The world economy is again at a cliff edge
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The world economy is again at a major turning point. Many non-Europeans believe the euro will fail. Europeans understand the arguments that this might be possible but believe the Germans will stop the problem at the edge of the cliff. Germany has too much to lose if the European project fails.

A key question for those who believe in the euro is this. Does anyone know where the cliff is?

Spain has now effectively lost access to global markets. The next round of Spanish borrowing is likely to have to be from official channels. Europe is currently committing the errors of the 1930s while clinging to the euro, despite the economic tsunami this creates.

There were several key reasons for the severity of the Great Depression. The first was that the US Federal Reserve did not attempt to save the banking system because it was not clear what its role was. Relatively new, its role was ill-defined. The European Central Bank is in the same position, resisting temptation to save states or banks because it does not believe that is its job.

Second, in the 1930s, countries embarked on fiscal austerity, which severely contracted growth. The agreements currently in place to secure financing in Europe involve large fiscal cuts. Fiscal austerity with a fixed exchange rate is a recipe for a sharp economic contraction which worsens debt sustainability. The politics of severe economic contraction are difficult to predict.

The main problem is a fundamental flaw in the design of the euro from its inception. One policy interest rate for all of Europe has accentuated different business cycles in Europe. Countries growing quickly had rates that were too low and countries growing slowly had interest rates that were too high.

Many argue that it works in the US to have a single currency, so why not in Europe? There are many reasons. One key problem is that there is a single monetary policy in Europe without a federal system to support economic differences across countries. One policy that is missing is fiscal transfers to smooth differential growth across countries.

Also, there are no Europe-wide institutions to protect national banks against failure, as the Federal Deposit Insurance Corporation (FDIC) does in the US. In Europe, the nation state has to intervene to help state banks, thus a banking crisis can become a fiscal crisis. Ultimately, Europe is not close to being an optimal currency area – thus a single currency would always be problematic given the structure of European economies. One key missing ingredient is that labour mobility is restricted. In summary, Europe's crisis is the logical consequence of the system itself.

European economists offer three main solutions for the euro to survive. The first is a fiscal union which would include the creation of euro bonds guaranteed by all governments in Europe.

A transition to this would be to immediately move away from the Maastricht Treaty-imposed deficit ceiling of 3 per cent of gross domestic product fiscal deficits (which causes pro-cyclical fiscal policy), to ceilings based on structural budget deficits. That is, fiscal deficits that are adjusted for the extent of economic slowdown.

The second need is to create a banking union or something like the FDIC for Europe. That is, an institution that could directly solve a banking crisis in a country without going through national governments. Currently, any funding for saving banks has to first go through nation states who then lend to the banks. This does not work, as the Spanish intervention has shown. Lending to Spain to lend to its banks accentuated a fiscal crisis in Spain.

The third part of the solution is to have much higher wage inflation in Germany to improve the competitiveness of non-German economies without needing substantial deflation in the southern European economies.

Unfortunately, the timing of these solutions does not line up with the crisis that is unfolding in Europe.

The election in Greece this weekend is a potential turning point. If there is an outcome in which Greece leaves the euro, there would need to be a major announcement to hold the euro together. Apart from the necessary co-ordinated intervention by the central banks to provide liquidity, the most likely announcement is a banking union that would enable someone to eventually save European banks.

I doubt there will be an announcement of the creation of euro bonds, because Germany is strongly against this. Even if another announcement can be pulled out of the hat in the next few weeks, this will only postpone the inevitable restructuring of the euro zone but may kick the can down the road one more time. The cost is continued volatility in the global economy.

It is amazing that, despite the clear path down which European policymakers and politicians have wandered since the early crisis in Greece, a basic understanding of Europe's problems has not been demonstrated. The world economy is again at the edge of a cliff, thanks to politicians who follow populist policies.

There are many lessons for Australia from this slow-motion economic train wreck. One is that it is important to understand the economic problems facing a country, and have a plan to deal with them. Such a plan is unlikely to emerge from talkfests involving political and economic vested interests.

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