Why Germany will break the Euro

Alan Brown, Chief Investment Officer of Schroders Group, paints a somber picture of the Euro's future.

Watching events unfold in Euroland is like watching a slow-motion train wreck. There is a ghastly inevitability to what is happening even if it could all have been so different. The inevitability comes from the maths and German insistence on austerity everywhere, coupled with its unwillingness to contemplate stimulating its own economy.

In the last decade there has been a dramatic loss of competitiveness in the PIIGS countries (Portugal, Italy, Ireland, Greece and Spain). Whether you look at real effective exchange rates or unit labour costs, there has been around a 30% deterioration compared to Germany. We have been here before: Germany's own real effective exchange rate rose by 25% around the period of re-unification. Germany took its own medicine and suffered a decade of weak growth, 10% unemployment and static labour costs to regain competitiveness. Hardly surprising then, that Germany prescribes the same medicine for Southern Europe. Wolfgang Schäuble, the German Finance minister, said recently:

- All Eurozone members must … cut their budget deficits to below 3%.
- Structural weaknesses … must be addressed by a long, painful process of adjustment.
- If a Eurozone member … finds itself unable to consolidate its budgets … this country should, as a last resort, exit the monetary union while being able to remain a member of the EU.

Germany's prescription is to put Southern Europe on the "naughty step" for a decade or more, condemning the whole Eurozone, and particularly the PIIGS, to sub-par growth.

To be clear, the scale of adjustment being asked of Greece is Herculean. If Greece does all that it is asked to do, its debt/GDP ratio will rise to around 150% as debt continues to accumulate and the denominator declines as a result of a renewed recession and deflation. With debt at 150% and real interest rates anywhere near today's level, Greece would have to run a primary surplus of 8% of GDP just to stabilise its debt ratio. In these circumstances it would be unsurprising if Greece took the view that restructuring (or default by any other name), coupled with withdrawal from the Euro, would be the lesser of two evils. This is familiar territory for Greece: Since it came into being as a modern country in 1829, it has been in default for over 50% of the time in 12 separate acts of default.

It could all be different. In a political or at least fiscal union, economic policies would be coordinated. Germany (and other Northern European countries) with relatively strong public finances and a large trade surplus would stimulate their economy to offset the deflationary impact of measures to improve public finances in the PIIGS. (Italy's deficit is actually not that large at 5% of GDP, but it starts from an uncomfortably high debt/GDP ratio of around 115% and has suffered the same rise in its real effective exchange rate.) Increased demand from Germany (and other Northern European countries) would boost demand for goods and services from the South, helping to maintain growth in the Eurozone as a whole and to reduce the current chronic current-account imbalances.

However, it is a brave (or foolish) man who bets on Germany changing tack so dramatically. After all, Germany, far from stimulating its own economy, has just passed legislation requiring the budget deficit to be virtually eliminated by 2016.

It is often argued that so much political capital has been invested in the Euro that it is inconceivable that it could break. It is also argued that a weak member coming out of the Euro would be bankrupted overnight with much of its liabilities denominated in Euros and its assets suddenly denominated in a depreciating "new currency". These arguments fail to recognise two points: First, in the event of a member country wishing to withdraw from the Euro, everything becomes negotiable, as happens after every sovereign default. Second, it is at least conceivable that the Euro could break up by way of the strong currencies rising out of it, leaving Portugal, Italy, Ireland, Greece and Spain within the Euro. The revaluation effects in that case would be benign, with those economies in an unchanged position and the countries leaving the Euro with assets denominated in an appreciating "new currency". How about New Deutsche Marks? Almost anything is possible, from a single country withdrawing, to one or more new currency zones being created, to a return to all the pre-existing national currencies.

What is clear is that almost all options would lead to a material realignment of exchange rates between the PIIGS and the DM bloc, leading to a reduction in today's chronic imbalances and a much earlier restoration of growth. Would that damage Germany's export sector? Yes it would, but ultimately rebalancing Germany's growth more towards domestic demand is a key element of getting Europe back on a sounder footing.

We have seen currency regimes come and go before. In the last century alone, we saw the Bretton Woods agreement last from 1944 to 1971. Between the 1880s and the late 1930s, the Gold Standard was the most common currency arrangement for most countries. And we should not forget the Latin Monetary Union: In 1865 four countries linked their currencies: France, Belgium, Italy and Switzerland. Later other countries joined, including Spain, Greece, Romania, Austria, Bulgaria, Venezuela, Serbia, Montenegro, San Marino and the Papal State. After the strains of World War I, the arrangement came to an end in 1927.

Will what we are suggesting actually come to pass? Not yet, for sure. But the maths, coupled with Germany's entrenched policy beliefs, suggest it is highly likely in the medium term. This tragedy (or pantomime) has many more acts to come. Stay alert.

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