An Essay Supplement to Chapter 16

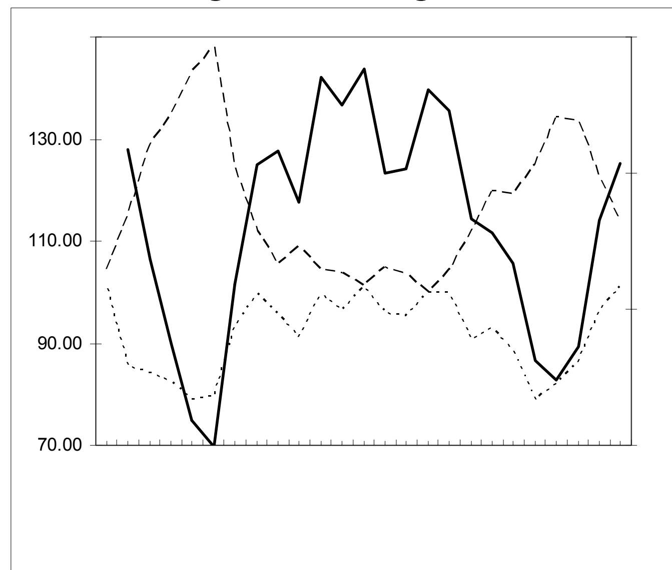
Is the Euro is too Strong?

The issue

Ever since its launch, the Euro has been on a roller-coaster. It started its life by falling sharply vis-à-vis the dollar, giving critics a wonderful "proof" that it was a misguided idea. Since 2001, it has appreciated so much that Jean-Claude Trichet, the Chairman of the ECB, has called this evolution "brutal". A number of governments have openly started to talk about the need to conduct foreign market interventions. Others blame the US for its massive budget and current account deficits, the twin deficits as they are called; for them it is not the euro that is too strong but the dollar that is too weak.

Figure 1 shows the evolution of the dollar and the euro since 1980. Of course, there was no euro before 1999, but it is possible to construct a "synthetic" euro as the weighted average of its constituent currencies.[1] The figure illustrates how widely the dollar/euro exchange rate has fluctuated. It shows that the trough in 2001 was not unique and that the current level is below previous peaks. The figure also shows the effective exchange rates of both the dollar and the euro, i.e. their average values vis a vis a basket of currencies of their main trading partners. Clearly, when the dollar goes up the euro goes down, and conversely. So is it unclear whether the euro is too strong or whether it is the dollar that is too weak.

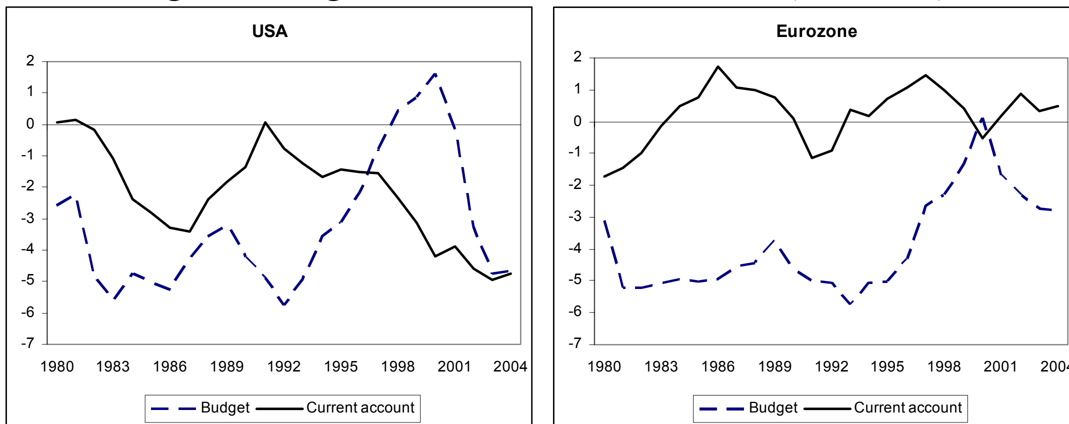
Figure 1. Exchange rates



Interpretations

A popular interpretation, especially in the financial markets, is that the dollar is weak because of the re-emergence of the twin US deficits. Figure 2 shows that the current account and the budget balances moved in parallel in the 1980s and have both deteriorated again since 2000. Yet, this parallelism was lost during the 1990s, raising questions about the nature of the phenomenon. The figure also shows that the Eurozone has never experienced a twin-deficit problem; if any pattern is visible it is one where the current account and the budget balance seem to move in opposite directions. So there is no general rule that deficits come in pair.

Figure 2. Budget and current account balances (% of GDP)



Source: Economic Outlook 2004:2, OECD

The timing is not supporting this view. The US deficit has deepened since 1996, and yet the dollar appreciated by 30% vis-à-vis the euro, and by 29% in effective terms, between 1996 and 2001. During that time, the financial markets were mesmerized by the ITC revolution and superbly ignored the growing external deficit. Obviously, they were wrong, and they could be wrong again now.

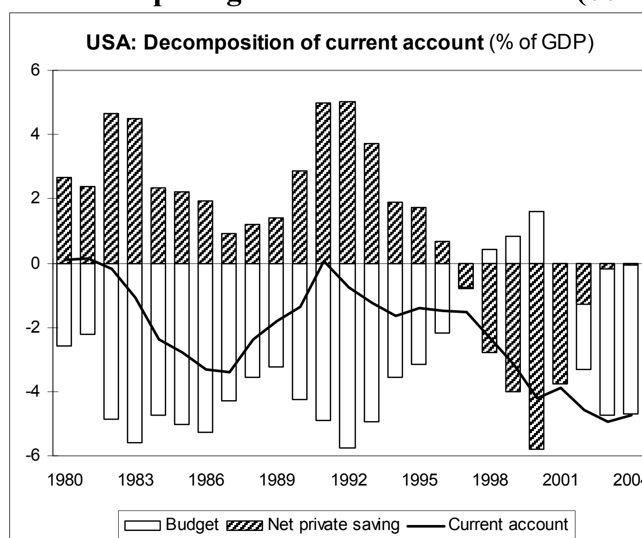
To see why, we need to look more closely at what is driving the US deficit. The current account measures the net saving of a country vis-à-vis the rest of the world. A surplus means that the country saves and invests abroad. A deficit means that it is borrowing abroad. Total national saving can be decomposed as the sum of the public net saving (a budget surplus means that the government is saving, a deficit that it is borrowing) and the private sector's net saving (whether it saves more than it borrows):

Current account balance = Budget balance + Private sector net saving

This decomposition is shown in Figure 3 for the case of the US. The twin deficits of the 1980s reflect the fact that the large Reagan budget deficit was only partially offset by an increase in private savings. These first twin deficits disappeared in the latter half of the 1990s when the current account deficit deepened despite a closing down of the budget deficit under the Clinton administration. This time around it is the private sector that was the driving force: as the ITC revolution took hold, firms borrowed

massively and household savings continued the decline that had started in the mid 1980s. The current re-emergence of the twin deficits occurs because the budget has swung to a sharp deficit as the result of tax cuts and increased military and security spending by the Bush administration while net private savings have settled down to near balance.

Figure 3. Decomposing the US current account (% of GDP)



Source: Economic Outlook 2004:2, OECD

What has this to do with the dollar? Not much, at least in the shorter run. Even a further sharp depreciation of the dollar will not reduce the budget deficits, and its effect on net private saving is very low. Of course, the current account deficit is not sustainable, but sustainability is a very long run consideration. If the deficits were to continue indefinitely, there would be reasons to be concerned about the US ability to serve its external debt. When such a concern arises, the rest of the world will stop lending to the US. Obviously, the time has not come yet, and is unlikely to come for many more years to come. Much the same applies to budget deficits; eventually the US government will not be able to borrow and will have to cut its deficit, but we are not there.

A dollar problem? A euro problem?

So where do we end up? A simple view is that the dollar has depreciated to correct the overvaluation caused by the "irrational exuberance" that characterized the boom years of the ITC revolution. While the dollar may now be close to (even possibly below) its equilibrium level, experience suggests that exchange rates overshoot: they tend to appreciate too much when they are initially undervalued and to depreciate too much when they were initially overvalued. The most likely reason is the herding behaviour of financial markets.

A novel feature of the recent evolution is that many economically significant countries (China and the rest of South-East Asia, most of Latin America) have attached their currencies to the dollar. As a consequence, when the dollar depreciates, so do these other currencies, leaving the euro on its own to balance the dollar's

retreat, with large gains not just vis a vis the US dollar but also vis a vis the East Asian currencies. In this view, the euro is left on its own as the only major currency against which the dollar can depreciate.[2] If, as is likely, the process continues, the pressure is building up on the Eurozone more than on the US.

In the end, it matters little whether we call this a dollar undervaluation or a euro overvaluation. It is both. The real question is whether the situation is something to worry about and, if so, who is bearing the burden and who is to do something about it.

Some are lucky, others are not

As it turns out, the timing is bad for Europe, and good for the US. The US economy has significantly recovered from the 2000-01 slump, but needs more growth to bring its unemployment rate down to a "normal" level. Even if Washington will not admit to it, a weak dollar is in the interest of the US economy.

In comparison with the US, Europe's recovery has come later and is weaker, with very high unemployment rates in many countries, especially the larger ones. The oil shock now threatens to derail the fledgling recovery. The euro appreciation has two opposite effects. On the one hand, it reduces the oil price increase in euro, and that is a welcome effect. On the other hand, it saps the Eurozone's external competitiveness, hurting its exports. A strong euro is not in the interest of Europe.

This is not the first time that the gyrations of exchange rates work in favour of the US and against the Eurozone. Already in late 1990s, when the US economy was overheating, the dollar overvaluation was helping to contain inflation and to slow growth down also good to the US.[3] This was also the time when the new-born ECB was desperately trying to bring inflation down below the self-imposed 2% ceiling. A weak euro was then exerting some inflationary pressure since the price of imported goods and materials was rising as the euro was depreciating.

Questions

1. Why is the euro forced to appreciate in effective terms when the dollar depreciates?

2. Imagine that the euro did not exist now, i.e. that we would still have national currencies throughout the Eurozone. What could be the impact of the weak dollar?
[Hint: you may want to look at how various European currencies fared during previous episodes of dollar weakness, as seen in Figure 1.]

3. If you were seating on the Executive Board of the ECB, what policy would you advocate?

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[2] This issue is the subject of another Essay "Will East Asia Save the Euro?".

[3] This is when Treasury Secretary Rubin famously stated that "s strong dollar is good for the US economy", a mantra that he repeated over and over again, and that all his successors keep repeating, including now. Never mind that the dollar is weak.