The Economist

UNHAPPY UNION

How the euro crisis – and Europe – can be fixed

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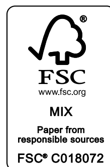

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1 “If the euro fails, Europe fails”

IN THE SPRING AND SUMMER OF 2012 there was a fad in offering advice on how to break up the euro. More than two years after the start of the Greek debt crisis, the experiment of the single European currency seemed to be close to failure. Successive bail-outs, crushing austerity and innumerable emergency summits that produced at best a half-hearted response were stoking resentment among creditor and debtor countries alike. And since national leaders seemed either unwilling or unable to weld together a closer union, the pressure of the euro crisis was remorselessly pushing the cracks apart. Better, thought some, to attempt an orderly dissolution than to be confronted with a chaotic break-up.

In May the former chief economist at Deutsche Bank, Thomas Mayer, proposed the introduction of a parallel currency for Greece, a “Geuro”, to help the country devalue.[1] In July Policy Exchange, a British think-tank, awarded the £250,000 Wolfson Prize for the best plan to break up the euro to Roger Bootle of Capital Economics,[2] a private research firm in London. The following month *The Economist* published a fictitious memorandum to Angela Merkel, the German chancellor, setting out two options for a break-up: the exit of Greece alone, and the departure of a larger group of five countries that added Cyprus, Spain, Portugal and Ireland as well. A footnote reported that the ever-cautious Merkel had turned down both possibilities, deeming the risks to be too great, and ordered the paper shredded. “No one need ever know that the German government had been willing to think the unthinkable. Unless, of course, the memo leaked.”[3]

The imaginary memo was closer to the truth than readers might have thought. That summer Merkel did indeed ponder, and reject,

the idea of throwing the Greeks out of the euro. German, European and IMF officials had by then drawn up detailed plans to manage a break-up of the euro – not to dissolve the currency completely but rather to try to preserve as much of it as possible if Greece (or another country) were to leave. The plans never leaked, which was just as well. The mere existence of a contingency plan for "Grexit" might have provoked a self-fulfilling panic in markets. Few had confidence that any plan to oversee an orderly break-up would work.

Officials thought the unthinkable on at least three occasions. The first was in November 2011, when Greece announced a referendum on its second bail-out programme. Germany and France, outraged by Greece's insubordination, demanded that the referendum question had to be whether Greece wanted to stay in the euro or not. For the first time, European leaders were openly entertaining the notion of Grexit. In the event the vote was abandoned after the fall, within days, of the prime minister, George Papandreou. The second moment of peril came between the two Greek elections in May and June of 2012, when the rise of radical parties of the left and the right increased the risk of the Greeks voting themselves out of the euro before cooler heads prevailed in the second ballot. (Even after the conservative leader, Antonis Samaras, had put together a government that belatedly committed itself to the EU adjustment programme, Merkel debated well into August over whether to expel Greece.) The third danger point was the tough negotiation over the bail-out for Cyprus in March 2013. The newly elected president, Nicos Anastasiades, threatened to leave the currency if a bail-out meant destroying the island's two largest banks and wiping out their big expatriate (mostly Russian) depositors. After two rounds of ugly negotiations Anastasiades succumbed to his rescuers.

The euro zone would have been ill-prepared to cope with Grexit in late 2011. Jean-Claude Trichet, who presided over the ECB until the end of October 2011, would not countenance detailed doomsday planning. And without the central bank's power to create money, a break-up might have been uncontrollable. Trichet's successor, Mario Draghi, did set up a crisis-management team in January 2012. Within a year the ECB and the IMF had developed an hour-by-hour, day-by-day plan to try to manage the departure of a euro-zone member.

By the time of the negotiations with Cyprus, admittedly a smaller country than Greece or the other rescued economies, the prospect of Cyprexit did not cause anywhere near the same degree of fear among officials, or markets.

Others also worked up contingency plans, not least in the European Commission and the European Council, though here co-ordination was weaker for fear of disclosure. "Everything in Brussels leaks," says one of those involved. Officials recount how on one occasion Herman Van Rompuy, president of the European Council, raised the prospect of Grexit with José Manuel Barroso, president of the Commission. "I don't want to know the details. But I hope you are taking care of it," Van Rompuy said. Even so, his own small team of economists also quietly worked up position papers.

It all made for a strange dance in the darkness. Within the Commission, staff at the economics directorate had been expressly ordered not to do any work on the response to a possible break-up, even though a discreet group of senior commissioners and officials did just that: plan for a split in the currency zone. They had two main purposes: first, to set out what would have to be done; and second, to make the case for why it should not be done. For others it was a matter of managing as well as possible. For all concerned a big dilemma was how much to tell the Greek authorities about the preparations for their country's possible return to the drachma. The answer was: hardly anything at all.

Like the gold standard, only worse

Fixed exchange-rate systems have fallen apart throughout history, from the gold standard to various dollar pegs. But giving up a fixed peg is very different from scrapping an entire currency. This has happened too, but usually only when political unions have broken apart: for instance, the break-up of the Austro-Hungarian empire, the collapse of the Soviet Union or the velvet divorce between the Czech Republic and Slovakia. And none of these precedents quite captures the special circumstances of the euro. It is a single currency without a single government. It is made up of rich countries, many of which have built up large debts and large external imbalances, so the sums

at stake are proportionately large. A map of the world sized according to each country's government spending shows Europe as a huge, puffed-up ball of public money.[4] Moreover, the euro zone is a subset of the European Union and its single market, within which goods, services, capital and people move more or less freely. As a result, the spillover effects on other European countries would be that much greater.

It had taken years for countries to prepare for the introduction of the euro. If any left, they might have to adapt to the redenomination of a member's currency overnight, or at best over a weekend. Nobody could be sure about the consequences should the supposedly irrevocable currency become revocable. There were two prevailing beliefs. One was the amputation theory: severing a gangrenous limb such as Greece would save the rest of the body. The other was the domino theory: the fall of one country would lead to the collapse of one economy after another. Grexit might thus be followed by Portexit, Spexit, Italexit and even Frexit.

Given such uncertainties, the objective for officials preparing contingency plans was clear: regardless of which country left the euro, the rest must be held together almost at any cost. Those involved speak only in guarded terms about precisely what they would have done. Would the departure of, say, Greece have required Cyprus to leave as well, given their close interconnection? The ECB would have flooded the financial system with liquidity to try to ensure that credit markets did not dry up, as they had done after the collapse of Lehman Brothers, and to forestall runs on both banks and sovereigns. Large quantities of banknotes would have been made available in the south to reassure anxious depositors especially if, as during the Cyprus crisis, banks were shut down and capital controls imposed. The ECB would probably have engaged in unprecedented bond-buying to hold down the borrowing costs of vulnerable countries. Loans to countries already under bail-out programmes would have been increased, and some kind of precautionary loan extended to Spain and Italy.

The IMF would have helped Greece manage the reintroduction of the drachma. This would probably have required a transition period (perhaps as short as one month) involving a parallel currency, or

IOUs akin to the "patacones" that circulated in Argentina after it left its dollar peg in 2000, though EU lawyers thought these would be illegal. The ECB would have dealt with the technicalities of adapting European electronic payment systems to the departure of a member. The Commission would introduce guidelines for capital controls.

Greece might have needed additional aid to manage the upheaval, not least to buy essential goods. In what remained of the euro zone there would have been difficult decisions to take over the allocation of losses arising within the Eurosystem of central banks. National governments would have to decide who should be compensated for losses in case of default and the inevitable bankruptcies caused by the abrupt mismatch between assets and liabilities as the values of currencies shifted. They might also have increased deposit guarantees, although in some cases that might have done more harm than good if the additional liability endangered public finances in weaker countries – as it had done in Ireland in 2008.

Perhaps, thought some, there should be a Europe-wide deposit guarantee. Indeed, many thought there would have to be a dramatic political move towards greater integration. Nobody quite knew what form this might take, but it would have had to signal an unshakeable commitment to stay together. Without the infuriating Greeks, greater integration might even appear more feasible. Indeed, it was such a prospect that convinced some senior EU officials that it would be a good idea to let the Greeks go after all: not because contagion could be contained, as the Bundesbank would sometimes claim, but precisely because it could not. Grexit would be so awful that it would force governments to make a leap into federalism.

Safe, for now

All these considerations, and more, were on Merkel's mind in the summer of 2012 when she decided instead to keep the Greeks in. Beyond the financial price, Germany could not risk the political blame for breaking up the currency and, potentially, the European project itself. As she had repeatedly declared since the first bail-out of Greece in 2010, "if the euro fails, Europe fails".

Two other events changed the dynamics of the crisis. First, at

a summit in June, Merkel and other leaders agreed to centralise financial supervision around the ECB and then have the option of recapitalising troubled banks directly from the euro zone's rescue funds. The move held out the promise, for the first time, of a banking union in which the risks of the financial sector would be shared. The aim was to break the doom-loop between weak banks and weak governments that threatened to destroy both, especially in Spain. The second, even more important, development that summer was Draghi's declared readiness to intervene in bond markets without pre-set limits, on condition that troubled countries sought a euro-zone bail-out and adjustment programme. He thus sharply raised the cost of betting against the euro – to the point that, at the time of writing in March 2014, Draghi's great bluff has yet to be called.

The euro has been saved, at least for a while. But even as economic output begins slowly to recover, the euro zone remains vulnerable and the wider European project remains under acute strain. As *The Economist*'s imaginary memo to Merkel noted, the contingency plans for the demise of the euro were never shredded; they were merely filed away. As *The Economist*'s imaginary memo to Merkel noted (see cover story headlined "Tempted, Angela?" in the issue of August 11th–17th in Appendix 4), the contingency plans for the demise of the euro were never shredded; they were merely filed away.

2 From the origins to Maastricht

THE EUROPEAN PROJECT was a consequence of the second world war and the cold war. How to tame the German problem that had led to two world wars? How to harness its economic power to rebuild Europe? And how to reconstitute the German army to help fend off the Soviet threat? The answer to these conundrums was to fuse the German economy within a common European system, and to embed its armed forces within a transatlantic military alliance.

Already in 1946, just a year after the war had ended, Churchill called in his Zurich speech for the creation of a "kind of United States of Europe", to be built on the basis of a partnership between France and Germany:[1]

> *At present there is a breathing-space. The cannon have ceased firing. The fighting has stopped; but the dangers have not stopped. If we are to form the United States of Europe or whatever name or form it may take, we must begin now.*

Four years later, with a strong nudge from the United States, the French foreign minister, Robert Schuman, produced a plan to integrate the coal and steel industries of France, Germany and anyone else who would want to join the project. This led directly to the creation of the European Coal and Steel Community (ECSC) in 1951.[2]

> *The solidarity in production thus established will make it plain that any war between France and Germany becomes not merely unthinkable, but materially impossible. The setting up of this powerful productive unit, open to all countries willing to take part and bound ultimately to provide all the member countries with the*

basic elements of industrial production on the same terms, will lay a true foundation for their economic unification.

This was the germ of the idea of European economic integration. Today the anniversary of the speech (May 9th) is celebrated as a holiday by the European institutions (known as Schuman Day). The ECSC encompassed not only France and Germany, but also Italy and the three Benelux countries, Belgium, the Netherlands and Luxembourg. Jean Monnet, a French civil servant and scion of a cognac-trading family, who was in many ways the *éminence grise* behind the entire European project, acted as the first president of its high authority.[3]

Schuman and Monnet followed the successful establishment of the ECSC with an attempt to set up a pan-European army, the European Defence Community. But this was a step too far for France. The plan was blocked by a vote in the French National Assembly in August 1954. Henceforth NATO would provide the necessary security umbrella, while European integration would focus on economic matters.

The Messina conference of 1955 prepared the ground for the signing in 1957 of the Treaty of Rome, under which the six European countries that had joined the ECSC established a European Economic Community (EEC), which proclaimed the objective of an "ever closer union". The treaty established a customs union and envisaged the progressive creation of a large unified economic area based on the "four freedoms" of movement – of people, services, goods and capital. The EEC is the direct forerunner of today's European Union.

Despite Churchill's ringing call in 1946, the UK, always a sceptic about European political integration, had stood aside from the process. Indeed, Churchill himself was clear that the UK would encourage but not join European integration. The British Labour government refused to sign up to Schuman's plan, with the then home secretary (and grandfather to a later European commissioner, Peter Mandelson), Herbert Morrison, declaring bluntly that "it's no good: the Durham miners won't wear it".[4] A later Tory government sent only a junior official to Messina, with clear instructions not to sign up to anything. Yet by 1961, only four years after the Treaty

of Rome, the Macmillan government lodged an application for membership, only to see it blocked by Charles de Gaulle's veto in January 1963.

Currency roots

The notion of a single currency was present at the very creation of the European project. Jacques Rueff, a French economist, wrote in the 1950s that "Europe will be made through the currency, or it will not be made".[5] The idea of a common currency has even earlier roots. Various exchange-rate regimes emerged in 19th-century Europe, including the Zollverein (customs union) and the gold standard. The Latin Monetary Union, set up in 1866, embraced a particularly unlikely sounding group: France, Italy, Belgium, Switzerland, Spain, Greece, Romania and Bulgaria (even more bizarrely, Venezuela later joined it). When it started Walter Bagehot, editor of *The Economist*, delivered a warning that has a curious echo today:[6]

> *If we do nothing, what then? Why, we shall be left out in the cold ... Before long, all Europe, save England, will have one money, and England be left standing with another money.*

In the event, the Latin Monetary Union fell apart when it was hit by the disaster of the first world war.

The 1930s was another period of currency instability in Europe – and the world. The UK and the Scandinavian countries all chose to do the unthinkable in 1931 by leaving the gold standard and devaluing. A rival "gold block" led by France and including Italy, the Netherlands and Switzerland, chose to stay on the gold standard until 1935–36. As Nicholas Crafts showed in a 2013 paper for Chatham House, the early leavers did much better in terms of GDP and employment than the stayers – and France, which suffered a lot from clinging so long to gold, played a role equivalent to today's Germany by hoarding the stuff and also insisting on running large current-account surpluses.[7]

Although the desire for currency stability carried through into the early years of the European project, the global system of fixed exchange rates linked to the dollar (and thus to gold) set up after

the 1944 Bretton Woods conference that established the International Monetary Fund (IMF) and the World Bank seemed sufficient for most countries. But over time, and especially in France, the perception was growing that this system gave the Americans some sort of exorbitant privilege. This was one reason why the European Commission first formally proposed a single European currency in 1962. By the end of the decade, the revaluation of Germany's Deutschmark against the French franc in 1969 created fresh trauma in both countries, which turned into renewed worries when the United States formally abandoned its link to gold two years later.

As the difficulty of living with a dominant but devaluing dollar increased, Willy Brandt, then German chancellor, revived plans for a currency union in Europe. His plan was taken up in the 1971 Werner report, named after a Luxembourgish prime minister, which argued for the adoption of a single currency by 1980. The report was endorsed in 1972 by all European heads of government, including those from the three countries that planned to join the club in 1973: Denmark, Ireland and the UK. Indeed, at a summit meeting of heads of government in Paris in December 1972, all nine national leaders, including the UK's Edward Heath, signed up blithely not only to monetary union but also to political union by 1980. A last-minute attempt by the Danish prime minister to ask his colleagues exactly what was meant by political union was ignored by the French president, Georges Pompidou, who was in the chair.[8]

It was the final collapse of Bretton Woods, followed by the Arab-Israeli war and oil shock and then by the global recession of 1974–75, that upset most of these ambitious plans. Yet by then West Germany, always on the look-out for greater currency stability, had already set up a system linking most of Europe's currencies to the Deutschmark, swiftly dubbed the "snake in the tunnel". The idea was to set limits to bilateral currency fluctuations, enforced by central-bank intervention. However, it turned out that the snake had only a fitful and unsatisfactory life. The UK signed up in mid-1972, only to be forced out by the financial markets six weeks later. Both France and Italy joined and left the snake twice. Devaluations within the system were distressingly frequent.

By 1978 there was still no sign of a general return to the Bretton