Nout Wellink: On the euro and exports, speculation and global trade

Speech by Dr Nout Wellink, President of the Netherlands Bank and President of the Bank for International Settlements, on the occasion of a luncheon conference of the Limburgse Werkgevers Vereniging, Herten-Roermond, 26 January 2005.

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I shall speak to you about the euro and the consequences of its rising rate for the exports sector. But I shall also dwell on the global causes as well as the macro-economic effects of the strong euro.

Consequences of a rising euro rate for businesses

Exchange rate movements may have considerable impacts, in particular at the level of industrial operations. While perhaps it was not the low dollar rate that finished Fokker, adverse exchange rates did play a role in that company's fate. This stiff westerly wind rose just when Fokker was most in need of the right updraught. And, if you will allow me to use an example from your region, Océ – which over the course of time has proved a rich source of supervisory board members for DNB – realises much of its turnover in US dollar. In addition, many of its competitors are based in the United States or in countries whose currencies are pegged to the dollar. Small wonder that they keep a sharp eye on the exchange rate of the euro.

On the one hand, exporters are recording declining sales and are compelled to settle for lower profit margins as a result of the high euro rate, whereas, on the other, citizens and businesses are benefiting from cheaper products from abroad. A case in point is the moderating effect of the rising euro rate on the increasing oil price. Since early 2003, the dollar price for a barrel of crude oil has gone up by 48%, while expressed in euro the price increase amounts to 21%.

Also some of the activities of financial institutions profit from exchange rate fluctuations. An increase in the number of businesses hedging against – or speculating for – exchange rate fluctuations leads to higher commission income from currency translations and future contracts.

The euro exchange rate not only influences the proceeds from business activities, like imports and exports. Exchange rate movements also work through to the value of assets and liabilities expressed in foreign currencies. The 20% fall of the dollar rate in 2003 translated into a EUR 4 billion loss for Dutch businesses, approximately 1% of Dutch national output. The net wealth effects of exchange rate and price movements in 2003 were insignificant, as overall cross-border claims and liabilities rose by about just as much.

Macroeconomic consequences of the rising euro rate

The consequences for individuals and businesses translate into macroeconomic effects. On this scale, too, there are pros and cons attached to an appreciation of the euro. The main minus point is that competitiveness will weaken, in particular initially. This in turn will affect exports, just when this sector is of vital importance as engine of the Dutch economy, domestic dynamics in the Netherlands and the rest of the euro area being less than optimal.

The credit side of the balance sheet shows that we have grown richer on account of the appreciation of our currency. With imports becoming cheaper, the appreciation of the euro – while on balance hampering economic growth, especially in the shorter term – is favourable for inflation. According to DNB simulations, in the next three years the euro's appreciation in 2003 and 2004 will reduce production growth in the euro area by about 0.3 percentage point per year on average. Inflation will each year come out circa 0.5 percentage point lower than it would have without the euro's appreciation. In making these technical calculations, we should remember that the euro appreciated significantly right after its launch. Set off against the dollar, the value of the euro is not much higher than it was in the mid-nineties.

The euro also turns out to be less strong than may seem at first sight if we bear in mind that, besides the American dollar, also other foreign currencies are important. For example, for the Netherlands, United Kingdom is more important as a trading partner than the United States. Of our goods exports, 11% goes to the UK, against 5% to the United States. Compared to all foreign currencies in terms of their weights in international trade, the euro has risen 11% in value since 2003, against 25% opposite the dollar.

The US dollar is more important to Europe than the trade flows between the United States and our continent would suggest. Many commodities are priced in US dollar. Besides, many countries seek to keep the value of their national currencies stable against the dollar. This policy may well be considered a source of concern. The preference of some countries, like China, not to use the exchange rate as an adjustment tool in their relations with the United States adds pressure to other currencies, e.g. the euro and the Canadian dollar.

Explanation for the strong euro versus the current account deficit of the United States

I would like to dwell briefly on the factors underlying the strong euro. The prominent role of the dollar is tied up with the United States ' global leadership, in both economic and political terms. Its prominence does not necessarily signify that the dollar is strong. At this moment, the dollar is weaker vis-à-vis the euro than in the period between 1980-2000, because the United States has lived beyond its means for so long. Both the average American citizen and central government are consuming too much and saving too little. Private savings in the United States make up a meagre 0.4% of disposable income. In the euro area, citizens lay by more than 10% of their income. While the low level of private savings in the United States is not easily accounted for, stock exchange and housing price movements are probably an important factor. From surveys it emerges that especially citizens in the higher income brackets are dissaving. They look upon their assets as a substitute for savings. Not only American citizens are not saving much, if at all, even central government is dissaving, witness the high budget deficit. The expense of the war in Iraq and internal security is one of the causes of the high budget deficit.

On the balance of payments, the national savings deficit of the United States translates into a current account deficit to the tune of 6% of the gross domestic product, or about 1.25 times the total annual output of the Netherlands. This means that funds must be raised from other countries on a structural basis. This cannot go on forever. A tad more Calvinism would not hurt. In some areas a lot can be achieved with little effort. The American administration might decide, for example, to raise tax on energy consumption, after the European example. This measure would bring down the public sector deficit and put a brake on private spending. Besides, it would enhance national security by limiting dependence on oil imports. And this measure would benefit the environment into the bargain. However, it is not just the United States that should be doing something to lessen the global imbalances on the balance of payments. The rest of the world, too, should pull its weight; Asia, by observing greater exchange rate flexibility, and Europe, by generating more growth. Healthy public sector finance may make a contribution within this scope. The vicissitudes around the Stability Pact show that the European house is also not in order in this respect.

The other side of the coin: the accumulation of dollar reserves in Asia

The countries that for internal reasons have resolved to stabilise their currencies against the dollar, have had to buy up substantial amounts of dollars to prevent their currency from increasing in value in dollar terms. As a result, they have built up unprecedentedly high dollar reserves. I'm referring to Japan, China and several other Asian countries. This policy cannot and will not be continued forever. Neutralising the monetary consequences will be at increasing cost. On top of that, the potential foreign exchange risks rise with each dollar by which the reserves increase.

The present situation shows a remarkable resemblance to the early seventies. Also back then, many countries had pegged their currencies to the dollar. In the post-war period most developed countries had adopted a system of fixed but adjustable exchange rates. This system was named after Bretton Woods, the American town where it was devised in the final year of World War II. The guilder and other currencies had fixed their exchange rates against the US dollar, which in turn was pegged to the gold standard. In the early seventies, the American balance of payments likewise began to deteriorate due to public sector overspending. This situation was related to the war in Vietnam. Also, the central bank kept interest rates low and oil prices were high in real terms. Under these circumstances, the fixed parity between the dollar and gold proved unsustainable and, in 1973, the Bretton Woods system collapsed once and for all. This historical parallel underscores the vulnerability of a combination of an unbalanced balance of payments and fixed exchange rates. By way of an anecdote, I might add that an American delegation visited the Nederlandsche Bank in 1971 in order to beg of us not to exchange dollar reserves for gold. In response, the then President, Jelle Zijlstra, decided to do the very opposite and to do so without delay and on a massive scale.

Global economy structurally sound

So, let us consider where we stand: the dollar is weak. In itself, this is not positive for our export sector. But the exchange rate is not the only factor determining our export position. The growth of world trade is of much greater importance. And as to that, the stars are favourably disposed. In our region it may hardly feel that way, but for the world economy 2004 was a peak year. At about 5%, real growth was the highest of the past two decades, and exports benefited accordingly. In all likelihood, 2005 will also be a propitious year, seeing the economy grow by approximately 4%, a rate that is still above-trend. In 2005, our export sector will continue to profit from a global trade growth by approximately 8%. And we should factor in something else. As economies grow more flexible, so will their ability to cope with exchange rate fluctuations. Take the Canadian, Australian and New-Zealand economies, for example, which in the past 5 years expanded by 3% or more. This contrasts sharply with the average growth rate of 1.6% in the euro area. The hefty movements in the euro/dollar rate seen in the past five years should therefore bring home the need for greater flexibility in the economy.

The favourable global picture is largely accounted for by the United States and Asia, more in particular China and India. Over a period of six years, exports from China doubled to 6% of world exports in 2003. China 's tempestuous economic development is taking place at the expense of the environment. It would be bad for the global environment if every Chinese citizen had a throbbing car and a humming fridge. And while signs are pointing to a gradual awareness in China of the downside of booming energy consumption, this does not take away the fact that we are dealing with a colossal problem. However, we should also count our blessings: it is pure gain that so many world citizens are sharing in wealth. I consider China's breakthrough final. From now on, we should refer to the G4, instead of G3. We live in a quadrupolar world, made up of the United States, Europe, Japan and China.

Europe is lagging behind the United States and Asia. More growth in Europe would be desirable, also from a global perspective. It would increase the United States ' export potential. What is especially required is a stronger European drive in the structural field. The EU enlargement in Central and Eastern Europe will provide an impulse in the short term. This is the only part of Europe that does share in the global growth acceleration. Furthermore, we should hope that the growth spurt seen in the nineties in the United States will spread to Europe. In a recent study, the American central bank estimates annual labour productivity growth at 2.6% in the next ten years. It is about time that Europe also manages to realise a substantial rise in productivity. If markets function properly, the chance of that increase materialising will be greater. Let us hope that the implementation of the Kok Committee proposals for structural reforms within the scope of the Lisbon agenda will get off the ground.

Conclusion

Considering all this, how are we to look upon exchange rate fluctuations? What it amounts to in simple terms is that highly integrated economies forming, so to speak, one economic block, benefit from fixed exchange rates. Economies that differ widely from each other and do not interact much, profit from mutually flexible exchange rates. Admittedly, exchange rates sometimes tend to move too uncontrollably, creating a breeding ground for speculation. But if exchange rate changes arise from structural factors, we should welcome them.

It is satisfying that these days there are fewer complaints about the euro exchange rate than before. At the macro level, this is appropriate. Rather than with the rock-bottom level seen several years ago, the current level of the euro/dollar rate should be compared with the average level over a prolonged period. To assess our competitive position, it would therefore be better to take the exchange rates with all trading partners into account and correct them for mutual inflation differences. This so-termed real effective exchange rate of our currency is now 8% above the average for the period 1980-2000. Moreover, there is little reason to complain about the euro exchange rate as its consequences are not that overwhelming. To the extent that the Netherlands is a small, open economy, the vast majority of its trade is confined to countries that also calculate in euro. On a corporate level, some operations are obviously sensitive to the exchange rate. They must adopt strategies that anticipate the adverse effects of exchange rate fluctuations. This is just what they are doing. The German car manufacturers BMW and Mercedes are cases in point. And judging by the parking area outside this building, they are successful enterprises. The fact that both costs and revenues would be expressed in dollar played a weighty role in their decision to set up production facilities in the US. With this move, both companies have covered themselves against exchange rate fluctuations in a natural manner. Another much-used way to do so is by means of financial instruments. I suggest that we send the euro rate as scapegoat for wrong economic moves into the desert, just as happens in the Jewish tradition at the time of the Day of Atonement.