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Positive Vision for the Euro Zone

By Michael Heise

Investors worldwide have rediscovered euro-zone markets. Risk premiums on peripheral debt have tumbled, equity markets have shot up and the euro is strong. Now all eyes are on the European Central Bank, on its measures to stem the alleged risk of deflation in the euro zone and on its efforts to clean up Europe's finance houses before they become part of the new EU banking union. But investors and policy makers need to look much further than Frankfurt when they ponder the future of the euro zone. Wide-ranging reforms will be needed to put the euro on a sustainable footing.

For starters, change the story: During the euro crisis, commentators and politicians focused on how public-spending cuts and structural changes imposed on struggling euro members were choking their economies. While it is true that fiscal consolidation was accompanied by collapsing growth, rising unemployment and social hardship, it is now time to look ahead. Political leaders need to show a positive vision for the euro zone. Citizens should no longer associate euro membership with misery, but with economic opportunity.

The evidence we have from recent years — and especially from those countries that were subject to bailout programs — confirms that reforms pay off. In countries such as Ireland, Portugal and Spain, growth has returned, unemployment appears to have peaked and external deficits have disappeared. Now these countries are continuing their reforms, not because bureaucrats in Brussels or Frankfurt are telling them to, but because it is in their own interest. The European Union can help to maintain that momentum, for example by helping to pay for new infrastructure or by allowing countries to overshoot fiscal targets under the condition that they implement reforms.

Policy makers also need to learn to manage a multi-speed Europe. If the euro countries want to avoid a repeat of the latest crisis, they need to integrate further. Different speeds of integration are already a reality today — not all EU countries have joined up to sign the banking union or the fiscal compact, or the Schengen agreement on borderless travel. Some countries have opted out of EU justice policies. All this has nothing to do with the euro crisis and it needs to be accepted. In a union of 28 nations, it does not make sense to insist on the same speed of integration in every member country. The EU is a master of compromise and complexity. It should be able to make integration at various speeds work.

The EU must also clean up its rule book. During the euro crisis, European countries adopted a plethora of new rules and established various new institutions. The euro zone's governance framework now encompasses the "Euro+ Pact" (governments inside and outside the currency union pledging reforms to improve their fiscal position and competitiveness); the "Fiscal Compact" and the "Six-Pack" laws on fiscal and macroeconomic surveillance; the "Two-Pack" laws on budget monitoring; new macroprudential provisions and the running "European Semester" of economic governance; and an outcropping of institutions with such catchy acronyms as the ESM, SSM and ESRB.

No wonder Europeans are confused while their governments struggle to comply with all the new rules. For the sake of transparency and effectiveness, the EU needs to consolidate all the elements of its new governance framework into a single "economic constitution."

And while the EU has already done much to make the euro function better, it must go further. For example, it needs to have a more powerful European fiscal watchdog that can guarantee that the old and new rules are respected. It needs a mechanism for sovereign default that helps to impose discipline on governments and investors alike. And it needs clearer rules for the exit of a country where the citizens no longer feel that the union serves them well.

Now that growth has returned and financial markets are calmer, complacency is the biggest risk that the euro zone faces. No longer looking into the abyss of a euro break-up, politicians may be tempted to duck difficult and unpopular reforms. But if the euro is to survive and prosper, their efforts must go on.

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