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Should Germany Leave the Euro?

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The weekend victory for the center-right keeps the Greek "austerity" plan alive and makes it less likely Greece will try to leave the Euro. It may be difficult to form a broad coalition government, but for the time being, the Greek election raises hope for market friendly reforms.

Initially, stock prices rose sharply as election results arrived. Then, as the different factions began to posture, threaten and negotiate, stocks pulled back. If Greece does not move forward with austerity, talk of it leaving the Euro may increase again. Leaving the Euro would be an unmitigated disaster for Greece and a problem for the Eurozone, but the odds of this happening are priced into the Euro already.

What isn't priced into the Euro is the exit of another country. No, not Spain, Portugal, or Italy. We're talking about the inner-most core of the Euro-zone: Germany.

Back in the 1990s, when the final details of the Euro were worked out, every country had a good reason to join, over and above the obvious one that it made it easier to do business across borders. France had always been jealous of "reserve-currency countries" – one used by other countries as a reserve. The UK, the US, and Germany all had that privilege and it galled the Gauls that France did not. The Euro changed this.

Many of the other countries that joined the Euro, like Italy, Greece, and Spain, got something even more important: good monetary policy. They had proven time and again that their central banks could not maintain low inflation. So why not, in effect, import tough German central bankers to run monetary policy. Germans, after all, often blamed the hyperinflation after World War I as laying the groundwork for the Nazi takeover in the early 1930s. As a result, since World War II, they had kept inflation relatively low.

Germany got something even more important when it joined the Euro: it got the other countries to treat it as a normal country again. No more guilt over WWI or II. Bygones were finally bygones, once and for all.

But now, given the trouble some other Euro-zone countries have gotten themselves into, it looks like the bargain is changing. Germany could find itself on the hook for other countries' debts – on a persistent basis. And, if other countries have their way, the European Central Bank could be used to run an inflationary monetary policy.

In other words, the Germans may be forced to pay higher taxes *and* accept a debased currency in order to fund profligate social welfare spending schemes in other countries.

So why not just leave the Euro behind and go back to the Deutschemark (DM)? In the end, only a strong currency can replace a weak one. This is why the Drachma is not going to make a comeback…it would fail miserably and do nothing positive. But, for Germany, it is a different story.

If Germany left the Euro and brought back the DM, it would likely soar versus the euro. Without Germany, the Euro would be dominated by countries with a track record of loose money. While a strong DM might hurt some German exporters, the Euro is already strong relative to the dollar and the unemployment rate is only 6.7%. In other words, this is a favorable time to make the move. Meanwhile, imports would cost less and Germany would have less inflation.

German debtors (including the government) who have debt denominated in Euro's would get a windfall gain; they would pay back debt denominated in a weak Euro with a strong DM. At the same time they wouldn't feel as responsible for bailing out profligacy. Life would be good.

France, Italy, Spain, Portugal, and Greece would finally get to run the loose money they all want the ECB to implement anyhow, so they couldn't complain about that. Their real problem is that Germany would no longer subsidize their spendthrift ways.

Most humiliating for the rest of Europe is that the ECB would probably want to buy German debt, denominated in DM as a reserve, while the Germans would have no need to buy the Euro-debt of the other countries to back up the new DM. So while short-sellers and pessimists try to ramp up fear of a "Grexit"…it's a more rational German exit from the Euro that would expose the flaws and irrational behavior of tax and spend government policy. It's way better to deal from a position of strength than from one of weakness.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-19 / 7:30 am	Housing Starts – May	0.721 Mil	**0.732 Mil**		0.717 Mil
6-21 / 7:30 am	Initial Claims - Jun 16	382K	**383K**		386K
9:00 am	Philly Fed Survey – Jun	0.0	**2.2**		-5.8
9:00 am	Leading Indicators - May	+0.1%	**+0.1%**		-0.1%
9:00 am	Existing Home Sales - May	4.560 Mil	**4.520 Mil**		4.620 Mil