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The time bomb no one can defuse

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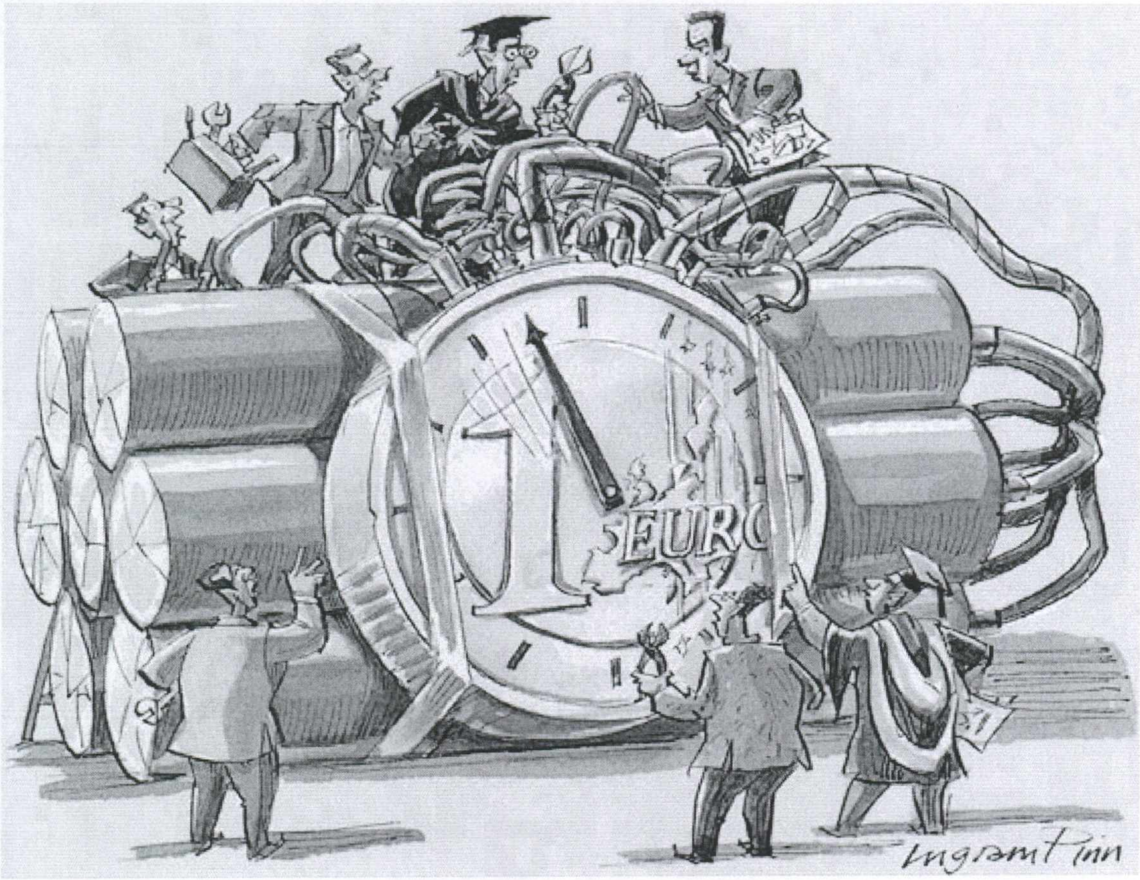

This should be a great time to be a eurosceptic. The sceptics predicted the single currency would not work. They would love to gloat. Instead, they face a dilemma. For now the sceptics are being told that they must do everything possible to keep the euro together – or risk economic Armageddon.

This conundrum has provoked much head-scratching in Downing Street. Both David Cameron and George Osborne thought the euro was a bad idea – and neither man is surprised to see it in trouble. Instinct and intellect lead the British prime minister and his chancellor to believe that the single currency could well fall apart. If that is the case, then it would seem futile and counterproductive to pour money and energy into trying to prop up a doomed project.

Yet all the briefings Mr Cameron and Mr Osborne are getting from the UK Treasury suggest that a break-up of the single currency could provoke an economic cataclysm – with banks and businesses collapsing across Europe, and the risk of another Great Depression.

Many of the academic and City economists consulted by the prime minister and his senior colleagues have been just as gloomy as the Treasury. Confronted with so many assurances that the break-up of the euro spells disaster, Britain's leaders have reluctantly gone against their initial instincts. They are urging European colleagues to do everything they can to keep the single currency together. In a memorable phrase, Mr Osborne told eurozone leaders to follow the "remorseless logic" of monetary union and press on towards a true fiscal union in Europe.

Is there a way out of this euro-conundrum? Tuesday may see the first tentative answers emerge, with the announcement of the shortlist for the Wolfson Prize. Following the sound free-market principle that economic incentives can work wonders, Lord Wolfson, a Tory peer, has offered a prize of £250,000 for the best plan to break up the single European currency. If there is a safe way of defusing the euro-bomb, then the prize may offer the blueprint.

A British discussion about the euro is by nature a bit of a sideshow. While ideas that emerge from the Wolfson Prize and elsewhere might influence the debate, the UK is not in the euro, so the key decisions are not going to be made in London.

Instead the fate of the euro will be decided in countries such as Greece, Spain, Italy and, above all, Germany. So it is significant that, behind the scenes, a debate about the break-up of the euro is also taking place among senior figures in the German establishment.

There was always a group of top German economists – call them the Bundesbank tendency – who had deep misgivings about the whole single currency project. Now some of these German sceptics believe their concerns are being vindicated and are even suggesting that – despite the current calm in the markets – Greece may have to leave the euro within months.

One scenario doing the rounds in Frankfurt and Berlin is that the crisis could be provoked by the Greek elections, which are likely to be held in early May. A new Greek government might seek to unpick the latest debt deal, provoking a chain of events leading to Greece leaving the euro. Technically, it is said that this would involve the sudden declaration of a temporary bank holiday, during which all euro-notes in Greek banks are stamped, to show that they are being reissued as drachmas. One obvious danger is that – as soon as this step was announced – there would be bank-runs in other vulnerable euro-area countries such as Portugal, as anxious account-holders rushed to move their money out of the country. This would be counteracted by the provision of massive emergency liquidity from the European Central Bank to financial institutions in vulnerable countries.

Doubtless, there are many flaws in this plan. But the very fact that such stark scenarios are doing the rounds in Germany may help to account for Chancellor Angela Merkel's recent decision to give interviews proclaiming her belief in Greece staying inside the euro and suggesting that the single currency's break-up would be a political disaster for Europe.

Ms Merkel's view that the whole euro project would be gravely damaged by a Greek exit seems right. If, as the doomsayers predict, Greece was plunged into economic chaos after leaving, the rest of Europe could not simply stand by and watch. It would be sucked back into the resulting political and economic mess.

On the other hand, if a Greek exit went well, then other countries that are struggling inside the eurozone would be severely tempted to follow suit. There are senior Spanish officials, for example, who fear that another round of budgetary austerity – when youth unemployment is already at 45 per cent – could lead to political and economic devastation in Spain. They argue that financial and economic crises in other European nations have rarely been solved by structural reform alone. In the cases of both Sweden in the 1990s and Iceland over the past couple of years, they also involved a major devaluation of the currency to boost competitiveness – something that is impossible inside the euro. The implication is clear. Spain has to get out of the euro.

So far, these siren voices are being ignored because Spanish ministers – like their British counterparts – have been told that a euro break-up would lead to disaster. If the entrants to Lord Wolfson's prize can show otherwise, they will have done the whole of Europe a service.