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How Europe Will Prove the Naysayers Wrong

By Klaus Schwab

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The eurozone will not break up. The price of departure is simply too great for any one country. Indeed, when European Central Bank president Mario Draghi announced on Sept. 6 that the bank would undertake unlimited purchases of government bonds, the continent crossed the bridge to its future.

Europe's leaders must see that the drawbridge has been lifted behind them. They cannot back out of this, and thus they must steel themselves for the journey ahead. Moreover, they must also realize that for the European project to succeed, monetary union must be accompanied by four other kinds of union: a banking union, a fiscal union, a "competitiveness" union and a political union. To be sustainable over the long term, the continent's political economy must be capable of reintegrating its young people and present an ideal worth fighting for.

This is a long and ambitious list, but the deeper one thinks about the European situation, the more inevitable these conclusions become.

Ever since Belgium, France, West Germany, Italy, Luxembourg and the Netherlands signed the Treaty of Paris in 1951, European integration has been of enduring benefit to generations. It is hard to imagine European history without the development of institutions designed to bring European countries together under shared values and common ideals.

The euro itself has provided major economic rewards. It eliminated exchange risk, lowered inflation, increased trade across the eurozone and more tightly integrated European financial markets. More generally, the single currency has contributed to an underlying culture of monetary stability and predictability in the eurozone, a critical point often forgotten in today's discussions.

The crisis, however, exposed critical flaws in the eurozone's structure. Europe lacked a strong and common fiscal policy. What's more, divergence in competitiveness between the northern and southern economies created a risk of default that had gone unrecognized, while the absence of a banking union created intolerable systemic risks. Adding fuel to the fire, the complexity of European political institutions, and the increasing democratic deficit that it represents in the view of the public, has led to an "executive deficit" — that is, an inability to make real decisions.

What is clear is that the euro must survive in more or less its current form, but the deficiencies in the institutions that surround it must be addressed. The first is a banking union, an absolute prerequisite for a monetary union to succeed. A robust banking union must have shared bank supervision, a shared bank recapitalization mechanism and a shared bank deposit guarantee. The good news is that the first of these was put in place on Sept. 12 with the proposal of a single supervisory mechanism under the European Central Bank. The two other items are destined to follow, with the ever-present caveat in Europe that negotiations will be complex and will take years to resolve.

As the talks of a banking union drag on, they will inevitably lead to discussion of a fiscal union. There will be three parts to any kind of fiscal union in Europe: a program of direct bank recapitalization, a European Union-wide system of deposit insurance that both prevents a run on banks in weaker countries and reduces moral hazard, and some form of debt mutualization.

Before the anti-federalists recoil in dismay, it is important not to fall prey to binary thinking. It is not all or nothing. Between no fiscal union of any kind and a fully fledged "United States of Europe" or Swiss-style confederation, many possible intermediate states exist that would contribute to a much greater sense of fiscal solidarity and discipline.

Reform of European financial governance is a necessary condition for success, but this alone is not sufficient. It will not be able to gloss over the major issue at the center of the crisis: the competitiveness gap between Europe's north and its south. Fixing the EU banking system and regaining macroeconomic stability will do a lot to help southern countries increase their productivity. But these countries will need to engage in a long-term project to increase their labor market flexibility, foster competition and competitiveness and make more and better investments in growth-enhancing areas such as education, technology and innovation.

A crucial consequence of all these reforms must be the injection of entrepreneurial energy into the Continent's lost generation. Youth unemployment is a cancer in the heart of the

European economy. It is stealing young people's future and sapping their growth potential for decades to come.

The good news is that reforms are under way. Despite slow progress in implementation, the Europe 2020 strategy is designed to kick-start competitiveness in the region. The path ahead is clear, and Europe's leaders need to look forward with hope and optimism, not backward with fear. Europe is more likely to confound the pessimists as the year ahead unfolds.

The Continent's optimism will strengthen as leaders recognize that if Europe doesn't stand together, it will fall apart. No European country is sheltered from the pain of this crisis. What is crucial now is that the Continent's polities be able to envision the gain that will emerge from the pain and be able to articulate this in a way that pulls them toward their shared future.

Klaus Schwab is founder and executive chairman of the World Economic Forum. His e-book, "The Re-Emergence of Europe," will be published on Dec. 14 and available free of charge at weforum.org/re-emergence

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