Reasons for the Weak Euro

In the transatlantic rivalry between the euro and the dollar, the ECB and the Federal Reserve, Wim Duisenberg and Alan Greenspan, the Europeans have come off the worse so far. With only a few short periods of respite, the euro's exchange rate has fallen steadily ever since it began trading on 4th January 1999, by a total of 27%. There are no convincing signs yet that the currency will buck this trend. Even if the European Central Bank has always argued cogently that its task is solely to. safeguard the euro's internal value (i.e. to prevent price inflation) and not to stabilize its external one (the exchange rate), it remains a truism that a currency's exchange rate is a yardstick for the confidence international investors, and those at home, place in the economic zone it represents, and also for the reputation enjoyed by its central bank. In its short life, the ECB evidently has not yet managed to build up the kind of reputation that has long been held by the Fed and its Chairman, Alan Greenspan.

However, it is also quite clear that the ECB is not the prime culprit as regards the weak euro, which actually has many different causes. Indeed, the central bank has made a good fist of performing the task assigned to it under the Treaty of Maastricht, namely "to maintain price stability". It has never left any room for doubt that it will pursue this objective with determination, and it has taken the necessary measures to do so. Taking the euro zone as a whole and bearing in mind the difficult environment, with the tripling of the oil price, the ECB has operated with great success, evenjf one has to admit that price level stability has not been achieved in all of the EMU participating countries (which was not to be expected anyway), and also that the foundations for today's low inflation had already been laid before the ECB's time.

Where the ECB does have a problem, though, is in convincingly putting across its monetary-policy strategy to the general public. It has not always been clear how the Bank has assigned its decision-making priorities between the two policy "pillars" of money supply growth and price stability, and it disregarded strong money supply growth for a long period without giving a compelling explanation. Alan Greenspan himself may not excel in justifying the Fed's monetary policy either, but he does not really need to, given the Fed's and the US economy's long run of success. The ECB, though, has an additional public-relations problem in the sheer size of its decision-making body. With 17 members sitting on the ECB Governing Council (and on subordinate bodies such as Germany's Central Bank Council, which has 15), it is small wonder that differing public interpretations are put on the ECB's strategy, and these do not help the process of conveying a clear line in monetary policy.

Moreover, the ECB currently faces an interest-rate dilemma. On the one hand, any increase in rates will always tend to retard the growth of the money supply and to dampen down the knock-on effects as oil price rises and the impact of devaluation feed through into domestic prices and wages. On the other, a rise could hurt Euroland's economic dynamism, which in any case falls well short of the United States' (with projected GDP growth of 3.5% as against 5.2% for the USA). This is what a lot of market participants apparently fear. To whatever extent the euro is weak due to the growth differential vis-a-vis the United States rather than the interest-rate differential, any measures that threaten to widen that gap will

only put the exchange rate under even more pressure. In other words, whatever the ECB does is liable to be considered the wrong thing by the markets.

There are other factors manifesting themselves in the weak euro too, such as ineffective decision-making in European foreign policy and home affairs, and the lack of a common economic policy. Many investors still find it hard to accept that a common currency zone can still work even if it is not backed up by centrally managed economic policies, or indeed that a uniform economic policy would probably prove counter-productive, given the different levels of development in European economies. They search in vain for a "Mister Euro" who could control European economic policy and convey coherent and understandable messages to the public. Anyone looking in on Europe from the outside sees a colourful patchwork of national measures and opinions, and sees European economic data given much less prominence than national ones, partly because they take so much longer to compile. So investing money in Euroland means putting up with higher information costs than investors in America have to pay. This deficiency is not one that can be eliminated in the foreseeable future. While it hampers the euro's recovery, it does not rule it out, however.

If the finance ministers' "Euro-12 Group" worked properly, there would be a lot it could do to provide visible backing for the ECB's policy stance. Yet the approach taken by this group so far - or at least by some participants - makes it more liable to arouse distrust and to paint a still stronger picture of European disunity. Although cooperation between monetary and fiscal policy should be the order of the day, the ministers in the Euro-12 Group tend to see their role primarily as a "counterweight" to a central bank that has done its job well so far. Instead of focusing on their own tasks of fiscal stabilization and encouraging growth, they are thinking out loud about dictating an inflation target to the ECB. Quite apart from the fact that there is no need for it, this would be in breach of the Maastricht Treaty.

It is not as if there were a shortage of tasks for a coordinated European fiscal and economic policy. For example, the rapid growth in Europe's "tiger economies", on occasion fuelled further by fiscal policy, has substantially increased upward pressure on prices in those countries, which the ECB alone is powerless to control. Meanwhile in Germany and Italy (and other countries besides) there are still many structural reforms to catch up with, in order to stimulate investment and reduce unemployment, more effectively. This would offer the Euro-12 council a rich, useful field of activity to develop a coordinated policy, lending sustained support to growth in the euro zone. But of course, these are rougher, more arduous paths than publicly skirmishing with the ECB, or speculating hopefully that the American economic boom may soon end.

Because economic trends in Europe continue to be rather heterogeneous and information costs are high, market participants keep a close watch on Germany, the euro zone's largest economy. By enacting the tax reform package, the federal government has taken a key step to reducing the burden on both businesses and households without exposing public-sector budgets to new risks. This has definitely improved the investment climate, and deserves every drop of recognition. Nevertheless, it is still not enough. Chancellor Gerhard Schroder declared while taking stock of his first half-term in office that, once this and the pension reform currently in the making were completed, there would be no need for further reforms in the current legislative period. Remarks such as these are quite liable to neutralize the desired positive impact of the measures on the German economy. The convoluted efforts to establish a consensus with the parliamentary opposition and the trade unions on the pensions issue, even though the government could go it alone if it wished, the announcement that shop opening hours will remain legally restricted (a symbol of German economic sclerosis), plans for new forms of regulation in the labour market, the chancellor saying he is "pleased" that the euro is weak: all of these things send signals to investors both at home and abroad that their money continues to be more profitably placed in North America than in the Old World. Without the support of bold policies for sustainable high growth the success of the recent coordinated intervention is likely to be short-lived.

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