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Claus Köhler*

Liberalisation and International Cooperation

While being a necessary consequence of the ongoing and desirable process of international division of labour, the increasing freedom of international money and capital movements has in recent years impaired the efficiency of national economic policy instruments. In order to overcome this drawback the loss in national economic policy autonomy should be counterbalanced by a gain in economic policy cooperation between the national economies.

In economic terms, the economies of Europe, America and the Pacific region are drawing closer and closer together. This development began several decades ago with the increase in frontier-crossing transactions in goods and services. Since then, import and export shares have risen in most countries. The international division of labour which this reflects has brought prosperity gains to all the economies which have freely exchanged goods and services.

As long as the freedom of international trade was largely confined to goods and services, economic policy could remain chiefly geared to national economic policy objectives. Of course, national economies were affected by international influences – the more so, indeed, the more they interlocked with other countries in goods and services transactions. Increasing or decreasing economic activity abroad influenced a country's own national economic development. Wrong exchange rates, currency depreciations or appreciations and exchange rate fluctuations were other factors which disrupted the course of the national economy. However, monetary and fiscal policy were generally able to counteract such disturbances by taking appropriate measures.

In the last few years, however, international influences have not only changed economic developments in national economies but also impaired the efficiency of national economic policy instruments. This is due to the increasing freedom which now prevails in frontier-crossing money and capital movements between the major European economies, the United States and Japan as well. International monetary flows now influence interest rates in the national monetary markets, especially in the bond markets, regardless of

the intentions of the national central banks. This has an adverse effect on interest rate policy. Monetary policy measures designed to control economic developments generally hit the banks. When under a system of free money and capital movements there are economies without a central bank and without any monetary policy, it is possible for banks to evade burdensome monetary policy regulations such as minimum reserves. The arsenal of monetary policy instruments is weakened. When the tax rates for monetary transactions differ from country to country, when for example there are different withholding tax rates or different securities transfer tax rates, international capital avoids the countries with the higher rates. National fiscal policy is affected too.

Free international money and capital movements are the necessary consequence of the ongoing and desirable process of international division of labour. Free movements of goods and services cannot expand any further if economic activity cannot be accompanied by monetary measures. Since free international trade is more advantageous to people in industrialised countries and developing countries than a concentration of economic activity in national economies, ways must be sought of overcoming the drawbacks for national economic policy associated with liberal frontier-crossing money and capital movements. All these approaches culminate in the demand that the loss in national economic policy autonomy should be counterbalanced by a gain in economic policy cooperation between the national economies. Further headway in the international division of labour, and also in European integration, depends on our success in meeting this demand.

The freedom of international movements of goods, services, money and capital is not a new concept to the Federal Republic of Germany, but one that has been practised for decades. However, this was only of limited

* Member of the Board of the Deutsche Bundesbank, Frankfurt, West Germany. – The article is a slightly edited version of the Fritz Machlup Memorial Lecture delivered by Professor Köhler in Salzburg on November 12, 1987 (in German).

relevance for economic policy autonomy in Germany as long as other major European countries and Japan subjected their international money and capital movements to administrative restrictions, and as the United States was mostly orientated towards its own huge national economy. The freedom of international money and capital movements in Germany was not matched by any corresponding freedom in other major economies. This situation has now changed. The administrative barriers are falling in many major economies, and the United States too is more strongly orientated towards the world economy than it used to be.

Necessity of a Policy Framework

In the traditional national economies the monetary policy of central banks and the requirements imposed by bank supervisors create a policy framework in the monetary markets. In these countries the process of monetary expansion depends on the volume of central bank money provided, i.e. on bank liquidity. Moreover, the pace of monetary expansion is influenced by the minimum reserve regulations and interest rates, which are controlled by the central bank. Bank supervisors ensure that the liable capital and the provision of liquidity are adequate. One would think that a closer economic cohesion of economies should not cause any further problems. All traditional national economies have such a policy framework. Hence, monetary expansion remains limited. This is also true when the banks in a given economy grant loans or accept deposits in a foreign currency, since these Euro-credits and Euro-deposits are subject to the same monetary policy measures and prudential rules as loans and deposits in domestic currency.

There is a problem when, under conditions of free money and capital movements, banks evade domestic monetary policy measures and prudential rules by setting up subsidiaries in areas which often do not have a central bank and hence do not impose monetary policy requirements, and whose bank supervision is less exacting than that in traditional national economies. These areas, situated just outside the traditional economies (offshore centres), are Luxembourg in Europe; the Bahamas, the Cayman Islands, the Netherlands Antilles and Panama in America; and Bahrain, Hong Kong and Singapore in Asia. Credit expansion in these centres is largely unlimited. The liquid funds of the banks in offshore centres are not restricted by central banks. Instead, the liquidity is provided by banks, namely by banks in the countries whose currencies are on offer in the offshore centres. The banks themselves consider this liquidity provision to

be virtually unlimited. In these areas, prudential rules curb credit expansion only slightly.

Policy frameworks are necessary for offshore centres too. The willingness to draw needful conclusions from unmistakable combinations of circumstances is a touchstone of the cooperation of national economic policies in solving international problems. Within the European Community this willingness can be taken for granted. The Member States have agreed on a directive which allows the national banking supervisory authorities to supervise their banks on the basis of consolidated balance sheets, i.e. including their subsidiaries. Thus the problem of the offshore centre Luxembourg is partly defused for the European countries. To come to terms with the problems worldwide, all economies (i.e. including the offshore centres) would have to agree on a prudential principle linking foreign lending to liable capital. Since one can be sure that the liable capital cannot be increased at double-digit annual growth rates over a lengthy period, credit expansion would be curbed in offshore markets as well. Euro-minimum reserve regulations would have a similar effect. Towards the end of the seventies, in view of excessive credit expansion in the international credit market an attempt was made to introduce one of these two instruments. The attempt foundered on the resistance of several countries.

Competition in the financial markets and for financial markets has pushed developments in a wrong direction: traditional economies try to compete with the offshore centres by establishing free banking zones resembling offshore centres within their own economy. London, New York and Tokyo have chosen this approach. Non-residents (not, however, residents) can carry out transactions on special, preferential conditions, e.g. minimum-reserve-free, tax-free or tax-privileged. In the United States and in Japan too there are minimum reserve requirements for bank deposits. However, a US bank can operate without minimum reserve requirements in the free banking zone of Tokyo, while a Japanese bank can hold balances in the free banking zone of New York free of minimum reserve requirements. A procedure of this kind is, however, the very reverse of cooperation, it is a "beggar-my-neighbour" policy. The only way to solve this problem is to attempt to understand the relevant issues and thus hope to find a way towards cooperation.

Dangers in the Absence of a Policy Framework

In the absence of an adequate policy framework, there is a tendency towards exaggeration in the monetary markets (including the foreign exchange

markets). Alas, we have already witnessed this situation three times, namely in the international credit market, in the international bond market and in the share markets. On the one hand, the international credit market is very effective. This was proved in 1972-73 in the wake of the first oil price shock, when it was necessary to recycle the balances accruing to the oil-producing countries to the oil-consuming countries as credits. But for the international credit market this problem could hardly have been solved, and the world economy would have got into great difficulties. On the other hand, the credit expansion was not curbed when it would have been necessary for the oil-consuming countries to initiate an internal adjustment process. In many countries this necessity was constantly postponed by raising new credits. A credit expansion with an average annual growth rate of 26 % was consequently kept up for more than nine years, until by 1981 many of the debtor countries had become insolvent. The fact that there was no self-regulation of the market was blamed on the fierce competition between banks.

Hence, the entire world economy is shouldering a heavy burden, which debtors and creditors will take a long time to reduce. This time can be gained only if the conditions for the debtor countries are favourable. Increasing commodity prices are improving the export proceeds of many of these countries. Strong economic growth in industrialised countries reinforces world trade and provides additional sales opportunities for developing countries. Together with other supporting measures, low interest rates may keep the interest burden borne by the debtor countries within tolerable bounds.

However, it is uncertain whether these conditions will in fact obtain in the next few years. The debtors themselves must play their part in mobilising their growth potential and containing inflation. They also have to adopt effective measures to counteract the flight of capital from their countries, and they must pay more attention to the problem of domestic income distribution in order to prevent undue social tensions.

High unrepayable debt is a threat to the world economy and the international payments system. It also affects central banks, which have already intervened several times to avert damage to the international payments system in the wake of the debt crisis. Of course, such a situation also has an impact on the actions of central banks when they realise that an increase of one percentage point in interest rates in the international credit market forces the developing countries to step up their exports by more than one per cent to enable them to pay this interest rate increase.

The expansion in the international credit market was followed by an expansion in the international bond market. Whereas the volume of new issues amounted to \$ 40 billion in 1980, it reached \$ 226 billion in 1986. This development reflects an average annual growth rate of 33 %. Such an expansion was only possible, because funding by means of bond issues was more favourable than other types of borrowing for many issuers. Investors were prepared to accept interest rates which were unfavourable to them, because many bond constructs involved a speculative element. Investors hoped for speculative gains in addition to the interest income. However, the international bond market lacks sufficient long-term funds for such a rapid increase in bond issues. Hence, the international money market, with maturities of six months or even less, was used for bond funding. The interest rates of the floating rate notes created in this manner are not fixed but tied to the money market rates. The frequent adjustment of interest rates was believed to prevent price losses and make these notes highly liquid. As a result, from 1980 to 1985 floating rate notes expanded at twice the pace of all international bond issues. During this period, their share in total issues rose from 12 % to 35 %.

When floating rate note issues expand at a rate of 65 % over a period of five years, signs of saturation and setbacks are bound to follow. These setbacks emerged in the case of perpetual notes, one sector of the market, late in 1986, but in spring 1987 they affected the entire market in floating rate notes. The market realised that these securities were by no means as liquid as had been assumed. Price losses were registered. In the first three quarters of 1987 the share of these securities in overall issues fell to 5.9 %. Thus the total volume of issues in 1987 has been below that of the previous year. Self-regulation is reigning in the international bond market. Long-term securities with fixed interest rates are dominant once again.

In 1986 investors shifted their attention to the share markets. Since then, share prices have increased rapidly, particularly in Tokyo. The impression that this development was being supported by a real or expected improvement of business activity was no longer justified. Compared with the Tokyo stock exchange, share prices on other exchanges seemed "cheap". Accordingly, other exchanges were soon caught up in the steep upward movement on the Tokyo stock exchange. In New York, London, Paris and Tokyo share prices rose more rapidly than dividends in 1986 and 1987, so that equity yields fell. Only in the Federal Republic of Germany were price movements more restrained. During this period share yields still increased. However, the sharp

setbacks of the last few weeks have also affected the German stock exchanges. The price decreases were very pronounced, compared with the stock exchanges in other countries, since heavy sales by non-residents impinged on a rather shallow and narrow market. Setbacks of this kind after previous exaggerations also have a certain impact on the real sphere. Confidence problems and consequent adverse influences on investment and economic growth have long-term effects.

Hence it is not surprising that the calls for supervision of the international markets too are becoming more numerous. More information on markets and their activities, rules for trading in securities and prudential measures are being considered necessary. Henry Kaufmann has suggested the establishment of an official international supervisory office (International Board of Overseers for Major Financial Institutions and Markets) for this purpose. "For the sake of improved financial stability and for its many attendant benefits, we should yield some financial sovereignty to this new board."¹

External Disequilibrium

In national economies, the frontier-crossing economic activities of banks, other business enterprises and individuals are recorded in the balance of payments. Special attention is paid there to current transactions. Nationally, external equilibrium is said to exist when a country counterbalances the goods and services received from abroad and the resources provided to other countries without a direct economic quid pro quo (transfer payments) by its own economic efforts. In economic terms, from the point of view of the international division of labour, the demand for such external equilibrium does not make too much sense, since the political frontiers of an economy are mostly arbitrary, economically speaking, and an equilibrium in frontier-crossing transactions is sheer chance. Nevertheless, in the world economy it is imperative to aim at balanced current accounts, because the deficit countries must offset the net inflow from abroad by foreign exchange payments or borrowing, and neither of these is possible indefinitely.

From 1982 to 1986 the United States recorded an annually increasing deficit on current account. 1987 will be the first year in which it is lower than a year before. In the five years from 1982 to 1986 the United States had to employ its own foreign exchange reserves and borrow

funds abroad to a total amount of \$ 420 billion. It was possible for an economically advanced and large country like the United States to finance such a deficit without reaching the limits of its borrowing capacity from other countries. Since 1985, however, this financing process has been accompanied by a lasting depreciation of the US dollar. Capital flows of these dimensions from Europe and Japan to the United States and the consequent exchange rate and interest rate effects have an impact on the countries outside the USA. Regardless of the monetary policy pursued by national central banks, they influence interest rates in the monetary markets.

The adjustment of current accounts requires a contribution on the part of national economic policy. An economy running a current account deficit, as in the United States, must stimulate exports. This aim will only be achieved if the authorities succeed in making overall economic output – the real gross national product – increase more rapidly than domestic demand. This way of putting it implies that an economic policy of this kind can only be expected to be successful in a process of growth. When the GNP is rising only slightly or stagnating, the increase in domestic demand would have to be curbed relatively sharply or domestic demand would even have to be reduced. Since this generates negative effects, especially on the labour market, it is difficult to implement such an economic policy when growth is sluggish or non-existent.

When there are deficits on current account in certain economies, there are corresponding current account surpluses in other countries. There are such surpluses in Japan in particular, and also in Germany. In these cases the opposite remedy applies. Economic policy must try to make domestic demand increase more rapidly than GNP. Only then will it be possible to reduce the surpluses. This was the case in Germany in 1986 and will be achieved again in 1987. In other words, countries running current account surpluses must seek to stimulate domestic economic activity, but countries running current account deficits must strive to dampen it.

This process of adjustment is impeded by rapid changes in exchange rates. A depreciation of the US dollar and an appreciation of the Deutsche Mark are supposed to contribute to a better equilibrium between the current account balances. The receipts of German exporters decrease as a result of the exchange rate decline. In consequence the volume of exports will rise more slowly. On the other hand, import prices are reduced. The volume of imports increases. However, these volume reactions take time. When the exchange

¹ Henry Kaufmann: Debt Relief for Developing Countries in a Volatile Financial World, Salomon Brothers Inc., 1987, p. 8.

rate changes rapidly, it is mainly import prices which alter at first. In the case of an appreciation, accompanied by unchanged import volumes, the value of imports declines. The current account continues to improve. This so-called J-curve effect is one reason why the current account deficits and current account surpluses have changed relatively little so far.

Instabilities in Foreign Exchange Markets

The 1980's, and especially the last few years, have been characterised by the growing significance of frontier-crossing capital transactions and their impact on national economies. In Germany, for example, frontier-crossing long-term capital investment (the average of German investment abroad and foreign investment in Germany) rose to 16 % in 1986 as a percentage of GNP. In many cases these transactions have a stronger effect than international movements of goods and services on national monetary markets and foreign exchange markets.

Since goods and services, too, can only be purchased from abroad when they are paid for directly or on credit, a current account deficit must always be matched by a surplus (i.e. an inflow) on capital account, and a current account surplus by a deficit on capital account. However, especially freely floating exchange rates lead to a complex picture here. When a country like the Federal Republic of Germany records a current account surplus, it is assumed that the economies which import German goods require Deutsche Mark against their own currencies, i.e. that the Deutsche Mark will appreciate. A non-resident who holds balances or securities in an appreciating currency receives appreciation gains in addition to the interest rate. Hence, expectations of an appreciation as a consequence of a current account surplus often result in a surplus on long-term capital account. In the first six months of 1987 there was a surplus of DM 39 billion on the German current account. The expectations entertained during that period that the Deutsche Mark would continue to appreciate resulted in considerable capital inflows (to the amount of DM 15 billion), especially through purchases of Deutsche Mark securities. So the basic balance (the current account plus long-term capital transactions) was in surplus to the tune of DM 54 billion.

Market mechanisms ensure that these surpluses on the basic balance are offset by short-term capital exports. The heavy demand for Deutsche Mark led to an imbalance in interest rate arbitrage. The decline in the spot rate for the dollar in Germany reduced the difference between the spot rate and the forward rate, i.e. lowered the cost of forward cover. Thus it became

more attractive to invest funds abroad, especially for German banks. In this manner, and through short-term capital transactions by non-bank enterprises with non-residents, DM 34 billion flowed abroad in the first six months of 1987.

This adjustment of the basic balance by interest rate arbitrage runs parallel to an appreciation of the Deutsche Mark. Inflows on long-term capital account with the aim of making gains on appreciations and the actual appreciation owing to interest arbitrage transactions are reasons for the rapid pace of exchange rate fluctuations. The crucial point is, however, the fact that, under the system of freely floating exchange rates, exchange rate expectations have become independent. Currencies appreciate or depreciate largely independently of the level of current account balances, price differentials and interest rate differentials.

A new landmark was set up in this field when in February 1987 some major economies agreed on the Louvre Accord, which was reaffirmed at the summit conference of the heads of state and government of seven leading economies in Venice in June 1987 and at the annual meeting of the International Monetary Fund and World Bank in Washington in September 1987. Under this accord, the central banks are endeavouring to stabilise exchange rates "around current levels". At the time, that meant DM 1.82 per US dollar. In the following seven months, exchange rates changed relatively little. After initially rather substantial interventions in the exchange market by central banks, exchange rate expectations stabilised. Only when statements by participants in the accord raised doubts as to the seriousness of the agreement did the US dollar start to depreciate strongly again.

Those countries which are participating in the intervention mechanisms of the European Monetary System and which maintain virtually stable exchange rates vis-à-vis one another are in a favourable situation. The European Monetary System has succeeded in stabilising expectations with regard to exchange rate changes. Although realignments are necessary from time to time when the pace of inflation varies as between the member countries, after each adjustment exchange markets in the countries of the European Monetary System remain peaceful for quite a long period.

Monetary Policy under International Influences

A central bank's possibilities of influencing interest rates, liquidity and monetary aggregates in its own country diminish as the freedom of frontier-crossing money and capital transactions increases. A central

bank was and is able to control interest rates in the money market. This used to be sufficient to influence yield movements in the bond market in the same direction. Nowadays, however, the yields on securities are determined not only by the interest rate and liquidity policy of the central bank in the money market only but also by exchange rate expectations and interest rate differentials vis-à-vis other countries.

Expectations of the appreciation of a certain currency lead to purchases by non-residents in its bond market. The buyers are hoping for exchange rate gains and, because of the increasing demand for these securities, also for price gains. Long-term securities are especially in demand. Not that the investors intend to hold these securities for a long period. Quite the contrary, in fact, but if the yield drops the price gains from long-term securities are likely to be larger than those from short-dated bonds. In the case of expectations of depreciation the opposite applies: non-residents sell securities in the depreciating currency. Hence the bond market is subject to some substantial yield fluctuations. The direction of these interest rate changes in the bond market can be the same as that of the changes in the money market determined by the central bank. It can, however, also be the very reverse.

Today, if a central bank intends to change its interest

rates in the money market, it has to consider which repercussions this measure will have on exchange rate expectations and on frontier-crossing money and capital flows. An interest rate reduction in the money market, for instance, can trigger off expectations of the depreciation of the respective currencies, thereby inducing non-residents to sell securities in the currency which is supposed to depreciate. Yields in the bond market increase, i.e. move in the opposite direction to that desired. In such a case, divesting oneself of one currency and switching into another does indeed lead to a depreciation in the economy which has lowered its money market rates. Awareness of this relationship has caused the Bundesbank to make very sparing use of interest rate policy measures which attract great public attention, such as changes in the discount and lombard rates. Money market rates are now generally managed with the aid of open market policy, which attracts rather less attention.

The financial flows which move freely between the economies always seek the most favourable place for investment. Institutional differences in the range of monetary policy instruments play a crucial role in this context. The Bundesbank, for instance, requires minimum reserve regulations to be able to perform its task of safeguarding the currency.

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Leonhard Firlus

ZWISCHEN SCHOCK UND KALKÜL

Die permanenten Verschuldungsprobleme der Entwicklungsländer

BETWEEN SHOCK AND CALCULATION

The Permanent Debt Problems of the Developing Countries

The debt crisis of the developing countries is among the most discussed problems of the world economy. Exogenous shocks and mistaken economic policies are generally named as the causes of the crisis. From an historical perspective, however, periods of debt servicing problems are the rule. It is thus too narrow a view to interpret debt problems solely as a consequence of exogenous shocks and mistaken economic policies. This study examines the question in how far calculated behaviour by decision-makers in developing countries must be included in attempts to explain debt problems, in order to be able to explain their permanence.

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Such minimum reserve requirements are a burden on banks and allow them to pay only relatively low interest rates on bank balances. In offshore centres such as Luxembourg there is no central bank and thus no minimum reserve instrument: in Luxembourg the interest rates on Deutsche Mark balances are in principle higher than in Germany. Funds flow from Germany to Luxembourg. Since these international discrepancies cannot yet be eliminated by harmonising monetary policy instruments, all one can do is minimise the resulting disadvantages. For this reason the Deutsche Bundesbank has changed the structure of its minimum reserve ratios, reducing the rates for time deposits, which are affected most by the outflow, and increasing the rates for sight deposits. The need to harmonise the monetary policy instruments as the liberalisation of international money and capital movements makes further headway remains a challenge, especially to the European Community.

When changes in interest rate differentials and exchange rate expectations trigger off frontier-crossing money and capital flows and thereby influence monetary aggregates, an atypical movement of monetary target variables may follow. This was the case in the first six months of 1987. Expectations of an appreciation of the Deutsche Mark led to an inflow of funds from abroad. Some of these funds, for example down-payments on orders, found their way to the accounts of domestic non-banks. The yield reductions occurring in this period caused potential domestic buyers of securities to lodge their funds temporarily in time deposits at first. The consequent increase in the monetary target variable central bank money stock did not constitute inflationary potential, since these funds were not accumulated in order to be spent in Germany. Forcing them back requires interest rate reductions rather than increases. Interest rate reductions are more likely to make the country of the appreciating currency appear less attractive to funds from abroad, thus providing an inducement for their withdrawal.

Changes in monetary aggregates attributable to expectations of currency appreciation and depreciation affected monetary developments in many countries in the first six months of 1987. In the European countries with appreciating currencies and in Japan, the monetary aggregates overshot their target corridor. In the United States, whose currency depreciated, the growth rate of the target aggregates M2 and M3 slowed down and fell short of the target corridors. Just as there was no reason to worry about the overshooting of the target corridor in the countries with appreciating currencies, the shortfall owing to the depreciation in the United States gives no

cause for concern. Incipient inflationary processes there can be financed (by borrowing), even when there is only a slight increase in the money stock.

If international influences on monetary aggregates are disregarded and curbed when the money stock increases more rapidly than had been expected for domestic reasons, or if the reins are loosened when it increases more slowly than had been desired for domestic reasons, then such an anticyclical monetary targeting policy may easily result in one losing sight of the real objectives from which the monetary targets are derived, viz. production potential, GNP and the inevitable prices. Under the influence of free frontier-crossing money and capital movements, changes in monetary aggregates, too, must be viewed in a more sophisticated way than they used to be.

Economic Strategy under International Influence

Economic policy in every economy pursues national economic objectives. In the Federal Republic of Germany, the law² requires that economic policy measures should be so taken as to "contribute simultaneously to price stability, a high level of employment and external equilibrium, accompanied by steady and appropriate economic growth". In an economy with an unemployment rate of 9.0 % this implies that the growth rate of real GNP must outstrip that of production potential (2 to 2½ %) if underemployment is to be gradually reduced. This necessitates a strengthening of potential supply by means of additional investment. Price stability can be maintained if demand is brought into line with potential supply. Implementing such a concept in a "closed" economy requires a great deal of skill and understanding on the part of all those involved – viz. the fiscal policy makers, the monetary policy makers, management and labour. Nowadays, however, economic policy takes place in an "open" economy. There are international influences. Reinforcing, curbing or tolerating these influences must be made an integral part of economic planning.

The rapid changes in exchange rates disturb the course of the world economy. They make it difficult for business enterprises to adjust, and they bring restrictive stimuli into countries with appreciating currencies and inflationary stimuli into countries with depreciating currencies. The Louvre Accord of February 1987 and the Venice summit meeting in June 1987 called for non-inflationary growth in the major economies along with a readiness to intervene in the foreign exchange markets, in order to ensure greater exchange rate stability.

² Stability and Growth Act of July 8, 1967, section 1.

Interventions in the foreign exchange market must have an objective. "Around current levels" can only be meant for a limited period of time, since there are still considerable differences in inflation rates, even though progress has been made in stabilising price levels. Under conditions of freely floating exchange rates, it would be a major step forward if the authorities succeeded in stopping exchange rates from over- or undershooting and in keeping them on the path of purchasing power parity. Then international trade will not be disrupted by exchange rate movements. Additional export proceeds due to higher inflation rates abroad are cancelled out again by a corresponding appreciation of the domestic currency. Neutrality of trade prevails.

An exchange rate path would thus be marked out for international money and capital movements. When central banks announce their intentions and back them up with deeds, i.e. with interventions, speculation will see to it that any deviations from this path are not too pronounced. It must not be forgotten, however, that overly wide or overly narrow interest rate differentials induce unwanted capital flows. If exchange rates follow the path of purchasing power parity, then neutrality of capital transactions prevails, provided that the difference in interest rates between two countries corresponds to the difference in inflation rates. In this case, the forward rates indicate the expected course of the spot rates, in keeping with the change in purchasing power parity. It is then immaterial whether funds are invested in the domestic market or in a foreign market. When the foreign exchange is converted back, higher interest rates in the foreign market are reduced to the domestic interest rate level because of exchange rate losses. Hence under a regime of freely floating currencies, greater exchange rate stability requires of those involved not only a willingness to intervene but also a readiness to cooperate in the field of interest rate policy.

When current account deficits and surpluses are high, there are only two ways of balancing the accounts by means of capital transactions: either the surplus countries supply the necessary funds to the deficit countries on a voluntary basis (in this case the current accounts are balanced at substantially unchanged exchange rates), or the current account adjustment takes place by way of interest rate arbitrage; then it is accompanied by exchange rate movements. If this is to be avoided, the surplus country must keep its interest rates below those of the deficit country. The interest rate differential may perhaps have to be larger than would be consistent with the state of neutrality with respect to capital transactions. For the sake of an exchange rate

system which is as stable as possible, the interest rate policy cooperation that is necessary to that end calls for mutual understanding of economic developments in the countries involved.

The debt problem facing many developing countries will have a bearing on the economic policy of national economies for a long time to come. It will take time for the debtor countries to grow into their unduly large "debt cloak", by increasing their GNP, their productivity and thus their external performance. Whether this time is available without a disruption of the world economy depends on many factors, e.g. the increase in world trade, the movement of commodity prices, interest rate levels, etc. Only interest rates can be influenced by economic policy. Each percentage point increase in interest rates in the international monetary markets necessitates a rise of more than 1% in exports if the higher interest rates are to be paid by export proceeds. However, it is more difficult for the developing countries to step up exports if economic growth and hence import potential are curbed in the industrialised countries. Conversely, every drop by one percentage point in interest rates eases the burden on the developing countries by an amount equivalent to just over 1% of their imports. Given the importance of the debt problem to the world economy, these relationships must clearly be kept in mind when contemplating any new interest rate policy measure.

The central bank governors and finance ministers of the major economies meet regularly, either under the auspices of the Bank for International Settlements in Basle or at meetings of the International Monetary Fund. These are the bodies in which cooperation in the fields of monetary and other economic policy can be intensified.

Challenge for the EMS

For the countries of the European Communities the process of liberalisation in international monetary and capital transactions constitutes a particular challenge. This is especially true with respect to the five member countries (Denmark, France, Germany, Ireland and the Netherlands) which have fully accepted the rules of the intervention mechanism in the European Monetary System both for monetary transactions in the context of goods and services transactions and for money and capital transactions. The currencies of these countries are linked together by fixed parities and exchange rates can deviate from these parities by only 2.25 %. When inflation rates in these countries differ over a prolonged period of time, parity realignments are occasionally necessary. When under these conditions of fixed

exchange rates international money and capital transactions are made free, a particular need for policy cooperation arises, not only with respect to monetary policy but also as regards other fields of economic policy. In line with the "Single European Act"³, the European internal market is to be created by 1992, i.e. an area "without internal frontiers, in which the free movement of goods, persons, services and capital is ensured". In principle, fixed exchange rates and complete freedom of frontier-crossing money and capital transactions do not permit independent monetary policies to be pursued any longer.

If exchange rates are fixed over a relatively long period of time and can fluctuate only within a narrow margin, interest rates in the member countries which fully accept the intervention rules cannot lie far apart. Any attempt by one of the central banks concerned to raise or lower its own interest rate level would be corrected by the market, i.e. by flows of money and capital. If the tensions that arise through changes in interest rates are to be avoided, a continuous dialogue concerning the interest rate policy of the member countries involved is necessary among the central banks.

However, interest rate policy is conducted by national central banks in order to ensure above all stability of the value of currencies and to contribute to an appropriate rate of economic growth, a high level of employment and external equilibrium. The cooperating central banks must not lose sight of these objectives. The question needs to be examined as to whether and how these objectives can be attained and what role has to be played by monetary policy in the process.

Upward and downward movements in freely floating exchange rates do not influence only one currency in the intervention mechanism, but affect all of them to more or less the same extent. Hence, a largely joint approach is necessary when intervening against freely floating currencies, especially against the US dollar. Such an approach, together with its implications for interest rate policy, needs to be agreed among the central banks involved.

Money and capital flows, especially from outside the small circle of participants in the intervention mechanism, can bring tensions into the system. In order to ward them off, intramarginal interventions can be useful, as was agreed among the central banks in September 1987. The essential point about such

interventions is that a demand for or supply of a currency can be partly met or provided through intramarginal interventions before it reaches the country concerned, as it were. If, for instance, there is a demand for Deutsche Mark, other member central banks frequently sell Deutsche Mark before the intervention points are reached in order to prevent their currency weakening any further. Thus part of the demand for Deutsche Mark is already met outside Germany. Here again, the associated problems require close cooperation between the central banks concerned.

The fixed exchange rate systems of the 1920's and the Bretton Woods system after the Second World War have taught us that at the centre of such a system there should not be a national currency as a key currency. The burden associated with supplying the world economy with sterling or US dollars as the key currency ultimately exceeded the strength of the national currency concerned. The Deutsche Mark has de facto formed the focal point of the European Monetary System for some years, despite the fact that a European monetary unit, the ECU, exists. The transformation of the ECU into the focus of the system is a further task for the internal market of the European Communities.

However, the high standards required of the willingness to cooperate will not be met if such willingness is limited to the loose cooperation practised by the bodies that exist at present. Institutionalisation is imperative. The institution to be created could be the nucleus of a future European central bank system. It would have to draw up the necessary analyses, promote cooperation and submit recommendations to the national central banks. The body that takes decisions on such matters should be appointed by national governments but be independent of instructions from these governments. It could be composed of the central bank governors of each member country that has fully accepted the rules of the intervention mechanism of the EMS.

Proposals of this nature will appear to be highly ambitious to some people. Then it must be recalled that the obligation undertaken by the national governments to create the European internal market by the end of 1992 is likewise ambitious. If one accepts this objective, then one must not shrink from the implications it has for national and European economic policy. If one were to do so, it is doubtful whether the international market of Europe could ever be established. But in view of the huge economic area constituting the United States and the rising economic power of Asia in a world of increasing freedom of international trade, this is something the countries of Europe cannot afford.

³ Law on the Single European Act of February 28, 1986, Deutscher Bundesrat, printed publication No. 150/85, article 13.