

Originally published in **The Wall Street Journal**

June 27, 2012

A Weaker Euro Could Rescue Europe

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The only way to prevent the dissolution of the euro zone might be a sharp decline in the value of the euro relative to the dollar and to other currencies. European politicians' dreams of political union and permanent fiscal transfers are not realistic solutions to the multiple problems of the euro zone's peripheral countries—especially on the tight schedule needed to halt the collapse of the single currency. The European Central Bank (ECB) may continue to provide additional liquidity, but experience has already shown that it cannot reduce sovereign bond yields to sustainable levels.

The peripheral countries—Italy and Spain, as well as Portugal, Ireland, Greece, Cyprus and perhaps others—can only remain in the euro zone if they solve four difficult problems. First, fiscal deficits must be permanently lowered to reduce the interest rates on sovereign bonds to levels that can be financed in the long run. Second, economic growth must be revived to create employment and sustain political support for that fiscal consolidation. Third, commercial banks must be recapitalized to stop the deposit runs and preserve lending capacity. Finally, large trade deficits must be eliminated so that these countries are not permanently seeking transfers or loans from foreign creditors.

Politically difficult decisions could solve the first three of these problems. Less government spending and higher taxes could reduce fiscal deficits. Changes in labor laws and other institutional barriers to productivity could produce stronger economic growth. And sufficient growth would give governments the fiscal capacity to recapitalize their commercial banks.

But implementing these policies would not solve the fourth problem: the periphery's staggering trade and current-account deficits. Those deficits reflect the peripheral countries' lower competitiveness after a decade of slow productivity growth compared to Germany and other northern euro-zone members.

If the peripheral countries were not locked into the euro but had their own individual currencies, they could follow the strategy of combining devaluation and fiscal consolidation that has been successfully adopted by countries in Latin America and East Asia and more recently by Britain. Devaluing currencies would boost exports and reduce imports, simultaneously eliminating trade deficits and spurring growth. Higher GDP would offset the depressing effect on aggregate demand caused by the higher taxes and reduced government spending needed to eliminate the fiscal deficit.

This route out of the trade and current-account deficits is not currently available because the members of the euro zone are locked into a single currency. That's why euro-zone officials argue that member countries must force wage levels to decline under the pressure of unemployment so as to achieve "real devaluations" of as much as 20%. But even with persistent unemployment rates of more than 20% in Spain and Greece, there has been little progress in reducing real wages. A strategy of massive real devaluation through high unemployment is simply not feasible in democratic nations. .

This structural impasse could be bypassed if the peripheral countries left the euro zone, returned to national currencies and devalued. But that dissolution of the wider euro zone could be avoided by a substantial decline in the value of the euro versus other non-euro-zone currencies. Euro devaluation

would not change the trade imbalances within the euro zone but would increase the global exports of the peripheral countries and decrease their imports from non-euro-zone nations. This in turn would raise the GDP of peripheral countries, allowing them to achieve positive growth while also reducing fiscal deficits.

A weaker euro would also render German products even more competitive in global markets than they are today, increasing Germany's already large trade surplus with the rest of the world. Increased demand in Germany might put upward pressure on German wages and prices. But the net effect would be an even stronger German economy.

Although a decline of the euro would mean higher import prices in euro-zone countries, it need not mean higher inflation or even a higher overall price level. The ECB could in principle continue to aim at a 2% inflation rate with lower prices of domestic goods and services offsetting the higher prices of imports from outside the euro zone. At worst, the ECB could allow a one-time pass-through of the higher import costs but prevent any further increases in inflation rates.

A one-time fall of the euro that eliminates the current-account deficits of the peripheral countries would not solve the ongoing competitiveness problem caused by stronger productivity growth in Germany and other northern countries. But a combination of policies that accelerate productivity growth in the periphery and slightly slower wage increases there would prevent a return of large current-account deficits. Eliminating today's large current-account deficits would make small annual adjustments in the future feasible.

A major decline of the euro does not require explicit action by the ECB or other euro-zone institutions. If major global investors in euro bonds conclude that there will be either a breakup of the euro zone or a sharp decline in the value of the euro, they will reduce their holdings of euros, driving down its value. In that way, the bond market may by itself deliver the conditions needed to eliminate the current-account deficits of the peripheral countries and prevent the dissolution of the euro zone.

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