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The twin shocks hitting the eurozone

CEPS Commentary/16 September 2008

Paul De Grauwe*

The downturn of economic activity in the eurozone has come as a surprise to many observers. The credit crisis appeared to be less severe in the eurozone than in the US and, apart from Spain and Ireland, none of the eurozone member countries experienced serious problems in the housing market. Yet the eurozone now comes close to a full-fledged recession. What happened to cause such a rapid and intense deterioration in the eurozone business cycle? The key to answering this question lies in the exchange rate of the euro.

From the start of 2007 until July 2008, the euro appreciated by about 14% on average against its main trading partners. This exchange rate shock came on top of a protracted appreciation in the preceding five years. The second shock hitting the eurozone was the doubling of crude oil prices since early 2007.

The effect of the exchange rate shock on the profitability of the eurozone companies that compete internationally has been of the same order of magnitude as the oil price shock. Take an average eurozone exporting company selling a product worth €100. Energy costs prior to the oil price shock represented €10. Now comes the doubling of oil prices leading to a doubling of the energy costs to €20. This squeezed profits by the same amount, unless the company could raise its price in foreign markets. But let us assume that the exporting firm 'priced to market' so as not to lose market share.

Now let us look at the implication of the appreciation of the euro during the same period. Our prototype exporting company has experienced a drop in revenues of 14%; that is, the euro value of its export dropped from €100 to €88. This squeezed profits even more than the doubling of the oil price. Our company recuperated part of the revenue loss because the euro appreciation led to a drop in the euro price of oil, reducing the energy cost. But this effect was small given that the energy costs are a relatively small fraction of the total value of the product.

There are many other effects of these two shocks, but they all point to the same conclusion. Since the start of 2007, the export sector in the eurozone has been hit by a twin shock, an oil price shock and an exchange rate shock, of approximately equal magnitudes. These two shocks squeezed profits of exporting firms twice.

* The author is Professor of Economics at the University of Leuven and Associate Senior Fellow at CEPS. CEPS Commentaries offer concise, policy-oriented insights into topical issues in European and world affairs. The views expressed are attributable only to the author in a personal capacity and not to any institution with which he is associated. This commentary was previously published in the Financial Times, 5 September 2008.

The opposite has happened in the US since the start of 2007. The effect of the oil price shock on export companies' profitability was fully compensated by the depreciation of the dollar, which on average amounted to 11% against the major trading partners. Thus the dollar depreciation allowed the US export companies to offset the profit squeeze resulting from higher oil prices. No wonder that the US export sector is booming and the exports of the eurozone countries are stalling.

The oil price shock was an event that eurozone policy-makers could not influence. The same cannot be said of the exchange rate shock. This occurred because the eurozone monetary authorities, the European Central Bank, allowed it to happen. The simple fact is that the ECB neglected the exchange rate. The ECB was influenced by a theory that says that exchange markets are efficient and that therefore the exchange rate always reflects economic fundamentals. In this view it is both undesirable and futile to fight market forces, which are always right. In addition, the ECB managed to sell a minimalist interpretation of its mandate. In this view, the ECB is only responsible for price stability. Only if exchange rate movements threaten price stability are they worth looking into.

Since 2001, the euro has more than doubled in value against the dollar. This appreciation can only be interpreted as a bubble driven by speculation gone wild. During the whole period of massive euro-appreciation, the ECB stood by and watched approvingly. It did not threaten price stability so there was no reason to do anything. This neglect harms the competitiveness of the eurozone export sector and is an important cause of the slowdown in economic activity. The ECB has abdicated its responsibility to intervene in the foreign exchange market and to oppose exchange rate developments that are out of touch with economic forces.

It is time to revise this minimalist view of its responsibilities. One way the ECB could do this today is by giving a forceful signal (including intervention) aimed at reinforcing the recent small downward correction in the value of the euro.