

## EFFECT OF HIGH EURO

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### ABSTRACT

Over the course of the last month, the US Dollar has reached an all time low versus the Euro. Several factors have played a significant role into this record setting slump. The research has been conducted to determine how increasing value of Euro could affect U.S. trade with Europe. To illustrate the significant outcomes of currency fluctuations, particularly, Euro versus Dollar, from a managerial economics perspective indicating implications of the Euro for U.S. trade and investment are discussed. Attempt and intention initially will be providing information in a clear, concise, and easily understandable manner. Consequently, the issues such as rationale for Euro, high Euro's impact on macroeconomic indicators mainly job market, the twin deficits, and the interest rates and finally the role of falling U.S. dollar on International trade, particularly importation and exportation are analyzed and clarified.

The term "globalism" is become overused, and often misused. In fact we might say that it has actually been devaluated to the level of the everyday language of buzzword-brandishing marketing pundits. Such freewheeling use has perhaps prompted many MBA/CEOs (or future MBA/CEOs) to launch into a global plan or strategy without proper consideration of the demands and dynamics of the international marketplace. Many would-be globetrotters neglect the acquisition of language skills, knowledge of foreign trade containing exportation concepts such as tariffs, quotas, and customs tax laws, accounting standards, etc. all of which are necessary to "effectively" go global. Superficial knowledge only leads to failure. As international cooperation increasingly growing in importance and world community loudly called upon globalization, it is very crucial to observe how euro establishes its durability. The relation between the U.S dollar and the European Union Euro directly affects the U.S. Firms and their international counterparts. To begin to appreciate this

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relationship and its implications for the international market place, one needs to understand the formation of the Euro and the history of the U.S. dollar in international trade.

The Euro is a single currency arrangement between 11 members of the European Union (EU) that came into theoretical operation in January 1999. On January 1<sup>st</sup> 2002, 12 European Union members replaced their own currencies by introducing the Euro as their sole currency. Although many citizens still convert the prices to their old national currencies, and the stores display the prices in both euros and national currencies, and euro has taken its place in the global marketplace. It is commonly used outside the euro zone as well, which strongly increases the demand for international traders both inside and outside the euro zone. The Euro area countries have a population slightly larger than the population of the United States and economies with a combined Gross Domestic Product (GDP) about 75% the size of the GDP of the United States. (Table1.1)

A single currency means that there are no longer separate national monetary policies, and instead a new central bank has been set up,-The European Central Bank (ECB).All the euro area countries surrendered the control of their monetary policy to the ECB, which controls a Europe wide monetary policy. Its activity is designed to influence the cost and availability of credit. In the U.S. the legislated goals of monetary policy are economic growth, full employment, price stability, and balanced trade with other countries. In the euro area, primary goal is price stability.

The real question remains to be answered is that ‘What is an international currency?’ An international currency is one that is used for payments and finance outside the issuing country’s borders. For example, a sizeable amount of international trade that never crosses the North American borders is conducted with the U.S. dollars. Euro’s emergence has raised questions about how the U.S. economy and firms will be affected, ranging from the dollar’s role as an international currency to effect on U.S. trade and the relative attractiveness of the U.S. to foreign firms. Over the past half century, the U.S. dollar has been the primary world currency for business transactions, holdings of currency for international business transactions, holdings of currency reserves at central banks, and private portfolios. Because Europe is an important trading partner of the U.S., there has been considerable interest in whether, and if so how, the introduction of the euro could affect trading and investment patterns.

Government leaders from euro area countries cite a variety of political and economic reasons for adopting the euro. In general, “European Union Countries” believe the euro supports the broader political goals of greater European economic and political integration. From an economic perspective, existence of euro eliminates potentially costly fluctuations among values of national currencies within the euro area. It also fosters integration of goods, services, and financial markets.

From a managerial economics perspective, U.S. firms will try to maximize their profits in the short-term that would lead their companies to have wealth in the long-term. As we always said, they will produce and export when  $MR=MC$  ( $MR$  = Marginal Revenue,  $MC$ = Marginal Cost) as to maximize their profits. This would refer to the general formula of  $Profits = TR-TC$ , resulting in short-term profits since the cost of exporting goods and services will be relatively low considering the weakening U.S. dollar. In retaliation, the action that will be taken by European Central Bank to weaken the euro in order to keep European exports competitive is to reduce the refinancing rate. U.S. firms should keep try to keep their growth at substantial rate (PV firm, growth rate, long-term wealth). It is important to mention that U.S. firms conduct international trade in two different categories merchandise and service trade. (Figure 2.1 and Figure 2.2) Therefore, U.S. companies not only export goods but also utilize European companies as their source of suppliers.

In the past, multinational conglomerates generally conducted trades in U.S. dollars. However, these entities have recently been shifting towards the use of euro for several reasons. During one of my meetings with a Kenyan counterpart, regarding a shipment of exports, method of payment terms and conditions; he offered the transaction be completed in euro. When asked about the reasons for doing so, the basic explanation was that the time-zone changes between North America and East Africa. Every international trade transaction conducted in the U.S. dollars has to go through an American Bank mainly Chase Manhattan or Bank of New York. This could either be by money transfer or opening a letter of credit which normally takes 48-business hours plus the 8 to 10 additional hours time difference that would put him behind his competitors, who were using euros in their international trade transactions. This reminds me the first class discussion of the relation between euro and U.S. dollars clarifying the supply and demand issues that were involved in the fluctuations.

As far as macroeconomic concepts are concerned, analysts' expectations do not meet the actual numbers announced by the U.S. Department of Labor. Job growth is a strong indicator of a recovering economy. When people are employed, they tend to spend more money, take out loans for purchasing homes and autos, and deposit money in their bank accounts. All of these activities bolster the economy. When the expectations were not met, the dollar took a hit. For nearly 20 years the U.S. current account, which is the broadest measure of net flow of trade and investment income, has been in deficit. Increasing foreign direct investment in the U.S., will in turn increase the current deficit. The value of foreign assets owned by the U.S. is less than the value of U.S. assets held by foreigners. Economists fear that the deficits eventually have to be reigned in, which could send the dollar plummeting, and force U.S. interest rates up. Low interest rates are another one of the reasons for the dollar's fall. U.S. recovery will gain momentum as the Federal Reserve Bank raises the interest rates. German Chancellor Gerhard Schroeder said in his interview with Financial Times that he hoped the people of the European Central Bank are doing everything to maintain the competitiveness of European exports against the background of the dollar/euro exchange rates. In addition, major international investors including Warrant Buffet and George Soros announced that they are buying foreign currencies against the dollar, which would only weaken U.S. dollar more and make U.S. exports very attractive to overseas markets.

The introduction of the euro is not expected to have significant direct impact on U.S. trade with the euro area or with the rest of the world. However, it may directly affect future U.S. international trade if it affects the economic growth of the euro area or its competitiveness. If euro area economies grow faster due to the emergence of the single currency, Europe's demand for U.S. exports could rise. That effect could, however, be offset to some degree if the euro leads to European producers becoming more efficient, and thus more competitive in international markets. In addition, the euro could potentially affect the relative attractiveness of U.S. exports to non-European markets, if European producers competing with U.S. exporters in those markets become more efficient producers.

In conclusion, the rise of the euro against the dollar over the last three weeks has Europe worried. During one of those weeks, for the eight straight days the dollar has dropped to a record low. (Figure 3.1 and Figure 3.2) Many of the factors contributing to this rise are oceans away. This is bad news for a group of countries that depend on their exports for

revenue. The increasing cost of the euro causes European exports to look more expensive. The reverse is true for American exports. In other words, prices of exports appear to be cheaper to foreign countries due to the dollar decreasing value. This leads to greater levels of exportation by U.S. firms. By contrast imports will appear to be costlier here in the U.S. for the firms to purchase raw materials or supplies. The decrease of the dollar should increase the level of exports by U.S., in turn, stimulating the U.S. economy and creating more jobs. Most people would assume that the dollar would be sinking against every currency making Americans feel poorer when they travel. But Asian governments will not allow it. Countries such as China, Malaysia, South Korea, and Taiwan have made every effort to prop up the dollar in order to keep a fixed exchange rate. Japan has been taking similar action to protect Japanese Yen from rising against dollar. Bank of Japan continues to buy U.S. dollar in currency, this is due to the fact that these economies rely heavily on exportation and the U.S. is a large consumer of goods from these countries. One positive effect on the U.S. of this drop in the dollar is that the trade deficit should decline thus lowering the current account. With more consumption of U.S. goods overseas and less foreign consumption here, the deficit should shrink and that in turn should lower the euro since one main reason for the rise is the huge trade deficit faced by the United States. Given this trade deficit, the benefits of greater international competitiveness prompted by the falling dollar greatly outweigh the costs.

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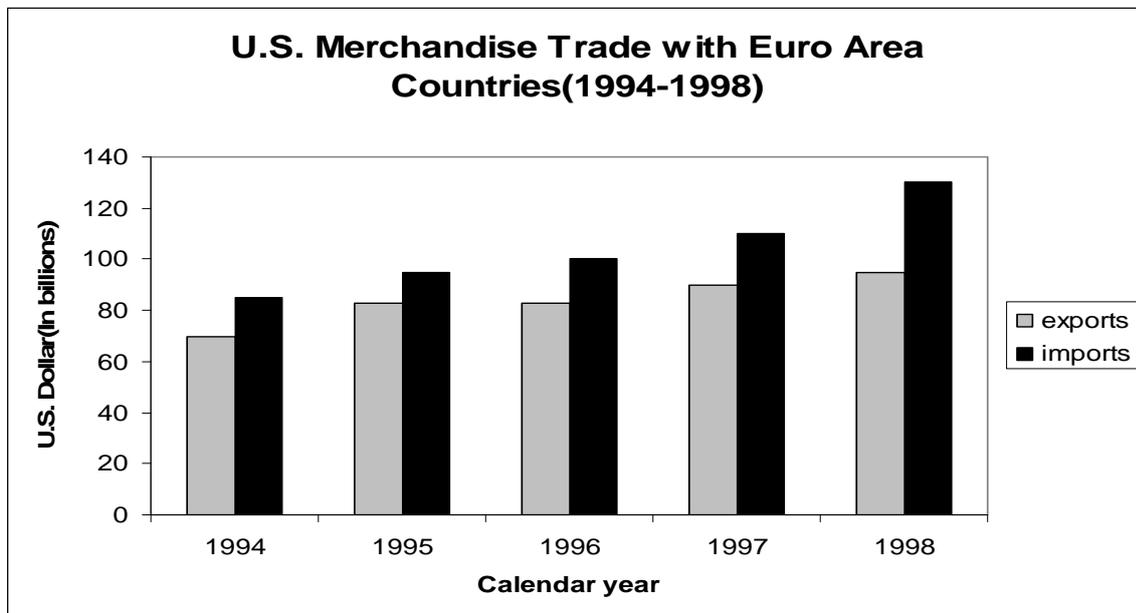
Table 1.1

*1999 Population and GDP of Euro area and the United States*

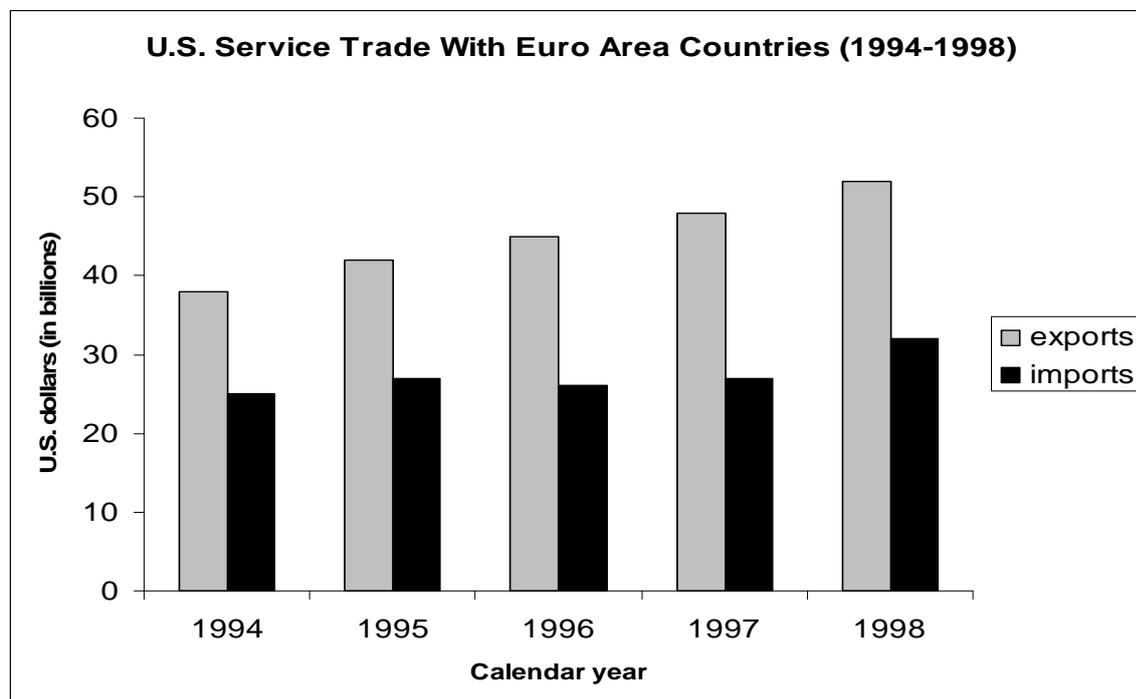
	<b>Population</b>	<b>GDP</b>
U.S.	272 million	\$9.1 trillion
Euro Area	291 million	\$6.7 trillion

Sources: European Union, Central Intelligence Agency, Census Bureau, and Bureau for Economic Analysis

**Figure 2.1** *U.S. Merchandise Trade with Euro Area Countries (1994-1998)*



**Figure 2.2** *U.S. Service Trade with Euro Area Countries (1994-1998)*



**Figure 3.1.** *U.S. Dollar - Euro Area Exchange Rate, November 2003- September 2004*



Figure 3.2. U.S. Dollar - Euro Area Exchange Rate: September 2004

