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Five ways to solve the eurozone crisis

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Myths and misinformation feed in to a general lack of ideas about how to save the eurozone

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The eurozone crisis is being felt in Portugal, where demonstrators protest about the state of their economy. Photograph: Patricia De Melo Moreira/AFP/Getty Images

The crisis of the eurozone seems to be going from bad to worse. Not only have the key players not yet found convincing solutions for the fiscal problems in Greece, Ireland and Portugal but we are already witnessing the beginning of a political backlash that could undermine the achievements of decades of European integration. There is generally a lack of ideas about what needs to be done to turn things around so here are my suggestions:

1. Say it as it is: it's about politics, not economics

As Wolfgang Muenchau observed, the debt to GDP ratio of the eurozone as a whole is less than that of the UK or the US and does not pose an overall economic problem. The problem is that there is a lack of political mechanisms to deal with fiscal crises in some areas of the eurozone. So this crisis is not about economics, it is about politics and economically illiterate politicians.

2. There are no payments – be honest with Europe's citizens

It is frankly shameful that most European leaders, especially in Germany, keep their population believing that there are direct payments to countries such as Greece. This nurtures the wrong assumption that the German taxpayer pays for early retirement and other luxuries they themselves do not enjoy.

This is just wrong. The bailout is not a direct payment – it provides IMF and EU lending facilities that lend at lower than market interest rates but at higher rates than the countries that underwrite it can get money for. So the bailout (actually a misnomer) is not a handout but a loan at a profitable rate if there is no default.

What this dishonesty does, however, is to undermine solidarity and to create a widespread mood against Europe in debtor as well as creditor countries.

The fact that anti-European parties are on the rise all over the place is therefore unsurprising and to a significant extent due to the mainstream parties not being honest about what is going on.

3. Stop the banking socialism

But why are Europe's leaders not straight? Almost certainly there has to be a debt restructuring at some point and it should naturally be the investors that take the first hit, not the taxpayers.

A significant part of the bailout is used to service sovereign debt so the money goes straight into the pockets of the bondholders and not to the people in the crisis countries who are actually exposed to crippling austerity measures. In essence, the bailouts help banks holding sovereign debt of crisis countries to socialise their investment risk. And the more debt is bought up by the ECB – or maybe by the lending facilities themselves – the more the taxpayers are liable.

Of course, if a haircut or some other form of immediate restructuring brought certain banks into trouble they would have to be supported if they are systemically relevant. But in such a situation it would at least be clear that normal capitalist rules still apply and the primary investment risk lies with the investor who was already compensated for this risk via the interest rate. At the moment we have privatised profits and socialised risks while keeping people in the dark about it. This cannot continue.

4. Breaking up the eurozone is the most expensive option – admit it

It also requires some political honesty to admit that there are no cheap options left to resolve this crisis. But breaking up the eurozone would be the most expensive one. Why?

Imagine Greece leaving the euro and reintroducing the drachma. Apart from the practical problems and costs a currency switch would create an immediate run on the Greek banks by savers wanting to take their assets abroad because the drachma would radically depreciate against the euro.

The debt to GDP ratio would also increase drastically as the debt would still be in euro, making a default much more likely. Given the low proportion of exports as a share of Greek GDP, the resulting increase in competitiveness would not outweigh the costs. So this surely looks like the worst option.

5. Forget the stability and growth pact – we need proper economic governance

It is simply wrong for some commentators to say that diluting the stability and growth pact was the reason for the euro crisis. First of all the pact is based on random figures. The 60% overall debt to GDP and the 3% annual deficit limits were just based on the average debt and growth rates of 1990. There is no economic rationale for these figures and they do not allow for specific circumstances either.

Germany was one of the first countries to break these rules as they do not allow for country-specific circumstances to be considered. Therefore the huge costs produced by German reunification could not be taken into account when judging German fiscal policy.

It is true that Greece's real fiscal position has been obscured by wrong figures, but Ireland for instance was in a very strong fiscal position – well within the pact criteria – when the crisis broke out. The pact did not, however, prevent Irish banks from creating balance sheets of a multiple of GDP, and it did not prevent the building up of a housing bubble and aggressive beggar-thy-neighbour tax policies either.