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TTIP or Transatlantic Currency Cooperation?

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At a glance

Trade between the United States and the European Union is modest; internal European trade is much more substantial. While TTIP is a controversial issue, there is little discussion of another, probably much more serious obstacle to trade than tariffs and non-tariff barriers: the sharply fluctuating euro/dollar exchange rate. The euro fluctuated between a trough of 0.82 US dollars in 2001 and a peak of 1.6 US dollars in 2008, similar to the earlier DM/dollar exchange rate. These fluctuations have nothing to do with economic fundamentals, much more to do with speculation. The volatile euro/dollar exchange rate distorts transatlantic trade and capital flows. Currency cooperation between the Federal Reserve and the ECB could substantially reduce these fluctuations and so boost growth and employment.

The TTIP project is being criticised from every direction: because of its undemocratic procedures, which appear to sideline parliamentary rights; because of the risks to environmental and consumer protection; because of its negligible effects on growth and employment; and because of the absence of a multilateral approach.

Besides the justified criticisms of the TTIP project we should not lose sight of the fact that trade between the United States and the EU is remarkably weak – even though tariffs and many other trade barriers are now trifling.[2] In the media focus on TTIP little attention is paid to the fact that trade in goods within the EU is much more substantial than transatlantic trade. If Germany, for example, exported as much to the United States as it does to France (its main trade partner), then, given the ratio between US and French GDP, more than six times as much would be exported to the United States as to France. To put it another way, in 2013 Germany exported more to Switzerland and to Austria than to the United States, although the latter's GDP is ten times the size. The share of US trade (exports and imports) in the total trade of the EU27 in 2012 was only 5.5 per cent and only 14.3 per cent of trade with non-EU states overall. This low trade intensity can scarcely be explained away by higher transport costs or by tariffs and non-tariff trade barriers.

Probably a much more important explanatory factor is the fluctuating euro/dollar exchange rate. Internal European currency cooperation since the end of the Bretton Woods fixed exchange rate system in 1973 – first, the "currency snake", then the European monetary

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system and finally the single currency since 1999 – has always been aimed at boosting internal European trade. And with great success. All experts expected the introduction of the euro to bring about a massive intensification of trade, which has indeed come to pass. At the same time, however, the "free" euro/dollar exchange rate, with its chaotic ups and downs, is regarded as sacrosanct. Currency cooperation to stabilise the exchange rate between the United States and the euro zone is considered to be taboo in Washington, Brussels, Frankfurt and, in particular, Berlin, even though the very opposite is being done within the EU – on one hand, due to the introduction of the euro (in other words, the abolition of fluctuating exchange rates), and on the other hand, due to the stabilisation of the exchange rates of those EU countries that would like to enter the euro zone sooner or later. Let's take a closer look at the exchange rates.

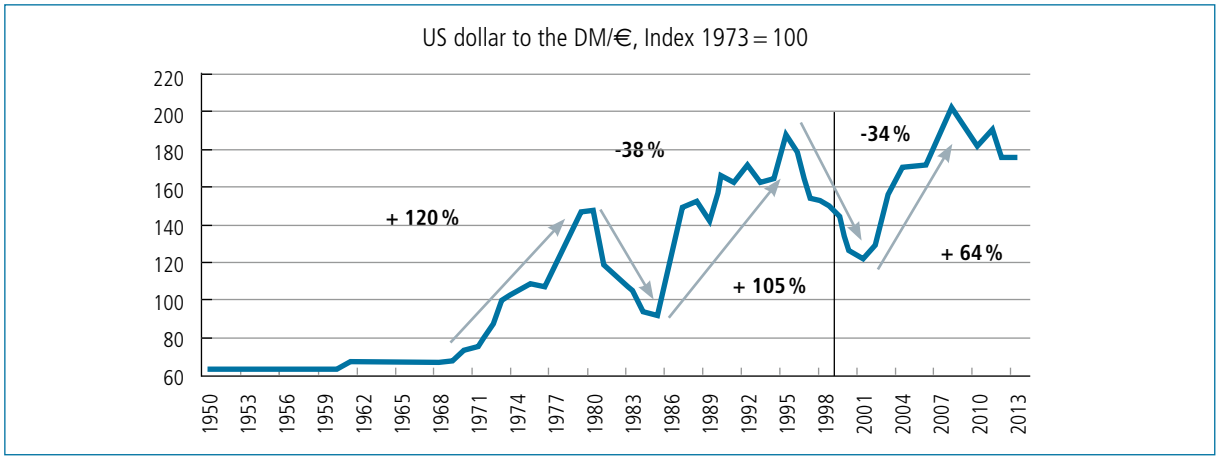
The Rollercoaster of the Euro/Dollar Foreign Exchange Market

Originally, those economists who favoured flexible, market-determined exchange rates believed that, despite some fluctuations, they tended towards stable equilibrium rates. The opposite proved to be the case. Rates follow a short-term zigzag pattern in long cycles upwards and downwards. As the weaknesses of the Bretton Woods fixed-rate currency system became apparent at the end of the 1960s, the German mark (DM) appreciated in value by 120 per cent (1968-1980, annual average), only to fall by 38 per cent by 1985 (see Figure 1). From 1985 to 1995 the German mark again rose in value by no less than 105 per cent, only – having morphed into the euro from 1999 – to be devalued again by 34 per cent up to 2001. This was followed by a massive revaluation by 64 per cent up to 2008, succeeded by a slight revival of the US dollar. If one looks at daily peak values, the DM achieved its lowest daily value of 3.46 DM to the dollar in 1985 and its highest external value of 1.34 DM to the dollar in 1995 (an appreciation of 158 per cent). The euro fluctuated between daily peaks of 0.82 dollars to the euro in 2001 and almost 1.60 dollars to the euro in 2008 (an appreciation of 95 per cent).

This rollercoaster has little to do with such "fundamentals" as purchasing power parities, interest rate differentials, growth differences or different inflation rates. Conventional exchange rate theories regard purchasing power parities as the "centre of gravity" of free exchange rates. In the 23 years from 1990 to 2012 the DM or the euro moved within a band of +/-5 per cent purchasing power parity to the dollar in only four years and in eight years within a band of +/-10 per cent (referring to annual averages; daily values varied much more sharply). At its lowest point in 2001 the euro stood 22 per cent below purchasing power parity, and at its highest point in 2008 around 25 per cent above purchasing power parity (annual averages). Mainstream theoreticians are thus confronted by an exchange rate puzzle.[3]

But the real exchange rate – that is, the rate adjusted for inflation – fluctuates almost as much as the nominal exchange rate between the DM/euro and the US dollar (see Figure 2). By contrast, the average (trade-weighted) exchange rate, adjusted for inflation differentials, between the euro or the DM and the currencies of 26 selected countries is much less volatile for Germany (the so-called real effective exchange rate). This is due to Germany's integration in the European monetary union. Furthermore, the exchange rates of many other countries often move in parallel with the euro and fluctuate more or less with it around the dollar. Germany has much more intensive trade relations with these

Figure 1: **DM/€ exchange rate against the US dollar (annual average), 1950 - 2013**



Source: Penn World Tables, Deutsche Bundesbank, World Development Indicators; own calculations.

countries than with the United States; the situation is similar for other EU member states. As a consequence, the strong trade integration of EU member states has a lot to do with the, for decades, relatively stable real effective exchange rates. For all the criticism of the European monetary system its positive side should not be overlooked.

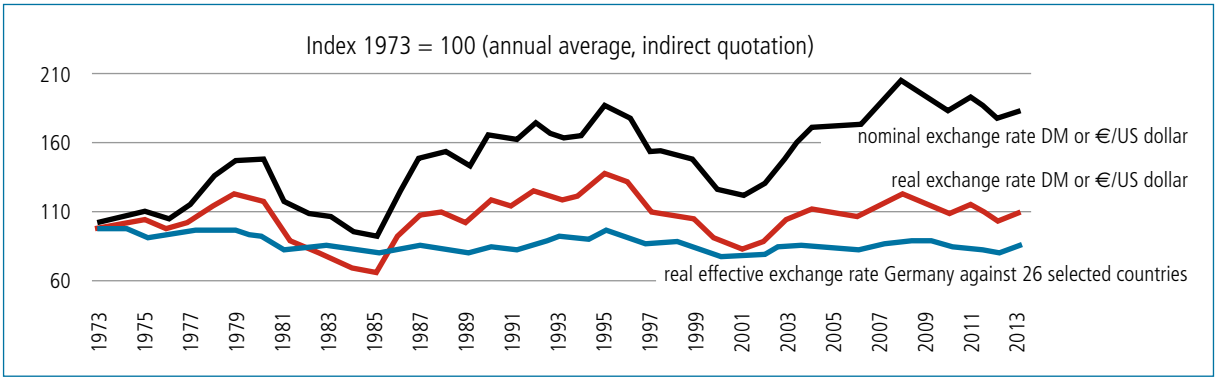
Why is the euro/dollar exchange rate fluctuating so much at present, similar to the DM/dollar exchange rate in the past? In reality, exchange rates develop in today's currency markets in ultra short-term rhythms with the help of technical computer-aided high-frequency trading ("algo trading").[4] Currency markets have four connected segments: spot markets, futures markets, currency futures and currency options (derivatives). The derivative markets are growing most rapidly. Their overwhelming purpose is speculation; hedging plays only a minor role. Only rarely do currency or forex traders – predominantly "technical traders" or "chartists" – take economic fundamentals into account in their calculations. So-called technical analysis is dominant. A trend reversal occurs when over- or undervaluations become so extreme that traders' "sentiment" shifts; or central banks or governments deliberately get involved through currency market interventions, interest rate changes or supranational agreements. Sometimes a trend reversal occurs due to a financial or balance of payments crisis. The behaviour of forex traders, oriented overwhelmingly towards large-volume speculation, thus affects what happens on the currency markets. Short-term phases succeed one another, interrupted by phases of »sideways movement« and thus determine the long up- or downturns. Currencies are assets just like real estate or shares. Currency markets are thus strongly susceptible to the development of speculative bubbles, just like other financial markets. Besides that, they are the biggest and most rapidly growing global financial market.

Exchange rates are – particularly in periods of globalisation – extremely important "prices". If they deviate systematically from equilibrium values, which since David Ricardo have been located in the vicinity of purchasing power parity, they distort trade in goods and services. Worldwide, currency markets are the biggest and most rapidly growing financial markets. More than 98 per cent of currency transactions have nothing to do with trade in goods. Also transactions related to firms' direct or portfolio investments abroad comprise only a fraction of currency deals. The most important of all currency markets is the so-called "eurodollar" market. Many other important currencies fluctuate like the euro – or earlier the DM – and form "super-cycles" around the international reserve currency, the US dollar. Many currencies, such as the yen, fluctuate even more wildly than the euro against the dollar, not to mention the currencies of emerging countries, which are beset by violent, often tsunami-like "tides".

Consequences for Enterprises and National Economies

Exporting and importing enterprises mainly hedge their payment obligations in foreign currencies through forward contracts or similar instruments. This insures them in the short term – usually up to a year – against exchange rate fluctuations. However, this does not alter the fact that, in the event of an appreciation of the euro against the dollar, costs increase substantially, potentially losses, which are countered only by falling costs during the next round of devaluation, sometimes only ten years later. Companies' investments, with a long-term orientation, cannot, like exports, be hedged against exchange rate changes. As a result, companies have to diversify more strongly in relation to imports and exports. Small and medium-sized enterprises are at a systematic disadvantage here. Multinational companies can cope more easily with exchange rate

Figure 2: **Nominal and real exchange rate, DM/€ against the US dollar, as well as the real effective exchange rate for Germany**



Source: World Development Indicators, Deutsche Bundesbank, Bank für internationalen Zahlungsausgleich, World Economic Outlook; own calculations.

fluctuations. Ultimately, foreign direct investment enables them to leapfrog currency areas. Flexible in- and outsourcing depending on the exchange rate can also play an important role. The most important hedge for companies, however, is to be active in a large currency area with low exchange rate fluctuations in order to have a counterbalance against trade with volatile currencies. This implies, however, that volatile exchange rates sometimes divert trade flows to stable currency areas. The juxtaposition of very robust exchange rates (or the use of a common currency) and very volatile exchange rates thus distorts global trade in goods. The WTO does not deal with this problem because it – rightly – considers that the IMF is responsible for it. Capital flows are also disrupted because the system favours short-term speculative flows.

The three phases of strong appreciation of the DM or euro against the US dollar – the 1970s, 1985 - 1995 and 2001 - 2008 – retarded overall economic development in Germany, as in other EU countries. In the event of a sharp appreciation firms come under cost pressure and try to reduce wage costs. During periods of devaluation the consequences of previous currency appreciations cannot simply be put into reverse. Many companies or even whole sectors will have been unable to withstand the revaluation pressure and contracted or gone to the wall. Bundesbank president Jens Weidmann's assertion that "a strong economy can put up with a strong currency" (Focus 16.6.2014) thus downplays the problems due to chronic "misalignments" with regard to exchange rates; in other words, sustained over- or undervaluations. Exchange rates uncoupled from fundamentals thus harm the real economy, in particular growth and employment. Advocates of "Ordnungspolitik" in particular should thus heed the importance of a rational currency system.

Options for Currency Cooperation

Stronger transatlantic cooperation on currency issues would thus represent a far more important and promising project than TTIP because it would be much more likely to bring about more substantial positive growth and employment effects. This does not have to involve a return to the old fixed-rate system of Bretton Woods. Rather the monetary authorities should jointly try to use the two most important reserve currencies in the world to reduce the extreme exchange rate fluctuations. This could be done with occasional coordinated interventions by the two large central banks ("managed floating"). A foreign currency transactions tax would help to curb speculative "algo trading" in currency trading. Perhaps it would be enough to announce that extreme, non-fundamental exchange rate fluctuations are not permitted. Exchange rate target zones or bands could also be set up, as already proposed by John Williamson in 1985 and by Paul Krugman in 1991, in which the two central banks intervene in a coordinated fashion, while at the same time sterilising the ensuing money creation in the event of inflationary fears.

Within the framework of transatlantic currency cooperation the monetary policies of the Fed and the ECB would have to be coordinated in such a way as to prevent extreme interest rate differences. This entails that national restrictive fiscal policy would have to play a more prominent role in fighting inflation during periods of strong growth. This would also underpin the control of public debt. The policy-mix of monetary and fiscal policy would be optimised. In the euro zone the responsibility for exchange rate regimes has to date lain with the European Council, not with the ECB. The latter would thus be given an additional task, which it could carry out independently.

Which approach to currency cooperation is chosen must be the object of negotiation. Most other currencies in the world would more or less follow the exchange rates of the two big currencies and get on board the cooperation. More global exchange rate stability would represent an enormous advance for all countries, not just for the industrialised, but in particular for the developing and emerging countries.

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2 See Priewe, Jan: Transatlantic Trade Partnership versus Transatlantic Currency Cooperation, in: Palley, Thomas I.; Horn, Gustav A.; Restoring Shared Prosperity, Amazon Distribution, Leipzig 2013, pp. 123 - 132.
3 See Rossie, Barbara: Exchange Rate Predictability, in: Journal of Economic Perspectives, 51 (4), 2013, pp. 1063 - 1119.
4 See Schulmeister, Stephan: Technical Trading and Trends in the Dollar–Euro Exchange Rate, Österreichisches Institut für Wirtschaftsforschung (WIFO), November, Vienna 2009.

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