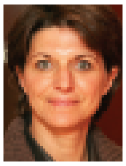
Appreciating the euro



VÉRONIQUE RICHES-FLORES EXPLAINS WHY THE RISE OF THE EURO MATTERS.

Executive summary

- Apart from the grumblings of a few politicians, most European commentators have been remarkably sanguine about the rise to new heights of the euro. But a close look at the situation shows the damage a strong euro does to the global competitiveness of the euro zone economies. A strong euro makes it hard to take advantage of the global boom, and even if it wants to there is little the European Central Bank can do about it.

After more than half a decade of rises, the recent highs reached by Europe's single currency do not seem to worry the economic community. There are a few complaints, mainly from politicians, but most observers regard the impact of the currency appreciation as muted, with little effect on economic growth.

Economic data has not contradicted this conclusion so far. Euro zone growth remains dynamic and is likely significantly to exceed its potential again this year. A number of observers also point out that, despite the historically high levels the euro has reached against the dollar, the average exchange rate of the currency against a larger basket of currencies (the so-called effective exchange rate) points to a much more limited appreciation. This summer, the index levelled off just shy of the highs seen in spring 2005.

Why then are we more worried than the consensus? Let us recap on the major reasons for concern prompted by the structural rise of the euro currency.

THE SHORTFALL IN EXPORT REALITY The euro/dollar exchange rate is the general focus of much attention, but the real problem may lie elsewhere. Although at historical highs, the €/$ level is not far from past peaks regularly reached, and not that far from its long-term average. The recent rise of the €/$ does not seem to have induced dramatic changes on euro zone activity or competitiveness.

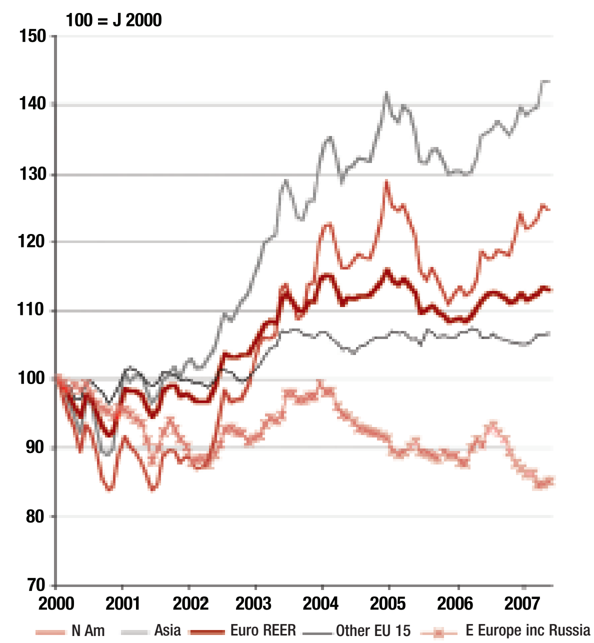
The trend of the euro versus Asian currencies is another story. In real terms the euro has climbed by more than 50% versus the Japanese yen since 2002 (63% since 2001), and a similar situation has occurred versus the Chinese yuan. Despite a slower upward movement towards the Asian NICs (the newly industrialising countries – Korea, Taiwan, Hong Kong and Singapore) over the past two years, the average exchange rate of the euro versus a basket including the yen, yuan and eight main regional currencies indicates 36% appreciation in real terms since 2002 (39% since 2001). That is much greater than the total effective exchange rate (20%).

WIDENING COMPETITIVE GAP This long-lasting and spectacular trend has played a key role in the widening of the competitive gap between the euro zone and exporters from the rest of the world, both in Asia and outside. Since 2002, the real exchange rate of the dollar against Asian countries has remained virtually unchanged while the yen, which trended stable up to 2004, has since fallen by more than 20%. European exporters have not only lost competitiveness against Asian competitors, they have also lost heavily in their relative competitive position against other trade partners on Asian markets.

As the world's leading exporter of manufactured goods, Europe has paid a high price for the breakthrough of Asian goods into the world market. Estimating the shortfall in exports from more than five years of euro appreciation gives us impressive numbers. Foreign exchange movements account for nearly half the export performance of Economic and Monetary Union (EMU) countries, with the other half attributable to trends in international demand. This lets us estimate the cumulative loss in exports linked to the exchange rate appreciation since 2002. The result is that the market shares of French, Italian and Spanish exporters have shrunk by no less than 20%, while German exporters have lost 15%. On average, annual losses in export momentum would then account for 4% or 3%, respectively – almost the exact slowdown registered on export growth in recent years in comparison with their past long-term trends.

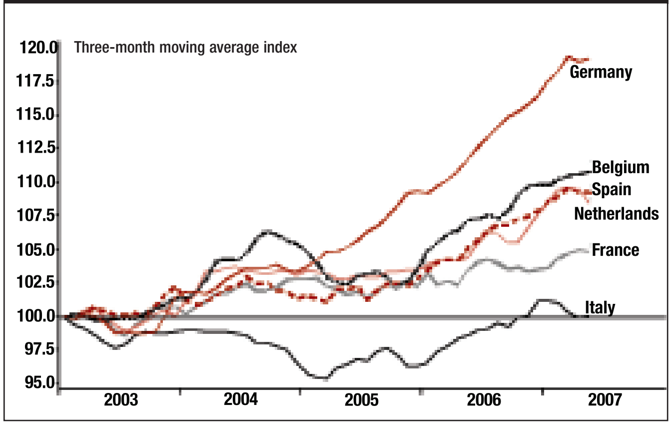
SUBSTANTIAL DISTORTIONS The degree of sensitivity to euro appreciation varies considerably between euro zone countries. Countries with high specialisation in the production of capital goods have largely benefited from the exceptional bounce in demand from

Figure 1. Real euro exchange rate



Source: SG Economics

Figure 2. Industry output excluding construction



emerging countries and appear far less sensitive to the exchange rate than others in recent years. Machinery and transport equipment alone counts for 40% of world demand for goods – a factor that has made German exporters significantly less sensitive to exchange rate fluctuations than other EMU exporters.

Actually, 45% of German exports consist of capital goods, a sector in which German exporters have kept a comfortable pricing power in recent years despite the surge in the euro. Other countries that are far less specialised in this sector appear to be much more exposed to the negative impact of the exchange rate appreciation.

This variation in the degree of sensitivity has been an essential factor behind increasing manufacturing gaps within euro zone countries in recent years (see *Figure 2*). There is a high correlation between the degree of divergence in industry output between Germany and the other EMU countries and the exchange rate fluctuation. Recent trends hardly contradict this observation: divergence within the EMU is on the rise and will very likely increase again in the second half of the year.

Overall, the strength of the euro is certainly to blame for a significant portion of the underperformance of euro zone exports and its inability to benefit from the boom in the global economy. Add to this the cost of intra-EMU distortions on the efficiency of economic policies and the economic cost of accelerating delocalisation, and the euro's appreciation is most likely responsible for a large part of the lacklustre state of productive investment, and, all told, the relative decline in euro zone economic growth in recent years.

Backtracking is difficult. The renewed rise in the euro has been almost exclusively driven by interest rate differentials. Going against the prevailing wind would require the European Central Bank (ECB) to downplay domestic factors that lead it to continue to tighten its monetary conditions while other major central banks are in a mood to pause on rate rises. In today's economic context, this trend would probably be viewed as a major risk in the light of its statutory mandate of maintaining price stability. In reality, the ECB's room for manoeuvre to counter the euro appreciation appears quite limited. The real problems are obviously linked to the Asian exchange rate policies and the structural fragility of the US dollar.

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