The Euro Is Dead

But, if Europe's leaders play their cards right, it can rise again.

BY CHARLES CALOMIRIS | JANUARY 6, 2011

Europe is living in denial. Even after the economic crisis exposed the eurozone's troubled future, its leaders are struggling to sustain the status quo. At this point, several European countries will likely be forced to abandon the euro within the next year or two.

European leaders tell us that this is impossible. There is no legal mechanism, they say, for exiting the euro. But the collapse of the euro is simple arithmetic: Once a country's debt-to-GDP ratio gets high enough, it becomes impossible for it to generate enough future taxes to repay its existing debt and interest costs. This week, Portugal became the latest country to threaten the integrity of the eurozone when it saw the yield on its Treasury bills soar, based on investors' fears that it would be unable to pay its debt.

The only way out of this conundrum is for countries with insurmountable debt burdens to default on their euro-denominated debts and exit the eurozone so that they can finance their continuing fiscal deficits by printing their own currency. Here's a hint for Europe's politicians: If the math says one thing and the law says something different, it will be the law that ends up changing.

The countries currently teetering on the precipice include "peripheral" countries — such as Greece, Ireland, and Portugal — as well as large countries, such as Spain, Italy, and France. It is extremely unlikely that all of these countries will still be members of the eurozone by the time revelers gather to ring in New Year's 2013. The most likely scenario is that the next two years will witness the departure of more than one peripheral country and at least one of the large countries.

Greece is at the top of that list. The country will soon have a sovereign debt-to GDP ratio of more than 150 percent and an economy that contracted approximately 4 percent in the past year. It has long suffered from the worst corruption and largest shadow economy in Europe, while also possessing some of the lowest labor participation rates, most generous pension systems, and highest consumption rates among its European peers. It is true that the Greeks have made heroic efforts in the past six months to cut spending and raise taxes, but it won't be enough to reverse the explosive costs of covering its debts. And yet, the story goes, Greece will somehow repay what it owes.

Following closely on Greece's heels is Ireland. During the so-called "Irish miracle," the country experienced a housing boom that saw twice the appreciation as did the United States. When this bubble popped, Ireland's banking system suffered a massive loss. The government's bank bailouts have added more than 20 percent of GDP to its budget deficit in the past year and will add a similar additional amount to its deficits in the near future.

The Irish case also shows the perils of EU intervention. Ireland was forced by its self-serving European partners to guarantee massive bank debts — in order to forestall debilitating losses to German, Belgian, Danish, and British banks, among others — as a condition for receiving emergency EU assistance. This Irish policy mistake has raised its debt to stratospheric levels, which the government will be hard-pressed to bring down. Thus, in effect, some of the largest EU countries proved their willingness to throw Ireland under the bus to postpone dealing with their own financial institutions' problems.

Now Spain is being pushed by those same European partners into making the same deadly mistake as Ireland. Spain's housing boom was similar to that of Ireland and was similarly financed by large external borrowings. The good news in Spain, however, is that most of the country's largest financial institutions appear to be solvent. If Spain shuts down its insolvent savings banks and allows closed banks to default on their external bond debts held by other EU countries' banks, Spanish sovereign solvency can be preserved.

A number of other European countries face similarly daunting fiscal challenges. Italy, for example, is running a debt-to-GDP ratio in excess of 125 percent. Although serious and immediate fiscal spending cuts could give Italy a reasonable chance of repaying its debts, the country seems so politically broken that it is unlikely to make the deep spending cuts that would permit it to stay in the euro. Its meager cuts this past year are an indication of how difficult it is for Italy's political system to confront its challenges.

The same failure of political will bedevils France, Belgium, and Portugal. The French proved that they are willing to riot over a two-year extension of the retirement age. They will need to reconcile themselves to far more drastic measures if they hope to get their dismal fiscal situation under control.

This partial collapse of the euro is inevitable, and Europe's leaders should focus on the next step: Their challenge now is to lay the groundwork for a sustainable currency union in the future, once exiting countries reform themselves enough to rejoin. To do so, however, they will need to take stock of the institutional deficiencies undermining the current union, so that the new eurozone is more crash-proof than the last one.

Europe must do far more to cut the growth of government spending — the only credible path to preventing ballooning deficits. But it needs to go even a step beyond that: Europe must agree on measures that prevent countries from behaving irresponsibly to take advantage of their membership in the eurozone. One of the reasons that Italy and Greece spent so much is that their interest rates on debt fell dramatically when they joined the eurozone, making deficit finance more attractive. There is no substitute for the creation of a fiscal union, which would centralize enforcement power that could credibly control spending. A currency union cannot survive without a corresponding fiscal union.

But fiscal reform is not enough without measures to strengthen the competitiveness of southern Europe. Southern European countries, notably Spain, Italy, Portugal, and Greece, are finding it increasingly difficult to compete in global trade — the result of restrictive union contracts and labor laws — and have accordingly suffered from high current account deficits and high unemployment. If left unchecked, these dynamics will produce a political powder keg of widening interregional economic-welfare differences that would threaten the long-term cohesion of the union.

The only way around this problem is to make southern Europe more business-friendly. That means making it easier for businesses to fire workers and cut wages. It also means less generous welfare programs and credible efforts to reduce corruption and lower entry barriers to foreign competition. A reconstructed eurozone should make the implementation of these reforms part of the requirement for membership.

The European financial sector is also in dire need of reform. New regulations should be put in place that make banking collapse less likely, most importantly through the creation of credible means of measuring bank risks and requiring capital and liquidity commensurate with those risks. Europe should also put in place policies that transparently and predictably allocate authority across different national regulators in the event of a bank's collapse. Without a credible plan for resolving a large global bank crisis, politicians will tend to prefer bailouts as a means of avoiding unpredictable financial chaos.

Policymakers must learn that the "too-big-to-fail" problem is both dangerous and avoidable, and that choosing not to bail out banks is a viable option. Politicians today are frightened of transparency in the recognition of bank losses and are often unwilling to close insolvent banks out of a fear of "systemic risk." However, it is only by credibly recognizing banking-system losses that governments can put an end to uncertainties in the financial market.

The eurozone's problems are not going away. Whether these problems will eventually be seen as bumps on the road to a credible currency union or as symptoms of the irreconcilable conflicts within Europe depends on how the eurozone countries react. The good news is that Europe possesses the techniques of statecraft and financial engineering to build the institutional foundations of a long-lived, stable union. The lingering question, however, is whether it possesses the political will to do so.