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The new feudal overlords of Europe will be the bankers of the ECB

According to the economist Friedrich von Hayek, the development of welfare socialism after the Second World War undermined freedom and would lead Western democracies inexorably to some form of state-run serfdom.

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By Peter Boone and Simon Johnson

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Hayek had the sign and the destination right, but was wrong about the mechanism. Unregulated finance, the ideology of unfettered free markets, and state capture by corporate interests are what ended up undermining democracy both in North America and in Europe. All industrialised countries are at risk, but it's the eurozone – with its vulnerable structures – that points most clearly to our potentially unpleasant collective futures.

As a result of the continuing euro crisis, the European Central Bank (ECB) now finds itself buying up the debt of all the weaker eurozone governments, making it the – perhaps unwittingly – feudal boss of Europe. In the coming years, the ECB and the European Union will dictate policy. The policy elite who run these structures – along with their allies in the private sector – are your new overlords.

It is arguable who exactly are the peasants, the vassals and the lords under this model – and what services will end up being exchanged, but there is no question we are seeing a sea change in the post-war system of property, power and prosperity across Western Europe, just as Hayek feared. An overwhelming debt burden will bring down even the proudest people.

The ECB-EU approach will not return countries to reasonable levels of growth – the debt overhang is simply too large. The southern and western periphery of the eurozone cannot grow out of their debts under these arrangements and so will stumble from stabilisation programme to stabilisation programme – as did Latin America in the 1980s. This is bound to lead to hostile politics, social unrest and more economic crises.

The International Monetary Fund will do just what the EU and ECB asks to keep the charade in place. The old days when all member countries got presents from the eurozone are long gone; now it is all instructions and austere requirements. But enough resources will be provided to keep everything rolling over.

The top three French musketeers – President Nicolas Sarkozy, Jean-Claude Trichet (ECB), and Dominique Strauss-Kahn (IMF) – presumably they think they will end up running things. More surprising is the reaction of other European leaders, who genuinely seem convinced that what they are doing makes sense – as opposed to being a series of crazed improvisations.

The market is telling them otherwise, and the market is probably right. Faced with the ugly reality of the loss of confidence in European finance and institutions, the Germans and even the normally sensible Swedish government are increasingly blaming "irrational" markets and speculators for homegrown problems.

The messy solution of the EU leaves the world at risk of the type of shocks we observed last week. This particular iteration may blow over, but another will arise when there is backlash in Athens, Dublin, Lisbon, or – heaven forbid – Madrid.

Meanwhile, rational market participants are selling debt of risky nations, and getting out of the euro. The whole fiasco is now leading to a shift away from risky assets all around the world, and the worldwide cost of such volatility is not small. Debt peonage looms for a range of countries that were recently thought immune to serious fiscal crisis, including the United States and UK.

It is inappropriate for the Europeans to subject the rest of the world to these large, chronic risks. Europe should recognize that insolvencies never end well. The crisis in Britain in the 1970s is the model for what can go wrong : ongoing strikes, populations disenchanted with authority and great economic disruption. When the assets are cheap, deep-pocketed investors from the US, China, India and, of course, Russia will swoop in for the crown jewels.

It is time to look in the mirror and recognize the problem. Several nations in Europe are bordering on insolvency, and it is now pretty clear that we shouldn't just "bandage" over that for a few years with aid packages.

To deal with this insolvency we need to restructure the debts of those nations, but in a way that does not destabilize Europe's fragile banking system. And it needs to be credible enough so that once restructured, the troubled nations will easily be able to finance themselves. Europe now has the €750bn package of assistance in place and they should use it to fix the problem once and for all. The ingredients for a solution include:

Announcing an orderly restructuring of the periphery countries' debt (Greece, Portugal and probably Ireland). This should start with a standstill budget.

Regulatory forbearance explicitly provided to all European banks, with a backstop of ECB liquidity and a €500bn support programme to provide capital injections – as happened in the United States in 2008-09.

The nations not restructured need to be supported via ECB liquidity lines that guarantee the rollover of their government debt.

The G20 needs to provide support to prevent chaotic foreign exchange markets, but also accept a further devaluation of the euro. At some point, the G20 will need to intervene to support the euro via central banks.

Such a comprehensive package of measures would be painful, but it is the only realistic solution to this chaos. It would also restore some credibility to Mr. Trichet and the ECB, who, at this stage, appear captives of the fiscal crises in the eurozone.

Unfortunately, there is no leadership today in Europe that could take such decisive actions, so Europe will only reform itself dragged kicking through successive crises until the current, and many ensuing, problems are resolved.

The UK and US need to prepare themselves for more storms. The United States will be in the pleasant position as the world's safe haven, but this will only encourage America's profligate politicians to spend more and build more debt.

The UK will bear much more pain from euro devaluation and financial dislocation, all exacerbated by its own large deficit and debts. We might well see one more invasion across the channel, this time by bond vigilantes who question Britain's ability to rein in inflation as it builds too large debts.

At the end of this great tumult, Europe and the UK will have sound fiscal regimes. Debt will be defaulted on or inflated away, and nations will have dramatically cut spending.

Hayek's predicted demise of western society as he knew it will prove correct, but welfare socialism will prove the victim, erased by a political and financial elite gone awry.

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How we moderate