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Hansjörg Herr*

ECB Monetary Policy during the “Weak Euro” Period of 1999/2001

Theoretical Approach and Reality

The European Central Bank has often been accused of lacking transparency in the conduct of its monetary policy. This article analyses the theoretical strategy of the ECB and compares it with the policy actually pursued. Conclusions are drawn and recommendations made for future policy.

The European Monetary Union (EMU) was established in January 1999. In its first Monthly Bulletin the newly created European Central Bank (ECB) presented its theoretical approach towards monetary policy.¹ The first aim of this paper is to present the theoretical approach adopted by the ECB and to show that the ECB follows a strategy that makes it difficult for the public to understand the monetary policy pursued in the euro area. The second aim of the paper is to demonstrate that the effectiveness of ECB monetary policy in the period under discussion was restricted by the relative weakness of the euro against the dollar. I will argue that the ECB followed – without clearly informing the public – an exchange-rate oriented monetary policy.

The Theoretical Approach – The Inflation Aim

The ECB has explicitly defined its criteria for inflation. “Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area below 2%”.² The inflation target “is to be maintained over the medium term”.³ Deflation has to be avoided. In comparison with international norms, this inflation target is very ambitious. Many central banks do not have an explicit inflation target, as is the case with the Federal Reserve System; or they have a higher inflation target. The Bank of England, for example, has an inflation target of 2.5%.⁴

Concerning the ECB’s inflation target, two points must be criticised. First the ECB’s inflation band of between zero and two per cent is too narrow. During a business cycle a certain fluctuation of the price level is normal and should be allowed. A strong investment boom will lead to a temporary instance of demand inflation, which will be reduced when capacities increase. Such demand inflation is not dangerous as long it does not trigger off a cost inflation that may lead to a wage-price spiral.⁵ Keynes⁶ as well as Schumpeter⁷ argued that economic development leads to temporary inflation. If a slightly inflationary boom is arrested prematurely, it may keep an economy in a permanent semi-slump.⁸ Secondly, the inflation band of the ECB is too close to the level of deflation. The possibility

¹ Cf. ECB: Monthly Bulletin, January 1999.

² Ibid., p. 46.

³ Ibid.

⁴ For an overview of different inflation targets cf. B.S. Bernanke, F. Mishkin: Inflation Target: A New Framework for Monetary Policy?, NBER Working Paper No. 5893, 1997.

⁵ Keynes referred to demand inflation as “profit inflation”, since excess demand leads to an increase in the price level and an increase in undistributed profits. Similarly cost inflation became “income inflation” as wages and interest constitute both costs for enterprises and income for households at one and the same time. Cf. J. M. Keynes: Treatise on Money, The Pure Theory of Money, 1930, reprinted in: The Collected Writings of John Maynard Keynes, Vol. V, London/Basingstoke 1973, Macmillan.

⁶ J. M. Keynes: Treatise on Money, The Pure Theory of Money, op. cit.

⁷ J.A. Schumpeter: The Theory of Economic Development, Cambridge 1951, Harvard University Press (originally published in 1934).

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that a very low inflation rate will produce a price shock leading to disastrous deflation cannot be discounted. The ECB is quite content with an inflation rate of, say, 0.3%, and will not act to increase the price level, as this figure falls well within the accepted range. In the same situation, the Bank of England, for example, would have to carry out expansionary measures to reach the 2.5% inflation goal it has set.

The First Pillar – Pure Milton Friedman

The ECB follows a so-called two-pillar strategy. The first pillar is based on traditional monetarism. "Inflation is ultimately a monetary phenomenon. (...) To signal the prominent role it has assigned to money, the Governing Council has announced a quantitative reference value for monetary growth as one pillar of the overall stability-oriented strategy."⁹ M3 was chosen as the best monetary aggregate. According to the ECB, the growth rate of M3 should be set at a level of 4.5% per annum. The thinking behind the first ECB pillar is derived completely from the tradition of the quantity theory of money. According to this thesis, inflation is always assumed to be a monetary phenomenon – the result of an excessively large money supply. A stable relationship between the monetary aggregate and the inflation rate is assumed. A stable growth rate for the monetary aggregate is recommended, in order to keep the public from getting confused. It was Milton Friedman who made this means of determining monetary policy popular.¹⁰

The growth target of 4.5% is based on the following medium-term assumptions:

- a price stability range of between zero and two per cent
- the trend of real gross domestic product will lie in the 2-2.5% per annum range
- over the medium term, the velocity of circulation of M3 will decline by about 0.5-1% every year.

Taking these three factors into its calculations, the ECB produced a figure of 4.5% for projected growth.¹¹ The reference value of the ECB is therefore

even stricter than the monetary target of the former German Bundesbank. The latter set growth rate targets for M3 from year to year, basing its criteria on the economic conditions that prevailed in any given year. The ECB however, continues to adhere to the 4.5% reference value of M3 it set back in 1999.

These calculations are based on weak methodological foundations. It should not be assumed that past tendencies will necessarily repeat themselves in the future. For example there is no good reason to suppose that real gross domestic product trends will be confined to the 2-2.5% per annum range, and not rise as high as those that obtained during the nineties in the USA. Nobody can calculate the future potential growth rate of real GDP in Europe. The danger is that the ECB's low estimate for GDP growth will prove to be a self-fulfilling prophesy, as a higher growth rate than that calculated will automatically lead to a restrictive monetary policy that could force growth down to the level erroneously established by the ECB. It is in the absence of potential growth rate targets for GDP that central banks can carry monetary policy flexibly and effectively.

The assumption concerning the velocity of circulation of M3 is also dubious. In the past the M3 velocity of circulation (or of any other monetary aggregate) has not been stable. Even if it had been stable, this would not in itself have guaranteed that the velocity would not have changed sharply at some point in the future. In any case, as things stand, the ECB cannot be pleased with the manner in which M3 has evolved.

In Figure 1 the unstable development of the growth rate of M3 becomes clear. During the second half of 2001 especially, M3-growth rates exploded as households switched from long-term investment in stocks etc. to short-term liquidity. Such movements between "long" and "short" are typical for market economies and it was Keynes¹² who first stressed the destabilising effects of these types of portfolio shifts by the public.¹³

From Figure 1 it is obvious that the ECB did not much care about the development of M3-growth rates. In the year 2000 when M3-growth dropped and came close to the reference value, the ECB increased money market interest rates. In the second

⁸ Cf. J. M. Keynes: *The General Theory of Employment, Interest and Money*, 1936, reprinted in: *The Collected Writings of John Maynard Keynes*, Vol. VII, London/Basingstoke 1973, Macmillan, p. 322.

⁹ ECB: *Monthly Bulletin*, January 1999, p. 47.

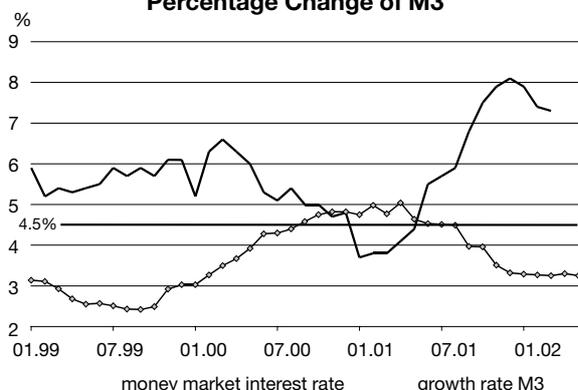
¹⁰ Cf. M. Friedman: *The Optimal Quantity of Money*, Chicago 1969, Aldine Publishing Company.

¹¹ ECB: *Monthly Bulletin*, January 1999, p. 48f.

¹² J. M. Keynes: *Treatise on Money, The Pure Theory of Money*, op. cit.

¹³ Cf. A. Leijonhufvud: *On Keynesian Economics and the Economics of Keynes*, Oxford 1968, Oxford University Press.

Figure 1
Money Market Interest Rates in the EMU and the Percentage Change of M3



Source: European Central Bank: several Monetary Bulletins.

half of 2001 when M3 rose dramatically, the ECB sharply reduced interest rates. In other words, the ECB simply ignored the first pillar of its monetary policy strategy.

The failure of the M3-rule à la Milton Friedman is not surprising. Monetarists seem to think that M3 is some kind of exogenous “money supply” that has to be kept by the public – like the helicopter money of Friedman’s thinking.¹⁴ But M3 is not a supply category. It is determined by portfolio decisions of the public and depends on the level of demand for demand deposits, time deposits, money market papers etc. If quick and strong portfolio shifts occur, neither M3 nor any other monetary aggregate can remain stable.

The Second Pillar – Unadulterated Greenspan

The ECB offers a second and completely different approach to monetary policy: “In parallel with the analysis of monetary growth in relation to the reference value, a broadly based assessment of the outlook for price developments and risks to price stability in the euro area will play a major role in the Eurosystem’s strategy. This assessment will be made using a wide range of economic indicators.”¹⁵ Some of the future price development indicators mentioned in the bulletin are wages, exchange rates, bond prices and yield curves, various measures of real activity, fiscal policy indicators, price and cost indices and business and consumer surveys.¹⁶ This second pillar of monetary policy

¹⁴ Cf. M. Friedman: *The Optimal Quantity of Money*, op. cit.

¹⁵ ECB: *Monthly Bulletin*, January 1999, p. 49.

¹⁶ *Ibid.*

has a discretionary character that owes nothing to traditional monetarism. It is, rather, in the tradition of Alan Greenspan who favours discretionary monetary policies that do not follow a monetarist-like ethos. Discretionary monetary policy is also in keeping with the tradition of Keynes and Wicksell. Both argued that monetary policy in a capitalist society has to be capable of stabilising all kinds of shocks – for example, sudden changes in the natural rate of interest¹⁷ or the marginal efficiency of capital.¹⁸ Stabilising monetary policy is only possible if central banks can act freely and are not forced to follow a rigid rule. This implies that monetary policy is an art to be practised by the right hands, and not merely a task to be surrendered to the clumsy ministrations of civil servants.

The strategic orientation of the ECB is not very clear as the bank follows two contradictory policies – a monetarist monetary law on the one hand, and a discretionary monetary policy inspired by the tenets of Keynesian economics on the other. How, one may ask, is it possible for the public to understand a muddled and makeshift policy that appears to be based on the confused teachings of John Maynard Friedman?¹⁹ The understanding of ECB policy could be improved if it abolished the first pillar of its monetary policy strategy and at the same time followed a more pragmatic approach concerning the target inflation rate.

To sum up, the ECB has not adhered to the first pillar of its theoretical approach. Monetary policy has, in fact, been shaped by the discretionary considerations that characterised its formulation in the past. The question that remains to be addressed is: which indicators mentioned by the ECB as forming the second pillar of its strategy were the most important elements in the creation of its monetary policy?

Price level or Exchange-rate Oriented?

For the ECB two indicators seem to be of special importance: prices and nominal exchange rates. These indicators are not independent of each other but they can be discussed separately.

¹⁷ K. Wicksell: *Interest and Prices*, 1898, reprint New York 1965, Kelley.

¹⁸ Cf. J. M. Keynes: *The General Theory of Employment, Interest and Money*, op. cit.

¹⁹ M. Heine, H. Herr: *Zwickmühlen der europäischen Geldpolitik: Muddling Through mit John Maynard Friedman?* in: A. Heise (ed.): *Neues Geld – alte Geldpolitik? Die EZB im makroökonomischen Interaktionsraum*, Marburg 2002, Metropolis, pp. 91 –123.

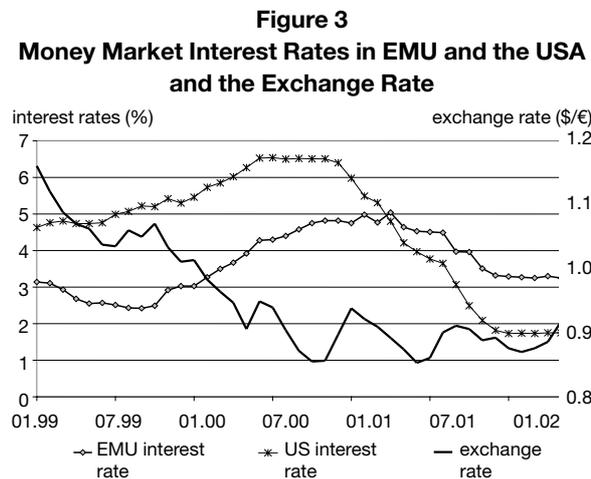
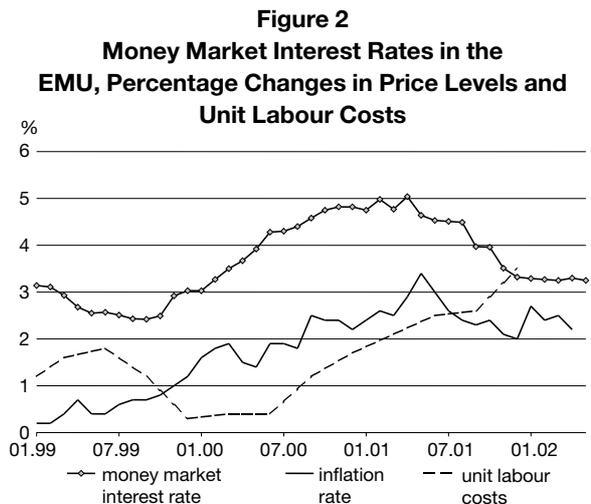
Let us start with the price level. Figure 2 shows that the ECB has not been able to achieve its inflation target. About mid-2000 the inflation rate rose above 2% and has remained at this figure until recently.²⁰ Interest rates have matched the inflation rate dynamic quite well. It would not be unreasonable to conclude that the ECB has kept interest rates in line with rising inflation rates in order to bring the latter back within the target zone. It could also be argued that the moderate price increases looked much more dramatic to the ECB than they really were, only because the ECB had adopted such tight inflationary parameters. When the inflation rate started to drop in 2001 the ECB immediately followed suit and reduced interest rates; an occurrence that would appear to confirm the argument outlined above.

Let us look at the factors behind the increase in price levels. Demand inflation was not one of the factors that led to higher price levels. There were some regions in Europe that experienced an economic boom – Ireland, for example – but in general economic growth rates were low. There were no signs of excess demand. The increase in the inflation rate was due to higher costs. Two factors were important. First, in 1999 the euro lost about 17% against the dollar (Figure 3) and this pushed up import prices. But the euro was not only weak against the dollar. In 1999, the nominal effective exchange rate showed a fall in the external value of the euro of around 8%.²¹ Also in 1999, there was a sharp increase in the price of oil. As oil prices are fixed in dollars this added to the inflationary push. Over the course of 1999 the oil price jumped from € 10.3 per barrel in the first quarter to € 23.0 in the fourth quarter. Excluding the prices for energy and seasonal foodstuffs, the inflation rate in the EMU was only 1%.²²

During the second half of 1999 it became clear that the weakness of the euro would lead to ever greater inflationary pressure. The ECB took immediate action. On November 5 the ECB increased the interest rate from 3.5% to 4%. This was the start of several interest-rate increases in early 2000. The ECB left no doubt that the weak euro triggered off the restrictive monetary policy that began in late 1999: “The exchange rate of the euro depreciated

²⁰ The small inflationary jump of the inflation rate during the first months of 2002 is due to the introduction of euro cash. In some industries – especially in industries offering services – the change from the still circulating national currencies to the euro was used to increase prices.

²¹ ECB: Annual Report 1999, Frankfurt 2000, p. 42.



further in this period. The Governing Council took the view that such a prolonged phase of depreciation combined with the significant increase in oil prices could have medium-term inflationary implications in a period of strong economic growth, and this could give rise to second-round effects on consumer prices via wage increases.”²³ The German Bundesbank came to the same conclusion: “The interest rate increases were intended to prevent external price pressures from influencing price and cost developments in the euro area and to safeguard price stability in the medium term.”²⁴ The arguments used by both the ECB and the Bundes-

²² Ibid., p. 24.

²³ ECB: The Monetary Policy of the ECB, Frankfurt 2001, p. 84f.

²⁴ Deutsche Bundesbank: Annual Report 1999, Frankfurt 2000, p. 34.

bank to justify their actions were therefore derived in toto from the Keynesian thesis that a wage-price spiral could be triggered off by a devaluation (see below).

The euro remained weak throughout 2000. Figure 2 shows that unit labour costs increased very slowly in 1999 but started to increase sharply in 2000. In 2000 the first signs of a wage-price spiral became evident, despite the efforts that had been undertaken to avoid this eventually. Wage increases in this period were not the result of high employment. They were stimulated, as Keynes asserted,²⁵ by other sources of increasing prices.²⁶ The devaluation that took place at this time led to a price increase which in turn stimulated a rise in nominal wages. Unit labour costs have continued to go up. Starting in mid-2001 the sharp rise in unit labour costs is indicative of a slowdown in the growth rate of real GDP rather than of a dramatic increase in nominal wages.

In the summer months of 2000 the ECB felt that “the exchange rate of the euro [had] moved out of line with the sound fundamentals of the euro area”.²⁷ The problem was addressed at the G7 meeting on 22 September 2002. On the initiative of the ECB a concerted intervention in the exchange markets by the monetary authorities of the EMU, the United States, Japan, and the United Kingdom took place. In November 2000 the ECB intervened again to strengthen the euro.²⁸ This was a clear sign that the ECB was worried about the weakness of the euro and was concerned about the exchange rate. The interventions in the exchange markets had some effect as the falling external value of the euro was arrested and finally halted.

The key to understanding monetary policy in Europe is the weakness of the euro. From early 1999 until autumn 2001 the value of the euro fell against the dollar by around 27%. Following this, the euro-dollar exchange rate levelled out, although it was still subject to frequent fluctuations. Central banks have to attend to nominal exchange rates for two reasons: (1) the stability

of the price level, and (2) the stability of the domestic asset market.

Let us start with the goods market. If a country devalues its currency, import prices directly or indirectly increase the domestic price level. The higher the import quota of a country, the stronger the tendency towards inflation. As higher prices reduce real wages, it is very likely that a devaluation will trigger a wage-price spiral. If the devaluation becomes pronounced, nominal wages cannot usually remain stable, as real wages would otherwise fall drastically. The higher the rate of inflation, the greater the likelihood of further devaluation, as the international competitiveness of the country would decline if such steps were not taken. In these circumstances the country in question finds itself trapped in a devaluation-inflation spiral, combined with a wage-price spiral. It can hardly be argued that the EMU was caught in a strong devaluation-inflation-wage-price spiral, but it has to be admitted that the first signs of such a development had begun to emerge. In such a situation the Central Bank has to act very cautiously to maintain its control over the exchange rate and price level, as discussed above.

The stability of the Asset Market is of even greater importance than that of the Goods Market. Fluctuations of exchange rates influence not only the price level and the international competitiveness of a country. They also determine the quantity of foreign wealth that can be obtained in exchange for one unit of domestic wealth. A devaluation of the euro against the dollar means that “euro wealth owners” become poorer in relation to “dollar wealth owners”. If wealth owners expect a future devaluation and are not compensated by relatively high interest rates in the weak currency, they will buy assets whose value is embodied and expressed in the strong currency. There is a particular danger that a country that continuously devalues its currency will be confronted with a sharp shift in expectations. Confidence in the currency may break down and trigger a destabilising flight of capital out of the country. The reaction of exchange rates to this event will exert an intensely negative effect on price levels and the cost of living of the population. Here, there is no “natural” equilibrium of the nominal exchange rate, in direct contradiction of the thesis forwarded by the neoclassical purchasing-power-parity theory.²⁹ This means the exchange rate may respond to the sequence of events set out above in an unpredictable and extreme way. In such situ-

²⁵ J. M. Keynes: *Treatise on Money, The Pure Theory of Money*, op. cit.

²⁶ Cf. H. Herr: *Wages, Employment and Prices. An Analysis of the Relationship Between Wage Level, Wage Structure, Minimum Wages and Employment and Prices*. Working Paper of the Business Institute Berlin, Berlin School of Economics, No. 15, 2002; http://www.fhw-berlin.de/fhw2000/lehre_und_forschung/working_paper_15.pdf

²⁷ ECB: *The Monetary Policy of the ECB*, op. cit., p. 85.

²⁸ *Ibid.*

ations the central bank may be forced to increase interest rates to very high levels in an attempt to stabilise the exchange rate. But in terms of growth and employment the costs of such an action are very high.

Of course in 1999 and the years that followed, the EMU was not confronted with a cumulative flight of capital. But there was the danger that the loss of external value of the euro could have gone out of control. Let us analyse the situation in 1999. In the autumn of that year, following a brief period of stability, the euro became very weak again. As well as this – and this is the key point – interest rates in the USA started to rise as the US Central Bank took measures to prevent the economy from overheating. A central bank confronted with a weak domestic currency and increasing interest rates in the leading reserve currency has not many options: it has to follow the interest-rate policy of the leading currency.

It is frequently argued that the ECB pursued a dysfunctional monetary policy. If it had not increased the interest rate it would have created higher growth in Europe. Higher growth in Europe – so the argument goes – would have increased confidence in the euro and made it a stronger currency. I do not believe this argument, even in cases where growth rates are – and this also applies to both longer and short-term periods – the key factor influencing expectations with respect to the vicissitudes of the exchange rate. The problem is that it often takes some time for growth to take place – if it occurs at all. Where the ECB policy is concerned, it is clear that the euro would have lost even more value against the dollar in the short term if interest-rate increases had not been introduced at the time. A failure to impose such increases would have stimulated inflation and led to the very real possibility of a complete collapse of the euro. Let us remind ourselves of what happened to the USA towards the end of the seventies under President Carter's administration. At that time the USA was confronted with a devaluation-inflation spiral and the flight of capital from the country. In an effort to prevent this from happening, Mr. Volcker, the then president of the US central bank, implemented a very restrictive monetary policy, which was costly for the USA and the world economy as a whole.³⁰

During the year 2001 the economic situation changed as US GDP growth rates began to drop, and the US entered a recession. The Federal Reserve cut interest rates in several steps from above 6% to below 2%. The ECB reluctantly followed the US interest-rate policy: it too implemented interest-rate cuts,

but at a later date and to a lesser degree. The result was that by early 2001, interest rates in the EMU were higher than those in the United States. At this stage it might have been expected that the dollar would have started to decline in value in relation to the euro. Such expectations, however, were not met. The exchange rate between the euro and the dollar stabilised overall but without the euro gaining in value against the dollar (Figure 3). The generally accepted explanation of this phenomenon is that the euro was not enjoying a very good reputation on the money markets and that relatively high interest rates in Europe were therefore needed to prevent the euro from falling any further in value.

It is not however quite such an easy matter to account for the weakness of the euro. Models like the purchasing-power-parity theory, which stress economic fundamentals, are not a very useful means of explaining the exchange-rate movement between the euro and the dollar. In the end the problem of the euro seems to be a political one. It is true that it is a new currency that has to establish and consolidate its reputation over time, but an even more decisive reason for the weakness of the currency is the current institutional and political vacuum in Europe. In the spheres of currency and trade Europe functions effectively as a unified state. However, in nearly all other areas – for example fiscal policy or political institutions – there is no such unity. The ongoing enlargement of the European Union and the EMU etc. continues to make matters even more complicated.

The clear conclusion to be drawn from the progress of events that have followed the introduction of the euro is that the dollar has dominated the new currency ever since its inception. In the hierarchy of world currencies, the dollar has proven itself to be the leader, and this has meant that all other currencies, including the euro, have had to submit to being dragged along in the wake of the Federal Reserve's interest-rate policy.³¹ So far the recession in the USA has not weakened the dominant role of the dollar in the world economy.

There is no guarantee that the dollar will remain a stable currency in the future. The US current account deficit is too large to be sustained indefinitely, and any reduction of net capital flows into the

²⁹ J. Robinson: *The Economics of Hyper-Inflation*, 1938, reprinted in: J. Robinson: *Collected Economic Papers*, Vol. 1, Oxford 1951, pp. 69-77.

³⁰ Cf. H.P. Minsky: *Financial Interrelations. The Balance of Payment and the Dollar Crisis*, in: J.D. Aronson (ed.): *Debt and the Less Developed Countries*, Boulder 1979.

USA will weaken the dollar. If the dollar starts to fall in value, how will the Federal Reserve respond? It is very unlikely that a restrictive monetary policy will be used to stabilise the exchange rate, for the following reasons.

- Foreign debt in the USA is denominated in the domestic currency. This means that the USA is untouched by a real-debt effect, which can result in disastrous consequences when countries whose debt is denominated in foreign currencies are compelled to devalue.
- As a strong devaluation would harm the economies in Europe and Japan, it is likely that the central banks in these countries would start to buy dollars.
- At the close of the seventies, the devaluation of the dollar failed, as it led to an inflation-devaluation spiral that ruined its reputation as a stable international reserve currency. From 1985 onwards, the devaluation of the dollar succeeded, as it did not trigger off inflation and, hence, did not destroy confidence in the dollar. It is very likely that a possible future devaluation of the dollar would have equally benign results. It seems from the evidence that there is very little chance that inflation will represent a danger to the USA in the future.
- Higher interest rates would harm the highly indebted enterprises and households in the USA. There is therefore a strong incentive for the Federal Reserve to accept less preferable terms of trade in exchange for lower interest rates and a weaker dollar.

The worst case would be one where a devaluation drew the USA back into a constellation reminiscent of that which prevailed at the end of the seventies. Then, the necessity of imposing a restrictive US monetary policy would lead to a world recession even greater than that of 1980/81. This would lead to conditions of economic hardship worldwide that would be particularly aggravated in developing countries.

Conclusion

The ECB has been compelled to follow the interest-rate policy of the USA. Due to the weak external value and low reputation of the euro, the dollar has incontestably occupied the position of the world's leading currency. At the time of writing (mid-2002) the euro remains a long way away from challenging the international role of the dollar.

The euro offers a good example of how flexible exchange rates do not automatically increase a nation's ability to autonomously pursue a domestically oriented monetary policy. Even such a strong currency area as the EMU cannot ignore nominal exchange rates. It was obviously a big illusion – one that succeeded in deceiving a great many people in the Bretton Woods period³² – that flexible exchange rates would allow individual countries the freedom to implement domestically oriented monetary policies independently of each other.

During the period under discussion, the ECB more or less followed a rational strategy to control the external loss of the value of the euro, especially against the dollar. Throughout these years there was hardly any room for manoeuvre, and the ECB had little option but to enact the policy it did. As it happens, the ECB did not inform the public of its strategy. Even worse, the inconsistent manner in which the ECB implemented the first strand of its monetary strategy only succeeded in causing confusion. In addition, the second strand of its policy was never made clear, as the ECB would not openly admit that the weakness of the euro was the key factor in the determination of the monetary policy that Europe pursued at this time.

What the world economy lacks is a cooperative monetary policy, at least between the countries that produce key international reserve currencies. Exchange-rate movements cannot be explained by fundamentals. Purchasing-power-parity theory – the nucleus of any neoclassical exchange-rate model – cannot, for example, adequately account for exchange-rate movements between the euro (previously: D-Mark) and the dollar.³³ Since the breakdown of the Bretton Woods system, exchange-rate movements have caused shocks and disturbances to national economies, which have often led – judging by domestic needs – to dysfunctional monetary policy. Better cooperation between the Federal Reserve and the ECB in the field of monetary policy, including early interventions particularly from the country confronted with appreciation, would have increased growth performance in Europe without at the same time harming the economic performance of the USA. In such a cooperative regime, of course, it would also be the ECB's responsibility to “scratch the USA's back” and help to stabilise the dollar in times of weakness.

³¹ For a discussion of the concept of a currency hierarchy cf. H. Herr: *The International Monetary System and Domestic Policy*, in: D. J. Forsyth, T. Notermans (eds.): *Regime Changes. Macroeconomic Policy and Financial Regulations in Europe from the 1930s to the 1990s*, Cambridge/USA 1997, Berghahn, p.124-168.

³² M. Friedman: *The Case for Flexible Exchange Rates*, in: M. Friedman: *Essays in Positive Economics*, Chicago 1953.

³³ Cf. P. Isard: *Exchange Rate Economics*, Cambridge University Press, Cambridge 1995.