Can Europe Be Saved?

By PAUL KRUGMAN

THERE’S SOMETHING peculiarly apt about the fact that the current European crisis began in Greece. For Europe’s woes have all the aspects of a classical Greek tragedy, in which a man of noble character is undone by the fatal flaw of hubris.

Not long ago Europeans could, with considerable justification, say that the current economic crisis was actually demonstrating the advantages of their economic and social model. Like the United States, Europe suffered a severe slump in the wake of the global financial meltdown; but the human costs of that slump seemed far less in Europe than in America. In much of Europe, rules governing worker firing helped limit job loss, while strong social-welfare programs ensured that even the jobless retained their health care and received a basic income. Europe’s gross domestic product might have fallen as much as ours, but the Europeans weren’t suffering anything like the same amount of misery. And the truth is that they still aren’t.

Yet Europe is in deep crisis — because its proudest achievement, the single currency adopted by most European nations, is now in danger. More than that, it’s looking increasingly like a trap. Ireland, hailed as the Celtic Tiger not so long ago, is now struggling to avoid bankruptcy. Spain, a booming economy until recent years, now has 20 percent unemployment and faces the prospect of years of painful, grinding deflation.

The tragedy of the Euromess is that the creation of the euro was supposed to be the finest moment in a grand and noble undertaking: the generations-long effort to bring peace, democracy and shared prosperity to a once and frequently war-torn continent. But the architects of the euro, caught up in their project’s sweep and romance, chose to ignore the mundane difficulties a shared currency would predictably encounter — to ignore warnings, which were issued right from the beginning, that Europe lacked the institutions needed to make a common currency workable. Instead, they engaged in magical thinking, acting as if the nobility of their mission transcended such concerns.

The result is a tragedy not only for Europe but also for the world, for which Europe is a crucial role model. The Europeans have shown us that peace and unity can be brought to a region with a history of violence, and in the process they have created perhaps the most decent
societies in human history, combining democracy and human rights with a level of individual economic security that America comes nowhere close to matching. These achievements are now in the process of being tarnished, as the European dream turns into a nightmare for all too many people. How did that happen?

THE ROAD TO THE EURO
It all began with coal and steel. On May 9, 1950 — a date whose anniversary is now celebrated as Europe Day — Robert Schuman, the French foreign minister, proposed that his nation and West Germany pool their coal and steel production. That may sound prosaic, but Schuman declared that it was much more than just a business deal.

For one thing, the new Coal and Steel Community would make any future war between Germany and France “not merely unthinkable, but materially impossible.” And it would be a first step on the road to a “federation of Europe,” to be achieved step by step via “concrete achievements which first create a de facto solidarity.” That is, economic measures would both serve mundane ends and promote political unity.

The Coal and Steel Community eventually evolved into a customs union within which all goods were freely traded. Then, as democracy spread within Europe, so did Europe’s unifying economic institutions. Greece, Spain and Portugal were brought in after the fall of their dictatorships; Eastern Europe after the fall of Communism.

In the 1980s and ’90s this “widening” was accompanied by “deepening,” as Europe set about removing many of the remaining obstacles to full economic integration. (Eurospeak is a distinctive dialect, sometimes hard to understand without subtitles.) Borders were opened; freedom of personal movement was guaranteed; and product, safety and food regulations were harmonized, a process immortalized by the Eurosausage episode of the TV show “Yes Minister,” in which the minister in question is told that under new European rules, the traditional British sausage no longer qualifies as a sausage and must be renamed the Emulsified High-Fat Offal Tube. (Just to be clear, this happened only on TV.)

The creation of the euro was proclaimed the logical next step in this process. Once again, economic growth would be fostered with actions that also reinforced European unity.

The advantages of a single European currency were obvious. No more need to change money when you arrived in another country; no more uncertainty on the part of importers about what a contract would actually end up costing or on the part of exporters about what promised payment would actually be worth. Meanwhile, the shared currency would strengthen the sense of European unity. What could go wrong?
The answer, unfortunately, was that currency unions have costs as well as benefits. And the case for a single European currency was much weaker than the case for a single European market — a fact that European leaders chose to ignore.

THE (UNEASY) CASE FOR MONETARY UNION

International monetary economics is, not surprisingly, an area of frequent disputes. As it happens, however, these disputes don’t line up across the usual ideological divide. The hard right often favors hard money — preferably a gold standard — but left-leaning European politicians have been enthusiastic proponents of the euro. Liberal American economists, myself included, tend to favor freely floating national currencies that leave more scope for activist economic policies — in particular, cutting interest rates and increasing the money supply to fight recessions. Yet the classic argument for flexible exchange rates was made by none other than Milton Friedman.

The case for a transnational currency is, as we’ve already seen, obvious: it makes doing business easier. Before the euro was introduced, it was really anybody’s guess how much this ultimately mattered: there were relatively few examples of countries using other nations’ currencies. For what it was worth, statistical analysis suggested that adopting a common currency had big effects on trade, which suggested in turn large economic gains. Unfortunately, this optimistic assessment hasn’t held up very well since the euro was created: the best estimates now indicate that trade among euro nations is only 10 or 15 percent larger than it would have been otherwise. That’s not a trivial number, but neither is it transformative.

Still, there are obviously benefits from a currency union. It’s just that there’s a downside, too: by giving up its own currency, a country also gives up economic flexibility.

Imagine that you’re a country that, like Spain today, recently saw wages and prices driven up by a housing boom, which then went bust. Now you need to get those costs back down. But getting wages and prices to fall is tough: nobody wants to be the first to take a pay cut, especially without some assurance that prices will come down, too. Two years of intense suffering have brought Irish wages down to some extent, although Spain and Greece have barely begun the process. It’s a nasty affair, and as we’ll see later, cutting wages when you’re awash in debt creates new problems.

If you still have your own currency, however, you wouldn’t have to go through the protracted pain of cutting wages: you could just devalue your currency — reduce its value in terms of other currencies — and you would effect a de facto wage cut.

Won’t workers reject de facto wage cuts via devaluation just as much as explicit cuts in their paychecks? Historical experience says no. In the current crisis, it took Ireland two years of
severe unemployment to achieve about a 5 percent reduction in average wages. But in 1993 a
devaluation of the Irish punt brought an instant 10 percent reduction in Irish wages measured
in German currency.

Why the difference? Back in 1953, Milton Friedman offered an analogy: daylight saving time. It
makes a lot of sense for businesses to open later during the winter months, yet it’s hard for any
individual business to change its hours: if you operate from 10 to 6 when everyone else is
operating 9 to 5, you’ll be out of sync. By requiring that everyone shift clocks back in the fall
and forward in the spring, daylight saving time obviates this coordination problem. Similarly,
Friedman argued, adjusting your currency’s value solves the coordination problem when wages
and prices are out of line, sidestepping the unwillingness of workers to be the first to take pay
cuts.

So while there are benefits of a common currency, there are also important potential
advantages to keeping your own currency. And the terms of this trade-off depend on
underlying conditions.

On one side, the benefits of a shared currency depend on how much business would be
affected.

I think of this as the Iceland-Brooklyn issue. Iceland, with only 320,000 people, has its own
currency — and that fact has given it valuable room for maneuver. So why isn’t Brooklyn, with
roughly eight times Iceland’s population, an even better candidate for an independent
currency? The answer is that Brooklyn, located as it is in the middle of metro New York rather
than in the middle of the Atlantic, has an economy deeply enmeshed with those of neighboring
boroughs. And Brooklyn residents would pay a large price if they had to change currencies
every time they did business in Manhattan or Queens.

So countries that do a lot of business with one another may have a lot to gain from a currency
union.

On the other hand, as Friedman pointed out, forming a currency union means sacrificing
flexibility. How serious is this loss? That depends. Let’s consider what may at first seem like an
odd comparison between two small, troubled economies.

Climate, scenery and history aside, the nation of Ireland and the state of Nevada have much in
common. Both are small economies of a few million people highly dependent on selling goods
and services to their neighbors. (Nevada’s neighbors are other U.S. states, Ireland’s other
European nations, but the economic implications are much the same.) Both were boom
economies for most of the past decade. Both had huge housing bubbles, which burst painfully.
Both are now suffering roughly 14 percent unemployment. And both are members of larger currency unions: Ireland is part of the euro zone, Nevada part of the dollar zone, otherwise known as the United States of America.

But Nevada’s situation is much less desperate than Ireland’s.

First of all, the fiscal side of the crisis is less serious in Nevada. It's true that budgets in both Ireland and Nevada have been hit extremely hard by the slump. But much of the spending Nevada residents depend on comes from federal, not state, programs. In particular, retirees who moved to Nevada for the sunshine don’t have to worry that the state’s reduced tax take will endanger their Social Security checks or their Medicare coverage. In Ireland, by contrast, both pensions and health spending are on the cutting block.

Also, Nevada, unlike Ireland, doesn’t have to worry about the cost of bank bailouts, not because the state has avoided large loan losses but because those losses, for the most part, aren’t Nevada’s problem. Thus Nevada accounts for a disproportionate share of the losses incurred by Fannie Mae and Freddie Mac, the government-sponsored mortgage companies — losses that, like Social Security and Medicare payments, will be covered by Washington, not Carson City.

And there’s one more advantage to being a U.S. state: it’s likely that Nevada’s unemployment problem will be greatly alleviated over the next few years by out-migration, so that even if the lost jobs don’t come back, there will be fewer workers chasing the jobs that remain. Ireland will, to some extent, avail itself of the same safety valve, as Irish citizens leave in search of work elsewhere and workers who came to Ireland during the boom years depart. But Americans are extremely mobile; if historical patterns are any guide, emigration will bring Nevada’s unemployment rate back in line with the U.S. average within a few years, even if job growth in Nevada continues to lag behind growth in the nation as a whole.

Over all, then, even as both Ireland and Nevada have been especially hard-luck cases within their respective currency zones, Nevada’s medium-term prospects look much better.

What does this have to do with the case for or against the euro? Well, when the single European currency was first proposed, an obvious question was whether it would work as well as the dollar does here in America. And the answer, clearly, was no — for exactly the reasons the Ireland-Nevada comparison illustrates. Europe isn’t fiscally integrated: German taxpayers don’t automatically pick up part of the tab for Greek pensions or Irish bank bailouts. And while Europeans have the legal right to move freely in search of jobs, in practice imperfect cultural integration — above all, the lack of a common language — makes workers less geographically mobile than their American counterparts.
And now you see why many American (and some British) economists have always been skeptical about the euro project. U.S.-based economists had long emphasized the importance of certain preconditions for currency union — most famously, Robert Mundell of Columbia stressed the importance of labor mobility, while Peter Kenen, my colleague at Princeton, emphasized the importance of fiscal integration. America, we know, has a currency union that works, and we know why it works: because it coincides with a nation — a nation with a big central government, a common language and a shared culture. Europe has none of these things, which from the beginning made the prospects of a single currency dubious.

These observations aren’t new: everything I’ve just said was well known by 1992, when the Maastricht Treaty set the euro project in motion. So why did the project proceed? Because the idea of the euro had gripped the imagination of European elites. Except in Britain, where Gordon Brown persuaded Tony Blair not to join, political leaders throughout Europe were caught up in the romance of the project, to such an extent that anyone who expressed skepticism was considered outside the mainstream.

Back in the ’90s, people who were present told me that staff members at the European Commission were initially instructed to prepare reports on the costs and benefits of a single currency — but that after their superiors got a look at some preliminary work, those instructions were altered: they were told to prepare reports just on the benefits. To be fair, when I’ve told that story to others who were senior officials at the time, they’ve disputed that — but whoever’s version is right, the fact that some people were making such a claim captures the spirit of the time.

The euro, then, would proceed. And for a while, everything seemed to go well.

EUROPHORIA, EUROCRISIS
The euro officially came into existence on Jan. 1, 1999. At first it was a virtual currency: bank accounts and electronic transfers were denominated in euros, but people still had francs, marks and lira (now considered denominations of the euro) in their wallets. Three years later, the final transition was made, and the euro became Europe’s money.

The transition was smooth: A.T.M.’s and cash registers were converted swiftly and with few glitches. The euro quickly became a major international currency: the euro bond market soon came to rival the dollar bond market; euro bank notes began circulating around the world. And the creation of the euro instilled a new sense of confidence, especially in those European countries that had historically been considered investment risks. Only later did it become apparent that this surge of confidence was bait for a dangerous trap.

Greece, with its long history of debt defaults and bouts of high inflation, was the most striking
example. Until the late 1990s, Greece’s fiscal history was reflected in its bond yields: investors would buy bonds issued by the Greek government only if they paid much higher interest than bonds issued by governments perceived as safe bets, like those by Germany. As the euro’s debut approached, however, the risk premium on Greek bonds melted away. After all, the thinking went, Greek debt would soon be immune from the dangers of inflation: the European Central Bank would see to that. And it wasn’t possible to imagine any member of the newly minted monetary union going bankrupt, was it?

Indeed, by the middle of the 2000s just about all fear of country-specific fiscal woes had vanished from the European scene. Greek bonds, Irish bonds, Spanish bonds, Portuguese bonds — they all traded as if they were as safe as German bonds. The aura of confidence extended even to countries that weren’t on the euro yet but were expected to join in the near future: by 2005, Latvia, which at that point hoped to adopt the euro by 2008, was able to borrow almost as cheaply as Ireland. (Latvia’s switch to the euro has been put off for now, although neighboring Estonia joined on Jan. 1.)

As interest rates converged across Europe, the formerly high-interest-rate countries went, predictably, on a borrowing spree. (This borrowing spree was, it’s worth noting, largely financed by banks in Germany and other traditionally low-interest-rate countries; that’s why the current debt problems of the European periphery are also a big problem for the European banking system as a whole.) In Greece it was largely the government that ran up big debts. But elsewhere, private players were the big borrowers. Ireland, as I’ve already noted, had a huge real estate boom: home prices rose 180 percent from 1998, just before the euro was introduced, to 2007. Prices in Spain rose almost as much. There were booms in those not-yet-euro nations, too: money flooded into Estonia, Latvia, Lithuania, Bulgaria and Romania.

It was a heady time, and not only for the borrowers. In the late 1990s, Germany’s economy was depressed as a result of low demand from domestic consumers. But it recovered in the decade that followed, thanks to an export boom driven by its European neighbors’ spending sprees.

Everything, in short, seemed to be going swimmingly: the euro was pronounced a great success.

Then the bubble burst.

You still hear people talking about the global economic crisis of 2008 as if it were something made in America. But Europe deserves equal billing. This was, if you like, a North Atlantic crisis, with not much to choose between the messes of the Old World and the New. We had our subprime borrowers, who either chose to take on or were misled into taking on mortgages too big for their incomes; they had their peripheral economies, which similarly borrowed much
more than they could really afford to pay back. In both cases, real estate bubbles temporarily masked the underlying unsustainability of the borrowing: as long as housing prices kept rising, borrowers could always pay back previous loans with more money borrowed against their properties. Sooner or later, however, the music would stop. Both sides of the Atlantic were accidents waiting to happen.

In Europe, the first round of damage came from the collapse of those real estate bubbles, which devastated employment in the peripheral economies. In 2007, construction accounted for 13 percent of total employment in both Spain and Ireland, more than twice as much as in the United States. So when the building booms came to a screeching halt, employment crashed. Overall employment fell 10 percent in Spain and 14 percent in Ireland; the Irish situation would be the equivalent of losing almost 20 million jobs here.

But that was only the beginning. In late 2009, as much of the world was emerging from financial crisis, the European crisis entered a new phase. First Greece, then Ireland, then Spain and Portugal suffered drastic losses in investor confidence and hence a significant rise in borrowing costs. Why?

In Greece the story is straightforward: the government behaved irresponsibly, lied about it and got caught. During the years of easy borrowing, Greece’s conservative government ran up a lot of debt — more than it admitted. When the government changed hands in 2009, the accounting fictions came to light; suddenly it was revealed that Greece had both a much bigger deficit and substantially more debt than anyone had realized. Investors, understandably, took flight.

But Greece is actually an unrepresentative case. Just a few years ago Spain, by far the largest of the crisis economies, was a model European citizen, with a balanced budget and public debt only about half as large, as a percentage of G.D.P., as that of Germany. The same was true for Ireland. So what went wrong?

First, there was a large direct fiscal hit from the slump. Revenue plunged in both Spain and Ireland, in part because tax receipts depended heavily on real estate transactions. Meanwhile, as unemployment soared, so did the cost of unemployment benefits — remember, these are European welfare states, which have much more extensive programs to shield their citizens from misfortune than we do. As a result, both Spain and Ireland went from budget surpluses on the eve of the crisis to huge budget deficits by 2009.

Then there were the costs of financial clean-up. These have been especially crippling in Ireland, where banks ran wild in the boom years (and were allowed to do so thanks to close personal and financial ties with government officials). When the bubble burst, the solvency of
Irish banks was immediately suspect. In an attempt to avert a massive run on the financial system, Ireland’s government guaranteed all bank debts — saddling the government itself with those debts, bringing its own solvency into question. Big Spanish banks were well regulated by comparison, but there was and is a great deal of nervousness about the status of smaller savings banks and concern about how much the Spanish government will have to spend to keep these banks from collapsing.

All of this helps explain why lenders have lost faith in peripheral European economies. Still, there are other nations — in particular, both the United States and Britain — that have been running deficits that, as a percentage of G.D.P., are comparable to the deficits in Spain and Ireland. Yet they haven’t suffered a comparable loss of lender confidence. What is different about the euro countries?

One possible answer is “nothing”: maybe one of these days we’ll wake up and find that the markets are shunning America, just as they’re shunning Greece. But the real answer is probably more systemic: it’s the euro itself that makes Spain and Ireland so vulnerable. For membership in the euro means that these countries have to deflate their way back to competitiveness, with all the pain that implies.

The trouble with deflation isn’t just the coordination problem Milton Friedman highlighted, in which it’s hard to get wages and prices down when everyone wants someone else to move first. Even when countries successfully drive down wages, which is now happening in all the euro-crisis countries, they run into another problem: incomes are falling, but debt is not.

As the American economist Irving Fisher pointed out almost 80 years ago, the collision between deflating incomes and unchanged debt can greatly worsen economic downturns. Suppose the economy slumps, for whatever reason: spending falls and so do prices and wages. But debts do not, so debtors have to meet the same obligations with a smaller income; to do this, they have to cut spending even more, further depressing the economy. The way to avoid this vicious circle, Fisher said, was monetary expansion that heads off deflation. And in America and Britain, the Federal Reserve and the Bank of England, respectively, are trying to do just that. But Greece, Spain and Ireland don’t have that option — they don’t even have their own monies, and in any case they need deflation to get their costs in line.

And so there’s a crisis. Over the course of the past year or so, first Greece, then Ireland, became caught up in a vicious financial circle: as potential lenders lost confidence, the interest rates that they had to pay on the debt rose, undermining future prospects, leading to a further loss of confidence and even higher interest rates. Stronger European nations averted an immediate implosion only by providing Greece and Ireland with emergency credit lines, letting them bypass private markets for the time being. But how is this all going to work out?
FOUR EUROPEAN PLOTLINES
Some economists, myself included, look at Europe’s woes and have the feeling that we’ve seen this movie before, a decade ago on another continent — specifically, in Argentina.

Unlike Spain or Greece, Argentina never gave up its own currency, but in 1991 it did the next best thing: it rigidly pegged its currency to the U.S. dollar, establishing a “currency board” in which each peso in circulation was backed by a dollar in reserves. This was supposed to prevent any return to Argentina’s old habit of covering its deficits by printing money. And for much of the 1990s, Argentina was rewarded with much lower interest rates and large inflows of foreign capital.

Eventually, however, Argentina slid into a persistent recession and lost investor confidence. Argentina’s government tried to restore that confidence through rigorous fiscal orthodoxy, slashing spending and raising taxes. To buy time for austerity to have a positive effect, Argentina sought and received large loans from the International Monetary Fund — in much the same way that Greece and Ireland have sought emergency loans from their neighbors. But the persistent decline of the Argentine economy, combined with deflation, frustrated the government’s efforts, even as high unemployment led to growing unrest.

By early 2002, after angry demonstrations and a run on the banks, it had all fallen apart. The link between the peso and the dollar collapsed, with the peso plunging; meanwhile, Argentina defaulted on its debts, eventually paying only about 35 cents on the dollar.

It’s hard to avoid the suspicion that something similar may be in the cards for one or more of Europe’s problem economies. After all, the policies now being undertaken by the crisis countries are, qualitatively at least, very similar to those Argentina tried in its desperate effort to save the peso-dollar link: harsh fiscal austerity in an effort to regain the market’s confidence, backed in Greece and Ireland by official loans intended to buy time until private lenders regain confidence. And if an Argentine-style outcome is the end of the line, it will be a terrible blow to the euro project. Is that what’s going to happen?

Not necessarily. As I see it, there are four ways the European crisis could play out (and it may play out differently in different countries). Call them toughing it out; debt restructuring; full Argentina; and revived Europeanism.

Toughing it out: Troubled European economies could, conceivably, reassure creditors by showing sufficient willingness to endure pain and thereby avoid either default or devaluation. The role models here are the Baltic nations: Estonia, Lithuania and Latvia. These countries are small and poor by European standards; they want very badly to gain the long-term advantages
they believe will accrue from joining the euro and becoming part of a greater Europe. And so they have been willing to endure very harsh fiscal austerity while wages gradually come down in the hope of restoring competitiveness — a process known in Eurospeak as “internal devaluation.”

Have these policies been successful? It depends on how you define “success.” The Baltic nations have, to some extent, succeeded in reassuring markets, which now consider them less risky than Ireland, let alone Greece. Meanwhile, wages have come down, declining 15 percent in Latvia and more than 10 percent in Lithuania and Estonia. All of this has, however, come at immense cost: the Baltics have experienced Depression-level declines in output and employment. It’s true that they’re now growing again, but all indications are that it will be many years before they make up the lost ground.

It says something about the current state of Europe that many officials regard the Baltics as a success story. I find myself quoting Tacitus: “They make a desert and call it peace” — or, in this case, adjustment. Still, this is one way the euro zone could survive intact.

**Debt restructuring:** At the time of writing, Irish 10-year bonds were yielding about 9 percent, while Greek 10-years were yielding 12½ percent. At the same time, German 10-years — which, like Irish and Greek bonds, are denominated in euros — were yielding less than 3 percent. The message from the markets was clear: investors don’t expect Greece and Ireland to pay their debts in full. They are, in other words, expecting some kind of debt restructuring, like the restructuring that reduced Argentina’s debt by two-thirds.

Such a debt restructuring would by no means end a troubled economy’s pain. Take Greece: even if the government were to repudiate all its debt, it would still have to slash spending and raise taxes to balance its budget, and it would still have to suffer the pain of deflation. But a debt restructuring could bring the vicious circle of falling confidence and rising interest costs to an end, potentially making internal devaluation a workable if brutal strategy.

Frankly, I find it hard to see how Greece can avoid a debt restructuring, and Ireland isn’t much better. The real question is whether such restructurings will spread to Spain and — the truly frightening prospect — to Belgium and Italy, which are heavily indebted but have so far managed to avoid a serious crisis of confidence.

**Full Argentina:** Argentina didn’t simply default on its foreign debt; it also abandoned its link to the dollar, allowing the peso’s value to fall by more than two-thirds. And this devaluation worked: from 2003 onward, Argentina experienced a rapid export-led economic rebound.

The European country that has come closest to doing an Argentina is Iceland, whose bankers
had run up foreign debts that were many times its national income. Unlike Ireland, which tried to salvage its banks by guaranteeing their debts, the Icelandic government forced its banks’ foreign creditors to take losses, thereby limiting its debt burden. And by letting its banks default, the country took a lot of foreign debt off its national books.

At the same time, Iceland took advantage of the fact that it had not joined the euro and still had its own currency. It soon became more competitive by letting its currency drop sharply against other currencies, including the euro. Iceland’s wages and prices quickly fell about 40 percent relative to those of its trading partners, sparking a rise in exports and fall in imports that helped offset the blow from the banking collapse.

The combination of default and devaluation has helped Iceland limit the damage from its banking disaster. In fact, in terms of employment and output, Iceland has done somewhat better than Ireland and much better than the Baltic nations.

So will one or more troubled European nations go down the same path? To do so, they would have to overcome a big obstacle: the fact that, unlike Iceland, they no longer have their own currencies. As Barry Eichengreen of Berkeley pointed out in an influential 2007 analysis, any euro-zone country that even hinted at leaving the currency would trigger a devastating run on its banks, as depositors rushed to move their funds to safer locales. And Eichengreen concluded that this “procedural” obstacle to exit made the euro irreversible.

But Argentina’s peg to the dollar was also supposed to be irreversible, and for much the same reason. What made devaluation possible, in the end, was the fact that there was a run on the banks despite the government’s insistence that one peso would always be worth one dollar. This run forced the Argentine government to limit withdrawals, and once these limits were in place, it was possible to change the peso’s value without setting off a second run. Nothing like that has happened in Europe — yet. But it’s certainly within the realm of possibility, especially as the pain of austerity and internal devaluation drags on.

Revived Europeanism: The preceding three scenarios were grim. Is there any hope of an outcome less grim? To the extent that there is, it would have to involve taking further major steps toward that “European federation” Robert Schuman wanted 60 years ago.

In early December, Jean-Claude Juncker, the prime minister of Luxembourg, and Giulio Tremonti, Italy’s finance minister, created a storm with a proposal to create “E-bonds,” which would be issued by a European debt agency at the behest of individual European countries. Since these bonds would be guaranteed by the European Union as a whole, they would offer a way for troubled economies to avoid vicious circles of falling confidence and rising borrowing costs. On the other hand, they would potentially put governments on the hook for one
another's debts — a point that furious German officials were quick to make. The Germans are adamant that Europe must not become a “transfer union,” in which stronger governments and nations routinely provide aid to weaker.

Yet as the earlier Ireland-Nevada comparison shows, the United States works as a currency union in large part precisely because it is also a transfer union, in which states that haven't gone bust support those that have. And it's hard to see how the euro can work unless Europe finds a way to accomplish something similar.

Nobody is yet proposing that Europe move to anything resembling U.S. fiscal integration; the Juncker-Tremonti plan would be at best a small step in that direction. But Europe doesn't seem ready to take even that modest step.

OUT OF MANY, ONE?

For now, the plan in Europe is to have everyone tough it out — in effect, for Greece, Ireland, Portugal and Spain to emulate Latvia and Estonia. That was the clear verdict of the most recent meeting of the European Council, at which Angela Merkel, the German chancellor, essentially got everything she wanted. Governments that can't borrow on the private market will receive loans from the rest of Europe — but only on stiff terms: people talk about Ireland getting a “bailout,” but it has to pay almost 6 percent interest on that emergency loan. There will be no E-bonds; there will be no transfer union.

Even if this eventually works in the sense that internal devaluation has worked in the Baltics — that is, in the narrow sense that Europe's troubled economies avoid default and devaluation — it will be an ugly process, leaving much of Europe deeply depressed for years to come. There will be political repercussions too, as the European public sees the continent's institutions as being — depending on where they sit — either in the business of bailing out deadbeats or acting as agents of heartless bill collectors.

Nor can the rest of the world look on smugly at Europe's woes. Taken as a whole, the European Union, not the United States, is the world's largest economy; the European Union is fully coequal with America in the running of the global trading system; Europe is the world's most important source of foreign aid; and Europe is, whatever some Americans may think, a crucial partner in the fight against terrorism. A troubled Europe is bad for everyone else.

In any case, the odds are that the current tough-it-out strategy won't work even in the narrow sense of avoiding default and devaluation — and the fact that it won't work will become obvious sooner rather than later. At that point, Europe's stronger nations will have to make a choice.
It has been 60 years since the Schuman declaration started Europe on the road to greater unity. Until now the journey along that road, however slow, has always been in the right direction. But that will no longer be true if the euro project fails. A failed euro wouldn’t send Europe back to the days of minefields and barbed wire — but it would represent a possibly irreversible blow to hopes of true European federation.

So will Europe’s strong nations let that happen? Or will they accept the responsibility, and possibly the cost, of being their neighbors’ keepers? The whole world is waiting for the answer.

Europe’s Odd Couple

By STEVEN ERLANGER

SHE MAKES FUN, in private, of the way he walks and talks, of his rapid, jerky gestures and facial grimaces. He mocks her deliberation, her reluctance, her matronly caution. She has compared him to Mr. Bean and to the French comic Louis de Funès, with his curly hair and large nose. He sometimes calls her La Boche, the offensive French version of “Kraut,” and goes out of his way to give her an embrace and a double-cheeked kiss in the French fashion, the kind of contact that he knows very well, aides say, she cannot stand.

While the agonies of the European Union — sovereign defaults, deficits and bubbles — unfold like a great wonk drama, at their core is something more intimate: the fractured tale of Angela Merkel and Nicolas Sarkozy. They have been photographed across Europe giving the appearance of happy partnership. They are the best hope Europe has for continued unity. But they do not like each other at all.

As with any couple in trouble, economic difficulty has added to the strain. Two years ago, at the beginning of the crisis, Sarkozy burst out in public, saying, “France is acting, while Germany is only thinking about it!” Later, before a European Union meeting in Brussels on the Greek bailout, the French president was in a rage at his inability to persuade Merkel to do more for that country. After yelling at the E.U.’s president, Herman Van Rompuy, he threatened to boycott the meeting, muttering, according to French officials, “The Germans haven’t changed.” Later, when Sarkozy took camera crews in with him to a meeting, Merkel insisted they leave and, aides said, told Sarkozy, “I won’t let you do this to me.”

So it is not an easy relationship. But they know that they need to keep going for the sake of the kids — that is, for the sake of Europe. They have instructed their top foreign-policy advisers, Jean-David Levitte and Christoph Heusgen, both consummate diplomats, to make the relationship function. Some of the symbolism is a stretch — joint cabinet meetings, ceremonies at the Arc de Triomphe and the Berlin Wall. But there is an extraordinarily close coordination between the two staffs, and before every major European Union summit meeting, Sarkozy and Merkel hash out a joint position to take to the other 25 member states. This isn’t very democratic; it probably isn’t very pleasant either. Yet if the European Union is to function, Sarkozy and Merkel have to get along.

The Sarkozy-Merkel relationship matters because the challenges they and Europe face are both enormous and complicated, combining dismal economics, national pride and anxious
electorates. They need to work out whether states that share a currency can still have independent fiscal policies — or, put differently, whether a currency union is viable without economic and even political union, and if it isn’t, whether it should be preserved. Behind this seemingly technocratic challenge, of course, are profound questions of democracy and citizenship, of national identity and self-determination and of the right way to handle Europe’s many ghosts.

Consider the meeting of Sarkozy and Merkel last October at the French seaside resort of Deauville. As they walked on the beach, they considered how to stabilize the European economy. The European Financial Stabilization Facility had kept Greece and Ireland from collapse, but it was ad hoc. Sarkozy wanted to extend it without touching the E.U.’s basic treaty. Merkel said that, constitutionally, she could not commit Germany to such an indefinite responsibility without a treaty change. She also did not want private investors to think that their national-bond investments were guaranteed a bailout if things went bad; she wanted private bondholders to face the prospect of a “haircut,” as the phrase goes, in the event of default.

Merkel committed herself to a permanent financial backstop, one whose stability would inevitably be based on the stability and solvency of Germany itself. Sarkozy agreed that with the new mechanism, beginning in 2013, investors would take some of the losses on bonds in insolvent euro-zone nations. That implied that some countries could actually default, and gave a strong signal to investors not to put money after 2013 in the bonds of countries like Greece, Spain or Portugal. The decision infuriated the European Central Bank chief, Jean-Claude Trichet, who predicted, accurately, that it would shake the markets and endanger Ireland.

But there was little Trichet or the plan’s many other opponents could do. Merkel is determined to make fiscal discipline the price of German credit. While Merkel did agree to drop her proposal for automatic penalties for countries that broke fiscal rules, she also refused to consider suggestions for a general “Eurobond” backed by all members. Many European countries like the idea of a Eurobond, because it might prevent private markets from trading on the differences between national economies and policies. But it would do so, ultimately, because of the strength of the German economy and its government’s own legendary prudence (and it would raise Germany’s own borrowing costs). That was not an obligation Germans wanted to take on. So Merkel said no.

As Ulrike Guérot, a German analyst once married to a Frenchman, puts it, Germans “sublimated hegemony. But we’re dropping the sublimation now.” She laughed, then added: “Of course, this doesn’t sound nice to others.”

A senior German official, however, says Sarkozy’s ambition to lead and his taste for big ideas — like his plans for the G20 this year to re-examine the role of the dollar and the regulation of food markets — are attractive and help Merkel. “She brings him down from 120 percent to 75
percent, and then they try to do half of that,” he told me. Sarkozy also sees an important role for himself in tethering Germany to the European Union, helping Merkel to resist demands at home that Germany stop financing anyone else. Anne-Marie Le Gloannc, a political scientist and German specialist at the Institut d'Études Politiques in Paris, says: “Sarkozy is catching Merkel from floating Germany too far away, compromising to try to pull her back into the European framework. But she needs this, too.”

BORN ONLY SIX months apart, the two could not be more different in terms of personality and worldview. Merkel, 56, grew up in a left-wing household in the farthest northeastern corner of Communist East Germany, in the Protestant flatlands where the Russian wind whistles. She learned to speak Russian and Czech. She is a physicist; her second husband is a chemist, a quiet professor who keeps to himself; she has no children. After the unification of Germany, she was an apprentice to Helmut Kohl, his “underestimated maiden” from the East, and she moved to Berlin — itself considered un-German, in a way, conquered territory on what is thought of as the barbarian steppe, far from the rich soil of German culture.

It was from Chancellor Kohl that she learned the importance of pandering to French vanities about being the true beating heart of the European ideal. And then when Kohl got into trouble, his Eastern maiden became Germany’s first female chancellor.

That is when she had to face Sarkozy. “She’s a scientist, almost like a German cliché, planning everything, going step by step, unemotional, not a show horse,” Stefan Kornelius, a senior editor of the Süddeutsche Zeitung, told me. “But Sarkozy’s the kind of macho man that she doesn’t like at all. And she and the chancellery are irritated by his jumping from issue to issue, his lack of attention, his inability to do German systematic work. She’s a technocrat with a hidden husband, and he’s flamboyant, with a beautiful woman” — the singer and former model Carla Bruni — “at his side.”

Sarkozy has been much criticized for his love of money and gaudiness. A wealthy lawyer with wealthy friends, he lives a gilded French presidential life, surrounded by staff members always ready with a glass of freshly squeezed orange juice. Merkel still lives in the central Berlin apartment she occupied before her election and can sometimes be seen out shopping, or stopping into a favorite French-style restaurant, Borchardt, for a quick meal with her husband.

Merkel has surrounded herself with strong women and technocratic men, and she manages men very well, a senior German official told me: “She takes them by their biggest weakness, which is ego, and caters to it to a point, and then coldbloodedly, like an aikido fighter, uses that energy and pulls it in her direction. She doesn’t function in terms of male mechanics, all ego and pumping up yourself and shouting; these male tools fail with her, and she uses these to her advantage. And those who team up with her, she lets take a lot of the credit.” It sounds similar to how she handles the French president. Unlike Sarkozy, famous for absorbing a complicated brief as he walks to a meeting, Merkel is an assiduous worker and normally the
best-prepared person in the room. Sarkozy rules France like a king; Merkel is a coalition politician who wants to bring others along. The Germans like to tell a joke about Sarkozy piloting a plane and informing the passengers he has good news and bad news: “The good news is that we’re ahead of schedule. The bad news is that we’re lost.”

There was a time when the trans-Atlantic tie enabled Europeans to find direction in the world as part of an American-led, American-protected liberal West. That moment seems to have passed, leaving Europe to find its own way. The United States never did take more than a mild interest in European unification. In a meeting with European journalists in 2005, President Bush said airily that he appreciated “how hard it was to get a federalist system in place that was balanced and fair,” adding that “every time I meet with the European leaders, I ask them how it’s going.” President Obama’s approach has not been much different, particularly as the Europeans have made it clear they are not eager to help solve the Afghanistan problem. In general, the Obama attitude has been: Europe, lovely place; European Union, lovely idea but wish it would do more on defense; euro, well, good luck with that.

**FRANCE AND GERMANY**, with their shared bloody past, are unlikely allies, and they have radically different notions of how Europe should work. France wants a state-dominated, centralized, bureaucratic Europe in its own image. France also maintains a Mediterranean attitude toward budget deficits, having last balanced a budget 35 years ago. Germany, a federal state with powerful regions, coalition governments and an influential constitutional court, wants a Europe of laws, discipline and fiscal probity, with a strong currency and real penalties for the spendthrift.

Long the financier of the European Union, Germany has made it clear that it will no longer pay for the mistakes and frauds of others. While Germany has always acted in its own interests, the Kohl generation interpreted those interests as being embedded in institutions like NATO and the European Union, which protected the new democratic Germany and kept its ambitions in check. But Germany, reunited, sees NATO as less necessary, even hollow. It needs the European Union less. And it is turning more toward the east — the old Soviet bloc and Russia — for energy and markets.

If centralized France has traditionally supported European Union institutions and currently advocates a form of “European economic governance,” federal Germany has become much less willing to subordinate national interests to European ones and has been a strong defender of national sovereignty, especially over budgets. In a recent speech in Bruges, Merkel spoke of the need to move away from “the community method,” led by the European Union’s Commission, to what she called “the union method,” in which the nation-states effectively take the lead in cooperating with the Commission and other E.U. institutions. “The ‘community method’ can only be applied in those areas in which the European Union actually has competence,” she said tersely, adding: “Where the community has no competence, the ‘community method’ clearly cannot be applied.” In other words, the E.U. should do only what it is authorized to do and can
do well. Otherwise power should remain with the states.

If Germany speaks for Europe’s largely industrial Protestant north, France has always combined north and agricultural south. “Sarkozy is being the spokesman for the south, but he also understands that Germany has the clout,” Le Gloannec says. “So you have to say yes to some of what they want, but at the same time Germany can’t talk to all Europeans or take a public leadership role. In a way, the Germans really don’t know how to talk to others. She and he may be like Laurel and Hardy — different but complementary.”

As the euro crisis grinds on and the German economy continues to outpace the others, Sarkozy is paying more attention to the German model and giving in more to German demands. He is extremely anxious, aides say, that France is losing its prominence in the new Europe, slipping behind Germany to second-class status. Inside the French cabinet, Germany’s economic model, labor relations and capacity for technical innovation are prominent topics, with German standards — and the fear of losing Paris’s AAA bond rating — driving French reforms and budget cuts.

The cliché used to be that nothing happened in the European Union without French and German agreement. Today France and Germany are regarded as necessary but no longer sufficient. Sarkozy fears, with some justification in a bigger European Union of 27 nations and a euro zone of 17, that French agreement may soon not be needed at all. The new E.U. members to the east are more German in their aspirations than French. The Czechs and Slovaks, as well as the Balts, are all fiscally conservative. Even Poland, which has such an emotional tie to France, sees its economic future with Germany.

**THE FUNDAMENTAL** problem is that Germans are worried that their manifold sacrifices for national prosperity will be dumped down the drain of Europe’s poorest and most profligate. Despite Germany’s economic success — almost a second economic miracle, after the expensive absorption of East Germany — Merkel therefore has serious political challenges. “The Germans have discovered that they are the only serious global economy in Europe, capable of competing with the United States and China,” says John Kornblum, a former American ambassador to Germany. “But they’re afraid their world is coming apart around them, and what they thought would support them, the European Union, is dragging them down. They realized that the stability pact isn’t working, that the Greeks were lying and maybe others, too, that their banks and French banks were deep in the muck, and they understood this is going to cost a lot of money. So they are behaving in a very demanding way, which smells to some like nationalism. But it really is fear.”

So while Merkel says she is deeply committed to the European Union and the euro, she must, as a politician, manage the angst. A strong minority of Germans feel she has already gone too far down the road of bailing out Europe’s “Club Med.” State elections in 2011 could further hamper her ability to make bold decisions to protect European unity. And she must always be
mindful of the German constitutional court, which plays a very strong role in interpreting treaties like those that bind Germany to the E.U.

Sarkozy’s political problems are also legion and likely to worsen as austerity programs bite. To win re-election in 2012, Sarkozy needs first to reunite the right behind him, in the face of a vibrant challenge from the far-right National Front and divisions within his own center-right party. His main opposition, the Socialist Party, is divided, and both France and Germany are waiting to see if Dominique Strauss-Kahn, the managing director of the International Monetary Fund, will run for the Socialist nomination. It was Sarkozy who pushed Strauss-Kahn to take the I.M.F. job, figuring he was getting a rival out of the way. But the euro crisis has made Strauss-Kahn, 61, even more important, giving him the international reputation and gravitas to challenge Sarkozy and even win. While Sarkozy tried to keep the I.M.F. and Strauss-Kahn at a distance — the I.M.F. is based in Washington — Merkel insisted that only the I.M.F. had the experience to make the Greek salvage operation credible. Strauss-Kahn has been crucial to the Irish bailout as well and will have a strong part in any future defense of the euro. He is a German speaker and has been a key negotiator with Merkel. With a German almost sure to take over leadership of the European Central Bank in November, and another German due to take over the secretariat of the European Union’s Council of Ministers, there should be even more support for Merkel’s vision.

With Germany ascendant and looking both inward and eastward, Britain staying out of the euro zone and France carrying less weight, the question of German leadership is now at the fore. Germany has traditionally avoided trying to lead Europe from the front; memories from World War II, though faded, have not yet gone away in the rest of the continent. Even now, anti-German feeling is rising among Greeks, Portuguese and Spaniards, who feel abandoned, even betrayed, by Berlin.

Still, Merkel is going to have to exercise more leadership if the euro is going to be saved, even if she still hides to some degree behind France. And active German leadership of the E.U. means a clearer understanding that politically difficult compromises are going to have to be made and that money will have to be spent and promised — all in the face of growing German discontent.

John Kornblum, the former American ambassador in Berlin and still a resident there, sees a model for Germany in the United States and the way it helped keep Europe together after the war, mediating disputes and finding compromises. “The Germans don’t see it yet,” he says. “But they will have to take on the role of the United States in Europe, and have the same kind of balancing role we had for such a long time.” At that point, Germany’s marriage with France won’t matter so much anymore.

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