A Eurostate or bust – the big Brussels gamble

The bailouts don't work but they do allow the EU to build up centralised power at the expense of nation states

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Another year, another train crash between politics and economics in Europe. One year ago, at 1am on Monday, May 10, 2010, the leaders of the EU took what seemed their boldest step yet towards the creation of a full-scale European political federation, bolder even than the launch of the single currency in 1999. This was the creation of a €750 billion fund, guaranteed collectively by all European taxpayers, to protect EU nations from the choice facing Greece that night: to abandon the euro or to declare itself bankrupt by defaulting on its government debts.

A year later, it is clear that the Greek bailout failed. Europe has, therefore, decided to repeat it.

Greece has missed most of its economic targets. It has exhausted €75 billion of the €110 billion emergency loan and its Government acknowledged last week that another huge bailout will be required to meet next year's debt repayments. Dissident German officials are judiciously leaking suggestions to the financial media that Greece could be expelled from the eurozone or that Athens will soon default. And indeed, the few private lenders to Greece who have not unloaded their bonds on to the European Central Bank or the EU bailout funds now face a 60-75 per cent probability of default. Meanwhile, the ECB and the European Commission continue to ridicule any idea of default or restructuring as "unthinkable", as they did a year ago.

There are, however, four important new elements to this rerun of the European financial crisis. The first is that instead of Greece alone, three, perhaps four, countries now face bankruptcy or expulsion from the eurozone: Greece, Ireland, Portugal and possibly Spain. Moreover, it is now much clearer that a Greek devaluation or default would trigger similar events in Ireland and Portugal and that Spain and Italy would be extremely vulnerable if the first three dominoes went down.

> The money lent last year was merely a down payment

Second, the total cost to taxpayers in Germany and other creditor countries of supporting Greece, Ireland and Portugal will be much higher than seemed likely last year because last year's bailout funds were largely spent on repaying private lenders to these countries and their insolvent banks.

Last year it was possible for EU taxpayers to share the burden of the bailouts with private investors who had foolishly lent money to the Greek Government and the bust Irish banks. Now many of these investors have been repaid in full, leaving much less scope for "burden sharing" between the remaining private creditors and governments. If and when a large part of the Greek and Irish debts are ultimately written off, most of the losses will fall on EU governments and the ECB. Within a year or two, this process of lending new money to debtor countries to repay private creditors will result in the entire national debts of Greece, Ireland and Portugal being owed to EU governments and the ECB.

Third, the political resistance to another round of bailouts will be even more intense than it was last year, not only in Germany, Finland, Austria and the Netherlands, but also among the debtors. The 2010 bailouts have whipped up powerful anti-European sentiment in both creditor and debtor countries.

In Greece, Ireland and Portugal, popular resistance to further tax rises and spending cuts will surely intensify as governments keep missing their financial targets despite last year's belt tightening. In Finland, Germany and other creditor countries, xenophobic parties are gaining ground as it becomes apparent that the money lent last year was merely a down payment, leaving the eurozone's fundamental problems unresolved and taxpayers staring into a bottomless pit.

Finally the good news, although not necessarily for Europe's leaders and central bankers: the global economy is much stronger than it was a year ago and could probably withstand a write-down in government debts, especially if it were carried out in an orderly manner, with EU governments jointly guaranteeing the reduced debts that remained.

So why do Europe's politicians and central bankers refuse even to think about debt restructuring and instead continue to lend money to Greece, Ireland and Portugal that simply goes to repay their private creditors?

Apart from the fear of triggering a Lehman-style banking meltdown — a threat that could easily be averted by creating a pan-European financial guarantee fund much smaller than the bailouts now under way — Europe's central bankers have a vested interest in spreading terror about the very idea of restructuring. The ECB itself is now by far the biggest holder of Greek, Irish and Portuguese bonds and would suffer enormous losses if their value were reduced. In addition to the €80 billion that it owns outright, the bank holds more than €500 billion of these toxic bonds as collateral against its loans to Irish, Greek and Portuguese banks. Since most of these banks would become insolvent in a big debt restructuring, the ECB would be left with hundreds of billions of euros of bust government bonds. With total capital of only €11 billion, the ECB itself would be bankrupt unless European governments provided a huge bailout. This would, of course, be forthcoming but perhaps only at the cost of increasing political influence in the ECB.

> Progression from the euro to full federalism is exactly on schedule

The political motivation for tightening the debt yoke on Greece, Ireland and Portugal is even clearer. By turning these countries into permanent debtors to the ECB and the various EU bailout funds, Brussels and Frankfurt are enormously increasing the power of centralised European institutions at the expense of nation states. While the unprecedented control of national tax, spending and social policies now exercised by the ECB and the Commission is presently confined to Greece and Ireland, the bailout exercise has set precedents and created institutional capabilities that can gradually be extended to the entire EU.

The inevitable progression from monetary union to fiscal federalism and ultimately to full-scale political union was predicted by both Eurosceptics and Eurofederalists in 1989 when the single currency was first suggested by Jacques Delors and again in 1999 when the euro was created. The journey from the single currency to full-scale political federalism is taking a somewhat different route from the one expected — but it is proceeding exactly on schedule.

The question is whether Europe will get to its intended destination before Greek and Irish workers or German and Finnish taxpayers decide that they have been taken for a ride.