EURONOMICS: IMF Paper Ties Euro To Persistently Large Trade Gaps

By Paul Hannon

Of DOW JONES NEWSWIRES

797 words

14 October 2010

07:43

Dow Jones International News

DJI

English

LONDON (Dow Jones)--Trade imbalances between members of the euro zone have soared since the currency was introduced in 1999, with countries that have large budget deficits, and inflexible labor and product markets, running larger deficits for longer, according to a paper published by the International Monetary Fund.

The IMF stressed that the paper's conclusions don't necessarily reflect its views as an institution, but one of the two authors is Helge Berger, the IMF's deputy division chief for the euro zone.

"We find that, with the introduction of the euro, trade imbalances among euro area members widened considerably," the economists write. "Intra-euro area imbalances also seem to have become more persistent with the introduction of the euro."

The paper's conclusions highlight some of the fault lines that have undermined the cohesiveness of the currency area ever since it was formed, and underlie the fiscal problems now being experienced by some the euro zone's members, including Greece and Spain.

Prior to the launch of the euro, economies with a history of weakening competitiveness against Germany and some other members had the option of allowing their currencies to weaken in order to narrow their trade deficits. Italy regularly did so in the decades running up to the currency's launch in 1999.

But without that option, weaker economies would have had to undertake deep and politically challenging reforms in order to regain competitiveness.

The euro's backers believed that those reforms would take place, while skeptics believed they wouldn't, leading to a buildup of imbalances that would eventually destroy the currency area.

The conclusions reached by the authors of the IMF paper suggest that in its first decade, the skeptics were closer to the way things worked out.

The economists don't give a detailed breakdown of how imbalances between euro-zone members have grown, but they do note that "for Italy, the trade deficit with Germany has risen by a factor of five within a decade, now even exceeding the country's overall deficit in external trade."

The economists conclude that with the euro in place, "countries with relatively higher fiscal deficits and less-flexible labor and product markets exhibit systematically lower trade surpluses than others."

Without the option of a weaker currency, a member facing a loss of competitiveness would have to increase labor productivity and limit price rises.

But that would require flexible labor and product markets, which are lacking in many of the currency area's weaker economies. Correcting those problems is politically difficult, since it involves making it easier for businesses to fire workers in order to adapt better technologies that require fewer workers to produce the same level of output.

It also involves opening many sectors of the economy, particularly those operating in the services sector, to greater competition, which tends to draw protests from powerful business groups.

"We find that bilateral trade balances tend to be significantly lower when the relative levels of overall labor-market and product-market rigidity in a country are higher than in the partner country, an effect that is particularly strong among euro-area members," the economists write.

Some of those problems are now being addressed. Spain has embarked on a reform of its labor markets, with the aim of cutting an unemployment rate that stands at more than 20% of all workers, and exceeds 40% of those aged 25 or under.

The paper's conclusions will also draw attention to the question of who benefited most from, and who lost most from, the introduction of the euro.

Taxpayers in Germany and other, stronger members are unhappy about the prospect of paying to rescue Greece and possibly other nations that have been excluded from the international bond markets because of large budget deficits that reflect their weak economic positions.

But some economists and policy makers believe that Germany in particular has benefited greatly from its competitive advantage over many other members of the currency area, given that they no longer have the option of devaluing their currencies.

In the years following the introduction of the euro, Germany became the world's largest exporter. Some of that reflected its strength in making goods that were in great demand in rapidly growing developing economies such as China.

But a good deal of that performance seems also to have come from Germany's increased dominance within the euro zone. German politicians argue that the nation didn't have an advantage that wasn't available to others if they had chosen to make the right policy decisions.

-By Paul Hannon; Dow Jones Newswires; 44-20-7842 9491; paul.hannon@dowjones.com [14-10-10 1143GMT]

1110