A depreciation of the euro is not the silver bullet to solve the eurocrisis that many are looking for.

by Blog Admin

Some commentators are now advocating a devaluation of the euro, citing that this would help the uncompetitive economies of the South to export more to non-EU countries as well as benefiting the eurozone's larger economies such as Germany. **Bob Hancké** *assesses the merits of devaluing the currency, but finds that owing to the eurozone's relatively closed nature as a trade area, the process would likely exacerbate the current north/south current account divergence.*

Earlier this month, Harvard University's Martin Feldstein wrote on the Guardian website in favour of euro depreciation, saying that it would help to reduce current account deficits in Italy, Spain and France and thus allow EMU to buy time for a deeper reorganisation. His basic point is simple. If the problems of the eurozone are expressions of a fundamental divergence in relative competitiveness of the export sectors of different countries – usually pitting the north-west of Europe against the south – then a depreciation of the single currency will have two effects. It will allow the uncompetitive economies to export more outside the EMU, thus compensating for their lack of competitiveness vis-à-vis Germany and its satellites with an increase to other EU and non-EU economies. And at the same time, it will allow Germany to export even more, this time outside the eurozone, meaning that demand in Germany will rise, imports will follow and other EMU economies will grow as a result.

Feldstein is not just anybody to come up with an idea for the euro. Back when the single currency was still a glint in European politicians' eyes, he warned for the political fall-out of imposing a single monetary policy on such different economies without the political framework to support it. That said, there are, I think, two problems with his proposal. Each one of them significantly qualifies the beneficial effects of a euro depreciation. Combined they spell doom for the idea.

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The first one is that EMU is a relatively closed trade zone, and much of extra-EMU trade is with the rest of the EU member-states, many of which de facto shadow the euro. A depreciation of the euro will therefore have a relatively small effect on trade. In fact, the idea has a perverse effect: since Germany is the machine tool builder for the rest of Europe, its economy will benefit twice from the euro's depreciation. Germany will not only export more Mercedes and BMWs, but also more machine tools to build Renaults, Peugeots and FIATs. The current account divergence between Germany (and its economic satellites) and the rest of the EMU might actually increase as a result.

Second, since a depreciation of the euro will (almost by definition) not change relative terms of trade within the eurozone, its net effects are, at best, unclear. In fact, things may be worse than that, since they are likely to be very similar to the first ten years of the euro, when the south grew relatively fast. That boom implied that the south imported goods from the north, without exporting as much as it imported. The consequence: growing current account deficits, pitting the north-west versus the south and south-east – precisely what this idea seeks to remedy.

The idea is, therefore, in all likelihood not the silver bullet that everyone is looking for to solve the eurocrisis. Sure, demand in Germany has to rise. Something needs to be done to make southern European economies better adapted to life in a single currency zone (leave out Greece for the moment, which needs a substantial Marshall plan, not a bit of tinkering in the margins). It will also require some form of redistribution from wealthy creditor nations to weaker debtors, as a realignment of current accounts suggests. And it will, almost certainly, entail deeper political integration. In other words, one short-term and three long-term projects, all of which are far from easy. Back to square one and on to the next solution…

Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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