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.

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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