An Optimistic Case for the Euro

By Martin Feldstein

CAMBRIDGE – The prospects for the euro and the eurozone remain uncertain. But recent events at the European Central Bank, in Germany, and in financial markets make it worthwhile to consider a favorable scenario for the common currency's future.

The ECB has promised to buy Italian and Spanish bonds to keep their interest rates down if those countries ask for lines of credit from the European Stability Mechanism and adhere to agreed fiscal reforms. Germany's Constitutional Court has approved the country's participation in the ESM, and Chancellor Angela Merkel has given her blessing to the ECB's bond-buying plan, despite strong public objections from the Bundesbank. And the international bond market has expressed its approval by cutting interest rates on Italy's ten-year bonds to 4.8%, and on Spain's to 5.5%.

Italian bond rates had already been coming down before ECB President Mario Draghi announced the conditional bond-buying plans. That reflected the substantial progress Italian Prime Minister Mario Monti's government had already made. New legislation will slow the growth of pension benefits substantially, and the Monti government's increase in taxes on owner-occupied real estate will raise significant revenue without the adverse incentive effects that would occur if rates for personal-income tax, payroll taxes, or value-added taxes were raised.

Reflecting these reforms, the International Monetary Fund recently projected that Italy will have a cyclically adjusted budget surplus of nearly 1% of GDP in 2013. Unfortunately, because Italy will still be in recession next year, its actual deficit is expected to be 1.8% of GDP, adding to the national debt. But economic recovery will come to Italy, moving the budget into surplus.

When the markets see that coming, they will drive Italy's sovereign interest rates lower. Given Italy's very large national debt, interest payments add more than 5% of GDP to the fiscal deficit. The combination of economic recovery and lower interest rates would produce a virtuous dynamic in which falling interest rates and a rising budget surplus are mutually reinforcing.

The situation in Spain is not as good. Despite cuts in government spending and increases in taxes, the IMF still projects the cyclically adjusted fiscal deficit to exceed 3.2% of GDP in 2013 and 2.3% of GDP in 2015. The key to solving Spain's fiscal problem lies in the semi-autonomous regions that generate spending and shift the financing burden to Madrid. Perhaps Italy's success will help to convince Spain to adopt the tough measures that reduce projected future deficits without more current austerity.

If Italy and Spain have budget surpluses and declining debt/GDP ratios, financial markets will reduce the interest rates on their bonds without the proposed ECB purchases. That would remove the serious risk that the ECB could start buying bonds on the basis of agreed fiscal packages, and then be forced to react if governments fall short on implementing them.

None of this would be enough to save Greece, where the fiscal deficit is 7.5% of GDP, or Portugal, where it is 5% of GDP. But if Italy and Spain are no longer at risk of default, or of abandoning the euro, Germany and other eurozone leaders will have room to decide whether to continue funding these very small states or politely invite them to leave the euro and return to national currencies.

Moreover, even under this optimistic scenario, the problem of the current-account deficits of Italy, Spain, and the other peripheral countries will remain. Differences among the eurozone countries in growth rates of productivity and wages will continue to cause disparities in international competitiveness, resulting in trade and current-account imbalances. Germany now has a current-account surplus of about $215 billion a year, while the rest of the eurozone is running a current-account deficit of about $140 billion.

Italy, Spain, and France all have current-account deficits equal to 2% or more of their GDP. As they come out of their cyclical recessions, incomes will rise, leading to increased imports and even larger current-account deficits. Those deficits must be financed by net inflows of funds from other countries.

If Italy, Spain, and France were not part of the eurozone, they could allow their currencies to devalue; weaker exchange rates would increase exports and reduce imports, eliminating their current-account deficits. Moreover, the increase in exports and the shift from imports to domestically produced goods and services would strengthen their economies, thereby reducing their fiscal deficits as tax revenues rose and transfers declined. And a stronger economy would help domestic banks by reducing potential bad debts and mortgage defaults.

But, of course, Italy, Spain, and France are part of the eurozone and therefore cannot devalue. That is why I believe that these countries – and the eurozone more generally – would benefit from euro depreciation. Although a weaker euro would not increase their competitiveness relative to Germany and other eurozone countries, it would improve their competitiveness relative to all those countries that do not use the euro.

If the euro falls by 20-25%, bringing it close to parity with the dollar and weakening it to a similar extent against other currencies, the current-account deficits in Italy, Spain, and France would shrink and their economies would strengthen. German exports would also benefit from a weaker euro, boosting overall economic demand in Germany.

It is ironic that the ECB's offer to buy Italian and Spanish debt has exacerbated external imbalances by raising the value of the euro. Perhaps that is just a temporary effect and the euro will decline when global financial markets recognize that a weaker exchange rate is needed to reduce current-account deficits in the eurozone's three major Latin countries. If not, the ECB's next challenge will be to find a way to talk the euro down.