The euro area may have a single currency, but it still has many different real exchange rates

HAVE the exchange rates between the 12 members of the euro area been permanently fixed? If you think so, you are wrong. Although their nominal exchange rates have been set in stone, their real exchange rates—ie, adjusted for differences in their rates of inflation—have shifted significantly. Since 1999, when the single currency was launched, Italy's real exchange rate has appreciated by more than 20% relative to Germany's.

Real exchange rates measure international competitiveness, and are therefore more important than nominal rates in terms of their economic impact. For example, if the dollar fell by 10% against the euro, but at the same time prices in America rose by 5% more than those in Europe, the price of American goods relative to European ones measured in a common currency—the dollar's real exchange rate—would fall by only 5%. Likewise, within the euro zone, if prices in Italy, say, rise more rapidly than those in other member countries, then Italy's real exchange rate against its neighbours will rise even though the nominal rate is fixed.

The European Commission calculates on a quarterly basis real effective (ie, trade-weighted) exchange rates for euro-area economies against other member countries as well as against a basket of external currencies such as the dollar, the yen and the pound. This requires for each country an index of inflation relative to that abroad. The tricky part is deciding exactly which price or cost deflator to use. The commission publishes no fewer than five different indices, based on consumer prices, the GDP deflator, export prices, unit wage costs in manufacturing, and unit labour costs across the whole economy. Each measure has its advantages and disadvantages. For instance, a real exchange rate based on relative export prices might seem to be the most direct way to capture international competitiveness. But it might tell only half the story, if firms initially absorb an increase in costs by trimming profit margins; eventually, export prices will rise. A real exchange rate based on consumer prices offers the most timely figures, because prices are available monthly, but it may be distorted by the inclusion of indirect taxes and non-traded goods and services. Most economists reckon that the best measure of underlying international competitiveness is relative unit labour costs.

When the single currency was born, Germany's unit labour costs were the highest in the euro area; but since 1999 they have fallen by 10% relative to the average. Put another way, Germany's real exchange rate within the zone has depreciated by 10%. In contrast, relative unit labour costs have risen by 9% in Italy, Spain and the Netherlands, implying a huge loss of
competitiveness relative to Germany (see left-hand chart). Economists at ABN Amro estimate that Germany's labour costs are now lower than Italy's. Ireland and Portugal have also lost competitiveness.

German labour costs surged in the early 1990s when the reunification boom boosted wages, labour taxes were increased and the D-mark rose against other European currencies. But more recently, German firms have struggled to regain their competitiveness by clamping down on wages and boosting productivity. In the past five years Germany has boasted faster growth in labour productivity than the euro-area average, combined with the zone's slowest growth in wages. The threat that firms will move factories to central and eastern Europe has forced workers at several large companies either to work longer hours without extra pay or to take a pay cut. The government's reforms will also help to reduce labour-market rigidities, making it easier for firms to dismiss workers and forcing unemployed workers to seek jobs.

In the long run this will help firms to become more competitive and profitable, and so create more jobs. However, in the short run unemployment has risen, and incomes and consumer spending have been squeezed. Germany's GDP fell by 0.2% in the fourth quarter as export growth was more than offset by a fall in domestic demand.

The divergent dozen

There has also been a lot of variation in the effective exchange rates of individual euro-zone economies against the rest of the world. This reflects differences not only in cost inflation, but also in the geographic patterns of trade. If, for example, a bigger share of a country's exports go to America, then the dollar will have a bigger weight in that country's currency basket.

Since early 2002, when the dollar started its decline, the euro's real trade-weighted exchange rate has risen by 18% (based on relative unit labour costs), slightly less than the 21% rise in its nominal trade-weighted value and considerably less than its 50% leap against the dollar. Yet Germany's real effective exchange rate has risen by only 4% since early 2002, the smallest increase of any euro-zone country. France's real exchange rate has gone up by 9%, and those of Italy and Ireland by 17%.

It turns out that the real exchange rates of the individual members of the euro area have all gone up by less than the 18% rise of the euro itself. This might strike you as odd. The explanation is
that the trade weights used to calculate the euro's overall index against other currencies exclude trade within the euro area, which accounts for around half of most members' total trade. When calculating national effective exchange rates this trade should rightly be included, giving a much smaller weight to the declining dollar.

Many economists worry that the cheap dollar will crush European business. But the modest rise in Germany's real trade-weighted exchange rate explains why, despite the euro's surge against the dollar, German exports have held up so strongly (see right-hand chart). Indeed, Germany is the only G7 economy to have increased its share of world exports in the past five years. The popular notion that high wage costs have left Germany uncompetitive no longer seems to be true. Alas, it could take some time before the gains feed through to household incomes and spending, and spur the German economy to grow again.