The Euro exchange rate

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Executive summary

The continuous appreciation of the Euro since the Fall of 2000 and the uncertainty surrounding its future course are obscuring the prospect for growth in Europe. When one looks in retrospect to the evolution of the euro (reconstituted from 1979), an important fact shows up: since the beginning of the nineties the evolution of the exchange rate has been procyclical . It is expected to continue to be so.

Whatever the story one can devise to explain this phenomena, the main message of this paper remains: overreaction or not, the movements of the exchange rate of the dollar are prima facie contributing to the stabilisation of the American economy, but those of the exchange rate of the euro – whether bilateral or effective – are rather destabilising for the European economy.

It is as if, absent an exchange rate policy of the euro area, the movements of the exchange rate of the euro are simply the reflection of the exchange rate policies of the rest of the world, and thus can't correspond generally to the needs of the European economy.

If we look at some determinants of the movements of the (real) exchange rate – growth differentials, inflation differentials, long term interest rates differentials – it does not seem that they can explain very much, although interest rates differential may go a long way to explain at least qualitatively the direction of the change.

Asset prices and bond yields did not evolve in such a way that one can infer that the appreciation of the euro was the consequence of capital inflows, and it was not. Investment in Europe, on the contrary, decreased in 2003.

On all accounts – the appreciation of the euro, the pathological evolution of labour productivity, wage moderation and the deepening of the output gap – time has come for the ECB to cut the interest rate.

The continuous appreciation of the Euro since the fall of 2000 and the uncertainty surrounding its future course are obscuring the prospect for growth in Europe. The problem lies not in the level of the Euro/dollar exchange rate, per se, but in the fact that the currency has appreciated in a scarce growth period, a period in which the rate of growth of the Euro area was well below that of the rest of the world. In retrospect, one can get the impression that the exchange rate of the Euro (reconstituted) since the beginning of the nineties has always been too high in period of slow growth: that was the case before the launching of the single currency, and has been the case since two years. One can always devise a rational for such a phenomena highlighting the beneficial effect of exchange rate appreciation in the midst of a slump, because in increasing the pressure on firms to restructure in order to compensate their lost of competitiveness, it speeds up the adjustment of the economy, a kind of shumpeterian view: "recovery is sound only if it does come of itself. For any revival which is merely due to artificial stimulus leaves part of the work of depressions undone and adds, to an undigested remnant of maladjustment, new maladjustment"[1]

The procyclical evolution of the Euro

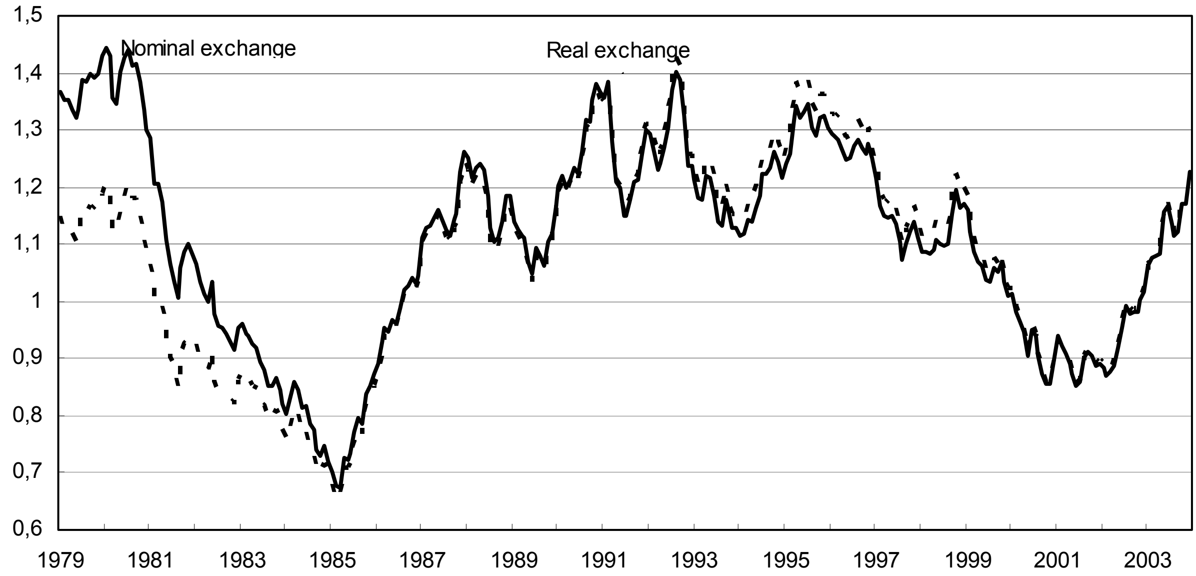
But for those who do not believe in this Nemesis theory, a procyclical evolution of the real exchange rate appears all but normal. Of course exchange rates are usually characterised by large movements as it is shown in the following graphs.

What is striking when we look at the evolution of the Euro-dollar exchange rate or at that of the effective exchange rate of the Euro is the radical change which seems to characterize them from the beginning of the nineties. (See graphs 1 and 2). In the eighties, even if the amplitude of the variations seems to point to some pathology[2], the direction of the change was basically right: the Euro was depreciating in a period of slump and reappreciating when the recovery was underway. From 1990 it seems that the converse is true: the Euro was very strong until 1996 – in a period of slow growth – begun to depreciate when growth did resume until 2000, and is appreciating since. That is not helping the stabilisation of the economy as it amounts to weaken external demand at the very moment internal demand is weak and, conversely, to strengthen it when internal demand is strong.

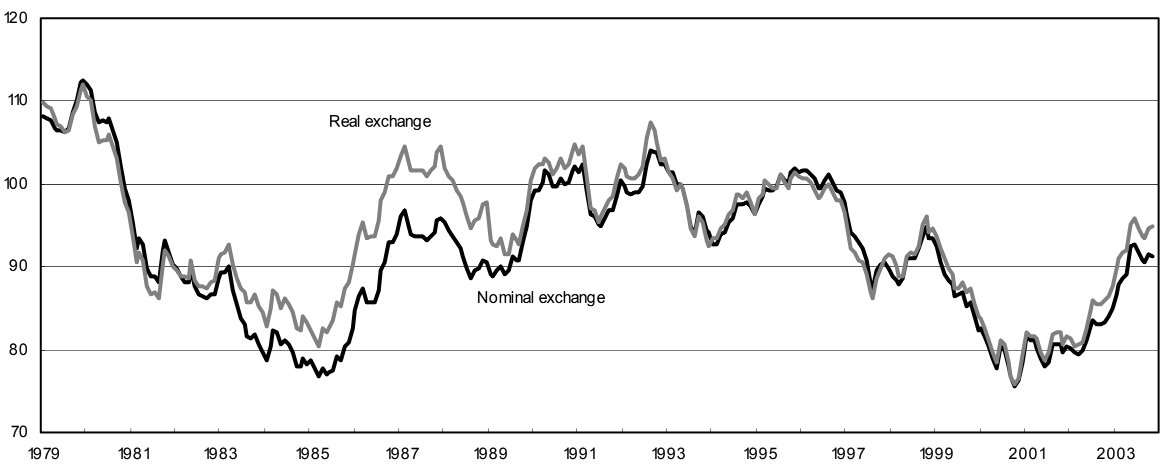
[1] J. Schumpeter : « Depressions » in D.V . Brown et al.., eds., *The Economics of the Recovery Program*, Cambridge, Harvard University Press, 1934.

[2] Cf. Jean-Paul Fitoussi and Edmund S. Phelps : *The slump in Europe. Reconstructing open economy theory*, Basil Blackwell, 1988.

The Euro/Dollar exchange rate 1979-2003



Exchange rate ZONE EURO

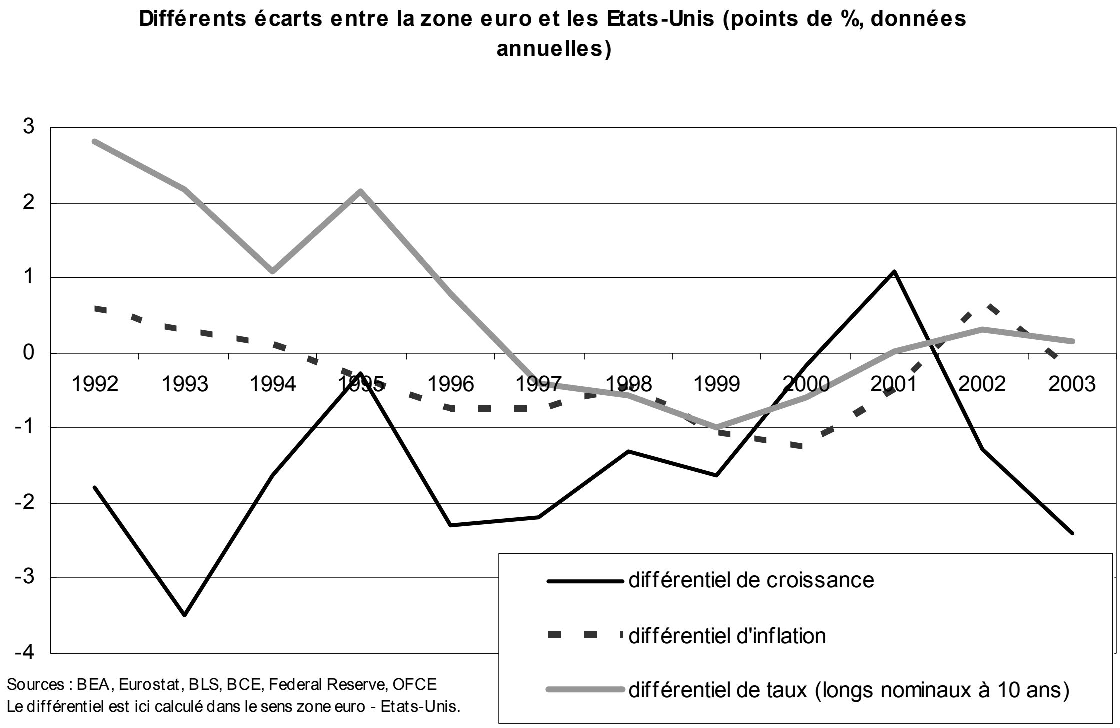


Four remarks are in order: 1) this picture is somewhat artificial as the Euro was launched only in 1999; the period before this launching reflects rather the consequences of (badly?) managing the EMS at the time of the German unification shock. 2) the recent depreciation of the dollar is also reflecting concerns about the huge US external deficit and the sustainability of present US growth. 3) it may only be an overreaction to the overappreciation of the dollar which has characterised the second half of the nineties. 4) to focus on the bilateral exchange rate vis à vis the dollar is exaggerating the picture. The effective exchange rate is a better indicator of the competitiveness of the whole

area, and its variation, although qualitatively the same, is quantitatively less spectacular, although sizeable.
But on the whole the problem remains: the evolution of the exchange rate is procyclical and is expected to continue to be so. In effect, on hope and expectations, most observers believe that growth has resumed in the Euro area since a few months and that the moment where the Euro will depreciate again is approaching.

Some determinants of the movements of the exchange rate

If we look at some determinants of the movements of the (real) exchange rate (see graph.3) – growth differentials, inflation differentials, long term interest rates differentials -- it does not seem that they can explain very much. There is a presumption that the huge positive long term interest rate differential of the first half of the nineties played an important role in the appreciation of the Euro in that period. This presumption is well grounded in the Mundell Flemming model: in effect, a recipe for the appreciation of a currency is a policy mix combining a very restrictive monetary policy and a lax fiscal policy.



But the depreciation of the Euro since 1997 is more difficult to elicit. Growth differentials have frequently be referred to as the best candidate, but as is apparent in the graph this negative growth differential was lower from 1997 than in the preceding period. In the period of depreciation of the Euro (1997-2000), the growth gap can't thus be the main suspect. The negative inflation differential may be part of the explanation, but its variation since 1994 has been too small to explain very much. That leaves the swing in long term interest rates differential -- from almost + 3 in 1992 to about – 1 in 1999 -- as the main suspect. In a way, short and long term interest rates have been kept artificially high in Europe in the first half of the nineties – due to the conjunction of the German unification shock and the interplay of the EMS – and their return to earth after 1997 contributed to lower the also artificially high level of the Euro. Of course, others factors contributed in those years to the appreciation of the dollar: the new Eldorado promised by the "new economy" lead to an increase of capital inflow in the US which may have induced an overreaction of the exchange rate of the dollar.

For the more recent period (2000-2003), the three gaps depicted in the graph do not explain very much. The closing of the interest rate differential may be part of the story, but again its variations have been too small to explain such a swing in the exchange rate of the Euro. Besides the deepening of the growth differential should have, if any, mitigated the appreciation of the euro. One may argue, obviously, that the explosion of the asset prices bubble together with mounting geopolitical uncertainty have made the Eldorado dream comes false, and underlined the possible unsustainability of US externals deficit and debt. One may add that the overreaction to the bottom of the exchange rate of the dollar is just a correction to its preceding overreaction to the sky.

Whatever the story one can devise, the main message of this paper remains: overreaction or not, the movements of the exchange rate of the dollar are *prima facie* contributing to the stabilisation of the American economy, but those of the exchange rate of the euro – whether bilateral or effective – are rather destabilising for the European economy.

It is as if, absent an exchange rate policy of the euro area, the movements of the exchange rate of the euro are simply the reflection of the exchange rate policies of the rest of the world, and thus cant correspond generally to the needs of the European economy.

In a nutshell, the story goes as follows: internal demand seems to have gained strength during the year 2003 in the US and in Asia, and to have faltered in Europe, possibly because the appreciation of the Euro in 2002 (this is of course a relative statement). This should have been twice beneficial for Europe, as it implies that the increase in external demand for European products is magnified by an appreciation of the currencies of the rest of the world. But in actuality, the euro has appreciated which has contributed to dampen the strength of external demand.

An alternative assumption is that the appreciation of the euro was simply reflecting the perception that Europe is a better place to invest relative to the rest of the world. But that would have implied at least two things: a bigger increase in asset prices in Europe relative say to the US, (and correspondingly a bigger decrease in long term interest rates); an increase in investment. But the converse was true: asset prices did increase more in the US than in Europe; total investment increased by about 3% in the US (4% in Japan) and *decreased* by 1% in the euro area.

Interest rates

Past appreciation of the euro thus does not seem to have had the expected effect on long term interest rates and on bond prices. The interest rates did decrease but less than in the US as it is apparent in graph 3. The increase in the yields of euro area public bonds in the second semester of 2003 may reflect more optimistic expectations about future growth. The future course of bond prices and yields depends, *ceteris paribus*, on expectations about the appreciation of the Euro – the expectation of the continuation of the depreciation of the dollar should have a depressing effect on yields – and about future growth which should, on the contrary, lead to an increase in long term interest rates.

As is well documented (cf. e.g. the briefing papers of November 2003 of Gustave A. Horn and Charles Wyplosz), the appreciation of a currency – when it is not itself the consequence of a buoyant internal demand – should have a depressing effect on output and on inflation. The evaluation of these effects varies according to the methods used – a 10% appreciation reducing after one year the rate of growth between a quarter of a point and a point, and the rate of inflation between a fifth of a point and half of a point – but their existence is not in doubt. On both account (using a normal monetary policy rule) it should lead the ECB to lower the interest rate.

One may object to this recommendation, that if the effects on output did show up, those on the inflation rate were very hard to detect. Furthermore, as the mandate of the ECB is mainly price stability (interpreted as a rate of inflation near from below to 2%), the ECB was right not to react to the appreciation of the Euro. But this argument is missing a point, an important point: at low level of inflation (and by all means 2% is a low level of inflation especially when one takes into account the numerous price shocks which have characterised the recent period), nominal rigidities imply that negative price shocks do not show up in the rate of inflation. In other words, the curve depicting the trade-off between say unemployment and inflation becomes flat over a considerable range. And it is of interest to emphasize that the work of the Commission has shown that nominal rigidities is not a distinctive feature of the European economy, as its degree is not different from that of the US economy. Besides, on normal expectations, it is likely that the return of growth in Europe will have a disinflationary effect. That is due to the fact that the European economy is operating since some years already at a very slow path of increase of productivity, an abnormally slow path. It is more than a conjecture, a quasi certainty, that an increase in economic activity will be accompanied by an increase in the rate of growth of labour productivity. Together with wage moderation – which is almost a structural feature of the European economy – that will lead to a pronounced decrease in unit labour costs.

On all accounts – the appreciation of the euro, the pathological evolution of labour productivity, wage moderation and the deepening of the output gap – time has come for the ECB to cut the interest rate.