INTERNATIONAL CURRENCIES AND COMPETITIVENESS

SETTING THE INTERNATIONAL SCENE

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The association of the two terms, currencies and competitiveness, suggests a link between money and trade via exchange rates and more generally a link between the economic and financial side of the economy. I shall try to set the scene for the debate on currencies and competitiveness by looking at four dimensions: first, real economy issues such as growth, trade and regional interdependence; second, the monetary and financial system; third, exchange-rate relations; and fourth, the framework of policies, institutions and governments.

Growth, Trade and International Interdependence

The years 2004-05 are projected to be the best biennium for global growth since the late 1980s. The United States and developing Asia are acting as the main drivers. Europe’s contribution, in contrast, is likely to remain modest. Taking a longer-term perspective, Asia, including China and India, grew on average by over 7 per cent per year since the mid-1980s and now accounts for over a quarter of world purchasing power. The U.S. economy, which grew consistently at around 3 per cent a year, has been the second engine for global growth. The signs are that growth in these two regions will continue for the foreseeable future.

Trade has been the major driver of world growth. Economic interdependence has increased phenomenally since the end of World War II. Trade has grown on average twice as fast as GDP. Moreover, it has increasingly extended from primary commodities and finished goods to intermediate goods. Many barriers to trade remain despite the important progress achieved. For developing economies, the most favored nation tariff rate is still double-digit and is often as high as 20-30 per cent. Non-tariff barriers to trade have gained importance relative to traditional and quantitative restrictions. Compared to the latter, they are a much less transparent tool of protectionism, and thus much more difficult to detect and to eliminate from an international perspective.

Poverty has been massively alleviated by global growth and trade expansion. Overall, the proportion of people living in extreme poverty, on less than USD 1 a day, dropped by almost half between 1981 and 2001, from 40 per cent to 21 per cent of the global population. Progress, however, has been very uneven in individual continents and absolute poverty is still a plague.

Regional integration has progressed in various areas in the world, although following markedly different patterns. Europe started in the 1950s and proceeded in a strongly institutionalized way. It achieved a single market in 1993, launched a single currency in 1999, drafted a constitution in 2003, and expanded from 15 to 25 countries in 2004. In the western hemisphere, NAFTA and MERCOSUR are projects to create free-trade areas with little or no supra-national rules or institutions. Asia is rapidly integrating in economic terms as it organizes itself as a single huge production line involving different countries at different stages of development. In 2002, six Asian countries reduced internal tariffs on most goods to below 5 per cent. The whole Asian region is scheduled to become a full-fledged free-trade area in the
coming years. The Chiang Mai Initiative can be seen as a first step toward greater regional monetary integration.

**Global Finance**

Capital mobility and financial integration are global and hardly reversible realities. In considering the implications of financial globalization, two points should be borne in mind. First, domestic financial systems continue to play a crucial role. They are a link between the country and the global market that cannot be avoided. Second, a country may be a net exporter of capital due to its external trade surplus and at the same time be very dependent on external capital. Financial vulnerability indeed depends on gross capital flows, not on net flows.

Due to the globalisation and the phenomenal growth of finance relative to the real economy, there is normally no scarcity of finance. More often than not, finance is actually over-abundant. Periodically, liquidity can dry up and the markets get scared and over-scared; hence, swings rather than scarcity in finance is the issue.

**Exchange Rates and Competitiveness**

We often contrast an old world in which trade was international and finance national, where exchange rates were often controlled by authorities and seen as a real variable, with a new world where the exchange rate is controlled by the market and is mostly seen as a monetary variable. What is less often recognized is that the evolution from the old to the new world has been uneven over time and across regions. There are marked differences between Europe and Asia with respect to the relationship with the dollar, the intra-regional exchange-rate relationship and financial liberalization. Europe de-linked from the dollar in the mid-1970s. Most European currencies, however, continued to be tied to each other through a regional peg and then adopted a single currency. Financial liberalization was carried out completely, both in intra-European relationships and vis-à-vis the outside. Asia has not really abandoned the dollar standard, nor has it fully pursued financial liberalization and removal of foreign exchange controls. The dollar standard was implemented in different ways, ranging from currency board arrangements to heavily managed floats.

Fifteen years ago, the tri-polar world was made of two economies with their respective currencies, namely the U.S. dollar and the Japanese yen, and a loose European agglomeration. Today, the loose agglomeration is Asia while Europe has become a one market, one currency area.

The euro brings for the first time an alternative to the dollar, that is, a currency whose international use is unrestricted and whose economy has a size and importance almost equivalent to the United States. From that, one should not infer that the dollar’s international role is bound to decline, even less that this might happen soon. Such changes are extremely slow and heavily driven by non-economic factors.

The last twenty years have been marked by two developments: first, growing and diverging current account imbalances of the United States and Asia; second, wide and prolonged fluctuations, to be distinguished from short-term volatility, in exchange rates between Europe and the United States. Asia was characterized by a widening surplus combined with heavily managed exchange rates. Europe was characterized by substantial current-account equilibrium and wide fluctuations in the real and nominal exchange rate. The widths of the exchange-rate fluctuations suggest that the market operates as an adjustment mechanism, but, also, that it tends to overshoot.
Policy, Governance and Institutions

In terms of policy, the agenda of the post-World War II economic order was based on assigning allocations of goods to an international market to be gradually developed, while reserving the allocation of services and capital, and indeed the determination of exchange rates, to the authorities. For about a quarter of a century, this organic construct has been very successful in fostering prosperity and stability, but eventually it became the victim of its own success. The expansion of trade implied the movement of money, which in turn implied the movement of capital, which in turn disrupted exchange-rate fixity. The market side of the post-World War II order progressively invaded the policy side.

Ideas have also evolved, affecting and eroding the post-war philosophy. From market pessimism to market optimism, from rules to discretion, from recognition of interdependence to the proposition that if each country has its house in order no further need for international policy cooperation arises. However, while leaving exchange-rate determination to the market, G-7 authorities never practiced total neglect of the exchange rate. The second half of the 1980s was a period of rather active management of exchange-rate relationships by the G-7. The 1990s were a much more hands-off period, which, however, did not exclude occasional concerted action by the G-7, such as the defense of the dollar in 1995 and the support of the euro in 2000.

International cooperation has moved from a tight governance of a narrow agenda to a loose governance of a broad agenda: in trade, not only tariffs and quotas, but also standards, non-tariff barriers and even social systems; in money and finance, not only exchange rates, but also banking supervision, payment systems, financial market regulations, accounting standards, etc.

The number of actors has increased phenomenally, complicating further the governance of the international system. In 1945, the United Nations had 50 members, the IMF 40 and the BIS 26. Today, they have 191, 184 and 54, respectively. Also, the number of countries that count has increased significantly from one to perhaps a dozen.

While there are more and more sovereigns, sovereignty is eroded and fragmented. Firstly, within countries, it is increasingly difficult for one person to take deliverable commitments at international meetings. That person cannot commit the central bank, or parliament, or colleagues in the cabinet. Secondly, the role of the nation state as the holder of total power has declined because sovereignty tends to be distributed across multiple levels of government: municipal, regional, national and supra-national. A government-led institutional system has thus gradually been replaced by a market-led one.

The decline of undisputed U.S. leadership has not given way to an effective and accepted collective leadership. Groups formed to exert leadership are a baroque and very outdated construct. The G-10, key in the 1960s and early 1970s, still exists in spite of the fact that the G-7 effectively replaced it in the 1980s and 1990s. The G-7 may well be ultimately split into a G-3 and a G-20, but the former does not exist yet and the latter will take time to gain strength.

The respective roles of leadership and institutions are thus blurred. The result is a loss of legitimacy and a weakening of institutions. The advocate of the international interest has a lesser role than twenty or thirty years ago. Public opinion and civil society are becoming increasingly aware of the erosion of sovereignty and of the problems of legitimacy and democracy in international governance. Segments of civil society are getting organized internationally via both advocacy and operational NGOs.

Let me end with some questions for the remainder of the decade. Is the correction of the U.S. external and fiscal deficit compatible with the continuation of high GDP growth? Can Europe become an area of high growth, possibly compensating slower U.S. growth? Can trade negotiations achieve the much needed
reduction of trade barriers in agriculture and textiles? Is the emergence of three, and perhaps more, large regional trading blocs to be seen a risk or an opportunity? How will exchange-rate relations affect trade relations? Will the current and future economic giants in Asia become monetary giants as well? How should they proceed in developing the global status of their currencies and financial markets?

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