BACKGROUND INFORMATION

FACTORS AFFECTING THE EXCHANGE RATE OF THE EURO

Ever since the introduction depreciation has been characterising the European single currency. This has launched a discussion on the euro's "theoretically right" price. The following factors are taken into account trying to find an answer:

Inflation differential *– according to currencies' relative purchase power parity (relative PPP) the currency of the country with faster inflation rate – in this case the US dollar – should depreciate to maintain equilibrium.*

Interest rate *– empirically interest rates of long-term bonds have been more efficient in explaining exchange rate spreads than money market interest rates. The interest rate spread between the euro area and the US 10year government bonds has shrank, indicating potential appreciation of the euro (see Figure 2.4, p 19).*

Economic growth potential *(including productivity) – according to investors the currency of the country with higher growth potential should appreciate due to investment inflow. Currently the growth potential prognosis favours the strong dollar on a premise of the US economy's soft landing in mid- and long-term period (see footnote 1, p 13). Contemporaneously several market participants tend to doubt in the strength and outlooks of the euro area economy. The relatively rigid structure of the euro area's economy and quite a large share of government expenditure support the weakness of the euro*[1]*.*

The oil price *– another terms of trade factor: sustained growth in the oil price weakens the currency of the country more dependent on oil imports. The euro area countries consume less oil per GDP unit but unlike the United States they are fully dependent on oil imports. If the oil price remains high (over 30 dollars per barrel), the euro should not strengthen significantly.*

Net foreign assets *– international investors will agree to finance growing external debt, ie current account deficit, only if it leads to higher return. Should the interest rates remain unchanged, higher return is ensured by (anticipated) strengthening of the currency of the investment recipient. Even if the US interest rates stop growing, large growth potential will sustain the rate-of-return-on-investment expectations. Still traditionally the US current account deficit as a potential threat is singled out.*

Foreign exchange markets *– compared to the above factors, rapid implications on the exchange rate arise from daily transactions on the money market. The latter depends mostly on technical analysis (including risk acceptance and profit estimates) and economic and political news. The foreign exchange market considers the euro weak.*

Although the euro's equilibrium exchange rate estimate based on the above mentioned factors (except the last one) is higher than the current exchange rate (about 1.10–1.25 USD/EUR), the current analysis forecasts relatively weak euro.

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[1] Growing government expenditure inhibits growth of gross productivity compared to the private sector.