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Dollar Parity May Be Euro’s Last Chance: Caballero and Giavazzi

By Ricardo Caballero and Francesco Giavazzi - Jan 15, 2012

The euro has dropped about 13 percent against the dollar since the sovereign-debt crisis hit Italy seven months ago. To a large extent, the decline reflects the increased likelihood of an Italian default, which would destroy the single currency.

Yet depreciation may be the only remaining hope for the euro’s survival, as long as it is carried out through swift and coherent policy support.

Since last summer, Italy has implemented the largest fiscal consolidation of the past 15 years, entailing an increase in the primary budget surplus of more than 6 percent of gross domestic product over three years. But because such a large fiscal contraction will happen mostly through higher taxes, investors rightly worry that the country is about to enter a deep recession. If that were to happen, the consolidation would fail.

A weaker euro could help avoid that outcome and make fiscal consolidation a success. For the euro area as a whole, a currency depreciation wouldn’t have a large direct impact, since most trade is within the area. However, that isn’t the case with Italy: 55 percent of Italian exports are to countries outside the euro area, particularly Switzerland, the U.S., Russia and emerging economies.

A 15 percent depreciation of the euro -- bringing it close to parity with the dollar -- would give a big boost to Italian exports, which would compensate for the contraction of domestic demand.

Restoring Growth

In 1992, when Italy suspended its participation in the European Exchange Rate Mechanism, the country implemented a similar fiscal contraction. This was accompanied by a 20 percent devaluation of the lira, limiting the damage to the economy. In the following three years, growth averaged 1.4 percent per year.

Of course, Italy has much more to do to make its economy competitive and to reduce its debt burden. But any reforms -- labor-and-product market liberalizations, a working judiciary, a better bureaucracy -- would take a long time to show their effects, even if adopted immediately.

That would be too late to avoid a recession that has already started and that in all likelihood will be much more severe than official predictions.

This isn't the first time that concerns about a possible sovereign insolvency inside the euro area have weakened the single currency. A similar event occurred at the peak of the Greek crisis: In just a few months (November 2009 to May 2010), the euro fell about 22 percent against the dollar. As we noted at the time, a weaker euro was needed to complement Greece's fiscal consolidation to avoid a deep recession. This would have been beneficial because, as is the case with Italy, more than 50 percent of Greece's exports are sold outside the euro area.

Yet the pressure on the euro eased because markets rapidly concluded that Greece wasn't big enough to bring down the monetary union. They understood that if the euro were to regain lost value, Greece might collapse, but the euro would survive. In less than a year, the euro regained all it had lost.

The same calculus doesn't apply to Italy. Markets understand that a failure of fiscal consolidation by the government in Rome is likely to mean the end of the euro. It's less clear that they understand that a weak currency will make the consolidation a success, and save the euro.

A swift depreciation would have the added benefit for investors of increasing the expected return of euro debt, making it easier to roll over the large stock of borrowing that will soon come due: about 200 billion euros ($253 billion) of European bank bonds in the first quarter of the year, in addition to the large rollovers of sovereign obligations.

Market Push

Markets have ways to push policy makers, though they don't always do so in the least disruptive manner. They are even less effective when they panic, as they are doing now.

It is up to policy makers to help markets understand that an orderly decline in the euro's value would be in everyone's interest. That means European leaders should encourage the depreciation of the euro instead of trying to prevent it. During the second half of 2010 and though July 2011, the euro appreciated 25 percent against the dollar. The increase was largely due to the European Central Bank's decision to raise interest rates twice.

The ECB today should make clear that a weak euro is the condition for its survival. It should cut interest rates to zero and pledge to keep them there for quite a while. This must be done, not as a replacement for the drastic fiscal adjustments that must occur in Italy and other countries, but to make sure those measures are effective.

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