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"It might be politically toxic - but we must join the euro now"

It is the City's need to borrow at least £100bn a year for the foreseeable future, on top of the government's need to borrow the same - made acutely more difficult by a sterling crisis - that is the heart of the problem. Suddenly membership of the euro - politically toxic - is beginning to look a very attractive escape route.

Will Hutton*

When the euro launched nearly 10 years ago, an unnamed euro-sceptic currency trader - now almost certainly redundant - famously called it a toilet currency. Last week it climbed to an all-time high against the pound.

Moreover, in Washington this weekend, the euro was the most important currency next to the dollar. The ease with which it can be converted into other currencies, and in huge scale, are two key preconditions to being a reserve currency. The euro and dollar qualify. So does the smaller yen.

Sterling does not. It may be convertible, but at present only sellers are exercising their rights. Three months ago a pound was worth more than two dollars. On Friday it bought $ 1.48 – an extraordinary fall. Shadow Chancellor George Osborne blames Gordon Brown's excessive government borrowing.

The explanation is far more complex, and for a Conservative, far less congenial. For years Britain has indulged the City, allowing our financial system to grow four and half times the size of our GDP, a more modest version of Iceland, Ireland and Switzerland, but with the same risks.

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Before growing too depressed, I should point out that we may muddle through. The fall in the pound will stimulate exports and, if it does not become a rout, it is welcome. But there is a real danger that in a country that currently resembles a gigantic hedge fund, the fall could get out of hand.

The foreign savers on whom the government and banks rely to finance their debts went on strike 12 months ago. Now they are actively withdrawing their cash. Last week one of the US's top banks, the Bank of New York Mellon, revealed that in September and October, three quarters of the capital that foreigners had brought into Britain in the preceding four years had left - more than £100bn.

What worries them is that with plunging property values, the viability of British banks remains questionable, but the UK government has not got a deep enough pocket to bail them out again. British savings are inadequate. If a company gets into this situation it declares bankruptcy because it has not the cash to continue trading. If foreign cash continues to leave, the UK faces the same fate.

However, bankruptcy works differently for a country; it spells economic stagnation. The ardent hope is that this does not happen. If investors start to consider the pound cheap and endorse the government's handling of the economy, they may start buying sterling assets again. But suppose the worst happens, what then?

There is the Latin American option. Instead of trying to sell bonds, the government would simply instruct the Bank of England effectively to print money. It may want to do this anyway if deflation looms, but now its hand would be forced. But once on this path there is no easy way back; savers and investors are crowded out by the printing press and the country gets locked in a cycle of inflation in a broken-backed economy with an angry, rapidly impoverished middle class.

The next option is to organise a jumbo - up to $200bn - loan from the IMF, EU and US to tide the economy over. The Europeans and Americans would both insist that Britain negotiate a deal with the IMF as the precondition for the loan. It would be a re-run of Labour Chancellor Denis Healey turning to the IMF in April 1976 - only now it would be Alistair Darling and Gordon Brown. One insider, contemplating the prospect, acknowledged it would be political suicide.

The last, best and most palatable option is to join the euro, and fight a referendum campaign on it being our get-out-of-jail-free card - a means of avoiding de facto national bankruptcy and emasculation of the property-owning middle class while offering a route to reindustrialisation and underwriting the City of London. Inside the euro, both the government and the City would be able to sustain the spending and lending necessary to avert recession. The competitive level at which we would join would boost industrial exports for a generation. And the middle class would not have its savings wrecked by inflation. We would avoid the clutches of the IMF.

Importantly, at the moment, the five tests for entry set by Gordon Brown are all met 100 per cent. Britain and Europe's economies are in perfect synch as we enter recession simultaneously. The labour market is flexible. Entry would attract much-needed inward investment, and save the City. It would boost growth. In economic and political terms it would be a masterstroke. Britain would become a member of a reserve currency zone at a competitive level, offering us a key role in the emergent debate about the governance of globalisation and the international financial system. We would remain prosperous and we would matter.

Brown, I am told, when the idea was put to him not only ruled it out, he did not want it repeated again for fear even its mention would imply it was actively being considered. Euro membership is political poison, even as its logic becomes more compelling. The same crowd who cheerleaded Britain into becoming a de facto hedge fund in the name of free markets would now rather risk endemic inflation or endless recession and stagnation to avoid the dark hand of Europe.

Political leadership is about taking a position in the national interest and arguing for it, rather than being cowed into silence. The best time to begin negotiations is now, rather than in the middle of an economic rout. The very fact that there is zero chance of this happening is one more reason why foreign investors are fleeing - and makes it more likely a rout is on the way.

The views expressed in this article are those of the author and do not necessarily reflect those of the FES London.

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