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No Euro-Zone Currency War, Just Tough Choices on Reform

By STEPHEN FIDLER

As economic policy makers around the world fret about the outbreak of currency wars, in the euro zone that possibility has been abolished.

Economists at Dutch bank NIBC estimate that at least 18 countries around the world have intervened to depress their currencies over the past few weeks. In some of the countries that haven't, such as the U.S. and Britain, central banks are preparing to engage in another round of quantitative easing, or printing money—a move that would also depress currency values.

But there's no currency war here in the euro zone. Not only is the European Central Bank policy looking tougher than those of most of the world's other monetary authorities, but the common currency's high-deficit countries have given up the right to independently launch foreign-exchange wars of their own.

That may be no bad thing, but without the apparently easy option of devaluation for its weaker brethren, the euro zone faces the deep dilemma of how to reform itself. At a summit at the end of the month, European Union leaders will examine a report from a task force led by European Council President Herman Van Rompuy on how this should happen. Mr. Van Rompuy will have to walk a fine line between what probably should happen to make the euro zone sustainable—a significant pooling of political sovereignty—and the political practicalities within a currency bloc of 16 (and soon to be 17 as Estonia joins) nation states.

With member states' weaknesses exposed by the financial crisis, few disagree on the need for change—both in the way governments of the common currency coordinate economic policies and in the structures of many of its members' economies.

A research paper published this week by the International Monetary Fund underlines just how the advent of the common currency has exposed frailties in some of its members' economies.

Its main conclusion: Trade imbalances within the euro zone have widened considerably and have become more persistent since the introduction of the euro. For Italy, the paper points out, the trade deficit with Germany has risen fivefold within a decade, and now exceeds the country's overall deficit in external trade.

The paper from Helge Berger of the IMF and Volker Nitsch of the Darmstadt University of Technology doesn't represent IMF policy. But it draws its conclusions from bilateral trade patterns among the euro-zone economies and a few other economies in Europe, such as Switzerland. It adjusts the results for factors such as Germany's longstanding export success and for examples, such as Ireland, where there have been marked shifts over time in trading patterns with all trading partners.

The conclusion perhaps isn't a surprise. Nor are the reasons for the bigger and more persistent deficits: that countries cannot respond to the trade surpluses with Germany by devaluing their national currencies—in economists' jargon, they are unable to adjust their nominal exchange rates.

For the deficit countries in the euro zone, Mr. Berger says, "the absence of the adjustment to the exchange rate has made things more complicated."

Going a step further, the paper analyzes what influences the size of the trade deficits. Again the conclusions are not unexpected—but interesting because the results reflect what economists would have predicted.

The more rigid a country's markets in tradable products and services and the more inflexible its labor market, the slower will be the pace of adjustment to the trade deficit. "You need flexibility in your labor markets and in your product and services markets. If you don't have that, the adjustment will take longer," says Mr. Berger.

The economists also found another pronounced connection: higher external deficits are associated with high budget deficits. "Among euro area members, a one percentage point increase in the (relative) fiscal balance is associated with an improvement in the bilateral trade balance by about two percentage points," the paper concludes.

There's a message for surplus countries too. They could reduce their surpluses by cushioning the swings in the business cycle. Economic volatility, the authors argue, tends to increase trade surpluses because it increases the tendency to build up precautionary savings and therefore lowers the propensity to consume, including on imports.

"Our findings imply both bad and good news for policy makers. The bad news is that irrevocably fixed nominal exchange rates do come at the cost of larger and more permanent trade imbalances, just as [the economist Milton] Friedman claimed more than half a century ago. The good news is that these imbalances are not completely unavoidable," their paper says.

So imbalances aren't inevitable. But tackling them through unpopular and profound reforms, confronting powerful interests, changing working practices of lifetimes, challenging modes of living, and cutting popular public spending is not a route many politicians willingly take. For much of the rest of the world, currency devaluation looks like the easier option. For many in the euro zone, only hard choices.

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