Europe's financial hurricane is about to hit

Italy's bond market turbulence means the EU faces an immediate decision: political union or scrap the euro

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The endgame for Europe is approaching — and much faster than anyone expected. With this week's sudden outbreak of panic in the Italian bond market, which had previously seemed immune from the crisis, the choice between a full-scale political union and the disintegration of the euro is becoming impossible to postpone much longer. Italy, unlike Greece, Ireland or even Spain, is a huge economy. But what makes Italy's role even more decisive is the vast size of its bond market and its national debt.

Italy's bond market is the third largest in the world, after the US and Japan, and far larger than those of Germany or France. If Italian investors started selling in earnest, the tide of money out of the country would overwhelm the ability of the German or French governments to intervene.

The huge size of Italy's bond market does not reflect the behaviour of the Berlusconi administration but the accumulated borrowing of profligate governments over the previous fifty years. Silvio Berlusconi, despite his lightweight reputation, actually has run one of the toughest budgetary policies in the world in the past few years — and this created a false sense of security among bond investors. In the past week, however, market attention abruptly shifted from the quite moderate flow of Italy's new borrowings to its vast accumulated stock of past debts. This sudden shift has revealed Italy to be Europe's next most vulnerable economy, only just behind Greece.

Is this shift of investor focus just another case of the irrational herd instinct? The answer in this case is clearly no. In fact, the decisions made by EU ministers were directly responsible for the panic in Italian bonds.

Last week, in their latest fumbling effort to deal with the Greek crisis, one eurozone finance minister leaked a plan for Athens to redeem some of its bonds at their present market prices, which is only about 50 per cent of the face value. This was designed to relieve the Greek Government's debt burden, which the EU has belatedly accepted as unsupportable — and to ensure that private investors bear some of the consequent loss. So far, so good. What the EU politicians did not seem to realise was that a plan to wipe out half the value of Greek government bonds might be seen as a warning to bondholders of other indebted EU countries. Italian bonds, trading a week ago at 100 per cent of their face value, immediately collapsed as some investors began to speculate that their bonds, too, might be redeemed at only 70 or 80 per cent of their face value.

> Italy's bond market is the third largest after the US and Japan

The upshot is that Europe now has to come up with a comprehensive and convincing solution to its debt crisis more urgently than anyone had imagined a few days ago. For if the flow of money out of the Italian bond market accelerates through the summer, the crisis could spin out of control, causing a break-up of the euro as early as September or October, the "financial hurricane season" when serious financial disruptions generally occur.

The broad outline of a solution is clear enough, since there is only one real alternative to a break-up of the euro. This is to reinforce the single currency with an EU fiscal policy, administered by an EU finance ministry and backed by rapid progress towards a federal political union.

It has been obvious since the eruption of the Greek crisis that, if the euro was to be preserved, a "quantum leap" to fiscal and political union, as Jean-Claude Trichet, the President of the ECB, described it, would sooner or later be required.

Until this week, however, it seemed that the choice between financial disintegration and political federation could wait for another two or three years. That was certainly the hope of Europe's politicians, since they would face huge hostility if they proposed the loss of national sovereignty implied by shifting decision-making on taxes, public spending and social security from national parliaments to the European level. In the minds of most politicians, and particularly of the Germans, at least two years would be needed to soften up public opinion before such controversial reforms could be openly discussed.

Even Mr Trichet, who in a speech last month called for Europe to "go as far as possible in the direction of an economic and budgetary quasi-federation", has acknowledged that public opinion may not yet be ready. A centralised EU finance ministry, he argued, was a logical and necessary complement for the single currency and single market, but it could only be contemplated "tomorrow, or the day after tomorrow". It now seems, however, that Mr Trichet's timescale may need to be taken more literally than anyone expected when he spoke last month.

> This crisis could cause a break-up of the euro as early as September

The two main functions of the EU finance ministry proposed by Mr Trichet are urgently needed to prevent the crisis spiralling out of control. The first function would be the authority to issue bonds and to guarantee national debts, using the full faith and credit of all the governments and taxpayers of the entire eurozone, or perhaps the entire EU. Like all EU leaders, Mr Trichet has always been carefully ambiguous about any role that might or might not be played by Britain and other non-members of the euro.

If such a pan-European entity, with unlimited borrowing powers, could be created to spread the responsibility for national debts across the entire eurozone, the crisis could be quickly resolved. This is effectively what Italy, France and several other nations have been advocating since last November, through the creation of so-called E-bonds, jointly guaranteed by all European governments, to replace half or more of existing national debts.

The problem is, of course, that taxpayers in Germany, the Netherlands and other northern European countries vehemently oppose the creation of such a "transfer union" to support their profligate southern neighbours. Which is why the leap to fiscal union would require a second, more controversial, reform.

The incipient EU finance ministry would need a veto over major tax, spending and social decisions by member governments. But the loss of national control over tax rates, retirement ages and government employment arrangements would make fiscal federalism even more controversial for the southern debtor countries than among the creditors in the north.

Will Europe be ready for a "quantum leap" before the financial markets break up the euro? Nobody knows for certain — but we will have to find out before long.