Europe EconoMonitor

Again on the strong euro. Present costs vs. future benefits: Towards a World Euro Area?

Roberto Tamborini | Apr 1, 2008

In his post on March 24th http://blog.rgemonitor.com/euro-blog/2008/03/24/beware-of-false-arguments-the-strong-euro-will-hurt/, S. Dullien warns against "false arguments" about the effects of the strong euro: it will eventually hurt the German economy, let alone the other European economies. Dullien argues with the "no-problem" view put forward by the FT Deutschland "and other papers". In a previous post, S. Guillou, S. Schiavo, and myself http://blog.rgemonitor.com/euro-blog/2008/02/07/the-threats-of-the-strong-euro-real-and-imagined/ concluded that the balance between the real and imagined threats of the strong euro is, to say the least, uncertain, and that the real costs are probably less heavy than it is feared by the public opinion. Which does not mean that there are no problems or that these are "Gute Zeiten" (good times) as claimed by the FTD page criticized by Dullien.

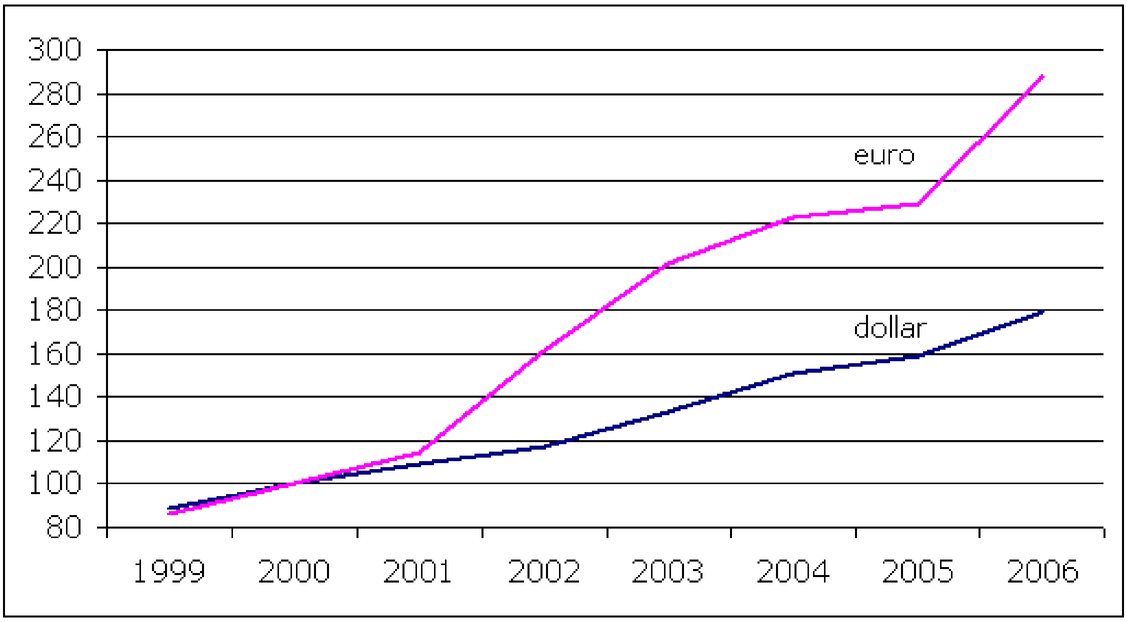
However harmful the strong euro may be, the true question is what (if anything) can be done in the interest of the euro-area (EA) countries. In this perspective, a different approach is needed. One that compares the (possible) present costs of the strong euro with its (possible) *future* benefits. The latter are much less discussed and perceived outside academic circles to the detriment of a balanced assessment of the EA future prospects.

In the first place, a premise of realism is necessary. The fate of the euro-dollar exchange rate is largely out of reach of central banks' powers: it is, and will be, dictated by fundamentals (the US external position) and the way in which global markets will read them and translate them into capital movements. As an anonymous replied to Dullien, "we are talking about a weak USD, not about a strong euro". Hence, the reasonable question is not whether the ECB could or should stop, let alone invert, the euro appreciation pace, but how a sensible policy may accompany this process so that threaths are transformed into opportunities for the EA.

In this perspective, the typical starting point of discussion is the potential of the euro as a global currency. A global currency is accepted worldwide as it provides the two fundamental services of money - means of payment and store of value - outside its national boundaries. Since its inception, the euro has been under observation as a challenger of the dollar as global currency. The composition of the world official reserves from 1999 to 2006 (IMF data) tells us that the dollar share fell from 55% to 43%, while the euro share rose from 14% to 17%. News and rumours say that in 2007 the process of substitution has been going on, though not a dramatic pace. The point, however, is how central banks will react to *consolidation of expectations* of *large* dollar depreciation ahead.

Currency depreciation means capital losses to foreign holders, that is to say, a poor service of the currency as store of value. The opposite occurs to the appreciating currency. To grasp the dimension of the phenomenon *to date*, we have elaborated the simple data in figure 1. It reports the *effective value* of world reserves in euros and dollars, that is, their nominal value in the respective currencies weighed by their nominal effective exchange rate. Roughly, this index yields a measure of the "purchasing power" of stocks of reserves denominated in different currencies *vis-à-vis* all other currencies (on the assumption that official reserves are held not to buy goods but to be exchanged for foreign currencies). The figure, we think, gives a vivid picture of the overwhelming performance of the euro as store of value. Now, if central bankers around the world project this performance into the future, as all reasonable scenarios suggest, it is likely that their willingness to hold dollars will decline further and further in favour of the euro. The same reaction may also spread among private holders (such as international commodity traders etc.) Being a reliable store of value is a necessary condition for a currency to be largely accepted in exchanges too. In other words, there are by now good chances that the euro may become a serious alternative to the dollar as a global currency.

Figure 1. Effective value of stocks of official reserves, 2000 = 100



The next issue is whether this is a valuable opportunity to the EA countries, an opportunity that is worth the present costs of the strong euro. Answers to this question trespass the boundaries of pure economics into the domains of history and politics. History provides two major examples of global-currency countries: Great Britain during the gold standard regime, and the US ever since World War II. Here we cannot dwell on the pros and cons of these complex experiences, but the attitude of Continental Europe towards them is perhaps best captured by Charles De Gaulle's famous sentence against the US "extravagant privilege". The privilege was of course that the US could ignore the balance-of-payments constraint to a large extent and for a long time, which first and foremost meant free hands to pursue domestic policies and interests in an open economy as if it were a closed one, without loosing the status of pivot of the international system. This state of affairs was particularly enjoyable under the straitjacket of fixed exchange-rate regimes (as it was the case with Great Britain, and the US until 1971), but it may also be valuable in a floating regime (as the present experience of the US shows) to the extent that it rescues the global currency from depreciating as much as, and as fast as, it would be necessary to correct the external imbalances. Is it not puzzling that now that history offers Continental Europe the long dreamed "extravagant privilege" nobody seems ready to seize it?

One possible explanation is that the main EA economies are structurally export oriented. Hence they are more interested in fostering their external competitiveness than in the privilege of expanding domestic absorption and neglecting external imbalances. This explanation is reinforced by the fact that the EA is not a single economy with a single government able to steer domestic aggregate demand and the exchange-rate policy in a coordinated way. These reasons have a grain of truth, but they are based on a biased premise: the US model of global-currency country leaving beyond the nation's means. History, if not theory, suggests that this is not the only possible model for a global-currency country. Great Britain in her heyday testifies just the opposite, namely that being the issuer of the global currency may accrue large benefits to a country whose best industries are export oriented and which structurally has excess resources to be allocated worldwide. What are these benefits?

1. Having a global currency allows for a strategy of "competitive stability" of the exchange rate *vis-à-vis* other global players. This is pursued by creating a network of countries whose exchange-rates are anchored to the global currency, and where it is used in foreign exchanges. The anchor of the area *need not be appreciating permanently* relative to other global currencies, but just act as a reliable store of value. The more other currencies are unstable or sunk in uncertainty, the more this strategy is valuable and effective

2. In fact, it is well-known that the real threat to long-run competitiveness of the export industry is not a high *level* of the exchange rate but its *variability*. It is exchange-rate *uncertainty* that undermines competitive strategies of export businesses. Competitive stability fosters long-run investment in the export sectors while tying up trade relationships to the benefit of both sellers and buyers

3. By and large the same considerations apply to domestic producers, too, who find a stable competitive environment *vis-à-vis* foreign exporter. Strong and stable trade relationships are also the premise to enlarge FDIs, and foreign investments in general, that are the natural complement to trade surpluses and excess domestic savings. Investments abroad are also the means whereby the global currency is re-circulated towards external users as long as the core country runs current account surpluses.

Our idea is that the EA should look at the creation of a WEA as an opportunity in the spirit of the competitive stability strategy sketched above. This long-run aim requires an attitude of the ECB that is "neutral" towards appreciation just as necessary to let the euro find its way as the international currency, at least in the area of EA's strategic trade partners (in particular North Africa, Middle East and Emerging Asia). Note that this strategy would not only be consistent with the supposed outward vocation of the EA, but it would also provide the right response to the global imbalances problem by redirecting real and financial resourse from the rich to the emerging areas of the world. Note, also, that this, on a grand scale, is essentially the same (successful) game played first by Germany in the D-mark age, and later by the EA as a whole, with the Eastern European countries.

The best policy for the future of our export industries and domestic producers is not to anchor the euro to the destiny of the dollar but to have the currencies of the emerging economies anchored to the euro in an area of stable trade partnerships.