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Is the Eurozone Doomed?

The Rescue Plan Cannot Address the Central Problem

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The trillion-dollar rescue package European leaders aimed at the continent's growing debt crisis in May might well have been code-named Panacea. Stocks rose throughout the region, and even Greek bond yields tumbled. The reprieve was short-lived, however, as markets fell on the realization that the bailout would not improve government finances going forward.

The entire rescue plan rests on the assumption that, with more time, the eurozone's "problem children" can get their fiscal houses in order. But Greece and some of the other major European debtors are seriously uncompetitive in comparison with countries that are either more productive or have lower production costs. No rescue plan can address the central problem: that countries with very different economies are yoked to the same currency. Lacking a sovereign currency and unable to devalue their way out of trouble, they are left with few viable options—and voters in Germany and France will soon tire of paying the bill.

Critics argue that the current crisis has exposed the profligacy of the Greek government and its citizens, who are stubbornly fighting proposed social spending cuts and refusing to live within their means. Yet Greece has one of the lowest per capita incomes in the European Union (EU), and its social safety net is modest compared to the rest of Europe. Since implementing its austerity program in January, it has reduced its budget deficit by 40 percent, largely through spending cuts. But slower growth is causing revenues to come in below targets, and fuel-tax increases have contributed to growing inflation. As the larger troubled economies like Spain and Italy also adopt austerity measures, the entire continent could find government revenues collapsing.

So what is to be done? Greece cannot "afford" default—nor can the EU—but it can restructure its debt. Basically, Greece needs more favorable credit terms: lower interest rates and a longer period in which to pay. The cash-flow improvement in servicing the country's debt, together with the ongoing rebalancing of its public finances, would raise its credit profile and make access to credit from private markets possible—a viable short-term fix.

But a more far-reaching solution is needed. For better or worse, it's time to start thinking about a major reconstruction of the European project, along two possible paths.

The first possibility, of course, is an amicable divorce. Yet a coordinated dissolution of the EU would open the door to higher transaction costs and tariffs, and curtail the mobility of labor and capital. The net result would be a more inefficient, fractured system, of the kind that inspired the creation of the euro in the first place. More broadly, the euro's disintegration would only bolster the preeminence of the dollar in global commerce and affairs—and perhaps leave China as the only plausible rival to American power.

The second possibility? Achieving a more perfect union. Immediate relief could be provided by the European Central Bank, which would create and distribute one trillion euros across all eurozone nations on a per capita basis. Each nation would be allowed to use this emergency relief as it saw fit. Greece, for example, might choose to purchase some of its outstanding public debt; others might choose fiscal stimulus packages. Over the longer term, a permanent fiscal arrangement, through which the central eurozone authorities could distribute funds to member states, would be necessary. Ideally, this should be overseen by the equivalent of a national treasury responsible to an elected body of representatives—in this case, the European Parliament. This arrangement would relieve pressures to adopt austerity measures, and limit the necessity of borrowing from financial markets in order to finance deficits.

For a more detailed discussion of this topic, go to www.levyinstitute.org/pubs/ppb_113.pdf.

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