GaveKal Ad Hoc Comment

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Germany and the EMU Ponzi Game

Most of our clients know the way we feel about the Euro and the odds that the single currency remains in its current form through the current crisis. So they will likely not be surprised to hear that we thought that the paper below, written by Bernard Connolly of Connolly Global Advisers (BNSConnolly@aol.com), was one of the better reports we had seen on the currency union since the Euro's launch. The report was passed on to us by our friend Simon Ogus of DSG Asia (Simon@dsgasia.com) who publishes our favourite weekly economic read on Asia.

For those amongst our readers who do not know Bernard Connolly, he is one of the most knowledgeable market analysts out there, whose background affords him an almost unique perspective on the political machinations underlying the great European project. Before he moved to the private sector, Bernard was the Head of the European Commission's Monetary Affairs Department from which he was summarily dismissed after publishing the magnificently prescient Rotten Heart of Europe. Following his 1995 departure from the Eurocracy, until late last year, Bernard served as Global Strategist at Banque AIG. Bernard has now started his own independent research firm.

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Until the global financial crisis began, European monetary union was perhaps the most egregious example in the world of a macro Ponzi game. Several euro-area countries (Spain, Greece, Portugal and Ireland) had large or increasing current-account deficits not justified by high rates of productivity growth and high anticipated rates of return on investment. Indeed, productivity growth was falling away in these countries as deficits were increasing. Spain, for instance, had registered effectively zero total factor productivity growth since the beginning of the decade: its relatively rapid growth rate came largely from falling unemployment and very high rates of immigration. Italy, though it had a relatively small current-account deficit, belonged conceptually to the same group because the evident cosmic gloom of its population about the country's future prospects should have implied a current-account surplus as Italians saved in anticipation of a future downturn in incomes. All these countries had extremely uncompetitive trade positions. In the case of the first four, strong domestic demand meant that non-competitiveness was reflected in large current-account deficits. In the case of Italy, rather weak domestic demand meant that non-competitiveness was reflected in what was its sluggish growth even during the boom. But in all five cases it was clear that the ruling constellation of economic outturns and market pricing in 2007 and earlier was not consistent with any politically realistic possibility of respecting the countries' inter-temporal budget constraints. Yet the debt of the countries concerned was willingly, indeed eagerly, held. That was the Ponzi game.

1– The Monetary Union Magnifies Credit Bubbles

Why were these countries in such a state? The answer is straightforward: it is monetary union. Strong domestic demand in the first four countries was an aspect of the global credit bubble. But the bubble was greatly magnified by the market perception that the absence of national currencies in monetary union meant that there could be no financial crisis in these countries. Given the impossibility, within monetary union, of currency depreciation (or, putting it differently, the zero actual and implied forex vol), carry trades and "the search for yield" were on everyone's agenda, forcing yield differentials down. Less than two years ago, there were no significant spreads between German government bond

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yields and equivalent yields in the current-account deficit countries (cads). What the market was forgetting was that in monetary union currency risk is replaced by default risk. This imprudent behaviour on the part of market participants was welcomed with smug satisfaction by monetary union policy-makers, who claimed it as evidence of the "success" of monetary union (their subsequent hypocrisy in blaming "Anglo-Saxon" financial markets for the financial crisis was all too predictable but none the less depressing).

Given that depreciation within monetary union is not possible, the default risk of weaker countries needs to be reflected in either a substantial depreciation of the euro, or relative disinflation in the current account deficit countries (cads).

The reality, monetary union or no monetary union, was that a country with a large current deficit, whether now or, in the case of Italy, in the future (Italian demand is already depressed by gloom about the country's prospects; when the anticipated downturn in output and income materializes as a result of the country's structural social, economic and political problems, the current-account deficit will widen), must, if it is to respect its international debt obligations, run future trade surpluses (there is an important caveat to this statement – one whose implications will take up much of this article; but we leave it aside for the moment). How are those surpluses to be achieved? The answer must inevitably involve a contraction of domestic demand relative to potential output. And because the countries concerned are, with the exception of Ireland, not particularly open in relation to their size, a large part of any contraction of domestic demand falls on non-traded goods and services, with no impact on the trade balance.

2– Achieving Improvements in Trade Balances

To achieve the required improvement in the trade balance requires a domestic demand contraction which is a multiple of the trade improvement. And unless net exports rise by as much as domestic demand contracts, there will be recession – a very deep and prolonged one. Achieving a large improvement in net exports requires a very substantial improvement in trade competitiveness. But given the impossibility of currency depreciation within monetary union, that in turn requires either a very substantial depreciation of the euro – which happens to be the currency not just of the cads but of several other countries, most importantly including Germany – or relative disinflation in the cads. Given the ECB's inflation target for the area as a whole, that means that, in the best of circumstances (that is, circumstances when the euro area as a whole is not suffering deflation, circumstances that may not obtain), there must be outright deflation in the cads (and, not without significance, above-target inflation in the rest of the area). But in a market economy, deflation can be produced only by a long period of high unemployment (if instead it is produced by administrative fiat, there is an immediate rise in the real burden of all debt in the economy, undoubtedly causing very widespread bankruptcy in the non-bank private sector, imposing enormous losses on banks – possibly bankrupting them – and causing intense and probably unmanageable strains in the public finances).

If the cads cannot by themselves find a way out of this nightmare as long as they remain in monetary union, is there any way that other countries can rescue them?

The combination of a long, grinding rise in unemployment and the unavoidable expectation of a slow deflation (which with nominal interest rates set outside the economy and little affected by developments within it) means a long period of high real interest rates in the depths of a recession – indeed, a Depression. Once the credit bubble bursts, asset prices (notably house prices) plummet and domestic demand begins to collapse, the monetary union Ponzi game collapses with it. The horrifying reality of the cads' position becomes apparent. Bond spreads increase, exacerbating the problem. The collapsing public finances force governments to raise taxes and cut spending, further aggravating the recession and deflation, so that real interest rates rise still further, crowding out even more private spending and adding to default risks throughout the economy. Even the ratings agencies have to accept at least a small element of reality and begin downgrading cad sovereign debt. At first, though, firms and households are led by their political leaders to believe that the recession, though painful, will soon

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The surplus countries would have to transfer — every year for ever — something like 7% of their joint GDP to the deficit countries.

come to an end. It is when they realize that there is no way for them to wake unaided from the nightmare – that the nightmare is the reality – that despair sets in. Despair among ordinary firms and households pushes domestic demand down even further than might be required to achieve the necessary trade necessary trade improvement. Deflation accelerates again; real interest rates rise even further; debt burdens become unbearable and bankruptcies become ever more widespread. Not only the economic and political fabric but also the social and political fabric become increasingly at risk of breaking down.

If the cads cannot by themselves find a way out of this nightmare as long as they remain in monetary union, is there any way that other countries can rescue them? If there are such ways, what are the incentives – and disincentives – for other countries to pursue them? The answer to the first question is straightforward: the cads could be rescued by very substantial euro depreciation or by very large, permanent, year-after-year transfers (*not* loans) granted them by the current-account surplus countries in the euro area.

3– The Hope of Euro Depreciation

Substantial euro depreciation would allow a rise in the cads' net exports to offset the plunge in domestic demand – or at least it would if there were ever any stabilization of world trade. Living standards in the cads would still have to remain depressed relative to their Ponzi-game levels, but at least the depression, mass unemployment, deflation, default and potential political and social breakdown would be avoided. But because about half, on average, of the cads' trade is within the euro area, the required euro depreciation would be very large indeed, given the horrendous starting positions (Greece, for instance, had a current-account deficit of 15% of GDP). Calculations done for me by an intern last summer suggested that, from a starting-point last summer of $1.57, the euro would have to depreciate to 60 US cents to do the trick for the worst-placed cads[1]. That would create roaring inflation in Germany (the calculations, using ECB model results, suggested that the German price level might have to rise by 70% over five years[2]. Those calculations were done before the collapse of world trade. Now, Germany as well as the cads faces a deflation risk, not, with the euro in its current range, an inflation risk. But that just means that the euro would initially have to depreciate even further than last summer's calculations suggested, in order to avoid cad depression, deflation, default and collapse. And the logic remains: using euro depreciation to avoid cad collapse must necessarily mean inflation in Germany.

4– Annual Transfers to Redress the Balance

The second way out involves large, annual transfers – forever. Recall that the current account is the sum of the balances on: trade in goods and services; net factor income paid to/from abroad; and current transfers to/from abroad. If the euro-area surplus countries (which one can represent by Germany) give the cads current transfers of a size equal to their trade deficits, there would be no need for the cads' trade to balance or go into surplus and thus no need for their competitiveness to improve. Since the transfers would be permanent, cad country consumption would increase by an equivalent amount, and there would be no depression of domestic demand. Euro depreciation and German inflation would be avoided. But the implication would be that Germany's trade surplus (about 5% of GDP last year) would, rather than providing resources for future German consumption, be providing resources for present and future cad consumption.

How big would those transfers have to be? Here, it is important to realize that France is becoming a cad. Because of the global economic collapse, near-term movements in trade and current-account balances are very difficult to assess and predict. But the full-employment current-account deficit in France is probably

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about 4% of GDP and rising. France is uncompetitive. Its position is not quantitatively as bad as those of, say, Greece, Spain or Portugal. But a similar logic applies: in the absence of French withdrawal from monetary union, substantial euro depreciation or substantial transfers to France from Germany, France must sooner or later – even if the world economy stabilizes – suffer a cycle of depression, deflation and potential default. Moreover, the logic of the analysis made earlier in this article implies that Italy's full-employment trade deficit will rise over time. Taking all of this into account, the surplus countries of the euro area would have to transfer – every year for ever – something like 7% of their joint GDP (or, on average, 16% of their budgetary receipts) to the deficit countries. As a benchmark, it appears that the Versailles reparations imposed on Germany in 1919 would have meant, had they been implemented as originally intended, a transfer from Germany of about 10% of its GDP for seventy years; depending on the discount rate one uses, the present values of the two streams are very similar – not a historically very encouraging comparison and one which, were it known, would quite rightly elicit very negative reactions from the German public.

The Versailles reparations imposed on Germany in 1919 would have meant transfers of 10% of its GDP for 70 years, had they been implemented as originally intended.

5– Will Germany Help the Current Account Deficit Countries?

The obvious question is whether and why Germany might or might not accept either of the two escape routes for the cads. As a preface to an answer, though, one first has to examine German official and public conceptions, or misconceptions, about monetary union and its impact on Germany.

What does German opinion think monetary union means? There is a considerable degree of either ignorance or short-sighted and ultimately self-defeating selfishness among high-level public officials. Most of them regard monetary union as working – finally – in a way satisfactory to Germany. That is, it is now – and only now, they claim to believe – operating to protect Germany's competitiveness and trade surpluses. What is the logic here? In the absence of monetary union, these officials reason, there would be an "exchange-rate shock"; the currencies of cad countries would be depreciating hard against the DEM, forcing the country to increase its domestic demand if it wished to avoid a rise in unemployment (in reality, of course there is going to be a huge rise in German unemployment in the wake of the collapse of world trade, and Germany could turn out to suffer a fall of perhaps 6% in GDP this year; but in the tunnel-vision thinking of officials, things would be much worse for Germany in the absence of monetary union). That combination of worsened German competitiveness and increased German domestic demand in response to an "exchange-rate shock" would threaten to eliminate Germany's trade surplus. And only last week Merkel emphasized what, to her, was the importance of maintaining trade surpluses.

The question is whether and why Germany might or might not accept either of the two escape routes for the cads.

Such attitudes are mercantilist and represent beggar-thy-neighbour policies. Moreover, they are arguably hypocritical. For it was the operation of the euro area, in its early years, in order to advance perceived German interests, that helped create the bubbles in the cads. Germany entered monetary union as the uncompetitive country in the area. It even had a modest current-account deficit by 2001. Its public finances were in difficulty and unemployment was very high. To help Germany out, the ECB – dominated by Tietmeyer and his protégé, Trichet – set euro interest rates well below the level theoretically recommended for the area as a whole. Those decisions helped produce a very substantial depreciation of the euro in its first two years[3]. The euro depreciation directly improved German competitiveness vis-à-vis non-euro-area countries (not least Britain, whose own monetary policy, unfortunately set in an inflation-targeting framework, was consequently distorted, ultimately contributing to bubbles in that country, too). And the combination of excessively-easy ECB policy and a very weak euro created booms – and ultimately bubbles – in the euro-area cads,

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forcing their inflation rates up and improving German competitiveness within the euro-area (see also endnote 2). In addition, the Schroeder government introduced a set of labour market reforms. Reforms were certainly needed to make the corporatist German labour market more flexible and efficient. But the reforms actually implemented were very different – defensive and negative. Essentially, workers were threatened that if they did not accept a squeeze on wages their jobs would be transferred abroad. The outcome – a sharp fall in relative unit labour costs in Germany – further improved German competitiveness. But the means used – instilling fear and depressing household confidence – meant that consumption demand in Germany remained sluggish even when output and employment, driven by net exports and, eventually, investment, picked up. The net effect was that Germany accumulated huge trade surpluses. In the present world environment, an attempt to maintain such surpluses rather than rebalancing the economy towards domestic demand, unambiguously represents a beggar-thy-neighbour policy.

As for the cads, German official attitudes are that Germany managed to adjust its economy and its current account, so the cads should do the same. This neglects many things: that the domestic demand booms and financial bubbles in those countries, largely created by the ECB in its efforts to help Germany at the beginning of monetary union, and the consequent trade and current-account deficits, are massively greater than any Germany had to contend with. Next, several of the cad economies are quite closed in relation to their size (some are significantly less open than Germany's), so that a bigger improvement in competitiveness is needed to offset a loss of domestic demand in the bust. Next, Germany benefitted, for most of its period of adjustment, strong world trade conditions. Indeed, part of the boom in German net exports – in addition to that coming from German competitiveness gains resulting from monetary union-induced inflation in the cads – came from the domestic demand bubbles in the cads. And, of course, Germany was helped directly and very significantly by the ECB in the early years.

German mercantilism is an alliance within an implicitly corporatist state, favouring the interests of certain castes (almost an extension of mediaeval guilds) over those of individual German voters, taxpayers, savers and consumers.

6– Behind Germany's Mercantilism

What accounts for German mercantilism? In large part, it is a direct descendant of the thinking of the 1890s and the early years of the twentieth century. What one might call "National Darwinism" was then supplementing "Social Darwinism" as the dominant state philosophy, drawing on both Hegel and Nietzsche in terms of political philosophy and on List in terms of economic philosophy. In addition, in the socially-rigid Wilhelmine Germany, in which class warfare was never far below the surface (Marx was German, after all), the interests of the business class and the preservation of its status were seen as being served by creating an extended zone of German economic and political influence.

The ideal of a German-dominated *Mitteleuropa*, advocated by German business, was at the heart of Bethmann-Hollweg's secret September 1914 memorandum of German war aims. An alliance, although now obviously of more benign intent, between German (or "European") geopolitical ambitions and business interests, especially exporter interests, is still very powerful. One cannot analyze or make predictions about the resolution of the EMU crisis without taking it into account. It is an alliance within an implicitly corporatist state, favouring the interests of certain castes (almost an extension of mediaeval guilds) over those of individual German voters, taxpayers, savers and consumers. It is an expression of contempt for the "individualistic", "Anglo-Saxon" model of the state, the economy and society. And, as I shall argue in a moment, it may determine the sharing-out of the terrible pain now being inflicted by monetary union.

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7– Withdrawing From the Euro

First, though, it is important to consider the option of withdrawals from monetary union, whether by one or more of the cads or by a German bloc. Any withdrawals would be complicated, messy and painful. That is why the creation of monetary union was so culpably reckless and irresponsible (it could probably never have happened in an "Anglo-Saxon" political and financial system[4]): it inevitably condemned at least some countries to economic misery through one route or another. But withdrawal would certainly be feasible.

No-one really gives much weight in general terms to the objection that the EU treaties do not envisage any mechanism for withdrawal – too bad for the treaties. And it would be almost certain that public international law would – if anyone cared about it – allow withdrawal as the life-or-death matter it obviously would be (the Vienna Convention on the Law of Treaties allows a state to denounce a treaty to which it is party if that treaty's provisions prove inconsistent with the inherent purpose of the state, and monetary union brings a clear and present danger of failed states; in any case, monetary union is inconstant with the objectives of the EU as advertised –however disingenuously – in the EU treaty, so a state could leave monetary union without having to denounce the EU treaty as a whole). The obstacle to withdrawal most frequently cited in the case of cads is that if a country left in order to devalue its new currency its euro-denominated debts would become a greater burden. That argument is too simplistic. First, the universally-recognized *lex monetae* means that a withdrawing country could re-dominate all internal debts into the new currency. It could also quite legally re-denominate its sovereign debt, including such debt held by foreigners. Private debts held outside the country (and derivatives such as CDS) would be a trickier matter, with no legal certainty about the outcome (see, for instance the latest edition, by Charles Procter, of the classic handbook, *Mann on the Legal Aspect of Money*, for one view, though, in my opinion, by no means an authoritative one, on this question from an English law perspective, important since it is probably the case that most of the relevant CDS are written under English law). Deciding these issues would be messy, expensive and long-drawn-out and would probably involve complex conflict-of-law litigation[5]. No-one could deny that the financial consequences of a cad withdrawal would – for someone – be highly unfortunate. But, in the end, any outcome of this process (which might have to involve asymmetric conversion of banking sector assets and liabilities, with important distributional, and thus political, consequences) would be very much better than the catastrophic effects of "internal devaluation" within monetary union via the process of, deflation and default outlined earlier in this article. Of course, any suspicion that a cad country might be contemplating withdrawal would lead to an immediate flight from its banking system – creating a huge dilemma for the ECB. This, of course, is the monetary union analogue of an old-fashioned currency crisis within a system of exchange-rate pegs, such as the ERM. The problem can snowball very rapidly indeed. And unless the ECB were prepared to do what the Bundesbank was prepared to do for some countries, but not for others, in the ERM – that is, not just provide borrowing facilities but also change its interest-rate policy for the sake of favoured countries – the outcome would have to be withdrawal, however painful it might be, and even though it would probably have to involve draconian exchange controls and severe financial disruption ahead of and during the transition.

This raises another question. Would a withdrawing country be able to survive without the provision of euro liquidity by the ECB, given that the domestic banking sector might have ongoing euro funding needs? This is not straightforward in principle, since it depends to some extent on the question, unanswerable ex ante, of the legal treatment of re-denominated private-sector

Would a withdrawing country be able to survive without the provision of euro liquidity by the ECB, given that the domestic banking sector might have ongoing euro funding needs?

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Eventually, the choice will have to be made: let cads be forced to withdraw, or bail them out, with all the horrendous costs to Germany that would be entailed .

debts. But there seems little doubt in practice that a cutting-off of the provision of euro liquidity by the ECB would have very serious effects. However, the ECB could, if it chose to, provide euro liquidity, via forex swaps with the central bank, to a country that had withdrawn. Indeed, since the devaluation allowed by withdrawal would reduce the solvency risk for the country concerned, as long liquidity was made available, than its current practice of keeping afloat banking systems in countries threatened with insolvency with monetary union. But might the ECB decide, or be ordered to decide, that it should withhold liquidity provision as a punishment or *pour encourager les autres*? The ECB would have to think very carefully before cutting off its nose to spite its face. In the conditions in which withdrawal might happen, the financial system of the whole of the EU – and beyond – would be extremely fragile. Even a country as small as Ireland might be deemed "systemically important" given the overseas funding of its banks (and, importantly, given the involvement of German banks and asset-management institutions in the Dublin financial market).

All that being said, withdrawal, or even the threat of withdrawal, would be horrible – even if less horrible than continued membership without help either from massive euro depreciation or from massive German transfers. But if nothing is done, the risk of economic, financial, social and even political meltdown in the cads will grow ever bigger. Eventually, the choice will have to be made: let cads be forced to withdraw, or bail them out, with all the horrendous costs to Germany that would be entailed.

But is there an alternative?

8 – An Alternative: Could Germany Withdraw?

But is there an alternative? Could *Germany* and its consorts withdraw? In purely economic terms, that would be the least bad outcome of all, given that the first best option – of there never having been a monetary union – is not available. The (rump) euro would undoubtedly depreciate against the new DEM. But the euro would not depreciate against itself, so the potential problem of a somewhat increased burden of debt on the cads would not need to be resolved in the courts since it would simply never arise – the same would be true of the euro liquidity question. German financial institutions which had invested large amounts in cad country debt would definitely lose out (instead of just potentially losing out in the case of cad withdrawals). That would be unfortunate for them but economically and financially manageable. And they would also definitely lose out, and probably even more painfully, in an unmitigated monetary union, as cads were eventually driven into default – but, given German misperceptions about monetary union, that seems to be difficult for German institutions to understand.

All in all, the least-bad option of a German-led bloc withdrawal seems the least likely to be adopted since the personal careers and ambitions of the political class throughout the euro area are completely tied up with "Europe" and its most visible manifestation, monetary union.

German exporters would lose out if Germany withdrew. But, like the financial institutions, they would lose out even more painfully in an unmitigated monetary union: the process of depression and deflation in the cads would eventually improve those countries' competitiveness against Germany, but in conditions of a catastrophic decline in their own domestic markets (Germany's export markets) as despair set in – but, given German misperceptions about monetary union, that seems to be difficult for German exporters to understand. Finally, the geopolitical ambitions of the German political class would also lose out. France would be reluctant to join a new monetary union with just Germany and its consorts (see my account, in *The Rotten Heart of Europe*, of the August 1993 crisis in the ERM for an intriguing parallel). Of course, geopolitical ambitions for "Europe" would be dealt an even more shattering blow by the collapse of economic, financial, social and political structures in an unmitigated monetary union – but, given German misperceptions about monetary union, that seems to be difficult for the German political class to understand. All in all, the least-bad option seems the least likely to be adopted.

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9– So What Will Happen?

So what *will* happen? Unfortunately, the personal careers and ambitions of the political class throughout the euro area (and also, very clearly, in a country such as Denmark) are completely tied up with "Europe" and its most visible manifestation, monetary union. They – cad politicians and non-cad politicians – will be prepared to allow almost any amount of pain to be inflicted on the cads for the sake of "Europe". They may not see it in that way. They are blind to what monetary union means. And, very obviously, frantic behind-the-scenes efforts are being made to hold things together. The problem is that stopgap measures – the measures that are currently being discussed and probably planned – cannot resolve the problems of monetary union. The ECB is currently performing the stopgap role of course, effectively financing the banking sectors of countries such as Ireland and Spain. It will announce additional "unorthodox" measures next month. But Trichet's very evident agitation when he was asked about this at the ECB press conference last week strongly suggested that a political decision must first be made, one with which the ECB will then fall in. It may involve buying corporate bonds; in the end it may even involve buying government bonds, despite the enormous political sensitivity involved in deciding *which* countries' bonds to buy.

The stopgap measures that are currently being discussed and probably planned, cannot resolve the problems of monetary union.

It looks very much as though in addition there will be bilateral *lending* to cad countries, primarily by Germany. Germany wants to keep the formal EU institutions out of the game as much as possible, for several reasons. First, it wants to avoid a formal breach of the "no-bail-out" rule in the Maastricht treaty. Second, it hopes that by keeping lending bilateral and intergovernmental rather than making it a euro-area-wide, or EU-wide, and proto-federal, affair, it will not be opening the door too wide to the formal debt union that the German public has always rightly feared would be an inevitable corollary of monetary union. Third, by making bilateral loans it hopes to impose its own conditions – like a sort of unilateral IMF – based on its own misconceived idea of what is required for successful "adjustment" by the cad countries – in the way it imposed conditions (admittedly less misconceived) on French domestic economic policy (to the enormous and openly-expressed chagrin of Delors) when France devalued three times between 1981 and 1983.

As Hawtrey put it:

"To rely on increasing liquidity in a case of fundamental disequilibrium is like trusting to bailing rather than stopping a leak."

Such intentions are problematic, both politically and economically. Politically, the old dilemma (a false one, in my view) posed between a European Germany and a German Europe would come to the fore again. In economic terms, bail-out loans are useless: the comments of the distinguished economist, Hawtrey (in 1962, on proposals to beef up the liquidity-providing role of the IMF) are very apposite: he wrote, "a reserve should be relied on only to cover temporary deficits in the balance of payments, that is to say, those caused by excess spending that can be brought to an end by a suitable restriction of demand. Liquidity is no solution for the chronic weakness due to overvaluation of a money unit… To rely on increasing liquidity in a case of fundamental disequilibrium is like trusting to bailing rather than stopping a leak."[6] Indeed, bilateral lending with German conditions attached – fiscal contraction and wage compression – would make things much worse.

However, the markets share some of the misconceptions about monetary union propagated by the policy-makers. A bailout in the form of loans, whether bilateral or through and EU institution, might initially be greeted with enthusiasm by the markets. Spreads could initially be compressed. A narrowing of spreads could be accompanied, initially, by a strengthening of the euro. Of course, though, any such strengthening would make the underlying problems even worse. The only viable resolutions are withdrawals, massive euro depreciation or massive transfers

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Might not the cads be pushed over the brink? One is almost too afraid to contemplate such appalling questions.

from Germany. The political class in Europe will not accept withdrawals; the German public will, if ever given a say, quite understandably not accept euro depreciation or transfers to the cads. It thus, terrifyingly, looks likely that the cads will be pushed to the very brink of economic, financial, social and political collapse. Might they be pushed over the brink? If they were, would that lead to a total breakdown of the post-war (western) European order of NATO-bestowed peace, democratic legitimacy and social stability? One is almost too afraid even to contemplate these appalling questions. And one certainly does not know the answers to them. But with the world as a whole already in the direst of straits, one must have the grimmest of forebodings about how much worse the monetary union disaster may make things. The temptation to bury one's head in the sand is strong. But there has been too much ignorance about monetary union. And ignorance will not remain blissful for much longer.

Notes

1 See "Adjustment in Monetary Union and German inflation: A Disaster Story", by Melissa Jordan, Banque AIG Market Research note, 14 August, 2008.

2 A 70% rise in German prices might seem implausible. But it is a calculation of the impact in Germany of a euro depreciation sufficient to create a large-enough instantaneous improvement in cad competitiveness. Obviously, German inflation would additionally improve cad competitiveness: euro depreciation would instantaneously improve cad competitiveness *outside* the euro area; German inflation (and inflation in other non-cad euro-area countries) would subsequently produce a gradual improvement in cad competitiveness *within* the euro area. Cad competitiveness would thus overshoot, producing overheating and inflation in the cads as well as in Germany. The euro would have to retrace some of its initial depreciation in order to restrain inflation in the cads. Ignoring the possibility of irreversible structural or political change during this process, the system would eventually converge on a euro depreciation – and a German price-level effect – smaller than suggested by the calculations. But the path would not be monotonic: there would be considerable instability in output, prices and unemployment throughout the euro area.

3 All this was very predictable to anyone who understood monetary union and its antecedents. For instance, I wrote in September 1997 ("Eternal Parities", in AIG Trading Group's World Market Advisory), that the only point in calculating Taylor Rules for the euro area, an enterprise in which hosts of economists were then busily engaged, would be to have an idea of how far below an appropriate area-wide rate the ECB would actually set its refi rate (which would undoubtedly be the very low German rate) and thus how weak the euro would be.

4 And it is also no coincidence that that the countries with the longest tradition of successful democracy – Britain, Sweden, Denmark and, outside the EU, Norway and Switzerland – are not members of the euro area, however much their political elites are keen to join.

5 There is a wrinkle in that standard CDS contracts allow re-denomination into a "permitted currency" – the currency of a G7 member or a Triple-A-rated country – without triggering a default. Ireland has just lost its Triple-A rating with one agency and looks fairly likely to lose it in the in the foreseeable future with the others; the same may be true of Spain; one should expect there to a kink in the relationship between CDS spreads (which would not currently pay out on re-denomination and devaluation) and bond spreads (which implicitly incorporate currency risk as well as default risk) as this eventuality looms.

6 Sir Ralph Hawtrey, "Too Little Liquidity – Or Too Much?", The Banker, Vol. CXII, November 1962, pp. 711, 712.

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