



John H. Cochrane

Luis Garicano

Klaus Masuch

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How the euro can break from its crisis cycle

European Central Bank intervention has been critical to fighting the multiple crises that have hit the euro over the last two decades. Yet as John H. Cochrane, Luis Garicano and Klaus Masuch explain, the expectation that the ECB will intervene routinely has locked the euro into a crisis cycle that now risks spiralling out of control.

A common currency is a wise and necessary component of European integration and economic vitality. The euro was set up presciently. But its evolution in a sequence of crises now leaves the euro in a vulnerable state. It needs fundamental reforms to survive and prosper. Our book, *Crisis Cycle: Challenges, Evolution, and Future of the Euro*, tells this story and recommends reforms.

Sovereign debt and default

A monetary union without fiscal union leads to an obvious temptation: Member states might borrow and spend more than they can repay, and then call on the central bank for a bailout using newly printed money. The architects of the euro understood this danger well. They designed an independent European Central Bank (ECB), whose mandate is exclusively price stability. The ECB did not buy sovereign debt. Countries would follow debt and deficit limits. The countries of the union also committed against fiscal bailouts.

But the founders left a few bits unfinished. In a currency union without fiscal union, overindebted countries must, in extreme circumstances, default just as companies do. The euro founders couldn't quite say this. They made no provision for sovereign default, or for a crisis mechanism to help sovereigns stave off default. Banks were and continue to be allowed to treat sovereign debt as risk-free, encouraging its holding but meaning that sovereign default imperils banks.

This is understandable. Nobody in the 1990s foresaw advanced-country sovereign debt problems or a financial crisis. One does not write every contingency in a founding document, as one might not negotiate a prenuptial agreement too harshly the day before the wedding. One naturally expects that a founding document will evolve and be elaborated over time. It is that continuing reform which has stagnated.

The crisis cycle

Already in the early 2000s, **France and Germany breached the debt and deficit limits**, without repercussion. In the financial crisis, the ECB began to lend much more freely to banks, against riskier collateral including sovereign debt, thereby encouraging banks to buy. The ECB began, unintentionally, to finance a large share of balance of payments deficits via Target2 balances. Countries paid for imported goods with debts to the ECB.

The **2010 sovereign debt crisis** was the earthquake. The ECB, feeling it was the only game in town, intervened on a large scale, including large sovereign bond purchases, lending to banks that funded banks' sovereign bond purchases, and Mario Draghi's famous "**whatever it takes**". Eventually, an adjustment programme mechanism emerged, allowing support with conditionality and imposing some losses on some creditors. But this institutional reform later fell from grace and has been crowded out by other ECB interventions starting in the early 2020s. Self-imposed rules on bond purchases weakened with each new programme.

Bond buying in the quantitative easing (QE) era further enlarged the ECB's sovereign bond holdings and surged during and after the **COVID-19 pandemic**. The ECB introduced "flexibility" in purchases to keep sovereign spreads from rising. The bout of inflation, reaching 10%, while the ECB continued bond purchases and kept rates low, undermined confidence that the ECB can and will control inflation, making any future crisis more unstable.

Breaking the cycle

So here we are. Europe is in a fragile state. Overregulation and bureaucracy stifles innovation and growth. European member states' debts have risen dramatically. The ECB holds large portfolios of sovereign bonds and is widely expected to buy more anytime yields or spreads threaten to rise. Banks remain stuffed with sovereign debt, so any sovereign crisis becomes a bank crisis. The next crisis will challenge European sovereign debts. That crisis may be bigger than even the ECB can handle without chaotic defaults, financial meltdown or sharp inflation.

Most of all, Europe is suffused with moral hazard. The incentives for governments to tax and spend wisely, reduce debts, and reform is much reduced. The incentives for investors to evaluate and monitor sovereign risks, and to shift those risks out of highly leveraged banks is reduced. The

problem does not lie in the ECB's expedients in crises. The problem lies in the failure of member states and European institutions to reform after each crisis so the ECB **does not feel the need** to jump in once again.

We outline a programme of reforms. Summarising, there must be a European fiscal institution that can quickly offer support, subject to conditionality, to help member states in trouble, allowing the ECB to avoid that inherently political and fiscal task. But the eventuality of default must remain a possibility.

Banks and their regulators must treat sovereign debt as risky and must hold diversified portfolios of that debt. Completion of European banking union is an important step to that goal. Sovereign debt must be in hands that can bear risk. The ECB must reduce its bond portfolio, its lending against weak collateral and its aversion to letting any sovereign spread rise.

Europe needs growth. One prerequisite is a common currency, a central bank, a banking system and a financial system that do not incentivise fragility and can withstand the next shock, as the founders envisioned.

*For more information, see the authors' new book, **Crisis Cycle: Challenges, Evolution, and Future of the Euro** (Princeton University Press, 2025).*

Note: This article gives the views of the authors, not the position of EUROPP – European Politics and Policy or the London School of Economics. Featured image credit: © Felix Schmitt for ECB



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About the author

John H. Cochrane

John H. Cochrane is the Rose Marie and Jack Anderson Senior Fellow of the Hoover Institution at Stanford University. He is the author of *The Fiscal Theory of the Price Level and Asset Pricing* (both Princeton University Press).

Luis Garicano is a Professor of Public Policy at the London School of Economics and Political Science. He served as a member of the European Parliament from 2019 to 2022.

Klaus Masuch

Klaus Masuch has worked at the European Central Bank from the start of the euro, first as head of the Monetary Policy Strategy Division from 2000 to 2006, then as head of the EU Countries Division from 2007 to 2013, and as principal adviser since 2014.

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