The Year of the Strong Euro?

Barry Eichengreen
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This was supposed to be the year of the strong euro. After a disappointing first 12 months, when Europe's new currency fell by 18 per cent against the dollar, the forecast for 2000 was for significant strengthening. How low, the experts asked, could the euro go before rendering European exports to the United States absurdly cheap? The U.S. trade deficit was already exploding. A euro-dollar exchange rate of one to one was simply not sustainable.

The last two months have not turned out as expected. In January, the euro breached "parity" against the dollar, plunging for the first time through the critical psychological barrier of one to one. After a brief recovery, the currency resumed its downward trend. On the last day of February, it tumbled 3.5 per cent to an intra-day low of 93.6 U.S. cents, ratcheting up the pressure for the ECB to raise interest rates.

Why were the pundits and many market participants so badly wrongfooted? None of the popular explanations is particularly convincing. In virtually every case, the timing of the events to which they point is simply wrong.

There is the confrontational attitude of some European officials, like former German finance minister Oskar LaFontaine, to the stability-oriented policies of the ECB. But Mr. LaFontaine is long gone, having been replaced by a minister who knows his place and that of the central bank. There is the exception that Italy was granted in mid-1999 from the strictures of the Growth and Stability Pact. But that exception is old news, and neither Italy nor its neighbors have shown signs of losing fiscal control. There is Mr. Schroeder's resistance to Vodaphone's hostile takeover of Manesmann and the questions it raised about Germany's commitment to market-friendly reform. But not only has that merger now been allowed to go through, but the German government has followed up with dramatic steps — notably the planned reduction of capital gains taxes so as to encourage the divestment of cross shareholdings — that will force management to focus on the bottom line.

The most popular culprits are, of course, Europe's monetary policy makers themselves, who have shown an unusual ability to speak out of both sides of their mouths. In recent weeks, Christian Noyer, the number two at the ECB, contradicted statements by his boss, Wim Duisenberg, that the Bank was looking to the level of the euro when setting interest rates. Klaus-Dieter Kuhbaher, a member of the Bundesbank Council, contradicted Otmar Issing, the ECB's chief economist, after the latter warned of mounting inflation risks. Against this background it is hardly surprising that the markets are confused about the importance the ECB attaches to the exchange rate. It is not surprising that they have questions about the consistency and coherence of Europe's monetary policy.

Again, however, this is old news. The Statute of the European System of Central Banks is famously ambiguous about the ECB's responsibility for the exchange rate. Conflicting statements by ECB officials were the rule, not the exception, in 1999. The inadvertent disclosure of interest-rate decisions prior to their official announcement became almost commonplace. Criticism of the ECB for failing to release its forecasts, its model of inflation and the minutes of its Governing Council, and above all for failing to explain its monetary-policy operating strategy clearly, are old hat. The ECB still has to clean up its act, to be sure, but its failure to do so can hardly explain the euro's sudden weakness. Those seeking the reason must look elsewhere.

The true explanation, I believe, lies in changed perceptions of the information-technology revolution and its implications for productivity and competitiveness in Europe and the United States. Throughout 1999, the importance of the IT revolution was disputed. Alan Greenspan's speeches were carefully crafted to signal his uncertainty of whether the acceleration in U.S. productivity growth was a temporary blip or a permanent shift fueled by new business applications of the Internet. But in his February 17th Humphrey-Hawkins testimony to the Congress, Mr. Greenspan struck a more confident tone. He spoke of the accelerating pace of innovation and the belief that "we still may be in the early stages of the rapid application of new technologies and not yet in sight of the stage when this wave of innovation will crest."

The implications of this uncharacteristic optimism are different for Europe and the United States. The U.S. has a head start in business applications of IT. American companies have been investing heavily in computers and software and adapting their business practices accordingly for the better part of a decade. For the first half of the 1990s, the payoff was slight. There was little return on U.S. individual companies' investment in IT until other businesses had undertaken comparable investments. Productivity growth was still slow, and the dollar was weak. Now, however, not just producers but their suppliers and customers are networked, and the returns are evident in improved efficiency and faster productivity growth. With this growth of U.S. productivity and competitiveness comes a stronger dollar. Newfound confidence, not limited to Mr. Greenspan, that U.S. productivity growth has accelerated permanently suggests that the dollar's strength is unlikely to end anytime soon.

Europe, in contrast, has not yet finished building the networks and restructuring its business practices so as to reap these returns. Europe's investment in IT should not be understated, of course, but it is still less advanced than that of the United States. The continent is not yet at the point where new technology will permit its economy to expand at a six per cent annual rate, as the U.S. did in the second half of 1999. And until it can, there is little reason for the euro to recover significantly against the dollar.

Clearly, the requisite reorganization of the European economy is underway. Its implications are already evident not just for business practices but for financial relationships, labor relations, and corporate governance. This is clearest in financial markets, where Europe has seen an explosion of corporate bond issues, initial public offerings, and merger-and-acquisitions activity. New technology and the advent of the euro have begun remaking European financial markets along "Anglo-Saxon" lines faster than anyone predicted. Faced with impatient shareholders and hostile takeover threats, corporate executives will soon have to pay as close attention as their British and American counterparts to the quarterly profit-and-loss statement. And as management practices converge with the American, Europe's labor relations and government policies will have to accommodate this new reality. Europe's social market economy will have to change.

But this adaptation will take time. The institutions of the social market economy are deeply entrenched. There will be a period of years during which Europe is caught "between the two banks of the river" — when some institutions have adapted but not others. Financial markets and management practices will have been updated to meet the needs of new 21st-century technologies, but not so labor relations and social programs, which are more deeply embedded. Until Europe has completed the entire battery of necessary adjustments, it is likely to grow more slowly, not more quickly. And until its growth accelerates to match the United States, there is no particular reason to bet on a strong euro.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economic and Political Science at the University of California, Berkeley.