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A two-pronged defence of the Euro

A combination of the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) is the last chance for a quick solution to the crisis.

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The current weakness of the Euro against the US dollar is not just the result of the different economic and interest rate outlook in Europe and the USA but also reflects the greater scepticism of the financial markets towards the management of the crisis in Europe. This scepticism is comprehensible. While in the past two years there was hope that Europe would still come up with a comprehensive approach to solving the crisis in the end, this led to disillusionment in the second half of 2011. There does not currently seem to be any comprehensive approach to a solution which seems to be politically and legally achievable.

Eurobonds are no longer a solution at the current point in time. It is true that there are numerous coherent proposals which cleverly combine community safeguards and conditionality. But the advocates of community responsibility, to which I belong, must acknowledge that it has not been possible to win the political debate in Germany for the time being. In addition, the constitutional obstacles have been clearly set out since the judgement of the federal constitutional court on the EFSF. If one denies these developments, one would be out of touch with reality.

But the often mentioned ECB solution will not work either. The legal and legitimising basis is missing. Contrary to the USA, the central bank of the 17 different states of the euro area does not have the basis for action to decide which securities from which countries to buy at what point in time. The fact that Silvio Berlusconi was virtually forced out of office by the high borrowing interest rates governed by the ECB has no doubt disturbed the least of Europeans - but there is no democratic basis for this kind of discretionary political participation by an independent central bank. It should not become the rule in any event. The ECB is not allowed to negotiate about conditionalities and should not do so either. The urgently needed quid pro quo - better borrowing conditions against trade-offs - cannot be done via the ECB. That is why Mario Draghi is right when he points to the "spirit" of the EU treaties and resists buying bonds as a minimum necessary measure for the basic functioning of the euro area. The ECB can keep the fire under control but cannot extinguish it.

Even the 'Fiscal Compact' that is currently being negotiated is not a real contribution to the short term solution to the crisis. It is basically right to make it harder to get into debt in the future and to set down a path for consolidation in the constitutions of the member states. But any debt brake is only worth as much as the political will from which it comes. Even after the signing and ratification of the Fiscal Compact, the document is no more than a strong political declaration of will. The Fiscal Compact does not offer real security that problem countries will actually take the route to consolidation. That is why it does not solve the current problem situation. The house is on fire. The new treaty envisages banning playing with fire in the future. That is not wrong but the fire is burning once again.

What can be done? Is there a measure which makes available sufficient but fixed term guarantees to problem countries in the eurozone so that investors basically have no state bankruptcy to fear, which at the same time foresees sufficient conditionalities to continue with the urgently needed consolidation of state finances, and which at the same time also generates the necessary growth stimulus to these countries and altogether again creates a climate of confidence in Europe's crisis policy? Yes, this measure does exist. It is no panacea but could provide an important contribution to the solution of the crisis.

Up until now, the plan was to let the EFSF basically go into the ESM. The credit of around 250 billion euro that has already been handed out by the EFSF (here the second Greek programme has already been taken into account) should be deducted from the existing sum of 500 billion euro in the ESM. Now the passage to the settlement of both instruments in the ESM treaty that has not yet been finalised must be cancelled in order to clearly increase the much talked of fire power (or rather 'capacity to extinguish') in eurozone.

With that Europe would have an effective guarantee of almost a billion euro. If the EFSF would raise its credit line of 440 billion euro by the beginning of the ESM, it would be exactly 940 billion euro - on the basis of the already decided EFSF programme of around 750 billion. The often cited figure of one billion euro in financial market circles would be as good as reached - but this time not via an absurd leveraging construction but by actual guarantees.

But the big advantage of the higher guarantee ceiling would be that it would be automatically limited in time. As from 1 July 2013, the EFSF cannot begin any new programme. From this date on the European volume of guarantees would constantly fall because the successive EFSF borrowings reach the end of their term and no new lending could be done. For the 10-year EFSF loans, the end of the EFSF guarantees would be reached by 2023 at the latest. And the possible guaranteed volumes in the eurozone would then correspond again to the current idea of having a maximum ceiling for the ESM of 500 billion euro.

This solution would also probably be thoroughly attractive both in a political and legal sense. The German parliament would neither have to extend the EFSF guarantee ceiling nor to foresee a clearly higher volume in the ESM. The sum of 500 billion, that has already been known for a long time, would be set down in the ESM. The terms could dispel the concerns of the German constitutional court. So the undertaking seems achievable even if the whole framework of German guarantees would actually rise to around 450 billion euro during the parallel phases of the EFSF and the ESM - depending on the concrete form of the ESM, which we still do not know.

By contrast with the leverage constructions, this solution would be both transparent and easily communicable. The ESM would negotiate conditionalities with overindebted countries and hand out loans as a kind of European monetary fund. The new total sum of almost one billion euro would also make the buying of bonds by the ESM in the secondary market credible and free the ECB from its current dilemma. Other than the ECB borrowing power, ESM activities would be controlled by the national parliaments.

The question remains as to whether the political will actually exists to extend the German guarantees. The past months have shown that all attempts to get around this question via legal or financial detours have been condemned to failure. The combination of the EFSF and the ESM would be a good opportunity to express this political will into an overall package which would be acceptable for eurosceptics too. That should be worth doing for the euro.

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