

Management *Insights*

WHAT HAPPENS IF GERMANY EXISTS THE EURO?

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Like marriage, membership in the euro zone is supposed to be a lifetime commitment, “for better or for worse”. But as we know, divorces do occur, even if the marriage was entered into with the best of intentions. And the recent turmoil in Europe has given rise to the idea that the euro itself might also be reversible, and that one or more countries might revert to national currencies.

As far as European Monetary Union goes, the prevailing thought has been that one of the weak periphery countries would be the first to call it a day (in Ireland’s situation, one could make a good case for it on the grounds of persistent spousal abuse). It may not, however, work out that way: All of a sudden, the biggest euro-skeptics in Europe are not the perfidious English, but the Germans themselves. Take a look at these headlines (kindly drawn to my attention by James Aitken of Aitken Advisors, LLP).

Germany and the euro: We don’t want no transfer union | The Economist (<http://www4.economist.com/node/17632957>)

Jenkins: Where Are the Business Europhiles Now? - WSJ.com (http://online.wsj.com/article/SB10001424052748703989004575652602965773126.html?mod=djemITP_h)

And even a book by Hans-Olaf Henkel, formerly of IBM (Germany), and hitherto one of Germany’s great euro-enthusiasts:

English translation: “Return our Money” (http://www.amazon.co.uk/Rettet-unser-Geld-Deutschland-aus-verkauft/dp/3453182847/ref=sr_1_13?ie=UTF8&qid=1291488652&sr=8-13)

So let’s consider what happens if Germany decides to follow Herr Henkel’s advice. On the plus side, given Germany’s historic reputation for sound finances, the country will likely emerge with a strong Deutschmark, a global safe haven currency for currency speculators keen to find a true store of value. But this will likely come with a huge cost: Germany will probably save its banking system at the expense of destroying its export base. The newly reconfigured DM will soar against the euro and become the ultimate safe haven currency. This will mitigate the write-down impact of the inevitable haircuts on euro-denominated debt, because the euro (assuming it is retained by the remaining euro zone countries) will fall dramatically. Even if the euro itself vaporises, the Germans simply will pay back debt in the old currencies, likely fractions of their previous value.

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But Germany's external sector will be wiped out. The resultant appreciation of the new Deutschmark, along with the inevitable banking crises in the periphery (which **will exert significant deflationary domestic** pressures in those countries and therefore reduce consumer demand in the euro zone ex Germany) **will engender a huge trade shock**: Germany's growth will slow dramatically, as exports comprise such a large proportion of GDP.

Another interesting byproduct: **By accounting identity, a fall in Germany's external surplus means a large increase in the budget deficit** (unless the private sector begins to expand rapidly, which is doubtful under the scenario described above), so Germany will find itself experiencing much larger budget deficits.

Let's elaborate a bit further: We start with the standard macro observation that in any accounting period, total income in an economy must equal total outlays, and total saving out of income flows must equal total investment expenditures on tangible assets at the aggregate level. The financial balance of any sector in the economy is simply income minus outlays, or its equivalent, saving minus investment. A sector may net save or run a financial surplus by spending less than it earns, or it may net deficit spend as it runs a financing deficit by earning less than it spends, but at the aggregate level the dollar spending of all three sectors combined must equal the income received by the three sectors combined. Aggregate spending equals aggregate income.

At the end of any accounting period, then, the sum of the sectoral financial balances must net to zero. Sectors in the economy that are net issuing new financial liabilities are matched by sectors willingly owning new financial assets. One sector can run a surplus (spend less than its income) so long as another deficit spends. In macro, fortunately, it all has to add up. This is not only true of the income and expenditure sides of the equation, but also the financing side, which is rarely well integrated into macro analysis.

We can next divide the economy into three major sectors: the domestic private sector (including households and businesses), the government sector, and the foreign sector (imports and exports), and ask a simple question relevant to current developments. What happens if one of those three variables experiences a dramatic shift from surplus to deficit (as we envisage occurring here under Germany's external accounts)?

The basic income-expenditure model in macroeconomics can be viewed in (at least) two ways: (a) from the perspective of the sources of spending; and (b) from the perspective of the uses of the income produced. Bringing these two perspectives (of the same thing) together generates the sectoral balances.

From the sources perspective, we get this equation:

$$\text{GDP} = C + I + G + (X - M)$$

This formula simply indicates that total national income (GDP) is the sum of total final consumption spending (C), total private investment (I), total government spending (G) and net exports (X - M). From the uses perspective, national income (GDP) can in the following ways:

$$\text{GDP} = C + S + T$$

This equation indicates that GDP (income) ultimately comes back to households who consume (C), save (S) or pay taxes (T) with it once all the distributions are made.

In aggregate, we can express the formula in the following manner:

$$C + S + T = \text{GDP} = C + I + G + (X - M)$$

So after simplification (but obeying the equation) we get the three sectoral balances view of the national accounts, which we discussed above:

$$(I - S) + (G - T) + (X - M) = 0$$

That is the three balances have to sum to zero (see here for more - <http://bilbo.economicoutlook.net/blog/?p=4870>)

- The private domestic balance (I - S) – positive if in deficit, negative if in surplus.
- The Budget Deficit (G - T) – negative if in surplus, positive if in deficit.
- The Current Account balance (X - M) – positive if in surplus, negative if in deficit.

These balances are usually expressed as a per cent of GDP but that doesn't alter the accounting rules that they sum to zero, it just means the balance to GDP ratios sum to zero.

This is also a basic rule derived from the national accounts. **It always applies.** This is not high Keynesianism, but simple double entry bookkeeping, developed some 6 centuries ago. Call it the tyranny of Accounting 101.

You can then manipulate these balances to tell stories about what is going on in a country, as we are seeking to do here with Germany. For example, when an external deficit ($X - M < 0$) and a public surplus ($G - T < 0$) coincide, there must be a private deficit. So if $X = 10$ and $M = 20$, $X - M = -10$ (a current account deficit). Also if $G = 20$ and $T = 30$, $G - T = -10$ (a budget surplus). So the right-hand side of the sectoral balances equation will equal $(20 - 30) + (10 - 20) = -20$.

As a matter of accounting then $(S - I) = -20$ which means that the domestic private sector is spending more than they are earning because $I > S$ by 20 (whatever \$ units we like). So the fiscal drag from the public sector is coinciding with an influx of net savings from the external sector. While private spending can persist for a time under these conditions using the net savings of the external sector, the private sector becomes increasingly indebted in the process. It is an unsustainable growth path.

This situation describes the recent history of the United States, notably under the Clinton years when the country was running budget surpluses. By the same token, using the sectoral balance approach, we can say that a current account surplus ($X - M > 0$), if large enough, allows the government to run a budget surplus ($G - T < 0$) which applies in the case of many Asian countries or a European country, such as Norway (where the world does its spending for it).

What about Germany today? In the current German situation, although the country runs a large current account surplus, it is insufficient to offset a high private sector predisposition to save (which means there is some deficit). But the current account surplus does allow for a smaller budget deficit than its so-called “profligate” Mediterranean neighbors, whilst still facilitating the private domestic sector’s desire to net save. As we have argued before, it is the “profligacy” of Germany’s Mediterranean trading partners, which has allowed it to rack up huge current account surpluses, and therefore run smaller budget deficits than the likes of the PIIGS countries.

Once divorce from the euro is complete, Germany will regain its fiscal freedom. This is itself is something the Germans should celebrate, providing their government takes advantage of their new-found fiscal freedom. Remember, once it returns to the DM, Germany becomes the issuer, as opposed to the user of a currency, as is the case under the euro, and is fully sovereign in respect of its fiscal and monetary policy.

Consequently, the German government can offset the external shock by running large government budget deficits, which will add new net financial assets to the system (adding to non government savings) available to the private sector.

It will become almost impossible to run budget surpluses under this scenario, but this is no bad thing for any country which issues debt in its own free-floating non-convertible currency. As unpalatable as this conclusion might be for many, it is entirely consistent with national income accounting. As Bill Mitchell has pointed out on many occasions (<http://bilbo.economicoutlook.net/blog/?p=2418>), “the systematic pursuit of government budget surpluses ($G < T$) is dollar-for-dollar manifested as declines in non-government savings. If the aim was to boost the savings of the private domestic sector, when net exports are in deficit, then taxes in aggregate would have to be less than total government spending. That is, a budget deficit ($G > T$) would be required.”

A budget deficit per se, then, will not cause any problems per se for Germany, as it will no longer have any external constraint, having restored the DM as its currency of choice. But historically, Germany has embraced an export based model at the expense of curbing domestic consumption.

So its policy makers face a choice: will the country offset the decline in its current account surplus via a more aggressive fiscal policy by choice (i.e. proactively, in search of a full employment policy), or reactively via the growth in the automatic stabilizers? If the Germany economy slumps (as I expect it will), the deficits via the automatic stabilisers will rise as a matter of course. Germany can easily counter that if it chooses to do so.

It’s never a laughing matter to see any economy slump, but anybody with a sense of irony will

naturally be wondering whether the German government and its voters will get themselves in a frenzy about being so “profligate” as the inevitable trade shock develops. I suspect there will also be a touch of “schadenfreude” on the part of its recently divorced euro zone “ex-spouses” (how does one say schadenfreude” in Greek or Spanish?). Personally, I’ve never seen the merits in eliminating government debt just so that the private sector is forced to go into greater deficit, and perhaps the Germans will eventually figure that out as well. In any case, one suspects that we are about to get a nice “teachable moment” for Frau Merkel, if Germany does embrace the course of action now so enthusiastically endorsed by the likes of Herr Henkel.

But the country might well find truth in the adage, “Be careful what you wish for”.

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As company Corporate Spokesperson, Mr. Auerback is a member of Pinetree’s Board of Directors and has some 28 years of global experience in financial markets worldwide. Mr. Auerback plays a key role in the formulation and articulation of Pinetree’s investment strategy. Currently, Mr. Auerback is a Senior Fellow at the Roosevelt Institute, a research associate for the Levy Institute and a fellow for the Economists for Peace and Security. He has previously served as an advisor to a number of fund management organizations, such as PIMCO, the world’s largest bond fund management group, RAB Capital and David W. Tice & Associates. Mr. Auerback graduated magna cum laude from Queen’s University in 1981 and received a law degree from Corpus Christi College, Oxford University in 1983.

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