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A stable euro requires more economic potential

Mark Twain famously quipped that history, while not repeating itself, does rhyme. In the case of the euro-crisis the rhyming amounts to an eerie echo of the recent Subprime debacle. The parallels between Europe's sovereign debt crisis and the financial crisis are manifold.

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First off, there is self-contented hubris. Prior to 2007, the demi-gods of finance and economics convinced themselves and the rest of the world of the wonders of efficient markets and applauded the so-called Great Moderation, while housing prices and financial risks skyrocketed around them. A little over a year ago, as the European Monetary Union entered its second decade, Europe's elite marvelled – in the words of the European Commission – how the euro "has clearly become the second most important currency in the world"; how "it has brought economic stability"; and how "its framework for sound and sustainable public finances helps ensure that future generations can continue to benefit from the social systems that Europe is justly famous for". What a difference a year makes; how bitter the taste of irony.

Next are the immediate causes of the calamity. As with the housing market and the derivatives craze, the euro tale is one of easy money, excessive leverage, bad accounting and failed supervision. Euro-membership allowed profligate Southern European countries to borrow cheaply and beyond their economic means. The euro's "Stability and Growth Pact", meant to restrain budget deficits and national debt, was violated in its application and ignored in its supervision. In short, this was a bubble of public excesses waiting to be pricked and blown into critical proportions through the deliberate rise of state spending in the wake of both the financial and the economic crisis.

When the bubble burst an unfortunately familiar scenario of improvised rescuing and predictable bailout ensued. In the subprime case, financial globalization had run ahead of its institutional and regulatory settings, leaving a global cacophony in charge of a threatening global meltdown. Greece exposed a similar endemic flaw in euro management. In the absence of supranational governance, the scramble for national interests produced delay and dithering. Only when the Greek crisis became potentially systemic did the national interest and the collective interest merge. For lack of any realistic alternative, the outcome could only be to lend the profligates even more money, notwithstanding the equally familiar and perfectly justified grumbling about moral hazard and rewarding failure.

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As with the bank bailouts, the euro sovereign bailout fund is thus a necessary evil and the price of a flawed framework. The dismal bailout scenario will be there to stay unless the framework itself is altered. That takes us to solutions, the most predictable of which – here too – will resemble the debate on financial reform elsewhere: tougher capital requirements (aka budgetary discipline in the euro case) and increased supervision. The European Commission has come up with proposals for bringing the dead letter of the Stability and Growth Pact back to life. After all, the Germans will not pay forever.

As with financial reform, reinforced budgetary targets and supervision will only take you so far. The real challenge is the equivalent of financial reregulation for euro-states: structural reform. Markets did not reduce Greek government bonds to junk status because of indebtedness per se. Portugal and Spain were not being infected for the sake of their budgets alone. After all, almost all OECD and euro-countries are knee-deep in the read. What separates the weak from the strong is the expected inability or ability of their national economy to grow out of the debt hole in the future. The root cause of the euro-crisis is not today's fiscal profligacy, it is tomorrow's economic potential. It is the market's appreciation of whether a country will be able to combine the austerity that is needed to reduce deficits and debt with improved economic growth. It is more an issue of longer term solvency than one of short-term liquidity.

The real failure of the euro is therefore not its hapless stability pact; it is the 2000 Lisbon Strategy to turn the European Union into "the most competitive and dynamic knowledge-based economy in the world" by this year. Lisbon has turned out to be a colossal pipe-dream because politicians and electorates across the EU did not want to pay the price of competitiveness. Too many insiders preferred the status quo or remained in denial about the need to reform strict labor markets, ballooning welfare states, inefficient public sectors, or shielded markets. This is the true Greek malaise that permeates the entire euro-zone in various degrees and endangers the long-term stability of its currency.

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Under then-Chancellor Gerhard Schröder, Germany was one of the few euro-countries to engage in reform and convince unions of moderate flexibility and wage restraint. The German economy now reaps the benefits and successfully surfs the resurgent waves of globalization. But instead of being praised, Germany gets the stick for creating an imbalance in the euro-zone and for insisting on accountability. Instead of recognizing their own policy failures, European politicians lambast the financial markets for "wolf-pack behavior". Speculation is a factor, but you cannot blame the coal mine disaster on the canary.

For the sake of the euro and the continent's future, political scapegoating needs to stop. Countries should get their act together and follow the German example in earnest. The clock is ticking. Structural reforms now have to coincide with increased austerity, are confronted with a crisis legacy of anemic growth and mass unemployment, and face the imminent entitlement crush of retiring baby-boomers. The cardinal issue for the euro is whether its member states will be able to avoid a welfare state trap: will they be able to reform before such reform becomes mutilation that furthers decline, instead of reversing it. Competitiveness and growth are central to the European Union's future. Whether by national mobilization, through enforced EU-coordination or through an IMF-cleansing, they will require tough policy choices in a harsh budgetary environment. The euro bailout is but the end of the beginning. The real test for the euro still lies ahead.

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