No Need to Fear a Strong Euro: Facing the World Economy's Gordian Knot in Europe

Paul Isbell *

Theme: The appreciation of the euro over the last two years –a trend likely to continue into the future, despite a recent slip from US$1.29 to US$1.21– is not only a positive development for the European economy but also a prerequisite for a sustained period of global growth.

Summary: The world economy cannot recover and begin a renewed cycle of strong sustainable growth until the remaining international macroeconomic imbalances –legacies of the 1990s' US-driven boom– have been unwound. Only dollar decline and European economic reform can hope to achieve the necessary adjustment. Europe would be well-advised to take advantage of the new window of opportunity for cooperation to resolve the Stability and Growth Pact controversy and to forge ahead with the Lisbon Agenda. While many may be sceptical that this can be rapidly achieved in Europe, it nevertheless remains a better bet than passively expecting the corollary adjustments to be made in the US on fiscal policy or in Asia with respect to currency policy. In the end, if the European project is to deliver on much of its long-awaited promise, the EU must assume its new role as a critical engine of world economic growth.

Analysis

Economic Reform in Europe
For a number of reasons the economic mood in most of Europe has been gloomy. First, the atmosphere within the European Union (EU) has been particularly acrimonious ever since the controversy surrounding the Stability and Growth Pact led to the temporary suspension of the pact's excessive deficit procedures last November by way of a narrow vote in the Council of Ministers. This gloom was accentuated by the EU's failure to reach an agreement on the new Constitutional Treaty (in which the economic governance components had already been left dangerously weak) by the end of the Italian presidency in December. These less-than-ideal outcomes within the EU contributed at least indirectly to a deepening pessimism in the business and financial communities both in Europe and abroad.

Then in January, the European Commission released its annual report on the progress achieved to date by the European economies in their pursuit of the mid-term objectives of the Lisbon Agenda, the EU economic programme agreed upon at Lisbon in 2000 which aims to make the EU the most dynamic and productive knowledge-based economy in the world by 2010. The EC's progress report, slated to be at the centre of discussions at the Council meeting in Dublin this weekend, was sobering to say the least, revealing that Europe remained significantly behind its Lisbon targets.

* *Senior Analyst, International Economy, Elcano Royal Institute*

Some encouraging signs have at least partially illuminated these darkening skies. Last fall, the German government made significant headway in laying the groundwork for the legislative approval of its economic reform programme, Agenda 2010, which aims to streamline the German welfare state and increase the flexibility of the highly rigid German economy. The success of the German reform programme would send a powerful signal to the world that leadership on reform efforts in the continent's biggest economies was finally being exercised. In late February, Germany convoked a summit in Berlin of the "big three" (with France and the UK), ostensibly to debate the Lisbon reform agenda in anticipation of the Dublin Council and to breathe fresh air into the economic reform process.

But the German reform process is not a done deal, and nor are the rest of the minimum reforms necessary to increase the long-run potential growth rate of the EU economy. Already Gerhard Schroeder, Germany's SPD Chancellor, seems to be losing influence. After having been forced to relinquish leadership of the party by SPD strongmen, Schroeder watched on haplessly as the SPD badly lost the Hamburg elections, turning in their worst electoral performance there since WWII. Now even the Christian Democrats, the conservative opposition party, are showing increasing signs of withdrawing legislative support for Schroeder's reform agenda (even though the CDU theoretically supports even more ambitious economic reforms). In any event, Schroeder appears to be willing to stake his entire political future and legacy on the success of the reform agenda. Having threatened to resign if a number of initial reform votes did not succeed, Schroeder continues to push his unpopular reform agenda even though his approval rating is no higher than 25%, lower than any previous German Chancellor and certainly far lower than Helmut Kohl was willing to see his popularity drop as a result of insisting on liberalizing economic reform.

Admittedly, German progress on reform would exercise a most powerful demonstration effect for other reform laggards in the EU. Indeed, Germany must be at least the symbolic leader of economic reform and provide important political stimulus to the other EU members. Even Spain, a supposed leader of the Lisbon programme, and a country increasingly accustomed to being described as an economic star in Europe, lags badly behind on the Lisbon objectives, particularly in areas related to research and development, innovation, information technology, human capital development and education. After much rhetorical attention lavished on the Lisbon Agenda by the Aznar government (but with only a patchy record, at best, of real action), it remains to be seen whether the new social democratic government, surprisingly elected on March 14 in the wake of the Madrid bombings, will be able to improve upon the Popular Party's reform record. At least the economic programme, designed for the election campaign by Miguel Sebastian, is consciously and meticulously trained upon the Lisbon objectives of enhancing productivity and bolstering the long-run potential growth rate.

But while insufficient economic reform continues to undermine Europe's potential growth, cyclical problems also plague the current economic environment. Although both Germany and France have continued to breach the Stability and Growth Pact's 3% deficit limit, the additional fiscal stimulus that this has implied has not served to dramatically push these economies forward, as the controversy surrounding French and German fiscal policy has contributed to undermining business and consumer confidence, limiting the positive anti-cyclical effect that higher deficit spending might have had. German growth was slightly negative in 2003, and the outlook for 2004 is only marginally better. Meanwhile, the recovery of German business confidence, which continued through much of 2003, has recently begun to falter, as the IFO economic sentiment surveys in the last months have begun to slip after several months of gains. At best, the higher deficits in France and Germany have simply served to keep Europe's double-dip slowdown from collapsing into a full-blown continental recession.

The Euro

Perhaps the issue which has caused the most apprehension in the press about the future of European recovery has been the appreciation of the euro. Since its cyclical low of US$0.82 in early November 2000 (more or less reached again during 2002), the euro has appreciated against the dollar by some 50% (swinging within the US$1.20-US$1.30 band now for several months). Concern has recently reached a near feverish pitch that euro appreciation could abort Europe's sluggish recovery by undermining export growth, particularly in Europe's biggest economies, Germany and France, where exports destined for non-Euro zone markets make up a larger part of GDP than in other Euro zone economies like Spain. This fear has led to numerous demands for looser macroeconomic policies. On the one hand, many in Europe are calling for the reform of the Stability and Growth Pact, arguing that it is too rigidly restrictive during cyclical downturns, and particularly given that many of the reforms called for in the Lisbon Agenda require significant increases in government spending on education, R&D, and other forms of public investment. On the other hand, forceful appeals are also emerging, insisting that the ECB should relax monetary policy to offset the contractional effect of the stronger euro.

Regardless of the merits of the above arguments for looser macroeconomic policy in Europe, it certainly makes no economic sense, given the international context, to continue to target the stronger euro as the source of European economic malaise. Although a weaker currency, *vis-a-vis* one's major trading partners, is always a potential source of short-term growth, via its effect on the GDP contribution from the external sector, it is not necessarily a firm foundation for a sustained cycle of growth. In the current scenario, a weaker euro might support the external sector's contribution to European growth, but that is all it would do. A secondary effect of such a development would be further upward pressure on the US current account deficit which is already at record levels (both in absolute and relative terms) and has shown no signs of moderating even with the strong dollar depreciation against the euro.

Indeed, there is generally a lag between the period of currency adjustment and the resulting current account adjustment; what is more, there is generally an initial worsening of the current account deficit (in the case of currency depreciation) due to a number of structural rigidities in import prices and contracts, which means that import volume is slow to react to depreciation, therefore creating a larger import bill at least until the full adjustment can take place (an effect known generally as the J-curve). Even in the case of the US, where the majority of foreign trade is contracted in dollars (partially sheltering the world's largest economy and trader from rapid adjustment effects), a weakening dollar will not necessarily rapidly translate into lower imports, while exports will also typically face a delay before responding. This situation has been mirrored by continued export growth in Europe, particularly in Germany, during the recent period of currency adjustment.

If the euro were to fall once more against the dollar –before current accounts have been adjusted– the external imbalances would remain and even grow, making the dollar even more vulnerable to a potentially precipitous decline in the future. The long and the short of it is that knowing that an increasingly strong dollar, along with strong US domestic demand, served as the driving forces in the last cycle of world economic growth in the late 1990s, a renewed period of world growth driven by the same factors will always be vulnerable to a reversal given the increasingly important constraint of the US current account deficit. The days of strong US domestic demand, coupled with weaker currencies abroad, as the key engines of growth are numbered, at least until the US's current account deficit has been sufficiently reduced, and until the trading surpluses elsewhere are also eliminated. To return to the world growth pattern of the 1990s –with the US economy growing exclusively on the basis of internal demand and supported by a long cycle of dollar appreciation, and the rest of the world's major economies in Europe, Asia

and the emerging world growing mainly on the basis of strong external demand provided by the US and supported by a cycle of currency depreciations– would no doubt prove to be short-lived. Furthermore, the inevitable outcome would be a return to a cycle of currency adjustment in which the dollar depreciated strongly against other major currencies, only this time around it would be more severe. The point is that this correction ultimately must occur.

This means that before another sustained cycle of world growth can get underway, two important changes must take place in the US and European economies (Asia will be dealt with below). The US must engage in a sustained recovery based on growth from the external sector and a slowdown of domestic (particular consumer) demand, while Europe must grow on the basis of expanded domestic demand, accompanied by a correction of its current account surplus. Only when this combination of adjustments takes place – allowing for an unwinding of US deficits and its consumer debt overhang, and accompanied by a revival of the reform impulse and domestic demand in Europe– will the world economy be on track for another period of sustained growth.

In this scenario, there is no viable role for a weaker euro or a stronger dollar. Indeed, a stronger euro, while eventually contributing to a readjustment of Europe's over-reliance on the external sector, will actually help stimulate domestic demand by increasing Europeans' real purchasing power and possibly even increasing consumer confidence. *Nevertheless, a stronger euro, while remaining a necessary ingredient for the revival of domestic demand, is not by itself sufficient.* If a strong euro is not accompanied by a stimulus from domestic macroeconomic policy and by a serious effort to rationally liberalize the European economy, then it will contribute to further economic stagnation in Europe. In this respect at least, one of the debilitating knots cramping the world economy today is found in Europe.

Nor is there a place for policies in the US designed to prop up domestic consumer demand. While the aggressive fiscal policy of the US during the last few years may have helped cushion the negative impact of the recession, there is now clearly no more convincing positive role for it to play. At most, fiscal policy stimulus should taper off to assure a gradual retrenchment of consumer spending and the accompanying draw-down of consumer debt. Paradoxically, had the US fiscal stimulus been designed differently, aiming the stimulus at those with the highest propensity to consume and/or those with the highest debt levels, it would have produced a greater stimulus effect, thereby creating a more likely possibility of faster job creation. At the very least, it would have allowed debtors to begin to lower debt levels earlier, allowing the subsequent consumer retrenchment to take place more gradually. Now the inevitable will only be harder and more painful to achieve. In the US –particularly in the realm of deficits and debt– we also find another important knot tying up the world economy.

Asia
Admittedly, Asia presents a piece which is difficult to easily fit into this puzzle. Formal and informal efforts in Asia to circumvent a decline in the dollar have contributed to increasing the pressure on both of these knots. In Japan, at least, the recent recovery offers the possibility that the yen will be allowed to gradually appreciate, after a long period of central bank intervention designed to avoid this from happening (and presumably to short-circuit the perceived negative effects on the nascent, but still vulnerable, recovery).

In China, however, where growth remains very robust –and has even threatened the economy with overheating– the situation remains more problematic. Rapid growth is a political necessity for the Chinese regime, given the overriding need to continue to absorb the onslaught of rural-urban migration to the booming industrial zones in search of paid employment. Furthermore, the delicate situation in which the banking sector finds itself –

dominated by four large state-owned banks with between US$400bn and US$800bn in bad loans– means that capital flow liberalization is, for the moment, not on the cards. A discrete revaluation (perhaps in the context of a new currency basket peg) might be considered, but it does not seem likely any time soon, considering the regime's thirst for stability and the potential threat this revaluation might mean for growth. If China's fixed exchange rate is maintained, on the other hand, its trade surplus with the US (constituting about 25% of the US's US$500bn dollar current account deficit) is unlikely to subside any time soon, placing the burden of currency and current account adjustment on Europe. Thus, Chinese domestic dilemmas continue to place pressure on yet a third, Asian, knot in the world economy.

Conclusions: Ideally, we would like to see all three knots (in the US, Europe and Asia) gradually loosened and undone. Unfortunately, each implies difficult domestic decisions which are politically problematic. In the US, this would require more fiscal discipline to take pressure off the current account and make the recovery more export dependent. In Europe this would mean more stimulus for domestic demand and further economic reform. In Asia, this would imply reform of the Chinese banking system and a stronger yuan and yen.

Perhaps over the course of this year interceding events will make such changes more likely. A change of government in the US could bring about a significant change in fiscal policy. Nevertheless, much will depend upon the fate of the US strategic agenda and military spending under a Democratic president who is unlikely to enjoy a majority, at least in the House of Representatives. If the Republicans win the November elections, however, the only chance for US budget deficits to begin to subside will be rapid growth; but given the pattern of the current recovery, such growth will rely strongly on US domestic demand and continued upward pressure on the current account deficit –not exactly a sound recipe for sustaining this growth–.

In Europe, the recent change in atmosphere in the EU that has come in the wake of the PSOE victory in Spain may lead to a more rapid agreement on the Constitutional Treaty. Such an agreement (possibly prepared for in Dublin this weekend) could also spill over into a more conciliatory environment in which the debates over the Stability Pact (due to be brought back onto the table for debate in April) could produce both the necessary reforms of the pact and the possibility of a more stimulating fiscal policy to support the recovery of domestic demand in Europe. The most optimistic scenario would also see this new positive atmosphere of cooperation feeding into a renewed impulse across the continent to make significant progress on the Lisbon Agenda.

In Asia, continued Japanese recovery might lead to a less interventionist stance by the Bank of Japan in the currency markets, while continued progress in Chinese banking reform could build enough confidence for the Chinese authorities to begin to consider a change in currency policy.

But none of this is guaranteed, making anything more than a cautious reading of the current signs of world recovery dangerously naive. Indeed, exogenous shocks could upset the apple cart altogether. Although one possible positive development would be a drop in oil prices this spring, this would be more than offset by another series of Islamic terrorist attacks in the US and Europe, particularly if the attacks were to take place in France or Germany, or if they occurred in the form of weapons of mass destruction (see *¿Qué significa el 11-M para la economía española, europea y mundial?*, Paul Isbell, Real Instituto Elcano, ARI nº 52/2004, 23/3/2004).

Ultimately, Europe will have to take up its destiny as a central engine of world growth. Failure to do so is indeed the greatest single extant threat to the success of the European

project. Even if the project were to survive this failure, the EU would remain a toothless entity in the international system, hardly an appetizing scenario for those who see the EU as a model for the world. The message to European leaders could not be clearer. To wait for European growth to be restored by demand from the US or Asia is not only naive but dangerous. A strong euro is not an obstacle, but rather a welcome –if not the only or even the essential– tool for the task Europe faces today.

Paul Isbell
Senior Analyst, International Economy, Elcano Royal Institute