Impact of Euro-Dollar Parity

Why in news?

The euro and the U.S. dollar reached parity, meaning one dollar could buy one euro in the foreign exchange market.

What has been the issue?

- For over two decades, it took more than one U.S. dollar to purchase one euro.
- Just a year ago it took about 1.2 U.S. dollars to purchase one euro.
- Since the beginning of the year the euro has lost about 12% against the U.S. dollar and it is expected to lose more value going forward.

What determines a currency's exchange rate?

- The price of any currency in a market economy is determined by supply and demand.
- The supply of a country's currency in the foreign exchange market is determined by various factors such as central bank policy and the local demand for imports and foreign assets.
- The demand for a country's currency, on the other hand, is determined by factors such as central bank policy and the foreign demand for exports and domestic assets.

Why has the euro fallen against the U.S. dollar?

- The divergence in the monetary policies of the U.S. Federal Reserve and the European Central Bank is the primary reason behind the euro's significant depreciation against the U.S. dollar.
- In response to the economic crisis caused by lockdowns imposed to fight the coronavirus pandemic, both the Federal Reserve and the ECB expanded their balance sheets to boost spending.
- But this soon led to a rise in prices.
- Inflation in the U.S. hit a four-decade high of 9.1% in June while inflation in the Eurozone reached its highest-ever level of 8.6% during the same month.
- The U.S. Federal Reserve responded to the rising prices by raising the

interest rates this year in order to slow down U.S. money supply growth.

- The ECB, however, has been far less aggressive in tightening policy even though the inflation rate is as high as 22% in some European countries.
- This has caused the value of the euro to slide against the dollar as currency traders' witness, or at least expect, the supply of euros in the market rising relative to the supply of dollars.
- The euro, however, is not the only currency that is depreciating at the moment.
- The Japanese yen is another major currency that has lost about 20% of its value against the U.S. dollar this year as the Japanese central bank continues to stick to its easy monetary policy.
- The value of euro has been affected by the uncertainty in energy supplies in the wake of Russia's invasion of Ukraine and the ensuing actions against Russia.
- Europe now has to shell out more euros to import limited energy supplies, which in turn has adversely affected the value of the euro against the U.S. dollar.

What is the way forward?

- As the U.S. Federal Reserve continues to raise interest rates, this is likely to exert further downward pressure on the euro.
- The ECB may be forced to raise interest rates to slow down money supply growth in the Eurozone in order to prop up the value of the euro against the dollar.
- But this is likely to lead to a slowdown in growth in the Eurozone, 19 countries use the currency, as its economy will have to readjust to tighter monetary conditions.
- If so, European nations might opt to enact tax and regulatory reforms to expedite the recovery.

Reference

1. https://www.thehindu.com/business/Economy/explained-what-will-be-the-impact-of-euro-dollar-parity/article65647228.ece?homepage=true

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