APPRECIATION OF THE EURO AND ITS IMPLICATIONS FOR THE EUROPEAN CENTRAL BANK

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Kurt Hübner
Institute for European Studies
The University of British Columbia

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I. Introduction

The appreciation of the Euro against the US-Dollar raised concerns over possible negative implications for the macro-economic performance in Europe. The argument is that an appreciation of the Euro undermines international price competitiveness of the export sectors of the Euro Zone and thus reduces the export multiplier-accelerator effects, resulting in decreasing growth rates of GDP and higher rates of unemployment. Less sanguine views stress that this mechanic chain of events is too simplistic to explain and understand the ongoing processes in the framework of exchange rate changes. For one, the appreciation effects depend on the pass-through rates; the flexibility of the private sectors to operate with diminished profit margins; the level and rate of capital and labor productivity, and also the degree of wage rigidity in the various Euro zone economies. It is also rightly stressed that changes of the nominal exchange rate do not matter and that it is the real exchange rate that generates exchange rate effects. This paper will analyze the forces that have driven (and will drive) the real exchange rate of the Euro against the US-Dollar and other currencies. It will be argued that the Euro has increased its international reputation and therefore strengthened the competition with the US-currency in terms of international money. This strength, however, is mainly due to the structural weakness of the US-Dollar and will change in case of a re-strengthening of the US-currency. This general thesis will be modified, though. First, I will argue that the US-Dollar will further depreciate and that the level of depreciation will depend on the outcome of a global currency competition and the speed of the rise of the national saving rate in the US. Second, I will argue that the ECB has a strong interest in an appreciated Euro and will continue to follow a strong Euro
policy. Third, I will argue that the longer the period of Euro appreciation is, the stronger will be the network externalities that finally may turn the Euro into an international reserve currency that competes with the US-Dollar. However, even in such a scenario the Euro will not become the new Master Currency of the global economy but add substance to an already oligopolistic global currency regime. Such a position creates advantages but also comes with constraints for the European Central Bank.

2. **The Depreciation-Appreciation Game**

The US-Dollar started its depreciation journey in 2001 (see graph 1). From a conventional-orthodox perspective, this depreciation was a bit confusing, as the usual suspects triggering depreciations of currencies were not guiding the exchange rate of the Euro. Economic fundamentals, like differentials in real interest rates and significant differences in growth rates of GDP between the US and its major trading partners, nor differences in inflation rates can explain the strong depreciation. Furthermore, pretty much similar differences of economic fundamentals were prevalent before 2001 and this was a period where the US-Dollar showed a strong appreciation. The dissatisfaction with the fundamental-based explanation of exchange rate movements is even higher if one takes the trade balance, respectively the current account, as lead variable. Following traditional reasoning the US-Dollar should have depreciated strongly a time ago when the US was running high and yearly-increasing deficits first in its trade balance and then in its current account. However, those deficits went hand in hand with periods of first, an appreciation and then, a depreciation of the US-Dollar.
From a logical point of view, such a co-movement is disappointing, as the same variable seems totally uncorrelated.

*Graph 1 US/Euro Exchange Rate*

with the direction the exchange rate takes. As graph 2 shows, the economies of the Euro zone achieved a surplus in their trade with the US since the launch of the Euro, and thus surplus went hand in hand with an appreciation and a depreciation of the Euro.

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2 A discussion of the fundamentalist view is provided by Huebner (2007).
The debate about an adequate exchange rate of the USD has been going on for a couple of years, especially since the depreciation of the USD started in 2001. For a long time it seemed as though the ‘fundamentalists’ were right when they argued that given the enormous deficit of the current account of the US, a – strong – depreciation of the USD is unavoidable. Most of the discussion was whether the US would experience a soft landing or a hard landing. Referring to historically unknown global imbalances and the strong deficit position of the
US, it was argued that necessary adjustments need a strong and immediate depreciation of the USD (Williamson 200; 2007; Roubini 2007).

**Obstfeld/Rogoff (2005)** specified their previous argument that the USD needs a depreciation of its trade-weighted real exchange rate of 35 to 50 per cent in order to get rid of its current account deficit. Baily (2007) modeled a further depreciation of the USD of about 20 per cent of a broad dollar index–based exchange rate. **Krugman (2007)**, to name one more scholar, made the point that a substantial effective depreciation still is in the books and urgent in order to re-order the global economy.

Some scholars expressed their doubts towards such ‘fundamentalist’ views and argued that the current account imbalances should be interpreted as a form of inter-temporal trade between the US and the RoW (Rest of the
World) where former sells financial assets to the RoW in order to finance the deficit in its trade balance (Corden 2008, Cooper 2008). Like all cross-border trade the welfare-increasing effects of international exchange should also hold for this exercise. Proponents of the Bretton Woods II-approach were equally optimistic that the US can run indefinitely a huge current account deficit without risking a severe depreciation as this deficit only reflects the needs of its main trading partners (Dooley/Folkerts-Landau/Garber 2003).

Other scholars took a middle position. Feldstein (2008), for example, only recently made the point that in order to deal with the huge deficit in its trade balance, the USD in real terms needs further depreciation but that such a depreciation of the USD is only a necessary condition. The sufficiency condition is a strong increase in the national saving rate of the US in order to achieve a turnaround in the ‘overconsumption’ of US-households that was identified as the mains source of the surge in US imports of goods and services\(^3\). A higher saving rate, in particular by private households, in combination with a further depreciation of the USD is supposed to increase exports of the US and to decrease consumption in the domestic economy, by this making room for higher investment expenditures. It should be underlined though that such a chain of events, assumed for the moment the chain would hold under the circumstances of stressed financial markets, might provoke a further deepening of the recession in the US and by this generate a dis-incentive for further investments. Whether the US government is in a position to reduce public budget deficits in order to

\(^3\) Others are stressing that both targets only can be achieved if at the same time China accepts a significant appreciation of its currency against the US-Dollar (Morgan 2008) – and against the Euro, I should add.
increase the national saving rate seems highly unlikely given the rescue operations they are involved due to the financial crisis.

*Graph 4 Trade Weighted US-Exchange Rate*

In any case, Feldstein rightly points to the fact that any resolution of the international position of the US comes with huge adjustment burdens for the global economy. It is my argument that the adjustment processes are more complex than some observers assume.

So far, the occurring adjustment costs are hugely unevenly distributed between the main economies. Given the different exchange rate regime choices in the global economy and also given varying political stances towards the exchange rate as a policy tool, it is evident by now that the depreciation of the USD so far was unbalanced (*Huebner 2007*; Fratzscher 2008). *Graph 5* shows the movement of the exchange rate Yuan/USD. Even though the Chinese authorities changed their exchange rate policy by
introducing a currency basket in order to stabilize its exchange rate, it is obvious that the political control of the exchange rate has prevented a strong depreciation.

**Graph 5 Exchange Rate USD/Yuan**

Similar policies were put in place by other emerging market economies in Asia. Those *mercantilist* strategies use the exchange rate regime as a policy tool in order to keep their export sectors competitive (see graph 6). The exchange rate regime choice of those economies has come under scrutiny, in particular by US scholars who argue that the significant share of the trade deficit of the US is with China and other Asian emerging marker economies and that therefore the forex market should generate a huge appreciation of those currencies. It is definitely correct to stress that market actors determine not all exchange rates. Simulations of Cline/Williamson (2008) show that in order to decrease the current account deficit of the US to 3 per cent of its
GDP, the exchange rate with China needs a depreciation of about 31 per cent (compared to the base value of February 2008), with Hong Kong 29 per cent; with Japan by 19 per cent; Malaysia 31 per cent; Singapore 42 per cent. The same simulation shows that the Euro needs to be slightly depreciated by .2 per cent. It goes without further saying that such simulations needs to be taken with a grain of salt.

Graph 6  Selected Exchange Rates with the USD

![Selected Exchange Rates with the USD](image)

Source: SVR 2007

However, given the actual depreciation of the real exchange rate of the USD against the Euro and other currencies of the global economy the point seems
to be valid that non-Euro currencies need to undergo relatively strong appreciations if global imbalances are to be overcome.

Those corrections neither come automatically nor will they be market-driven. Appreciations will only occur if the governments of the emerging market economies decide to change their preferred exchange rate regime. If they decide to stay put it will be up to the Euro and a few other currencies under the auspices of free float regimes (like the Canadian Dollar) who will experience appreciation pressure.

3. The International Positioning of the Euro

The launch of the Euro was foreshadowed by the debate as to whether the new currency could and would become a competitor for the US-Dollar as the key currency in the global economy. Although it was never an explicit part of the Euro project, European policy-makers had (and still have) their own fantasies about the international role of the Euro. Economists, in particular from the US, were much more skeptical towards the Euro and its future role in the global economy. Feldstein (1997) in as (in)famous article in Foreign Affairs saw in the launch of the Euro the coming of serious transatlantic conflicts due to the economic disaster that will be generated by the new

\[\text{4 From the beginning, politicians from various camps made the point that the Euro finally will end the dominance of the US-Dollar as the only key currency of the global economy. This position won significant strength with the appreciation of the Euro against the US-currency. See for the example the speech of the Head of the Delegation of the European Commission to the United States, G. Burghardt, at the Federal Reserve in Atlanta in 2003 (Burghardt 2003).}\]
currency. The appreciation of the Euro since 2001 fundamentally changed the nature of public and academic discourses about the new currency.

In an economic perspective, a national money becomes an international money if it is used outside of its home country as (i) a unit of account, (ii) a medium of exchange, and (iii) a store of value. In all those dimensions the Euro is playing a more important role today than when it was launched in 1999. The unit of account-function of a currency is connected with the choice of private actors for invoicing as well as the unit of quotation in international (commodities) markets and the usage of a currency as an anchor currency. The share of the Euro as a settlement currency in the extra-euro area for exports of goods and services to member states of the EU is slightly above the 50 per cent margin; the share for imports is slightly below. Given the financial architecture of the Euro and the EU it comes as no surprise that non-euro area EU member states dominantly use the Euro as a settlement currency for their exports. This usage also reflects the relative weakness of their national currencies. All in all, the Euro has established itself as a dominant European currency that covers much of the euro area neighborhood as well as the EU neighborhood. Based on IMF data, the Euro is used as an anchor by overall 18 countries. If one includes all economies

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5 I’m obviously writing this paper in a situation where the US-Dollar experiences regained value on forex markets. The financial crisis of the US may generate new changes, though. As argued above, I still expect that the ‘structural factors’ dominate and the USD will come under further depreciation pressures.
6 For the period up to 2005, only eight out of the twelve member states were compiling data. It also needs to be mentioned that the methods of data compilation vary (ECB 2007:35). – The average share is slightly higher then for the USD (in value terms) with about 44 % of the extra-US trade. However, this only holds for exports to EU member states. In extra-EU trade the Euro share is significantly lower then the USD share.
7 The data for the countries vary strongly.
using a currency basket for the management of their exchange rate policies, the number increases to 40 (ECB 2007:40).

Currencies can be used as vehicle currencies in order to exchange a relatively illiquid money into a more liquid money. Those exchanges are organized via the foreign exchange markets. One can use the turnover of foreign exchange markets as an indicator to assess the relevance of a national money as an international medium of exchange. Graph 7 shows that the US-Dollar tops the ranking with an 86.3 % share of the daily turnover. The share of the Euro was 37.5 % in 2007, still lower as the share of the Deutschmark in 1992. The USD-Euro pair is by far the most actively traded pair on the global forex markets, hinting to the fact that international traders are overly using both currencies as kind of (partial) substitutes. In any case, the network externalities provided by the US-Dollar are far bigger than those of the Euro. This demonstrates the superior network externalities the USD provides to the global economy. The data for the years after 1998 show that the Euro roughly took over the position formerly held by the Deutschmark. Given the status of a new currency this can be interpreted as an achievement – but it also shows that the build-up of reputation is a difficult and time-consuming process (Huebner 2002).
Comparing the currency distribution of official foreign exchange reserves of 1999 and 2007 slightly changes the picture. The share of the Euro increased in this period from 18% to 26%, mainly due to a slight reduction of the US-Dollar share (EC 2008:21). It needs to be stressed though that this indicator does not very well reflect the usage of international currencies as the liquidity of new institutions like Sovereign Wealth Funds (IMF 2008) far exceeds the foreign exchange reserves of national governments.

Unlike as a medium of exchange, the Euro has established a strong role as an international store of value. Global financial markets were eager very early on to use the Euro in this respect. Euro-denominated debt securities accounted for close to half of all outstanding stock of bonds and notes in 2005 (EC 2007:25). The dominating position of the Euro reflects in part the enormous speed in integration of the European financial market place as
well as the rising concerns about buying US-American Treasury Bills due to the depreciation of the US-Dollar\textsuperscript{8}. Euro-backed financial instruments may even gain in importance in the course of the unfolding crisis of the US financial system.

The fall in the exchange rate of the US-Dollar against the Euro should not be read as a fundamental loss of the international role of the US currency. Exchange rate movements and international functions of a national currency are de-coupled. Only in the case that a dominating currency would be rapped in a long-term depreciation path, the international function of such a particular currency may be damaged and finally undermined. It has also been argued that path dependence plays a strong role in stabilizing the international role of a national money: ‘whatever currency has been used in the past will continue to be used in the future’ (Chinn/Fraenkel 2008). However, if a ‘currency challenger’ comes close to the dominant currency in its international role a tipping may happen fast (Eichengreen 2005\textsuperscript{9}).

I argue that the Euro has not reached such a tipping point\textsuperscript{10}, though the ongoing deep and fundamental crisis of the US financial system has the potential to undermine the trust in the US and especially in its currency. History has shown that such a tipping point not only depends on economic factors but is also crucially defined by political factors and parameters. Scholars of Political Economy have pointed out numerous times that international currency regimes rest on international-turned national monies

\textsuperscript{8} Masson (2007) argues that the Euro—denomination of bonds and notes may already have reached it high time and that developing economies more and more return to the US-Dollar.

\textsuperscript{9} Eichengreen/Flandreau (2008) provide a excellent analysis of the processes that led to the replacement of the British Pound by the US-Dollar.

\textsuperscript{10} It needs to be stressed that a ‘tipping point’ only can be identified post festum.
that come with particular political regimes (Strange 1970; 1971; Gilpin 1987; Cohen 2007). National monies can only turn into an (dominant) international currency if they are equipped with a source of trust that creates confidence on the side of users. The level of trust is usually stressed in situations of global economic and political turmoil: in such cases international investors search for the *safe haven* that may be generated by the political and military clout of the issuing economy and/or political support of its financial regime.

How exactly this kind of trust and confidence is being produced is not well analyzed in the literature. The usual but highly unsatisfactory explanation hints to very general factors like the need of a unified foreign policy on the side of the issuing economy, the presence and readiness of a strong military, the political willingness to guarantee international open markets, the ability to act as an international lender of last resort, i.e. the usual traits of a (benevolent) hegemon (Kindleberger 1970; Helleiner 2008; McNamara 2008). The production of trust as a social construction is based on all those features, but goes beyond\(^\text{11}\). One element of this construction is the belief of main financial market actors regarding the features of a superior financial regime. Those beliefs are guiding sticks for currency market actors and help explain the movement on top of the global currency hierarchy (Herr/Huebner 2006; Huebner 2009).

It was a widely shared belief in the 1980s that the global economy in general and its financial and currency arenas in particular consist of a triad of the US, the EU, and Japan. Since Japan sank in its liquidity trap the political stalemate has been exacerbated and has put Japan on the fringes of the

\(^{11}\) This problem is part of a research project at the IES that is only in its beginning.
global currency regime (Katada 2008). The 1990s were the era of US-financial domination and the majority of scholars pointed to the urgent need to restructure the byzantine European financial regime towards the US model in order to keep up with the pace of the US. The first decade of the 21st century then demonstrated the heterodox Polanyi critique that unfettered financial markets tend to undermine the moral and social base of a capitalist accumulation regime.

The crisis of the US financial regime has not turned into a zero-sum game for the Euro, not least because the European financial system is not immune or overall better equipped to handle the financial storms. The ECB has managed so far to create trust and reputation in the new currency but definitely missed to add political clout to the European financial architecture but giving the political representatives of the Euro a stronger political weight in the realm of the international economy. This is in particular true in regard to international organizations where until now national interests and representation dominates.

The loss of trust in the US-Dollar happened in a long and so far overall smooth process (‘soft landing’) that gave the economies of the Euro area time to prepare economic and political adjustments. The appreciation of the Euro against the USD partly reflects the market sentiments. However, the Euro area missed the opportunity to improve its political standing in order to generate the level of trust a truly Master Currency (Strange) needs. In terms

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12 McNamara (2008:7) only recently made the point ‘…Europe is still some ways to matching the financial depth and efficiency of US markets…”. It is one of the problems of orthodox scholarship not to be too literate in the complexities of modern financial markets and hastily to accept what is being offered in mainstream literature. McNamara is only one example of many. – An excellent overview on the relationship between the US financial regime and global finance can be found in Konings (2008).
of the political base of the Euro I suggest to distinguish the aspect of economic from the aspect of political governance. Despite the fact that the mode of economic governance has undergone a couple of changes since the launch of the new currency, international financial markets have well observed that the ECB and also the EU Commission came forward with policies that were supposed to gain the trust of international actors\textsuperscript{13}. The reform of the ill-designed Stability and Growth Pact and the clarification of the overly orthodox two pillar-strategy of the ECB are the most prominent examples of those reform efforts. Other elements of economic governance have been either neglected or have failed. This is in particular true for the Lisbon Agenda and the arena of innovation policies where the EU largely failed\textsuperscript{14}. The political mode of governance also ran into deep problems when the several attempts to design a political constitution for the EU failed. As a result, the EU is not in a shape to act as an international power in order to rebalance the global order.

The lack of political clout has repercussions for the international role of the Euro. Given the deep-going structural problems of the financial regime of the US and the still existing global imbalances with the US center, the Euro will continue to be a top international currency that is seen as a partial substitute to the US-Dollar. The weakness of the US-Dollar will, as argued above, put additional pressure on the exchange rate of the Euro. Given the level of global liquidity, the Euro may ‘benefit’ from investment strategies

\textsuperscript{13} The Euro has shown a high level of stability in terms of inflationary processes; using the ‘target’ of the ECB as a benchmark, the average inflation rate of the Euro can be interpreted as satisfactory. See the forum discussion by Rajan/Kiran and Hefeker in Intereconomics May/June 2006 where the more traditional views are exchanged.

\textsuperscript{14} It needs to be stressed though that national innovation regimes still dominate and as a result the innovation activities of member states differ enormously (Huebner 2007).
of international investors. However, due to the structural weaknesses of the Euro area those potential processes will not result in enthroning the Euro to the Master Currency of the global economy. The result of all those movements will be an oligopolistic global currency regime (Herr/Hübner 2005) that brings a high level of volatility to the currency markets. It may be not so much a leaderless currency system as Cohen (2008) is suggesting but a regime with a few leaders who may favor different paths out of the current stalemate.

4. Appreciation of the Euro and its meaning for the ECB

The public at large sees the appreciation of a currency as ‘proof’ of the strength and international reputation of a national currency. Cross-border travelers make the experience that buying goods and services abroad is becoming a attractive and relatively cheap transaction and this in turn may not only improve their well-being but also generate the kind of proud and identity stable currencies seem to generate (Huebner 2005). On a more economic level an appreciation of a currency has two main effects. First, the price competitiveness of the export sector is reduced leading to a (volume) shrinking of exports; the import-competing sectors of the domestic economy come under pressure, too, as the import-prices denominated in domestic currency are getting lower. Both processes may discourage domestic producers to increase investment. An appreciation, secondly, lowers the cost of imported inputs, may they be intermediate goods or raw materials.\(^{15}\)

\(^{15}\) A crucial product is oil that is denominated in US-Dollar. Any depreciation of the USD triggers a -time-delayed – increase of the price for raw oil. In this respect, the
Depending on the depth of international production chains of a national accumulation regime this positive price effect may compensate for the negative price competitiveness effect. Blecker (2007) showed in an time-series based econometric study for the period 1973 – 2004 that the US manufacturing sector suffered heavily under the appreciation episodes of the US-Dollar. Given the well-known hysteresis effects of changes of the real exchange rate, an appreciation may undermine the export ability of crucial sectors and therefore delay export-stimulating effects in case of a period of a depreciation of the currency (Baldwin/Krugman 1998). In the short-run, the international competitiveness is mainly determined by price and cost factors. Because the external dimension of the cost and price factors are driven by the exchange rate, it is obvious that the appreciation of the Euro will have implications. In order to get an accurate picture of those effects we can turn to the (real) effective exchange rate of the Euro, i.e. the exchange rate with its main trading partners weighted with their respective trading shares. Calculations show that since 2001 the real effective exchange rate increased significantly (Hildebrandt/Antionette/Sigoner 2007); the member states of the Euro area as a collective nevertheless achieved external trade surpluses over most of the years of the Euro appreciation (see below).

The appreciation of a currency also impacts the financial sector. In an open economy a relatively stronger currency attracts business, either in the sector of international bond issuance, securitization and/or in

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strong appreciation of the Euro against the USD reduced the price increase effects of oil for the Euro area economies.

16 Berthou (2008) shows that the effects of real exchange rate movements on bilateral exports tend to differ in the group of OECD countries. Geographical proximity as well as the quality of institutions plays an important role in the explanation of the different outcomes.
financing the internationalization of the production sectors. The increase in scope and scale that comes with a strong currency is of enormous advantage for the financial sector of this economy. Financial institutions will use the relatively higher purchasing power of an appreciated currency to increase their stakes in global financial markets; they will also make use of the ‘home advantage’ in servicing the internationalization strategies of other sectors of an economy with an appreciated currency. Lane (2007) provides strong empirical support for the general observation that the launch of the Euro not only precipitated the process of European financial integration but also strengthened the international competitiveness of the European financial industry in the global economy (see also ECB 2007). Despite active efforts on the side of the European Commission and national governments to strengthen the financial sectors, the degree of financialization in the Euro area was lower then in the US (Boyer 2000; Orhangazi 2007). Assuming that financialization is a strong determinant of network externalities of a currency, we can explain the position of the Euro in the currency hierarchy by the difference in financialization between the US and the EU.

Central banks usually have no particular exchange rate target. Their main interest is in a stable exchange rate that allows building firm expectations on the side of the private sectors and by this supports the monetary policies of central banks. This rule also holds for the ECB. The brief historical experience indicates though that the ECB goes one step further then other central banks by supporting a relatively high exchange rate of the Euro vis-a-vis the currencies of the main trading
partners of the Euro. The reason for this particular strategy is deeply rooted in the monetary philosophy and approach of the ECB.

Unlike other modern central banks the ECB is a one-sided mandated institution whose overarching policy target is the guarantee of stable prices (article 105). Albeit the ECB does not have an official inflation target, it does interpret price stability as an average inflation rate ‘below 2 per cent per year’ in medium term. Given its narrow defined function, the ECB is not involved in an active macro economic management or a deliberate policy mix. In order to achieve the designated price stability it makes use of its monetary policy that was based on a two-pillar strategy. Following the (monetarist) tradition of the Deutsche Bundesbank, the ECB issued a growth for the monetary base (M3); this pillar was seconded by a basket of price indicators that should be taken into consideration in setting the lead interest rate. The experience so far has shown that the ECB not only violates systematically its money growth target but that despite all rhetoric it orients its actual interest rate policy on pragmatic interpretations of ongoing economic processes. This discretionary behavior contradicts its own policy stance and makes it difficult for market participants to really understand (and anticipate) moves of the ECB. Despite those problems it is only fair to state that the ECB could report a strong degree of price stability over the years. This record has been achieved by using the appreciation of the Euro to a policy tool in order to keep

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17 It has been well demonstrated that the first pillar never really worked – what was seen as an ideological disaster for the leading representatives of the ECB. The second pillar is much more fuzzy, and it is this fuzziness that explains the overall pragmatic monetary policy behavior of the ECB. Wyplosz (2008) rightly makes the point that the ECB is a closet inflation targeter.
inflation down. Turning the exchange rate to a policy tool in order to fight price inflation is a remarkable achievement on the side of the ECB that so far has not been analyzed carefully.

The launch of the Euro drastically changed macroeconomic policy making for the member states. Unlike in the past, fiscal policies and/or exchange rate policies are no longer available to responding to macroeconomic challenges for any individual member of the Euro area. This changes fundamentally the adjust processes in case of internal or external shocks. In a situation where fiscal policy is tamed by the Stability and Growth Pact and a depreciation of a national currency is no longer in the books, it is in the short run up to managing costs like indirect and direct wages to keep a economy internationally competitive. As the ECB is not in a position to directly influence direct and indirect wage costs she uses its monetary policy to announce harsh punishments in case wage negotiator and governments do not take international price competitiveness into their consideration when they negotiate wages and make tax and budget decisions. The punishment available for the ECB is its lead interest rate. Due to shifting its monetary philosophy from pillar one to pillar two, the exchange rate moved center to the procedure of interest rate setting. It is still true though that the ECB on a regular base comments on wage and cost developments in member economies. Additionally, she refers to exchange rate movements in order to create a price stability consciousness. In this respect it is obvious that the ECB follows an asymmetrical approach regarding the exchange rate of the Euro vis-à-vis the US-Dollar and other main currencies. During the
period of depreciation of the Euro, the ECB intervened heavily in the
global forex markets in order to restore the exchange rate and to
secure the reputation of the new currency. No interventions can be
reported since the strong appreciation of the Euro - despite the harsh
and in times provocative appeals of national politicians to convince
the ECB to go for a lower exchange rate towards the US-Dollar and
some other currencies. The reason can be seen in the inflation
dampening effect of a strong Euro, particularly in times of strong
increases in dollar-denominated prices of raw materials.

The ECB not only established a reputation as an inflation hawk but
also as a proponent of a strong Euro policy. Creating a strong Euro is
not so much an end in itself but a policy tool in order to shift the
adjustment processes resulting from the efforts of keeping up
international price competitiveness to the actors who decide about
direct and indirect wages. The result so far has been an overall muted
inflation rate in the Euro zone, not least due to the successful efforts to
decrease unit labor costs. However, it seems as not all member
economies can deal equally with a high (real) exchange rate as the
differing movements of unit wage costs indicate. As a result the Euro
zone experiences a strong polarization of current account balances

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18 Henning (2006) portraits the discussions between EcoFin members, ECB and
other central banks if and when how strong to intervene in order to give the Euro
exchange rate an upward push. It is only logical that European politicians as for
example former German Chancellor Gerhard Schroeder were absolutely happy with
the weak Euro as this helped the ailing export sectors and provided the economies
with a motor of growth in difficult times,
19 Huebner (2007) discusses the political and legal framework of the exchange rate
politics of the ECB. Henning (2006) provides an excellent analysis of the economic
policy debate.
that mirrors the imbalances of the global economy. What this means for the stability of the Euro zone is a topic for another paper.

References


