2 Reasons Why Germany Could Leave The Euro

Should Germany leave the euro? It is, after all, the big country with an obvious exit option. The question becomes more pertinent after the decision by Angela Merkel, Germany's conservative chancellor, to support Mario Draghi, president of the European Central Bank, against Jens Weidmann, her appointee as head of the Bundesbank, over plans to buy bonds of governments in difficulty. The president of the Bundesbank, Germany's most respected institution, has now become a spokesman for conservative German eurosceptics. The ECB, Germans realize, will not remain a reincarnated Bundesbank. Once again, we are reminded that the eurozone is set to be a miserable marriage. Might a separation, however disruptive, be better?

If we are to address that question from a German perspective, we must distinguish false arguments from valid ones. As Paul de Grauwe, the Belgian economist, now at the London School of Economics, shows in a recent co-authored article, it is easy to find examples of the former.
This paper asks whether the accumulation of net claims within the European System of Central Banks means that Germany would lose a great deal if the eurozone were to break up. Its response is: no.

First, Germany has accumulated net claims on the rest of the world – and on other members of the eurozone – not because of internal central bank accounting, but because it has large current account surpluses. Germans have been running two businesses: exporting goods, at which they are excellent, and importing financial claims, at which they are not. In brief, Germany's surpluses have exposed Germans to financial risk. But balances inside the eurosystem are not a good indicator of that risk. They have exploded, argues the paper, because of speculative financial flows, not current account imbalances (see chart).
These flows do not alter the net cross-border claims. Suppose that owners of a Spanish bank account were to transfer their money to a German bank. This would increase the liabilities of the Spanish central bank and the assets of the Bundesbank, inside the eurosystem. Meanwhile, the German bank would have a liability to the Spanish depositor and a reserve position at the Bundesbank. The net position of Germany would be unchanged. But the net claims of the Bundesbank would rise, while those of Germany's private sector would shrink.

Second, this does not expose the Germany taxpayer to huge losses. The value of the liabilities of the Bundesbank – the monetary base – do not depend on the value of its assets. The value of money depends on its purchasing power. In a fiat (unbacked) monetary system, central banks do not need assets, other than for purposes of monetary control. They are able to create money out of thin air. What makes money valuable is not its backing, but that people are prepared to settle transactions, and the state to settle tax obligations, in return for it.
The danger for Germany, in the event of a break-up of the euro, is that there might be too much of the German currency as a result of non-residents' efforts to convert into the new money. The Bundesbank could prevent this, however, by restricting conversion to German residents alone. Losses would then fall on residents of the countries whose new currencies would collapse in value.
I accept Prof de Grauwe's points. But we could turn them on their head. If Germans have accumulated worthless claims, via their huge current account surpluses, they might have done better not to have run the surpluses. Similarly, the fact that Germany might exit without suffering some of the damage people fear makes exit an option.

Indeed, Charles Dumas of London-based Lombard Street Research argues that euro membership has encouraged Germany into a costly mercantilist strategy at the expense of its people and the productivity of the economy. He notes that Germany's real personal disposable incomes have risen remarkably little since 1998 (see chart). So, too, has real consumption. Productivity per hour also grew more slowly in Germany than in the UK or US between 1999 and 2011, perhaps because euro membership protected business from a strong currency. The stagnant real wages, fiscal tightening and relatively high real interest rates constrained demand tightly. But now the necessary cure for the ills of the eurozone will impose higher inflation in Germany, which the Germans will detest; prolonged deflationary recessions in important eurozone markets; and ongoing transfers of official resources to its partners.

All this ensures that neither the economic nor the political gains of eurozone membership are what German policy makers would have wanted. Worse, years of conflict over "bailouts", debt restructurings, structural reforms and unpopular adjustments in competitiveness now lie ahead. Maybe a painful divorce really would be better than that.
Mr. Dumas believes so. He argues that going back to an appreciating Deutschmark would squeeze profits, raise productivity and increase real consumer incomes. Instead of lending surplus savings to profligate foreigners, Germans could enjoy higher living standards at home. Moreover, this would generate swift adjustment in competitiveness of eurozone members, which would otherwise occur too slowly, via high inflation in Germany and high unemployment in partner countries.
The analyses by Prof de Grauwe and Mr. Dumas do converge on one significant point. If Germany continues to run large current account surpluses, it necessarily has to accumulate huge claims on foreigners. If experience is any guide, much of these will prove a waste. Prof de Grauwe is right that the accumulation of claims inside the eurosystem is not itself the danger. The danger is that the strategy of real wage suppression and soaring external surpluses is a costly dead end. It may well damage the German economy. It certainly compels Germany to transfer resources to its "customers", in one costly way or the other.

Exit is indeed an option. If it is rejected, as I predict, much the same adjustments will ultimately occur in even more painful ways. The alternative is the transfer union that Germans fear. Germany has paid a heavy price for the mercantilist strategy. Inside or outside the euro, it cannot – and must not – endure.