CPB Netherlands Bureau for Economic Policy Analysis

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Second opinion on Lombard Street Research's report 'The Netherlands and the Euro'

On request by the Lower House of the Dutch Parliament

Centraal Planbureau

CPB Memo

To: The Standing Parliamentary Committee on Finance

CPB Netherlands Bureau for Economic Policy Analysis
Van Stolkweg 14
Post office box 80510
2508 GM The Hague

T (070) 3383 380
W www.cpb.nl

Contact persons

Michiel Bijlsma, Arjan Lejour, Bas Straathof

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1 Introduction and summary

1.1 Background

During the rules on procedure of 6 March 2012 the Standing Parliamentary Committee on Finance (VKF) of the Dutch Lower House asked the Netherlands Bureau for Economic Policy Analysis (CPB) to analyse the study 'The Netherlands and the Euro' carried out by Lombard Street Research (LSR) and commissioned by the Freedom party (PVV). On 21 March the CPB received 49 additional questions from the VKF. The CPB tested the request against the Instructions for the Planning Offices, which were recently adopted by the Prime Minister (*Staatscourant*, 21 February 2012).[1] The CPB is happy to comply with the request to the extent the questions can be answered on the basis of the expertise and capacity available at the CPB.

1.2 Delineation

The CPB confined itself to an evaluation of the main conclusions as cited in the summary of the LSR report (*The Netherlands and the Euro*, referred to hereafter as the *summary*) and the supporting arguments for these conclusions given in the report itself (*The Netherlands and the Euro: The Full Report*, referred to hereafter as the *full report*), as the CPB indicated in its letter to the Lower House of

[1] In doing so the CPB anticipated the taking effect of the Instructions as of 1 April 2012.

Parliament dated 22 March 2012 (reference 1200548).[2] The CPB did not perform any extra or supplementary research. An alternative cost-benefit analysis of the euro is not given either. As a consequence of this, some of the additional questions that the VKF submitted to the CPB could not be answered. A significant reason for this is that a soundly supported cost-benefit analysis of the euro is particularly complex and time-consuming.[3] This is also demonstrated by, *inter alia*, reports on a possible euro exit published in the last two years by, among others, ING, Rabobank, Citigroup and UBS.[4] All these reports make different assumptions and give different estimations of the consequences of breaking up the euro, but the methodology of these reports is very much open to question. The consequences of the breaking apart of the Euro-zone are strongly dependent on the particular way and circumstances this would occur.

The CPB has concluded that LSR's study 'The Netherlands and the Euro' has shortcomings. On the basis of the two reports that LSR has published, it is not possible to endorse its key findings, namely that the introduction of the euro cost the Netherlands financially and that the Netherlands would save money by leaving the euro.

Section 1.3 summarises and comments on the two main conclusions of the *summary* of the LSR report. Chapter 2 discusses the costs and benefits of the euro until the European banking and government debt crisis in 2010. Chapter 3 addresses the financial consequences of the crisis after 2009, including scenarios for the breaking up of the euro zone. We use this distinction also on the basis of the additional questions from the VKF. The additional questions from the VKF are discussed, where possible, with the sections to which they relate.

1.3 Findings

The *summary* of the LSR report contains two main conclusions. The first is that the euro cost the Netherlands financially in the period prior to the banking and debt crisis. In the *summary*, LSR states: *"There are advantages to the euro, ..., but these are in no way proportionate to the disadvantages. The growth rate of the Dutch GDP has collapsed compared to its pre-euro rate, moreover this rate lags significantly behind the growth of comparable non-euro countries like Sweden and Switzerland. "*

[2] In a number of cases the conclusions that are presented in 'The Netherlands and the Euro' do not follow or do not follow directly from the analysis given in 'The Netherlands and the Euro: The Full Report'.

[3] Such an analysis also requires knowledge of various disciplines. Baldwin (2012) argues that a comprehensive analysis of a euro exit requires knowledge of macroeconomics and international economics, the banking system in Europe, contract law, European law and European decision-making.

[4] Examples include Buiter and Rahbari (2011), ING (2010), Rabobank (2010) and UBS (2010).

The second conclusion is that the Netherlands would save money by leaving the euro, albeit not in the first year of departure, since the Mediterranean countries would no longer have to be supported. *"But the savings of at least 37 billion and 38 billion euros in the two [years] subsequent and 19 billion euros in the years following that outweigh these short-term costs."*

LSR's analysis does not lead to these conclusions.[5] There are methodological objections to how the first conclusion has been reached. The most important objection is that the differences in GDP growth between EMU countries and non-EMU EU countries cannot be automatically ascribed to the euro. LSR ascribes all differences in economic growth between the Netherlands and Sweden to the euro. These differences could be traced back to many other non-euro-related causes however. This is further explained in Section 2.

Concerning the second conclusion LSR overestimates the costs of the aid to other countries and underestimates the costs of a euro exit. LSR assumes without further substantiation that upon leaving the euro, the Netherlands would no longer provide aid to EU member states with financing difficulties and that this would have no economic, legal or political consequences for the Netherlands. According to the CPB, the reintroduction of the guilder would not result in savings of tens of billions of euros in the short term.

The *summary* has a different structure and content from the *full report*. In the *summary*, one of the three chapters relates to the period up to 2009. The other two chapters discuss future scenarios. In the *full report*, four of the five chapters discuss the period up to the banking and debt crisis and only the last chapter addresses the future of the euro zone. The costs of the euro cited in the *summary* cannot be found in the *full report*. Both publications fail to give a clear source for the figures presented and provide no references to the scientific economic literature. Since the CPB is only providing a second opinion on the general points, not all the figures on which LSR relies have been verified and not every detailed line of reasoning has been checked.

The analysis in the *full report* is focused on macroeconomic imbalances, often discussing the short-term effects and devoting less attention to the long term. The method is usually comparatively empiric, dominated by comparisons between countries. No econometric or statistical methods were used to indicate the effects of the euro and/or the return to the guilder. No attention is paid to changes in economic structure, the role of institutions (banking supervision, etc.) or the role of expectations for financial markets.

[5] A great many of the VKF's questions are answered in the elaboration of the CPB's argumentation.

2 The costs and benefits of the euro up to 2009.

LSR's conclusion that the Netherlands has mainly experienced disadvantages as a result of the introduction of the euro is based on the following interim conclusions, as they are also formulated in the *summary*.

1. Introduction of the euro reportedly resulted in lower GDP growth in the Netherlands: 1¼ % on average per year during the 2001-2011 period instead of 2¼% like in Sweden. This reportedly resulted in 900 euros less in consumer spending per person per year.
2. The introduction of the euro reportedly resulted in lower consumption growth: ¼% on average per year instead of 1¼% if consumption growth had been equal to the GDP growth just as in Sweden and Switzerland. This reportedly resulted in 1,800 euros less in consumer spending per person per year.
3. Because of the low interest rate, the euro reportedly caused 115 billion euros in investment losses, 7,000 euros per person.
4. The benefits of the euro due to increased international trade reportedly accounted for 2% of GDP, or 800 euros per person per year.
5. The euro was the cause of the current debt and banking crisis.

2.1 GDP growth

LSR describes a number of economic problems in the Netherlands. The year 2001 is taken as a dividing line for this, so that the state of the economy before and after the introduction of the euro can be compared. LSR argues that the lower average growth in GDP and consumer spending in the second period is exclusively the result of the euro. This conclusion is incorrect for two reasons.

The first reason is that LSR gives no reasoning for the assertion that the euro reportedly resulted in lower economic growth. LSR assumes that wage moderation in the Netherlands and Germany was a result of the introduction of the euro and that wage moderation brought about lower economic growth. LSR has not presented any evidence for the assertion that the euro caused wage moderation. Wage moderation certainly also occurred in the Netherlands before the introduction of the euro, since the nineteen eighties in fact. The guilder was linked to the German mark at the time. Both Dutch GDP and Dutch consumption grew substantially in this period. LSR does not indicate why wage moderation reportedly resulted in problems since the introduction of the euro. For the rest, it also emerges from the data that LSR itself presents that Dutch wage costs rose more strongly than the average in the euro zone (*full report*, p. 4) and that in Sweden, the unit wage costs fell more strongly than in the Netherlands or Germany (*full report*, p. 47).

Secondly, LSR does not take into account other factors that impacted economic growth: the ICT boom before the introduction of the euro, the terrorist attacks of 11 September 2001 and thereafter, the mortgage crisis in the United States and the global banking crisis that ensued. There are major differences even between Western European countries, for example in terms of housing market policy, sector structure (in particular the financial sector's share in the economy), (over)valuation of property, exposure to risks related to US sub-prime mortgages and Mediterranean government bonds. These differences between countries also cause economies to respond differently to the worldwide shocks mentioned above. Ascribing the difference in economic growth between two countries entirely to a single factor therefore leads to incomplete conclusions.

In calculating what LSR claims are the costs of the euro for the Netherlands, two choices are made which cause these 'costs' to work out particularly high. The first choice is that in its calculations, LSR takes 2001, not 1999, as the year of the introduction of the euro.[6] By using this introduction year, the second period shows up as extra unfavourable compared to the first period. The difference involves two years with a great deal of economic growth. The Central Economic Plan 2012 (p. 52-53) shows that GDP growth for 1996-2000 was very high, partly due to consumption growth. The choice of the dividing line is decisive for the outcomes, as shown by the table below. The average annual real GDP growth difference is 1% instead of 1.8%.

Table 1. Growth in real GDP in the Netherlands, 1991-2010

1st period				2nd period		
	Cumulative	Annual, average			Cumulative	Annual, average
1991-2000	33 %	3.2%		2001-2010	15%	1.4%
1991-1998	23 %	2.9%		1999-2010	25%	1.9%

Source: Statline CBS

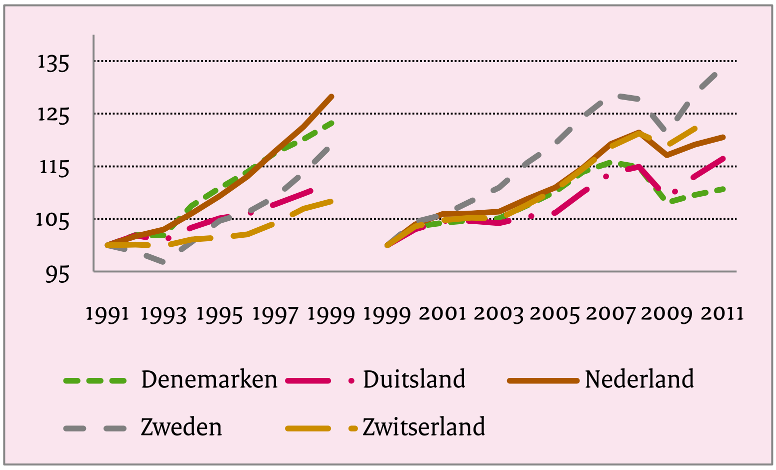
The second choice which makes the 'costs' of the euro for the Netherlands work out to be extra high is that in the *summary*, LSR argues that the difference in economic growth between the Netherlands and Sweden since the introduction of the euro can be entirely attributed to the euro. In the *full report*, LSR compares the Netherlands and Germany to Sweden, Switzerland and Denmark. Denmark scores the worst for many macroeconomic indicators, but LSR claims this is because the Danish krone is linked to the euro. LSR then largely leaves Denmark out of the analysis. No statistical analysis is presented which indicates that the euro is responsible for differences in economic growth between the five selected countries and no scientific references are given that support this starting point.

[6] On pages 3 and 6 of the *full report*, 1999 is referred to as the year in which the euro was introduced.

In the *summary*, based on the difference in GDP growth between the Netherlands and Sweden, the conclusion is drawn that the euro resulted in 900 euros less in consumer spending per person per year. There are three reasons why this conclusion is questionable. Firstly, LSR does not demonstrate that the Swedish economy grew faster than the Dutch economy because of the euro. For one, the Dutch and Swedish economies have different structures, with the financial sector having a larger share of the economy in the Netherlands. Both economies were therefore affected differently by worldwide shocks such as the ICT boom of the nineteen nineties, the terrorist attacks of 11 September 2001 and thereafter, the mortgage crisis in the United States and the banking crisis that ensued. Sweden is also currently working to catch up after a period of low, even negative economic growth.

Secondly, the Dutch GDP is not compared with the average GDP of the reference countries, but with the country that performed the best. The third reason is that 2001 is used as the introduction year of the euro, not 1999. The figure below shows that Dutch growth may well have been lower than Swedish growth, but it was similar to Swiss growth and a bit higher than Danish growth.

Figure: Development in real GDP for a number of EU countries with base years 1991 and 1999



Source: OECD

[Denmark Germany The Netherlands Sweden Switzerland]

2.2 Consumer spending

LSR not only concludes that the Dutch economy grew more slowly because of the euro, but also that the euro caused growth in consumer spending to lag behind economic growth. In the *summary*, LSR draws the conclusion that this resulted in 1,800 euros less in consumer spending per person per year in the Netherlands. According to LSR, the relative decline in consumer spending was both directly and indirectly the result of wage moderation. Directly because households' disposable income grew less quickly and indirectly because the wage moderation eliminated any incentive for productivity growth. For the rest this last argument is irreconcilable with the data on production per worked hour (*full report*, pp. 37, 46): both the Netherlands and Germany performed relatively well in comparison to other countries in terms of productivity growth.

LSR gives no clear reasoning why the euro reportedly caused wage moderation in the Netherlands and it also does not emerge from LSR's figures that the wage costs in the Netherlands lagged behind those in other countries. The reason for the difference in consumption growth between the years prior to 2002 and those thereafter was that Dutch households' incomes and assets barely increased in the first decade of this century. In the period 1986 to 2000, the growth in capital of almost three percent per year on average was the most important reason for consumption growth (CEP 2012, p. 57). Between 2000 and 2005, the average growth in capital was one percent, and virtually nil thereafter.

2.3 Return on foreign investments

The Dutch export surplus and therefore its savings surplus (savings minus investments) increased over the past ten years: business savings increased substantially, but this did not result in a substantial increase in the investments in the Netherlands (Kieft, 2010). Of the total foreign investments of 710 billion euros, approximately 60 billion euros was invested in the Southern European countries and Ireland (2010 levels, source: DNB). The returns on these foreign investments do not always seem very high and that prompts the question of whether the height of the Dutch savings is optimal. A recent report from DNB[7] shows that this is partly due to an accounting reason: foreign assets are often valued at historical value instead of market value. LSR's claim that because of a low interest rate, the euro caused investment losses of 115 billion euros is therefore insufficiently substantiated.

2.4 The benefits of the euro

In the *summary*, the benefits of the euro are estimated at 800 euros per person based on data up to and including 2004. That is somewhat higher than the CPB's calculation (at most a week's salary, which implies an upper limit of 500 euros).[8] The CPB calculation gives the benefits of the euro up to 2008. The study from Barrell et al. (2008) on which LSR's calculation is based (p. 5 of the *summary*) uses a methodology that analyses the benefits. It is concluded on the basis of an

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[7] http://www.dnb.nl/nieuws/nieuwsoverzicht-en-archief/dnbulletin-2012/dnb270308.jsp.

[8] This is, in response to the VKF's question, partly based on the article from Baldwin (2008). This involves the effects that have already occurred.

econometric analysis that the introduction of the euro resulted in two percent higher GDP for the Netherlands, Germany, Belgium, France and Italy. In addition, LSR estimates that the reduction in transaction costs added 0.3 percent to the GDP, based on a report from the European Commission. These benefits are only discussed in the *summary*; no attention is devoted to this in the *full report*.

2.5 Banking and debt crisis

In the *full report*, LSR argues that the low real short-term interest rate in countries like Greece, Ireland and Spain was the result of savings in Germany and the Netherlands that grew faster than GDP.[9] These savings allegedly prompted northern euro-zone countries to loan an irresponsibly high amount of money to the southern euro-zone countries. LSR claims that the loaned money was subsequently not used for productive investments, as a result of which debts emerge to be difficult to pay off.

It was already explained in section 2.2 that LSR did not properly substantiate how the euro reportedly resulted in more savings in the Netherlands and Germany. Another problem is that a low interest rate due to high savings does not explain why investors underestimated the risks on many loans. In the CPB's opinion, it is more logical that insufficient supervision on banks was the underlying cause for this. Added to this it was the major recession caused by problems on the US housing market that caused government debts to rise strongly. As such the major recession is also partly responsible for the European banking and government debt crisis. It is therefore not clear that the euro was the direct cause of the current economic problems. This does not detract from the fact that the euro has many shortcomings. These are discussed in the first chapter of the *full report* (“*The Inherent Economic Flaws in EMU*”) and in Teulings et al. (2011).

3 The costs and benefits of leaving

A second important part of LSR's study is the costs and benefits of leaving the euro. LSR's arguments relating to this consist of two elements. The first element is an estimate of the minimum and maximum expected aid operations for problem countries. The second element is the macroeconomic adjustment costs of reintroducing the guilder.

[9] Kieft (2010) gave a breakdown of the savings surplus. This indicates that since the turn of the century, the national savings surplus has no longer been the result of a drive to save on the part of households, but on the part of non-financial businesses.

3.1 The costs of aid operations to other countries

In estimating the costs of aid operations, LSR assumes that the governments of Greece, Italy, Portugal and Spain cannot satisfy their payment obligations. LSR uses starting points here that differ per country.

- For Greece, the starting point is a government debt of 325 billion euros in 2011 that will be reduced to 110.4 billion in 2016. This will take place entirely because aid that EMU countries provide will be written off in a period of three years. The presumable assumption is that this involves the restructuring of government debt. A possible contribution from the IMF remains outside of consideration.
- For Italy, LSR assumes a scenario in which the government debt of that country increases from 2,026 billion euros in 2011 to 2,358 billion euros in 2015. In the optimistic scenario, the EMU countries must take on the government deficit of the problem countries. The aid provided is therefore equal to the government deficit. In the pessimistic scenario, in addition to this all the expiring Italian debt securities will have to be refinanced by the healthy EMU countries. The aid granted is entirely lost in both cases.
- For Spain, LSR assumes a scenario in which the government debt of that country decreases from 1,096 billion euros in 2011 to 1,068 billion euros in 2015. In the optimistic scenario, the EMU must contribute aid equal to the government deficit. In the pessimistic scenario, in addition to this all the expiring debt securities will have to be refinanced by the healthy EMU countries. The aid granted is entirely lost in both cases.
- For Portugal, LSR assumes a decrease in government debt from 192.5 billion euros in 2011 to 0 in 2015. All the debt is refinanced by the EMU countries and written off in three years.

These assumptions are based on the expectation that these four countries will find themselves in even greater difficulties than they face now and that aid via the European Financial Stability Facility (EFSF) and/or European Stability Mechanism (ESM) with the participation of the IMF, structural reform and cutbacks and ECB interventions in monetary markets will prove ineffective. A second important starting point is that all the aid granted will be entirely lost and that the total losses will be at the expense of the EMU countries that do not find themselves in difficulties. The Dutch share of this is 10 percent. According to LSR, the Netherlands will ultimately pay between 127 billion and 241 billion euros[10] in financial assistance for Greece, Portugal, Italy and Spain during the 2012-2015 period.

The bankruptcy of countries in the past shows that a part of the debt is always repaid, however. Historical data show that the percentage of the debt that is ultimately not repaid in the event of

[10] The non-discounted sum of maximum and minimum aid in the table on p. 33 of the full LSR report.

restructuring ranges from 13% to 73%, and for most restructurings the downgrading of debt securities is around 25 to 35 percent.[11] This means that on average, 65-75 percent is repaid.

The optimistic scenario also assumes that countries will not repay their obligation to the aid providers. LSR's most optimistic scenario therefore assumes that Italy and Spain will have to restructure their debts. The CPB does not rule out that more countries may yet find themselves in difficulties and have to write off part of the government debt. In that scenario, there are also other possibilities of lightening the debt burden, such as renegotiating the debt with private debt holders as occurred with Greece. This reduces the burden for governments. It is also possible that the aid measures already taken, the reforms and cutbacks that countries like Spain and Italy are implementing, as well as the possible future liquidity support from the ECB, may be sufficient to prevent these countries from having to appeal for aid from other countries.

3.2 The costs and benefits of leaving

According to the *summary*, the reintroduction of the guilder will result in an immediate saving of tens of billions of euros that would otherwise be spent on aid operations. Along with these benefits of reintroducing the guilder, LSR indicates in the *full report* that leaving the euro would also entail costs. LSR takes as starting point here that the consequences of leaving a currency union are the same as abandoning a fixed exchange rate. The impact of the Netherlands and Germany leaving the euro on the financial stability of the EU is left out of consideration.

The benefits that LSR ascribes to leaving the euro are strongly exaggerated. If the Netherlands were to leave the euro zone, the LSR claims that the Netherlands would pay much less in aid for these countries, specifically 9 billion euros. Obligations already entered into, also in the form of the ESM or the EFSF, would not be complied with in that case. This follows from the table on page 4 of the *summary*. It is unclear what assumptions this amount is based on. The failure to comply with these obligations could result in legal proceedings. The CPB cannot judge what the legal and political consequences of this would be.

It is not likely that failing to support other EU countries will save the Netherlands from economic costs. Dutch financial institutions have substantial investments outstanding in Spain and Italy, for instance. In 2009 the total in Direct Foreign Investments (DBI) by the Netherlands in Spain was 100 billion euros, for instance, or 21½% of the total DBI in Spain.[12] In some situations, granting aid to a country like Spain is in the best interest of the Dutch investments. For example, the UK

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[11] See Sturzenegger and Zettelmeyer (2008). The losses of investors are calculated as the difference in the net present value of the original and the restructured instrument, whereby the yield of the restructured instrument immediately after the restructuring is used as the discount interest rate.
[12] See http://www.bde.es/webbde/Secciones/Publicaciones/PublicacionesAnuales/chapter3.pdf

contributed to the bilateral loans to Ireland. Because of the economic interconnectedness of European countries, financial uncertainty in parts of the EU curbs economic growth in the rest of the EU.

A second element in LSR's analysis is the macroeconomic costs that are associated with leaving the euro. According to LSR, the reintroduction of the guilder would cause appreciation of maximum ten percent. This is also at the heart of the third and fourth scenarios that LSR discusses in chapter E. In the third scenario, the Netherlands and Germany leave the euro zone; in the fourth scenario just the Netherlands leaves the euro zone. LSR states that consumers will profit, while businesses will face some difficulties. Another two scenarios are also addressed. In both cases LSR says nothing about the costs of this for the Netherlands.

The motivation that LSR gives for a limited appreciation of maximum ten percent is based on the following arguments:

1. An increase in the guilder will cause higher consumer spending because it will become less expensive to import goods.
2. An increase in the guilder will not hurt Dutch exports but will only be at the expense of profit margins.
3. The productivity of Dutch companies will increase.
4. If the Netherlands and Germany both leave the euro, the risks are smaller.
5. Sweden and Switzerland show good performance even though these countries are not part of the euro group.

An appreciation of the guilder will lower the price of imported goods and lower the price that Dutch companies receive for their exports. The statement that exports do not respond to exchange rate adjustments and imports is inconsistent with this. Prices on the foreign sales markets will probably increase and export volume will decrease. Both effects are only short-term. In the long term, wages will adjust to the developments and the effect on Dutch prosperity will be determined by any productivity growth that results from the reintroduction of the guilder. This means lower sales and profit margins. It is not clear that productivity would increase. LSR assumes that large-scale intervention by the DNB would have a positive effect on growth, export and banks, but this is not supported with any evidence. The possible costs of such an intervention, which could include inflation, for instance, are also left out of consideration.

LSR also analyses the effect of the appreciation of the euro on Dutch foreign assets. LSR assumes that the decrease in value of foreign assets by 75 billion euros which results from the appreciation of the euro will partly be cancelled out by an increase in share capital. It remains unclear what this is based on.

The possible macroeconomic effects of policy and the uncertainty on the financial markets that accompanies the conversion of contracts to a different currency remain outside of consideration in LSR's analysis. If the Netherlands and Germany were both to leave the euro, it would mean the end of the euro zone.[13] Germany is the country that underpins the credibility of the monetary policy. The markets expect a decline in the price of the euro or what is left of it and an increase in the price of the new German currency. The result would be a massive flight of capital from the southern countries to Germany. Economists call this a *flight to quality*.[14] The exchange rate fluctuations that would accompany this would enable markets to actively seek opportunities to make a profit. If financial parties can take up positions with these kinds of transactions before split-off has taken place, a great deal of money will be able to be made in a short period of time. All financial institutions, citizens and businesses with assets that fall under the law of one of the remaining euro countries will pay the price for this. This is a loss item not only for German banks, but also for Dutch banks. They have loaned a great deal of money to countries like Italy and Spain.

LSR seems to (implicitly) assume that if the Netherlands leaves the euro, it will still remain in the EU. Teulings et al. (2011), Buiter and Rahbari (2011) and others argue that leaving the euro is not so simple a matter.[15] It is unclear to what extent it is possible under current European legislation. The prevailing view is that exit from the euro will involve exit from the EU. The question then is to what extent the advantages of EU membership in the form of lower trade barriers will be retained. A political solution may be able to be found for this in Europe, but it will most likely take time and also bring with it uncertainty, which can have repercussions for economic growth. LSR does not address this point.

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[13] This situation is described in Teulings et al. (2011).

[14] Eichengreen (2007) describes this situation in more detail.

[15] For legal considerations about a euro exit, see, among others, Allen & Overy Global Law Intelligence Unit (2010) and Athanassiou (2009).

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Publisher:

CPB Netherlands Bureau for Economic Policy Analysis
P.O. Box 80510 | 2508 GM The Hague
T (070) 3383 380

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