Dollar depreciation—Euro pain[☆]

Gerhard Fink [a,*], Peter Haiss [a,b],
Magdalena Oeberseder [a], Wolfgang Rainer [a]

[a] *Research Institute for European Affairs at the Vienna University of Economics and Business Administration, Althanstrasse 39-45, A-1090 Vienna, Austria*
[b] *Bank Austria Creditanstalt, Vienna, Austria*

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Abstract

According to U.S. economists the American economy needs a further depreciation of the dollar by 25%. Can the euro accommodate the needs of the U.S. economy? We apply the Fink (1995) scoring model and analyze the country risk of the Euro zone, Bulgaria and Hungary. We find that a further appreciation of the euro is hardly sustainable for the Euro zone. For countries like Bulgaria, which tied their currency to the euro, the risk of a currency crisis is prevalent. We argue that more detailed ECB debt statistics are necessary to gauge the risk inherent in the Euro zone.
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1. Introduction

This paper aims to investigate into the adverse consequences of the appreciating euro for the country risk of the Euro zone. The rapid appreciation of the euro against the dollar since 2002 has caused major concerns about the future competitiveness of the Euro zone. Cheaper imports and more expensive exports have a negative effect on the current account balance.

At the 2007 annual meeting of the American Economic Association U.S. experts discussed "why is the dollar still so high?" (Feldstein, MacKinnon, Mundell, Mussa, Rogoff, Salvatore) and

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[*] Corresponding author. Tel.: +43 1 31336 4137; fax: +43 1 31336 758.
   E-mail address: gerhard.fink@wu-wien.ac.at (G. Fink).

came to the conclusion that the dollar still would have to depreciate by about 25%. But, what about the euro? Can the euro accommodate the needs of the U.S. economy?

Since the Euro zone is a fairly large economic area with an important internal market, we include two relatively small and export-oriented economies into our analysis, which both depend on the Euro zone and have a euro-oriented monetary regime. The first is Bulgaria, which since 1997 has pegged its currency to the euro. The second is Hungary, which has pegged the forint to the euro, but permitted its exchange rate to fluctuate within a band of ±15% around the central parity. The issues are whether the Euro zone could sustain a further appreciation against the dollar and whether small economies, dependent on the Euro zone, could sustain a further appreciation?

We adopt a signaling approach to assess the country risk of these three countries. Our analysis is based on an application of the Fink (1993, 1995) scoring model that uses a medium size set of macroeconomic variables to assess the economic risk of a country and attributes a heavy weight to debt outstanding. Over the 2000–2005 period we analyze the country risk of Hungary and the Euro zone. For Bulgaria, the investigated period has been extended to 1991–2005 to illustrate how our model covers the two severe economic crises of the 1990s. The assessment is followed by a groupwise comparison of the indicators used in the country risk model for Bulgaria, Hungary and the Euro zone. Based on debt, trade and currency movements, we conclude that if the euro would continue to appreciate, the outlook for both Bulgaria and the Euro zone would not be bright for the 2007–2009 period.

The rest of the paper is structured as follows. In Section 2 we give a brief introduction into our method of country risk assessment. Section 3 presents our findings of the risk assessment of Bulgaria, Section 4 of Hungary and Section 5 of the Euro zone. In Section 6 we compare our findings. Finally, Section 7 presents our economic policy implications. The paper ends with a summary in Section 8.

2. Method

The scoring model that we use to assess the country risk was developed by Fink (1993, 1995). It is largely based on macroeconomic indicators, which relate to competitiveness of nations, but includes also debt service, international liquidity and net capital flows (transfer quota). For an application and discussion of the predictive power of the individual indicators, see for example, Fink (1993, 1995), Ciarlone and Trebeschi (2005) and Kaminsky, Lizondo, and Reinhart (1998).

The indicators are first transformed into key-ratios, which are then assigned a score from 0 to 100 points according to an individual function for each ratio. In order to be able to better distinguish between the three countries under investigation, for the key-ratios of debt burden a "soft rating" has been used: For external debt/GDP, for example, the lower end (=Ø points) has been set at 90%. If the key-ratio exceeds this limit, the resulting score is zero. The highest possible rating of 100 points is assigned when the ratio is equal to, or lower than, 10%. This range is to be compared with the Maastricht criteria, which had assumed that a 60% level of public debt to GDP should be considered as critical.

The scores are weighted and aggregated in four categories: economic power, stability, debt burden and transfer quota (Table 1). The key-ratios of debt burden are given a higher weight in this model, accounting for 50% of the weighted score, because it can be assumed that they have the greatest predictive power of an economic instability or a crisis (Fink, 1995). Finally, the sum of the scores of the four categories represents the overall country risk. A higher score represents a lower country risk and vice versa. The best possible rating is 100 points; the lowest is zero points.