DExit Revisited

No Euro (Image is from the Adesso Fuori Dai Coglioni (AFDC) initiative "Referendum 'No Euro' E' Iniziata la Raccolta Firme"
http://www.adessofuoridaicoglioni.it/referendum-no-euro-e-iniziata-la-raccolta-firme/).

[In May, 2012 I noted a proposal from Mr. Paul Feldman of Spencerville, MD.]() At that time there was a great deal of discussion about the possibility of **GRexit, the possibility that Greece would exit the Eurozone. Mr. Feldman made the brilliant proposal that Germany should give up the euro instead, presumably restoring the Deutschemark as the national currency. His reasoning was that without Germany the other Eurozone countries would have to get their acts together since they could no longer depend on bailouts from Germany.**

Naturally, I fully endorsed Mr. Feldman's proposal for DExit.

I also claimed credit, albeit a tiny amount, for inventing that word (tip: **Deutschland**). **And, with that, the whole issue vanished.**

Until today. [“Marketplace” (American Public Media) included a story about Alternative for Deutschland (AfD)], a new political party that wants to pull Germany out of the euro.

> ***There’s a political tornado brewing in that country that could blow the euro off course and reignite the debt crisis. Germany’s newest political party – Alternative for Deutschland (AfD) – which wants to pull out of the single currency – is on the rise.***
>
> ***“I think we are becoming a real force in German politics, ” says party worker Friedrich Hilse. “ We have broken through into the European parliament, we have won seats in three regional assemblies, and we’re likely to get into the Bundestag (the German parliament) at the next election.”***

Currently, AfD has about seven percent of the votes in Germany. But **two factors** make it worth noticing. First, **AfD has come out of nowhere and grown rapidly**. And second, **the party’s appearance and appeal break the “German consensus” that more European integration is better**.

Having said all that, **I don’t forecast the Eurozone breaking up any time soon. But nationalism is on the rise across the continent. The AfD is yet another indication of this**

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Image is from the Adesso Fuori Dai Coglioni (AFDC) initiative “Referendum ‘No Euro’ E’ Iniziata la Raccolta Firme” (http://www.adessofuoridaicoglioni.it/referendum-no-euro-e-iniziata-la-raccolta-firme/).

Germany Harmonizes With Other European Countries

Angela Merkel

"Harmonization" has been a key word in discussions of European integration. In the past this has usually meant **talking about tax regimes in the different countries, with Ireland's low taxes held up as an example of anti-competitive behavior.** "Anti-competitive" means Ireland is better at competing for business than other European countries. **Persuading Ireland to raise their tax rates would be closer to cartel price-fixing.**

But the latest move is from Germany. **Germany harmonizes with other European countries by imposing their first-ever minimum wage**. CNN has a story about this. By increasing their minimum wage (from a base of zero) Germany moves closer to the rest of Europe.

What Is the European Union?

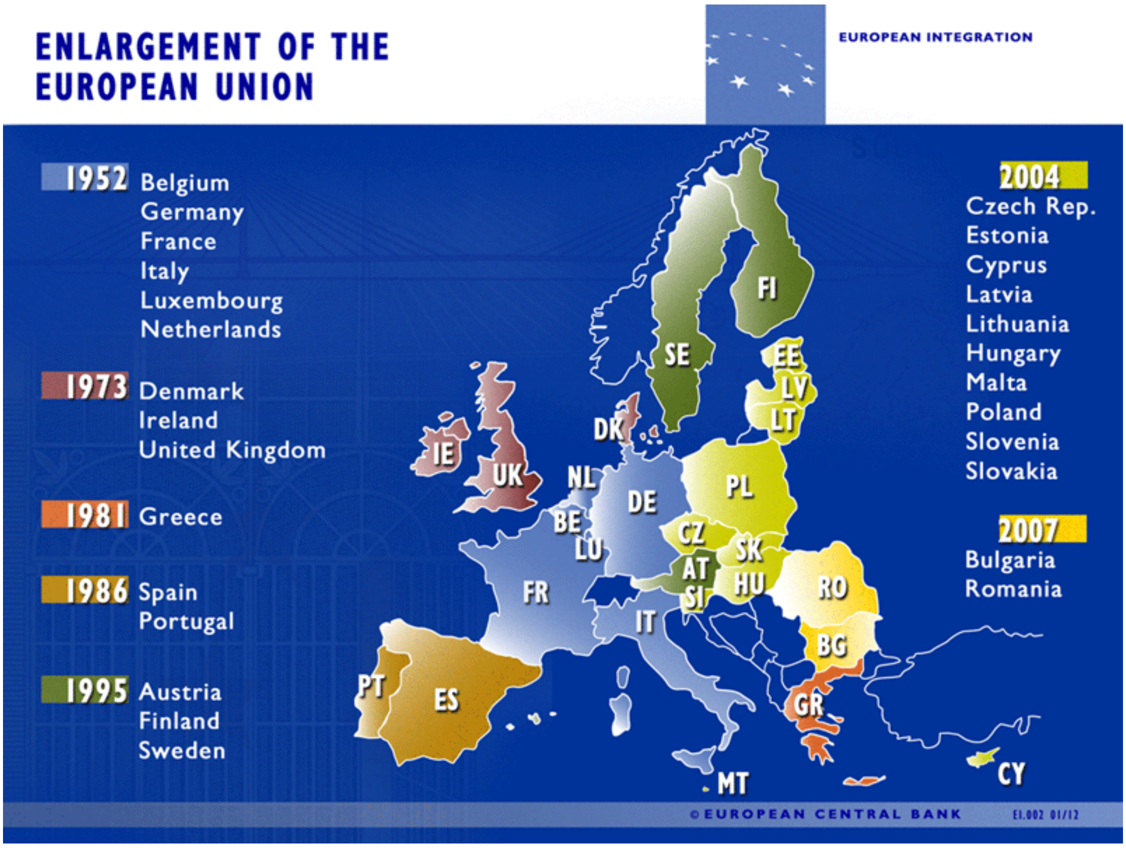
This morning the Nobel Prize committee awarded the Nobel Peace Prize for 2012 to **the European Union**. **Media confusion abounds, Nobel Peace Prize edition. What is the European Union, anyway?** Many newsreaders seemed to think the prize was awarded to the **European Monetary Union, commonly called the Eurozone.** These are the 17 countries that use the euro as a currency. However, **the Nobel committee made it clear that the award was to the European Economic Union.** There are 27 countries in the economic union. Major countries that do not use the euro include the United Kingdom, Denmark, and Sweden. (Interestingly, **Norway, the country that hosts the Nobel awards, is not a member of either European union.**)

The exact language used by the Nobel committee in making the award referred to the **"60 year history" of the European Union**. That would be **1962, the beginning of the European Coal and Steel Community**. In **1958** the countries decided to change to a more compact name, the **European Economic Community (called the Common Market)**. In **1993** the name was changed to the **European Union**. Therefore, the Nobel prize must be shared among 27 countries of the EU instead of the 17 countries in the eurozone. (According to one comment, that works out to about €0.10 per capita. The reporter asked that her share be deposited directly into her checking account.)

More media humor: "**Good thing the EU got the Peace Prize. There was no chance of them winning the prize for economics.**"

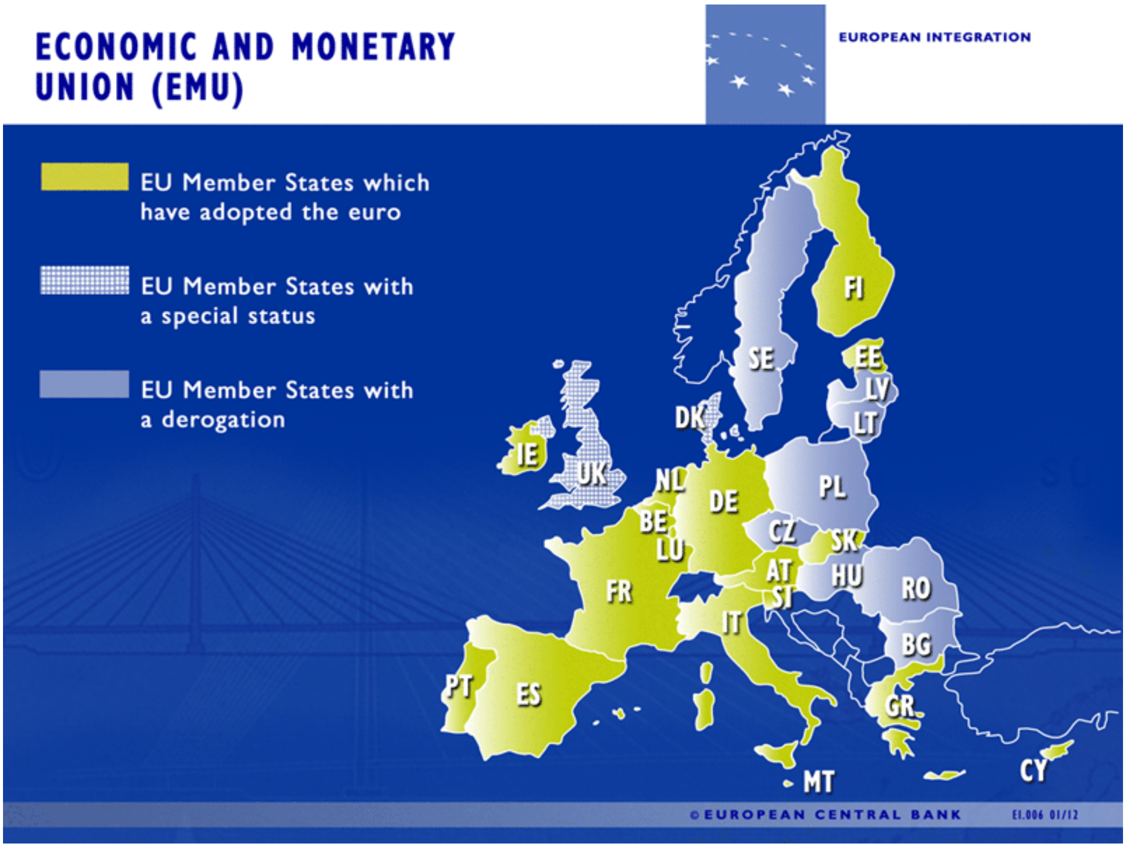
This information is incredibly easy to find. The European

Central Bank website has two maps of the respective zones.
The European Economic Union map includes the list of member countries:



European Economic Union countries

And the European Monetary Union:



European Monetary Union countries

Remember when reporters actually reported and did research?

A New Eurozone Conspiracy Hypothesis

In today's New York Times, business columnist Floyd Norris proposes a new eurozone0 conspiracy hypothesis: suppose the ongoing eurozone crisis was actually planned all along by Germany.[1]

Better sit down because this is a good one. According to Mr. Norris's model, the story begins in 1992. Having been frustrated twice in the 20th century in their attempts to take over Europe by military force, the government decided to use economics instead. His reading of the history of the euro as a German conspiracy is entertaining and insightful. Unfortunately, he is limited to the space allocated by his Times editors. Here on GonzoEcon we are our own editors and can consume as much space as we want. Let's look back at the real beginning, 33 years ago.

Ancient History: The ERM

In March, 1979, France and Germany formed the Exchange Rate Mechanism (ERM). The ERM was designed to "stabilize exchange rates, reduce inflation, and prepare for monetary integration."[2] Other countries joined the ERM, including Italy, the Netherlands, Belgium, Denmark, Ireland, and Luxembourg.[3] Participating countries were required to keep their exchange rates within a 2.25% band around each bilateral exchange rate.[4] However, the peg was, to some extent, a crawling peg. There were nine realignments between 1979 and 1985.

Naturally, other countries joined the ERM. The United Kingdom signed up in 1990 at an exchange rate of 2.95 deutschemarks per pound and a band of 6%. Everything was fine until the West German government made a critical policy error involving German reunification.

More Recent History: German Reunification

Once upon a time there were two countries named Germany. West Germany was a modern democracy, while East Germany was part of the Soviet Union (USSR).[5] In 1987 former U.S. president Ronald Reagan gave his famous "tear down this wall" speech, calling on Soviet leader Gorbachev to remove the concrete wall separating East and West Germany. Two years later, the wall came down, the Soviet Union dissolved, and the two Germanies became one in 1990.

The problem was the exchange rate conversion. West Germany used the deutschemark, while East Germany used the ostmark. The ostmark was a nontraded currency, but the black market rate was around 8 ostmarks per deutschemark. However, to integrate peacefully, the West German government agreed to convert ostmarks to deutschemarks at a 1:1 ratio.[6] Effectively, there was a huge transfer of purchasing power from West Germany to East Germany. In response, the Bundesbank began printing deutschemarks. Inflation surged and the Bundesbank reversed course, causing interest rates to rise. As predicted by Irving Fisher and Robert Mundell (among many others), German interest rates were high relative to other countries in the ERM. There was a financial flow into Germany, increasing the demand for deutschemarks and causing the DM to appreciate. To maintain the peg, other ERM members were forced to raise their interest rates. However, those countries were not facing an inflation problem. Many experienced recessions.

The United Kingdom and George Soros

The United Kingdom was in an especially difficult situation because their economy was already in a recession. Raising interest rates would make the recession worse. The choice was stark: make the recession worse or get rid of the peg. The lowest-cost alternative was to drop out of the ERM.[7] Incidentally, George Soros placed huge bets on the pound depreciating, effectively selling the currency short and putting pressure on the Bank of England. The Bank bought £15 billion. Not enough. On September 16, 1992 (“Black Wednesday”) the Bank raised interest rates from 10 to 12%. Still not enough. The Bank announced its intention of raising interest rates to 15%. Finally, at 7 pm, Chancellor Norman Lamont announced that Britain would leave the ERM and interest rates would be reduced to their initial 10% level. Italy also dropped out of the ERM. In testimony before the House Banking Committee, C. Fred Bergsten, the director of what later became the Peterson Institute for International Economics said, “Successfully defending a fixed rate can also be quite costly. Mr. Bachus [Rep. Spencer Bachus, R-Alabama] asked, ”Are there alternatives?” Well, you can defend a fixed rate if you are willing to push interest rates to 20 percent, 50 percent, 100 percent or if you are willing to push the economy into a recession, but those are huge, costly steps. Countries usually aren’t willing to do it; and, as a result, they may get the worst of all worlds – huge costs in trying to defend the fixed rate and then it is still knocked off by speculation, and all sorts of crises result.”[8]

Mr. Soros made a huge pile of money on the deal. But it’s pretty clear that the fundamentals were on his side. The ERM was simply untenable without macroeconomic coordination among the member countries.[9] The fundamental condition proposed by Dr. Mundell’s theory of optimum currency areas is a high degree of economic integration among members of the currency union. Germany was experiencing inflation while the U.K. was in a recession. There is hardly any better indicator of a lack of integration.

A Conspiracy in Three Steps

Which brings us back to Mr. Norris. Remember him? The guy with the conspiracy theory? Contrary to Dr. Bergsten’s earlier statement, Europeans learned a different lesson from the collapse of the ERM. “… common currencies had to be rigid, so there was no possibility of an attack on a weak currency by speculators.”[10] And, of course, a single currency is the ultimate defense against speculation.

Speaking of speculation, here’s what Mr. Norris has to say (hypothetically, of course). Germany learned three lessons.

1. Their export-oriented industries would be subjected to periodic devaluations from other European countries. These ongoing devaluations would reduce German exports

and have a deflationary impact on the economy.
2. A currency union would, on the other hand, be helpful to Germany. The exchange rate of the common currency – let's call it the euro – would be below the deutschemark exchange rate because the euro's exchange rate would be kept low by less competitive economies. After all, the euro's exchange rate is nothing more than the weighted average of hypothetical individual country currencies.
3. After the currency union, Germany could adopt a low interest rate policy. This would create low interest rates for other Eurozone members, banks would "open the credit spigot and create a debt-financed boom in much of Europe." The result: massive imbalances, deeply indebted countries (Greece, Italy, …) and a crisis that could only be solved by acquiescing to German policies. The debtor countries would be forced to give up a large part of their national sovereignty.

Conclusion

There is much more in Mr. Norris's column. I urge everyone to read it. Are Germany's politicians and economists really that smart? I don't know, but some people apparently believe it.

Endnotes

[1] Norris, Floyd, " As Europe's Currency Union Frays, Conspiracy Theories Fly." New York Times, June 15, 2012, p. B1. Available at http://www.nytimes.com/2012/06/15/business/as-europes-currency-union-frays-conspiracy-theories-fly.html?smid=pl-share as of June 15, 2012.

[2] http://olesiafx.com/Kathy-Lien-Day-Trading-The-Currency-Market/George-Soros-the-Man-Who-Broke-The-Bank-Of-England.html. Accessed June 15, 2102.

[3] Notably, in order to join the ERM, Ireland had to give up pegging the Irish pound to the British pound.

[4] For those keeping score at home, eight countries mean 28 bilateral exchange rates for each country to track. The formula is n(n-1)/2.

[5] For insight into life in East Germany, it's hard to beat the movie *The Lives of Others (2006)*.

[6] The actual ratio included two steps. Ostmark balances above 4,000 were converted at a 2:1 ratio. Wikipedia has a good page explaining all this in detail.

[7] Those who see an analogy with Greece, Spain, *et. al.* today are not alone.

[8] Testimony before the House Banking Committee, available at http://commdocs.house.gov/committees/bank/hba57160.000/hba57160_0f.htm.

[9] Again, this sounds eerily familiar.

[10] Norris, *op. cit.*

Better sit down because this is a good one. According to Mr. Norris's model, the story begins in 1992. Having been frustrated twice in the 20th century in their attempts to take over Europe by military force, the government decided to use economics instead. However, history shows the actual beginning was in March, 1979, when a number of European countries

Growth in the Eurozone

“The only growth in the Eurozone is in three and four letter acronyms.” – Heard on the BBC World Service at 3:36 pm Pacific Daylight time March 31, 2012.

First There Were 27

First there were 27 European countries negotiating the fiscal union. Wait – there are only 17 countries using the euro! Where did the other ten come from? And, more important, why were they even involved in the negotiations? The eurozones problem – OK, one of the problems– is trying to become a monetary union without two key elements. First, the European Central Bank is prohibited from acting as lender of last resort. Second, the rules for fiscal policy have not been enforced. Every eurozone country has violated at least one fiscal rule with no penalty.

The other ten countries belong to the European Economic Union, but do not use the euro currency. Why they were even involved in these negotiations is a mystery. Probably the arrogance of French and German negotiators trying to maintain the fiction that there is only one Europe.

Nine of those ten countries should send thank you notes to British PM David Cameron. He pulled out of the negotiations after eurozone members insisted on regulating Britains financial sector. That gave cover to the other nine countries which promptly followed the UK out the door.

If they keep this up, the euro is doomed.