**FINANCIAL TIMES** WEDNESDAY AUGUST 2 2006

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# Europe has to face the threat of America's trade deficit

The inevitable decline of the US trade deficit will pose a big challenge for the economies of Europe. Shrinking America's $800bn (£427bn) annual trade imbalance requires a decline of US imports and a rise in its exports. When US imports decline, European exports will fall; and when a lower dollar makes American exports more competitive, US shipments to Europe will rise and American products will replace European goods in global markets.

This fall in the demand for European products will cause a slowdown in Europe's already weak growth. With lower demand, European companies will invest less and hire fewer workers. The resulting slowdown in incomes will hurt consumer spending and have second-round effects on business investment. This cumulative process could be enough to send some European economies into recession.

Instead of planning for the day when this will happen, many European officials prefer to believe that Europe need not be affected by the decline of theUS trade deficit.

A common view in western Europe is that Europe is not part of the global imbalance (since it now has an overall trade balance) and therefore need not be part of the solution. This senseof denial is reinforced by the assumption that there is no scope for anoffsetting expansionary demand policy in Europe because the EuropeanCentral Bank has to focus on reducing inflation while fiscal policy concentrates on reducing the excessive budget deficits.

It is wishful thinking to believe that Europe need not be part of the solution. When American consumers reduce their imports because of a slowdown of demand in the US or because a decline of the dollar makes foreign goods more expensive, European products - as well as those of Asia and Latin America - will be hit. And when US exports increase, they will displace European products as well as those of other countries.

The most dangerous response to this likely course of trade adjustment would be the imposition of policies designed to protect European producers from the increase in imports. In spite of the World Trade Organisation rules, European governments could use administrative procedures to deter imports and put political pressure on domestic companies to make them use domestic products in their production. In the wake of the Doha round, this could lead to a spiral of damaging retaliatory steps by the US and other

governments. Protectionism is always a dangerous course because, once started, it is hard to stop and reverse.

But what policies can be adopted to stimulate domestic demand from European households and companies so that a decline in Europe's net exports does not reduce overall aggregate spending and employment?

A stimulative monetary policy has a significant role to play. Until now,the ECB has been correct to resist the pressures from finance ministers and others to pursue an easier monetary policy aimed at stimulating current employment. Today's high rate of European unemployment reflects structural problems rather than inadequate demand. An easier monetary policy now would simply raise long-term inflation. But a substantial incipient decline in aggregate demand due to lower exports and rising imports should cause the ECB to limit or reverse its current path of tightening. While it would be wrong to try to reduce the current structural unemployment by an expansionary monetary policy, it would not be wrong to respond to a fall in external demand by such a monetary easing.

Monetary policy can offset a common weakness of demand in the entire euro area but it cannot target the conditions in individual countries. The decline of net exports is not likely to be the same in each of the countries of the euro area. Fiscal and regulatory changestailored to each country's circumstances can therefore play an important role in maintaining aggregate demand.

Designing a fiscal stimulus is a difficult challenge because European fiscal deficits are already too high. The political structure of the eurozone creates a bias towards high budget deficits because individual national governments determine fiscal policies while the countries share a common currency and common interest rates.

With this separation of monetary and fiscal responsibilities, there is virtually no feedback from larger budget deficits in the form of higher interest rates and a weaker currency that would otherwise discipline fiscal authorities. The revision of the growth and stability pact only exacerbates this problem by substantially weakening the Maastricht treaty that required eurozone countries to limit their fiscal deficits and national debt.

It may nevertheless be necessary to accept a temporary increase in the fiscal deficit in some countries to supplement the effect of expansionary monetary policy. A temporary investment tax credit or accelerated depreciation could stimulate business spending on plant and equipment. A temporary reduction of the household value added tax would give individuals an incentive to accelerate consumer spending. It would be possible to finance these fiscal changes in ways that retained the enhanced spending incentives while eliminating the increased budget deficit. For example, the business investment incentives could be financed by a temporary rise in corporate income taxes while the lower VAT rate could be financed by temporarily higher personal income taxes.

Many of the existing regulations on European labour and product markets are correctly criticised for reducing productivity and growth. Eliminating or modifying the regulations to improve long-term performance would also act to stimulate demand in the short run. To cite just two possible examples, reducing the restrictions on the hours that stores can stay open or changing the zoning rules that inappropriately limit construction could help Europe deal with a temporary weakness of demand while also providing a long-term economic benefit. Fear of rising unemployment may provide the catalyst to overcome the political resistance to these regulatory changes.

The slowdown of the US economy and the probable decline of the dollar mean that US net imports are now likely to decline. Taken by itself, this will reduce growth and employment in Europe. It is important that European officials now recognise this problem and decide how best to respond. Because of the natural lags in the policy process and in the economy's response to new initiatives, it would be wrong to wait until Europe's net exports begin to decline.

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