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Crises and bailouts are what's best for the euro

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We have three options: collapse of the currency (disaster), Germany forced out (no chance), or stagger on

Another month, another failed Euro-summit — the seventeenth in the two years since the Greek crisis. Monday's summit failed to agree on policies for growth and on details of a new austerity pact. Angela Merkel embarrassed everybody with a plan to impose Euro-viceroys on Greece and other debtor countries. And financial markets concluded that Portugal would inevitably follow Greece into debt default.

Given this farrago of incompetence, David Cameron is rightly terrified of the collateral damage if the euro blows up. The best thing Mr Cameron could do to help the British economy, as well as his colleagues in Europe, would be to offer them some disinterested neighbourly advice — to spell out clearly the conditions necessary to save the euro and draw from these three possible scenarios, one of which Europe's politicians must now choose.

The fatal flaw in the euro project is that a single currency requires a single fiscal policy and a single fiscal policy requires a single political authority. In short, the eurozone must turn itself into a fully fledged federation, the United States of Europe. The problem is agreeing on what exactly federalism should mean.

Three aspects of federalism are necessary conditions for the euro's survival: fiscal federalism, which means collective responsibility for sovereign debts; political federalism, which means centralised control over tax and spending; and monetary federalism, which means political control over the objectives — though not necessarily the daily operations — of a central bank, one of whose primary duties must be supporting a healthy market in government bonds. All these conditions might still not be sufficient for the euro's survival, since they would not guarantee competitiveness or economic growth, but at least they would give the euro a fighting chance.

Once these three aspects of federalism are recognised, they imply three scenarios for the euro's future.

In the best case, the euro governments would agree a full-scale federal treaty, incorporating not just the political federalism demanded by Germany but also the jointly guaranteed European bonds and political control of the European Central Bank that Germany refuses to discuss. Such a comprehensive deal is today unrealistic because of German resistance, but if Mrs Merkel genuinely wants to prevent the euro from collapsing, Europe will have to stagger along in this direction for the next few years.

Such a long transition period will be very unstable. Whenever conditions improve, political backsliding in the South or second thoughts in Germany will trigger new crises. Whenever economic conditions deteriorate, despair will force debtor countries to re-examine their options while Germany's political bullying will intensify. So the best-case scenario is one of recurrent crises, followed by new bailouts, periods of relief, over-optimism and then political backsliding or missed targets, and new market panics, followed by bailouts.

Now consider the worst case. If Ms Merkel succeeds in imposing her present one-sided treaty, and if her demands are taken literally, then the euro will surely collapse. The treaty as it stands gives Ms Merkel everything she demanded while offering nothing in return. Greece and the other debtors are condemned to endless austerity and German economic colonisation, with no reciprocal benefits, since joint debt guarantees or monetary easing have been ruled out.

If anything like this deal is actually implemented, public protests will become irresistible and Greece will be forced out of the euro. Once this happens, the euro will effectively change from an "irrevocable" currency union into a temporary fixed exchange-rate peg of the kind that markets always attack — and the main attackers will not be speculators but ordinary citizens and savers.

If Greek savers lose half their savings when euros are converted into new drachmas, the citizens of Portugal, Spain and Italy will not wait idly to suffer a similar fate. They will immediately pull trillions of euros out of Spain and Italy, a capital flight too powerful even for the ECB to resist. And once Italy and Spain are out of the euro, France will follow, with French farmers rioting against devalued tomatoes and Renault's French factories undercut by Spanish factories whose costs are suddenly reduced by 30 per cent. This domino effect would be the most chaotic and destructive form of currency break-up. Yet many German politicians and business leaders fail to understand this and now openly advocate the expulsion of Greece and other "weak" countries, believing this would strengthen the euro, rather than destroy it.

The widespread misunderstanding of finance in Germany brings me to a third scenario, between the best and the worst. Instead of meekly accepting the misconceived German treaty, the other members of the euro could turn the tables on Ms Merkel. They could agree among themselves on a properly balanced federal treaty and present it to her with an ultimatum: Germany could stay in the euro on terms acceptable to the other members, or pull out. A euro without Germany would immediately become more stable, since Germany runs huge trade surpluses with all the other members; Germany refuses to allow jointly guaranteed debt issues; Germany prevents the ECB from supporting government bond markets; and Germany refuses to relax its own fiscal policies to support growth. In short, Germany is willing to "do whatever it takes" to save the euro, apart from any of the things that would actually work.

Germany's exit from the euro would be far less disruptive than the expulsion of Greece, Spain, Italy and France, since it would not trigger any capital flight or domino effects. But at present, Germany's expulsion from the euro is inconceivable because it would break the Franco-German alliance. Yet France would be the biggest gainer from such a move, no longer forced to play second fiddle, and would become the unchallenged leader of the eurozone and hence of the EU as a whole. For this very reason, Germany would almost certainly stay in the euro if faced with an ultimatum. It would then be Germany's turn to accept meekly the treaty conditions dictated by France, Italy and Spain.

The eurozone leaders have shown that they lack the understanding and courage to call Ms Merkel's bluff and thereby save the euro. It is time for David Cameron to offer them some neighbourly advice and guidance.