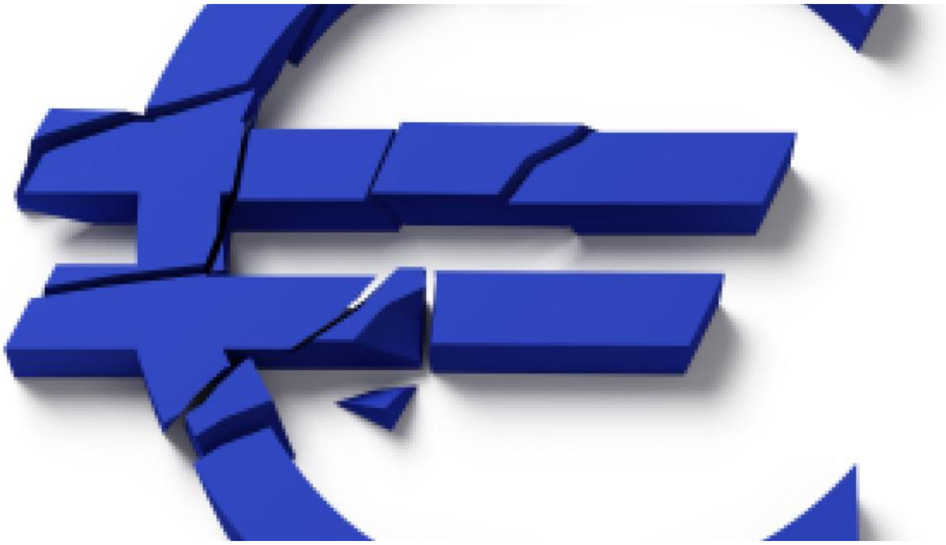
The Wisdom of Default



By Peter Dollé, Germany Correspondent

Germany's support for the euro has thus far been consistent but behind the united façade, there are signs of cracks in Chancellor Angela Merkel's united CDU party. Some members are even mentioning the "D" word when it comes to countries such as Greece.

Picture yourself on a sunbaked terrace overlooking the Mediterranean, savouring a cappuccino, a morning bread roll and the daily newspaper. Things couldn't get better on this Greek isle where the luxury suite – complete with private pool - now runs for just US$30 a day.

Sound like a dream? This could be the outcome of a Greek exit from the eurozone.

That's the unannounced notion of free-market Europeans who insist a national insolvency and even an exit from the Eurozone would be the best medicine for Greece and other embattled countries – most of them now in the Mediterranean area. They argue that heavily-indebted countries would benefit more over the long term by leaving the Eurozone, adopting new currencies, and riding out the turbulence of a rapid devaluation. They're convinced the downward spiral of the new (or old) currency would attract outside investment and boost exports, thereby fanning economic activity and competitiveness over time.

“We would be quite a bit further along in resolving the problem if we would have allowed Greece to default in 2010,” German parliamentarian **Klaus-Peter Willsch** told INSEAD Knowledge during an interview in Berlin. “What happens then? It has happened all over the world several times. All those who have money invested would come together at a table. They will bargain shares – how much do I get back – how much do you get back? So this is the way it works with companies, this is the way it has worked very often in the IMF history with countries.”

Merkel strongly disagrees and is keen on keeping Greece, Cyprus, Spain, Portugal and Ireland in the Eurozone and she enjoys the full support of the IMF and Group of Eight leading economic nations. They fear the exit of one of the members would shock the global financial system, cripple European banks and lead to the collapse of the entire Eurozone. Not to mention wreaking havoc in the defaulting country itself.

What’s at Stake for Germany?

Germany has more at stake in saving the euro than any other European country. German exports to Eurozone members are now worth €412 billion a year, or roughly 38 percent of the country’s global export total (Federal Statistical Office, Destatis).

The overriding question now is how much it will cost to keep financially-weakened countries in the Eurozone and who will pay for it. Willsch points out that Germany, as the Eurozone’s largest economy, will foot roughly 27 percent of the bill, or €190 billion in capital and guarantees, and the final sum is still largely unknown, he insists. “Bailing them out is the wrong approach... The reason for their problems is that they spend more money than they have. So I’m not a follower of the theory that debt is most appropriately fought by more debt. So, when you’re sitting in a hole, stop digging."

Willsch is viewed as a rebel in the eyes of many German Conservatives. He is a member of Chancellor Angela Merkel's own Conservative CDU party (Christian Democratic Union), but draws the line on many of her policies – especially those associated with the euro crisis. Willsch fears the centre-right coalition government is giving away too much and exposing German taxpayers to potentially higher rescue costs. As a member of the German Parliamentary Budget Committee, he has the "power of the purse" and is threatening to block the government's installment in the joint-Eurozone bailout facility, the European Stability Mechanism (ESM), if he's not satisfied with economic reforms in the heavily-indebted countries.

Willsch says the German Parliament, the Deutsche Bundestag, can stop the ESM "at any stage of the game." And he adds: "There has to be a parliamentary debate in Germany – we forced this into the legal framework - so at any case we can stop it."

The ESM was setup in September 2012 with "an authorised capital of €700 billion, of which €80 billion is paid-in capital." It is the permanent replacement to the temporary European Financial Stability Facility (EFSF), which was established to "safeguard financial stability in Europe by providing financial assistance"to Eurozone states. The EFSF will be phased out once Ireland and Portugal repay their credit obligations.

Merkel's balancing act

This is an election year in Germany and Chancellor Angela Merkel has been balancing mounting criticism at home with the need to assist troubled Eurozone states. Aside from Willsch, there are other CDU party members who oppose her rescue plans. And they are joined by parliamentarians from her junior coalition partners, the business-friendly Free Democratic Party (FDP), and the opposition liberal Social Democratic Party (SPD). Ironically, the SPD has approved all major bailout packages, albeit with conditions attached.

Douglas Webber

INSEAD Professor of Political Science, **Douglas Webber**, points out in a recent study that domestic politics play an ever-increasing role in EU decision making, as the number of "Eurosceptics" grows (European Journal of International Relations, Sage Publications. How likely is it that the European

Union will disintegrate? A critical analysis of competing theoretical perspectives). Eurobarometer surveys also show the percentage of Europeans with a positive image of the EU falling to 31 percent in 2012 from 52 percent in 2007. Much of that decline in sentiment toward the EU is in the embattled countries of Southern Europe, where leaders had imposed unpopular austerity measures to reign in public spending.

Willsch and his supporters have published a list of ten demands they insist Eurozone leaders should meet. Among them are calls for the European Central Bank (ECB) to stop purchasing sovereign bonds of heavily-indebted countries and demands for phasing out the ESM. "Bailing out another EU country is against the Maastricht Treaty," he says. "It also restricts the sovereignty of the receiving country."

Asked whether his demands would make it difficult for Chancellor Merkel and the CDU to pass legislation that would help troubled countries, Willsch said: "I don't think so. I think the opposite. When she can act on the European level, and say my parliament won't pass this, this might enhance her position and not weaken it." Willsch won a commanding 46 percent of the vote in a parliamentary race against 12 candidates in Limburg in 2009, so the CDU will have to live with him.

To be fair to the efforts of Greece, Spain and Ireland, as well as Chancellor Merkel and the Troika, there has been improvement in bringing down deficits, although at a high social and political cost. Financial markets are also calmer in response to the rescue packages. But the crisis is not over yet as indicated by the bank turmoil in Cyprus.

Germany is compelled to act. Whatever it decides, it will ultimately have to pay for it, or go out on a limb to guarantee it.

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