The Euro Experiment

How and why did the euro crisis happen? What are the implications for the economic and political future of Europe? This book, written by a leading commentator on the economics of the European Union, provides a clear and analytical guide to the euro experiment and the subsequent crisis. Written in a balanced way that is neither pro-euro nor euro-sceptic, it explains the political forces that helped to create and maintain the single currency. Further, it argues that the recent crisis can be best understood in terms of six fundamental issues: sovereign debt, banking, private debt, macroeconomic imbalances, economic governance and the interplay of national and European politics. This accessible account will appeal to a wide readership, including general readers and students as well as academics and policymakers working in banking and public policy.

PAUL WALLACE is European Economics Editor at *The Economist*, covering the economies and public finances of the European Union. He is also a former economics editor of the *Independent*.

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PAUL WALLACE

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Preface

There are times when history speeds up and the early 1990s was one such juncture. The decision to create a single currency in a Europe of obdurately surviving nation states was audacious and its effects continue to reverberate. The elder statesmen of France and Germany who decided to jump-start history at the Maastricht summit of 1991 were seeking to answer an old and vexed question about the role of Germany in Europe, but they posed a new and also fraught one. Could the experiment of creating a monetary union of still sovereign countries work?

Both the launch of the euro, on schedule in 1999, and the first decade of the single currency seemed to suggest that the venture was feasible in practice as well as bold in spirit. The European Central Bank (ECB) established its credentials and the overall performance of the euro area was satisfactory. Despite the diversity of the member states and the lack of any genuine economic union, it appeared that an ever-growing number of countries, rising from eleven at the start to sixteen a decade later, could indeed share a common currency while retaining fiscal and political autonomy. Even banks, which lay at the heart of the monetary union, could remain under national supervisory control. Although historical experience suggested that a single money required a single state, the euro might prove to be an exception.

But the euro crisis was another time when history speeded up, in this case revealing the early sanguine assessment of the euro area's performance as largely illusory. The creation of the single currency paid an instant dividend for the countries on the periphery, by causing their interest rates to fall dramatically. It spurred a decade of easy credit that papered over the fact that the members in southern Europe had economies that were less able to cope with the rigours of the monetary union once the good times ended.

Between 2010 and 2012, the euro area came close to disintegrating as financial markets assailed the vulnerable economies, forcing one after another to seek bail-outs even though a founding principle of the union supposedly ruled out any such assistance. In a series of hastily improvised reforms led by Germany, euro-zone governments shored up the shallow foundations of the currency union. New rescue funds were created for countries unable to access private finance in the bond markets. Fiscal rules were reinforced both at euro area level and within countries. The first steps towards a 'banking union' were taken in order to loosen the links between banks and national governments.

Most important of all, the ECB reinvented itself, sloughing off its initial conception as a narrowly circumscribed central bank and adopting a much more expansive role. Throughout the crisis, the ECB played a crucial role in supporting banks in countries such as Spain that were experiencing capital flight. But after Mario Draghi took the helm in late 2011, the central bank became more proactive, especially when he made his 'whatever it takes' vow to save the euro in July 2012, which was translated into a commitment in principle to buy unlimited amounts of sovereign bonds in countries under siege from the markets. Even though this crucial policy remained unused, at least in the first three years after Draghi delivered his historic pledge, it succeeded in dispelling break-up fears that had pushed up bond yields to punitive levels. Not only did the ECB transform itself within its existing remit, but it also won new powers following the decision by European leaders to make the central bank responsible for supervising banks within the euro area, the main advance towards a banking union.

In emerging fortified from a crisis, the ECB had much in common with other central banks in advanced economies. The Bank of England hardly covered itself in glory before and during the early stages of the financial crisis, yet it was rewarded rather than penalised by regaining its former powers as a banking supervisor. Indeed, the ECB's own short if momentous life formed part of a bigger story about independent central banks, which increasingly held sway in advanced economies. This was all the more remarkable since the gravest financial crisis since the early 1930s had happened under their watch.

The genesis of that crisis was manifold, going beyond mistakes by central banks. But to the extent that they failed to do enough to restrain risky behaviour in the preceding decade, the ECB as well as the Federal Reserve (and the Bank of England) could be blamed for a blinkered policy that concentrated on price stability while paying too little heed to financial stability. In particular, the ECB allowed dangerous credit booms and housing bubbles to take hold on the periphery of the euro area, taking false comfort from the more stable performance of the monetary union as a whole.

Indeed, the euro crisis was in many respects a second European leg of the global financial crisis of 2007–8. Greece's prominence in instigating the euro crisis in 2010 meant that it was initially characterised as a sovereign-debt crisis since fiscal improvidence resulting in high public indebtedness had brought the country to a point where it could no longer finance itself in the markets. But banking crises associated with build-ups of excessive private debt were a more common cause of difficulties on the periphery, above all in Ireland, but also in Spain and Cyprus.

Despite its similarities to other central banks (and their mistakes), the ECB remained in many ways an exceptional central bank. Uniquely, it was a supranational institution, the embodiment of a monetary union that lacked a fiscal and political union. This left it in a solitary position, which hampered a swift and appropriate response to the crisis. Although the ECB eventually adopted quantitative easing (QE) in early 2015, it was late in pursuing a policy deployed by the Fed and the Bank of England in the wake of the financial crisis. That was because QE was far more difficult in a European context since there was no euro-wide state whose bonds the ECB could purchase. As a result, the programme of sovereign bond purchases that the ECB eventually launched was one in which the national central banks bought their own governments' bonds and bore any losses that might be incurred, a significant departure from the general risk-sharing rule.

The difficulties in responding adequately to the euro crisis reflected a broader failure in European integration. In various ways and in different countries, most notably in referendums held in France and the Netherlands in 2005, voters were clearly hostile to further steps towards 'ever closer union'. Bruised by such close encounters with electorates, euro-zone leaders for their part were reluctant to adopt any steps that would require significant changes to European treaty law, requiring unanimity and referendums in some countries. As a result, they had to improvise measures that could be adopted on an intergovernmental basis or that used existing powers under the treaties. For example, some argued that the job of single supervisor should have been given to a new institution rather than to the ECB in order to ensure that monetary policy decision-making was not influenced by worries about individual banks. But the ECB was made responsible, among other reasons, because this could be done without any awkward treaty amendment.

The legal blockage reflected a wider political standstill. Opinion surveys showed that in most member states there were majorities who favoured the euro. However, that support did not translate into backing for the far-reaching steps needed to stabilise the monetary union fully and to make it work better. That required further ceding of national sovereignty, such that the currency union would be able to conduct a common fiscal policy. However, there was little genuine appetite for that either in Germany, which worried that this could become a way for countries to backslide on controlling their budgets, or in France, which feared the loss of national control.

The lack of deeper integration left the euro hostage to national politics within the various states throughout the crisis. These continued to sour even after the worst of the crisis appeared to be over and a recovery, however flimsy, got under way in 2013. Within the northern creditor countries, there was popular resentment of the taxpayer-funded bail-outs. Within the southern debtor countries, the hardship endured during the crisis spurred the sudden rise of parties that were opposed to the painful measures imposed as a condition of the rescues.

The vulnerability to the vagaries of national politics was exposed most dramatically in 2015. Just as the recovery was at last strengthening, in part because of the fillip of lower energy prices owing to the fall in world oil prices, in part because of the ECB's belated decision to undertake quantitative easing, the Greek crisis erupted again. The victory of Syriza, a radical-left party that thought it could defy German-led policies, in the Greek election of January 2015 revived the worries that had come to the fore in 2012 about the wider and damaging effects on the monetary union of a country being forced to leave the euro. As before, Greece, which had already required not just one but two bail-outs, was the most likely candidate.

Protracted and acrimonious negotiations ensued between Greece and its creditors, particularly Germany. As a crucial deadline of 30 June neared, an agreement appeared tantalisingly close. That prospect was shattered when Alexis Tsipras, the Greek prime minister and leader of Syriza, unexpectedly called a referendum on the proposed deal and vowed to campaign against it. This sudden decision was disastrous, since leaders like Angela Merkel, the German chancellor, regarded it as a breach of trust that had been painstakingly built up. Within days, Greek banks were forced to close and strict capital controls were imposed. Greece looked set to tumble out of the monetary union, with catastrophic consequences for Greeks as a new depreciated drachma replaced the euro. The immediate effects on the remaining euro area were expected to be manageable, in contrast with 2012 when it was feared that an exit could have a domino effect forcing other weak countries out. Such an event would nonetheless inflict enduring damage on the single currency by revealing it to be a harder but ultimately breakable fixed exchange-rate system rather than the capstone of European integration.

During a tense and bitter weekend summit in Brussels in July, Germany at first pressed for a temporary exit on the part of Greece from the euro area, a 'time-out' lasting at least five years. Under pressure from other big countries, notably France and Italy, Merkel retreated but it was an extraordinary occurrence in the history of the euro area and the wider European Union that Germany, which had invested so much in the cause of integration, could contemplate such an act. A grudging settlement set out steps that would pave the way to a third bail-out in which Greece would have to carry out yet more austerity and reforms in return for more loans.

Despite this reprieve, the events of mid 2015 highlighted a deep and abiding flaw in a currency union that essentially remained a club of sovereign states rather than a political federation. Joining the euro was legally an irrevocable decision. That was necessary because otherwise markets would bet on its members leaving the euro if they found it difficult to cope. Moreover, it would take only one country to leave to create a precedent for others to follow, whether willingly or under pressure from the markets. But in order for the club to function, there had to be rules and its members had to obey them. If a country like Greece refused to play by the rules, and indeed sought to exploit the wider impact of its possible exit on the rest of the euro area in order to enhance its bargaining position, then it had to be possible to show such a recalcitrant state the door.

Although the renewed Greek crisis in 2015 did surprisingly little damage to the euro-zone economy, which continued to revive, its political repercussions were disconcerting. A project supposed to draw the peoples of Europe together was instead tearing them apart. National antipathies were intensifying rather than attenuating as crude caricatures of bullying Germans and feckless Greeks were drawn. Hopes that the euro would spur deeper political integration appeared fanciful, yet without that it would remain a fragile construction.

Although the euro area remained intact – for the time being – and had indeed expanded since the start of the crisis to nineteen members, as the three Baltic states joined, mere survival was not enough. Judged by other gauges, the single currency had failed. An apparently respectable record before the financial crisis looked very different after first the sharp ensuing 'great recession' and then, after a short revival, a two-year double-dip recession followed by a weak and faltering recovery. That left growth of living standards in the first fifteen years of the euro disappointingly sluggish across the currency club as a whole. Moreover, that mediocre overall performance disguised the contrast between Germany, which fared well, and southern Europe, where outcomes were dismal. A similar story could be told by looking at unemployment, which was far higher on the periphery in 2014 than when the single currency started, in 1999, whereas in Germany it was considerably lower.

In fact, Germany had benefited from the euro not just economically but in political and strategic terms. All roads appeared to lead to Berlin and to the German government, which commanded authority owing to the strong German economy and public finances. Early fears that Germany would cast off its commitment to Europe proved false but the price that it exacted for underwriting the shaky currency union was that the rest of the euro area should become more German in spirit, especially in pursuing fiscal discipline and structural reforms. A project conceived to answer the old question about Germany's place in Europe, by taming it within the framework of a monetary union, had instead reinforced German power.

Just as early judgements on the first decade of the euro proved unduly optimistic, so verdicts reached after fifteen or so years might turn out be too pessimistic, especially if a long sustained recovery could be achieved. The danger nonetheless was that the euro area remained trapped, unable either to retreat because of the costs of dissolution or to advance because of the political obstacles to creating a European state. That could condemn its citizens to a future of lacklustre economic performance, which could be all the more problematic as population ageing took its toll, adding new fiscal pressures to strong as well as weak countries since it would be especially intense in Germany.

This account of the euro experiment is necessarily partial, because the story of the single currency can be told at many levels, ranging from the ECB itself to all the countries belonging to the euro as well as international actors such as the IMF, and spanning politics, economics and finance. It is also necessarily provisional, because the outcome of the experiment remains to be determined. That it has been possible at all is thanks to the many people who have offered me their insights and expertise while covering the euro crisis since early 2011 for *The Economist.*

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sought to incorporate changes suggested by those who have read it the arguments that I have presented are mine alone, and in particular should not be interpreted as the views of *The Economist*.

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