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The Broken Building: How the Euro Was Designed to Fail

The euro was built on a bet: that living under one monetary roof would eventually teach twenty very different economies to behave like one. It didn't. And instead of fixing the architecture, Europe's central bank has been running heaters in the cold rooms ever since. Every fix works. Every fix makes the real problem slightly worse.

INSTITUTIONS, MONETARY POLICY

I. One Thermostat, Many Apartments

Most economists treat currency as infrastructure. It is the foundation beneath all economic activity, and like most foundations, we only notice it when something cracks. Interest rates and inflation fill the models and dominate the debates. The currency itself is assumed to work. But when it does not, everyone feels it.

This makes the euro one of the most ambitious and simultaneously least examined experiments in modern monetary history. Twenty member states, each with distinct fiscal positions, political traditions, and capital structures, unified under a single monetary regime and a single interest rate. The premise was straightforward: convergence would follow integration. Residents would renovate their apartments to match each other. They never did.

Picture the building. Not an abstract building, this one specifically. A sprawling structure where the northern apartments are solid, well-insulated, their pipes recently replaced. The southern units run colder, with drafty windows and walls that have needed attention for years. One apartment is running a restaurant out of the kitchen, generating its own heat. Another has been subdivided so many times nobody is sure who owns the boiler. Each unit has its own exposure and its own needs, and there is only one thermostat in the lobby, controlled from a centralized office, set to a temperature that satisfies no one completely and several units not at all.

Interest rates are the economy's primary signal across time, coordinating savings against investment and telling entrepreneurs what the future costs. You cannot run the same rate across vastly different economic regions at different stages of development and under different inflation pressures. Set it to the eurozone average and it sits structurally too low for the booming periphery and too high for a stagnating Germany. Arithmetic alone guarantees it.

The euro was constructed on an optimistic theory of convergence that failed, leaving the ECB to

paper over divergence with increasingly improvised machinery. Each intervention buys time but worsens the underlying fragility. The building still stands, running on hidden heaters, rotting insulation, and wiring that was never built for this load. And the architects knew this when they drew the blueprints.

II. The Blueprint — What the Euro Was Supposed to Be

Economics already had the answer in 1961. Mundell had built the framework for an Optimum Currency Area, naming the conditions under which surrendering exchange rate flexibility is not self-destructive: labor mobility, synchronized business cycles, diversified production structures, and fiscal transfer mechanisms for asymmetric shocks. Europe met almost none of them.

Language and culture constrained labor mobility, and welfare systems structurally tied to national citizenship constrained it further: a Spanish worker cannot move to Germany and carry their pension entitlements, unemployment benefits, or healthcare access with them. Business cycles between Germany and Greece, Germany and Spain, were demonstrably unsynchronized in 1999. There was no fiscal union, no eurozone budget, no automatic stabilizer, no mechanism to transfer resources from a booming region to a depressed one.

The architects' answer was the Maastricht criteria: if every apartment meets the insulation standard before moving in, the thermostat problem is manageable. Debt below 60%, deficits below 3%, stable inflation. The convergence criteria would substitute for structural compatibility.

What gave this intellectual cover was a convenient theory: that monetary union itself would drive convergence, that living under one thermostat would eventually make all apartments the same temperature. Trade would integrate and business cycles would synchronize until the zone grew into its own justification. It was motivated reasoning, economists working backward from a conclusion politicians had already reached. The specific flaw was visible in advance: deeper integration between structurally different economies reinforces specialization rather than eliminating it. If Germany produces capital goods and Spain produces construction and tourism, tighter economic integration sharpens that difference. Asymmetric shocks then strike each economy differently rather than alike. The thermostat problem does not dissolve with time, it compounds.

What the architects knew and never said plainly was that fiscal union was always the necessary complement to monetary union and always politically impossible. The euro was built deliberately incomplete, on the bet that crisis would eventually force the political integration that voluntary cooperation never would. This was a political gamble dressed in economic language. A gamble paid by the residents, not the architects.

III. The One Thermostat Problem — A Single Rate for Divergent Economies

The convergence of interest rates was the system's first achievement and its first failure. It arrived almost immediately. Spreads between German and Italian sovereign debt — the gap in borrowing costs between the two countries — collapsed to near zero. This was used as proof that the system

worked as intended. This was the first heater turning on before anyone had thought of a heating program: markets had priced in the implicit guarantee that the eurozone would never allow a member state to default, regardless of underlying fundamentals. The political logic of the project made default unthinkable, and bond markets responded accordingly. Germany vouching for its less stable partners was the system's first improvisation, and it arrived before the building was even finished.

This led to cheap credit flooding the periphery. Spain and Ireland fueled housing bubbles. Greece expanded its public sector. Italy accumulated debt at rates its pre-euro borrowing costs would never have permitted. Spain and Ireland were running fiscal surpluses before 2008. Their crisis was a private credit boom, not a public one. The Stability and Growth Pact was watching the wrong thermometer entirely. It measured public debt and saw nothing wrong while the real disaster was building in the private sector.

Germany ran the Hartz labour reforms in parallel, suppressing wages and sharpening its competitive position, while the compressed rates channelled its growing surplus into southern credit expansion. The thermostat drove the apartments systematically further apart. This was never a story of profligate southerners and virtuous northerners.

Suppress a price signal centrally and you do not eliminate the information it would have conveyed. You defer it. It accumulates as structural imbalance until it forces itself into the open as crisis. Spain is the canonical illustration: from 2001 through 2005 mortgage debt grew at 25% annually, eventually producing three to four million empty houses, completed and standing, that nobody lived in. The misallocation was finished before the crisis arrived. This was the structural liquidation of a boom the ECB's one-rate-for-all had subsidized. Its bust was written into the boom.

IV. The Hidden Heaters — ECB Interventions as Symptomatic Treatment

The building was cold. Instead of fixing the insulation, the landlord brought in heaters. Each one worked. Each one made the insulation problem slightly worse, because as long as the room was warm nobody had to fix anything. Every major ECB intervention since 2010 follows the same logic: buy time at the cost of increased dependence, and send a signal to every government in the building that the consequences of fiscal excess will be managed away. The programs differ in scale and mechanism; the underlying message never changed.

The APP, the ECB's asset purchase programme, was the baseline: quantitative easing running quietly through the expansion years, the ECB purchasing sovereign and corporate bonds across the eurozone, keeping spreads compressed and borrowing costs low. A small heater in every room. Nobody noticed the insulation was not being fixed because nobody was cold. It also punished savers and subsidized sovereign borrowers, compressing yields to near zero and transferring wealth from the German and Austrian middle class, the high-savings demographic, to peripheral governments running structural deficits. The distributive effect of QE is deeply regressive, a fact its architects rarely acknowledged.

Then COVID arrived. Spreads spiked. Italy faced borrowing costs that would have rendered its debt

unserviceable within months. The ECB responded with PEPP, its pandemic emergency purchase programme, uncapped and flexible, with no pretense of proportionality. Industrial heaters blasting into the coldest rooms. It worked. Italy survived. But the signal sent to every eurozone government was now unambiguous and permanent: the ECB will prevent the consequences of fiscal excess. Moral hazard had become structural.

OMT and TPI — the Outright Monetary Transactions facility and the Transmission Protection Instrument — operate differently from the purchasing programs. These are closer to a promise of heaters than to heaters themselves: the ECB pledges unlimited intervention if spreads become unwarranted, and the pledge alone is supposed to be enough. Draghi's whatever it takes in 2012 stopped the sovereign debt crisis without a single OMT bond being purchased. The announcement collapsed the spreads. The deterrent worked because markets believed it unconditionally. That is also where the fragility lives: the button works only as long as everyone believes it is connected to something. If that belief wavers, the button becomes useless at precisely the moment it is most needed. The heater exists only as long as nobody doubts the landlord.

Then there was the LTRO, a long-term lending facility: the ECB lending over a trillion euros to eurozone banks at extremely low rates, with the implicit understanding that those banks would use the funds to purchase their own governments' bonds, pocket the spread, and stabilize the bond market in the process. It worked as a short-term fix. It loaded European banks with even larger quantities of sovereign debt than they held entering the crisis. The institutions most exposed to a sovereign default became more exposed, as a direct consequence of the intervention designed to prevent that default. The wiring was being asked to carry more current through the same old infrastructure, and everyone involved understood this.

Then there is TARGET2, the ECB's internal payment clearing system, normally invisible and never designed as a policy instrument. During the crisis, as capital fled the periphery, it produced something that could no longer be ignored: Germany's Bundesbank accumulated claims on the ECB system approaching one trillion euros, uncollateralized and impossible to call in. The Austrian and ordoliberal reading is a wealth transfer of historic magnitude from northern savers to peripheral current account deficits, routed through balance sheet mechanics rather than democratic decision. Nobody voted for it. Nobody was asked. You cannot eliminate the transfer mechanism, you can only choose whether it is transparent or opaque. The euro chose opacity, and TARGET2 is the receipt.

The heaters created comfort. Comfort meant nobody had to fix anything. And while the rooms stayed warm, the insulation continued to rot and the wiring quietly took on more load than it was ever designed to carry.

V. Rotting Insulation — What Persistent Intervention Prevents

The ECB's interventions worked, which is precisely what made them dangerous.

A crisis that never arrives is also a reform that never happens. Borrowing costs that never rise keep a government from ever facing the fiscal pressure that makes difficult decisions unavoidable. The ECB's programs did not merely paper over the structural problems of the eurozone. They removed the mechanism by which those problems would have forced a response. Price signals carry the

information that tells decision-makers what needs to change. Suppress them and you make the problem invisible to the people responsible for solving it.

This is what the rotting insulation actually looks like. Not dramatic collapse, not visible crisis. That room stays warm. Its walls quietly lose their integrity. Nobody fixes anything because nobody has to, and by the time the damage becomes visible it is no longer cosmetic.

Labor market reform in France and Italy has been politically deferred for decades. French and Italian policymakers understand their structural problems as well as anyone. Reform is painful and borrowing is cheap, and as long as borrowing remains cheap the political calculus never shifts far enough. The ECB removed the pressure that would have made the alternative unavoidable.

Fiscal consolidation followed the same pattern. What was achieved was achieved under external compulsion during 2010 to 2012, when the ECB had not yet committed to unlimited backstops and markets were still allowed to communicate risk. Once Draghi spoke and the spreads collapsed, the momentum for consolidation collapsed with them. The heaters came on and the renovation stopped.

European banks remain inadequately consolidated, their balance sheets still heavily exposed to their own governments' bonds, the doom loop intact. The market incentive to rationalize was removed by the same sovereign backstops that stabilized the bond market. The problem is understood and the pressure to address it is absent.

Whether some eurozone members would be better served by exchange rate flexibility than by continued membership in a monetary regime that cannot accommodate their economic structure is the question the OCA framework was designed to ask. It has not been asked seriously since 2015 because the ECB always arrives before the asking becomes unavoidable. The thermostat is always adjusted before anyone has to discuss whether some tenants might be better off in a different building.

A system that prevents price signals from reaching decision-makers makes the underlying problems accumulate silently, in the walls, in the balance sheets, in the unreformed labor markets and the unconsolidated banks and the debts that compound quietly because the cost of carrying them has been artificially suppressed. The adjustment that crisis would have forced is replaced by an indefinite suspension of consequences.

The building looks fine from the hallway. It has looked fine for years. That is the most dangerous thing about it.

VI. The Wiring Problem — The Doom Loop

Old wiring was not built for this load. It was designed for a building with fewer tenants and circuit breakers that actually worked. What runs through the eurozone's financial system now is something the original architects never stress-tested: a structural connection between sovereign debt and the banking sector so deep that a failure in one cannot be contained before it reaches the other. The circuit breaker was disabled deliberately, one intervention at a time, because the alternative was allowing the system to reset at a cost nobody was willing to pay.

Its mechanism is straightforward. European banks hold large quantities of their own governments' bonds. If sovereign debt becomes distressed, bank balance sheets deteriorate. Deteriorating bank balance sheets force governments into fiscal pressure to recapitalize. Recapitalization worsens the sovereign debt position, which further distresses the banks. The loop closes on itself and accelerates. This mechanism activated in 2010 in Greece, Ireland, and Portugal, and came close enough in Italy and Spain in 2012 that Draghi had to speak before markets finished the calculation.

The LTRO carry trade deepened bank exposure to sovereign debt during the crisis years rather than reducing it. Banks borrowed cheap from the ECB, bought their own governments' bonds, and pocketed the spread. For a time, the bond market stabilized. Underneath, the structural problem deepened. European banks ended the crisis more wired into sovereign solvency than they entered it, and the ECB program designed to prevent a sovereign default was the mechanism that made the banking sector more dependent on sovereign solvency than before. The wiring now carries more current than it was designed for, with the circuit breaker off.

Italy is where the arithmetic becomes concrete. Debt approaching 140% of GDP. A banking sector heavily exposed to BTPs, Italy's government bonds. An economy structurally stagnant for two decades, with no serious growth mechanism in sight. A political environment that has already produced two governments in the last decade that markets treated as existential threats to eurozone stability: the 2018 League–M5S coalition, which proposed cancelling €340 billion of ECB-held debt and floated exit referendums, and the 2022 Meloni government, whose election more than doubled sovereign spreads within months. This is a description of conditions that exist right now, beneath a surface kept stable by the credible promise of unlimited ECB intervention.

That promise is also where the loop becomes most dangerous. TPI requires conditionality. A government under acute market pressure, facing borrowing costs that threaten debt sustainability, must agree to ECB oversight and fiscal adjustment in order to access the backstop. A government that is simultaneously under market pressure and politically unable to accept conditions creates a gap. Markets read that gap. Spreads widen faster. The loop activates before the ECB can close it. The circuit breaker depends on the landlord's hand staying steady on the switch. Whether it does is now a political question, not a monetary one.

VII. The Superintendent Loses Authority — The Political Preconditions for ECB Credibility

The ECB's unconventional programs did not become credible on their own. They became credible because markets believed that the political coalition behind them would hold. Draghi could promise whatever it takes because Germany, despite its objections, would ultimately not allow the alternative. The Bundesbank dissented from nearly every major intervention. The German Constitutional Court challenged the legality of QE. And yet Germany acquiesced, every time, because eurozone fragmentation was a worse outcome for German exporters than the discomfort of open-ended southern backstops. That calculus was the load-bearing wall behind a decade of ECB credibility.

That wall is thinner than it has been since 2012.

Germany is not the country it was when Draghi spoke. Deindustrialization is accelerating. Growth has stalled. The debt brake, once the institutional embodiment of German fiscal culture, is under serious political pressure for the first time in its existence. A German government navigating its own economic difficulties is a different political actor than a German government presiding over export-driven prosperity. The tolerance for bearing the costs of eurozone stability does not disappear overnight. But it shifts, quietly, and the shift is already visible in the political rhetoric coming out of Berlin.

Germany's position within the ECB is beside the point. OMT and TPI are deterrents, and deterrents work through unconditional belief. If markets begin pricing in even a modest probability that Germany hesitates, that the northern coalition fractures at the critical moment, the spread compression that those programs produce starts to unwind before they are ever deployed. The credibility of the backstop is the backstop: a guarantee that might not hold is categorically different from one that will.

The superintendent has not stopped maintaining the building. He still shows up and still fixes what breaks. But the tenants have started to notice that the building committee meetings are running longer, that the votes are closer than they used to be, that there is more argument about who pays for what. Nobody has refused yet. The question is what happens the next time something expensive breaks, and whether the hesitation lasts long enough for the damage to spread.

VIII. Three Ways the Building Fails

Three things can happen when the heaters overload the system.

The first is the blown fuse. A sovereign debt crisis in a systemically important member state that exceeds the ECB's political capacity to contain. Italy is the only realistic candidate and the arithmetic is not subtle: debt approaching 140% of GDP, a banking sector whose balance sheets are deeply tied to BTP performance, an economy that has not grown meaningfully in two decades, and a political class that has already demonstrated it cannot survive the conditionality that TPI requires. The trigger is a spread widening that persists long enough for markets to conclude that the ECB hesitates, at which point the doom loop does the rest. Everything to this point has described this mechanism being loaded. It has not fired yet.

The second is the tenant revolt. A member state government that concludes exit is preferable to continued membership in a monetary regime that cannot accommodate its economic structure. This is less likely than it was in 2015, but the parties capable of raising the question are stronger now across Italy, France, and the Netherlands than they were then. The ECB's success in suppressing the economic costs of membership has kept the political debate about membership permanently unresolved. If the consequences of staying are always managed away, the argument for leaving never gets properly answered. The question stays open partly because of the interventions themselves.

The third is forced renovation. Genuine fiscal union: debt mutualization, a eurozone budget with real stabilization capacity, common deposit insurance, a transfer mechanism that can absorb asymmetric shocks without routing them through the ECB's balance sheet. This is what the architecture actually requires and what the architects always knew it required. The obstacles are civilizational. Germany

and the Netherlands accepting open-ended liability for southern fiscal decisions requires a degree of political trust that does not exist. Southern electorates accepting the oversight conditions that northern electorates would demand in return requires a surrender of sovereignty that their politics will not support. The renovation has been discussed for thirty years. The building committee cannot agree on who pays or who is ultimately liable. In the meantime the walls continue to deteriorate.

The three scenarios are not cleanly separated. A blown fuse accelerates the tenant revolt debate. Tenant revolt makes forced renovation simultaneously more urgent and more politically toxic. The system fails in combination, each pressure amplifying the others faster than institutions designed for deliberation can respond.

None is inevitable. All three are in motion. The building has survived every shock it has faced so far. Each survival has been more expensive than the last, leaving the ECB with a larger balance sheet and a thinner margin. The tools are depleted. And the conditions under which they are being asked to work are worse than they have been at any point since Draghi spoke in 2012. The building can survive more shocks. That has always been true right up until it was not.

IX. What the Metaphor Is Really Saying

The thermostat metaphor is ultimately about a political choice made in the 1990s to build the building before anyone agreed on who pays for maintenance and what happens when the wiring fails. The architects knew the foundations were incomplete. They built it anyway, on the bet that living in the building would eventually teach the residents to finish it. Thirty years later the residents are still arguing about the blueprints and the ECB is still running the heaters.

No central institution can substitute for what a functional monetary system actually requires: price signals that reflect real conditions and the local knowledge that no committee in Frankfurt can possess about twenty structurally distinct economies making millions of decisions every day. The hidden heaters are the inevitable consequence of asking one thermostat to serve a building it was never designed to heat. Every intervention that works postpones the reckoning. Every postponement raises the cost.

Most people who live in the building have stopped seeing it. The cracks in the walls are familiar. By now, the smell of the rotting insulation is just how the hallway smells. The heaters have been running long enough that nobody remembers what the building felt like before they were switched on. That is habituation to a structure that was compromised at the foundation and has been quietly deteriorating ever since.

The euro has survived everything it has faced so far. Impressive, and insufficient.

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