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What the European Council needs to do to save the euro – and why they probably won't do it

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We have reached the first bifurcation in the eurozone crisis. If Europe's leaders revert to default mode at Thursday summit and come up with a fudge, they risk a premature end to the euro. If they get it right, they might put the crisis behind them. As of now, it is not looking good.

To prevent the ultimate calamity, the European Council should take three decisions, of which only a single one has been prepared by ministers and civil servants. The following list is not about what is desirable, let alone optimal. It is about the minimum needed to avoid the risk of a meltdown.

The first is a credible debt reduction strategy for Greece. At a debt-to-GDP ratio of 160 per cent, Greece is insolvent. The European Council needs to say loud and clearly what a sustainable level would be, and how the debt can be reduced to that level. Europe's finance ministers have wasted months on debating the pros and cons of a default, or a bailout. The leaders must choose one of those options today. If they come out of today's meeting with another confused message, they will have failed. The expectation is that they will avoid anything that smacks of a default. They will improve the terms of the existing Greek loan, and they may levy a special tax on banks, to cofinance the next loan. In doing so, they will once again kick the can down the road.

The second decision would be to increase the flexibility of the European finance stability facility (EFSF). This is politically difficult since Germany in particular insisted on the present restrictions. At the moment, the EFSF can only grant an official credit to an applicant country, which must accept an EU/IMF supervised austerity programme in return. You are either in or out of the EFSF. It would be much better if the EFSF could act pre-emptively. It could have issued guarantees for the national deposit insurance schemes in Ireland or Spain. Or it could have swapped its own bonds for Greek sovereign bonds at a discount. If they had set up a flexible EFSF, there would now be a structure in place that could manage the crisis on a day by day basis. There is no way the eurozone will get through this crisis with the EFSF in its current inflexible form. Officials have been looking at various options to increase the flexibility of the EFSF, including the possibility that it might support primary market bond issues by countries that are not in an EFSF programme. But a secondary market purchase programme is not likely.

The third decision will be the most difficult of all. It would be an extension of the rescue umbrella. The EFSF is big enough for Greece, Ireland and Portugal, but not for Spain and Italy to where the crisis has now spread. Ten-year bond yields are at over 6 per cent in both countries. Italy will have to refinance €400bn of its debt in the next 18 months. At current levels of interest rates, Italy would be insolvent. And it is hard to see how Spain could solve its banking crisis in an economic environment of high market interest rates.

The EFSF currently has a fixed ceiling of €750bn, co-financed by the EU and the International Monetary Fund. To accommodate Italy and Spain, the EU could double or treble the size of the EFSF. But that is technically difficult. Is Italy's 18 per cent share in the EFSF still credible if Italy is itself in difficulty? Can France maintain an AAA-rating, if it guarantees Spain and Italy? If we are doubling, or trebling the size of the EFSF, we are no longer talking about a credit guarantee scheme, but a joint and several guarantee, in other words, a eurozone bond. And that means the EU not only needs to make the EFSF larger, but also change its nature. The European Union must set the foundation for this change today. It does not appear likely that they will announce an increase in the size of the EFSF. They might issue a statement that they would adjust the size if necessary. But they said this before, and it has no legal meaning.

They have wasted the first part of this year setting up silly schemes like the euro-plus pact. They wasted the last two months squabbling about the fine print of a Greek package. Now they have put themselves in a situation where they have to construct a eurozone bond in a few days. Without it, Italy, and possibly Spain too, may not be able to remain in the eurozone.

If they take all three decisions today, the crisis will be over, for now. If they do none of these things, hell will break lose.

What if they only agree of a subset, as is most likely the case? That would depend on the subset. If they agree on a credible programme for Greece, no longer rule out a eurozone bond, but remain vague on the EFSF's flexibility, they may still have to find plausible answers about how to construct effective bond repurchase programmes, and how to backstop national deposit insurance schemes. But it might be sufficient for now.

If they end up agreeing only a half-hearted programme for Greece now, and second and third best options for the rest, the summit will have failed. I suspect that this is what will happen.

The crisis will go on and on. The longer they wait, the harder the choices will be.

The author is president of Eurointelligence ASBL, and an associate editor and columnist of the Financial Times.

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