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The Biggest Poker Game Ever

Will the European Debt Package Really Work?

By Bahador Saberi and Christian Teevs

Germany's cabinet has passed a draft law to provide for its portion of Europe's 750 billion euro package to prop up the ailing currency. But will the fund work? Experts are warning that the side effects may be difficult to stomach.

"The biggest 'all-in' in the history of poker." That is how Henrik Enderlein, an economy professor at the Hertie School of Governance in Berlin, describes the massive €750 billion ($955 billion) package put together by European Union governments on Sunday night in an effort to save the common European currency, the euro, from collapse.

The package, which includes €440 billion in guarantees from euro-zone countries, €60 billion from the European Union budget and a further €250 billion from the International Monetary Fund, is designed to provide liquidity to those European countries that run into difficulties raising money on the financial markets. More immediately, however, EU politicians wanted to clearly demonstrate that they would not let the debt crisis facing Greece, Portugal, Spain and other countries bring down the common currency.

On Tuesday, the German cabinet agreed on a draft law that provides for Germany's €123 billion share of the package. Should other EU countries not be in a position to pay their share, Germany's contribution could rise to as high as €150 billion, the opposition fears. The Bundestag, Germany's parliament, will take a first look at the bill next week. Since money for the fund is already available via the EU, German Chancellor Angela Merkel said on Monday that the law does not need to be rushed as much as the bill providing aid for Greece last week was.

"We are protecting the money of people in Germany," Merkel said.

Still, despite the best efforts of European heads of state and government to put a positive spin on the package and put on a display of unity, plenty of doubts remain. There will be side effects. The structure of Europe's monetary unity has been fundamentally changed, not least by the provision allowing for the European Central Bank to begin buying up member states' debt. The principal mandating that each country is responsible for its own budget would appear to have been jettisoned. Indeed, the package may result in countries' abandoning tough austerity programs in the knowledge that they will be bailed out.

But what does the package really look like? And what are the potential consequences for European monetary union? SPIEGEL ONLINE takes a closer look.

How does the EU aid package work?

The measures passed in the wee hours of Sunday morning are a product of the lessons learned from the tug-o'-war preceding the eventual passage of an aid package for Greece. For weeks, European leaders debated whether they should help Greece as the country slid ever closer to insolvency and, if so, how it should be done. But the back and forth proved harmful and essentially confirmed investors' doubts about euro-zone solidarity.

To avoid such speculation in the future, euro-zone countries rapidly hammered together a package of aid measures, the size of which surprised even optimistic analysts. In the future, countries facing ultra-high interest rates on the capital markets can apply to receive money from the new EU fund.

The €440 billion to be contributed by euro-zone members is to be made available through a so-called "special purpose vehicle" established specifically for the fund. The vehicle will then raise the money on the financial markets and is guaranteed by European Union governments. The German share of the guarantees is €123 billion, but this could rise should other EU countries run into financial trouble. That amount is roughly equal to what Berlin made available to prop up Hypo Real Estate and Commerzbank in the height of the financial crisis.

Such "euro bonds" have been in existence for some time. But until now, only those countries not part of the European currency union could profit from them. Euro-zone countries could not. That rule has now been lifted, which could result in a spike in interest for the bonds as crisis states rush to take advantage.

Historical U-Turn

The reason is clear: Money from the fund, similar to the aid package passed for Greece last week, can be borrowed at fixed interest rates. Countries facing high interest rates on capital markets will thus have a source of affordable liquidity.

"The result is that governments don't have to worry as much about their own ratings," warns Jens Boyen-Hogrefe, of the Kiel Institute for the World Economy. "They will have access to the attractive euro bonds."

It remains unclear, however, exactly how the special purpose vehicle will be constructed. EU governments rushed to put the package together on Sunday night -- final approval didn't come until 2:30 a.m. "Just how the credit will be made available remains open," says the Hertie School economist Enderlein. "What role will the European Commission play? How big is Germany's influence? Will member states all have the same say?"

In addition to the €500 billion supplied to the fund by the European Commission and the EU member states, the International Monetary Fund has also pledged €250 billion. Experts have nothing but praise for the IMF's participation, as the IMF can demand much stricter austerity measures from crisis countries than the EU can. "Europe grew out of consensus, which makes it difficult for Europeans to put massive pressure on their partners," says Jörg Krämer, head economist at Commerzbank.

In addition, the European Central Bank (ECB) has done its part for the fund with a historic U-turn: The bank has begun buying state bonds from crisis-ridden European Union member states, a measure which had long been taboo. It is not yet clear, though, how large the program will be.

Krämer calls the ECB the "second line of defense" in the euro crisis, but he warns against releasing too much capital. "The ECB has to make sure that the money released through the purchase of bonds is withdrawn via other activities. Without such neutralizing measures, inflation becomes a real risk."

Will the Measures Work?

Experts expect that, at least for the short term, the measures will stabilize financial markets. "If there really were attacks from speculators, they'll now be pointless," says Boysen-Hogrefe. "It's simply not worth it."

The new fund means that "the endangered EU states essentially won't have to turn to capital markets for financing until the fall of 2011," explains Krämer. The EU, he says, has bought time for itself with the rescue package.

One should be careful of reading too much into the euphoric reaction of the markets on Monday. Indeed, Tuesday has seen the correction come sooner than many had anticipated. Nevertheless, the package has had a very real effect on the bond markets. The danger that Spain and Portugal find themselves in a position similar to that of Greece has been greatly reduced. Most of all, though, the package is there to reduce the exposure of banks that own bonds in the wobbling countries.

"Europe has erected a massive bulwark against speculative attacks," Enderlein says. "And that's a good thing." As he sees it, the most important signal is the daunting figure of €750 billion, and the ECB's decision to put more money in circulation by buying government bonds.

"I didn't anticipate either of the measures," Boysen-Hogrefe admits. "Perhaps just one of them would have been enough -- either the ECB intervention or the bailout funds."

But EU leaders apparently decided that half-hearted gestures were no longer enough. Many economists had accused German Chancellor Angela Merkel of dragging her feet too much during the Greece crisis. Now, however, they are marveling at the sheer size of the bailout plan.

Still, there are risks. "No one knows if the bulwark has been solidly constructed," Enderlein warns. Should push come to shove, it is still unclear whether the figures announced will actually materialize. "Many details are still unclear," Enderlein says. "Political majorities could fail to materialize, and the financial wiggle room of the rich euro-zone countries is limited."

Krämer adds: "It's their last shot. It has to hit the target."

How Will the Agreement Affect the Currency Union?

The bailout package will massively alter the character of the euro zone. Until now, every country was responsible for balancing its own budget. The stability pact was to prevent budget deficits from growing too large. But it didn't work.

Before now, it was also inconceivable that strong member states would come to the rescue of those on the verge of insolvency. In fact, the so-called "no-bailout clause" of the Maastricht Treaty specifically stated that the community would not assume the debt of individual EU member states.

As Krämer sees it, the bailout package is transforming the currency union into a transfer union. "The aid package is putting an end to the Maastricht model of a currency union," he says, warning that keeping this framework in place for long could harm the EU both politically and socially.

Kai Carstensen, an expert at the Munich-based Ifo Institute for Economic Research, is ever more searing in his criticism. "The measures," he says, "go against the spirit of the pacts." He fears that states will no longer feel any pressure to lower their deficits. Like Krämer, he is calling for euro-zone members to implement radical savings plans, though he is at least encouraged that the EU countries on the verge of insolvency once again pledged to do so on the weekend.

"Should they not massively reduce their debts," says Carstensen, "the problems will only be bigger three years down the road … because the stronger countries are currently guaranteeing the debts of the weaker ones." Europe's heavyweights -- Germany and France -- could be taking on more than they can handle, he says.

Boysen-Hogrefe sees the danger as manageable. "I think that the funds are primarily meant to serve as a signal to the markets," he says. "Chances are that not much of it will be needed at the beginning." And even if it is, he adds, the money won't be lost. What's more, he says, "if things go well, Germany could even turn a profit."

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