Europe
A View from 2020: The Eurozone Break-Up of 2013
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Viewed from 2020, events over the past three years and events over the coming years may still be debated. Charles Goodhart, emeritus consultant of Morgan Stanley, looks back in his old age at the difficult events of 2009-13.

Looking back now with the benefit of hindsight, the European collapse of 2013 appears from the vantage point of 2020 to have had a certain grim inevitability. Yet at the time, and in the years leading up to this debacle, it was far from clear what the future would hold, and many protagonists, especially in the policymaking arena, continued to contend that all would turn out alright, especially if their own policy proposals were followed.

Although much was made at the time of the failure of Greece to get its public finances under control, even before 2008, many of the countries with construction booms, e.g., Ireland and Spain, had been running public sector surpluses. It was not so obvious in 2007/8 that these countries would be in any future difficulty. Yet such booms, and imbalances, cannot go on forever. It should have been clear that, once the housing/finance boom (as marked in the UK as anywhere else) was punctured, it would not be easy for the countries involved to grow their output and exports sufficiently to pay off their external/internal debts without distress.

The Build-Up to Collapse

Cause of the Break-Up: Two Chief Policy Failures

The collapse was mainly caused by two key failures among European leaders. The first was the assumption that the unbalanced pattern of intra-European growth that had persisted from 1999 until 2008 could, and would, last indefinitely. The second was that these leaders could not agree on an over-arching vision for the longer-term future of the eurozone.

1. Assuming debt-fuelled growth could persist:

Imbalances that were a natural result of the construction of the eurozone were allowed to persist far too long.

- **Low interest rates = construction boom:** The entry of the southern European and peripheral countries, such as Ireland, into the eurozone (and the prospective entry of Eastern European economies) had led to a housing and construction boom in those countries as nominal interest rates fell sharply; at the same time interest rates converged to a euro area ‘norm' in the build up to the euro's launch.

• **Accelerated by bank lending:** Accelerating the boom, housing and construction sectors were enthusiastically financed by banks (and their shadows) both within and outside their own country.

• **Result = Private indebtedness and a loss of competitiveness...** The result in these countries was a massive increase in private sector indebtedness, largely matched by increasing capital inflows (from banks in Germany, France, etc.), and by the same token a large current account deficit. The construction boom of 1999-2007 in the peripheral European countries had been partly responsible for unit labour costs rising faster there than in Germany; indeed, this was part of the adjustment process in response to the boom.

• **...leading to almost insoluble problems when the boom turned to bust...** By the time the boom broke in 2007/8, several eurozone economies had seen major losses in competitiveness over that boom. If a recovery in competitiveness was to be the chosen route to salvation, then this required wage/price declines (relative to Germany), i.e., internal devaluation, of eye-popping intensity. Some succeeded (Latvia - not a eurozone member, but pegged to the euro); some made a good attempt (Ireland); but in others it was beyond the capacity of the body politic. The shift of national indebtedness from the private to the public sectors in 2008-10 deferred, but did not resolve, this issue.

• **...and a weakened banking system:** As economies had become over-indebted during the preceding boom, their banks were in particular difficulties. These banks held claims on local property, now fallen in value, and with liabilities (e.g., via the interbank market) to banks elsewhere in Europe.

2. The lack of a unified vision

The second main policy failure was that the European political leaders could not agree on an over-arching vision for the longer-term future of the eurozone, for the ultimate end-game.

One set of leaders continued to hanker for a more centralised, federal Europe with a shift of fiscal competences to a central budget, and enhanced political unification. A second set of leaders felt that the eurozone, and to a lesser extent also the single market, should comprise a narrower grouping of nation states with similar economies, and between whom labour and capital could flow very freely.

Group 1: Stick together at all costs: For this group, even the weakest member of the eurozone (Greece) had to be propped up, kept intact. Restructuring their debt, even if done in an orderly way, if that was feasible, would be a disaster and unthinkable. Entry into the euro system should be a one-way street with no exit. But in return for continuing (fiscal) support, all the member nation states should increasingly lose their independence to set their own fiscal policies, becoming more like US states in this respect. Given the difficulties that the periphery would have in regaining growth and competitiveness, that vision of the European end-game implied (fiscal) transfers from the stronger members of the eurozone of an unlimited and potentially unbounded (both in time and amount) extent.

Group 2: No ‘transfer union': Many countries, notably Germany and the Netherlands inside the eurozone, and the UK outside, were not prepared to sign up for such a ‘transfer union'. They had a different vision of the longer-term development of the eurozone. Their end-game was that the eurozone should be a narrower grouping of nation states with similar economies, and between whom labour and capital could flow very freely, more akin to the optimal currency area of theory, rather than the more inclusive eurozone of 1999-2012. In their view, fiscal transfers were a wasted subsidy to bad behaviour and replete with ‘moral hazard'. If other countries could not match up to the German example, they should be encouraged to restructure, not prevented. As countries' economic conditions changed, they should have (and utilise) the option of leaving, and possibly then subsequently rejoining, the eurozone. The eurozone should be a voluntary union of similarly minded and similar-economic nation states, not a mélange of differing economies herded together within a nascent federal United States of Europe.

The Consequences of Policy Failure...

The main consequences of these policy failures was 1) an almost inevitable over-focus on austerity measures post-recession. 2) An open debate about the European ‘end-game' that caused the markets to become, and remain, unsettled.

1) Policymakers focused excessively on austerity: Given lost competitiveness and over-indebtedness, a major focus of economic policy should have been on the questions of how to enable these countries to meet their debts through enhanced competitiveness and growth. Instead, the focus was almost entirely on additional public sector austerity. This focus was largely forced upon the politicians by the developing Greek crisis of 2009-10, whereby a vicious spiral ensued. Market doubts about the ability of the Greek government to meet its debt commitments led to higher risk premia, which led to further doubts about solvency. And such worries about Greece soon led to contagious overspills into the risk premia of other over-indebted eurozone countries.

2) Open political disagreement and so unsettled markets: Once the European crisis began to unfold, in 2010, the incompatibility of these differing visions began to cause difficulties. At each stage in the crisis, the federalists would insist that some way of helping Greece, or Spain, or Portugal must be found, and that such help would soon be on its way. But in each case, such help meant putting cash on the table, and in almost every instance those opposed to a 'transfer union' would then express doubts about whether they could/would/should put up the money. The backing and filling, the internal debate about the European end-game among the political elite was a major factor causing markets to become, and to remain, unsettled.

When the crisis did reach a local climax in spring 2010, there were hopes that the combined IMF/EU support for Greece, and the wider and bigger European Stabilisation Fund, could assuage market fears. But both of these were perceived as temporary financing measures, not a means of resolving or removing the underlying problem of over-indebtedness in these countries. Moreover, there were valid concerns that such temporary measures would not give sufficient time for readjustment in the peripheral countries, and would not be extended should there still seem to be a continuing need for that.

Response to the Crisis: Shooting the Messenger?

There were several measures employed to counter the crisis. One of the most important was the weight political leaders put on attempting to limit the capacity of the markets to destabilize the eurozone.

The Lehman collapse in September 2008 punctured the European housing/construction boom. A combination of automatic fiscal stabilisers and Keynesian stimuli led to sharply increasing fiscal deficits and rising debt ratios. Whereas in October 2008 most fiscal authorities could credibly support their own banking systems, by mid-2010 in many countries the fiscal system and the banks were struggling. The worse the fiscal position, the more threatened was the solvency of the banking system, and vice versa.

But there was also an element of self-fulfilling amplification via market pressures. Such pressures raised risk premia and interest rates and hence made sustainability harder to maintain. Many political leaders convinced themselves, though few others, that the crisis was largely the result of market over-reaction, and of failure by the credit ratings agencies to give due weight to the determination and to the reforms of the European political leaders.

The need was, therefore, felt to be to limit the capacity of markets to destabilise the eurozone.

Step 1: CDS restrictions

The first step was taken in May 2010, when Germany took measures to prevent the use of 'naked' CDS in its own country, though there was no apparent evidence that the CDS market had had any significant effect on European sovereign bond markets, or their risk premia. Although the EC encouraged the adoption of similar measures elsewhere in the EU throughout the summer of 2010, bond markets did not recover, except temporarily in July to October, and risk premia remained elevated.

Step 2: The formation of the ERA

Credit ratings agencies (CRAs) followed the market down, and a slow but steady drumbeat of ratings downgrades for the eurozone peripherals continued throughout 2010. But each such downgrade triggered off some further sales. European politicians believed that the CRAs were being willfully blind to their major reforms and restorative measures.

No more private rating agencies: On January, 2011 the European Commission announced the formation of the European Ratings Agency (ERA). Henceforth no European body, sovereign or corporate, could use, display or pay for any rating except that of the ERA. To mark its independence from politics the ERA was sited in Cologne, not Brussels or Strasbourg.

ERA rated most EU sovereigns AAA... All EU sovereigns with the exception of Greece, Iceland and the UK were then rated AAA, with a special rating of AAA* for Germany and France.

...upon which market prices failed to rise... Much to the chagrin of both the EC and of the ERA, market prices failed to respond significantly to the (changes in the) ratings applied by the ERA. But this was taken by these same groups as yet another instance and indication of the inefficiency of such market prices.

Ratings become 'fundamental' values and 'mark-to-fundamental' accounting followed: If market prices did not reflect fundamentals then what did? The answer, of course, was the ratings of the ERA. Given a rating of an asset by the ERA, another committee was established to transform that rating into a 'fundamental value', often markedly different from the current market value. Pressure was then placed, increasingly through 2011 and 2012, on the IASB to shift from a 'mark-to-market' accounting procedure to a 'mark-to-fundamental' procedure.

Banks incentivized to buy 'cheap' government bonds: 'Mark-to-fundamental' accounting had the consequence that it provided financial institutions with an incentive to buy and hold assets, such as Portuguese bonds, where market values were below 'fundamental' values. Say such a bond traded at, say, 60, but its fundamental value was assessed as 100. Its purchase would generate an immediate profit, and addition to capital, of 40, with a similar disincentive for any sale. Likewise 'mark-to-fundamentals' could dissuade purchases of assets whose market value exceeded its assessed fundamental value.

Attempts to circumvent the market power of the ERA's ratings and assessed fundamental values by the use of various ‘artificial' derivatives were vigorously resisted and combated.

The Dénouement

The initial stage of the sovereign debt crisis had built up quickly, once realisation of the parlous state of Greek public finances interacted with an appreciation of the clash of political vision on the future of the eurozone. That clash of political vision, investors decided, not only could, but probably would, leave Greece on its own and virtually unable to pay its debts (at least in full and on time).

Naturally the authorities sought to portray the plight of Greece as peculiar, even unique to Greece. While there was some truth in that, the deeper reality was that the crisis was one of over-indebtedness, with the debts distributed variously in the peripheral countries among their public sectors, banks, non-financial companies and households. The underlying problem was that the counterpart assets, castles in Spain, office blocks in Dublin, etc., were not such as quasi-automatically to generate repayment flows, for example in higher net exports. Indeed, much of the capital inflow had pushed up property prices, rather than new building, leaving the borrowers in net negative equity when the tide went out. After the event, this became obvious, but beforehand hardly anyone, whether borrower, lender, regulator, politician or economist saw the dangers.

Early Stages of the Break-Up

April 2010: Debt rollover and bank financing problems: The immediate and most pressing problem soon became one of financing the new and roll-over debt requirements of these peripheral countries. The snowball effect, whereby increasing risk margins led to higher interest rates, and higher interest rates made solvency ever more questionable, was taking hold. This vicious spiral was leading towards a collapse of some peripheral countries' bond markets, and a fiscal crisis. Moreover, many European banks held large amounts of such debt, and the bond price declines reinforced concerns about bank solvency, leading to problems for banks in refinancing themselves in wholesale markets.

May 2010: IMF/EU rescue package: The first, and immediate, objective was to stop the snowball from gathering speed. This was done in two steps. First, after - what seemed to the markets interminable delays, largely - an IMF/EU ‘rescue package' of €110 billion was put together on 2 May 2010 for Greece. Second, in order to counter the overspill onto other countries, and other markets, a number of steps were taken over the weekend of May 9. These included the assemblage of a European Stabilisation Fund, amounting to € 440 billion, (which could be called upon by countries facing acute financial difficulties, but which would require severe IMF-style constraints on their fiscal independence if they did so); and also a, less than full-hearted, agreement by the ECB to buy some bonds of those countries where the markets had become ‘dysfunctional'.

The impact on markets of such measures was reduced by the accounts of political tensions at the highest eurozone levels, and by the patent unhappiness with these developments in Germany, so risk margins and bond yields having initially retreated sharply, soon began edging back up again. But this mattered less now since a financing back-stop was now in place, if only temporarily. Such financing measures had bought time.

Summer 2010: the calm before the storm: For a time a lull in the crisis did ensue. The publication of the stress tests on the largest European banks did not do as much to restore confidence, as the prior 2009 US precedent had done, but at least it did not make matters worse, and showed that the prospects for the bigger banks were controllable. Moreover, 2Q10 proved to be the peak of the recovery for most developed economies that year, so the arriving data from July till October for out-turns remained good. The onset of the holiday season was a welcome relief, and as policymakers departed to the beaches in July/August 2010, there was some hope that an awkward corner might have been turned.

No Fundamental Solutions in Prospect

No corner was turned in summer 2010, as equity and bond markets, and forward-looking surveys, indicated. The fall in output and quite dramatic rise in the debt ratio of the eurozone peripherals apparent in the early months of 2011 made the prospect of debt repayment seem increasingly improbable. Against that background it was hard to see how and why markets in such debt would ever recover on their own.

Burden of indebtedness had simply shifted... The financing deals for Greece, and potentially for the other peripherals, simply shifted the indebtedness from weak holders to stronger creditors, such as the ECB and potentially the German taxpayer, without resolving the over-arching question of whether, and how, that debt might ever get paid back.

...with fading prospects of that debt being paid back: If one is excessively indebted, the first imperative is to stop running further huge current deficits. So, whether pressured from outside, by markets, or jumping voluntarily, the watchword for public finance in the developed world in 2010 was retrenchment. Almost all the peripherals, inside and outside the eurozone, and many of the major EU countries took strong measures to cut government expenditures and raise tax rates, simultaneously. The problem was that both the household sector, and indeed the banks, felt just as over-indebted and in need of deleveraging as governments. Companies, or at least large companies, were relatively flush with cash, but in the generally deflationary conditions of 2008-14, where was the incentive to invest?

What is so odd, looking back on the debacle from the comfort of 2020, is why anyone should have thought that fiscal austerity on its own could have been a solution for the over-indebtedness of 2009/11. If one tries to read the literature of that time, it appears that the authorities put a lot of weight then on a, largely illusory, deus ex machina entitled ‘structural reform'. Whereas the measures actually proposed under this general heading, such as making it easier for employers to fire long-term employees, reducing workers' pensions and raising retirement ages, would have long-term benefits, it is less apparent why they should have been expected to raise growth in the immediate future.

The exports of peripheral countries failed to pick up: So where was growth to come from, which might lessen the debt burden? The desideratum, of course, was that it should come from net exports, but net exports over the world as a whole must sum to zero. The decline in the euro and pound vis a vis the dollar, yen, yuan and Asian/commodity countries did provide some assistance to the Northern European states, such as Germany and UK, but even so this was partly offset by a fall in exports to the peripherals. Moreover, these latter countries depended quite heavily on tourism, and the political/social disturbances there, for example the general strikes in Greece and Spain, had the unfortunate side-effect of stunting the tourist trade during the main holiday season in 2010.

But net exports grew as domestic demand shrank: Effectively, the only way to achieve consistency between surplus/deficits in the peripheral countries, and also, though to a much lesser extent, for the UK, was for a decline in real output/expenditures. This reduced the level of private sector savings and surplus, raised the public sector deficit, and cut imports, thereby raising net exports. While this squared the circle between surpluses/deficits and incomes/expenditures, it made the debt overhang even worse. With GDP falling, tax revenues declining, and debt ratios rising even further, and fast, the over-indebtedness problem rapidly came to seem insurmountable. Although the European Ratings Agency maintained its sang-froid and AAA ratings, e.g., for Ireland, Portugal and Spain, the commercial CRAs did not.

Re-instatement of QE in the UK... As an offset to the general shift towards fiscal austerity in 2010, apart from just a vague hope that something (new innovation, ‘structural reform', demand from China) would turn up, there was one available strategy, which was to use monetary easing to counteract fiscal deflation. With nominal interest rates already nearly at zero, that implied a return to greater use of credit and quantitative easing, thereby also driving down relative exchange rates, and putting further downwards pressure on real interest rates from higher expected future inflation.

When the first disappointing estimate of GDP in the UK for 3Q appeared in October 2010, a heated debate ensued in the MPC there. On the one hand disappointing output growth, a fall in exports to Southern Europe, rising unemployment, especially as individuals were shifted from disability benefit to unemployment benefit, strikes and social disaffection in response to the expenditure cuts, and the prospect of continuing fiscal austerity, all served to press the argument for a vigorous re-start to QE. On the other hand, both inflation and inflation expectations remained above the desired level, with the prospect of the sharp rise in VAT yet to come; QE had not been a panacea before, and it was unclear whether QE and potential future inflation would be consistent with the mandate of achieving the two percent inflation for CPI, which was required of the MPC. The final decision to reinstate QE, and on a large scale, was finely balanced.

...but not in the eurozone... While the decision to go for further monetary easing was difficult in the UK, it was impossible to take this route in the eurozone. The country that benefited most from the decline in the value of the euro was Germany, and the rate of growth of Germany in 2H10 was better than in any other eurozone country. Although credit expansion and the broad monetary aggregates in the eurozone as a whole remained sluggish, the Germans, and several of their northern supporters, such as Austria and the Netherlands, could see no case for monetary expansion in the eurozone as a whole, simply in order to benefit the countries in difficulty in southern Europe.

...or the US: Similarly, in the US, there was insufficient consensus on the FOMC to enable further resort to CE or QE. The continued high level of the monetary base and concerns about future inflationary dangers and about the constitutional propriety of credit and/or quantitative easing, left the majority in doubt at the wisdom of pursuing QE further. This was in spite of the fact that the housing market continued to weaken quite sharply and unemployment remained depressingly high.

And QE's prospects for success had anyway faded: There was a further problem in trying to use monetary expansion as a counterweight to fiscal austerity. This was that the weakness of the banks and the prospective introduction of tougher regulations, despite the welcome delays announced in July 2010, meant that the banks had no enthusiasm; indeed, they claimed little capacity, to expand their balance sheets. Thus QE, and CE, simply generated ever-larger cash balances for banks at their central banks, an outcome which unduly frightened those who saw future inflationary dangers from such a build-up of ‘excess' balances at the central nanks. This argument was eerily reminiscent of the Fed's concern with similar ‘excess' cash balances in 1937. Thus one major channel for expansion via monetary easing appeared to be largely blocked off.

The Final Stages of the Crisis

5 August 2011 - German objection to EFSF extension: It was at this stage, on August 5, 2011, that the final stage of the crisis began. The trigger was an announcement by a senior official in the German Ministry of Finance that under no circumstances would Germany agree to any extension of the European Stabilisation Fund. During the subsequent press conference, the official said that, if the Southern European countries had failed to achieve a recovery through their own reforms that would enable them to stand on their own feet by 2013, then some other means with dealing with their debt would have to be found. This announcement was taken by all market participants as implying that some form of debt restructuring for several of these countries would, almost inevitably, take place in 2013; and, as one would expect, the effect of that on current bond prices was immediate.

With yields going up, and bond markets in these countries effectively shutting, several of the affected countries, such as Portugal and Spain, immediately applied to draw on funding from the European Stabilisation Fund. This, of course, put further pressure on the need for support from the German taxpayer, and made the Germans, and their supporters, even more determined that the ESF should not be continued indefinitely.

Debt restructuring came to seem inevitable: Such economic and market developments led virtually everyone, with the exception of a few super-optimists in the EC, to appreciate that the game was up, and that, at a minimum, some form of restructuring of the debt burden of such over-indebted countries would be necessary. Such pessimism was further reinforced by additional gloomy data on GDP from these countries for 2Q11 arriving in late-summer 2011. But how was this restructuring to be undertaken and where would the burden fall? In particular banks throughout the eurozone held large volumes of such debt, much of which was being used as collateral against borrowing from the ECB, and some of which was held directly via bond purchases of the ECB.

February 2012: First debt restructuring negotiations: The first proposal was to restructure the outstanding debt of the peripheral countries involved into zero coupon long-dated nominal bonds with a final bullet repayment. These bonds' present value in July 2011 would be equal to the nominal outstanding value of existing debt, i.e., that there would be no reduction in nominal debt, but that the resulting cash flows would be pushed out into the far future. With no default, the European Ratings Agency (ERA) would continue to give such debt an AAA rating, and, under the mark-to-fundamental procedure, earlier described, banks could continue to hold these at face value on their books. While this seemed in principle a neat way of handling the problem, the calculated nominal end value of the debt that would have to be ultimately repaid was so enormous that the whole exercise was perceived as pure artifice.

2012: Growing discontent across Europe: Meanwhile, the peripheral nations themselves were becoming increasingly unhappy at the prospect of interminable negative growth, decay and austerity. There was a need to break away from this appalling set of constraints. Fortunately, there was no extremist political ‘ism', as there had been with communism and fascism in the 1930s waiting in the wings. Nevertheless, the electorates in all these countries were becoming increasingly unhappy and demanding some way out of the economic waste-land that appeared to be stretching ahead of them. Where was hope to come from?

January 2013: Madrid ‘Accord': The Prime Minister of Spain called a ‘secret' meeting of Prime Ministers from other Mediterranean countries. They discussed what additional possible measures could be undertaken, while in each case being consistent with continued membership of the eurozone. Unfortunately, the media reached the conclusion that the meeting was being held to consider a joint exit from the euro. While this was not true in fact, formal denials were not believed, especially since earlier denials that the meeting was taking place at all were soon shown to be false.

12 January 2013 retail banking crisis: Once that (unfounded) rumour hit the tabloids, a major bank run on the banks in Greece, Portugal and Spain started almost immediately, with queues of depositors trying to switch their funds into banks in Germany or France. For a few hours the ECB sought to withstand the flood of recycling the flow out of the Mediterranean countries back to the banks there. But this involved taking on ever more risky assets as collateral for these loans, exposing the ECB itself to increasing risk of loss. At this point the ECB urgently notified all member governments of the eurozone that it could not continue to recycle the flood of transfers without being formally indemnified against loss by the joint and several guarantee of all member governments, and that it needed a positive answer before markets reopened the next morning.

In such circumstances the potential extent of commitment that such an indemnification might involve was not quantifiable. Several governments, despite much soul-searching at overnight meetings, therefore felt unable to give such a commitment on behalf of their taxpayers.

17 January 2013: Grey Wednesday: It became clear that the banks in these countries were facing illiquidity and closure, since the ECB felt unable to help further. The result was then effectively inevitable, and involved, for these countries,

1. Putting in place exchange controls and an Argentine-type ‘corralito' on depositors bank withdrawals;

2. Calling a bank holiday, until new national notes, reverting to drachma, pesetas and escudos, could be printed and distributed;

3. Abandoning the euro, and passing a decree that all foreign debts, whether public or private, were now to be payable in local currency, in effect a default; and

4. Recapitalising locally head-quartered financial intermediaries by issuing them with local currency bonds, with a counterpart equity participation.

The Birth of the Medi

New currencies devalue sharply: The currencies that had exited the euro immediately suffered a major devaluation, of about 35-40%, and nominal interest rates on their bonds rose sharply. Although their departure from the euro was, in a sense, both inadvertent and unwanted, steps were put in motion to expel such countries from the EU, unless they agreed to honour their debts denominated in euro, which by then had become effectively impossible for them to do.

Further bank solvency pressure: The default of these countries, and the collapse in the euro-value of credits against them, both public and private, such as interbank claims, placed great pressure on the solvency of those banks, especially in France, Germany and Ireland, that had lent to the defaulting countries. The immediate response of governments in the EU (exclusive of the defaulters) was, as it had been in October 2008 (after the Lehman collapse) both to guarantee, once again, all bank liabilities and to purchase bank equity in sufficient amount to meet the higher Basel III core tier 1 requirements. A problem for both Ireland and Italy was that this pushed up yet further their own debt/GDP ratios which were already regarded, by markets, as dangerously high.

Another bout of contagion: The euro's foreign exchange market value against the dollar was subject to much uncertainty and enhanced volatility. On the one hand, shorn of the weaker Mediterranean brethren and ever closer to a DM grouping, it could be expected to soar. On the other, both the banks and public sector finances in the eurozone had been damaged by the default of the leavers, and so the eurozone itself was weakened. Such weakness, however, was not evenly spread, with Ireland, Italy and then France in that order falling under suspicion. Credit ratings, other than those of the ERA, for Ireland and Italy fell further, and their CDS rates rose sharply. These countries were next in line for contagion.

Different paths for Italy and Ireland: At that point, the Italians had a difficult choice to make. They could either withdraw from the (northern) euro, and put themselves in a position of leading the southern bloc of European countries, or they could try to hang on, with enforced deflation, as the ‘weakest link' of the euro. Much the same dilemma faced the Irish; rejoin sterling (an option dismissed on political grounds); go it alone (dismissed since Eire was too small on its own); join the southern bloc of countries; or tough out continuing deflation in the remaining eurozone. It was a very close call in both cases, but they chose differently. The Italians decided that they would rather dominate a Mediterranean tier of countries than be a weakened appendix to a northern eurozone, while the Irish concluded that their ability to generate FDI from the USA depended on them staying in the eurozone.

The establishment of the medi: Following the Italians' decision, a new Southern European currency, the medi, was established with an accompanying MCB (Medi Central Bank) set up in Florence. The medi depreciated further against the US dollar, while the Euro appreciated. In Germany and France those in work enjoyed sharp increases in real incomes, even though unemployment rose. Feeling richer they consumed more. The sharp decline in competitiveness in the euro-area countries led manufacturers there increasingly to invest abroad, including in the medi countries, much to the disquiet of their governments.

Imbalances finally start to correct...at enormous cost: The sharply divergent path of exchange rates, depreciating for the medi, appreciating for the euro, was accompanied by an increase in inflation in the medi countries and deflation in the euro. Real interest rates rose in the eurozone and fell in the medi countries; investment ratios and net exports fell in the euro-countries and rose in the medi countries. Consumption, as already noted, rose in the euro-countries, while in the medi countries the experience of over-indebtedness, followed by austerity and crisis, restrained consumption. At least this time the fall in real interest rates encouraged business investment, not housing and commercial property, in the southern bloc. Thus the intra-European imbalances were, finally, being corrected, but at what enormous cost?

Even after the event one has to wonder whether there could have been a better way of sorting out Europe's internal difficulties.

Lessons from the Crisis

The origins of this crisis went back a long way in history, back to the debates in the 1970s and 1980s between the French ‘monetarists' and the German ‘economists'. The French ‘monetarists' believed that political and economic union could, and should, be driven forwards by adopting monetary union. Whereas a monetary union without prior political and fiscal unification would surely cause tensions, these could, it was hoped, be creatively harnessed to push forward to ever closer union.

In contrast, the German ‘economists' felt that monetary union should properly come last in the sequential build-up to political and economic union, the final coronation of a successful process. The German economists lost the key battle in 1990 when Gemany's Chancellor Kohl agreed to accept a single European monetary system, but the debacle in Europe in 2012-13 suggests that they have won the longer war.

The crisis was essentially about the broader politics of Europe and to a lesser extent about the economic details of deficits and debt ratios.

A major political problem had been that the European executive, e.g., the President of the European Commission, was not democratically elected and had no popular mandate. Instead, they were appointed by national leaders responsible to them (i.e., to the leading national political figures) rather than to the people of Europe. Imagine how the USA might have developed if the President was appointed by the leading politicians in the big States rather than by a Presidential election. Instead, what was needed, we can see with hindsight, was a new political initiative.