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What if… Germany left Euro

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By Partha Ray & Biju Paul Abraham

Much has been written about the Greek tragedy whose denouement seems imminent. We are informed that the Greeks entered the eurozone based on data whose sanctity was in question. We are also constantly reminded that their retirement age is low, their wages are high when compared to their productivity and, above all, that they have borrowed far beyond their means. This, then, is the nemesis of a lazy, extravagant and stubborn people led by a populist government. Despite this caricatured version, it sums up the mainstream view on the current crisis. However, such an interpretation could well be incorrect, from an economic as well as historical perspective.

In some sense, the current crisis was waiting to happen and can be seen as a curse of 'optimum currency area' (OCA). The original contribution of Nobel-winning economist Robert Mundell, whose work gave the theoretical foundation to the eurozone, conceived an OCA as a club of a few nations each giving up their currency. As in the case of any club, a necessary prerequisite for its success would be the similarity between its members. In fact, in Mundell's conception, the countries joining an OCA should be so similar that any extraneous shock should hit all of them in a similar manner.

But what if an extraneous demand shock hits one of the constituent countries without affecting the others? A comparison with a political union like India will make the point clear. If two Indian states, say, West Bengal and Tamil Nadu, are affected differently by some demand shock, then the central government will initiate a fiscal transfer in favour of the affected state. That's the advantage of being in a political union having the same fiscal and monetary policies.

But if West Bengal and Tamil Nadu are independent states with different currencies, then the possibility of fiscal transfer will not be there. The currency of the state affected by the extraneous shock would depreciate to adjust for the initial shock. Being part of the euro currency area, Greece has a different fiscal policy but the same monetary policy with the rest of the eurozone. So, it is deprived of the advantages of fiscal transfer and currency depreciation.

That is why constituent nations in an OCA being similar is so important. In Mundell's construction, that similarity of

synchronised business cycles is ensured by prefect labour mobility or perfect wage-price flexibility between OCA states. Unlike the economic conditions of the constituent nations of the eurozone, thereby making Mundell's preconditions not valid. Why then was Greece allowed to enter the eurozone? A corollary to this question would be to question the IMF's role in the Greek crisis. After all, Greece did not face any balance of payments problem (the euro is also the Greek currency) and the IMF's mandate is to assist those nations facing a balance of payments problem.

The answer lies in two critical decisions that European leaders took in the 1990s. First, the creation of a common currency was conceptualised as a hedge against Germany emerging as an independent economic power in Europe post-reunification. Second, the creation of an integrated Europe with a common currency that would 'move ever closer' to political union and challenge not just the global economic dominance of the United States, but also the status of the dollar as the global currency. Germany was never keen on giving up the Deutsche Mark and joining a common currency mechanism that included countries, such as Greece, Italy and Spain who had difficulty meeting inflation and fiscal deficit targets set as criteria for entry. But the creation of the euro was a price that erstwhile West Germany under President Helmut Kohl had to pay to avoid a French veto over Germany unification. The creation of the euro had a profoundly negative impact on lending by European banks. The international financial markets, typically represented by German (and French) banks, chose to ignore the facts of Greek public finances and started accepting Greek sovereign debt at a low interest rate. The moral hazards in lending seem to have been both serious and systemic.

Did the banks lend without caution because of an expectation that in the eventuality of a crisis, the Greeks would be rescued by Big Brother Germany? Was it a feudal syndrome of an unsuccessful younger brother from a Hindu Undivided Family getting a loan from the village moneylender on the strength of his more successful elder brother? Or was it a feeling that Germans would be forced to bail out weaker European nations to atone for historical 'sins'? Greek Prime Minister Alexis Tsipras actually demanded that Germany pay reparations for 'Nazi atrocities' in Greece at a joint press conference with German chancellor Angela Merkel in March this year. From such a vantage point, it would seem that European banks, including German ones, also have blood on their hand. Having reached a situation where Greek debt is seen as unsustainable, there are only limited options available. An economy is unlike a company. Thanks to the innovation of limited liability corporations, there are standard procedures of bankruptcy for a company whereby debt holders (or a hierarchy of various forms of debt) get precedence in bankruptcy proceeds and equity holders (being owners of the company) take a hit. No such procedure exists for an orderly evolvement of sovereign debt restructuring.

Despite bouts of activity in various international fora at different points of time, no tangible progress has happened. So historically, the global community took responsibility for seemingly orderly resolution of debt restructuring problems of nations. And who knows it better than Germany, whose head of delegation (of the then West Germany) Hermann Josef Abs signed an agreement in London on February 27, 1953 so as to effectively cut its debts to its foreign creditors in half. Thus, Germany at the current juncture is suffering from selective amnesia. Effective debt relief and debt restructuring is one way out of this crisis.

The other could be a German exit from the euro. What would be the economic impact of Germany leaving the euro would be? Obviously, the exit of the best performer will make the averages look worse for the euro area as a whole. But that could improve the extent of homogeneity within the euro area, thereby making the euro area more stable.

So would Germany leaving the euro be a solution acceptable to Europe? Or to the Germans? Some practical difficulties are immediately apparent. The headquarters of the European Central Bank is in Frankfurt and it would be certainly considered odd for the central bank of a currency area to be outside its borders. However, Switzerland was not a member of the UN until 2002 and this did not stop the UN from effectively running its second headquarters in Geneva for decades prior to Swiss membership.

A German exit might result in other indebted nations reneging on their debt to German banks, something that Germans seem insistent on avoiding — hence the aversion to debt relief. These are, however, problems with near-term solutions. A German exit from the euro might solve the longer-term problem of an unsustainable common currency area which the eurozone currently is.

But despite its attractions, a German exit seems highly unlikely. First, while there might be an economic justification for considering such a possibility, the current situation in Europe makes it politically almost impossible. First, a euro without Germany would rapidly decline in value. While some amount of depreciation in the euro will act as a wanted adjustment in its external accounts, it could also lead to further European misery. It might then become impossible to prevent extreme right-wing parties such as the National Front in France coming to power. European concerns about German hegemony would

certainly re-emerge, straining relations between Germany and its European partners. The US, worried that a divided Europe would further embolden Russia would press the Germans to remain within the eurozone.

The US, both directly through statements of its treasury secretary Jacob Lew, and indirectly through the IMF, recently asked for debt relief for Greece to prevent a Grexit. Germans, who see greater integration within Europe as an insurance against a nationalist revival at home, will certainly resist. Whatever its economic merits a German exit from the euro seems unlikely. The Greek tragedy then might only be the foretaste of future tragedies in Europe in the not-too-distant future.

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