Does Europe have an External Economic Strategy?

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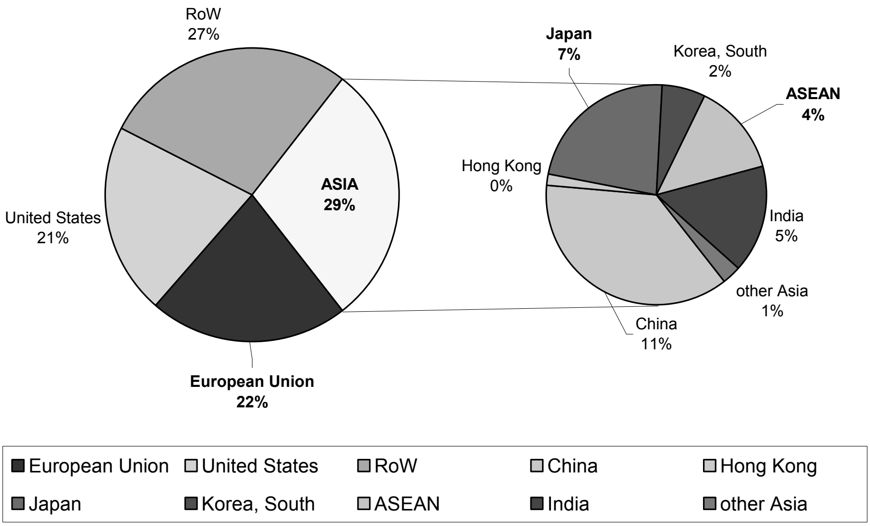
The European Union is the second largest economy in the world, but does it have a global economic strategy? 10 years after the creation of the euro, there is little evidence for it. Policy makers are more concerned with protecting narrow domestic advantages than with improving opportunities for the European economy as a whole. The Lisbon Treaty offers now a new perspective. It explicitly calls for policies that "encourage the integration of all countries into the world economy" (art. 21). It will be the task of the new President of the European Council and the High Representative for Foreign Affairs in the European Commission to translate this objective into a coherent strategy that takes into account the euro as the second world reserve currency. This chapter looks at the most urgent issue: how to restructure the world economy after the financial crisis and remove the huge global imbalances. This is an important task, because macroeconomic imbalances were a major cause for the financial crisis. Exchange rate policies for the euro will have to play a major part in such a strategy and this is an eminently political project. I will first discuss the lessons to be learned from the crisis, and then draw conclusions for an international strategy.

The Transformation of the Global Economy after the Financial Crisis

In November 2009, President Obama went to China and asked for a revaluation of the Chinese currency, the Renminbi. President Hu Jingtao refused. Two weeks later, the European trio Barroso, Junker, Trichet went to Bejing with the same request and got the same response. A common view is that China manipulates its currency to gain unfair trade advantages. However, the world benefits from Chinese rapid growth and an appreciating currency could undermine such growth. China is therefore right to resist demands for a stronger currency and Europe is wrong to copy American demands. Europe needs its own economic foreign strategy. Such strategy must address the lessons learned from the financial crisis.

China is of crucial importance for the European economy. With a global market share of 11.4%, China is the world's third largest economy, after the United States (21%) and the European Union (22%). Japan is fourth with 7% of world GDP. See Figure 1. After the crash of 2008/9, the world is now returning to positive growth, most rapidly in Asia, but trailing behind in Europe. The IMF expects the Chinese economy to grow by 9% in 2010, but the Euro Area only by 0.3 %, less than the US (3.1%), Japan (1.7), and the UK (0.9)[1]. The additional economic wealth generated by China in 2010 year is equivalent to nearly 5% of the EU's total GDP.

Figure 1
Regional Shares in World GDP (ppp 2007)



Source: CIA Factbook, 2009

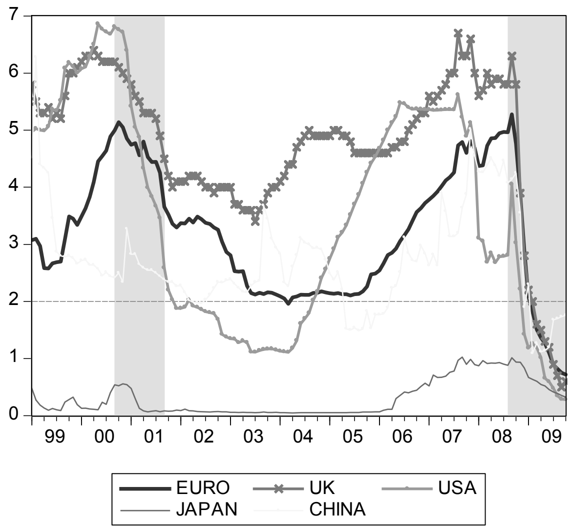
But clearly, the US economy also matters. After all, that is where the financial crisis started. A popular view is that the financial bubble was caused by greedy bankers, and the best remedy against future crises is to take bankers' bonuses away. Hence, better financial regulation should prevent future crises. But financial bubbles only develop when speculators get finance. A number of observers have argued that the American central bank had adopted an overly accommodative policy stance and maintained it for too long[2]. Although it is true that insufficient financial regulation allowed banks worldwide to buy high risk and under-performing (subprime) American assets, so that the global financial system was affected, the ultimate cause of the crisis is found in the interaction between under-regulated financial systems, excessive liquidity creation and global imbalances. The recent asset market bubble was financed by the Federal Reserve System and huge capital inflows from Asia to America. Preventing future crises requires more restrictive monetary policies and dealing with global imbalances, without neglecting the framework for financial supervision.

1. "World Economic Outlook", IMF, Washington DC, October 2009.
2. Maurice Obstfeld and Kenneth Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes", November 2009, http://elsa.berkeley.edu/~obstfeld/santabarbara.pdf; see also John B. Taylor, *Getting Off Track,* Stanford, Hoover Institution Press, 2009.

The Roots of the Financial Crisis

Financial crises occur when credit bubbles burst. One bubble often generates the next. The roots of the recent financial and economic crash go back the previous so-called dot.com crash in 2000 that destroyed asset values of 7 trillion US dollars, and to the Asian crisis of 1997/8. In 2000, the Federal Reserve System sought to prevent the stock market crash that originated in the ITC sector from spilling over into the real economy, and it responded by cutting interest rates and providing liquidity to the markets. A year later, the 9-11 attack on the World Trade Centre shook America's confidence and, again, the Federal Reserve System cut interest rates. See Figure 2. For the next three years, real short-terms interest rates were negative in the United States. This highly accommodating monetary policy fuelled a new credit bubble and appreciated asset values for stocks, real estate and commodities. Given that lending rates were extremely low, banks sought to increase their return on capital by leveraging their operations, and the abundant liquidity was absorbed by asset price inflation. When the FED started to raise interest rates in the middle of the decade, initial rate hikes had no effect on the financial exuberance until they reached the level of 7%. Such "irrational exuberance" is frequently observed during financial bubbles. But the subsequent crash is usually quick and dramatic. Asset price increases slowed down and then turned negative, thereby weakening banks' balance sheets, ultimately leading to the collapse of major banks like Lehman Brothers. The lesson from this development is that one must not keep interest rates too low for too long, otherwise one bubble generates the next.

Figure 2
Short term nominal interest rates

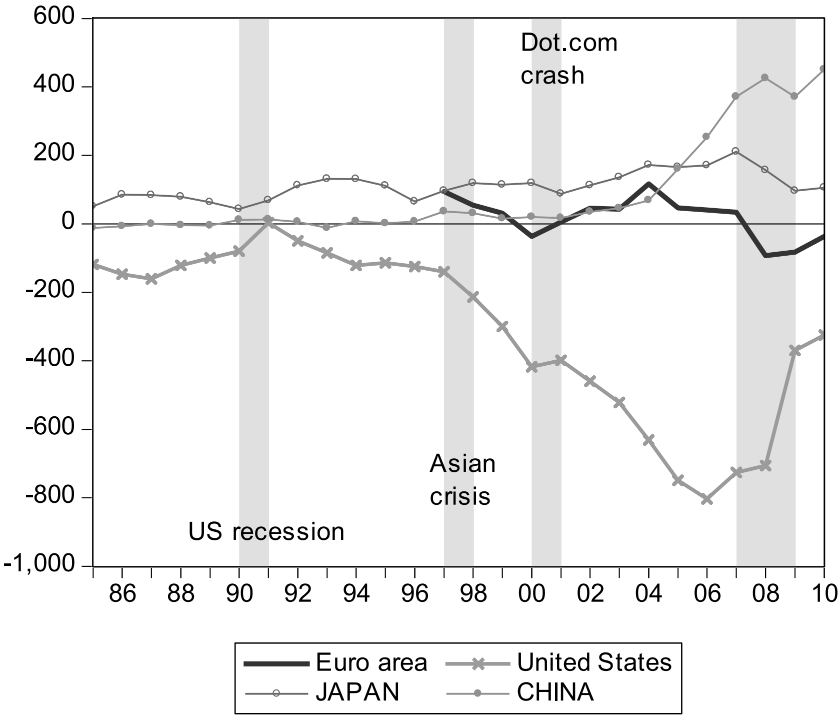


Source: Bloomberg

Financial market exuberance in the United States attracted capital from across the world. Especially many Asian countries had learned from the Asian crisis in 1997 that they needed to accumulate foreign exchange reserves as a buffer against future monetary instability.

As a consequence savings in Asian emerging economies increased. Asian central banks kept their foreign exchange reserves in profitable US government bonds and contributed to the world-wide asset price adjustment. European commercial banks bought American assets of sub prime quality to get a share in the booming American market. The large capital inflows seemed to indicate that the world experienced a "global savings glut"[3], which kept long term interest rates down and fuelled capital gains allowing American households to reduce their savings. As a consequence the US current account deficit started to widen significantly. See Figure 3.[4]

Figure 3
Current Account Balances in bn USD

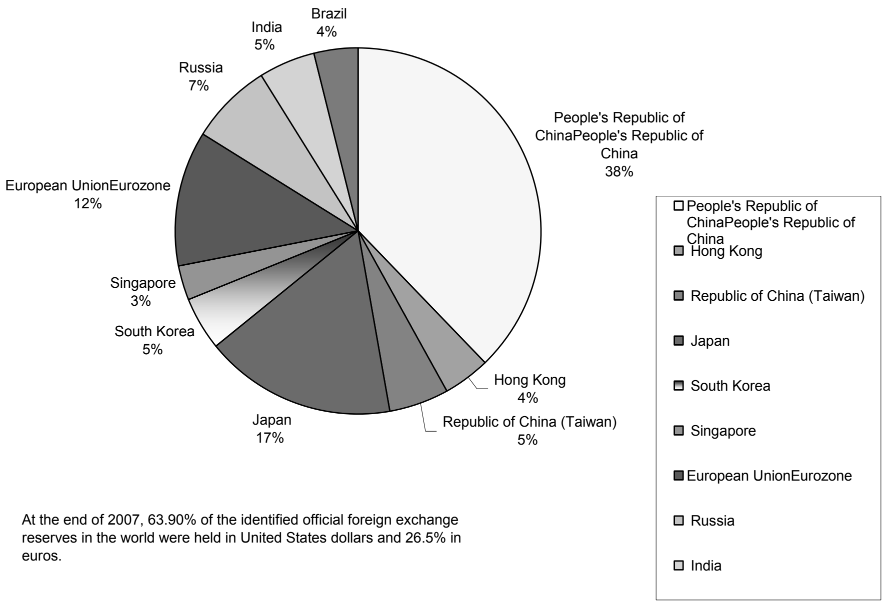


Americans got used to living above their means, Asian and European exporters benefited from American demand. The boom crashed in 2008. But in the meantime, China and some other emerging economies accumulated huge current account surpluses and foreign exchange reserves, while the external position of the Euro area remained close to balance. Figure 4 shows the distribution of reserves among the major reserve holders in the world. Asian monetary authorities hold more than 2/3 of the world's major foreign exchange reserves.

3. Ben S. Bernanke, "Remarks by Governor Ben S. Bernanke: The Global Saving Glut and the U.S. Current Account Deficit", The Sandridge Lecture, Virginia Association of Economists, Richmond, VA, 10 March 2005, URL: http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm

4. The grey shaded areas indicate recessions or financial market crashs.

Figure 4
Foreign Exchange Reserves 2009



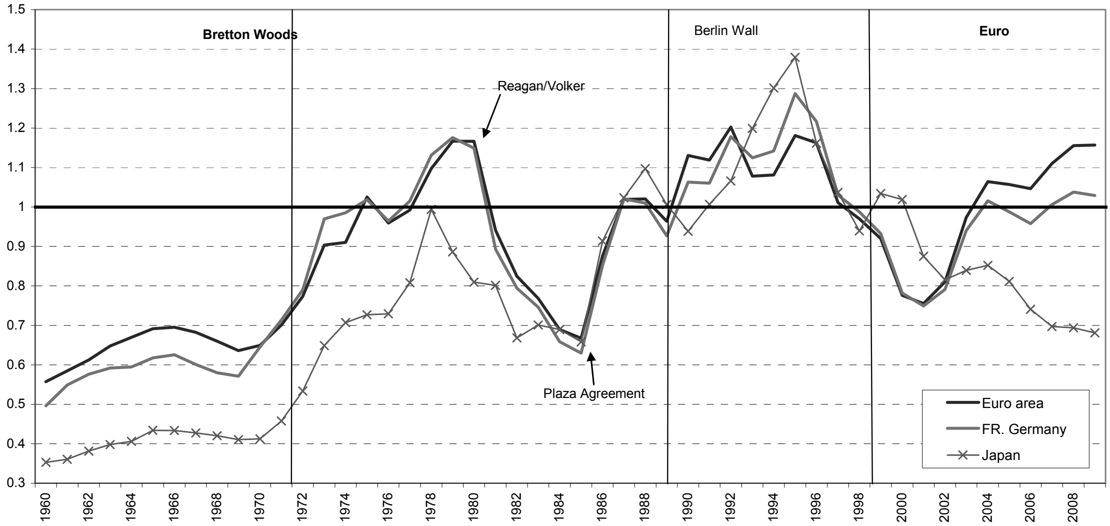
Source: http://en.wikipedia.org/wiki/Foreign_exchange_reserves; accessed 10.12.1009

Asia's Successful Development Strategy

The global imbalance between Asia and America was the unintended result of strategically pegging Asian currencies to the dollar. The only relevant non-attached currency in Asia is the Japanese Yen. The fixed exchange rate policy has laid the foundation for Asia's rapid development and its integration into the world economy. Especially China's development strategy is built on the combination of stable and competitive exchange rates with long term wage stability. Labour market conditions determine the long run feasibility of the exchange rate regime, but without the latter, rapid economic growth would not take off. Hence, the important lesson learned from the Asian crisis was that the stability of their development strategy depended on sufficient foreign exchange reserves.

Europe and Japan are familiar with this model of development; they have gone through a similar experience in the 1950's and 1960's. As Figure 5 shows, under the fixed exchange rate regime of Bretton Woods, unit labour costs in Japan and Europe remained stable at 40 to 70 percent of the American level. The strategy produced economic miracles. After Bretton Woods collapsed, exchange rates became flexible, European unit labour costs rose 20 percent above the US-level and the miracle disappeared. In subsequent years, nominal exchange rate movements caused big swings in competitiveness levels, but economic conditions in the United States were hardly improved by such flexibility.

Figure 5
Relative Unit Labour Cost



Recent developments in East Asia follow a similar logic. Pegging local currencies to a leading world currency like the dollar at highly competitive exchange rates encourages rapid development, because exports into large world markets are cheap and imports are expensive. The export orientation generates economies of scale. Furthermore, domestic wages are low relative to international standards and profits are high. These high profits generated high national savings. By contrast, instable and volatile exchange rates create uncertainty, and this deters investment and lowers savings. Pegging their exchange rates to a major international currency can therefore reduce uncertainty and will affect foreign investment. However, a competitive and undervalued exchange rate is only a necessary, not a sufficient condition for rapid economic development. The profitable environment must be sustained. Exchange rate stability needs to be complemented by stable wages, for otherwise the currency would appreciate in real terms and destroy the competitive advantage. Such a constellation will stimulate domestic investment, high employment, and learning by doing of the domestic labour force. Thus, successful development requires exchange rate stability *and* wage moderation.

The Chinese economy effectively operates under conditions of perfectly elastic or "unlimited" supply of labour. The model was described by Arthur Lewis in his Nobel Prize winning essay more than half a century ago[5]. Roughly 200 millions workers have migrated from the rural countryside into the industrialised urban regions along China's southern coasts[6], where they produce cheap consumer's goods for the world market.[7] This has stabilized

5. W. A. Lewis, "Economic Development with Unlimited Supplies of Labor," *Manchester School of Economic and Social Studies*, vol. 22, 1954, pp. 139-91.

6. Cai Fang, 农村剩余劳动力减少带来的机遇和挑战 (Decreasing Supply of Rural Surplus Labour, Opportunities and Challenges), *Chinese Economists 50 Forum* 中国经济50人论坛, 4.2006.

7. For example China supplies about 1/5 of the world textile consumption; by 2025 the market share is expected to increase to ½.

wages, not only in China, but world-wide. The enormous supply of excess labour in China has therefore contributed to the "great moderation" in wage and price inflation over the last decade.

Regional Asian Integration

There is, however, an additional reason for Asian countries to peg their currency to the US dollar: it supports regional trade and investment within the Asian region. Europeans had a similar experience under the Bretton Woods System: their fixed exchange rates to the US dollar supported the integration of the European market. East Asia has benefited from local currency pegs to the US dollar, because they have created a zone of monetary stability, which has encouraged regional cross-border investment and trade. Inter-Asian trade flows are now exceeding the importance of traditional markets in the United States and Europe. Half of ASEAN exports go to and nearly 70 % of ASEAN imports come from ASEAN+4 countries[8] (see Table 1). Japan is the single most important trade partner in the region. It is also the major source of FDI. The Japanese Prime Minister Hatoyama has therefore rightly prioritized regional integration and monetary cooperation as a cornerstone of his government's new foreign strategy.

Asia as a region is also a major export market for the United States, who send 20.7% of their exports there, and for Europe which directs 15% of the exports outside the European Union into the region. Asia is nearly three times more important than Europe as a foreign supplier to the US market, and twice as important as the United States for Europe.

Table 1
Import and export shares for Asian countries (2006)

EXPORT DESTINATION

Exporter	China	Japan	Korea	India	ASEAN	ASEAN+4	USA	EU12	RoW	World
China		9.5	4.6	1.5	7.4	22.9	21.0	14.2	41.8	100.0
Japan	14.3		7.8	0.7	11.8	34.6	22.8	10.8	31.9	100.0
Korea	21.3	8.2		1.7	9.9	41.0	13.3	10.3	35.3	100.0
India	6.6	2.3	2.0		10.0	20.8	15.0	15.3	48.9	100.0
ASEAN	8.7	10.9	3.7	2.5	24.8	50.6	13.9	12.1	23.3	100.0
USA	5.3	5.8	3.1	1.0	5.5	20.7		15.0	64.2	100.0
EU12	1.9	1.3	0.7	0.7	1.5	6.1	8.1	59.1	26.7	100.0
EU12 external	4.7	3.3	1.7	1.8	3.6	15.0	19.8		65.2	

8. Established in 1967, ASEAN now encompasses 10 South-East Asian countries: Brunei, Burma/Myanmar, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand and Vietnam. Only the original 6 founding members, abbreviated as ASEAN-6, (Thailand, Singapore, Indonesia, Malaysia, the Philippines and Brunei) can be considered as emerging market economies in the proper sense. See also European Commission, *Quarterly Report on the Euro Area*, Vol. 8.2, Dec. 2009, http://ec.europa.eu/economy_finance/publications/publication_summary16509_en.htm

IMPORT

Import source	China	Japan	Korea	India	ASEAN	ASEAN+4	USA	EU12
China		20.5	15.7	9.4	11.3	56.9	15.9	5.7
Japan	14.6		16.8	2.5	12.3	46.2	7.9	2.4
Korea	11.3	4.7		2.6	5.0	23.6	2.5	1.2
India	1.3	0.7	1.2		1.6	4.8	1.2	0.7
ASEAN	11.3	13.8	9.6	9.7	24.9	69.4	6.0	2.4
ASEAN+4	38.6	39.7	43.3	24.2	55.1		33.6	12.4
USA	7.5	12.0	10.9	6.3	10.5	47.2		5.8
EU12	9.6	7.8	8.0	11.8	9.8	47.1	13.2	53.9
RoW	44.3	40.5	37.8	57.6	24.6		53.2	27.9
World	100.0	100.0	100.0	100.0	100.0		100.0	100.0

Source: United Nations Statistics Division – Comtrade dataset

The emergence of East Asia, and of China in particular, as the dominant growth pole in the world is transforming the global economy. We can no longer conceive Asia's relations with Europe or the USA as purely bilateral. Policies pursued by China, America, or Japan affect Europe. Europe's choice is between passively receiving these policy externalities and pushing for international macroeconomic cooperation.

Opportunities for Global Economic Cooperation

Global economic policy coordination must remove the global imbalances, which have contributed to the financial crisis, but it would be counterproductive if this process would push all the adjustment costs to Europe. Global policy cooperation requires therefore a specific strategy for Euro-Asian exchange rate management and an institutional framework to administer it.

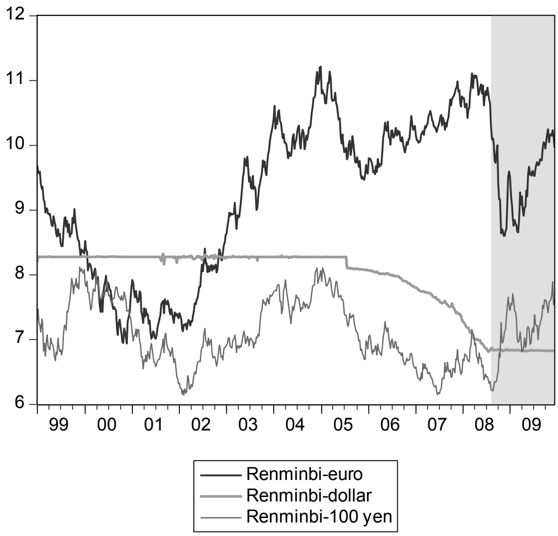
Adjustment Policies

The fixed exchange rate strategy has reduced risks and uncertainty for foreign trade and investment, and it has allowed Asia to become the growth centre of the world economy. But in terms of per capita income China is still only at the 118 position out of 232 countries. It therefore has the justified aim to secure the economic catch-up process.

America has been Asia's privileged partner. It has imported Asian goods and capital and served as the reference for Asian market orientation. By contrast, the Euro Area has remained a bystander because Europe's economic relations with East Asia are handicapped by the volatile exchange rate of the euro relative to Asian currencies. See Figure 6. The Renminbi was fixed to the dollar between 1999 and 2005; it was then allowed to gradually appreciate against the dollar and the yen, while it simultaneously weakened against the euro.

But when the financial crisis occurred and the US dollar suddenly appreciated significantly against the euro, Chinese authorities again pegged to the dollar. Since then, the dollar has weakened against the euro and the yen, taking the Renminbi down as well. While this depreciation has improved China's competitiveness relative to Europe and Japan, exchange rate uncertainty narrows the scope for trade and investment opportunities. Euro-Renminbi volatility has been seven times higher over the last decade than for the dollar-Renminbi rate.[9] It can be shown that this higher volatility has negative effects on Foreign Direct Investment and trade.[10]

Figure 6
Exchange Rates Renminbi to Euro, Dollar and Yen



Source: Bloomberg

However, the peg of Asian currencies to the dollar prevents the rapid adjustment of the unsustainable American current account deficit. As the trade deficit with Asia cannot be corrected by relative price adjustments, American consumption, and therefore world demand, needs to be reduced. This slows down economic growth world-wide, while a high growth rate would be necessary in order to reduce unemployment after the financial crisis. Alternatively, the relative price adjustment would concentrate on currency areas with flexible exchange rates to the dollar, most importantly the euro and the yen. But this means that the required appreciation of the euro would be significantly higher than if dollar exchange rates would generally be more flexible. In other words, without the Asian currency pegs,

9. Volatility is here measured as the standard deviation of the weekly exchange rate variation over the period 1/1/1999 to 12/11/2009.

10. In Collignon, 2008, I have shown that the relation between Chinese FDI and the Japanese yen, which fluctuates between euro and USD, is statistically indeterminate. But volatility in the RMB-USD, RMB-Yen and the Yen-USD exchange rates lower foreign direct investment in China. See also Agnès Bénassy-Quéré, Lionel Fontagné, and Amina Lahrèche-Révil, "Exchange-Rate Strategies in the Competition for Attracting Foreign Direct Investment", *Journal of the Japanese and International Economies 15*, 2001, p.178-198.

the nominal and real effective exchange rates for the United States would be more flexible and would support the adjustment process. Obstfeld and Rogoff[11] estimated that if US, Asian and European imbalances were all to go to zero, the Euro would have to rise by 28.6% against the dollar in real terms, and depreciate by 6.7% against Asian currencies. However, if Asian currencies were to remain unilaterally pegged to the dollar, the burden of adjustment would fall largely on Europe: the elimination of the US current account deficit would then be associated with a real appreciation of the Euro of roughly 60%. Since Asian currencies would be depreciating, Asian surpluses would rise under this scenario, while Europe would experience an exploding current account deficit.[12] This can hardly be the solution to the world's economic disequilibria.

Policy makers are therefore asking China to give up its currency peg and to allow the appreciation of the Chinese currency. Europeans have joined Americans in pressuring China. But while American requests for a revalued Renminbi, and therefore a devalued US dollar, are part of a coherent strategy to reduce the US current account deficit, it makes no sense for Europeans to echo such demands. The motive for complaints about China's exchange rate regime is in most cases nothing else but a latent form of protectionism: policy makers and firms complain about supposedly unfair competition and seek to keep cheap imports out of the European market, although importing cheap consumer goods would benefit Europeans and exporters would benefit from demand in a rapidly growing Asian region. Unless Europeans (and Americans) understand that Chinese authorities have good reasons for keeping their exchange rates fixed and deal with it intelligently, the dialogue with China will go nowhere. Asia is potentially the most important growth market for the European Union. It therefore serves Europe's interest to contribute to sustained and rapid economic growth in China.

Can Europe Delink from the World Economy?

The danger of an *excessive* euro appreciation is nevertheless real. Not because cheap imports would swamp European markets, but because an excessively strong euro would damage the competitiveness of European firms. One may argue that the external competitiveness matters less since the creation of the euro, given that the degree of openness of the Euro Area to the rest of the world is only 12.5 percent. Hence nearly 88 percent of the Euro Area's economic activity is dependent on domestic demand. If Euroland is losing competitiveness in foreign markets, it could compensate this by higher demand at home. But where would this demand come from? Fiscal policy is already severely constrained by the high debt levels in member states. Increasing wages would quickly translate into higher inflation because productivity is slowing down. Monetary policy is already accommodative and we have learned from the financial crisis that interest rates must not remain low for too long. Thus, there is little the Euro Area could do to actively stimulate domestic demand and lift the growth potential of Euroland.

In this context, an excessively strong euro would be damaging, because it deprives large globally operating firms, mainly in Europe's North, from reaping the benefits of economies

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11. Maurice Obstfeld and Kenneth Rogoff, "Global Current Account Imbalances and Exchange Rate Adjustments" *Brookings Papers on Economic Activity* 1, 2005, p.67-146.

12. Kevin O'Rourke, *The world rebalances at Europe's expense,* 2009, www.eurointelligence.eu

of scale at the global level. For many firms, the European market alone is not of sufficient size to guarantee efficient production technologies. Losing price competitiveness would imply scaling down production and increasing the weight of fixed costs, while other companies in America and Asia will capture European market shares. This process damages not only exports, but domestic developments as well, because it lowers European productivity and thereby reduces the scope for wage increases, government spending and economic growth. Hence, an excessive euro appreciation would reduce the scope for domestic growth dynamics. The euro Area cannot cut itself from the world market. It needs to remain an active player in global markets and formulate a strategy that simultaneously allows rising the Euro Area's growth potential and integrating emerging economies into the global economy by providing a stable macroeconomic framework. This is, of course, precisely what the Lisbon Treaty has told policy makers to do.

Global Macroeconomic Policy Coordination

An external economic strategy for Europe requires macroeconomic policy concertation not only with America, but increasingly also with Asian authorities. The two key players are China and Japan. While China is a major market for exports from and imports to Europe, Japan is the most important provider of foreign direct investment to China. The European Union is now a more important supplier for China than the United States, despite the appreciating Euro. With greater exchange rate stability, Euroland could significantly extend its trade potential. It is therefore in the European interest to contribute more actively to rebalancing of the world economy by creating more stability in the exchange rate relation between Europe and Asia.

European complaints about the undervaluation of the Chinese currency are short sighted. China needs to continue its successful development by undervaluing its currency; all industrialised countries would benefit from the resultant growth effects. The problem with today's global environment is the privileged relation between Asia and the USA. There is no reason, why China and other Asian economies focus their exchange rate strategy exclusively on the dollar, when Europe is at least as important a market. If the US economy needs more exchange rate flexibility for its current account adjustment, the appropriate response would be to stabilise exchange rates between Asia and Europe. Such a strategy should focus on reducing exchange rate volatility, in order to lower uncertainty and improve investment, rather than on the undervaluation, which fuels China's engine of growth.

Here is how it could be done. First, China and other East Asian countries agree to peg their currency to a basket of currencies, which contains the Euro and the Japanese yen and to a much lesser degree the US dollar. Initially the dollar weight may even be zero. Second, the Euro Area and Japan agree to minimize exchange rate volatility between their currencies by setting a band for euro-yen fluctuations. Japan must be part of this package, given its weight in regional trade and the volume of foreign direct investment from Japan to China and the rest of East Asia.

In this way China and emerging Asia could continue their strategy of competitive development, while the effects of rapid Asian growth and regional integration would spill over into major industrialised countries. European consumers would benefit from cheap imports and domestic demand would be stimulated by their improved purchasing power. Furthermore, the stability of exchange rates within the euro-yen basket and those countries who peg to the basket would support further regional integration in East Asia. Finally, as Asian authorities will continue to accumulate foreign exchange reserves, they would have to reinvest them in Europe and Japan.[13] These capital flows would stimulate European financial markets, which is particularly important in the present post-crisis environment.

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Removing global imbalances requires new ways of managing the world economy. Instead of weakening China, Europe has an interest of becoming an active partner for Asia. At the same time Europe should share the burden of global adjustment with the USA and Japan by accepting to run a moderate current account deficit in exchange for capital inflows from countries who peg their currency to the euro-yen basket.

The political forum for setting up global monetary cooperation is the G20, although the experience from many international bodies indicates that this forum is too large for making bold policy decisions. A coherent global economic strategy must therefore be designed in smaller working groups, which bring together European, American, Japanese and Chinese authorities. European policy makers should use their privileged forum in the ASEM dialogue for discussing policy issues with Asia.[14] The subsequent implementation and surveillance of such agreement should be delegated to the IMF.

However, the efficiency of European policy issues is seriously handicapped by the inefficient governance of economic policies within Europe. According to the Lisbon Treaty, the European Central Bank has authority for monetary policy, but exchange rate regimes are set by the Ecofin Council. Given the privileged role of the euro in such policy strategy, the ultimate decision of how to "integrate all economies into the world economy" should be worked out by the Euro group.

Finding a solution to the global imbalances remains the most important challenge for Europe's future.

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13. See M. Obstfeld and K. Rogoff, "Global Imbalances and the Financial Crisis: Products of Common Causes", November 2009, http://elsa.berkeley.edu/~obstfeld/santabarbara.pdf. The authors argue that pegging and the currency composition of reserve holdings are not necessarily related. However, imagine a speculative attack against a country that has pegged against the euro, but keeps foreign exchange reserves in dollars. If the dollar is weak at that moment, the mobilization of reserves would be more costly. Prudent reserve management therefore requires keeping reserves in the pegged currency.

14. ASEM stands for regular Asia-Europe Meeting of 27 EU and 13 Asian countries and provides the forum for high level policy dialogue.