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(18. 30 juin)

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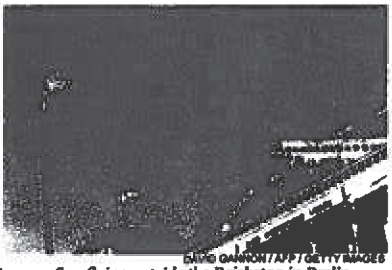
EUROPE

Why Germany Should Leave the Euro Zone

The departure of Germany would take pressure off the weaker countries, and the costs of breaking up the euro zone will have to be paid no matter who leaves

By Michael Sivy | @MFSivy | April 12, 2012 |



DAVID GANNON / AFP / GETTY IMAGES
German flag flying outside the Reichstag in Berlin.

Most discussion about a potential breakup of the euro zone assumes that Greece and other financially troubled countries would be the ones who ended up abandoning the common euro currency. But there's a compelling alternative to that conventional wisdom — that the true problems of the euro zone could be best addressed if Germany were the one to leave, accompanied, perhaps, by a few other rich countries.

The argument for the weak countries leaving is that they would be able to escape the austerity policies imposed by Germany. Once they abandon the euro, their new national currencies would quickly depreciate, making their economies more competitive internationally because their exports would be cheaper for foreigners to buy. In the process, of course, the weak countries might have to default on their euro-denominated debt, but that would be the inescapable price of freedom. Presumably, the richer European countries would then try to establish a smaller, more viable common-currency zone.

The trouble with this conventional scenario is that it rests on a couple of big misconceptions — namely that the chief problems of the weak countries are budget deficits and debt, and that if budgets are balanced and debt is managed down, those countries would be able to make interest payments on their bonds and the banks that own those bonds wouldn't have to suffer big losses.

In reality, though, the biggest problem of financially troubled European countries is not debt but high labor costs. Easy credit over the past decade allowed those costs to rise rapidly in some countries, which were then less able to export their goods or compete with cheap imports. From 2000 to '07, higher labor costs reduced competitiveness by 10% to 20% in Italy and Spain. And even with all the austerity policies since 2008, Spain and Italy have been able to improve their competitiveness only by a few percentage points, if at all. Those countries will never be able to compete economically until they get their labor costs down significantly. And it's very difficult politically to get workers to accept 10%-to-20% wage cuts.

Well, there is one way: financially weak European countries could devalue their currencies, which would bring down labor costs across the board almost invisibly. That's a lot easier for a population to accept than overt wage cuts industry by industry. Moreover, in the absence of devaluation, countries would spend the next decade chipping away at labor costs in an atmosphere reminiscent of the Great Depression. The only catch is that devaluation is precisely what the euro was designed to prevent.

So why shouldn't the weaker countries just pack up and leave? Trouble is, although their new currencies would immediately fall in value, the euro would remain strong. And as soon as people anticipated a devaluation, they would withdraw money from local banks and instead deposit it in the banks of countries that were going to keep the euro. Moreover, countries that left the euro zone would still be stuck with debts to foreigners that would be denominated in euros – but they would have to pay back those loans with their own devalued national currencies, which would make the debt burden seem even heavier.

At the very least, the result would be capital flight and higher interest costs. And more likely, countries that leave the euro zone would be unable to make all the payments on their debt and would end up defaulting anyway. That would be incredibly disruptive to the global banking system, and the countries that defaulted would probably be locked out of the credit markets for several years.

By contrast, if Germany were the one to leave, the euro would be the currency that falls in value, relative to Germany's new national currency and also to the dollar. The weaker European countries would get to keep the euro but still get the devaluation they need, which would reduce their labor costs far less painfully than through wage cuts. In addition, the value of their outstanding debt would decline along with the value of the euro, and they would be more likely to be able to make payments on that debt and avoid defaulting.

The standard argument against this solution is that as the value of euro-denominated debt falls along with the euro, banks in many countries would have big losses on bonds they own. But losses from falling bond prices are less disruptive than sudden defaults. And the fact is that those losses have really already occurred, they just haven't been acknowledged. The goal at this point is not so much to prevent losses, but to find a way for banks and other international financial institutions to absorb their losses without triggering sudden bank failures or a global financial crisis. In short, it's not about the money, it's about stability. And for once, it may be easier to maintain order without the help of Germany.