The Euro is Not A US Problem!

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The popular press is continuously harping on the weakness in the US dollar versus the Euro, blaming everything from the weak US economy and the rising budget deficit to the $500+ billion trade gap. Furthermore, they view the strong Euro as evidence of the resounding success of the new currency, the vindication of its founders, and the humbling of once proud Euro skeptics. A closer look, however, reveals that in more important ways:

1. The dollar is not weak, as its purchasing power has not been damaged by the Euro's move;
2. The last 12 months dramatic 21% decrease in the dollar/ Euro exchange rate has not had a material adverse impact on individual Americans and the US economy;
3. The US government is correct in not actively chasing Euroland down its potentially devastating, deflationary trajectory; and
4. The appreciation of the Euro is clearly not evidence of European economic strength, but rather some extremely unfavorable economic dynamics in Euroland.

Though the US dollar "weakened" dramatically against the Euro last year, the headline US Consumer Price Index has increased only 3.0% from March 2002 to March 2003, and the recent sharp declines in energy will soon be dampening the price indices. (Excluding energy costs, CPI only increased 1.7%.) The core US Personal Consumption Expenditure Price Index grew only 1.5% as of the end of the first quarter of 2003.

Thus, while the US dollar depreciated 21% versus the Euro, the US dollar lost very little purchasing power domestically. In fact, latest Fed report reiterated that it is on high alert for that dreaded, Japan style, deflation.

Sure, Americans who traveled to Europe probably paid more for hotels etc., but even those prices are likely to decline over time in response to weakening demand. Additionally, the strong Euro can be viewed by US politicians as a positive, providing a ray of hope for domestic employment, since American exports become more attractive overseas. Recent releases have shown that overseas earnings are gaining from advances in the Euro, while many Euroland exporters are losing their profit margins.

The strong Euro is symptomatic of dire problems in Euroland. Using sector analysis we know that Government deficits are equal to non-governmental savings (Euro denominated financial assets in this case) and the non governmental sector can be further subdivided into the domestic and foreign sectors. Therefore Govt. deficits = domestic savings plus foreign savings.

Thus, domestic savings can come from either the government sector or the foreign sector. However, from the perspective of euroland, the foreign sector has no euros, and no desire to go into debt in euros, leaving only the government sector as the provider of desired euro savings, and the euroland national governments are severely limited in their ability to proactively run deficits to meet domestic savings needs.

The obvious evidence that euro members are experiencing a shortfall in available net savings of euro denominated financial assets is high and climbing unemployment, widespread excess capacity, intensifying downward pressure on wages, and soft prices. There is insufficient spending of euros to clear the shelves and expand output, as income goes unspent in an attempt to net save. Unfortunately, as taught as the 'paradox of thrift', at the macro level not spending means less output and lower income, resulting in even lower actual savings.

As euroland economies weaken, the only internally acceptable policy tool to manage this problem is lowering interest rates. Though changing interest rates does not change net savings (only govt. deficit spending can do that), it is hoped that lowering rates will reduce savings desires, as consumers and businesses are induced to instead increase their debt to make additional purchases. There are, however, at least three problems with this. First, the ECB is bound by CPI guidelines, even though CPI is not necessarily reflective of relevant price pressures. Second, there is little evidence to hope that lower rates will increase aggregate demand and lower the net desire to save. Third, even if lowering rates did help, it is not sustainable. Note that Japan has had near 0 rates for over 10 years, along with a weak economy and a strong currency.

There are two other paths to curing the ills of euroland. Unfortunately, both are deemed politically unacceptable. The first is to increase government deficit spending. The European parliament, however, will not likely even consider running a deficit, and certainly not deficits in the range of 5% of GDP that are probably needed for recovery. Additionally, the national governments can't be expected to proactively run the large deficits called for, due to both restrictions in the treaty, ideology, and, unlike the European Parliament, the risk that markets may not buy their securities.

The remaining operational option is for the ECB to buy $US, as the bank of Japan routinely does, thereby net spending Euros and increasing the net savings of the non government sector, and stabalizing the exchange rate at levels friendly to euro exporters. However, unlike the BOJ, the ECB is treaty bound, and ideology is also thwarting the use of this tool, as it would give the appearance that the ECB is using the $US as the reserve currency for the euro. This would be taken as a sign of absolute failure as the euro was formed to compete with the $US as a reserve currency, not support the $US's role as THE reserve currency.

Currently, therefore, euroland attempts to fight weak aggregate demand and to increase net euro savings by exporting. However, converting export profits into needed euros in the market place causes the euro to strengthen further (as previously stated, export customers do not have stores of euros and don't want to go into euro debt), thereby eroding profit margins. Euroland firms then focus on reducing costs, primarily labor costs, to restore profitability, as the demand for euroland exports softens when the euro appreciates, unless they cut prices accordingly. Reducing labor costs in euroland, however, puts upward pressure on unemployment and downward pressure on income. Weaker domestic demand and the continuing drive to export cause the euro to further appreciate, as this non virtuous cycle continues.

It is most unfortunate that there is no way out under current political constraints. History tells us that rising unemployment eventually results in policy change- hopefully sooner rather than later.

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