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A weak euro is Europe's best means of beating deflation

The European Central Bank responded correctly to recent news of very low eurozone inflation by loosening policy further. The big question now is whether its decision - reducing the main financing rate from 0.5 to 0.25 per cent - will have a big enough impact to move inflation from less than 1 per cent a year back close to the ECB's target of 2 per cent. The answer to this question lies in the foreign exchange markets.

A lower short-term interest rate will certainly not, by itself, raise inflation through increased spending by businesses and households. The primary route from a lower ECB interest rate to higher inflation would be through the exchange rate of the euro. The strength of the euro over the past year has depressed import prices and forced eurozone companies to keep prices down to be competitive at home and abroad.

Eurozone interest rates are still higher than rates in the US, a situation that maintains upward pressure on the international value of the single currency. The US Federal Reserve has reduced the short-term federal funds rate to just 0.08 per cent, and has promised not to raise it while the unemployment rate remains above 6.5 per cent and there is inadequate evidence of strong labour market conditions. Participants in the financial market are now betting that a rate rise will not happen until late 2014 or 2015.

The ECB's decision has caused a small fall in the value of the euro relative to the dollar and other currencies. The euro fell immediately after the ECB's announcement by about 1.5 per cent to a dollar exchange rate of $1.33 per euro.

The ECB should seize this opportunity to indicate that it is not worried about a declining euro exchange rate but sees it as a way to move the inflation rate back towards its target of 2 per cent. And an indication that the interest rate could be reduced again in December unless inflation rises back to 2 per cent would reinforce the market's understanding of the ECBâ€™s relaxed attitude towards a lower-value euro.

A cheapening euro would be an important boost for eurozone countries such as Spain, Italy and France that have very large fiscal deficits. Those deficits, combined with slow growth and very low inflation, are causing the ratios of national debt to gross domestic product to rise. And rising debt ratios increase the risk of renewed increases in their sovereign borrowing rates and even the possibility of pressures to leave the eurozone.

A more competitive euro would strengthen demand in all the eurozone countries by increasing exports, and causing domestic buyers to substitute local goods and services for imports. Although the lower euro would not change the relative prices among the eurozone countries, it would have a powerful effect because nearly half the trade of the eurozone countries is with countries outside the eurozone. So a weak euro can lead to stronger demand and increased economic activity.

Reducing the fiscal deficits in Italy, Spain and other high-deficit countries has been difficult to achieve because reductions in government spending and increases in taxes depress economic activity. Lower economic activity causes increased transfer payments and reduced tax revenue, offsetting the original fiscal contraction. And "austerity" policies generate substantial political resistance, which makes such policies hard to achieve and maintain.

A lower euro can provide the increased demand that makes it politically â€“ and economically â€“ possible to pursue enough fiscal consolidation to put the ratios of national debt to GDP on a sustained declining path. The ECB need not target a weaker euro to achieve these important favourable effects. But a positive ECB attitude about a declining euro in the context of raising the inflation rate will allow financial markets to achieve that goal.

Market participants should recall that the euro began with an exchange value of just $1.13 and dropped at one time to less than a dollar a euro. The eurozone was hurt when the euro rose recently to nearly $1.38 per euro while sterling and the Japanese yen both declined by 25 per cent.

A substantial fall in the euro should be welcomed as an escape from the risk of deflation and the key to improved fiscal policies.

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