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The roots of the Euro crisis [1]

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The Alliance of European Conservatives and Reformists holds its conference in London today, with speakers such as Baroness Warsi, William Hague MP, Dan Hannan MEP and Mikheil Saakashvili, the President of the Republic of Georgia. Naturally, the Eurozone crisis is top of the agenda. I've been asked onto a panel to discuss the origins of the Euro crisis.

There are plenty of reasons why the Euro is falling to bits, but three strike me as particularly significant. First is the politicians' discovery that they could fund all their projects by borrowing. Politicians love spending, of course, because they can buy votes with other people's money. There was a time when people thought the only way to do that was to raise taxes. But raising taxes has its limits ? for every voter you please with a cash handout, there is another whom you irritate with a tax rise.

But after the Second World War, politicians discovered another way in which to pay for their spending without having to raise taxes. You simply print money, and spend that. No gold standard to restrain you any more, so you could print as much as you like. Sure, politicians going back to Diocletian and through the Weimar Republic had already discovered this tactic, but in the 1960s and 1970s, blessed by the holy water of neo-Keynesian theory, it became a systematic policy. But eventually, politicians discovered that this too has its unpleasant obverse ? rising prices. So widely and freely did they use the printing presses that world inflation peaked at 29% in 1994. Inflation at that rate, unless you act on it, soon dislocates your economy and in turn your society.

Today, politicians have found another wizard way of paying for their extravagances. You borrow the money from the next generation. They don't vote, they don't complain, so you can borrow as much as you like with no downside. Until, of course, people start looking at your books and figuring that if they carry on lending to you, you might not be able to pay them back. Then you are in another nasty hole.

The second factor I would mention is the creation of the Euro itself. Trying to bring together countries with very different histories, trading links and economies was always a brave move. But like many things, it worked fine when things were booming and it could motor ahead in a straight line. Only now, when it hits a corner, do the wheels come off.

The problem is that before the Euro, dodgy countries had to pay more to borrow precisely because people figured that there was a chance of them defaulting on their debts. After the Euro, people took the view that Euro-denominated government IOUs were pretty well much of a muchness. That the Euro countries would stick together to make sure that creditors were paid. So it became suddenly much cheaper for over-spending countries like Italy, Greece, Spain, Portugal to borrow. And the more they borrowed, the more they shored up dysfunctional economies.

The bust that followed the US boom was the third factor. Not exactly a cause, because the Euro problem is entirely home grown. But the gust of wind that blew down the whole pack of Euro cards. The US was forcing banks to give mortgages to people who, in normal times, would have no hope of repaying them. Maybe a fifth of the US housing market had become pure speculation by 2006, before it crashed. Britain's governemnt was spending and borrowing like mad, its budget rising 42% under the Blair years, and its borrowing concealed by off-balance-sheet PFI deals and other wheezes. Like a raucous evening in the pub, it felt good at the time, but eventually the pain had to come. As the boom subsided, and mortgage holders and banks started to go bust, governments leapt in to prop them up. Unfortunately, it has now become clear that those governments are in just as much debt as the people they were trying to save.

If anyone tells you they know what is going to happen, don't believe them. That's what makes it so scary. Maybe the Euro will split apart under the pressure of the markets. Maybe it will all end in tiers ? a Euro of sounder countries, and Club Med doing its own thing. The best solution ? Euroland politicians realising the game is over and deconstructing the Euro peacefully ? is the least likely.

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