As doom and gloom about the euro abound, an increasing number of commentators and economists question whether the common currency can survive. The world economy, they allege, is teetering on the edge of an even deeper crisis than today's.

To be sure, the eurozone faces serious economic and financial problems. The area is in the midst of multiple overlapping and mutually reinforcing crises. The first is a fiscal crisis, which has taken its biggest toll in Greece but pervades the southern part of the eurozone and Ireland. The second is a competitiveness crisis, long evident in the large current account deficits along the eurozone's periphery and the even larger current account...
imbalances between eurozone countries. The third is a banking crisis, which first unfolded in Ireland and has become particularly acute in Spain.

Yet for all the turmoil, fears of countries' repeatedly defaulting on their debts or the total collapse of the euro are vastly overblown. The eurozone countries have demonstrated that they can and will resolve each successive stage of the crisis by cooperating and sharing decision-making powers. They have created a host of new continent-wide institutions, built a substantial financial firewall to prevent debt problems from spreading, and are now well on their way to creating a banking union and a partial fiscal union. When the dust settles, the common currency, and indeed the entire project of European integration, is likely not only to survive but to emerge even stronger.

WATCH WHAT THEY DO, NOT WHAT THEY SAY

The European crisis is rooted in a failure of institutional design. The Economic and Monetary Union (EMU) that Europe adopted in the 1990s comprised an extensive, if incomplete, monetary union, anchored by the euro and the European Central Bank (ECB). But it included virtually no economic union: no fiscal union, no banking union, no shared economic governance institutions, and no meaningful coordination of structural economic policies.

The EMU's architects assumed that economic union would inexorably follow monetary union. But European countries faced no pressure to create one during the years of expansion prior to the Great Recession. When the crisis hit, the absence of crucial policy tools constrained Europe's ability to reach a solution quickly, triggering severe market reactions that continue to this day. Europe now has only two options. It can jettison the monetary union, or it can adopt a complementary economic union. Given how much is at stake, Europe will almost certainly complete the original concept of a comprehensive economic and monetary union.

From its creation in the 1990s, the common currency has lacked the institutions necessary to ensure that financial stability can be restored during times of acute uncertainty and market volatility. The task before the eurozone's leaders today therefore consists of much more than putting together a financial bailout sufficient to restore market confidence. They must rewrite the eurozone's rule book and complete the half-built euro house. This will require both creative financial engineering to resolve the immediate crisis and the establishment of a wave of new institutions to strengthen the real economy and restore growth.

To divine the likely trajectory of the euro, one should look at what the Europeans have done rather than what they have said. They have resolved the many crises that have threatened the integration project throughout its more than six-decade history in ways that ultimately resulted in a more unified Europe. At each key stage of the current crisis, they have done whatever was necessary to avoid the euro's collapse. In the crunch, both Germany and the ECB -- the continent's financial powerhouses -- have demonstrated that they will pay whatever is necessary to avert disaster.

The problem for the markets is that for two reasons these central players cannot say outright that they will always come to the euro's rescue. First, an explicit commitment to unlimited bailouts would represent the ultimate moral hazard. It would relieve the debtor countries of the pressure their leaders need to sell tough political decisions to their parliaments and publics in order to effectively adjust their economies.
Indeed, it is the intention of neither Germany nor the ECB to end the crisis quickly. Rather, their goal is to use the crisis to further the economic reforms needed to create a strong European economy over the long run. This helps explain why the eurozone authorities have not built as large a financial firewall as the markets have craved.

Second, each of the four main classes of creditors -- Germany and the other strong northern European governments, the ECB, private-sector lenders, and the International Monetary Fund (acting as a conduit for funding from non-EU governments, such as Beijing) -- will naturally try to transfer as much as possible of the cost of a financial rescue to the other three.

Europe's financial turmoil, then, is not only a crisis of faulty institutions; it is also one of presentation. The markets will not receive the sweeping declarations that they want and so will periodically revert to states of high anxiety. But every policymaker in Europe and even the European publics know that the collapse of the euro would be a political and economic disaster. And fortunately, since Europe is an affluent region, solving the crisis is a matter of mobilizing the political will to pay, rather than the economic ability.

Each of Europe's key political actors will exhaust all options in trying to secure the best possible deal for itself before at the last minute coming to an agreement. The result is a messy process, exacerbated by the cacophony of voices within each country, which understandably unsettles markets. The possibility of miscalculation will continue to loom over Europe. But pressure from the financial markets will ultimately prod the eurozone to find the way forward. And Europe's overriding political imperative to preserve the project of integration will drive its leaders to secure the euro and restore the economic health of the continent.

AN IMPERFECT UNION

More than anything else, the project of European integration was driven by the geopolitical goal of halting the carnage that had ravaged the continent for centuries and reached its murderous zenith in the first half of the twentieth century. This overriding imperative has driven successive generations of political leaders to subordinate their states' national sovereignty to the greater goal of maintaining and extending the European project.

The region's vision of that project always included the concept of a common currency. In early plans for monetary integration, such as the 1970 Werner report and the 1989 Delors report, monetary union was supposed to go hand in hand with an economic union that would place binding constraints on member states. But when the common currency finally came to be, it was not because of a carefully considered and detailed economic analysis. It was instead a result of geopolitics. The unforeseen shock of German reunification in October 1990 -- and the fear this produced in Paris of a newly dominant Germany -- provided the impetus for the Maastricht Treaty of 1992, which paved the way for the creation of the euro.

The imperative of quickly launching the euro meant that politically necessary compromises, rather than unambiguous rules, would determine the currency's framework. For example, since the founding members of the eurozone came from very different economic starting points, it was politically infeasible to impose firm fiscal criteria for membership. As a result, by 2005, the eurozone was a common currency area that was composed of very dissimilar countries, lacked a central fiscal authority or any way to enforce budget discipline, and had made virtually no progress toward bringing its countries' macroeconomic policies into line.
Initially, none of these design flaws mattered. But as borrowing costs in private financial markets across the eurozone fell toward the traditionally low interest rates of Germany, many new members suddenly had access to unprecedented amounts of credit regardless of their economic fundamentals. The financial markets failed to assess the riskiness of different countries, and European leaders continued to deny any problems in the common currency's design. As a result, in the run-up to the global financial crisis, governments and private sectors built up unsustainable amounts of debt. So when the eurozone was finally struck by its first serious financial crisis in 2009, it had to contend not only with huge debt overhangs but also with a faulty institutional design that prevented an expeditious solution.

PLAYING CHICKEN

The eurozone was woefully unprepared for the Great Recession. It entered the crisis as a common currency zone flying on just one engine -- the ECB -- without the kind of unified fiscal entity that traditionally helps countries combat large financial crises. The eurozone's leaders have had to build from scratch their crisis-fighting capacities and bailout institutions: the European Financial Stability Facility (EFSF) and, subsequently, the European Stability Mechanism. And in the midst of stemming an immediate crisis, they have had to reform the flawed foundational institutions of the area.

The ECB, as the only eurozone institution capable of affecting financial markets in real time, wields tremendous power. Its institutional independence is enshrined in the EU treaty, and it does not answer to any government. Unlike normal central banks, which always have to worry about losing their independence, the ECB in this crisis has been able to issue direct political demands to national leaders, as in August 2011, when it conveyed an ultimatum for reform to then Italian Prime Minister Silvio Berlusconi and engineered his ouster when he failed to comply.

On the other hand, unlike the Federal Reserve in the United States, the ECB has not had the luxury of responding to the crisis within a fixed set of national institutions. When the financial crisis hit the United States, the Federal Reserve could immediately create trillions of dollars to steady market confidence with the knowledge that it had a federal government that could formulate a longer-term response (although it has not yet fully done so). The ECB cannot act similarly because there is no eurozone fiscal entity to which it can hand off responsibility. Moreover, to commit to a major monetary rescue would undermine the chances of a permanent political resolution to the eurozone's underlying problem: a lack of effective institutions. Were the ECB to cap governments' financing costs at no more than five percent, for instance, national politicians would probably never adopt the adjustment policies and structural reforms they need to sustain economic growth in the long run.

Saddled with administering a common currency and endowed with governing institutions flawed by early political compromises, the ECB is, not surprisingly, focused on forcing the eurozone's leaders to prioritize reforms. It is not the primary purpose of the ECB to end market anxieties and thus resolve the eurozone crisis as soon as possible. It instead aims to induce national leaders to fundamentally reform the eurozone's institutions and structurally overhaul their economies. The central bank cannot directly compel democratically elected leaders to comply with its wishes, but it can refuse to bail their countries out and thereby permit the crisis to pressure them to act.
So far, the ECB has been quite effective in its strategic bargaining with national authorities. The initial Greek crisis in May 2010 led to a deal whereby the ECB agreed to set up the Securities Markets Program to buy European sovereign bonds in exchange for a commitment from the eurozone governments of 440 billion euros for the newly created EFSF, which proved to be an effective way of channeling resources to Greece, Ireland, and Portugal.

The EFSF, however, would simply not be large enough to rescue Italy and Spain. So in August 2011, the ECB itself bought Italian and Spanish bonds to drive down their interest costs. In return, Rome and Madrid committed to making specific reforms, such as substantial budget tightening, detailed by the ECB in secret letters to their leaders. Then, in December 2011, the ECB provided the continent's banks with huge amounts of fresh liquidity in the form of three-year loans as a quid pro quo for the eurozone's governments to agree to the new European fiscal compact, which seeks to assure budget discipline. Most recently, in June 2012, after the eurozone governments agreed to accept common banking supervision, the ECB signaled a willingness to provide targeted support for Spanish banks and subsequently reduced its benchmark interest rate.

And yet at each stage of the crisis, many pundits and even serious economists have proclaimed the end of the euro. This outlook utterly fails to recognize just how effective the type of bargaining described above has been. All the key political decision-makers in Europe -- the ECB, Germany, France, Italy, Spain, and even Greece -- harbor no illusions about the catastrophic costs of the common currency's collapse. Most Greek politicians and voters, as evidenced by the latest elections, know that without the euro, their country would become a vulnerable economic wasteland. German Chancellor Angela Merkel knows that were the eurozone to disintegrate, Germany's banks would also fall under the weight of their losses on loans to the periphery; the new deutsche mark would skyrocket, undermining the entire German export economy; and Germany would once again be blamed for destroying Europe. The ECB, of course, would not want to put itself out of business.

These actors are playing a game of political chicken, but in the end, they will all compromise. Once Germany and the ECB feel they have gotten the best possible deal, they will pay whatever it takes to hold the eurozone together. Neither can afford the alternative. But neither can say so in advance.

It is still possible that Greece will abandon the common currency. But this would leave the eurozone stronger, not weaker, because it would be rid of its weakest economy. The eurozone would address a Greek exit by bolstering its financial firewall and speeding the pace of integration, particularly by creating a banking union, in order to counter the resulting risks of contagion. Most important, the total chaos that would descend on Greece would prompt the other debtor countries to do whatever was necessary to avoid suffering the same fate. Europe's leaders should try to prevent a Greek exit if at all possible, and they will probably do so, but its occurrence would certainly not doom the euro.

LIVE LONG AND PROSPER

The eurozone has already taken some decisive steps to complete its economic and monetary union. It decided at the EU summit in June to implement a banking union, jointly supervised and regulated, with the authority to shut failed banks and to provide regionwide deposit insurance to prevent bank runs. The eurozone countries have begun to develop a partial fiscal union by sharing responsibility for modest amounts of debt and by adopting firm common rules for budget discipline. And more and more European leaders have talked about moving
toward some sort of political union that would address the questions of democratic legitimacy that surround these economic reforms.

It is thus highly likely that the eurozone will emerge from the crisis having done more than just fix the flawed institutions that produced much of the current difficulties. As in the continent's past crises, national governments will move to preserve the project of integration by enlarging Europe's mandate even further.

Even the most successful financial and institutional engineering will ultimately fail, however, if the debtor countries cannot get their economies to grow again. This is a difficult task in almost all high-income countries, including the United States, due to the prolonged slowdown that inevitably follows financial crises and the subsequent need to reduce debt levels. But there must be light at the end of the tunnel if the eurozone's strategy is to succeed.

Restoring growth will require at least three major steps. First, in addition to controlling their deficits, the borrowing countries must adopt convincing structural reforms. In particular, they must increase the flexibility of their labor markets by easing firing procedures and thus encouraging hiring, by raising retirement ages as part of pension reforms, and by allowing for collective bargaining within industries or even firms instead of only on the national level. They need to open up restricted professions, especially in their service sectors. And they should boost productivity by intensifying competition, especially by helping small firms and start-ups grow rapidly. Recent studies by the Organization for Economic Cooperation and Development have demonstrated that although some structural reforms pay off only in the long term, others can bring faster growth and increased competitiveness in as little as three years. Meanwhile, the fiscal tightening that comes with budgetary austerity will lead to lower interest rates and more investment in the debtor countries, also spurring economic growth.

Second, the strong economies in the northern core of Europe, especially Germany, must stop focusing on deficit reduction for a while and generate more spending and inflation. They should buy more of Greece's and Italy's goods and services and less of their debt. For years, Germany kept its wages and domestic spending too low, creating competitiveness problems for the rest of Europe, and it now needs to help offset those results.

Finally, the eurozone needs to continue working on a continent-wide stimulus program. At the June 2012 EU summit, the EU member states agreed to boost spending by roughly one percent of the region's GDP. The pending relaxation of deficit-reduction targets in some of the debtor countries will also help them grow, as will the ECB's recent decision to cut interest rates by 0.25 percent. But the eurozone can do considerably more on all these fronts. The ECB can stimulate the economy through quantitative easing, and European countries can jointly issue so-called project bonds aimed at boosting spending on infrastructure. These bonds would simultaneously accelerate the continent's progress toward fiscal union.

As it stumbles forward, the eurozone must combine the financial engineering that is necessary to overcome the immediate crisis with a growth strategy to restore the area to economic vitality. Fortunately, the way the eurozone's leaders have responded to the current turmoil suggests that the economic self-interests of all the key countries, creditor as well as debtor, will coalesce. The markets, too, might come to understand this reality and start betting on the euro rather than against it.

After Europe adopted a common currency, it took almost ten years for the first serious economic and political crisis to hit. Now that it has arrived, Europe must use the opportunity it presents to get the continent's basic
economic institutions right and complete the euro's half-built house. This process will require more treaty
revisions and fixes to the eurozone's institutions. If the history of the continent's integration is any guide,
however, Europe will emerge from its current turmoil not only with the euro intact but also with stronger
institutions and far better economic prospects for the future.