The recent French and Dutch votes to reject the European Union’s constitution have raised doubts about the sustainability of Europe’s single currency, the euro. Although it lost some ground to the U.S. dollar in the first two quarters of 2005, the euro remains far above the initial exchange rate in January 2002. Moreover, the euro/British pound exchange rate remained fairly stable over the same period.

All this might seem to imply that the decline in the euro’s value against the dollar is related to the strengthening of the U.S. economy. Some member countries of the European Monetary Union showed signs of economic weakness before the euro was introduced. Unemployment rates in France and Germany have been rising steadily and now hover near 10%; Italy’s unemployment is around 8%. GDP growth for France, Germany, and Italy has been less than 2.5% recently, compared to 4% for the U.S. These low growth rates are expected to continue into the near future; indeed, Italy’s growth is expected to fall into negative territory.

The European Central Bank established a “two-pillar” monetary strategy at the time of its creation. One pillar is inflation control; the other is monetary growth. During the past five years, the Bank’s inflation target of “close to, but below, 2%” has rarely been met, although the European Union’s inflation rate recently dipped just below 2%. Unlike the Federal Reserve System, the European Central Bank has no policy goal related to the output side of the economy. Whereas the Fed may take a policy action in response to real economic conditions, the ECB would probably not, if doing so threatened its inflation objective.

a. Forecast data (dashed lines) are provided by the Organisation for Economic Co-operation and Development.

SOURCES: Organisation for Economic Co-operation and Development; European Central Bank; Eurostat; and Bloomberg Financial Information Services.