Austerity

The History of a Dangerous Idea

BY MARK BLYTH

It's only common sense: when governments run big deficits, the way to restore public confidence – and prosperity – is to tighten their belts. Of course, the austerity prescription didn't work in the Great Depression, and it doesn't seem to be working now in Europe or the United States. But that hasn't stopped a surprising number of government leaders from preaching the ole time gospel.

To explain this obstinacy, most commentators look to history (German hyperinflation) or psychology (no pain, no gain) or worship of old gods (Friedrich von Hayek). But in his pathbreaking book, *Austerity: The History of a Dangerous Idea*, economist Mark Blyth offers a radically different perspective. Here, we've adapted the chapter on Europe's stubborn commitment to austerity, which threatens to blow apart both the Eurozone and the continent's grand experiment in political integration. Read it and weep.

— *Peter Passell*

ROGER CHOUINARD

It's true that Europe, especially the part of Europe that uses the euro as its currency, is not in great fiscal health. But it is not true that this came about through an orgy of public spending and borrowing.

The profligacy story is plausible only for Greece; it simply doesn't apply to the other European periphery states. Yet today, all we hear about is the bad behavior of the Greek government (along with the work-shy character of Greek labor) as the root cause of Europe's alleged sovereign debt crisis.

I stress "alleged" because while the debt-to-GDP ratios of European states have grown substantially since the start of the crisis (from an average of 70 percent in 2008 to 87 percent at the end of 2011), this is the result of the financial calamity and subsequent recession rather than the cause. As in the United States, the private debt of highly leveraged financial institutions became the debt of governments for two reasons – one familiar, and one rooted in the project of European monetary union itself.

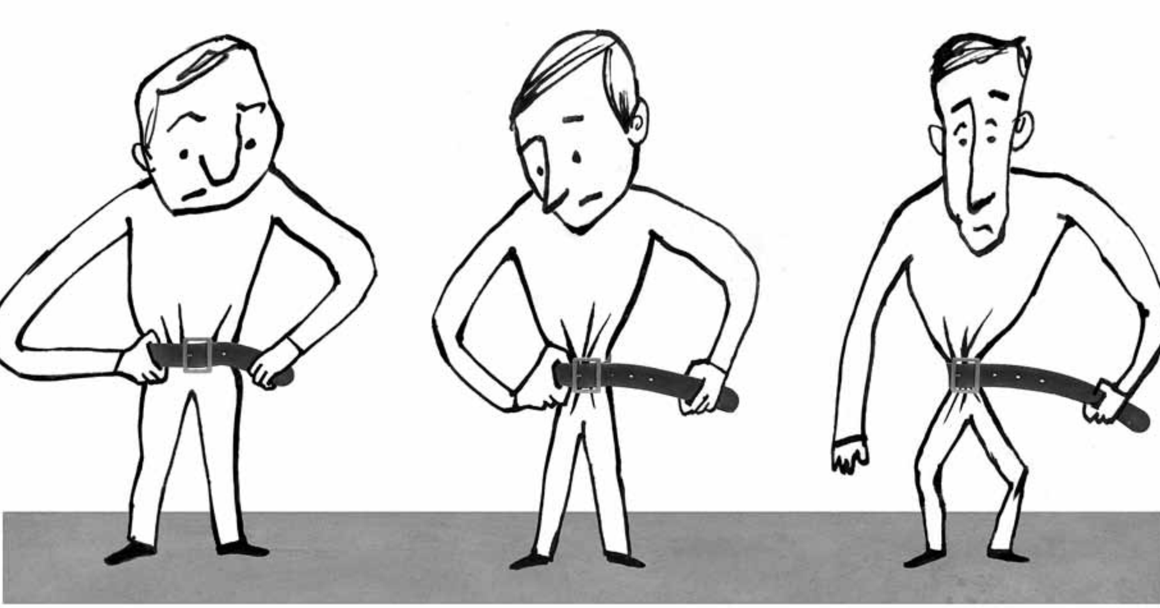
The familiar cause was the global freeze-up of banking in 2008 that led the European economy to contract. Public debt took the place of private debt as governments bailed out and recapitalized their banks even as their automatic fiscal stabilizers kicked in, driving up budget deficits. In that moment, the debt of already debt-loaded sovereigns that hadn't seemed especially risky suddenly looked scary, indeed. And as a consequence, yields on sovereign bonds shot up.

The hidden cause was the role played by European banks in generating the debt crisis. Back in late 2008, it seemed that the banks had missed the worst of it. What we had, said German politicians in particular, was a crisis of U.S. and UK banking. As German Finance Minister Peer Steinbrück put it, the real cause of the financial crisis was "the irresponsible overemphasis on the laissez-faire principle – namely giving market forces the most possible freedom from state regulation in the Anglo-American financial system."

The European banking model, by contrast, was said to be much sounder due to its conservative practices. So there was no need to throw money at the problem, as America and Britain had done. Once the immediate liquidity crunch of 2008 had passed, Germany's preferred diagnosis was that the origin of the continent's problem was state spending. Thus the fix was to cut the budgets of the undisciplined states.

There is just one problem with this diagnosis: it's wrong. The ongoing Eurozone crisis really has little to do with the profligacy of governments on the periphery. Only one of them was meaningfully profligate. Make no mistake: there is a crisis in European sovereign debt markets. But treating it as one brought about by debt-fuelled consumption and uncontrolled state spending is to confuse correlation with causation.

Rather, the crisis has almost everything to do with the incentives facing banks since the



ROGER CHOUINARD

euro was introduced. To see why, we start with the official story of the European crisis. Then we switch gears and examine why European politicians shy away from the real story – and the real reason they are now insisting on austerity.

THE CRISIS HITS EUROPE

Europe's largest economy, Germany, saw the first signs of trouble approaching in August 2007 when IKB, a Düsseldorf-based lender, had to be rescued after suffering losses on its investments in U.S. subprime securities. Thereafter, it seemed for a while that German banks had dodged the bullet until the state was forced to rescue the Hypo Real Estate Bank in 2008 after its wholesale loans to Eastern European mortgage lenders dried up. This served as an alarm that other, bigger German banks were still exposed through their loans to Austrian banks, which had loaned the equivalent of 70 percent of Austrian GDP to mortgage lenders in Eastern Europe.

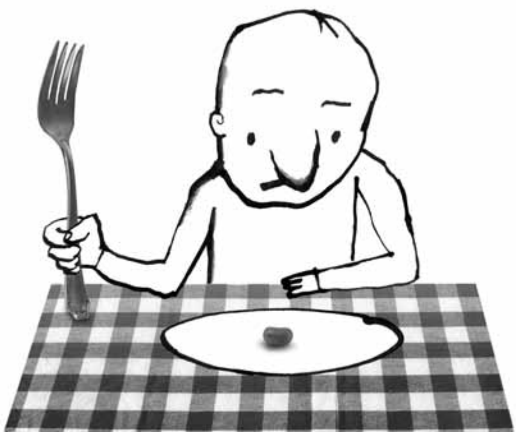
In response, the German government announced a €500 billion bank bailout fund in late 2008. Germany got a little nervous again in 2009 when several *Landesbanken*, Germany's public-private regional development banks, came a cropper. But these losses, too, were easily dealt with. By the end of 2009 the German banking system was stable, if not quite healthy. What worried the Germans was how the global credit crunch would affect their exports – their growth machine – not their exposure to U.S. mortgage bonds.

Those fears seemed justified when, in the fourth quarter of 2008, German export declines contributed 8.1 percentage points to an overall 9.4 percent annualized decline in GDP. However, a surprisingly robust rebound in demand from Asia quickly made up the loss.

True, Germany had its own stimulus program in the form of the original "cash-for-clunkers" car rebates, a boost to family allowances and most significantly, subsidies to employers to induce them to retain workers. But there was no need to turn on the money pump to fuel recovery. Little wonder, then, that the Germans looked on aghast as the United States and the UK did just that.

TWELVE-MONTH KEYNESIANS

One of the oddest aspects of the arrival of the financial crisis in Europe was the sudden embrace of Keynesian economics by almost everyone other than the European Central Bank and the German government. A large part of the reason was that reigning neoliberal ideas pretty much denied such a crisis could ever happen. So when it did, it was bound to open up some room for ideas that suggested such events could happen if you left markets alone to regulate themselves – which is exactly the Keynesian point.



It was hard to defend the logic of self-correcting markets at a time when they were so obviously not self-correcting. No one was buying the state-bad, market-good story. Indeed, traditional standard-bearers for the neoclassical cause including Eugene Fama, Edward Prescott and Robert Barro found their views confined to the opinion pages of the *Wall Street Journal*.

In any event, neoclassical macro policy was entirely focused on avoiding one problem (inflation) and providing one outcome (stable prices). As a result, it seemed to have very little to say about a world in which deflation was the worry and price stabilization meant raising – not lowering – inflation expectations. Also helping along such ideas was the fact that academic Keynesians found unexpected allies in prominent neoclassical economists and fellow travelers including Martin Feldstein and Richard Posner. Even international economic institutions famous for enforcing austerity on developing countries, such as the IMF, began to argue that monetary tools were inadequate to solve the crisis and that an active, coordinated fiscal policy was needed.

The results were both immediate and dramatic. China led with stimulus equal to a whopping 13 percent of GDP; Spain and the United States promised 5 percent. Even Germany stimulated to the tune of just under 3 percent. As Keynes' biographer Lord Skidelsky put it, we had witnessed "the Return of the Master."

The only problem was that by the time the Master arrived on the scene, some very important actors – the Germans, followed by the British and the Canadians – had already left the building. The global return of Keynes was to last only a year from start to finish.

THE GERMAN IDEOLOGY

Why were the Germans determined to halt the embrace of Keynes? Three factors are often cited. The first is Germany's collective neuralgia over the inflation of the 1920s, which inevitably leads German policymakers to the conclusion that "throwing money around" is never a good idea. Yet, while inflation-phobia did have some impact, reality is both more nuanced and more interesting.

The German inflation of the 1920s was not actually the result of monetary stimulus in trying to stave off recession. For starters, it didn't just happen to Germany. Other Mittel-European countries including Austria, Hungary and Poland all experienced episodes of hyperinflation, and none were due to Keynesian stimulus. Their common origins instead lay in how World War I had been financed – through debt rather than through taxes – which lowered postwar exchange rates and made imports

ROGER CHOUINARD

more expensive, and in turn fostered inflation.

Second, while it was caused by government policy, the German hyperinflation was intimately bound up with the desire of the Weimar government to break the stranglehold that war reparations had on the economy. France wanted Germany to pay off reparations in either gold or foreign currencies. But to earn foreign currency when its own exchange rate was falling required ever more German marks, and so inflation was stoked still higher.

Today, this specter of "hyperinflation" is invoked by German and (usually) ECB policymakers when they want to curtail criticism of austerity measures and/or go on the offensive against stimulus proposals. Yet this seems an odd thing to argue when the hyperinflation experience that still haunts Europe's most powerful country was singularly not caused by monetary stimulus.

A second, more subtle ideological argument that pushes in the same direction is that German policymakers are really "ordoliberals" (order liberals) rather than neoliberals – that the philosophy of German economic elites has never been the neoliberal mantra of "markets good, state bad." Rather, the ordoliberal tradition stresses the importance of state provision of the *rahmenbedingungen* (framework conditions) within which markets can operate in orderly fashion. According to this view, states must provide adequate social safety nets and support extra-economic institutions to allow labor to adjust skills to match market needs, to ensure cartels do not develop and to limit unproductive speculation. In short, regulation to make the market possible becomes the core of a *sozialmarktwirtschaft* (social market economy). *Ordnungspolitik* – a politics of order and stability, especially financial stability policed by a strong independent central bank – is the result.

Third, nothing succeeds like success, and the German economy has been very successful, to say the least. Despite its almost-total devastation in World War II, Germany regained its place as the largest economy in Europe by the early 1960s. Its strength was (and still is) based on the export of high-quality manufactures. This not only made West Germany rich, it enabled the Federal Republic to buy bankrupt East Germany, to integrate it with the West in the 1990s and to brush off the 2008-9 recession with a shrug.

Consequently, the Return of the Master and his stimulus measures were seen by the Germans and their allies at the ECB as the inflation camel's nose under the tent.

THE ROAD TO TORONTO

In 2009 the United States and Britain (under the Labour Party's Gordon Brown) had attacked Germany for free-riding on other countries' stimulus efforts. In fairness, when one actually examines German policy, the picture is less clear. But what the Germans were not about to do was to stimulate further since their exports were picking up and they did not – or so it seemed at that time – have a banking crisis to deal with.

Meanwhile, some of the neoliberal old guard in both Europe and the United States began to strike back. For example, former Fed Chairman Alan Greenspan went from admitting that the crisis had forced him to reconsider a "flaw" in his "ideology" of markets to defending austerity and worrying, in a very German manner, about future inflation. By mid-2010, increasingly-on-the-defensive Keynesians were pitted against a coterie of conservatives and neoclassicals. Significantly, major German politicians began to join forces with principals at the ECB to send a common message. As ECB Chief Jean-Claude Trichet put it in a much-reported broadside: "stimulate no more – it is now time for all to tighten."

A week before the full G20 meeting in June 2010, the group's finance ministers get together to lay out the agenda. This meeting signaled that global Keynesianism was about to become roadkill. As the *Financial Times* reported, the G20 finance ministers concluded that, "recent events highlight the importance of sustainable public finances, … growth-friendly measures to deliver fiscal sustainability."

Trichet explicitly rejected Keynesian demand deficiency arguments, citing the need for "a budget policy … that we would call confidence building" – one centered upon the reduction of debt. For his part, German Finance Minister Wolfgang Schäuble stressed the need for "expansionary fiscal consolidation."

At the summit, the Canadians and British sided with the Germans, leaving the Americans isolated. The final communiqué repeated the meme authored by Trichet and amplified by Schäuble of "growth-friendly fiscal consolidation."

But German inflation phobia and ordoliberalism aside, why were the Europeans suddenly so sensitive to government debt and against more stimulus spending? The answer they gave brings us back to the PIIGS (Portugal, Ireland, Italy, Greece, Spain) and their allegedly profligate ways.

THE PIIGS AND THE DISCOVERY OF SOVEREIGN DEBT: GREECE

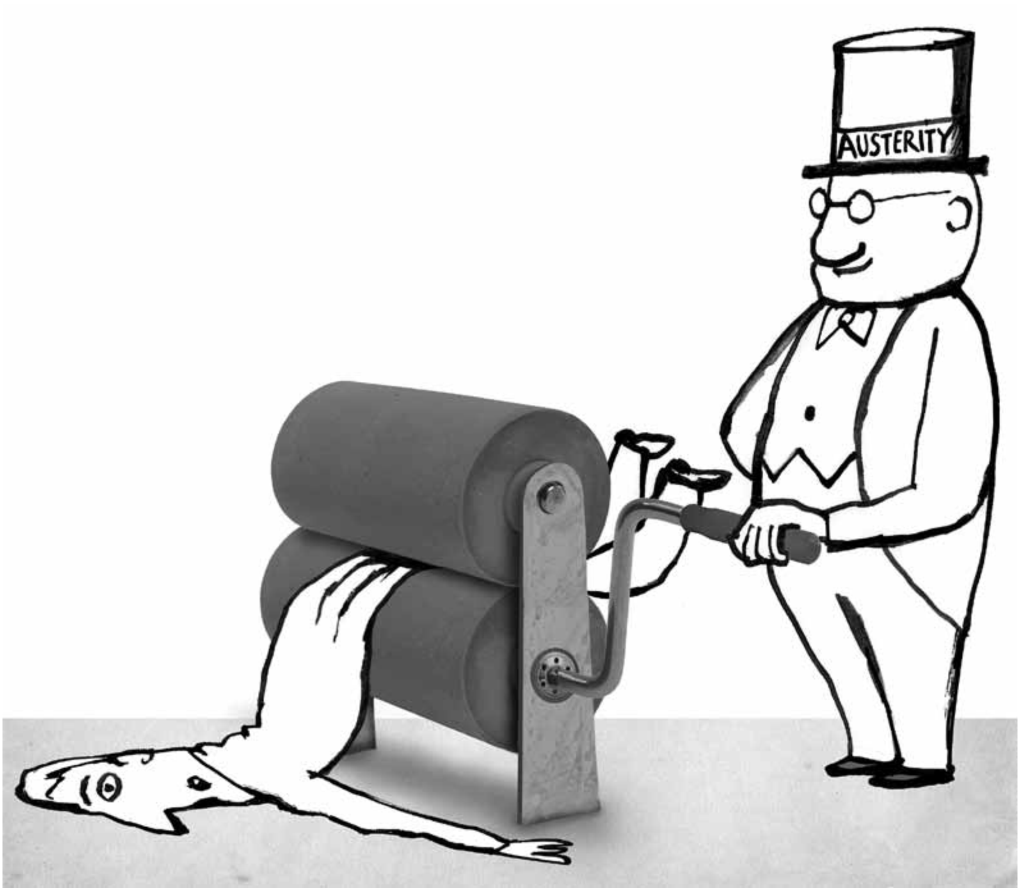
While the Germans were recovering and the Anglos were bailing, a quiet crisis was brewing elsewhere in Europe. After World War II, Greece plunged into the bloodiest civil war in modern European history. Once it ended, this already-poor country stagnated inside an unstable political order that finally collapsed into a brutal military dictatorship. When Greece emerged in the late 1970s, the EEC (as the EU was then known) provided much-needed external funding for infrastructure investment as a modern political party system took shape.

Greek politics in the 1980s and 1990s was dominated by the socialist Papandreou administrations, which sought to increase personal consumption – an understandable response to decades of instability, violence and political polarization. These governments ran persistently expansionary policies that, given low productivity growth, resulted in increasing debts and widening deficits. In fact, Greece hasn't run a budget surplus in 50 years. Debt-to-GDP passed 100 percent in 1994, hovered around 105 percent for a decade and then rose to 165 percent of GDP in late 2011.

What made this spending possible was that, upon joining the euro, Greece and the other PIIGS were effectively endowed with Germany's credit rating on the market's assumption that the ECB would back all outstanding debt issued by member-states. Greece's borrowing costs fell from 20 percent on a 10-year bond before the adoption of the euro to around 3 percent in 2005. Since the government was able to borrow more easily, money became more plentiful locally, financing both consumption and investment. However, this also raised Greece's labor costs relative to their euro neighbors, and its competitiveness fell.

Greece also had some special structural problems that turned these vulnerabilities into accidents waiting to happen. First, leaving aside the stories of endemic corruption and dubious early retirements (of which there are many), Greece had weak tax collection capacity and an even weaker political will to enforce collection, so revenues have never balanced expenditures. Second, government spending was notoriously uncoordinated, with the result that, in October 2009, the Greek government revealed that the reported fiscal deficit of 6.5 percent of GDP was, in fact, closer to 13 percent.

Unsurprisingly, investors regarded this as



the ringing of a rather loud alarm bell. The low interest rates that Greek debt had enjoyed since joining the euro shot up, which suddenly made a difficult interest payment environment an awful one. The ratings agencies took notice and downgraded Greek bonds from A to BBB-, which compounded the debt burden by spiking yields further. Debt increased as GDP collapsed.

In such a situation, the market for Greek bonds become unstable – no investor wanted to be the last one out. Compounding the systemic risk problem, observers worried that a fire sale in Greek bonds might lead the fire to spread to the other PIIGS.

The ECB (or Germany, as the ECB's major creditor) would thus have been well advised in 2009 to buy the secondary market Greek debt that was subject to near-term rollover risk and bury it somewhere deep in its balance sheet. The cost: around €50 billion. So why didn't they?

One answer lies in German politics: it was politically easier to blame the Greeks for being feckless than to explain to the German public that somebody needed to bail out Greece to stabilize the European banking system. The other answer lies in the ECB statutes that forbid one country bailing out another.

Remember, the ECB recognizes only one problem, price inflation, and has only one tool, changes in the rate of interest. As such, the ECB was unable (while the Germans were unwilling) to take responsibility. Private investors thus began to price in the risk of contagion, and the yields on all periphery bonds

ROGER CHOUINARD

began to rise – which is why Portugal, Ireland, Spain and Italy got lumped with Greece.

IRELAND AND SPAIN: BUBBLE TROUBLE

Ireland and Spain hardly belong in the same basket as Greece. Both have better reputations for tax collection. More important, Ireland and Spain were "best in class" in terms of debts and deficits going into the crisis. In 2007 Ireland's net debt-to-GDP ratio was 12 percent, while Spain's was 26 percent. In contrast, Germany's debt sat at 50 percent of GDP.

So why, then, did Ireland and Spain experience a crisis when Germany did not? The answer begins and ends with the banks – specifically with the banks' lending practices. If Greece dug itself a fiscal hole that was papered over by low interest rates, then Ireland was unaware that the hole even existed and built houses right on top of it. Spain, as we shall see, is Ireland magnified a few orders of magnitude.

Ireland, like Germany, did well prior to the crisis by exporting to countries that were growing while up-skilling its workers to take advantage of the influx of multinationals keen to use the country as a gateway to a single-market Europe. And the rise of the Celtic Tiger in the late 1990s encouraged more people to look to property as an investment.

Part of what stoked the bubble in Ireland was what also affected Greece: the bond-buying activities of major European banks that funneled cheap money to the periphery, combined with low interest rates set by the ECB. Irish property prices soared 64 percent between 2002 and 2006.

To fund lending on a massive scale, Irish banks also turned to wholesale money markets in the United States, essentially borrowing overnight to fund 30-year mortgages. The three main Irish banks' combined asset footprint at the time of the crash was around 400 percent of GDP; one of those banks, Anglo-Irish, lent €67 billion to the non-financial sector (real estate) in 2007 alone. When the interbank money market froze following Lehman's collapse, the ability of these banks to service their loans collapsed along with Irish property prices.

What we have here is what we saw in the United States and the UK – a quintessentially private-sector phenomenon that has now become a public-sector problem.

Fearing financial Armageddon, the Irish government issued a blanket guarantee for the entire banking system's liabilities. In doing so, that 400 percent of GDP in liabilities on the private sector's balance sheet became the Irish public's problem. Government debt increased to over 110 percent of GDP as the government spent some €70 billion to shore up the banking system. Meanwhile, unemployment rose to 14 percent by mid-2011, a figure that would have been higher had it not been for emigration.

Spain is really a case of "the song remains the same," albeit translated and amplified through different banking institutions. To understand where Spain is now, you have to start from the fact that in 1979 it boasted the eighth-largest industrial economy in the world. Today, it has slipped to 17th place. In the years between, Spain morphed into a banking, services and tourism hub.

This created a new vulnerability, since Spain's services income comes primarily from outside the country. When foreigners stop spending and lending, you are in serious trouble. Compounding the vulnerability, the domestic growth that Spain did enjoy was based on little more than the swapping and refinancing of houses.

The scale of the Spanish property bubble was astonishing. Real estate became so central to the economy that construction and related sectors generated one quarter of both employment and GDP. Unsurprisingly, credit expanded to meet demand. Indeed, loans to developers alone were equal to nearly half of GDP by 2007. When the bubble burst, unemployment shot up from 8 percent to 25 percent in three years, with youth unemployment reaching 52 percent in mid-2012.

Where Spain differs from Ireland – apart from the magnitude of the bust – lies in the peculiar institutions of Spanish banking. The big three Spanish banks were reasonably well hedged against domestic exposures by their international portfolios. The real problem lay in the regional savings banks, or *cajas de ahorros*. These institutions collectively made nearly half of all domestic banking loans.

The *cajas* are undercapitalized and are not coming back soon because the other side of their collective balance sheet consists of private-sector debt equal to over 200 percent of GDP, which is owed by a population of whom a quarter are unemployed.

Add to this the fact that Spanish mortgages are "recourse" loans. In the United States, you can walk away from the money owed on a house, making it the bank's problem. In Spain it remains your problem: banks can come after debtors for the full amount of the original loan, forever – and thus they have every incentive to sit tight and not allow the housing market to clear.

With both Ireland and Spain, the story of profligate government and feckless workers rings false. Certainly Spain's regional governments are burdened by some great white elephant projects – airports with no traffic, opera houses with no customers and the like. But government is hardly the primary source of Spain's debt problem.

What we have here is what we saw in the United States and the UK – a quintessentially private-sector phenomenon that has now become a public-sector problem. The difference between Ireland and Spain is that Ireland, by guaranteeing banks' debts, overnight transformed private into public debt that Dublin is now hard-pressed to pay off.

Spain, for its part, hasn't even managed to get a full accounting of its banking crisis. But the fact that it's occurring in an economy seven times larger than that of Ireland and with more opaque banking institutions is enough to make the bond markets fret about the solvency of the sovereign standing behind those banks. A Greek default would be a risk on its own. But if it spread to Ireland and then Spain, all bets would be off.

PORTUGAL AND ITALY: THE SLOW MOTION GROWTH CRISIS

Portugal is to Italy as Ireland is to Spain – only in the former two, the common problem is a combination of low growth, aging population, low productivity and institutional sclerosis. Despite all the cheap money papering over the cracks, Portugal was in trouble long before the crisis of 2008. Its two main export industries, footwear and textiles, were clobbered by Asian and Eastern European competition in the 1990s. As a consequence, its trade deficits widened and its competitiveness fell while services were left to take up the slack. Economic growth per capita averaged a miserable 0.2 percent annually between 2000 and 2010.

Demography has compounded the competitiveness problem. Eighteen percent of all

Portuguese are over 65 and the figure is rising fast, guaranteeing that a shrinking working-age population would face rising debt burdens even if the total debt remained unchanged. Before the crisis, this could be ignored because capital flows from the European core masked slow growth. But once those flows stopped and the contagion issue surfaced, what had not been a problem suddenly became one.

Italy is a giant version of Portugal – and, in many ways, the polar opposite of Spain. Italy has little private debt and massive public debt. Massive, in the sense that Italy, the 11th-largest economy in the world, has the third-largest government bond market.

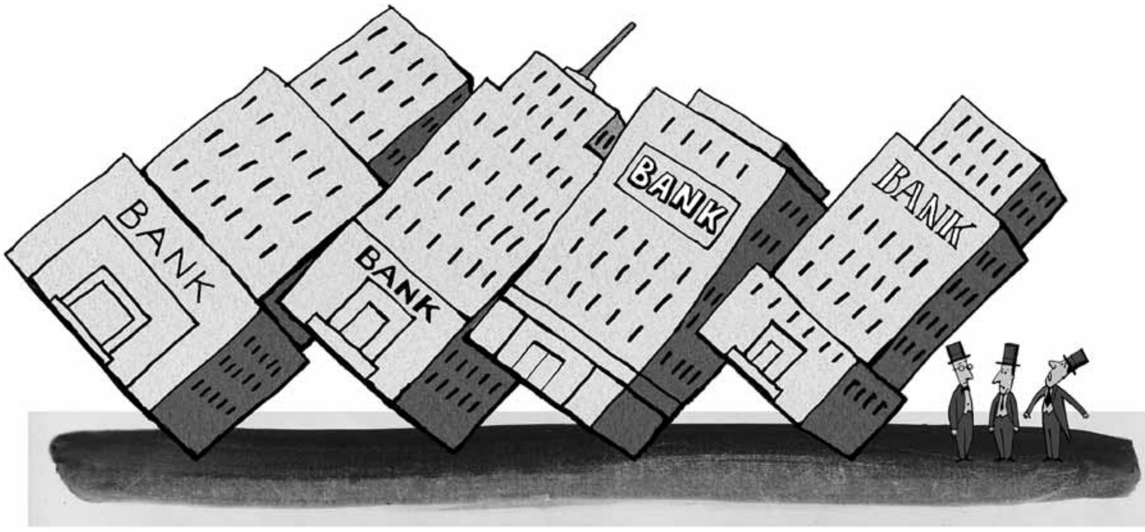
This debt accumulation was driven by the division between northern Italy, one of the world's most developed industrial economies that could boast of competitive exports, price-inelastic products and high incomes; and southern Italy, whose economy is dominated by agriculture and small, low-productivity firms. The resulting political tensions led to an equilibrium in which resources were transferred from the north to south, but politicians dared not demand that the transfers be financed with taxes. The real value of the public debt was only controlled by frequent devaluations of the exchange rate.

Joining the euro ruled out such devaluations, but the collapse in interest rates engendered by currency union sustained the unsustainable a bit longer. In 2000, Italy's net debt-to-GDP was 93 percent. In 2007, thanks to lower interest rates, it was 87 percent. Today, it is 103 percent, as the recession reduces the size of the economy even as higher interest rates and automatic fiscal stabilizers drive up the government deficit.

What wasn't an issue a few years earlier became one in 2010 when the markets noticed that Italy does, indeed, have a public debt disproportionate to its GDP, that the economy's long-term growth rate is terrible and that the shrinkage of the labor force and rapid growth of the dependent population constitute an even worse problem than the one faced by Portugal. Twenty percent of the country is already over 65 – and that figure will almost certainly top 50 percent by 2035. Meanwhile, Italians are showing no inclination to increase immigration as a way out of this demographic jam.

Italy is most assuredly in a financial pickle. But it doesn't follow that it is in trouble because of government spending. Chronic reliance on devaluations, which was replaced

ROGER CHOUINARD



after currency union by reliance on cheap capital imports, suggests a slow moving fiscal train wreck instead. The timing of the wreck was accelerated by the euro crisis and threat of contagion from other PIIGS. But, one way or another, the markets would have eventually awoken to the reality that, 30 years from now, there will be no one working in Italy to pay the interest on those 30-year bonds.

Confusing Correlation and Causation: Austerity's Moment in the Sun

With bond yields spiking in Greece, Ireland and Portugal, each received a bailout from the EU, ECB and the IMF as well as from other Eurozone governments, on condition that they implement austerity packages. Cut spending, raise taxes and all will be well – or so the story went.

In May 2010, Greece got a €110 billion loan in exchange for a combination of tax increases, a 20 percent cut in public sector pay and a 10 percent cut in pensions. The lenders forecast a return to growth by 2012.

But far from being stabilized by the bailout, the Greek economy continued to deteriorate and required a second rescue in July 2011. Another €110 billion of debt was added to the government sheet, while another 20 percent wage cut was imposed along with similar across-the-board reductions in public spending and increases in taxes. Eventually, even private-sector bondholders were forced to take a haircut on the value of Greek debt of around 75 percent. Yet despite this swan dive into austerity, which left Greece with 21 percent unemployment in late 2011, the IMF forecasts the debt will reach 145 percent of GDP by 2020.

In March 2011, it was Portugal's turn, receiving €78 billion in exchange for a similar dose of austerity. However, given the contraction in the PIIGS economies and the fear of contagion, yields on Portuguese 10-year bonds still reached 17 percent in early 2012.

It's worth noting the timing of events. Opposition to Keynesian policies intensified in the spring of 2010 just as the Greek crisis really became newsworthy. In the UK, Germany and the United States, politicians in favor of austerity zeroed in on the Greek crisis as a metaphor for the perils of Keynesianism. "Becoming Greece" became a scare-story to justify cutting back at home.

George Osborne, the new Conservative British Chancellor of the Exchequer, made repeated comparisons between the UK's fiscal situation and that of Greece. Conservative historian Niall Ferguson likened the United States to Greece, with collapse just over the horizon. Meanwhile in Europe, the ECB repeatedly alluded to the fate of Greece as the future of all European states unless budgets were cut.

The Great Bait-and-Switch

The result of all this opportunistic finger-pointing was the greatest bait-and-switch operation in modern history. What was essentially private-sector debt was rechristened "the debt" generated by "out-of-control" public spending. Yet, of all the PIIGS, only Greece was in any meaningful sense profligate.

To say that the fiscal crisis was the cause of the financial crisis is to (deliberately) confuse cause and effect. We really should know better: Carmen Reinhart and Kenneth Rogoff, the authors of *This Time Its Different* and no friends of Keynesian policy, note that 80 percent of the time there is a banking crisis, it is followed by a sovereign debt crisis. Why, then, have European policymakers chosen to misrepresent the crisis?

It's tempting to say that neither German politicians nor ECB bankers understand what's happened – that both groups are allergic to inflation, and leave it at that. But to really understand why Europe has been slashing itself to insolvency, we need to embed these very real factors within an account of how the common currency enabled the development of a system of banks that is too big to bail. European governments are rightly terrified of a banking system failure – which is the real reason austerity reigns.

THE EU AND THE EURO: A BRIDGE TOO FAR?

As a political project, the European Union has been an astonishing success. Built on the ashes of a continent ravaged twice by war in a little over 30 years, it has both helped to keep the peace and spread prosperity. If only the founders hadn't extended their ambitions to monetary union. For the euro has proved an unmitigated disaster for all, with the possible exception of the Germans.

Bringing Europe closer together through a common currency was supposed to work on multiple levels. First, it would drive toward convergence economies that were not well integrated, experienced separate business cycles and weren't specialized according to their relative economic strengths simply by using the same unit of account. Second, a common currency would eliminate inefficiencies ranging from the hassle of trading and traveling across currency zones to the cost of hedging against changes in exchange rates in business contracts. Third, it would banish the temptation to use devaluation as an alternative to fiscal prudence or labor market reform as a means of remaining competitive in trade. Among other problems, reliance on devaluation as an adjustment policy leads to inflation – a syndrome exemplified by Italy, which devalued the lira every year between 1980 and 1987, save 1984.

European leaders struggled with exchange-rate volatility through much of the postwar period, building successively more elaborate systems to tamp it down. Currency arrangements called "snakes" were replaced by "snakes in tunnels" and then by formal "exchange rate mechanisms" that were really meant as solutions to the problem of keeping up with the Germans.

The "German problem" in Europe used to be the problem of how to constrain German aggression. After 1970 it became how to remain competitive with the German economy. One way, noted above, was to serially devalue, but that generated collateral damage. The other was to tie your currency to the Deutsche mark – which, it turned out, would also hurt, but in a different way. For when you lock currencies, you are effectively betting that your industry can match German industry in costs and productivity gains.

That's a tough bet to win. And the odds were made longer by financial players willing to wager large sums that the currency pegs wouldn't hold. Defending a peg requires the will and ability to buy back your own currency with foreign currency. But if the markets can figure out how much foreign currency you have in reserve, they can outspend you, forcing devaluation and pocketing the difference between the peg and the new market value.

George Soros (and other hedge fund managers) famously did just that to the European Exchange Rate Mechanism in 1992, making billions as they blew the UK and Italy out of the system. Soros was confident there was no way the UK or Italy could sustain competition with Germany without serious cost-cutting at home – and that there would be only so much deflation and unemployment their governments could tolerate before they either ran out of foreign exchange or lost the next election. The expensive lesson: you cannot run an international exchange system in a democracy where the only way to adjust is through internal deflation of costs and prices.

Well, you can try, and the architects of the EU are nothing if not tryers. Following the ERM debacle, the Europeans doubled-down, irreversibly pegging their currencies to the German mark. National currencies would be abolished and the metaphoric presses that printed money would be handed over to the Germans to make sure that neither inflation nor depreciation of the common currency would be options. Instead, armed with a new independent central bank that had only one goal – to keep inflation around 2 percent regardless of the output and employment costs – prices and wages would automatically adjust to the external balance. In other words, they built the equivalent of a gold standard – again.

Einstein is credited with the observation that doing the same thing over and over while expecting different results is the definition of madness. The European monetary project was a bit mad from the get-go. It has only recently revealed itself to be a bald exercise in insanity.

WHY THE EURO BECAME A DOOMSDAY DEVICE

At the time of the euro's launch, there was no shortage of economists predicting it would fail. Martin Feldstein noted that the countries adopting it did not constitute an "optimal currency area," where efficiency gains could be easily realized. Paul Krugman saw trouble in the decade of recession and high unemployment necessitated by the budget cuts and inflation reduction that were set as preconditions for joining the euro area.

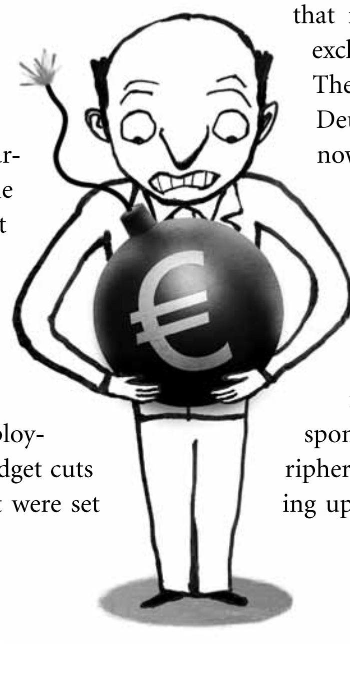
Both Feldstein and Krugman proved correct. But what really doomed the common currency project was that, instead of driving convergence among the European economies, the euro actually drove divergence in almost everything except their bond spreads.

Actually, there was a convergence of sorts: every member except Germany started to run deficits in their external accounts. To see why this happened – or, rather, how it could have persisted – consider how these deficits were financed and, more specifically, the role of European banks in the unfortunate dynamic.

In 1993, before the euro was introduced, Greek 10-year bonds yielded around 25 percent. But by 2001, yields fell to within half a percentage point of yields on German bonds. Similarly, Italian bonds fell from 13 percent yields in 1994 to becoming "almost German." Yet it is manifestly obvious that neither Greece nor Italy (nor Ireland, nor any other Eurozone member) actually earned Germany's credit status.

So why the convergence in yields? The popular answer is that the introduction of the European Central Bank and its anti-inflationary credibility signaled to bond buyers that inflation risk as well as foreign-exchange risk were things of the past. The euro was basically an expanded Deutsch mark, and everyone was now German.

Despite the fact that national bonds were still issued by the same national governments, banks and other financial players loaded up with them on the assumption that the risks had all been magically sponged away. This flooded the periphery states with cheap money, pumping up private-sector indebtedness and



ROGER CHOUINARD

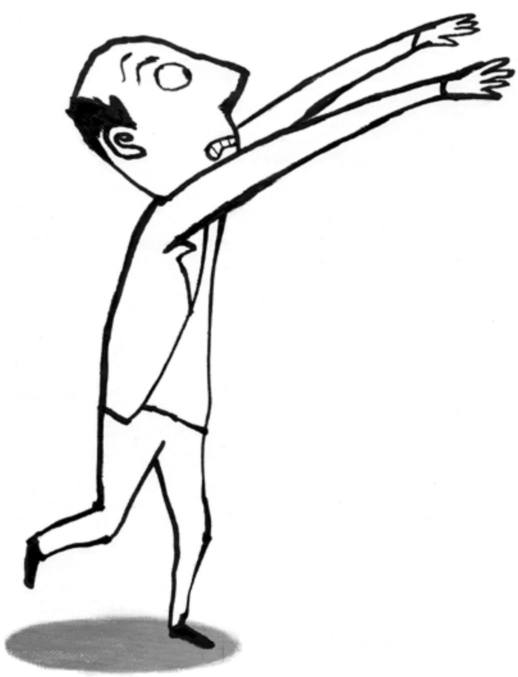
rendering them vulnerable to capital flight.

But why did investors believe that the new and untested European Central Bank would, in fact, stand behind the sovereign debt of the periphery? *The answer: they didn't need to believe anything of the sort.*

THE MOTHER OF ALL MORAL HAZARDS

If you were a European bank back in the late 1990s and you saw sovereign bond yields falling, you might be bothered because a source of risky profits was disappearing. On the other hand, if this new ECB gizmo really got rid of exchange-rate risk and took inflation off the table by housing the only European mint in Frankfurt, it really did create a banker's dream – safe assets with an upside. So you would be a fool not to load up on them, and load up they did.

But note a problem here: as yields converged, to make any real money you needed to buy an awful lot of paper. So banks swapped lower-yield German and Dutch debt for as much PIIGS debt as they could find, and then turbocharged the potential profits by leveraging their assets as high as 40-to-1.



Still, if you (a bank) knew that collapsed risk premiums on PIIGS bonds was symptomatic of buying frenzy rather than any realistic re-estimate of risk, why would you purchase the securities? You might realize that if you bought enough of them and they were to lose value, your own risk of insolvency would become a danger to your national banking system, and you would have to be bailed out. Indeed, if you were not bailed out, you would pose a risk to the whole European financial sector.

Thus the more risk that you took on, the more likely it would be covered by the ECB and/or your national government. The euro may have been a political project, but it was private-sector actors who quite deliberately jumped at the problematic deal.

Major European banks thus took on as much periphery sovereign debt as they could. Indeed, these banks were given extra incentives by the European Commission, which decreed that the securities could be used as collateral in repo transactions.

There was, however, one flaw in playing the too-big-to-fail "moral hazard" card. While bank lending crosses borders in the Eurozone, bank bailout responsibilities are still national. So when all the big banks dove into the trade, "too big to fail" for individual banks very quickly became "too big to bail" for the group as a whole.

DWARFING THE KING

The combined assets of the top-six U.S. banks in the third quarter of 2008 was equivalent to 61 percent of U.S. GDP. In light of the risk of contagion, each was "too big to fail."

By contrast, the top-three French banks had a combined asset footprint of 316 percent of France's GDP, while the top-two German banks had assets equal to "only" 114 per-

ROGER CHOUINARD

cent of German GDP. It wasn't much less scary in 2011: these figures were 245 percent and 117 percent, respectively. Deutsche Bank alone has an asset footprint of over 80 percent of German GDP and runs an operational leverage of around 40:1. This implies that a mere 3 percent turn against its assets would impair its whole balance sheet and potentially imperil the German sovereign.

The rest of core Europe hardly looks better. ING Bank in Holland has an asset footprint that is 211 percent of its sovereign's GDP. The top-four UK banks have a combined asset footprint of 394 percent of Britain's GDP. No sovereign – even one that had the advantage of printing its own money – could bail out a bank with exposures of this magnitude.

COLLATERAL DAMAGE, EUROPEAN STYLE

So let's imagine that you are a big European bank and you have executed a giant moral hazard trade against EU sovereigns. To make this work you would still need vast sums to profit from it. Where would you get the money?

One source was the U.S. money market funds, which were reaching for returns in a low interest rate environment after 2008. According to a study by Hyun Song Shin of Princeton, by September 2009 foreign banks had collectively raised over $1 trillion dollars' worth of wholesale funding in the United States.

At the time, U.S. banks sourced about half of their funds from deposits; the comparable figure for French and British banks was less than 25 percent. In June 2011, $755 billion of the $1.66 trillion in U.S. money market fund assets consisted of short-term European bank debt, with over $200 billion issued by French banks alone. Thus, once again, these banks were borrowing overnight to fund loans (this time to sovereigns) with much longer maturity.

Piling misery on misery, it also turned out all those "conservative" European banks hadn't missed the U.S. mortgage crisis after all. In fact, over 70 percent of the infamous "special purpose vehicles" set up to conceal holdings of U.S. mortgage-backed securities were set up by European banks. Thus the 2008 U.S. mortgage-markets crisis had European funders and channels. And most of those devalued assets remain stuck on the balance sheets of European banks domiciled in countries lacking the ability to print money. In 2010, then, just as the sovereign debt yields began to diverge, the ability of European banks to fund themselves through short-term U.S. borrowing collapsed in a manner that was an almost perfect rerun of the United States in 2008.

In the United States in 2008, the collateral being posted for repo borrowing began to lose value. As such, more collateral had to be posted or you ran out of liquidity really fast – which is what happened to the U.S. banking system. The same thing began to happen in Europe, where the collateral of choice was AAA-rated European sovereign debt.

Just as U.S. borrowers needed a substitute for Treasury bills and turned to AAA-rated mortgage bonds, so European borrowers had too few nice safe German bonds to pledge as collateral. So they began to pledge the periphery debt that they had purchased by the boatload. This debt was, after all, rated almost the same – as noted above, a policy that was driven by a European Commission directive that "the bonds of Eurozone sovereigns would be treated equally in repo transactions." By 2008, PIIGS debt was collateralizing 25 percent of all European repo transactions.

You can see where this is going. PIIGS sovereign bonds fell from AAA ratings to BBB and worse. As such, you needed to pledge more and more of them to get the same

True Confessions

Imagine you were a Eurozone leader determined to reveal the reason that austerity was the best among the wretched alternatives. That's an unlikely scenario if you wanted to survive politically. But just suppose. The confession would read something like this...

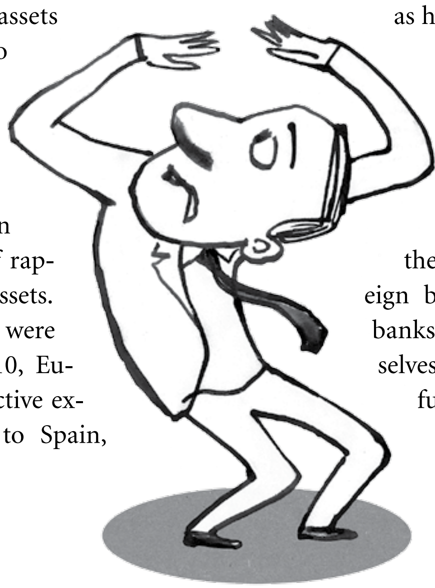
My fellow citizens, we have been telling you for the past three years that you are out of work and that the next decade will be miserable because states have spent too much. So now we all need to be austere and return to something asinine called "sustainable public finances."

What actually happened was that the biggest banks in the core countries of Europe bought lots of sovereign debt from their periphery neighbors. This flooded the PIIGS with cheap money to buy core-country products – hence the current account imbalances in the Eurozone that we hear so much about and the consequent loss of competitiveness in these periphery economies. Why make a car to compete with BMWs if the Germans will lend you the money to buy the real thing?

Then the bond market panicked over Greece, figuring out that the institutions designed to run the Eurozone couldn't deal with any of this. For one thing, we had given up our money-printing presses and independent exchange rates – our economic shock absorbers – in joining the euro. For another, the European Central Bank, the institution that was supposed to stabilize the system, had no authority to act as a lender of last resort. Whereas the Fed and the Bank of England can accept whatever assets they want in exchange for however much cash they want to print, the ECB cannot monetize or mutualize debt, or bail out member countries, or lend directly to banks in sufficient quantity. Indeed, in a banking crisis it's kind of useless.

amount of cash in a repo. Thus when those bonds fell in value, the ability of European banks to fund their highly levered structures began to crumble.

Banks with healthy assets might have been able to withstand this sudden loss of funding. But along with the U.S. mortgages cluttering up their books, European banks were stuffed full of rapidly depreciating PIIGS assets. Here, too, the exposures were astonishing: by early 2010, Eurozone banks had a collective exposure of $727 billion to Spain, $402 billion to Ireland and $206 billion to Greece. French and German banks were exposed to nearly $1 trillion in PIIGS debt. All told, S&P estimated French exposures to be as high as 30 percent of GDP.



Again, the bulk of the exposure was private-sector exposure – property lending in Spain and the like. But what mattered was how levered these banks were; once sovereign bonds lost value, European banks increasingly found themselves shut out of U.S. wholesale funding markets.

As in the United States in

ROGER CHOUINARD

Now, add to this the fact that the European banking system as a whole is three times the size and nearly twice as leveraged as the U.S. banking system, accept that it is filled with crappy assets the ECB can't take off its books and you can see why we have a problem that hasn't been solved with countless summits. All we can do is kick the can down the road, which takes the form of you suffering a lost decade of growth and employment.

You see, in bailing out the banks in 2008, we took on a whole load of new sovereign debt to pay for their losses and ensure their solvency. But the banks never really recovered. So in 2010-11, the ECB had to act against all of its instincts and flood the banks with a trillion euros at very low interest rates. The banks did use some of the money to buy short-term government debt. But most of it stayed at the ECB earning 0.25 percent interest, rather than circulate into the real economy and help you get back to work.

With the Eurozone economy in recession, people are paying back debts and no one is borrowing. This compounds the economic sclerosis, but there is literally nothing we can do about it. We need to keep the banks solvent or they will collapse, and they are so big and interconnected that even one of them going down could blow apart the whole system. As awful as austerity is, it's nothing compared to a general collapse of the financial system. Really.

So we need to deflate for as long as it takes to get the balance sheets of these banks into sustainable shape. This is why we can't let anyone out of the euro. If the Greeks left, we might weather it since most banks have managed to sell their Greek assets. But you can't dump Italy – there's too much of it. The contagion risk would destroy everyone's banks. So the only policy tool that we have to stabilize the system is for everyone to reduce prices and wages relative to Germany.

It's horrible, but there it is. Your unemployment will save the banks, and in the process save the sovereign governments that cannot save the banks themselves – and thus save the euro. We, the political classes of Europe, would like to thank you for your sacrifice.

2008, a general liquidity crunch loomed in Europe in 2010 and 2011. It was only averted by the Long-Term Refinancing Operations (LTROs) of the ECB in late 2011 and early 2012.

But this unorthodox policy of quasi-quantitative easing offered only temporary respite. Within two months of the first LTRO, sovereign bond yields were rising again and the banks those sovereigns were responsible for now had even more sovereign debt on their balance sheets – a fact not lost on investors worrying about Spain and Italy.

You can run a gold standard in a democracy (for a while) …

Another continent, another banking crisis – and yet all we heard about was profligate sovereigns spending too much. Why?

The short answer: with Europe's banks leveraged beyond anything the U.S. banks had managed, with asset footprints multiples of their sovereigns' GDPs and with balance sheets that were seriously impaired, the banks' problems become the sovereign states' problems. But unlike the U.S. case (and the UK's), the countries in question could not even begin to solve those problems since they gave up their printing presses.

Recognizing this, when France's AAA status came under threat in 2011 the bond markets were not worried about the ability of the French state to pay the pensions of teachers in Nancy or Toulouse. But they were worried about its ability to deal with any of its big three banks (Société Générale, BNP Paribas and Crédit Agricole) going bust. If states cannot inflate their way out of trouble (no printing press) or devalue to do the same (no sovereign currency), they could default. But that's out of the question because it would blow up the banking system. The only alternative is to deflate internally, squeezing prices and wages by means of fiscal austerity. This is the real reason why we all have to practice austerity – it's all about saving the banks.

THE EURO'S HUBRIS AND HAYEK'S NIGHTMARE

When bond premiums accurately reflect risk, cross-border borrowing in euros has the same consequences as borrowing in a foreign currency. Although there is no exchange rate risk to cover, if your sovereign's yields go up and your parent economy deflates, then your ability to pay back your loans declines just as if you were making payments in a declining currency.

I could go on listing the ways the euro is emerging as an ever more creative financial doomsday weapon. But what makes the situation in Europe terrible at its core isn't just these glaring holes in institutional design or the immoral hazard posed by its banks. Rather, it's the "epistemic" hubris behind the whole euro monetary project – the power of a set of economic ideas to blind Europe to the flaws in the design.

There was, of course, a worry that some states would not follow the rules, so more rules were put in place. But there was never much attention paid to the possibility that private actors, such as banks, would behave badly. Nonetheless, the EU is still blaming sovereigns, tying them down with new rules and insisting this will solve the problem. One is reminded of a drunk looking under the lamppost for the keys he dropped because that's where the light is.

Friedrich Hayek is often seen as the father of neoliberal economics. He was certainly no fan of the state. But what he really railed against was the epistemic arrogance of the planner who assumes that he could anticipate the future better than a local actor whose knowledge is more fine-grained. Although usually applied to Keynesian planners, the Hayekian critique is today more germane to EU planners, who think that by setting the right rules they can make the future conform to their expectations. In the words of the Belgian economist Paul De Grauwe, "this is like saying that if people follow the fire code regulations scrupulously there is no need for a fire brigade."

In focusing on inflation, budget deficits and sovereign debts, EU planners failed to see the incentives driving the banking system to become too big to bail. The price of their hubris is the stubborn belief among European elites that only a decade or more of unremitting austerity will suffice to keep the banks afloat. The true price of saving the banks may not just be the end of the euro, but the end of the European political project itself. M

ROGER CHOUINARD