January 12, 2011

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.

Paul Krugman is a Times columnist and winner of the 2008 Nobel Memorial Prize in Economic Sciences. His latest book is "The Return of Depression Economics and the Crisis of 2008."