



# Policy Note

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## WHAT HAPPENS IF GERMANY EXITS THE EURO?

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Like marriage, membership in the eurozone 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 a national currency.

As far as the Economic and 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:<sup>1</sup>

Germany and the Euro: We Don’t Want No Transfer Union

—*The Economist*, December 2, 2010

Business World: Where Are the Business Europhiles Now?

—*The Wall Street Journal*, December 4, 2010

And even a recent book by Hans-Olaf Henkel, formerly of IBM (Germany) and hitherto one of Germany’s great euro-enthusiasts: *Rettet Unser Geld!* (2010). English translation: *Return Our Money!*

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So let's consider what would happen if Germany decided to follow Herr Henkel's advice. On the plus side, given Germany's historic reputation for sound finances, the country would likely emerge with a strong Deutschmark, a global "safe haven" currency for currency speculators keen to find a true store of value.

But this would likely come at a huge cost: Germany would probably save its banking system at the expense of destroying its export base. The newly reconfigured DM would soar against the euro and become the ultimate safe-haven currency. This would mitigate the write-down impact of the inevitable haircuts on euro-denominated debt, because the euro (assuming it is retained by the remaining eurozone countries) would fall precipitously. Even if the euro itself vaporized, the Germans would simply pay back debt in the old currencies, likely at a fraction of their former value.

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

Another interesting byproduct: by accounting identity, a fall in Germany's external surplus would mean an increase in its budget deficit (unless the private sector began to expand rapidly, which is doubtful under the scenario described above), so Germany would find itself experiencing much larger 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 true not only of the income and expenditure sides of the equation but also the financing side, which is rarely well integrated into macro analysis.

Next, we can 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). We can then ask a simple question relevant to current developments: what would happen if one of those three variables experienced a dramatic shift from surplus to deficit, as we envisage occurring here under Germany's external accounts?

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 its current account surplus does allow for a smaller budget deficit than those of 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 that has allowed it to rack up huge current account surpluses, and therefore run smaller budget deficits than the likes of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain).

Once divorced from the euro, Germany would regain its fiscal freedom—in itself something the Germans should celebrate, providing their government takes advantage of it. Remember, by returning to the DM, Germany becomes the issuer, as opposed to the user, of a currency (as is the case under the euro), and fully sovereign with respect to its fiscal and monetary policy. Consequently, the German government could offset the external shock by running large budget deficits, making new net financial assets available to the private sector (by adding to non-government savings).

It would be almost impossible to run budget surpluses under this scenario, but this is not a bad thing for any country that issues debt in its own free-floating, nonconvertible currency. As unpalatable as this conclusion might be for many, it is entirely consistent with national income accounting. As Bill Mitchell (2010) has pointed out, "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.” (The sector financial balances approach to national income accounting is outlined in the Appendix.)

A budget deficit per se, then, would not cause any problems per se for Germany, as it would 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 policymakers would face a choice: to offset the decline in its current account surplus via a more aggressive fiscal policy by choice—that is, proactively, in search of a full employment policy—or reactively, via the growth in the automatic stabilizers. If the German economy slumped (as I expect it would), the deficits would rise as a matter of course, via the automatic stabilizers. Germany could easily counter that if it chose to do so.

It’s never a laughing matter to see an economy slump, but anybody with a sense of irony would naturally be wondering whether the Germans—the government as well as voters—would get themselves into a frenzy about being so “profligate” as the inevitable trade shock developed. I suspect there would also be a touch of *schadenfreude* on the part of its recently divorced eurozone “ex-spouses” (how does one say “*schadenfreude*” in Greek or Spanish?). Personally, I’ve never seen the merits of eliminating government debt simply to force the private sector into greater deficit, and perhaps the Germans would eventually figure that out as well. In any case, one suspects that it would be a nice “teachable moment” for Frau Merkel if Germany did 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.”

## Appendix<sup>2</sup>

The model devised by the late Distinguished Scholar Wynne Godley and detailed in the Institute’s Strategic Analysis series divides the macroeconomy according to its three main sectors: domestic government, domestic nongovernment (or private), and the foreign sector. By accounting identity, the deficits and surpluses across these three sectors must sum to zero; that is, one sector can run a deficit so long as at least one other sector runs a surplus.

The basic income-expenditure model in macroeconomics can be viewed in (at least) two ways: (1) from the perspective of the sources of spending; and (2) 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:

$$GDP = C + I + G + (X - M)$$

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 be illustrated in the following way:

$$GDP = C + S + T$$

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:

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

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

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

That is, the three balances must sum to zero. In addition:

The private domestic balance ( $I - S$ ) is positive if in deficit, negative if in surplus.

The budget deficit ( $G - T$ ) is positive if in deficit, negative if in surplus.

The current account balance ( $X - M$ ) is positive if in surplus, negative if in deficit.

These balances are usually expressed as a percent of *GDP*, but that doesn’t alter the accounting rules that they sum to zero; it just means that 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 six centuries ago. Call it the tyranny of Accounting 101.

You can then manipulate these balances to tell stories about what is going on within 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  $M = 20$ , then  $X - M = -10$  (a current account deficit). Also, if  $G = 20$  and  $T = 30$ , then  $G - T = -10$  (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  $I$  exceeds  $S$  by 20 (using whatever currency 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 by 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 during the Clinton years, when the country was running budget surpluses. By the same token, using the sectoral balances approach, we can say that a current account surplus ( $X - M > 0$ ) allows the government to run a budget surplus ( $G - T < 0$ ), which applies in the case of many Asian countries or to a European country such as Norway (where the world does its spending for it).

## Notes

1. James Aitken of Aitken Advisors, LLP, kindly drew my attention to these headlines.
2. Adapted from Mitchell 2010.

## Reference

Mitchell, B. 2010. "Norway and Sectoral Balances." Billy Blog: Alternative Economic Thinking, May 19, 2009.