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THE EURO'S FUTURE
The worst may not come to pass

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Leading European politicians have taken to bemoaning the "irrationality" of markets which price Spanish debt the same of that of Pakistan; they point their finger at speculators who they claim are looking for their next victim - they have Greece and Ireland firmly in their clutches and are baying for the blood of Portugal, Spain and maybe Italy. Many of them give the impression of being overwhelmed, wringing their hands as the bond markets hunt for their next victim. Blaming speculators is hardly a new sport but, whatever the responsibility those who play the market, political leaders should face up to the facts.

A fundamental question needs to be asked: who created the Frankenstein like deficits which have pushed debt levels both public and private across much of Europe "off the charts" in the words of Kenneth Rogoff, former chief economist at the International Monetary Fund and co-author of one of the more lucid books on the origins of the crisis which has engulfed the Western countries since 2008? When that question is answered, Europe's political leaders need to make a serious effort to get on top of the crisis: six factors here could help dispel the current sense of gloom and despondency.

A few figures will help set the stage: the outstanding government debt of Italy, Europe's biggest bond borrower and home of the world's third largest market for public debt, is Euros1,800bn and it will issue about Euros 340bn worth of bonds next year. Spain will have to raise an estimated Euros 160-180bn. In both countries banks and companies will also have to refinance hundreds of billions of Euros coming due. Until now, private bond holders have not had to share in the cost of the bail out for Greece and Ireland but when the permanent vehicle for stricken eurozone countries being promoted by Germany, the European Stability Mechanism, comes into operation after 2013, investors will share the pain.

That is an eminently sensible proposal but only the German Chancellor, Angela Merkel, has come clean on this issue. The timing of her announcement was however extremely unfortunate, coming in the midst of the unfolding crisis on Ireland: the result was to send the ten year bond yields on Spain and Italy sharply up. Unlike shareholders whose upside is great, bond holders can only hope to get their money back – a default or restructuring would thus wipe out part of their investment. Politicians are in the awkward position of having to placate the markets they blame but if they fail to do so however, bondholders will close the market.

European leaders have themselves to blame as one botched rescue follows another amidst solemn vows that the breakup of the single currency is unthinkable. Yet some in the market are beginning to wonder whether the euro can survive. After all, Britain left the gold standard in 1931, something which was unthinkable in 1929 and that is not the only time in economic history when the unthinkable turned in a very short period of time into the inevitable. The weaker peripheral countries might exit but so might Germany which, together with Austria and the Netherlands would form a new D-mark bloc. Leaving the Club would be messy but not impossible. Would the departing country be better off? Germany might appear to be in a better position than say Ireland. However aggrieved Germany may be at the profligate ways of the peripheral countries, exiting would not usher in a period of greater monetary and fiscal stability, rather a long period of financial and social disarray.

The first mistake was to address solvency problems through liquidity policies. There is no way Greece can pull through this crisis without restructuring its debt unless Europe's leaders believe that years of deflation will produce the economic growth which is necessary not simply to find the money to repay debt but for future employment growth and broader political and social stability. Ireland was insolvent: not amount of political posturing or hand wringing is going to change that. Meanwhile, and this is the second mistake, every political leader is optimising his corner and no one taking political responsibility for the whole system. Why blame bond holders and other creditors for looking at the system as a whole? Shooting the messenger is populist policy at it very worst.

Blaming speculators and hyping every decision the EU takes is disastrous, all the more as after a first moment of euphoria, the small print of EU decisions is always disappointing and this is the third mistake. In such circumstances, blaming each other only adds fuel to the fire. Last winter the Germans went for the Greeks, more recently the Spaniards and the Irish were bashing the Germans, the French seem to hesitate between blaming the Germans or ranting at Anglo-Saxon speculators – as if this type of person was an unknown species in Paris or Madrid. Bashing Germany will serve no useful purpose nor will Angela Merkel's finger waving at profligate spenders who happen to sit on the periphery of the EU. Finally, everybody turns on the European Central Bank (ECB) as if its decision to buy hundreds of millions of Irish and Portuguese bonds could save the Euro.

Last week, one of the founders of the European Monetary System and one of the EU's most prominent politicians and strategic thinker since 1945 bemoaned the incapacity of Europe's politicians, among whom he included his successor, to understand the strategic necessity of integrating Europe. The only two personalities the former German Chancellor Helmut Schmidt singled out for praise was the head of the ECB Jean Claude Trichet and the head of the Eurogroup, the Prime Minister of Luxembourg, Jean Claude Juncker. The European Commission he scornfully pointed out was led by people whose name no one had ever heard of.

One proposal at present stands out – creating Euro-wide bonds which would halt the disruption of sovereign bond markets and stop negative spillovers which are bound to continue if the mistakes listed above persist. That would be a bold move, one recently mooted by Jean Claude Juncker, Giulio Tremonti, the Italian minister of finance, the former president of the EU Commission, Jacques

Delors, and supported by the leaders of the Socialist opposition in Germany.. The current crisis has laid bare the design flaws of the Euro but it is worth the peripheral countries remembering that even if they left the Euro, they would have to implement deep reforms; Germany for its part may feel virtuous but the resentment its leaving the euro would spawn across the continent would have disastrous political and economic consequences for all. The weeks ahead will tell whether Europe's political leaders will dare move ahead, be bold and integrate political and economic decision making further. If they fail to tackle the crisis head on and as they confront a restive southern and eastern Mediterranean and a rising China, they will consign the continent they are in charge of to the dustbin of history.