germany.

In 2003, France and Germany had both overspent, and their budget deficits exceeded the 3 per cent limit to which they were bound. The Commission – then led by the former Italian Prime Minister Romano Prodi – had the power to fine them. But finance ministers voted not to enforce the rules, which were designed to protect the stability of the euro. Britain's Chancellor, Gordon Brown, still committing sterling to its love affair with prudence, voted with the French and Germans.

The EU is often criticised for the power wielded by the unelected European Commission. On this pivotal occasion, the Commission ran up against something much more powerful: the combined will of democratically elected governments.

"Clearly," Romano Prodi told me, "I had not enough power. I tried and they [the finance ministers] told me to shut up."

Jacques Lafitte was seconded to Brussels in the Nineties to help construct the single currency. He said the technocrats working on the project knew that some central mechanism was needed to ensure member governments complied with the rules. "We made suggestions to the member states at the time but these were rejected because they would have involved transferring sovereignty from national governments to Brussels or maybe Frankfurt," he says.

"We knew deep inside. Again, we could not say so publicly. We were mere technocrats. We were supposed to shut up and listen to the member states who, almost by definition, knew better. I was convinced it was not enough."

Sir John Grant was Britain's ambassador to the EU at the meeting of finance ministers. He says: "The credibility of the Commission and the readiness of the member states to accept its authority as the independent enforcer of the Maastricht criteria was gravely undermined."

It was also a signal to everyone else in Europe. "The view," says the Greek budget minister Peter Doukas, "was that if the big boys won't impose discipline on themselves, they'll be more relaxed in enforcing the treaty [on us]. No one can impose sanctions on Germany and France. They are the European superpowers. So they won't adhere. The pressure was simply not there."

Europe is wise after the event. The power the nations retained to police their own budgets is being stripped away. Governments in the eurozone will, in future, be required to submit their budgets to Brussels for approval. How long before national populations revolt in the name of democracy?

From Helsinki to Athens, revolt is stirring, and often shot through with anti-German sentiment. "Germany is the locomotive of pain for other people's problems," says Doukas. "It will ask to have a much bigger say in what's happening in Greece and Italy and Spain. The centre of gravity of Europe is rapidly moving towards Berlin. In the fiscal union they will be the ones dictating the terms, with France as a junior partner."

> *"Admitting Italy into the first wave of the euro was the key mistake*

The idea of Germany throwing its weight around spooks the Germans themselves. They do not seek, and do not want, leadership in Europe. But leadership has been thrust upon them.

In November, in a speech in Berlin, the Polish Foreign Minister Radoslaw Sikorski appealed to Germany to act. "I will probably be the first Polish foreign ministry in history to say so but here it is: I fear German power less than I begin to fear German inactivity."

The unfolding paradox is this: that a process motivated 20 years ago by a desire to Europeanise Germany looks likely to have precisely the opposite effect. Much of Europe will now be required to Germanise its economic governance.

Allan Little is a special correspondent for the BBC. His three-part series, 'Europe's Choice', begins today on Radio 4 at 1.30pm