



EUROPEAN CENTRAL BANK

# Exchange Rate Moves in A Global Economy: A Central Banking Perspective

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# Overview

- **Challenges with exchange rate economics**
- **History of the Monetary System**
- **Do swings in the exchange rate matter?**
- **Macroeconomic Stability**
- **Monetary integration and exchange rate regimes in Europe**
- **Challenges ahead**

# Challenges with exchange rate economics

## Common view

- Imprecise estimates of “fair values”: rare clear signs of over/undervaluations
- Exchange rates in the short run often disconnected from fundamentals (while in the long run and ex-post this is more controversial)
- Relevant explanatory variables shift
- Exchange rates are asset prices, depending on expectations

# Importance of exchange rate economics

## But the exchange rate matters:

- affects relative export prices and real exports
- influences import and consumer prices
- affects the tradables/non-tradables production structure
- can be a source of shocks

# The international monetary system

- **Gold Standard**
- **Interwar period**
- **Bretton Woods regime**
- **Trial and error system of the 1970s**
- **System of today: flexible exchange with loose co-operation (G7, IMF, regional arrangements)**

# Impact channels of the exchange rate

## Competitiveness

- **Theory: Impact of exchange rate changes depends on the structure of the economies, (e.g. the degree of openness, trade patterns)**
- **Empirical models offer a wide range of estimates**

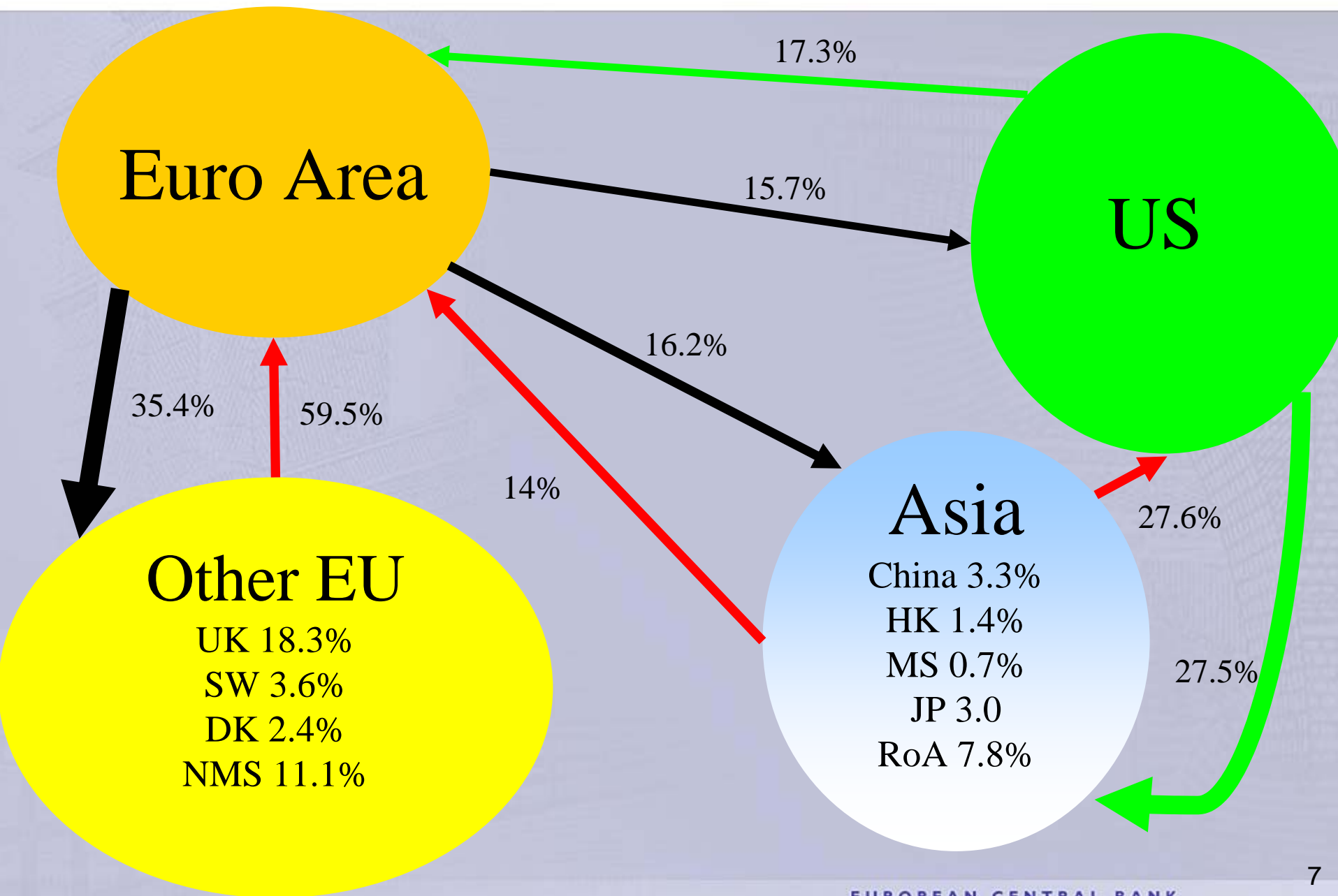
## Uncertainty

- **There is some evidence of costs of high exchange rate volatility in the long run**

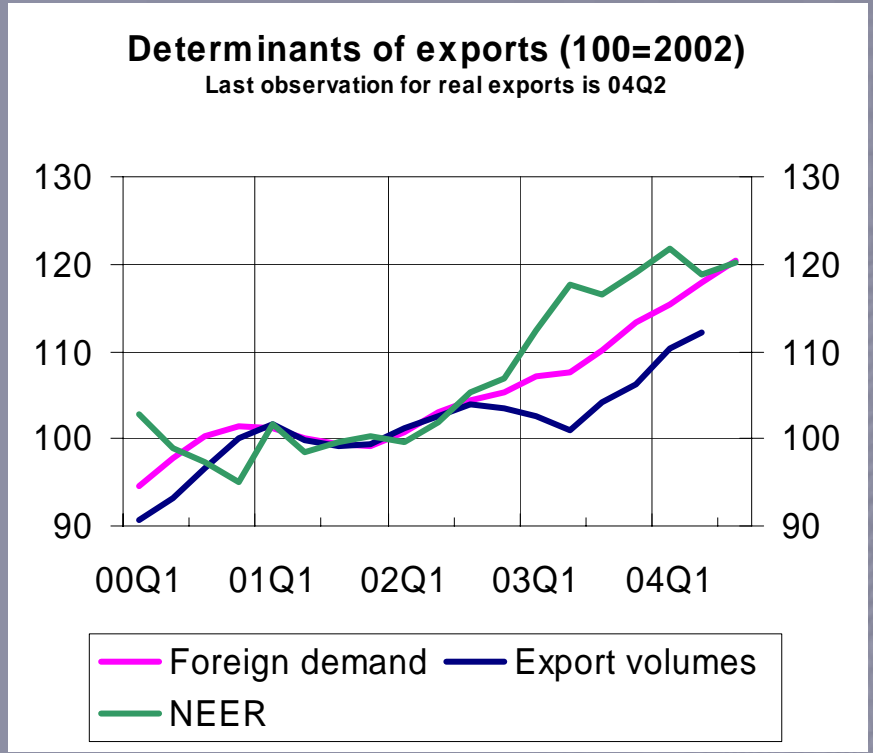
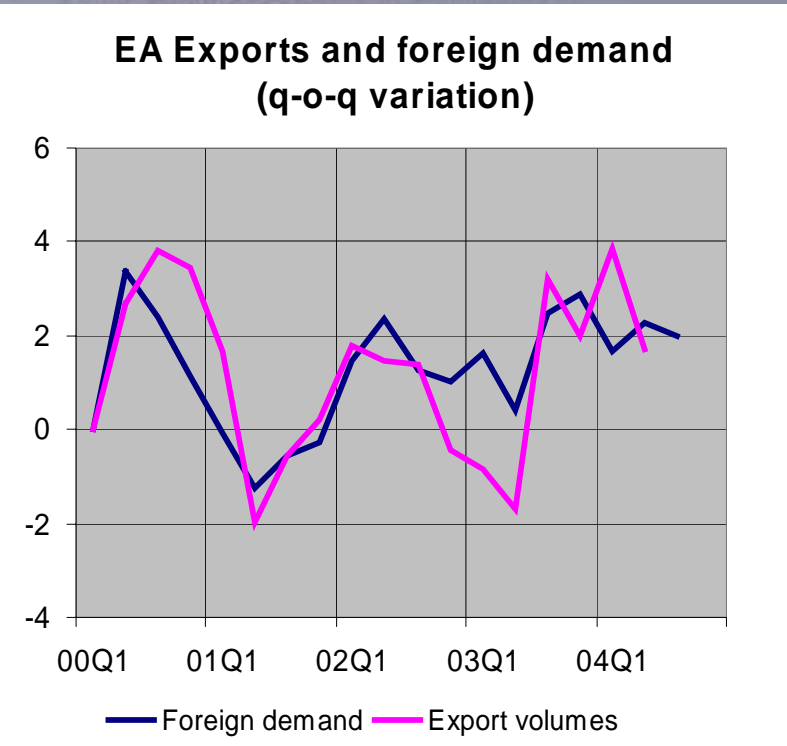


# Trade patterns

(in per cent of total exports)



# Extra-exports move with foreign demand



However, in 2003, during strong appreciation export growth has been below foreign demand



# Some factors dampening the impacts

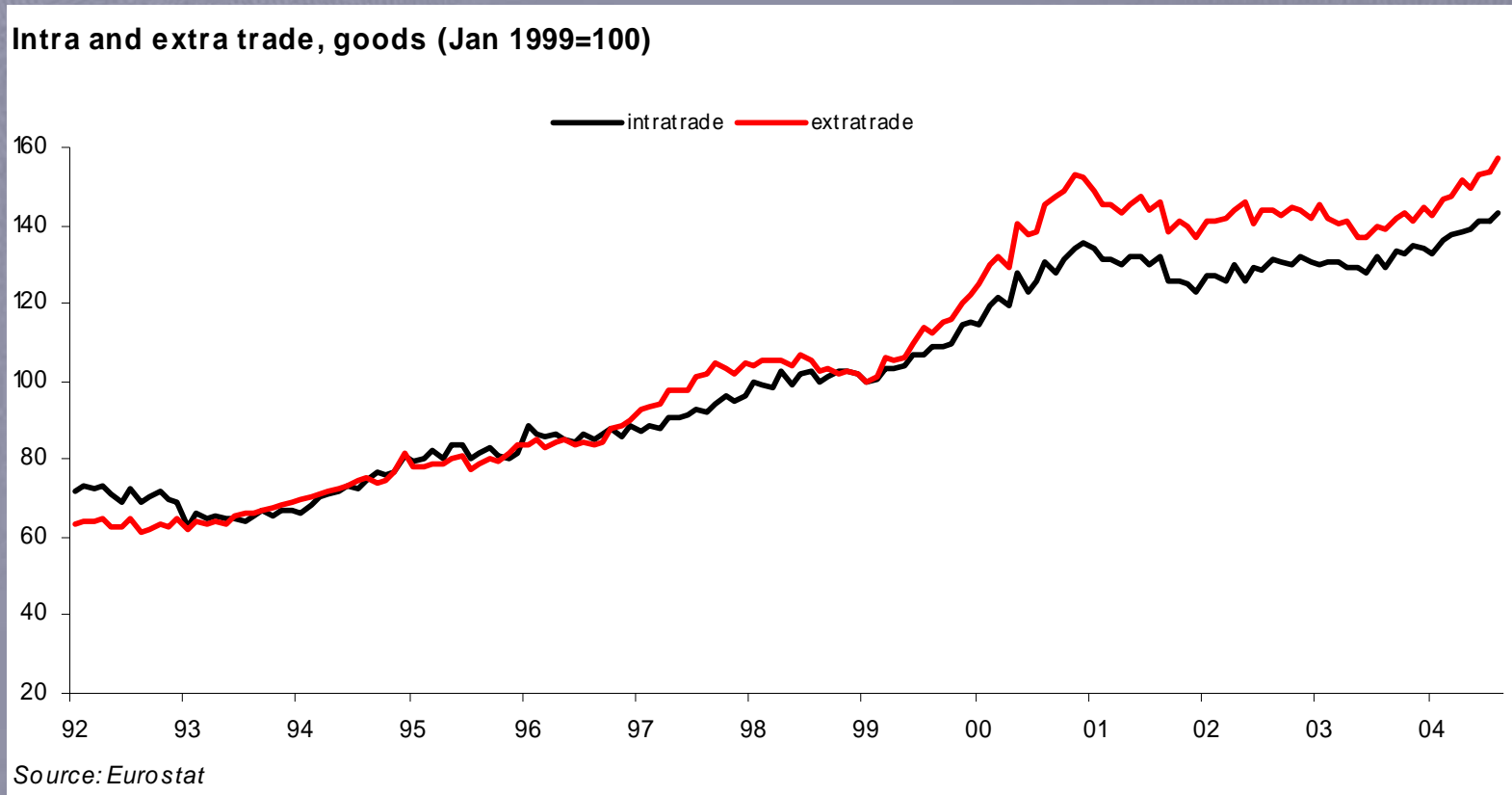
## Private sector

- Firms adjust profits margins
- Use hedging instruments
- Multinationals' increased role

# Importance of regional integration in Europe

- **Greater regional integration due to European Monetary Union**
- **Theory**
  - **impacts on regional trade**
  - **monetary unions offer additional benefits (Rose effect)**
- **Empirical evidence so far**

# Importance of regional integration in Europe



# Policy response:

## Macroeconomic stability is the key

- The best way to provide boundaries to exchange rate instability and minimise global imbalances is to ensure sound fundamentals
- Price stability as the guiding principle
- Every country must do its “homework” and avoid “excessive domestic or external imbalances” or “inflationary pressures” in the medium run
- Structural reforms to make the economy more resilient and flexible

# Monetary Integration in Europe

## New EU Member States

- EU accession: exchange rate matter of common interest
- ERM II: exchange rate stability for at least two years
- Adoption of the euro after fulfilling the Maastricht criteria

# Exchange rate regimes in EU neighbour states

- currency boards
- pegs or managed floating
- independent floating
- euroisation

# Challenges ahead

- **New challenges ahead, as the world is rapidly changing**
  - **Evidence of increased financial market integration**
  - **FDIs to emerging markets: opportunities and challenges**
  - **Stability oriented policies remain the best safeguard, also for emerging markets**



# Concluding remarks

- Exchange rate is a fascinating, difficult, yet important subject
- Macro stability is the best policy objective
- More than one solution for exchange rate regimes
- Key challenge: increase long-term growth prospects



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