Exchange rate power

In an open economy, exchange rate parity is the most important of prices

by Jean-Jacques Rosa

So what is going on in European economies and more particularly, in the French economy? The cheerless prospects of last fall - with downwards spiralling official growth forecasts for 1999 - were suddenly swept away by a burst of optimistic announcements, with Mr Strauss-Kahn implying that the growth rate from now until the end of the year would take everyone by surprise, and La Tribune headlining "French industry scents a recovery" (Friday April 30 and Saturday May 1). So what has changed, given the fact that world trade has not stopped slackening and that the slight recovery reported in some South East Asian countries and possibly Brazil has been offset by an equivalent deterioration in other regions?

In Euroland itself, Germany and Italy's situation remains difficult and for the latter, worsening. The fall in the BCE nominal interest rate is, as predicted, causing perverse effects by stimulating growth where it is already strong, notably in Ireland where interest rates should have been increased and where the upwards trend in inflation has caused a bigger reduction in real rates than in Frankfurt's nominal rates. On the other hand, France and Germany's falling prices during the last quarter of 1998 have most likely already offset the 0.5% reduction in the April intervention interest rate, which secured the stability and not the lowering of real rates.

Communications and the economic climate

Yet, according to Insee, France's deflation cycle has recently come to a stop, whilst its export order books are filling up.

Should this unexpected turnaround be solely credited to the Coué method, so dear to our leaders, who do their best to saturate the public with encouraging messages based on the simplistic - and false - notion that households and industrialists' opinions on the economy suffice to spark off recession or expansion? This, of course, is complete nonsense. Where it so, macro-economic policy would be child's play, confined to calculating the government's communications policy budget to be in a position to modulate growth at will.

Yet French industrialists' production and prices prospects do seem to be showing signs of slight improvement, with a very modest upwards shift in last year's downturn – despite continued world trade slackening. The reasons for this chink of light piercing through the clouds come from changes of economic policies rather than the actual international environment itself. Not in terms of real interest rates, which have scarcely changed as mentioned above, and which are still too high. But more in the fact that since January, the Euro and hence the franc have dropped by some 10% against the dollar. And consequently, against other currencies - both European and non European. And as we all know, in an open economy, the most important price of all, directly affecting all firms, is the exchange rate, the external price of money.

Timely depreciation

A 10 % drop in the exchange rate instantly and simultaneously reduces export cost by 10 % and increases import costs by 10 %. The impact is substantial, not only on exporters' business results and prospects, but also on all firms competing against imports, in other words, on a large proportion of companies.

Remember the "blast of fresh air" given to French companies by the dollar rise in 1997 (and the inevitable drop of the franc and the mark), minimally acknowledged by the advocates of a strong franc and a strong Euro. As a matter of fact, the fall in the European currency was largely instrumental in the 1998 mini-recovery experienced in France, whilst the world economy continued to trudge through a period of crisis.

The situation is just the same today. The sudden more favourable economic outlook, especially in France, can be traced down to the recent Euro depreciation. For the last few months, the franc was particularly overrated against the dollar, in fact even more so than the mark (see my analysis of the indicators concerning the parity equilibrium of exchange rates using the Big Mac standard as calculated by The Economist, "Euro and Big Mac", in Le Figaro April 9, 1999). The exchange rate stranglehold was therefore more keenly felt by the French economy than the rest of Euroland.

The exchange rate's crucial influence on business and employment was also confirmed by the south east Asian and Brazilian economies which finally managed to stabilise the deflationary and recessionary spirals primed by the financial crisis, thanks to a massive depreciation of their currencies over recent months. The fall in parity allowed these emerging economies to strike a new balance.

Repeated national and international experience have shown how dangerous and in fact, almost suicidal it is, in a world of open and inter-dependent economies, to try and fix all exchange rates once and for all. And what brilliant growth prospects the French economy could soon enjoyed if we were to give up the Euro and fixed exchange rates dogma for the 11 member states of the European Union.

Today, growth is within our reach. But are our political leaders prepared to act and publicly admit their mistakes by casting off their strait jackets?

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