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Lessons From the Eurozone's Growing Success

By Michael Heise

Only a few years ago the eurozone seemed doomed to long-term stagnation and recurrent turmoil. Its politicians had let the crisis go to waste, critics claimed. Riven by internal imbalances, they added, the euro would ultimately be unsustainable unless its governance was fundamentally reformed, most notably by adding a joint fiscal policy.

Yet average gross domestic product growth in the eurozone slightly outpaced the U.S. in 2016 and will maintain the same speed of about 2% in 2017. More people in the eurozone have jobs today than during the previous peak in 2008. The recovery has reached all eurozone countries, including Greece, with the momentum mirrored in the foreign-exchange markets, where the euro has made significant gains. On the stock markets, European companies are suddenly all the rage.

These developments are at odds with many critics' predictions. The euro's periphery would remain mired in stagnation, they said, since only an "internal devaluation" through lower wages and prices could enable crisis countries to regain competitiveness and growth. But this couldn't be achieved because economic structures were too rigid, labor unions too strong and societies rife with unrest, the pessimistic view went. The eurozone would prove simply too diverse to survive.

Instead, adjustments happened. Not everywhere, not completely, but

adjustments nonetheless. Unit labor costs in former troubled countries such as Ireland, Portugal and Spain are lower now than in 2008, while in Germany these costs have grown several times faster than the eurozone average. Eurozone countries that were once vulnerable because of their gaping external deficits have managed to close them.

Fiscal deficits have shrunk, with seven euro members achieving balanced or surplus budgets. Many countries have reformed their labor markets and social-security systems. Nonwage labor costs have fallen and employment has rebounded. Households and businesses have worked through parts of the debt they had amassed before the crisis.

The lackluster growth of the post-crisis years was virtually inevitable due to the large consolidation and adjustment needs that had accumulated in the years of the boom. It was not the euro but misguided national policies that had let the big imbalances arise. People suffered most in those countries where fiscal policies had been consistently lax, private debt and current account deficits had exploded and wage growth had outstripped productivity gains.

The common currency is teaching politicians and economists how economies really recover from stress.

Bearing this in mind, euro member countries after the crisis rewrote the eurozone's rules for fiscal sustainability and added new rules for macroeconomic stability. Adhering to such rules would above all be in a country's own interest. But the eurozone can undertake further steps to strengthen their motivation.

The monitoring of national economic policies, as carried out by the Eurogroup of national finance ministers and the European Commission, remains overpoliticized, undermining its legitimacy. A completely apolitical surveillance and enforcement of eurozone rules may be unachievable, but independent experts could be given a greater say in things, perhaps by transferring monitoring and assessment duties to the European Stability Mechanism.

More effective still would be the addition of a mechanism for the eurozone to handle sovereign insolvencies. This would make it clear to profligate governments that they ultimately risk sovereign default, with painful consequences to the holders of sovereign debt, many of whom are also ultimately voters.

Fearing a loss of value, international investors, too, would pay more attention to the sustainability of national economic policies when adding eurozone bonds to their portfolios. Rising risk premiums would then be a clear signal to politicians that their economic policies should

be more solid. Strip away the implicit assumption that other eurozone countries will always step in with a bailout, and market pricing could accomplish what complicated rules and ineffective sanctions have so far failed to achieve.

Such changes in the governance of the eurozone should come before any further fiscal centralization through new joint budgets and large-scale transfers between countries. As long as several euro countries remain unwilling to cede national autonomy in fiscal and social policies, or even call the rules-based constraints of the Stability and Growth pact into question, doubts about their commitment to responsible policy making will persist. That makes it too risky to mutualize the burdens of persistent unemployment or macroeconomic imbalances.

The eurozone has surprised its critics by proving itself capable of adjustment. But adjustment in a crisis is usually painful. For the eurozone to be successful and prosperous, member countries must prevent the emergence of destabilizing fiscal and macroeconomic imbalances in the first place. This is the prerequisite for a fiscal union that goes beyond common support for investment in infrastructure or existing crisis-management provisions.

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