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Structural Reform and Institutional Convergence in Europe

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The Greek election on January 25, 2015 brought the extreme left wing Syriza party to power. During the campaign Alex Tsipras – Syriza's leader and the new Prime Minister - vowed to repudiate austerity policies and renegotiate Greece's debt. The Greek public is angry with Germany and their other lenders, but, in fact, prior governments implemented very few creditor demands. The Greek government did not privatize state owned assets, nor did they improve tax collection, dramatically raise the retirement age, deregulate business or seriously tackle corruption. Even government budget cuts were small relative to the scale of Greece's fiscal problems. Rather than demanding deeper reforms to improve economic competitiveness, the electorate instead gave Syriza a mandate to roll back the modest changes already implemented.

Granted the economic situation in Greece is dire and its options are not good, but maintaining failed socialist policies will not achieve the results desired by the Greek people. Shirking debt and exiting the Euro (now called "Grexit" by the media) would consign the Greek economy to permanent poverty unless accompanied by the very same unpopular reforms required in its present situation. So Greece is between a rock and a hard place, unwilling to change but unable to Grexit without immense cost.

Establishment politicians in the Eurozone worry if Syriza successfully repudiates its debt without consequences it could bolster other populist political parties such as Podemos in Spain, the Five Star Movement in Italy or the Popular Front in France. So Germany and Greece's other creditors took a hard line stance with the new Syriza government. Greece needs cash so Mr. Tsipras is backing away from his radical demands. Rather than Syriza upending the Eurozone, it looks like the Eurozone may upend Syriza.

The Greek saga is the most extreme example of a broader transformation in Europe. Since the Euro was introduced in 1999 skeptics argued that European countries were too dissimilar for a currency union to succeed. How could incorruptible and frugal Germany coexist with corrupt and profligate Italy or Greece? What about more market friendly countries such as the Netherlands or Ireland working with France's more government influenced economy? Rather than break-up, however, the common currency is pressuring weaker states to clean up their act.

The Euro is Forcing Weak States to Cleanup their Act

Eurozone countries with weak institutions, market impediments or that owe a lot of money cannot debase their currencies or devalue their debt with inflation. Instead they must adopt pro-growth policies or face dire consequences. Fortunately, many troubled Eurozone countries are looking toward the two biggest powers with the strongest institutions for answers: Germany and the United Kingdom (a member of the European Union but not the Euro).

The U.K. is Europe's financial center. Like the United States, the U.K. has multiple redundant financial systems that allow capital to flow even if the banking system falters. Whereas Eurozone countries rely almost exclusively on banks (and in many instances government owned banks) for their capital needs, the U.K. has much more robust capital markets. Outside of the United Kingdom, European countries have very small stock and bond markets, asset-backed securities are almost non-existent and alternative financial institutions – so common in the United Kingdom and the United States – are relegated to very small corners of the financial system.

Under the heading "Banking and Capital Markets Union" the Eurozone is converging toward a financial system that reduces the government's role in the banks, enhances the importance of securities markets and expands the role of non-bank financial institutions. For example, Spain recently privatized their regional banks called Cajas. Italy passed a law last month allowing its state owned banks to reorganize as joint stock companies. All EU countries are studying U.K. laws and policies to facilitate securitization and govern capital markets.

Europe is Slowly Becoming More Market Friendly

Outside of the financial system economic models are also converging. Recent reforms in Spain and Italy liberalized labor markets, using reforms already implemented in Germany as a model. The common currency is pushing Europe toward more market oriented systems with similar macroeconomic policies. Prior to their adoption of the Euro, Greece, Italy and Spain were high inflation economies that typically devalued their currencies rather than reform their economic systems. Today, only Greece remains recalcitrant while the other troubled Eurozone countries seek to emulate the U.K. and Germany.

It is easy to dismiss visionaries as unrealistic dreamers, but the European Union's founders envisioned a democratic "United States of Europe", free from war, with prosperous market economies. Rather than accentuate divisions as it is now, the Euro currency might ultimately provide the catalyst for a dynamic and unified European economy.