



Column: Why the EU, and euro, will survive

By R. Daniel Kelemen, and Erik Jones

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One after another, European countries are losing the confidence of bond markets and turning to neighbors for bailouts. European Union leaders have agreed to a series of responses over the past year, but they have been unable to stop the crisis from spreading. Prominent economists such as Nouriel Roubini now warn that Europe's common currency might break apart. *Time* magazine ran an ominous cover story last week titled, "The End of Europe."

The escalating crisis has brought the eurozone to the edge of an abyss. A breakup of the currency or a series of disorderly defaults would wreak havoc on both sides of the Atlantic — sending stock markets plunging, causing a global banking crisis and pushing the U.S. and European economies into a deep recession. Fortunately, none of this is likely to happen. The crisis will not destroy the euro or the EU. Instead, it will make both stronger.

National interests at stake

To understand why, consider the interests of key players in this drama. No country will willingly stop using the euro in order to return to a national currency. For struggling countries on the periphery such as Greece or Portugal, to do so would cause a collapse of their financial system. Moreover, unless a government planned on repudiating all its foreign debt, which is implausible, it would find itself burdened with a debt denominated largely in euros, while its national currency — a new drachma or escudo, for instance — was plummeting in value.

Though German citizens and leaders are loath to bail out southern European states, in the end Germany will do whatever is necessary to maintain the euro. Germany will do so not just because of its political commitment to European integration, but also because it derives enormous benefits from the 12-year-old currency. Membership in the eurozone has been vital for Germany's successful export-based economy. In a world without the euro, Germany would see its currency skyrocket in value, damaging its competitiveness. Also, Germany lies at the heart of European finance, and were the eurozone to break up, German banks would suffer devastating losses.

Path to a solution

By Hannelore Foerster, Bloomberg News

A euro sign sculpture stands in front of the European Central Bank headquarters in Frankfurt, Germany.

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So how will governments hold together the 17-country eurozone? The solution will likely have three elements:

- First, the European Commission will be handed greater powers to audit eurozone countries' budget statistics and to engage in broader macroeconomic coordination. This is already evident in the bailout agreements reached with Greece, Ireland and Portugal.

- Second, EU member states will enshrine fiscal rules limiting borrowing in national laws. Germany is

demanding such legal commitments in exchange for any further support of eurozone bailouts. More important, such guarantees might be necessary for national governments to convince the markets of their commitment to fiscal discipline.

- Finally, an EU body will issue Eurobonds — sovereign bonds backed by the eurozone governments. Eurobonds promise to address two problems at the heart of the crisis. First, they will reduce borrowing costs for states on the periphery because they will be underwritten by the most creditworthy countries. Second, Eurobonds will create market incentives to help police fiscal discipline. Members will be allowed to issue Eurobonds only up to a fixed threshold, likely 60% of GDP. Beyond that, national governments could borrow on their own, but the markets would demand higher rates.

The sovereign debt crisis has exposed flaws in the design of the euro. Strengthening eurozone governance along these lines will be costly and controversial. Yet governments will swallow these bitter pills because the alternatives would be more painful still.

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