The Euro - Cause for Concern?

Since its first day of trading on 4 January 1999 the euro's exchange rate - until very recently - did nothing but fall, except for some short breaks. By mid-July it had already lost a seventh of its initial external value of 1.1789 dollars and at an exchange rate of 1.0124 (on 12. 7.99) it was hovering around the 'magical' mark of 1:1. Against sterling, the yen, the Swedish and the Norwegian crowns, the Canadian, Australian and New Zealand dollars too, the euro went down - in some cases quite considerably. Its effective exchange rate in the same period dropped by 8 per cent. This was not the result of a 'strong dollar'; we were clearly dealing with a weak euro. Its rate, however, recovered to 1.0621 on 27 July. Some observers even expect the euro to reach 1.10 dollars in the near future.

Except for its exchange rate, the euro was, and is, by no means weak, of course. At one per cent, the rate of inflation in Euroland is low and there are no signs that it is getting out of European Central Bank (ECB) control. As the euro rate fell import prices rose, but with an import share from third countries of only 16 per cent of GDP, this influence is limited and in the present economic climate prices can be passed on for raw materials only (particularly mineral oil and natural gas). Nor was there an inflationary influence coming from export prices - pressure of competition from Asia places narrow limits on higher prices in exports. So there is no current danger of imported inflation. We can also see this in the level of euro interest rates. Till recently, there has been a steady decline in short-term and long-term interest rates and they are still at historical lows, despite the latest turnaround. The European share, bond, derivatives and money markets are converging under the euro and developing dynamically. And finally the ECB has demonstrated determination and independence in disputes with governments over interest rates and exchange-rate goals; the Bank board speaks with one voice.

Does the down and up of the euro give cause for concern and should the monetary authorities therefore intervene on the foreign exchange market? First, let us recall that just over a year ago, in early April 1998, the D-mark, the leading currency and benchmark of the European Monetary System, was quoted at 1.85 against the dollar, very close to today's rate. We should also recall that market players can change their minds quickly: only six months after its low, in mid-October 1998, the D-mark had risen by 13 per cent to 1.62 - with only a slight narrowing of the interest rate differential to the USA. This kind of exchange rate recovery is also possible now, especially as euro interest rates are climbing again. Like all prices on an effective market, the exchange rate is subject to fluctuations, which in and of themselves give no grounds for concern or for activist policy interventions.

Unlike the prices of single goods or financial titles, though, the exchange rate as a link between price levels at home and abroad has macroeconomic implications. Its level and variation influence the attractiveness of a country or economic area as an investment location, bear upon returns on investment in industries exposed to international competition (export industries as well as industries competing with imports), affect exports and imports and hence employment and via the terms of trade decide on the relative real income and wealth position of a monetary area as compared with other regions. This explains the interest of economic policy-makers but also the interest of academic economists in the direction and speed of exchange-rate trends, in short-term exchange-rate fluctuations and medium-term misalignments.

From this standpoint, too, there was, and is, no discernible reason for activist interventions on the foreign exchange markets. Firstly, there has been no cause for them, and secondly, they would not work in the long term, which is why the ECB has rightly withstood all demands to that end, and the recent upswing proves that policy right. There has been no cause, since the positive employment and growth effects in the present economic climate far outweigh any possible adverse inflationary trends. The relative weakness of the euro - also against the currencies of East Asian countries - buffered the quantity effects on production and employment of price offensives by Far Eastern suppliers. It rechannelled a part of the export flows from this region to countries better able to cope with external shocks thanks to their more adaptable labour markets. To a certain degree therefore, the euro's downward flexibility offset the internal rigidity of the euro countries. In this way it mitigated short-term pressure on businesses and economies to adapt - admittedly without being able to obviate the need for long-term internal structural reform.

Exchange market intervention would not work for one thing because the euro's exchange rate reflects present and expected interest rate differentials, primarily against the dollar and the pound sterling. The cut in interest rates by the ECB in mid-April and the Fed's increase in dollar interest rates has widened the interest rate gap once again. If exchange-rate policy action were required afcall, the interest-rate policy of the ECB is where measures should be taken. The recent recovery of the euro indicates that the market players reckon with such a step after relevant hints by ECB president Duisenberg.

For another thing, though, the weak euro also reflected sins of omission in budgetary consolidation by some euro member states and sluggish economic growth in Europe. The ECB has rightly pointed out the risk that major participating countries of the European Monetary Union (EMU) could grow lax in their fiscal consolidation efforts. More strongly than feared by opponents of the stability pact, opportunistic national interests had an effect on the euro. Germany too, the leading economy in the euro area, sent worrying financial policy signals in the first months of the Schroder government and it took some time for the shift in budget policy by the new finance minister Eichel to allay the fears. This policy turn, if credible, should continue to positively affect the euro; but it will need support from the other euro-11 governments.

This also holds for general economic policy. Amongst the members of EMU, the best performers regarding economic reform and sustained economic growth so far have primarily been the smaller and peripheral countries. Outside the euro bloc, the United Kingdom demonstrates that economic growth can be sustained even with high exchange rates and high interest rates. In contrast, euro core countries such as Germany and France have stood out more for their reform backlog, inflexibility of wages and salaries and low rates of expansion. There are signs of a policy reversal in Germany here too, which might prompt rethinking as regards economic policy in France as well. This should make for a lasting improvement in the climate for growth in the.euro monetary area. Even in the short term, the incipient economic recovery indicates that Europe may catch up with the pace of economic expansion in the USA.

These developments could result in a further upturn in the external value of the euro without impairing growth and employment. This, however, places demands on financial and economic policymakers in all the euro countries. A weak euro is no substitute for economic reform.

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