Europe, the source of the Enlightenment, the birthplace of modern science, is in crisis. The 2008 global financial crisis morphed seamlessly into the 2010 “euro crisis.” This part of the world, which hosted the Industrial Revolution that led to the unprecedented changes in standards of living of the past two centuries, has been experiencing a long period of near-stagnation. GDP per capita (adjusted for inflation) for the eurozone—the countries of Europe that share the euro as their currency—was estimated to be barely higher in 2015 than it was in 2007. Some countries have been in depression for years.

When the US unemployment rate hit 10 percent in October 2009 most Americans thought that was intolerable. It has since declined to 5 percent. Yet the unemployment rate in the eurozone reached 10 percent in 2009 as well, and has been stuck in the double digits ever since. On average, more than one out of five youths in the labor force are unemployed, but in the worst-hit crisis countries, about one out of two looking for work can’t find jobs. Dry statistics about youth unemployment carry in them the dashed dreams and aspirations of millions of young Europeans, many of whom have worked and studied hard. They tell us about families split apart, as
those that can leave emigrate from their country in search of work. They presage a European future with lower growth and living standards, perhaps for decades to come.

These economic facts have, in turn, deep political ramifications. The foundations of post–Cold War Europe are being shaken. Parties of the extreme right and left and others advocating the breakup of their nation-states, especially in Spain but even in Italy, are ascendant. What had seemed inevitable in the arc of history—the formation of nation-states in the 19th century—is now being questioned. Questions are arising, too, about the great achievement of post–World War II Europe—the creation of the European Union.

The events that precipitated the acute euro crisis were symptoms of deeper problems in the structure of the eurozone, not its causes: interest rates on the bonds issued by Greece and several of the eurozone countries soared, peaking in the case of Greece at 22.5 percent in 2012. At times, some countries couldn’t get access to finance at any terms—they couldn’t obtain the money they needed to repay the debts they owed. Europe came to the rescue, providing short-term financing, with strong conditions.

After the euro crisis broke out in early 2010, Europe’s leaders took a succession of actions, each of which seemed to calm markets for a while. As this book goes to press, even the Greek crisis has slipped to the background as Europe hopes that its latest agreement, in the summer of 2015, will at last work, and as other crises have come to the fore: the migrant crisis erupted to take front stage, as did that posed by the threat of Britain’s exit from the EU and the terrorists’ threats made so clear by the attacks in Paris and Brussels. The euro was supposed to bring about closer economic and political integration, helping Europe address whatever challenges the region faced. As we emphasize in the next chapter, the reality has been otherwise: the failure of the euro has made it more difficult for Europe to face these other crises. Thus, though this book is about economics—the economics underlying its failure and what might be done about it—
the economics is intimately intertwined with the politics. Politics make it difficult to create the economic arrangements that would enable the euro to work. And there, in turn, are grave political consequences to this failure.

This book will make clear why the actions taken so far to “solve” the euro crisis have been only temporary palliatives: more likely than not, the next episode of the euro crisis will break out in the not too distant future.

THE CENTRAL THESSES

While there are many factors contributing to Europe’s travails, there is one underlying mistake: the creation of the single currency, the euro. Or, more precisely, the creation of a single currency without creating a set of institutions that enabled a region of Europe’s diversity to function effectively with a single currency.

Part II of the book (chapters 4 to 6) looks at the requirements for a successful monetary union, what Europe actually did, and how the gap between what was required to be done and what was done led to the failures of the euro, to the crises that ensued shortly after its creation, and to divergence, with the rich getting richer and the poor poorer—making it ever harder for the single-currency system to work. Part III (chapters 7 and 8) looks more closely at how the eurozone responded to the crises as they seemingly came to the “rescue,” with programs that in fact deepened and prolonged the downturns. Part IV (chapters 9 to 12) explains what can be done to restore Europe to prosperity.

A NOTE ON THE HISTORY OF THE EURO, AND THE SCOPE OF THIS BOOK

In this book, I do not offer a detailed history of the euro, nor do I provide a detailed description of its institutions. But by way of orientation, it is useful to note a few facts about the chronology and the establish-
ment of the euro. The common currency was an outgrowth of efforts that began in the mid-20th century, as Europe reeled from the carnage and disruption of two world wars that claimed some 100 million lives. Europe’s leaders recognized that a more peaceful future would necessitate a complete reorganization of the politics, economics, and even the national identities of the continent. In 1957, this vision came closer to being a reality with the signing of the Rome Treaty, which established the European Economic Community (EEC), comprising Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany. In the following decades, dominated by the Cold War, various other Western European countries joined the EEC. Step by step, restrictions were eased on work, travel, and trade between the expanding list of EEC countries.

But it was not until the end of the Cold War that European integration really gained steam. The fall of the Berlin Wall in 1989 showed that the time for much closer, stronger European bonds had grown near. The hopes for a peaceful and prosperous future were higher than ever, among both leaders and citizens. This led to the signing, in 1992, of the Maastricht Treaty, which formally established the European Union and created much of its economic structure and institutions—including setting in motion the process of adopting a common currency, which would come to be known as the euro.

Still, there was disagreement about how that greater unity should be accomplished. Today, the official history of the EU may look like a bullet-point list of events leading inevitably to the creation of an ever-expanding common market and common currency area, the eurozone. But the formation of these institutions was in fact the result of years of negotiations that were fraught with deep disagreements about the extent and form of European integration. The results were only possible because of European leaders’ bargains and compromises. In the case of the euro, Helmut Kohl, the German chancellor, reportedly agreed to its creation in return for French president François Mitterrand’s acceptance of the reunification of Germany. Both men were
pivotal in advancing the idea of integration—and in designing many of the policies that I discuss in this book.

ALL THIS HISTORY is important, but much of it is beyond the remit of this book. The point I want to make—and which I will return to throughout—is that the euro was a political project, and in the case of any political project, politics matters.

The personalities in the politics matter, too—one thinks, for instance, of Jacques Delors, whose commission laid out the plan for the creation of the euro in 1989—though again, that is not my focus here. In describing the creation of the euro, I do not fully know what was in the minds of those who were there at its founding. They clearly thought that the system would work—or else they would not have agreed to it. They would have been naïve if they thought that problems wouldn’t be exposed down the road; but presumably they believed that any such problems could and would be addressed. They believed that the single currency, the euro, and the institutions that supported it, especially the European Central Bank (ECB), would be a permanent feature of the European Union. But this book is not about that history or about the founders’ individual understandings of the workings of this new system.

Instead, I am interested in the outcomes of that history—what we can read into them, and what we can do about them. This book is about economics and economic ideologies and their interactions with politics: it is a case study of how, even with the best of intentions, when new institutions and policies are created on the basis of oversimplified views of how economies function, the results can be not only disappointing, but even disastrous.

FLAWED AT BIRTH

*The eurozone was flawed at birth.* The structure of the eurozone—the rules, regulations, and institutions that govern it—is to blame for the poor performance of the region, including its multiple crises. The
diversity of Europe had been its strength. But for a single currency
to work over a region with enormous economic and political
diversity is not easy. A single currency entails a fixed exchange rate among the
countries and a single interest rate. Even if these are set to reflect the
circumstances in the majority of member countries, given the eco-
nomic diversity, there needs to be an array of institutions that can
help those nations for which the policies are not well suited. Europe
failed to create these institutions.

Moreover, there has to be sufficient flexibility in the rules to allow
for adaptation to differences in circumstances, beliefs, and values.
Overall, Europe has enshrined this in its principle of subsidiarity,
which entails devolving responsibility for public policy to the national
level, rather than the European level, for as wide a range of decisions
as possible. Indeed, with the budget of the European Union only about
1 percent of its GDP (in contrast to the United States, where federal
spending is more than 20 percent of GDP), little spending occurs at
the EU level. But in an arena crucially important to the well-being of
individual citizens—monetary policies that are critical in determin-
ing unemployment and the bases of livelihoods—power was central-
ized in the European Central Bank, established in 1998. And, with
strong constraints on deficit spending, the individual countries were
given insufficient flexibility in the conduct of their fiscal policy (taxes
and expenditure) to enable a country facing adverse circumstances to
avoid a deep recession.

Worse still, the structure of the eurozone itself built in certain ideas
about what was required for economic success—for instance, that the
central bank should focus on inflation, as opposed to the mandate of the
Federal Reserve in the United States, which incorporates unemploy-
ment, growth, and stability as well. It was not simply that the euro-
zone was not structured to accommodate Europe’s economic diversity;
it was that the structure of the eurozone, its rules and regulations, were
not designed to promote growth, employment, and stability.

The problems with the structure of the eurozone have been com-
pounded by the policies the region has pursued, especially in the aftermath of the crisis, and within the crisis countries. Even granting the zone’s flawed structure, there were choices to be made. Europe made the wrong ones. It imposed austerity—excessive cutbacks in government expenditures. It demanded certain “structural reforms,” changes in how, for instance, the afflicted countries ran their labor markets and pensions. But for the most part, it failed to focus on those reforms most likely to end the deep recessions the countries faced. Even if they had been perfectly implemented, the policies pushed on the crisis countries would not have restored the afflicted countries or the eurozone to health.

Thus, the most urgent reforms needed are in the eurozone structure itself—not in the individual countries—and a few, halting steps have been taken in that direction. But those steps have been too few and too slow. Germany and others have sought to blame the victims, those countries that suffered as a result of the flawed policies and the flawed structure of the eurozone. Yet without the needed reforms of the structure of the eurozone itself, Europe cannot return to growth.

DIGGING DEEPER: WHY THE FLAWED STRUCTURE AND POLICIES?

Why would well-intentioned statesmen, attempting to forge a stronger, more united Europe, create something that has had the opposite effect? This book is not just about this major event, the euro crisis, which is transforming Europe, and the economics that lay behind it. It is about the intertwining of politics and economics, and about the role of ideas and beliefs.

While the euro was a political project, the political cohesion—especially around the notion of delegation of powers from the sovereign countries to the EU—was not strong enough to create the economic institutions that might have given the euro a chance to succeed.

Moreover, the founders of the euro were guided by a set of ideas, notions about how economies function, that were fashionable at the
time but that were simply wrong. They had faith in markets and lacked an understanding of the limitations of markets and what was required to make them work. The unwavering faith in markets is sometimes referred to as market fundamentalism, sometimes as neoliberalism. Market fundamentalists believed, for instance, that if only the government would ensure that inflation was low and stable, markets would ensure growth and prosperity for all. While in most of the world, market fundamentalism has been discredited, especially in the aftermath of the 2008 global financial crisis, those beliefs survive and flourish within the eurozone’s dominant power, Germany. They are held with such conviction and certainty, immune to new contrary evidence, that these beliefs are rightly described as an ideology. As I note in the preface, similar ideas, pushed by the IMF and the World Bank around the world, led to a lost quarter-century in Africa, a lost decade in Latin America, and a transition from communism to the market economy in the former Soviet Union and Eastern Europe that was, to say the least, a disappointment.

The failures in the eurozone, both in its structure and policies, can thus in large part be attributed to the combination of a misguided economic ideology that was prevalent at the time of the construction of the euro and a lack of deep political solidarity. This combination led the euro to be created in a way that sowed the seeds of its own destruction.

MISCONCEPTIONS ABOUT THE PROCESS OF ECONOMIC AND POLITICAL CHANGE

Flawed beliefs about the process of reform contributed as well. Leaders knew that the eurozone project was incomplete. But the project was seen as part of a long-term process. The dynamics unleashed by the euro would force the creation of any necessary but missing institutions. This success would then further political and economic integration.
In my time as chief economist of the World Bank, I learned that one must be extremely careful in the timing and pacing of reforms.\textsuperscript{14} An initial failure increases resistance to further reforms. This is the story of the euro.

\textbf{THE WAY FORWARD}

Advocates of the current policies within the eurozone, led by Germany, have essentially said “\textit{there is no alternative}” to the current structure (the small modifications which it has been willing to accept aside) and to the policies it has imposed. This has been said so often that it has the dubious distinction of having its own acronym: TINA. Part IV (chapters 9 to 12) shows that there are alternatives to the current approach—reforms that would make the euro work (chapter 9), an amicable divorce (chapter 10), and a halfway house, but a markedly different halfway house than the current one (chapter 11), one that could easily morph into a single currency should there be sufficient resolve to make such a system work. But the current halfway house—a single currency without the minimal institutions required of a common currency area—has not worked and is not likely to do so. There either has to be “more Europe” or “less.”

\textbf{WORSE THAN A LOST DECADE?}

From time to time—when crises hit—it takes years for economies to return to precrisis levels of growth and unemployment. What Europe faces is worse: in most of the European countries, standards of living almost surely will \textit{never} reach the level that they would have hit had it not been for the euro crisis—or if the euro crisis had been better managed. But the failure of the euro goes even deeper.

Advocates of the euro rightly argue that the euro was not \textit{just} an economic project that sought to improve standards of living by increas-
ing the efficiency of resource allocations, pursuing the principles of comparative advantage, enhancing competition, taking advantage of economies of scale, and strengthening economic stability. More important, it was a political project; it was supposed to enhance the political integration of Europe, bringing the people and countries of Europe closer together and ensuring peaceful coexistence.

The euro has failed to achieve either of its two principal goals of prosperity and political integration: these goals are now more distant than they were before the creation of the eurozone. Instead of peace and harmony, European countries now view each other with distrust and anger. Old stereotypes are being revived as northern Europe decries the south as lazy and unreliable, and memories of Germany’s behavior in the world wars are invoked.

**DISMAL ECONOMIC PERFORMANCE**

The economic performance of the countries in the eurozone has been a disappointment. The eurozone has essentially stagnated, and its economic performance has been particularly dismal since the global financial crisis. Critics of the euro always said its test would be when the countries of the eurozone faced an asymmetric shock, a change that hit some countries differently than it did others. The aftermath of the global financial crisis of 2008 has shown that these fears came true and then some: the economies of the eurozone have done more poorly than even its greatest critics had predicted. The crisis began in the United States, but the United States has recovered—albeit anemically—with real GDP in 2015 some 10 percent higher than in 2007; the eurozone’s GDP has hardly changed since 2007—indeed, as we noted, per capita income adjusted for inflation has fallen. The eurozone even saw a double-dip recession. Some of those outside of the eurozone, such as Sweden and Norway, have been doing quite well. There is one overriding factor contributing to the eurozone’s poor performance: the euro.
**EVEN GERMANY IS A FAILURE**

Germany holds itself out as a success, providing an example of what other countries should do. Its economy has grown by 6.8% since 2007, implying an average growth rate\(^{17}\) of just 0.8 percent a year, a number which, under normal circumstances, would be considered close to failing.\(^{18}\) It’s also worth noting that developments in Germany before the crisis, in the early 2000s—when the country adopted reforms that aggressively cut into the social safety net—came at the expense of ordinary workers, especially those at the bottom. While real wages stagnated (by some accounts decreased), the gap between those at the bottom and the middle increased—by some 9 percent in a short span of less than a decade. And through the early years of the century, poverty and inequality increased, as well.\(^{19}\) Germany is talked about as a “success” only by comparison with the other countries of the eurozone.

**HOW THE EURO CREATED THE EURO CRISIS**

Proponents of the euro counter that the euro *did* work, even if it worked only for a short period. Between 1999 and 2007,\(^{20}\) *convergence* reigned, with the weaker countries growing rapidly as the interest rates governments and firms had to pay on their loans came down. The euro succeeded in promoting economic integration, as capital flowed toward the poorer countries. For them, the euro was the victim of an unfortunate storm coming from the other side of the Atlantic, a once-in-a-century hurricane. The fact that the hurricane resulted in devastation should not be blamed on the euro: good economic systems are built to withstand normal storms; but not even the best designed could stand up against such rare events. So the proponents claim.

It is true that the global financial crisis exposed the euro’s weakest point: the way it impeded adjustments to shocks that affect parts of
the eurozone differently. But the euro was not the innocent victim of a crisis created elsewhere. Markets, ever prone to irrational exuberance and pessimism, mistakenly and irrationally presumed that the elimination of exchange risk (with the single currency, there no longer was any risk associated with changes in the value of, say, the lira, Italy’s currency, relative to Spain’s, the peseta) meant the elimination of sovereign risk—the risk that a government could not pay back what it owed. The markets shared in the euphoria of the creation of the euro, and like the politicians who had helped create it, didn’t think deeply about the economics of what had been created. They didn’t realize that the way the euro was created had actually increased sovereign risk (see chapter 4).

With the creation of the euro in 1999, money rushed into the periphery countries (the smaller countries, like Greece, Spain, Portugal, and Ireland, surrounding the “core” of Europe, France, Germany, and the UK) and interest rates came down. Repeating the pattern seen around the world where markets were liberalized, the rush of money into a country was followed by a rush of money out, as markets suddenly grasped that they had been excessively euphoric. In this case, the global financial crisis was the precipitating event: suddenly, Greece, Spain, Portugal, and Ireland found themselves without access to credit, and in a crisis for which the founders of the eurozone had not planned. In the East Asia crisis a decade earlier, when sudden changes in investor sentiment reversed capital flows, exchange rates plummeted in the affected countries, helping the countries adjust. In the peripheral euro countries, this couldn’t happen. The leaders of the eurozone had not anticipated such an event, and as such they had no game plan.

CREATING A DIVERGENT EUROZONE

There is a large economic literature asking, what is required for a group of countries to share a common currency and have shared pros-
perity? There was consensus among economists that for the single currency to work, what was required is that there be sufficient similarity among the countries.

What kind of similarity is required can be debated, but suffice it to say here that what many Europeans (Germans in particular) thought was required—a movement toward so-called fiscal prudence, low deficits and debts—was not sufficient to ensure that the euro would work, and possibly not even necessary.

So much importance was assigned to these fiscal concerns that they came to be called the convergence criteria. But the way the euro was designed led to divergence: when some country had an adverse “shock,” stronger countries gained at the expense of the weaker. The fiscal constraints imposed as part of the convergence criteria—limits on deficits and debt relative to GDP—themselves contributed to divergence.

In particular, chapter 5 will explain how the structure of the eurozone led people—especially the most talented and highly educated—and capital to flow from the poor and poorly performing countries to the rich and well-performing. The rich and well-performing could invest in better schools and infrastructure. Their banks could lend more, making it easier for entrepreneurs to start new businesses. Even worse, EU strictures prohibited the lagging countries from undertaking certain policies that might have enabled them to catch up to the more advanced.

Rhetoric about solidarity aside, the reality is a more divided Europe with less chance to undertake the sort of policies that would restore the region to prosperity.

BLAME THE VICTIM

The adverse effects of a eurozone structure almost inevitably leading to divergence have been compounded by the policies that the eurozone has chosen to follow, especially in response to the euro crisis. Even
within the strictures of the eurozone, alternative policies could have been pursued. That they were not is no surprise: a central theme of this book is that the same mindset that led to a flawed structure led to flawed policies.

It is perhaps natural that eurozone’s leaders want to blame the victim, to blame the countries in recession or depression for bringing on this state of affairs. They do not want to blame themselves and the great institutions that they have helped create and which they now head. Blaming the victim will not solve the euro problem—and it is in large measure unfair. And with such a “blame the victim” mentality, it is no wonder that solidarity has been weakened.

As Greece went into crisis, it was easy to blame. If only Greece would reform—if only it stuck by the rules, brought its debt down, and overhauled its welfare, pension, and health systems—it would prosper and its problems would be easily resolved. There was, of course, much to complain about with the Greek policies and institutions. By most accounts, the economy was dominated by oligarchs (a relatively small group of families with large amounts of wealth who exert an enormous influence over the economy, dominating certain critical sectors, including banking and the media). Successive governments had run unconscionable deficits, exacerbated by perhaps even worse tax collection than in other countries in which small businesses play a large role. The issue was not whether Greece was perfect. These problems had plagued Greece even when it was growing faster than the rest of Europe. They were there when Europe decided to admit Greece to the European Union and the eurozone. The question was, what role did these problems play in the crisis? The story that it was flaws in Greece that had brought on the euro crisis might be convincing if Greece were the only country in the eurozone with difficulties. But it is not. Ireland, Spain, Portugal, Cyprus, and now even Finland, France, and Italy face severe difficulties. With so many countries facing problems, one cannot help but suspect that the problem lies elsewhere.
It is unfortunate that the first of the countries to go into crisis was Greece, for Greece’s problem enabled Germany and others to focus on the alleged failures of Greece, and especially its fiscal profligacy, while ignoring problems afflicting other countries that did not have high debts and deficits (at least before the crisis). Before the crisis, Spain and Ireland were running surpluses—their revenues exceeded their spending—and both had a low ratio of debt to GDP. If Germany’s theory that deficits and debts were the cause of crises—and thus the best crisis-prevention policy was enforcing strictures against deficits and debts—were correct, then Spain and Ireland should never have had a crisis. In the aftermath of the global financial crisis of 2008, they both saw high debts and deficits—but it was the deep crisis and its long duration that led to the debts and deficits, not the other way around.

HERBERT HOOVER FAILS AGAIN

Criticism of the euro has focused on the “programs” imposed on the crisis countries that required support—Portugal, Ireland, Greece, Spain, and, later, Cyprus. Designed by the Troika, which is the triumvirate of the International Monetary Fund, the European Central Bank, and the European Commission, these programs effectively required crisis countries to surrender large elements of economic sovereignty to their “partners” in return for the assistance. Money is lent to the crisis country (it is seldom given) but with strong conditions. The loan, together with its conditions, and the country’s timetable for meeting the conditions is called the program.

Unlike conventional loans, where lenders typically add conditions to make it more likely that the loan will be repaid, the conditionality imposed by the eurozone branches into areas not directly related to loan repayment. It attempts to ensure that the economic practices of the country conform to what the finance ministers of the eurozone countries (dominated in particular by Germany) think the country
should do. This coercion has backfired—the conditions imposed have often led to economic contraction, making it less likely that the money that was borrowed will be repaid.

These programs did save the banks and financial markets, but otherwise they were a failure: things that should have gone down are up, and things which should have gone up are down. Debt is up, both absolutely and relative to GDP, so it is less sustainable. In many crisis countries, inequality is up, as are suicides and mass suffering, and incomes are down. As this book goes to press, only one of the crisis countries (Ireland) has returned to precrisis levels of GDP. The Troika’s forecasts were consistently very much off the mark. They predicted that the crisis countries would return quickly to growth. The depth and duration of the recessions were far greater than their models had anticipated.

AUSTERITY

There were two critical parts of each of the programs—macroeconomics, focusing on cutbacks in expenditures, and structural reforms.

The dominant powers in the eurozone not only believed (wrongly) that low deficits and debts would prevent crises, they also believed the best way toward restoration to the health of a country in recession was a big dose of austerity—cutbacks in expenditure intended to lower the deficit. Herbert Hoover was president of the United States at the time of the 1929 stock market crash; his policies of austerity converted the crash into the Great Depression. Since Hoover, such policies have been tried repeatedly, and have repeatedly failed: the IMF tried them more recently in Argentina and East Asia. Chapter 7 will explain more fully why they failed there—and why they have failed in Europe. They fail to restore prosperity; worse, they deepen the recession. Austerity has always and everywhere had the contractionary effects observed in Europe: the greater the austerity, the greater the economic contrac-
tion. Why the Troika would have thought that this time in Europe it would be different is mystifying.

**STRUCTURAL REFORMS**

The second piece of each program was a mélange of changes to the economic and legal “rules of the game,” called structural reforms. While the Troika thought excessive spending was at the root of the crisis, they did recognize the problem posed by the euro’s rigidity.

Countries in crisis couldn’t lower their exchange rate, which would boost their trade by making exports cheaper. Thus, in the view of the Troika, to regain “competitiveness” they had to lower wages and prices and *restructure* their economies to be more efficient, for instance by getting rid of monopolies. Unfortunately, the Troika did a terrible job in identifying the critical structural reforms. Some of the reforms focused on trivia; others might be important for standards of living over the long run but would have little short-term effect on the current account deficit. Chapter 8 will show that some of the reforms were even counterproductive, at least in the short run, as far as restoring the economies to health.

Of course, some of the Troika reforms led to lower wages directly (by weakening workers’ bargaining rights) and indirectly (by increasing unemployment). The Troika hoped that the lower wages would lead to lower prices of export goods, and thus higher exports. In most cases, though, the increase in exports was disappointing.

There were, of course, alternative ways by which the eurozone could have brought about adjustment. If German wages and prices had risen, the value of the euro would have fallen, and thus the crisis countries would have become globally more competitive. This would have been a far more efficient way of adjusting—the costs imposed on Germany would have been small relative to those now being imposed on the crisis countries. But this would have put a little more of the bur-
den of adjustment on Germany, and Germany would not have any of it. They have become the dominant country within the eurozone, and as such, they could ensure that all of the burden of adjustment rest on their poorer “partners,” the countries in crisis.

Thus, both austerity and the structural reforms failed to bring the crisis countries back to prosperity. By blaming the countries and focusing on fiscal deficits, Germany and others in the eurozone had misdiagnosed the source of the problem. What is needed is not structural reform of individual countries—especially when they are so often poorly conceived, ill-timed, and even counterproductive—so much as structural reform of the eurozone. Of course, every country needs structural reforms. In the United States we should reform health care, education, energy, intellectual property, and transportation. Countries that do not make such changes in a timely way will suffer lower living standards. Such reforms are likely to be especially relevant for poorer countries—like Greece. There is obviously something holding them back. The desirability of such reforms is not the issue. However, successful reform requires careful sequencing and pacing, and citizens’ buy-in—their ability to see the benefits of the policies. It does little good to say that in the long run these policies will make one better off.25

The Troika has done an amazingly bad job of selling the structural reforms that it has attempted to impose on the citizens of the crisis countries, because the timing and sequencing is wrong and partly because many of the reforms are, at best, questionable. No salesman, no matter how good, could have “sold” them. We’ll see ample evidence in the chapters that follow.

THE PUZZLE OF COUNTERPRODUCTIVE POLICIES

One has to ask, in the case of the programs in the crisis countries, why lenders (the Troika) would impose counterproductive conditions that
reduced the likelihood of repayment. Was it that the lenders really thought their programs would quickly restore prosperity? The fact that their forecasts were wrong, and repeatedly so, and by large amounts, is consistent with this hypothesis. But, given the history of failed austerity programs, one has to ask, why would anyone believe they would work in Europe when they failed elsewhere?

I have already suggested part of the answer: ideology, deeply held beliefs about how the economy functions, which change little, if at all, as evidence against these beliefs mounts. Even more technically driven “modelers,” providing numerical forecasts of the economy, are influenced to some extent by such beliefs.²⁶

But this may not provide a full explanation. Alternatively, there might have been a political agenda—bringing down left-wing governments, teaching electorates in other countries the consequences of electing such governments, and making it more likely that a conservative economic and social agenda would prevail more broadly within Europe. Discussions with some of Europe’s leaders involved in the euro crisis leave me with the impression that this political agenda played some role.²⁷

Moreover, governments are complex institutions. The arrangements underlying the European social model—Europe’s economic system, which combines a market economy with strong systems of social protection and often a more active engagement of workers in economic decision-making than characterizes America’s “shareholder capitalism”²⁸—often have the least support from each country’s finance ministry, the true architects of the programs imposed on the crisis countries. Perhaps the finance ministries see this as an opportunity to do abroad what they cannot do at home.

Finally, many have argued that there is an element of vindictiveness, almost anger—at least in the conditions imposed on Greece—at the seeming defiance of its leaders, such as when they turned to a referendum to assess popular support for the programs being imposed
(see chapter 10). It is hard to believe that responsible officials in the eurozone would make an entire nation suffer simply because they disagree with a country’s choice of leaders, or that they would impose conditions they believed might not be in the best interests of the country out of spite. Yet the tone of some of the discussions has left the impression that this in fact may have been the case.

SOLIDARITY AND COMMON ECONOMIC UNDERSTANDINGS

When a group of countries shares a common currency, success requires more than just good institutions. (What those institutions are will be discussed extensively in later chapters.) For reforms to work, decisions have to be made, and those decisions will reflect the understandings and values of the decision-makers. There have to be common understandings of what makes for a successful economy and a minimal level of “solidarity,” or social cohesion, where countries that are in a strong position help those that are in need.

Today, there is no such understanding, no real sense of solidarity. Germany says repeatedly that the eurozone is not a “transfer union”—that is, an economic grouping in which one country transfers resources to another, even temporarily in a time of need. Indeed, just as the years since the onset of the crisis have led to economic divergence among member states, they have also led to a divergence in beliefs.

Of course, the leaders of the eurozone point to their repeated “successes” in reaching difficult agreements. Compromise is the essence of democracy, they rightly argue, and the process is slow. But sometimes compromises can be self-defeating, lacking the minimal level of coherence necessary to achieve economic success. What leaders of the eurozone boast about is more normally described as muddling through. It is possible that this compromise path could continue, at least for a few years. At each point, the afflicted country may say: “Hav-
ing invested so much to stay in the euro, surely it will pay us to do the little more that is being asked of us—even if it prolongs and deepens the depression.” In reasoning so, they fly in the face of the basic economic principle of letting bygones be bygones.29 They compound past mistakes with further mistakes. Each of the parties grabs at straws, looking for confirmation of the success of the program.30

Governments in the afflicted country do not want to tell their citizens that they have suffered in vain. Those in government at the time of a decision to leave the currency know there will be turmoil, and know that there is a large chance that in the aftermath they will be thrown out of office. They know that regardless of who is actually to blame, they will bear the brunt of the criticism if things do not go well. Thus, all around, there are strong incentives not only to muddle through but also to claim victory on the basis of the weakest of evidence; a slight decrease in unemployment, a slight increase in exports: any signs of life in the economy are now grounds for claiming that austerity programs are working.

And eventually, the recessions will come to an end. They always do. But the success of an economic policy is to be judged by how deep and long the downturn before the recovery, how much suffering, and how adverse the impacts on future economic performance. In these terms, no matter how Europe’s political leaders try to paint a rosy picture on the programs they have imposed on the crisis countries, they are a failure.

There have been some reforms in the eurozone, and they are justly celebrated. The European Stability Mechanism, a new EU institution funded by bond sales31 and capital from eurozone countries, lends to countries in trouble and has helped recapitalize Spain’s banks. But some of what has been agreed to so far is another halfway house, constructed such that it may be worse than nothing. We will explain in chapter 8 how current reforms in the banking system may actually exacerbate the problem of economic divergence noted earlier.
The problem is not only the lack of broad consensus as to what is required to ensure the healthy functioning of an economy and the eurozone. The problem is that Germany has used its economic dominance to impose its own views, and those views are not only rejected by large parts of the eurozone but also by the majority of economists. Of course, in some areas—like seeing the coming of the 2008 crisis—the majority of economists did not do well. But later in this book, I explain why they were especially right about the effects of austerity.32

Market fundamentalism, to which we referred earlier, assumed that markets on their own are efficient and stable. Adam Smith, often viewed as the godfather of this perspective, actually argued to the contrary: that there was an important role for government. Research in economics over the past half-century has shown that not only is there a presumption that markets are not efficient and stable; it has also explained why that is so and what governments can do to improve societal well-being.33

Today, even market fundamentalists (sometimes also referred to as “neoliberals”) admit that there is a need for government intervention to maintain macro-stability—though they typically argue that government interventions should be limited to a rules-based monetary policy focused on price stability—and to ensure property rights and contract enforcement. Otherwise, regulations and restrictions should be stripped away. There was no economic rationale for this conclusion—it flies in the face of a huge body of economic research showing that there is a need for a wider role for government.

The world has paid a high price for this devotion to the religion of market fundamentalism/neoliberalism, and now it’s Europe’s turn. In later chapters, we will see the role that these misguided ideas played in shaping the structure of the eurozone; in the design of policy responses to the crisis as it evolved and to the imbalances and distor-
tions that arose before 2008. The eurozone embedded many of these neoliberal ideas into the currency’s “constitution”—without providing for enough flexibility to respond to changing circumstances or revised understandings of how economies function. As a result, the European Central Bank focuses only on inflation—even in times of high unemployment.

The belief that markets are efficient and stable meant, too, that the ECB and central banks within each of the member countries studiously avoided doing anything about the real estate bubbles that were mounting in several of them in the early to mid-2000s. Indeed, a basic principle of the eurozone was that capital could move easily across borders—even when the money was being used to create real estate bubbles. But, of course, in the ideology of market fundamentalism, markets do not create bubbles.

I recall in the midst of the Spanish real estate bubble—and it should have been evident to anyone that there was a bubble—suggesting to senior people in Spain’s central bank that they take actions to try to dampen it. As is now evident, the risks to the economy of the bubble breaking were enormous. The response bordered on perplexity: Was I suggesting that the government was smarter than the market?

Central bankers with a strong belief in free markets had a common mantra, beginning with the efficiency and stability of markets: one can’t tell for sure whether there is a bubble. Even if there were a bubble, the only policy instruments that are available could do little about it and/or would distort the economy. And it is much better to simply clean up the mess after the bubble breaks than to distort the economy on the basis of a worry that there might be a bubble.

These beliefs predominated in spite of the fact that the 1990s East Asia crisis had shown that private-sector misconduct—not that of government—could bring on an economic crisis.

Beliefs about how economies function matter a great deal, and it should not be a surprise that the outcome of an economic project so influenced by flawed concepts would fall short of expectations. How-
ever flawed its origins, the euro might have worked had certain details been gotten right. But even this lack of attention to detail can partly be explained by the ideology, which held that market forces ruled, that they prevailed, whatever the institutional arrangements, provided that markets were given enough scope to do their magic. Ideology led to the belief that with free mobility of labor and capital, economic efficiency would be ensured. We'll see later why, without common deposit insurance in the banking system (where a single entity insures the deposits throughout the eurozone) and without some system of shared debt, free mobility of labor and capital ensure that economic efficiency will not be obtained.

HINTS AT A DEMOCRATIC DEFICIT

While, as we have noted, neoliberal views predominated in many finance ministries and central banks, they were far from universally shared, even within the very same countries where they had sway over finance ministries. Within all countries, there are differences in views about how the economy works, and neoliberalism is strongest in finance ministries and treasuries and weakest in labor and education ministries. Indeed, the European social model, with its strong systems of social protection, is well accepted throughout the region.

Within democracies, the particular perspectives of finance ministries and central banks should be and typically are checked and tempered; but given the structure of decision-making within supranational bodies, like the EU and the eurozone, such tempering is much less apparent. Within the current structure of the eurozone and the EU, and especially as the crisis countries’ power over economic decision-making is increasingly circumscribed and delegated to the Troika, the perspectives of finance ministries and the ECB have come to dominate.

Both the structural reforms and macroeconomic adjustments were viewed as economic programs, to be designed by experts from finance
ministries and the ECB. But these programs affected almost every aspect of society in fundamental ways. For instance, when the programs were being designed for Greece and the other crisis countries, the labor ministries were often not meaningfully involved as provisions related to labor markets and unions were being formulated. Europe might pretend that, in the end, everyone was consulted; after all, the program only went into effect if it was approved by the relevant country’s parliament. But that approval was given as if a shotgun was held to their head: it was a yes or no, typically with a short deadline, and in the background hovered the reality that a no vote would plunge the country into a deep crisis.

THEORIES OF REFORM

One of the related failures of neoliberalism was the assumption that since the perfect markets model was the ideal toward which we should strive, any “reforms” that moved us in the direction of that model were desirable. But more than a half a century earlier, that idea had been discredited in what came to be called the theory of the second best, pioneered by Nobel Prize–winning economist James Meade, my Columbia University colleague Kelvin Lancaster, and Richard Lipsey. They showed that removing one distortion, in the presence of other distortions, could even make the economy worse off. For instance, in the absence of good risk markets (where one can buy insurance for all the risks that one confronts at reasonable prices), reducing trade barriers often leads to greater risk; the greater risk induces firms to shift production to activities that yield lower returns but are safer, and the net effect is that everyone can be worse off, in marked contrast with situations where risk markets are perfect.

Other examples of second-best economics have played an important role in the failure of Europe: Free mobility of capital might make sense if there were perfect information. Money would then flow from low-return uses to high-return uses. When a country goes into
a recession, money would flow in, to help it out. Capital flows would be countercyclical—increasing in weak times, diminishing in good times, offsetting the business cycle and helping to stabilize the economy. The actual evidence is to the contrary. And the reason is that capital markets are rife with imperfections. Every banker knows that you don’t lend to someone who needs the money. That’s why capital market integration has often been associated with an increase in economic volatility—the flows are pro-cyclical and exacerbate economic fluctuations. More generally, around the world, capital has been flowing from poor countries, where capital is scarce, to the rich—exactly the opposite direction predicted by neoliberal theories. In chapter 5, we’ll examine other reasons that free capital flows—in our second-best world—have contributed to divergence, with the rich countries in Europe getting richer at the expense of the poor.

AN ALTERNATIVE WORLD IS POSSIBLE

Europe faces a choice. There are alternatives to the current structures and policies. It could make the reforms to the eurozone structure as well as the eurozone policies suggested in this chapter (and further elaborated in chapter 9), giving the euro a fighting chance of working.

These reforms begin from the premise that the euro is a Europe-wide project, and that it requires fundamental reforms in the structure and policies of the eurozone. The problems were collectively created. The only solution is a collective solution.

The reforms are based on different economic understandings than those that currently underlie the structure of the eurozone. They are designed to promote convergence and include a common bank deposit system throughout the eurozone and some form of common borrowing, such as the Eurobond.

These reforms recognize that austerity on its own does not bring growth and that there are policies that could and would do so more quickly, and with less pain restore prosperity to the afflicted coun-
tries. The adoption of these policies requires a modicum of solidarity within the eurozone.

Another alternative is a carefully designed end to the euro as it exists today, perhaps with the exit of a few countries, perhaps with the breakup of the eurozone into two or more currency areas. The breakup will be costly. But so, too, will staying together—without making the necessary reforms. The current strategy, muddling through, is enormously costly. Neither is a pleasant alternative.

The euro is often described as a bad marriage, and at various places in this book I will make use of that metaphor. A bad marriage involves two people who never should have been joined together making vows that are supposedly indissoluble. The euro is more complicated: it is a union of 19 markedly different countries tying themselves together. When a couple in trouble goes for marriage counseling, old-style counselors would try to figure out how to make the marriage work, but a “modern” one begins by asking the question: Should this marriage be saved?

The costs of dissolution—both financial and emotional—may be very high. But the costs of staying together may be even higher. One of the first lessons of economics is that bygones are bygones. One should always ask: Given where we are, what should we do? In asking what Europe should do, it does little good to opine, “They should never have married.” It is wrong, too, to ignore the emotional bonds that have been created in the years of marriage. But still, there are circumstances where, taking into account the history, it is better to part ways.

Many have worried that the end of the euro would mean turmoil in Europe and in global financial markets, exacerbating the problems that Europe already faces. That may in fact happen, but it is not necessary: there are ways to end this marriage smoothly, without trauma, and I lay out one such path in chapter 10.

If the eurozone chooses this path or is driven to it, dissolution does not require a Europe where each country has its own currency.
Several may share the same currency—perhaps the countries of northern Europe or perhaps the countries of southern Europe. But the 19-nation eurozone, slated for even more enlargement, perhaps should be thought of as an interesting experiment—like so many other experiments of monetary arrangements, like the European Exchange Rate Mechanism (ERM) that preceded it from 1979 to 1999, and which attempted to keep exchange rates between members of the ERM within a narrow band.\(^{36}\)

There is one more alternative, which I sketch out in chapter 11, *the flexible euro*, a monetary arrangement whereby each country still trades in euros, but a Greek-euro may not exchange on par with a Cypriot-euro or with a German-euro. For those invested in keeping the flame of monetary union alive, the flexible euro provides a good way forward. It recognizes that there is not now enough political solidarity and broad consensus about economic fundamentals to undertake the reforms needed to make a single currency work; but there is enough common understanding and too much political solidarity to let the idea of a common currency simply go. A flexible euro builds on the accomplishments and successes of the eurozone, but it is based in reality.

Without using these terms, and without full consciousness of the implications of what they were doing, Europe has already partially created such a system (on a temporary basis) in Cyprus and in Greece.

The long-term ambition of the flexible euro (or of the system of multiple European exchange rates described previously) may be to *eventually* create a single currency, a full monetary union. But sequencing and pacing is crucial. In the early stages of integration, Europe seemed to have recognized this: the European Coal and Steel Community (founded in 1952) only gradually evolved into the European Union.

Europe went too fast with full monetary union, without ensuring that the changes necessary for the success of a monetary union had been made. If Europe is truly committed to monetary integration, those changes can occur, though it is likely to be years or decades
before that happens. The flexible euro keeps the concept of a single currency front and center but creates a framework with sufficient flexibility that there is a prospect that it could actually work—that is, rather than leading to the depressions associated with the current regime, it would restore full employment and high growth. When solidarity among the European partners increases and the other institutions and conditions that are required to make a single-currency system work are put into place, the bands within which the different euros fluctuate can gradually be narrowed—to the point where there is only a single currency.

URGENCY

It will not do to say, Yes, we know we need a banking union (an important reform discussed later in this book), but we must construct it carefully, and that will take years. These will be years during which suffering mounts, years during which irreversible damage occurs, years during which the promises of the European project are further dashed. In my mind, the consequences of such a course are barely distinguishable from that of muddling through, keeping open the hope of reform in the future to ensure that the euro will not fall apart, but in ways that inflict unconscionable harm on the citizens of countries in trouble.

In short, Europe should move in one of two directions: there should be “more Europe” or “less Europe.” This means a choice: (a) implementing the reforms that would make the euro work for all of Europe. Doing so would require changes not only in how the eurozone works but in the creation of more economic integration—for instance, a common deposit insurance scheme for all of Europe. These changes are hardly revolutionary—elsewhere outside Europe they have worked—and the role of the “central” authority could still be much less than it is across the Atlantic in the United States; but it would be far more than it is today in the eurozone. Or (b) scaling down the currency project.
This could be done in a variety of ways described in later chapters. It could be done, for instance, with the exit of a just a few countries—I will explain later why the easiest, least costly way, would be for Germany to exit. Alternatively, and at a greater cost, it could be done with the exit of some of those in the “periphery.” A third alternative would be the formation of two blocs using a northern- and a southern-euro. A fourth approach is the flexible euro that I suggest in chapter 11. But the current halfway house is unsustainable, and attempts to sustain it by muddling through will lead to untold economic, social, and political costs.

A persuasive case can be made that the best course from a purely economic/technocratic perspective is the first, creating a eurozone that works. As a political forecaster, I would, however, place my bets on a course of muddling through, doing the minimum set of reforms that prevent the collapse of the euro but do not allow for a true recovery, at least not any time soon. One might call this course the course of brinkmanship, giving the countries enough assistance to maintain their hope but not enough to support a robust recovery. But the danger of brinkmanship is that one sometimes goes over the brink.

If the analysis of this book is correct, the euro crisis is far from over. Greece will stay in depression. It will not be able to pay back its debt. Germany may pretend otherwise, saying that the debts have only to be “reprofiled”—that is, repayments stretched out over decades. But such charades are no healthier than any other hypocrisy. The eurozone will be hit by other shocks, and the weakest countries again may be thrown into crisis—there simply isn’t enough flexibility within the eurozone, as currently constituted, for the eurozone to work for the weakest. And the eurozone itself is likely to have very slow growth at best.

The euro was always a means to an end, not an end in itself. Monetary arrangements come and go. The great achievement of the post–World War II era, the Bretton Woods monetary system, lasted less than three decades. First and foremost in our minds should be the ultimate objectives: shared prosperity within Europe and closer eco-
nomic and political integration. The monetary union increasingly appears as a well-intentioned detour in the attempt to achieve those loftier goals.

There are alternative and better ways of fostering European political integration than the monetary union, which, if anything, has actually undermined the entire European project. The best way forward requires creating a shared understanding of basic economics that goes beyond the market fundamentalism that has informed the eurozone project to date. It will require greater solidarity—of a different sort than the common commitment to blindly follow poorly designed rules that virtually guarantee depression and divergence.

The current path should be viewed as unacceptable. Europe need not abandon the euro to save the European project of closer integration—a project that is so important not only for Europe but for the entire world. But at the very least, there is a need for more fundamental and deeper changes than are now under discussion. But if those deeper reforms cannot be made—if they seem politically infeasible, because there is a lack of solidarity and/or of common understanding of what is required for a common currency to work—then the more fundamental question of the euro itself will have to be revisited.
The euro was founded with three hopes: (1) that it would bring Europe ever closer together, and was the next step in Europe’s integration; (2) that the closer economic integration would lead to faster economic growth; and (3) that this greater economic integration and the consequent greater political integration would ensure a peaceful Europe.

The founders of the euro were visionaries who tried to create a new Europe. They were argonauts in uncharted waters, traveling where no one had ever been. No one had ever tried a monetary union on such a scale, among so many countries that were so disparate. So it is perhaps unsurprising that matters turned out so different from what these visionaries must have thought.

I shall argue in this chapter that even with the best-designed euro project, the benefits of a single currency would have been more limited than its advocates claimed, that its impact on overall economic integration was likely to have been ambiguous, and that one should not have been surprised that the euro was more divisive than unifying—thus setting back political integration. The very reason that the euro was an incomplete project was the reason that it was likely to prove divisive. Far from being an important step in the creation of a