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Mid- and long-term risks of German Bonds

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1 Introduction

In the final reckoning, when it all comes down to a full-fledged balance-of-payment crisis within the Eurozone (EZ), it will turn out that a deficiency in any one a number of key factors doomed the entire endeavor to failure. This brief analysis sets forth the dynamics of the EZ crisis and particularly offers a comprehensive explanation of mid- and long-term risks of German bonds. In doing so, the analysis provides guidance for related investment options.

The dynamics of the EZ disintegration can be illustrated by means of a distinction between core and periphery members. In this respect, the EZ core – think of Germany, Finland, Netherlands and, Austria – is characterized by current account surpluses (net capital exporters or net creditors), while the EZ periphery is generally characterized by current account deficits (net capital importers or net debtors). It is shown that there is rational but costly delay of necessary policies re-balancing macro-economic misalignments between core and periphery EZ economies. In this regard, one of the reasons for being pessimistic about the prospects for the German bond market as a 'safe haven' is the fact that Germany, one way or another, will make further concessions on some iteration of burden-sharing within the current crisis. It already shares the costs of the incipient balance-of-payment crisis within the EZ. The financial assistance, particularly that provided to the EZ periphery, has fiscal and monetary dimensions. Related activities have led to a direct increase in financial exposure for the German government and the entire economy. Effected and guaranteed payments by Germany for other EZ-members mount up to about 1450 billion EUR (1780 billion USD up to July 2012). This financial burden will further increase in the course of pending decisions on future European bail-out schemes. Although there is a rationale for taking such short-term provisions, the dynamics of the EZ crisis hardly inspire confidence in a good ending.

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The remainder of the discussion has the following structure: In section 2, we take stock of the current economic situation with a focus on Germany. The anamnesis in section 3 sets forth the 'natural' inclination towards over-borrowing within the EZ. In section 4, we shed light on quasi-automatic fiscal and monetary mechanisms within the EZ that have undermined effective crisis management in the context of the European Union (EU). On the same token, we highlight the rational delay in enforcing an economic rebound. In this regard, section 5 sets forth why neither the EZ core nor the EZ periphery have any real incentive for keeping track of an eventually dysfunctional EU crisis management. The final section points to investment options in the German bond market contingent on most likely policy responses in the mid- and long-term.

2 Taking stock: the symptoms of the crisis

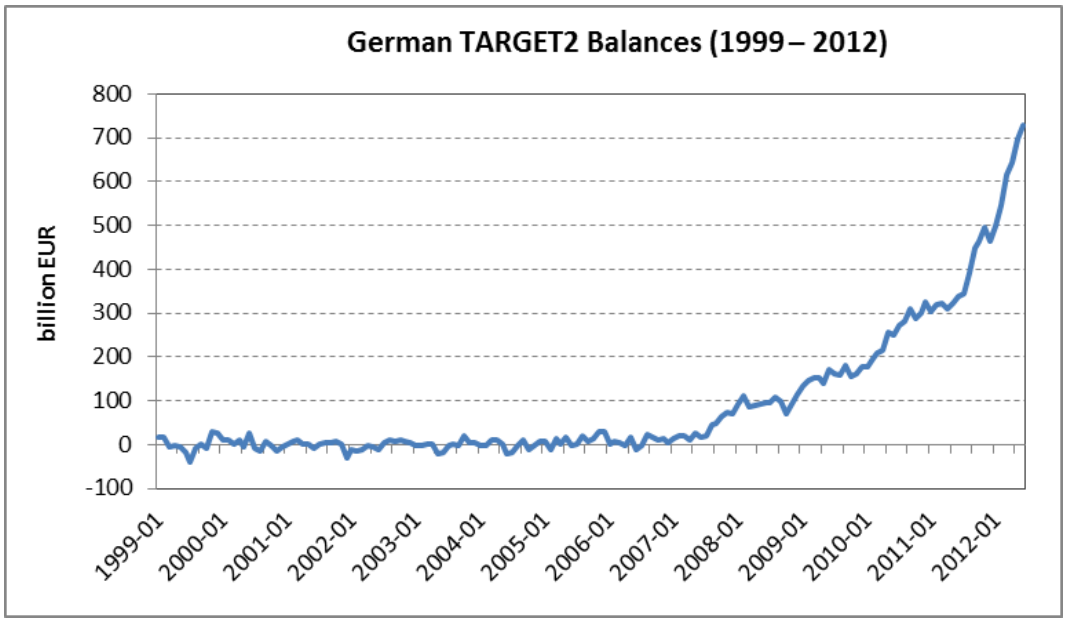
Continental Europe is stuck with the deepest political and economic crisis since WWII. The 'adolescent' Euro has reached its puberty and hits a balance-of-payment crisis within a common currency area. This may sound paradoxical but it is not: There still prevail country-specific default risks within the EZ, as it is a currency union still comprising sovereign members. Contrary to the federal organization of the US, the EU is a confederation currently gathering 17 members under the umbrella of a common currency.

A struggling economy facing a balance-of-payment crisis bears much resemblance with an over-indebted household. Similar to a representative household subject to a budget constraint, a sovereign economy faces an external budget constraint, i.e., the balances-of-payment. In this context, 'sovereignty' boils down to the ability to raise funds (i.e., collecting taxes and revenues) and to enact economic policies that affect the future tax base, i.e., the level of aggregate output. In this regard, a sovereign EZ member renders scope and limit of all its economic agents' ability to produce and use real goods and services, either in the form of tradables or non-tradables. If the entire economy's usage of tradables exceeds the domestic production of tradables it has a current account deficit. Such an economy can usually finance this deficit by selling financial claims on its future production (i.e., a capital export surplus). As long as foreign lenders keep lending, this is not a problem at all and the economy's agents can – temporarily – enjoy the advantages of living beyond their means. A problem occurs as soon as the private (financial) sector, particularly foreign lenders, stops rolling-over the excessive usages of tradables. At this stage, the economy is facing the hardship of its inter-temporal balance-of-payments constraint as it cannot sell further financial claims sufficient to cover its shortfall in production of tradables, relative to the desired amount of tradables. The usual reaction is that agents will now lower their spending and possibly even default on existing obligations vis-à-vis foreign lenders. The concomitant activation of the current account will help reduce the trade deficit of the entire economy. This way the debtor economy compensates the creditors, particularly foreign lenders, in real terms. The usual macro-economic outcome is a contraction of economic activity in the short-term and an economic rebound following soon afterwards.

The case of the EZ balance-of-payment crisis is a little different. This applies, at least, in respect of the stipulated economic adjustments in the course of an incipient crisis. Apparently, the private financial sector has stopped lending for rolling over accumulated debt and for refinancing current account deficits of the EZ periphery. However, the financial assistance provided to the EZ periphery through the provisional European Financial Stability Facility (EFSF) in conjunction with the European Financial Stabilization Mechanism (EFSM), the permanent European Stability Mechanism (ESM) – supposed to come into operation later this year –, and other bilateral/multilateral arrangements involving, for instance, the European Central Bank (ECB) and the International Monetary Fund (IMF) have averted a full-fledged balance-of-payment crisis of the EZ periphery economies.

At the same time, these financial maneuvers have particularly increased the risk exposure of the German government debt. This is to say that Germany's pledged and paid-out fiscal assistance within the EZ currently sums up to about 720 billion EUR (880 billion USD up to July 2012). Most notably, however, the largest single direct German exposure traces in a monetary system. This pertains to the payment and clearing mechanism of the Eurosystem, i.e., the Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET2). Figure 1 shows that TARGET2 imbalances particularly evolved after summer 2007 (i.e., in the aftermath of the 'Lehman credit event').

Figure 1: German TARGET2 Balances, January 1999 – June 2012, bn. EUR



Source: Deutsche Bundesbank

For about five years now, the TARGET2-claims recorded at the Deutsche Bundesbank are sky-rocketing more or less every month (see Figure 1). Having gained considerable momentum during the EZ crisis, the TARGET2-claims of Germany vis-à-vis the Eurosystem currently increase by about 1-2 billion EUR per day. The present peak is at 730 billion EUR (900 billion USD up to July 2012).

The heterogeneous EZ has been and still is characterized by internal macro-economic imbalances, which have now become particularly visible in the form of TARGET2 imbalances. In this regard, the TARGET2 represents an adequate barometer of the EZ balance-of-payment crisis. The TARGET 2 principally allows the EZ periphery to do away with its rigid budget constraints, i.e., the external balance-of-payment constraint. This is to say that the EZ periphery uses the TARGET2 as an 'over-draft credit' for excessive usage of tradables. Macro-economic imbalances within the EZ are not only preserved but aggravated. Furthermore, the TARGET2 considerably alleviates the transfer of deposits and other assets from the periphery to the core, i.e., 'capital flight'. In crisis times, the TARGET2 lacks a pawl that helps to back-stop the bleeding of periphery assets. In doing so, the TARGET2 propagates macro-economic imbalances within the EZ.

The increasing level of TARGET2-claims and other fiscal claims due to various rescue packages reflect, in particular, claims of Germany on the EZ periphery's future real production. All these financial maneuvers impact the German net international investment position (NIIP), i.e., the 'wealth' of Germany (see Figure 2).

Figure 2: German Net International Investment Position, 2004 – 2012 (Quarterly), bn. EUR

Source: Deutsche Bundesbank

It may turn out that wealth in the form of claims on some future real production becomes irrecoverable. The 'improving' NIIP of Germany traces in a protracted balance-of-payment crisis. The question arises why such risk exposures have been rather disregarded or underestimated for such a long time in the run-up to the current crisis. The following section elaborates why according macro-economic imbalances within the EZ have emerged and why such real misalignments have only recently been revealed.

3 The run-up to the crisis: anamnesis

Reasons for mounting real misalignments between the core and periphery of the EZ primarily stem from a 'natural' inclination towards over-indebtedness in periphery economies. As the EZ membership is 'irrevocable' and as there is no debt restructuring regime, moral hazard behavior evolved and has led to excessive credit supply. At the same time, there has been a lack of political incentives for enacting effective countermeasures that help curtail excessive credit demand. As a result, the EZ is now heading towards the trough of a credit-boom-bust cycle.

Macro-economic imbalances can be an outcome of an unsustainable real convergence process. Such process in terms of narrowing income levels, interest and price level differentials between the periphery and the core has characterized the first decade of the Euro. The according real appreciation of the EZ periphery may matter or not depending on its causes. If it stems from improvements in economic fundamentals such as labor productivity, the real appreciation would have benign effects. If it only comes from higher production costs, i.e., particularly wage increases, the real appreciation would involve losses in competitiveness and contribute to the external deficits accumulated in these countries. Relatively higher productivity rates in the tradable sector of the EZ periphery have come along with increasing wages. The rising level of wages, however, could not be exclusively restricted to the tradable sector but has spilled over into the less productive sector of non-tradables, i.e., the Balassa-Samuelson effect. Ultimately, this phenomenon has triggered a real appreciation trend and the subsequent occurrence of real economic imbalances within the EZ.

The natural inclination towards real appreciation and excessive indebtedness within peripheral economies has been topped by a private sector convergence play. This is to say that the private sector has believed in a successful economic convergence process at the commencement of the Euro. With the introduction of the Euro as the legal tender of EZ-members there has been a fall in risk premia from the perspective of the private financial sector. In this regard, the financing costs of the periphery have fallen disproportionately in relation to the EZ core. The convergence play has further contributed to an excess provision of private sector credit supply. Due to previously existing financial constraints in periphery economies, credit demand was substantially constrained. Admittance to the EZ has largely alleviated these constraints. This has built the grounds for enhanced risk taking and indebtedness (both in the private and in the public sectors) in these economies. Equipped with these new credit funds, enhanced demand side pressures led to increased domestic supply of non-tradables in combination with a rapid increase in imports of tradables. Although this situation of excess demand would imply an upward trend in the price level, in the case of small open economies in a common currency area, the leeway for diverging price levels has been low but translated into mounting macro-economic imbalances in the form of unsustainable current account deficits in the periphery and current account surpluses of the EZ core.

For all these genuine economic reasons, real misalignments have emerged between both the core and the periphery of EZ. At the same time, it has turned out that there are hardly any incentives for cushioning against potential adversities of non-sustainable real appreciation trends within the EZ periphery. From the perspective of political economics, the reason is that indebtedness usually gives front-loaded benefits in terms of stimulating production and employment in the short run and only delayed costs in terms of endangering the financial stability of the entire EZ in the long run. This moral-hazard behavior has been severely exacerbated by the 'irrevocability' of EZ membership. The 'irrevocability' represents an implicit guarantee that EZ economies will eventually support each other. It goes without saying that such an unsustainable process does not run infinitely. One way or another, the EZ will be subject to considerable revisions of its institutional underpinnings – a revision that may even comprise a break-up.

We have highlighted that there exist tendencies towards immoderate real appreciation, over-borrowing, and mal-investments. This has triggered economic and political turmoil within the EZ. At this stage, fiscal rescue packages and the monetary 'bypass' TARGET2 have replaced dried-up private financial sector activities in the course of the EZ balance-of-payment crisis. At both dimensions, however, macro-economic imbalances have been rendered to even more unsustainable positions in the long run. The following section sheds more light on the role of these quasi-automatic fiscal and monetary mechanisms within the EZ. We provide a positive explanation for fiscal austerity and monetary accommodation within the EZ periphery. At the same time, we highlight to what extent this stance of EU crisis management does also give front-loaded benefits to the EZ core. As a result, the dynamics of the EZ crisis can be captured as a two-fold tragedy of the commons, which will eventually leave its mark on all parties upon collapsing.

4 Quasi-automatic mechanisms propagating the crisis: diagnosis

A two-fold tragedy of the commons with both a fiscal and a monetary dimension is at the heart of a dysfunctional institutional set-up of the EZ. These institutional backlashes prepare the ground for a self-enforcing EZ disintegration. The trigger has been an exogenous shock, at which financial investors realized that an EZ member's level of indebtedness might be unsustainable, i.e., the case of Greece in autumn 2009. To understand the self-enforcing dynamics of the EZ crisis this section investigates the institutional problems. First, we touch upon the fiscal arena before we, second, inquire into monetary deficiencies.

At the eve of the Euro commencement, the founding fathers already recognized that the institutional set-up of the EZ supports fiscal free-riding behavior. Every single sovereign member has an incentive for fiscal profligacy. The reason is that there is only a relatively marginal effect of excessive national fiscal policy on the future inflation rate of the common currency. As all individual members face the same incentive, however, the overall result might indeed put considerable pressure on the price stability of the Euro.

For that reason the founding fathers introduced the Stability and Growth Pact (SGP) and the no-bail-out-clause. The goal has been to deter sovereign members from fiscal profligacy and to manage fiscal slack with the help of official European deficit procedures. However, the irrevocability of EZ membership, which represents an implicit guarantee for public debt, has completely jeopardized all such efforts (see above).

Furthermore, the irrevocability of EZ membership created a gigantic moral hazard on the part of both markets and politics. At the economic end, with this implicit protection, investors have for many years taken too much risk by treating, for instance, Greek and German bonds essentially the same. It reduced market discipline, lowered interest rates and provided easy access to capital, which in turn led countries like Greece to indulge in excessive fiscal spending. The resulting external macro-economic imbalances are now threatening the stability of the entire EZ.

At the political end, the irrevocability of EZ membership has shifted the political bargaining power to the profligate economy and provided a leeway to passing some portion of their fiscal adjustment costs on to the rest of the EZ. Since problems, for instance, in Greece create a negative externality on other EZ members, the latter economies have little choice but to provide a bailout. There is no credible enforcement mechanism and a profligate member can take hostage the rest of the EZ. It has, thus, turned out that there is a short-term trade-off between fiscal adjustment costs and the long-run stability of the EZ. Sovereign members may easily forgo the short-term fiscal adjustment costs necessary for safeguarding the EZ stability in the long-run. Rather, governments may comfort their domestic constituency at the expense of the long-term EZ stability. The sketched negative externalities lend further support to unsustainable fiscal policy stance.

At the monetary end, there is a similar trade-off at work. This is the second portion of the two-fold tragedy of the commons. At this stage, again, the TARGET2 comes into play as it provides a mechanism for quasi-automatic indebtedness.

The TARGET2 is a prerequisite for turning the EZ into a common currency area. Without an automatic clearing of a net transfer of payments a periphery NCB, for example, would have to bid for funds to wire a payment to a core NCB. This would be akin to the situation of foreign exchange markets, at which such bid – buttressed by pledging adequate collateral – would increase the price of core funds relative to periphery funds. As a result a floating exchange rate regime would ensue and would jeopardize the idea of a common currency area. In ‘normal’ times, i.e., if commercial banks trust one another, the private financial sector uses the TARGET2 to wire cross-border payments within the EZ and any imbalances are only of temporary nature. To see why, consider the financing of periphery current account deficits by core members’ net capital exports. In this case, the core purchases a periphery asset, while the periphery uses the according funding for importing tradables from the core: all possible TARGET2 transactions set off each other. However, the TARGET2 still clears cross-border payment flows even in crisis times. As long as commercial banks within the periphery are able to pledge collateral at their NCB in exchange for central bank money, payments can be wired across borders.

This allows, for instance, for importing tradables in crisis times at private (financial) sector stalemate, i.e., when there is no off-setting transfer of payments from the core to the evening out temporary TARGET2 imbalances. There is no settlement of irregular TARGET2-claims and -liabilities as is, for instance, the case within the US Federal Reserve System. The only thing that is 'acquired' by the EZ core is an 'IOU' issued by the periphery NCB to the core NCB via the TARGET2. One may argue that the TARGET2 system acts like an automatic stabilizer cushioning against the adversities of a sharp activation of the periphery current account. However, the problem here mostly is that the increasing indebtedness of the EZ periphery via the TARGET2 monetary system does not create incentives for a return of the private sector. The corresponding TARGET2-imbalances represent the EZ periphery's inability to fund itself via private sector avenues. In doing so, the TARGET2 balances replace withdrawn deposits and foster the crowding out of eligible collateral within the private financial sector of the EZ periphery. Such formation will eventually require restructuring debt. However, as long as the TARGET2 works the EZ periphery economies have an incentive to allow for alleged, short-term stabilization of struggling national financial sectors.

The same applies to all other EZ members, particularly the creditors in the EZ core, as an immediate default will leave its splashes on all EZ members. Increasing indebtedness as a result of rational delay in economic adjustments, nevertheless, endangers the long-term stability of the EZ.

The two-fold tragedy of the commons sets the stage for the dynamics of the EZ crisis. The subsequent section elaborates whether and when – if at all – there are turning points in EZ members' rational delay of economic adjustments in the course of the EZ desintegration.

5 When the going gets tough: Europeans procrastinate – therapy?

Fiscal austerity and monetary accommodation characterizes the current stance of the EU crisis management. Both policies are apparently the natural order of play given the sketched incentive structure of the actors involved. However, the fundamental problem is that this stance of EU crisis management has triggered a debt-deflation spiral that crunches its way through the periphery to the core of EZ. This section explores the range of possible turning points. In lieu of political forces endogenously changing the dynamics of the EZ balance-of-payment crisis, market forces may set in and alter the political-economic configuration of the current EZ.

For the time being, the EZ balance-of-payment crisis has triggered one de facto default in the case of Greece. At the same time, financial rescue packages have prolonged the public solvency of Ireland, Portugal, and Spain, while Cyprus is ready for applying to the EFSF. The next potential candidates comprise, for example, Slovenia and Italy. The pattern of EU crisis management consists of averting de facto defaults in the short term at the expense of increasing the overall level of indebtedness within the EZ. Apparently, this strategy comes along with ever broader ramifications. However, this is the outcome of rational but costly procrastination in the interest of all parties involved.

From the viewpoint of the EZ periphery, fiscal rescue packages and a dysfunctional monetary clearing mechanism provide the opportunity to postpone necessary economic adjustments. Institutional drawbacks of the EZ set-up undermine structural reforms needed for returning to sustainable levels of indebtedness. Such reforms are always costly in the short term. This applies to both the economic and the political sphere. The resulting delays, however, occur at the expense of further indebtedness. From the EZ core perspective, particularly Germany, these economies are able to preserve their export-oriented production structure. Hence, such EZ members have an incentive to ensure that distressed periphery economies continue to repay their debt and to keep at purchasing tradables. In doing so, they forgo the adversities of economic adjustment and re-balancing real misalignments. This is to say that the EZ core avoids the short term costs of decreasing production and employment. Moreover, credit economies (i.e., net exporters) such as Germany gain from a depreciating Euro vis-à-vis the rest of the world that helps maintain its export competitiveness. Furthermore, the flow of funds from the EZ periphery to the core is advantageous to the liquidity of the German bond markets. In the short run, the safe-haven decisions of financial investors are very much akin to a free lunch for Germany's debt roll-overs.

For periphery EZ members there are no incentives for voluntary opting-out of the EZ. The reason is that there is hardly any scope for increasing their export competitiveness by devaluation. Given a highly import-oriented production structure of the EZ periphery, possibly re-starting an economy with introducing a new national legal tender that devalues vis-à-vis the Euro cannot be conducive to export competitiveness in the short-term. Moreover, cutting off the bypass TARGET2 and other public and private sector assistance will represent a plunge into the economic abyss. It goes without saying that conditionality of fiscal support – the monetary bypass TARGET2 is unconditional – creates political hardship for every EZ periphery administration in the form of voter alienation. However, these governments weigh these political costs against the short-term severe adversities of exiting the EZ. Knowing, furthermore, that a (partial) break-up of the Euro would also leave the EZ core with significant losses, the EZ periphery has a very high propensity for accepting re-negotiable conditionality of fiscal support in the short term.

Against this backdrop, it seems only natural that Germany has been in favor of the first Greek bailout in May 2010. This bailout stipulates austerity – subsequently accompanied by monetary accommodation – and has triggered a debt-deflation spiral, i.e., a general deleveraging within periphery EZ economies. Triggering such a debt-deflation process has been a cardinal error in EZ crisis management. Instead of riding a dead horse they should have had a sit down with financial investors, i.e., the creditors of Greece, and workout of reckless debt. Apparently, Europeans have avoided the short-term pain at the expense of an effective management of the EZ balance-of-payment crisis in the long term.

The consequence of stipulated austerity is a full-fledged deleveraging process within the periphery private sector. The according contraction of economic activity puts considerable pressure on, for instance, wages. This might be conducive to international competitiveness in the long run.

However, a key characteristic of a debt-deflation process is that this potentially positive price effect is outweighed by the overall contraction of the volume of economic activity. The declining output and falling prices (which, in turn, increase the real debt burden) lead to widespread financial distress among borrowers, lessening their capacity to pledge collateral. As debtors' cash flows and liquidity were also impaired, this increases risks to the creditors in the private financial sector, as well.

The natural exit towards a debt-deflation process is reflation. While the US, for example, has done so in the course of its 'operation twist' and other treasury purchasing programs, this is hardly a feasible option for the case of the struggling EZ. Given the current institutional set-up of the EZ, particularly TARGET2, Europeans only encounter further capital flight from the periphery, instead of reflation. The experiences of the Long-Term Refinancing Operations (LTRO) by the ECB in 2011/12 are a very illustrative example. Such reflationary stance may only work if every economy in the world is doing it, or with capital controls within the EZ. The latter curfews are means of indirect confiscation and seizure of private sector assets and are heavily conflicting with, for instance, the 'freedom of capital movement' within the EU. Such countermeasures would put a de facto end to the common currency area.

There is seemingly a high probability for breaking-up with the EZ as a result of rational but costly delay of thorough economic reform. Nevertheless, the internal dynamics of the EZ crisis, i.e. the political-economic configuration, may adjust to altering financial investor expectations. The provision of fiscal rescue packages, for instance, will eventually come into conflict with electoral interests within the EZ core. Austerity will also force many European economies into recession for a prolonged period undermining, for instance, German exports inside the EZ. This is how the debt-deflation spiral crunches little-by-little through the EZ periphery to the core. As is the case with the EZ periphery also the core must roll over debt at regular intervals. As soon as financial investors realize that the German financial burden and level of indebtedness may render unsustainable, Germany will be subject to a surge in its country-specific default risk premium. At this stage, going for revaluation – presuming that the German economy will still represent a 'safe haven' in the long run – will become a politically feasible option for Germany and EZ core members. Lacking means of reflation EZ core members such as Germany may accept revaluation. This helps crafting an economic rebound and also protects from lingering into the debt-deflation spiral. The accordingly altered political-economic configuration of the EZ puts an end to procrastination and muddling-through the EZ balance-of-payment crisis. At this stage, incentives crop up which will allow, for instance, for negotiating a controlled dismantlement of the EZ and/or a concomitant replacement of the Euro by national currencies.

The self-enforcing dynamic towards a break-up of the EZ in the long-term is a result of rational decision-making in the short-term. It has turned out that a deficiency in any one a number of key factors dooms the entire Euro endeavor to failure. Nevertheless, there might be a turning point in the EZ crisis put into effect by international financial investors. This provides a range of investment opportunities that can be inferred from the analysis and are subject to the final section.

6 Implications for future investment

The German banking sector is soaked up with liquidity, the export sector is still booming, the entire economy is heading towards full employment, and the German Ministry of Finance celebrates historically low interest rates. At first glance, this is seemingly investors' paradise. It is not, however. It is the quiet in the eye of a 'balance-of-payment' storm. Particularly from the viewpoint of non-EZ investors the perception of German bonds as a 'safe haven' – nominal interest rates are literally zero or even negative – might be misleading in the medium term and wrong in the long term.

The German bond market currently exhibits perverse characteristics: Euro-dominated German government debt is becoming ever riskier at declining returns. In general, savers and investors will always get compensated (though sometimes only with a discount, which will, however, not be the case for EZ core economies) as governments do not go bankrupt in the same way that private sector entities do. The case of Germany and other EZ net creditors, however, is special.

Given the political-economic configuration of the EZ and the prompted debt-deflation spiral, the EZ balance-of-payment crisis will not come to halt at the doorway of the German economy. As soon as Germany directly faces the adversities of ineffective EU crisis management – i.e., the repercussions of the pledged and paid-out fiscal and monetary assistance on its own creditworthiness – the public administration will alter its policy stance. Such a policy shift will take place when the benefits of expected higher export earnings vis-à-vis the rest of the world (because of a devaluing Euro) as well as the advantages of declining costs of government debt (because of the EZ core investors currently withdrawing from the periphery, and the EZ periphery savers transferring their assets to the core) are offset by non-EZ investor flight. This happens as soon as concerns mount about future German creditworthiness. This is when a crucial faction of such foreign investors realizes that the current track of EU crisis management does not effectively shield against the crunches of the debt deflation spiral but eventually overburdens the financial capacities of Germany. When non-EZ investors charge higher interest rates on German government debt because of generally increasing default risks, the German administration may weigh the outcome of a tremendous revaluation higher than the evaporating benefits of the current undervaluation of the German economy. A caveat might be in order: The EZ crisis constitutes a drag on the global economy. Global economic activity, however, may bounce back. Accompanied by a devaluing Euro global effects may mitigate and seemingly resolve the current EZ balance-of-payment crisis. Though, given an unaltered political-economic configuration of the EZ, such a rally is not sustainable. As long as the bugs of the EZ set-up are not fixed the currency area will always be crisis-prone and exposed to lapsing into debt-deflation spirals. The reason for unsustainable rallies is that the present level of indebtedness at global scale renders an inevitable general deleveraging process. The sword of over-indebtedness also hangs over the Americas and Asia. Hence, any signs of economic recovery will only be of a temporary nature, representing some kind of short-term relief.

In general, real misalignments have to be re-balanced and the according mal-investments have to be worked out. This applies to all mature economies in the world, although the weakest link in the chain is the EZ because of its institutional deficiencies. Within the group of sovereign EZ-members particularly Germany may opt for revaluation as soon as the current benefits of undervaluation are gone. At such turn, past borrowing from the future may represent a free-lunch from the viewpoint of the German government. When opting-out and exiting from the EZ by introducing a new legal tender, the new currency (either unilaterally issued or jointly with some other European net creditors of the EZ) may considerably revalue against the Euro. It goes without saying that the scope for revaluation hinges on the underlying design of the new institutional set-up. Either way, Germany may easily be able to repay its existing external debt in a then devalued Euro. In doing so, the net wealth of German household savings will most probably be destroyed in both nominal and real terms. Because of the flawed payment and clearing mechanism of the current Eurosystem, the corresponding glut of money is indeed in the public sector. Nevertheless, to a considerable extent, it will probably be wealthy German households that will incur the costs of managing an incipient runaway inflation at the commencement of a new currency and a central bank with negative equity.

At the same time, the revaluation will be a boost – and not a sting(!) – to the German export-oriented business sector. The reason is, first, that the business sector may also reap windfall profits from paying off Euro-denominated loans. Second, export earnings will rise as long as Germany gains from reduced import prices and the rather inelastic external demand for tradables in the short- and medium-term. Although the German economy will experience some welfare losses this is not a problem for social inclusion and political stability in the long run. The EZ balance-of-payment crisis erodes some of the real value of previous export volumes. However, the public will hardly notice these real losses as they simply will not have the tradables at their disposal which they have exported anyway at earlier stages. The moderate re-balancing of real mis-alignments will take place by price-level adjustments. This effect will be outpaced by a full-fledged economic recovery – if sophistically managed by German authorities – after the commencement of the new currency.

It is certainly politics that determines the timing of a German U-turn concerning the opt-out of the EZ as well as the scope of a subsequent economic recovery. The German economic endowments, unless not deteriorated in the course of the crunching debt-deflation spiral, are the best precondition for high returns on investment. Regarding the mid- and long-term risks of German bonds, we suggest that non-EZ financial investors should make up their mind in due course. There are certainly some investment opportunities for increasing German bond prices in the course of some rallies. In the mid- and particularly in the long-term, however, investors with exposure to Euro-dominated German bonds should consider switching to more defensive plays than aggressive bets. The reason is that such investors run the risk of getting fully compensated only in a severely devalued currency. For investors considering a fresh exposure to Euro-dominated German bonds in the medium- and long-term we recommend to stay in the sidelines and to wait for an awesome German recovery at the commencement of a new currency.