

The European Collapse of 2012/13

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(written in August 2010)

A. Background

Looking back now with the benefit of hindsight, the disastrous European collapse of 2012/13 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 policy-making arena, continued to contend that all would turn out alright, especially if their own policy proposals were followed.

The collapse was mainly caused by two chief policy failures amongst European leaders. The first was to assume, myopically, that the unbalanced pattern of intra-European growth that had persisted from 1999 until 2008 could, and would, last indefinitely. The entry of the southern European, and peripheral, countries, such as Ireland into the eurozone (and prospective entry in Eastern Europe), had led to a housing and construction boom in those countries as nominal interest rates fell sharply, enthusiastically financed by banks (and their shadows) both within and outside their own country. 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. Although much was made of the failure of Greece to get its public finances

under control, even before 2008, in fact 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 shift of national indebtedness from the private to the public sectors in 2008/10 deferred, but did not resolve, this issue. Moreover, 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. But when the boom broke in 2007/8, recovery in competitiveness in such countries within the eurozone, or pegged to the euro (the Baltics), then required wage/price declines, i.e. internal devaluation, (relative to Germany) of eye-popping intensity, if this was to be the chosen route to salvation. Some succeeded (Latvia); some made a good attempt (Ireland); but in others it was beyond the capacity of the body politic.

The periphery of the eurozone had thus become over-indebted during the preceding boom; their banks were in particular difficulties, holding claims on local property, now fallen in value, and with liabilities (e.g. via the inter-bank market) to banks elsewhere in Europe. A major focus of 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 overflows into the risk premia of other over-indebted eurozone countries.

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. For this group, even the weakest member of the eurozone (Greece) had to be propped up, kept intact. Restructuring, 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. 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 'normal hazard'. If other countries could not match up to the Germany example, they should be encouraged to (not prevented from) restructure. 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 melange of differing economies herded together within a nascent federal United States of Europe.

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 amongst the political elite was a major factor causing markets to become, and to remain, unsettled. When the crisis did reach a local climax in May 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.

B. Shooting the Messenger?

There were several triggers for the collapse. The Lehman bankruptcy 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 appeared more like two flailing drowning swimmers dragging each other down. 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. 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. 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 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.

As is their wont, credit ratings agencies (CRAs) followed the market down, and a low but steady drumbeat of ratings downgrades for the eurozone peripherals continued throughout 2010. But each such downgrade triggered off some further sales. All this infuriated European politicians who believed that the CRAs were being wilfully blind to their major reforms and restorative measures. So, on Thursday, January 6th, 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. Its first CEO was an official from the French Tresor.

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. The UK was rated only as A, since its failure to contribute to the European Stabilisation Fund was a patent indication of deep-rooted fiscal problems. The USA was also rated as A, given the absence of any credible plan there for medium-term fiscal consolidation; note that a similar view was taken by the Chinese rating agency. The rationale for the ERA's corporate ratings was harder to discern, but research (Ozes, Strelak and Tigpus, NBER, October 2015) suggested a gravity model, wherein the rating was inversely related to the corporate's (HQ) distance from Cologne, positively related to the corporate's political value-added (the well-known Slitsch index) and to a French dummy variable (worth two notches up for all French corporates).

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. “The failure of markets to price Spanish debt in line with our AAA rating is yet another sign of their inefficiencies, herd instinct and over-reaction. Market prices do not reflect fundamental values”, J. Grand-du-Loup, CEO of ERA, June 16, 2011.

But 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, and intentionally so, markedly different from the current market value. Pressure was then placed, increasingly through 2012, on the IASB to shift from a ‘mark-to-market’ accounting procedure to a ‘mark-to-fundamental’ procedure.

This latter had the pleasing 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.

C. The Dénouement

The initial stage of the sovereign debt crisis built up quickly, once realisation of the parlous state of Greek public finances interacted with an appreciation that the clash of political vision on the future of the eurozone, see Section A, 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, with its lax public accounting, endemic corruption, cosy public sector jobs, private sector cartels, etc. 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.

But 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.

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 in order to assuage political *amour propre* – an IMF/EU ‘rescue package’ of €10 billion was put together on May 2, 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 8/9. 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 euro-zone 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.

And for a time a lull in the crisis did ensue. The publication of the stress tests on the 91 European banks in July 2010 did not do as much to restore confidence, as the prior 2009 US precedent had done, partly because concern focussed more on those not yet tested, but at least it did not make matters worse, and showed that the prospects for the bigger banks were controllable. Moreover, Q2 2010 proved to be the peak of the recovery for most developed economies (other than Germany) 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 the policy makers departed to the beaches in July/August 2010, there was some hope that an awkward corner might have been turned.

But, of course it had not been, as equity and bond markets, and forward-looking surveys, indicated that summer. 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.

If one is excessively indebted, the first imperative is to stop digging the hole even deeper by running further huge current deficits. So, whether pressured from outside, by market vigilantes, 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 2008-2014, where was the incentive to invest?

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 drastically stunting the tourist trade during the main holiday season in 2010.

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 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 disgraced commercial CRAs did not (see Section B).

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, though this is not to be recommended, 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.

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 Q4 appeared in January 2011, a battle-royal 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 finally balanced, with the Governor, Mervyn King, having to cast the decisive extra vote to break a 4/4 tie on the MPC.

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 H2 2010 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. Similarly in the USA, 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, meant that there was insufficient consensus on the FOMC to enable Chairman Bernanke to proceed with further resort to CE or QE, despite the fact that the housing market continued to weaken quite sharply and unemployment remained depressingly high.

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 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 Banks. 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.

In these circumstances, 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. 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 the end of 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 by the end of 2013; and, as markets do, the effect of that on current 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.

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 Q1 2011 arriving in mid-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.

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, whose 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.

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, with the possible exception of the Green Party, who reacted to the crisis with proposals for returning to a pre-industrial simple lifestyle.

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?

It was at that point that the incoming Prime Minister of the PP in Spain, which had defeated the previous ruling Socialists in the election in February 2011, called a (secret) meeting of Prime Ministers from other Mediterranean countries to discuss what additional possible measures could be undertaken, while in each case being consistent with continued membership of the eurozone. Unfortunately a reporter, from a well-known British newspaper, got wind of the meeting, (he was later jailed in Spain for three years for refusing to divulge his sources), and jumped to the (published) conclusion that the meeting was considering 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.

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 worse and dodgier 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.

So at the start of the second day of the run, January 13, 2013, it became clear that the banks in these countries were facing total 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;
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.

D. The Crisis Unfolds

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.

The default of these countries, and the collapse in the euro-value of credits against them, both public and private, such as inter-bank 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 bankruptcy) 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.

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, (Belgium having already split in late 2011, with Wallonia becoming part of France). 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.

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 instantly 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.

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 then 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, even fury, of their governments.

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, and this brings us to our concluding Section.

E. 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. Jacques Rueff was a leading exponent. 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 [19xx] when Kohl agreed to accept a single European monetary system in return for Mitterrand's support over German reunification, but the debacle in Europe in 2011/12 suggests that they have won the longer war.

The crisis was essentially about the broader politics of Europe and less about the economic details of deficits and debt ratios. Faced with the catastrophic break-up of the single euro in 2012/13, where was the European ideal headed? It was Nick Clegg, elected Prime Minister of the UK in 2015 under the new AV system of voting, now in coalition with the Labour Party, who took the lead in focussing on political reform as the touchstone for re-energising the European vision.

The main 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 in smoke-filled backrooms, and 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! It is a sure recipe for horse-trading and back-biting between States. Instead what was needed, as we can see with hindsight, was a new political initiative.

The lesson has, one hopes, been learnt now that economic and monetary union depend on prior political union, not vice versa. The constitutional Conference that, following Clegg's initiative, opened in 2019 and will finally report later this year in 2020, will, we hope, embody this understanding and take the European ideal down a better-designed road.