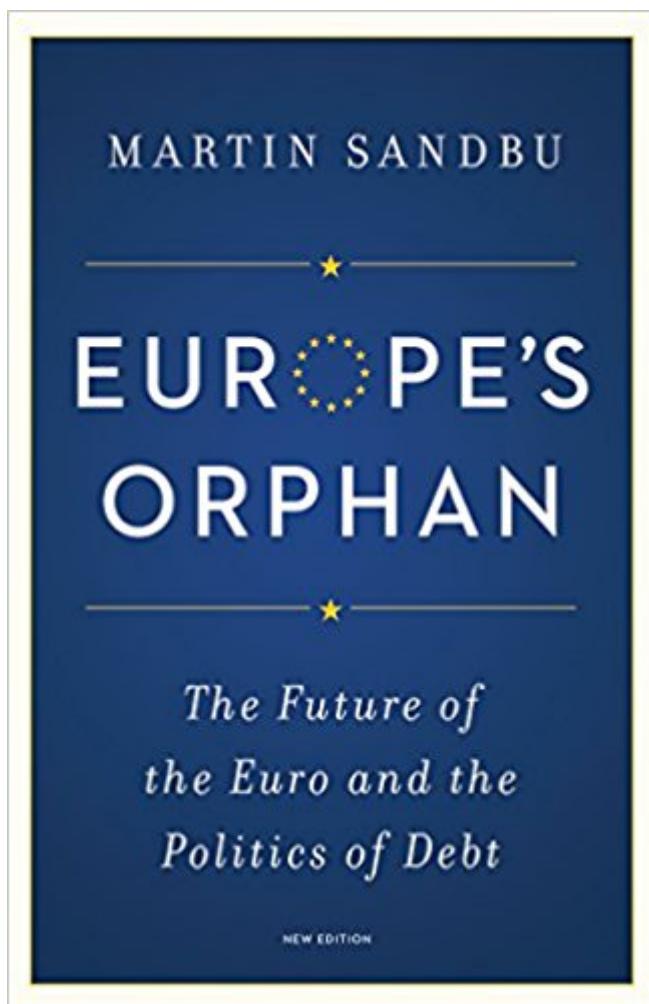


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Europe's Orphan: The Future Of The Euro And The Politics Of Debt



Synopsis

Originally conceived as part of a unifying vision for Europe, the euro is now viewed as a millstone around the neck of a continent crippled by vast debts, sluggish economies, and growing populist dissent. In Europe's Orphan, leading economic commentator Martin Sandbu presents a compelling defense of the euro. He argues that rather than blaming the euro for the political and economic failures in Europe since the global financial crisis, the responsibility lies firmly on the authorities of the eurozone and its member countries. The eurozone's self-inflicted financial calamities and economic decline resulted from a toxic cocktail of unforced policy errors by bankers, politicians, and bureaucrats; the unhealthy coziness between finance and governments; and, above all, an extreme unwillingness to restructure debt. Sandbu traces the origins of monetary union back to the desire for greater European unity after the Second World War. But the euro's creation coincided with a credit bubble that governments chose not to rein in. Once the crisis hit, a battle of both ideas and interests led to the failure to aggressively restructure sovereign and bank debt. Ideologically informed choices set in motion dynamics that encouraged more economic mistakes and heightened political tensions within the eurozone. Sandbu concludes that the prevailing view that monetary union can only work with fiscal and political union is wrong and dangerous and risks sending the continent into further political paralysis and economic stagnation. Contending that the euro has been wrongfully scapegoated for the eurozone's troubles, Europe's Orphan charts what actually must be done for the continent to achieve an economic and political recovery. This revised edition contains a new preface addressing the economic and political implications of Brexit, as well as updated text throughout. Europe's Orphan charts what actually must be done for the continent to achieve a full recovery.

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"Thanks to the economic crisis that threw a quarter of the eurozone's youth into unemployment and

poisoned its politics, it seems the euro has few friends left. In this fascinating book, Martin Sandbu salvages the shipwreck of monetary union from the blunders of its political leaders. He argues persuasively that the problem lay not with the euro itself but with the decision to avoid sovereign bankruptcy. Sandbu exposes for Europe's policymakers the uncomfortable truth that the fault was not in their stars, but in the choices they made."--Dani Rodrik, Harvard University"An extremely original take on the eurozone crisis, Europe's Orphan boldly tackles the conventional wisdom that the common currency is a disastrous halfway house. Europe's woes do not lie in its weak central institutions, but in its poor macroeconomic framework and moralistic resistance to debt write-downs. With better policies, Martin Sandbu argues, the eurozone can thrive in its current form. Indeed, the UK should stop gloating and join. Brilliant and profoundly provocative, Sandbu's book will surely influence the debate on the future of Europe."--Kenneth Rogoff, Harvard University and coauthor of *This Time Is Different*"With its novel interpretation of events and policies, Europe's Orphan offers a refreshing discussion of the recent financial crisis in Europe and the failed attempts to solve it."--Thorsten Beck, Cass Business School, City University London"This is a timely book with a striking message. It argues that the apparent failure of the euro can be attributed to specific policy mistakes rather than inherent weaknesses, and that those mistakes could be set right, saving the single currency."--Diane Coyle, author of *GDP: A Brief but Affectionate History*"Discussing the eurozone crisis, Europe's Orphan contends that the euro was not the culprit and if anything, the crisis would have been worse without it. It is a gutsy and provocative work."--Ugo Panizza, Graduate Institute of International and Development Studies"With an unconventional perspective and new information, Sandbu provides a powerful, consistent, and comprehensive overview of the eurozone crisis. Telling the story as a clash between creditors and debtors that inevitably becomes ever more bitter, this lively account will interest a wide audience."--Harold James, author of *Europe Reborn: A History, 1914–2000*

I disagree with many of the premises and even more so with most conclusions of this book. Thing is, there is so much stuff in here that is right and so much stuff I have never thought about before and so much that is totally original that it is difficult to deny it is one of those books that taught me tons and made me think and helped me convert many of my prejudices into views. In the ten days since I picked up this book, my views on the EUR and Europe have evolved so much, albeit in a different direction from the author, that I cannot but recommend it. So who cares if I think Martin Sandbu is

ultimately mistaken? The first idea the author gets out of the way is to refute something we all take as a given: that the common currency is at fault for Europe'sills. Rather, he states, it was unlucky to be born at the time when European governments were busy overborrowing due to the fact that productivity gains were not as quick as the accumulating burdens of welfare states across the continent (p.23), while at the same time the US was in the middle of the biggest ever private overborrowing binge. He then proceeds to "clear" a number of misconceptions, some convincingly and some less so:¹. Yes, it is impossible for the single Eurozone interest rate to perfectly fit all European economies. But the individual states would not really have enjoyed enormous autonomy in setting rates if the Bundesbank had still been around setting the German rate, same way Scandi central banks and the Bank of England have kept it close to the ECB since the inception of the EUR.² The EUR is not necessarily why huge amounts of capital flowed from the core to the periphery, as very similar buildups happened in the direction of Iceland, for example. (I disagree rather vehemently with this point: there was a vast number, of Landesbanken, Sparkassen and sleepy banks in Germany and the Benelux, for example, that could only buy EUR-denominated paper and there's no telling me the banking system could have produced EURGRD or EURITL currency swap in the requisite amount, though it did provide trillions of EURUSD swap to accumulate all the American mortgage CDOs)³. The sudden stop in borrowing from French banks to Greek or Italian corporates, should not be blamed on the EUR, as much as it should be blamed on the fact that financing in Europe comes from banks rather than via equity. Tough to disagree with that view, until you realize it's a piece of sophistry: if we're talking Europe let's not say "if it wasn't for a very European feature of the landscape idea X would have been a great idea."⁴ The fact that they did not have a sovereign currency they could devalue surely did not help the Southern countries recover, but there can be little doubt it at least prevented local banks, for example, from borrowing in hard currency and lending in domestic. Similarly, many sovereigns issue in USD or JPY (Greece included) so issuing in EUR at least conferred an advantage to the peripheral economies.⁵ Besides, exports of peripheral countries did not suffer one iota during the crisis, despite the fact that no devaluation took place. It was the non-tradable part of the economy that collapsed. And conversely, pre-crisis it had been the non-tradable sector that had registered the highest salary increases. Would the periphery have expanded capacity mid-crisis to meet the extra demand stemming from a more favorable exchange rate? With what money? Excellent, excellent point. Besides (and the author restrains himself from saying this) what country ever devalued its way to prosperity? And what about currency

overshoots?6. All this business about the Eurozone not being an optimal currency area is far too overhyped. Labor mobility can't be both too low (which is what the sundry economists claim) and too high (which is what everybody else is complaining about). Capital can't be moving too slow and too fast at the same time. And nobody was complaining that the US was not an optimal currency area for the first 150 years of its existence when the federal budget was well under 5% of GDP.(My view, incidentally, is that the EUR was an idea we HAD to try, because if it had worked out it would have been fantastic, but it has probably failed at this point. It did not have to fail, it probably would have succeeded if the UK had joined and if limits had been enforced on peripheral borrowing, which of course would have required France and Germany not to have been the first to break the stability and growth pact, but that's all in the past and its goose is probably cooked at this point. But these are all points worth discussing.)Then come three chapters leading up to the main thesis of the book, which I crib from page 183: "The moment it becomes clear that losses are unavoidable, the political imperative is to remove doubt about where the losses will fall" and whether predominantly on lenders (who cannot get back what they expect), on borrowers (who find themselves poorer, and their debt burdens heavier, than they had thought) or on society at large (including those who have no responsibility for the crisis). The eurozone's political haplessness since 2008 can be put down to its inability to settle this question, instead leaving every group to fight as hard as it could to protect its own interest. With all sides trying to minimize the cost to themselves no one was working to minimize the total losses for all.
Martin Sandbu's bete noire is with no doubt Jean-Claude Trichet, who refused to haircut Greek government debt in May 2010 and Irish bank debt in November 2010, not only throwing billions of good money after bad in subsequent mop-ups, but in essence lying on both occasions about the facts on the ground (insolvency) in the interest of some high and mighty principle such as "no default in the Euro" and "no losses to senior bank bondholders in the Euro". Both the Greek and the Irish stories are given in tremendous detail, not to fill out space, but as examples of what's eating the Eurozone from the inside: doctrinaire outsiders violating national sovereignty in the name of principles that are subsequently shown never to have been truly held by anybody, with all that entails in terms of how people end up feeling about the European project.The author takes a different line from the Economist / FT / Martin Wolfe axis he hails from, actually: rather than draw a target on the back of Wolfgang Shaeuble and his frenemy Angie, he recognizes the point his colleagues harangue us all about once a week (that Germany, by means of refusing to spend is

being unhelpful to the recovery of its neighboring states) but is not afraid to say this can't but be a small part of the European issue. (Amen) His beef is mainly with the French. First, he argues, France is less of a true market economy than it says it is. Mandarins decide what projects will be funded and the French banks fund them and while in theory they are private in practice they are fully government steered and backed, which is how come 1. they can get away with so little capital and 2. the slightest hint that senior bank debt is not sacrosanct was anathema to the Trichet (ECB) / Dominique Strauss Kahn (IMF) / Sarkozy (French Presidency) triumvirate. Similarly, with French banks being the biggest lenders into Greece (and also Italy, of course) they were not at all prepared to contemplate a Greek default or exit, much as a haircut would have been the best and cheapest solution for Europe. Second, he argues, France is not a true believer in equality between the bigger and smaller states and cherishes its right to flaunt rules such as the stability pact, which are meant to keep the lesser states in line and them only. The French priority is "not to improve the rules, but to make it less likely to be stopped from breaching them." Third, he argues, France ought to act as the Keynesian counterweight to German austerity-mindedness, but is too vainglorious to be seen chumming it with Italy, Spain, Ireland, Portugal and Greece. He thinks France was squeezed even further into this position by the fact that French banks were caught with their pants down in 2009, borrowing hundreds of billions in the short-term USD market (a fact that made the Fed extend USD lines to the ECB and the US Treasury guarantee money market funds, incidentally) Finally, he accuses France with engaging in a Faustian pact with Germany, whereby Germany would shoulder as many of the costs as possible, in exchange for France subscribing fully to the austerity solution to the crisis. Heady stuff! I think he gets it wrong in principle and right in practice. Of course it was a lie and a fabrication that the peripheral countries are equal partners in the project. Of course it's fine if France breaks the rules once in a while, it IS Europe, and of course it's unacceptable if the worst student in class thinks it's OK to not do his homework: he needs to be doing it most. So in principle I disagree with Martin Sandbu. Except he's right, after all, because it all goes through the ballot box and it therefore needs to be palatable to the new joiners from the periphery. And that's the problem! Germany does not come off lightly either, but most of the scorn is reserved for the more conservative voices within Germany, such as Hans-Werner Sinn and his problems with debt monetization (Sandbu defends Draghi's QE to the hilt, repeating arguments you will have read elsewhere, and adding his own very circular interpretation of European law along the lines of "QE will be effective and will thus increase GDP and will thus increase tax receipts and will thus make

the central bank whole and therefore itÃ¢â€šÄ“s not monetary financing and therefore itÃ¢â€šÄ“s constitutional (and Target II). The reasoning around Target II is again biased. The authorÃ¢â€šÄ“s arguments would end up in limbo and his pockets empty should a country choose to leave the EUR, redenominate its liabilities and devalue.

Possession is nine tenths of the law. If I, a Greek citizen, have benefitted from a double entry book keeping system called Target II to move my deposits in a Greek bank to deposits in a German bank, my deposit is now a liability the German banking system has to me. itÃ¢â€šÄ“s probably still a Greek bank that holds an obligation of mine as an asset. But should Greece decide to leave the EUR (dunno, but I seem to remember we voted to do so in a referendum the other day) I still expect the German bank to honor its liability to me, so score one for Mr. Sinn. A tremendous chapter on the UK follows, and I must say I found it fascinating. I totally agree that had the UK joined, the Bank of England would have been for the ECB what the New York Fed is to the FOMC, basically. And I could not agree more that all the geniuses who are patting themselves on the back for not having joined the common currency are refusing to understand that Neymar could have done for Brazil what Maradona repeatedly did for Napoli, basically and we could be looking at a very different score from that 7-1 result which is what the Eurozone seems to be suffering at the hands of its politicians at the moment. The UK could have brought to the Eurozone the discipline that was missing in May of 2010 when the ECB went on a buying spree of GGBs, thatÃ¢â€šÄ“s for sure. It easily could have overruled Trichet. It could have turned the club into one where it would be happy to be a member and it could have reaped the benefits. Instead, the UK now finds itself in a position where its banks need to contend with legislation like Mifid II, where there are caps on bonuses, where Frankfurt is trying to undermine the London Clearing House, all while the UK is well down the way of losing its voice on issues it considers central to its sovereignty, such as migration. Worst of both worlds. The author keeps quiet on manufacturing, btw, but not one factory has been built in the UK since it decided not to lock itself into the 300+ million consumer market for goods called the Eurozone. So where does that leave us? One has to agree that we should not be blaming EuropeÃ¢â€šÄ“s ills on the EUR experiment. Martin Sandbu is right in saying we should first and foremost blame it on the doctrinaire unwillingness to recognize a loss, especially if it was a combination of doctrine and convenience (given who was facing the loss: the core European banking system) that landed us in hot water. But the past is the past and it cannot be changed. And while Italy, for example, was super happy to get rid of the Ã¢â€šÄ“scala mobileÃ¢â€šÄ“ of salary indexation to inflation as well as super happy to reform its pension system (it now has the most modern in Europe) to get into the common currency in 1999 (a few

swaps here and there with JP Morgan helped too, of course), the fact remains that the periphery of Europe will not reform its microeconomics in the absence some lofty goal it is trying to attain. Italy, will not get rid of Article 18 and will not get rid of the closed professions that date from Diocletian's times merely to stay in the Eurozone. Similarly, Greece was given an ultimatum, precisely like Martin Sandbu describes it: Either accept our strict terms and our humiliating supervision, or leave the EUR and go bankrupt. Well, the Greek people carefully considered those choices and it chose exit. The political class then performed an enormous pivot and Greece is still in there, referendum result notwithstanding. But nobody will reform for the sake of preservation. It cannot be done. Sacrifice and reform requires a dream. Greece, Spain, Italy and Portugal would be happy to abandon the low productivity 1.0 version of capitalism they are running, the type based on closed professions (guilds) acting as a counterweight to a moneyed political class running a clientelist democracy and all the protections this old version of capitalism affords to its participants at the cost of poor growth if 1. there was a promise of a common European goal that would affect their lives and if 2. it was clear that the moneys were in place to support those whose narrow interests would be affected first. So, for example, Greek and Italian society would probably relish a fight with the education lobby if the result was to join a pan-European educational system, rather than losing the cream of the graduating class to foreign universities every year, never to be seen again. Italy has not won a Nobel for scientific work done domestically since 1965, 50 years ago. Italians would welcome a continuation of the original European dream. Europe used to represent this dream of advancement, but the dream of a better, fairer, more civilized, united Europe was abandoned post 1989, when the opportunity opened for Europe to step into the void left by the Soviet Union. Our leaders' ambition swung from integration in the benefit of everybody to expansion at all costs. It was a dream that suited our vainglorious leaders (Trichet once said), but not the people. And that brings us to the point Martin Sandbu makes about France and the double standard: you can't court Poland and Romania and add them to the European Empire, only to subsequently slap them in the face and tell them their workers are not welcome in the UK for seven years. It's either one or the other. And you can't turn Orban into a persona non grata in the West for sticking it to the core-Europe owned banking system in Hungary that was trying to force Hungarian citizens to keep servicing CHF loans. This is not to say Greece, Italy, Spain, Portugal and Ireland are not making a massive, massive mistake in refusing to change the microeconomic structure of their economies. And it is not to say they are right to blame the EUR. They are wrong to stick by their unproductive

economic models and they are wrong to blame the EUR. They are wrong to blame Germany for their own microeconomic ills and wrong to blame austerity for problems that predated austerity by years. But who cares? These are sovereign democracies and they have not been shown any carrot in two decades. And they are tired of the stick. End of story. The bit Martin Sandbu does not seem to get is that politics is not about right and wrong. It's about steering the ship back to the harbor. Our leaders, who decided they'd like to be in charge of a European Empire, a counterweight to the US, to expand rather than improve, have now condemned Europe to disintegration. It's too late. But yes, it wasn't the EUR that did it. Agreed.

About the first sensible read on the 2010+ eurozone crisis, but still too narrowly-focussed and, despite the welcome Spinelli angle, lacking historical depth (no mention of Werner, Schuman, Adenauer, Monnet) although that would show how little in this crisis has actually been new. Hopefully this book will stimulate further constructive discussions that rely less on the national governments getting their act together - this has been a crisis of regions and classes, not nations, whatever the media say. The best way to be enlightened about it all is still to read Keynes's writings of 1921-33, which you can get in the new paperback volumes for a couple of hundred euros all in. A year's reading there - this book was comfortably polished off in 24 hours, mostly with approving pencil marks. Highlights on page 269 the euro advantages 112, 140 tragic Trichet 156-7, 201 dynamic Draghi 147 banking union 224 the hornets (i.e. bond-dealers) 47 not the euro's fault BUT 240 too national in its approach. and curiously nothing on the outflow of funds back to the US in the great recession that dried up peripheral Europe in the first place. Great on debunking depreciation though; better than Krugman on this subject (reminds me of Keynes vis-a-vis Meade on that issue). Recommended, but I suspect the septic trolls are about to descend on the review panel, so adieu!

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