Chapter 8

ECONOMIC FACTS POINT TO A WEAK EURO

The governor of France’s Central Bank doesn’t have quite the mythic stature of his counterpart in the United States. Nevertheless, Jean-Claude Trichet is one of the most influential and respected figures in Europe’s high financial circles. Besides his Bank of France domain, he is also a member of the governing council of the European Central Bank and a prominent candidate to succeed the ECB’s present head at the end of his tenure.

So, when Mr. Trichet asserts, as he recently has done, that “... the euro is undervalued compared to our [i.e., Europe’s] fundamentals,” it can be presumed that the assertion reflects a prevalent and perhaps dominant view in those circles.

The euro was established on January 1, 1999 as the common currency for members of the European Monetary Union, which includes all members of the European Union except the United Kingdom, Sweden, Denmark, and Greece. The value of the euro was initially set at 16 percent above the dollar (1 € = $1.16), but thereafter was left to float against the dollar and other currencies.

This initial value was accompanied by a chorus of forecasts from numerous knowledgeable sources—including Nobel prize winner Robert Mundell, Fred Bergsten, Barton Biggs, Roger Kubarych, among many others—that establishment of the euro would reduce the dollar’s role as the principal global reserve currency, that the

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larger size of euroland’s collective gross product and trade volume would buttress the euro, and that the result would be a significant weakening of the dollar.

Instead, what has ensued recalls Paul Samuelson’s trenchant quip some years ago: “Wall Street indexes predicted nine of the last five recessions.” Rather than appreciating, the euro has steadily depreciated against the dollar, settling in recent months at a level about 20 percent below its initial par value (1 € = $.93).

This is the background of Mr. Trichet’s assertion.

To assert that a particular market price—in this instance, the euro’s dollar price—is “undervalued” is to belie a central tenet of economics: the theory of efficient markets. The efficient market theorem, drawing on the work of Friedrich Hayek and Robert Lucas—both Nobel prize winners in economics—postulates that efficient markets incorporate all information available at the time the prices in these markets are set. Consequently, price changes must be attributed to information emerging subsequent to the time any particular price or set of prices was set.

In any event, contradictions to this theory sometimes do occur in practice. Markets may overshoot for a host of institutional or psychological reasons—for example, so-called “herd” behavior, or “contagion” effects, or the effects of arbitrary rules of thumb governing buying and selling operations by large institutional investors. And such overshooting or undervaluations may take time to correct through price movements in the direction presumably indicated by new information—in the case of the euro, new information about the “economic fundamentals” which Mr. Trichet alludes to, although without further specification.

These “fundamentals” presumably are factors affecting the demand for and supply of euros and dollars in international markets. However, the difficulty this presents for Mr. Trichet’s contention is that examination of the “fundamentals” does not support the contention that the euro is undervalued.

On the one hand, euroland will probably continue to have a trade and current account surplus (about .6 percent of its gross product), while the United States has a large current account deficit (nearly 4
percent of its gross domestic product). In itself, this would tend to boost the euro’s value. But this first of the “fundamentals” is offset by a second: the continuing outflow of direct investment (recall Deutsche Bank/Bankers Trust, DaimlerChrysler, Bertelsmanns/Random House, Vodafone/AirTouch, BP/Amoco, etc.), and large-scale portfolio capital from euroland seeking higher-yielding assets in dollarland. And this outflow, of course, tends to strengthen the dollar and weaken the euro.

Among the several other “fundamentals,” the balance is still less favorable for the euro. For example, the increased economic growth that is underway in Europe and the slower growth that may impend in the United States will still leave U.S. growth about 1 percent above that of Europe. Also, while labor productivity in the United States is only slightly above that in Europe, total factor productivity—a rough measure of technological advance based on a weighted combination of both labor and capital inputs—is appreciably higher in the United States than in Europe.

Inflation is not an evident problem in either Europe or the United States, thanks to the successful management of monetary policy by the ECB and the Federal Reserve, respectively, and to the current and prospective large budget surpluses in the United States. Germany’s recent tax reforms, and especially its planned elimination of capital gains taxes over the next two years, are encouraging signs of a loosening of capital markets in Europe’s largest economy. Such measures might be expected to enhance the euro’s value if they were not overbalanced by another “fundamental” factor: namely, the expanded regulatory reach of the European Commission in Brussels and its top-level cabinet of 20 power-hungry Commissioners.

Finally, there remains the “fundamental” anomaly of the purchasing power disparity between the euro and the dollar: even with a euro valued at 93 U.S. cents, most consumer goods are more expensive in Europe than in the United States.

The bottom line is quite the contrary of the Trichet supposition: when the “economic fundamentals” are examined, they add up to at least as strong a case for an overvalued as for an undervalued euro. This conclusion also provides some redemption for the efficient markets theorem in practice as well as in theory.
Postaudit

This forecast in 2000 has proved to be right on target. The euro had depreciated another 10 percent by 2002.