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Living with a strong euro

by Alessandro Leipold

Another European Council and another set of good intentions to boost the recovery and reduce unemployment, this time centered on the digital economy. Yes, these are undoubtedly "good intentions" but, devoid of financial backing, they remain unfunded commitments that risk being little more than words to the wind. At the same time, the EU perseveres in upholding the Holy Grail of the nominal 3% of GDP limit on public deficits, even though economists have gone hoarse noting that what matters is the structural deficit, adjusted for cyclical effects. In this setting, the European Central Bank is about to launch its "comprehensive assessment" of the 130 largest eurozone banks – this exercise, however, also lacks a financial backstop. In the absence of such a safety net, how can the ECB "fail" banks with capital shortfalls without generating renewed uncertainty?

In spite of these headwinds, the euro-dollar exchange rate keeps on rising, reaching a two-year peak. How can it be, one wonders, that the euro is so strong just as the outlook for eurozone growth remains weak and its leaders, despite some progress, keep postponing important decisions from summit to summit? Let us remember however that the exchange rate is by definition a ratio, and that in this relation the strength of the euro is above all a reflection of the weakness of the U.S. dollar. This argument may appear circular, but consider, for example, the fact that during the entire summer of 2011 – when the eurozone crisis was in full swing (to the point of inducing the ECB to undertake its first purchases of government securities) – the euro remained constantly above 1.43 against the dollar. This was in a setting in which the U.S. was concomitantly being deprived of its triple-A status by Standard & Poor's, following yet another ineffectual agreement on the federal budget. A similar situation prevails today, with uncertain prospects and Washington paralyzed by political divisions.

The euro-dollar exchange rate is definitely important, not only because of its visibility and its effect on market psychology, but also because trade with the U.S. has an appreciable weight in the euro area's trade flows. But to a lesser degree than is generally thought: in the ECB's calculation of the euro's effective exchange rate (i.e., weighted for trade flows), the weight of the U.S. dollar is equal to 16.8 % – lower than for China (18.6%) and not far from that of the United Kingdom (14.8 %; data from the most recent reference period, 2007-09). But the euro-yuan or euro-sterling rates rarely make the headlines. Since the beginning of monetary union in 1999 to date, the euro, while strengthening by 18% against the U.S. dollar, has remained unchanged in effective terms. Arithmetically, this implies that it depreciated against most other currencies (for example, by about 13% against the yuan).

Still, given the attention paid to the euro-dollar rate and its role in shaping agents' expectations, the question arises: should the ECB react and, if so, how? There are two main obvious tools: a further drop in official interest rates and/or a new wave of easy financing to banks (LTRO). Although both measures are at least in principle on the table, a rate cut has been shown to have little effect, with the euro's exchange rate continuing to rise unabated after the last reduction (to 0.5%) in May. More likely, the ECB might simply repeat, as it did in February (when the euro was at 1.37 to the dollar) that the euro's appreciation poses "downside risks" for inflation – currently well away from its "close to 2%" target. A new LTRO operation, for its part, appears unlikely as the ECB sets out to sift through banks' balance sheets. In this setting, recourse to its soft loans could be viewed as an act of desperation – indeed banks are rushing to repay the funds drawn in the past.

The focus on the euro-dollar rate distracts from what really weighs on exports: the real effective exchange rate. And that is precisely where the shoe pinches, especially for Italy. While other crisis countries – most notably Spain – have improved their competitiveness in this respect, Italy has stood still. The latest IMF country report estimates that a real effective depreciation of up to 10% would be need to restore competitiveness in Italy. And so one is back to the all-too-familiar square one. There is little point in relying on ECB action or, even, in taking refuge in improbable conspiracy theories (according to which the Fed is merely playing with the timing of tapering to benefit U.S. exporters – in truth, the least of its concerns). The point is rather to reduce Italy's unit labor costs, boost its productivity, appreciably narrow its tax wedge, and carry out the long unfinished structural reform agenda. For the rest, there is not much that can be done, with various analysts awaiting the next threshold to test: a euro-dollar exchange rate at 1.40 and, some venture, even 1.50 by year-end.