How the euro was saved

Peter Spiegel, *Financial Times*, May 2014

To the astonishment of almost everyone in the room, Angela Merkel began to cry. "*Das ist nicht fair*." That is not fair, the German chancellor said angrily, tears welling in her eyes. "*Ich bringe mich nicht selbst um*." I am not going to commit suicide. For those who witnessed the breakdown in a small conference room in the French seaside resort of Cannes, it was shocking enough to watch Europe's most powerful and emotionally controlled leader brought to tears. But the scene was even more remarkable, those present said, for the two objects of her ire: the man sitting next to her, French President Nicolas Sarkozy, and the other across the table, US President Barack Obama.

It would be the low point in a brutal, recrimination-filled night, one many participants would recall as the nadir of the three-year eurozone crisis. Mr Sarkozy had hoped his leadership of the Group of 20 summit would cement his standing on the global stage en route to re-election. Instead, everything was falling apart.

Greece was imploding politically; Italy, a country too big to bail out, appeared just days away from being cut off from global financial markets; and Ms Merkel, try as Mr Sarkozy and Mr Obama might, could not be convinced to increase German contributions to the eurozone's "firewall" – the "big bazooka" or "wall of money" they believed had to grow dramatically to fend off attacks by panicking bond traders.

Instead, a cornered Ms Merkel threw the French and American criticism back in their faces. If Mr Sarkozy or Mr Obama did not like the way her government ran, they had only themselves to blame. After all, it was their allied militaries that had "imposed" the German constitution on a defeated wartime foe six decades earlier. "It was the point where clearly the eurozone as we know it could have exploded," said a member of the French delegation at Cannes. "It was the feeling [that with] the contagion, at this point, you were on the brink of explosion."

And yet less than a year after that November 2011 night, the existential crisis for Europe's single currency would, for all intents and purposes, be over. The markets that once threatened to tear the euro apart would be tamed and the seemingly endless series of all-night emergency summits would come to an end. When the history of the eurozone crisis is written, the period from late 2011 through 2012 will be remembered as the months that forever changed the European project. Strict budget rules were made inviolable; banking oversight was stripped from national authorities; and the printing presses of the European Central Bank would become the lender of last resort for failing eurozone sovereigns.

Next week, European voters will go to the polls to render a verdict on what EU leaders created over those 12 months. If opinion polling is any indication, their judgment will be harsh: anti-EU parties are poised for unprecedented gains from France to Finland, Athens to Amsterdam.

Over the course of the past six months, the Financial Times has interviewed dozens of participants in those decisions to tell the full story of how this new eurozone was created. From mid-level bureaucrats to prime ministers, they tell an unsettling tale of accidents, near misses and seemingly foolhardy brinkmanship. But in the end, these same leaders appear to have prevailed. The euro has been saved. The Europe they have created, for good or for ill, will be their legacy.

'I hope he's told Merkel'

As with nearly everything in the eurozone crisis, it started in Greece. George Papandreou, the lanky scion of Greece's most famous political dynasty, had returned to Athens from one of the most consequential EU crisis summits to find his country in upheaval. On October 27 in Brussels, he had agreed to the largest sovereign default in history – a €200bn debt restructuring that cut what Athens owed private bondholders in half. But at home, he was being vilified.

For the son and grandson of Greek prime ministers arrested on the same night by a military junta in 1967 – Mr Papandreou can still recall arming himself aged 14 with a double-barrelled shotgun when authorities arrived at his childhood home – what happened the day after his return from Brussels was particularly unnerving.

During a military procession in Thessaloniki to mark the anniversary of Greece's entry into the second world war, thousands of anti-austerity protesters, including rightwing radicals and anarchists, stormed the parade route, forcing Karolos Papoulias, Greece's president, to flee. Mr Papandreou would later tell his fellow prime ministers he felt the incident was a sign his country was on the verge of another coup.

"Everybody was saying that the government are traitors," Mr Papandreou recalled. "I realised the situation was getting out of control."

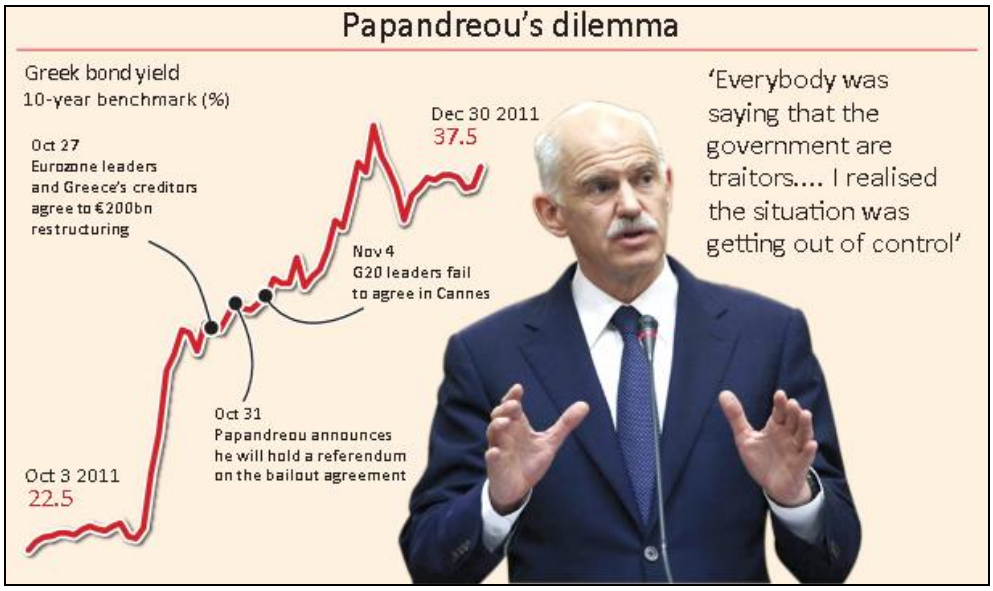
That weekend, he gathered a small group of advisers and unveiled his plan: he would call a national referendum on the new €172bn bailout programme. Those criticising the agreement, including opposition leader Antonis Samaras and rebels within his own party, would be forced to pick sides, Mr Papandreou reasoned, and most would back the rescue – particularly since without EU bailout funds, disorderly default and euro exit was the likely outcome. Victory would give him the mandate for the reforms that bailout lenders were demanding.

But Mr Papandreou did not consult outside his tightly knit inner circle. Instead, he presented his plan as a fait accompli to parliamentarians from his centre-left Pasok party the following evening. Those in the room were in shock, including Evangelos Venizelos, Mr Papandreou's finance minister. "On Sunday evening, during our last meeting in person, in private, Papandreou [spoke] only on a proposal of [a vote of] confidence, not at all about the referendum," Mr Venizelos said, adding that he suffered acute abdominal pains in the following hours, forcing him to go to hospital. "This was the result, the medical result, of the stress."

Others had a different, non-medical worry. "I remember the first thing that went through my mind: 'I hope he's told Merkel,'" said one minister. Mr Papandreou later claimed he had tipped off fellow EU leaders. Some acknowledge vague recollections but others remember nothing. "I never took it seriously," said a fellow leader. "It sounded a little bit desperate."

So when Mr Sarkozy learnt that Mr Papandreou had decided to put their carefully crafted bailout deal up for a vote, he exploded. "He was ballistic," said an aide. "He was ballistic."

Eurozone bond markets, which had briefly rallied after the Greek debt restructuring was agreed, sold off in a panic. Yields on Greece's benchmark 10-year bond spiked by 16.2 per cent in a single day. More worryingly, borrowing costs for bigger eurozone governments began to approach levels where others had been forced into bailouts: yields on Italy's 10-year bond jumped to more than 6.2 per cent.



She was torn over Grexit

Mr Sarkozy summoned his closest advisers for an emergency meeting at the Elysée Palace. According to a person in the room, the French president's initial reaction was to force Mr Papandreou to reverse course: that either he accept the new bailout conditions immediately or Greece would be forced out of the euro.

But Henri Guaino, a Sarkozy confidant and speech writer, noted Charles de Gaulle himself preferred referendums to parliamentary politics. Asking Mr Papandreou to cancel a plebiscite would go against their Gaullist traditions, he argued. So Mr Sarkozy came up with a compromise: Mr Papandreou could go ahead with a referendum – but not on the bailout.

Mr Sarkozy called Ms Merkel and agreed a strategy. They would summon Mr Papandreou to Cannes, where the G20 was to get under way in just 48 hours, and persuade him to hold a referendum on whether Greece would remain in the eurozone.

In Berlin, Ms Merkel was torn over the issue of "Grexit", with several advisers – particularly Wolfgang Schäuble, her powerful finance minister – arguing that it would bind the 16 remaining eurozone members more closely, allowing them to pull themselves out of the crisis. "She was very keen on it being a clear 'in or out' question," said a German official. "For her . . . a key issue was whether the Greeks themselves wanted to be in or out, and if there would have been a referendum and the Greeks would have decided that they want out, that would have made the path easier." Many EU officials still wonder why Mr Papandreou agreed to show up in Cannes to be hauled over the carpet. While he was stunned by the outpouring of anger from EU leaders that Tuesday morning, the Greek prime minister said he relished the chance to win international support for his referendum idea on a global stage.

Helping hand: Christine Lagarde, IMF managing director, offered Italy an €30bn line of credit

Although famous for hosting the glamorous Cannes Film Festival, the Palais des Festivals is a charmless hulk of stone and glass jutting into the Mediterranean. In an effort to give the Palais' long, beige halls some panache for the G20 summit, French organisers decorated them with fluorescent green bunting and carpets. But a chilly drizzle cast a pall over the meetings. Soon the carpets began turning a muddy brown. Mr Sarkozy summoned his fellow leaders to the Palais at 5.30pm on Wednesday, an hour before they were due to meet Mr Papandreou, to agree on how to confront him. Those invited included Ms Merkel; Jean-Claude Juncker, the Luxembourg prime minister who chaired the eurogroup of finance ministers; Christine Lagarde, managing director of the International Monetary Fund; and the EU's two presidents, José Manuel Barroso and Herman Van Rompuy.

When the group assembled in a small, bland conference room, seated on rococo Louis XV chairs around a long table, Mr Sarkozy passed around a single sheet, titled "Position commune sur la Grèce" – common position on Greece. "The idea was to put Papandreou against the wall, in the corner," said one person in the room.

'Italy has no credibility'

Mr Sarkozy's six-point plan, obtained by the FT, was clear and tough: Mr Papandreou must accept the bailout plan agreed the week before, and no further aid would be forthcoming until his parliament voted its assent. "We are always ready to help Greece, despite the unilateral decision to announce [the referendum] without any prior notification," point two read, a clear reflection of Mr Sarkozy's anger. Point six was clearest of all: "The referendum shall be only on the membership of Greece in the euro area and the European Union."

Mr Papandreou would later claim it was primarily Mr Sarkozy who fought with him to change the referendum's wording to "in or out" of the euro, and that Ms Merkel was on his side. But those in the room said there was little dissent from any of the leaders, including the German chancellor.

With the Greek lines agreed, Mr Sarkozy turned to the subject weighing more heavily on their minds: Italy. Mr Papandreou's referendum had created a dilemma for Greece but it also gave rise to a much greater fear that contagion from Athens would spread across the eurozone. No country posed more of a contagion danger than Italy. With nearly €2tn in sovereign debt – the fourth-largest debt pile in the world – Italian finance ministry officials estimated a three-year bailout programme would cost about €600bn. There was not enough money in the EU or IMF to foot that bill. Italy was simply too big to bail. "We could not afford Italy," said a French finance ministry official. "No one could afford Italy, so that was the end probably of the eurozone."

Ms Lagarde arrived in Cannes with a plan to put Italy into an €80bn "precautionary programme", a line of credit that could be used in emergency but would also come with intensive monitoring to ensure Silvio Berlusconi, the Italian prime minister who had lost the confidence of his EU peers, would implement economic reforms. Only then, she argued, would markets begin lending again at sustainable rates. "Italy has no credibility," Ms Lagarde told the group. But any Italian decision would have to wait. Mr Papandreou was about to arrive.

'The full Sarkozy'

The meeting would leave many participants shell-shocked. In his journal, François Baroin, Mr Sarkozy's finance minister, would call it "psychological warfare". Others, particularly the EU's two presidents, would later tell associates they were extremely uncomfortable with a small group of European leaders forcing the hand of the elected prime minister of a sovereign country. "For me, I have never seen a meeting so tense and so difficult," said another aide.

Once Mr Papandreou and Mr Venizelos arrived in the conference room, Mr Sarkozy began what one official called "the full Sarkozy": a pointed, angry denunciation of Mr Papandreou's referendum decision.

"Clearly the feeling was: We've done everything to help you, we've done everything to keep you in the eurozone, we've taken financial, political risk," said a member of France's delegation. "It's the biggest debt restructuring in the world, ever, and now what you do is you betray us."

Mr Papandreou was taken aback. "He goes there and he starts ranting and raving on the referendum," he said of Mr Sarkozy. Added Mr Venizelos: "The position of Sarkozy was very offensive. It was not polite. Very, very strong and very offensive, in order to put Greece in a dilemma: in or out."

The Greeks attempted to fight back. Mr Papandreou laid out his plan: the referendum would be in a month's time, and it would force Mr Samaras and his own Pasok rebels to fall into line, since even his most virulent mainstream critics could not oppose the country's only lifeline to staying in the eurozone. Then Mr Papandreou read his proposed wording for the referendum. "I had a slightly long paragraph," Mr Papandreou conceded.

Ms Merkel was the first to respond, and she was not happy. "We either solve this among ourselves here, or we will fail in the eyes of the world," she said. "*Wir müssen entscheiden*" – we must decide. "Either you want to stay in the euro or go out."

Those in the room said Mr Papandreou visibly deflated as the fight continued. As he fatigued, Mr Venizelos took up the battle, a sign many saw as the sudden realisation by the Greek prime minister that he had become a spent political force – and Mr Venizelos, who had long coveted the premiership, was moving to exploit the change in circumstances.

It was a shift in body language that caught the attention of Mr Barroso, who had sat quietly through most of the fireworks. The European Commission president would later tell associates that the scene playing out in front of him was making him increasingly alarmed. On top of the loose talk of a Greek euro exit, which commission officials long believed would trigger uncontrollable market panic throughout southern Europe, the prospect of a month-long referendum campaign would have sown weeks of uncertainty – exactly what they were trying to avoid as Italian bond yields were rising to dangerous levels.

Unbeknown to Mr Sarkozy or Ms Merkel, Mr Barroso had called Mr Samaras, the Greek opposition leader, from his hotel before the meeting. He knew Mr Samaras was desperate to avoid the referendum. Mr Samaras told Mr Barroso he was now willing to sign on to a national unity government between his New Democracy party and Pasok – something he had assiduously avoided for months in the hopes he could secure the premiership on his own.

Mr Barroso summoned his cabinet and other commission staff to his suite at the art deco Hotel Majestic Barrière to plot strategy. He decided he would not tell Mr Sarkozy or Ms Merkel of the conversation but according to people in the room, they began discussing names of possible technocrats to take over from Mr Papandreou in a national unity government. The first person to come to Mr Barroso's lips was Lucas Papademos, the Greek economist who had left his post as vice-president of the ECB a year earlier. Within a week, Mr Papademos would have the job.

Watching Mr Venizelos assert himself hours later inside the Palais, Mr Barroso saw his opportunity. Mr Sarkozy brought the meeting to a close, rereading his six-point plan and telling Mr Papandreou to go back to Athens to "take a decision", and Mr Barroso pulled Mr Venizelos aside. "We have to kill this referendum," Mr Barroso said. The finance minister agreed almost immediately. Killing the referendum idea would also be the end of Mr Papandreou.

Barroso's gambit

Antonis Samaras
To avoid a referendum, reversed course and backed a national unity government

José Manuel Barroso
Feared plebiscite would sow instability and covertly worked to kill it

Evangelos Venizelos
With Barroso's urging, denounced the referendum upon return to Athens

After brief remarks to the press in which he said the referendum would be "a question of whether we want to remain in the eurozone", Mr Papandreou headed back to Nice airport. In the car, he turned to Mr Venizelos and said that things had not gone as badly as he had feared. Mr Venizelos was incredulous. As Mr Papandreou slept on the flight home, Mr Venizelos, emboldened by Mr Barroso's admonition, ordered an aide to write up a statement to be released when they landed, at 4.45am on Thursday. "Greece's position within the euro area is a historic conquest of the country that cannot be put in doubt," the statement read. "This acquis by the Greek people cannot depend on a referendum." Mr Papandreou's referendum was dead. As was his premiership.

'A sign of weakness'

For months the Obama administration had been watching the eurozone crisis with frustration and mounting concern. Tim Geithner, the US Treasury secretary, and his team in Washington had tried to impart lessons learnt during their banking crisis – namely that only a huge wall of public money would calm panicked investors. Despite repeated high-profile European tours by Mr Geithner, and more discreet visits by his deputies, the Americans felt eurozone leaders still fell short. In some quarters, the White House was suspected of playing politics. "The Americans had only one objective, which is fully understandable," said one European who dealt directly with Mr Geithner. "The eurozone has to be saved because otherwise we'll enter into a depression in Europe, and this will

impact the economy of the US and my re-election." US denials were not entirely believed in Europe. The awkwardness was epitomised by Washington's relationship with Ms Merkel, who occasionally found US intervention improper and unwelcome. Berlin had pushed for the Washington-based IMF to be part of the crisis response. But on occasions when Mr Obama weighed in, Ms Merkel would tell colleagues that European decisions should be made by Europeans.

Although the two leaders appear similarly cerebral and unemotional, people close to Ms Merkel say their styles are fundamentally different. Mr Obama can be professorial and lecturing, something Ms Merkel finds off-putting. Ms Merkel shuns such academic musings and is more short-term and tactical in her decision-making.

Still, many in Brussels, Frankfurt and Paris welcomed American intervention, particularly as a counterweight to Berlin. US officials say they were frequently dragged into crisis disputes by competing national capitals and urged to press the Germans to move more decisively. On other occasions, they say, the German government called on Washington to push struggling eurozone countries to implement promised reforms.

Regardless of whether European leaders welcomed US intervention, they felt Mr Obama was on top of the eurozone portfolio, something they found remarkable for a leader with so much on his plate. Yet when eurozone leaders were summoned again by Mr Sarkozy at 9.30pm that night in Cannes, several were surprised to find Mr Obama chairing the meeting. "It was strange," said a member of the German delegation. "It was also a signal that Europe was not able to do that; it was a sign of weakness."

Many in the room expected the evening to be dedicated to persuading Mr Berlusconi to accept IMF assistance. The Italians had rejected it that morning, arguing it would create the impression they could not handle the crisis on their own, while providing insufficient resources to deal with the fallout. They countered with an offer to accept IMF monitoring, but not funds.

But Mr Obama opened the session with something different. He had a new plan to increase the size of the eurozone firewall – an idea that put Germany front and centre. The decision by Mr Sarkozy to cede the chair to Mr Obama, consciously or not, should not have come as a surprise. Since the outset of the crisis, Paris and Washington had almost identical recipes for solving it: a firewall of such size that no bond trader would question whether the eurozone had sufficient funds or political will to rescue the heavily indebted south.

To both Mr Geithner and his French counterparts, the most obvious source for that firewall was the ECB, which literally has the power to print money. The US had demonstrated the crisis-fighting power of a central bank when the Federal Reserve bought up huge tracts of Treasuries in the wake of Lehman Brothers' collapse. But Berlin has long opposed using a central bank to fund governments.

It was a matter of principle

German opposition was rooted in its dark history: the hyperinflation of the interwar years that helped doom the Weimar Republic had been caused, in part, by central bank printing presses, which churned out marks to pay war reparations. At German insistence, the ECB had been modelled after the Bundesbank, which was given complete independence from meddling politicians when it was established in the 1950s, to avoid a repeat of the 1920s . The German government also demanded that the EU's 1992 Maastricht treaty, which laid the foundations for the euro's creation, bar the ECB from buying sovereign bonds.

Both Mr Geithner and Mr Sarkozy had spent months trying to solve two seemingly mutually exclusive problems: increasing the firewall enough to convince bond traders there was sufficient eurozone money to prevent a Greek default from being repeated elsewhere, while not falling foul of German objections.

On the eve of Cannes, US and French delegations agreed a new plan to increase crisis-fighting reserves they hoped would be acceptable in Berlin. It involved a form of cash known by few beyond the cognoscenti of international public finance: special drawing rights, or SDRs.

Technically, SDRs are not money. They are an asset created by international agreement in 1969 and held by the IMF for its member countries, a substitute for gold or US dollars in global financial accounting. Sometimes referred to as "paper gold", they cannot be held by anyone other than the IMF and must be converted into another currency before they can be spent. And yet they have real value, with one SDR currently trading close to the value of one British pound.

In 2009, in the wake of the Lehman crisis, G20 leaders increased the amount of SDRs in existence by $250bn, essentially creating new IMF firefighting reserves out of thin air. At Cannes, the US and France wanted to do it again but instead of giving them to the IMF, the eurozone would devote €140bn in SDRs to its depleted bailout fund.

Even those involved in drawing up the plan admit it was hastily thrown together. Back in that Obama-chaired meeting, the group found themselves enmeshed in German politics. "Our preference in the US is that the ECB should act a bit like the Federal Reserve did but that doesn't seem to be a viable option," Mr Obama said at the start, in a clear reference to German opposition.

But Ms Merkel now had another problem. Officials said she was open to Mr Obama's idea. But SDRs are not controlled by national governments; they are controlled by central banks. And Jens Weidmann, the head of the Bundesbank, was opposed.

The Bundesbank, which is responsible for representing Germany at the IMF, had picked up word of the scheme through sources at the fund in Washington. Mr Weidmann had quickly drafted a letter to the German government outlining his objections. Mr Weidmann's reasoning was both practical and ideological. Practically, the German central banker felt the plan smacked of desperation. Using foreign reserves to fill the bailout fund would send markets the wrong message: only through financial jerry-rigging could funding be found.

But more importantly to Mr Weidmann was the principle: SDRs are, like a country's gold holdings, part of a government's foreign reserves, which are the exclusive responsibility of the independent central bank to manage – not for politicians to commit willy-nilly to rescue programmes. The Bundesbank had no problem with the 2009 decision to increase SDRs for the IMF, since that is what SDRs were for. But committing them to the eurozone's bailout fund set a dangerous precedent.

Mr Weidmann's letter urged Ms Merkel to bury the proposal. But according to German officials, their delegation did not get the letter before leaving for Cannes. Instead, they only learnt of Mr Weidmann's objection over the phone after they arrived in France, and then in a series of calls attempted to convince him to change his mind. It had become clear to Ms Merkel's camp that they were about to be surrounded that morning during a bilateral meeting between the chancellor and Mr Obama in the cellar of the Palais. "The French, the Italians all would be willing to do this," said a member of the German delegation.

But Mr Weidmann could not be moved. So when Mr Sarkozy quickly endorsed Mr Obama's idea at the evening session, and turned to Ms Merkel for her support, she delivered the bad news: the Bundesbank had rejected it and she could not agree without the Bundesbank. She supported the plan politically, and if Italy agreed to the €80bn IMF programme she may be able to go to the Bundestag to increase the size of the rescue fund itself. But on SDRs, the answer was no.

'The storm was over'

To some in the room, the discussion seemed otherworldly. Although the eurozone was on the brink of imploding because of Greece and Italy, it was Ms Merkel – whose economy was the stalwart anchor of the continent – who had been cornered. Mr Obama had agreed with the Italians that the IMF programme was a bad idea. "I think Silvio is right," Mr Obama said.

Mr Sarkozy attempted to manage the three-way impasse. The US wanted Germany to contribute its SDRs but Germany was only willing to give a partial commitment if Italy gave in on the IMF programme. Giulio Tremonti, Italy's finance minister, held firm: Rome would accept IMF monitoring but no programme. Would the Italian monitoring plan, plus a commitment by Germany to contribute bilateral loans, be enough, Mr Sarkozy asked.

"No. Germany has one-fourth of all [eurozone] SDR allocations," Mr Obama objected. "If you have all the EU countries together but not Germany . . . it starts losing credibility."

Then came Ms Merkel's tearful breakdown. "That is not fair. I cannot decide in lieu of the Bundesbank. I cannot do that."

The emotional outburst appeared to temper the American and French demands for an agreement there and then. "He saw that he went too far," one European in the room said of Mr Obama.

The US president asked whether Ms Merkel could work it out with the Bundesbank by Monday. Mr Sarkozy suggested finance ministers meet to agree the details before the summit ended the next day. Perhaps something vague could be mentioned in the summit's communiqué, Mr Obama suggested. No, said Mr Sarkozy, but we could meet again in the morning.

It was as if the two men had not heard her. She made the point again: “I’m not going to take such a big risk without getting anything from Italy. I’m not going to commit suicide.”

And with that, the meeting ended. Leaving the late-night session, Mr Obama put his arm around Ms Merkel as if to comfort her – a scene captured by the White House’s official photographer. The image adorned the walls of the West Wing for months.

The leaders met again the next morning but the momentum was gone. “The storm was over,” said one person at both meetings. The SDR plan would never again see the light of day. Italy would get a monitoring programme but no funding. And to compound the failure, Mr Berlusconi at his closing news conference publicly acknowledged what everyone had assiduously attempted to keep secret: that the IMF had offered him a rescue programme. Italy would suffer the stigma of needing a rescue but without receiving any assistance.

The Cannes failure provided new oxygen to the eurozone fire. When markets reopened, Italian borrowing costs soared. Within the week they would nearly touch 7.5 per cent. Greece’s would go above 33 per cent, a level almost without precedent for a developed country. Now, with no new firewall in place, it was unclear what would save the euro.

INSIDE EUROPE’S PLAN Z

Every working day since the crisis struck, George Provopoulos, the silver-haired governor of Greece’s central bank, summoned a small “emergency team” of aides to his offices at 6pm to review the health of the nation’s banks. What he was told on June 15 2012 was enough to make the courtly central banker blanch. It was the Friday before a parliamentary election – the second national vote in as many months – and the country appeared to be edging towards panic. On that day, Greeks

withdrew more than €3bn from their bank accounts, or about 1.5 per cent of the country's entire economic output. The Bank of Greece had watched people moving money from their banks to their mattresses for nearly three years, but never on such a scale.

"In a matter of a few days, a full-blown banking crisis could have erupted," Mr Provopoulos said in an interview. At that rate, Greece would run out of bank notes in a day or two.

Unbeknown to almost the entire Greek political establishment, however, a small group of EU and International Monetary Fund officials had been working clandestinely for months preparing for a collapse of Greece's banks. Their secret blueprint, known as "Plan Z", was a detailed script of how to reconstruct Greece's economic and financial infrastructure if it were to leave the euro.

The plan was drawn up by about two dozen officials in small teams at the European Commission in Brussels, the European Central Bank in Frankfurt and the IMF in Washington. Officials who worked on the previously undisclosed plan insisted it was not a road map to force Greece out of the euro – quite the opposite. "Grexit", they feared, would wreak havoc in European financial markets, causing bank runs in other teetering eurozone economies and raising questions of which country would be forced out next.

But by early 2012, many of those same officials believed it was irresponsible not to prepare for a Greek exit. "We always said: it's our aim to keep them inside," said one participant. "Is the probability zero that they leave? No. If you are on the board of a company and you only have a 10 per cent probability for such an event, you prepare yourself."

Over the past six months, the Financial Times has interviewed dozens of officials directly involved in fighting the eurozone crisis to examine how, over the course of the conflagration's final year, those leaders transformed the European project into something entirely new: a far more centralised eurozone where EU institutions have assumed vast swaths of economic and financial authority that once rested with national governments. Voters seeking to reject this new concentration of power in Brussels and Frankfurt could be a significant force in next week's European Parliament elections.

A new sense of urgency

It was yet another near-catastrophe in Greece – which by mid-2012 had experienced street riots, soaring unemployment and austerity that had produced four years of Great Depression-style economic contraction – that would spark European leaders to act decisively. Since 2009, Greece's economy had shrunk by 20 per cent.

At no time in the crisis was Europe's single currency more at risk of blowing apart than the weeks either side of the Greek parliamentary election in June. Grexit planning took on new urgency when it appeared that the leftist Syriza party – led by anti-bailout insurgent Alexis Tsipras – was on the verge of winning. "That was the time when we really said: We've got to finalise our work," said another person involved in Plan Z.

With most of the world's economic leadership flying to Los Cabos, Mexico, for the annual Group of 20 summit the same weekend as the Greek vote, a small group of top EU officials stayed at their desks in case Plan Z had to be activated. They were led by Olli Rehn, EU economic commissioner, who cancelled his flight to Mexico to stay in Brussels. Mario Draghi, the European Central Bank chief, remained in Frankfurt and Jean-Claude Juncker, the Luxembourg prime minister who headed the eurogroup of finance ministers, was also on call.

Plan Z was never used. Mr Tsipras's Syriza party finished second, allowing Greece's mainstream parties to form an uneasy coalition that eventually agreed to stay the bailout course.

But senior officials said the near-miss that summer, and the ensuing debate about Greek membership, helped focus minds in capitals across the eurozone – particularly Berlin, where fights over the advisability of Grexit raged for three more months, before Angela Merkel, the German chancellor, finally put an end to them.

A stunning reversal

Greece's membership of the euro has been a contentious subject since the moment Athens joined the common currency in 2001. After years of raising alarms, Eurostat, the EU's statistical agency, conducted an investigation in 2004 that found Greece had misreported its financial data, producing figures that vastly overstated its fiscal health in the run-up to euro membership. Despite endemic mismanagement, Athens was able to take advantage of the low interest rates that came with eurozone membership to keep its economy humming on borrowed cash. EU leaders largely ignored the warnings about Greece from bean-counters in Brussels.

But when Greece's bailout began to falter in 2011, the issue moved from dust-covered EU reports to closed-door deliberations between Europe's most influential leaders. According to multiple EU officials, Wolfgang Schäuble, the powerful German finance minister, became Grexit's most influential advocate.

Until early 2012, however, much of the discussion remained theoretical, the province of competing economists within various finance ministries, as well as the commission's economics directorate, which attempted to model the impact Grexit would have on Greece and the rest of the eurozone.

Actual Europe-wide contingency planning remained limited, if it occurred at all. Jean-Claude Trichet, the ECB chief until November 2011, barred any discussion of Grexit for fear that even a hint the central bank was considering it could become a self-fulfilling prophesy, former ECB officials said.

In Brussels, a group directed by Marco Buti, head of the commission's economics directorate, had quietly compiled data aimed at convincing Germany and its allies that Grexit would wreak far more havoc than they were anticipating. But more concrete planning was curtailed for fear of leaks. Only at the IMF, which had vast institutional experience gained from all manner of economic disasters, had any serious work begun.

When Grexit was first publicly broached during the November 2011 G20 summit in Cannes – where both Ms Merkel and host Nicolas Sarkozy, the French president, pushed for an in-or-out referendum in Greece – there had been no planning for an outcome in which Greece opted to leave.

Several senior officials said they were stunned Ms Merkel and Mr Sarkozy had aired the idea that the eurozone could be left voluntarily, something that had previously been vigorously denied. Even officials who had worked closely with the two said they were caught unawares.

"I fell off my chair," said one who had participated in closed-door discussions with both leaders. "For the first time, instead of the word being expunged out of conversations, they were using it. I remember thinking then: we're heading for trouble now."

Leaving the Greeks out

Work on Plan Z began in earnest in January 2012, largely overseen by four men. Jörg Asmussen, a German who had joined the ECB executive board that month, was assigned by Mr Draghi to head a Grexit task force within the central bank. Thomas Wieser, a long-time Austrian finance ministry official, was appointed permanent head of the "euro working group" of finance ministry deputies and helped co-ordinate work in Brussels with Mr Buti. And Poul Thomsen, a Dane who had headed the IMF's Greek bailout team since the onset of the crisis, provided input from the fund in Washington.

Efforts to keep information from leaking from the small teams around the four men were extreme for the same reason Mr Trichet had banned such planning: public discovery could be enough to cause the kind of panic that would force them to put their plan into action.

According to one participant, no single Plan Z document was ever compiled and no emails were exchanged between participants about their work. "It was totally fire-walled even within [the institutions]," said the official. "Even between the teams there was fire-walling." A decision was made not to involve Greek officials out of fear of leaks. Their firewalls worked. During a dinner between José Manuel Barroso, the commission president, and Ms Merkel at the chancellery in Berlin less than two weeks before the Greek vote, Ms Merkel asked for reassurance from Mr Barroso that a plan was in place in case Greece rejected bailout conditions and Grexit ensued.

Mr Barroso acknowledged the plan's existence and offered to show it to Ms Merkel but she said his word was enough, according to officials in the room. Under the German system, such documents can be requested by the Bundestag, and senior German officials were concerned they would be obliged to disclose such planning if they had it in writing.

An argument and a plan

Although the FT was not given access to Plan Z documents, officials who saw them said they amounted to a detailed script of how to create a new financial system from scratch. In Washington, IMF officials prepared a 20-page matrix of actions. Drawing on their experience on bank runs and currency crises, officials said the detailed IMF blueprint included such drastic action as turning off all ATMs and reinstating border controls to prevent massive capital flight.

At the ECB, officials studied Argentina's experience of issuing IOUs during their 2001 currency crisis, since the euro notes and coins circulating in Greece would no longer be legal tender. Among the options was issuing Greek IOUs worth about half the value of those euros, since getting new bank notes to Greece would be a logistical nightmare.

ECB officials examined the US military's introduction of new dinars into Iraq in 2003 but were humbled by the logistical challenge; the US effort took only three months but relied on the air and land assets of the world's largest armed forces. Greece's capacity to print notes on its own was limited; since the euro was introduced, Athens had mostly printed €10 notes.

Drop in Greece's economic output in the four years leading up to the 2012 election period

Equally complicated was the basic "plumbing" of the Greek economy. Greece, like all other eurozone countries, is connected by a network called Target 2, a giant proprietary computer system run by the ECB and national central banks that make most commercial transactions possible. Once Greece was disconnected from Target 2, it would have no way to clear transactions, grinding the economy to a halt. The entire system would have to be rebuilt. Similar work was occurring in Brussels. Some of it was thick in EU law: how can a ringfenced economy still be a fully integrated member of the EU's internal market, which requires a free flow of goods? What were the legal authorities to set up capital controls? Other preparations were much more practical, such as which officials would appear in public to announce Greece's new status. "The people who would have been responsible for pulling a switch, they would have received in good time a paper saying: you've got to do this and this and this," said a participant.

To many who worked on the project, Plan Z was as much an argument as an action plan. They wanted to demonstrate to those advocating for Grexit that the job was Herculean, something they could not conceivably back once they realised how difficult it would become. But in the summer of 2012, Greek voters almost forced their hand.

A hard default

With most of Europe's attention focused on France, where Mr Sarkozy was fighting an unsuccessful effort to win re-election on the same day as Greece's first parliamentary election, few outside Greece anticipated the storm that was approaching. Even within Greece many political leaders were stunned when results started rolling in on the evening of Sunday May 6.

For most of the four decades since its return to democracy in 1974, Greece's electoral politics had been dominated by two parties, Pasok on the left and New Democracy on the right. But as the crisis deepened, amid accusations by bailout monitors of mismanagement under governments led by both parties, that status quo began to splinter.

Anti-government activists on the far left and right, once dismissed as radical fringe groups tossing Molotov cocktails in Athens' central Syntagma Square, began to gain support from a disaffected electorate. The neo-Nazi Golden Dawn party found a receptive audience among the alienated urban poor; the charismatic Mr Tsipras found his own fertile ground among supporters of Pasok, which had negotiated the hated bailout agreements.

As expected, New Democracy finished first in the vote but it polled less than 19 per cent – a stunning 14.6 percentage points less than it had received in national elections three years earlier. Even more remarkable was the complete collapse of Pasok. It finished third behind Syriza, with just 13 per cent of the vote – 31 points less than in 2009.

"We were not reading properly what was happening in Greek society," said a veteran Pasok politician. "We knew there was a lot of anger but when you're caught up in the [bailout] programme and wanting to make it a success and believing that the country needs to change, we did not pick up – nobody did, really – the rise of Golden Dawn, nor the spectacular rise of Syriza, nor our collapse."

We were not reading properly what was happening in Greek society. Nobody picked up the rise of Golden Dawn, nor the spectacular rise of Syriza, nor our collapse

One person who was not surprised was Lucas Papademos, Greece's technocratic prime minister who had managed to hold the country together during a truncated six months in office. In an interview, the former central banker said opinion polling on the eve of the vote had made him so concerned the election would prove inconclusive that he remained in his office on the Sunday night of the election to prepare for the market shock.

According to Mr Papademos, Greek authorities were concerned in the vote's immediate aftermath that things could spin out of control if the antagonistic parties were unable to form a government for weeks. But they also feared that a new government, led by Syriza or even New Democracy, would reject the bailout deal, leading EU authorities to pull the plug. "The risk was that the constellation of election results would not allow the formation of a government supportive of the new economic programme," Mr Papademos said.

In a teleconference, the seven European leaders heading to the Los Cabos G20 summit agreed to stick to a common line: they would promise to support Greece – but only if it abided by the existing bailout's conditions. There would be no renegotiation. Without bailout funding, Athens would no longer be able to pay its bills, and there was a €3.1bn bond due on August 20, a portion of which was held by the ECB.

A "hard default" – failing to pay an outstanding bond – was long seen as the most likely route to Grexit since, if there was no one left to lend to Athens, it would not be just the government that ran out of money. At the time, Greek banks were relying on emergency central bank loans to stay afloat because private investors had stopped lending. To get those central bank loans, Greek banks had to provide some kind of collateral, which, for banks in most countries embroiled in the crisis, meant government bonds. But those government bonds would become worthless in a hard default, so central bank loans would be cut off. Without emergency liquidity assistance, Greece's banks would collapse. With no banks there was no economy.

This would not happen in a traditional monetary system. But Greece did not have a central bank in the traditional sense. Its central bank was in Frankfurt, run by officials who were mainly not Greek, and there was no way to compel the ECB to lend to Greek banks. The only way to restart the banking system would be for Athens to set up its own central bank and begin printing its own currency.

'Kill the country in hours'

But Mr Papademos and EU officials began to worry about a second "accidental" route to Grexit after the May election results: a bank run.

If panicked withdrawals began, it could lead to the same place as a "hard default". Greek banks would literally run out of cash, and the ECB would be unable to fund them because they would be insolvent. "Rules would clearly prohibit providing liquidity without adequate collateral, so that means you kill the country within hours," said an ECB official involved in the deliberations. To restart the banks, a new currency would be needed.

As Greece's political parties fought over whether they could form a government, Mr Papademos was receiving daily updates from the central bank on totals being withdrawn by depositors; the amounts were becoming so large that he wrote a warning letter to the Greek president. If no government was possible, elections had to be called quickly.

Since the start of 2009, Greek authorities had successfully managed a slow-motion "bank jog" that had seen deposits fall from €245bn to less than €174bn on the eve of the 2012 elections. According to Greek officials, about a third of that money was pulled out of the country entirely; another third was spent to maintain rapidly falling living standards; and a final third was squirrelled away in mattresses and pillowcases for fear the euros could be turned into drachma if they were kept in banks.

Under Mr Provopoulos, the central bank went so far as to fly in extra euros from other parts of the EU to ensure even large withdrawals could be accommodated. A pattern was established: if a Greek depositor asked for a big withdrawal, they were told to come back the next day. For Greek central bankers, it was essential the account holder got the cash when they returned.

"What if a depositor had walked into a bank and asked for his or her money? What if the answer was: 'I'm sorry, we are short of cash'?" said Mr Provopoulos. "Under the then prevailing conditions, it would have led to widespread concerns and very likely panic among depositors." An astounding €28.5bn in new banknotes was pumped into Greece in the run-up to the 2012 elections. But the feverish withdrawals between the May and June votes – the central bank was making shipments 24 hours a day – spooked officials, none more so than those watching from the ECB. A bank run raised questions of democratic legitimacy – should an unelected group of central bankers in Frankfurt, by deciding on their own that Greek banks were no longer solvent, really be the ones to force Greece out of the euro?

Amount of new banknotes pumped into Greece during the election period

Inside the ECB, there was broad consensus that the call that would lead to Grexit should not be made by central bankers. Instead, they would pass the decision to eurozone politicians. During a June 25 meeting in Brussels with Mr Barroso and Herman Van Rompuy, the European Council president, with Mr Juncker joining by phone, Mr Draghi informed the leaders that eurozone politicians would be asked to guarantee emergency loans to commercial banks before the ECB pulled the plug. Mr Draghi's warning was not an academic exercise. One official said Mr Draghi had told the leaders a "period of uncertainty" would begin 30 days before the August bond was due, on July 20. Although Antonis Samaras had cobbled together a coalition the week before, the new government was still demanding renegotiated bailout conditions. And Ms Merkel had not yet decided whether Greece should remain a member of the eurozone.

The infected leg camp

For Germany, the Grexit debate echoed nearly every negotiation over Europe's common currency since its founding document, the 1992 Maastricht treaty. Should it be a German-led monetary union made up of a small number of neighbouring states with similar economies or a broader political project that welcomed even those less competitive economically?

As a scientist trained to search for certainty, Ms Merkel began her own attempt to answer that question in the months leading up to her 2012 summer break. It would be an exaggeration to say she privately consulted every great economic and political mind in Europe during those weeks. But only a slight exaggeration.

During a Berlin meeting in early June with Mr Barroso, she solicited his view, fretting that Greek voters were about to force their hand by choosing a government that rejected the current bailout. When Mr Barroso told her Grexit would be a disaster and that Mr Samaras would probably win, Ms Merkel said it was Mr Samaras she was worried about, since he was on the campaign trail advocating scrapping the programme.

Two days later David Cameron, the British prime minister, engaged in a similar debate with Ms Merkel in Berlin, according to officials who participated in the meeting. Although Mr Cameron was less optimistic than Mr Barroso regarding Greece's ability to turn itself round, his advice was the same: the market reaction was likely to be violent and a eurozone bank run would be hard to stop, citing the UK experience with Northern Rock.

Ms Merkel's advisers were divided into two camps: the "domino" camp and the "infected leg" camp. The domino camp warned that Grexit would trigger panicked selling of all troubled eurozone government bonds, potentially followed by large-scale bank runs in Portugal, Italy and Spain.

The infected leg camp argued that cutting off Greece would allow the rest of the eurozone to return to health. "You had these two camps and you had good economists in both camps," said a German official. At the head of the infected leg camp was Mr Schäuble. Several people who spoke with him said he viewed a Greek exit almost idealistically, as something necessary to save a European project that he had worked for his entire political career.

"What is little understood is that this is because he is such a fervent pro-European," said one eurozone official who discussed the issue with the gruff German finance minister. "People think he doesn't like the Greeks. That's not true. It is because he so much loves Europe that anybody who's screwing European ideas is just so anti-European that they don't have a place in his scheme of things."

Moral hazard

That drive would occasionally lead to conflict with Ms Merkel, officials said. Where Mr Schäuble was far more prepared than his chancellor to cut Greece loose, he was also more willing to increase Germany's contributions to the eurozone's bailout fund to help create an impenetrable firewall to protect other euro members.

Within the German finance ministry there was a core group who took an even harder line. Most focused on the "moral hazard" that they argued was emerging in the eurozone, where countries believed there were no consequences to their fiscal mismanagement. Some senior aides felt that "you need to sacrifice one to scare the rest", said a person involved in the finance ministry discussion.

Ministry officials compiled analysis arguing that Grexit would cost less in the short term than trying to keep a fundamentally insolvent country on life-support indefinitely. Outside consultants were brought in to run similar studies.

Ms Merkel was being given conflicting advice by three central bankers whom she relied on heavily during her pre-holiday soundings and trusted implicitly: Mr Asmussen, who had been Mr Schäuble's deputy before moving to the ECB; Jens Weidmann, her former economic adviser whom she had named head of the Bundesbank a year earlier; and Philipp Hildebrand, former head of the Swiss National Bank.

Aid package released to Greece in late 2012 after Barroso urged Samaras to change his mind

All shared the concerns about moral hazard and felt it was unlikely Greece would live up to promises made as part of its bailout, which could lead to endless transfers of German taxpayer money to Athens. But they also told the chancellor that trying to predict the cost of Grexit was folly. One eurozone official who spoke to Mr Asmussen at the time said his advice to Ms Merkel was: "You could have something which is priced in already, and then you could contain it, or you could end up with a eurozone of 10 [countries]." The work of Mr Buti and his team in Brussels also appeared to have paid off. German officials said Ms Merkel was told it would be nearly impossible to get all 17 eurozone governments to agree to an exit plan, doing it all in secret without the markets catching wind of the effort, particularly with Greece showing no interest in leaving.

The political discussion in Berlin surrounding Grexit was the most subjective. Many EU leaders who dealt directly with Ms Merkel say she has less sentimental attachment to the European project than did her Christian Democratic predecessors, such as Helmut Kohl and Konrad Adenauer. EU leaders attribute that to her pre-politics life in communist east Germany, where she moved as an infant and lived into adulthood.

At the same time, several officials said they had begun to sense the weight of history on her shoulders. Did she want to be the German chancellor who "potentially breaks up Europe, even though it's not clear that would happen – but there's a possibility?" said one German official

In mid-July, Ms Merkel left for her six-week summer break to weigh the advice. Although the chancellor was undecided, the cacophony of senior German politicians publicly calling for Greece to leave had reached a crescendo. "If Greece no longer meets its requirements, there can be no further payments," Philipp Rösler, head of Ms Merkel's junior coalition partner the Free Democratic party, said as he prepared for his own summer holiday. "For me, a Greek exit has long since lost its horrors."

A spectacular U-turn

One leader acutely aware of the debate going on inside the chancellery was Mr Barroso. The commission president told aides he believed one of his cardinal duties as guardian of the EU's treaties was to keep the eurozone and EU from losing members, be it Greece from the currency union or Britain from the EU itself. With a massive, long-delayed €34.3bn aid payment hanging in the balance and Mr Samaras continuing to argue for big bailout revisions, Mr Barroso decided to become the first of the inner circle of EU crisis-fighters to visit Athens since the crisis began.

The talks between the two men went on for two hours. Sitting in front of an unlit fireplace in Mr Samaras' wood-panelled office, Mr Barroso told the new prime minister that demands for wholesale reforms of the bailout programme needed to stop. According to officials in the room, he urged Mr Samaras to spend at least a year executing the existing requirements. After that, the topic of revisions to the programme could be addressed, Mr Barroso suggested. But execution had to come first.

"Don't start asking for new conditions; there's no way," one person in the room recalled Mr Barroso saying. "The first message you have to convey to Germany . . . you have to say you are going to deliver."

The blunt message from a political ally appeared to have the desired effect. Officials in the room said Mr Samaras began redrafting his press statement by hand even as Mr Barroso delivered his admonition, later telling gathered reporters he would begin "the implementation of agreed measures" immediately. "Samaras did the most spectacular U-turn in history," said a minister in the preceding Pasok government.

They just don't know

Ultimately, however, it would come down to Ms Merkel herself, and after six weeks of contemplation, the German chancellor returned to Berlin with her verdict. There would be no certainty for the scientist. A cautious politician by nature, she could not abide Grexit if none of her advisers could agree on its consequences.

"You all say: 'Sorry, finally, we don't know'; If you don't know, then I won't take this risk," one adviser recalled her saying. "Her sense was: all these people, they might all be idiots, but they don't know."

Talk of Grexit within the eurozone receded. Ms Merkel made a highly symbolic trip to Athens in October. In Brussels, after a series of tendentious meetings of eurozone finance ministers, a revised bailout was agreed where Greece was promised more debt relief as soon as it achieved a primary budget surplus, which was projected by 2013.

The deal to release Greece's €34.3bn aid payment was struck just hours before an EU summit in November 2012. As he arrived, Mr Samaras made a quick statement: "Solidarity in our union is alive. Grexit is dead." Never again would Greece threaten the existence of the euro.

‘IF THE EURO FALLS, EUROPE FALLS’

As soon as Angela Merkel was handed the piece of paper Barack Obama had just passed around the table, her guard went up. “What is this?” the German chancellor asked. “I haven’t seen this before.”

The US president characterised the paper as talking points he and his seven European counterparts in the room could rally around when the Group of 20 summit ended that afternoon in Los Cabos, Mexico.

Most of the items were concise recitations of what had been formally agreed. But the last point was something new, say officials who read the sheet: a full-scale endorsement of a plan that had only been informally shopped around the summit by the man sitting next to Ms Merkel – Mario Monti, the Italian prime minister.

The scheme, which Mr Monti and his closest advisers had been working on for months before the June 2012 summit, called for the European Central Bank to protect eurozone countries when they came under attack from financial markets by automatically buying their bonds.

Only “virtuous” countries that obeyed the EU’s budget rules would be eligible. But the Monti plan would ensure borrowing costs, which for Italy and Spain were again rising to dangerous levels, would be capped. “We wanted to develop something that would not be dangerous for the control of the money supply in Europe, would not be offensive to German purism, would help concretely moderate the [bond] spreads, but could be earned only as a reward for virtue,” Mr Monti told the Financial Times.

As she read the page, Ms Merkel’s anger rose. “She was absolutely livid,” said another person in the room. Although her objections were procedural, it was clear the Italian and US delegations had conspired to get her to endorse an ECB bond-buying scheme that would have fundamentally changed the way the eurozone fought the crisis.

Washington had been advocating an ECB-backed “firewall” almost since the start of the crisis, arguing that the Federal Reserve had proved indispensable to quelling the US banking panic. Mr Monti was viewed by the White House as its strongest ally, particularly after Nicolas Sarkozy, the French president, lost a re-election bid a month earlier.

Mr Obama pushed Ms Merkel to embrace the understated Italian. In an intimate meeting over a picnic table on the patio of his Aspen Cabin at Camp David only weeks before Los Cabos, Mr Obama told her: “You need to work with him.”

In the face of Ms Merkel’s angry objections in Los Cabos, however, Mr Obama turned to his summit sherpa, White House international economics chief Michael Froman, to ask whether he had failed to share it with other delegations – a gesture many took as a graceful way to end the stand-off. When Mr Froman acknowledged the oversight, the discussion ended. At the time, the bust-up appeared to be the latest in a series of failed efforts by Mr Obama and EU co-conspirators to push Ms Merkel into backing a larger firewall to shield besieged eurozone countries. The year before, he had teamed up with Mr Sarkozy at the G20 in Cannes; this time it was Mr Monti.

In retrospect, it marked the beginning of the final turning point in the crisis. Three months after the testy exchange, Ms Merkel would give her tacit endorsement to an equally ambitious bond-buying scheme designed by another Italian technocrat, ECB president Mario Draghi. This would end the existential crisis that had faced the euro for more than three years.

That plan – unveiled after ECB staff spent a furious summer constructing the system following Mr Draghi's declaration he would do "whatever it takes" to ensure the euro's survival – has long been hailed as the *coup de grâce* of the eurozone crisis.

Yet Mr Draghi's programme was unlikely to have quelled markets without Ms Merkel's acquiescence, which was given despite the public objections of the powerful German Bundesbank. This was the quiet political victory that proved to be the linchpin of the ECB's success.

A year of evolving ideas

Those who spoke to Ms Merkel at the time said her reservations about Mr Monti's scheme were rooted in her view of how the eurozone should work. It was not the role of politicians to set bond rates. The ECB deciding such a plan on its own, on the other hand, was an appropriate decision for an independent central bank to make.

But many officials, particularly those who worked with her team in other eurozone capitals, argued Ms Merkel's ultimate embrace of Mr Draghi's programme capped a year-long shift of thinking in Berlin. If Germany's original vision of the eurozone – no bailouts, no shared debts and, in some quarters, no Greece – was becoming unachievable, Berlin was going to ensure that shared burdens came with centralised control.

In December Ms Merkel won agreement for a "fiscal compact" requiring all eurozone countries to write the EU's tough budget rules into national constitutions. And two weeks after the fight in Los Cabos she struck a deal that would mark the biggest shift in sovereignty since the euro's creation: in exchange for allowing common eurozone funds to rescue failing European banks, oversight and liquidation of those institutions would move from national to EU control. In both initiatives, she found an energetic partner in Mr Draghi.

German officials insist Ms Merkel did not back these policies to clear the path for ECB action. Similarly, Mr Draghi never explicitly promised EU politicians he would act if they moved to shore themselves up first. "Have you ever heard two Jesuits talking to each other?" said a person who participated in meetings where Mr Draghi lobbied for government action. "You have to listen not to what they say, but to what they do not say."

Some ECB officials who worked with Mr Draghi argue that securing Ms Merkel's support for his bond-buying plan, formally known as "outright monetary transactions", or OMT, was the result of a carefully orchestrated political cultivation of the chancellor. "The real difference was his relationship with Merkel," said a former ECB official who worked closely with Mr Draghi. "He knew that if one day something difficult had to be decided, he had to have her confidence." Senior officials close to both leaders acknowledge Mr Draghi was far more willing to engage with Ms Merkel and other political leaders than his predecessor, Jean-Claude Trichet, who was more likely to keep his deliberations to colleagues within the bank.

Without compromising the ECB's independence, Mr Draghi worked informally with Ms Merkel, carefully testing what might be acceptable, while Mr Trichet had preferred formal settings such as EU summits, officials said. But others insist a Draghi charm offensive is too simplistic to explain Ms Merkel's embrace. Even Draghi critics within the German government dismiss talk of a deal between the two leaders. "It wasn't a deal," groused one. "We didn't get anything in exchange." Instead, several officials said they believed Ms Merkel's willingness to back OMT was a reflection of how deep the crisis had grown that summer. But more importantly, it was the final move of a two-step dance between political leaders and central bankers that was crucial at every important turning point in the crisis.

A crisis-fighting team

Since the start of the crisis, ECB firefighting power had been politically constrained by Germany. Mr Monti's idea of the ECB buying bonds of struggling countries had long been seen as the solution to the crisis among policy makers from Washington to Paris. If the ECB made such a commitment, especially if it were unlimited, no bond trader would dare challenge its bottomless pockets. Panicked sell-offs could end overnight, advocates argued.

But many in Berlin saw such ECB action as improper. Buying eurozone bonds was, in essence, lending those governments money printed by the central bank, a practice known as "monetary financing". That not only put off the day of reckoning for ministers tasked with balancing budgets, it could also spur inflation.

Mario Monti called for the ECB to protect eurozone countries by automatically buying their bonds

Mr Trichet had twice pulled the euro back from the brink – when he agreed to purchase Greek bonds at the outset of the crisis in May 2010 and when he expanded the bond-buying programme to Italy and Spain in the turbulent summer of 2011. But his plans were always described as limited. "It was a way for governments to buy time," said Lorenzo Bini Smaghi, an ECB executive board member under Mr Trichet. "It was not something to save the euro." When Mr Draghi took the ECB helm in November 2011, the bank resembled a foreign outpost in enemy territory. The German public, never enthusiastic about bailouts, were outright hostile towards Mr Trichet's bond-buying. His efforts, formally known as the security markets programme or SMP, had been challenged in the German constitutional court and survived. But they also led to the resignation of Axel Weber, the Bundesbank chief. Mr Trichet's decision in August 2011 to expand SMP to Spain and Italy also led to the loss of a second German who, until then, had kept his objections private: Jürgen Stark.

The lone German on the ECB executive board, Mr Stark had been uncomfortable with Mr Trichet's approach but had refrained from public objections. "I was loyal maybe for too long to the ECB," Mr Stark said. The day after the ECB board approved Italian and Spanish bond-buying, Mr Stark resigned. There was little doubt in Berlin who would be next in line: Jörg Asmussen, the shaven-headed economist who had been the finance ministry's point man since the crisis began.

Almost uniquely among German officials, Mr Asmussen had maintained cordial ties across the eurozone despite complaints of German arrogance in the struggling south, which would need to approve the appointment. Those close to him say Mr Asmussen fretted over the job, since he knew he would ultimately face the same choice as Mr Stark and Mr Weber: agree with an ECB programme that was radioactive in his home country or resign.

“Either you do what is right for Europe and they crucify you in Germany or you are the hero of the FAZ [the conservative Frankfurter Allgemeine Zeitung newspaper] and you ruin Europe,” he told a confidant.

When Mr Asmussen was announced as the German choice, French officials realised they needed a nominee who could work closely with a man they believed could give Mr Draghi the German cover needed to be more aggressive. They settled on Benoît Cœuré, an economist of Mr Asmussen’s generation and political affiliation who knew the German well.

Like Mr Draghi, who spent most of his government career as head of the Italian Treasury before heading the Bank of Italy, Mr Asmussen and Mr Cœuré were not traditional central bankers. Both rose to prominence in their respective finance ministries, where they became accustomed to the rough and tumble of politics. The tone in Frankfurt began to change.

“Central bankers are very sensitive. If half a sentence in a newspaper is critical, they are completely offended,” said an official who knows all three men well. “When you come from the Treasury, you have this every single day . . . [All three were] used to much more public pressure and to a more dirty environment.” The two pragmatists would become the core of Mr Draghi’s new crisis-fighting team, building bridges to Paris and Berlin in ways their predecessors could not.

Draghi, Asmussen and Coeuré lobbied hard for approval for a new crisis-fighting scheme

Peacetime and wartime

Amid the chaos of two Greek elections that nearly led to “Grexit” and new fears about Spain’s banks, panic returned to bond markets in May. Bankia – created by merging Spanish savings banks brought low by the bursting of the housing bubble – went bust itself, requiring partial nationalisation. Concern spread to the health of all European banks.

Mr Draghi knew the ECB had to do more. By early June, he began discussing with a small circle of confidants, including Mr Asmussen and Mr Cœuré, the need for a new crisis-fighting programme, officials say.

People try to violate principles every day. You have to resist it 99 per cent of the time. But this situation was very different

Word of Mr Monti’s plan reached ECB officials before he presented it in Los Cabos but they deemed it unworkable. As they began to discuss their own blueprint, the central bankers in Frankfurt knew any new bond-buying plan would cause political problems for Mr Asmussen. He shared the economic worldview of Mr Stark and Mr Weber but believed an extreme crisis required extraordinary measures.

"People try to violate principles every day. You have to resist it 99 per cent [of the time] and say, 'this is not the extraordinary situation'," Mr Asmussen said. "You have peacetime and then you have wartime. In peacetime, I'm on the Bundesbank line but the situation was very different."

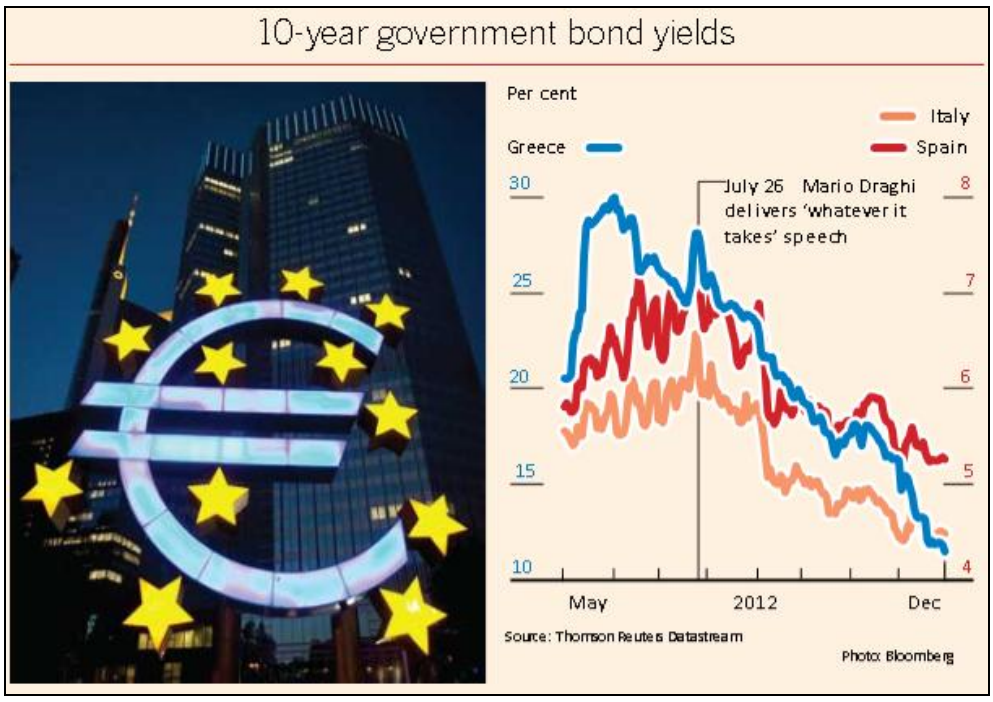
Evidence was mounting that wartime had arrived. Companies were making contingency plans for a euro break-up. Eurozone banks were holding day-to-day cash in far-flung subsidiaries – an expensive policy but one that would protect them if the euro split apart. Italian and Spanish borrowing costs soared.

At the ECB, discussions about how to stop the panic intensified. But even those close to Mr Draghi were taken by surprise when, at the end of July, he said the ECB would do "whatever it takes" to prevent euro break-up. His words had an immediate calming effect on the markets. Now ECB officials had to develop a policy to back it up – one that would pass muster where it faced its biggest challenge: Germany. In Frankfurt, Mr Draghi's allies worked furiously to peel off opponents to the plan, tweaking provisions in a bid to win over conservatives on the ECB governing council, including Mr Asmussen and the Dutch and Finnish central bank chiefs. Once they had succeeded, Jens Weidmann, the Bundesbank's president, was isolated in opposition.

Jens Weidmann, Bundesbank president, was left isolated in opposition to the plan

By now, Ms Merkel was secure in her belief that allowing the euro to fall apart would be far too dangerous. Gaining her approval for the ECB plan would come down to something she had argued for all along: in exchange for aid, struggling countries had to agree to economic reforms. That "conditionality" had to be thorough and legally binding.

When Mr Draghi unveiled the final version of his plan in September, the political winds had shifted in Berlin. Having secured her banking union, Ms Merkel gave the Draghi plan her public blessing. Speaking the day after Mr Draghi's announcement, she highlighted the prerequisite of economic reform. "Conditionality is a very important point," she said. "Control and help . . . go hand in hand."



The day she spoke, Italian 10-year bonds yields closed below 5.1 per cent for the first time in five months. Spain's fell below 6 per cent for the first time in four months. Those levels would not be reached again.

Europe's debt crisis was over.

Two years on, it is clear the frantic, improvised actions of the final year of the crisis saved the euro. Yet the eurozone is far from full health. Debt levels in Europe's south are extreme. Unemployment remains near historic highs, a side effect of the bitter medicine imposed by the crisis-fighters. Anti-EU parties may be the beneficiary of the fallout in next week's European elections. But the 15-year-old currency union passed its most important test: in its darkest hour, its leaders did whatever it took to hold it together. And no one mattered more than Angela Merkel, raised in east Germany, chancellor of a united Germany and, thanks in part to the crisis, Europe's most powerful leader.

"I have chosen for Europe and the euro, and thus for Greece," Ms Merkel said near the end of the crisis. "If the euro falls, then Europe falls."