

Why the Euro Will Survive

A breakup won't solve anything. Only reforms will.

by Michael Heise



New year, same old challenges. The past few months have seen the debate on European government debt mutate into calls for a breakup of the euro zone. Many of the suggestions border on the surreal: Let's reintroduce the German mark or at least kick out Greece, Ireland and maybe even Portugal and Spain. Or how about a northern and a southern euro?

Fantasizing about the demise of the euro may garner applause in talk shows, but it is certainly not in the union's interest, nor indeed in Germany's. Germany benefits from political and economic integration in Europe, which is driven and symbolized by the euro. The disintegration of the single currency is not a solution. Governments are wisely focusing on better policies instead.

First of all, the "crisis-ridden countries" have embarked on budget consolidation and economic-reform programs that need to be continued. It is not about axing spending in a blind rage, but rather about reforms in areas such as welfare spending and the labor market, using tools like privatization or moves to boost public-sector efficiency.

Claims that these policies will hurt domestic demand and economic growth contradict historical experience and the economic mechanisms of a market economy. Numerous countries have in the past swiftly returned to strong growth in the aftermath of consolidation efforts, often without substantial currency devaluation. One example is Ireland in the late 1980s, another Belgium in the mid-1990s or Canada in the late 1990s.

The often deep-rooted faith in the healing properties of currency devaluations is misplaced. Devaluation can help temporarily, but over time it tends to spawn higher wage demands and inflation, which in turn guzzle up any competitive advantage gained. It is salutary to recall the periods of devaluation in Greece, Portugal, or even Spain and Italy, and ask whether it would really benefit these countries to step back into the past.

Second, the reform of the Stability and Growth Pact, despite some shortcomings, represents a major game changer. There will be earlier and stricter surveillance of member states' fiscal policies, together with a broader take on macroeconomic imbalances. The new rules' direct impact on economic and budget policies might not be immediate. But a swift legal implementation of the rules would instantly signal to investors that the European Union is willing and able to act. The faster the plans are implemented, the sooner it will dawn on financial markets that the new regulations really do imply important changes.

Third, politicians should steer clear of eurobonds as a means of papering over the current financing crisis in some countries. Eurobonds would require far more political integration, particularly of fiscal policy, than we have achieved so far. What is more, eurobonds fail to tackle the underlying problems, namely the tendency of some countries to live beyond their means. Eurobonds may even encourage such behavior.

Before the sovereign-debt crisis, some experts argued that Germany would benefit from eurobonds, which would create a larger market with a lower liquidity premium. This argument has now gone up in smoke. Germany's refinancing costs would clearly rise, reflecting also the costs of lower quality borrowers. Unlike the present system of guarantees, the extra costs for eurobonds would have an immediate fiscal impact. Bond yield spreads are an important instrument in exerting a disciplinary effect on government borrowing.

Perhaps financial markets are now overreacting. But policy makers should not make the same mistake by indulging in activism. This is the fourth point. The decision not to immediately increase the size of the European bailout fund in response to the rise in risk premiums for Spanish and Italian government debt was correct. No doubt, the markets would also have pounced on the additional funds. There is no reason to believe that Spain, for example, with a lower debt and interest burden than Germany, is on the brink of default. Madrid can cope with risk premiums of two or even three percentage points until markets become more convinced that economic and fiscal reforms are bearing fruit. Of sole importance is the political message that solidarity in the euro area will win the day.

While these measures should help prevent any sovereign defaults, the euro zone may still need in the long run an agreement on sovereign-debt restructuring and how to share the burden between private investors and taxpayers. In case of a pending debt crisis, countries in need of help will have to accept far greater interference in their sovereign fiscal and economic policies.

The way forward is clear: Reject talk of dismantling the euro, demonstrate political cohesion, push ahead with economic and fiscal reforms and refrain from kow-towing to the whims of the financial markets. On this foundation, the euro can look forward to a promising future.

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