

Who Should Care about the Euro-Dollar Exchange Rate Anyway?

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If I walk down almost any street in an American city and ask someone who walks by to tell me the euro-dollar exchange rate, I expect that virtually no one would know. Local newspapers and television newscasts in the U.S. hardly ever mention anything outside the country at all, much less the exchange rate. I strongly suspect that the same experiment run in a city in the euro area would yield a very different result. Europeans care deeply about exchange rates and Americans do not. Why is that?

The euro area resembles the U.S. in a number of important ways: in population, overall level of GDP and, most importantly the degree of openness. Imports account for roughly 11% of U.S. GDP and 12 1/2% of euro area GDP. Some European trade, including oil imports, is invoiced in dollars, but even so the total amounts are small. The impact of exchange rate movements on the welfare of the typical American is roughly the same as is the typical resident of one of the eleven countries participating in monetary union. And yet, in Europe people are very concerned that they should maintain a strong euro to the point where the 20%+ decline in the value of the euro relative to the dollar over the past year and a half has become a serious political problem for both the finance ministers of the EU and the members of the ECB council.

This all leads to two questions: What should the euro-dollar exchange rate be, and who should care about it? Answering the first question is extremely difficult. Typical estimates based on economic fundamentals suggest that the euro should be worth at least \$1.10, while *The Economist* magazine's Big Mac index suggests a rate closer to the current 95 cents. My own sense is that we really don't know, but that in evaluating the value of the euro, a better benchmark to have in mind might be a value parity with the dollar, rather than the 1 January 1999 level of 1.17 \$/€.

Until Europe becomes a better place to invest, or the U.S. a significantly worse one, we are not likely to see any significant appreciation of the euro. By most estimates, the sustainable growth rate in the euro area is below 3% per year, while that in the U.S. is near 4%. Even with the recent volatility in NASDAQ and the NYSE, there is a clear perception that U.S. is a terrific place to invest. How else could we sustain a capital account surplus (the mirror of our current account deficit) approaching \$400 billion, or 4% of GDP?

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None of this seems likely to change in the short term. Barring an American collapse, both U.S. growth and interest rates are poised to remain substantially above those in the euro area, suggesting that the euro is likely to depreciate even further.

The solution in the long term, and the only way to create a sustainable euro appreciation, is to push forward with the structural reform program outlined at the recent Lisbon summit. The hope everywhere is that the productivity improvements sustained in the U.S. over the past five years or so will prove contagious. When this happens, European potential growth will rise, the euro will appreciate, and the American current account will move closer to balance.

This leaves us with my second question: Who should care about the euro/dollar rate? Here, I believe, European anxieties over short-term exchange rate movements arise out of two related issues. First, there is the hold-over from the days prior to monetary union when the individual countries faced very high levels of external exposure, and so exchange rate movements were of critical importance for virtually every aspect of the domestic economy. Second, there is the likelihood that in the minds of many, euro weakness is linked to unpleasant memories of inflation and the loss of value of currency in past decades.

Prior to the euro conversion, for small countries, like Ireland or Finland, it made sense to be very concerned about the value of their currency. Even Germans, particularly the small and medium-sized industries, and especially the Bundesbank were justified to worry.

This mentality must change. With the decline in the degree of openness must come a change in the level of concern. No one in the euro area should be fixated on the exchange rate. The ECB must not ignore it, as fluctuations in the value of the euro, along with a myriad of other things, do affect inflation and growth in the Euro-11, but it cannot be a primary focus of their concern.

Overall, it is important that a central bank concern itself with movements in the exchange rate only in so far as they have an impact on the goals of price stability and stable growth. To do so requires forecasts of the fluctuations in the external value of the currency, but not the implicit or explicit targeting of any particular level. First and foremost monetary policy should be directed at domestic concerns.

For the Federal Reserve this has meant refraining from public comment about the value of the dollar, regardless of whether it is thought to be too high, too low or just right. Of course, in setting interest rates to maintain price stability and maximize sustainable economic growth, the movements in the dollar have clearly played a role.

The answer to the question posed in the title, the ECB and the Federal Reserve must care about the euro-dollar exchange rate, but only insofar as it affects the stability of domestic inflation and growth. Information on exchange rates feeds into the forecasts on which interest rate policies are based, and it is important for policy makers to be transparent about how this is done. In the end, actions must be taken with an eye toward domestic inflation and growth objectives, and this is how they should always be explained.