Why Germany should leave the eurozone

Oliver Hartwich | The New Zealand Initiative | 14 April 2014

Last week, I wrote about Ben Bernanke's critique of Germany's exorbitant trade surplus (Bernanke's misguided fix for Germany). My conclusion may have surprised a few readers – the best way to deal with the German surplus would be to take Germany out of the eurozone.

This week, I would like to take this argument one step further. Not only would a German exit from the eurozone give Germany the currency it deserves, but it would also leave the rest of the eurozone with the carcass of a currency well suited for its needs. Analysts at investment bank Morgan Stanley have just calculated fair exchange rates for individual eurozone members based on their economic strength. They come to the conclusion that, as a whole, the euro at its current exchange rate to the US dollar is undervalued by about 20%. Instead of its current level of roughly US$1.06, the euro should trade at about US$1.32.

Having said that, the fair level of the euro is quite meaningless since it masks astonishing differences between member states. The extremes of the spectrum are marked by Germany and Greece. While the euro should be worth US$1.59 based on Germany's strength, it ought to be US$1.09 for Greece. Note that both Germany and Greece have to be regarded as undervalued in this way. However, it is clear that Greece is much closer to having a fairly valued currency than Germany.

Now, if you were meanspirited, you might say that Europe's common currency has more in common with Greek's old drachma than with Germany's old mark. Indeed, based on the data, it would be quite hard to argue with such an assessment.

Morgan Stanley's valuation should indeed trigger the question of who should really leave the eurozone – Greece and other crisis prone periphery countries? Or Germany?

If the euro is already trading at an exchange rate very close to what it ought to be for Greece, maybe Greece should just keep the euro. Under one proviso, of course – that Germany exits (and, with it, a few other countries whose exchange rate would should be much higher according to Morgan Stanley – namely, Ireland, Austria, France and Finland).

If this conclusion from current exchange rate dislocations seem too radical, then just consider what might happen if the current euro mechanism continued.

This year, Germany's trade surplus will already reach around 8.5% of its GDP. For a developed economy of this size, this is a remarkable figure, but it is unlikely to be the end point of the development. Since the European Central Bank has only just started its quantitative easing program that is designed to weaken the euro's exchange rate, Germany's trade surplus will continue to rise. In a few years' time, we could be talking about 10%, 11% or 12% of GDP, which Germany exports more than it imports. Such levels are not only unsustainable in the long run, they are totally ludicrous.

What such a persistent export surplus means is that Germany will build up claims against the rest of the world which it may not be able to call in when it needs to. It also means that Germany's savings surplus will be invested abroad instead of being used to turn its own domestic net capital formation from negative to positive.

A German departure from the euro would have some highly beneficial effects on the remaining eurozone members. Countries such as Greece would find it easier to service their debt since the euro would weaken further. Put differently, if Greece left there would be no chance that Athens would ever repay its euro debt, now denominated in a foreign currency. The chances of repayment would however improve substantially if Greece had the chance to repay in its own currency, the "euro drachma".

As a realist, I know of course that the chances of a German euro departure are close to zero. There is too much political capital invested in the project of monetary union. Besides, the German public would not understand why they had to leave the euro when other countries such as Greece are more visibly in crisis and Germany seems to be doing just fine. They would see it as unfair punishment.

Despite these objections, form a standpoint of pure economic logic there is something to be said for Germany's euro exit. It would deal with Germany's trade surplus and eliminate it. It would help other European countries to regain competitiveness vis-à-vis Germany. It would give Germany the exchange rate it needs to bring its current account back into balance, and it would do the same for the rest of Europe in reverse.

What a pity that the European Union never played by the rules of economic logic but by its own rules of political necessities. But that is, of course, precisely why the euro is in crisis now – or, indeed, why the euro was brought into existence in the first place.

Dr Oliver Hartwich is Executive Director of The New Zealand Initiative, the Wellington-based think tank formed by the merger of The New Zealand Business Roundtable and The New Zealand Institute. www.nzinitiative.org.nz. Dr Hartwich is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.

This article was first published in Business Spectator and is reproduced with permission.
