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THE EUROSISTEM IN THE INTERNATIONAL MONETARY SYSTEM

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The introduction of the euro will have far-reaching implications not only for the evolution of central banking and monetary policy, but also for international monetary and financial relations and the world economy at large. It will modify the environment in which players outside the euro area, the large as well as the medium and small ones, will operate in the years to come. It will therefore entail new responsibilities for policy-makers in Europe.

The purpose of this article is to offer the reader an overview of how the Eurosystem views its role as a major actor in international monetary relations. The article suffers from a very important limitation in that it is confined to only one aspect, albeit a crucial one, of “monetary relations”, i.e. exchange rate relations. Although for decades the latter were seen as the sole monetary issue generated by international interdependence, the reader should be aware that this is no longer the case. Over the last quarter of a century, with the emergence of a global monetary and financial market, the agenda for international monetary co-operation has expanded considerably. It now includes such key central banking fields as the efficiency and soundness of the payment systems and the stability of the banking industry and securities markets. Co-operation in these areas has in fact progressed at a faster pace than in the field of exchange rates.

The next section outlines the background against which the euro came into being, showing how its creation constitutes a rather unique answer to the problems and contradictions of international economic interdependence. After highlighting the size

factors that contribute to the international responsibility of the euro area (Section 3), the article examines the possible implications of the euro for the relationships among the three key currencies (Section 4). It then discusses the scope and methods of international co-operation in a tripolar system (Section 5) as well as its institutional framework (Section 6). The role of the euro in relation to non-key currencies (Section 7), particularly those seeking an external anchor for their monetary policy, is then considered. Finally, the article ends with a short conclusion (Section 8).

The underlying rationale

With the stipulation of the Maastricht Treaty in 1992 (the “Treaty”), Europe has adopted an entirely new approach to the choice of the monetary order of a group of interdependent but sovereign countries. Going beyond fixed exchange rates between national currencies, it has created a single currency and established a single central bank. The importance of this step is apparent if one looks back over the last 50 years and considers the repeated attempts to stabilise exchange rate relations through adjustable peg regimes. The evolution of international monetary relations illustrates that *i)* open trade and *ii)* free international movement of capital render *iii)* fixed exchange rate systems hardly compatible with *iv)* independent national monetary policies. Exchange rates pegs have repeatedly been chosen to stabilise trade and financial relationships between economically interdependent countries, at both the global and the European scale. If, however, the policies of the countries involved diverge, markets question whether exchange rate commitments can and will be maintained. As the doubt grows, pressure may become enormous and eventually lead to the abandonment of the peg. The four elements mentioned above form what is sometimes called an “inconsistent quartet”.

In the Bretton Woods System the inconsistency became apparent in the 1960s when the development of an international capital market made it possible to circumvent official restrictions and controls.

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The crucial role of the Eurosystem in exchange-rate relations

It became increasingly difficult to subordinate economic policies to the exchange rate objective. When the policy stance in the United States (the anchor country) came into conflict with anti-inflationary preferences of other important players (such as Germany), the dollar became increasingly overvalued and tensions grew. With economic fundamentals in the United States deteriorating sharply speculative activity in the foreign exchange market reached a level far exceeding the defensive capacity of national authorities. A devaluation of the French franc and a temporary floating of the German Mark were, at the end of the 1960s, the first signs of the coming breakdown of the system. Eventually, the Bretton Woods regime collapsed as a result of the waning of the two conditions that had ensured its initial success: a balanced macroeconomic situation in the anchor country and limited capital mobility between national financial markets.

Intra-European relations went through a similar experience. Europe's exchange rate peg moved from a US dollar to a Deutsche Mark standard, which took various forms and lasted until the advent of the euro. Its main manifestation, the European Monetary System (EMS), was designed in full awareness of the two drawbacks of the Bretton Woods regime: inflexibility and asymmetry. Flexibility was pursued, for more than half of the ERM "narrow band" life, through timely realignments (11 between 1979 and 1987). As to symmetry, no currency was explicitly given a leading role and parities were decided by "common accord" in relation to the ECU currency basket. In practice, however, the Bundesbank led the monetary policies of other members and the German Mark was de facto the anchor of the system.

However, even intra-European relations came under increasing strains as a result of capital liberalisation and the creation of a single market in banking and financial services. Economic and Monetary Union (EMU) was decided upon and enshrined in the Treaty, not only for reasons of "high politics", but also to remove the inconsistency of the quartet and to firm up the Single Market. When uncertainties about the ratification of the Treaty pointed to the risk that Monetary Union might not come about, an exchange rate crisis erupted because markets rediscovered domestic imbalances and policy contradictions. Only the substantial widening of the fluctuation band to $\pm 15\%$ in August 1993 restored calm in the market. In the years that followed, economic

convergence in Europe was achieved through considerable fiscal consolidation and successful disinflation. Financial markets rewarded these efforts with lower interest rate differentials and relatively stable foreign exchange relations.

EMU is not just an evolution or a tightening of previous arrangements such as the European "snake" and the EMS. It is not a binding international agreement to co-ordinate monetary policies. Rather, it is a complete change of regime, the establishment of the same monetary order that normally exists within a nation: *one* currency, *one* central bank, and *one* monetary policy. The countries that have transferred their monetary competencies to a new supranational institution, however, retain their separate sovereignties in many areas, and even in the economic field. This is the unprecedented feature of EMU.

It appears from this glance at the past that two different solutions have been chosen, at the global and the European level respectively, to resolve the same problem. In both cases the inconsistent quartet had come about as a result of rising capital mobility. To overcome the inconsistency, one element of the quartet had to be dropped. The international community decided to drop the fixed exchange rate element and moved to a regime of floating rates. Europe decided to drop independent monetary policy and founded a single currency to complement the Single Market. The solution adopted for one area would not have been possible, or would not have worked, in the other area. Europe, in particular, could – and, in a way, was almost compelled to – move to the single currency because its economic and financial integration had gone extremely far and because it was politically ready to establish common institutions. Using the jargon of today's debate on exchange rate regimes, the approaches taken by the world and by Europe respectively correspond to the two "corner solutions" that are sometimes seen as the only viable ones in a world of capital mobility. The unresolved problem of exchange rate arrangements for non-key currencies will be discussed below.

A new player on the field

The advent of the euro has brought a new player onto the field. "Euroland" (a name that was quickly adopted for the euro area) is, in economic terms, around the same size as the United States and twice

A single currency at the European level was combined with a floating-rate system at the global level

as large as Japan. With almost 300 million people, it produces 15% of world GDP (the United States produces 20% and Japan 8%). Accounting for approximately 20% of world exports (the United States accounts for 15%, Japan 8.5%), it is the largest trading partner in the world economy.

In the monetary and financial field the euro, assuming the mantle of the German mark and its other predecessors, has from the start been the second international currency. Euro/dollar trading is the most active and liquid segment in the foreign exchange market at the global level, followed by the dollar/yen currency pair. As for international bonds, the US dollar and the euro now jointly account for 80% of new issuance, making the international bond market increasingly a two-currency market. As a reserve currency, the share of the euro is expected to have contracted somewhat in 1999 from the 15% of its legacy currencies, because German mark reserves held by euro area central banks are no longer recorded as foreign reserves. However, there are signs that official authorities outside the euro area, in particular in Asia where the bulk of global official reserves are held, are gradually diversifying their portfolios towards the euro.

As a reserve currency, the share of the euro is likely to have fallen below the 15% of its legacy currencies in 1999

The new economic player created by the single currency has come hand in hand with a new institution, the Eurosystem. This institution is the world's second most important central bank.

These "size" factors obviously generate an international responsibility for the euro area policy-makers, particularly the Eurosystem. Three questions can be asked in order to explore the issues confronting the Eurosystem. First, what kind of exchange rate regime will be established between the major currencies? Second, what implications will the euro have for international co-operation? Third, what role will the euro play in relation to non-key currencies?

Three floating currencies

With regard to the exchange rate regime, the introduction of the euro has coincided (it was indeed largely a coincidence) with proposals for tighter exchange rate arrangements among the three main currencies. In particular, the concept of target zones, first advocated by Williamson in 1986, seemed to gain renewed favour in Germany and in some other quar-

ters. Establishing such a system would have required the leading industrial countries to agree on desirable exchange rate levels and to act in order to keep market rates within a range of permitted fluctuation.

In the debate that followed those proposals, the Eurosystem expressed serious reservations about the feasibility and desirability of any scheme that would attempt to enforce stability between the dollar, the euro and the yen. The Eurosystem warned that as long as major players conduct independent and domestically-oriented monetary policies such schemes would be impossible to reconcile with the increasing mobility of capital, as the occurrence of the inconsistent quartet has proved in the past. In today's highly integrated and extremely liquid international capital markets, the amounts of funds that can be mobilised to push a currency out of the target zone far exceed the amounts that proved sufficient to destabilise both the Bretton Woods regime and the EMS. None of the leading central banks would now be willing to forego domestic policy objectives in order to absorb or create the large amounts of liquidity needed to defend the exchange rate objective.

It is true that pressures may be generated by unjustified market sentiments, uncertainty or misperceptions about the conditions and prospects of an economy, as has been the case with the euro in late 1999 and early 2000. The belief that "markets are always right" is indeed naïve and unjustified. Even when they are wrong, however, markets are stronger than policy-makers. Moreover, and most importantly, they tend to correct their own mistakes and to reflect, over time, the so-called "fundamentals", be they divergences in relative cyclical positions, different patterns of monetary policies, changes in competitiveness, or macroeconomic imbalances.

In theory, a fixed rate system allows *one* country or area to benefit from a higher degree of freedom if the other two countries or areas were willing to follow in line. In practice, however, the hierarchical structure displayed by both Bretton Woods and the EMS – in the sense that in both systems one country was leading the monetary conditions of the others – could not be reproduced in the new environment. Given the comparable economic weight of the United States and the euro area, a hierarchy would be politically unacceptable. The three regions taken together are too far from conforming to the usual economic criteria for an optimum currency area. Furthermore, the

increasing relevance of emerging markets for global trade, capital flows and also crisis potential means that co-operation among the three main global players alone would be difficult to sustain.

The truth of the matter is that it would be neither realistic nor desirable to attempt to establish a kind of European Monetary System, or a less ambitious variant thereof, at the global level. The EMS owed much to factors specific to the European Union (EU), such as relatively homogenous economic structures, a very high level of economic and political integration and a comprehensive institutional edifice. Even so, the EMS itself came under great pressure when full mobility of capital was established and markets questioned its credibility and sustainability. The degree of co-ordination and political commitment that would be required for a system of more or less fixed exchange rates to function on a global scale – and thus to overcome the inherent inconsistency problem mentioned before – is so great that it cannot be realistically expected from the major players in the foreseeable future. This is why floating exchange rates among the major currencies are bound to stay.

Co-operation: Scope and Method

What requirements will be laid down, for international co-operation and the Eurosystem, by a three-currency system where exchange rates are market-determined?

Before addressing the specifics of this question, two broader observations should be made. Firstly, in the present state of the world the preservation of economic order requires nation-states to be conscious of their international responsibilities. This is a matter of both enlightened self-interest and “international public spirit”. Indeed, in a world where countries or regions are economically and financially interdependent there are, as in any “single economy”, certain public goods which are “public” with respect to the world itself. Global financial stability or the maintenance of open trade are prominent examples. As long as countries are sovereign in the conduct of their policies, such international public goods cannot be expected to automatically result from the spontaneous behaviour of market participants and national governments, because such spontaneous behaviour tends to ignore the numerous externalities that arise at the international level. In principle, international institutions and forums exist

to address these externalities, and indeed they try to. However, since they have been given only very limited instruments, it is the task of countries themselves to internalise global externalities.

Secondly, compared to its predecessor central banks, the Eurosystem is a much stronger international player, is much less vulnerable to external shocks and influences, produces much greater external effects with its own actions. Owing to its sheer size and to the size of Euroland, the Eurosystem makes a considerably larger contribution to world affairs and has a correspondingly larger role and responsibility. These observations suggest that the Eurosystem should adopt an active and positive attitude towards international monetary co-operation.

Coming to more specific considerations, the first question is whether the three main currencies will continue to exhibit the high degree of exchange-rate variability witnessed over the past 25 years. Looking ahead, two factors linked to the introduction of the euro may be at work and pushing in opposite directions.

The first factor is the fact that Euroland is far less open than its national components, although its ratio of exports of goods and services to domestic GDP, at 17.1%, is well above that of the United States (11.0%) or Japan (11.5%). Euroland, Japan and the United States are all large and rather closed economies. The strong and unsurprising positive correlation between a country’s openness and its willingness to take the exchange rate into account in policy-making suggests that attitudes towards exchange rate developments will be relatively neutral in the coming years. This might lead to greater exchange-rate variability.

The second factor is the fact that all the three countries or regions clearly gear their monetary policies towards medium-term price stability and have an independent central bank. Although, of course, price stability is never a permanent acquisition, some of the special circumstances behind the high inflation of the 1970s and 1980s in many industrialised countries are no longer there. The “culture of stability” and the conviction that monetary policy can best contribute to economic growth and employment by ensuring an environment of stable prices now characterise the world economy. This positive combination should lead to more stable exchange-rate relations.

Two opposing factors are at work regarding the future exchange-rate variability of the three major currencies

On the whole, we cannot expect, for the years to come, a significant decline in exchange-rate variability, in the form of both short-term volatility and prolonged misalignments. We shall continue to see large day-to-day movements in exchange rates, often driven by one-day market reactions to events that are quickly forgotten the next day. We shall also continue to see deep and long exchange-rate waves that, over quarters and years, seriously affect competitive positions.

Should a wide variability of exchange rates be a cause for concern? My answer is a clear yes. Although little can be done about it, we should not fail to notice the costs and damages it may inflict on economic activity, financial stability and the smoothness of international relations. If large and prolonged, variability may negatively affect macroeconomic stability and distort the allocation of real and financial resources. It may determine shifts in competitiveness with distribution and even political implications. As a result, it may fuel trade conflicts and protectionist pressures.

Even limiting the observation to the last two decades, several examples of harmful consequences of wide exchange-rate variability can be recalled. The overvaluation of the US dollar in the mid-1980s and its subsequent sharp weakening was the first prominent example of a major exchange-rate misalignment since the collapse of the Bretton Woods system. The reversal was finally triggered by the Plaza and Louvre accords, which ended a period of “extreme neglect” of the exchange rate and marked the return to active co-operation. Since the mid-1980s, the movements of the yen – which exhibited high variability along a rising trend from 250 yen per US dollar in mid-1985 to 85 yen per US dollar in mid-1995 – have been a continuous concern to policy-makers in Japan and its trading partners and have at times also given rise to protectionist tensions. This exchange-rate variability also partly interacted with the rise and subsequent bursting of the Japanese asset price bubble in the late 1980s.

A third example is the global financial crisis of 1997-98, which was caused, inter alia, by unsustainable exchange rates in emerging market economies. In many of the Asian economies concerned, the crisis was partially due to movements in the dollar/yen exchange rate. As these countries had linked their exchange rates to the dollar, they suffered major losses in competitiveness when the yen sharply

depreciated against the dollar from the mid-1990s onwards. The resulting exchange-rate variation in Asia – in some cases exceeding 50% – has contributed to banking crises and deep recessions in these countries, and it has been one of the main mechanisms of global contagion and systemic risks.

These considerations illustrate that wide swings in the world’s major exchange rates have indeed had damaging consequences not only for the three major countries or regions but for the international economy as a whole. The latter consequences arise because the United States, Japan and Euroland influence the world business cycle and have strong trade, financial and exchange rate links to third countries.

However if, as argued above, exchange-rate stability is unlikely to become an end in itself for the three major economic players in the global economy, not least because it would lead to a re-occurrence of the inconsistency problem, what kind of *objectives* could be set for co-operation arising from those concerns? Unfortunately, rather limited ones. When large exchange-rate movements result from inadequate macroeconomic and structural policies within the three major economic areas, international co-operation may generate peer pressure for the adoption of appropriate corrections. When volatility arises from market uncertainties or misperceptions of actual or future policies, co-operation conducted in a transparent manner may be supportive in correcting market perceptions. A very recent example is the position the G7 expressed – in October 1999 and again in January 2000 – on the yen. Although an adjustment of the large and opposite current account imbalances of the United States and Japan arguably requires a rise in the yen/dollar rate, too rapid a rise was seen by the G7 as detrimental to the strengthening of the long awaited Japanese recovery.

What *instruments* are available to pursue such objectives? Very few, and they are rather inadequate for the task of removing “undesirable” variability from the foreign exchange market. Inadequacy pertains, in the first place, to *diagnostic* instruments. We have a sufficiently precise quantitative measure of price stability (the value of money in terms of goods and prices) and there is little controversy about its desirability. Much less can be said, however, for the value of money in terms of another money: assessing the “equilibrium” exchange rate and hence undesirable exchange rate

Wide variability of exchange rates is a cause for concern

variations is much more difficult and controversial. Second, *prevention*, i.e. measures aiming at building greater stability into the market mechanism itself, is also controversial and hardly effective. Restrictions on capital movements or “sand in the wheels” in the form of “Tobin taxes” on transactions, which belong to this category of measures, are technically difficult to enforce and would only work if all countries agreed to adopt them, which is quite unlikely. Thus, only *symptomatic cures* are left, in the form of declarations and occasional interventions. This is what key industrial countries have resorted to in the last quarter of a century. On some occasions these cures have proved effective. On the whole, however, they have not fundamentally corrected the imperfections of the market mechanism.

The institutional framework

Since the breakdown of the dollar-based adjustable peg, exchange rate co-operation among the main economic areas has completely changed. It used to be based on firm rules (for the dollar, convertibility to gold; for the other currencies, pegging to the dollar) and on an institution, the IMF, empowered to ensure their implementation. Now, there are no rules, nor does the institution play a significant role. Discussions on macroeconomic and exchange rate developments take place within the small group of G7 Finance Ministers and Central Bank Governors. In the G7 no formal decision-making procedures have been established, the IMF has been relegated to the modest role of a technical secretariat, the agreed conclusions rarely modify the policy that would otherwise be chosen and implementation of the conclusions is voluntary. No mechanism of this kind would allow policy to be conducted effectively within a country. So, nobody should be surprised by its great weakness for ordinary international policy-making. The mechanism hardly functions other than as a tool for crisis management. Indeed, only a crisis or a near-crisis provides the extra incentive to reach agreements that go beyond exchanges of views and information.

What does the introduction of the euro bring to this system? Paradoxically, it brings both a simplification and a complication; but it also brings innovations that may exert an influence in the years to come.

First, let us consider the *simplification*. By reducing to three the number of relevant players, the advent of the euro makes the process of co-operation

more efficient and perhaps facilitates the formulation of common understandings. It is true that no G3 has come into being as yet as a result of the euro, nor is this likely to come in the near future. However, the debates within the G7 have rapidly evolved from a round table of seven countries to a focused discussion on the three major economies, their situations, how they interact and the implications for the rest of the world.

Second, the euro leads to *complication*. This needs a few words of explanation. Euroland is a currency area that corresponds not to a state, but to a regional entity formed by several largely sovereign states. From an economic policy point of view, this peculiarity complicates the co-operative game because it introduces an entity, a player, where different policies (monetary, fiscal, structural) are conducted at different levels (European, national, sub-national). In other words, while Japan and the United States are single-tier entities, Europe is a multi-tier one. From an institutional point of view, the complication relates to the fact that all international organisations and forums are built on the twofold presumption that their members are countries and that policy responsibility rests with the countries. To fully accommodate the Eurosystem in organisations such as the IMF, the BIS, the G7 or the OECD would require rather difficult adjustments because Euroland is neither a country nor a single-tier policy-maker. In the present international institutional framework, both the Eurosystem and the EU still have a somewhat special position, because they cannot claim the status of full members. At the same time, the countries that have adopted the euro have also changed their positions, because they are no longer responsible for one of the key policies that form the object of international co-operation. Furthermore, in forums such as the G7 or the G10, the Eurosystem also speaks on behalf of numerous countries (eight for the G7, six for the G10) that are not members of those same forums. For procedures involving consultation and the circulation of information this is clearly a complication.

Third, the euro has brought about *innovation*. In the second half of the 20th century the foundation and development of the EU has brought two major novelties in the field of international relations: the supranational and the regional character of its construction. The euro has galvanised and further advanced such innovations. Europe, once the theatre of tragic conflicts originated by unfettered nation-

At the institutional level, the euro brings a simplification, a complication, and innovations

states, has created and successfully applied two formulas that, in my view, will also be increasingly needed in the organisation of global relations. A degree of *supra-nationalism* is a *sine qua non* condition for an effective provision of international public goods, just as a national power is indispensable for the provision of national public goods. A degree of *regionalism* in organising relations between countries is an indispensable intermediate layer in a world where the number of sovereign countries has grown to almost 200. Only the future will show whether these two innovations will find their way into the institutional profile of global forums and organisations. Working to this end should be regarded as a special task for the EU, Euroland, the Eurosystem, and the member countries.

Key currencies as anchors

The implications of the advent of the euro for the international monetary system are not confined to the relationships with the two other key currencies. They also derive from the decisions of non-key currencies seeking to anchor their monetary policy to one of the major currencies.

Unlike the three major economies, many of the almost 200 countries of the world do assign, and will probably continue to assign, a central role to the exchange rate in the formulation of their monetary policies. The reasons for this range from the smallness and openness of the economy to a need to build credibility rapidly to strong trade links with, and financial dependence on, a large neighbouring country. Over the past decades, the means most frequently chosen by “third” countries to integrate the exchange rate in their monetary policy strategy has consisted in pegging the national currency to a major currency, often the US dollar. In a world of capital mobility, this may no longer be the only, or the most effective, means. Indeed, in the aftermath of the Asian crisis, those who view pegs as being inherently unstable argued that either free floating or firm fixing in the form of currency boards or “dollarisation” should be preferred to any intermediate regime. The Mexican and the Asian crisis have actually shown that the requirements for sustaining pegged exchange rates have become increasingly demanding. Nevertheless, in the discussion, which is still ongoing, a consensus is emerging that no single formula meets the needs of all countries at any one time. Any strategy has to be consistent with coun-

try-specific characteristics, such as the size of the economy, its trade and financial linkages, and the development and soundness of its financial sector. Intermediate solutions, including pegs and managed floating, will remain the preferred option for a number of countries unwilling to go for a more radical surrender of their monetary sovereignty and yet seeking an external anchor. Regional links and political objectives will also play a role in the decision on the appropriate strategy in any specific case.

Even now, a significant number of countries, especially in central and eastern Europe and Africa, have monetary or exchange-rate regimes involving the euro in an exclusive or partial role.¹ These arrangements are mainly a legacy of past links to the former national currencies of the euro area countries. In the future, the euro can be expected to gain further importance as a reference or anchor currency for the more than 80 countries located in what could be called the “*European hemisphere*”, i.e. the European, Mediterranean and African regions. In particular, small open economies entertaining significant trade and financial links with the EU may increasingly resort to the euro as a reference currency. The group of accession countries is a prominent case. In their efforts to achieve economic and financial integration with the EU these countries will devote special attention to the exchange rate. Moreover, accession to the EU will at some point be followed by participation in the exchange rate mechanism ERM II and, eventually, the adoption of the euro. As to non-accession countries within the European hemisphere, for virtually all of these the EU is by far the largest trading partner, the base of their financial system and a counterpart in important bilateral agreements in the fields of trade, technical assistance and support for economic development. To the extent that these countries seek an external monetary anchor, the euro is the natural choice.

For the United States, and even more for Japan, a similar process of regional clustering around the major economy of the area seems less likely. In the *American hemisphere*, comprising 35 countries, regional co-operation is at an early stage of development, is mainly confined to trade arrangements, and has a weak institutional structure not involving any binding legislation or supranational powers. The NAFTA agreement is mainly a free trade

¹ For a description of these arrangements see the article entitled “The international role of the euro”, in the August 1999 issue of the ECB Monthly Bulletin, pages 31–53.

The euro will also serve as an anchor for the monetary policy of other Countries

arrangement without a monetary or exchange-rate dimension. The same holds for the Mercosur countries, whose trade links (sometimes closer with the EU than with the US) make it difficult to peg exclusively to the dollar. Of course, the US dollar nevertheless plays and will continue to play a dominant role in the American hemisphere, as the current issue of dollarisation in Argentina and Ecuador illustrates.

With regard to the *East Asian and Pacific* region, the prospects for the Japanese yen to play the role of reference currency seem remote. While the European economies moved away from the dollar standard as soon as the Bretton Woods system collapsed, Asian economies generally remained on the dollar standard for another 25 years, until the crisis of the late 1990s (partly resulting from the exchange rate regimes themselves) severed that link. Most emerging market countries in Asia have rather diversified trade connections with all regions of the world. Their external trade with Japan is about the same as that with Europe and somewhat less important than that with the United States. This configuration would hinder a peg exclusively to the yen, even though the crisis has clearly shown these countries that the yen cannot be excluded from their currency arrangements. As a result, many small open Asian-Pacific economies may continue to face difficulties in choosing a single external anchor. The financial crises of these emerging market economies in 1997-98 illustrated their vulnerability to exchange rate variability among key currencies.

Of the three key currencies, the euro may therefore be the one which develops the most important international role as an anchor. Active promotion of the role of the euro as an anchor by the EU and the Eurosystem should be ruled out, as it would be inconsistent with the key policy mandate defined by the Treaty. This role should only come about as a result of unilateral decisions by third countries. The Eurosystem will have to follow it closely and also to define its position. A fear of potential implicit constraints deriving from an expansion of the international role of the euro would be neither justified nor appropriate. Euroland is large enough, and the Eurosystem is sufficiently strong and independent, to have little to fear. After all, this role was not refused by Germany vis-à-vis the ERM countries, whose GDP in 1990 was triple that of Germany, while the total GDP of the 85 non-EU

countries of the European hemisphere is less than a third of that of Euroland!

Conclusion

This article specifically centres on a review of the implications of the euro and the Eurosystem for what has been, over around half of the last 50 years, the key aspect of the international monetary system, i.e. exchange-rate relations. On the one hand, it shows that for the relationships between the three key currencies these implications are likely to be limited. On the other hand, it gives an idea of how far-reaching the implications could be in other fields, such as the institutional framework of international organisations and forums or the monetary strategies of the many third countries which seek an external anchor for their policies. This is new ground where predictions and the formulation of a policy are very difficult.

The advent of the euro and the Eurosystem opens a new chapter in the history of national and international monetary regimes. Both Euroland and its international partners, be they the major economies of the world or smaller players, will need time to adapt to the new reality, to understand in full its implications, and to design the best policies to address them.

As Otmar Issing explains in another article of this journal, the Eurosystem quickly understood that a *monetary strategy* mechanically repeating the highly successful approach of the Deutsche Bundesbank would not have been appropriate for the newly created euro area. This is all the more true for the design of an *international policy* for the Eurosystem. The economic and financial conditions as well as the historical and political constraints of the pre-euro world were so different from what is already emerging and will become ever more visible, that using past schemes as the paradigm for the future would be misleading. A combination of firmness on the key mission to preserve price stability and of openness on the strengthening and improvement of international monetary governance is the way forward.

The advent of the euro and the eurosystem implies a new reality to which all players need to adapt