



**DIRECTORATE GENERAL FOR INTERNAL POLICIES**  
**POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY**

# **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 and very low inflation, while 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 using the monetary policy toolkit to address the external target is not free of risks.

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## 1. INTRODUCTION

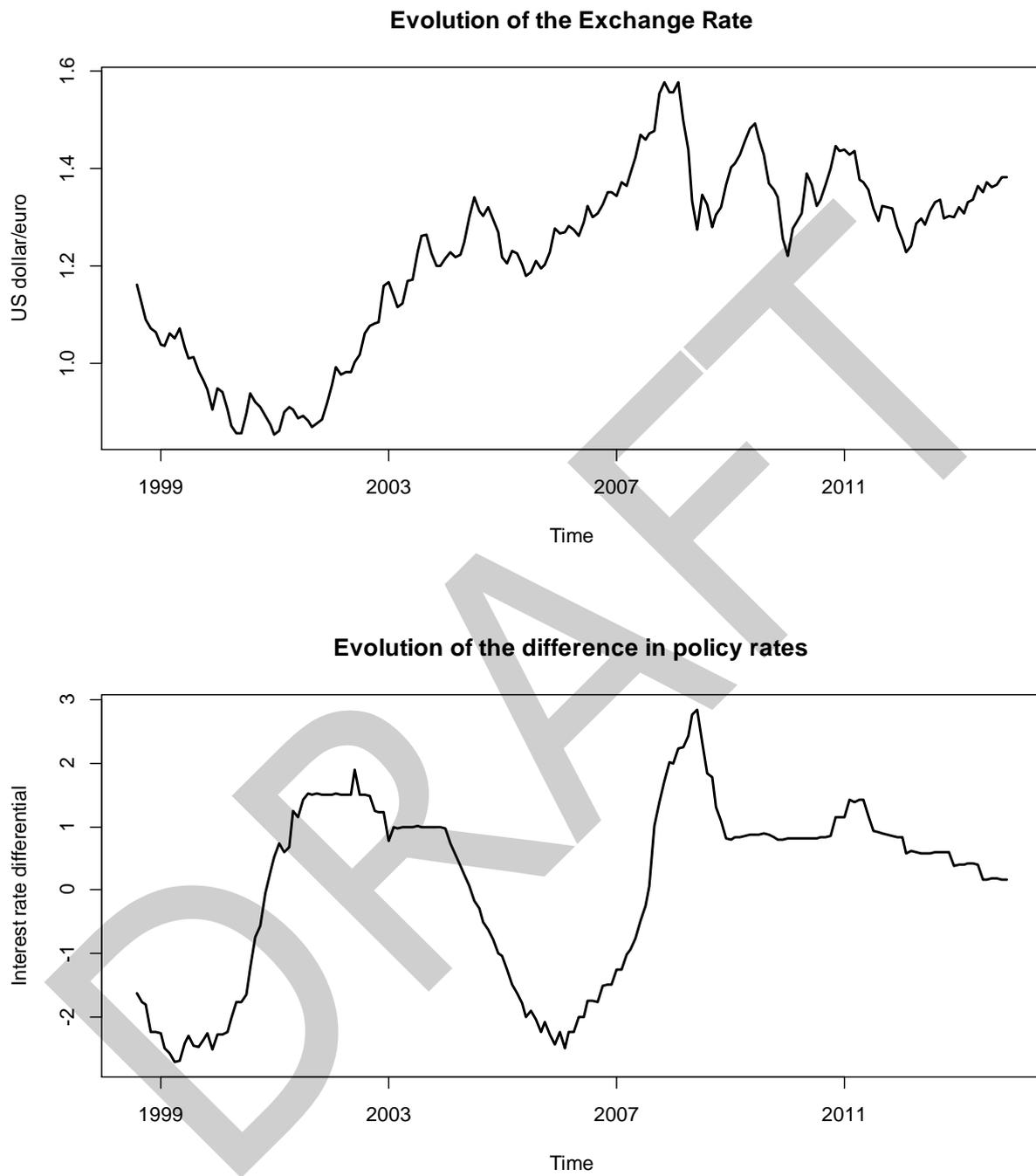
This paper discusses some of the policy challenges posed by the rise of the euro in trade-weighted terms as well as against the dollar. To put the issue in perspective, Figure 1 plots the evolution of the euro-dollar exchange rate since the inception of the euro (top panel) as well as the difference in policy interest rates (bottom panel), as the discussion of the exchange rate is often framed in the context of interest rate parities.<sup>1</sup> 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 shows as well that the Euro has known several higher peaks in the past decade. The appreciation of the Euro is a topic of discussion because an expensive Euro hampers economic recovery in the Euro area. Moreover, many observers believed that the economic recovery in the US and the monetary policy choices of the European Central Bank would have weakened the Euro in 2014. In contrast, a combination of increasing investor confidence and current account surpluses led to a further strengthening of the Euro. This paper starts by reviewing some theoretical considerations on the conduct of exchange rate policies. Subsequently, it discusses the evolution of inflation in the Euro area, an issue which is important in the current debate on the strength of the Euro. Then, it briefly lays out arguments on "good" monetary policy. Final Section concludes.

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<sup>1</sup> In the next section we discuss this further when reviewing some 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 in favour of a more tempered euro. Before entering this discussion on exchange rate policy, it may be useful to take a step back and 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 the 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:**

<b>Conflicts between the ECB's Internal and External Monetary Policies</b>		
<i>Internal / External</i>	<i>ECB's exchange rate policy aimed at the appreciation of the Euro</i>	<i>ECB's exchange rate policy aimed at the depreciation of the Euro</i>
ECB's restrictive money supply policy (overshooting of target and/or expected inflation)	<i>No conflict: internally and externally higher European money market interest rate</i>	<i>Possible conflict: internally higher, but externally lower EU money market interest rate</i>
ECB's restrictive money supply policy (overshooting of target and/or expected inflation)	<i>No conflict: internally and externally higher European money market interest rate</i>	<i>Possible conflict: internally higher, but externally lower EU money market interest rate</i>
ECB's expansionary money supply policy (undershooting of target and/or expected inflation)	<i>Possible conflict: internally lower, but externally higher EU money market interest rate.</i>	<i>No conflict: internally and externally lower European money market interest rate.</i>

**Source:** Eijffinger, S. and de Haan, J. (2000), p.175

Domestic monetary policy refers to policy aimed at influencing money growth and inflation through the money market interest rates. By reducing or expanding the money supply, the ECB aims at shaping the structure of market interest rates.

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Table 1 indicates that in two of the four situations considered, a conflict between objectives may arise. The occurrence of a conflict is also determined by broader market conditions as well as characteristics of the Euro area economy.

Given that the primary objective of the ECB is price stability<sup>2</sup> (internal monetary policy objective), the possibility and the economic consequences of a conflict shall always be properly assessed.

In the current environment of very subdued growth and too low inflation<sup>3</sup>, the monetary toolkit could be used to weaken a currency deemed to be too strong, thus helping growth, while at the same time safeguarding 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 worthwhile to take a look at the data on inflation and interest rates in the Euro area.

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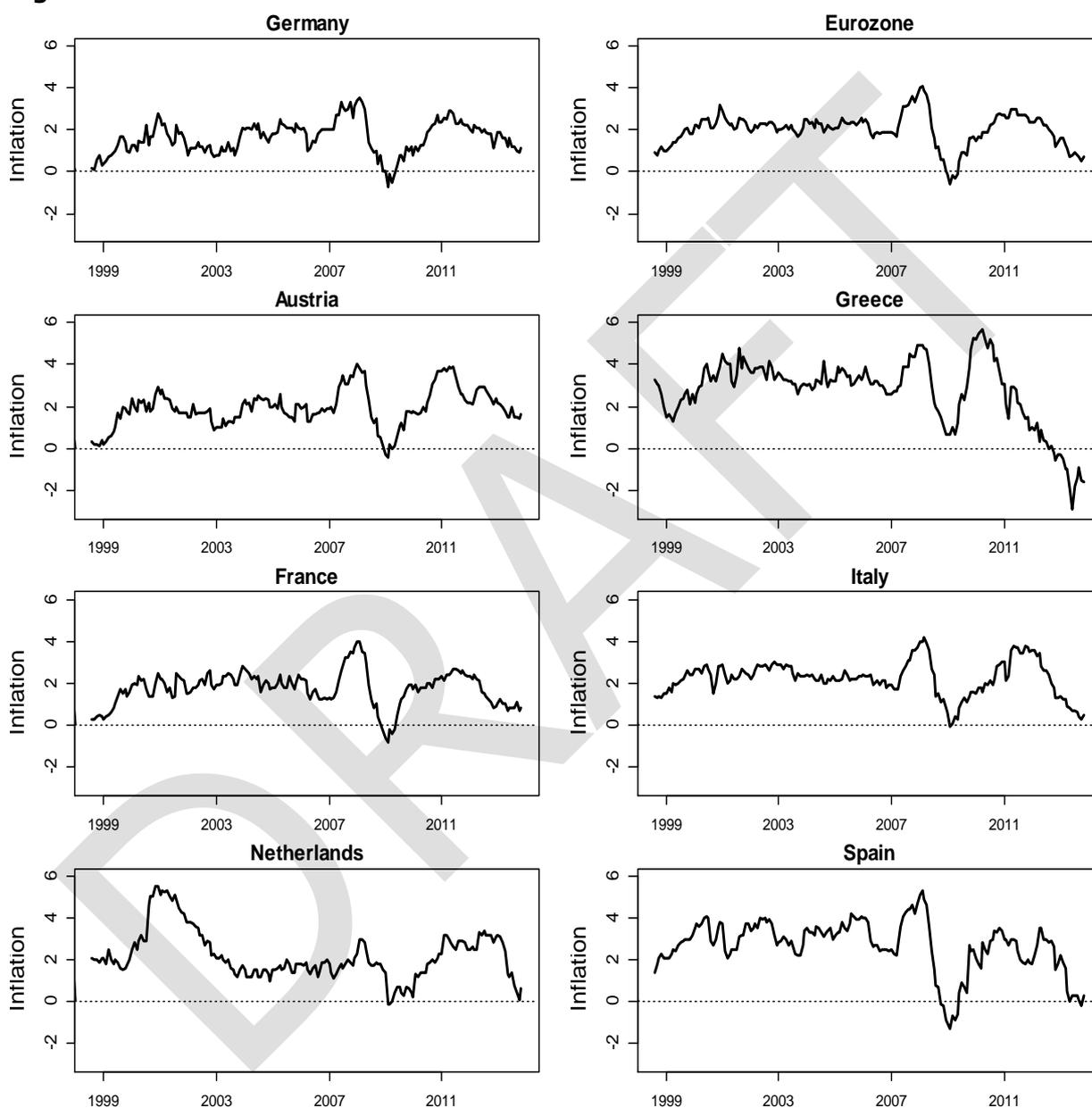
<sup>2</sup> See article 2 of the statute of the ECB.

<sup>3</sup> Draghi, Mario (2014) 'Monetary policy in a prolonged period of low inflation'. Speech at the ECB forum on Central Banking: <http://www.ecb.europa.eu/press/key/date/2014/html/sp140526.en.html>

### 3. CURRENT SITUATION

There is a broad consensus that currently inflation in the Euro area is (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**



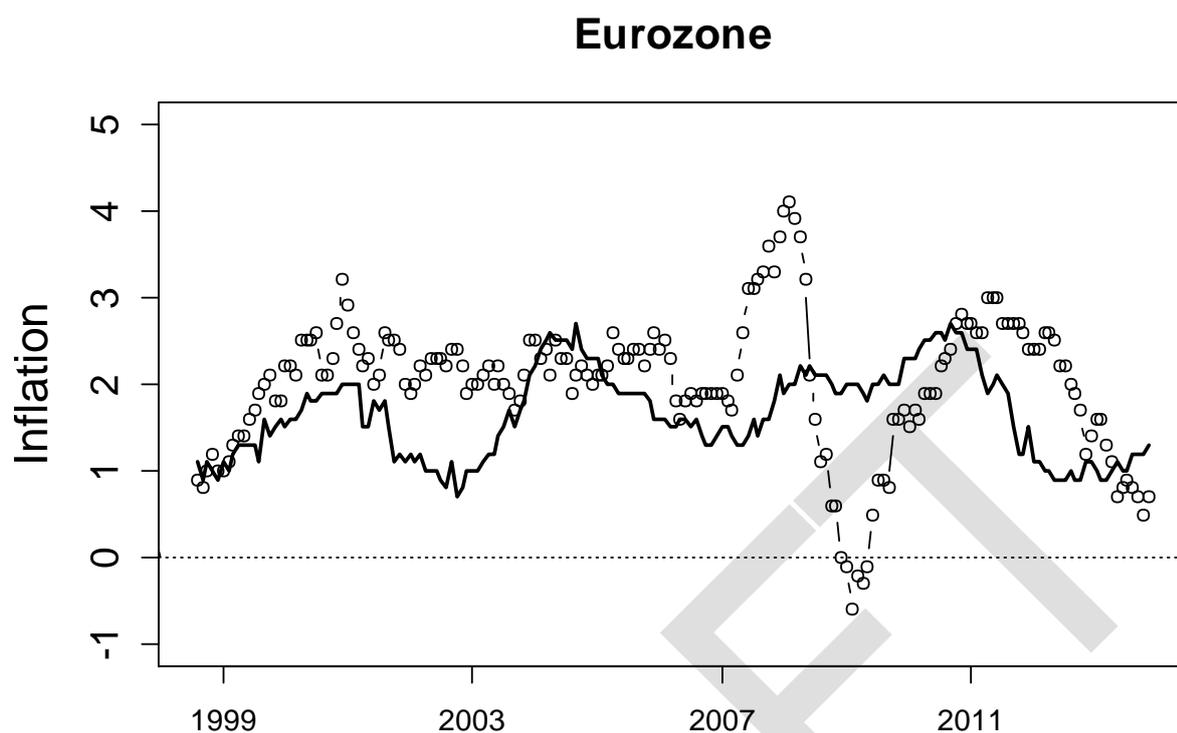
**Source:** Author's elaborations. Data was obtained from Eurostat.

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 in selected Southern Euro-area countries. Country-specific graphs show that inflation has

been recently trending down in all regions considered. In the euro area, inflation is currently averaging around  $\frac{1}{2}$  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 affecting 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 and was emphasised by ECB president is that the very low level of inflation in core Euro-area countries to some extent hampers 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 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 should be the appropriate aggregate price index to look at. Indeed, core inflation excludes the more volatile (short-term) components of energy and unprocessed food from the overall price index (headline inflation). Figure 3 depicts patterns for core inflation (black line) as well as headline inflation (round circles). 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)**

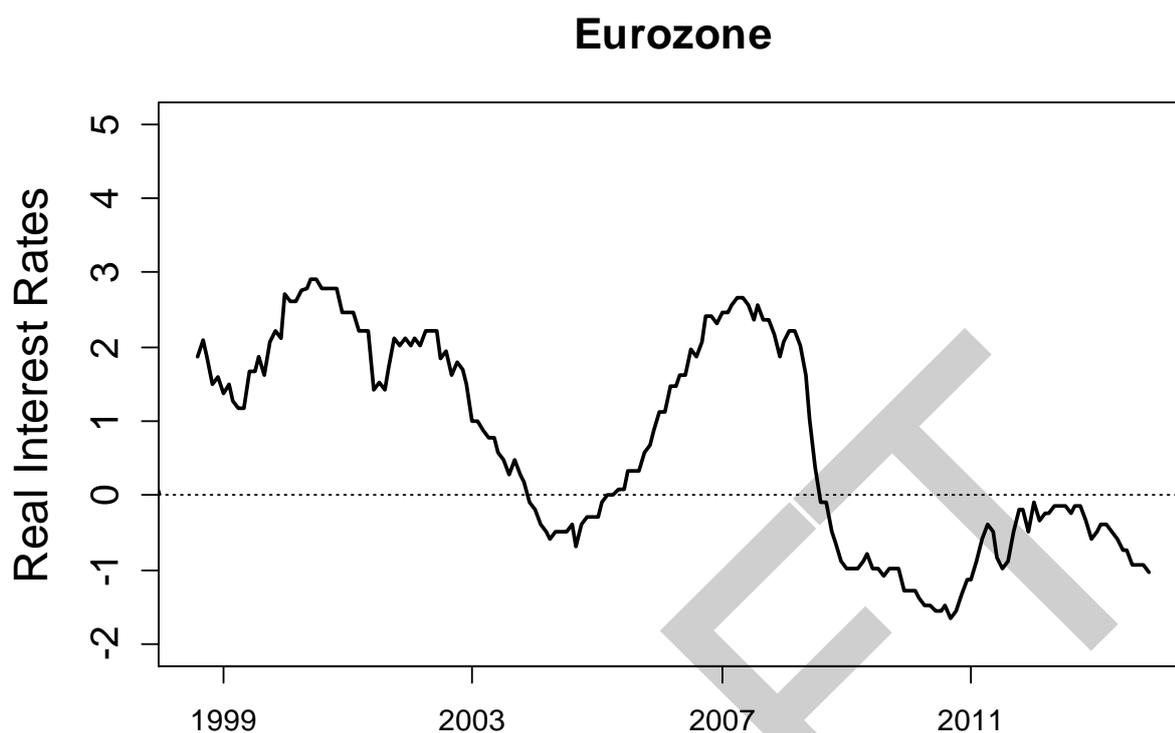


**Source:** Author's elaborations. Data was obtained from the European Central Bank and Eurostat.

Short-term nominal interest rates are central banks' key policy targets. However, agents' decisions to spend and save are more affected by real rather than nominal interest rates. The real interest rate is the nominal interest rates corrected for inflation (or expected inflation). Figure 4 shows the evolution of the (short-term) real interest rate<sup>5</sup> 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 is an undesirable feature for an economy. Such a situation is often referred to as one of financial repression, with adverse effects on savings and relevant challenges for monetary policy.

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

<sup>5</sup> The following Fisher identity is used to calculate the real interest rate  $r$ :  $r = ((1+i)/(1+\pi) - 1) * 100$  where  $i$  is the Euro-area policy rate and  $\pi$  the inflation rate.. We used observed headline inflation instead of expected inflation.



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

#### 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 of (excessive) strength of the Euro. The combination of low growth and low inflation allows monetary authorities to pursue simultaneously the external and the domestic policy objective without conflicts. Some Euro-area countries are even experiencing negative growth and are - at the same - on the brink of deflation. An expansionary monetary policy seems to be just the single and appropriate policy response under the current favorable combination of events. 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 (risks) of the economy; Second, the impact on the euro area economy of an early tapering by the Fed remains highly uncertain; Third, in a globalized financial system, ECB policy-reaction function will need to take into account Fed monetary policy. Therefore, an economic situation whereby the domestic policy goal calls for a more restrictive monetary policy at a time when the external policy goal (i.e. the excessive strength of the Euro) is not yet attained cannot be excluded. Keep pursuing an external policy goal 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 a throughout assessment of the cost vis-a-vis demand effects in the fall of import prices.

In this comprehensive assessment, country-specific factors may play a significant role. In the speech mentioned above, Mario Draghi's hinted to ongoing adjustments between Euro-area countries and to the intricacies of the problem the stemming from the differentiated evolution of the economies as well as of the limits of ECB monetary policy to address country-specific issues. National factors still impeding a sustainable growth path in peripheral countries need to be addressed by the national policy makers, through painful budgetary and structural reforms. In this perspective, the current very accommodative stance for 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. These include Germany, which, however, is already on a reasonable growth path. A fiscal stimulus from northern Euro area countries may prove useful in the current situation where the effectiveness of monetary policy is constrained by policy rates 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.

The aim of this paper is not to oppose expansionary monetary policy per se. Resuming growth in the Euro area is a policy imperative and in the current economic circumstances there appears to be room for monetary policy to weaken the currency, thereby spurring growth. Since the lesson of Tinbergen, however, economists are well aware that different (independent) targets should be addressed by different (independent) instruments. In this regards, the paper warns about the use of expansionary policy for goals which fall outside of the ECB key mandate of ensuring 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. Main reservation stems from the fact that the ECB primary mandate is to guarantee price stability (domestic monetary policy objective). Jointly assessing macroeconomic and financial stability conditions is a difficult task at the current juncture; they could change in the near future, impeding the use of monetary policy to deal with the external monetary policy 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 continue to be so. There is no easy way out. While a cheaper Euro would help to resume growth in these countries and strengthen the recovery in the euro-area as a whole, the level of the euro shall not be considered a policy target by the ECB.

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