

**ECONOMICS:** EUROPEAN PERSPECTIVES—JANUARY 13, 2012

# Weaker Euro Provides Some Relief to Contracting Euro-Area Economy

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In trade-weighted terms, the euro is now at its weakest since 2003. A lower exchange rate cannot solve all the euro area’s problems but, along with the European Central Bank’s aggressive moves to support bank funding, it should help the economy avoid a severe economic contraction.

Having defied gravity for much of 2011, the euro has weakened significantly in recent weeks. It’s not difficult to understand why. The sovereign-debt crisis has finally spilled over into the real economy and, in response to this and difficulties in the bank-funding channel, the European Central Bank (ECB) has lowered interest rates and allowed a significant expansion of its balance sheet. Moreover, these developments have taken place at a time when the outlook for economic growth elsewhere has held steady or improved.

Despite its recent fall, the euro is still much stronger against the US dollar than it was in mid-2010 when the sovereign-debt crisis first hit. From an economic standpoint, though, the most important measure of the euro’s external value is its trade-weighted exchange rate. On this basis, the euro is now at its lowest level since 2003 (**Display 1**), 9% below last year’s peak and 8% below its average over the last five years. Taking a broader perspective, the euro’s real trade-weighted exchange rate is now back close to its long-run

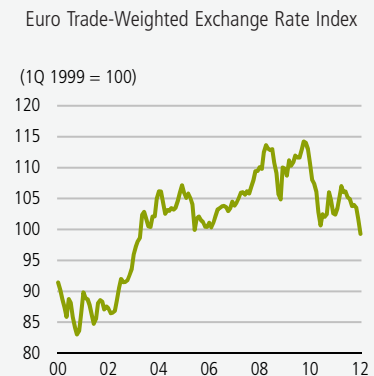
average.

To help gauge the impact of the euro’s recent decline, we constructed a simple monetary conditions index (MCI) for the euro area. Our MCI assumes that a 7% increase/decrease in the euro’s trade-weighted exchange rate has roughly the same economic impact as a 1% point increase/decrease in short-term interest rates (measured by the three-month interbank rate). On this basis, monetary conditions in the euro area have eased significantly in recent months and are now extremely loose (**Display 2**). This is in sharp contrast to the period prior to the 2008 recession, when there was a marked tightening of monetary conditions in the euro area.

### Rising Oil Price

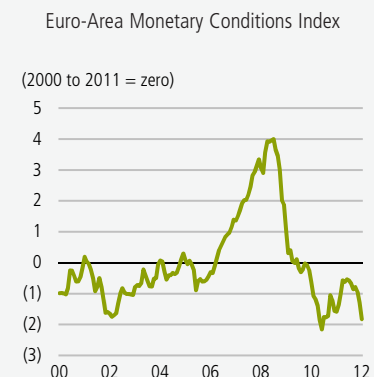
Another factor to consider when trying to gauge the impact of the euro’s recent decline is the oil price. In US dollar terms, the oil price is currently well below its peak in the first half of last year and 30% below the record highs reached in mid-2008. It’s

Display 1  
Euro Drops to Eight-Year Low



As of January 12, 2012  
Source: ECB and Haver Analytics

Display 2  
Marked Easing of Monetary Conditions



Assumes that a 7% increase/decrease in the trade-weighted exchange rate has the same impact as a 1% point increase/decrease in short-term interest rates; expressed as an interest-rate equivalent and rebased so that the average reading between 2000 and 2011 is zero.  
As of January 12, 2013  
Source: ECB and Haver Analytics

a different story in euro terms, though, as the oil price has risen strongly in recent weeks and is now just 4% below its all-time high (**Display 3**).

So which matters more, the beneficial impact on exports of a weaker euro or the negative impact on real incomes of higher euro oil prices? To provide some guidance, we constructed a series combining the change in the euro's trade-weighted exchange rate, oil prices and nonenergy commodity prices (both in euro terms) over a rolling six-month period and weighted these three factors on the basis of their estimated impact on economic growth over the following year (**Display 4**). Two points stand out.

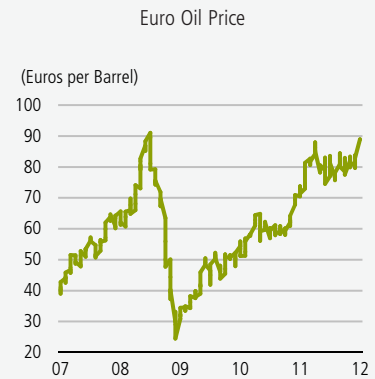
First, a strong euro and rising euro oil and nonenergy commodity prices are likely to have weighed heavily on euro-area growth in the first half of 2011. This helps explain the sharp slowdown that took place after a strong first quarter. Second, this analysis suggests that the boost from a weaker euro is more powerful than the negative impact of rising euro oil and nonenergy commodity prices. The net impact on growth from these three factors is now likely to be positive.

Of course, this does not mean we should be optimistic about the economic outlook. Growth slowed sharply in the second half of 2011, with output likely to have fallen in the fourth quarter. Unemployment is rising, business and consumer confidence have been sapped by the sovereign-debt crisis, austerity is now spreading across the euro area and the sclerosis of the banking system continues to represent a significant downside risk to growth.

Moreover, it's important to remember that a decline in the external value of the euro per se will not be sufficient to correct the imbalances that exist within the euro area itself. That will require a series of large internal (real) exchange-rate adjustments.

But even if a weaker currency cannot solve all the euro area's problems, the overall impact is still positive. Downside risks remain, but the euro's recent decline, ongoing growth elsewhere in the world and the ECB's massive liquidity injections suggest that a mild recession is still the most likely outcome for the euro-area economy this year. ■

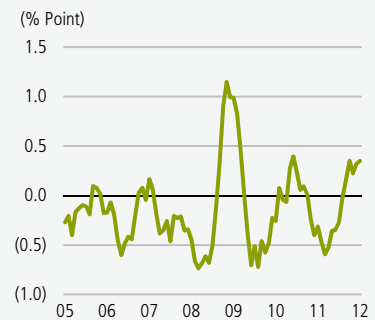
Display 3  
Euro Oil Price Close to Record Highs



As of January 12, 2012  
Source: Bloomberg and Haver Analytics

Display 4  
Net Positive Impact

Estimated Impact of the Euro and Euro Oil and Commodity Prices



Estimated impact of the change over the previous six months in the euro and (euro) oil and nonenergy commodity prices on real GDP growth over the following year  
As of January 12, 2012  
Source: Bloomberg, ECB and Haver Analytics

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