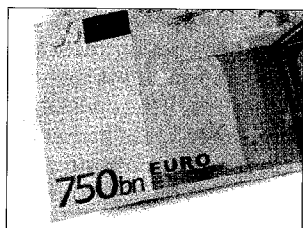


The euro and the future of Europe

No going back

Ambitious but incomplete, the rescue plan for the euro could change the way Europe is run



EUROPE'S €750 billion (\$950 billion) plan to defend its single currency may have been received with euphoria, but it was born of despair. When euro-zone leaders gathered over the weekend of May 8th-9th they faced the sickening reality that

the fear in southern Europe's government-bond markets was spreading to its banking system and beginning to infect global credit markets. This plan was not just about preventing Greece's sovereign-debt crisis spreading to Portugal and Spain. It was about stemming a growing financial panic that could have plunged the world economy back into the quagmire from which it has spent the past two years struggling to escape.

So European leaders were right to act—boldly as well as quickly. For once, nobody could accuse them of lacking ambition. They have committed an awesome €60 billion of EU-backed bonds, a €440 billion fund guaranteed by euro-zone countries, and potentially up to €250 billion of IMF money. The European Central Bank (ECB), a pillar of monetary orthodoxy, turned apostate and set about buying government bonds in order to lower the cost of borrowing for the euro zone's most troubled economies (see page 71).

In the short term this massive show of financial firepower has worked. Bond markets have calmed; the odds of a cascading series of defaults have diminished. The temptation is to declare victory and move on. Yet the job is not even half-complete. This plan buys time, but it does not repair the fiscal and structural flaws that led the euro zone into this mess in the first place. Worse, it comes with risks attached that Europe urgently needs to deal with.

What would Monnet have said?

The starting point is to acknowledge that the plan lacks detail. Nobody is exactly sure how the loan guarantee will work or how the IMF will make its money available. That matters because the stopgap until this is arranged is the ECB, which has now started buying government bonds in the open market. The ECB insists that its actions are exceptional, a short-term response to dysfunctional markets and that it is just as independent from bullying politicians as it ever was. That impression, already battered, will be impossible to sustain if the ECB ends up giving a liquidity lifeline to profligate governments for long.

A still larger question is over moral hazard. You do not have to be a German taxpayer to fret that the corollary of giving weaker euro-zone governments refuge from the bond markets is to ease the pressure on them to cut their deficits. Hard-pressed euro-zone governments now know that, if the worst comes to the worst, they have somewhere to run. In the short term that is an invitation to shirk the hard decisions that still lie ahead. In the longer term it is a recipe for the euro zone's collapse. Having opted for collective insurance, Europe now needs to develop the collective discipline to stop their reserve fund from being abused.

Some safeguards are to be found in the plan itself. Portugal

and Spain were persuaded to announce extra fiscal belt-tightening this week. Any country that borrows from the new stabilisation funds will have to agree on an adjustment programme with the IMF, just as Greece already has. If imprudent economies seek cash from the rescue fund, they will have to import discipline from a body that specialises in imposing it.

But this will surely not be enough. The euro zone's governments must find ways to impose good behaviour long before the profligacy becomes acute. That is the biggest task—not least because the euro's history is replete with failed attempts at doing so. The single currency's architects put their faith in the “no bail-out” clause coupled with a “stability and growth pact”. The rules failed utterly. The sanctions for misbehaviour were not credible: to threaten a deficit-ridden country with huge fines is like chastising a man hanging on to a cliff by treading on his fingers. And too many countries, including the euro zone's biggest members, were allowed to flout the rules with impunity. Worse, no one really believed the “no bail-out” clause, which is why financial markets for too long failed to distinguish profligate governments from prudent ones.

What might work instead? The European Commission this week offered some ideas, from more intrusive and early collective monitoring of national budgets to an incentive system where profligacy is punished by withholding EU funds. These are a good start, but they share many of the flaws of the old ones. The euro zone also needs to think about political tools—denying profligate countries a vote in any euro decisions, for instance. And it needs mechanisms for dealing with failure, such as an orderly system for sovereign-debt restructuring.

This one will run and run

Hardest of all will be finding the political will to curb profligacy. This struggle will become woven into the conflict that now tugs at the political fabric of Europe. German voters have just shown that they will punish leaders who spend their money bailing out feckless foreigners (see page 32). Hence the German demand that countries swallow savage budget cuts before they get any money—a demand that, taken to extremes, could condemn Europe to deflation and stagnation. On the other side, the violence in Greece is a reminder that democratic governments can impose only so much hardship before people rise up. Even if you accept that deficits must fall and economies must modernise, nobody can be completely sure which will come first, economic growth or social rebellion.

The one thing that seems clear is that all this will lead to greater interference in countries' politics (see page 36). But what sort exactly? The French have long fought for a communal *gouvernement économique* with wide powers over taxation and monetary policy—one which would trouble many of its partners (and *The Economist*). The Germans want a different sort of centralisation, built on rules to punish the profligate. But that demands too little of Germany itself. Just as weak southern-tier economies need to free up their labour and product markets and boost competitiveness, so surplus countries like Germany need to promote spending at home. The scene is set for an ugly political battle over how to run Europe. ■