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What happens if Angela Merkel gets her way

The Bundesbank said there should be no banking union until there is a fiscal union. Angela Merkel said that there should be no fiscal union until there is political union. And François Hollande said that there should be no political union until there is a banking union. They have 10 days to disentangle that knot.

The interesting thing is that all statements are correct in a certain way, but only the French president offered a practical solution; without crisis resolution, there can be no political union. Mr Hollande made a concrete proposal to allow the European Stability Mechanism to inject unlimited equity into banks; allow it to refinance itself through the European Central Bank; and to let the ECB supervise the 25 largest financial institutions. The German chancellor responded, respectively, with *Nein*, *Nein* and *Ja*.

Unfortunately, the 25 largest banks have no bearing on this problem. It is the other banks that matter. Ms Merkel has accepted the weakest and least relevant bit of Mr Hollande's proposal.

With so many ideas on the table, it is critically important to understand what is required right now. Spain needs an equity injection into its banking system from the eurozone, not through a loan to the Spanish recapitalisation fund. Only when that happens, can Mariano Rajoy, the Spanish prime minister, claim to have nailed the problem and set off to watch the football – an activity at which he excels. And to address Italy's problem, the EU needs to find a way to lower its interest rates. This can only occur through one of the following three measures: a eurobond; direct bond purchases through the ECB, or the ESM. But Italy is too big to fit under the umbrella, the ECB does not want to monetise debt and Germany is opposed to a eurobond.

The obvious solution to a sequencing problem is to have it all: a banking union, a fiscal union and a political union. That may well happen. But I somehow did not have the impression that Ms Merkel was kidding when she rejected any proposal that could solve the crisis. So 10 days before the next European summit, my optimism is restrained.

What if there is no deal or another fudge? In that case, I would expect Italy and Spain to leave the eurozone. If a banking union is a necessary prerequisite for a monetary union, and you are told that a banking union is politically unacceptable, then one must sadly conclude that the monetary union is unfeasible. I do not say this lightly. A break-

up would be catastrophic.

In the absence of a deal next week, I would expect to see an acceleration of a slow-motion bank run. Why should citizens leave their money in their local banks, when foreign investors are pulling out and when even the EU is making preparations to impose capital controls? Market interest rates will rise further and it will only be a matter of time before both Italy and Spain are cut off from market funding.

In the case of Greece, the best moment to default would not be now, but next year. The country still runs a primary deficit – before the payment of interest. A default would make more sense for Spain, but not quite yet. It would be easiest for Italy. It has a large pile of debt, but a low deficit. With an interest rate of more than 6 per cent and a loss of competitiveness, Italy cannot simultaneously remain solvent and inside the eurozone.

Clearly, Mario Monti is not going to pull the trigger. He was installed in the job of Italian prime minister to avoid such an outcome. But the political mood in Italy is changing. The arrival of Beppe Grillo and his populist Five Star movement as a force in Italian politics tells us that we should not expect Brussels-compliant technocrats to run the country for ever. “The EU is out of control and the euro is a box of dynamite with a fuse that is getting ever shorter. And we are sitting on top of it,” Mr Grillo wrote in his blog.

If Italy and Spain were to leave the eurozone, they would probably also default on their foreign debt. Such an act would probably cause the European financial system to collapse – something that would ultimately reverberate in Italy and Spain, too. But the irony is that an Italian or Spanish exit would probably end up hurting France and Germany more than it would hurt Italy or Spain.

Ms Merkel said there was now a race going on between the eurozone and the financial markets. That comment tells us that she clearly understands what is going on. But that does not mean that she is willing, or in a position, to do what needs to be done. I get the sense that her talk about political union is only a ruse to deflect from a catastrophic failure to resolve the crisis.

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