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A rapid fall in the euro can save Spain

The possible breakup of the eurozone is now openly discussed by policy officials and financial executives. The interest rate on Spanish government debt has soared above 7 per cent, reflecting its lack of progress in reducing its fiscal deficit and those of Valencia and other regional governments. Greece is likely to fail its inspection by the "troika", bringing it closer to a eurozone exit by the autumn. Even Germany is under financial pressure because the Bundesbank has so much explicit and potential exposure to peripheral European countries.

The last eurozone summit ended with an optimistic communiqué but nothing of substance. Meanwhile, financial markets may already be in the process of forcing a solution upon Brussels policy makers. The declining value of the euro holds the key to the eurozone's survival.

The euro has fallen in the past year by 15 per cent relative to the US dollar (from $1.44 to less than $1.21). If it falls an additional 15 per cent it would reach near parity with the dollar and would still be about 20 per cent above the euro's historic low of 84 cents.

A lower value of the euro would reduce the prices of eurozone exports and raise the cost of imports, reducing or eliminating the current account deficits of the peripheral European countries, since about half of their trade is with countries outside the eurozone. The weaker euro would also boost Germany's net exports, raise German wages and prices and reduce the trade imbalance within the eurozone.

The increase in peripheral country net exports would also raise their gross domestic product and so reverse their recessions that were caused by higher taxes and cuts in government spending. That would make it politically easier to achieve the needed fiscal consolidations. And shifting from recession to growth would raise business incomes and employment, reducing the volume of bad loans and mortgage defaults now hurting the banks.

In recent weeks I have discussed the case for a declining euro with current and former eurozone officials. I expected that they would just say that I am a long-time "eurosceptic" who is always critical of the euro. But the opposite happened. These eurozone experts all agreed that a lower value of the euro is necessary for the survival of the single currency.

The continuing decline of the euro reflects the market's perception that the euro must fall or the eurozone will collapse. Investors also recall how rapidly a currency can fall: the euro fell by nearly 30 per cent against the dollar in about a year and the British pound declined by 25 per cent during six months in 2008.

The decline of the euro can therefore occur without specific action by the European Central Bank. But a further shift by the ECB toward a looser monetary policy would speed the euro's decline.

While the improvement in the eurozone's net exports would have a negative effect on American exports, the impact on the US economy would be relatively small since US trade with eurozone countries equates to less than 5 per cent of US GDP. There is no reason to expect any policy reaction by Washington to prevent a weaker euro. The US has no tradition of exchange market intervention and interest rates are already so low that no further reductions would be possible even if the US Federal Reserve wanted to do that. Moreover, both President Barack Obama and Fed chairman Ben Bernanke have recently emphasised the risk to the US of a collapse of the eurozone.

I believe now, as I did 20 years ago, that imposing a single currency on a heterogeneous group of countries is a mistake. Europe lacks the kind of geographic mobility and automatic transfers from rich to poor states that allow the US to operate with a single currency. But while the creation of the eurozone was an economic mistake, allowing it to dissolve now would be very costly to governments, investors and citizens.

A rescued eurozone would still face the problem inherent in the single currency: an inappropriate monetary policy in different countries at different times. But the other problems of the euro may not continue. The bond markets will prevent the excess borrowing by governments and private individuals that occurred in the past decade. And the peripheral countries are beginning to take the necessary reform steps that could reduce the differences in productivity and unit labour costs that have contributed to widening trade deficits.

A new start for the euro is still well worth trying.

The writer is professor of economics at Harvard University