REAL INSTITUTO elcano ROYAL INSTITUTE

What Europe needs is not an end to the euro, but better leadership

Miguel Otero-Iglesias | Senior Analyst in International Political Economy at Elcano Royal Institute and Senior Research Fellow at the EU-Asia Institute at ESSCA School of Management | @miotei

Erik Jones | Senior Analyst in International Political Economy at Elcano Royal Institute and Senior Research Fellow at the EU-Asia Institute at ESSCA School of Management | @Erik_Jones_SAIS

Published on 21/3/2016 in The Telegraph.

> "What Europe needs is not an end to the single currency, it is better economic leadership."

Former Bank of England governor **Lord King** argues in his new book, *The End of Alchemy*, that the time has come to give up on **the euro**. It was a bold experiment, he says, but it did not work well for all its members. By the time the structural imbalances proved unsustainable, Europe was already awash in debt. Now those countries worst affected on the periphery have to depend on the generosity of German taxpayers at the core. Lacking their own national currencies or a consensual mechanism for restructuring sovereign debt, the peripheral countries of the eurozone are forced to suffer through **austerity and high unemployment**.

Lord King concludes that even the high costs of leaving the euro would be better than accepting this dire fate. This is a scathing critique of the euro from a former high British public official. That it reflects a growing conventional wisdom in Britain only makes it all the more convincing.

Lord King's critique is inaccurate in several respects. He misdiagnoses the roots of the crisis, which has much more to do with cross-border capital flows than lack of competitiveness. He sees the euro as the source of Europe's adjustment problems, when it would be more fair to blame those on a mix of bad economic ideas and political bullheadedness. What Europe needs is not an end to the single currency, it is better economic leadership.

The point about **competitiveness** is based on an outdated understanding of economics. Notwithstanding institutional problems at home, what hurt the eurozone periphery was not the loss of price competitiveness but the sudden withdrawal of credit. For two decades, savers in Germany and other parts of Europe relied on investment on the periphery of the Continent to pad the return on their savings. But once the crisis struck, they suddenly and collectively headed for the exits. Bond prices shot up in Germany and collapsed in the periphery. All those firms, households and governments that depended on cheap credit to balance their accounts were left hanging. Once-sound business models turned overnight into Ponzi finance. This is why peripheral Europe experienced a sudden spike in bankruptcies and unemployment.

The challenge for European policymakers was to respond to this sudden flight of capital. This was complicated by a misdiagnosis of a different sort. Given the prominence accorded to the **Greek case**, they focused too much attention on fiscal matters. They called for **austerity and deep structural reform**.

The fact that **Ireland** and Spain showed none of the same pathologies did not dent this pro-austerity consensus – particularly in those countries in the northern core. Neither did the fact that fiscal consolidation reinforced the economic downturn. Instead, Northern European policymakers began to emphasise the dangers of "moral hazard". That is why they have been reluctant to find a way to resolve unsustainable public debts; and why they have become enthusiastic converts to "private sector involvement", code for putting the cost of any resolution on private investors rather than supporting financial stability via the public purse.

There is a logic to the argument in favour of fiscal consolidation and against moral hazard, but as financial history shows, it is self-defeating in times of crisis. That is one of the great lessons that Britain taught during the early phases of the global financial crisis when Gordon Brown emphasised the importance of bailing out the banks; it is a lesson that policymakers in Germany and other parts of Northern Europe quickly copied and then unlearned. The policies that stabilised Deutsche Bank and wound up banking giants like Dexia and Fortis are no longer permitted. This is already looking to be a big mistake. **There is bailout anger in the north and austerity fatigue in the south of the eurozone**. Here Lord King is right.

But **most citizens want to retain the euro**. Polls show that 75pc of Dutch, 73pc of Germans, 67pc of Spaniards and Portuguese and 70pc of Greeks are in favour of the single currency. Even the majority of Italians, the eurozone's most sceptical group at the moment, support it. People in peripheral countries are smart enough to recognise that the euro is not the cause of their problems. In Germany there is an understanding that there was reckless borrowing alongside reckless lending, which means creditors and borrowers are in the same eurozone boat.

If there is a consensus, it is that **the eurozone should integrate further**. But politicians have failed to translate this into action. The time has come for European policymakers to advocate an economic policy prescription that promotes growth and employment while also restarting the flow of capital from the core to the periphery.

The Italian government, headed by Matteo Renzi, recently announced a new European economic strategy that works along these lines. This strategy is the antidote to the kind of defeatism that takes root in Lord King's analysis. The key is to convince the German economic establishment to relax its insistence on austerity and take advantage of any available fiscal leeway to restart growth and investment. Rejuvenation will not result from structural reform alone. More robust institutions are needed to stabilise European financial markets so savings can flow across borders without the threat that it will suddenly return in times of duress.

Reforms are already in discussion as part of Europe's banking union. That will take concessions on the part of **Germany**, particularly in sacrificing long-held but mistaken ideas. Much larger concessions have already been made elsewhere with painful but necessary structural adjustments. Europeans must complete the single currency by pooling a degree of fiscal sovereignty. It will be difficult, but it is far better than breaking up a currency union that most people actually support.