Ein Leser der NachDenkSeiten, Dieter Wermuth, Consultant der japanischen Bank UFJ, macht auf wahrscheinliche Verschiebungen der Währungsrelationen – eine zu erwartende Abwertung des US$ – aufmerksam.

Currency issues move up on the international agenda
November 16, 2004

1. European money, bond and FX markets were briefly rattled yesterday afternoon by rumours that the authors of an influential market newsletter had been making the case that in the first quarter of next year the ECB would finally begin to raise rates, notwithstanding the new slowdown of euro area growth and the strength of the euro. Perhaps these rumours have been a new variant of verbal intervention. They were certainly a reminder that betting on the euro and on ever lower interest rates is not without risks, and that there is at least one actor in the market who may have quite a different view of the world. According to the rumour, the ECB could justify a rate hike by arguing that inflation has remained too high for too long, that there is a large and threatening monetary overhang, that exchange rate moves will have only a minor impact on Europe's real economy, and that slow GDP growth in Q3 (0.3% q/q) will prove temporary given that the world outside of euroland continues to expand briskly.
2. If one accepts that the huge and rising US current account deficit is a major, perhaps the major imbalance in the world economy today, a rate increase by the ECB makes only sense if one argues that an even stronger euro appreciation than we have seen so far is needed in order to pre-empt an otherwise inevitable full-scale dollar crash. The effects on Europe's economy would be very negative. Higher rates increase the incentive of consumers to save more, and of business to spend less on investment. The opposite – faster European growth – is actually called for. It would boost not only the demand for domestic but also for American and other foreign goods and services and thus help to reduce the US current account deficit. As far as the so-called income effects on foreign trade are concerned, Europe should stimulate its economy by lowering rates while the US should restrain demand via higher rates.
3. Changes in relative prices, ie exchange rates, have historically been the quickest way to eliminate trade imbalances. But what does that imply in the present situation? Most FX market models suggest that the trade-weighted dollar has to depreciate by another 15%. Given that the countries that are not pegging their currencies to the dollar have a weight of only about 50% in the effective exchange rate of the US dollar as calculated daily by the Bank of England means that the dollar has to depreciate by around 30% against the group of freely floating currencies, such as the Can$, the euro, sterling, the Swiss franc and the Scandinavian kronas, to achieve the overall decline of

15%. We are talking about a decline of the dollar from _0.77 today to _0.539, the inverse of which is $1.86 per euro. page 2 November 16, 2004 Dieter Wermuth

4. This is a scary scenario. So it can be expected that Europeans will join the US and begin to exert increasing pressure on the governments of China, India, Taiwan, South Korea, Mexico, Russia and other "peggers" to let their currencies appreciate against the dollar. But these countries are reluctant to give up their competitive edge resulting from the combination of very cheap labor and land, state-of-the-art technology and a stable dollar exchange rate, given that they are mostly still quite far behind in the catching-up process as far as per-capita incomes are concerned. In addition, they are afraid of the capital losses on their large dollar holdings which would accompany any dollar depreciation.
5. Japan will also be urged to cooperate more, ie to stay on the sidelines when the yen comes under upward pressure next time. For Japan which is still fighting deflation, a stable exchange vis-à-vis the dollar block is a means to import inflation. The Bank of Japan has lost its interest rate tool long ago, and fiscal policies have no bite any more either, so remaining an informal member of the dollar area is crucial. A yen appreciation would be very counterproductive and will therefore be resisted as long as possible.
6. The G-20 conference which begins this Friday in Berlin will be the appropriate place to discuss the necessary exchange rate adjustments. It is unlikely that there will be announcements about regime shifts, but the guidelines will once again emphasize the virtues of more flexible exchange rates. The problem is that countries whose currencies tend to appreciate have unlimited resources (also called money printing presses) to prevent this. They just have to accept that their currency risk increases all the time as their dollar assets may be worth less than they currently believe, and that they give up their independence in monetary policies. In their view, these may be minor drawbacks compared to the at least temporary advantage of growing at a rapid pace. The pressure on them to let go will increase, but it is too early to expect concrete results. While many actors prefer to look away, the 1000-pound gorilla keeps gaining weight.
7. Finally, a note for readers who want to study the pros and cons for the statement in the second paragraph above that the US current account deficit is the world economy's main imbalance and that a large dollar depreciation is almost inevitable. A well-organized plain-language presentation of arguments can be found in former US Secretary of the Treasury Larry Summers' 2004 Per Jacobssen lecture of October 3, available on the internet.