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Franz-Josef Rose*

The Euro and the World Monetary System

Stage Three of European Economic and Monetary Union is scheduled to begin on 1st January 1999 at the latest; by 1st July 2002 the euro will probably be the only legal tender in the participating countries. The role of the European Central Bank and the euro in the international monetary system is still very unclear, however. This poses a risk for the intended independence of the ECB.

When the euro is introduced, national currencies will be abolished within the European Economic and Monetary Union. As a result, all existing trade within the internal market and part of the foreign trade of the EU will be transacted in the new currency. In 1995 the fifteen EU countries exported goods and services worth \$134 billion to the USA, equal to 7% of their total exports of \$1,911 billion, and imported \$147 billion from that country, equal to 7.7% of their imports of \$1,901 billion. Exports to Japan accounted for 2.2% of the total and imports for 4%. Around 22% of EU exports went to developing countries, while 20% of EU imports originated in those countries. They are therefore important trading partners of the EU. As trade with them will soon be conducted partly in euros, it can be assumed that there will be strong demand for the new currency in the international foreign exchange markets to cater for these transactions. Nevertheless, the US dollar will also continue to be widely used in trade with third countries. In 1994 57.1% of all foreign exchange reserves worldwide (51.5% in the industrial countries) was held in US dollars, 14.8% in Deutsche Mark (16.9%), 8.1% in yen (7.7%) and 7.8% in ecus (14%). The latter will be exchanged for euros on a 1 for 1 basis.

The introduction of the euro is linked to the implementation of a single monetary and exchange rate policy. The European Central Bank (ECB) will be responsible for maintaining price stability.¹ Its independence is enshrined in the Maastricht Treaty (Article 107 of the EC Treaty; Chapter III, Article 7 of the Protocol on the Statute of the ESCB and the ECB). The national central banks will transfer part of their

foreign reserve assets to the ECB, which will be able to use them for exchange market intervention, either centrally or on a decentralised basis. In order to achieve these objectives, a number of adjustments in powers and responsibilities are necessary, but they have yet to be agreed in detail. The interesting question is whether member countries are prepared to surrender powers to the new ECB.

Under Article 14.4 of the Protocol on the Statute of the ECB, national central banks may perform other functions on their own responsibility and liability. However, the Governing Council of the ECB can determine, by a two-thirds majority, that these functions are incompatible with the objectives and tasks of the ESCB. The ECB therefore has the possibility of acquiring powers that the politicians want to deny it. In addition, Article 23 of the Protocol empowers the ECB to establish relations with international organisations. The President of the ECB will play an important role with regard to the reputation of the institution. Part of his task will be to ward off attacks by national governments on the independence of the Bank. During the initial period, in particular, he will have to demonstrate his steadfastness so that it quickly becomes clear that the ECB is not a plaything of national interests.

The Euro and the IMF

If the euro becomes the sole legal tender in the EMU, it will be necessary to redefine the Special

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¹ For a critique of the ESCB, see G. Heinsohn, O. Steiger: Kategorie-2-Sicherheiten: alarmierende Defekte im zukünftigen ESZB, in: WIRTSCHAFTSDIENST, No. 5, 1997, pp. 265-267. The Treaty speaks of "price stability", but it undoubtedly means "price level stability".

Drawing Right (SDR), the accounting unit of the IMF.² At present the SDR consists of the following currencies: US dollar (40%), yen (17%), DM (21%), French franc (11%) and pound sterling (11%). Soon there will be only four components: the US dollar, the yen, the euro and sterling. The weight of the euro in the SDR depends partly on the IMF's estimation of the scale of trading in euros on the international foreign exchange markets. A strong euro would probably have to account for about 30% of the SDR, a true counterweight to the dollar. The revaluation of the SDR could provide the EMU countries with an opportunity to combine forces and to begin to pursue a common policy in the international monetary arena.³

After the introduction of the euro, all transactions with international organisations will be conducted in the new currency. For the IMF this means that the countries' paid-in quotas will be converted into euros. It would then suddenly find itself holding large quantities of euros. The extent to which it will use these in drawings by member states remains to be seen. If the euro meets a lukewarm reception in world markets and cannot establish itself as a world reserve currency, this could have consequences for the liquidity of the IMF. The two following scenarios describe conceivable alternative positions of the EMU:

□ *Scenario 1: the European variant:* The EMU member countries relinquish their national quotas and voting rights in the Board of Governors and Executive Board, join forces and belong to the IMF as the EMU. They are represented in the Board of Governors by the President of the new European Central Bank, whose alternate is the Commissioner for financial affairs or the President of the Commission. The EMU also appoints the area's Executive Director. The number of members of both the Board of Governors and the Executive Board decreases. The EMU (e.g. Germany, France, Austria and the Benelux countries) then has around 16% of the votes in the Executive Board (as presently constituted). If Italy and Spain are also members of the EMU, it accounts for 21% of the votes, and if all fifteen EU states participate in EMU the EU has just under 30% of the votes

Even the first possibility gives the EMU a veto in "high majority" decisions requiring 85% approval,

something that hitherto only the USA has enjoyed, with 17.78% of the votes. At present Japan has "only" 5.54% of the votes. Against opposition from the EMU, no new member countries could be admitted and no quota increases, gold sales or new SDR allocations agreed. A joining of forces would therefore shift the balance of power within the IMF in favour of the Europeans.

□ *Scenario 2: the nation state variant:* The EMU countries continue to think in national terms and speak with many tongues, as hitherto. Agreement is still possible only at the level of the lowest common denominator. National governments are not prepared to surrender real responsibility and hence to transfer power to a supranational organisation. They continue to be represented at the IMF by their national central bank governors or finance ministers, so that there is no change in the Board of Governors and the Executive Board. The chances of the euro becoming a world reserve currency are reduced. It could appear that the EMU has no confidence in its own currency or institutions. The EMU would have only observer status at the IMF.

The EMU is not a member of the IMF and therefore has no rights or obligations. As a result, only the separate, albeit now euro-denominated balances of payments of individual countries can be taken into account. Moreover, the individual countries also retain their quotas and the associated voting rights. The quotas are based partly on political strength, but primarily on economic performance as evidenced by national statistics. The nation states therefore continue to have the possibility of making drawings in the IMF. If an EMU country got into balance-of-payments difficulties, it could obtain credit without the ECB being able to prevent it. The ECB's monetary policy could therefore be undermined. There are no restrictions on drawings within the reserve tranche, although drawings in the higher tranches are subject to conditions. In theory, an individual EMU country could therefore agree an adjustment programme with the IMF without the consent of the ECB. The inherent potential for conflict would adversely affect the reputation of the ECB and hence the standing of the euro.

In the case of Germany, the Law amending the Law on Accession to the IMF and the World Bank (BGBl. II

² With regard to the organisation structure and functions of the IMF, see: Articles of Agreement, Washington, D.C., 1978, the more recent Annual Reports of the IMF and F.-J. Rose: *Der IWF und die Weltbankgruppe*, in: *International Economics, Working Papers 9501*, Paderborn 1995.

³ The last round of GATT negotiations, in which the EU presented itself as a single negotiating partner, serves as a model in this respect. On the problems of the external competence of the EC, see P. Gillsdorf: *Die Außenkompetenz der EG im Wandel*, in: *EuR*, No. 2, 1996, pp. 145-163.

1970, pp. 1325ff.) has stipulated since 1970 that the financial claims and obligations deriving from membership of the IMF and drawing rights in the reserve tranche fall within the competence of the Deutsche Bundesbank. The extent to which such transactions would have to be agreed with the ECB if they had consequences for the latter's job has not yet been clarified.

Other IMF Problems

Every IMF member country is obliged to sell its currency to the IMF for SDRs up to a limit of three times its cumulative net allocation of SDRs. If the IMF demanded this of an EMU country, the national central bank would have to exchange euros for SDRs. In such circumstances, the ECB would not be a direct party to negotiations with the IMF and hence would not be involved in these transactions. One of the tasks of the IMF under its Articles of Agreement is to maintain strict supervision over the exchange rate policy of member countries. Article IV is the legal basis for the annual consultation exercise. Monitoring focuses in particular on member countries' exchange rate policies, as well as monetary and fiscal policies. The members of the IMF are the individual EMU countries, whereas the ECB is responsible for monetary and exchange rate policy. Whom should the IMF consult? A non-member? It would have to continue to consult solely the nation states, which on the one hand could blame the ECB for any adverse developments and on the other could use IMF recommendations to exert pressure on the ECB. Neither would do the standing of the ECB any good.

The General Arrangements to Borrow (GAB) are also affected by the euro. Should the ECB or national central banks or governments decide on recourse to credit? The relevant European participants in the GAB are Belgium, Germany, France, the Netherlands, Italy and the United Kingdom. If, for example, the IMF were to ask an EMU country for a loan under the GAB in a crisis, under current law that country could decide whether money (euros) should be created or not, without reference to the ECB. Under a strict interpretation of the functions of the ECB, it should at least have a say in such decisions, and possibly even a right of veto.

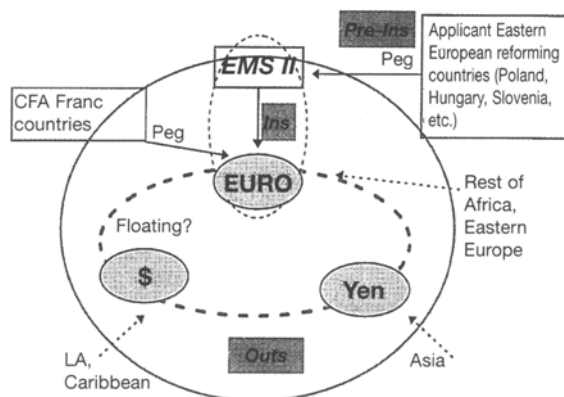
The situation regarding the World Bank group is different, in that a member country of the IBRD must

pay in 2% of its capital subscription in gold or dollars and a further 18% in domestic currency; the remainder is uncalled capital. Contributions to future capital increases would therefore have to be paid in euros (in Germany, the Federal Ministry for Economic Cooperation and Development has been responsible for such payments up to now) and the national currencies already paid in would have to be converted into euros. If the IBRD grants loans in euros, the interest must also be paid in that currency, which would require the borrowers (developing countries) to have a holding of euros. Future contributions to replenish the capital of the IDA, the IBRD's "soft window", would also be made partly in euros. Here too the euro would be used internationally. The distribution of votes in the World Bank group is similar to that in the IMF. Here too the EMU countries could join forces and "speak with one voice", particularly as the EU already has elements of a common policy towards developing countries (e.g. the Lomé Conventions, the GSP).

The Euro in the World Monetary System

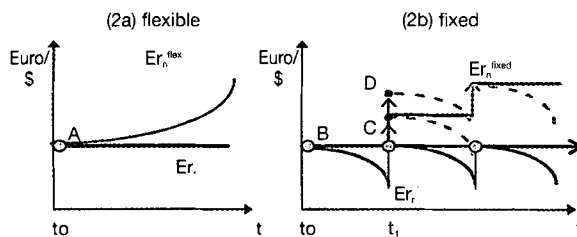
The Maastricht Treaty gave the ECB responsibility for maintaining price stability. The European System of Central Banks (ESCB) will begin to apply a common monetary policy on 1st January 1999. The strategy will be to aim for a money supply target, a direct inflation target or elements of both.⁴ By contrast, the decision as to the exchange rate of the euro in relation to third currencies remains the prerogative of the European Council. The ECB will probably not set an exchange rate target. Experience shows, however, that exchange rate regimes can have a significant effect on the efficiency of monetary policy. Here there is latent potential for conflict that can be resolved only

Figure 1
The New World Monetary System



⁴ See European Monetary Institute: Annual Report 1996, Frankfurt am Main, April 1997.

Figure 2
Comparison of Exchange Rate Systems



by means of co-operation between the ECB and the European Council. There is provision for this in the Treaty, but it is impossible to foresee how it will actually be interpreted in the event of a conflict.

After the introduction of the euro the shape of the new world monetary system will be more or less as depicted in Figure 1. The question is whether one prefers a floating euro or should aim for a fixed rate system. Both options have advantages and disadvantages, which have been described in the relevant literature.⁵ In theoretical terms, neither system has a clear advantage over the other. As the practical experience of some countries in transition introducing a new currency has shown, a floating rate for the euro may be appropriate initially. The new currency must first establish a reputation in world markets. Later, over the medium to long term, it might be possible to consider pegging the euro to the dollar. Figure 2 portrays the two systems separately.

If we assume the purchasing power parity theory ($ER = P_{dom}/P_{ext}$) to be valid, the nominal exchange rate (ER_n) equalises price movements between two countries. For example, if domestic prices increase more rapidly than external prices, the domestic currency depreciates. After conversion, the domestic price level and the price level abroad are therefore identical (ignoring transport costs and the like). This mechanism ensures that with rising inflation the nominal exchange rate adjusts, as shown in Figure 2a, so that the real exchange rate ($ER_r = ER_n \times P_{ext}/P_{dom}$) remains constant.

The transition from national currencies to the euro may see substantial shifts of funds, or even capital flight. During this initial period a flexible exchange rate against third currencies would be appropriate, if only to counteract speculative attacks, which would

create serious problems in a system of fixed exchange rates.

In a system of essentially fixed but adjustable exchange rates (managed flexibility), there will always be movements in the real exchange rate if domestic inflation is higher than in the country's main trading partners. With rising domestic inflation, the domestic currency appreciates in real terms. Figure 2b shows the typical movement in the real exchange rate. At point B the real and nominal exchange rates are identical (index), but the real exchange rate then adjusts while the nominal exchange rate remains constant – in other words, precisely the opposite of what happens with flexible exchange rates. If the nominal exchange rate is lowered by enough to neutralise the real appreciation in relation to the original rate, the previous real exchange rate is reached and the process begins again, *ceteris paribus*. The currency can also be devalued in real terms, so that the real exchange rate follows the path traced from point C, which almost immediately leads again to a real appreciation. If, however, the domestic currency is devalued to such an extent that it is significantly undervalued in real terms, as at point D, this can considerably improve the competitive position, even if, on the assumptions adopted, the undervaluation will eventually be eliminated. The latter could be a medium-term strategy for the euro, namely to manoeuvre the currency into a position of undervaluation. One need only look at Germany in this connection, whose position in the world economy was greatly improved by long periods of undervaluation of the DM under the Bretton Woods system. The same can be said of Japan. Such a policy could enable the EMU to increase its exports to third countries and hence help reduce high unemployment. For that purpose the euro would have to be pegged to the dollar. This could be decided either unilaterally by the EMU (with a unilateral obligation to intervene in the foreign exchange markets) or in the context of a new world monetary system.

The CFA Franc Zone

France has special currency relations with four groups of developing countries that were formerly her colonies: the CFA franc zone⁶ (West African and Central African monetary unions, the Comoro Islands) and the Pacific territories. All of the zones operate a monetary union, in the sense that the common

⁵ See J. Williamson (ed.): *Exchange Rate Rules*, New York 1981; J. R. Artus, J. H. Young: *Fixed and Flexible Exchange Rates*, in: IMF Staff Papers, No. 26, Washington, D.C., 1979, pp. 654-698; J. S. Bhandari, B. H. Putnam: *Economic Interdependence and Flexible Exchange Rates*, Cambridge 1983.

⁶ With regard to the franc zone, see A. Delage, A. Massiera: *Le Franc CFA: Bilan et Perspectives*, Paris 1994.

currency has a fixed exchange rate with the French franc. In the three African zones the currency is the CFA franc, in the Pacific the CFP franc.⁷ The Comoro Islands are not a member of the two African unions, but a special part with its own central bank.

The CFA franc zone, which was officially established in 1945, is characterised by a fixed parity, freedom of capital movements, a common foreign exchange pool, borrowing limits for member states and a uniform system for settling trade and foreign exchange transactions with third countries. The central banks of the countries concerned maintain an operations account with the French Treasury, which acts like a deposit bank. The exchange rate (1 CFA franc = FF 0.01 and 1 Comoro franc = FF 0.013) is fixed and convertibility is guaranteed by France. For this purpose the countries transfer 65% of their foreign exchange reserves to the French Treasury. The central banks of the zones do not have accounts with the Bank of France. The CFA franc holdings of the French central bank are in effect claims on the Treasury, which operates the operations account. The Bank of France is therefore not directly connected with the zone. Deficits and surpluses on the operations account bear interest, but there is no mechanism for financing long-term balance-of-payments deficits. All members of the zones are also members of the IMF, have their reserve positions in the Fund and are entitled to make drawings. In reality, it is France that determines monetary policy in the zones, partly by controlling the central banks through strong representation in their administrative bodies and partly by dominating the private banking system.

Via the link with the franc, the CFA franc zone is indirectly associated with the EMS Mark I. If this group of countries also ties their currency to the euro, the same will apply to the EMS Mark II. The EMU countries and some EMS II countries are the main trading partners of the countries in the CFA franc zone. Pegging to the euro is therefore an advantage for the Africans, as it offers them low exchange rate risk and wider trade with the EU area. On the other hand, they must automatically go along with all movements of the euro against third currencies, which could be a disadvantage if the euro appreciated. Thanks to the guaranteed convertibility of the CFA franc against the French franc, the countries of the

zones can acquire any convertible currency they need. The advantage for France lies in the extension of its economic area to these countries, the additional foreign exchange receipts and the strengthening of French pre-eminence in the zone.

A protocol to the EU Treaty states that "France will keep the privilege of monetary emission in its overseas territories under the terms established by its national laws, and will be solely entitled to determine the parity of the CFP franc". At present the CFP franc is worth FF 0.055.

Such an arrangement does not explicitly apply at present for the CFA franc zone. If France had the same privilege for the CFA franc zone as well (in accordance with Article 109(5) and Article 104 of the Treaty), conflicts with European monetary policy could arise. For example, inflationary pressures could develop if the zone countries must deliver large inflows of foreign exchange from third countries to France and the operations account is not closed. Under the EU Treaty, however, monetary policy within the EMU is determined independently by the ECB. How can France's possible claim to continue to exercise sole control over policy with the franc zone be reconciled with the mandate of the ECB to determine monetary policy in the EU without receiving instructions from any other body? The scale of these transactions is rather small at present, but this problem of competence is fundamental, and hence of interest.

If the franc zone countries continue to prefer the existing system and France is also willing to maintain it, a problem would arise with the ECB. There are three possible solutions: a) France has its way, and operates the system itself as in the past; b) France transfers all powers to the EMU and its central bank, and c) a compromise is reached. In cases a) and c) it would not be possible for the ECB to exercise completely independent control over monetary and exchange rate policy.

Conclusions

The selected examples described above show that the role of the ECB and the euro in relation to the world monetary system, including the franc zone, remains extremely unclear. In practice, the independence of the ECB is still far from assured. Against this background, the assertion of many German politicians that the euro will be as strong as the Deutsche Mark appears to be very courageous. Serious hurdles have still to be overcome if it is to have a chance of becoming reality.

⁷ CFA: Franc de la Communauté Financière d'Afrique for the West African Monetary Union, Franc de la Coopération Financière en Afrique Central for the Central African Monetary Area; CFP: Change Franc Pacifique.