My undemocratic survival plan for the euro

The single currency will probably pull through, but only a full-scale federal Europe will keep it secure

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Sometimes it is best just to admit that you were right — and then move on. Yes, I did say right. Many predictions about what could be the most important event of the coming decade — an imminent break-up of the euro — come from people who have said all along that the euro was a fatally flawed project, a Frankenstein's monster with the superficial trappings of a genuine currency, but without the political and economic coherence that would truly give it life. Speaking as one of these longstanding Eurosceptics, it has been tempting to say: "I told you so."

That, however, would probably be a mistake. If Europe can avoid a financial breakdown at the end of this month, when its banks undergo stress-tests to expose which are potentially insolvent, then the euro will almost certainly survive. Indeed, this could be the year when the single currency mutates from being a morbid enterprise that is threatened by its internal contradictions into the project to create a United States of Europe that its architects always intended.

Although I am saying that the euro is likely to survive, I yield to no one in my opposition to the single currency, which I believe to be undemocratic, economically damaging and intellectually incoherent.

I also pointed out years ago that the euro's survival depended on a financial circle of manipulation: German property investors and banks recycled their excess savings to the heavily indebted countries on the periphery of the eurozone, whose farmers and homeowners then sold or mortgaged their land at exorbitant values and used the money to buy German cars.

This process was exactly analogous to the recycling of capital from China to America, but with a difference. The European recycling was potentially more dangerous and unstable than the US-China circle of manipulation, because lending to America was a policy deliberately undertaken by the Chinese Government, whereas Germany's capital flow to the Club Med depended on private individuals and banks. Once the private-sector recycling came to a standstill following the Lehman crisis, Europe faced a stark choice. Either the euro would break up or the recycling of capital by German banks and private savers would have to be replaced by government-to-government support between Germany and the Club Med.

> Just because something is undesirable doesn't mean it cannot happen

Since the Maastricht and Lisbon treaties explicitly prohibited such mutual assistance, and since German voters would have overwhelmingly opposed such government bailouts, many Eurosceptics concluded that the euro would fall apart. But it is always a mistake in diplomacy to assume that, just because something is undesirable, unlawful or undemocratic it cannot happen. The main argument against the Maastricht treaty that we Eurosceptics have been presenting for the past 20 years has been proved right. Sustaining the monetary union is impossible without creating mechanisms for a full-scale political and fiscal union, involving mutual support between governments and transfers of taxpayers' funds from the stronger to the weaker regions.

Europe's politicians were finally forced to accept this inexorable logic on the historic weekend of May 9-10, when the Greek, Portuguese and Spanish government bond markets and banking systems came to the brink of a Lehman-style meltdown. But instead of abandoning the monetary union, as many of the Eurosceptics had expected or at least hoped, European politicians moved towards a full-scale fiscal and political union.

They did this by creating what was in effect a huge federal borrowing programme, backed by the full faith and credit of all the eurozone governments. In doing this they shamelessly ignored the no-bailout clause of the Maastricht and Lisbon treaties, which specifically prohibit eurozone governments from collaborating fiscally to guarantee each others' debts. As one of the main authors of the treaties noted, the no-bailout clause had taken ten years to negotiate, but ten minutes to tear up.

The good news for the euro, therefore, is that governments now have both the will and the way to channel excess savings from Northern to Southern Europe. For the single currency to prove sustainable in the long term, however, this mechanism will have to be made permanent, and evolved into a full-scale federal European budget whereby poorer and less competitive areas are permanently supported by richer regions, just as London supports Scotland and Massachusetts supports Mississippi.

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For this to happen, three key conditions will have to be satisfied. In the next few months, the European Central Bank must be willing to offer unlimited and unconditional support to Club Med banks and governments whenever private savers show signs of withdrawing their money. Only a central bank's unlimited monetary fire-power can restore confidence once savers start to withdraw from a national financial system.

Henry Paulson's troubled $700 billion asset-relief plan was not enough to restore confidence after Lehman until the Federal Reserve offered unlimited lending to all financial institutions. In the same way, the ECB must make clear that it will provide unlimited and unconditional backstop lending to support whatever bailouts the European governments arrange. Such support will be particularly crucial in the next month or so, as the bank stress-tests potentially undermine confidence in some of Europe's leading banks.

In the long term, public spending and tax policies in the Club Med countries will have to be brought into closer alignment with those of Germany. Fiscal transfers will be politically toxic if the Greeks don't raise their retirement age of 60 or 62 towards that of Germany's 67. Once it becomes clear, however, that the whole eurozone is converging on a single concept of the welfare safety-net, the politics of fiscal union should become manageable, even if not popular.

Which leads us to the final condition for the euro to survive. Voters must not be asked to give their verdict directly on the euro programme. Even assuming substantial fiscal convergence, German taxpayers will never vote for their money to be spent on supporting Greece, Portugal and Spain. But luckily for the euro's survival, German voters will never be asked this question. The construction of a federal Europe has never relied on democratic support, merely on acquiescence and the force of habit. The creation of a viable single currency, backed by a European federal budget, will merely be the next stage of this non-democratic process.