Alice in Euroland

If you have a taste for make-believe, fantasy and unreason the shifts and contortions of the European elite in the face of the Eurozone (EZ) crisis, culminating in the latest plan for the European Central Bank (ECB) to purchase unlimited quantities of the bonds of EZ members in financial difficulties, have left you spoilt for choice over the last few months.

Since the beginning of the year ineffectual high-level meeting has followed ineffectual high-level meeting, all of them grandly trumpeted as solving the crisis for good. Meanwhile three of the largest EZ economies – France, Spain and Italy – are moving steadily nearer the event-horizon of the black hole of debt default.

The mathematics of debt default are simple and inexorable. If you pay more in interest on your debt than you earn in income you will sooner or later default. Nonetheless the political, financial and bureaucratic elite of the EZ continue to pretend, not least to themselves, that they are moving resolutely towards a durable solution to the EZ crisis which will decisively confirm the strength and reliability of the Euro as an alternative global reserve currency and enable the members of the EZ community to return to solid growth.

The most recent figures are as follows:

	France	Italy	Spain
Debt as % of GDP:	90	123	81
10-year bond rate % p.a.:	2.2	5.1	5.6
Fiscal deficit as % of GDP, 2012:	-4.5	-2.5	-8.0
Growth rates % p.a., 2012:	0.0 (falling)	-2.4 (falling)	-1.6 (falling).

Thus, in the absence of an unprecedented, strong and durable turn-round, France and Spain will reach the 100% debt/GDP default event-horizon in about 3 years. Italy passed it some years ago but has hitherto survived thanks to complacent EZ 'convergence' thinking and the fact that much of its debt is held domestically (though the rise in the rates for Italian debt issues this year suggests that this reprieve is now at an end).

Ominously, as the crisis has worsened, the last 18 months has seen serious capital flight out of the peripheral economies. This is now accelerating; Spain lost Euros 163 billion (16% of the country's GDP) in the first 6 months of this year and Euros 74 billion in July alone. Greece has already lost 30% of its bank deposits. Unless capital controls are introduced soon, this flight will continue; if so, this would effectively mean the end of the EZ. The flight money is moving partly to financially sound EZ members (Germany, Netherlands) but also, increasingly, out of the EZ altogether (Switzerland chiefly) to avoid any devaluation of the Euro. This capital is fleeing to avoid two potential disasters: first, the default of the home country and secondly the devaluation of the Euro in the event of a disintegration of the EZ.

The fundamental problem at the heart of the EZ crisis is the massive imbalance in economic strength between, essentially, Germany and the peripheral economies and the enormous debts which this imbalance has generated. The precondition of any valid solution to the crisis, socially, politically, financially and economically, is that the peripheral economies be enabled to return to durable growth. The fact is that this will not happen while they share the same currency as Germany.

Nonetheless the successive policy responses of the EZ authorities to the crisis have been, besides issuing ever more insistent assurances that the Euro is irreversible (reiterated again by Mr. Draghi last month), to insist on the adoption by the debtor economies of crushing austerity programmes and to pretend that the crisis can be solved by temporary financial maneuvers, whether bank recapitalization, the creation of an EZ-wide bank supervisory body, a pan-EZ Eurobond, or fiscal union. At every stage in the now long-running saga, the authorities have determinedly resisted facing up to and addressing the economic imbalances at the heart of the crisis and the basic flaw in its structure. Instead, the Eurozone elite have decided to insulate themselves from reality and maintain the delusional fantasy that time, money and exhortation will solve the problem.

The financial markets have been understandably sceptical. Italy and Spain are now effectively shut out of the international debt markets and can borrow only limited amounts for short-term maturities, with most of their debt purchased by their central banks. After momentary enthusiasm following the announcement of each short-term, 'kick-the-can-down-the-road' measure, market reaction has turned rapidly negative:

- interest rates on Spanish and Italian debt have fallen from the 7% and 6% rates of a few weeks ago but are still at levels which presage debt default in the near future. These countries' debt markets, except for the very short-term, are now effectively off-limits to non-national investors,

- EZ debt and financial markets are well down the path of complete balkanization/re-nationalization, having reversed almost entirely the convergence process which preceded the launch of the Euro in 1999,

- the EZ interbank market is on life-support, with banks in member countries forced to rely on their central banks to finance their operations,

- the operation of the banking money multiplier in generating growth by supplying finance to the real economy has gone sharply into reverse, with a severe tightening of borrowing conditions in all the peripheral economies.

As noted, the first, and still the main, response to the economic imbalances at the heart of the crisis has been to require the peripheral economies to adopt severe austerity measures. The wished-for result was that these economies would successfully and rapidly transform themselves into financially-sound, competitive mini-Germanies. The actual result has been steadily deepening recessions in these countries (evidenced most recently by Italy's admission that growth this year, at a negative -2.4%, will be twice as bad as earlier forecast), with much worse fiscal deficits, mounting unemployment and growing social distress. Socially, politically, financially and economically the 'solution' has proved catastrophically counterproductive.

Since the start of the crisis there has been no lack of authoritative, and accurate, comment pointing out that, as a currency union, the EZ is inherently flawed, not being supported by a commensurate political union. Recently this has led to the notion that the structure would be automatically saved and the Euro rendered durable if the EZ adopted fiscal union. Even George Soros, founder of the Open Society Foundation, and disciple of the political libertarian Karl Popper, appears, somewhat ironically, to favour this solution. Besides the fact that imposition of a fiat political union does nothing to resolve the underlying problem of the economic and financial imbalances, it would constitute a giant step towards the creation of an authoritarian, bureaucratic tyranny.

More than a decade ago, Larry Siedentop, then a lecturer in politics at Oxford, used exactly these terms, in his book 'Democracy in Europe', to describe the structure and operation of the EU. For the economic and financial affairs of the EU countries to be managed by a group of unelected, unaccountable commissars (whose record for efficiency, thrift and probity is lamentable) would be worse than irrational; it would open the door to the kind of authoritarian government in Europe which the formation of the EU was supposed to consign finally to the dustbin of history.

The most recent proposed 'solution' to the crisis, now given official status with Draghi's announcement, is that the ECB should commit itself to unlimited purchases of the debt of EZ members experiencing financial difficulties. There has been talk of sterilization of these purchases but no details whatever have been given of how this would be achieved and the impression is that this 'condition' was included in Draghi's speech only to satisfy German demands that the fundamental 'no direct sovereign financing' veto in the original treaty be adhered to and to finesse the German Constitutional Court.

If implemented, this commitment to unlimited bond purchases would have two serious consequences: first, the ECB would quite soon find itself the only buyer of Spanish, Italian and, in due course, French debt as these countries pass the event-horizon of the debt/default black hole in a few years; secondly, unless the purchases were indeed fully sterilized, the world would rapidly be awash with Euros.

In February, 1996, before the launch of the Euro, Otmar Issing, then a board member of the Bundesbank, later first chief economist of the ECB and one of the advisers deeply involved in the creation of the Euro, wrote a short paper 'Europe: Political Union through Common Money' (published in the UK by the Institute for Economic Affairs). In it he set out his doubts as to the soundness and durability of a currency union functioning in the absence of a concurrent political union.

Last month, in an article in the Financial Times, he re-confirmed his sceptical view of the EZ structure. For him, one of the wise men present at its launch, the Euro is not irreversible. All the evidence from economies, financial markets and societies since the start of the crisis has confirmed that the Euro is not simply unworkable in its present structure but catastrophically malign.

Nonetheless the European elite continue to insist the opposite. It is becoming increasingly clear that they are quite ready to sacrifice the populations of Europe to this misconceived bureaucratic monster.

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