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COMMENT
OPINION

Eurozone needs a permanent bail-out fund

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With two comprehensive stabilisation programmes, one for **Greece** and one for the whole **eurozone**, the EU has demonstrated its willingness and ability to defend European monetary union under extremely difficult conditions. This is a resounding success of the European Council.

Yet with major economic challenges persisting, a "wait-and-see" approach for EMU would be a dangerous course. The threats to the stability and cohesion of the eurozone remain high. Budget deficits exceed the 3 per cent limit in most countries and debt is rising dangerously, making fiscal consolidation a priority. Countries with particularly high fiscal and current account deficits – mainly Greece, Ireland, Portugal, which was advised on Monday by the Organisation for Economic Co-operation and Development to increase taxes, and Spain – need especially tough fiscal retrenchment. After years of accumulated losses of competitiveness, several countries require significant wage restraints and/or productivity increases.

These harsh medicines are necessary but carry a risk. They might well trigger a prolonged period of depressed economic activity, with negative repercussions in the rest of the eurozone. Adding to the difficulty, most euro countries enjoying current account surpluses are not in good enough shape to afford fiscal measures boosting growth across the eurozone, and thereby ease the strain in high-deficit countries. The eurozone thus faces a scenario where economic policymaking becomes extremely difficult. Public support for the euro might be undermined. Ultimately, the resulting instability could jeopardise the very existence of EMU.

EDITOR'S CHOICE

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Given that national economic and budgetary policies in deficit and surplus countries are constrained, and given that major economic, financial and social tensions might threaten or destroy the eurozone, a European solution is required. In fact, it has already been created. Now it needs to be made permanent.

On June 7 2010, the **European Financial Stability Facility** was established in Luxembourg. The EFSF can and should be mobilised to support deficit countries with loans. By helping deficit countries consolidate successfully, EFSF loans would significantly strengthen the stability of EMU. They would need to rest on two pillars: low interest rates and strict conditionality.

Benefiting from the favourable current situation in bond markets and its likely excellent own rating, the EFSF should be able to borrow at low rates. It should pass these rates on to borrowers with a minimum service charge. By reducing the interest rate burden, the prospects for a successful **consolidation in highly indebted euro countries** would improve significantly (for the same reasons, lower interest rates should also be applied in the bilateral loan scheme with Greece). In exchange for these loans, borrower countries should commit verifiably and credibly to achieve a return to sound public finances and a competitive economy. The negotiation of a memorandum of understanding with the European Commission, as required under EFSF statutes, would be very important for this.

A successful consolidation in high-deficit countries would help avoid debt restructuring and a crisis of confidence in EMU's sustainability. Using the EFSF to support such consolidation would therefore be legitimised as a vital step for the eurozone as a whole. As all legal provisions for the EFSF are already in place, the scheme can be activated at short notice. As time matters, action is required now.

Mobilising the EFSF should only be a first step. The eurozone requires long-term solutions. The statute limits EFSF operations to three years. But the recent past has shown that financial market shocks are a fairly common phenomenon, that they may affect the eurozone irrespective of its members' fiscal discipline, and can endanger the **financial stability of the whole area** and even the euro. This vulnerability will remain even if the planned reform of the stability and growth pact leads to a considerable improvement of its effectiveness.

A decision to make the EFSF permanent should not exclude sovereign insolvencies in the eurozone. An orderly procedure for sovereign debt restructuring is needed and should be agreed in parallel. But the EFSF should not be temporary. It should be fully integrated into the EU's institutional framework.

The eurozone must be able to cope with serious market disruption. It requires an effective stabilisation mechanism. The proposals contemplated in the task force led by Herman Van Rompuy, which met on Monday night, will be decisive for the future of EMU. They should include the transformation of the EFSF into a permanent European instrument. Other decisions are needed, but this is the first and easiest to implement – and of critical importance.

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Comments

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Christian Deubner | September 28 10:31pm | Permalink Report

"...should include the transformation of the EFSF into a permanent European instrument. Other decisions are needed, but this is the first and easiest to implement – and of critical importance."
Thankfully, this is not as easy as the four gentlemen would like it to be.
In fact, the EFSF should only be perpetuated under one condition: that an insolvency régime be first installed in the Euro area, which includes the rule primo that every state which would benefit from its help, first pass through an insolvency procedure, and secundo that its creditors would not be repaid at par.

nicholas mudie | September 28 2:06pm | Permalink Report

Before going on to dispute a couple of points raised in the article of which Padoa-Schioppa is one of the main authors I should remind readers of his fine performance under the short lived Prodi régime in Italy. a) He managed with a slightly helpful tailwind of growth to reduce total government debt by some 3-4 percentage points and b) he proposed some good reforms to the pension and welfare provisions which were rejected out of hand by the usual sindicalistic sinners.

HIs best point is to mention the "I" word (insolvency) word in the company of dedicated Europeans. The sooner we get used to the idea the better.

His mistake in this article is to assume that even if (for want of a better shorthand for surplus countries) the Germans were to raise private consumption what is the certainty that this money would be largely spent on goods and services inside the eurozone?

The other is to fail to take account of the structural shortcomings of the EFSF which inter alia your very own Wolfgang Muenchau pointed out yesterday. If you're going to institutionalise EFSF it would be best to make it a little more bomb proof first, as we all know it's very difficult to revise things inside the EU once they are inscribed in stone, stein, pietra, pierre, lapiz etc.....

bazza | September 28 11:22am | Permalink Report

A bond by any other name...

Penruddock | September 28 8:13am | Permalink Report

The key, surely, is how much it would cost to obtain loans from the EFSF. The authors rather blandly say that the EFSF should pass "low rates" on to borrowers with a minimum service charge, but exactly how low is "low" one wonders? Wolfgang Münchau, writing in this newspaper yesterday, thinks on the basis of very persuasive calculations that borrowers from the EFSF may have to pay rates as high as 8 percent. If he's right, there are not going to be many takers for EFSF loans, one suspects. And would the EFSF be fully capable of rescuing several deficit countries simultaneously? The EFSF has yet to show what it's capable of, but the auguries are nowhere near as cheerful as the authors seem to suggest, and until the EFSF has been put to the test, there's little point in turning it into a "permanent EU instrument" – or so one would suppose.

RiskManager | September 28 8:09am | Permalink Report

Discount loans? A transfer union no less!! Round and round the EUropeans go, cricling the same central truth that cannot be recognised - any monetary union requires large semi permanent fiscal transfers to be sustainable in the medium to long term. Europeans do not want to make any payments however. The EU is a one way deal, or at least that is what they have been told and sold. Until this is faced, what to do?

Well..... how about trying gaffer tape? If it cannot be fixed with gaffer tape, then it cannot be fixed ;-)

The Slog | September 28 7:39am | Permalink Report

We need to wake upon this: numbers are beginning to spill out about just how big the problem's going to be.
Without ESFS Ireland will fail, bit bailing it out is going to empty the coffers.
UK banks are exposed all over the place....breaking...Irish Government ready for the worst...
http://nbyslog.blo...ve-ireland-is.html

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