CHAPTER TEN EURODÄMMERUNG

It is now ten years since a pioneering group of EU Member States took a momentous step and launched the single currency, the euro. After many years of careful preparations, on 1 January 1999 the euro became the official currency for over 300 million citizens in the newly created euro area. And three years later, on New Year’s Day 2002, shiny new euro coins and crisp new euro banknotes began to appear, replacing 12 national currencies in people’s purses and pockets. A decade into its existence, we are celebrating economic and monetary union and the euro, and looking at how it has fulfilled its promise. There have been welcome changes since the euro was launched: today, the euro area has grown to 15 countries with the arrival of Slovenia in 2007 and Cyprus and Malta in 2008. And employment and growth are rising as economic performance improves. Furthermore, the euro is progressively becoming a truly international currency and giving the euro area a bigger voice in international economic affairs. Yet the benefits that the euro has brought are not only found in numbers and statistics. It has also introduced more choice, more certainty, more security and more opportunities in citizens’ everyday lives. In this brochure, we present some examples of how the euro has achieved, and continues to achieve, real improvements on the ground for people across Europe.* —

Introduction to “Ten Years of the Euro: 10 Success Stories,” a brochure released by the European Commission at the beginning of 2009

FOR THE PAST few years the comparison between economic developments in Europe and in the United States has seemed like a race between the halt and the lame—or, if you like, a competition over who can bungle the crisis response more. At the time of writing, Europe seemed to be nosing ahead in the race to disaster, but give it time.

If this seems hard-hearted, or sounds like American gloating, let me be clear: the economic travails of Europe are a truly terrible thing, not just because of the pain they inflict but also because of their political implications. For some sixty years Europe has been engaged in a noble experiment, an attempt to reform a war-torn continent with economic integration, setting it permanently on the path of peace and democracy. The whole world has a stake in the success of that experiment, and will suffer if it fails.

The experiment began in 1951, with the creation of the European Coal and Steel Community. Don’t let the prosaic name fool you: this was a highly idealistic attempt to make war within Europe impossible. By establishing free trade in, well, coal and steel—that is, by eliminating all tariffs and all restrictions on cross-border economic shipments, so that steel mills could buy coal from the closest producer, even if it was on the other side of the border—the pact produced economic gains. But it also ensured that French steel mills relied on German coal and vice versa, so that any future hostilities between the nations would be extremely disruptive and, it was hoped, unthinkable.

The Coal and Steel Community was a great success, and it set the model for a series of similar moves. In 1957 six European nations established the European Economic Community, a customs union with free trade among its members and common tariffs on imports from outside. In the 1970s Britain, Ireland, and Denmark joined the group; meanwhile, the European Community expanded its role, becoming a provider of aid to poorer regions and promoting democratic governments throughout Europe. In the 1980s, Spain, Portugal, and Greece, having
gotten rid of their dictators, were rewarded with membership in the community—and European nations moved to deepen their economic ties by harmonizing economic regulations, removing border posts, and guaranteeing free movement of workers.

At each stage, economic gains from closer integration were paired with an ever-closer degree of political integration. Economic policies were never just about the economics; they were always also about promoting European unity. For example, the economic case for free trade between Spain and France was just as good when Generalissimo Francisco Franco still ruled as it was after his death (and the problems with Spanish entry were just as real after his death as before), but adding a democratic Spain to the European project was a worthwhile goal in a way that free trade with a dictatorship wouldn’t have been. And this helps explain what now looks like a fateful error—the decision to move to a common currency: European elites were so enthralled with the idea of creating a powerful symbol of unity that they played up the gains from a single currency and brushed aside warnings of a significant downside.

The Trouble with (One) Money

There are, of course, real costs to the use of multiple currencies, costs that can be avoided by the adoption of a common currency. Cross-border business is more expensive if currencies must be exchanged, multiple currencies kept on hand, and/or bank accounts in multiple currencies maintained. The possibility of exchange rate fluctuations introduces uncertainty; planning becomes more difficult and accounting less clear when income and expenses aren’t always in the same units. The more business a political unit does with its neighbors, the more problematic it would be to have an independent currency, which is why it wouldn’t be a good idea for, say, Brooklyn to have its own dollar the way Canada does.

But there are also significant advantages to having your own currency, of which the best understood is the way that devaluation—reducing the value of your currency in terms of other currencies—can sometimes ease the process of adjusting to an economic shock.

Consider this not at all hypothetical example: Suppose that Spain has spent much of the past decade buoyed by a huge housing boom, financed by large inflows of capital from Germany. This boom has fueled inflation and pushed Spanish wages up relative to wages in Germany. But the boom turns out to have been inflated by a bubble and has now gone bust. As a result, Spain needs to reorient its economy away from construction and back toward manufacturing. But at this point Spanish manufacturing isn’t competitive, because Spanish wages are too high compared with German wages. How can Spain become competitive again? One way to get there is to persuade or push Spanish workers into accepting lower wages. That is in fact the only way to get there if Spain and Germany have the same currency, or if Spain’s currency is, as a matter of unalterable policy, fixed against Germany’s currency.

But if Spain has its own currency, and is willing to let it fall, its wages can be brought in line simply by devaluing that currency. Go from 80 pesetas per Deutsche mark to 100 pesetas per Deutsche mark, while keeping Spanish wages in pesetas unchanged, and at a stroke you’ve reduced Spanish wages relative to German wages by 20 percent.

Why is this any easier than just negotiating lower wages? The best explanation comes from none other than Milton Friedman, who made the case for flexible exchange rates in a classic
1953 article, “The Case for Flexible Exchange Rates,” in Essays in Positive Economics. Here's what he wrote:

*The argument for flexible exchange rates is, strange to say, very nearly identical with the argument for daylight saving time. Isn’t it absurd to change the clock in summer when exactly the same result could be achieved by having each individual change his habits? All that is required is that everyone decide to come to his office an hour earlier, have lunch an hour earlier, etc. But obviously it is much simpler to change the clock that guides all than to have each individual separately change his pattern of reaction to the clock, even though all want to do so. The situation is exactly the same in the exchange market. It is far simpler to allow one price to change, namely, the price of foreign exchange, than to rely upon changes in the multitude of prices that together constitute the internal price structure.*

That’s clearly right. Workers are always reluctant to accept wage cuts, but they’re especially reluctant if they aren’t sure whether other workers will accept similar cuts and whether the cost of living will be falling as labor costs fall. No country that I’m aware of has the kind of labor market and institutions that would make it easy to respond to the situation I’ve just described for Spain by means of across-the-board wage cuts. But countries can and do get large declines in their relative wages more or less overnight, and with very little disruption, by means of currency devaluation.

So establishing a common currency involves a trade-off. On one side, there are efficiency gains from sharing a currency: business costs decline, business planning presumably improves. On the other side, there is a loss of flexibility, which can be a big problem if there are large “asymmetric shocks” like the collapse of a housing boom in some but not all countries.

It’s hard to put a number to the value of economic flexibility. It’s even harder to put a number to the gains from a shared currency. There is, nonetheless, an extensive economics literature on the criteria for an “optimum currency area,” the ugly but useful term of art for a group of countries that would gain from merging their currencies. What does this literature say?

First, it doesn’t make sense for countries to share a currency unless they do a lot of business with one another. Back in the 1990s Argentina fixed the value of the peso at one U.S. dollar, supposedly forever, which wasn’t quite the same thing as giving up its currency but was intended to be the next best thing. As it turned out, however, it was a doomed venture that eventually ended with devaluation and default. One reason it was doomed was that Argentina isn’t all that closely linked, economically, with the United States, which accounts for only 11 percent of its imports and 5 percent of its exports. On one side, whatever gains there were from giving businesses certainty about the dollar–peso rate were fairly small, since Argentina did so little trade with the United States. On the other side, Argentina was whipsawed by fluctuations in other currencies, notably big falls in both the euro and Brazil’s real against the dollar, which left Argentina’s exports seriously overpriced.

On this score, Europe looked good: European nations do about 60 percent of their trade with one another, and they do a lot of trade. On two other important criteria, however—labor mobility and fiscal integration—Europe didn’t look nearly as well suited for a single currency. Labor mobility took center stage in the paper that started the whole optimum currency area field, written by the Canadian-born economist Robert Mundell in 1961. A rough synopsis of Mundell’s argument would be that the problems of adjusting to a simultaneous boom in Saskatchewan and slump in British Columbia, or vice versa, are substantially less if workers move freely to
wherever the jobs are. And labor does in fact move freely among Canadian provinces, Quebec excepted; it moves freely among U.S. states. It does not, however, move freely among European nations. Even though Europeans have since 1992 had the legal right to take work anywhere in the European Union, linguistic and cultural divisions are large enough that even large differences in unemployment lead to only modest amounts of migration.

The importance of fiscal integration was highlighted by Princeton’s Peter Kenen a few years after Mundell’s paper. To illustrate Kenen’s point, consider a comparison between two economies that, scenery aside, look quite similar at the moment: Ireland and Nevada. Both had huge housing bubbles that have burst; both were plunged into deep recessions that sent unemployment soaring; in both there have been many defaults on home mortgages.

But in the case of Nevada, these shocks are buffered, to an important extent, by the federal government. Nevada is paying a lot less in taxes to Washington these days, but the state’s older residents are still getting their Social Security checks, and Medicare is still paying their medical bills—so in effect the state is receiving a great deal of aid. Meanwhile, deposits in Nevada’s banks are guaranteed by a federal agency, the FDIC, and some of the losses from mortgage defaults are falling on Fannie and Freddie, which are backed by the federal government.

Ireland, by contrast, is mostly on its own, having to bail out its own banks, having to pay for retirement and health care out of its own greatly diminished revenue. So although times are tough in both places, Ireland is in crisis in a way that Nevada isn’t.

And none of this comes as a surprise. Twenty years ago, as the idea of a common European currency began moving toward reality, the problematic case for creating that currency was widely understood. There was, in fact, an extensive academic discussion of the issue (in which I was a participant), and the American economists involved were, in general, skeptical of the case for the euro—mainly because the United States seemed to offer a good model of what it takes to make an economy suitable for a single currency, and Europe fell far short of that model. Labor mobility, we thought, was just too weak, and the lack of a central government and the automatic buffering such a government would provide added to the doubts.

But these warnings were brushed aside. The glamour, if you can call it that, of the euro idea, the sense that Europe was taking a momentous step forward toward finally ending its history of war and becoming a beacon of democracy, was just too strong. When one asked how Europe would handle situations in which some economies were doing well while others were slumping—as is the case for Germany and Spain, respectively, right now—the official answer, more or less, was that all the nations of the euro area would follow sound policies, so that there would be no such “asymmetric shocks,” and if they did somehow happen, “structural reform” would render European economies flexible enough to make the necessary adjustments. What actually happened, however, was the mother of all asymmetric shocks. And it was the creation of the euro itself that caused it.

The Eurobubble

The euro officially came into existence at the beginning of 1999, although euro notes and coins didn’t arrive for another three years. (Officially, the franc, the mark, the lira, and so on became denominations of the euro, with 1 French franc = 1/6.5597th of a euro, 1 Deutsche mark = 1/1.95583th of a euro, and so on.) It immediately had a fateful effect: it made investors feel safe.
More specifically, it made investors feel safe putting their money into countries that had previously been considered risky. Interest rates in southern Europe had historically been substantially higher than rates in Germany, because investors demanded a premium to compensate for the risk of devaluation and/or default. With the coming of the euro, those premiums collapsed: Spanish debt, Italian debt, and even Greek debt were treated as being almost as safe as German debt.

This amounted to a big cut in the cost of borrowed money in southern Europe; it led to huge housing booms that quickly turned into huge housing bubbles.

The mechanics of these housing booms/bubbles were somewhat different from the mechanics of the U.S. bubble: there was much less fancy finance, more straight lending by conventional banks. Local banks, however, didn’t have nearly enough deposits to support all the lending they were doing, so they turned on a massive scale to the wholesale market, borrowing funds from banks in the European “core”—mainly Germany—which wasn’t experiencing a comparable boom. So there were massive flows of capital from Europe’s core to its booming periphery.

These inflows of capital fed booms that in turn led to rising wages: in the decade after the euro’s creation, unit labor costs (wages adjusted for productivity) rose about 35 percent in southern Europe, compared with a rise of only 9 percent in Germany. Manufacturing in Europe’s south became uncompetitive, which in turn meant that the countries that were attracting huge money inflows began running correspondingly huge trade deficits. Just to give you a sense of what was happening—and what now has to be unwound—the figure below shows the rise of trade imbalances within Europe after the introduction of the euro. One line shows Germany’s current account balance (a broad measure of the trade balance); the other shows the combined current account balances of the GIPSI countries (Greece, Ireland, Portugal, Spain, Italy).

![European Trade Imbalances](chart)

After the creation of the euro, the GIPSI economies (Greece, Ireland, Portugal, Spain, Italy) moved into huge deficits in their current accounts, a broad measure of the trade balance. Meanwhile, Germany moved into a huge matching surplus.

Source: International Monetary Fund
That widening spread is at the heart of Europe’s problems.

But few realized how great the danger was as it was building. Instead, there was complacency bordering on euphoria. Then the bubbles burst.

The financial crisis in the United States triggered the collapse in Europe, but the collapse would have happened sooner or later in any case. And suddenly the euro found itself facing a huge asymmetrical shock, one that was made much worse by the absence of fiscal integration.

For the bursting of those housing bubbles, which happened a bit later than in the United States but was well under way by 2008, did more than plunge the bubble countries into recession: it put their budgets under severe strain. Revenues plunged along with output and employment; spending on unemployment benefits soared; and governments found (or placed) themselves on the hook for expensive bank bailouts, as they guaranteed not only deposits but, in many cases, the debts their banks had run up to banks in creditor countries. So debt and deficits soared, and investors grew nervous. On the eve of crisis, interest rates on Irish long-term debt were actually a bit lower than rates on German debt, and rates on Spanish debt were only slightly higher; as I write this, Spanish rates are two and a half times German rates, and Irish rates four times as high.

I’ll talk about the policy response shortly. First, however, I need to deal with some widespread mythology. For the story you have probably heard about Europe’s problems, the story that has become the de facto rationale for European policy, is quite different from the story I’ve just told.

**Europe’s Big Delusion**

In chapter 4 I described and debunked the Big Lie about America’s crisis, the claim that government agencies caused a crisis by mistakenly trying to help the poor. Well, Europe has its own distorting narrative, a false account of the causes of crisis that gets in the way of real solutions and in fact leads to policies that make things worse.

I don’t think the purveyors of the false European narrative are as cynical as their American counterparts; I don’t see as much deliberate cooking of the data, and I suspect most of them believe what they are saying. So let’s call it a Big Delusion rather than a Big Lie. Yet it’s not clear that this makes it any better; it’s still dead wrong, and the people propounding this doctrine are just as unwilling as the U.S. right to listen to contrary evidence.

So here’s Europe’s Big Delusion: it’s the belief that Europe’s crisis was essentially caused by fiscal irresponsibility. Countries ran excessive budget deficits, the story goes, getting themselves too deep into debt—and the important thing now is to impose rules that will keep this from ever happening again.

But, some readers are surely asking, isn’t this pretty much what happened in Greece? And the answer is yes, although even the Greek story is more complicated than that. The point, however, is that it’s not what happened in the other crisis countries—and if this were only a Greek problem, it would not be the crisis it is. For Greece has a small economy, accounting for less than 3 percent of the combined GDP of the euro nations and only about 8 percent of the combined GDP of the euro nations in crisis.

How misleading is the “Hellenization” of discourse in Europe? One can, maybe, make a case for fiscal irresponsibility in Portugal, too, although not on the same scale. But Ireland had a budget
surplus and low debt on the eve of crisis; in 2006 George Osborne, now running Britain’s economic policy, called it “a shining example of the art of the possible in long-term economic policy-making.” Spain also had a budget surplus and low debt. Italy had a high level of debt inherited from the 1970s and 1980s, when policy really was irresponsible, but was steadily bringing the ratio of debt to GDP down.

As a group, the European nations now in fiscal trouble were steadily improving their debt position until the financial crisis struck.

Source: International Monetary Fund

How did all this add up? The figure above shows debt as a percentage of GDP for the “average” country now in crisis—an average, weighted by GDP, of the debt-to-GDP ratios for the five GIPSI countries (again, Greece, Ireland, Portugal, Spain, Italy). Up through 2007 this average was steadily declining—that is, far from looking as if they were being profligate, the GIPSIIs as a group seemed to be improving their fiscal position over time. It was only with the crisis that debt soared.

Yet many Europeans in key positions—especially politicians and officials in Germany, but also the leadership of the European Central Bank and opinion leaders throughout the world of finance and banking—are deeply committed to the Big Delusion, and no amount of contrary evidence will shake them. As a result, the problem of dealing with the crisis is often couched in moral terms: nations are in trouble because they have sinned, and they must redeem themselves through suffering.

And that’s a very bad way to approach the actual problems Europe faces.

Europe’s Essential Problem

If you look at Europe, or more specifically the euro area, in aggregate—that is, add up the numbers from all of the countries using the euro—it doesn’t look as if it should be in such bad shape. Both private and public debt are somewhat lower than in the United States, suggesting that there should be more room for maneuver; inflation numbers look similar to ours, with no hint of an inflationary outbreak; and, for what it’s worth, Europe as a whole has a roughly balanced current account, meaning that it has no need to attract capital from elsewhere.
But Europe is not an aggregate. It’s a collection of nations that have their own budgets (because there’s very little fiscal integration) and their own labor markets (because labor mobility is low)—but that don’t have their own currencies. And that creates a crisis.

Think about Spain, which I consider the emblematic euro crisis economy—and ignore, for a moment, the question of the government budget. As we’ve already seen, during the first eight years of the euro, Spain experienced huge inflows of money that fed a massive housing bubble, and also led to a large rise in wages and prices relative to those in the core European economies. The essential Spanish problem, from which all else flows, is the need to get its costs and prices back in line. How can that happen?

Well, it could happen through inflation in the core economies. Suppose that the European Central Bank (ECB) followed an easy-money policy while the German government engaged in fiscal stimulus; this would mean full employment in Germany even as high unemployment persisted in Spain. So Spanish wages wouldn’t rise much if at all, while German wages would rise a lot; Spanish costs would therefore hold level while German costs rose. And that would be a relatively easy adjustment on Spain’s part—not easy, just relatively easy.

But the Germans hate, hate, hate the idea of inflation, thanks to memories of the great inflation of the early 1920s. (Curiously, there is much less memory of the deflationary policies of the early 1930s, which are what actually set the stage for the rise of you-know-who. More in chapter 11.) And perhaps more directly relevant, the ECB’s mandate calls on it to maintain price stability—period. It’s an open question how binding that mandate really is, and I suspect that the ECB could find a way to rationalize moderate inflation despite what the charter says. But the mind-set is certainly one in which inflation is considered a great evil, no matter what the consequences of a low-inflation policy may be.

Now think about what this implies for Spain—namely, that it has to get its costs in line through deflation, what is known in eurojargon as “internal devaluation.” And that’s a very hard thing to achieve, because wages are downwardly rigid: they fall only slowly and grudgingly, even in the face of massive unemployment.

If there were any doubts about that downward rigidity, the track record in Europe should dispel them. Consider the case of Ireland, generally thought of as a nation with highly “flexible” labor markets—another euphemism, meaning an economy in which employers can relatively easily fire workers and/or cut their paychecks. Despite several years of incredibly high unemployment (around 14 percent at the time of writing), Irish wages have fallen only about 4 percent from their peak. So yes, Ireland is achieving internal devaluation, but very slowly. The story is similar in Latvia, which isn’t on the euro but has rejected the notion of devaluing its currency. In Spain itself, average wages have actually risen slightly despite very high unemployment, although this may be partly a statistical illusion.

By the way, if you want an illustration of Milton Friedman’s point that it’s much easier to cut wages and prices by simply devaluing your currency, look at Iceland. The tiny island nation is famous for the scale of its financial disaster, and you might have expected it to be doing even worse right now than Ireland. But Iceland declared that it had no responsibility for the debts of its runaway bankers, and it also enjoyed the great advantage of still having its own currency, which made it very easy to regain competitiveness: it simply let the krona fall, and just like that its wages in terms of the euro were cut 25 percent.
Spain, however, doesn’t have its own currency. This means that to get their costs in line, Spain and other countries will have to go through an extended period of very high unemployment, high enough to slowly grind wages down. And that’s not all. The countries that are now being forced to get their costs in line are also the countries that had the biggest buildup of private debt before the crisis. Now they’re faced with deflation, which will increase the real burden of that debt. But what about the fiscal crisis, the soaring interest rates on government debt in southern Europe? To a large extent, this fiscal crisis is a byproduct of the problem of burst bubbles and out-of-line costs. When the crisis struck, deficits soared, while debt took a sudden leap upward as the troubled countries moved to bail out their banking systems. And the usual way governments end up dealing with high debt burdens—a combination of inflation and growth, which erodes debt relative to GDP—isn’t a path available to euro area nations, which are instead condemned to years of deflation and stagnation. No surprise, then, that investors wonder whether the nations of southern Europe will be willing or able to pay their debts in full. Yet that’s not the whole story. There’s another element in the euro crisis, another weakness of a shared currency, that took many people, myself included, by surprise. It turns out that countries that lack their own currency are highly vulnerable to self-fulfilling panic, in which the efforts of investors to avoid losses from default end up triggering the very default they fear.

This point was first made by the Belgian economist Paul De Grauwe, who noted that interest rates on British debt are much lower than rates on Spanish debt—2 percent and 5 percent, respectively, at the time of writing—even though Britain has higher debt and deficits, and arguably a worse fiscal outlook than Spain, even taking into account Spain’s deflation. But as De Grauwe pointed out, Spain faces one risk Britain doesn’t: a freeze-up of liquidity. Here’s what he meant. Just about every modern government has a fair bit of debt, and it’s not all thirty-year bonds; there’s a lot of very short-term debt with a maturity of only a few months, plus two-, three-, or five-year bonds, many of which come due in any given year. Governments depend on being able to roll over most of this debt, in effect selling new bonds to pay off old ones. If for some reason investors should refuse to buy new bonds, even a basically solvent government could be forced into default.

Could this happen to the United States? Actually, no—because the Federal Reserve could and would step in and buy federal debt, in effect printing money to pay the government’s bills. Nor could it happen to Britain, or Japan, or any country that borrows in its own currency and has its own central bank. But it could happen to any of the countries now on the euro, which cannot count on the European Central Bank to provide cash in an emergency. And if a euro area country should be forced into default by this kind of cash squeeze, it might end up never paying its debts in full. This immediately creates the possibility of a self-fulfilling crisis, in which investors’ fears of a default brought on by a cash squeeze lead them to shun a country’s bonds, bringing on the very cash squeeze they fear. And even if such a crisis hasn’t happened yet, it’s easy to see how ongoing nervousness about the possibility of such crises can lead investors to demand higher interest rates in order to hold debt of countries potentially subject to self-fulfilling panic.

Sure enough, since early 2011 there has been a clear euro penalty, in which countries that use the euro face higher costs of borrowing than countries with similar economic and fiscal outlooks that retain their own currencies. It’s not just Spain versus the United Kingdom; my favorite comparison is among three Scandinavian countries, Finland, Sweden, and Denmark, all of which should be considered highly creditworthy. Yet Finland, which is on the euro, has seen its
borrowing costs rise substantially above those of Sweden, which has kept its own, freely floating currency, and even those of Denmark, which maintains a fixed exchange rate against the euro but retains its own currency and hence the potential to bail itself out in a cash squeeze.

Saving the Euro

Given the troubles the euro is now experiencing, it looks as if the euroskeptics, who warned that Europe wasn’t really suited for a single currency, were right. Furthermore, those countries that chose not to adopt the euro—Britain, Sweden—are having a much easier time than their euro-using neighbors. So should European countries now in trouble simply reverse course and return to independent currencies?

Not necessarily. Even euroskeptics like me realize that breaking up the euro now that it exists would have very serious costs. For one thing, any country that seemed likely to exit the euro would immediately face a huge run on its banks, as depositors raced to move their funds to more solid euro nations. And the return of the drachma or the peseta would create huge legal problems, as everyone tried to figure out the meaning of debts and contracts denominated in euros.

Moreover, an about-face on the euro would be a dramatic political defeat for the broader European project of unity and democracy through economic integration—a project that, as I said at the beginning, is very important not just for Europe but for the world.

So it would be best if a way could be found to save the euro. How might that be accomplished?

First, and most urgently, Europe needs to put a stop to panic attacks. One way or another, there has to be a guarantee of adequate liquidity—a guarantee that governments won’t simply run out of cash because of market panic—comparable to the guarantee that exists in practice for governments that borrow in their own currency. The most obvious way to do this would be for the European Central Bank to stand ready to buy government bonds of euro nations.

Second, those nations whose costs and prices are way out of line—the European countries that have been running large trade deficits, but can’t continue to do so—need a plausible path back to being competitive. In the short run, surplus countries have to be a source of strong demand for deficit countries’ exports. And over time, if this path isn’t going to involve extremely costly deflation in the deficit countries, it will have to involve moderate but significant inflation in the surplus countries, and a somewhat lower but still significant inflation rate—say, 3 or 4 percent—for the euro area as a whole. What this adds up to is very expansionary monetary policy from the ECB plus fiscal stimulus in Germany and a few smaller countries.

Finally, although fiscal issues aren’t at the heart of the problem, the deficit countries do at this point have debt and deficit problems, and will have to practice considerable fiscal austerity over time to put their fiscal houses in order.

So that’s what it would probably take to save the euro. Is anything like this in the cards? The ECB has surprised on the upside since Mario Draghi took over from Jean-Claude Trichet as president. True, Draghi firmly turned away demands that he buy the bonds of crisis countries. But he found a way to achieve more or less the same result through the back door, announcing a program in which the ECB would advance unlimited loans to private banks, accepting the bonds of European governments as collateral. The result is that prospects of a self-fulfilling
panic leading to stratospheric interest rates on European bonds have at the time of writing receded.

Even with this, however, the most extreme cases—Greece, Portugal, and Ireland—remain shut out of private capital markets. So they've been reliant on a series of ad hoc lending programs from the “troika” of stronger European governments, the ECB, and the International Monetary Fund. Unfortunately, the troika has consistently provided too little money, too late. And in return for this emergency lending, deficit countries have been required to impose immediate, draconian programs of spending cuts and tax hikes—programs that push them into even deeper slumps and that keep falling short even in purely budgetary terms as shrinking economies cause falling tax receipts.

Meanwhile, nothing has been done to provide an environment in which deficit countries have a plausible path to restored competitiveness. Even as deficit countries are pushed into savage austerity, surplus countries have been engaged in austerity programs of their own, undermining hopes for export growth. And far from accepting the need for somewhat higher inflation, the European Central Bank raised interest rates in the first half of 2011 to ward off an inflation threat that existed only in its mind. (The rate hikes were reversed later, but a great deal of damage had been done.)

Why has Europe responded so badly to its crisis? I've already suggested part of the answer: much of the continent's leadership seems determined to “Hellenize” the story, to see everyone in trouble—not just Greece—as having gotten there through fiscal irresponsibility. And given that false belief, there's a natural turn to a false remedy: if fiscal profligacy was the problem, fiscal rectitude must be the solution. It's economics as morality play, with the extra twist that the sins being punished for the most part never happened.

But that's only part of the story. Europe’s inability to come to grips with its real problems, and its insistence on confronting fake problems instead, is by no means unique. In 2010 much of the policy elite on both sides of the Atlantic fell head over heels for a related set of fallacies about debt, inflation, and growth. I’ll try to explain these fallacies and also, a much harder task, why so many important people decided to endorse them, in the next chapter.