Klaus Liebscher: Currency and competitiveness

Opening remarks by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the CEEI 2007 – "Currency and Competitiveness", Vienna, 19 November 2007.

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Ladies and gentlemen!

It is a great pleasure for me to open our annual Conference on European Economic Integration. I take the participation of a sizeable number of key experts from national and international institutions, outstanding policymakers, bankers and academics as proof of the high importance that is attached to currency and competitiveness matters, which we have chosen as the theme for this year's conference. Let me extend a warm welcome to all of you.

Let me pick out a few currency and competitiveness issues to give you an idea of our motivation for this conference.

Currencies are at the core of central banks' business: As a form of money, currencies facilitate the transfer of goods and services by serving as a means of exchange, enable the storage of wealth and serve as a unit of accounting.

In order to help money accomplish its tasks across national boundaries we need exchange rates – the prices at which currencies can be traded against each other. With respect to exchange rates, three main questions have been debated by academics and central bankers for years: How are they determined? What is their economic impact? And how should monetary policy act?

In today's first two sessions we will try to get a better understanding of the drivers of exchange rate changes. Factors influencing both supply and demand forces can be either structural or monetary policy related.

1. As for long-term structural factors, one usual suspect is the purchasing power parity theory. It states that identical baskets of goods should ultimately cost the same in one currency as in another currency times the exchange rate between these currencies.
2. Another possible long-run factor of real exchange rate movements – that take into account inflation – is the development of overall or relative productivity levels.
3. A more medium-term structural factor is the balance of payment model, which holds that a foreign exchange rate in an equilibrium level requires a stable current account balance.
4. Another, rather short-term explanation related to monetary policy is suggested by the so-called uncovered interest rate parity. Under this condition, differences in interest rates between two economies should be equal to the expected change in exchange rates between their currencies.
5. A further element of explanation can be derived from asset market models identifying interconnections between stock, bond and foreign exchange markets.
6. Finally, ever more research is devoted to non-fundamental causes of exchange rate instability. The "overshooting hypothesis" helps explain why unstable foreign exchange markets can be efficient. Yet, looking at the microstructure of foreign exchange markets, individually rational behavior might generate complex dynamics in which bubbles and crashes can occur.

So far the debate on determinants of currencies seems to be far from being conclusive. Alan Greenspan[1] once noted that "forecasting exchange rates has a success rate no better than that of forecasting the outcome of a coin toss". I wonder whether we can derive valuable insights from hindsight. Getting answers about the consequences of exchange rate movements for the economy seems to be by no means easier. The impact of the exchange rates changes depends on a set of interrelated transmission channels, of which

1. the trade channel probably is the most obvious way in which currency developments can impact the economy. An appreciation is likely to entail a negative trade balance, as the prices of foreign currency-denominated exports increase while import prices fall.
2. Apart from that, there are financial market channels through which currency movements have an impact on the economy: A trend increase in the exchange rate raises the relative attractiveness of assets denominated in that currency while it results in the loss of value of investment abroad.
3. Currency fluctuations are also transmitted through the consumer prices channel, according to which exchange rate appreciation would lower consumer prices. In this sense the "strong euro" has cushioned our economies from recent crude oil shocks.
4. Finally, the confidence channel completes the list. However, consumers and firms can react asymmetrically, since appreciation dampens inflation pressure on the one side but challenges the competitiveness of firms on the other.

If exchange rates and their impact on the economy are apparently so difficult to explain, let alone predict, should monetary policy interfere? As for the euro area, the ECB has no exchange rate target. A key implication of flexible exchange rate system is that the external value of the currency is determined by financial markets and hence cannot be an instrument of economic policy. The primary objective of the Eurosystem, that is the ECB and the national central banks of the euro area, is to maintain price stability in the medium term. However, when analyzing the economic situation and taking monetary policy decisions the Governor Council of the ECB considers all parameters – including exchange rates – to the extent that they influence risks to price stability. In this respect, excessive exchange rate volatility is not welcome!

Turning from currency issues to our second topic, competitiveness, I am tempted to use a play on words and ask: "does competitiveness still have currency?" My answer to this is definitely yes! Competition should not be understood as a zero-sum game, where winners can only gain what losers lose. A competitive environment might lead to situation where both sides are absolutely better off. More importantly, it is the consumers who are the ultimate beneficiaries of competition. Competition gives incentives for self-improvement and produces excellence. Competitiveness is linked with the creation, diffusion and application of new knowledge resulting in technological progress. And I do believe that there is still room for further improvement when it comes to the euro area's international competitiveness.

Extensive global imbalances have built up between major economic regions during the last few years. Whatever their presumed causes, either overspending or underinvestment in the USA; or the saving glut in surplus economies, particularly Asian emerging markets and oil exporting countries – current account imbalances have undoubtedly amplified the pressure on currencies, with possible harmful consequences for global financial stability. It is clear that all regions involved have to assume their responsibility for ensuring the sustainability of their external and internal balances, and for enhancing their growth potential. However, for the time being it appears that the euro area takes the major burden of this adjustment process.

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[1] Remarks by Chairman Alan Greenspan at the European Banking Congress 2004, Frankfurt, Germany; November 19, 2004; http://www.federalreserve.gov/boarddocs/Speeches/2004/20041119/default.htm

The G7 meeting of Finance Ministers and Central Bank Governors of this past October, including the president of the ECB, reaffirmed that "exchange rates should reflect economic fundamentals. As announced, they "welcome China's decision to increase the flexibility of its currency, but "stress its need to allow an accelerated appreciation of its effective exchange rate"[2]. Earlier in October, the Finance Ministers of the Euro group noted with great attention that the "US authorities have reaffirmed that a strong dollar is in the interest of the US economy"[3] and commented that "the sustainable recovery path" of the Japanese economy should "be incorporated in the assessment of risks".

Meanwhile "the Euro area is playing its role by implementing structural reforms and contributing to a rebalancing of growth."

For the first time in its existence the euro area outpaced the United States in terms of economic growth. The euro area's seasonally adjusted jobless rate came to 6.9% in 2006, thus hitting its lowest level in more than a decade. This drop is not only the result of economic activity. The labor market and welfare reforms of the past few years have also reduced structural unemployment. Since the introduction of the euro in 1999, some 15 million new jobs have been created in the euro area. This is not to depict an unduly positive picture. The inflation rate for October came to 2.6% after being below the 2% mark for a year. The outlook for price stability over the medium term is subject to upside risks as increased oil, commodity and food prices as well as the favorable labor market situation are likely to make higher wage settlements possible.

Nevertheless, there are signs that the competitive position of the euro area has improved. Since 2002, productivity growth has contributed considerably to falling unit labor costs in the euro area. Also, the shock resilience of the euro area seems to have improved owing to the "stability architecture" of the Eurosystem. This architecture rests on three pillars: a stability-oriented monetary policy, sustainable public finances, and growth- and competition-oriented structural policies. As for the third pillar, the Lisbon strategy adopted in 2000 with the aim of creating a modern and competitive economy seems to be finally bearing fruits.

However, the observed persistent divergences in unit labor cost growth and inflation in a number of euro area countries clearly point to increasing risks of further competitive losses and potentially costly real economic adjustment. Since the single monetary policy cannot address inflation divergences in individual countries, it is evident that structural reforms, wage-setting processes and budgetary policies must contribute to reverse competitiveness losses in individual euro area countries. If the lessons from success stories both within and outside the euro area are applied elsewhere, the euro area as a whole will emerge as a stronger and more dynamic economy.

On January 1, 2008, Cyprus and Malta are going to adopt the euro. Let me offer my warm congratulations to Governor Orphanides and Governor Bonello for reaching this milestone. You can be proud of your countries' successful convergence process. Looking ahead, the adoption of the euro will allow you to reap all the benefits of the common currency and enhance your integration with all EU partners. Together with Slovenia, you give a positive example for all other new member countries.

For these new member states, it is vital to achieve real growth that permits their income-per-capita levels to gradually approach average EU levels. Therefore, further steps in monetary integration should be geared toward achieving sustainable real and nominal convergence.

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[2] G7/8 Finance Ministers Meetings, Statement of G7 Finance Ministers and Central Bank Governors, Washington, October 19, 2007 (http://www.g8.utoronto.ca/finance/fm071019.htm)

[3] Reuters, Eurogroup position for G7 meeting; Monday 8 October 2007 (http://www.reuters.com/article/companyNewsAndPR/idUSL0846597920071008)

Since the speed of further monetary integration must not compromise its quality, decisions have to be taken on a case-by-case basis in accordance with the Treaty. At the same time, equal treatment for new and established EU Member States must be ensured throughout the whole process. I am sure that the participation of the new member countries in the stability architecture of Eurosystem will make EMU an even greater success.

This conference provides proof of our research-based approach to the issues of currency and competitiveness. It also demonstrates our readiness to open discussion and to address understandable apprehension. In the same way it promotes a better understanding of price stability as an important contributor to both orderly exchange rate adjustment and the maintenance of economic competitiveness. Taken together these functions may help build confidence – probably the most essential task central banks have.