To save the euro, the crisis must get worse

Only when the currency is on the brink of collapse will Germany accept that it has a duty to bail out Greece

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There are only two possible solutions for the Greek crisis, which reaches its next (though not its last) climactic moment this morning, with a parliamentary vote on whether to accept the intensified austerity demanded by the EU and IMF.

The first solution would be for Greece to default on its debts and leave the euro. This would allow a return to business as usual. By issuing a new paper currency that it could print without limit, the Greek Government could provide itself with the wherewithal to continue paying its civil servants, pensioners and corrupt officials, albeit at the risk of suffering Weimar-style inflation.

The second would be for the EU to accept collective responsibility for roughly half of Athens' debts. If its debt burden were lightened from the present 150 per cent of GDP to around 80 per cent — roughly the level in Germany, France and Britain — Greece could hope to become a functioning economy again.

This second solution is much more likely, because a break-up of the euro is unacceptable to the German and French governments — and a break-up would surely follow a sudden Greek default. If Greece found itself unable to borrow in euros and devalued its citizens' savings into a new currency, the Irish would fear similar treatment and immediately transfer their savings to German banks, destroying Ireland's banks and forcing it to exit the euro. That capital flight, in turn, would pose a mortal danger to the membership of Portugal, Spain, Italy, Belgium and even France.

Europe will therefore be compelled to give Greece more money even if its politicians vote against the austerity policies today. And having lifted a large part of the Greek debt burden, Europe can hardly deny equal treatment to Ireland and Portugal, which are far less culpable for their financial plight.

In the end, the creditworthy euro

Ireland and Portugal are far less culpable for their plight

members will have to accept collective responsibility for around €500 billion of Greek, Irish and Portuguese debts if they want to ensure the single currency's survival. That may sound like a huge figure, but in relation to the eurozone's total GDP of more than €10 trillion, it is an easily manageable sum. Politically, however, it will be impossible to transfer this debt from national to pan-European taxpayers without some big institutional changes. As explained this month by the President of the European Central Bank, Jean-Claude Trichet, the EU will have to create a new institution fulfilling the key functions of a federal European finance ministry: to manage and guarantee public debts on behalf of all the eurozone nations and to exercise a power of veto over tax, spending and social policies in all the eurozone states.

If the EU could create such an institution it could quickly resolve the euro crisis. What, then, is the problem? Quite simply that the fiscal federation proposed by Mr Trichet is at present unacceptable to public opinion — both in solvent countries such as Germany and bankrupt ones such as Greece.

The creditor countries do not want to accept an additional euro-federal debt burden, while the debtor countries are even more resistant to the loss of national sovereignty and democratic self-determination that centralised tax, spending and social welfare policies would imply.

The implication is that both the creditor and the debtor countries will resist the only possible solution to the euro crisis until they have exhausted every possible alternative. Even to maintain the present unstable equilibrium in the European financial system will require a continuous sense of crisis. For only in an atmosphere of crisis will Germany continue financing the debts of the bankrupt nations — and only in a desperate situation will Greece, along with other debtor nations, even pretend to implement the painful austerity policies the Germans demand as a quid pro quo.

Ironically, therefore, a continuous threat of crisis is the necessary condition for even a temporary financial stability in Europe. As for the "quantum leap" to fiscal federalism that Mr Trichet has rightly identified as the key to the crisis, the logical requirement for this to happen is that the crisis must get even worse.

European leaders hope, by contrast, that the crisis can be resolved

The Germans and French would pay any price to placate Greece

gradually, avoiding the need for radical measures, because conditions will improve through the passage of time. This approach of "kicking the can down the road" is by no means stupid, since time can be a great healer. Banks can rebuild their capital, the world economy can strengthen and voters can be reconciled to fiscal federalism — or bored and confused to the point where they no longer care.

There are, however, two much more powerful ways in which time works against the euro's survival. The first is random shocks and policy misjudgments. If progress can only be achieved by bringing the euro to the brink of collapse and then pulling it back with an improved ad hoc solution — and if this continues for years rather than months — then it becomes much more likely that someone will step over the brink at some point, as the US Government did in the Lehman disaster.

The second big risk is that time will make public opinion more hostile instead of more compliant, especially in the debtor countries. The anger of Greek voters will intensify, probably spreading to Ireland, Portugal and Spain. Voters in debtor countries will also realise that they have more bargaining power than their leaders let on. So strong is the German, French and EU commitment to the euro that they would pay almost any price to placate Greece or Ireland if they threatened default. And even in the unlikely event that creditor countries called the Greek or Irish bluff, default would not necessarily be a disaster.

Nations have often defied creditors, restructured debts and then returned to prosperity, belying the dire prophecies of their own leaders. The latest example was Iceland, where a referendum repudiated a debt deal with Britain and the Netherlands last month. The consequence was not the financial meltdown predicted by Icelandic leaders. Instead, Iceland's credit rating was upgraded and its access to global bond markets restored. Whether Greece, Ireland or Portugal would enjoy similar benefits from default is unclear, but their voters will be tempted to try their luck.

"Kicking the can down the road" is therefore a strategy for disintegration and conflict. If Europe's politicians genuinely want to save the euro, they must make the quantum leap to a fiscal federation — and do it soon.