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EXCHANGE RATES AMONG KEY CURRENCIES
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INTRODUCTION

Under the Bretton Woods System, the assessment of the « right » bilateral exchange rates was, in principle, made relatively easy because of one fundamental reason : trade and trade related services were the dominant element of international payments and of capital movements. We then lived in a “physically” trade related world where currencies could be compared on the basis of purchasing power parities (P.P.P.).

And yet, even at that time, the assessment of the “right” exchange rate under the aegis of the IMF was in fact a pretty difficult exercise.

With deregulation and the abolition of exchange controls, capital movements non related to trade and services have become, by far, the dominant component of international financial flows.

This evolution combined with the floating exchange rate system established since 1973 has profoundly changed the conditions which govern exchange rate relationships. Of course, the PPP rationale and the importance of current accounts have not disappeared. But they have become factors among many others in the judgments and expectations of the market.

The economy and the way it is understood have become more complex. Operators dont only look at short term macroeconomic and current account conditions but more and more to the fundamental underpinnings of durable growth.

In this context, I shall attempt to address three questions :

I. How can one assess the recent behavior of the three major currencies -the dollar, the euro and the yen- in terms of their “traditional” fundamentals ?
II. How can one assess this behavior from the standpoint of structural and other factors ?
III. Has the creation of the euro -some twenty months ago- entailed or been accompanied by more exchange rate volatility ?

In conclusion, I shall give a few tentative views on what could be done to stabilize the functioning of the system.

I. HOW ARE THE THREE MAJOR CURRENCIES FARING IN TERMS OF THEIR TRADITIONAL "FUNDAMENTALS" ?

The traditional yardsticks used to assess exchange rates -i.e. purchasing power parities (PPP), differences in economic cycles and current accounts- suggest for some time an upward correction of the euro vis à vis the US dollar and a downward move for the yen.

1. PPP :

- graph I which relates the actual exchange rate US $/yen against the PPP suggests that the yen has been overvalued for the last 10 years vis a vis the US$;
- graphs II and III which relate the US $ to the DM and the FF suggest that the US$ is getting clearly overvalued since early 2000, although the magnitude of this overvaluation appears to be less than it had been in the early 80's.

2. Growth discrepancies :

Actual US economic growth is currently close to 5 % while in Europe the rate is moving towards 3 to 3.5 %.

The world growth profile is therefore : US > Europe > Japan

Short term interest rates are well in line with this pattern. This also helps to explain a strong dollar versus the euro.

However the situation is changing : the US authorities have been tightening monetary policy and growth in Europe is stepping up, which will help the appreciation of the euro.

3. External accounts :

If one looks at current accounts alone (surplus in Europe, large deficit in the US) the picture is difficult to reconcile with actual exchange rate patterns.

But if one looks at a larger concept (integrating current account and direct investment) the picture becomes more consistent.

Indeed, European investors have massively invested in the US over the last two years. The net outflows of European direct investment to the US has reached 91 Billion US$ in 1998 and 166 Billion in 1999. (In the years 1990 to 1997 the figures were much more modest, of the order of 10 Billion a year).

If one adds the net acquisition by Europeans of US corporate bonds and equity (respectively : 140 Billion US $ in 1998 and 98 in 1999) one understands better that the massive amounts of capital movements out of Europe towards a dynamic US economy have largely contributed to the exchange rate trends. As Mr. Greenpeace observed a few months ago : "So long as foreigners continue to seek to hold ever-increasing quantities of dollar investments in their portfolios, as they obviously have been, the exchange rate for the dollar will remain firm".

This leads us to look into other factors than the traditional ones.

II. THE SIGNIFICANCE OF OTHER FACTORS IN TERMS OF THE PRESENT EXCHANGE RATE SITUATION :

1. Structural factors :

Recent reports show that "structural fundamentals" are stronger in the US than they are in Europe and in Japan.

Thus US productivity growth in the year ending June 2000 has reached 5.2 % (in the second quarter productivity growth even peaked at 5.7 % in annual terms), which is substantially higher than in Europe.

If one looks at large measurements of competitiveness (significantly more comprehensive than traditional PPP indices) one can observe that the US has been ranked number 1 in 2 of the last three years (in 1999 it has been ranked number 2 after Finland).

If one refers to growth competitiveness measurements (including innovation, technological advances, efficiency of the financial sector, openness of the economy, factor mobility…), the US economy appears the most competitive economy in the world [1].

2. Market factors :

Market behavior has been influenced on the one side by the hope or expectation of a strong economic upturn in Japan and on the other side in Europe by the lack

[1] Calculations by the Geneva based Economic Forum.

of a clear and consistent message on the euro and by the perception of deep seated structural problems. This has weakened the normal play of the traditional factors.

It can be added that self-fulfilling behaviors have gone in the same direction (in the context of higher dollar, investors dont want to “miss” it and want to be sure that the corresponding downward euro move has reached its bottom before they reposition themselves). This compounds the ”overshooting” trends observed on the market.

III. HAS THE EMERGENCE OF THE EURO ENTAILED MORE VARIABILITY OF VOLATILITY ON THE EXCHANGE RATE MARKETS ?

Why is it that some observers have been presuming a greater volatility of the euro (in comparison with the previous behavior of the currencies that make up the euro) ?

Two reasons are put forward :

- Firstly, there could be a “volatility transfer” phenomenon : since volatility bas disappeared, by definition, within the Euro zone, there would be a sort of an offsetting trend towards more volatility between the euro/US $ and the euro/year rates. I fail to understand that argument.

- Secondly, some argue that the relatively modest degree of external openness of the Euro zone vis a vis the rest of the world could lead monetary authorities to be less reactive (than would have been the case before the euro) to exchange rate movements of the euro against the US$ and the yen. In other words, since inflationary risks stemming firm exchange rate moves have, for the greatest part of euro’s trade, been abolished, the authorities might be less inclined to worry about the volatility of the euro/US$ exchange rate. I don’t believe that argument is right ; the European Central Bank is clearly pursuing an anti-inflationary policy. The markets understand it as the Euro and $ long term yield curves amply demonstrate.

  Be it as it may, if you look at the daily volatility of the euro since its emergence (euro against US$) nothing would lead to conclude that volatility has increased.[2]

[2] Monthly volatility as measured by the IMF has not significantly changed over the period 1973-1998.

CONCLUSION :

All in all, the present misalignments are not inconsistent with exchange rate behaviors observed over the last decades (which doesn't not mean that the system is satisfactory). The graphs show that we have witnessed in the past very large swings (overevaluation of the $ from 1980-85, high yen in the first half of the 90's followed by a depreciation until 1998).

If one believes in the importance of structural (non traditional) factors -as the market seems to do- one comes to the rather simple conclusion that the present situation of the euro exchange rate is very much determined by the healthy and dynamic growth of the US economy.

If that is true, fundamental policy orientations in European countries should focus on a basic question : how can the European countries grow more dynamically ? And here we are confronted to the well known (but insufficiently addressed) structural issues relating to market factor flexibility, entrepreneurship, efficiency of public administration, tax pressure and structure, etc….

All this does not mean, of course, that traditional yardsticks are not important. They are crucial. But they no more govern alone the markets.

In the older days of the US current account deficits, non residents used to finance the US Treasury. Now they are financing a booming private economy. They seem to be more attracted, at this stage, by the opportunities of the American market than they appear to be deterred up to now by the magnitude of the US external debt.

With growth catching up in the European countries, progress made on the efficiency of their economies, and the magnitude of the US current account deficits, things will change and misalignments will tend to correct themselves.

Of course, in saying this, I am conscious of the vulnerability of the exchange rate system :

- exchange rate variations are sharp and do have economic distorting consequences,
- these consequences are particularly severe for emerging and open economies,
- corrections can be all the more costly that misalignments have gone too far.

Therefore it is of the essence that a more systematic and effective cooperation (including on structural problems but also on market related actions as we are witnessing) takes place between the members on the three major currencies.

In this respect, the recent intervention actions and the G7 communiqué are a powerful statement in favor of a strong and stable international monetary system and a clear sign of cooperation in exchange markets.

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