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Greek tragedy won't end in the euro's death

The good news: everything is in place for an EU rescue. The bad: Southern Europe's economies will feel the pain for years

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I cannot claim to have predicted the turmoil in Greece, Portugal and Spain when I wrote in early January that "the eurozone will be tested to near-destruction" this year. I was merely repeating what I had written in the depths of the 2008-09 financial crisis.

I can, however, claim some prescience in using the words "test" and "*near*-destruction". For it is now clearer than ever that the single currency will survive this test. And if the conditions that it faces in the Club Med countries continue to deteriorate, the euro's near-death experience will, if anything, accelerate the march towards a fully federalist United States of Europe.

This argument begins with several items of unexpectedly good news, at least from the eurofederalist standpoint. The first is that the EU has the financial wherewithal, the institutional capacity, the legal mechanisms and, most importantly, the political willingness to offer unlimited support to Greece and any other stragglers in the eurozone. The idea that only Germany is strong enough financially to rescue the Club Med and, therefore, that German public opinion will prevent a bailout is eurosceptical wishful thinking.

The most likely structure for a rescue would not require any funding from Germany at all. The rescue would simply consist of a decision, approved by a qualified majority on the European Council to implement Article 122 of the Lisbon treaty.

This article states: "When a [member country] is in difficulties or is seriously threatened with severe difficulties caused by exceptional occurrences beyond its control, the council, on a proposal from the commission, may grant union financial assistance to the member state concerned."

Crucially, such assistance would come straight from the EU itself, not from Germany or any other individual country — and there would be no limit on the amount of help potentially on offer. The beauty of this arrangement is that it would absolve the German Government from any direct responsibility for the bailout while delighting the eurofederalists in Paris and Brussels by finally giving some substance to their demands for an "economic government of Europe". This call, incidentally, is explicitly repeated by Herman Van Rompuy, the new EU President.

But who would actually pay for such an EU bailout? This brings us to the second reason why eurofederalists should be delighted with recent events. As it happens, the European Council quietly approved an increase in the EU's borrowing powers from €12 billion to €25 billion in December 2008 and to €50 billion last April. This borrowing was approved to make sure that the EU had plenty of money to help new members such as Hungary, Latvia and Romania, which have not yet joined the euro. To extend the facility to all EU countries would take just another quick majority decision. And given that EU bonds are automatically guaranteed by all member governments, including Germany, France and Britain, there would, in practice, be no limit to the amount that could be raised overnight.

Which leads to the third item of cheerful euro-news. Because of the EU's essentially unlimited borrowing powers, a rescue plan along the lines above would never have to be implemented once it was announced. If investors knew that Greek government debt had an EU safety net, they would be delighted to keep lending money to Athens at almost double the interest they are getting from Berlin or Paris. Greece would, therefore, have no trouble in refinancing its borrowings and the crisis would be over without any EU money actually flowing to Greece.

Where, then, is the catch? The answer lies in that old central bankers' bugbear from the long forgotten days before Lehman and Northern Rock, "moral hazard". If all the profligate politicians and voters in

Southern Europe (or indeed in Westminster, Paris and Dublin) were offered unlimited EU guarantees, there would be no end to the fiscal debauchery.

To overcome this moral hazard, countries requiring an EU bailout must be forced to take some serious pain. That, in itself, should not preclude a Greek rescue, since its Government has announced drastic tax increases, reductions in public sector wages and reforms to its pension systems designed to reduce its budget deficit by 9 per cent of GDP over the next three years. And despite all these painful reforms, the Papandreou Government's popularity has risen since it won a big election victory four months ago, suggesting that it will probably be able to carry out its plans.

But now we must turn to the bad news. For Greek voters to continue accepting the necessity of bitter medicine, the country must remain under severe financial pressure. This means that investors must be left in sufficient doubt about the terms and duration of any guarantees to keep demanding such high interest rates from Greece. That, in turn, means that financial conditions in Portugal and Spain must also remain uncomfortable.

Which brings us to the worst news of all. The extreme deflationary policies now being imposed on the weakest eurozone countries point to frightening implications. The Greek and other Club Med governments can slash their deficits only at the cost of huge falls in economic activity. Without the possibility of devaluation they cannot hope for big export gains, nor even for the capital inflows that have helped to end the slump in British property.

Instead of the broadly Keynesian policies that have helped to revive growth not only in America and Britain but also in Germany and France, these weaker members of the eurozone are pursuing measures that are almost guaranteed to prolong and deepen their recessions.

And now, to make matters worse, Germany is planning to cut its own budget deficits and to rely for the next phase of its recovery on export-led growth — which can only mean crushing even more Club Med businesses unable to compete against German goods.

Unlike most Greek tragedies, this one has many possible endings. Germany could adopt full-scale Keynesian policies that encourage its domestic consumers to spend and borrow more money. The EU could ease the financial constraints on the weaker members of the eurozone by offering to lend them vast sums of money on preferential terms. Or, in the very long run, the euro could, after all, break up. Nobody can say which ending is most likely. But we in Britain can count ourselves lucky to be watching this drama from a safe vantage point outside the eurozone.

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