

Opinion: Europe's choice is to integrate or disintegrate  
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The aim of the rescue package agreed for Greece cannot conceivably have been to prevent a default. For all the daunting austerity and structural reform it requires, the numbers do not add up. The main purpose I can detect is to reverse the rise in Greek bond yields and stop contagion.

We should not knock this deal from Athens. The eurozone might not have survived otherwise. This column would have been an obituary. I am also glad to note that those in charge gave a positive answer to a question I posed last week, which was whether the authorities would ever get ahead of the situation. They did, and they deserve credit.

But in spite of the readiness to accept extreme austerity, Greece will not get by without some form of debt forgiveness. I can understand why the International Monetary Fund and the European Union did not want to open that can of worms at this point. It would have prolonged the negotiations. In the middle of an acute bond market crisis one has to manage expectations very carefully.

A debt restructuring will eventually be necessary, however, because Greece's debt to gross domestic product ratio is going to rise from its current 125 per cent to about 140-150 per cent during the adjustment period. Without restructuring, Greece will end up austere, compliant, and crippled.

Greece promises harsh cuts in exchange for bailout

The decision to take Greece out of the capital markets for three years will prevent immediate ruin but has only a marginal impact on the country's future solvency. The underlying assumption of the agreement is that Greece can sustain austerity beyond the time horizon of the accord, without falling into a black hole. The latter is particularly optimistic. Standard & Poor's, the rating agency, last week estimated that Greece would not return to its 2009 level of nominal GDP until 2017.

Last week gave us an inkling of the vicious circles at play in such a crisis. First, a country's financial situation deteriorates. Then a rating agency downgrades the debt, which in turn triggers a rise in market interest rates. That leads to a further financial deterioration.

Another such loop goes via the banking sector. If a government's solvency is in doubt, so is the solvency of the banks, whose liabilities are guaranteed by the government. Last week, the banking sector in large parts of southern Europe was in effect cut off from the capital markets.

Angela Merkel and her inexperienced economic advisers have no idea about the dynamics of sovereign crises. They never bothered to look at the experience of other countries, notably Argentina. Waiting until the moment a country is about to fail -- which is how the German chancellor interpreted the political agreement she accepted in February -- constitutes an abrogation of leadership that is bound to end in financial ruin. It means that everybody, Germany especially, has to pay billions of euros more than would have been the case if the EU had sealed this in February.

On my estimate, the total size of a liquidity backstop for Greece, Portugal, Spain, Ireland and possibly Italy could add up to somewhere between €500bn (\$665bn, £435bn) and €1,000bn. All those countries are facing increases in interest rates at a time when they are either in recession or just limping out of one. The private sector in some of those countries is simply not viable at those higher rates.

As I have argued before, three things are required if the eurozone is to survive in the medium term: a crisis resolution system, better fiscal policy co-ordination, and policies to reduce intra-eurozone imbalances. But this is only the minimum necessary to get through the next few years. Beyond that, the eurozone will almost certainly need both an embryonic fiscal union and a single European bond.

I used to think that such constructions would be desirable, albeit politically unrealistic. Now I believe they are without alternative, as the experiment of a monetary union without political union has failed. The EU is thus about to confront a historic choice between integration and disintegration.

Germany can be relied on to resist every one of those measures. In the meantime, European leaders will treat each new crisis with the only instrument they have available: an injection of borrowed liquidity. But this instrument has a finite lifespan. If it is not blocked by popular unrest, it will be blocked by constitutional lawyers.

On one level, I agree with those lawyers. There can really be no doubt about what the "no bail-out" rule was intended to mean. It meant that Greece should not be supported. The EU had to resort to some unseemly legal trickery to argue that advancing junior loans at a massive scale to an effectively insolvent country does not constitute a bail-out. The clause -- Article 125 of the Lisbon treaty -- is irresponsible. If you follow it, you end up breaking the eurozone. So far, the choice has been to break the clause instead, and now would be the right moment to change it.

So what is the endgame of the eurozone's multiple crises? For Greece it will be debt restructuring, a polite term for negotiated default. The broader outcome is more difficult to predict: it will either be deep reform of the system or a break-up.