ASHOKA MODY

EURO TRAGEDY

A DRAMA IN NINE ACTS

EuroTragedy

ASHOKA MODY

EuroTragedy

A Drama in Nine Acts

OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

Oxford University Press is a department of the University of Oxford. It furthers the University's objective of excellence in research, scholarship, and education by publishing worldwide. Oxford is a registered trade mark of Oxford University Press in the UK and certain other countries.

Published in the United States of America by Oxford University Press
198 Madison Avenue, New York, NY 10016, United States of America.

Library of Congress Cataloging-in-Publication Data
Names: Mody, Ashoka, author.
Title: EuroTragedy : a drama in nine acts / Ashoka Mody.
Other titles: Euro Tragedy
Description: New York City : Oxford University Press, 2018.
Identifiers: LCCN 2017046690 | ISBN 9780199351381 (hardback) |
ISBN 9780199351398 (updf) | ISBN 9780199351404 (epub)
Subjects: LCSH: Europe—Economic integration—History. |
Europe—Economic conditions—1945– | BISAC: BUSINESS & ECONOMICS / International /
Economics. | BUSINESS & ECONOMICS / Economics / Macroeconomics.
Classification: LCC HC240.M694 2018 | DDC 337.1/4209—dc23
LC record available at https://lccn.loc.gov/2017046690

1 3 5 7 9 8 6 4 2

Printed by Sheridan Books, Inc., United States of America

To Shalini,
Who never asks for anything in return

CONTENTS

LIST OF FIGURES

ACKNOWLEDGMENTS

Willy Kiekens, formerly an IMF Executive Director, suggested in a phone conversation soon after I left the IMF that I write a book explaining the euro crisis. He set me off on an amazing journey.

My greatest debt is to George Akerlof. He understood what I wanted to write long before I did. Through many lunches over five years, he gave me an opportunity to talk about my findings and ideas. These ideas crystalized at a particularly long lunch in Georgetown in late 2016, when he prodded me on potential titles for the book and then came up with one himself: "EuroTragedy: A Drama in Nine Acts."

My other mentor during these past years was André Szász. My breath was taken away by his little but magnificent book, *The Road to European Monetary Union*. Following a long phone conversation with him, I visited him twice in Amsterdam. With a twinkle in his eye, he said to me that he would be my archive. Sure enough, over a period of three years, he wrote me beautifully composed emails, sometimes twice a week. His last email to me was on December 19, 2016. In place of his customary cheer, he wrote, "This makes it clear that when member states agreed to proceed toward a common currency, there was no consensus on important political implications, notably for national sovereignty. I think it is this fact that should be stressed." Two weeks later, through a common friend I heard, with great sorrow and dismay, that André had passed away.

Among other important influences, Liaquat Ahamed read several drafts and pointed me in the direction of writing a story instead of a conventional thematically organized economics book. He even drew me a flow diagram of

how the story could evolve. Writing the book as a story has been so much fun—and it helped me recognize that often the story itself is the story.

In the honor list of those who read the entire manuscript are Madeleine Adams, Paulette Altmaier, Michael Bordo, Kevin Cardiff, James Conran, Barry Eichengreen, Henry Ergas, Edward Hadas, Juha Kähkönen, Elizabeth Litchfield, Mico Loretan, Thomas Mayer, Peter Smith, and Enzo Rossi. As the end approached, many of them became virtual coauthors in taking me to the finish line. I am grateful to them all. Their knowledge and their generosity was one of the many gifts of writing this book.

To my great delight, my 85-year old mother—a former school guidance counselor and someone who only skims the economics section of the *Times of India*—volunteered to read my final draft. By the time she completed reading the manuscript, she had strong views on needed changes; when she said the book was done, I was reassured that I was, in fact, done.

Several colleagues, friends, and family members kindly read chapters of the book. Among them were Suzanne Albers, Lee Buchheit, Ajai Chopra, Geoff Cooper, Michael Carlston, Stefania Fabrizio, Peter Hall, Rahul Jacob, Nigel Lawson, Michael Leigh, Paul Lever, Colleen McHugh, Graham McKee, Matina Meintani, Sophie Meunier, Kevin O'Rourke, Swaha Pattanaik, Morgan Steelman, Neil Unmack, and Emil Verner. David Wheeler, one of my PhD thesis advisors, played that role again with his matchless wisdom and humor. D. C. Rao, once a distinguished economist at the World Bank and ever since a spiritual teacher, acted as my guardrail. The mathematicians in the family, Krishnan and Andra, read parts of the manuscript with their customary attention to precision and logic, helping me think straight and thus greatly improving the exposition.

The Woodrow Wilson School at Princeton University was the perfect place to work on a book that aspired to blend economics, politics, and history. The school has it all: a vibrant academic community, bright and curious students, and extraordinary resources. Among colleagues, I was fortunate to learn from Yacine Ait-Sahalia, Markus Brunnermeier, Harold James, Robert Keohane, Andrew Moravcsik, and Sophie Meunier. Andy and Sophie also organized regular seminars on European economics and politics, to which they brought distinguished scholars and policymakers. Perhaps the most unexpected ideas for the book came from lively classes where my students challenged and probed. Teaching truly is an exciting way to learn. The librarians with their unflagging patience searched for the exact data and the perfect story. Elana Broch started me off, and Ashley Faulkner—for whom being a librarian is a calling—found me virtually anything I could dream of.

And Bobray Bordelon surely knows more about economic databases than any other human being.

I am grateful also to Jean Pisani-Ferry and, especially, to Guntram Wolff and Matt Dann for welcoming me over many summers to Bruegel and giving me access to their valuable platform to test some of my ideas. Jan Krahnen at Goethe University and the Centre for Financial Studies in Frankfurt also generously hosted me for a summer. Through these visits, I was able to meet and correspond with Otmar Issing, Horst Köhler, Romano Prodi, and Jean-Claude Trichet, to all of whom I am most grateful for their valuable time. Thomas Moser of the Swiss National Bank graciously gave me the opportunity to spend several weeks there.

On yet another roll of honor are my research assistants and students. With extraordinary diligence and pride in her work, Uuriintuya Batsaikhan did several iterations leading to the final production of the charts in the book. Several others helped me with the data analysis, proof reading, and editing: Nidhi Banavar, Rachel Lurie, Graham McKee, Giulio Mazzolini, Arvind Natarajan, Brandon Tan, Fabian Trottner, Aron Villarreal, Nancy Wu, and especially Junho Choi. Anton Pluschke was with me from the very start; with Daniela Gandorfer, at first, he translated German texts and gave comments on various aspects of the book. Hartley Miller and Andrew Atkins were my French consultants; and Maria Rusak worked on Italian translations. Quentin Becheau, Nick Ligthart, and Daniel Kang were students who gave me many specific data and written inputs; they also critically read large parts of the manuscript with the diligence and candor that makes students so special. Christine Östlund helped with many aspects of the book; perhaps most important, she pitilessly reminded me of opposing views and perspectives.

My editor, David McBride, gently pushed me to attempt greater clarity in my writing, all the while reassuring me that I was making progress. My previous editor, Scott Parris, was an especially important influence. He commissioned the book, commented on several drafts of chapters, and reread the final manuscript. From the very start, Scott gave me the opportunity to talk to him at great length about where I was going, and he expanded my horizons with several important suggestions. The ever-courteous Emily Mackenzie at Oxford University Press helped keep things moving. Deepti Agarwal shepherded the complex production process.

Through this all, Jyothsna, my wife for thirty-eight years, allowed the book to live with us for, oh, so many years. With her instinctive intelligence and empathy, she probably now knows more about Europe than I do. This is as much her book as it is mine.

LIST OF ABBREVIATIONS

ABCP	Asset-backed commercial paper
AfD	Alternative für Deutschland
AIB	Allied Irish Bank
AIG	American International Group
ARRA	American Recovery and Reinvestment Act
BBC	British Broadcasting Corporation
BDI	Bundesverband der Deutschen Industrie (Federation of German Industries)
BIS	Bank for International Settlements
BNP	BNP Paribas
BOE	Bank of England
BOJ	Bank of Japan
BRRD	Bank Recovery and Resolution Directive
CAP	Common Agricultural Policy
CDU	Christian Democratic Union
CSU	Christian Social Union
D-mark	Deutschmark
EBA	European Banking Authority
EC	European Community (see also EEC)
ECB	European Central Bank
ECJ	European Court of Justice
ECSC	European Coal and Steel Community
ECU	European Currency Unit
EDC	European Defense Community
EEC	European Economic Community

EFSF	European Financial Stability Facility
EFSM	European Financial Stability Mechanism
ELA	Emergency Liquidity Arrangement
EMS	European Monetary System
EMU	European Monetary Union
EONIA	Euro Overnight Index Average
ERM	Exchange Rate Mechanism
ESM	European Stability Mechanism
ESRI	Economic and Social Research Institute
EU	European Union
EURIBOR	European Interbank Offered Rate
FDIC	Federal Deposit Insurance Corporation
FDP	Free Democratic Party
FOMC	Federal Open Market Committee
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
IKB	IKB Deutsche Industriebank AG
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
LIBOR	London Interbank Offered Rate
LREM	La République En Marche
LTCM	Long-Term Capital Management
LTROs	Longer-Term Refinancing Operations
MEP	Member of the European Parliament
MPS	Monte dei Paschi di Siena
NATO	North Atlantic Treaty Organization
NPL	Non-Performing Loan
OECD	Organisation for Economic Co-operation and Development
OIS	Overnight Index Swap
OMTs	Outright Monetary Transactions
PASOK	Panhellenic Socialist Movement
PISA	Programme for International Student Assessment
QE	Quantitative easing
R&D	Research and development
S&P	Standard and Poor's
SEA	Single European Act
SGP	Stability and Growth Pact
SMP	Securities Markets Programme
SPD	Social Democratic Party

SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TAF	Term Auction Facility
TARP	Troubled Asset Relief Program
UKIP	UK Independence Party
VIX	Measure of expected volatility in the US stock market
WAMU	Washington Mutual
WEO	“World Economic Outlook”

Introduction

Europe Ends Up Someplace Else

THE EURO—THE single currency shared by nineteen European nations—is unique in human history. Never before has a group of countries created a brand-new currency that they would share with one another. Some idealists have seen this uniqueness as a virtue, as the harbinger of a better future world in which nations cooperate on a wider range of economic and political decisions. In due course, a political union might emerge; national parliaments would give increasing authority to a European parliament, which would make decisions for everyone. With this vision, almost half a century ago, European nations began exploring the idea of a single currency. Such a single currency, their leaders said, would bring greater prosperity and greater political unity.

At the time, Europe had a lot going for it. The wounds of World War II were receding into the past. Europeans had made another war unthinkable. They had learned to "fight across conference tables" rather than on battlefields.[1] They had opened their borders to allow greater trade with one another. None of this had been easy. They had wisely taken little leaps in the dark to slowly leave behind the shadows of two great wars fought earlier in the twentieth century, and they had learned to rely on one another's goodwill. They were rightfully proud of their success.

At that point, the essential historical purpose—to build the best human defense against another European war—was largely fulfilled. The question was how best to use the space opened up by this peace parenthesis. The task that lay ahead was to build on the liberal values that European citizens had come to cherish. To create an open society. To enable competition for ideas. To foster creativity and prosperity.

At The Hague in December 1969, European leaders, possibly unknowingly at first, took another leap in the dark: they set about creating a single currency. The thinking was that businesses and travelers would save the costs of exchanging currencies, and so they would trade more and travel more within Europe. Furthermore, with a European central bank, the eurozone would have a uniform monetary policy, which governments of member nations could not bend toward their purposes. Hence, to prevent domestic inflation and to promote domestic growth, the governments of all the countries would have to be fiscally responsible. Countries using the single currency would also need to coordinate their economic policies. And as they learned to cooperate, peace would be even more firmly established.

Despite the economic and political crisis of the eurozone over the past decade, some continue to believe in this vision.

In fact, as the history I document in this book shows, key decision makers came very quickly to understand the dangers of the leap they were taking. They understood that the benefits of easier transactions within Europe were small. What they possibly did not think clearly about is an economic proposition that comes as close to a theorem as economics can have. In a classic 1968 paper, Milton Friedman, one of the foremost economists of the twentieth century, explained that the main function of monetary policy is to help minimize a macroeconomic dislocation—to prevent an economic boom from getting too big and reduce the time that an economy spends in a recession.[2] Monetary policy, Friedman insisted, cannot help an economy *raise* its long-term growth prospects. And, here was the kicker: if monetary policy is badly implemented, it can cause lasting damage and can, hence, *reduce* long-term growth prospects. Like a "monkey wrench" thrown into a machine, ill-chosen and ill-timed monetary policy frustrates normal economic functioning.[3] By going down the route of monetary union, European leaders were making it more likely that European monetary policy would throw monkey wrenches into their economies.

European leaders may not have been aware of Friedman's near-theorem on the proper role and limits of monetary policy. They should have been aware that a single currency could not deliver economic prosperity. And they were surely aware that Italy and Greece had always bucked economic directives from European authorities, and thus these countries were unlikely to meet the standards of economic management needed to accompany a single currency, a single monetary policy.

European leaders also knew that the promised political gains were illusory. Although they often repeated the mantra of "political union," they knew they would not give up their own tax revenues to provide meaningful help to other nations in distress. They knew that the risk of economic conflicts of interest was real. And economic conflicts would create political conflicts. From the moment the single currency was proposed in 1969 to its introduction in 1999, validations of these forewarnings recurred. Again and again. But the risks were downplayed, and alternative viewpoints were deflected.

The essential flaw of the single currency was elementary. In giving up their national currencies, eurozone members lost important policy levers. If a member country went into recession, it would not have a currency it could devalue so that its businesses could sell abroad at lower US-dollar prices in order to boost exports and employment. The member country would also not have a central bank that could reduce *its* interest rates to encourage domestic spending and stimulate growth.

This basic flaw creates acute difficulties as soon as the economies of countries that share the currency diverge from one another. If the Italian economy is in trouble and the German economy is humming along, the common interest rate set by the European Central Bank (ECB) will be too high for Italy and too low for Germany. Thus, Italy's economic troubles will persist, and the German economy will get even more of a boost. It is in the nature of the single currency that once member economies begin to diverge from one another, the common interest rate will cause the divergence to increase.

These elementary problems considered, economists concluded by the late 1960s that if the single currency were to have a chance—any chance at all—there would need to be significant fiscal transfers from the humming countries to those that were in the dumps.[4] In a single-country, single-currency customs union such as the United States, states receive more funding from the federal budget; also, residents of states hit hard by recession pay reduced federal taxes relative to the residents of states that are less seriously affected. When such benefits are provided, no one fusses about them, because under the current political arrangement (the United States), they are legitimate. Indeed, some US states, such as Connecticut and Delaware, make large permanent transfers to states such as Mississippi and West Virginia. Economists thus concluded that for the euro leap into the dark, a common budget under a single fiscal authority would be needed.

If Europe wanted to go down this route, national parliaments would need to take back seats; they would mainly transfer resources to a common budget. A European finance minister reporting to a European parliament would use funds from a common European budget to stimulate the economy of the troubled country and thus shorten its recession. Fiscal transfers would not guarantee success, but without them, this was a dangerous venture.

From day one, however, it was clear that the Europeans would never be willing to agree on a common budget. The Germans were understandably worried that if they agreed to share their tax revenues, they would become the financier of all manner of problems in the rest of Europe. Thus, a common budget to smooth the path to the United States of Europe with the euro as its common currency was politically off the table.

Although they described the project in grand terms, Europeans set about creating an "incomplete monetary union," one that had a common monetary policy but lacked the fiscal safeguards to dampen booms and recessions. Within this incomplete structure, conflicts involving the conduct of monetary and fiscal policy were bound to arise.

To be clear, such conflicts arise even within nation-states. But within a nation, political procedures are typically in place to achieve some resolution. In the European single-currency project, there was no political contract for how the conflicts would be resolved. When financial crises occurred, there would be no mutually acceptable way to resolve them. Some countries would "lose," and others would "win"; the "winners" would become "more equal" than the others. Divergence among countries would increase, and the monetary union would become even more unmanageable. The incomplete monetary union contained the seeds of its own breakup.

To make matters worse, breakup of the incomplete monetary union would be extremely costly. If a country exited during a crisis, its domestic currency would depreciate rapidly, and the country's government, businesses, and households would need to pay their euro (or dollar) debts in their depreciated currency. Many would default. Especially if the country was large, the defaults could set off panic, leading to more exits from the euro and a widening circle of financial mayhem.

In this book, I ask a series of questions. Why did Europeans attempt such a venture that carried no obvious benefits but came with huge risks? How did they reconcile its obvious contradictions? How did these contradictions play out once the euro was launched? Where has Europe ended up?

There is an overarching answer to all these questions. European leaders had little idea why and where they were going. And as it has been said, if you don't know where you are going, you end up someplace else. This will be my story in the pages ahead: how, despite their idealistic vision, Europeans ended up someplace else. As could be expected, that someplace else has not been a good place. The euro has hobbled many of its member countries. It has created bitter division among Europeans. If Aristotle were alive today, he would see how "eminently good and just" men and women enacted the EuroTragedy, "not by vice or depravity," but by "error or frailty."

The rest of this introductory chapter narrates, in summary, the story I will tell. I have followed the discipline of never looking ahead to guess what people might have done with the benefit of hindsight. We will be witness to an economic and political drama played out over nearly half a century. The events will unfold, with the discussions, debates, and decisions reported as they happened.

Before the Euro: The Europeans Create a "Falling Forward" Narrative

In its origin, the single currency was a French initiative. French President Georges Pompidou called for a summit of European leaders at The Hague in December 1969. The process of opening borders, initiated by the Treaty of Rome in 1957, was well on its way. Stuck in an inertial mindset, Europeans were anxious to achieve more European integration. And, as if it were just a regulatory extension of Europe's expanding common market, Pompidou proposed a European monetary union. In fact, he said, monetary union must be made a priority.

France had suffered the humiliation of frequent devaluations of its currency, the franc. The country had lost the economic standing it had up to the mid-nineteenth century, and its political stature had declined through the course of the twentieth century. Pompidou established a French view that a European monetary union would gain France greater equality with an ascendant Germany.

The single currency was a bad idea at a bad time. Having given up their own currencies, countries that adopted a single currency would permanently fix their exchange rates with one another. Global productivity growth was slowing down, and the global economy had become more turbulent. The post-World War II Bretton Woods system of fixed-but-adjustable exchange rates was collapsing. Countries were required to keep their exchange rates fixed unless exceptional circumstances required adjustment. The exceptional circumstances were becoming more common and more disruptive. A consensus toward more flexibility, even floating, of exchange rates was emerging. The values of currencies would change continuously as national and global conditions changed.

German officials opposed a monetary union. Germans, traditionally more pro-market, were inclined toward floating exchange rates. But the French initiative to create a single European currency was pulling them in the opposite direction.

From the start, the political worry for Germans was that they would be sucked into paying for countries that had fallen into prolonged recessions and financial crises. Yet at The Hague, German Chancellor Willy Brandt did not disengage from the discussion. This moment of history is crucial. Brandt was keen to pursue *Ostpolitik*, bringing East and West Germany together. German leaders had personal memories of the war, and the French were never shy of reminding the Germans that they needed to be good Europeans.

Ironically, the one thing the French and the Germans agreed on was that there would be no common pool of funds to finance fiscal transfers. In 1954, the French National Assembly had rejected a proposal for a European army with its own budget. The French prized their sovereignty over tax revenues just as much as the Germans did. The French wanted a free lunch.

The December 1969 Hague summit appointed a committee led by Luxembourg Prime Minister Pierre Werner to lay out the plan for Europe's single currency. In October 1970, the Werner Committee completed its report.

In the pages of that report, a European narrative evolved. The report pledged that a single currency would *grow* into a more complete monetary union. This "falling forward" thesis became the European single currency's guiding philosophy. One thing would lead to another. Crises would make Europeans more determined to move forward. The contradictions of the single-currency project would not just be resolved, Europe would emerge stronger and more vibrant.

European leaders, introspectively, described this falling forward phenomenon as "pro-Europeanism." As custodians of pro-European philosophy, they believed that the great reconciliation after World War II, followed quickly by the opening of borders to trade, had established abundant goodwill, which would extend to new ventures.

But such extrapolation of postwar achievements to the creation and functioning of a monetary union was a mistake. The early successes had a sound foundation. Peace and open trade borders were clearly in the interests of all European nations. Importantly, neither of these goals required a surrender of core national sovereignty—the opening of borders to European trade required only minimal coordination. And the early postwar initiatives did not give any one nation intrinsically greater authority or influence over the conduct of European affairs. A monetary union would be in opposition to each one of the principles that had made the original successes possible. By the very nature of a single monetary policy, some nations would benefit more than others. Crucially, moreover, monetary union would require conceding a nation's core national sovereignty, the right to determine taxation policy and the distribution of a country's tax revenues, possibly to countries that its citizens might deem "unworthy" of such trust. And so it followed inevitably that monetary union would increase the political influence of some countries over others. Conceived originally as a community, even a brotherhood, Europe now would have a hegemonic governance structure.

Contemporaries warned that the contradictions would not be resolved; the single currency would not fall forward into a more robust monetary union. No European nation was willing to let go of its sovereign right to tax and spend, not even the French, despite their role as the prime movers toward monetary union. Countries would give up their currency and monetary policy, but no pan-European fiscal pool would be there to open its floodgates in a crisis. The problems would come, and it would be each ship on its own bottom.

But the small group of European leaders who mattered persuaded themselves that they could have their cake and eat it, too; essential national sovereignty over tax revenues could be preserved, and a monetary union could be made to work. No matter what, in order to erase the history of the wounds they had repeatedly inflicted on one another in the past, they would resolutely pursue a "pro-European" future.

I use the term *groupthink* to describe this unwavering collective belief.[5] European leaders fell into a groupthink that all would be well. The narrative of pro-Europeanism, of Europe as exceptional, would carry them forward. More Europe—an increased range of functions with an ever-expanding number of countries within its fold—was the common destiny. European leaders endlessly repeated this story. And a story told often enough is eventually embedded in people's psyches. Indeed, the story becomes the motivation to pursue an often-unrealizable agenda.[6]

The most prophetic critique of the proposed single currency—startling when read today—was by University of Cambridge economist Nicholas Kaldor.[7] In March 1971, just five months after the Werner Committee presented its single currency proposal, Kaldor wrote that European leaders were grossly underestimating the financial consequences of their plan. If they truly wanted a monetary union, a fiscal pool merely for crises would not be enough. Economically strong nations would need to finance some of the weaker nations on a more or less permanent basis. Could Kaldor have been thinking nearly four decades ahead of Greece in 2009? He warned that the single currency would divide Europeans, and, recalling the words used by Abraham Lincoln, Kaldor said that a house "divided against itself cannot stand." Rather than bringing Europeans together, a single currency would tear them apart.

They went ahead, nevertheless. Following the Werner Committee's recommendation, European nations took the first step toward monetary union by attempting to fix the exchange rates of their national currencies in an imaginatively named "snake-in-the-tunnel" system. The idea was to create a training ground for countries to learn to live with fixed exchange rates. It did not work. Exporters operating in countries experiencing high inflation rates lost competitiveness. National authorities were forced to devalue their currencies to help their exporters and boost domestic economic growth and employment. France dropped out of the snake arrangement, came back in, and dropped out again. The snake died, and countries floated their exchange rates.

In 1979, French President Valéry Giscard d'Estaing, still pursuing the goal of parity with Germany, pulled Europe back to the path set out in the Werner Committee report. German Chancellor Helmut Schmidt agreed, for his own mysterious reasons, to join the venture. Together, Giscard d'Estaing and Schmidt revived the snake. Only this time, they called it the European Monetary System (EMS). By now, the Bretton Woods system, the global arrangement of fixed-but-adjustable exchange rates, had irrevocably broken down, and the world was decisively moving toward more exchange-rate flexibility. Yet invocation of Europe's postwar achievements and exceptionalism continued. The myth of Europe began to form. I am reminded of an old Indian saying, "The bee came to suck the honey, but its feet got stuck in it."[8]

The EMS did not do any better than the snake. Many countries needed the option of devaluing their currencies. And no one took a deep breath to think ahead. Once these countries were in the eurozone, they would have no currency to depreciate. How would they manage then? The evidence made it clear that the warnings of contemporary economists against tightly fixed exchange rates within a monetary union were not just theoretical.

By now, the tradition and motivation were set. Following Pompidou and Giscard d'Estaing, a third French president, François Mitterrand, pushed for monetary union. In Germany, Helmut Kohl became chancellor. The year was 1982. He opposed the single currency. He rightly pointed out that a single currency, which would fix exchange rates, was ill suited for countries on divergent economic paths.

Kohl plays a central role in this drama. Although he was too young to have fought in World War II, he had seen the war's destruction and had suffered great personal loss. He described himself as the last pro-European chancellor and believed that as memories of the war faded, Germany's commitment to Europe would diminish. After the Berlin Wall fell on November 9, 1989, Kohl became the chancellor of German unity, bringing the East and West together. In German politics, he acquired exceptional autonomy and was able to make executive decisions in the manner of American presidents, relying on a small group of close advisers.

Riding on his extraordinary authority and invoking the themes of peace and friendship, Kohl came to believe it was his historical role to make a European single currency possible. His role is crucial, because the single-currency idea kept crashing into economic and political reality. Under ordinary circumstances and without a forceful champion, the idea would have gradually faded and disappeared. European "fixed" exchange rates remained fragile, causing crisis-like conditions and eventually requiring adjustment. The world continued to move toward floating rates.

Yet in December 1991, at Maastricht, Kohl, overriding the counsel of the Bundesbank (Germany's central bank) and the finance ministry, committed Germany to the single-currency project.

Even at this early stage, one country was deeply suspicious of the project. British Prime Minister Margaret Thatcher had been the single currency's fiercest opponent. Her opposition was based on exactly the right considerations: the lack of clear gains, the important risks, and the loss of national sovereignty. Thatcher's successor, John Major ensured that the United Kingdom had the right to opt out. Although the United Kingdom would continue in what would soon be called the European Union, it would be under no obligation to give up the pound and adopt the single currency.

Among those countries that did begin to move toward the single currency, a political rebellion began almost immediately. In a referendum held in June 1992, Danish voters said they wanted no part of the single currency. In September of that year, French voters almost walked away from the prized single currency that French presidents had dreamed of for so long. If another 1 percent of the French had voted no, there would have been no euro.

Amid this rebellion, the EMS, which had appeared for a short while to have stabilized, came under renewed fire. It was, in effect, dismantled and European currencies floated. While there was much hand-wringing about the breakdown of the EMS, few took heed of the troubling French referendum vote. French citizens who voted "no" to the single currency felt economically left behind and feared for their futures. European policies, many of them believed, were further restricting the limited opportunities of upward social mobility. They wanted France to disengage from European projects.

The French referendum was an early window into a widespread rift that was beginning to form between Europe's leaders and citizens. After the Maastricht Treaty was signed, public support for European institutions fell quite sharply in many prospective member states of the eurozone. Europe's leaders dismissed the warning. They continued to decide on European priorities and policies without public consultation. The leaders claimed that they had a "permissive consensus," the right to act on European matters without democratic authorization because the issues were too complex for most citizens.

But although the issues were complex, European decisions intruded ever more into daily lives, and people wanted more of a say. The problem was that they had no forum to express their concerns. Domestic issues dominated in national elections, giving little space for debate on European priorities. Only the rare referendum provided voters an opportunity to express their protest against the European project. The French referendum was such an expression. It was a pivotal moment in European history. Instead of heeding the voice of the people and healing the growing rift, European decision makers barreled on.

The rest of the 1990s belonged to Kohl. He gave the eurozone's groupthink its roots. Kohl was a master of framing the political narrative. More than anyone else, he drilled into the European psyche the idea that the single European currency was an instrument for peace. The illogic of this proposition did not matter; a common currency has never been a deterrent to civil wars, and countries do not go to war with one another just because they have different currencies.

To deflect criticism and debate of the outlandish connection he made between the single currency and peace, Kohl continually repeated an aspiration for a European "political union." Of course, Kohl never literally intended that Germany would form a real political union with other European countries. In a real political union, German tax revenues could be spent on people in other countries. Thus, Kohl's genius was that he coded his logical contradictions in a suitably high-minded narrative. Within that narrative, everyone was free to believe that his or her cause was being served.

Kohl wanted the single currency to be his legacy as chancellor of European unity, but he understood that the German public fiercely opposed giving up the deutschmark. Hence, he endlessly reassured Germans that they would not pay to bail out other countries using the single currency. At the negotiating table, therefore, Germans insisted that the incomplete monetary union be governed by a fiscal rule, one that required member countries to keep their budget deficits below 3 percent of GDP.

They called this rule, in another masterly stroke of framing, a "convergence criterion." It created the illusion that the economies of countries that followed the rule would "converge" or align with the movements of other countries, making the single monetary policy more relevant to all. In June 1997, they made this rule the centerpiece of the Stability and Growth Pact (SGP). But of course, a budget rule, like a single currency, neither promotes convergence nor creates stability, as every economist recognized from the very start. To the contrary, a government forced by the rule to reduce its budget deficit during a recession will place its economy in a deeper recession. Divergent economies will not converge; they will diverge, and they will be more unstable.

Nevertheless, the budget rule got locked in, periodically tweaked through administrative changes, but shielded by a protective stability ideology. The view was that even a bad rule is better than no rule.

The ECB, set up to conduct the single monetary policy, reinforced the stability ideology through its commitment to price stability. Two Nobel Laureates in economics, Franco Modigliani and Robert Solow, warned that excessive commitment to price stability would restrain output growth and, hence, would raise the eurozone's unemployment rate. Moreover, like the budget rule, price stability when pursued unthinkingly, can—as it did during the eurozone's financial crisis—become a source of instability. But the ECB's stability ideology is even more insulated from criticism than the budget rule, because the ECB is accountable to no one. Germans insisted on this, believing that otherwise governments would try to bend ECB policy in their own favor. As a result, ECB mistakes can also remain unchecked, making a bad situation worse.

In addition to giving a boost to the groupthink within which the stability ideology gained adherents, the pro-European Kohl used his enormous authority to bring an obviously unprepared Italy into the inaugural group of eurozone member countries. This did neither Italy nor the rest of Europe any favors. Italy's politics were deeply corrupt, its governments were unstable, and by the 1980s, Italian businesses relied on a steady dose of industrial subsidies and repeated depreciations of the lira to sell their products in international markets. The all-would-be-well narrative said that the single currency would act as Italy's "external anchor." Without the crutch of a lira to depreciate, politicians and businesses would mend their ways.

Kohl had completed his historical role. He had navigated the single currency project through economic and political minefields. Without him, the project could easily have blown up. Kohl's euro gift package came with enticing visions of peace and political union, with a stability ideology that veiled the destabilizing nature of the eurozone, and with Italy among the inaugural members.

For three decades, French presidents had pushed for a euro, even though the French public cautioned against going ahead. Kohl made the euro possible, even though Germans would have much preferred to keep their deutschmark. The French had compromised by letting the Germans write the rules. It is not clear whether the protagonists had understood what they were really doing. They certainly seemed to believe their own rhetoric. On January 1, 1999, the single currency idea became a reality—a euro that French leaders had desperately wanted but that worked on German terms. That is the EuroTragedy.

After the Euro, Before the Crisis: In a Bubble

The new German chancellor, Gerhard Schröder, had no personal memories of the war. He was not shy to assert the German national interest. Economic unification of West and East Germany had not been the free lunch Kohl had promised. Higher inflation and higher taxes had put the economy in recession. Schröder, for good reasons, challenged the German-inspired stability ideology.

However, being the German chancellor, Schröder needed to keep up a façade of pro-Europeanism. He repeated the mantra that Europeans would eventually join in a "political union," although—as in Kohl's case—what Schröder meant by that remained fuzzy. In his signature pro-European gesture, Schröder waved Greece into the eurozone in 2001. As in Italy, Greek politics had been entangled in corrupt networks and governments had been dysfunctional. As in Italy, European rules had never reined in the Greeks. But Greece had a small economy. Schröder judged that there would be little trouble mopping up a Greek crisis.

Apart from those easy, feel-good measures for Europe, Schröder kept up a hard-nosed commitment to German interests. In European politics, he demanded greater German say. When European leaders met at a summit in Nice in December 2000, he fought for power and influence in running the European Union. He protected the German automaker Volkswagen by blocking a European Union corporate takeover code, which would have made hostile takeovers easier. The euro was in its early years. Predictions of falling forward into greater political unity were already crumbling.

Serious economic handicaps, hitherto largely ignored, now came into focus. For the previous three decades, productivity growth had been slowing in all advanced economies, but now eurozone productivity growth was particularly anemic. Loss of productivity momentum is never welcome but it was an especially serious problem for eurozone countries. Having given up national monetary policy and lacking a national currency that they could depreciate to boost exports and employment, member countries of the eurozone needed the benefit of strong productivity growth to pull themselves out of recessions. Yet another serious problem was that European nations had inherited bloated banking sectors, which their governments had promoted and coddled for years in the hope that domestic banks would act as agents of economic growth. Europe was "overbanked," the banks earned low returns on their assets, and they were looking for easy ways to make money.

These liabilities—no independent currency and monetary policy, low productivity growth, and large banking sectors—fashioned the next phase of the eurozone's evolution.

Between 2004 and 2007, amid a global financial euphoria, the eurozone had its own bubble. The financial bubble was sustained by a cognitive bubble, a widespread belief among European policymakers that the euro was proving to be a great success. Riding on the global wave, economic growth in the eurozone picked up. But even in those hospitable years, there was no evidence that the sudden turn in fortunes was due to the euro's promised economic dividends. A prominent econometric study had claimed that the euro would boost trade among European nations. However, the study proved to be flawed, and the original author later retracted his claim. The fact is that the share of trade among eurozone nations was steadily falling. As another achievement, European officials pointed to lower inflation rates, which they said were a direct benefit of the ECB's wise monetary policy. But average inflation rates in the eurozone declined exactly in step with global trends. European countries that had not adopted the euro did just as well in maintaining moderate and stable inflation.

While there were no evident benefits from the euro, predictions that a single monetary policy would increase divergence among countries did come to pass. The "periphery" countries—Greece, Ireland, Italy, Portugal, and Spain—experienced higher-than-average inflation rates, their products became more expensive for foreigners, and their exporters lost competitiveness to Chinese and Eastern European producers. Nevertheless, banks from the "core" countries—especially German and French banks—were keen to lend to borrowers in the periphery. Higher inflation gave the periphery borrowers more euros to repay debts. Core banks lent them more money, which pushed inflation rates further up, which attracted more lending from core banks. Economic divergence—in this case, inflation divergence—was actively at work.

Along with the divergence came financial bubbles in the periphery countries. With their especially low productivity growth rates, they were inflating their economies and, hence, losing international competitiveness; all the while, they were gorging on debt. Ireland and Spain, moreover, had particularly outsized property price bubbles, which fostered a frenzy of construction activity. After initial worries that this could all go wrong, concerns abated. Instead, a euphoria settled in, drawing attention away from the fundamental problem of weak productivity growth in the periphery. Italian and Portuguese GDPs barely grew even in these bubble years. European policymakers believed all was going well. The narrative was that the euro made their economies more stable. They could handle a financial bust should one occur.

It is remarkable that despite the elites' sense of well-being, political discontent was brewing among European citizens. The concern was that European institutions and policies were acquiring too much influence in people's lives. In 2005, Dutch and French citizens decisively rejected a largely symbolic European constitution. As in the French vote on the Maastricht Treaty, low-income, poorly educated citizens voted against the European initiative. Many believed that European decisions, handed down without a democratic vetting process, were making already onerous social inequalities worse. By now, the votes showed, the young were also growing disenchanted with Europe.

Ignoring these concerns and irritants, with eurozone banks enmeshed in the burgeoning global financial crisis, European leaders celebrated the first decade of the single currency in 2008. They took particular delight in ridiculing critics who had predicted that the euro would fail. Those celebrations proved premature.

Eurozone's Rolling Crisis: Policymakers Respond with Half-Measures

Already by mid-2007, the gathering financial crisis in the United States had trapped several eurozone banks seduced by apparently easy pickings in the subprime market. By mid-2008, at home in the eurozone, banks began to totter as property prices collapsed and economies fell into recession.

As eurozone economic activity fell, the ECB, keeping faith with its stability ideology, focused on the threat of inflation and raised its interest rate.

Rhetorically, the Europeans denied that they had a crisis on their hands; they insisted that the crisis was mainly an American problem, which the Americans deserved for having lived well beyond their means. Thus, while the eurozone and US GDPs fell at around the same pace, only the US Federal Reserve (Fed) eased monetary policy.

Acting on the time-honored risk management principle that a stitch in time saves nine, the Fed started lowering its interest rate in September 2007. The goal was to put more money in people's pockets so that they would spend more and help revive economic activity. By December 2008, having concluded that reducing its own interest rate was not enough to stimulate the economy, the Fed established quantitative easing (QE), a bond-buying program to speed up the decline in long-term interest rates, such as mortgage rates. These Fed actions eased fears of a severe economic crunch and slowly helped revive spending.

The ECB, in contrast, remained unwilling to back off from its stability focus and waited. Only after the near global meltdown following the Lehman Brothers bankruptcy in mid-September 2008 did the ECB lower its interest rate for the first time. Its subsequent rate reductions were always too little, too late. Not surprisingly, in late 2009 and early 2010, the eurozone recovered at a slower pace than the United States. The ECB, which had forecast a quicker return to better times, lost credibility that it could assess risks appropriately and act in time to ward off a gathering crisis. Milton Friedman's ghost was at work: monetary policy badly implemented was causing long-term harm.

The eurozone's home-grown crisis started in October 2009 when the Greek government revealed that its budget deficit for the year was much larger than anticipated. European authorities could now no longer blame the Americans. The crisis was squarely in their backyard, and European leaders had two choices. They could let the Greek government default on its creditors, which many rightly argued was the proper course to take. Or they could stick to the doctrine espoused by both ECB President Jean-Claude Trichet and US Treasury Secretary Timothy Geithner that a Greek default would cause contagious financial panic and inflict incalculable damage. Eurozone policymakers chose to drum up anxiety about contagious panic. There was little basis for such fearmongering. Greek banks and borrowers had limited interconnections in the global financial system. If a panic did occur and depositors and creditors did begin to pull funds out of financially sound banks, the ECB could have provided those banks with cheap funds.

By preventing the Greek government from defaulting on its debt, European authorities made their own task more difficult. They did not have a fiscal transfer system to give Greece financial assistance. Thus, European leaders waited in the hope that the Greek problem would go away. They relied on "cheap talk"—optimistic rhetoric—in the hope that their upbeat words would entice investors into lending to the Greek government at lower interest rates and would thus help tide the government over a rough patch. But the Greek government was not merely going through a rough patch. It was in severe financial distress, and investors remained wary. The Greek government needed its debts restructured quickly, official financial assistance, and a program of moderate fiscal austerity. The delay in mounting an early response only deepened the Greek distress.

The flaws of Europe's incomplete monetary union were now starkly evident. In the United States, states in financial crisis automatically received large financial transfers, which aided their recovery. These US financial transfers were part of the political contract. No one questioned why Nevada was a net recipient of funds from the federal government, some part of which was coming from taxes collected in Connecticut. The eurozone did not have such a system of transfers, as Kohl had repeatedly emphasized in order to reassure German voters.

Finally, when no good options were left, European governments and the International Monetary Fund (IMF) loaned the Greek government a large sum of money to repay its private creditors. Greece still had the same amount of debt to repay. But now the government had to repay mainly its official creditors and the remaining private creditors. For this privilege of keeping its unpayable debt burden unchanged, Greece agreed to extraordinary fiscal austerity, which soon crushed the Greek economy.

Through the evolution of the Greek crisis in 2010, German Chancellor Angela Merkel became the de facto European chancellor. No decision was possible without German backing; hence, Merkel acquired veto power. But she was a reluctant European. Born in 1954, she had no direct connection to the war. The daughter of a pastor, she had grown up in East Germany. Until the Greek crisis started, Merkel showed little inclination for pro-European causes or rhetoric. Protecting Germany's interests was her primary goal, and she was cautious by nature. She delayed the loans to Greece until it became clear to her that any further delay could cause a financial meltdown with widespread consequences. In a pattern that would recur, she made her decisions at the last moment and then only to extend bare-minimum support to defuse the ongoing crisis rather than to solve the problem decisively.

The inequality in power relationships, always inherent in the incomplete monetary union, now became manifest. Germany became "more equal than others." This was the European quandary. Without Merkel in a coordinating role, the European response might well have been chaotic, since national interests would have been difficult, if not impossible, to align. But with Merkel steadily increasing her reach, resentment of German dominance and euro skepticism grew.

The euro crisis entered its darkest phase in the first half of 2011, when the entire eurozone adhered to the norms of fiscal austerity and price stability. These German norms became, as it were, defining features of the European identity. Instead of a European Germany, as Kohl had promised, a German Europe was now in place.

On top of severe fiscal austerity adopted across the eurozone, the ECB raised interest rates in April and July 2011 to fight a phantom inflation scare. The July 2011 interest-rate hike was surely the most egregious policy error of the crisis. The ECB had received repeated warnings from investors and analysts that especially the July rate hike would do incalculable damage. The unaccountable ECB stuck in its isolation to a misguided assessment of the eurozone's economic condition. It thus generated intolerable financial stress and pushed the eurozone economy into a new crisis. Now Milton Friedman's ghost was really at work.

Italy's Mario Draghi became ECB president in November that year, and while he reversed the egregious rate hikes from earlier in the year and while he spoke of more forceful monetary stimulus, the actual stimulus the ECB delivered remained meager as the German members of its governing council continued to hold back ambitious measures. Under the double squeeze of fiscal austerity and tight monetary policy, euro-area economies struggled in what seemed like perpetual economic recession.

Investors lost confidence in the ability of the Italian and Spanish governments to repay their debts, and in mid-2012, a debt default seemed imminent. In July 2012, Draghi famously announced that the ECB would do "whatever it takes" to save the eurozone. For political support, Draghi needed Merkel's tacit approval to follow through on his announcement. Merkel had no wish to lay out German money to save Italy and Spain, but she was not ready to see the eurozone melt down. The ECB's promise of "unlimited" financial help relieved pressure on Italian and Spanish bonds. Thus, Merkel held political control of Europe, but at this critical moment, she needed the ECB's deep pockets to achieve her objectives. The power in the eurozone was now definitively concentrated in a few hands.

Throughout these years, resentment against Merkel increased. Especially governments and citizens of the periphery countries viewed the policy of all pain and no gain as a German imposition. Merkel's association with the departure of the Greek and Italian prime ministers in November 2011 heightened the perception of German imperialism; that perception intensified when pro-European technocrats took over as prime ministers in Greece and Italy in a bid to cut through political gridlock and implement stricter austerity. In Greece, anti-German sentiment fueled the rise of the radical Syriza party. In Italy, popular support for the anti-euro Five Star Movement soared. In Germany, many citizens had the opposite anxiety that Merkel was being soft on undisciplined countries. In September 2012, rebels within the Christian Democratic Union (CDU) began an anti-euro movement, which then emerged as the Alternative für Deutschland (AfD) in February 2013. Thus, political fissures among eurozone member countries widened.

The Italian Fault Line

For the period 2014 to 2017, I focus on how the ECB made an already bad Italian situation worse. All the pathologies of the eurozone—low productivity, high government debt, chaotic banks, short-lived governments, receding opportunities for upward social mobility, and euro skepticism—come together in Italy. And Italy is several times larger than Greece. Italy, I believe, is the eurozone's fault line.

In early 2014, the ECB's monetary policy was still too tight. With Italy in near-perennial recession since 2011, its economy had so weakened that a price-deflationary tendency had begun to set in. While too high inflation causes loss of international competitiveness, too low inflation creates its own ills. Once they experience an extended period of low inflation, businesses and consumers begin to postpone purchases, believing that the inflation rate could decline further, and prices might actually fall. The slow pace of spending, in fact, keeps inflation low. And low inflation and low growth make existing debt burdens more onerous, which further restrains spending and growth. As growth suffers, financial vulnerabilities increase.

To gain perspective on Italy's economic problems, a comparison with Japan's lost decade of the 1990s is helpful. Because of delayed and timid monetary policy responses to the property and stock market crash that began in 1990, the Japanese economy slid into almost perpetual "lowflation," long periods of very low inflation interspersed with brief periods of declining prices. The lesson from Japan is that once it sets in, such a lowflation tendency is very difficult to reverse. Inflation does rise for short periods but tends to come down quickly. Essentially, as Japan's experience shows, the central bank loses the credibility that it has the competence and patience to bring inflation back up to normal rates.

In January 2015, Draghi and his ECB colleagues belatedly began purchasing eurozone government bonds to bring long-term interest rates down. Yes, for those keeping track, this was just more than six years after the Fed had begun similar action in December 2008. The eurozone's "core" inflation rate—the inflation rate stripped of volatile food and energy prices—barely budged. While the average core inflation rate stayed around a low of about 1 percent, even lower inflation rates appeared to have set in to large parts of the eurozone, adding to their many vulnerabilities.

Throughout these years, eurozone authorities touted one solution to get them out of their morass: structural reforms. Structural reforms were a code phrase for making it easier to fire workers. Sure enough, in 2015, Italian Prime Minister Matteo Renzi's Jobs Act, following the playbook, made it easier to fire workers. Judging by a vast amount of past evidence, the measures will do little to help economic growth. To the extent that they make jobs more precarious, they will reduce the incentives to invest in raising worker productivity. Thus, if anything, measures taken under the Jobs Act will hurt long-term growth prospects and increase financial vulnerabilities. Moreover, these "labor market reforms" will increase social inequalities as some workers are trapped in temporary and insecure jobs.

Italy's true problems lie elsewhere. With low levels of research and development (R&D), lagging educational standards, and many college-educated Italians migrating, Italian productivity growth seems likely to remain low. Without inflation and growth, government debt will tend to stay at high levels, and while banks are beginning to get over their worst phase, their journey out of trouble is a long one. An economic or financial tremor in Italy or in the global economy could open up Italy's cracks, which could radiate earthquakes and cause damage along other vulnerable fault lines.

Amid Renewed Optimism, the Reality of a Divided Europe

Starting in mid-2017, optimism spread through much of the world economy. The optimism raised world trade growth and, thus, brought economic and financial cheer also to the eurozone. But this short-term relief rally faced the force of long-term trends that pointed to a more worrying future. Productivity growth rates had declined during the crisis years from already low levels; meanwhile, populations were barely growing and could start declining in some countries within the next generation.

Thus, once the current global sweet spot receded, economic growth rates in the eurozone countries seemed set to fall back down to their low potential. Eurozone economies remained well behind the United States in R&D intensity, and they were falling behind the most dynamic Asian economies not only in R&D but also in the international league tables of university rankings. A severe long-term growth and competitiveness challenge lay ahead for the countries in the eurozone.

Moreover, within the eurozone, after nearly ten years in and out of crisis, the economic divide across member countries had widened—and, hence, political divisions had also sharpened and become more entrenched. Nicholas Kaldor's predictions from 1971 were proving eerily correct. In the successful "northern" eurozone group, led by Germany, citizens had reason to be optimistic over the long term. Their economies were productive by European standards, their government debt burdens were back to or below pre-crisis levels, and their young could find jobs. These countries were relatively insulated from the eurozone in the sense that they were not severely hurt by the orthodoxies and errors in eurozone policies.

However, even in these relatively successful countries, nationalism and euro skepticism had steadily increased. Northern governments were ever more fearful of footing the bill for southern countries. A large number of citizens in the northern countries had not experienced material gains for nearly a generation. Such left-behind citizens were stuck on the lower rungs of the economic ladder. Their fears that their economic security was slipping away fed the fear of refugees and migrants. Thus, as the populations of the northern nations turned their gazes inward, their governments were increasingly constrained in their ability to make pro-European gestures.

On the other side of this divide, the southern countries had low productivity growth rates, high government debt burdens, bleak work opportunities for their young population, and schooling systems that did a poor job of lifting children above the economic and social status into which they were born. All these problems were rooted in weak governance and institutional structures, which weakened growth prospects by creating incentives for corruption, raising costs of doing business, inducing people to work in the so-called "shadow" economy, and lowering the quality of education that schools and universities delivered—to different degrees in different countries. Moreover, the eurozone's ideologically driven policies inflicted the most harm to growth potential in the south. Because the southern countries had remained in recession-like conditions for long periods, businesses had cut back on long-term investments and R&D, and unemployed workers had lost skills or otherwise become unemployable. Of the southern countries, Italy, as

I have pointed out, had the most grievous long-term problems and posed the greatest risk to the eurozone's integrity. But France, too, I believe, was now squarely in the southern part of the eurozone.

Looking ahead, I am afraid the groupthink will continue. Dismissing the evidence of the past several years, eurozone leaders continued to assert that the euro delivered "huge, often invisible benefits."[9] As past generations of leaders spoke of "political union," the new leadership talked of "governing together," "shared sovereignty," "pooling of sovereignty," and "European sovereignty," they spoke of a "eurozone finance minister" and a "European budget."[10] As in years past, the different actors used the same sets of words and phrases to represent their very different interests and preferences.

And they repeated the mantra of "democratic accountability," knowing that real European accountability could be achieved only if national parliaments were subordinated to the European Parliament. Even if such a far-reaching outcome was ultimately desirable—and it is debatable whether it was—no one believed that Europeans would ever be ready for such a big leap. Thus, responsibility and accountability in the governance of the eurozone remained hard to pin down. Who was responsible for fiscal and labor market policy, the national government or European authorities? Who was to blame when policies implemented had counterproductive consequences? If they were upset, whom should citizens vote out of office? As economic historian Alan Milward wrote in 2005, European democracy was slipping "between the interstices of the nation states and the supranation."[11] Which only added to economic and political anxiety.

Rather than evolving into a politically legitimate governing system, the eurozone is set to continue on an inward-looking involutionary path of newly invented administrative measures. Groupthink will continue to lull European leaders into a false sense of confidence that another clever measure will strengthen the eurozone. However, history keeps reminding us that the fundamental national unwillingness to share tax revenues will severely limit what can be achieved.

Unfortunately, few European leaders recall and learn from that history. Thomas Schelling, Nobel laureate in economics, wrote in a 1988 essay, it is in the nature of us human beings to forget that we keep forgetting.[12] In the eurozone, repeated efforts, unburdened by the memory of past failures, return to circle around the same themes; each time, with the same words and the same arguments, the hope is that the latest effort will finally pay off. Instead of falling forward, instead of an evolution, "involution" continues.[13]

The next financial crisis will start from a point of greater economic and financial vulnerability than the last one did. Meanwhile, as the economic divide between member states stays wide—and possibly widens—the sense of nationalism and euro skepticism in the north and south will grow steadily more acute. The next crisis could tear Europe's delicate fabric apart.

A New Pro-Europeanism

In these introductory pages, I have given the reader the essence of a nearly seventy-year history of postwar Europe. One message comes across through these long years. The sovereignty barrier remains alive. Why is that? True falling forward required the euro project to deliver tangible benefits to spark increased popular willingness to share sovereignty. That would have led to greater willingness to share tax revenues and agree to democratically legitimate European governance mechanisms. That has not happened because the euro has predictably not generated any noticeable economic benefits, and the costs imposed by the euro in people's lives have often been stark. Without real evidence that the euro improves the economic welfare of a substantial number of European citizens—and basic economic principles tell us that the prospects of that happening are not good—administrative efforts to pool sovereignty will not mobilize the needed political legitimacy and the euro scaffolding will, therefore, remain fragile under conditions of stress.

Those who are already persuaded by my interpretation of the history and the conclusions that they lead to will, I hope, read on to relive in greater detail the economic and political drama as it unfolded. You will hear the principal actors as they framed the European narrative and worked with—and continue to work with—its contradictions.

For those who are skeptical, I hope you, especially, will read on. I say—with no attempt at irony—that I have written this book as a pro-European. I do not believe in more Europe or even a cleverly reengineered Europe. The lack of political legitimacy will continue to undermine the credibility of European institutions that step into domains reserved for national sovereigns. Instead, I believe it is time to change the narrative of what truly is pro-Europeanism. True pro-European values can flourish only when the bonds that tie Europe so tightly today are loosened. As a first step toward that goal, I offer some technical suggestions on necessary policy steps.

But more important, I believe, is that it is time to recommit Europe to its principles of an open society, with its emphasis on democracy, social protection, freedom of travel, and cultural diversity. Europe had embarked on exactly this path in the early postwar decades before the euro project led it astray. To achieve an open society, Europe must go back to the model within which the Enlightenment flourished between the sixteenth and eighteenth centuries. In that model, nation-states competed in the marketplace of ideas. Such a new European Republic of Letters will erase the harm done by the euro and will make Europe a stronger contender in the global economic race. It will shrink social inequalities, and will strengthen the European identity.

CHAPTER 1 | Three Leaps in the Dark, 1950–1982

IT WAS A little after six p.m. in Paris on May 9, 1950. At a hurriedly arranged press briefing, French Foreign Minister Robert Schuman announced that France and Germany had agreed to operate their coal and steel industries under unified supervision.[1] Such "solidarity in production," Schuman said, would make war between France and Germany "not merely unthinkable, but materially impossible."[2] Schuman also invited other European nations to join the Franco-German venture. Together, he promised, they would all take "a first step in the federation of Europe."

Although World War II had ended five years earlier, its long shadows still fell across the European continent. It was time, Schuman said in his bold declaration that evening, to lay "common foundations for economic development" to strengthen European solidarity and preserve peace.

That soaring vision and rhetoric meant little to the gathered journalists. They wanted to know how the extraordinary transnational plan would work, and Schuman seemed unwilling, or unable, to give details. A frustrated newspaperman finally asked him, "In other words, it's a leap in the dark?" Surprised by the question—and mindful that he needed to rush to catch his train to London—Schuman instinctively replied, "Yes, that's what it is, a leap in the dark."

The previous evening, Schuman had sent his proposal to German Chancellor Konrad Adenauer. The Federal Republic of Germany ("West Germany") had been constituted only the year before, in 1949. Adenauer had swiftly replied that he accepted the proposal with "all his heart."[3] To his aides, the elated Adenauer exclaimed, "'Das ist unser Durchbruch'—this is our breakthrough."[4] Sharing German sovereignty over coal and steel production was a small price to pay for reintegration into Europe and the international community.

The Schuman Plan created advantages for France as well. Germany's economy, having long since surpassed that of France (figure 1.1), was now poised to surge even further ahead based on its strengths in machine, automobile, and pharmaceutical production. France, in danger of losing European and global influence, feared that it would be left merely with the thankless task of monitoring a politically quarantined but economically dominant Germany.[5] By making Germany more of a political partner, the Schuman Plan would open an opportunity for France to shape Europe's future.

The newly formed "High Authority," a central feature of the plan, would supervise the transnational coal and steel production facilities. In this authority lay the seed of a visionary post-nineteenth-century state within which sovereign nations would work together—perhaps in an increasingly federal structure—toward a "pro-European" future.

While the goal was political reconciliation and eventually a European federation, the methods were economic. Under the proposed arrangement, rearmament efforts, which required ramped-up coal, iron, and steel production, would be easy to detect. But Schuman also emphasized that pooling of coal and steel production was the first step in laying "common foundations

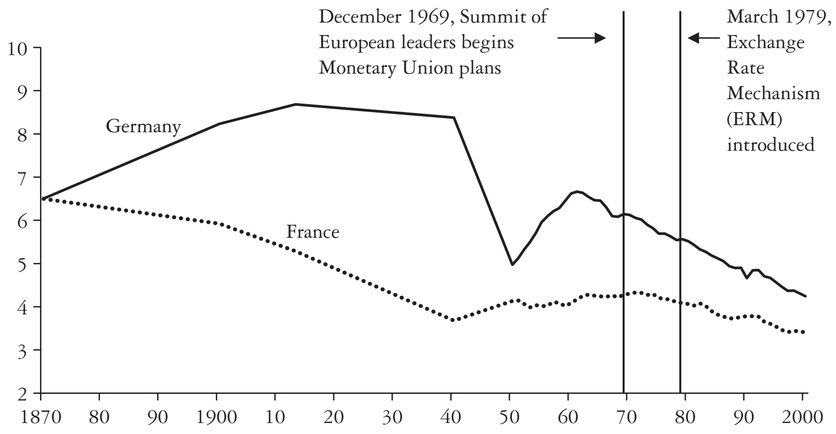

FIGURE 1.1. France falls behind Germany starting around 1870.
(Each country's share of world GDP, percent)
Sources: Angus Maddison. "Historical Statistics of the World Economy: 1–2008 AD." University of Groningen, available from: http://www.ggdc.net/maddison/oriindex.htm, series "GDP." The values for 2009 and 2010 are from the Conference Board (GDP adjusted for purchasing power parity, series "GK GDP"), available from https://www.conference-board.org/data/economydatabase/index.cfm?id=27762.

for economic development." Working together to raise standards of living would be the glue of a politically united, postwar Europe.

In his instantly historic declaration, Schuman had outlined the basic contours of postwar European integration: centralized governance and the promise of economic prosperity. The details were to be decided once European nations were airborne on their first leap into the dark.

Paris 1951: The First Leap

Jean Monnet followed Schuman to London. Born in November 1888, Monnet had left school at the age of sixteen, set up a canned-food business, sold cognac for his family's company, been a merchant banker, and become an "entrepreneur in the public interest."[6] In May 1950, as head of the French Planning Commission, Monnet was also the author of the Schuman Plan.

Monnet was keen for the British to sign on to the Schuman Plan and give the fledgling initiative gravitas and momentum. But the skeptical British saw the French initiative as an effort to create an unaccountable European bureaucracy, which could override the decisions of the British government and parliament. As Monnet himself later reported in his memoirs, a section of the British press "recoiled at the word 'federation'" and expressed alarm that the plan would "be the end of British independence."[7]

British officials were polite but firm. The plan, they said, was too vague and open-ended. In particular, they questioned the need for a "High Authority," which they feared would acquire great powers and undermine British sovereignty. But to Schuman and Monnet, a "High Authority" was crucial and, hence, nonnegotiable. Monnet's final meeting on that London trip was with Sir Stafford Cripps, Chancellor of the Exchequer, Britain's finance minister. When Cripps refused to budge, Monnet darkly warned him that the British would regret their stubbornness and eventually "adjust to the facts" after seeing Europe "succeed."[8]

Four other countries—Italy, Belgium, Luxembourg, and the Netherlands—responded to Schuman's call. Country representatives soon met to discuss and negotiate the way forward. Those were heady days for Europe. François Duchêne, an Anglo-Swiss public intellectual and longtime aide to Monnet, would write that the officials who negotiated the Schuman Plan "thought of themselves as laboring together for a common good." Their shared sense of history and purpose "created a brotherhood of politicians and high officials."[9]

When national leaders gathered on April 18, 1951, to sign the Treaty of Paris and formally create the Coal and Steel Community, a number of matters remained unresolved; indeed, there was no real treaty to sign. Luuk van Middelaar, a European scholar and former senior Eurocrat, writes that the ministers (including Adenauer for Germany and Schuman for France) "signed a blank sheet of paper." Such was the sense of goodwill: "Europe began on an unwritten page."[10] Monnet was appointed the first president of the High Authority of the European Coal and Steel Community, and the first European institution was in place.

The main goals of Schuman's leap-in-the dark strategy—political reconciliation and European security—were achieved. Germany was brought back into the fold. The Coal and Steel Community created forums for economic and political coordination, and European leaders learned to speak to and work with one another.

But could Europe develop further, as Schuman had visualized, into a "federation"? The signs were not promising. Even with the goodwill at the time, the Treaty of Paris had dropped any reference to a European "federation." Instead, the German negotiators had proposed the word *Gemeinschaft*, translated into English as "community." Van Middelaar explains that *Gemeinschaft* signifies a stable and durable association, and the principle was that member states, working together in a "community spirit," were to be "all equal under law."[11] Thus, rather than rushing into hierarchical relationships within the rigid structure of a federation, the consensus was to gain strength from durable ties among equals.

Nevertheless, the idea of a European federation remained alive. In the summer of 1950, soon after Schuman's historic declaration but before the Treaty of Paris was signed, new tensions prompted another initiative. The Americans began insisting that Germany needed to rearm itself as part of a broader European defense against the Soviet threat. "Once again," Monnet wrote, "there was talk of an arms race, and above all of returning to the former aggressor the weapons he had seemed glad to lay down."[12] The French were aghast at the thought of a German army. French leaders and citizens alike asked, "Are we going to have to go through it all over again?"[13] The Americans, however, remained insistent.

The French were in a dilemma. Although they abhorred the idea of a rearmed Germany, the risk was that Americans might give Germany the legitimacy and latitude to form its own army. If that happened, Germans could decide to walk away from Schuman's proposed Coal and Steel Community.[14] Monnet was also concerned that Germans were becoming more "nationalistic."[15] In a bid to prevent the Americans and the Germans from getting too far ahead, French Prime Minister René Pleven reluctantly proposed the creation of a European army under the supervision of a European Defense Community (EDC).[16] The goal was to embed German forces within a newly assembled European army operating under the control of a European minister of defense, with the policies and strategic objectives set by a Council of Ministers from member states. Although it was a response to American pressure, the ambition of the latest plan was breathtaking. With its European governance structure and its own budget, the EDC remains to this day Europe's most far-reaching initiative to achieve political union.

The EDC Treaty, signed on May 27, 1952, was ill fated. The Germans bristled at the "blatantly inferior" ranks at which their soldiers were to be included in the European army.[17] Despite such reservations, the German parliament, the Bundestag, did ratify the treaty in March 1953. Adenauer supported the EDC because Germany was still an "occupied territory" and "a mere object in diplomatic contests"; the EDC offered Germany another opportunity to become a "co-actor" in European and global affairs.[18] The French, however, having initiated the project reluctantly, had second thoughts. They were not ready for a rearmed Germany, and they were unwilling to see their own army disappear into a "stateless hotch-potch."[19] Moreover, with France experiencing "defeat and humiliation in Vietnam," the new prime minister, Pierre Mendès France, decided that his tenuous coalition government could crack if he insisted on a vote in favor of the EDC Treaty.[20] With no advocate, the French National Assembly unceremoniously rejected the treaty on August 30, 1954.

The words *federal* and *supranational* became tainted, and "the idea of a Europe in some sense above nations" was discredited.[21] Although memories of World War II were still fresh and the ground for political unity was more fertile than it had ever been, the French refused to cross a threshold that compromised core fiscal and political sovereignty. The EDC, despite its original impetus from the Americans, was a real effort toward a United States of Europe. But the ambition overreached. As Mendès France bluntly said, "In the EDC there was too much integration."[22]

Soon even the Coal and Steel Community came to be viewed as intrusive and irrelevant. Ostensibly, there were technical difficulties with the coordination of production. The real problem, however, was that Monnet began stepping on the toes of national politicians. He tried to shape the High Authority as a European administration run by a technocratic elite based in Brussels. He asserted the right to levy taxes, with only the obligation to consult the Council of Ministers.[23] The High Authority quickly became the largest foreign issuer of bonds on the New York market in its effort to be "the hub of Community investment."[24] Asserting that he was Europe's representative, Monnet established direct relations with foreign governments. Put simply, Monnet was performing tasks reserved for national governments elected through a democratic process. The smaller member states felt particularly threatened by him.[25]

European leaders aspired to do more but they were uncertain about what should come next. In his biography of Monnet, Duchêne has sympathetically described that moment of contemplation. Contemporaries recognized that Europe could not be built through either "security or political means."[26] Instead, they concluded that "approaches henceforth would have to take more oblique—meaning, in practice, *economic*—avenues." This renewed emphasis on the economic interests of European nations was a return to Schuman's message that peace and European integration required long-term commitment to deliver material progress. While Schuman had focused on immediate postwar priorities, he had said that Europe could be successful only if it raised people's standards of living. It is to the credit of European leaders that they recognized that efforts to forge ahead with political structures would only lead to more dead ends, and thus that it was time to change course. Thus, the first leap ended with an institutional framework to discuss matters of common European interest. More important, it made clear the limits of how deeply Europeans were willing to integrate with one another and imparted the momentum to begin a second leap to the Treaty of Rome.

Rome 1957: The Second Leap

Belgian Foreign Minister Paul-Henri Spaak led the effort and drew on the Dutch for support. These two smaller European nations had been minor bystanders in the "first" Europe; they now pushed to promote their interest, which lay in greater commercial integration. Being small countries, they relied heavily on international trade and stood to benefit considerably from reduced barriers to trade. The Spaak Committee's report, published in April 1956, emphasized that all European nations would gain from expanded opportunities for trade with one another.[27] Indeed, Europe had no choice, the report warned. Failure to generate more prosperity through trade would cause Europe to fall farther behind the United States.

The political logic behind this new initiative was also sound. More trade reduces the risk of war by creating mutual economic interests and personal empathy among businesses transacting across borders.[28] Importantly, this gain is achieved without sacrificing national sovereignty. Instruments to foster trade require minimal international supervision and allow nations to retain their core sovereign authority based on national democratic processes.

Germany and France, for their different reasons, resisted this new effort at first. Ludwig Erhard, Germany's economics minister (1957–1963) and later chancellor (1963–1966), wanted borders opened to all countries, not only to European nations; the French did not want borders opened, not even to European nations.[29]

The French exacted a price for moving forward. To protect their inefficient farmers, French authorities persuaded other European nations to join in subsidizing all European farmers. Thus was born the Common Agricultural Policy (CAP), which created egregiously large and long-lasting costs for Europe and for the world. Indeed, the CAP was postwar Europe's most disgraceful economic policy. It led to wasted food, lower prices for developing country farmers, and a heavy drain on the meager European budget (see Appendix at the end of this chapter).

The rest was smooth sailing. Global economic forces were favorably powerful. World trade was growing rapidly, and the Europeans stood to gain from joining rather than opposing this opportunity.[30] On March 25, 1957, the "original six," those that had formed the Coal and Steel Community, signed the Treaty of Rome. They now joined to form the European Economic Community (EEC), which started functioning on January 1, 1958.

The Treaty of Rome responded to the clear message from member nations that they would push back against efforts to encroach on their sovereignty. As Duchêne sums it up: "The governments rejected anything or anyone that threatened, like Monnet, openly to compete with their monopoly."[31] Hence, the European Commission, which replaced the unpopular High Authority, was given reduced powers so that another president of Monnet's standing could not expand the range of actions taken at the European level. The new commission's tasks were limited to drafting proposals for European laws and conducting the "day-to-day business" of implementing policies and spending European funds.[32] Even Charles de Gaulle, who had opposed the treaty before he became France's president in 1958, ultimately reconciled himself to it.[33] The Treaty of Rome, de Gaulle wrote in his memoirs, was "an improved treaty of commerce that does not alter the sovereignty of the Six [members], notably in political matters."[34]

The engagement of the smaller countries in forging and implementing the treaty allowed a clearer expression of "community spirit." The community functioned to strengthen economic links but did not relegate the smaller member states to a second-tier status from where they would have to work harder to preserve their sovereign status. As historian Alan Milward would write in 1992, the European community, with its shared institutional structure, "rescued" the nation-state. Member nations, differing in their economic capabilities and social priorities, could work within a system that extended their ability to bring opportunities to their citizens but, at the same time, treated all nations in a fair manner and as equals.

As a trade agreement, the Treaty of Rome set out with modest ambitions. Tony Judt, historian and author of the classic *Postwar*, reminds us that the treaty was "for the most part a declaration of future good intentions."[35] It outlined a process rather than specific goals and measures. The Treaty of Rome nevertheless succeeded so spectacularly because it was ideally suited to the times. Benefiting from the momentum of postwar recovery, GDP growth rates were still high. World trade was expanding rapidly, and the need to reduce the barriers to trade—even if not recognized at first by all participants—soon became self-evident. France was the last nation to board the Treaty of Rome bandwagon. All member states of the European Economic Community (EEC) found it in their interest to reduce tariffs, lowering them faster than proposed in the treaty.[36] Quantitative restrictions on trade virtually disappeared by 1961. In pushing ahead with freer trade in its self-interest, Europe also led the global effort to bring trade barriers tumbling down.

This happy coincidence of trade integration, economic progress, and European "self-confidence" continued during these years despite de Gaulle's efforts to disrupt the European sense of collegiality and community. De Gaulle believed that the community's institutions, unless checked, would override national authority and undermine French priorities. For de Gaulle, European institutions were of value only if they promoted French interests, if they were, in his words, "the means for France to recover what she ceased to be after Waterloo: first in the world."[37]

In 1960, de Gaulle began an effort to coordinate European defense and foreign policy under French leadership.[38] De Gaulle had an ally in Adenauer, who, having gained legitimacy for Germany, was willing to bypass EEC institutions in favor of an intergovernmental approach. Adenauer's support for de Gaulle was sometimes grudging, not least because de Gaulle made no effort to hide his contempt for "les petits gens de Bonn" (the little people of Bonn).[39] Adenauer, however, played along because he shared de Gaulle's instincts to curtail European authority; Adenauer was a "Gaullist" on matters related to Europe.[40]

Dutch Foreign Minister Joseph Luns led the fight against de Gaulle's effort to take charge of Europe. De Gaulle's project, Luns said, would "serve as the infrastructure of the greater French international power position" and do nothing "to strengthen European unity and integration."[41] Fierce Dutch and Belgian resistance ensured that de Gaulle's first attempt to hijack Europe went nowhere.

De Gaulle created the next governance crisis between March 1965 and January 1966. He was responding, in part, to a European Commission effort to gain taxation authority. If that proposal went into effect, the eminent Eurocrat Robert Marjolin noted, "the Commission would {have} become, in budget matters, a kind of government of the Community."[42] All member states had reacted angrily to the commission's encroachment on sovereign rights. But de Gaulle went a step further. He tried to undo the Treaty of Rome's provision for decisions by majority vote and sought, instead, a right for member states to veto European proposals. Eventually, under the so-called Luxembourg Compromise of January 1966, European leaders agreed that they could veto decisions on matters they considered to be of very high national interest. With that, as Marjolin summed up: "The Community was stripped of the few supranational elements that had been written into the Treaty of Rome."[43] De Gaulle instigated this outcome, but the others, especially the Germans, found the arrangement entirely congenial.

Yet through these power struggles during the first half of the 1960s, the Treaty of Rome continued to function smoothly. The treaty was a magnificent achievement precisely because it did not depend on elaborate coordination among nation-states or on supranational regulation. As commerce among the EEC members expanded, so did public support for Europe. Reflecting back on those years, with some pride in the role he played, Marjolin later described the decade after the signing of the Treaty of Rome—the years from 1958 to 1967—as the "springtime of Europe." A widespread "spirit of self-confidence" accompanied the "feeling that great things were happening."[44]

By the mid-1960s, it was possible to look back with a sense of accomplishment and pride. The first two leaps in the dark, despite their despondent moments, had proven to be historically courageous and wise. For political idealists, there was much to celebrate. As Oxford University's Timothy Garton Ash has written, although Europe was an "externally ill-defined, internally diverse, and historically disorderly" continent, Europeans had developed mechanisms for institutional cooperation.[45] Europe had made big strides toward a "liberal order"; the people of Europe could pursue "different ends," and although these ends could not all be "reconciled," they could "coexist peacefully."[46] For economic idealists, Europe's nation-states had adapted to the needs of an interconnected global economy, and commercial relationships within the community had increased the sense of European identity and deepened the foundations of peace. The essential purpose of postwar Europe was complete.

Europe at a Critical Juncture

The contrast with what came next is stark. The postwar boom began to fade by the late 1960s. Amid growing worries about Europe's economic future, European leaders sought to push European integration but without a sense of where they were going or, indeed, why more integration was needed. "The world had changed," writes Duchêne.[47] Germany did not need Europe for political recognition, and de Gaulle had made it legitimate for European nations to reject anything perceived as "outside interference." In addition, whereas in the previous two decades the world economy had been generally buoyant, now the postwar economic miracle years were ending. Perhaps most important, differences in national economic performance had thus far not been especially relevant for the construction of Europe. But now, as Europe took its next steps, widening inflation differentials across countries were signs that European nations were moving on different economic paths.

A notable troubled spot was France. Although buoyed by the postwar momentum and expanding world trade, the French economy had "aged," wrote economic historian Charles Kindleberger. The loss of vitality had steadily strengthened "vested interests" and created a sense of being entitled to a higher standard of living.[48] Businesses had reaped easy gains from the favorable economic environment but had not adapted to the needs of a competitive global economy. French government policies propped up consumption and reduced incentives for risk-taking. The result was frequent bouts of inflation, and "when all groups demand 110 percent of the national income, and government is unable to resist them, 10 percent inflation is inevitable."[49]

This tendency to experience bouts of domestic inflation caused a recurring headache for France with its international finances. At the heart of the international problem was the exchange rate, the price at which one currency buys another. Under the postwar Bretton Woods international monetary system, countries were required to keep their exchange rates "fixed"—the price of the currency was to remain within a narrow band around an agreed parity. This system did not suit France. With the French franc's exchange rate fixed, French exporters struggled. If, as their domestic costs went up, they kept US dollar or German deutschmark (D-mark) prices for their international buyers unchanged, their profits would be squeezed; if they raised their international prices to compensate for rising domestic costs, they would sell less abroad. Also, a fixed exchange rate induced French consumers and businesses facing high inflation at home to buy the now less expensive goods from abroad. Thus, France developed a tendency to sell less abroad than it imported; this shortfall of exports over imports, the "current account deficit," had to be financed by borrowing from lenders abroad. It was neither prudent nor possible to keep running deficits, because the country would become overly indebted to the rest of the world.

About every ten years, the pressure became unbearable, and French authorities were forced to devalue the franc to make imports more expensive and exports cheaper.[50] In principle, devaluation (formally, "downward adjustment of the parity") required the permission of the International Monetary Fund (IMF)—guardian of the global monetary system under the Bretton Woods Agreement. French authorities tried to bypass the humiliation of seeking the IMF's nod. But with or without the IMF's concurrence, devaluation was seen as an admission that the country's authorities had mismanaged their economy.

Repeated devaluations were truly embarrassing. Following a devaluation of the franc in 1948, the reprieve quickly wore off, and it was devalued by more than 30 percent during 1957-1958. French inflation, however, remained too high, and pressure for another devaluation kept building.[51] In its annual review of the French economy in 1968, the IMF said that France had not kept pace with international competition at least since 1960.[52] The French executive director of the IMF objected to this characterization, but other directors endorsed the bleak assessment of French competitiveness.

The underlying structural problem was that French businesses were unable to raise their productivity rapidly enough to compete in the global marketplace and France, as a nation, was, therefore, unable to live within its means. Exchange-rate devaluations were not a solution to France's long-term problems. Devaluations can help only temporarily to revive economic activity, and each devaluation makes the country poorer, since more domestic goods have to be sold abroad to buy the same quantity of imports. Rather than continuing to rely on frequent devaluations, the French economy needed fundamental changes. Businesses needed to become more innovative, and workers needed to moderate their wage demands. Progress on both those fronts would have dampened domestic inflationary pressures, made the French economy more competitive, and made French citizens more prosperous.

The contrast with German economic performance was striking. German companies held a dominant position in the global exports of sophisticated industrial products. Moreover, with German citizens still haunted by the memories of interwar hyperinflation and the accompanying political calamity, the Deutsche Bundesbank, Germany's central bank, had kept a determined lid on inflation. The combination of high productivity growth and low inflation led to large excesses of exports over imports and, hence, to chronic current account surpluses.[53] Because German products were in such great demand, international buyers perpetually scrambled for German D-marks, and German authorities were always under pressure to revalue the D-mark (to make it more expensive) and thus dampen the incentive of foreign buyers to purchase German goods.

For France, the strong D-mark and the weak franc became depressing symbols of German ascendancy and French decline. Things came to a head with the French student uprising in May 1968 and the workers' strikes in June. The government's efforts to pacify students and workers "satisfied no one."[54] The huge increase in workers' wages increased demand for domestic goods and services, fueling a new bout of inflation.[55] French investors lost confidence in their own government's ability to stabilize the economy and so rushed to convert their francs into safer D-marks, which were expected to rise in value. To meet this panicky demand for D-marks, French authorities drew down their reserves of gold and US dollars, according to one estimate, from nearly $6 billion in April 1968 to $3 billion by November 22 that year; of that total, $1 billion was drawn down after November 14 as investors fled with their money.[56]

On November 22, finance ministers of leading industrial nations met in Bonn. It was widely anticipated that the French would announce devaluation of the franc, which would make D-marks more expensive for French residents and, hence, slow the outflow of funds from France.[57] In France, the prospect of devaluation was read (correctly) as a sign of national decline, and it caused widespread dismay. The Germans intensified the hurt. The most mild-mannered jibe came from the usually strident German tabloid *Bild-Zeitung*, which carried the headline "Germany is number one again."[58] German Finance Minister Franz Josef Strauss dealt French prestige a blow by preemptively announcing that the franc would be devalued.[59] And the French felt the greatest sense of shame when the newspaper *Le Monde* reported that German journalists had "passed the hat for France" at a news conference.[60] These German assaults registered deep in the French psyche. Michel Debré, de Gaulle's foreign minister, looking back at this event in his memoirs, wrote: "I know the Germans sufficiently to be aware that they abuse their power as soon as they are in a position to do so."[61]

We can only speculate how de Gaulle felt about France's shame on November 22. The next day, he called a cabinet meeting at three thirty in the afternoon and kept the meeting running for hours as reporters and investors waited for his decision. Late in the evening, a brief statement from the Presidential Palace read: "The present parity of the French franc is maintained."[62] The franc would not be devalued after all. De Gaulle went on to impose austerity measures to reduce imports; in addition, France borrowed from abroad (including from Germany) to finance its current account deficit.[63]

De Gaulle briefly regained the adulation of the French people, who were elated by his willingness to "fight" the foreigners in a "financial war."[64] The drama of de Gaulle's defiance was exhilarating, but France's economic and social problems had not gone away. French exporters needed a weaker franc to be competitive in international markets, and a misguided attachment to the strength of the currency only prolonged the anguish and made matters worse. By thumbing his nose at the Germans, de Gaulle had, one last time, given French citizens something to cheer about. But he could offer no longer-term vision consistent with the aspirations of the people. On April 27, 1969, French citizens voted against de Gaulle's proposals for changes to the French constitution. De Gaulle had lost the confidence of French citizens and he resigned on April 28. He died in November 1970, having completed only the first volume of his *Memoirs of Hope*.

History's currents were meeting. Georges Pompidou, who had served under de Gaulle as prime minister between 1962 and 1968, was about to take over as president. The French economy was falling behind the German economy and needed a boost from the devaluation that de Gaulle had valiantly withheld. Pompidou did not share de Gaulle's disdain for Europe. And so Pompidou wondered if "more Europe" could solve France's problems and help it catch up. True, the European integration process had reached a successful end. But the narrative of more integration as a solution for European problems was still alive. Psychologists Amos Tversky and Daniel Kahneman coined the phrase "availability heuristic" to explain that human beings instinctively believe the world will continue to work in the future as it has in the recent past.[65] Europe's infrastructure seemed "available" to take another leap.

The Hague 1969: The Third Leap

Georges Pompidou was elected president of France in June 1969. The franc came under pressure again, and the new president waited until August 8 to announce another devaluation.[66] In the meantime, he had called for European leaders to meet at The Hague later that year.[67] One of the topics of discussion at the leaders' summit was European monetary union. It was thus that France led Europe to take its third leap in the dark.

Although a Gaullist and therefore protective of symbols of French sovereignty, Pompidou decided it was time to give up de Gaulle's allegiance to the cherished French franc.[68] The franc, in his view, had become a perpetual headache. Pompidou persuaded himself that the way forward lay in monetary union, in which France and Germany would use the same currency. Once the franc disappeared into the miasma of a single currency, the need for humiliating devaluations would disappear. Thus, the French would not have to suffer continuous reminders of German economic superiority.

Pompidou was willing to give up de Gaulle's assertive nationalism, but he retained the Gaullist instinct that Europe must serve France's purpose. For him, "containing Germany" was the principal objective.[69] As would become clearer over time, "containing Germany" was mainly a code phrase indicating the goal of gaining economic parity with Germany. Parity, however, could be achieved only in the superficial sense. A single currency would eliminate the glaring difference between the strength of the D-mark and the French franc. But, to gain real parity, French leaders needed to build a more dynamic economy.

"Monetary union must be our priority," Pompidou declared. "This is where concrete results can be achieved."[70] Hubert Védrine, who later served as one of the closest advisers to French President François Mitterrand, later wrote that from Pompidou onward, monetary union became "a principal goal of French diplomacy."[71]

Pushing Back the Tide of History

A single currency within a monetary union would fix the exchange rates among France, Germany, and other member states that joined the monetary union. Member countries sharing the currency would also share a central bank that set a single monetary policy for all of them. French authorities would no longer have a currency that they could devalue if businesses in France lost competitiveness, nor would they be able to reduce domestic interest rates to pull the French economy out of a recession. Instead, France would depend on a European central bank that set the common interest rate and thus steered the exchange rate for the entire single-currency area. That common interest rate and exchange rate would depend, importantly, on the German economy, which could well be performing strongly and running current account surpluses at the same time. A European central bank could not respond to France's domestic economic needs.

It is helpful here to step back in time to fully recognize the folly of Pompidou's monetary union proposal. That proposal attempted to push back against the rushing tide of international monetary history. The experience of the past nearly one hundred years had plenty of cautionary warnings to offer about the risks of fixing exchange rates and giving up national monetary policy. The one apparent exception was the period between 1880 and 1913 when fixed exchange rates had, indeed, served the international community well. During those years, the world's major economies exchanged their currencies for a fixed amount of gold, giving rise to that system's name as the "gold standard." The world enjoyed rapid economic growth and, for the most part, achieved financial stability.[72] Because the gold standard and global prosperity coexisted, many observers inferred that the prosperity was the result, at least in part, of the gold standard and, therefore, fixed exchange rates were the only proper way to organize the international monetary system.

In truth, however, fixed exchange rates are helpful only during periods of economic calm. Economic historians Barry Eichengreen and Peter Temin have explained that "in good times," the ability to conduct international transactions at unchanging exchange rates creates an additional sense of stability. But "when times are bad," fixed exchange rates "intensify problems."[73] After 1913, governments of high-inflation countries often urgently needed to devalue their currencies to prevent excessively large current account deficits. Because such governments were held back from devaluing, they imposed harsh domestic austerity to restrict imports. That led to high unemployment. The problem became especially acute during the Great Depression in the 1930s, and according to Eichengreen's influential analysis, the gold standard had greatly added to the misery of the Great Depression.[74]

Thus, the interwar period—and, especially, the experience during the Great Depression—undermined the rationale for fixed exchange rates.[75] However, the world's policymakers had not fully absorbed the lessons from the Great Depression when they met at Bretton Woods, New Hampshire, in July 1944 to decide on a new international monetary system. They did recognize that requiring rigidly fixed exchange rates would be foolish. And so, in a modest concession to that reality, they had allowed for "adjustment" of exchange rates under international supervision. That, then, was the origin of the postwar "fixed-but-adjustable" exchange rates.

The new system had serious problems, as became quickly evident to University of Chicago economics professor and later Nobel laureate Milton Friedman. First in 1950 and again in 1953, Friedman explained that when exchange rates are fixed, warnings of trouble are initially not striking enough. Governments, therefore, delay their response, hoping that matters will be set right. But the "disequilibrium" in the current account grows (the current account deficit increases) to "crisis dimensions, requiring drastic action at home, international consultation, and help from abroad."[76]

Almost as if he could foresee the recurring need to devalue the French franc and the tendency for French authorities to cling to the fixed rate and delay that decision until a financial crisis loomed, Friedman called for abandoning the Bretton Woods system.[77] It was time, he insisted, for currencies to float freely: the exchange rate—the currency's price—should not be decided once every several years by the government or the IMF but should be determined continuously by market forces of supply and demand. Under floating or "flexible" exchange rates, the value of the currency would, he said, respond to rising inflation and widening current account deficits well before crisis-like conditions set in. The exchange rate, a "sensitive" price, would act like a shock absorber.

Over the two decades that followed, Friedman was proven right in his diagnosis of the shortcomings of fixed exchange rates. The Bretton Woods system was poorly equipped to deal with persistent differentials in inflation rates across countries. All politicians—not just those in France—preferred to delay devaluations because reducing the value of the home currency was associated with public loss of face and prestige; and the international community discouraged devaluations because one currency's devaluation could set off cascading "competitive devaluations" by others seeking to regain export advantage. The delays encouraged speculators to test if governments would keep their commitment to the fixed rate. Policymakers fought back with a mélange of responses, including controls on imports and capital movements.[78]

But growing numbers of international investors were willing to speculate on impending devaluations by selling the currency whose value they expected would fall. To maintain their commitment to the fixed rate, governments had to use their foreign-exchange reserves to buy their own currency, and when the reserves began to fall too low, governments that refused to devalue had to either hike interest rates or impose fiscal austerity to restrain imports and, hence, contain the current account deficit. However, higher interest rates and austerity caused domestic economic activity to slow down and threatened to raise unemployment to politically intolerable levels. Speculators understood that governments would not be able to withstand the political pressure arising from a slowing economy and widespread unemployment and hence that the governments would eventually capitulate and let the currency depreciate.

As French authorities surely understood, for countries that were losing international competitiveness, it was not possible in a world of active financial speculators to maintain a fixed exchange rate and simultaneously conduct domestic macroeconomic policy to meet the country's growth and employment objectives. France's problem was not Germany. France, quite simply, had been unable to get its own house in order.

By the late 1960s, many countries found it impossible to live within the constraints of fixed exchange rates and the postwar Bretton Woods system of fixed-but-adjustable exchange rates was slowly breaking down. The United States, the linchpin of the system, struck the final blow. Running high inflation rates, it could not sustain its commitment to pay $35 for an ounce of gold. On March 15, 1968, a "two-tier" system was introduced under which central banks would continue to transact with one another at the $35 price but would not interfere in the setting of gold's market price. At that point, monetary historian Michael Bordo says, the Bretton Woods system effectively ended, although an attempt to stay within a fixed exchange rate regime continued for some years.[79]

In March 1969, another towering economist, Harry Gordon Johnson, repeated Friedman's call for flexible exchange rates. Such was Johnson's intellectual heft that Yale University economist James Tobin (and future Nobel laureate) later wrote of him: "For the economics profession throughout the world, the third quarter of this [the twentieth] century was the 'Age of Johnson.' [He] bestrode our discipline like a colossus."[80] Johnson pointed to an embarrassing void in the economics profession: "little reasoned defense of the fixed exchange rate system has been produced beyond the fact that it exists and functions after a fashion, and the contention that any change would be for the worse."[81] In contrast, he said, the case for flexible exchange rates was undeniable. Friedman, Johnson said, was right. Greater exchange-rate flexibility would give countries greater insulation from macroeconomic shocks and would allow national authorities more freedom in the pursuit of domestic policy objectives.

Thus, while in 1957 the Treaty of Rome had been in the vanguard of international trade liberalization, in late 1969, Pompidou's call for permanently fixed exchange rates embedded in a European monetary union was not just an eccentric priority for France, it was mystifyingly opposed to the global trend toward a system of flexible exchange rates. In seeking what appeared to him an easy fix, Pompidou was shirking his true obligation to seek real solutions to France's long-term competitiveness problems. He was, moreover, pulling other European nations into a gamble whose historical context and risks he evidently did not understand and whose complexities he had no idea how to manage. Pompidou was doing everyone a disservice.

Of course, Pompidou's proposal could have simply died at the meeting in The Hague. There was, after all, the matter of Germany. Germans shared with many in the English-speaking world, the "Anglo-Saxons," a respect for the market economy. In the 1950s, Ludwig Erhard, seeking to foster truly competitive markets in Europe, had wanted Europe's trade borders to be opened to all countries—and not just to other European nations. Similarly, to German officials, it now made sense that the price of the currency was best set by market forces.

Indeed, although the US-based Friedman had given impetus to the concept, German scholars were the real aficionados of flexible exchange rates ("flexible Wechselkurs" or "schwankender Wechselkurs") (see figure 1.2). They had run with this theme faster than the Anglo-Saxons had. And, in this respect, German scholars were a world removed from their French counterparts. In France, academics, bureaucrats, and politicians remained steeped in a dirigiste mindset: the idea that governments could (and should) manage virtually all aspects of the economy. Not surprisingly, the French showed little interest in exchange-rate flexibility ("taux de change flexible" or "taux de change flottant"). To them, it seemed unimaginable that anyone other than the government would set the price of a country's currency.

On September 29, 1969, two months before the summit at The Hague, Germany let the D-mark's exchange rate float against the dollar. Soon after, the German authorities did peg the D-mark again. However, German officials had shown a willingness to move toward a floating-rate regime. As

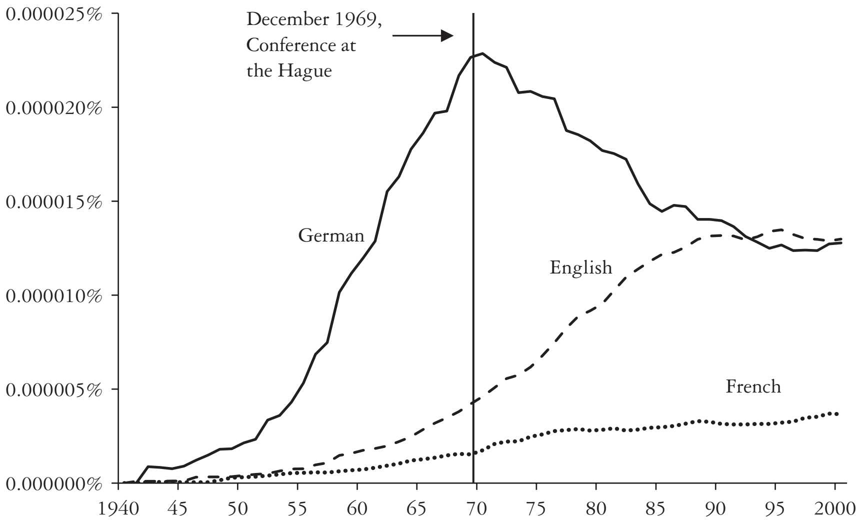

FIGURE 1.2. Germans led the intellectual inquiry into "flexible exchange rates."
(Frequency of reference to "flexible exchange rate" in books digitized by Google)
Note: The graph was created using the Google Books Ngram Viewer (https://books.google.com/ngrams/info). It reports the frequency with which the phrase "flexible exchange rate" is mentioned in the books scanned by Google. The term "flexible Wechselkurs" was used for German books, and "taux de change flexible" was used for French books. The English variation "floating exchange rate," the German variation "schwankender Wechselkurs," and the French variation "taux de change flottant" yielded similar trends.

Robert Hetzel, economist at the Federal Reserve Bank of Richmond, would later explain: "Germany's commitment to a free market economy pushed it to reject fixed exchange rates and adopt floating exchange rates."[82]

Thus, in proposing a monetary union, Pompidou was defying not only the global experience that was causing fixed-exchange-rate systems to break down, but he was also ignoring the clash between the French dirigiste temperament and the German market-oriented economic ideology. Pompidou nevertheless pushed ahead, because a quarter century after World War II had ended, he believed that France still had leverage as "moral guarantor for the Federal Republic [of Germany]."[83]

As the Hague summit approached, Pompidou pushed harder. Two days before the summit, on Saturday, November 29, the *New York Times* reported that Pompidou would "press for closer monetary links within the European Economic Community" at the summit.[84] Pompidou's finance minister, Valéry Giscard d'Estaing, added that the summit would chart a path toward a common European monetary policy.

The Germans could have said no and walked away. Germany was an economically powerful nation. It preferred floating exchange rates. The idea of a European monetary union would have been shelved in the archives.

The Shadow of the War Continues to Fall on Germany

Germany's politics and leadership were also changing. The Christian Democratic Union (CDU) had finally lost its postwar grip on power, and Willy Brandt of the Social Democratic Party (SPD) had just become chancellor. Brandt had left Germany in 1933 soon after Hitler came to power.[85] When he returned to Germany in 1947, some Germans considered him a traitor for living abroad while they had endured unspeakable tyranny at home. However, on his return, he wrote and spoke eloquently about German responsibility. He came "to symbolize a Germany of peace, tolerance and a measure of modesty."[86] Brandt became mayor of West Berlin in 1957 and West German chancellor in 1969.

Above all, Brandt wanted to atone for German brutality and crimes. In December 1970, a little more than a year after he became chancellor, Brandt traveled to Warsaw to lay a wreath at the Monument to the Ghetto Heroes. There, in an unplanned and unexpected gesture of penance, he bowed and went down on his knees. Amid the stunned silence, clicking cameras captured images of that remarkable "Warsaw Genuflection."[87] Years later, Brandt wrote: "From the abyss of German history, under the burden of millions of victims of murder, I did what human beings do when speech fails them."[88] He was awarded the Nobel Peace Prize in 1971 for his "attempt to bury hatred" and his courage in promoting peace and detente.[89]

Although he set high value on establishing international harmony, Brandt had a skeptical view of the European project. He wrote in his memoirs that "emotional" calls for European integration were common, but "national prejudice and recalcitrance" shaped real decisions. European politicians, he went on, found it "easy to soar above national egocentricities on the wings of rhetoric, but this achieved little more than a Europe of declamations."[90] Brandt's "financial experts" warned him that the French proposal for European monetary union was not in Germany's best interests. The experts asked him "to exercise the utmost caution."[91] Brandt himself was clear that "structural disparities between member countries and divergences in economic aims and practices were real problems" in moving toward monetary union.[92] Thus, neither a greater European cause nor a specific idea of European monetary union enthused Brandt.

Brandt's overriding priority was *Ostpolitik*, reconciliation between West and East Germany. "We must prevent a further drifting apart of the German nation," he said, and begin working "with each other."[93] This was a historic task, to which there was great resistance. Within West Germany, Brandt faced opposition from the Christian Democrats.[94] Abroad, reconciliation and eventual German reunification aroused fear of renewed German nationalism. Thus, although the war had ended more than a quarter century earlier, it continued to cast its shadow on Europe. *Ostpolitik* was still too radical, and Brandt needed allies to make progress.

In a bid to gain French support for *Ostpolitik*, Brandt showed willingness to discuss Pompidou's monetary union idea. Since his experts were trying to dissuade him from going down this path, Brandt consulted Jean Monnet. For Monnet, "more Europe" was always the right way forward. He never quite grasped the strength of the European nation-state.[95] Monnet "encouraged" Brandt to consider establishing a European Reserve Fund, a concept long advocated by Robert Triffin, the Belgian-born Yale economist and avid proponent of monetary unions.[96] The Reserve Fund would pool contributions from member states to lend to countries running current account deficits and even to promote growth.[97]

Karl Schiller, German minister of economic affairs, strongly opposed the Reserve Fund.[98] Schiller's position and that of other German "experts" was that Germany would discuss a common fund only after other European economies had "converged"—in other words, had achieved economic performance standards acceptable to Germans. Otherwise, Germans could end up financing those running persistent fiscal and current account deficits. Nevertheless, at the Hague summit, Brandt, who knew nothing of these matters and had barely given them any thought, agreed to further consider a European Reserve Fund.[99]

After the summit, the European public was excited by the possibility that Britain would finally become a member of the EEC. Having rejected Monnet's overtures to join the Coal and Steel Community in 1950 and having also chosen to stay out of the EEC created by the Treaty of Rome in 1957, Britain fell into a despondent mood of national "declinism."[100] British leaders had begun knocking on Europe's doors, believing that joining the EEC would "remedy" Britain's economic failures and increase its international political influence.[101] Twice, in 1963 and 1967, de Gaulle vetoed British entry. De Gaulle was convinced that Britain's true allegiance was with the United States and that as a proud, seafaring nation, Britain would disrupt a truly "European Europe."[102] However, de Gaulle was now gone, and Pompidou believed that Britain would help counter Germany's growing influence in European matters. Brandt, for his part, understood that Britain would not be an "easy partner." But, he believed, "Britain's steadfast resistance in World War II, her sacrifices and sufferings, should not be consigned to oblivion. Hadn't they already demonstrated their membership in Europe's darkest hour?"[103]

In public appearances after the summit, French and German leaders declared that their friendship was again driving European progress by enlarging membership in the EEC. Among other countries expected to join at that time were Denmark, Ireland, and Norway (Norway ultimately stayed out).

Tensions continued to bubble behind the public face of Franco-German amity. Brandt's preliminary agreement to the European Reserve Fund meant little because he himself was worried about divergent countries living within a monetary union; for which reason, both he and his officials were worried that Germany may be called to finance deficits in other countries. And, despite Pompidou's claim, France could no longer exercise any leverage as Germany's "moral guarantor." German newspapers reporting on the Hague summit emphasized that Germany was not only a superior economic power but had "emerged as at least equal to France in political weight."[104] Germany's economic ideology and national interest did not favor a monetary union, and Brandt attached no special value to European integration. A Franco-German tug of war was about to begin over what was as yet a hazy monetary union.[105]

1970: Werner Committee Proposes an Incomplete Monetary Union

At their summit in The Hague, European leaders set up a committee to chart a path toward monetary union.[106] Led by Luxembourg Prime Minister Pierre Werner, the committee immediately confronted the fundamental problem of monetary unions. When national authorities give up the ability to conduct monetary policy tailored to their domestic needs, they lose an essential macroeconomic management tool. Domestic monetary policy is typically in the front line of efforts to deflate excessive economic exuberance and help pull the economy out of recessions and crises. Within a monetary union, however, a common monetary policy applies to all members. If the common monetary policy is set to meet the needs of the "average" nation, inflation will rise faster in rapidly growing, high-inflation countries; countries struggling with a weak economy and low inflation will be further handicapped by what, for them, would be a too-tight monetary policy. Bringing countries into a monetary union was, therefore, a bad idea when countries were diverse and their performances were on divergent trajectories.

In an article published in September 1961, Robert Mundell, then an economist at the IMF and later a Nobel laureate, explained that a monetary union could succeed if workers were willing to migrate from struggling to booming economies.[107] However, the likelihood that European workers would migrate in sufficient numbers from one member country to another in response to shifting economic fortunes seemed unrealistic. Compared with US workers, who moved in significant numbers across states, European workers were much less mobile across national boundaries or even within their own countries.[108] In 1969, economist Peter Kenen, then a professor at Columbia University, argued that even if workers were mobile, a stable monetary union also required a substantial pool of centralized funds: a smoothly functioning monetary union needed a "fiscal union."[109] Such central funding, delivered through the federal government, was available in the United States.[110] The US government provided temporary relief to states facing short-term distress and gave long-term support to chronically underperforming states. No such funding was available, or seemed possible, in Europe.

The US government also facilitated private "risk sharing," which further evened out economic conditions across its various states.[111] Uniform regulations, federally backed deposit insurance for banks, and social security transfers from the federal government created an integrated national economy. A business could operate nationally rather than primarily within a single state, a bank could borrow and lend throughout the country, and households were willing to own stocks and bonds that financed companies with offices and production facilities nationwide. Thus, financial risks were diversified across states, and such diversification—like the flow of migrants—helped absorb the shock of economic contraction in a particular state.

The Werner Report, published in October 1970, recognized Europe's evident handicaps in creating a successful monetary union. In the report's words, European workers did not circulate across borders "in an entirely satisfactory way," and the "community budget" that was needed to support a fiscal union would always be "insufficient."[112] The report stated plainly that European nations needed to form a political union—a unified, democratically legitimate, political entity—to achieve sizable pooling of tax resources and thus operate a budget appropriate to the needs of a monetary union. The report's conclusion was straightforward: monetary union would be "unable to do without" political union.[113] Without political union, the necessary fiscal safeguard could not be established, and without that safeguard, the monetary union would remain fragile and would not survive.

Based on its analysis, the Werner Committee could easily have said that a European monetary union was a bad idea and needed to be stopped in its tracks. Europe could not mobilize sufficient political unity to achieve a safely functioning monetary union. Even in the shadow of World War II, when goodwill for other European nations and the sense of "brotherhood" was greatest, willingness to compromise on core sovereign rights had been absent. Taxation was a core sovereign right. No European nation was willing to hand over sufficient tax revenues to a European authority to make a monetary union work. Everyone on the Werner Committee understood that.

However, instead of counseling European leaders to abandon the venture, the Werner Committee discovered reasons to move ahead. The committee's report predicted that the inevitable tensions and pressures within the incomplete monetary union would force member nations toward "progressive development of political cooperation." Thus, the incompleteness of the monetary union was actually a virtue: it would be the "leaven," the yeast, that would cause Europe to ferment and transform into "political union."[114] The Werner Committee was expressing the French "monetarist" position: monetary union was the path to political union. Faith in such transformation lay in Jean Monnet's proposition that when Europe stumbled and fell, it got up to move forward. Monnet expressed this falling-forward idea in throwaway, but memorable words: "I have always believed that Europe would be built through crises, and that it would be the sum of their solutions."[115]

The Werner Committee members did understand that even if this benign progression unfolded, its end-point—a political union—could take decades to reach. But the Committee did not draw the obvious conclusion. As long as the "community budget" remained "insufficient," costly financial crises could occur. Was that good reason to put monetary union on hold?

The committee was under pressure to deliver something. Drawing on extensive correspondence during that time, David Marsh, author of *The Euro: The Battle for the New Global Currency*, writes that French leaders continued to push for monetary union. They were concerned that Germany was speaking in "a loud voice" because the D-mark was so strong. The risk, as the French saw it, was that Germany would be "master of Europe" for a long time.[116] The Germans were worried that the French were trying to put "shackles" on what they regarded as Bundesbank's "sinister" monetary policy, which kept interest rates too high for the comfort of other nations.[117] Hence, German leaders, unwilling to be "shackled," continued to resist monetary union.

The Werner Committee said to the French, "there is, in fact, a way forward," and to the Germans the committee said the way forward "is on your terms." The German terms were simple. All countries should manage their economic policy just as the Germans did.

Translating the German terms into a concrete proposal, the Werner Committee's report asserted that an incomplete monetary union could work if all member states agreed to "norms" of fiscal prudence, around which they would "harmonize" their policies.[118] The norms would include the "size" and "variation" of public budgets; and they would "be made *increasingly restrictive*."[119] To ensure compliance with the norms, a central authority would "*control*"—indeed, exercise a "*decisive*" influence" over—the budgetary and economic policy of member states.[120] Eventually, responsibility for all policy decisions would transfer from the national to Community authorities.[121] These steps to support a single currency, the Werner Report concluded, would "ensure growth and stability within the Community," and "make it a pillar of stability," in the world economy.[122]

Thus, a European "stability ideology" was born. The Werner Committee report did not even try to present an economic logic to justify its strange proposal, which had no historical precedent or analytical basis. The committee did not explain why "harmonization" around unenforceable "norms" would help ensure a workable monetary union. Nor did it explain why national parliaments would agree to steadily give up their budgetary authority to Community institutions.