Greek saga won't kill the euro but the end may begin here

Could the endgame of this Greek tragedy be a eurozone break-up? The single currency's supporters maintain that such an outcome is mere mythology.

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Greece accounts for only 3pc of the 16 member states' combined GDP, they say, and has lower debts than some of the banks bailed-out during sub-prime. A loan of €20bn (£17.5bn) would do the trick, we're told. That's less than the British government injected into either Lloyds or the Royal Bank of Scotland.

Such analysis sounds vaguely plausible. But its naïve and politically dishonest. Then again, the single currency was built on political dishonesty. That's because, at the heart of the eurozone project there was always a fundamental contradiction – one that the architects of monetary union never dared to address. Now its being highlighted for them, whether they like it or not.

While the European Central Bank controls eurozone interest rates and the money supply, the size of each country's fiscal deficit results from the spending and taxation decisions of its own sovereign government.

How can you enforce collective fiscal discipline in a currency union of individual sovereign states, each answerable to their own electorate? The truthful answer is you can't – not unless you subjugate the autonomy of democratically-elected politicians and, by proxy, their voters.

Voters don't like that. Neither do politicians. Faced with a choice between seriously annoying their own voters and seriously annoying the ECB, the most ardently "pro-European" lawmakers, even those with years of Brussels trough-nuzzling under their belt, will always side with their own. That's why the eurozone will ultimately break-up – whether Greece is bailed out or not.

The eurocrats blame "speculators" for the single currency's woes. That's a bit like sailors blaming the sea. The eurozone is ultimately doomed because, in the end, economic logic wins and the will of each country's electorate bursts through. This current Greek saga won't end the eurozone – but future historians will identify it, perhaps, as the beginning of the end.

Many have said it's hardly surprising that Greece e_SEnD with its history of financial profligacy and capital flight e_SEnD has emerged as the eurozone's Achilles heel. A more germane observation is that, while fiscally wayward, Greece is also the birthplace of democracy. If the Greek population wants to get upset, throw out its elected politicians and reject austerity, it must be allowed to do so. I think they'd be mad, but it must be their choice.

If Berlin and Brussels try to impose their own view on Greece and the "cuts" come from outside, the situation will become absolutely incendiary. Protests will turn into fully-blown riots. Greece will endure very serious social unrest. Deep-seated rivalries and suspicions between countries will be re-ignited. And for what?

Greece is running a budget deficit of 12.7pc of GDP. The real number could be 15pc or more as Greek politicians have lied for years about the extent of their country's liabilities. They're not the first European leaders to do so and they won't be the last. But Greece was, almost uniquely, assisted in its fiscal cover-up by Brussels – with the usual "convergence criteria" being bent to allow Greek euro entry.

As recently as September 2008, the euro seemed to be going well, despite the massive variation between member states. The five-year Greek credit default swap spread was less than 50 basis points. In other words, buying insurance against Greece reneging on its sovereign debt cost only slightly more than insuring German government bonds. Those, such as this columnist, who continued to warn that the eurozone was "dangerous and inherently unstable" were dismissed as cranks, xenophobes or worse.

Then sub-prime hit in earnest. Insuring against Greek default suddenly became a lot more expensive, the CDS spread rising six-fold in eight weeks. The same risk measure is now around 400 basis points, the cost of insuring against Greek default no less than 20 times higher than it was in January 2008. Default risks are growing in Portugal and Spain too, the eurozone's fourth biggest economy.

The problem is that default dangers in Greece – where €20bn of debt falls due in April and May – are making creditors think twice about lending to other cash-strapped governments. Even if Greece avoids default, this latest crisis means governments everywhere will have to pay more for their finance, which in turn will push up borrowing costs for everyone – right across the eurozone and beyond, including in the UK. This is so-called "contagion".

The Greek government has been desperately trying to convince the rest of the world – the Germans in particular – that it will keep its promise to reduce the deficit in its still-shrinking economy to 8.7pc of GDP next year and less than 3pc by 2012. Yet this would amount to the most severe fiscal contraction in the history of modern Europe. It simply won't happen.

The reality is that Greece has two choices – both disastrous for the eurozone. One is to default, leave the euro and re-establish the drachma at a rate low enough to stimulate exports and growth. To write this is heresy. But with general strikes now in the offing, and the Greek public-sector unions resurgent, such a scenario is possible.

For years, the ECB has set rates low to suit France and Germany. This has made life difficult, causing dangerous debt bubbles, in smaller and more inflation-prone eurozone members. Were Greece to take the exit route, the governments of several other single currency members would come under intense pressure to do the same. The eurozone's vital cohesion would be seriously undermined. Its ultimate break-up - or, at least shrinkage to a Franco-German rump - would only be a matter of time.

The other, more likely, option is that Greece accepts a German-led bail-out and "muddles through". But even that would spark an eventual eurozone split. On extending assistance, Berlin and Brussels would talk tough and Greece would promise to behave. Anything less wouldn't be tolerated by German voters. After the horrors of inter-war hyperinflation, Germany has spent more than 50 years building policy credibility. Backing a Greek bail-out would be a massive step – the first time in decades Germany has departed from its fiscal and monetary hard line.

Yet the German government will do it. Refusing to bail-out Greece would risk being labelled "bad Europeans" – something anathema to Germany's post-war elite. Berlin also has a massive financial stake in the euro's status as the world's second most-used reserve currency.

Although Greece will be presented as a one-off e_SEnD a "very exceptional" case e_SEnD once that line has been crossed there is no going back. Other eurozone countries will want a bail-out. Why should Portuguese, Estonian or Spanish workers endure austerity and unemployment, while those in Greece were spared? Why them and not us? If big banks can compete for bail-outs, walking the line of "moral hazard", political leaders will do so too. A Greek rescue by the Germans would spark repeated bail-outs.

In the end, voters in the big eurozone economies, faced with their own fiscal problems will say enough is enough. Europe's monetary union will collapse, just like every other currency union in the history of man. The exception is America – yet the US, as the eurocrats hate to acknowledge, had been through a century and a half of political union before the Federal Reserve was founded in 1913.

That's the key difference. America is a political union, with a system of explicit inter-regional fiscal transfers, and the eurozone isn't. That's why the single currency will ultimately split and be exposed as what it is – a triumph of European hubris and political vanity over unavoidable economic logic.

http://www.telegraph.co.uk/finance/comment/liamhalligan/7230255/Greek-saga-wont-kill-the-euro-but-the-end-may-begin-here.html