How to save the euro

It requires urgent action on a huge scale. Unless Germany rises to the challenge, disaster looms

SO GRAVE, so menacing, so unstoppable has the euro crisis become that even rescue talk only fuels ever-rising panic. Investors have sniffed out that Europeu leaders seem unwilling ever to do enough. Yet unless politicians act fast to persuade the world that their desire to preserve the euro is greater than the markets' ability to bet against it, the single currency faces ruin. As credit lines gum up and outsiders plead for action, it is not just the euro that is at risk, but the future of the European Union and the health of the world economy.

It is a sobering thought that so much depends on the leadership of squabbling European politicians who still consistently underestimate what confronts them (see page 73)- But the only way to stop the downward spiral now is an act of supreme collective will by euro-zone governments to erect a barrage of financial measures to stave off the crisis and put the governance of the euro on a sounder footing.

The costs will be large. Few people, least of ali this newspaper, want either vast intervention in financial markets or a big shift of national sovereignty to Europe. Nor do many welcome a bigger divide between the 17 countries of the euro zone and the EU'S remaining ten. It is just that the alternatives are far worse. That is the blunt truth that Germany's Angela Merkel, in particular, urgently needs to explain to her people.

The failure of austerity and pretence

A rescue must do four things fast. First, it must make clear which of Europe's governments are deemed illiquid and which are insolvent, giving unlimited backing to the solvent governments but restructuring the debt of those that can never repay it. Second, it has to shore up Europe's banks to ensure they can withstand a sovereign default. Third, it needs to shift the euro zone's macroeconomic policy from its obsession with budget-cutting towards an agenda for growth. And finally, it must start the process of designing a new system to stop such a mess ever being created again.

The fourth part will take a long time to complete: it will involve new treaties and approval by parliaments and voters. The others need to be decided on speedily (say over a weekend, when the markets are shut) with the clear aim that European governments and the European Central Bank (ECB) act together to end today's vicious circle of panic, in which the weakness of government finances, the fragility of banks and worries about low growth ali feed on each other.

So far the euro zone's response has relied too much on two things: austerity and pretence. Sharply cutting budget deficits has been the priority—hence the tax rises and spending cuts. But this collectively huge fiscal contraction is self-defeating. By driving enfeebled economies into recession it only increases worries about both government debts and European banks (see page 74). And mere budget-cutting does not deal with the real cause of the mess, which is a loss of credibility.

Italy and Spain are under attack not because their finances have suddenly deteriorated, but because investors fret that they may be forced to default. For this loss of confidence, blame the pretence. Europe's leaders have repeatedly denied that Greece is insolvent (when everyone knows it is), failing to draw a line between it and the likes of Spain and Italy, which are solvent but short of liquidity. The excuse is that a Greek restructuring may cause contagion. In fact denying the inevitable has undermined pledges about solvent governments.

Instead of austerity and pretence, a credible rescue should start with growth and, where it is unavoidable, a serious restructuring of debt. Europe must make an honest judgment about which side of the line countries are on. Greece, which is unambiguously insolvent, ought to have a hard but orderly write-down. The latest, inadequate plan for a second Greek bail-out, agreed at a summit in July, should be thrown away and rewritten. But all the other euro members (and on present numbers Portugal is just about in the solvent camp) should be defended with overwhelming financial firepower. All the troubled economies, solvent or insolvent, need a renewed programme of structural reform and liberalisation. Freeing up services and professions, privatising companies, cutting bureaucracy and delaying retirement will create conditions for renewed growth-and that is the best way to reduce debts.

How to prevent contagion? A Greek default would threaten many banks, not just in Greece: this week the markets took aim at French banks that hold southern European debt. Moreover, solvent countries need a breathing-space to push through reforms. That points to agreeing to two measures at the same time: a scheme to shore up the banks, which may take months to put into practice, and a rock-solid promise to support solvent governments, which has to be immediate.

The recapitalisation of Europe's banks must be based on proper stress tests (which should this time include possible default on Greek sovereign debts). Some banks may be able to raise money in the equity markets, but the most vulnerable will need government help. Core countries like Germany and the Netherlands have enough cash to look after their own banks, but peripheral governments may need euro-zone money. Ideally that would come from the European Financial Stability Facility (EFSF), whose overhaul was the most useful thing to emerge from the July summit. But it also makes sense to set up a euro-zone bank fund, together with a euro-zone bank-resolution authority. That is part of the longer-term institution building. However, the ECB could help the banks by giving a commitment to provide unlimited liquidity for as long as it is required, rather than a rolling six months, as now.

The great firewall of Europe

None of this will work unless the Europeans create a firewall around the solvent governments. That means shoring up euro-zone sovereign debt. Spain and Italy owe €2.5 trillion. What if the markets suddenly took fright over Belgium or France? Some have argued for a system of Eurobonds in which every country's debt is backed by all. But the political oversight to ensure that high-spending countries do not fritter away other people's money would take years to sort out—and one thing

• the euro zone does not have is time. The answer is to turn to the only institution that can credibly counter a collective loss of confidence on such a scale.

The ECB must declare that it stands behind all solvent countries' sovereign debts and that it is ready to use unlimited resources to ward off market panic. That is consistent with the ECB'S goal to ensure price and financial stability for the euro zone as a whole. So long as governments are solvent and the bank sells the bonds back to the market after the crisis, this does not amount to monetising government debt. In today's recessionary world, the ECB could buy several trillion eurosworth of bonds without unleashing inflation.

Even so, this is a huge step. The ECB'S German officials have taken to resigning in protest at the limited bond-buying undertaken so far. They fear not only that so young an institution is vulnerable to a loss of credibility, but also that the ECB, which is independent but unelected, could become embroiled in political decisions-especially by declaring a state insolvent and cutting it off. Both these longer-term risks are real, but they are far outweighed by the need to stop the rot. It would be a nonsense if the ECB'S dogged defence of monetary rigour led, say, to an Italian default and a global depression.

A bad deal, or a much worse one?

Put our plan to many Europeans-creditor Germans, debtor Greeks or Eurosceptic Britons—and they may moan that this is not what they were promised when the euro was set up. Completely true, and sadly irrelevant. The issue now is not whether the euro was mis-sold or whether it was a terrible idea in the first place; it is whether it is worth saving. Would it be cheaper to break it up now? And are the longer-term political costs of redesigning Europe to save the euro too great?

The sobering truth about the single currency is that getting in is a lot easier than getting out again. Legally, the euro has no exit clause. If Greece stormed out, and damn the law, as it might yet have to do, it would suffer a run on its banks, as depositors withdrew euros before they were forcibly converted into devalued new drachma. It would have to impose capital controls. Greek companies with international bills would risk bankruptcy, as they would suddenly be without the cash to cover them; and the pressure on other wobbly countries would increase. That is why we favour restructuring Greece, but letting it stay in the euro.

If, on the other hand, a strong country like Germany walked out of the euro, probably taking other strong countries with it, the result would be just as terrible. The new hard currency would soar, hitting German exporters. Turmoil in the rump of the euro zone would batter export markets just as the north's firms became less competitive. German banks and companies, in a mirror image of what would happen in Greece, would suffer from the sudden devaluation of euro assets outside the new hard-currency zone. And the rump might still break apart, as Italy or Spain would not want anything to do with Greece. Amid the debris of broken treaties, wild currency swings and bitter recriminations, Europe's single market could collapse and the EU itself—the rock of the continenfs post-war stability-could start to crumble.

Attaching hard numbers to any of this is difficult. Analysts at UBS, a bank, reckon that euro break-up could cost a peripheral country 40-50% of GDP in the first year, and a core country 20-25% (see page 75). Yes, that is a guess (as are the various estimates for the ongoing costs of break-up and those of a bail-out in future years). But the immediate bill for a break-up of the single currency would surely be in the trillions of euros. By contrast, a successful rescue would seem a bargain. Add together the money already spent on rescues, to what is needed to recapitalise European banks and any potential losses to the ECB, and the total will still only be in the hundreds of billions of euros. If the ECB'S intervention is bold and credible it might not even have to buy that much debt, because investors would step in. In short, the euro zone would be reckless to flirt with collapse when an affordable rescue is possible.

German taxpayers might accept that the immediate costs of our rescue plan are smaller than break-up. But what they detest is the idea that it might let feckless Italians and Portuguese off the hook. Safe in the knowledge that the ECB stands behind their bonds, they may shy away from reform and rectitude.

TWo risks flow from this. The immediate (and real) one is that furious Germans will demand that Greece is thrown out (or bullied out) of the euro to frighten the others. Such a horrific event would indeed scare Portugal and Ireland, but a threat to expel Italy or Spain is empty: they are too big and too tightly tied into the EU. Simply chucking out Greece because it was convenient would permanently undermine the security of small members of the EU. Besides, once Greece defaults and restructures, its economy stands a good chance of making a credible start on its long journey to economic health.

The longer-term risk has to do with "more Europe". Fans of political integration say that the only way to enforce discipline is to create a United States of Europe (see Charlemagne). Perhaps a fiscal union that would supervise the issuance of common Eurobonds? Or a new supervisory role for euro-zone governments, or, heaven forbid, the useless European Parliament? Somewhere behind this also looms the idea that the ins will now be able to boss around the outs. The ten countries, including Sweden, Poland and Britain, that kept their own currencies may face a choice: to join the euro or be excluded from a new "core Europe", which in effect starts setting policies. And, this being Europe, there is every chance that the politicians will try to avoid discussing a lot of this with their electorates.

The Economist concedes that our rescue plan begins with a democratic déficit that needs to be fixed if steps towards closer fiscal union are to work. But there must be ways for good governments to force bad ones to keep in line that do not require the building of a huge new federal superstate. The Dutch have suggested a commissioner in Brussels with power to veto countries' fiscal excesses, and to impose his judgments by law. Mrs Merkel has talked of giving the European Court of Justice the right to impose good behaviour. These are big steps-make no mistake-and because they involve treaty changes they would have to be sold to voters. But they are a long way short of a United States of Europe.

Mrs Merkel, it's time to explain the choices

The outs, in particular, may still be nervous about ali this. So frankly is this newspaper. But the alternative may be the collapse of not just the single currency but the single market and the whole European project. The euro has reached the point where nobody is going to get what they want—something that needs to be spelled out to the Germans more than anybody. Over the past 18 months they have grudgingly supported half-rescue after half-rescue—and the bill has gone up. In the end confidence and credibility are ali. For the ECB to stand behind less prudent countries may be unwelcome to Germans; but letting the euro fali to bits is much, much worse. Spell that out clearly to your voters, Mrs Merkel. •

Fonte: The Economist, London, v. 400, n. 8751, p. 11-12, September 2011.