Mr Welteke offers some thoughts on the euro/yen/dollar: managing a tripolar world

Speech delivered by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the Annual Meeting 2000 of the World Economic Forum in Davos on 28 January 2000.

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“Managing a tripolar world” - for a long time, this meant managing the exchange rates of the currency triad at that time: the US dollar, the Japanese yen and the Deutsche Mark.

The question was always whether the prevailing exchange rates between these three currencies were appropriate and how their movements could be stabilised. The external value of the dollar was revalued extensively on the foreign exchange markets during the 1980s. After a long period of neglect by the Americans this led to the Plaza (1985) and Louvre (1987) agreements - the results of which were partly positive and partly problematic. And even during the 1990s this topic has come up in debates time and again, as for example when the dollar was devalued in 1995.

Some people now fear that the establishment of the new “dollar/euro/yen” triad may lead to a retrogression in international cooperation. In any case, concerns are voiced sometimes that the ECB could assume a position of benign neglect or even malign neglect as regards the external value of the euro.

It is true that the ECB has to assign priority to internal stability in cases of conflict. However, this was always the Bundesbank’s policy, too. So that is nothing new.

In Europe, however, we have not yet achieved American-style independence. Thus, in the USA “a dollar is always simply a dollar”, while in Europe some people fear the possibility that “a euro is a dollar” although this is very unlikely considering the substantial appreciation potential of the euro.

No such thing as neglect, as if to say “The exchange rate is irrelevant”, exists in European monetary policy. That would be inconsistent with the strategy of the ECB. In this “two-pillar strategy”, with the money stock forming one pillar and a multitude of inflation indicators forming the other, the exchange rate is one of the factors being watched very closely by the ECB; it is an important aid in assessing the outlook for prices. In this respect, there is no neglect. By the way: under the critical eyes of today’s international financial markets, no central bank in the world can afford to neglect exchange rate movements.

It is, however, an entirely different matter to go beyond today’s problem-oriented cooperation in international bodies, as is being sought in proposals to establish a more formalised exchange rate regime based, for instance, on target zones.

These suggestions have remained dry runs, and I assume they will probably remain so in the future. Under the present conditions of deregulated financial markets and free movement of capital, there are only three ways such systems can work to begin with - either:

– There is already a strong convergence of the real economy and of anti-inflationary policy between the partners, causing parities to naturally remain in existence “on their own”, so to speak. This convergence has rarely existed within the triad over a relatively lengthy period of time. At the moment, the structural differences between America, Japan and continental Europe are becoming more evident.

– Or, the countries are otherwise willing to change parities quickly, as unobtrusively as possible and in a forward-looking manner. However, experience has shown that such systems tend to be “too little, too late”.

– A third possibility is to subordinate other internal economic policy targets almost completely to the exchange rate. But this probably only makes sense if carried out by a small country with strong external trade links and if it is desired that external trade links exercise a disciplinary effect on policy.

However, none of these considerations make a stronger exchange rate management in the tripolar world realistic today.

II

Managing a tripolar world: there is still another facet to this topic.

It is also about the monetary policy of those countries which are not part of one of the three poles but which have to define their relationship to these three poles somehow.

As regards the European countries, some of them are reassessing their positions towards the monetary union or are making considerable progress in the convergence process. A case in point is Greece, which was recently able to carry out a realignment rather unobtrusively.

At the EU summit in Helsinki, important preliminary decisions on the enlargement of the EU were taken. I assume that those countries will use the euro as a beacon to guide their monetary policy over the long term. Upon accession to the EU they will automatically become “Member States with a derogation”, the Maastricht Treaty’s term for those EU countries not yet participating in monetary union.

The emerging economies, too, must define their position in the currency triad. How do they intend to fix their exchange rates? Should they aim for floating exchange rates or for fixed but adjustable exchange rates? Or should they establish a currency board?

Some countries are even debating whether or not to abolish their currency entirely. This is a decision that requires serious consideration. The abandonment of a sovereign currency would deprive the national economic policy of the ability to take action in two fields: exchange rate policy and monetary policy. The question as to which currency to orient one’s economy to is only of secondary importance and is determined mainly by trade flows.

Many emerging economies have been forced to learn that today, monetary issues can hardly be separated from topics such as the functioning of international financial markets or the soundness of the national banking system. The financial crises in Asia, Latin America and Russia have shown that the exchange rate policy has often been too rigid, as:

– It prevented domestic monetary policy from curbing liquidity sufficiently; and

– the apparent exchange rate guarantee towards the dollar all but invited residents to incur debt in US dollars.

These experiences must be taken into consideration whenever emerging economies seek to peg their currencies to one of the poles. Pegging a currency can actually help to improve the standing of the country on the international financial markets. It can also help to establish internal discipline. This can enhance credibility. However, such pegs have their limits where, during periods of tranquillity, disequilibria develop which cannot be adjusted appropriately.
A currency board has its limits, too. It can make a contraction of the domestic money stock - at least temporarily - necessary with accordingly high interest rates. To see this through, a country needs a sound financial sector, and its real economy must have sufficient flexibility.

III

Therefore, there is no one-size-fits-all method of managing a tripolar world.

The euro, the dollar and the yen are all in a state of healthy competition with one another. The international monetary system as a whole can only profit from this competition. Three conditions serve to promote a healthy competition:

- First, a lot of common ground is necessary regarding the anti-inflationary stance of the countries' monetary policy;
- Second, further sustainable progress in consolidating public sector budgets is needed - especially in Europe;
- Third, the currency areas have to rise to the economic challenges.

The USA has to prove that its large external debt is justified by its growth, innovative power and efficiency. In Europe it is important to enhance competitiveness and to reduce unemployment by implementing structural reforms.

Japan has to rebuild confidence in its financial sector and has to create the conditions for a self-propelling upswing.

A healthy competition does not mean rejecting greater worldwide cooperation with the aim of preserving the ability of the international financial markets to function. On the contrary, this is useful and desirable.

However, exchange rates are not the main instrument. Instead, more stable exchange rates are the result of the participating countries undergoing sound economic growth and conducting an anti-inflationary economic policy.