The strength of the Euro

IN-DEPTH ANALYSIS

Abstract
This paper discusses the challenges of euro-area monetary policy in the current macroeconomic environment of subdued growth, very low inflation and featuring at the same time a strong currency. The paper argues that ECB monetary policy should focus on the internal monetary policy objective, that is the ECB should stick to its primary mandate of ensuring price stability for the euro area as a whole. The exchange rate of the Euro is not a policy target of the European Central Bank and the use of the monetary policy toolkit to address the external target is not risk-free.
This document was requested by the European Parliament’s Committee on Economic and Monetary Affairs.

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Manuscript completed in June 2014
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1. INTRODUCTION

This paper discusses some of the policy challenges posed by the rise of the Euro exchange rate both in trade-weighted terms and against the Dollar. To put the issue in perspective, Figure 1 plots the evolution of the Euro-Dollar exchange rate since the inception of the Euro (top panel) as well as the difference in policy interest rates (bottom panel), as the discussion on the equilibrium exchange rate is often framed in the context of interest rate parity theory.\(^1\) The graph shows the evolution of the difference between the euro-area policy rate and the Federal Funds rate. Over the last few years the difference was positive i.e. the euro-area policy rate was higher than the Federal Funds rate. Lately, due to further easing by the ECB, the two policy rates have been converging and both are now approaching the zero lower bound.

The top panel supports the notion that the Euro has appreciated recently, but also shows that the Euro has known several higher peaks in the past decade. The appreciation of the Euro is a topic of discussion because a strong Euro makes exports relatively more expensive than imports, thus adversely affecting the economic recovery in the Euro area. Many observers believed that the economic recovery in the US and the monetary policy choices of the European Central Bank would have contributed to weaken the Euro in 2014. In contrast, a combination of increasing investor confidence and current account surpluses led to a further strengthening of the euro-area currency.

This paper starts by reviewing some theoretical considerations on the conduct of exchange rate policies. Subsequently, it discusses the evolution of euro-area inflation in the current context of a strong currency and near absence of growth. It concludes with a brief assessment and some recommendations for current monetary policy.

\(^1\) The interest parity theory states that interest rate differentials between two different currencies will be reflected in the premium or discount for the forward exchange rate on the foreign currency if there is no arbitrage. Interest rate parity is a no-arbitrage condition representing an equilibrium state under which investors will be indifferent to interest rates (returns) available in two countries. In the next section we discuss this further when reviewing some aspects of this theory.
Figure 1: Evolution of the Euro-Dollar Exchange rate and of the difference in policy rates

Source: Author’s elaborations. Data was obtained from the European Central Bank and Eurostat.
2. EXCHANGE RATE POLICIES

The Euro has appreciated substantially in 2014 both vis-à-vis the Dollar and in trade-weighted terms. At the time of writing, the Euro is at its highest level against the Dollar since the summer of 2011. As discussed later in this paper, there are good arguments supporting a more tempered Euro. But before entering the discussion on exchange rate policy, it may be useful to frame exchange rate policy in the context of European Central Bank (ECB) mandate for price stability.

The ECB can influence the exchange rate of the Euro against any third currency either via foreign exchange interventions (coordinated or not) and/or via adjustments of domestic money market interest rates. The theory of interest rate parity suggests that an increase in the domestic money market interest rate relative to foreign money market interest rates results in an appreciation of the domestic currency. Likewise then, a decrease of the domestic money market rates weakens the domestic currency. It is well known that the domestic money market interest rate is a target for the ECB policy rate. Hence, using the domestic money market interest rate as a policy instrument may result in a possible conflict between external and domestic monetary policy objectives. Table 1 provides an overview of different situations which may arise.

Table 1: Overview of different situations:

<table>
<thead>
<tr>
<th>Conflicts between the ECB’s Internal and External Monetary Policies</th>
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<tbody>
<tr>
<td><strong>Internal / External</strong></td>
</tr>
<tr>
<td>ECB’s restrictive money supply policy (overshooting of target and/or expected inflation)</td>
</tr>
<tr>
<td>ECB’s expansionary money supply policy (undershooting of target and/or expected inflation)</td>
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Domestic monetary policy refers to the policy aimed at influencing money growth and lending to the economy through the money market interest rates. By reducing or augmenting policy rates, the ECB is affecting money supply and demand for credit, thus shaping the structure of market interest rates.

Table 1 indicates that in two of the four situations considered, a conflict between domestic and external objectives may arise.
Given that the primary objective of the ECB is price stability\(^2\) (internal monetary policy objective), the possibility and the economic consequences of a conflict with the external objective shall always be properly assessed.

In the current environment of very subdued growth and too low inflation\(^3\), the monetary toolkit could in principle be used to weaken the currency. Thus would seem to catch two birds with one stone: supporting growth and at the same time safeguarding both the domestic and the external monetary policy objectives (see bottom-right panel in table 1).

Before assessing the pros and cons of the monetary policy toolkit under such circumstances, it is worth to take a look at the data on inflation and interest rates in the Euro area.

\(^2\) See article 2 of the statute of the ECB.

3. CURRENT SITUATION

There is a broad consensus that inflation in the Euro area is currently (excessively) low. This is confirmed by Figure 2, which presents headline inflation rates in the Euro area and in selected Euro-area countries since 1999.

**Figure 2: Headline inflation in the euro area and selected Euro-area countries**

![Inflation graphs for Germany, Eurozone, Austria, Greece, France, Italy, Netherlands, Spain](image)

*Source:* Author’s elaborations. Data was obtained from Eurostat.

The left column of Table 1 depicts the evolution of headline inflation in Germany, Austria, France and the Netherlands, traditionally considered the core of the Euro zone. The right column depicts the evolution of headline inflation for the Euro area as a whole as well as in selected Southern Euro-area countries. The country-specific graphs show that inflation has
been trending down recently in all regions considered. In the euro area, inflation is currently averaging around ½ pp., thus significantly below the ECB target of "below, but close to 2%, over the medium term". This reflects inflation rates below their historical average in most individual countries. There are, however, important cross-country differences. Inflation has dropped more strongly in the peripheral countries. Main reasons are quite well known and have been laid out by ECB president Mario Draghi in a recent speech. Two key factors explaining low euro-area wide inflation are the fall in import prices as a result of the strength of the Euro and the improved competitiveness (in terms of relative price-cost adjustment) of peripheral countries. What is perhaps less well known is that the very low level of inflation in core Euro-area countries is - to some extent - hampering a larger (and beneficial) price-cost adjustment process in peripheral countries. It is important to keep this distinction between common factors (the currency) and country-specific elements in mind when assessing the appropriate response in terms of euro-area monetary policy.

A qualification is also in order regarding the (best) target for inflation. When discussing inflation in a policy context, the medium term should be the correct and relevant timing horizon. Accordingly, core inflation rather than headline inflation is the appropriate aggregate price index to be monitored. Indeed, core inflation excludes the volatile (short-term) components of energy and unprocessed food from the overall price index (headline inflation). Figure 3 depicts the series for core inflation (black line) as well as headline inflation (round circles) in the euro area since 1999. Currently, not only is core inflation higher than headline inflation but, more importantly, the underlying trends point in different directions: headline inflation is still decelerating, while core inflation appears to have bottomed up. From the perspective of ECB policy objectives, core (i.e. medium-term) recent inflation numbers seem to be somewhat less worrying than headline figures.

**Figure 3: Headline inflation (circles) and core inflation (black line)**

![Graph showing headline and core inflation](image)

**Source:** Author’s elaborations. Data was obtained from the European Central Bank and Eurostat.
Short-term nominal interest rates are central banks' key policy targets. However, agents' decisions to spend and save are affected by real rather than nominal interest rates. The real interest rate is defined as the nominal interest rates corrected for inflation (or expected inflation). Figure 4 shows the evolution of the (short-term) real interest rate\(^4\) in the euro area since 1999. In normal times, the real interest rate is positive, reflecting the premium for postponing consumption. The real interest rate tends to move in tandem with the business cycle. During the current "great recession" the real interest has been mostly into negative territory and even resumed a downward trend over the last year or so. A negative real interest rate lasting over a prolonged period of time is an undesirable feature for an economy. Such a situation is often qualified as one of financial repression, with adverse effects on savings and relevant challenges for monetary policy.

**Figure 4: Real Short Term Interest Rate**

![Figure 4: Real Short Term Interest Rate](image)

**Source:** Author's elaborations. Data was obtained from the European Central Bank and Eurostat.

\(^4\) The following Fisher identity is used to calculate the real interest rate \(r\): \(r = \frac{(1+i)/(1+Pi) - 1}{100}\) where \(i\) the Euro-area policy rate and \(Pi\) the inflation rate. We used observed headline inflation instead of expected inflation.
4. POLICY

From the previous discussion it may be argued that in the current economic circumstances the monetary policy toolkit could successfully address the issue represented by the (excessive) strength of the Euro. Indeed, the combination of low growth and low inflation allows monetary authorities to pursue simultaneously the external and the domestic policy objective. Some euro-area countries are even experiencing negative growth and (close to) falling prices (deflation). An expansionary monetary policy appears to be the appropriate policy response. Risks, however, are not absent. Two are worth mentioning: First, as the timing of the turnaround of the current economic cycle remains highly uncertain, it is particularly difficult at his juncture to assess the financial stability and ensuing risks for (too loose) monetary policy; Second, the impact on the euro area economy of an early tapering by the Fed also remains highly uncertain, but, in a globalized financial system, ECB policy-reaction function must take this into account. It cannot therefore be excluded that the domestic objective calls for a more restrictive monetary policy before any progress on the external objective (i.e. the excessive strength of the Euro) is achieved. To keep pursuing the external objective in such circumstances must be the result of a comprehensive assessment of the different factors behind the (too) low inflation rates in the Euro area, including the price (cost) effects of the strong euro on the euro-area trade balance as compared to demand effects.

In this comprehensive assessment, country-specific factors may also play a role. In the speech mentioned above, Mario Draghi recognized the progress made in terms of cross-country adjustments in recent years. However, it also pointed out that significant differences in the business cycles of the various euro-area economies make the task of ECB particularly difficult as the single monetary policy cannot address country-specific shocks. National factors still impeding a sustainable growth path in peripheral countries need to be tackled and solved by the (national) policy makers, through painful budgetary and structural reforms. In this perspective, the current very accommodative stance of ECB monetary policy may actually give the wrong signal in terms of policy responsibility and commitment to reforms in the periphery.

Some northern euro-area countries may have room for fiscal stimulus, including Germany. A fiscal stimulus from these countries may prove all the more useful in the current situation where the effectiveness of monetary policy is constrained by policy rates being close to the zero lower bound. Countries with large trade surpluses (notably Germany) could think boosting consumption and domestic demand with significant positive spillover growth effects on the rest of the euro area. The southern euro-area countries, on the other hand, have limited choices, but to continue on the disinflation path to regain competitiveness. When fiscally feasible, tax cuts focused on low and middle incomes as well as jointly (public-private) financed investment projects may help growth in the periphery.

Resuming growth in the Euro area is a policy imperative. In the current economic circumstances there appears to be room for monetary policy to weaken the currency, thereby spurring growth. Economists should however keep in mind the lesson of Tinbergen: different (independent) targets should be addressed by different (independent) instruments. In this regards, the paper warns about using expansionary monetary policy for goals which fall outside of the ECB key mandate of price stability.
5. CONCLUSION

This paper has discussed whether it is advisable for ECB monetary policy to affect the level of the Euro in the current macroeconomic conditions of low growth and low inflation. The paper briefly assessed the pros and cons and concluded with reservations for the ECB to use such an option. The main reservation stems from the fact that the ECB primary mandate is to guarantee price stability (domestic monetary policy objective). And at the current juncture, jointly assessing the business cycle position of an economy and its financial stability conditions is a daunting task; those conditions may suddenly change, impeding in the near future the use of monetary policy for the external objective without breaching the ECB primary mandate. Moreover, by engaging in external monetary policy, the ECB might be easing the pressure on political leaders in various European countries to pursue the necessary structural reforms. The process of disinflation in the southern countries is painful and is likely to remain so for quite a while. There is no easy way out. While a cheaper Euro would help to resume growth both in the periphery and the euro-area as a whole, the level of the Euro shall not be considered a policy target by the ECB.
REFERENCES
