The most critical week for the eurozone

The euro zone summit in Brussels last week was considered to be an epoch making event, having a bearing on the future of the euro and the monetary union. Ahead of the summit, there were any number of scholarly analyses and reports, all of them claiming that the euro is structurally flawed and unless its basic defects are rectified, the crisis in Europe will not abate.

Financial Scene

French President Nicolas Sarkozy (left) walking with German chancellor Angela Merkel to a working meeting during an European Union summit at the EU headquarters, early on December 8 in Brussels.

This line of thinking was in evidence during the talks in Monday last between the leaders of Europe's two largest economies, Germany and France. German Chancellor Angela Merkel and French President Nicolas Sarkozy said that they favor a whole sale change to European Union treaties to restore fiscal discipline and investor confidence in the euro zone. The consensus was that structural changes, which go beyond agreements, are needed.

Germany and France have however, espoused fundamentally different approaches to tackle the euro crisis. Germany has been in favor of fully automatic sanctions (in case any country breached the new fiscal rules) with national budgets submitted are balanced for review by a supranational technocrat as a men's of restoring confidence in the currency bloc. France has favored a more flexible, politically governed approach. It wants to retain the inter-governmental approach, has been found wanting.

The plan that both countries agreed to sell to the euro zone members envisages adoption of tight fiscal rules. National governments should pass legislation to ensure that the national budgets are balanced.

They should have a common corporation and financial transactions tax. The European Commission should have the power to penalize countries than run excessive budgetary deficits.

The third important player in the monetary union, Mario Draghi, President of the European Central Bank (ECB), would like politicians to deliver their part of the bargain before he does. Specifically, the ECB has resisted the pressure to provide unlimited support to the system either by backing the bailout fund or through a long-term guarantee of bond prices.

Crisis affects the whole world

On the eve of the summit, there were not many who were hopeful of a significant breakthrough. But there has been a near unanimity on what caused the crisis and the way forward. Politicians have failed to deliver on their promises of reform and it is this growing cynicism over politicians, which is the single biggest factor, underpinning the crisis. Fear about the ability of states to service their debts has become self-reinforcing. The break-up of the single unthinkable is freely talked about.

Banks in Europe have become extremely vulnerable. Most of them are undercapitalized and face a severe shortfall in funding. Those have made them pull out funds from around the globe. Such is the size of the euro zone debt crisis that the stability of the entire global financial system, not just the portion relating to Europe, is at stake.

What the summit achieved

Britain's veto of a pact aimed at saving the euro divided the members but it forced the euro zone's 17 members led by France and Germany to opt instead for an inter-governmental deal that will be negotiated outside the European Union's legal framework.

Britain held out for safe guards to its financial sector. The new 'fiscal compact' aims for stronger coordination of economic policies in the areas of common interest. Its important ingredients are in consonance with the spirit of the pre-summit Franco-German agreement.

Euro zone states' budgets should be balanced or in surplus; the annual structural deficit should not normally exceed 0.5 per cent of the GDP. These rules will be built into their national legal systems.

If any euro zone member is in breach of the 3 per cent debt ceiling, there will be automatic consequences, including possible sanctions.

In the early days after the summit, it is by no means clear whether the pressure on the euro and the euro zone countries will ease. The reactions from the financial markets have been mixed and only in the coming weeks will there be a clear indication.