Mr. Tietmeyer considers European monetary integration and its implications for the international monetary system Lecture delivered in honour of Professor Xenophon Zolotas, Honorary Governor of the Bank of Greece, by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, in Athens on 17/10/97.

I.

The twentieth century does not lack for experience or lessons derived from different international monetary arrangements. Now -- just before this century comes to a close -- Europe is about to embark on a new experiment with far-reaching implications: a monetary union of nation states with a supranational central bank.

Some economists see this as things coming full circle. The century began with the gold standard. It will end with a monetary union. As at the beginning of this century, at its end there will be a "denationalised" currency. Countries cannot produce this money more as they see fit. Whereas earlier this century they tied themselves to the availability of gold, in the future European monetary union the guardian of the currency will be a European Central Bank which is independent of national decision-making and which is committed solely to the objective of internal monetary stability.

Those economists who stress this historical connection generally take an optimistic view of it. They expect the single currency to bring about an economic and political commitment which is in itself strong enough permanently to compel the participating countries to abide by the rules of the game. Without the option of altering the exchange rate and without the option of an autonomous interest-rate policy, national monetary policy will not be available as an instrument for correcting a current account deficit within the Union. The only possibility will be an adjustment in the real economy.

According to this view, monetary union will have a strong disciplining effect. It will exert sufficient pressure on countries to tackle their real problems and to solve them internally, too. To that extent, it will carry on those effects of the gold standard which are regarded as having been successful. This optimistic reference to experience of the gold standard is not entirely convincing, however.

First of all, one might ask how far that view idealises the way in which the gold standard worked. That is something which historians may argue over. At all events, that era was by no means a golden age. Be that as it may -- above all, the conditions for the functioning of the gold standard were different then. Countries' government ratios were in the order of scarcely more than ten per cent at that time. The adjustments that were necessary given a change in competitive conditions -- which, naturally enough, primarily concern the private sector -- were spread comparatively widely over the major part of the economy.

By contrast, the government ratio in many European countries nowadays is around fifty per cent or more. Adjustment in line with market conditions is thus now concentrated -- more or less -- on half of the economy. Prices and wages were also more flexible a hundred years ago; at any rate, more flexible than they are now in the majority of countries on the European continent. And, above all, the government had a different perception of its own role. Its core tasks at that time were to frame and protect the domestic legal system and to pursue national interests abroad.

Nowadays, in the eyes of citizens and the electorate, the nation state and the government have a much deeper and more general economic and social responsibility for growth, incomes and employment. It is, at any rate, very optimistic under present-day conditions to assume that monetary commitment by the monetary union and the supranational central bank would only have to be strong enough and that it would then be able to enforce any desired adjustment needs automatically.

What should not be overlooked is that abiding by the rules of the game depends on countries having an adequate capacity to be correspondingly flexible, just as it presupposes the common political will to submit to those rules of monetary stability on a lasting basis. That far-reaching economic and political dimension of monetary union should not be underestimated -- precisely in the world of today and tomorrow. The abolition of the exchange rate is, at all events, an occurrence of far-reaching importance.

II.

The exchange rate is a price; one of the most important in an economy. Like all prices, its prime task is to manage allocation. Put in simple terms, this means that if the exchange rate is at a level which is appropriate to competitive conditions and if the fundamental determinants -- such as differences in the inflation rate and productivity or the conditions of demand -- remain largely constant, then the exchange rate can and should be as stable as possible, too. It is then that its information content is at its highest. And this also brings about a high degree of certainty in planning for economic arrangements.

If, on the other hand, there is a change in the fundamental determinants, the exchange rate should realign as rapidly as possible -- unless an economy is in a position to correct disequilibria quickly and efficiently by virtue of its own adjustment measures. These two requirements which exchange rates are expected to meet appear at first glance to pose a dilemma for monetary policy.

On the one hand, the exchange rate should be stable; on the other, it should react as quickly as possible to fundamental imbalances. But, given appropriate policies, this is a pseudo-problem. It is largely solved for a monetary policy which is guided by the internal objective of stability; a steady policy geared to monetary stability helps in both respects. It reduces volatility because it introduces calm into the markets. At the same time, it is the best contribution that monetary policy can make to keeping fundamentally forced exchange rate changes at a low level and to strengthening flexibility and market mechanisms domestically.

This pseudo-dilemma is then essentially solved for exchange-rate policy, too. That is because a country cannot in any case freely decide between exchange-rate systems -- say, more fixed or more flexible rates -- in line with its preferences like a visitor to a restaurant between different dishes on the menu. Fixed exchange rates presuppose the ability to cope with that arrangement. It is therefore not a matter of whether one finds less flexible exchange rates, or even their final elimination in a monetary union, “appealing” or “attractive”. The crucial point is: fixed exchange rates must be feasible and, above all, sustainable under prevailing political and economic conditions.

III.

Post-war global and European monetary history was inseparably linked for a quarter of a century with the Bretton Woods system. In origin, it was a gold exchange standard with fixed but adjustable exchange rates against the US dollar, for which there was an obligation to exchange currency for gold. At its inception there was, above all, the desire to overcome the monetary conditions of the 1930s. Competitive devaluations, far-reaching import restrictions and exchange controls seriously hindered world trade and economic cooperation between countries at that time. Against that historical backdrop, many economists rightly celebrated the Bretton Woods system as a great success.

Without doubt, it put in place important groundwork for today's high degree of openness in the goods and financial markets. Admittedly, a comprehensive assessment must not overlook at least three problem areas. Firstly, even the Bretton Woods system displayed the "vulnerability" of almost all systems of fixed exchange rates. Current account imbalances were combated too hesitantly. Corrections of exchange rates were made too late and often brought about new misalignments.

Secondly, the years in which the system flourished have to be seen against the backdrop of restricted convertibility. It was not until 1961 that most west European countries introduced full convertibility. And precisely in the United States, too, capital controls were a frequently deployed instrument into the 1960s. Incidentally, even the financial markets which -- from the present perspective -- were still not very developed at that time showed their strength in that situation. There was, on the one hand, the ability to bypass administrative regulations. The Euro-dollar market came into being as early as the late 1950s, for example. On the other, there was the ability to exert speculative pressure on a currency with an exchange rate that appeared no longer to deserve confidence.

Thirdly, countries with a better domestic stability record than the anchor country at that time, the United States -- such as Germany in the 1096s and early 1970s -- imported inflation through the fixed rate system. The expression "dollar inflation machine" was in use for a time. A firm anchor and a timely realignment of parities -- those are the basic requirements of any stability-oriented system of fixed exchange rates.

The European Monetary System established at the end of the 1970s has performed better than the Bretton Woods system in a number of respects. It has provided a better solution for the question of the nominal anchor -- without officially designating the D-Mark for that role. Rather, it is a role which the D-Mark has acquired on account of its long-standing stability and its early convertibility.

The parity-grid system permits the currency which is most stable on a long-term basis to set the standard. The anchor in the ERM is a position which can be recalled, however. Admittedly, even in the ERM there have been times when exchange rates that had become doubtful have not been corrected in time -- as the events of 1992 and 1993, in particular, showed. At all events, it was possible to guide the ERM out of the crisis by a formal widening of the fluctuation margins and largely stabilise it in the ensuing period.

IV.

Despite a number of earlier reform efforts, the Bretton Woods system eventually collapsed in 1973. Since then, the exchange rates of most European countries and of Japan have floated against the US dollar. By abandoning the fixed rates against the US dollar, monetary policy gained new freedom. From that time onwards, it has, above all, been able to pursue a domestic goal.

The initial phase in the era of flexible exchange rates was clearly marked by differences in the domestic stance of monetary policy in a large number of countries. That was apparent particularly in the 1970s when most countries were hit hard -- although to differing degrees -- by oil price movements. A number of countries -- including Germany -- were principally concerned with restoring domestic monetary stability or with ensuring that it was jeopardised as little as possible in the long term. Others attempted to use a relaxed monetary policy to cushion the adjustment needs of their economies caused by the oil price shocks.

In line with that, there came to be wide differences between inflation rates. Those differences had the following results. Firstly, the countries which gave priority to safeguarding monetary stability adapted more quickly to the new conditions and also achieved better results in the medium term with regard to the goal of employment. Secondly, a disparity arose between individual countries in terms of the reputation and credibility of their anti-inflationary stance -- some of the effects of which are still felt today. Thirdly, the plan to realise a European monetary union which was initiated at the end of the 1960s at the Hague Summit foundered before a real political decision had been taken.

The initial phase of world-wide flexible exchange rates thus up to now has two crucial messages. Firstly, the best contribution that monetary policy can make to lasting growth and employment is a clear anti-inflationary stance. In the long term, jobs cannot be "bought" by higher inflation. That was already true even in the 1970s when unemployment -- at least in many industrial countries -- was still predominantly cyclical in nature. That is all the more the case today when unemployment in Europe has largely structural causes. The permanent anti-inflationary stance of the monetary union is therefore an essential condition for Europe's future success in creating and safeguarding jobs.

Secondly, it would be disastrous for the monetary union if political differences concerning the role of monetary policy were to emerge as they did in the 1970s. That is because countries cannot pursue different monetary policies in the monetary union. That would lead to political conflicts -- with the European Central Bank, which operates supranationally, and probably also between the political opinions that prevail at the national level.

V.

That first phase with -- in some cases -- high rates of inflation initially brought the system of flexible exchange rates into disrepute. The 1980s taught new lessons, however -- at least following the change of course in domestic policy starting in France after 1983. Inflation rates gradually receded in many countries. This was a broad process. It took place in the European countries which belonged to the European Monetary System. It also took place in countries without fixed exchange rates, however. Obviously, many countries changed their orientation. External exchange rate pegging, such as to the D-Mark in the European Monetary System, certainly made that easier for some countries. But it also became apparent that what mattered crucially in the final analysis was the political will for monetary stability.

This reorientation was undoubtedly in part a reaction to the negative experience of an inflation-accommodating monetary policy in the 1970s and early 1980s. At the same time, it was made easier by the fact that over the years, together with a clear-cut target, a number of central banks had also gained greater independence. For that reason, the system of flexible (or, at least, sufficiently, flexible) exchange rates is now regarded in a certain way as having been rehabilitated. It is precisely on the condition of free movement of capital and financial markets which nowadays largely operate internationally that it can indeed exert pressure for a monetary policy geared to stability.

Another hope of the supporters of flexible exchange rates is likely to remain unfulfilled, however: the hope that speculation will always have only a stabilising impact and that, following a change in the fundamentals, the exchange rate will glide smoothly and gently to a new equilibrium level. In actual fact, the path taken by exchange rates is often quite bumpy and cannot always be explained convincingly even ex post. Overreactions are not infrequent. Obviously, expectations of future economic and political trends play a major role in the formation of exchange rates. Not only do they contribute to higher volatility because swings in mood often set in abruptly. They can apparently also superimpose themselves on current data so strongly that misalignments may occur, at least for a while. The sharp appreciation of the D-Mark against the US dollar in spring 1995 was a development of that kind.

Admittedly, a fair critic has to concede two mitigating arguments to the system of flexible exchange rates. First of all, it is undoubtedly too simplistic to blame the system for every obviously excessive exchange rate movement of currencies whose rates are formed flexibly. There are some, for example, who regard the excessive trend of the US dollar in the 1980s as the nightmare of the present global monetary system. But one has to recognise, of course, what lay behind this. It was during that period that the resolute reversal in the Fed's monetary policy under Paul Volcker coincided with the expansionary fiscal policy of the Reagan administration. In particular, US fiscal policy stood in marked contrast at that time with German fiscal policy, which was on a course of moderate consolidation.

It is quite possible to ask the question: "What other exchange rate arrangement would have actually withstood those tensions?" If anything, fixed exchange rates would probably have increased those tensions or would at least have politicised them more strongly. The Plaza and Louvre cooperation initiatives were probably the most that could be achieved at that time, although it has to be said in passing that the results were by no means only positive ones -- as is shown by the example of the development of asset price inflation in Japan, which was encouraged at that time by an expansionary monetary policy, and its consequences -- from which that country is still suffering.

As a second line of defence it can be pointed out that world trade is developing at a furious pace despite flexible exchange rates between the major international currencies. That may be due to the fact that incorrectly valuated exchange rates tend to correct themselves in the medium term. It may also be due to the fact that good possibilities are now available for guarding against sharp exchange rate fluctuations.

This can take the form of hedging operations in the financial markets. It can also take the form of a diversification of production centres. To that extent, highly volatile exchange rates can influence not only trade but also direct investment. And that undoubtedly has longer-term effects which should not be underrated. For that reason, exchange rates which are as stable as possible are, of course, important -- but more in terms of real rather than nominal stability. However, the question remains of how the objective of real exchange rate stability can be achieved as comprehensively as possible. There is unlikely to be an answer which is valid for all countries and their relations with each other.

VI.

In the current debate in Europe the question is also asked repeatedly whether the future euro/dollar exchange rate will be more stable than, say, the present relationship between the D-Mark and the dollar. Ultimately, this is an empirical question, of course. It can really be answered only in the light of the monetary union. There are a number of considerations which point in differing directions.

The euro will probably have a larger and deeper financial market than the D-Mark. That means, first of all, that the price effects will tend to be slighter when assets are switched by the individual investors and that the exchange rate will also be moved less as a result. The larger euro financial market might, however, also lead to investors generally regarding the euro -- more than the D-Mark now -- as a substitute for the US dollar. That might increase the desire to switch funds in certain situations. In that case, the exchange rate would tend to fluctuate more.

At times, one also encounters the argument that the euro area -- as a large economic and currency area -- will be relatively less dependent on foreign trade, particularly as the structure of exports is heavily diversified. The outcome would be -- at least, according to the standard textbooks -- that the euro/dollar exchange rate is not as important for Europe. This argument is undoubtedly fundamentally correct and also of significance. The comparison with other major currency areas -- such as the dollar area -- has only limited validity, however. The high share of domestic transactions is not the only reason why the United States can, if anything, neglect the dollar’s exchange rate. It can also do that because its own currency area corresponds to its national boundaries. In the United States, not only is there a comparatively high degree of labour mobility and flexibility in labour costs, there are also compensatory and cooperative mechanisms in the area of public finance at the level of national government. These are able to cushion remaining regional and sectoral tensions which cause major exchange rate fluctuations.

The supranational monetary union in Europe has neither comparable mobility and flexibility nor compensatory mechanisms in the area of public finance. This, too, reveals, the particular conditions of monetary union in Europe. In the European monetary union asymmetrical effects will probably tend to lead more quickly to a need for real adjustment in the countries or regions concerned.

VII.

The present world monetary system is, of course, not just characterised by the major international currencies floating against each other. At the same time, many countries have entered into arrangements to peg exchange rates of varying intensity. There are essentially two motives for this:

Firstly -- particularly in the case of smaller economies -- the foreign trade motive. Countries want to strengthen their international economic integration with a fixed exchange rate.

Secondly, the stability motive. By pegging the exchange rate, countries want to import credibility for an anti-inflationary stance -- particularly one which is to be newly established.

The record of these arrangements is as varied as the forms of pegging themselves. A number of emerging countries and countries in transition have had mixed experiences of pegging their exchange rates to other currencies. However useful it was for them in an initial phase to gain confidence in the international markets by pegging their exchange rate, it has almost always been the case that tensions have arisen and, unfortunately, often erupted after a few years if the trend in domestic competitiveness was not able to keep up with the anchor country on a long-term basis. That has become apparent not only for some countries in Latin America and in eastern Europe but only just recently in South-East Asia, too -- especially if exchange rates have not been adjusted quickly enough to changed competitive conditions. The prospects of a pegging of exchange rates being successful have to be seen in the context of the present-day international financial markets. Their impact on the permanence of exchange rate pegging is an ambivalent one.

On the one hand, the international financial markets can make arrangements of this kind obsolete more or less overnight if the conviction disappears that the pegging will hold. On the other hand, they encourage strategies of this kind since they offer the countries the option of financing quite sizeable current account deficits. Mainly two problems arise when pegging the exchange rate. Firstly, it may be that a country is currently achieving a comparatively high level of monetary stability but the markets still doubt the country's determination to persist with that strategy. In that case, real interest rates -- at least in a transitional phase -- are relatively high. Doubts about sustainability threaten to become a kind of self-fulfilling prophecy. That was at certain periods the French problem with its franc fort policy. Secondly, it may be that a country achieves a significant fall in inflation by pegging the exchange rate. But a certain -- if only slight -- inflation differential vis-à-vis the reference currency often stubbornly remains nonetheless. That may be due to inflation expectations from the past which are not entirely eliminated. That may also be due in part to a political deficit; a fiscal policy that fails to give adequate support to the pegging of the exchange rate or an overgenerous domestic monetary policy in the light of capital inflows.

Be that as it may, the outcome is that the currency gradually appreciates in real terms. The current account shows a chronic deficit. In a situation of that kind, a country must consider a strategy to find its way out. The fixed parity is not sustainable on a lasting basis, even if the financial markets go along with it for a time. This implies an important message for the envisaged monetary union in Europe since monetary union does not offer the possibility of a way out.

The requisite ability to achieve lasting domestic and external stability must be established and proven before entry in all the member states. That is what the entry criteria aim for. It would be a risk to hope that a country's necessary ability to achieve stability will gradually come about after entry into monetary union. Even if this were achieved over time, price competitiveness might already have been seriously impaired by then. And the catching-up process would be even more ambitious. There will, in fact, be certain regional differences in inflation rates within the monetary union. That is a normal process, to the extent that it will reflect differing trends in productivity or shifts in patterns of demand. Enormous economic tensions would occur, however, if it were also a reflection of varying ability to achieve stability and hence to accept the supranational monetary policy. Sufficient anti-inflationary convergence must therefore precede entry into monetary union, not the other way round. At all events, the reverse order would not be without considerable risks.

VIII.

It is desirable and beneficial to have as high a degree of exchange rate stability as possible against the currencies of other EU and non-EU countries, too. Stable exchange rates need convergence -- either in the sense that fundamental deviations do not occur or in the sense that existing imbalances are rapidly eliminated owing to a high level of flexibility in domestic prices and in the structure of the economy. In principle, that is a valid statement irrespective of the exchange rate system, in fact.

It just happens to be the case that in the reverse situation -- if there is a lack of convergence -- the exchange rate system plays a major role. If exchange rates are flexible, divergence in anti-inflationary policy can increase volatility but it is less dramatic overall. In turn, the degree of convergence is also lower, of course. The degree of convergence tends to be higher with fixed but adjustable exchange rates. If there is, nevertheless, no adequate convergence, costs will depend on whether there is a timely realignment. If prompt action is taken, the consequences will be contained. By contrast, if the realignments take place only under pressure from the markets, high costs can easily arise -- not just for the country itself, by the way.

A “case” like this can easily negate the credibility of a whole system or make the unilateral pegging of other countries -- even those in other continents -- more difficult. For that reason the fact that the alignment of the exchange rates in ERM II is to be made easier than in the present system is a positive development. It is to be hoped that this will prove its value in practice, too, in future.

The choice of the exchange rate system must, at any rate, be consistent with the economic and political conditions which obtain in the participating countries. A mixed world monetary system -- with floating key currencies, on the one hand, and regional integration through monetary union and fixed exchange rates, on the other -- might not be the best of all hypothetical worlds. But that system is probably the one that corresponds most closely to conditions in the real world. It is not inherently a badly designed structure or a non-system. There can indeed be appropriate graduations of flexibility that are in line with the realities.

IX.

Understandably, the question is now frequently being asked: “What place will the euro take in the future world monetary system?” The answer which is often given is the notion of a future tripolar system consisting of the dollar, the yen and the euro. That vision is, at least, not very accurate. If one wants to speak of a tripolar system at all, the weights in it will differ quite considerably. Even now, it is becoming apparent that the yen’s potential relative to the other two currencies will, if anything, remain limited. At all events, in the foreseeable future it will probably lack the regional base in Asia itself which the euro is likely to have in Europe.

But the euro will first have to earn its position. That is because an international currency essentially needs three properties:

- a high level of lasting stability
- a strong base in the real economy
- and efficient financial markets.

The euro has the potential to fulfil those three conditions. But that will not occur automatically. For that to happen, the preconditions have to be right.

Replacing the dollar as the leading currency is, however, probably not on the agenda. Monetary history has shown that a key currency being superseded is ultimately due to an internal crisis in the country in question. The former leading country loses the confidence of the markets. The capacity for domestic stability diminishes. The economy becomes less competitive. That was also the history of the decline of the pound sterling as a global key currency following the Second World War.

There are no indications whatsoever of a comparable development in the case of the US dollar. On the contrary, the dollar is a strong currency and -- despite a current account deficit and growing external debt -- the US fundamentals do not point to a change in that situation.

X.

The euro and the dollar can enter into fruitful competition, however. The world monetary system as a whole will be able to benefit from healthy competition between two currencies which are geared to stability. There are three particular factors which would promote productive competition of this kind:

Firstly, that the current high degree of correspondence in the anti-inflationary stance of the United States and Europe continues; secondly that fiscal policy in both the Unites States and Europe remains on a similar course of consolidation and -- particularly in Europe -- achieves further progress; and thirdly, that both the United States and Europe fulfil the expectations of meeting the economic challenges which they face.

The United States must demonstrate that its high debtor position and hence its future financial obligations are covered by the dynamism, efficiency and innovative potential of its economy. The Europeans must show that they are making structural changes to tackle the problem of unemployment and that they are improving their competitiveness in global markets. Productive competition of this kind does not imply a rejection of greater world-wide cooperation in economic and monetary policies with the aim of contributing to higher exchange rate stability. On the contrary, it is precisely in the future, too, that cooperation of this kind will be meaningful and desirable.

In saying this, what should not be overlooked is that exchange rates are not the actual operational parameters. Rather, they are the result of economic developments and economic policy in the participating countries. For that reason, there is one lesson which should conclude this lecture. It is perhaps as old as monetary history itself. A suitable monetary framework can help a country to carry out the structural reforms which are needed. Being a substitute for the adjustments which an economy has to make to changed conditions, however, is something which monetary policy -- however good it is -- cannot do.