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European Integration and International Co-operation in Exchange Rate Policy

The debate about monetary integration within Europe often distracts attention from the Community's external relations.¹ In the field of monetary and exchange rate policy, however, thought is being given to ways in which countries could co-operate more efficiently at the world level.² How should these ideas be assessed, and what are their chances of success?

The prospects for international monetary co-operation will be determined to quite a large extent by the future monetary policy environment in Europe. Three scenarios are conceivable:

- the Deutsche Bundesbank will retain the de facto leading role it currently plays in the EMS,
- member countries will agree on another form of co-operation in which the Bundesbank will not call the tune; this may entail the establishment of a European central bank or a more evenly balanced means of arriving at consensus,³
- the Community will relapse into dissent, with each country pursuing its own ideas, even if they run counter to those of other countries and cause fresh strains within the system.⁴

The options for worldwide monetary co-operation and action that will foster European interests are likely to be different in each of these three instances.

Public opinion often regards large Western industrial countries as a community united by identical interests, as reflected in the titles "G3" and "G7". At first sight this appears to be self-evident: at their economic summits, for example, do not these countries repeatedly call for the stabilisation of exchange rates, the curbing of worldwide inflationary tendencies and the elimination of imbalances in the world economy? The difficulties encountered with international economic and exchange rate co-operation in practice show, however, that things

are not quite so simple. The interests of these countries, their relations with one another and the problems they face will be analysed more closely in the following article with the help of club theory.⁵

The theory of clubs is concerned with the optimum size of group, the circumstances in which an individual will be inclined to join the group and the quantity of a collective good that it should provide. Applying this to the situation under consideration here, the analysis therefore needs to investigate the combination in which international co-operation in monetary and exchange rate policy would stand the best chances of success, the circumstances in which the European countries, individually or as a group, would be prepared to co-operate in this way and the aspects in which they should be most interested.

¹ Exceptions in this respect are P. Bofinger: European and International Economic Policy Cooperation – The Need for an Integrated Approach, contribution to a joint research project on "International Macroeconomic Policy Cooperation" by the Sasakawa Peace Foundation, Tokyo, the Institute for International Economics, Washington, D.C., and the Hamburg-Institute for Economic Research (HWWA), Hamburg, September 1989; and E. Thiel: Das EWS im internationalen Währungssystem – Eine Herausforderung für die USA? – Äußere Profilierung und innere Konvergenz, in: H.-E. Scharrer and W. Wessels (eds.): Das Europäische Währungssystem, Bonn 1983.

² The spotlight is primarily on the co-ordination of monetary and fiscal policy within the G7 – Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom and the USA – as envisaged by Miller and Williamson. After the completion of European integration it would become co-operation among the triad of Europe, North America and Japan. However, trilateral monetary co-operation among the USA, Japan and Germany, as foreseen in the McKinnon proposal, is also under discussion. See J. Williamson and M. H. Miller: Targets and Indicators: A Blueprint for the International Coordination of Economic Policy, Washington, D.C., 1987; R. I. McKinnon: Currency Substitution and Instability in the World Dollar Standard, in: American Economic Review, Vol. 72, No. 3, June 1982.

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It is generally assumed that the willingness of the individual to co-operate depends not only on the direct costs and benefits he expects to derive but also on the prospects for success. These in turn are influenced by group size; as a rule, the clearer the situation and the smaller the number of participants to be co-ordinated, the better the prospects for success.⁶ On the other hand, if the group is small there is the danger that some of the main protagonists will not even be members and that their actions may jeopardise the success of the undertaking. The two aspects must be weighed one against the other.

By definition, a club is any voluntary association of players with the objective of deriving an (economic) advantage from one of the following: the sharing of production costs and the exploitation of economies of

scale, the exploitation of particular attributes of the members and/or the consumption of a so-called club good that can be denied to non-members.⁷ Whether countries striving for a common or co-ordinated monetary and exchange rate policy can really be regarded as a club in this sense depends on the extent to which they satisfy these criteria.

Clubs of Industrial Countries

The fact that all the countries in question can be described as "large Western industrial countries" certainly does not meet the requirement. This characteristic alone confers no economic advantage that the group could exploit. It is true that "large"

³ On the first possibility, see R. Hasse: Die Europäische Zentralbank: Perspektiven für eine Weiterentwicklung des Europäischen Währungssystems, Gütersloh 1989. On the second alternative of finding a more evenly balanced means of arriving at consensus, see also H.-E. Scharer: Eine Zentralbank für Europa?, in: Integration, July 1988, pp. 97 f.

⁴ See for example W. Filc: Europäische Geldpolitik nach 1990, paper for the symposium "Europäische Zentralbank – Europäische Währungspolitik im Wandel" held from 12th to 14th October 1989 at the Universität der Bundeswehr Hamburg, Trier 1989.

⁵ Club theory dates back to the works of Buchanan and Olson. See J.M. Buchanan: An Economic Theory of Clubs, in: *Economica*, Vol. 32, No. 125, 1965, pp. 1-4; M. Olson: *The Logic of Collective Action*, Cambridge 1965. A survey of more recent approaches to the theory of clubs is to be found in R. Cornes and T. Sandler: *The Theory of Externalities, Public Goods, and Club Goods*, Cambridge 1986.

⁶ In itself, this argument would support the McKinnon approach rather than the proposal of Williamson and Miller. However, in small groups conflicts may actually break out more easily than in larger groups because the confrontation between individual players is stronger. The validity of this argument therefore remains to be tested in individual cases.

⁷ See for example R. Cornes and T. Sandler, *op. cit.*, p. 24.

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The number of developing countries which have signed agreements on structural adjustment with the IMF and the World Bank has increased rapidly in the eighties. At the same time, the discussion on the conflicts involved in such adjustment programmes has intensified considerably. Against the background of the belief that the success or failure of programmes, the way in which they are implemented, as well as the period of time in which they can be politically supported, are decisively determined by the activities of interest groups, the example of Turkey is subjected to an empirical analysis.

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industrial countries, however defined, frequently find themselves in a similar monetary situation that creates comparable interests – for example, rapid inflation is a problem for any country – but these do not arise simultaneously in all countries, are not given the same priority everywhere and do not rule out the possibility that the strategies required from a national viewpoint will conflict with those of other countries.

Having similar interests therefore does not necessarily mean that a “common” interest exists. That would be the case, for example, if the countries wanted to provide a common “club good”. A club good is a public good characterised by partial rivalry and/or exclusivity. Objectives such as the promotion of world trade, the curbing of worldwide inflationary tendencies or exchange rate stability meet these criteria to varying degrees. For example, the benefits of successful exchange rate stabilisation cannot be withheld from any country whose currency is traded freely for the currency of the stabilising country; nor does any rivalry develop here, in the sense that one country’s enjoyment of the good reduces the consumption chances of another.

The situation is different where combatting inflation or promoting growth are concerned; countless discussions on beggar-my-neighbour behaviour have shown that these objectives can indeed be achieved at the expense of others. For example, one can conceive of a club of countries that direct their economic efforts towards raising the economic growth of a particular region but which pass the associated adverse effects – such as weakening of their export competitiveness as a result of an increase in prices due to rising capacity utilisation – on to non-member countries by means of appropriate exchange rate changes.

The Central Problem

In some respects these considerations miss the true core of the question, that is to say whether there is indeed a desire to provide a common good. In a world in which economic policy-makers must justify their actions to national parliaments and where their political fortunes depend solely on the electors in their own country, a common objective of any kind – and a club good is just this – must take second place to national interests in the event of any incompatibility.

Hence if states co-operate in international economic policy, whatever political rhetoric may claim, they are to be considered a club only in so far as they fulfil the criterion of burden sharing and band together to bear jointly the cost of achieving national objectives that are not in mutual conflict. Their behaviour is similar to that of

a car pool whose members travel a certain distance together before their ways part to different destinations. As long as their route is the same they are prepared to share their travelling costs; they may accept minor detours if overall they can still travel more cheaply than they could alone (or with other travelling companions) or if they expect that their fellow travellers will be similarly accommodating on another occasion. As a rule, however, they are not travelling to a common destination.

How the Europeans work out the future monetary and exchange rate route that they can or wish to travel in company with other countries and how many detours they accept depends ultimately not only on objectives and economic conditions but also on their ability to assert themselves, their readiness to compromise and their ability to reach consensus in international negotiations. The greater the unity among them, the more forcefully and credibly will they be able to represent their interests to countries outside the group.

Leading Role of the Bundesbank

If the Deutsche Bundesbank continues to perform the role of leading central bank in the EMS, the chances of this happening are particularly good. The fact that the country with the second most important investment and reserve currency in the world determines the basic course of monetary policy in Europe with approval of other countries guarantees that at least none of the principal official players in financial and exchange rate developments are excluded from co-operation or work against it. This should help minimise conflicts between objectives and contradictions between regional and worldwide co-operation.

The situation is less clear if the European countries arrive at a form of co-operation in which the Bundesbank does not play the leading role. In this case the ability to assert European interests vis-à-vis third countries would depend on the reputation of the Europeans, which in turn is likely to be influenced strongly by the attitude of the Bundesbank.

A distinction should be drawn here between the benefits for the Community as whole and those for an individual country. For example, it is conceivable that Germany or any other country may wish international co-operation to take place within a coalition different from or smaller than the EMS – such as the grouping for the Plaza Agreement. It is also conceivable, however, that alliances could differ according to the situation; if the Bundesbank were to lose its leading role, that could be the occasion for all parties involved to consider a

wider range of options than in the past. This would be particularly true if they were striving for a balanced consensus in Europe and no country or supranational body, such as a European central bank, claimed a clear hegemony that could provide guidance. In times of crisis, however, when conflicts break out within the Community and uncertainty increases, such a consensus can waver more easily and third countries will therefore regard an alliance of this kind as less reliable.

Uncertain Coalitions

From Germany's point of view the question arises as to the conditions in which it would be beneficial to accept the constraints of group membership in Europe, even if it meant, for example, retreating from a stabilisation course on which the reputation of a policy had hitherto been based. The theory of clubs dictates that the benefits Germany hopes to derive from this may not be less than those it could expect either acting alone or within any other combination of countries.⁸ This criterion is not as clear-cut as it sounds, however. The deciding factor is what it is that should be seen as a benefit of co-operation, and here the theory offers no help. Is it simply the directly recognisable economic advantage associated with co-operation, or do longer-term aspects also play a role, such as the strengthening of relations or increasing progress towards integration within Europe? The difficulty in deciding where the advantage lies is compounded not only by the incentive to consider more alternatives but also by the fact that the criteria for assessing these alternatives are now more complex, for it is no longer possible to work on the basis of a reasonably well-functioning status quo whose familiarity provided a certain degree of security.

If the Bundesbank went along with the decisions of others but let it be known that it was doing so reluctantly, the cause of international co-operation would have gained little. Doubts about the credibility of Community policy and the durability of the Community consensus would weaken the Europeans' position in international negotiations or even force them to take demonstrative action that would do more harm than good. Non-member countries would have to expect instability in international economic and monetary relations to be more likely than in the past to lead to conflicts within the Community, which would endanger the continuation of the alliance and render past decisions at international level obsolete.

⁸ See for example the concept of the core in a treatment of coalitions from the point of view of game theory, such as J. McMillan: *Game Theory in International Economics*, Chur 1986.

Disunity

The worst situation would be if the EMS countries failed completely to agree on a policy. Each country's international relations would then have to be assessed separately; countries such as Belgium or Denmark would probably find it much more difficult to pursue their own monetary policy interests at world level or even to make their voice heard. Only the countries belonging to the Group of Seven – France, the United Kingdom and Italy – might perhaps stand a chance of being included in negotiations on monetary issues.

Germany's situation would be different. The position of the D-mark as the second most important investment and reserve currency in the world would give Germany sufficient weight to pursue her interests independently. According to the theory of clubs, she would probably even find it easier to reach compromises at world level if the circle of players were smaller and she did not have to heed the concerns of other European countries. But however attractive the prospects for an independent policy towards non-EC countries may seem, it would entail a heavy cost in terms of the tensions it might cause in the EMS and the setback to European integration that would then have to be feared. This explains the desire of member countries to reach agreement even in difficult circumstances.

It would be helpful in this regard to arrive at a uniform assessment of the situation, both within Europe and in relation to non-member countries, that would make it possible to agree on an efficient use of economic policy instruments, either jointly or separately. It would also be helpful to bear in mind that as far as monetary and exchange rate policy are concerned the countries do not constitute a club pursuing a common interest but must co-ordinate differing objectives.

The more openness there is on this point, the greater the chance of agreeing on the forging of external relations whose credibility and binding force are beyond reproach. From the European perspective, the comparative advantages offered by the international reputation of strategies pursued hitherto should not be gambled recklessly nor should the risks inherent in a less well-defined and hence potentially more unstable configuration be accepted lightly. The theory of clubs has the merit of pointing out the ambivalence of every joint strategy and showing that not all forms of co-operation are equally beneficial, from the point of view of the group and that of individual members. However, other criteria must be used to assess the political benefits offered by this or that alternative.