Trapped in the EMU?

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As the euro crisis progresses without any resolution in sight, a rift is emerging between a small group of Northern European countries including Germany, the Netherlands and Finland, and a larger group of Latin European countries including France, Italy and Spain. The former group of countries emphasizes the importance of economic adjustment and austerity, and is only prepared to consider pooling debt among euro area countries once states have ceded large swathes of political sovereignty to the euro area level. The latter group insists that there is a limit to the amount of adjustment and austerity that their societies are willing to accept and is pushing for the mutualisation of debt as soon as possible; and before seriously considering relinquishing more sovereignty. In France, in particular, opinions are deeply divided over the debt pooling issue.

Many observers believe that the Latin European countries are in a better position to impose their will on Northern European countries than *vice versa*. For even if Northern countries use the principle of unanimity at the political level to block the direct pooling of debt through joint issuance, Latin countries can still use their majority in the ECB's Governing Council to achieve the indirect pooling of debt *via* the ECB's balance sheet. All that is required to achieve debt pooling via the back door of the ECB is a decision by the Governing Council to buy the bonds of governments and/or banks experiencing financial distress. The consequences of debt pooling *via* the ECB's balance sheet would naturally be less severe (and hence preferable) for creditor countries than the assumption of joint liability. Instead of facing direct budgetary consequences in the case of the default of an EMU country that has issued jointly guaranteed debt, creditor countries would share in the inflation tax levied on the entire euro area if the ECB were to monetize government debt.

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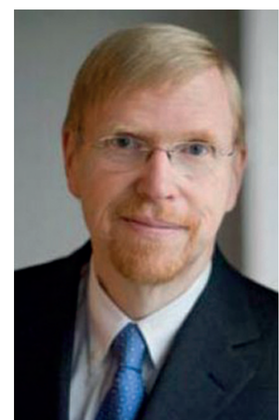


Large Latin countries can rely on ECB bond purchases when markets are closed to them, as defaults could trigger a systemic crisis and financial meltdown. The only way for Northern European countries to escape paying the inflation tax arising from the debt of insolvent countries accumulating on the ECB's balance sheet is to leave the eurozone. Although this option is currently being openly discussed in the press (see, for example, the cover story of *Der Spiegel* of 26 June 2012), the general conclusion has been that an exit from the EMU would be too costly to be considered an option. The German Council of Economic Experts points to German claims in euros amounting to 2.8 billion euros and the Bundesbank's additional Target2 credit totaling 728.6 billion euros (June 2012), implying that part or all of these sums could be lost if the euro were to collapse. The Council would also expect uncertainty created by any demise of the euro and the expected appreciation of a new D-Mark (Sachverständigenrat 2012) to plunge the economy into a deep recession. Dirk Meyer of Helmut-Schmidt University Hamburg attempts a more precise estimate of the costs of a German exit from the EMU and comes up with 295.3 to 390.1 billion euros (see Meyer 2012). The largest position in his calculation is an exchange rate loss of up to 237.3 billion euros on German net claims on euro area countries totaling 950 billion euros. Against this, he sets 74.8 to 149.8 billion euros in annual costs for Germany's continued EMU membership.

The apparently prohibitive costs of leaving the EMU has led prominent German economists to complain that Germany has been trapped by its partners who, thanks to the EMU, can extort contributions from the German taxpayer to fund their general budgets.[1] Interestingly, the Finish government has taken a more nuanced view. According to Finance Minister Jutta Urpilainen, Finland will not keep the euro 'at any price' and would prefer to exit the EMU than to be held liable for other countries' debt.[2]

This paper takes a preliminary look at the potential costs for Northern European countries, notably Germany, of leaving the EMU. Needless to say that

[1] See, for example, the interview with Hans-Werner Sinn in *Handelsblatt* of 2 July 2012.
[2] See *Frankfurter Allgemeine Zeitung* of 7 July 2012.

such a scenario is highly fictitious, at least at this stage. The paper's perhaps somewhat surprising conclusion is that there are two ways to leave the EMU that keep its economic and financial costs manageable. For now, governments and large parts of the electorates in Northern European countries remain committed to the EMU. However, overly aggressive brinkmanship on the part of their EMU partners to extract more help could change this. The leverage of Latin Europe over Northern countries in the EMU may be smaller than generally perceived.

What could trigger an exit from the EMU by economically stronger countries?

German Chancellor Merkel is adamantly opposed to the pooling of sovereign or bank debt without material progress towards political union. Her position is backed by a large majority of the German electorate, which rejects the introduction of Eurobonds. Other governments and the populations of the financially stronger EMU countries seem to feel similarly. However, should larger EMU countries and/or systematically important banks located there lose access to the credit market and thus be in danger of defaulting, the ECB would probably be forced to intervene and buy the debt of these entities to avoid financial disaster. With the ECB being perceived as senior creditor since its refusal to participate in Greek debt restructuring, ECB intervention would probably increase the aversion of market participants to the debt of the distressed entities. The ECB could end up as the latter's only source of funding and the bank's balance sheet could grow quickly. Although this would not immediately lead to inflation, a large-scale monetization of debt could raise inflation expectations and fears in the inflation-averse Northern countries; and inflation could eventually rise.

Three steps to a euro exit

Are Northern Europeans condemned to live in a monetary union, where inflation and exchange rate policy is driven by the preferences of Southern Europeans for higher inflation and a declining exchange rate? Not necessarily. It seems possible for Northern Europeans to leave a high inflation/weak exchange rate union without too much disruption. This would be possible if the euro continued to exist as the currency of a Southern – or Latin – monetary union. The following section outlines how an exit from the EMU could work using Germany as an example.

Step 1: as inflation, especially in the Northern EMU member states with balance-of-payments surpluses, and notably Germany, begins to rise in response to lax monetary policy and exchange rate depreciation, these states could introduce clauses in contracts indexing prices and wages to their national inflation rates. Savers could be protected by the issuance of inflation-indexed government bonds and savings vehicles. Since tax revenues would also rise with inflation, the government's exposure to inflation on the liability side would be hedged on the assets side of its balance sheet, as long as the issuance of inflation-indexed bonds did not exceed tax revenues as a share of GDP. Banks issuing inflation-linked savings products could hedge their inflation exposure by acquiring inflation-indexed government and corporate debt.

Step 2: if inflation exceeded a certain level, inflation-indexed contracts and financial instruments could be converted into a new currency, let us call it the hard euro (HE). The HE could exist alongside the euro as a virtual parallel currency. The printing of new notes and minting of new coins would not be necessary as euro notes and coins could continue to be used for cash payments. There would be no obligation on the part of the private sector to nominate all contracts in the HE, but both the euro and the HE would have the status of legal tender (allowing residents to make a choice and settle contracts in either of the two currencies).

Step 3: assets and liabilities still existing in euros could be converted into hard euros if so desired by German residents to protect their euro assets from depreciating in HE terms. All *domestic* assets and liabilities could, of course, be exchanged simultaneously from euros into HEs. However, the same would not be possible for balance sheet positions *versus* foreign residents. Consider the case of a domestic entity having only domestic liabilities of 100 euros, but domestic and foreign assets of 50 euros each. Assume that the HE would appreciate by 20 percent against the euro immediately after its introduction. The foreigners would naturally keep their liability denominated in euro. Following the appreciation, the foreign assets of our entity would therefore be worth only 40 HEs. Thus, the entity would suffer a loss from the appreciation of the HE against the euro of 10 HEs, which would show up as negative equity on its balance sheet. Of course, there would probably also be domestic entities with

the opposite balance sheet structure (only domestic assets of 100 euros, but foreign and domestic liabilities of 50 euros each). These entities would gain 10 HEs from the currency switch and appreciation of the HE, again assuming that foreign entities were to keep their claims in euros.

Table 1
Germany's nominal net foreign assets denominated in euros (Q1 2012)

	Nominal net foreign assets (billion euros)
MFIs	– 23.48
Enterprises	407.90
Government	– 1,086.75
Bundesbank	671.70
Total	– 30.63

Source: Deutsche Bundesbank.

For domestic residents, gains and losses from the currency switch could be compensated at zero net cost before administration costs through taxes and tax credits, similar to the compensation of owners of nominal assets by owners of real assets after the switch from Reichsmark to D-Mark at a rate of 10:1 in 1948. For Germany as a whole, just as in the above case of an entity with foreign assets denominated in euros, costs would arise if, after the netting of all individual positions, the country itself was left with net assets denominated in euros that would not be re-denominated into stronger HEs. Let us now consider the case of Germany.

In Germany's national balance sheet only nominal foreign assets and liabilities in euros would remain unaffected by the currency switch. Real foreign liability positions, such as foreign ownership of entire companies, shares in companies, or real estate, would have to be re-denominated into HEs as soon as these entities were to switch from accounting in euros to accounting in HEs. Real foreign assets held by German residents and denominated in euros would, of course, remain in euros.

Table 1 shows Germany's nominal net foreign position denominated in euros for the country as a whole and classified by the key sectors. Perhaps surprisingly, Germany has been a net debtor in euros on balance since the introduction of the euro (Figure 1).[3] This is mainly due to sizeable foreign ownership of euro-denominated German government debt that has exceeded German private net ownership of euro-denominated nominal assets. More recently, the rise in the Bundesbank's claim on the ECB in the context of the Target 2 interbank payment system has added to Germany's public foreign assets denominated in euros. However, the effect of this increase on the net position of the public sector was partly offset by increased foreign buying of German government debt, leaving the country as a whole with a small net debtor position in euro-denominated nominal instruments (at least up until the end of Q1 2012).

Figure 1

Source: Bundesbank.

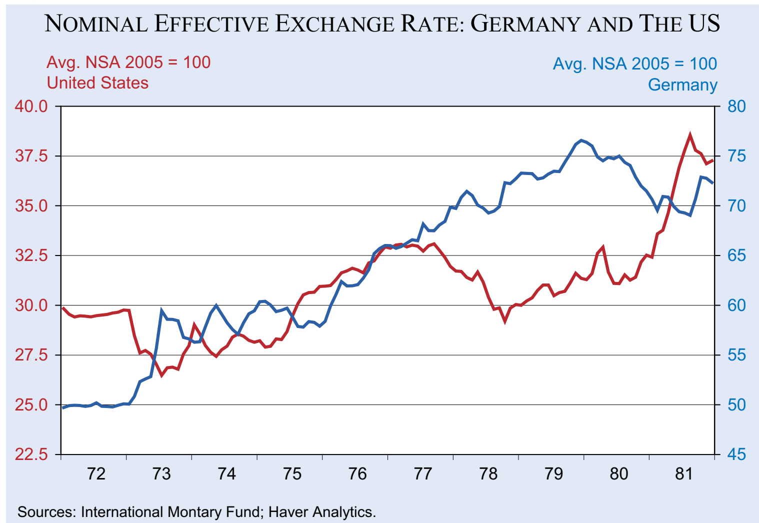
What would happen to foreign investors?

Many foreign investors have crowded into the German government bond market in the expectation that their holdings will be re-denominated into a new Germany currency should Germany decide to leave the euro. This may perhaps be the case if the euro ceases to exist. However, if the euro continues to exist alongside the HE, the German government could offer German taxpayers income tax credits to compensate them for any losses due to an exchange of

[3] The data here differ from those used by Meyer (2012). Meyer does not give a source, but the term he uses *(Euroauslandsnettoforderungen)* suggests that he uses Germany's investment position *versus* euro area countries, and not Germany's position denominated in euros. This would lead to an underestimation of Germany's liabilities in euros, as there are significant euro liabilities towards non-EMU countries.

their holdings of German government bonds from euros into HEs, but elect to leave bonds held by foreigners denominated in euros without any compensation. Since the government would fulfill all contractual obligations stipulated in the covenants of euro-denominated German government bonds and the euro would remain legal tender, it would seem difficult for foreign owners to legally enforce currency conversion. As entities not paying taxes in Germany they would also not be eligible for any German tax credits. There would be no discrimination of foreign investors as the tax compensation would not be tied to nationality, but to taxpayer residence.

Figure 2



Sources: International Montary Fund; Haver Analytics.

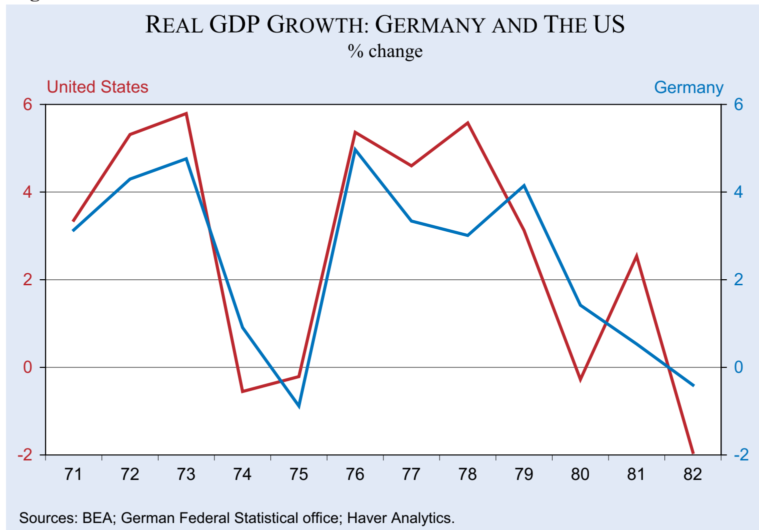
Consequences of a German EMU exit for the real economy

Many observers have argued that the German economy would seriously suffer as a result of the appreciation a new German currency, the hard euro, would experience against the euro. However, both model simulations and historical experience show that the economic consequences of currency appreciation would be manageable.

According to simulations with the OECD's Interlink model, a ten percent euro appreciation would lower German GDP by 1.1 percent from the baseline in the first year. Thereafter, GDP would gradually return to baseline over the following three years and reach 0.3 percent above the baseline in the fifth year (Dalsgaard, Andre and Richardson 2001). Of course, the HE would also appreciate against the currencies of most of Germany's EMU partners, to whom about 40 percent of German exports go. This alone would probably double the effect calculated by the OECD for euro appreciation. Moreover, the HE may rise more, say 20 percent, than the 10 percent assumed in the simulation. Doubling the elasticity and the currency appreciation would raise the GDP loss for Germany to 4.4 percent in the first year. However, as early as in the fifth year, German GDP would climb to 1.2 percent above the baseline. The conclusion from the model simulation is that the costs of appreciation would be severe in the short-term, but quickly fade and turn into a longer-term gain.

Model simulations can, of course, deviate substantially from reality. Therefore it would seem wise to cross-check the above conclusion with historical experience. Figure 2 shows the trade-weighted performance of the D-Mark and the US dollar after the collapse of the Bretton-Woods System of fixed exchange rates in the early 1970s. Between the mid-1970s and the end-1970s the D-Mark appreciated by about 25 percent in nominal trade-weighted terms. During this period the dollar depreciated at first, and then appreciated again to end the decade at a level similar to its mid-1970s level.

Figure 3



Sources: BEA; German Federal Statistical office; Haver Analytics.

Figure 4

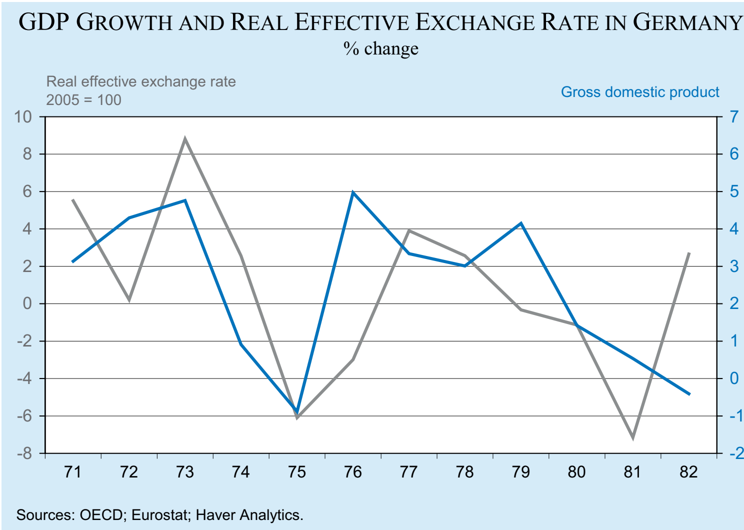


Figure 3 shows the growth performance of both economies during the 1970s. Following the recession of 1975, both economies rebounded strongly. Thereafter, Germany grew only a little less than the United States until the end of the 1970s, despite the sizeable appreciation of the exchange rate. Figure 4 shows German GDP growth together with changes in the real effective exchange rate again during the 1970s. Both variables are positively correlated, contradicting the hypothesis that exchange rate appreciation was a major drag on growth during this period.

Conclusion

The widely held view that Northern European countries are trapped in the EMU because of prohibitive costs of leaving is misguided. There are ways to exit a soft currency, inflation-prone EMU for a country with preferences for low inflation and a strong currency. Such a divorce would naturally be a long-term process and should only take place if all of the ways of preserving the existing EMU intact have been exhausted. However, in the end, an orderly divorce may be preferable to deepening political conflicts over the destination of the EMU. By creating ways for countries that prefer significantly stronger or weaker currencies to step out of the EMU, the political cohesion of Europe may be better served than keeping these countries in the straightjacket of a dysfunctional EMU.

References

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