Long live the euro – at parity with the dollar

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The euro is crumbling. Does this mean that the single currency project is nearing its end? Not quite. In fact, if well managed, the euro's depreciation is just what the doctor ordered to complement the much-needed fiscal consolidation in Greece as well as in the rest of southern Europe. Somewhat paradoxically, a weaker euro is the precondition for its survival.

Markets have their own ways to get us to the right place, although they do not always do it in the least disruptive manner. They have been bringing the euro down more out of fear than understanding that the solution lies therein. Yet we should understand that the goal is a good one rather than a tragedy. It is up to policymakers to ameliorate the markets' natural clumsiness during such periods of collective confusion.

The first beneficiaries of a weaker euro are the countries of southern Europe whose difficulties have been putting the future of monetary union in doubt. Greece has been the focus, but Spain, Portugal and Italy also face a sharp loss of competitiveness.

Greece can take one of two paths: a repeat of Ireland 1982, or of Ireland 1987. In 1982, in the middle of a deep recession and with public debt growing by 5 percentage points of gross domestic product a year, Ireland slashed the budget. The result was a worsening of the recession and an acceleration of debt growth. Dublin tried again in 1987. This time fiscal consolidation was a big success. By 1989 the ratio of debt to GDP was falling and output was growing at 4 per cent a year. What explains the difference between the two episodes?

One reason is the composition of the fiscal correction – mostly tax rises in 1982, with more spending cuts five years later. The European rescue package for Greece resembles the good Irish stabilisation. But there is another important difference between the two Irish attempts. The first was accompanied by an appreciation of the punt, while in 1987, just before the successful stabilisation, the punt depreciated by 11 per cent. The same happened in Italy in the 1990s, during the fiscal stabilisation before euro entry, and in Argentina in 2001. But how can Greece accomplish this within the euro straitjacket?

Since Greece is part of the euro area, it is often assumed that the country is condemned to regain competitiveness the hard way, through recession and deflation. But this is not quite right: the euro has plenty of room to depreciate against the currencies of the US and emerging markets.

For the eurozone as a whole, such a depreciation would not have a large direct impact, since most trade is within the area. But, as if by divine coincidence, this is not the case with Greece. Fifty-six per cent of Greek exports are to countries outside the euro area. Even including Sweden and the UK, two countries whose currencies might shadow a euro depreciation, that proportion remains as high as 50 per cent.

A 30 per cent depreciation of the euro would significantly cut the Greek trade deficit and boost exports. This is because tourism accounts for 70 per cent of total Greek exports. Tourism is highly price sensitive and one in three visitors to Greece travels from outside the euro area.

The gods are also aligned through the denomination of Greek debt, mostly in euros. This eliminates a key obstacle to using depreciation as a recovery tool, since an Argentinean-style debt spike is not a concern.

The second-greatest beneficiary of euro depreciation would be Germany, as 40 per cent of its exports are to countries outside the euro area. Germany does not need further competitiveness gains or a pull from net exports. Thus, it could afford to use this benefit for an expansion in domestic demand. This would give an additional boost to the net exports of distressed regions within the euro area, amplifying the remedial role of depreciation.

Policymakers should facilitate the depreciation of the euro instead of trying to prevent it. Misguided interventions by the European Central Bank could be the final nail in the currency's

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coffin. Interest rates should be cut to bottom levels and the ECB should pledge to keep them low for quite a while. This it has to do, not instead of the required fiscal adjustment but in support of it.

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