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A European Monetary Fund and governance mechanisms with bite would address the problems underlying the current crisis

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The problems Greece and some other eurozone countries are experiencing have highlighted a design flaw in the euro: it is ill-prepared to deal with asymmetric shocks because its balancing mechanisms, as Paul Krugman says, are inadequate. But in the case of Greece, there is also no doubt that serious fiscal irresponsibility combined with creative accounting ideas from Wall Street have severely aggravated the predicament.

But what can you do to prevent a Greek meltdown? In the worst case scenario the crisis spreads across the eurozone, seriously destabilising the financial system and triggering even greater social tension in Greece and elsewhere – not to mention the political implications for the euro and European integration in general. Britain too, as Will Hutton argued, will be hit hard if the Greek problem is allowed to escalate. So there is a clear case to take action.

Any sort of direct help from another European country, for instance Germany, for troubled Greece is difficult because of tight legal and constitutional restrictions. It would also outrage public opinion in both countries. In Germany, people would not understand why they had to endure wage reductions as well as social security cuts and now have to pay for a country that had not adjusted to competitive pressures. The Greeks would be outraged on sovereignty grounds, given that their fiscal policy would basically be run from Berlin if they received direct help.

Realistic measures that address the underlying problems can therefore only be taken at the European level. We need two mechanisms that we currently do not have: first, an emergency system that prevents a crisis like this from spreading across the eurozone; and second, better mechanisms to maintain and police fiscal responsibility. Let me explain the latter point first.

The Maastricht criteria had been revealed as inadequate even before the financial crisis struck. Even though there were some minor changes, the rules were too inflexible to account for special situations that required more flexibility (such as dealing with the costs of unification in Germany) and were therefore more a fiscal straitjacket than a helpful mechanism to maintain financial stability. Furthermore, as we have just seen, the criteria can be circumvented by creative derivative deals. And when a crisis of global magnitude hits, it actually means very little because deficits will have to rise beyond the Maastricht limits.

These inadequacies point to the lack of an institutional mechanism to deal with such shortcomings. The stability criteria should remain the norm, but we badly need an economic governance system for the eurozone that has much greater oversight over fiscal discipline and that coordinates fiscal planning to prevent eurozone members from drifting too far apart. The Maastricht criteria policed by the European Commission are obviously not enough. The Lisbon treaty has formalised the Eurogroup for the first time. We need to use this as a basis to build new eurozone governance mechanisms with bite.

We also need a safety net to help EU member states in trouble. The idea of a European Monetary Fund (EMF), currently being floated, is a very interesting one. A newly established EMF should not only cover the eurozone but the whole of the EU and should be funded by contributions from all EU member states and some sort of European tax on the financial sector. This would also allow it to function as insurance for financial institutions funded by the industry itself. This is an idea the IMF is also working on. Countries outside the eurozone, like Britain, would then also have an additional security mechanism.

To be clear, having an EMF would not stop Greece and other countries from implementing cuts to realign themselves with the rest of the eurozone. But it would provide a tool to supply short-term liquidity attached to specific conditions, provide security for the financial system and, as a Centre for European Policy Studies report argued, even a structure way to deal with a default when it cannot be avoided.

In a nutshell, what the eurozone is currently experiencing is a theoretical design flaw becoming painful reality. It is not too late to address these issues but it is time that European governments make a decisive move.