First of all, there is little to add to what Prime Minister Marek Belka described as most important for the enlarging Europe from the new members’ perspective: on balance, a common currency on a common market is a reasonable decision, and competitiveness has been won on the front of labour costs and on the front of productivity gains. I am equally impressed and enlightened by Stanley Fischer’s verdict that on a common market with uncompromised freedom of capital movements in all forms, i.e., including foreign direct investment, and given a reasonable degree of labor-market flexibility, the euro is a reasonable concept as a currency for Europe.

Considering the circumstances, Euroland will in my view move from being a club of 12 to a club of 16 by 2007 and will be a club of well above 20 by 2010. I have no forecast on whether the three “not-yet-ins” of the old members will be in by then. My guess is they won’t.

During the last 12 months, discussions and policy events among the old European Union and the then-applicants interrupted a longstanding convergence process. Interventions from academia and from both sides of the Atlantic, recommendations from the European Central Bank and other central banks, and controversial debate about the Stability and Growth Pact have made early-entry expectations obsolete in a number of countries, particularly the more important countries in Central and Eastern Europe. Therefore, we have witnessed exchange-rate gyrations in Europe and moves to safeguard interest rates in those very countries themselves. High volatility is likely to weigh on the hoped-for momentum in investment activity in the new member countries. Under such circumstances, when costs of financing are higher, real adjustment may be slowed down, i.e., what may happen is exactly the opposite of what an important school of thought claims will be fostered by flexible exchange rates. I am pretty sure that the persons in charge in all the institutions I mentioned, including academia, will carefully study the empirical results and, hopefully, learn from them.

What Drives Exchange Rates

What an unfortunate situation. We have only one set of empirical data on exchange-rate developments but we have a wide range of exchange-rate theories. Exchange rates, including the USD/EUR rate, fluctuate widely, and this has been no different over the last several quarters. There are quite plausible exchange-rate explanations, and there are even better theories to explain exchange-rate changes. We have a purchasing power parity theorem and the explanation that changes in purchasing power should follow the differences in inflation rates. Furthermore, there are plausible theories stating that exchange rates can be explained by international growth and interest-rate differentials. Nonetheless, reality is unfriendly enough to foil all these good theories.

Now, we are looking into another hypothesis, namely, the question of current-account imbalances. And if I understand the foreign-exchange markets correctly, this is now the theory that takes centre stage in many of the foreign-exchange dealers’ mindset. What is the argument behind the theory? It is that the
appetite for a certain asset class declines if too much is offered. As a rough empirical observation, a current-account deficit or 5% or more of GDP for a sustained period is not considered sustainable.

In the specific case of the United States, hardly anybody would claim that the United States has to balance its current account. I would like to bring forward an argument not often made, but which is quite important. The financial sector of the United States is of such high quality that it is capable of extracting 1.5 times the yield from an investment there as the rest of the world’s financial markets can elsewhere. Therefore, the debt service of the United States is much lower than it would be otherwise and, as a rough calculation, for a considerable period of time a 3% current-account deficit seems to be acceptable. If this is indeed the case, we can make some calculations to find out how we could get there from the present 5% deficit. This won’t happen overnight because we all know that there are long lags to consider.

What instruments are there? One instrument, of course, is to accelerate growth in the rest of the world. This should be done by using monetary and fiscal policies. We then have to ask, particularly for Europe, whether Europe is capable and/or willing to do so. With respect to monetary policy, Europe is perfectly capable of doing so, but it is not willing to. In terms of fiscal policy, the willingness is probably there, at least with respect to some of the heads of state and even some finance ministers, but they are not capable of doing so because the money was spent in the past for no good purposes, especially in terms of the rate of return.

An alternative strategy would be to lower growth in the United States. While this would be perfectly possible, the question is would it be desirable? Another question to ponder would be how likely it is. I argue that it is neither desirable nor probable. However, the two possible administrations after the U.S. elections in November might have a different attitude. I take up the position that a Kerry administration would pursue a less expansionary fiscal policy than another Bush administration would, but I also claim that there will be a compensating monetary policy response. So, in Kerry’s case, U.S. interest rates would not rise by as much as they would in the case of another Bush government.

The third instrument, namely exchange rates, is the one most likely to be used. For the foreign-exchange rate instrument to work, one must look into the issue in a more detailed way. One has to ask if it is up to Europe to do the adjustment or up to somebody else, or should there be a joint responsibility of the rest of the world to accept the exchange rate as an instrument. It is very obvious that not every country is in a floating regime, and it is very obvious at the same time that there are countries that are anything but willing to let the exchange rate move freely in the direction needed for correcting the U.S. current-account deficit. And as an indication, the difference in opinion with Asia is particularly strong, but less so with Europe. So, if there were a bilateral approach, the appropriate answer would be exchange-rate corrections of the Asian currencies, but anybody who has studied economics would not argue that this will happen. As an aside—and I know I should not say this—but I hate the fact that we have many multilateralists who—when it comes to issues such as exchange rates—forget about this and only talk about bilateral balances. I certainly will not participate in such debate.

But let’s assume that only the euro is flexible. If it were up to the euro to correct the U.S. current-account deficit from 5% to 3% over a three-year period, we would need to have an exchange rate of USD 2/EUR. I don’t have to comment on that. If all currencies were willing to support the adjustment, the euro-dollar exchange rate would be USD 1.60/EUR and all other currencies, including the renminbi, would appreciate by 30%. As you obviously realise, neither of these events will happen. Thus, for the next four years the disequilibrium in the U.S. current account will remain. We will add more dollars to the coffers of certain investors. The big question is, will the Bank of Japan and the People’s Bank of China be willing to continue to intervene to the same extent as they did over the last two years? That was a rhetorical question. The answer is “no,” because their interest in fighting an appreciation of their currencies is less strong now after having conquered deflation.
Voluntary capital inflows into the United States seeking to finance an unsustainable current-account deficit necessitate one or the other of the following: the Dow has to rise sharply because the returns of U.S. companies increase dramatically; interest rates go up to attract international funds; or, if that does not work, the exchange rate has to depreciate until it is low enough that everyone expects it to appreciate, thus overshooting in order to get appreciation expectations for the dollar.

**What Should Happen**

What should happen? The ECB should cut rates. The European finance ministers should courageously continue to pursue structural and fiscal reform, cut subsidies, cut transfers, cut tax rates and social-security contribution rates and be very supportive in order to bring about better infrastructure in education and research through privatisation. Privatization should be pursued so that the capital market provides finance. Such projects would, most probably, violate the letter of the Stability and Growth Pact again in 2005. In my view, however, this would not oppose the thrust of the Pact because it would help to bring down deficits thereafter.

What should happen in the United States? The Fed should increase rates; it will do so in June anyhow, by 50 basis points. The United States should stretch or reduce the tax-rate cuts, and the foreign exchange rate could do the job. I expect 1.25-1.45 dollars to the euro would do it.

**German Competitiveness**

A last word on German competitiveness. Everyone, including me, complains about the pace of reforms, particularly in the labor market, but compared to Euroland as a whole, Germany has nevertheless managed to improve its competitiveness over the last three years. In relative terms compared with the Netherlands, Spain and Italy (less so with France), Germany’s total labor costs declined by something like a good 10%. Therefore, German suppliers are now more competitive inside Euroland and more competitive internationally than their Euroland partners —because some of our neighbors have not fully understood the implications of the monetary union. They did not consider cost control as necessary. Germany will also benefit from the bonanza from a world investment boom in the course of this year and probably next. Therefore, Germany, because it has become somewhat more competitive, will surprise on the upside.

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