CENTRE FOR EUROPEAN REFORM essays

The euro at ten: Is its future secure?

By Simon Tilford

★ The euro is riding high on the foreign exchange markets, and the financial crisis has graphically illustrated that euro membership provides a safe haven. On the face of it, this would seem to be a strange time to question the stability of the currency union. But this essay argues that the euro is about to face its first serious test, and that the stability of the eurozone cannot be taken for granted.

★ The trade imbalances within the eurozone continue to widen. Meanwhile, the pace of the reforms that are needed to increase flexibility and prevent these economic imbalances becoming entrenched has slowed. The problems of the most vulnerable countries – Italy, Spain, Portugal and Greece – stem partly from their own policy failures, but also from the economic strategies being pursued by other eurozone members. Economic growth in Germany – easily the biggest economy in the currency bloc – has become even more reliant on exports to the rest of the currency union.

★ The current economic crisis threatens to exacerbate the tensions within the eurozone. There is a serious risk that the growth prospects of struggling eurozone economies will be handicapped for many years by their inflexibility and the external surpluses of other eurozone member-states. If so, investors will lose confidence in the credit-worthiness of governments and firms in these countries, leading to a dramatic increase in their borrowing costs.

★ A number of scenarios are possible. The most straightforward – accelerated political integration within the eurozone and a move to some form of fiscal federalism – is the least likely. Another would be a bail-out of the affected member-states by the rest of the eurozone. This is unlikely, but not totally inconceivable, especially if a bail-out were accompanied by IMF-style conditionality. An insolvent member-state could also default on its debt, but remain in the eurozone, or go for the 'nuclear option', which would be to default and leave the eurozone.

★ However, the most likely outcome is that the hardest-hit countries will be forced into wrenching fiscal adjustment and that Germany and others with large external surpluses will take modest steps to rebalance their economies. Eurozone economic growth will be weak, and some member-states will experience prolonged stagnation. Governments will struggle to manage the political strains caused by fiscal austerity at a time of anaemic economic growth, and political tensions between the member-states will rise.

Introduction

Ten years have passed since 11 of the EU's member-states swapped their national currencies for the euro. The single currency has confounded its critics, many of whom said it would fall apart, citing the lack of lasting economic convergence between the participating economies and the absence of a political union. As of late December 2008, the currency was trading at an all-time high on foreign exchange markets.[1] The eurozone has now embraced 16 member-states, with Slovakia the most recent to join, on January 1st 2009. Several others want to join. The European Central Bank (ECB) has won plaudits for its sure-footed handling of the financial crisis. The euro has even started to challenge the dollar's status as the world's principal international reserve currency. The adoption

[1] *On a trade-weighted basis.*

Centre for European Reform
14 Great College Street
London SW1P 3RX UK
T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

of the single currency has accelerated the integration of Europe's financial markets and helped to boost trade. On the face of it, this would seem to be a strange time for anyone to raise questions about the stability of the currency union. But the euro is about to face its first really serious test.

This essay argues that the economic crisis threatens to exacerbate underlying imbalances within the eurozone, thereby creating difficulties for some of its members. The problems of these – mostly southern – countries stem partly from their own policy failures, but also from the economic strategies being pursued by other members of the currency union. These tensions are beginning to manifest themselves in the differences ('spreads') between the yields on German government bonds (bunds) and those of the weaker members of the eurozone, such as Italy and Greece, which have widened sharply since the middle of 2008. Some of the widening is a temporary phenomenon: in times of financial distress investors want the most liquid and the safest assets, so they pile into German bunds. But the widening spreads also reflect the concerns of investors that some member-states will suffer economic stagnation, and that this will raise doubts over their solvency, and conceivably even over their continued membership of the euro. If serious questions were to be raised about the ability of any member-state to remain in the euro, it would deal a devastating blow to European integration. Policy-makers need to take the steps that will ensure such questions are not raised.

'Will the eurozone crack?'

In 2006 the Centre for European Reform published a report entitled 'Will the eurozone crack?' In that report I argued that the euro's success was crucial not only for the economic health of the eurozone and its members but also for the credibility of the EU as a whole. However, the report also suggested that it was too soon to talk about the single currency being a success. Countries that decide to forego exchange rate flexibility sacrifice a powerful source of economic adjustment, and need to ensure that their economies can be flexible in other ways. This is especially so in the eurozone, where there is limited political integration and no fiscal union. In such circumstances, the paper argued, labour markets need to be flexible, there must be a high level of competition across all sectors, a very high degree of trade integration is required, and public finances should be soundly managed. If not, some countries would lose competitiveness and be unable to regain it, leading to huge economic imbalances within the eurozone and eventually fiscal crises.

The paper argued that reforms to increase flexibility and accelerate integration had been slow in many members of the eurozone since the single currency's launch in 1999. The southern member-states urgently needed to implement structural reforms aimed at boosting their productivity if they were to regain competitiveness within the currency bloc. In addition, it argued that the chronic weakness of domestic demand in Germany was as big a threat to the stability of the eurozone as the failure of the Greek and Italian governments to take steps to reverse their economies' decline in competitiveness. The trade surpluses of Germany (and the Netherlands) with the rest of the eurozone would prove dangerously contractionary and destabilising for the euro unless they were reversed. Unable to devalue to restore their competitiveness, countries such as Italy had no option but to ensure that wages and prices fell relative to those of the surplus countries. Only if the surplus countries became a source of demand within the eurozone economy, rather than a drag on it, would the bloc's hard-hit economies be able to adjust smoothly.

The paper concluded that there was a serious risk that a number of eurozone economies would ultimately get caught in a cycle of weak economic growth and rising public debt. Investors could then start to baulk at holding these countries' government bonds, and they could find themselves experiencing the worst of all worlds: a severe lack of competitiveness and high interest rates as investors demand steadily higher premiums for buying their debt. At this point, political support for euro membership in the affected countries could weaken and investors could start to question the sustainability of the single currency. I did not argue that this would be inevitable, only that there was a more than theoretical risk of such a scenario coming about. The paper concluded that participating economies urgently needed to become more integrated with one another; that the governments of countries that had lost competitiveness had to take steps to regain it; and crucially, that economic growth in Germany and the Netherlands needed to become more focused on domestic demand, and less on exports.

The CER was heavily criticised for making these points. Some critics even went so far as to accuse it of euroscepticism. But it is not pro-European to ignore negative trends, especially as these trends could do a lot of damage to the whole EU if they led to some countries leaving the eurozone. The fact that we highlighted these concerns was not motivated by a desire to see the single currency fail. The CER strongly believes in the potential of the euro to deepen economic integration within Europe and to boost Europe's unimpressive rate of productivity growth. It is hard to see how 27 national currencies would be compatible with an increasingly economically integrated Europe. The CER also believes that the UK's political interests would be served by joining. But the potential upsides of the euro should not blind us to the risks. And they are considerable.

Following publication of the CER report in October 2006, the eurozone enjoyed 18 months or so of relatively robust economic growth. After averaging just 1.4 per cent in 2001-05, the rate of economic expansion accelerated to 2.9 per cent in 2006, before slowing slightly to 2.6 per cent in 2007. Even laggards such as Italy and Portugal saw their economies pick up, albeit only slightly, with Italian growth averaging 1.7 per cent in 2006-07 and Portuguese 1.6 per cent. Crucially, growth in the German economy rebounded strongly – averaging almost 2.8 per cent in 2006-07 – raising hopes that Germany would start to be a driver of economic growth within the eurozone.

A safe haven

The financial crisis that began in the latter part of 2007 and deepened dramatically in September 2008 demonstrated the 'safe haven' advantages of euro membership. Various Central and East European countries have announced that they want to bring forward their timetables for joining, and popular opinion in Denmark and Sweden is turning in favour of signing up to the single currency. Denmark's status as half in and half out of the eurozone (the country is a member of the exchange rate mechanism) forced it to raise interest rates during a time of recession, despite its economy being better placed to weather the economic downturn than most members of the eurozone. There have even been suggestions that the British government's mismanagement of the UK economy and the steep fall in the value of the pound could help overcome the British public's hostility to euro membership.

There is little doubt that small member-states, especially those with big banking sectors such as Ireland, would have had a torrid time in 2008 were it not for their membership of the euro. If national currencies had been retained, a number of smaller member-states would almost certainly have suffered severe foreign exchange crises on top of everything else. The volatility of European currencies which have remained outside of Economic and Monetary Union (EMU), such as the pound, cannot help but have a destabilising impact on trade and investment. The euro has insulated its members from this kind of volatility and also allowed fiscally weak member-states to borrow more cheaply than would have been the case had they not been members of the single currency.

Unfavourable trends

However, a closer look at the underlying economic and policy trends in the eurozone gives cause for serious concern. There has been no pick-up in the pace of economic reform. For example, the Spanish government recently dismissed out of hand calls by the International Monetary Fund (IMF) to accelerate the structural reforms needed to boost the country's poor productivity performance. But without stronger productivity growth, Spain will face economic stagnation. With the credit bubble having burst, Spain can no longer rely on construction and debt-fuelled consumption to drive economic growth. The Italian government has taken steps to strengthen the country's public finances (largely by raising taxes), but has done very little to address the underlying reasons for the country's loss of competitiveness (and hence dreadful economic growth performance). Without faster growth, the country's huge debt burden will not be sustainable. Political instability in Greece, while not the result of the country's membership of the euro, will make it hard to push through the reforms needed to rebalance the economy – which ran a current account deficit equivalent to 14 per cent of GDP in 2008.

Alarmingly, there is a risk that the downturn will increase resistance to precisely the kinds of economic reform that are needed to make economies more flexible and hence ease adjustment within the eurozone. There is little evidence that governments pay an electoral price for implementing reforms of labour markets and opening up more sectors to competition. But the financial crisis has emboldened those political forces that have always been sceptical of the case for liberalisation and more integration. For example, faster action to liberalise and integrate service sectors across the eurozone now looks almost out of the question. Service sectors account for around two-thirds of economic activity in most euro-zone states, but service sector productivity has been extremely weak for a number of years now, especially in Italy, Spain, Greece and Portugal. More competition at both national and European level would do much to change this, and boost economic growth.

The divergence in labour costs within the eurozone has intensified rather than eased since 'Will the eurozone crack?' was published. In 2006 and 2007, German unit wage costs (wage costs adjusted for productivity) fell by 0.6 per cent per annum (the only other OCED economy to experience this in 2006-07 was Japan, another chronically export-dependent economy). By contrast, annual growth in Italian and Spanish unit wage costs averaged 3 per cent. Indeed, Spanish labour costs rose by 6.1 per cent in the year to the third quarter of 2008, whereas productivity growth weakened further. As a result there will havebeen another steep rise in Spanish unit wage costs relative to the eurozone average, and crucially relative to Germany.

The growing divergence in competitiveness between the various members of the eurozone, and the extreme caution of consumers in Germany (and the Netherlands), mean that the imbalances within the eurozone have worsened substantially over the last two years. Growth in the German economy may have picked up strongly in 2006 and 2007, but this was almost exclusively due to exports and investment in export-orientated sectors. In fact, consumption fell by 0.5 per cent in 2007 and will have barely grown in 2008. Germany's current account surplus hit 7.7 per cent of GDP in 2007 (and will have remained around this level in 2008). Over half of the country's surplus is generated through trade with the economies of the currency union.[2] Germany is sometimes portrayed as the locomotive of the eurozone economy, but nothing could be further from the truth. Spain's current account deficit ballooned to 10 per cent of GDP in 2007 and Greece's to 14 per cent. Italy's rose to 2.6 per cent of GDP, despite economic stagnation (an economy growing as weakly as Italy would not normally be running a deficit).

[2] *The current account balances include transfers such as payments to and from the EU.*

	2001	2007
Germany	0.0	7.7
The Netherlands	2.4	6.5
France	2.0	-1.2
Italy	-0.1	-2.6
Spain	-3.9	-10.1
Portugal	-9.9	-9.8
Greece	-7.3	-14.1

Current account balances
(percentage of GDP)

Source: OECD economic database

Why should it matter that Germany is running an ever larger surplus with the rest of the eurozone? After all, now that the 16 participating economies share a currency, how is this different from, say, California running a surplus with the rest of the US? There are a number of reasons why it matters. First, unlike the US, the eurozone is not a unitary state with large fiscal transfers to compensate uncompetitive regions. In the US, taxes generated in economically vibrant parts of the country find their way to less dynamic states, much as they do within individual EU member-states. This does not happen within the eurozone, and it is highly unlikely that significant fiscal transfers will emerge any time soon. Second, many of the individual economies in the euro are less flexible than US states and will find it much harder to regain trade competitiveness. There is thus a greater risk of the imbalances becoming entrenched in the eurozone. Countries such as Italy, Spain and Greece have inflexible labour markets and very poor records of productivity growth. They will struggle to boost exports, especially if domestic demand remains so weak in Germany, and to a lesser extent the Netherlands.

The structural mercantilism of the Germans (and the Dutch) – both produce far more than they consume – was a big enough issue for the eurozone when the economic outlook was reasonably positive. It is now a serious problem because it threatens to exacerbate the economic downturn across the eurozone. Despite having done many things right in recent years – labour market reforms, industrial restructuring and fiscal consolidation – Germany's economic prospects are poor. If it could reduce its dependence on exports and generate stronger domestic demand, its economy would become less vulnerable to shifts in demand for its key exports (such as cars, machinery and equipment). It would be in the interests of Germany as well as the rest of the eurozone. Unfortunately, this is unlikely to happen. The German government has been sceptical of co-ordinated EU moves to stimulate domestic demand across the EU. It has preferred to concentrate its efforts on improving the international competitiveness of its manufacturing industries, and only reluctantly taken steps to boost domestic consumption. But in a currency union, large economies have to think about the impact of their policies on their neighbours. Allowing domestic demand to collapse is akin to pursuing a beggar-thy-neighbour strategy.

In the face of the worst recession since the 1930s, the German government is considering more decisive steps to stimulate the economy. Unfortunately, there is a risk that such a rebalancing will only happen slowly. Tax cuts for those on low incomes (who tend to save very little of their income), coupled with increased investment in infrastructure, would help. But the structural changes needed in the German economy – a shift away from the excessive dependence on export-orientated manufacturing in favour of services – could take a number of years to bring about. Although Germany's surpluses with countries outside the eurozone will fall, as the strength of the euro depresses demand for German exports, its surplus with the eurozone is likely to rise further. German costs will continue to fall relative to those of other eurozone economies, enabling German firms to expand their market share. At the same time, rising unemployment will weaken German demand for imports from other eurozone states. If Germany runs a bigger surplus with the rest of the eurozone, other eurozone economies will have to run bigger deficits.

When economic growth is robust, countries can run sizeable current-account deficits, so long as they can persuade foreigners to buy their assets and invest in their economies. But in a recession, current account deficits pose a much bigger problem. Countries with huge external surpluses such as Germany and the Netherlands are depressing demand across the eurozone at a time when it is already very weak. This is exacerbating the severity of the downturn and making it harder for countries with big external deficits to rebalance their economies away from domestic consumption in favour of exports.

These trends are causing concern among investors, who are now differentiating much more actively between the sovereign debts of the various member-states. When I wrote our 2006 report on the euro, the difference ('spread') between the yield on German government debt and that of Italy and Greece was about 30 basis points (0.3 of a percentage point). As of late December 2008, the spread between Greek and German debt had widened to 220 basis points and that between German and Italian debt to over 140 basis points. Investors are also attaching much higher risk to holding Irish debt, for which spreads over bunds have increased to 150 basis points. This largely reflects concerns about the Irish government's exposure to the liabilities of the country's crisis-hit banks.

	November 2007	December 2008
Ireland	22	148
Belgium	19	82
Greece	34	221
France	14	46
The Netherlands	12	57
Spain	16	83
Italy	36	134
Portugal	27	99
UK	65	5

European ten-year government bonds
(spread in basis points over German bunds)*

** 100 basis points equals one percentage point. Sources: European Central Bank, Financial Times*

The widening of yield spreads need not be bad news. Our 2006 report argued that investors needed to differentiate more actively between the sovereign debts of the member-states. This would help to discipline governments and prevent them from using the protection afforded by membership of the eurozone to delay necessary reforms and pursue unsustainable fiscal policies. Furthermore, the recent move by investors to make a much greater distinction between the debts of the various member-states is partly a function of the financial market turmoil. In times of great risk adversity and constrained liquidity, they will tend to want to hold German bunds – for which there is an extremely liquid market – rather than Greek debt. However, this is only part of the story.

The eurozone is experiencing an economic downturn of exceptional ferocity, exacerbated by a steep rise in the value of the euro. It is now perfectly plausible that the bloc's GDP will contract by 2 to 3 per cent in 2009, and some member-states could see GDP declines of as much as 4 per cent. The result will be a dramatic weakening of fiscal positions. With borrowing by governments all over the world set to rise steeply, it will become much harder to raise funds. Some investors may fear that the growth prospects of struggling eurozone economies will be permanently handicapped by their inflexibility and the external surpluses of other eurozone member-states. If so, investors' confidence in the fiscal solvency of these countries could drain away, leading to a dramatic increase in their borrowing costs.

Greece and Italy are probably most vulnerable to such a loss of confidence. Both are inflexible and bear the weight of very high levels of public debt. So they are likely to have a battle on their hands to attract funds. The Italian government recognises as much, and has refrained from implementing any fiscal stimulus, despite the scale of the economic downturn. However, the problems are unlikely to be confined to this pair. The Spanish economy is on course to contract very sharply in 2009. Although Spain's public finances were in decent shape prior to the economic crisis, they are deteriorating rapidly. A deep recession in 2009 could see Spain's budget deficit widen to at least 5 per cent of GDP in 2009. Spain's overall public debt burden is relatively low (as a percentage of GDP), but unless the Spanish government moves rapidly to introduce the reforms that will boost productivity (and hence its chances of escaping economic stagnation), investors could also start to shun Spanish debt issues.

In short, too much attention has been devoted to the safe haven effect of eurozone membership, and too little attention to the impact of permanently weak economic growth on fiscal solvency. For example, numerous commentators have argued that Britain cannot afford to stay outside the euro, on the grounds that it will face punitively high interest rates and that investors may baulk at holding Sterling assets. Sterling has certainly weakened dramatically since the start of 2008, but the spread between the yield on UK debt and German bunds was just 5 basis points at the beginning of January 2009, lower than any member-state of the eurozone. This is striking, given the weakness of the UK's public finances and the risk of further falls in the value of the pound. Investors appear much more concerned about the solvency of a number of eurozone economies.

The currently very low yields on UK government debt are not an argument against the UK joining the eurozone, or for the return of floating exchange rates within the eurozone. But the widening bond yield spreads within the eurozone highlight that membership is no panacea: membership insulates countries from the risk of a currency crisis, but currency risk can be replaced by credit risk. A country can only run a current account deficit if foreigners are prepared to buy its assets, either public or private. They will only buy private assets, such as company shares and bonds, as long as they believe in their creditworthiness. And they will only buy government bonds if they believe in the solvency of the deficit country's government.

What is going to happen?

On the basis of these trends, a number of scenarios are possible. The first is that the difficulty of raising funds will force the governments of the deficit countries to take drastic steps to strengthen their public finances, thereby assuaging investor concerns and bringing about a narrowing of yield spreads. They could adhere strictly to the Stability and Growth Pact (SGP), which requires members of the eurozone to limit their budget deficits to 3 per cent of GDP. It is a moot question whether governments would be able to cut spending by the sums required without triggering some sort of political crisis. Against a backdrop of recession or economic stagnation, painful spending cuts would be extremely difficult for any government to sell to voters. Moreover, it is not clear that such measures would achieve the desired objective: drastic cuts in spending and/or tax rises would run the risk of deepening the recession, which would in itself prevent an improvement in the fiscal position. The deficit countries would stand a much better chance of pulling this off if the member-states with big trade surpluses and stronger fiscal positions moved decisively to boost domestic demand.

A second scenario would be a bail-out of the affected member-states by the rest of the eurozone. This is unlikely, but not totally inconceivable, especially if such a bail-out was accompanied by IMF-style conditionality and portrayed as a pre-emptive move to prevent further runs on the debt of other eurozone members. But there would be plenty of political obstacles. In the stronger member-states, such a bail-out would be a tough sell politically. The financial crisis has highlighted the limits of co-ordinated policy action within the eurozone, and exposed the reluctance of the fiscally strong member-states to engage in burden-sharing. Furthermore, this scenario could prove controversial in the country being bailed-out. Much as in the first scenario, the government in question would be forced into steps that would exacerbate the economic downturn.

A third scenario would be faster political integration within the eurozone and a move to some kind of fiscal federalism. In short, a belated attempt to address what many economists have always believed to be the inherent contradiction in EMU: the absence of a political union. The sovereign debt of all the member-states could be issued centrally by a sovereign eurozone issuer, and a mechanism put in place to transfer resources to struggling member-states. This option would be the one most compatible with the long-term sustainability of the currency bloc, but it would require big political shifts, not least in the richer countries that would have to share their fiscal credibility and provide direct financial support.

A fourth scenario would be for an insolvent member-state to default on its debts, but remain with the eurozone. This would spare it the economic dislocation that would accompany a move to quit EMU. A decision to remain in the eurozone following default would probably bring forward the point at which such a country could resume borrowing on reasonable terms. After all, it would be issuing debt in euro rather than in a revived national currency that would lack credibility. For small, flexible, member-states, which could restore competitiveness by successfully holding down costs or boosting productivity growth, this might be the most attractive option. But such countries are unlikely to find themselves in this predicament in the first place.

Finally, a country could default and leave the eurozone. This would be the 'nuclear option.' No weak member-state would leave without defaulting, since its debt burden – as its newly-created national currency was devalued against the euro – would become crippling. This scenario would be messy, as any number of economists have pointed out. It would no doubt prompt widespread economic dislocation. However, for inflexible (and especially bigger) economies, it is far from clear that default within the currency union is more plausible than a default and a move to leave it. If the country concerned stayed within the eurozone, it would still struggle to regain competitiveness. Its public finances would remain weak, raising some doubts over how quickly the defaulting country would regain access to capital on affordable terms. Such a country could decide that having defaulted (and in the process cut itself off from most sources of capital, at least for a time) it may as well devalue, which would at least help to restore competitiveness and get the economy growing again.

Each of these scenarios is conceivable. But the most straightforward – accelerated political integration within the eurozone and a move to some form of fiscal federalism – is the least likely. While it is conceivable that a serious economic crisis could lead to greater support for some kind of political union, there is very little sign of this happening at present. The second scenario is rather more plausible. A crisis could lead to a bail-out of the hardest-hit states and an increased appreciation of the need for closer policy co-ordination.

The most likely scenario is almost certainly the first – wrenching fiscal retrenchment in hard-hit member-states and some modest moves by Germany and others with large external surpluses to rebalance their economies. This 'muddling through' option is the best that can be hoped for, but it will be uncomfortable. Economic growth across the eurozone will be very weak, and some economies will experience prolonged stagnation. Governments will struggle to manage the political strains caused by fiscal austerity at a time of very weak economic growth. Political tensions between the members of the eurozone are also likely to rise, as was already apparent during the run up to the EU summit in December 2008. The frustration of the deficit countries at the macro-economic policies of the surplus countries will mount.

Of the two least desirable outcomes – a default within the eurozone, and default combined with leaving the eurozone – the first would be preferable, at least from the perspective of the bloc as a whole. A decision to quit the currency union might not be as big a catastrophe as is sometimes predicted for the country in default. But there is no doubt it would be hugely damaging for Europe. A decision by one member-state to leave would probably trigger a chain reaction, with investors forcing other countries out of the currency union. That would do untold damage to the credibility of the EU. The single market could be severely damaged if the remaining members of the eurozone erected protectionist barriers against imports from countries that had created national currencies and embarked on competitive devaluations. European integration would suffer a devastating blow.

Conclusion

This essay has revisited the arguments made in our 2006 report entitled, 'Will the eurozone crack?' Despite the current strength of the euro, and obvious advantages of a safe haven that membership provides at a time of financial turmoil, the concerns raised then are even more valid today. Trade imbalances within the currency bloc have widened further, and the pace of reforms needed to increase flexibility and prevent economic imbalances becoming entrenched has, if anything, slowed. Germany has become even more dependent on exports to the rest of the currency union.

Indeed, the severity and longevity of the economic downturn threatens to further exacerbate the underlying tensions within the eurozone. There is a serious risk that the growth prospects of struggling eurozone economies will be permanently handicapped by their inflexibility and the external surpluses of other eurozone member-states. If so, investors will lose confidence in the credit-worthiness of governments and firms in the hard-hit countries, leading to a dramatic increase in their borrowing costs. Indeed, this has already started to happen.

This trend need not have disastrous consequences for the eurozone if it leads to accelerated integration and support for the affected member-states. But this is highly unlikely. In the absence of such moves, it is crucially important that a number of other things happen. First, there must be much closer policy co-ordination among the member-states of the eurozone. Second, Germany and the Netherlands need to move aggressively to rebalance their economies and become drivers of economic growth within the eurozone. Third, the countries that have lost competitiveness – in particular, Italy, Spain, Greece and Portugal – need to get serious about improving their productivity. Finally, the EU must renew its commitment to deepening the single market.

★

Simon Tilford is chief economist at the Centre for European Reform.

January 2009