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A Devaluation Option for Southern Europe
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CAMBRIDGE – This year is likely to mark a make-or-break ordeal for the euro. The eurozone’s survival demands a credible solution to its long-running sovereign-debt crisis, which in turn requires addressing the two macroeconomic imbalances – external and fiscal – which are at the heart of that crisis.

The crisis has exposed the deep disparities in competitiveness that have developed within the eurozone. From 1996 to 2010, unit labor costs in Germany increased by just 8%, and by 13% in France. Compare that to 24% in Portugal, 35% in Spain, 37% in Italy, and a whopping 59% in Greece. The result has been large trade imbalances between eurozone countries, a problem compounded by large fiscal deficits and high levels of public debt in southern Europe (and France) – much of it owed to foreign creditors.

Does addressing these imbalances require breaking up the eurozone? Suppose, for example, that Portugal were to leave and re-introduce the escudo. The ensuing exchange-rate devaluation would immediately lower the price of Portugal’s exports, raise its import prices, stimulate the economy, and bring about much-needed growth. But a euro exit would be a messy affair. The resulting turmoil could very well trump any short-term gains in competitiveness from devaluation.

There is a remarkably simple alternative that does not require southern Europe’s troubled economies to abandon the euro and devalue their exchange rates. It involves increasing the value-added tax while cutting payroll taxes. Our recent research demonstrates that such a “fiscal devaluation” has very similar effects on the economy in terms of its impact on GDP, consumption, employment, and inflation.

A currency devaluation works by making imports more costly and exports cheaper. A VAT/payroll-tax swap would do exactly the same thing. An increase in VAT raises the price of imported goods, as foreign firms face a higher tax. To ensure that domestic firms do not have an incentive to raise prices, an increase in VAT needs to be accompanied by a cut in payroll taxes.

Moreover, since exports are exempt from VAT, the price of domestic exports will fall. The desired competitiveness effects of exchange-rate devaluation can thus be had while staying in the euro.

This policy can also help on the fiscal front. As is true of an exchange-rate devaluation, the positive impact on growth of an increase in competitiveness can strengthen the fiscal position by raising tax revenues. Moreover, an important advantage of fiscal devaluations is that they generate additional revenues in proportion to the country’s trade deficit. For countries that are suffering from weak competitiveness and, as a consequence, running trade deficits, this typically means more revenues, especially in the short run.

Like exchange-rate devaluations, fiscal devaluations create winners and losers. Both act as a wealth levy: inflation means that bondholders suffer a real loss in proportion to their wealth and the size of the devaluation. If taxes on capital are not adjusted, holders of domestic stocks suffer a comparable loss.

By contrast, many transfers, such as unemployment benefits, health benefits, and public pensions, are indexed to inflation, and thus maintain their real value. The same is true of minimum wages. These distributive effects play an important role in the politics of exchange-rate devaluations, and most of these effects appear in fiscal devaluations as well.

Fiscal devaluations already have some advocates. Indeed, French President Nicolas Sarkozy’s government just announced one. And concerns that a fiscal devaluation will conflict with euro rules can be met by simply pointing out that Germany’s government carried one out in 2007, though by another name, when it raised VAT from 16% to 19% and cut employers’ contribution to social insurance, from 6.5% to 4.2%.

In short, there are simple fiscal alternatives to exchange-rate devaluation that can address southern Europe’s short-term competitiveness problems. To be sure, feasible fiscal devaluations would be limited in size. But, together with debt restructuring, accommodative monetary policy, liquidity support from the European Central Bank, and much-required structural reforms, they can help to put these troubled economies on a sound footing without a euro breakup or a major austerity-induced recession.