

THE EURO'S SURPRISES

On 22 September last, the ECB and the Fed intervened to support the euro, which had fallen to \$0.84. Two years previously, most economists had guessed that the euro would be a strong currency. They were optimistic about the outlook for growth in Europe and worried over the prospects of America's trade deficit. Accordingly, they felt that the euro would provide an attractive alternative investment to the dollar. In practice, the strength of the American economy, boosted by the New Economy, has attracted record investments across the Atlantic. Trends in the real economy continue to play a vital role in setting exchange rates. The capacity of the euro-zone to enter this "New Era" will largely determine the future parity of the single currency. In the short term, better predictability of European policy would help to reduce the uncertainties that currently penalise the currency.

Economists have the reputation of being poor forecasters. The depreciation of the euro since its creation could well confirm this reputation. While most economists had reckoned that the euro would be a strong currency, it actually fell from \$1.18 at its launch on 4 January 1999 to \$0.84, prior to the central bank intervention on 22 September 2000 (see Graph 1). To get

United States and the euro-zone. In the last quarter of 1998, the gap in rates stood at 1.3% in the money markets, compared to 0.5% for long term government bonds.

Such cyclical effects were backed up by exchange rate pressure emanating from current account trends in the two zones. At the end of 1998, it was estimated that the US deficit would continue to rise, while the European Union was expected to carry on accumulating surpluses. On the basis of the notion of fundamental equilibrium exchange rates¹, it was thought that the euro-dollar parity would move progressively to a rate compatible with "normal" current account levels. Although normalcy is very hard to define in this area, there seemed to be little doubt that American deficits of 3% of GDP were not "normal". It was thus possible to expect the dollar to shift progressively to a fundamental equilibrium level ranging from \$1.15 to \$1.40 to the euro².

However, this macroeconomic analysis would not by itself justify a rapid depreciation of the dollar. Indeed, a country may continue to run a substantial current account deficit for a long period of time, as long as the rest of the world accepts to hold an ever-increasing amount of the country's debt. According to estimates by Mann³, international investors only have to accept to hold a constant share of dollar assets in their portfolios for an annual US deficit in the order of 4.5% to 5% of



Source: <http://pacific.commerce.ubc.ca/xr/>.
* dollars per euro.

an idea of how the currency may evolve in the future, it is necessary to try to understand why the forecasts were wrong.

Why a Strong Euro?

At the end of 1998, economic forecasts predicted a slowing down of American growth and a strengthening of the recovery in Europe. This was to lead automatically to a closing of the interest rate differential between the

1. J. Williamson, *The Exchange Rate System*, Institute for International Economics, Washington DC, 1984.

2. R.L. Driver and S. Wren-Lewis, *Real Exchange Rates for Year 2000*, Institute of International Economics, Washington DC, 1998; M. Aglietta, C. Baulant and V. Coudert, "Pourquoi l'euro sera fort, une approche par les taux de change d'équilibre", *Revue économique*, May 1998.

3. C. Mann, *Is the US Trade Deficit Sustainable?* Institute of International Economics, Washington D.C., 1999.

GDP to be absorbed without market tensions. Still, investor choices cannot be considered as immutable. It was precisely for this reason that it was believed the euro would lead to a break with existing trends: the emergence of a competing international currency was expected to modify investors' behaviours.

The belief that the dollar should share its status as an international currency with the euro was based foremost on the impact of size. Given that the euro area is the largest monetary zone in terms of exports, and that its GDP is of a similar scale to that of the US, it seemed logical that the euro would acquire progressively the same status as the dollar. The internationalisation of the euro was to be favoured by the unification of European financial markets (especially for Treasury bonds) and by trends to greater disintermediation in European finance. A deep and liquid European market was expected to attract investors seeking markets which they could switch into and out of easily, without incurring losses. Overall, the internationalisation of the euro could have led to the re-allocation of private portfolios from the dollar to the euro, in the order of \$500 billion to \$1 trillion (or between 15% and 20% of global portfolios)⁴. With no equivalent issue of euro assets, such a massive re-allocation of portfolios would lead to a substantial appreciation of the euro⁵. Indeed, with unchanged yields, a rise in global demand for assets denominated in a given currency leads to an appreciation of the currency, while an increase in the supply of assets in the same currency leads to a fall.

However, it is necessary to specify that this interpretation of financial changes was not unanimous. Some economists did indeed stress that the need to diversify portfolios would not necessarily favour the euro. Thus, the relatively weak diversification of portfolios held by institutional European investors and the termination of possibilities for spreading currency risks within Europe would lead to a re-allocation of portfolios in favour of third currencies. Other analysts pointed out that a significant development of bond issues in euro would likely limit any appreciation of the European currency, even if such issues were to remain modest when compared to existing stocks. Lastly, some commentators stressed the possibility of "multiple equilibria", with the emergence of the euro as an international currency, required for transaction costs to fall, being supported precisely by a fall in costs.

Overall, however, most economists agreed that the euro had the potential to become a strong currency, because it would offer investors alternative investments, thus bringing to an end

US "deficits without tears", with agents demanding higher American yields as US foreign debts increase. Disagreements were limited largely to the time such movements would take, with some analysts pointing out the inertia in the international monetary system, and others insisting on the speed of portfolio adjustments compared to other adjustments. Lastly, it should be noted that forecasts of a rapidly-rising euro were often more manifestations of fear rather than hard predictions.

■ Why a Weak Euro?

The forecasters were wrong-footed both by the macroeconomic outlook and by the time span of changes in financial behaviour.

To begin with, growth in the United States and Europe has not been in line with expectations (Table). The uninterrupted pursuit of strong growth in the United States has been surprising, whereas growth in Europe during the first half-year of 1999 continued to be modest. It was thus logical for the ECB to cut interest rates in April 1999, just as the Federal Reserve increased rates throughout the first half year. Then, in November 1999, the ECB began to raise its rates, but at a pace which did not exceed the Fed's (Graph 2).

The second surprise concerns the volume of bond issues in euro. According to the Bank of International Settlements, the share of issues in euro on the international debt market (bonds and notes as well as money market instruments) stood at 45% in 1999, in other words at practically the same level as the dollar (47%). In 1998, the respective shares were 33% and 60%. Taken by itself, this factor does not, however, explain the depreciation of the euro that has occurred, as the flows of new debt issues are modest in comparison to existing stocks. Reasons for the fall of the euro are to be found mainly in the demand for assets.

While investors substantially increased the share of their holdings in European currencies and then in euro towards the end of 1998 and in early 1999, they subsequently shifted back to portfolio allocations

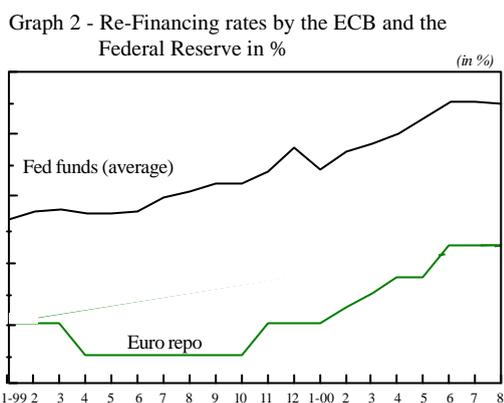
Table - Growth forecasts in June 2000

	1999		2000		2001	
	I	II	I	II	I	II
Euro area	2.2 (-0.2)	3.2 (+0.5)	3.6 (+1.0)	3.6 (+0.7)	3.3	3.1
United States	3.8 (+2.9)	5.1 (+3.2)	5.6 (+3.4)	3.5 (+1.1)	2.9	2.7
OCDE	3.3 (+1.7)	3.5 (+1.4)	4.4 (+2.1)	3.5 (+1.0)	3.1	2.9

The figures in brackets are forecast revisions with respect to December 1998.
Source: OECD *Economic Outlook* December 1998 and June 2000

4. See, for example, C.F. Bergsten, "The impact of the Euro on Exchange Rates and International Policy Cooperation", in *EMU and the International Monetary System* P.R. Masson, T.H. Krueger and B.G. Turtleboom eds., International Monetary Fund, Washington DC, 1997.

5. R. Portes and H. Rey, "Euro vs. Dollar: Will the Euro Replace the Dollar as the World Currency?", *Economic Policy* April 1998.



Sources: Federal Reserve website (www.bog.frb.fed.ws) and the Monthly Bulletin of the ECB.

favouring the dollar⁶. The expected break in portfolio behaviour thus did not occur. Besides, foreign direct investment into the United States, which had grown strongly in 1998, continued to rise, reaching \$275 billion⁷ in 1999 (four times the level in 1997). Remember that the trade deficit was \$331 billion. As for the euro-zone, it was investing massively abroad, with net foreign direct investments exceeding 3% of GDP.

Two factors explain this unexpected behaviour by international investors.

The first stems from the still-limited activity of the market in euro denominated assets: liquidity and transaction costs have not changed significantly since the introduction of the single currency. The beginning of the virtuous circle described above (the concomitant rise in the size of the market and in its liquidity) only really materialised for the unsecured money market. Financial market integration has remained incomplete due to institutional differences persisting for stocks (market practices, taxation, bankruptcy laws etc.) The significant inertia characterising the internationalisation process had already been underlined. It was perhaps neglected by some optimistic operators, who took positions on the euro at the end of 1998, but who subsequently liquidated these positions as they became disillusioned with the behaviour of the euro. However, this strictly financial explanation for the fall of the euro does not coincide with the nature of net flows, that is dominated by long term investments.

At this point it is necessary to stress the doubts about Europe's capacity to enter the "Era of the New Economy". The excessively-slow pace of structural reforms has often been put forward as a major obstacle to the emergence of a New European Economy. This may

have discouraged purchases of European stocks, in spite of positive, medium term forecasts for European growth. In particular, there have been worries that faster European growth would lead to an unsustainable current account deficit, due to low productivity and high dependence on imported hi-tech products. In contrast, the New Economy was felt to render the US long term deficit more sustainable because of rapid American productivity growth. The New Economy also explains the very strong correlation between rising stock market indices and a rising dollar, observed in 1999 and in early 2000⁸. In this context, capital flows from the euro area to the United States would appear to be motivated by long term considerations: the arrival of the euro has sparked massive industrial restructuring and has accelerated the internationalisation of European activity, whereas structural reforms have gone ahead too slowly to convince international operators to invest in the zone substantially.

Lastly, it should be recalled that worries concerning the future workings of the euro area, prior to 1999, underpinned the scenario of a strong euro. It was thought that the ECB would be primarily interested in establishing its credibility, and would hence adopt a tight stance. In practice, these worries have actually contributed to the fall of the euro. Policy pronouncements by the ECB and the Council of Finance Ministers relating to exchange rates have lacked coherence. Added to this are doubts surrounding the institutional evolution of the Union, which have been reinforced by the resignation of the Commissioners, the opening up of negotiations with potential new member states, as well as the debate concerning the governance of the Union. It is well-known that uncertainty encourages herd behaviour by investors.

■ What Are the Lessons to Be Learnt?

The macroeconomic and structural explanations for the evolution of the euro suggest that its weakness is tied mainly to the economic performance of Europe's economies. If the European Monetary System had not changed on 1 January 1999, then it is likely that European monetary policy led by the Bundesbank would have been just as accommodating (Germany in fact experienced one of the lowest rates of inflation in the euro area in 1999). Similarly, structural reforms would not have gone ahead more quickly in Europe, while the attractiveness of the American economy would have been

6. See, for example, the benchmark portfolios published by *The Economist*.

7. A break is indeed to be observed in 1998, with investments rising to \$215 billion. Source: *Survey of Current Business* June 2000 and September 2000.

8. This correlation could also be interpreted as a double, speculative bubble on the dollar and US stocks. However, the fall of the NASDAQ in 2000 and the continued appreciation of the dollar brought such parallelism to an end.

just as marked. Nevertheless, the change of the monetary regime has been important, in as far as it has introduced new uncertainties in the short term and has led to accelerated mergers and acquisitions activity in the zone, with massive investments in the United States as a corollary.

One lesson which may be learnt is that even if the international forex markets trade **daily** the equivalent to one and a half month's worth of world GDP, trends in the real economy remain crucial in setting exchange rates. From this point of view, the forecasts which are made today (along with any assessment of the effectiveness of official forex interventions) are strongly dependent on the trust accorded to continued growth in the US economy and the capacity for Europe to enter this "New Era".

From a cyclical perspective, the euro area could now do with a moderate appreciation of its currency. As energy prices rise and output capacity tensions emerge, such an appreciation would allow pressure on capacity constraints to be tempered by lower exports and higher imports, and would improve the purchasing power of labour without increasing nominal wages (and hence prices and interest rates) excessively. To raise the chances of such an appreciation, it is necessary to reduce uncertainties which lead agents to ignore "fundamentals" and to adopt herd behaviour which is often destabilising. The concerted intervention by the central banks on 22 September 2000 has reduced scepticism relating to the possibilities of an exchange rate policy and coordination with the United States in this area. But, other areas of uncertainty remain, relating to the reform of European institutions,

tax policy, pension reforms etc. Substantial progress in these areas would contribute to an appreciation of the euro, while limiting the danger of upwards overshooting, which would perhaps be even more difficult to manage, given that the interests of the actors in Europe's economic policy could potentially diverge.

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