

# Management *Insights*

## TO SAVE THE EURO, GERMANY HAS TO QUIT THE EURO ZONE

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When the euro was launched, leading German politicians used to argue, with evident relish (and much to the chagrin of the British in particular), that monetary union would eventually require political union. The Greek crisis was precisely the sort of event that was expected to force the pace. But, faced with a defining crisis, Ms Merkel's government is avoiding airy talk of political union – preferring instead to force harsh economic medicine down the throats of the reluctant Greeks, Irish, Portuguese and Spanish electorates. This is becoming both economically and politically unsustainable. If the objective is to save the currency union, perhaps policy makers are looking at this the wrong way around. In the end, paradoxically, to save the European Monetary Union, the least disruptive way forward would be for the Germans, not the periphery countries, to leave.

One major reason why political, and social, unification is so important is that it provides conditions under which the adjustment mechanism, to being uncompetitive, is facilitated. Labour mobility is much greater within, than between, countries. Cross-regional fiscal transfers help to smooth the adjustment process. Social and national unity makes break-away policies almost unthinkable and hence provides the cement to keep the discipline of adjustment in place.

None of the above are, as yet, strongly anchored in the euro-zone. Nor are they likely to be in the current context in which any moves toward a broader supranational fiscal structure continue to be resisted by the Germans, who perceive this as a backdoor mechanism for yet more bailouts of their “profligate” Mediterranean European “partners”.

And yet some sort of broader fiscal expansion is becoming increasingly necessary if the euro project is to be sustained. From a standard Keynesian perspective, shrinking a fiscal deficit is virtually synonymous with shrinking economic growth. Keynesians emphasize the prevalence of multiplier effects. Cuts in government spending and hikes in taxes are expected to reduce incomes and spending in the private economy. If the fiscal consolidation is ambitious enough, it can deliver an outright recession.

At the time the euro was launched, there was much hopeful talk that a surge in trade and investment between the euro zone nations would create a truly unified European economy, in which national levels of productivity and consumption would converge on each other. It was also assumed – or perhaps just hoped – that the euro would create political convergence. Once Europeans were using the same notes and coins, they would feel how much they had in common, develop shared loyalties and deepen their political union.

The designers of the single currency were hoping for a third form of convergence, between elite and popular opinion. They knew that in certain crucial countries, in particular Germany, the public did not share the political elite's enthusiasm for the creation of the euro. But they hoped that, in time, ordinary people would embrace the new single European currency. This has clearly not been reflected by the reality. Crudely speaking, the markets today are calculating that governments lack the shared political commitment to underwrite the stability of the single currency.

The main disadvantage of adopting a currency union in the absence of a fully fledged political union is that it limits the ability of the constituent regions (countries) to adjust to an (asymmetric) shock by using domestic fiscal policy to mitigate the deflationary impact of this shock, as well as eliminating the ability to deploy exchange rate adjustments to do so. The European Monetary

Union doesn't work and without a federal fiscal redistribution mechanism it will never be able to deliver prosperity. Every time an asymmetric demand shock hits the Eurozone, the weaker nations will fail. Trying to impose fiscal rules and austerity onto the EMU monetary system just makes matters worse.

The fiscal austerity that accompanied the period of transition into the EMU as governments struggled to reach the entry criteria established under the SGP manifest now as persistently high unemployment and rising underemployment; vaporising social safety nets; decaying public infrastructure and rising political extremism.

Some 10 years after the introduction of the EMU, these problems are increasing rather than decreasing, as the proponents of the system claimed. Already, Greece has disappointed and requires more EU financing than the \$150 billion that seemed more than enough a year ago. Despite the very great weakness in the Irish economy, its fiscal deficit still remains at 15% of GDP. The Portuguese finance minister has conceded that the Portuguese economy will contract 2% this year and 2% next year, and these forecasts tend to be optimistic. Portugal's real GDP was still growing at a 1% pace versus a year ago, but the sequential contraction in the final quarter of 2010 also places that growth path in question (and in fact Portugal's policy makers have shifted to a forecast of a 2% real GDP recession in 2011 and 2012). No surprise, then, that Portugal is joining Greece and Ireland in seeking loan assistance from the EFSF. Italy's real GDP growth was the strongest versus a year ago at 1.5%, but the pace of growth was slipping by year end, and Moody's has recently threatened the country with a debt downgrade.

And then there is Spain: Spain's recovery through the end of 2010 was primarily a consumer led advance, yet the fundamentals for consumer spending were hardly favorable. The tumble in retail sales growth that began late last year appears to have accelerated to the downside through March of this year. Higher taxes, plus the onset of the global consumption tax, have put the squeeze on consumer spending. The GCT also makes it more difficult for Spain to improve its current account balance. Investors and policy makers are fixated on reducing the fiscal deficit without considering what that requires for the financial balances of other sectors. The fact of the matter is that Spain has tended to run a chronic current account deficit, not a chronic fiscal deficit. The fiscal deficit is to a great extent just an artifact of the sharp reversal in private sector deficit spending that arrived once Spain's housing boom went bust and the GFC hit. Private sector debt/income ratios are multiples of the government's, yet all eyes are on containing the public debt/income ratio. Some earnest efforts at restructuring are underway, and early results may be showing up favorably in capital goods production, but unless more heroic efforts are taken to improve the rate of reinvestment of corporate profits in Spain's economy, growth shortfalls may indeed lead to a destabilizing cycle at a time when the unemployment rate already tops 21%. This in turn could knock the euro off its perch as expansionary fiscal consolidations become elusive across the eurozone periphery. Investors do not appear to fully appreciate the challenge Spain faces in maintaining an expansionary fiscal consolidation.

With three of the five peripheral nations contracting in the final quarter of 2010, and a fourth decelerating markedly, the elusiveness of an expansionary fiscal consolidation in the eurozone periphery is becoming all too evident. That is entirely consistent with the view that the cards may be stacked against an outcome which allows the periphery countries to grow their way out of trouble.

Of course, this wasn't an issue prior to the creation of the EMU, during which each of the member states were sovereign in their own currencies and had their own central banks. That means they were not revenue-constrained and could conduct fiscal policy and monetary policy in a co-ordinated way to best serve the socio-economic interests of their citizens.

The German political class in particular seems incapable of recognizing this basic fact, as they continue to view this as a problem defined in terms of lax government fiscal discipline. Chancellor Angela Merkel's interpretation of the woes of the Eurozone, for example, focus on what she claims are the problems of "excessive public debt":

*We now have a clear crisis of indebtedness. But let me tell you, there is no crisis of the euro as such. This is a debt crisis. Let me say this very clearly again. The euro is our currency. And it is much more than just a currency. It is the embodiment of Europe today. Should the euro fail, Europe will fail. We are going to defend the euro ...*

Which is tantamount to ignoring the real issue: There is no public debt crisis without the Euro. Japan has a public debt to GDP ratio at a level some 2.5 times bigger than the euro zone, yet there is no solvency crisis in Japan. The only reason the euro has hitherto survived to this point is because the ECB has stepped in as the "missing" fiscal agent and keeping the bond markets at bay. As

the ECB's bond purchases have wound down, however, the crisis has intensified, because the ECB remains the only entity in the EMU which has currency sovereignty and can "fiscally fund" member state deficits permanently. Given the central bank's political resistance to continuing these purchases (largely supported by the Germans) the underlying logic of the monetary system will continue to ensure these on-going crises will spread across the union.

This in turn has led to discussions that the weaker constituents of the euro zone – notably, Greece and Ireland – undertake debt restructuring. Christian Noyer of the ECB recently set out the rationale as to why the central bank opposes such restructuring (<http://www.bloomberg.com/news/print/2011-05-24/ecb-s-noyer-rejects-greek-restructuring-as-horror-transcript.html>):

*"If we restructure Greek debt, that means Greece defaults."*

*"And what are the consequences of a default? The banks with the most Greek bonds are Greek banks. The Greek banks themselves will be badly damaged. When the banking system is stricken, what do you have to do to prevent the financing of the economy from collapsing? You have to recapitalize the banks. Who will recapitalize the Greek banking system? The Greek state."*

*"That means the Greek state will gain nothing. It will invest in the banking sector everything that it has gained in the restructuring."*

*"Next there are the Greek insurers and pension funds" who will be hurt. "That means it will weigh on the Greek population's savings, which could cause a drop in [consumer spending](#) and Greek growth will take a hit. This counters the Greek recovery."*

*"Then, what else is there in terms of Greek creditors? There's the European public sector; European governments and the central banks. This is directly tapping the European taxpayer."*

*"If we make European states pay, the mechanism of European financing will stop immediately. The states will not continue putting their taxpayers' money on the line when their loans have just been cleaned out, when they're taking losses on the money they're lending. So that's the end of support from other European states."*

*"And for the central banks, what happens? Greek debt will become debt that is no longer worth anything. It's no longer debt that can be considered as sufficiently safe for operations in the Euro System. That means by definition that to restructure is to become ineligible as collateral. If it's ineligible, then it means a large part of what the Greek banks bring as collateral for refinancing can no longer be used. That means the Greek banking system can no longer be financed."*

*"The next day what happens? Greece needs to find investors because the Greek state won't move from deficit to surplus overnight. As long as it doesn't have a primary surplus, the Greek state needs to borrow. International investors, that small group that remains, have just been restructured. It's not the next day they'll come back with financing."*

*"The Euro System won't refinance. The European states won't finance. The IMF won't go there alone. No one will finance the Greek state in coming years. That means the meltdown of the [Greek economy](#). This is a horror story. That's why we're against a restructuring."*

Perhaps we're looking at this the wrong way around: Given the continued German aversion to more broadly-based pan European style fiscal programs, which its populace continues to see as nothing but bailouts for lazy Mediterranean free-loaders, there is another way to solve the euro crisis.

Let Germany leave the euro zone.

Let's leave aside the politics for a moment as there are many who believe that a German exit from the euro zone in effect means the end of the euro because a number of other countries would leave.

So consider this exercise solely from an economic context: The likely result of a German exit would be a huge surge in the value of the newly reconstituted DM. In effect, then, everybody devalues against the economic powerhouse which is Germany and the onus for fiscal reflation is now placed on the most recalcitrant member of the European Union. Germany will likely have to bail out its banks, but this is more politically palatable than, say, bailing out the Greek banks (at least from the perspective of the German

populace).

To be sure, this will not come without some cost to Germany: 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 vaporizes, the Germans simply will pay back debt in the old currencies, likely fractions of their previous value. And the German populace would likely find it far more palatable to be bailing out its own banks (as it did during the reunification period), as opposed to spending German taxpayer funds to recapitalize the banking systems of a bunch of Mediterranean “profligates”.

By the same token,, 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. 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 so-called PIIGS countries.

Once divorce from the euro is complete, Germany will regain its fiscal freedom. This is itself something the Germans should celebrate, providing their government takes advantage of their newfound fiscal freedom. Remember, once it returns to the Deutsche Mark (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. Germany might well decide not to adopt this course of action, given its historic resistance to aggressive fiscal policy, but it will no longer be bound by any of the institutional constraints inherent in the European Monetary Union.

In the meantime, the rest of the euro zone gets a huge boost to competitiveness via a (likely) substantial fall in the euro against the newly reconstituted DM. Also, the resultant potential instability means that the ECB would likely have to stand ready to backstop all of the bonds to prevent this from becoming a fully-fledged crisis, but it would encounter less political resistance to doing so, given the absence of a restraining German voice in the European Monetary Union.

It seems like an odd way to consider the problem, but the paradox of the current situation suggests that an exit from the euro zone of its strongest member, rather than its weakest links, might well be the optimal means of saving the euro, in the absence of a fully fledged return to separate national currencies.

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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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