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The European Monetary System and International Currency Questions

by Heinrich Matthes, Frankfurt*

As the recent struggles connected with the readjustment of exchange rates within the European Monetary System have shown, the relatively unproblematic "running in" period of the EMS, which was supposed to be a constructive contribution to the creation of a more viable international monetary system, is over. Dr. Matthes doubts that the EMS can live up to the original expectations and argues in favour of a restoration of the US dollar to its function as the key currency of the Western monetary system.

The present international monetary system is a degenerated grandchild of the gold standard. As a matter of fact, the example of the gold standard shows up, as under a magnifying glass, the cancer of the present world monetary order. Under the gold standard the dominant economy in the world, which was initially the UK and later on the USA, also submitted to the strict requirements of symmetrical adjustment. This in turn implied that the "magic triangle" (the three-cornered incompatibility between a stable price level, full employment and free collective bargaining) could be reduced to "one dimension" by gearing monetary policy only to the level of monetary reserves.

The great error of the Bretton Woods system was the institution of a world monetary order which developed into a system with an absolute lack of symmetry in the adjustment requirements of the key currency country, the USA, and the rest of the world. With the benefit of hindsight one can say that the constructors of the Bretton Woods system more or less overlooked the implications for the system of the "natural" key currency role of the US dollar. The USA cannot easily be released from the role of the "natural" reserve currency country because of its enormous economic potential. After all, the USA is the world's largest economic area within a national boundary. This means that there is relatively little foreign trade at its external border (much of what is foreign trade in Europe is domestic trade in the United

States), so that the USA is much less dependent on the exchange rate. Moreover, the USA can offer other countries investment opportunities for their monetary reserves without its own economic policy being significantly affected. In other words, in the United States "national area" and economic area" are identical, to a greater extent than in any other country in the world.

Overburdening of the Dollar

However, the dollar, as the key currency, was overburdened from the outset by the exchange standard created in Bretton Woods. The USA was supposed to supply the world with international liquidity (which implies deficits in the US balance of payments), but at the same time it was expected to observe the right balance, so as not to destabilise the "rest of the world". A certain mechanism to strike a balance between the domestic requirements of the key currency country and the needs of the "rest of the world" was in fact planned in the conception of the Bretton Woods system, in the form of the gold parity of the dollar. But this disciplinary pressure could not work because the Bretton Woods system degenerated into a hegemonic world monetary order.

As a matter of fact, as long as the "rest of the world" was only too willing to include the currency of the key currency country in the respective central bank balance sheets as an asset – thus assigning it a leading role in the domestic money supply process – while changes in dollar liabilities of the USA had no monetary consequences, the key currency country was in

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constant danger of succumbing to the temptation to balance its external payments by creating additional dollars.

Intentions of the EMS

Creating checks and balances in the present hegemonic world monetary order arising from the fact that the dollar is the "natural" key currency was the basic idea behind the EMS, which was called into being partly with the aim of ultimately confronting the dollar with another roughly comparable monetary area. Such checks and balances could be created only if the dollar area (where – as already pointed out – national area and economic area are almost identical) was confronted with a similarly self-sufficient locational entity which, as a final goal, should be given a uniform currency.

The founding fathers of the European Monetary System had a twofold objective:

- From the *external point of view* the EMS was supposed to be a constructive contribution to the creation of a more viable international monetary system.
- From the *internal point of view* the other intention of the EMS was to insulate roughly half of the foreign trade of the participating countries from the serious results of exchange rate volatility. As a matter of fact, over 40 % of German foreign trade is transacted with countries participating in the EMS, and this trade was to be spared the disintegrative effects of pronounced exchange rate fluctuations.

However, from the outset it was clear that the idea of an enlargement of the "snake" was bound to encounter considerable philosophical difficulties if the "snake" was also to encompass major countries with their own gravitational zones like France and Italy.

In the old "snake", comprising Germany and those countries which conduct a very large proportion of their foreign trade with Germany, there were in fact marked conditions of dominance and subordination. For those countries the D-Mark had a definite key currency function, and it was obvious that they had to gear their monetary policy primarily to maintaining their parity against the D-Mark. But from the moment when the EMS encompassed several partners of similar economic weight, such clear-cut conditions of dominance ceased to exist, and the discussion of the EMS was therefore almost bound to give rise to a discussion of the European key currency.

The founding fathers of the EMS originally sought to solve this problem by making the arithmetical mean of EMS inflation rates the common stabilisation norm. The philosophy of the common average of inflation rates

was, however, finally discarded and the EMS was designed as a parity grid system with bilateral ECU parities. This meant, however, that an insoluble contradiction was inherent in the system from the start: the system could and can work only if inflation rates tend to converge on that of the low-inflation country Germany. But quite the opposite has been the case.

This constantly intensifying contradiction was obscured for two and a half years by the fundamental weakness of the German balance of payments and current account and its consequences. Hence the system worked remarkably smoothly during the initial phase. It was the changed position of the D-Mark that stabilised the EMS for an unexpectedly long period, so that one of the aims of the EMS – exchange rate stability – was achieved to a surprising extent. But with respect to its other domestic objectives, the EMS was not so successful. The desired economic convergence has hardly taken place; in particular, inflation rates have moved further apart. As the D-Mark has been weak against the dollar, the ECU has depreciated very considerably relative to the US currency. Internally, between the EMS member countries, this has been accompanied by increasing inflation differentials and thus by a growing real appreciation of the currencies of EMS member countries against the D-Mark.

The period of exchange rate stability was bound to end at the moment the German current account recovered markedly. This has now happened. As the degree of freedom of the D-Mark grows, the (insoluble) problem of the common dollar policy becomes acute once again. In this context strong centrifugal forces might develop once foreign countries rediscover the D-Mark as a substitute reserve currency. As in the past, the further development of the dollar will therefore continue to be of great importance for the working of the EMS. It is true that the currencies participating in the EMS are floating jointly against the dollar, but if one EMS currency suddenly becomes very strong in relation to the dollar, it drags along with it the other currencies, for which such an appreciation implies heavy reserve losses; under these conditions the pattern of exchange rates in the EMS could be exposed to severe strains.

Even though a softening of the conditions for participating in the EMS was largely avoided in its technical design, this by no means guarantees that the system will continue to operate satisfactorily. Thus, in smaller and largely open EMS countries, such as Belgium, which conduct a sizeable part of their OECD-trade with Germany, the EMS has had serious structural consequences. For example, Belgium has found that it

could pursue an independent real wage policy only at the cost of grave economic policy repercussions. As a matter of fact, for a small country like Belgium the fixed exchange rate vis-à-vis the dominant economy (Germany) has acted as a key domestic price stabiliser preventing an inflationary recorection of disturbed income distribution ratios. Hence over several years Belgium imported a price stability which was not justified by its economic fundamentals. In fact, it would have been particularly important under conditions of fixed exchange rates for such a country to maintain some relative constancy in income distribution ratios vis-à-vis the dominant economy. As this was not the case, the wage ratio in Belgium has risen far faster than in Germany. It is true that until recently this has resulted in very high real income levels for Belgian wage earners, but at the price of a chronic profits squeeze, record unemployment and record public sector deficits. To quote the IMF:

“For such small open economies most of the burden of adjustment is initially borne by profits in the traded goods sector. If the fall in profits persists, marginal firms are closed, few new firms are established and the traded goods sector shrinks. The productivity of employed may increase, but this of course does not necessarily prevent a weakening of the external position or a rise in unemployment.”

In its present design – in particular, in the absence of a minimum consensus on incomes policy – the EMS is thus giving rise to a decay of the periphery and to consequent shifts of location into the dominant economy. In other words, in the smaller countries bordering on Germany, which stabilise their price levels through the exchange rate without producing the necessary social consensus, the EMS results in a departure of the factors of production and in disindustrialisation. These consequences were predicted by pessimists at a very early stage. In this respect, therefore, a basic, hardly soluble contradiction is inherent in the EMS.

The Future of the EMS

The future of the EMS will depend on whether the various countries succeed in putting and keeping their own houses in better order. The EMS cannot be better than the sum of its component parts. Despite a strong conviction that it would be highly desirable to press on with European integration, one cannot but be sceptical about the idea that this should be possible by means of purely technical solutions. With all the existing systems of credit mechanisms and intervention techniques, one thing should not be forgotten: real progress towards a

monetary union can only be made against the background of a minimum of consensus on the formulation of the social welfare function. This includes, first and foremost, a common position on the *priority of monetary stability*. These difficulties cannot be solved by technocratic ideas. In the final analysis the problem posed by the further development of a European monetary zone is that of “power or economic law” as already discussed by Böhm-Bawerk. In the long run, however, political power can only be successful if it does not violate the economic laws.

This brief analysis leads to the conclusion that in the EMS the unproblematic “running-in” period is over. For a certain length of time the true problems could be suppressed in the light of the fundamental weakness of the D-Mark. Now the real difficulties are making themselves strongly felt. Judged in terms of its original objectives, namely as a solemn declaration of intent by the member countries to unify their economic and stabilisation policies, the EMS has brought insufficient progress.

Importance of US Economic Policy

A factor of particular importance for the future operation of the international monetary system is the further recovery of what remains the only natural key currency. As the German Council of Economic Experts put it, the dollar must credibly resume the vacant role of a key currency. The mooted reintroduction of some gold cover for the dollar and the consequent self-disciplining of the “*économie dominante*” might well be helpful in this context although serious doubts as to the practicability of this project (which in itself is quite interesting) seem warranted. What would be needed to stabilise the dollar is a sound fiscal policy coupled with continued strict control of the money stock. To this extent the efforts of the USA to arrest the erosion of the domestic purchasing power of the dollar and maintain greater price stability over the longer term deserve full support from Europe and especially from Germany. In fact, the renewed strengthening of the dollar was in the interest of the entire world economy, so that short-term cyclical disadvantages in individual countries had to be accepted. But despite having every sympathy for the resolute fight against inflation in the USA, one could not help wondering whether the abrupt swings in interest rates associated with the new US monetary policy stance, with its greater orientation towards narrowly defined money stock concepts, were always necessary. At all events, the foreign exchange markets were strongly affected by the ups and downs in interest rates in the USA, so that massive intervention by the other central banks was frequently required; even so, it was

not always possible to prevent major exchange rate movements. A more relaxed monetary policy, taking due account of the repercussions on the money and foreign exchange markets, would probably have curbed inflationary tendencies in the USA just as well as, or perhaps even better than, an overly rigid short-term orientation towards the money stock.

It is to be hoped that the return of confidence in the dollar is strong enough to restore the dollar fully to its function as the key currency of the western monetary system. Central banks and enterprises, too, may then stop diversifying their exchange reserves to avoid exchange losses.

An evolution of the international monetary system along the lines of a multi-reserve standard was no doubt largely unavoidable after the oil crises had caused great upheavals in the world economy and the USA had drifted more and more into domestic inflation and balance of payments disequilibria. The huge foreign exchange surpluses of the oil-producing countries made it imperative to spread risks, so that countries like Germany and Japan inevitably slipped into the role of "substitute reserve currency countries". Although it would hardly have been possible to object to this process if it had taken place gradually and in keeping with the significance of the new reserve centres for the world economy, it should not be overlooked that uncertainty and instability in the international monetary system have increased considerably as a result of the urge to diversify provoked by the uncertainties affecting the world economy.

Alternatives to a Multi-Reserve Standard

In the substitute reserve currency countries, unlike the USA, the money and capital markets are much too small to cope with the investment and disinvestment – or even the mere restructuring – of reserves without undesirable fluctuations in liquidity and interest rates. There is also a danger of cumulative, self-reinforcing exchange rate movements triggered by variations in the preference shown for a currency. In the initial phase the currency of the substitute reserve currency country will

constantly tend to be overvalued (as Germany has experienced itself), with all the resultant implications for the structure of domestic production and employment. Once a country's short-term external liabilities have reached a certain size, even more regard must be paid to the external constraints, for it is then necessary to prevent funds from being withdrawn by foreign countries and hence an unjustified depreciation of the national currency.

In a small reserve currency country these dangers are accompanied by practically no benefits. For example, large amounts of funds flowed into Germany from abroad when it was running surpluses on current account and therefore did not need this foreign capital. But after the current account slid into deficit, not only did the quasi-automatic capital imports arising from the diversification process stop, but the Bundesbank also had to ensure, by pursuing an appropriate monetary policy, that the funds which had previously flowed in remained in Germany. It should not be forgotten in this connection that even in the USA the build-up phase of the dollar as a reserve currency was accompanied until the mid-sixties by some substantial surpluses on current account. In other words, the United States did not become a net borrower from the rest of the world, and provided foreign countries with the requisite dollars by means of direct investment and foreign loans, which would not be possible without difficulty for a substitute reserve currency country – and even for the USA worked only under the special conditions prevailing in the fifties. The United Kingdom provides a striking example of the high price which a country had to pay when it actively sought to play a reserve currency role for which it was not fitted in terms of its economic potential.

If the world economy is to remain workable, the evolution of the international monetary system towards a multi-reserve standard is therefore to be viewed with scepticism, as such a standard is an unstable structure involving the risk of constant exchange rate disturbances. Advantage should be taken of the strengthening of the dollar to stop, or at least to slow

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down, the diversification process; after all, none of the currencies that are given preference today can replace the dollar in its function of being the key currency of the western world.

As an alternative to a gradually evolving multi-reserve standard it has been suggested that artificial reserve assets, such as the special drawing right created in 1969, should be placed more at the centre of the international monetary system. This would make the monetary authorities' provision with international liquidity independent of the vagaries of balance of payments developments in the USA and other reserve currency countries; instead, the creation of special drawing rights could be controlled in a rational way, in line with the requirements of the international community. In much the same way as, at the national level, the monetary system has developed from a gold currency into a freely manipulated currency, international money should free itself from "archaic relics" and become subject to deliberate decisions by all those involved in the monetary system. However, special drawing rights, even though their design is without doubt intellectually impressive, have not so far been as successful as was hoped. They have not been used very widely in private contracts and they have not developed into a major reserve asset among central banks, as was intended by the new IMF Agreement of 1978. The conception of special drawing rights was obviously based on the mistaken premise that – to paraphrase a famous remark of Bismarck's – the great issues of our time can be solved by technical ideas. In the last ten years, at all events, one of the chief problems of the international monetary system has not been, as supposed, a shortage of international liquidity, but rather the reverse.

Dilemma for Germany

Finally, let me draw from all this some conclusions for Germany. In a substitute reserve currency country, exchange rates are determined even less than usual by the equilibrium of flow variables or by other fundamentals, such as purchasing power parities. Instead, the exchange rate of the D-Mark is greatly influenced by the portfolio decisions of domestic and foreign investors or borrowers, speculative expectations playing a major part. Hence the monetary authorities, even if they intervene heavily in the foreign exchange market, can by no means ensure that the exchange rate of their national currency develops satisfactorily. Overshooting exchange rate fluctuations in both directions can hardly be avoided. The exchange rate of the D-Mark has in such cases often lost touch

with economic reality in Germany; reflecting investment decisions, the exchange rate was frequently at the mercy of varying expectations.

For a substitute reserve currency country there thus arises a dilemma which should not be underestimated. On the one hand, a country can hardly be expected to readily accept the structural shifts that result from overshooting exchange rate movements. On the other hand, the Bundesbank's battle against excessive exchange rate fluctuations is all too likely to conflict with the domestic objectives of monetary policy, above all the fight against inflation. A country of Germany's size is obviously overtaxed by the role of a reserve currency country – at least when non-residents hold more D-Mark assets in their portfolios than is consistent with Germany's significance in the world economy. The instability of a multireserve standard exposes Germany to adjustment pressures which it is hardly able to bear. Economically speaking, overshooting exchange rate movements have no meaningful function in the adjustment process; however, they initiate developments which may have considerable consequences for the economy. After the breakdown of the old Bretton Woods system and the various dollar crises which persisted until 1979, the further evolution of the international monetary system into a multireserve standard was no doubt inevitable. The D-Mark, too, had to assume new responsibilities, albeit involuntarily. But it should not be overlooked that such a system aggravates the instability in the world. While a large key currency country like the United States can cope with the associated exchange rate fluctuations relatively easily owing to the breadth of its financial markets and its relatively limited foreign trade ties, the smaller reserve currency countries are under permanent external pressure.

The crux of the current international monetary system is the lack of approximate symmetry between the adjustment needs of the "économie dominante" with relatively few external ties (the United States) and the rest of the world. As long as the "économie dominante" submitted to the strict requirements of the gold standard, such a symmetry existed. A return to those conditions is, however, inconceivable. This underlines the necessity of not allowing unduly large inflationary disequilibria to accumulate in the "économie dominante", which by definition is exposed to less external pressure to take action; later on such disequilibria can be eliminated only at the price of drastic deflationary treatment, and they are accompanied by exorbitant real interest rates, which Germany and other countries have to follow whether they wish to or not.