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# How the Euro Will End

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The euro is the world's first currency invented out of whole cloth. It is a currency without a country. The European Union is not a federal state, like the United States, but an agglomeration of sovereign states. European countries are plagued by rigidities, including those in labor markets—where language differences and the protection of trades and professions in many countries impede labor mobility. That makes it difficult for their economies to adjust to cyclical and structural economic shifts.

For such reasons, when the euro was created in 1999, Milton Friedman famously predicted its demise within a decade. He was wrong about the timing, but he may yet be proven right about the fact.

Greece is the epicenter of a currency and fiscal crisis in the euro zone. Markets fear a "Grexit," or Greek exit from the euro. That exit is almost a foregone conclusion. The endgame for the euro will be played out in Spain.

But first to Greece, which is devolving from a money-using economy. Firms, households and even the government are short on cash. The government isn't paying its suppliers and workers in a timely fashion, so households cannot pay their bills to businesses with whom they transact. Businesses, in turn, cannot pay their suppliers. There is a cascade of cash constraints.

Normally, credit supplements cash in economic transactions. But there is scant credit in Greece. Anyone who can is moving their money out of the country, either to banks in other euro-zone countries, such as Germany, or out of the euro to banks in Switzerland, the United Kingdom and U.S. (the franc, pound and dollar, respectively).

Absent a truly dramatic event, Greece will exit the euro not by choice but by necessity. It will do so not because the drachma (its old currency) is superior to the euro, but because the drachma is superior to barter. Greek standards of living, which have already fallen substantially, will fall further in the short- to medium-term. It will then be up to the Greek people to forge a new future.

While a Greek exit from the euro zone will have substantial repercussions, it won't unleash the doomsday scenario painted by some. A Spanish exit would be an entirely different matter. Unlike Greece, Spain is a major economy. According to the International Monetary Fund, at official exchange rates in 2011 the Spanish economy was more than five times the size of Greece's. And unlike Greece, Spain has numerous banks, some large and global.

The Greek tragedy began with a fiscal crisis—brought on by the government spending more money than it took in—that became a banking crisis. In Spain, there is a fiscal crisis that exacerbates a banking crisis.

Fiscal and banking crises are often linked because in modern economics the state and banking are joined together. Banks purchase government debt, supporting the state, and governments guarantee the liabilities of banks. When one party is weakened, so is the other.

Spanish banks are impaired not only because the Spanish government is running large fiscal deficits, but also because of bad loans to the private sector. Many Spanish banks lent heavily to property developers and to individuals who wanted to purchase homes built by the developers. Spain's construction sector is substantially larger relative to the rest of its economy than is the construction sector in other euro-zone countries or the U.S. And bank debt to finance that sector grew much faster than elsewhere.

Spanish banks have taken huge write downs on their loans, but not enough. Only the exact size of the future write downs is in doubt, not that they will be very large. The Spanish government has effectively nationalized one bank, Bankia—due to threatened insolvency—but will very likely be faced with more takeovers.

The Spanish government has finally admitted that it does not have the funds to recapitalize its banks. EU finance ministers have reportedly committed up to 100 billion euros ($125 billion) for that effort. Experience with banking crises in general suggests that early estimates of losses will prove to be too low. Political leaders start with denial and then offer only belated recognition of the size of banking problems. That was true in the U.S. savings and loan crisis of the 1980s and the 2007-08 bust in housing finance, the banking crisis in Ireland, so far in Spain.

How the Spanish banking situation is handled will determine the future of the euro and possibly of the larger European Union. Will German's taxpayers and those of other solvent countries be willing to fund an even larger bailout of Spanish banks to save impecunious Spaniards? Will the citizens of EU countries outside the euro zone, such as Sweden and the U.K., be asked to chip in? Or will Spain be allowed to descend into a catastrophic 1930s-style banking crisis and Great Depression?

Spanish banking problems are not the end, but only the beginning, of European banking problems. Banks in France, the U.K. and Germany also hold large amounts of the sovereign and private debt of Portugal, Italy, Ireland, Greece and Spain. The government of Cyprus has already made an "exceptionally urgent" request for funds to recapitalize its banks, and markets are now worried about Italy's debt, which limits Rome's ability to deal with banking problems.

The euro zone is in a crisis, in the correct sense of the word, a turning point from which it will either recover or enter a terminal phase. One important factor that may determine the outcome is the degree of leadership in Europe.

By and large, political leaders in Europe are a feckless lot. There are exceptions, particularly in some of the Nordic countries (e.g., Estonia), but the absence of leadership may be the decisive factor leading to the euro's demise. In Spain and elsewhere, leaders have been willing to apply temporary fixes to their banking problems rather than to recognize the true size of the problem. The banks, not fiscal deficits, will be the undoing of the euro.

In the end, I side with Milton Friedman. If Europe had made the political decision for a federal state, a single currency would have been a natural outcome. When 17 states decided to adopt the euro first without political union, they got it backward.

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