ONE
A Giant Historic Mistake?

Spinelli's Proposition

The most ambitious vision of European unity was conceived in circumstances far more inauspicious than those putting it to the test today. The spring of 1941 was Europe's darkest hour, and Hitler's forces looked invincible. The Soviet Union was still allied with Nazi Germany; the United States stood on the sidelines of Europe's war. To believe that Europe might transcend national division would have taken extraordinary faith in humanity – or great naivety – most of all in the camps and prisons that held the opponents and victims of the continent's totalitarian regimes.

Yet at that very moment, in an eighteenth-century jail repurposed by Benito Mussolini on a volcanic rock off the tiny Italian island of Ventotene, Italian anti-Fascist prisoners were composing a programme for the political union of Europe after the Nazis' defeat. One of them was Altiero Spinelli, who would later become a European commissioner, a member of the European Parliament, and leader of the movement for a federal Europe.

In the 'Ventotene Manifesto', scribbled on cigarette paper and smuggled out to resistance movements across Europe, Spinelli and his fellow prisoners dismissed the relevance of old divisions between left and right. After the war, he wrote, the dividing line between the forces of progress and reaction would run right through traditional parties and pit those who aimed to restore the order of national sovereignty against those aspiring to a federated Europe:

> The question which must first be resolved, without which any other progress is mere appearance, is that of the definitive abolition of Europe's division into national sovereign states.

The Ventotene Manifesto did not specifically mention the abolition of national currencies. But of all the efforts to dismantle the borders erected between the nations of Europe by two hot wars and one cold, the euro is the most radical answer to Spinelli's call for an end to the nation state. Rarely if ever has there been a greater voluntary concession of national sovereignty than Europe's Economic and Monetary Union (EMU), created with the promise of greater prosperity and stability, and a convergence of both status and destiny. There is no better test for Spinelli's proposition that Europe is best served by ever closer union than the success or failure of EMU.

In response to the eurozone debt crisis, EMU's leaders have moved towards sharing yet more sovereignty. They have pooled fiscal resources in rescue funds for cash-strapped governments; they have centralised control over policies through the conditions attached to the common funds; they have handed power over their banks to the European Central Bank. But among ordinary Europeans, these moves have generated resigned acceptance at best, and fierce rejection at worst, rather than any Spinelli-like enthusiasm for deeper integration. Many more people say things are going in the wrong direction in the European Union (EU) than in the right one. Those who distrust the EU outnumber those who trust it. Support for the single currency has weakened, as has Europe's democratic legitimacy. In the euro's most crisis-hit countries, less than one in four citizens believe that their voice counts in the EU (the exception is Ireland, where 40 per cent do). Only 14 per cent of Europeans say they trust political parties; the numbers are the lowest in the countries worst hit by the eurozone crisis.[1]

The euro was supposed to strengthen the union between European nation states by allowing the poorer 'peripheral' countries to catch up with the richer core, increasing prosperity for all, as well as permanently channelling the growing strength of a reunified Germany into a common European destiny. Instead, the periphery found itself abandoned by financial markets and fell into an economic black hole. The call for more German money put Berlin firmly in the driver's seat of European policymaking. In the rest of Europe, voters, creditors and debtors alike felt angry and disempowered. Rather than being the crowning glory of Europe's successful reconciliation, the common currency came to look more like a millstone around the continent's neck.

Much more is at stake than economic well-being. If a present-day economist had been able to go back in time and warn the Ventotene visionaries that Europe may not be an 'optimal currency area', that would have been the least of their concerns. Seven decades later, Angela Merkel, Germany's chancellor and Europe's most powerful politician, described the euro as a 'community of fate' in the same German parliament building that once housed the Ventotene prisoners' ultimate enemies:

> Nobody should think that another fifty years of peace and prosperity in Europe can be taken for granted. It cannot. This is why I say: if the euro fails, Europe fails. That must not be allowed to pass. We have a historic duty to protect by all means within our reach Europe's work of unification, which our forefathers set in motion more than fifty years ago after centuries of hatred and bloodshed. None of us can foresee the consequences, were we to fail.[2]

It would be naive to think that grand sentiments alone drive our leaders' decisions at times of crisis. But we should not be so cynical as to dismiss all their lofty rhetoric as cheap talk. Consciously or not, echoes of Spinelli's vision resonated through some leaders' minds when they conceded sovereignty to an extent unimaginable only a few years earlier.

The prospect of successful deeper integration in Europe depends not only on the euro's material success but also on a more fundamental fight over its political merit. Tragically, the policies now being pursued, ostensibly to make the euro work better, are grinding away the public support needed to achieve that goal. No pooling of sovereignty can save the euro if its users are left thinking the euro is not worth saving.

Since the crisis, this battle of ideas has been dominated by the sceptics. As the euro's detractors see it, the single currency has already been put to the test and failed. A striking number of the euro's supposed friends have unwittingly strengthened their case.

Vindication of the Sceptics?

Downing Street might seem an unlikely home for European federalism, but in the summer of 2011, David Cameron and George Osborne, the British prime minister and his chancellor, urged their euro area counterparts to 'get a grip' on the economic crisis by moving decisively towards sharing tax revenues and budget powers. If Britain's leaders channelled Spinelli, they did so in plain self-interest: the eurozone sovereign debt crisis was shattering their hopes of an export-led recovery at home. Even so, their intervention gave up a long-held foreign policy tradition of opposing any European configuration of power without the United Kingdom at the top table. Their lack of visible consternation at doing so demonstrates that they truly believed this was necessary for Europe's monetary experiment not to end in disaster. Osborne's pithy diagnosis was that a 'remorseless logic' points from monetary union to fiscal union.[3]

The 'remorseless logic' view is shared by many economists and policymakers, both within the eurozone and outside it. The general claim is that without some way of sharing economic resources, a monetary union is eventually bound to experience financial instability or economic depression, to the point where it will break-up. The broad inspiration for this view is the 'optimum currency area' (OCA) theory pioneered by Robert Mundell (who, interestingly, has strongly supported EMU) half a century ago.[4] The theory compares the benefits of monetary unification to those of using the exchange rate to maintain full employment in the face of economic disturbances. An OCA is a region in which the loss of this tool is outweighed by the gain of having fixed prices between countries. That will be the case when full employment can be achieved to a sufficient degree without exchange rate adjustments, e.g. through price and wage flexibility, easy displacement of workers and/or capital between regions of different economic fortunes, or private or government transfers between countries to insure against idiosyncratic economic disturbances. Those arguing in the OCA vein tend to doubt the presence in the eurozone of the required price/wage flexibility or worker/capital mobility, and therefore conclude that there is a need for some form of 'fiscal union' to cushion against unsynchronised swings in the economy. And for fiscal transfers to be politically acceptable, a 'political union' is also needed to establish shared control over how fiscal transfers are used.[5]

To create the euro without a fiscal transfer mechanism and a political union to govern it was 'a giant historic mistake', Harvard economics professor Kenneth Rogoff has said, and many other prominent commentators have made a similar assessment.[6] Some of those who thought the euro was a bad idea nevertheless take the 'remorseless logic' as a reason to push integration further rather than winding it back. As Martin Wolf puts it, creating the euro 'is the second-worst monetary idea its members are ever likely to have. Breaking it up is the worst.'[7] For hardened eurosceptics, the 'remorseless logic' leads to the opposite conclusion. Seeing deeper integration as either unachievable or as compounding the damage already done, they predict and even encourage the dismantling of the single currency. One of the more eccentric encouragements was a £250,000 prize offered by Lord Wolfson in 2012 for the best proposal to manage an exit from the euro. Others are more serious. A determined group of German academics have made it their cause célèbre to take the eurozone's anti-crisis policies, which they see as covert transfer mechanisms, to the German constitutional court. In the summer of 2015, German finance minister Wolfgang Schäuble broke a taboo by proposing that Greece should 'temporarily' leave the euro if it could not pass the policies its creditors demanded. Most sinister is the rise of fringe parties that make undoing the single currency a main rallying point. In Germany, the new *Alternative für Deutschland* (Alternative for Germany) party won seven seats in the European Parliament in May 2014. The neo-Fascist *Front National* is now France's biggest party. The comedian Beppe Grillo's protest party *Movimento Cinque Stelle* (Five Star Movement) commands up to a quarter of the Italian electorate for its anti-politics and anti-euro platform.

One might have expected those committed to European integration to stand up for the euro's merits against these condemnations. But what is their reply to the sceptics who want the euro gone or diminished? That if the euro fails, Europe fails; that letting the euro disintegrate would do more harm than good. This is true, but in political terms it amounts to a discreet parricide of the euro's founders by their successors. To say we must stick with the euro now that we have come this far, or all hell will break loose, is to say it would have been better not to have set out on this route to begin with. By capitulating to the view that design flaws in the euro caused the crisis, leaders gain a useful decoy for their own unforced policy errors but at the cost of their ability to formulate good policies and of voters' willingness to accept them.

The moves towards closer integration have been justified by the refrain: 'there is no alternative'. Through gritted teeth and holding their noses, political leaders have cajoled stunned electorates and bullied wary parliaments into lending money to crisis-hit neighbours (in creditor states) or accepting the disenfranchising conditions that come with the loans (in debtor states). Voters have been told there is no alternative but catastrophe to the financial rescues that shuffled loans in the hundreds of billions between governments, to draconian policy conditions extracted from the recipients of those loans, to a 'fiscal compact' that enshrines in international law German standards of fiscal discipline, or to new powers for Brussels to tell member states how to organise their economic affairs.

The currency bloc's official agenda is more of the same, even if the will to go through with it waxes and wanes. The road map to 'genuine' economic and monetary union, drawn up by the EU's highest officials at the behest of national leaders, accepts Osborne's remorseless logic in fact if not in name. It envisages, for example, that the single currency will be endowed with 'an appropriate fiscal capacity'. The plans have also endorsed the idea that countries should sign contracts that would legally prevent them from having second thoughts about reform promises, in return for more financial aid. The president of the European Central Bank has called for centralised powers over euro countries' structural economic policies.[8] These are all building blocks of fiscal and political union. But they labour under the paradox of their own justification: that more powers must be unified to fix the damage unification has already wrought. That argument is not only unconvincing, it is also dangerous.

A Politics of Blackmail

Eurosceptics get many things wrong, most of all their inability to imagine that people could ever adopt European as well as national identities. It is as if they do not merely disagree with Spinelli, they cannot even understand him. What eurosceptics lack in imagination, however, they make up for in tactical political instinct from which the supporters of closer union would do well to learn.

The sceptics have long lambasted the EU's centralising trajectory as undemocratic and illegitimate. They charge that the euro rode roughshod over Europeans' resistance to giving up national sovereignty. European leaders do indeed have a disturbing tendency to harangue their peoples, sometimes through repeated referendums, until they make the right choice. The French approved the Maastricht Treaty with the thinnest of margins; the Danes only voted yes after they first voted no. The 2004 treaty on an EU constitution was rejected by referenda in both France and the Netherlands and had to be repackaged as the Lisbon Treaty (about which the two recalcitrant electorates were not asked to express an opinion).

The charge of illegitimacy is not wholly warranted – there is no authority in Brussels, Strasbourg or Frankfurt that was not vested there by democratic governments accountable to their national electorates. Still, making light of the need for popular consent is now exacting a price. The success of protest movements in many countries reflects a blowback against the political hubris with which European integration was pursued and a reaction against a political class that has presided over economic catastrophe. The former may be stronger in creditor states and the latter in debtor states, but either way, the management of the euro has unplugged classic wellsprings of populist protest.

Swathes of popular opinion object to the governing elite's chosen direction of travel. In creditor Europe, growing fatigue with financial aid is extinguishing the early willingness to help out neighbours in trouble. In debtor Europe, voters are hard put to say whether they resent the subordination to foreigners more than they despise their own political class. But the more that European politics concentrates on how to balance creditors' and debtors' interests, the more the trade-off itself – money from creditor states in return for control over debtor states – is taken for granted. Europe's politicians have almost without noticing it translated an economic conflict between classes (creditors and debtors) into a political conflict between nations. This cannot but undermine the broader solidarity the euro was meant to embody – a term, incidentally, which in the stultifying idiom of EU negotiations has been impoverished into a synonym for 'subsidy'.

As if it were not enough for Europeans to be told they are trapped in an imperfect monetary union that must be fixed, the substance of the alleged fix is the exact opposite of what they were promised when the euro was launched. Deficit countries were offered prosperity and equality with Germany; instead they have faced economic decline, social despair and political disempowerment. The Germans, and their fellow surplus countries, were promised they would never need to subsidise others, and even secured a treaty article they thought outlawed such subsidies. While the eurozone's rescue policies have largely survived legal challenges, it is clear that both *political* promises have been broken. If Europeans feel betrayed by the euro, it is because everything they are told about it implies that they have been.

This offers anti-European populists and extremists prolific recruiting conditions, while renouncing any positive argument that mainstream political forces could use to counter them. The guardians of the single currency have had nothing to offer beyond trying to beat voters into resignation. But pushing for greater integration on the basis that the first time round we did not try hard enough will erode what solidarity and aspiration to unity remains in Europe. This is not the politics of common purpose; it is the politics of reciprocal blackmail. The logical destination is that the euro's governing elites follow in the direction they are driving their voters, and increasingly question whether monetary union is worth it. The bitterness of the Greek–German stand-off in the summer of 2015 sharply foreshadowed this future of disunity.

To break free from politics of blackmail, the first step must be to correct the misperception that there is no alternative within the euro. Unsettling that view is needed to open up a political space for those who want to achieve greater European unity through genuinely voluntary pursuits of mutual interests and not simply because they have their backs to the wall. That is the purpose of this book.

The Disowned Currency

By arguing that there is no alternative to their policies, lest the euro fails, eurozone leaders have produced a useful decoy for their own mistakes. But since the 'remorseless logic' endorses the notion that the euro was designed with dangerous and unsustainable flaws, these leaders have by the same token relegated their common currency to the status of an inconvenient foundling. Hard to love, quietly wished away by many, and all but impossible to expel, the euro has been disowned by its own kin. The loftiest aspiration Europe seems able to muster for its own creation is that a thorough reform of its character will make something good of it yet. But just as an orphan inconveniently dumped on its relatives arouses resentment and guilt rather than love, an orphaned euro cannot inspire loyalty or affection. Citizens of democratic societies expect to be authors of their collective destiny, not aimless elements of remorseless logic. The more often Europeans are told they have no choice, the more their resentment towards the euro will grow.

This book refutes the claim that there is no alternative, within the euro, to greater transfers of resources and more tightly centralised control over national policy autonomy.[9] It rejects the supposedly remorseless logic as being neither remorseless nor logical. Instead it aims to show that the disastrous political and economic experience of so many eurozone countries was caused by policymakers' entirely avoidable errors. The structure of the euro, as a monetary union without a fiscal union, did not force their hand: they retained alternative policy options that would have had much better results, economically and politically, than the ones they actually pursued. Had leaders made better choices, worries of a currency break-up would never have been awakened.

There are two ways in which the allegedly flawed structure of Europe's monetary union is blamed for a crisis that first erupted in US mortgages. One is its role in creating the crisis: because of their monetary union, so the charge goes, European economies racked up greater risks in the 2000s boom than they would have done had they kept their individual currencies. The other is in how it unfolded: whether or not the euro made a crisis more likely, it stands accused of taking out of policymakers' hands the best tools with which to fight it. Most of the rest of this book is devoted to the latter claim, but first, Chapter 2 addresses the former. It outlines the main ways people argue that the euro sowed the seeds of disaster and concludes that these arguments do not stand up well to scrutiny. Our best guess is that the excessive debt and credit build-ups that have been at the heart of the eurozone's near-death experience would have happened in much the same way without the euro.

In any case – and this is the theme of the rest of the book – the crisis was not preordained to develop the way it did because of the euro's construction. To make this argument, the next part of the book retells the main episodes of the sovereign debt crisis and shows that at key points, eurozone leaders made mistakes not because the euro left them with no alternative, but because of misguided ideas about what was needed – above all the idea that debt restructuring must be avoided at any cost. Chapters 3 and 4 tell the stories of the Greek and Irish sovereign debt panics and the two countries' 'rescues' at the hands of the eurozone. In both cases, the unwillingness to write down debts – of a sovereign in the former case and of private banks in the latter – was a key consideration, which in turn entailed further mistakes, both economic and political. The sanctification of debt into something that must be respected above all else led to unnecessarily severe fiscal consolidations and credit droughts. Politically, it required the suspension of national democratic autonomy.

If the book delves deeply into these two particular experiences, it is because far from being special cases, they set the precedent for broader policies. Chapter 5 explains how the intellectual principles behind the eurozone's approach to Greece and Ireland were generalised to guide policy in 2010–11 towards larger countries and to the currency union as a whole. The result was a disaster: a self-inflicted second recession, a poisoned politics, and a gratuitous existential threat to the euro itself. The costs of these mistakes are still being paid in ongoing economic suffering, political ill will and uncertainty. Chapter 6 tells the story of how the eurozone's leadership redeemed itself in 2012–13, though only very partially, by moving from an abhorrence of sovereign and bank debt restructuring to an embrace of both – from 'bail-out' to 'bail-in'.

The idea that underpins all these chapters is that this move could and should have happened sooner, more fully and more firmly. Chapter 7 offers the reader a dive into the alternative history in which the eurozone did the right thing from the beginning. As a denunciation of past mistakes and an admonition for future policy, it shows that restructurings could have been managed in ways that were as orderly as the bail-outs that actually took place, if not more so, and with much greater fairness. Europe's economic well-being and political health would have been vastly better as a result.

The final part of the book looks ahead. Some of the biggest questions raised by the euro – including its irreversibility (or not) – remain unsettled. Even so, the book's last four chapters aim to offer a modest guide to the future. Where is Europe's currency union headed now? Which course should it stake out? Chapter 8 defines the eurozone's three main economic challenges: completing the shift in policy attitudes from bail-out to bail-in to improve financial stability; vigorously boosting aggregate demand and preventing it from ever becoming so deeply deficient again in the future; and focusing in the long term on productivity rather than obsessing over export competitiveness. Chapter 9 reflects on the political imperative of establishing a coalition among eurozone countries and institutions that can achieve the economic goals just listed and articulate an alternative to the transfers-for-centralised-control paradigm that is driving voters to political extremes. Chapter 10 asks the taboo question that nevertheless matters to the future of Europe: doesn't the United Kingdom belong in the euro?

A book that sets out to refute claims about the euro's inherent flaws risks seeming overly defensive, so Chapter 11 concludes with the positive case for the single currency: reminding us what the euro is good for. The rest of this chapter, meanwhile, briefly tells the story of the euro's birth.

The Overlapping Goals of Monetary Unification

Before taking on the accusations against the euro, we must recall why countries adopted the common currency in the first place. Today, the idea that the euro is fundamentally flawed is so widespread that it is hard to imagine how Europe's old and jealous nations could ever have embarked on history's largest voluntary cessation of sovereignty. It is often said that EMU is the unsustainable product of a single commanding political vision that overruled any misgivings. It would be closer to the truth to say the problem was one of too many distinct (if overlapping) visions.

These overlapping motives have to be understood against the economic upheaval from which Europe was emerging in the late 1980s when, after several aborted attempts, a renewed push for monetary unification was gathering strength. The Bretton Woods system of fixed exchange rates, which had defined monetary stability in the post-war era, had unravelled in the early 1970s, causing lasting trauma to Europe's political economy. In the decades that followed, European finance ministers were on a Sisyphean quest to regain the monetary stability of the Bretton Woods years.

One country did retain its monetary moorings: Germany, whose inflation was low and whose Deutsche Mark became not just an international reserve currency but the political symbol of the West German people's quietly recovered self-confidence. Their central bank, the Bundesbank in Frankfurt, was admired at home, feared abroad and trusted everywhere. Germany's neighbours quickly realised that achieving stability in an economically open world meant they needed to track as closely as possible whatever monetary policy was set in Frankfurt. The alternative was to be forced, whenever financial markets smelled blood and picked off weaker currencies one by one, into serial devaluations and the high inflation and loss of international purchasing power that this produced – unless the Bundesbank itself could be implored to support exchange rates that the markets no longer found credible. Either way, the monetary independence so mourned by the euro's critics today revealed itself in the 1970s and 1980s as little more than the freedom to do what Frankfurt wanted.

Politically intolerable as this was for the rest of Europe, it was from Germany that the decisive impetus for currency union came, a fact often forgotten today in Germany itself. Hans-Dietrich Genscher, West Germany's liberal foreign minister for nearly twenty years, relaunched the momentum for monetary unification after earlier false starts by calling for a single currency in 1988. It may seem ironic today that Genscher's reason for wanting a single currency was to secure economic stability – a shelter from the ravages of fluctuating exchange rates and soaring inflation in many countries. But in light of the push for a single market in financial services – one from which Germany, that fount of surplus savings, stood to benefit significantly – the violent currency swings of the post-Bretton Woods years were a serious obstacle.

Meanwhile, for Germany's partners – France above all – monetary union promised an end to the humiliating inferiority of their own currencies to the Deutsche Mark, the anchor of Europe's financial system which it seemed necessary yet never quite achievable for the others to tie themselves to.

Greece, Spain and Portugal had joined the European Communities (as they were then called) in the 1980s. For these newly restored democracies of southern Europe monetary unification was both a means of exiting a cycle of inflation, depreciation and low productivity growth so as to catch up with their economically more advanced neighbours, and a powerful emblem of their elevation to a higher political status. Their accession to the euro would prove they had joined the ranks of Europe's stable democracies for good, and that any return to their bad old ways – politically or economically – had been institutionally bricked up.

Then the Berlin wall fell, opening the prospect of a truly unified Europe. This did not fundamentally transform the motives for currency unification; rather it updated them. With a reunified Germany, the fear of German dominance – de facto if not intentional; economic if not political – was even stronger than before. A single currency came to be seen as the solution to Europe's old 'German problem' of one country being too big and mighty to be kept in check in a stable balance of powers. For Germany, meanwhile, melding the Deutsche Mark into a larger common currency helped to reconcile its neighbours to reunification. Not that they could really have stopped it. But Genscher and Helmut Kohl, the chancellor, had no desire to undo decades of building a 'European Germany'. Jacques Delors, then European Commission president, once said: 'Kohl sensed his partners' unease. He knew that economic and monetary union gave him an instrument to calm them down. And so he used that instrument.'[10]

A more general political wave also carried the project forward. The European Community was fresh from the success of making good – more or less – on the promise of the 1957 Rome Treaty to create a single market for goods and services. This paved the road for the euro in two important ways. One was the economic logic of complementing the single market with a single currency: 'one market, one money', as the slogan went. The other was political: the achievement of the Single European Act meant that the political momentum for unification – the spirit of Spinelli – was strong.

Neither argument, of course, provided conclusive reasons for replacing national currencies with a single international one. Currency union is not a sine qua non for a prosperous trading relationship – but it does help.[11] Political momentum is also far from self-justifying. The feeling that progress towards an exalted vision is possible does not necessarily mean the vision is one that ought to be pursued.

It would be frivolous to call the euro a lowest common denominator – the extraordinary pooling of sovereignty that currency union involves went beyond the limits of what many would have thought possible. But a common denominator it certainly was (perhaps the highest rather than the lowest). Conversely, no single idea could on its own make a conclusive case for the euro. A reduction in economic volatility does not inspire enthusiasm in the hearts of the average citizen. Nor does the idea of counterbalancing Germany's power in post-cold war Europe. Had the euro not seemed to serve a number of different political imperatives simultaneously, it would never have been born.

A Currency Designed by Economists

It is sometimes said that the euro was a political project that ignored economics. But economic thinking was central to the creation of the euro. The group charged with designing the common currency was made up largely of technocrats. Although it was chaired by Delors, whom no one would mistake for an apolitical bureaucrat, it comprised the governors of the all the EU's national central banks. Central bankers are, of course, political animals, but they also pride themselves on their economic expertise. They were, moreover, the ones with the most to lose from monetary union, since the key function of the national central banks they headed – setting monetary policy – would cease to exist. Though collectively they would regain this power as members of the Governing Council of the common central bank, they would also be left exposed if the project turned out to be a failure. If anyone had an incentive to find reasons against monetary union, it was the Delors committee. Yet its report – the euro's blueprint – ensured that the political motives enumerated above doubled up as genuine economic considerations as well.[12]

The most obvious economic effect of the euro is the elimination of exchange rate fluctuations. Currency volatility has real economic costs. It discourages international trade and investment by making their profitability more uncertain. It makes cross-border financial flows potentially more destabilising. It is in the nature of exchange rates to change violently and excessively. In part this is because, when prices and wages take time to react to changing economic circumstances, exchange rates, which can adjust instantaneously, overcompensate relative to their long-term equilibrium.[13] Double-digit appreciations or depreciations within a period of months are not unusual, and such large, rapid changes in relative prices disrupt the economies that suffer these swings. A sudden shift in relative prices does not have to be enormous before it completely undermines a previously solid business plan. The measures that people can take to shield themselves are costly. Hedging against currency risk – that is, buying insurance against exchange rate swings – adds another cost of doing business, and is in any case only available for short periods or at a high price, especially for the smaller businesses that create the most jobs. Alternatively, businesses can simply avoid activities that are sensitive to exchange rates, but that makes the economy more closed to international trade than it could ideally be. 'One market, one money' was not merely a catchy slogan – it contained a respectable economic logic.

Monetary union also brought the promise of better macroeconomic policy. Since for many, monetary stability in practice required shadowing the Bundesbank, much of Europe was originally bound to a policy that was designed to suit only Germany. A pan-European central bank would instead choose the best policy for all. Moreover, the Delors committee's central bankers – reclaiming collectively some of the power they were to lose individually – ensured that the new European Central Bank (ECB) would inherit the Bundesbank's independence from political control as well as its single-minded focus on keeping inflation at bay. The French had never warmed to the idea of central bank independence and a narrow focus on inflation, but this was the condition set by a German government confronted with grumbles about the currency project at home. And for the countries most plagued by high inflation and volatile exchange rates, German-style monetary stability was attractive in its own right.

It is worth noting in retrospect how workaday these benefits can seem. While monetary union was an enormous political undertaking, the direct economic consequences it promised – in brief, better business conditions through more predictable prices and cheaper credit – were rather pedestrian. These ambitions hardly matched the calibre of the Ventotene Manifesto.

There was, however, one big economic aspiration: that membership of the euro would encourage governments to undertake policies to improve productivity. Competitive devaluation – letting the exchange rate fall to shift demand from other countries' exports to one's own goods and services – would now be a thing of the past. Without resort to this quick fix, it was hoped, laggard economies would be forced to put in place genuine productivity improvements to improve long-term growth, rather than just address slowdowns with temporary demand boosts that did nothing to improve the economy's capacity.

This indirect effect was the only route by which the euro was ever going to solve Europe's real economic problems, which were not at their root monetary. Whether an economy thrives or stagnates in the long run is only partially determined by the currency and monetary regime under which it operates. The desire for more stable exchange rates was an eminently reasonable one, and eliminating volatility took one foot off the brake on the engine of growth. Making the engine run faster was, however, an altogether different thing. By creating better conditions for trade and capital flows, it was hoped that the euro would broaden the opportunity and, over time, intensify the need for its member economies to become more productive.

Misplaced Misgivings

Monetary union obviously presented economic risks as well as opportunities. The euro's founders were far from blind to them, though their vision may be said to have been partial. Not so much because they were unimpressed by OCA theory, which by then had failed to keep up with decades of macroeconomic understanding,[14] but because they were concerned to the point of obsession with the implication of leaving fiscal deficits and debts in the hands of national governments.[15]

Fiscal policy in one economy influences economic activity in the economies it trades with because national aggregate demand fluctuations spill across borders through the trade balance. Capital movements can amplify this interdependence as well as create interdependence on their own. Since investors treat different governments' bonds at least partly as substitutes, one government's decision to alter its borrowing directly influences the cost of credit to others, in addition to any monetary and credit consequences of the aggregate demand repercussions through trade.

As a consequence of these spillovers, uncoordinated fiscal policy is inefficient, since national governments decide their budgets without taking into account the economic costs (or benefits) to other countries. More generally, a lack of coordination makes it difficult for the region as a whole to have the right size of fiscal deficit or surplus. This is not a problem caused by monetary union but a consequence of economic integration generally, though a single currency makes it more important to address. The problem is far more general than suggested by the cliche of a profligate government exporting instability to others. Indeed, imprudently large deficits in one country can be *beneficial* to trading partners whose domestic demand falls short of supply; and insufficient deficits (or excessive surpluses) can cause damage in the same situation. A good case can be made that these two patterns characterise the most significant spillovers in the eurozone's first decade and a half. Before the crisis, public- (and private-) sector deficits in other euro members helped sustain Germany's exports while domestic demand stagnated there; after the crisis, fiscal consolidation by Berlin held back the already sickly aggregate demand in the eurozone as a whole. In the run-up to the euro, however, only the spillovers from excessive deficits were a politically salient concern.[16]

Deficits aside, the *stock* of public debt was a preoccupation in its own right. The fear was that if a state within a monetary union ran into difficulties refinancing a large debt burden, others might prefer to bail it out rather than let it default. Foreshadowing the feeling of blackmail that would sour eurozone politics in 2010, the European Commission warned that in such a situation 'markets cannot be expected to behave as if solidarity across Community Member States were completely ruled out, since concerns for solidarity are integral to the philosophy of the Community'.[17] The unstated assumption – that it would be more pressing for EMU members to show such solidarity than for the rest of the Community (i.e. non-euro EU countries) – is crucial for how events were to unfold. This is a strange assumption, however. No one has ever suggested that in the pre-euro area, 'solidarity' (i.e. subsidies) was the required response to a government having to reduce the real value of its debt by the then commonly used method of printing money. Why was there a greater need for 'solidarity' to help it avoid a debt reduction through default? Here was an unquestioned *moral* premise about monetary union – that the prospect of a member defaulting on its debt should be avoided as a matter of joint responsibility, in a way that a country's inflating away its debt had never been. It would play a big role in the decisions made for Greece in 2010.

Amid the general momentum towards making the single currency a reality, the especial pessimism on these issues was striking.[18] This came above all from Germany, which saw itself as most likely to have to pay for the lax public finance practices of other countries if their deficits threatened stable prices or their debts made them ask for financial aid. Attention was focused disproportionately on the costs of excessively loose policy, to the neglect of the potential harm from excessive tightness. The risks of deficits and debts in the public sector were feared while the risks of those in the private sector were disregarded. The concern was more with financial outcomes themselves than with the deeper economic ailments of which they were the symptoms. All this incoherence would be on vivid display during the crisis.

The proposed solution was single-minded too in its disproportionately legalistic approach, which was to prevent a problem by proscribing it. The Maastricht Treaty was fitted with a prohibition on monetary financing of government budgets as well as the so-called no bail-out clause. The latter was a politically significant misnomer. It prohibits the assumption of a member state's liabilities by others – it makes it illegal, in other words, to treat the obligations of one as the obligations of all after the fact. That still leaves room for voluntary intergovernmental lending, which the eurozone resorted to when the sovereign debt crisis exploded in 2010.

Maastricht also created a 'stability and growth pact' (SGP) of supposedly mandatory public finance conditions to govern a country's entry into the euro and its behaviour once admitted. Among the rules were prohibitions on deficits above 3 per cent and public debt levels above 60 per cent of annual national income. The rules were never applied all that stringently before the crisis. Belgium, Italy and Greece were all admitted with debt levels far above the limit. As for the deficit rule, Greece barely met it thanks to some creative accounting. And Germany of all countries saw to it that the pact was definitively defanged by breaking the deficit ceiling with impunity in 2004. The lesson drawn by Germany's policymaking establishment – as much, perhaps, because of its own violation of the pact as those by others – was that it needed to be more strictly enforced.

As a set of entry criteria, though applied with a great deal of latitude, the SGP did some good in motivating the more incontinent of

Europe's public treasuries to regain a measure of self-control. Before the single currency's 1999 launch, deficits fell, public debt tapered off, and inflation slowed down abruptly in the countries that had been most plagued with these ills of economic mismanagement. The reward, in the form of lower interest rates, followed swiftly. Investors found monetary unification credible, even if many academic experts on OCA theory did not.

Europe's Economic Drift

The disproportionate focus on public finances was understandable, and not just because of German sensitivities. When the single currency was being designed, the public debt stocks of most of its prospective members were on a sharply upward trajectory. In the decade to 1990, their average public debt-to-gross domestic product (GDP) ratio doubled, as Figure 1.1 shows.

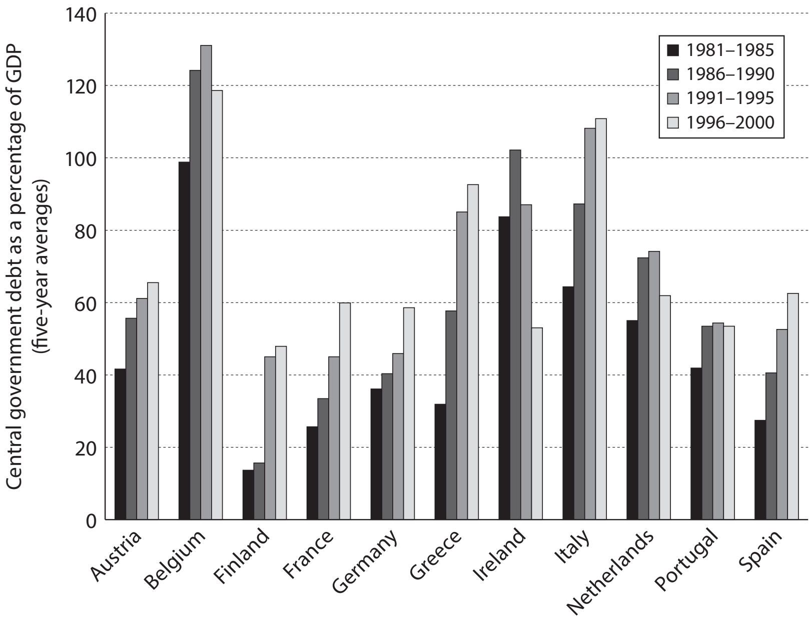

Figure 1.1. The rise of public debt, 1981–2000.
Source: EC Annual Macroeconomic Database.

This development followed the economic earthquakes of the 1970s – the collapse of the Bretton Woods system of fixed exchange rates and Opec's quadrupling of oil prices – which marked the death of the post-war period of monetary stability and fast progress in productivity.[19] In its place came a new era of volatile prices and fitful, unevenly distributed growth. The result was a slow undoing, that is still continuing, of the great levelling that happened during social democracy's heyday in what the French call *les trente glorieuses* – the three decades after the war in which the West rose from the ashes and when, for the first time, all its castes and classes rose together.[20] (See Figures 1.2 and 1.3.) Rather than curing this economic ailment – admittedly no easy task – most European governments indebted themselves much faster than their economies grew in order to fund increasingly expensive welfare states.

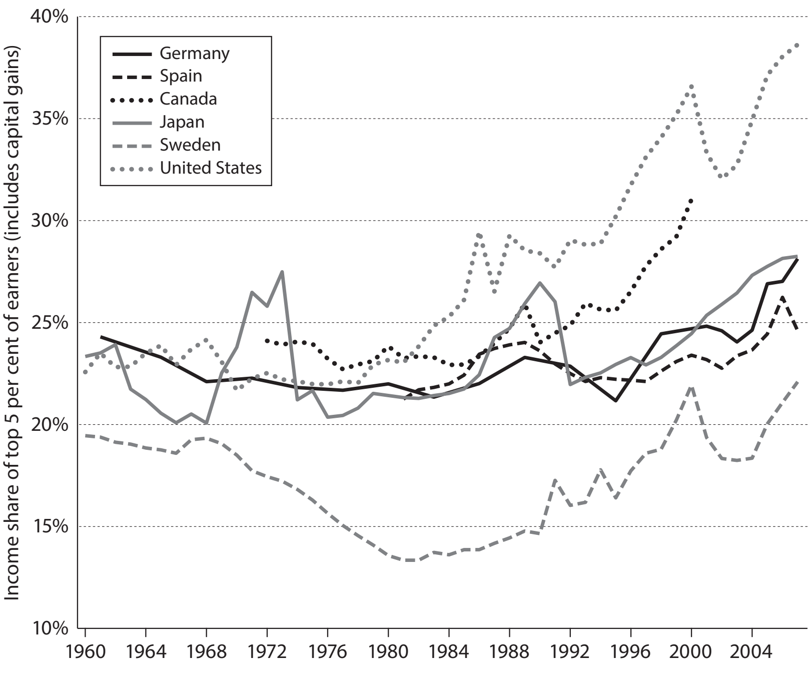

Figure 1.2. The return of income inequality.
Source: World Top Incomes Database.

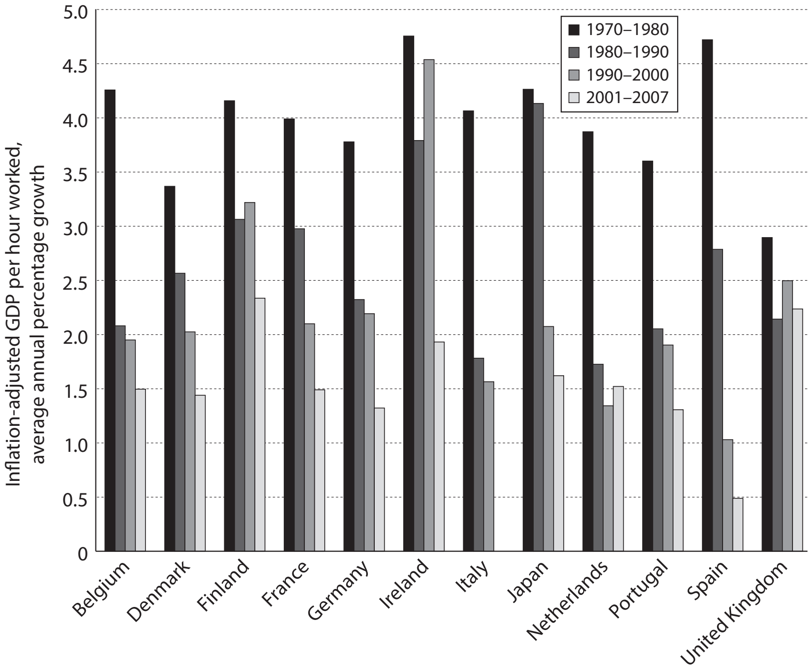

Figure 1.3. Europe's slowing productivity growth.
Source: OECD.

It was clear that maintaining prosperity by rapidly rising state indebtedness could not go on forever. But it is difficult – and can be counterproductive – to remove the symptoms without addressing the underlying causes. What were these causes? Angela Merkel often makes an observation that reveals much about the German mindset around European economic policy: 'If Europe today accounts for just over 7 per cent of the world's population, produces around 25 per cent of global GDP and has to finance 50 per cent of global social spending, then it's obvious that it will have to work very hard to maintain its prosperity and way of life', she likes to say, adding 'All of us have to stop spending more than we earn every year.'[21] Merkel's numbers are striking, suggesting an imbalance that cannot possibly be sustained. 'We do not want a German Europe,' says her finance minister Wolfgang Schäuble, 'but we want a Europe that can compete… [Europe's] strategy aims to overcome imbalances by improving the competitiveness of all eurozone countries.'[22]

Clearly Europe's redistributive systems and public welfare provision are more generous than those in any other region on earth. But that has nothing to do with whether the region is 'competitive' enough against other parts of the world. As Paul Krugman pointed out decades ago, economies are not like companies, for which competitiveness is (or should be) a requirement for profitability, and without which they (should) go out of business. A country does not go 'out of business'. The question is simply: can it offer enough exports to the world for what it wishes to import; or, in financial terms, can it pay its bills.[23]

The eurozone as a whole pays for what it consumes – and then some – and has done since the euro's birth. To think that Europe is not selling enough abroad is to be blinkered by mercantilism. And even in countries that did live beyond their means during the boom and were struck by the sovereign debt crisis when it stopped, loss of export competitiveness was not the central factor it is often made out to be, as Chapter 2 will show.

If Europe's social model is under economic pressure, it is not because of 'competitiveness'. Rather, it is because of productivity – how much each hour of labour or each unit of capital produces in absolute terms, regardless of whether it is more or less than other countries. European productivity is not keeping up with the cost of welfare states having to respond to ageing and costlier medical provision. The productivity predicament is not confined to the old world – in the United States, too, productivity has slowed sharply since the 1970s and only temporarily rebounded in the 1990s. The response to this situation of trying to maintain living standards with the aid of debt has been broadly shared too, as Raghuram Rajan has persuasively argued.[24] The United States also applied the credit card palliative, trying to make the fruits of prosperity available even if prosperity itself was elusive. The main difference with Europe lay in who was using the credit cards. In Europe, it was governments that increased their borrowing from the 1980s on, and several had not kicked the habit before the global financial crisis hit. In the United States, policies encouraged the private sector to do the same, particularly in the 2000s through ballooning mortgage debt used to fund living standards that borrowers could not actually afford.[25] Some European countries followed the US example. Instead of old-style government deficit spending (which, however, persisted in Greece and to a lesser extent elsewhere), the Spanish and Irish economies, for example, were inflated through private credit bubbles.

The euro had the great misfortune of being born into the greatest private credit bubble of all time. This made it possible for the eurozone economies to postpone their reckoning with accumulated public debts and to allow new private debt mountains to build up. Later, it also afforded them a *post hoc ergo propter hoc* argument: blaming the euro for their mess. But rather than being a consequence of monetary union, Europe's credit binge was merely the local outbreak of a global disease: an unholy bargain between governments and financial markets to enjoy credit-driven but unsustainable growth – from the United States and the United Kingdom to Iceland, Spain and Greece.[26] The next chapter explains why the single currency should not be held responsible.