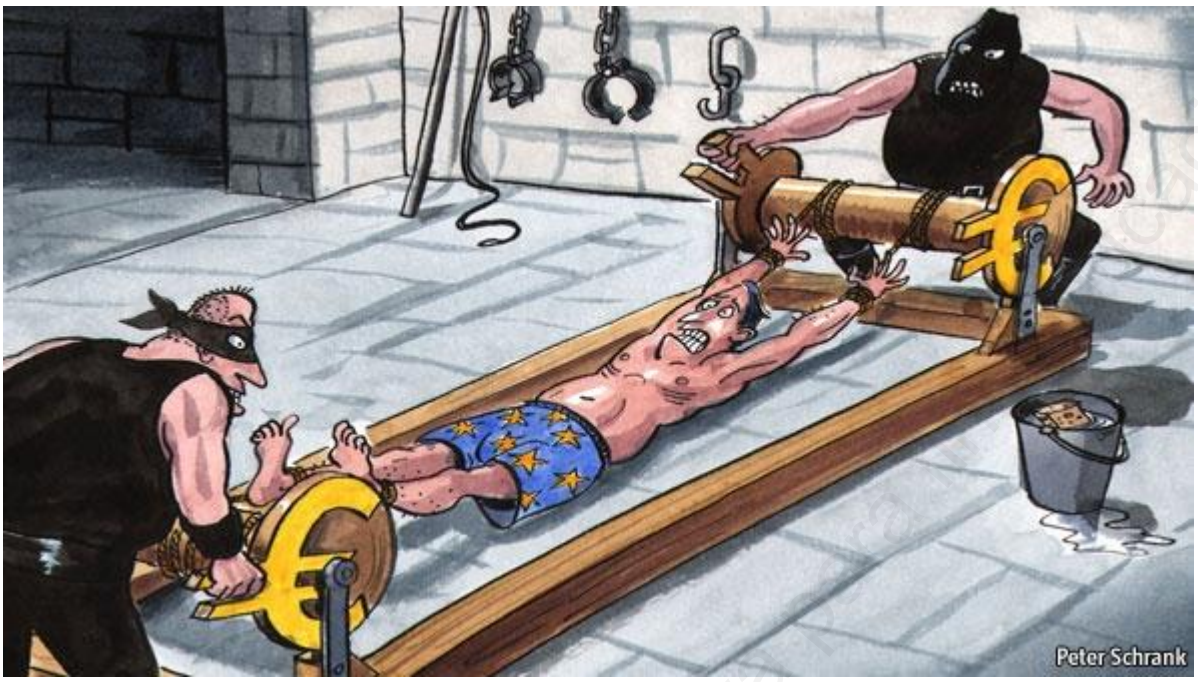
**Europe on the rack**

*Why the euro is breaking the European dream*




THE longer the euro area's debt crisis drags on, the more it resembles an instrument of economic torture. Like the medieval rack, every turn of the crisis tears Europe further apart. This week Cyprus announced it would seek a bail-out. Spain formally asked for money to recapitalise its banks. The Greek limb is close to being ripped off. How long can the Italian one hold?

Monetary union was meant to be a blessing. The euro's founders dreamed that it would end chronic and divisive currency crises, promote growth and multiply Europe's economic power. After the creation of the single market, the euro was the next step toward political union.

For decades European integration worked. Through trade and regional aid, poorer members joining the club quickly started catching up with rich ones. But the euro has now set the "convergence machine" in reverse. Parts of southern Europe are in depression and must pay high interest rates, while Germany enjoys record low borrowing costs. The debtors plead for mercy, but the creditors think they must suffer for their sins.

Now, after first blaming speculators, then profligate states, then, more broadly Europe's lack of competitiveness, the cardinals of monetary union have belatedly come to understand that the main problem is the euro itself. A new report by a group of prominent economists—sponsored by Jacques Delors, the former president of the European Commission, and Helmut Schmidt, the former German chancellor—describes in telling detail how the euro is destroying itself.

Start with the European Central Bank's "one size fits all" interest rate, which the report's leading author, Henrik Enderlein of the Hertie School of Governance in Berlin, relabels a "one size fits none" rate. Differences in inflation are magnified: in countries with higher-than-average inflation (eg, Italy), the real interest is too low, fuelling more inflation; the opposite is true in countries where inflation is low (eg, Germany). Another problem is that the single market is far from complete, so that competition does not even out price differences across the EU. The market in services, which represents the biggest share of economic output, is still fragmented. Moreover, European workers are less likely to move in search of jobs than, say, American ones. A further curse is that countries of the euro zone

do not independently control their own money. Because each lacks its own central bank to act as a lender of last resort, troubled countries can more easily be pushed into default as markets panic. Lastly, cross-border financial integration has spread far enough to channel contagion from one country to another, but not so far as to break the cycle of weak banks and weak sovereigns bringing each other down.

These shortcomings have now become painfully familiar. Some of them were known when the euro was created. Mr Delors himself, in a seminal report of 1989 launching the process of monetary union, warned about the dangers of economic imbalances and the risk that states could be shut out of bond markets. Yet the dangers were for the most part ignored, or reckoned to be manageable through fiscal rules and the promise of economic convergence. Those who saw trouble in store thought a crisis would provide the impulse for greater integration in future.

What the euro's disciples underestimated, however, is how abruptly and severely the crisis would fall upon the euro zone. It is overwhelming leaders. One reason is that the crisis is also fraying Europe's politics. The hope of forging a common European identity has given way to greater national assertiveness, even chauvinism. Anti-immigrant and anti-EU parties are gathering strength. Greece has seen the sharp rise of parties of the far left and far right. Some Greeks depict German leaders as Nazis. Many Germans regard Greeks as lazy cheats.

**Horror fiction**

Any fair reckoning of the euro must therefore judge it to have been a failure. For noble reasons, perhaps, the euro's founding fathers created a federal currency before creating a federal state to back it. Like Victor Frankenstein, they defied nature and created a monster. Part of the horror story is that the cost of returning to national currencies is greater than keeping the euro. And there were only modest hopes that the European summit in Brussels this week, held as The Economist went to press, would find a way of fixing its many flaws.

Economic logic dictates that the euro zone must become more federal, sharing banking risks and issuing debt jointly. Political reality, however, works against this. European treasuries are still national, as is politics. For creditor nations, "more Europe" could come to mean paying the debts of unworthy foreigners; for debtors, it could mean having foreigners intruding ever deeper into their affairs.

The breakdown of the Franco-German partnership, for the moment, makes a solution even more elusive. France's new president, François Hollande, wants joint Eurobonds and the use of euro-zone rescue funds to recapitalise banks. Angela Merkel, Germany's chancellor, says there can be no mutualisation of liabilities, at least until there is strong central control of national budgets and big banks.

Europe's most senior officials presented a compromise before this week's summit, whereby financial, economic and political union would move in parallel. Their paper breaks a taboo but is vague, with no timetable or sequence of steps. It proposes drawing up a clearer plan—perhaps the successor to Mr Delors's 1989 report—in December. Can the euro zone survive the rack for that long? Perhaps the pain will be such that citizens and leaders will look to integration for relief. The danger is that, if the torture goes on, the European project will expire first.

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