



# Future Social Market Economy

Policy Brief # 2013/01

## How Germany Benefits from the Euro in Economic Terms

There can be no doubt about the fact that Germany benefits from the euro in a significant number of ways. For example, monetary union membership helps to reduce the cost of international trade, and provides protection against excessive exchange rate volatility. This means that even if Germany had to write off a large percentage of the loans that it has made available to the heavily indebted states of southern Europe as part of the various euro rescue measures, the economic advantages of its membership of the monetary union would continue to predominate. Reverting to the deutschmark would thus be disadvantageous even in purely economic terms.

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### Focus

#### How real GDP will develop if Germany remains in the eurozone or if it has a separate currency



Source: Prognos AG.

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Without the euro, that is, if Germany had a separate currency, the annual increase in real gross domestic product (GDP) would be about 0.5 percentage points lower. If one adds up the advantages of eurozone membership between 2013 and 2025 in terms of greater growth, the benefits as far as Germany is concerned amount to almost € 1.2 trillion.

Since the advent of the European sovereign debt crisis German citizens have voiced mounting criticism of the European Monetary Union and of the euro. In a representative opinion poll on the “Value of Europe” conducted in the summer of 2012 by the Bertelsmann Stiftung, 65 percent of German respondents said that they thought they would now be better off if the deutschmark were still in existence (see Bertelsmann Stiftung 2012a, p. 3). A number of politicians and academics have also joined in the chorus of criticism. Hans-Olaf Henkel, who used to be in favour of the euro, has now become a bitter opponent, and in a book published in 2012 he included a telling subtitle, “How the Euro fraud threatens our prosperity” (Henkel 2010). In the “Bogenberg Declaration,” which was released at the end of 2011, the signatories, who included Roland Berger, Georg Milbradt and Hans-Werner Sinn, subscribe to the idea that “Germany does not benefit from the euro” (Bogenberger Erklärung 2011, p. 3). However, the following model projections demonstrate that German economic growth and indeed the German labour market both benefit to a considerable extent from the euro.

## 1. What the Projections Can Do

The goal of the model projections presented below is to assess the impact of Germany’s membership of the eurozone on growth, income and the labour market. For this purpose there will be a scenario in which Germany has a separate currency: the “deutschmark scenario.” The real economic consequences associated with this scenario are assessed with the help of the VIEW global macroeconomic projection

model provided by Prognos AG (see Bertelsmann Stiftung 2012a, p. 8). In order to calculate what the real economic consequences are likely to be, the model simulates the economic performance – i.e. the real gross domestic product (GDP) – in the 42 countries covered by the VIEW model up to the year 2025 if Germany decides to introduce a separate currency in 2013. Only the results which show the real economic consequences on Germany are taken into consideration. The projections relating to the size of real GDP in Germany (and the associated development of the labour market) that emanate from this scenario are compared with the economic developments described in “World Report 2012,” which assumes the survival of the eurozone (“basic forecast”). Its predictions relating to global economic development were also made with the help of the VIEW projection model. The “World Report 2012,” which was compiled in the summer of 2012, predicts a noticeable decline in global economic growth as a result of the much-needed consolidation of public budgets throughout the world until 2016/2017. The difference between the real economic development depicted in the two scenarios describes the advantages that Germany derives from its membership of the eurozone.

Subsequently we look at a number of other scenarios in which we assume that the states which have assisted the European countries hit by the crisis by providing loans and guarantees will have to renounce some of their claims. These scenarios – the “euro survival plus debt written off scenarios” or, to put it even more succinctly, the “write-off scenarios” – take into account the fact that in order to stabilize the common currency the countries which are trying to rescue the euro will have to provide the appropriate financial resources.

In this context it is important to remember that the following model projections are not designed to tell us what the consequences would be if Germany decided to leave the eurozone. If Germany left the European Monetary Union, the net result would almost certainly be the sudden demise of the entire system. And this would go hand in hand with a major global economic crisis, the consequences of which would be completely unpredictable.

## 2. Projections Based on Certain Assumptions

The “deutschmark scenario” starts out from the assumption that from 2013 onwards Germany will go back to having a separate currency. This has four major effects. First, having a separate currency will lead to higher transaction costs. Thus German companies will have to protect themselves against deutschmark exchange rate fluctuations. Furthermore, people will have to pay for currency conversion, for bank transfers between different currency areas, and for currency management in banks and companies. Secondly, after the reintroduction of the deutschmark price transparency will be lower than would have been the case if Germany had remained in the eurozone. The higher price transparency of the euro is advantageous in that it stimulates cross-border trade and enhances price competition. The latter leads to significant price-cutting and thus to an increase in international competitiveness. Third, it should be taken for granted that a separate currency will lead to a great deal of pressure to revalue the deutschmark. Since this will make German goods and services more expensive in other countries, it will have a negative impact on German exports. Fourth, if Germany had a separate cur-

rency, interest rates would be lower than those in the eurozone. Falling interest rates reduce manufacturing costs, and act as an incentive when it comes to making investments. Thus a separate currency can have an impact in a number of different ways. Of the four listed above, the first three can have a negative effect on economic growth and the labour market, whereas lower interest rates can stimulate growth. These effects are incorporated into the model projections as follows:

- With regard to the increase in transaction costs, it is assumed that the euro saves annual transaction costs amounting to 0.5 percent of GDP. In 2013 these savings will come to about €12 billion. This means that in the model projections import prices for goods and services, when compared with the basic forecast, will increase by 1.1 percent from 2013 onwards.
- The lower level of price transparency forms part of the “deutschmark scenario” because companies have more pricing flexibility. This leads to greater price increases, which augment the rate of inflation during the projection period by an average of 0.13 percentage points, and reduces the real income of private households.
- The assumed deutschmark exchange rate is based on the development of real exchange rates after 1999. After the advent of the euro the real exchange rate fell by 23 percent in Germany, whereas the real exchange rate in the rest of the eurozone rose by 7 percent. That is why, in the simulated projections, the introduction of a separate currency leads to a revaluation of the deutschmark by 23 percent and to a 7 percent devaluation of the euro.
- Finally, the lower interest rates are determined with the help of what is known as the “Taylor interest rate” (for more information on this point see Deutsche Bundesbank 1999). The ap-

plication of the Taylor rule means that between 2013 and 2025 German interest rates will on average be about 0.5 percentage points lower than in what remains of the eurozone.

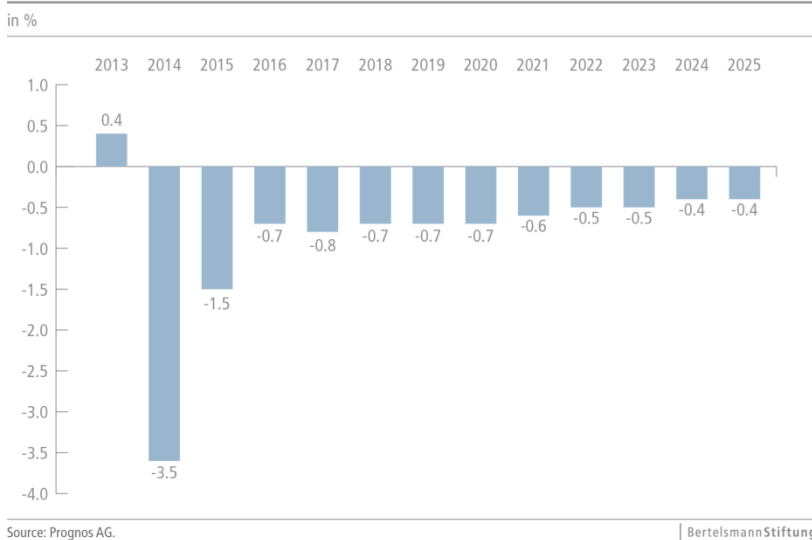
The “write-off scenarios” are based on the assumption that the eurozone will continue to exist unchanged. However, they also assume that the four European states hit by the crisis cannot repay in full the financial assistance that they have received. As in the preceding study (see Bertelsmann Stiftung 2012b, and in particular pp. 21-23) the assumption is that there is going to be a debt haircut amounting to 60 percent of the claims on (up to) four south European states. A debt haircut of this kind will be applied to both public budgets and the private sector. As far as public budgets are concerned, these losses will have to be written off in full. Such costs are clearly definable in auditing terms, so that the budget deficits in the states which have provided direct or indirect guarantees for the countries hit by the crisis will increase in size. This means that in the states concerned government debt will increase, and so will the debt servicing requirements. For this reason governments will be compelled to introduce consolidation measures elsewhere. In other words, they will either have to reduce the level of expenditure, or they will have to raise taxes and contributions. Both of these things will lead to a decline in the demand for goods and services, and this in turn will lead to a decline in manufacturing and employment. The private write-offs lead to a reduction in net wealth, and in the final analysis this has an impact on private households. These losses mean that there is a decline in private consumer expenditure and in investment in new housing construction.

### 3. Principal Results

A VIEW model projection based on the assumption that from 2013 onwards Germany once again has a separate currency, that is, that it has left the eurozone, will be compiled in order to assess the economic development of Germany in the “deutschmark scenario.” In this model projection Germany’s separate currency initially has the effect of promoting growth. Thus in 2013 the positive aspects of a strong deutschmark still outweigh the negative ones. For example, they include lower import prices, which have the effect of reducing inflation, or lower interest rates, which act as an investment incentive. The revaluation of the deutschmark, which has an adverse effect on exports, sets in at a later stage. In other words, the level of exports and the level of imports both react with some delay. However, from 2014 onwards the changes in the basic framework start to have a dramatic impact on the pace of German growth. The shock waves which are part and parcel of the introduction of a separate currency continue to reverberate rather noticeably until about 2020. After this the annual differences in growth between the basic forecast and the exit model prediction begin to stabilize (see Fig. 1).

When one attempts to interpret these results it is important to bear in mind the purpose of the model predictions described at the beginning of this study. The goal is not to assess the economic consequences and what will happen if and when Germany leaves the European Monetary Union. The question is in fact about the advantages that Germany derives from its membership of the eurozone. In this context the long-term consequences of the abrupt introduction of a new currency are of crucial significance,

**Fig. 1: Annual Differences in Real GDP Growth in Germany between the Basic Forecast and the Exit Model Prediction**



Source: Prognos AG.

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and not the direct impact or the short-term fluctuations. Thus the long-term and relatively constant differences in growth, which become apparent from 2021 onwards, are of decisive importance.

The long-term growth which derives from Germany’s membership of the eurozone becomes apparent at the end of the projection period. It oscillates between 0.4 and 0.6 percent. Thus in order to calculate how German economic performance might develop in an imaginary scenario in which Germany has a separate currency, the long-term difference in growth of about 0.5 percent is used as a yardstick. The economic consequences may be summarized as follows:

- In 2025 German GDP in the “deutschmark scenario” will amount to about €2,630 billion, whereas if Germany continued to be a member of the Monetary Union it would amount to about €2,800 billion (see Focus diagram on p. 1). For every German citizen in 2025 this signifies an average loss in real income of about €2,200.
- If one compares the data with the basic forecast and adds up the lost growth

between 2013 and 2025 in the “deutschmark scenario,” the total comes to almost €1.2 trillion. If this sum is divided by the total number of German citizens, it signifies an accumulated loss in income amounting to more than €14,000 per inhabitant.

- Slower economic growth also means that fewer people are gainfully employed. The number

of people out of work increases by about 200,000, and as a result the unemployment rate rises. For example, in 2013 the unemployment rate in the “deutschmark scenario” is 7.4 percent, whereas in the basic forecast it is merely 6.9 percent.

All in all this means that Germany’s membership of the eurozone has a positive effect on real GDP, income, and the labour market. Membership of the eurozone would also make sense for Germany even if it had to write off many of its loans to the four countries hit most by the crisis. A series of four additional scenarios elucidate what the real economic consequences for Germany will be if it waives 60 percent of its claims in Greece (“G write-off” scenario), or 60 percent of its claims in Greece and Portugal (“GP write-off” scenario), or indeed is confronted with a situation in which it has to waive 60 percent of what it is owed by all the four countries hit by the crisis (“GPSI write-off” scenario).

As fig. 2 demonstrates, as far as Germany is concerned these bad debts lead to a de-

cline in growth that is hardly perceptible. Even if there were a 60 percent debt haircut in all of the four countries hit by the crisis, this would merely lead to a short-term and in fact minimal decline in the real GDP growth rate of 0.05 percentage points. There are two significant reasons why a debt haircut has such a relatively small impact. On the one hand, a haircut merely increases the indebtedness of the euro rescuers, though without – as in the preceding study – provoking major economic upheavals in the debtor country, e.g. state insolvency, a different currency, etc. (See Bertelsmann Stiftung 2012b, p. 20). On the other hand, as far as a debtor country is concerned, a haircut leads to a lower level of indebtedness. This increases the government’s room for manoeuvre in the area of fiscal policy, and has a positive impact on the economy. An exporting nation such as Germany benefits from this more favourable economic state of affairs because it can boost its level of exports.

The net result of all this is that, even if it has to write off sizeable losses, Germany continues to benefit from its membership of the eurozone. As a result of the frame-

work provided by the common European currency, the German economy grows more robustly than it would do in an imaginary environment and with a separate currency. It is true, of course, that a comprehensive debt haircut for Greece or perhaps other members of the eurozone would increase the level of sovereign debt in Germany. However, such an event would do very little to inhibit growth.

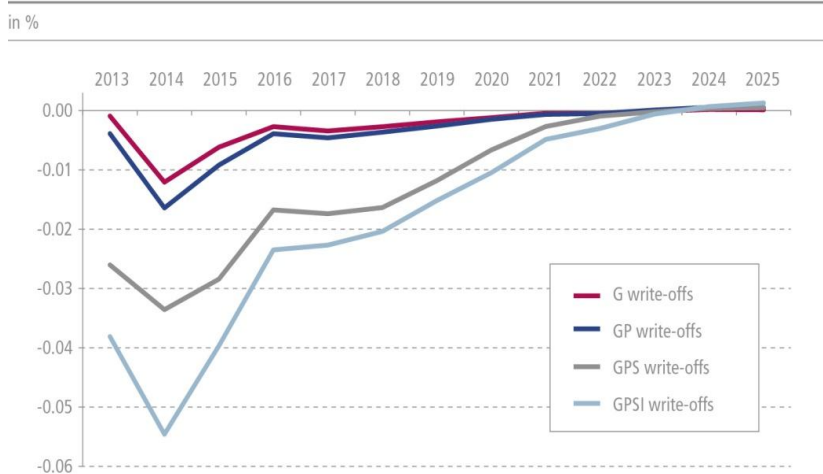
#### 4. Political Consequences

The projections on which this policy brief is based show that Germany derives important benefits from the euro. Membership of the common European currency leads to a growth trajectory that is always higher than what is achieved in the case of a separate currency. Without the euro the annual German GDP growth rate would be about 0.5 percent lower. Even if Germany and the other creditor countries have to write off a significant part of the loans which they have given to the highly indebted countries in southern Europe in the context of the various euro rescue

measures, the advantages of the Monetary Union, at least as far as Germany is concerned, outweigh the disadvantages.

But over and above the economic advantages one is also prompted to ask a rather basic question, especially in view of the revived debate

**Fig. 2: Annual Differences in Real GDP Growth in Germany between the Basic Forecast and the Four Debt Write-off Scenarios**



Source: Prognos AG.

about whether we need more or less integration in the European Union. “What would have happened if the euro had never materialized?” That also happens to be a scenario that cannot simply be dismissed as if it were of no importance. Plans for a European monetary union were mooted in the 1970s, but there were a number of delays, most of which were caused by external shocks (e.g. the oil crises). Right at the start the European Monetary Union had to weather the storm when the dot.com bubble burst in 2000. Will the euro once be seen as a golden opportunity that was seized just in time?

It is becoming apparent that the European integration process has given our policymakers more room for manoeuvre in the global context. It has never been possible to confine upheavals in the European monetary system and the various ways in which they impinge on the national economies to the sphere of monetary policy. They have always led to a more or less major political crisis in the EU. Without the impending threat of the wholly unpredictable collapse of their common currency the countries of the European Union would not have been able to agree on the measures that were needed in order to rescue their banking system. However, the fact that an independent European Central Bank was a viable institution that operated in a global context significantly changed the policymaking framework. After a severe financial crisis the euro is still in use in all of the original 17 countries. This, if nothing else, demonstrates the learning ability of policymakers in an integrated Europe.

## 5. References

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### Policy Brief 2012/06: Euro-exit in Southern Europe

While Greece defaulting on its sovereign debt and leaving the European Monetary Union would have relatively little effect on the world economy, such a move could lead to contagion in Portugal, Spain and Italy, thus evoking not only a sovereign default in those states as well, but also a severe worldwide recession. Economic growth would be reduced by a total of 17.2 trillion Euros in the world's 42 largest economies in the lead-up to 2020. Hence, political actors are well advised to prevent Greece from leaving the euro, and the domino effect that this event could induce.

### Policy Brief 2012/07: Sustainability and solidarity – basic ideas of new financial structures

Federal financial structures which include fiscal equalization between the German states remain indispensable for leveling out significant regional economic differences and for ensuring sufficient funding for the responsibilities of the public sector across the nation. The necessary revisions of financial structures beginning in 2020 provide an opportunity for a substantial overhaul. The objective is to consolidate in the long term the budgets of federal, state and municipal governments and to safeguard a modern welfare state.

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