

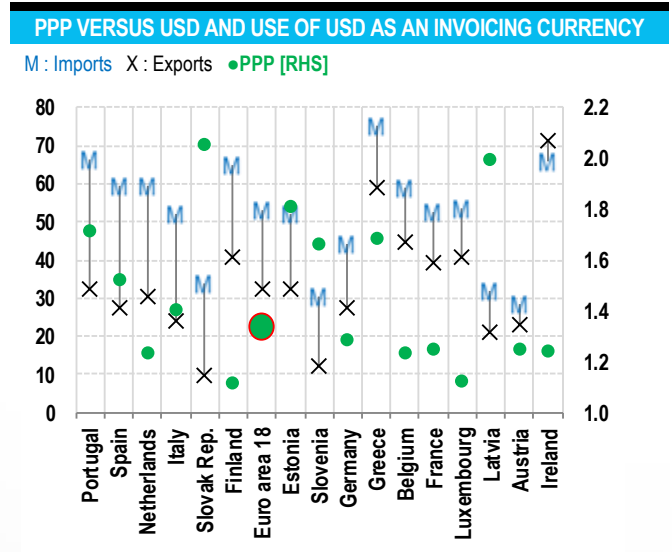
# ECOWEEK

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## A strong euro: inflation impact matters more than growth

■ The euro is undervalued versus the dollar on a purchasing power parity (PPP) basis ■ This raises the prospect of an appreciation of the euro ■ In gauging the consequences one should focus on inflation rather than on the growth impact

Purchasing power parities (PPPs) show the ratio of the price in national currencies of the same good or service in different countries. The concept was made popular by The Economist's BigMac index based on the price of hamburgers. The OECD uses a large basket of goods and services for its calculations. They show that the euro is currently 10% undervalued against the dollar (fair value corresponds to 1.34). As shown on the chart, Finland and Luxembourg have a PPP which is significantly below the eurozone PPP versus the dollar but also below the current EURUSD exchange rate: based on the relative price structure, these countries are already expensive versus the US. Belgium, Ireland, France, Austria and Germany have a PPP which is below the eurozone PPP yet above the current exchange rate. For them the euro is still somewhat cheap versus the dollar. Countries like Portugal, Estonia, Latvia, the Slovak Republic could afford a significantly stronger euro. Admittedly this calculation provides only a rough approximation of price competitiveness of various countries (and it does not take into account non-price competitiveness factors) but it raises the question whether, based on their PPP, some countries would be hurt more than others in case of a stronger euro. A relevant factor is the role of the dollar in the international trade of a country. In this respect it is appropriate to look at the use of the dollar as an invoicing currency rather than focusing on the bilateral trade with the US. For all countries except Ireland, the dollar has a significantly bigger role as an invoicing currency in imports than in exports. This is, at least partly, explained by commodities, which are typically traded in dollar. For Portugal, Spain, the Netherlands or Italy the difference is huge. This invoicing mismatch needs to be taken into account when assessing the impact of a stronger euro versus the dollar. Under the assumption that sales prices don't change, a stronger euro would weigh on exports invoiced in euros (volume effect) and reduce the revenues in euros from exports invoiced in dollars (translation effect). However, it also lowers the import bill expressed in euros to a very considerable degree. This would imply that a stronger euro is not so much an issue from a growth impact perspective. One caveat is the role of second round effects: reduced profitability of exporting companies can have an impact on the economy. The general conclusion however is that in gauging the impact of a stronger euro, one should focus more on inflation than on growth.



Sources: OECD, Eurostat, BNP Paribas

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