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Commentary

Stepping into the abyss?

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It is crunch time: the upcoming days and weeks will determine the future of the euro. However, it is not just the stability of the EU's common currency but also the future of the whole European project which is at stake. Unless decisive action is taken now, the unthinkable will become possible: the break-up of the euro zone and even the disintegration of the EU – at least as we know it.

While there might be differences in scale, an implosion of the common currency would affect all EU countries inside or outside the euro zone, independent of their size. While there is always a 'day after', the implosion of the euro area would provoke an unprecedented nightmare for the EU and its members: with horrendous financial, economic, social and political consequences. The collapse of the global financial system, a long and deep depression, mass unemployment and impoverishment, the permanent collapse of the EU's peripheral economies, social riots and violent conflicts, nationalism and populism reaching levels not seen for generations – all these are real risks.

In political terms, failure to stop the crisis would most likely lead to divisions between national capitals, with countries blaming each other for the inability to contain the crisis. This would inevitably have severe negative spill-over effects well beyond the future of the common currency, undermining the coherence of the Single Market, the Schengen area and Europe's future global role.

Learning the lessons of history

Bearing in mind these potential consequences of the euro's implosion, some argue that none of this will be allowed to happen, with EU members and institutions – as well as other global political and financial actors – doing everything possible to avoid Armageddon. But history has proven more than once that risks can run out of control: for instance, how was it possible for the Great Depression of the late 1920s and early 1930s to eventually end up in World War II? Didn't past generations realise the dangers? And why did they not take decisive action to avoid that cataclysm?

History does not repeat itself. But we must draw the right conclusions: sometimes the avoidable becomes unavoidable if we fail to react early enough. Today, the worst can still be averted, but the crisis has now reached a level at which the EU and especially eurozone countries need to devise and agree on much bolder responses in order to arrest the downward spiral.

There certainly is no silver bullet and there won't be a quick fix. Boosting national reform efforts, strengthening the EFSF (European Financial Stability Facility), establishing a permanent rescue mechanism (ESM), implementing the 'six pack' of legislation designed to enhance economic governance, operating more effectively the European Semester and the Euro Plus Pact, recapitalising major European banks, restructuring Greek debt, and attempting to foster growth on the European and national level – all this must be continuously promoted and will take time to work. At the same time, the existing EU Treaties have not yet been fully exploited, as the Union's primary law provides the legal grounds to further deepen fiscal and economic cooperation between the Euro 17 and the EU 27.

But more needs to be done if the EU and the euro zone are to start rebuilding trust and confidence. Three things must be achieved: (1) the creation of fiscal and economic union; (2)

the collateralisation of debt; and (3) establishing the European Central Bank (ECB) as (temporary) lender of last resort. The latest Franco-German proposals at least recognise the first objective (although details and commitments still need to be specified), but no substantial progress has been made on the other two yet.

Towards fiscal and economic union

First, the EU has to embark on a credible path towards a fiscal and eventually an economic union. Setting up a fiscal union by providing the instruments and procedures for more effective *ex ante* budgetary coordination and *ex post* control, which *inter alia* involves the European Court of Justice, will require limited amendments to be made to the EU's primary law. In an attempt to send a strong signal to the 'markets', limited treaty reform should be completed as quickly as possible on the basis of the simplified revision procedure and within the EU framework.

The strong involvement of both the European Parliament and the European Commission will be a *sine qua non* for ensuring the legitimacy and effective functioning of a fiscal union, as well as potentially addressing some of the objections of Germany's Constitutional Court. At the same, one could also consider establishing an independent European budgetary authority.

An intergovernmental treaty – along the lines of the Schengen or Prüm Treaty – should be seen as a second-best alternative if there is no agreement at the level of the 27. However, the content of such a treaty should in any case be incorporated into the EU treaty framework as quickly as possible, and all member states that are obliged and willing to eventually join the common currency should – from the outset – be able to sign up to the intergovernmental treaty.

However, moving towards a fiscal union will not be enough. The crisis has provided clear evidence of the 'existential interdependence' between EU members and especially between euro countries. As a consequence, EMU (Economic and Monetary Union) will have to be further developed in the direction of a fully-functioning economic union. This will require more profound adaptation of the Union's institutional and legal set-up.

The qualitative leap towards an economic union will necessitate much more substantial reform of the EU Treaties, which will have to be worked out on the basis of the 'ordinary revision procedure'. This will involve a European Convention featuring representatives of EU governments and the European Commission, as well as national and European parliamentarians. Completing this exercise, including full ratification, will take years. But the 'markets' would then take the prospect of a gradual process towards establishing a fiscal and economic union worth the name into account, if EU governments and institutions were ready and able to make a credible and sustained commitment.

Second, the Euro 17 should signal their readiness to introduce collateralised debt arrangements once it becomes clear that EMU is moving towards a fiscal and eventually economic union. Many models are on the table, including the 'blue bond/red bond model' originally proposed by Jakob von Weizsäcker and Jacques Delpla (2010) and the more recent proposal made by the German Council of Economic Experts (November 2011), which is based on a euro area-wide debt reduction strategy aimed at a gradual but compulsory reduction of government debt to below 60 per cent.

The latter includes the idea of a "redemption fund", into which sovereign debt exceeding 60 per cent of euro countries' individual GDP is pooled. Every participating country would commit itself to autonomously redeeming the transferred debt over a period of 20-25 years following a defined consolidation plan. In return, the fund would issue 'safe bonds', which would be used to cover the pre-agreed financing needs for servicing outstanding debt and new borrowing.

The particular attractiveness of the 'redemption model' stems from fact that the common issuance of bonds would be temporary and used only for euro countries with debt ratios over 60 per cent of GDP. The redemption fund could thus be more in line with the EU Treaties and national constitutional requirements, which prohibit a permanent collateralisation of debt. The redemption fund could also function as a precursor of more permanent arrangements, for example by introducing Stability Bonds, as proposed by the Commission in its recent Green Paper (November 2011).

More alternatives or a combination of different alternatives could be foreseen. The key today is to send a signal to the 'markets' that current and future euro members are ready and willing to tie themselves together more closely than in the past, which would increase confidence in the future of the common currency. The gradual collateralisation of debt would send such a signal, without the risk of 'moral hazard' if it were accompanied by a higher level of binding and controllable mechanisms and instruments of fiscal and economic governance.

ECB as a (temporary) lender of last resort

Third, the crisis has now reached a level where even stronger involvement of the European Central Bank (ECB) has become essential. The solutions proposed above will take time to implement – and we have run out of time. True, the ECB cannot and should not take on the responsibilities of national governments. However, the credible prospect of a fiscal and economic union, and readiness to introduce some form of collateralised debt, should send a clear signal to Frankfurt and pave the way for stronger engagement of the ECB, which in the current situation is the only EU institution credible and powerful enough to stop the downward spiral.

For this, the ECB could extend its securities markets programme and purchase even more sovereign bonds on the secondary market, beyond the approximately €200 billion already acquired; the ECB could also provide loans/funding to international financial institutions like the IMF (International Monetary Fund), which in return could use additional liquidity to assist euro countries under market pressure; the ECB could even define a maximum level of debt spreads, guaranteeing viable interest rates for new debt issued by euro countries.

In any case, the ECB must effectively act as a 'lender of last resort' at least until more permanent arrangements are in place. Yes, this would increase inflation risks in the euro zone. But maintaining price stability with a fragmented currency will not be possible, and in any case inflation is not the immediate challenge, especially since recent data suggest that Europe is likely to experience an economic downturn and may move into recession. More importantly, at the end of the day, a higher inflation rate would be justified if in the end it were to contain the crisis and ultimately avert the danger of the euro imploding.

It is still possible to avert meltdown: but at a price. Not only will eurozone countries have to agree to 'more Europe' – both in terms of public debt and enhanced EMU governance – but they will also have to allow the ECB to step in to prevent immediate collapse. This is a hard ask, but the alternative is infinitely worse.

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