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The only solution to the eurozone crisis

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It is easy to solve the eurozone crisis on a piece of paper. I have done it many times. It is also easy to invent new institutions: a fiscal union, a treasury secretary, a common sovereign bond and a banking union. I would welcome most of these. But we must subject these discussions to a reality check. While these institutions will emerge from this crisis, none of them can solve it. That will have to be the job of the existing institutions.

This applies particularly to the idea of a common bank resolution fund. It is a great idea, but political resistance to it will be so big that it will not be implemented in full and in time. It will not solve the crisis.

The solution can come only from a combination of two instruments – debt monetisation through the European Central Bank and default into the European Stability Mechanism, the €500bn rescue fund that becomes operational in July.

In practice, any resolution of the crisis will involve more of the latter than the former. We have reached the limits of what the ECB will do. I agree with Paul de Grauwe, of the London School of Economics, that direct purchases of government bonds would have been more effective than the indirect route of long-term refinancing operations. But the ECB is unlikely to go that far.

Instead, the most obvious solution will come through a default by a troubled eurozone country into the ESM and the other rescue funds.

I can see a scenario in which Greece remains in the eurozone. But I cannot see one in which Greece can honour its future debt liabilities. Greece's economy is already slipping behind the forecasts of the latest bailout programme. There is a big ESM wall at the end of the road.

The same result – default into the ESM – will happen in other eurozone countries. The Spanish government is considering setting up a company to manage the assets of its banking system. It would not be a bad bank. The government is not in a position to pay for the losses. But those losses will ultimately have to be funded and there is no way that the Spanish banking sector will attract new private capital on a sufficient scale. An ESM programme is thus inevitable. But ESM programmes are loans, which the Spanish government will have to repay. The best way to mutualise the losses would be to default into the ESM system, rather than set up a eurozone-wide bank resolution system.

At the point of default by Greece or Spain, the ESM would register losses. Barring a further agreement, member states would be obliged to fund these losses, which would effectively become cross-border transfers. I doubt it will come to that, however. Some member states will not be able to take part. Does anybody really believe that Italy will be in a position to pay for Spain? An alternative could be to split the ESM into a bank resolution fund and an ordinary crisis mechanism. The first would have to be funded through a joint-and-several debt liability – in other words a eurozone bond.

Let us think through the politics of all this. If the ESM is split, nobody will be asking the question: are you for or against a eurozone bond? The question becomes: do you accept a specific eurozone bond to deal with bank resolution and insurance, or would you rather honour your contractual obligations under the ESM and pay up. The latter is, literally, the default option. If nothing else happens, member states have to make up the losses of the ESM under existing rules. I predict that the Germans and Dutch would at that point want a eurobond as a means to cut their losses.

In that case, we would be well on the way to a properly funded bank resolution system, a deposit insurance system, and common regulation and supervision, which can then be done by the ordinary EU legislative route. It is much faster and more effective to start from the ESM and build up the remaining institutions later, than to design a new system from scratch.

This whole exercise will probably have to be done at eurozone rather than at EU level. This is because the need for such a system does not derive from the idea of a single market for financial services, but from the need of systemic stability of a monetary union. A monetary union requires a banking union, but not necessarily a single market.

I am not predicting this is how it will happen – that countries will default into the ESM. But it would make sense because it would solve the problem, reduce the creditor countries' sudden losses, and it would also be legal. The ESM is the only important institution the eurozone has created as part of its crisis management – and it is the only mechanism that can be used in the short term. The ESM should have a banking licence, so it can obtain funds beyond its present ceiling – which it will ultimately need. The ceiling is clearly not high enough for what I am suggesting. However, at least the ESM has the advantage that it actually exists.