Thinking *the* Unthinkable

BY DANI RODRIK

The eurozone may not be viable.

When Greece was bailed out by a joint eurozone-IMF rescue package back in May, it was clear that the deal had bought only a temporary respite. Now the other shoe has dropped. With Ireland's troubles threatening to spill over to Portugal, Spain, and even Italy, it is time to rethink the viability of Europe's currency union.

These words do not come easily, as I am no euroskeptic. Unlike others, such as my Harvard colleague Martin Feldstein, who argues that Europe is not a natural monetary area, I believed that monetary union made perfect sense in the context of a broader European project that emphasized—as it still does—political institution building alongside economic integration.

Europe's bad luck was to be hit with the worst financial crisis since the 1930s while still only halfway through its integration process. The eurozone was too integrated for cross-border spillovers not to cause mayhem in national economies, but not integrated enough to have the institutional capacity needed to manage the crisis.

Consider what happens when banks in Texas, Florida, or California make bad lending decisions that threaten their survival. If the banks are merely illiquid, the Federal Reserve in Washington is ready to act as a lender of last resort. If they are judged to be insolvent, they are allowed to fail or are taken over by federal

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authorities, while depositors are made whole by the Federal Deposit Insurance Corporation.

Similarly, in case of bankruptcy, federal laws and courts readily adjudicate claims among creditors, and do so without regard to state borders. Regardless of the outcome, private debt is not socialized by state governments (but by the federal government, if at all), and does not threaten public finances at the state level.

State governments in turn have no legal power to abrogate debt contracts *vis-à-vis* out-of-state creditors, and no incentive to do so (given the help they get from the federal government). So, even in the throes of a financial crisis, banks and non-financial firms can continue to borrow if their balance sheets are sound, uncontaminated by the "sovereign risk" of their state government.

Meanwhile, the federal government makes up for a good chunk of the drop in state incomes by transfers or reduced taxes. Workers who nonetheless have it bad can move easily to better-performing states without worries about language differences or culture shock. Almost all of this happens automatically, without long, contentious negotiations among state governors and federal officials, assistance from the International Monetary Fund, or calling into question the existence of the United States as a unified political-economic entity.

So the real problem in Europe is not that Spain or Ireland has borrowed a lot, or that too much Spanish and Irish debt sits on bank balance sheets elsewhere in Europe. After all, who cares about Florida's current-account deficit—or even knows what it amounts to? No, the real problem is that Europe has not created the union-wide institutions that an integrated financial market requires.

This reflects the absence of adequate political institutions at the center. The European Union has taught us valuable lessons over the last few decades: first, that financial integration requires eliminating volatility among national currencies; next, that eradicating exchange-rate risk requires doing away with national currencies altogether; and now, that monetary union is impossible among democracies without political union.

It should have been expected that the political side of the equation would take time to fall into place. It is easy to blame European politicians for lack of leadership. But let us not underestimate the magnitude of the task that European governments took on.

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In fact, the closest analogue to it is America's own historical experience with building a federal republic. As the long American struggle for "states' rights"—and indeed the Civil War—shows, creating a political union out of a collection of self-governing entities is hardly a smooth or speedy process.

States naturally cherish their sovereignty. Worse still, economic union itself can fan the fires of nationalism and endanger political integration. It places strains on each country's institutions (seen in the pressure on Europe's welfare states), breeds resentment against foreigners (witness the recent success of anti-immigration parties), and renders financial crises originating from abroad both likelier and costlier (as the current situation makes all too clear).

Alas, it may now be too late for the eurozone. Ireland and the southern European countries must reduce their debt burden and sharply enhance their economies' competitiveness. It is hard to see how they can achieve both aims while remaining in the eurozone.

The Greek and Irish bailouts are only temporary palliatives: they do nothing to curtail indebtedness, and they have not stopped contagion. Moreover, the fiscal austerity they prescribe delays economic recovery. The idea that structural and labor-market reforms can deliver quick growth is nothing but a mirage. So the need for debt restructuring is an unavoidable reality.

Even if the Germans and other creditors acquiesce in a restructuring—not from 2013 on, as German Chancellor Angel Merkel has asked for, but now—there is the further problem of restoring competitiveness. This problem is shared by all deficit countries, but is acute in Southern Europe. Membership in the same monetary zone as Germany will condemn these countries to years of deflation, high unemployment, and domestic political turmoil. An exit from the eurozone may be at this point the only realistic option for recovery.

A breakup of the eurozone may not doom it forever. Countries can rejoin, and do so credibly, when the fiscal, regulatory, and political prerequisites are in place. For the moment, the eurozone may well have reached the point where an amicable divorce is a better option than years of economic decline and political acrimony. ◆