Bloomberg Businessweek
05/24/2012

Who Lost the Euro?

The arc of Europe's postwar history is turning toward tragedy. It isn't just that much of the Continent has fallen into a new Great Depression, or that in some countries things will get worse before they get better. It isn't even that the whole mess was avoidable in the first place. It's that the crisis is dividing Europe along the very lines the European project was intended to erase.
Decades of clichés about European "solidarity" and "the European idea" are being held up to ridicule. The notion that Greeks, Spaniards, Britons, Germans, and Italians are instinctive partners whose commonalities transcend their cultural differences and historical enmities—that "Europe" is a real community, not just a heavily worked-over blueprint in Brussels—turns out to be, let's say, disputable. Ancient stereotypes are as livid as ever, framing conversations about the crisis right across the European Union. Germans are bossy and severe. Italians are idle. Greeks are corrupt. Brits are arrogant. The French are vain. So much for 60 years of European unification.

Until recently, Germany could claim to be expressing the consensus of rich northern Europe, but no longer. France has chosen the socialist Francois Hollande as president, ditching German Chancellor Angela Merkel's erstwhile ally, Nicolas Sarkozy. The resolve of other northern governments to stand with Merkel in her demands for fiscal austerity in the south is weakening.

Meanwhile, resentments thought to be dead and gone have revived. Three generations after the end of World War II, newspapers in Greece publish caricatures of Merkel as a swastika-sporting Nazi. In Spain, Italy, and other countries suffering the stress of a German-directed drive to restore Europe's public finances, anti-German sentiment is better disguised but no less widely held. Germany stands increasingly isolated in a union that was intended, not least by Germany's own leaders, to bind and subdue the country within a larger whole.

Why did it all go wrong? Three main reasons: French grandiosity, German shame, and a universal law of bureaucratic self-aggrandizement. Together these formed a European Union that was poorly adapted to the stresses the project was sure to encounter. The EU was perhaps unlucky that the crisis came when it did—before national loyalties had diminished and an emerging European identity had begun to take their place. Yet the EU's designers had some sense of the risk they were running. They gambled and lost.

The overriding goal for a Europe in ruins after 1945 was to create a secure zone of peace and prosperity. Reconciliation between France and Germany, formerly bitter enemies and sure to be the dominant economic entities in a new Europe, was vital. As a matter of the highest priority, the two countries formed a close alliance and began building a new, united Europe around it. They began modestly in 1951 with the European Coal and Steel Community, but they entertained bigger ambitions from the outset.
As early as 1957, the Treaty of Rome enshrined the notion of "ever closer union." This became the organizing principle for Europe's subsequent evolution. The path not taken was that of an enhanced free-trade area, a zone of economic cooperation among sovereign states, a kind of Nafta-plus. The architects of European integration had larger designs. If Europe was to compete and engage on equal terms with the U.S., it would need to aim higher. Ultimately, a United States of Europe was the goal.

Germany mainly wanted a broader union—to surround itself with friendly states even if the newcomers were at different stages of economic development than those at the European core. France sought a deeper political union, one that would subdue German economic power and give Paris more reach. Compromising, they chose to broaden and deepen at once. The European Economic Community expanded to take in new members. It developed a thin, yet feverishly proliferating, federal layer of government, complete with a parliament and executive. These two drives were in tension. Members of an ever-widening union had less in common than countries in the advanced-economy core, making political and economic integration ever harder.

The critical juncture was reached in talks for the Maastricht Treaty of 1992. This provided for European monetary union, the boldest step yet.

As expected, France was keen on the new single currency: This was deepening with a vengeance. Under then-existing arrangements, French monetary policy was in practice constrained by the choices of Germany's mighty central bank. France had no vote on the Deutsche Bundesbank's governing board, but its interests would be recognized by the European Central Bank. Back then, France saw monetary union as adding to, not subtracting from, its own monetary sovereignty.

More gloriously—and what is France for if not *la gloire*?—the single currency advanced the goal of a Europe fit to contend with the U.S. in global affairs. The dollar needed a rival. The euro would be it. A truly single European market, which the EU had resolved to build, needed to eliminate exchange-rate risk, and that required a single currency. What better way to incubate a European sense of identity than to create such a currency?

As before, Germany viewed deepening more skeptically. Polls told the government that, had Germany's constitution permitted a referendum on dropping the esteemed deutsche mark, the country would have rejected the idea. But Chancellor Helmut Kohl gave greater weight to other considerations. After the fall of the Berlin Wall, the country's enlargement to the east had stirred concern about resurgent German power. Kohl wanted to offer reassurance. This was not *Deutschland über alles*, you understand. There's no going back to that shameful past—we'll surrender the D-mark to prove it. Germany acquiesced in the annihilation of its currency out of meekness.

Yes, that's ironic.

There was another factor, almost as laughable in hindsight. Starting in the 1970s, a view had gained ground around the world that central banking was above politics. The goal of monetary policy—price stability—is simple, according to this view, and the means purely technocratic. The old Keynesian idea that governments could trade a bit of inflation for a spurt of faster growth stood discredited. If such choices ever arose, central banking would be political; but they don't, the thinking went, so monetary policy should be held above the fray.

That’s why Europe’s leaders weren’t too worried that the union’s democratic underpinnings, including its arrangements for fiscal policy, were so much weaker than those of a traditional, currency-issuing nation-state. Actually, they thought, this was a good thing. The EU’s governance deficit would make the ECB all the more independent. Left alone, it would be able to do its job better and without controversy.

Nice theory. One thing this crisis has proved is that central banking is a branch of politics. Under some extreme circumstances, such as those we’re in, monetary policy is just fiscal policy by other means—as when a central bank engages in “quantitative easing” and takes government debt onto its books, as the U.S. Federal Reserve has done. To underline its independence, the ECB was forbidden to do that, but out of necessity it’s lately found ways around the prohibition. Many economists are now calling for more quantitative easing in the euro zone.

In addition, with economies across the euro area diverging, the supposed simplicity of the stable-prices goal has evaporated. Price stability in Germany means depression in Greece. But the euro area can have only one monetary policy. Setting it involves choices that are as political as they come—yet no clear line of democratic accountability connects the ECB and the EU’s citizens or governments.

Some economists drew attention to the fragility of the euro system’s design from the start. Harvard’s Martin Feldstein presciently stressed that as economic performance differed from one country to the next, a single currency would pit winners against losers. Europe lacked both the political machinery and the democratic legitimacy to mediate these disputes.
The standoff between Germany and its allies in fiscal austerity on one side and Greece, Ireland, Spain, and the distressed peripheral economies on the other comes down to a fight about who bears what burden. German taxpayers are unwilling to further subsidize what they see as their reckless and feckless EU partners. In the end, if this reluctance brings the ceiling down, it may do Germany more harm than good. You can understand it nonetheless. And since Europe’s national solidarities look more entrenched than ever, you can also understand resentment in Greece and elsewhere at being dictated to by Berlin.

One way of describing Europe’s dysfunction is to say that economic integration, which sped up with the euro’s arrival, got too far out in front of political integration. While that’s true, you’d be wrong to conclude that political integration could have moved much faster. Successive treaties have foundered because of popular resistance to the transfer of decision-making power to the EU. Across Europe, politics is still resolutely national. To many Spaniards, Madrid, let alone Brussels, seems remote. The same goes for the citizens of most other EU member countries.

For that reason, adopting the single currency was always going to be a risk, but it didn't need to be as risky as it proved. National governments understood what the economic demands of the euro would be, then spent more than a decade doing nothing about them. Successive Greek governments not only overborrowed but also cooked the books to hide the fact. Greece was an outlier only in the latter respect. Everywhere, complacency about the safety of sovereign debt was total. For years governments borrowed, and creditors lent, as though Greek (or Spanish or Italian) debt was as safe as Germany's.

That bad behavior was compounded by the failure to align financial regulation with monetary union. The single currency fostered deep financial integration across the EU—that's one of the reasons why leaving the single currency is so difficult. But progress toward a consistent EU-wide system of financial regulation—such as uniform banking rules or a single deposit insurance scheme—has been slow.

Labor markets also remain more national than continental, leaving workers and businesses at the mercy of the EU's imperfectly synchronized business cycles. Migration is permitted in theory but can be difficult in practice because pension arrangements and labor certifications aren't easily portable. Anyway, how many Frenchmen want to live in Britain? Or vice versa?

Until the crisis intervened, labor market craziness as notorious as Spain's—where a dual system of permanent and disposable workers has driven the unemployment rate to 25 percent—was left unattended. Powerful unions and broken wage-setting systems allowed labor costs to get out of hand and created a widening competitiveness gap between Germany and southern Europe. This is the main underlying cause of the peripheral countries' current plight.

The EU's executive arm, the European Commission, is much to blame for this neglect. For years it focused on enlarging and complicating its areas of competence, but it failed to prioritize the issues that would make or break the currency union. Its pathological zeal to standardize the regulation of products and services fueled resistance to more rule from Brussels—resistance the commission then deflected by spraying regional development funds hither and yon. Its intrusiveness contrived to be both threatening and absurd. The commission thrived on tasks that neither made the euro system safer nor prepared the EU for the economic stresses of the crash.

The result is the fateful choice that confronts Europe in the coming days and weeks. Already a breakup of the euro system has gone from being “unthinkable” to a contingency for which officials are planning. The immediate question is whether Greece will exit. Europe’s leaders would hope to stop the rot there. But if Grexit happens, attention will turn instantly to which country goes next. To stop the system from unraveling with who knows what consequences, the EU may have to take the strides toward deeper union that Germany has been resisting since this crisis exploded: joint guarantees of sovereign debt and unlimited intervention by the ECB.

That’s fiscal union. It commits the EU to potentially enormous transfers among its members and makes them explicit. Can there be fiscal union of that sort without political union? And do Europe’s divided nations—the bossy Germans, idle Italians, arrogant Brits, and vain French—actually want to be one country? In Maastricht in 1992, the Treaty on European Union arranged things so those questions would one day have to be answered. Sooner than anyone bargained for, and before Europe was anything like ready, that day has come.

http://www.businessweek.com/articles/2012-05-24/who-lost-the-euro