Preface

Understanding exchange rates is not an easy task. Unforeseen movements in one direction or another have fuelled the perception in economics that exchange rate behaviour is disconnected from macroeconomic fundamentals, at least in the short and medium term. This disconnection leads to a puzzle, or rather three puzzles, regarding exchange rate levels, exchange rate volatility and purchasing power parity. Yet others reject such a perception. To abandon macro fundamentals – they claim – would be like throwing the baby out with the bath water. In their view, even a microstructure approach leaves some role for macro fundamentals.

_Currency and Competitiveness in Europe_ – the title of this book – combines two key economic concepts that have both generated a bulk of literature. Bringing those two terms together, we focus the debate on the real side of the economy. Moreover, we put a regional focus on Central, Eastern and South-Eastern Europe (CESEE), which allows us to include the aspect of transition and convergence. After all, notwithstanding the very different stages of catching up in the region, differing exchange rate regimes and different degrees of openness constitute major elements influencing the competitiveness of those countries, that is, their ability to participate successfully and sustainably on European or global markets.

The book is based on the Conference on European Economic Integration 2007 of the Oesterreichische Nationalbank, which took place on 19 and 20 November in Vienna. The conference explored the links between the external value of currencies and structural developments in the real economy, focusing specifically on the integration process in CESEE. The conference addressed a wide range of issues, including the worldwide current account imbalances; international currency competition; the role, objectives and challenges of regional monetary unions; the competitiveness of catching-up countries and related challenges for monetary policy. While acknowledging that exchange rates are an important indicator in evaluating a country’s competitive position, speakers also highlighted the influence of other factors for international competitiveness – like unit labour costs; sectoral and regional trade structures; quality and technological upgrading of production and location factors, such as tax systems.

The majority of catching-up countries exhibit relatively strong exchange rate appreciation, driven by large productivity gains in the tradable sector,
as is also evidenced by the Balassa-Samuelson effect on inflation. CESEE member states of the EU are a case in point, as many of them experienced real appreciation coupled with substantial gains in international market shares. It is worth noting that new EU member states, similar to the first and second tier of Asian Tigers, are especially open economies. Their export structure is very much distinguished by trade in goods, as opposed to more advanced economies, which seem to export relatively more services.

As a result, despite currency appreciation, the new EU member states have exhibited a strong economic performance since the mid-1990s. Their growth rates are on average three percentage points higher than those of the euro area, thus keeping the catching-up process alive. Furthermore, the positive relationship between net foreign liabilities and real appreciation in these new EU member states during the convergence process is also worth noting.

Next to external and internal imbalances of CESEE countries, the book tackles also the problem of global imbalances – net deficits or surpluses in trade and investment among major economic regions. In the framework of the IMF's multilateral consultation initiative, five key global players have presented policy plans on their contribution to reducing global imbalances in an orderly fashion. Some of these countries (or economic areas) considered the IMF to have created the right instrument at the right time and developed their plans in the endeavour to face up to their global responsibility. Others see these voluntary plans as being mainly in the countries' own national interests. Still, the crucial question is whether these multilaterally consistent plans will be implemented, in which case the euro area has a lot to gain.

In the wake of financial integration, a large number of developing countries worldwide had deregulated their financial markets and opened up to pro-cyclical capital flows. In those instances where these decisions went hand in hand with the adoption of fixed exchange rate regimes, deregulation often led to booms and busts, dollarization of the economy and portfolio imbalances. More recently, countries have therefore increasingly moved toward more flexible exchange rate regimes. To regain credibility, however, they have had to establish a new anchor, for instance, via inflation targeting. Alternatively, monetary unification similar to Europe’s economic and monetary integration (EMU) might be an option for a few countries. However, monetary union is certainly not a remedy that would fix problems immediately. In fact, the experience with EMU shows that it takes more than mere exchange rate fixing to reap the benefits of a common currency.

Positive examples in this respect are Slovenia, but also Cyprus and Malta. At the time of the conference the latter two were on the verge of adopting the euro. But for most of the potential euro area candidates the
fundamental challenges prevail. In particular, the following questions arise: can nominal and real convergence take place simultaneously? What are the specific challenges the candidate countries face? And, how can these challenges best be tackled by monetary, fiscal and structural policies? In this respect the Treaty on the European Community not only represents a transparent, rule-based framework, but also offers leeway for the CESEE EU member states in calibrating their convergence paths.

As to their economic development, there is strong evidence that the introduction of the euro has had positive effects on trade, foreign direct investment and financial integration. The evidence of the impact on growth, however, is mixed. Certainly the loss of the exchange rate as a policy instrument may entail some costs. But in general, monetary integration may contribute to growth by enhancing the quality of macroeconomic policies, providing incentives for reforms and mitigating divergences within the monetary union. EMU increases macroeconomic stability by providing a reliable, well-targeted monetary policy.

Overall, the book touches upon the wide range of topical issues that come to the fore when currency matters are combined with competitiveness considerations. We would hope that the findings established and the new questions raised in this book will serve as a valuable source for future research.

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