COLLOQUIUM OF BRUGES : EUROPEAN MONETARY SYSTEM AND INTERNATIONAL MONETARY REFORM : 5th JUNE 1981

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THE MONETARY RELATIONS BETWEEN USA AND EUROPE : EUROPEAN VIEWS ON PROBLEMS OF INTERDEPENDENCE IN A MULTIPOLAR WORLD.

INTRODUCTION

This conference provides an excellent opportunity to detail the reactions of a European to transatlantic monetary events of the spring of 1981 and to express the concerns that may be felt in the Community : sharp fluctuations in the dollar disturb trade between the Community and the United States, may affect the price of oil and other primary commodities, aggravate tensions within the EMS, and disrupt the coordination of exchange and intervention policies.

Yet, if we were to focus entirely on today's events, we would not do justice to the complexity and to the depth of our monetary relations.

Indeed, this is not the first time that Europeans have voiced their dislike of American monetary stances. Did we not suffer from the dollar scarcity, from United States investments in Europe and from American seignorage? Later the inflationary potential of excess dollar balances left some of us aghast while others welcomed the United States dollars which - at long last - enabled them to escape the balance of payments financing constraints. How often have "substitution accounts" been discussed only to be replaced by an excessively strong dollar and inflationary prices?

THE EMERGENCE OF A TRIPOLAR WORLD

Comments of figures Table 1 and 2 annexed.

First, while the United States economic weight has decreased, its financial importance does not seem to have diminished much. On the other hand, the economic importance of the Community and of Japan has increased considerably, but this has not been paralleled in the financial and monetary field. These developments explain the difficulties encountered in managing world macro-economies as there is no absolutely dominant power as in the fifties, while the United States nevertheless still seem to hold a preponderant position.

Second, world economic integration has continued to make progress and has even accelerated. Cyclical and policy interdependence is high.

The third conclusion concerns the gradually emerging third European pole. This pole is obviously much less coherent than the other two : its foreign trade and GDP aggregates reflect to some extent only statistical magnitudes. However, the relative decline of the United States economic power and especially the exchange rate regime that has prevailed since 1973 has brought about a degree of individualization of the Community in the field of macro-economic policy that did not previously exist.

The evolution which led to the present floating regime and floating itself have "deprived" individual European countries of the organizing factor represented by the dollar. After a long period of increasing divergences and of a lack of any form of monetary organization, the coordination of monetary and exchange policies has been strengthened by the implementation of the European Monetary System which has thus resulted in an increasingly more orderly joint float against the dollar and the yen. This tends to individualize the third pole without it being possible to determine its nature exactly : for example whether it could be considered a DM zone, given the important role of Germany, or whether it could be seen as an ECU zone in which policy coordination is predominant. The third pole manifestly lacks a widely held international currency.

INTERDEPENDENCE AND FLOATING

Without taking any side in the fixed versus floating exchange rate debate, I shall try to draw from the experience of the last years to emphasize the links between policy formulation, external signals and market reactions in an interdependent world when governments take account of this interdependence in differing degrees.

The proponents of a floating exchange rate system were not only aiming at improving the technical working of the then existing system by making exchange rate changes more timely, by bringing about a more adequate exchange rate structure, or by introducing a greater degree of exchange rate or interest rate variability to take account of larger capital mobility. They were also advocating greater independence for national policies. It was claimed that exchange rate flexibility was a way to comply with what could be called the "interdependence constraint".

During the seventies we have thus observed the interplay of highly independent national policies : floating has not only strengthened the technical ability of central banks to control money supply, it has also made it possible for governements to pursue for longer periods of time different national objectives. On the other hand, floating rates have also brought new problems, that were not all expected by their proponents, such as J curve effects and destabilizing capital flows. Such problems have placed new and unexpected constraints on the elaboration of national policies.

It seems to me that three types of problems emerge when governments, encouraged by floating, follow non-coordinated policies and thus, to a great extent, "let the rate find its own level". Ranked by decreasing time dimension they are the structural and allocation problems posed in the long run, the effects of cyclical divergences on exchange rates and trade, and the dominance of monetary policy in the short run. I will now turn to them. I shall not, indeed, deal with exchange rate variability on a day to day basis at it seems to me that, within limits, it serves a useful role in inciting portfolio managers to prudence.

LONG TERM PROBLEMS

In the early seventies it was widely held that a country could support expansionary policies by a depreciating exchange rate. It was thought that, despite high inflation, such a country could not only sustain its exports and hence its employment by restoring the export industries' profit margins through devaluations, but it could also improve its industrial structure as the profits earned in the export sector would lead to investment.

For various reasons, however, the experience of the seventies has not supported the above-mentioned views with as much success as it had been predicted. Firstly, industrialists are well aware of the temporary nature of the depreciation of the real exchange rate achieved when inflation rates are high. They refrain therefore from investing their profits. Secondly, the depreciating real exchange rate grants, though only temporarily, a new lease of life to otherwise obsolescent industries; furthermore, if investments are being undertaken, they may be misallocated to industries that will turn out to be non-competitive once the exchange rate has returned to a more normal level. In any event, investments in industries whose profitability is mainly ensured by devaluation do not contribute much to the rejuvenation of a domestic industry. Thirdly, since domestic consumption is not cut back sufficiently by such a policy, there is little room for exports and investments. Finally, when inflation becomes unbearable and must be reversed, a "stabilization crisis overshooting" occurs and false signals are once more given to the markets, though in the opposite direction (see Chart II - United Kingdom).

In the opposite sense, continuously appreciating real rates, which were celebrated a few years ago as the driving force behind virtuous circles also may give rise to problems.

MONETARY POLICY : TODAY'S DEVELOPMENTS

In a situation of very high financial interdependence, the ups and downs in United States interest and exchange rates confront the European Community with difficult choices. It could eliminate exchange rate volatility vis-à-vis the dollar by pegging its interest rates to United States interest rates. In this case the Community would be guided by a variable, the movements of which are explicitly disregarded as meaningless by the very authorities who determine them. Moreover, both European interest rates and money supply would be determined by short run domestic developments in the United States and by the personalities and institutions of that country. Alternatively, the Community could itself adopt the United States procedures of giving absolute priority to quantity-oriented monetary control; exchange rate volatility could then be compounded. Imagine the extreme case in which all major countries adopted United States procedures: in these periods when short term economic fluctuations failed to offset one another, there would be extreme exchange rate volatility. It seems highly unlikely that private speculators would even it out. Thus we seem to be left with no other choice than the one we are making in practice, and that consists of a mixture of devaluation and restrictive policies, of passivity, solidarity and expressions of concern.

We must be able to find a way to subdue these strains by an enhanced co-ordination of our monetary policies. We have lost, as I have illustrated above, the "dominant country" method of organizing international monetary relationships. We have lost faith in organizing the world around perfectly flexible exchange rates. As a consequence we must be capable of finding a new solid principle around which to organize international monetary matters. Just because we have no ready solution, the problem will not go away.

.../...

The first change which is needed in this respect is one of attitudes. There was a period when "international cooperation" was in fashion; now in some quarters, the pendulum has moved to the extreme in which the wise maxim "put your own house in order first" is charicaturized as meaning that the external aspects of monetary policy are not merely to be ignored but are indeed irrelevant. I believe that we should be able to find a solution in which a recognition of the consequences for trade relationships of policy actions on our partners is in some way integrated in the process of policy formulation.

A change of attitude is, however, not enough. It is necessary to pursue some systematic improvement in the way monetary actions are coordinated among the three poles of which I spoke before.

UNITED STATES MONETARY POLICY AS SEEN FROM EUROPE : OBJECTIVES

From the abandonment of simple rules for international monetary coordination, such as fixed and freely floating exchange rates, one should certainly not draw the negative conclusion that coordination is unnecessary or automatically assured by ensuring "domestic order". Interdependence is still there and would require appropriate action even among perfectly stable and well-managed economies, as long as economic policies are positively conducted in each of them. Instead of that negative conclusion, two positive conclusions have to be drawn from the existing state of monetary relationships.

Firstly, that a much wider range of policies, objectives, instruments, etc. have to be discussed in the fora where officials discuss problems stemming from interdependence. An exchange rate rule was a simple way, perhaps too simple for our complex world, to summarize the links between partners. Today we have to engage on the much more complicated and politically delicate exercise of discussing and comparing our policies in all their aspects including some which have a less evident relationship with the external sector, like the techniques adopted for monetary control.

Secondly, to the extent to which the recognition of interdependence involves not only an exchange of information but also leads to action or to changes that are, in substance, acts of international policy, then this is closer to the "discretionary pole" of the rule vs. descretion spectrum than it would be under the simple, objective regime of an exchange rate rule.

For both these reasons, international policy coordination has become more difficult, not less necessary, than in the past and it requires that we go rather deeply into each other's "internal affairs".

CONCLUSIONS

I shall try to summarize my remarks in a few points.

First, the world monetary and economic order that prevailed in the first two post-war decades has disappeared in the seventies. The break of the double, fixed link, between gold and the dollar, and between the dollar and the other currencies, the emergence of a multicurrency reserve system, the floating of exchange rates, the shift of the power to fix energy prices from oil companies to OPEC, are all at the same time manifestations and causes of the end of that order. They are interrelated expressions of the same historical developments.

Second, that order has not been replaced by a new one. Interdependence being as close as before, and probably closer, an organization to grant "peaceful" economic and monetary relationships is as necessary as it was under the old order provided by the "pax americana".

Third, in the existing world institutional setting, problems stemming from interdependence can only be dealt with by way of bi- and multilateral consultations, in the (perhaps too) numerous fora where officials and/or politicians meet : OECD, IMP, G-10, Summits, etc. The assumption on which such consultations are made is an acceptance of the proposition that each member's policies have effects on their parteners, and that it may not always be true that what is good for one is good for the others. A denial of this proposition by one of the partners is a dangerous step, particularly when none of the partners is sufficiently strong and well-behaved to impose order on the others.

Fourth, when there are no agreed rules (like, in the past, fixed exchange rates), and severe stagflation makes policy choices politically very hard, consultations are a difficult and fragile instrument to deal with interdependence. In such circumstances, consultations have to touch upon a wide range of policy objectives, instruments, and techniques.

Fifth, if asked to speak out about US policies in a consultation round, I would say that there is little reason for a European to disagree either with the high priority given to anti-inflation policy in the US , or with the importance given to the control of monetary aggregates. However, the choice of techniques of monetary control unnecessarily increases the strains imposed by a tough monetary policy both on the economic system and on the external partners. The relief coming from improved techniques would, however, be marginal. On the other hand, an approach to exchange rate policy based on a rule of no intervention is hard to accept for European countries. As the exchange rate involves two currencies, disagreement in this area is particularly undesirable.

Sixth, and last, the fact that there may be only limited disagreement on US policies means that we recognize that these policies are good for the US. It does not mean that they are good for their partners, or that they do not hurt. For several European countries, in particular, the level of real interest rates necessary to keep their currency from depreciating to a level inconsistent with economic fundamentals, is much higher than the level required for domestic reasons.

Thus, the ball comes back into our court. What can we Europeans do to get out of this impasse ? Two things, I would say : to show that our approach works in practice and to be united. And, I would add, these two things largely coincide. That opens up another field, that I shall not explore here. But to put in a nutshell what ought to be said in this respect, I could find no better words than those used by Anthony Solomon less than three years ago :

"If we can't lead the way, through meaningful policy coordination between the US and Western Europe, there is little reason to expect broader success. Understanding of each others perspectives is prerequisite to building a stronger relationship. We should acknowledge and build on our mutual successes. Close US-European cooperation dominates the post-war record. But there are also irritants and sources of tension. The United States continually hears European calls for stronger US leadership in the economic area and specifically in the monetary area. Yet when the United States does attempt to exercize leadership, there is frequently a notable absence of European willingness to follow. This is not a recent phenomenon. It is understandable if there are differences of view over the substance of such questions. There inevitably will be. The substance can be debated. But Europe itself has and should acknowledge a growing responsibility to exercize leadership, not only in the expression of its view, but in contributing to the solution of common problems. The responsibility cannot be one-sided, and Europe collectively has major potential for leadership of its own. What is not constructive is for Europe to cloack its substantive disagreements, and avoid accepting its own responsibilities, by resting on accusations of failure of US will and leadership. Much of the problem may well relate to the particular phase of European efforts to unify through the Community, it is in a unified Europe that real and constructive leadership becomes possible. But the present decision-making processes make that possibility difficult to realize. Hopefully, this problem will evaporate as the unification process evolves - it is generally least evident in the trade area, where the European Community has formal competence - but it does represent a real impediment to meaningful policy coordination on a global scale".

TABLES AND CHARTS

Table 1: Some structural characteristics of the world economy

	1960	1965	1970	1975	1979
1. EC and Japan GDP as % of US GDP					
EC-9	54	62	64	90	102
Japan	n.a.	13	21	33	43
2. Relative shares in world trade (excl.intra-EC trade)					
EC-9	26	26	24	22	24
Japan	5	5	8	8	9
USA (1)	15	15	18	15	18
3. Openness : imports of goods and services as % of GDP					
EC-9 (2)	12	11	11	13	14
Japan	-	9	9	12	13
USA	4	4	5	7	10
4. Productivity (in ECU, at current prices and exchange rates)					
- GNP per capita					
. Japan	n.a.	,853	1,937	3,631	6,367
. USA	2,655	3,306	4,685	5,761	7,777
. EC-9	1,105	1,627	2,438	4,290	6,735
- GNP per employed person					
. Japan	n.a.	1,631	3,682	7,242	13,119 (3)
. USA	6,765	8,332	11,107	13,437	16,330
. EC-9	2,528	3,828	5,903	10,717	16,739
- Compensation per salary earner					
. Japan	n.a.	n.a.	2,434	5,702	10,172 (3)
. USA	4,474	5,351	7,553	8,986	11,095
. EC-9	1,640	2,487	3,820	7,427	11,165

Source: Eurostat
All figures are rounded.

(1) US : Fob + 10 per cent
(2) Excluding intra-Community trade and services (estimated)
(3) 1978

Table 2: Currency composition of international financial assets

A. Currency denomination of Euro-market liabilities (1)

	1968	1970	1971	1973 (2)	1974 (2)	1975	1976	1977	1978	1979	1980
US dollar											
estimate A			76	73	77	78	79	76	74	72	75
estimate B	80	78	72	68	71	73	74	70	68	65	69
Deutsche mark	9	11	15	17	15	15	15	17	18	19	16
Japanese yen								1	1	1.5	1.5

B. Currency denomination of official reserves (3)

	1968	1970	1971	1973 (2)	1974 (2)	1975	1976	1977	1978	1979	1980
US dollar				85	84	85	87	85	82	78	
Deutsche mark				6	7	7	7	8	10	12	
Japanese yen						1	1	1	2	4	

All figures are rounded.

(1) Source A: Morgan Guaranty Survey; an estimate relating to non-European as well as to European markets.
All other data: BIS, Currency breakdown of external positions of banks in the reporting European countries.
(2) The figures for official reserves refer to 1973 I and 1974 II respectively.
(3) IMF, Annual Report, 1980

CHART I TWENTY YEARS OF US-EUROPEAN MONETARY RELATIONS

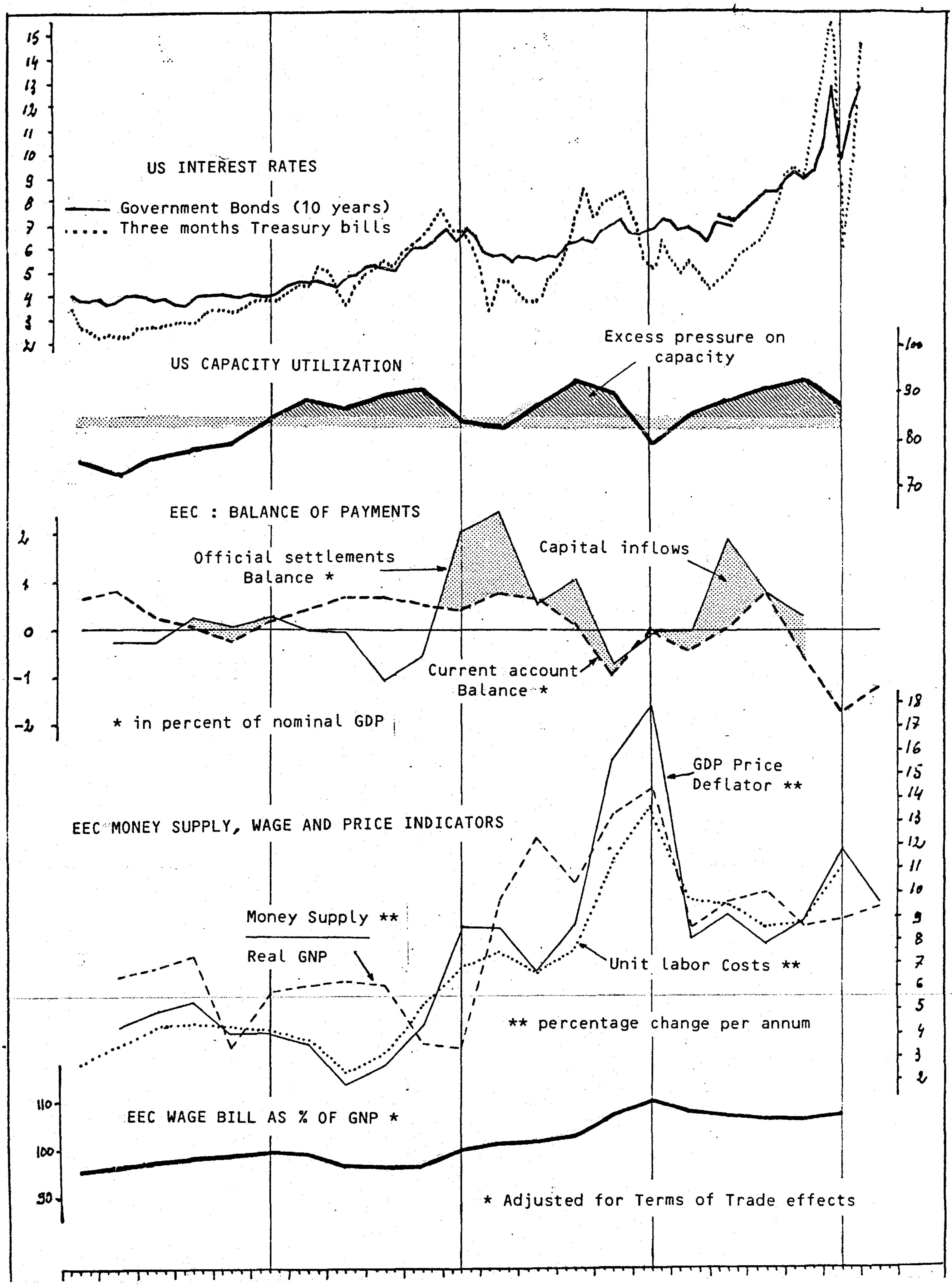


CHART II

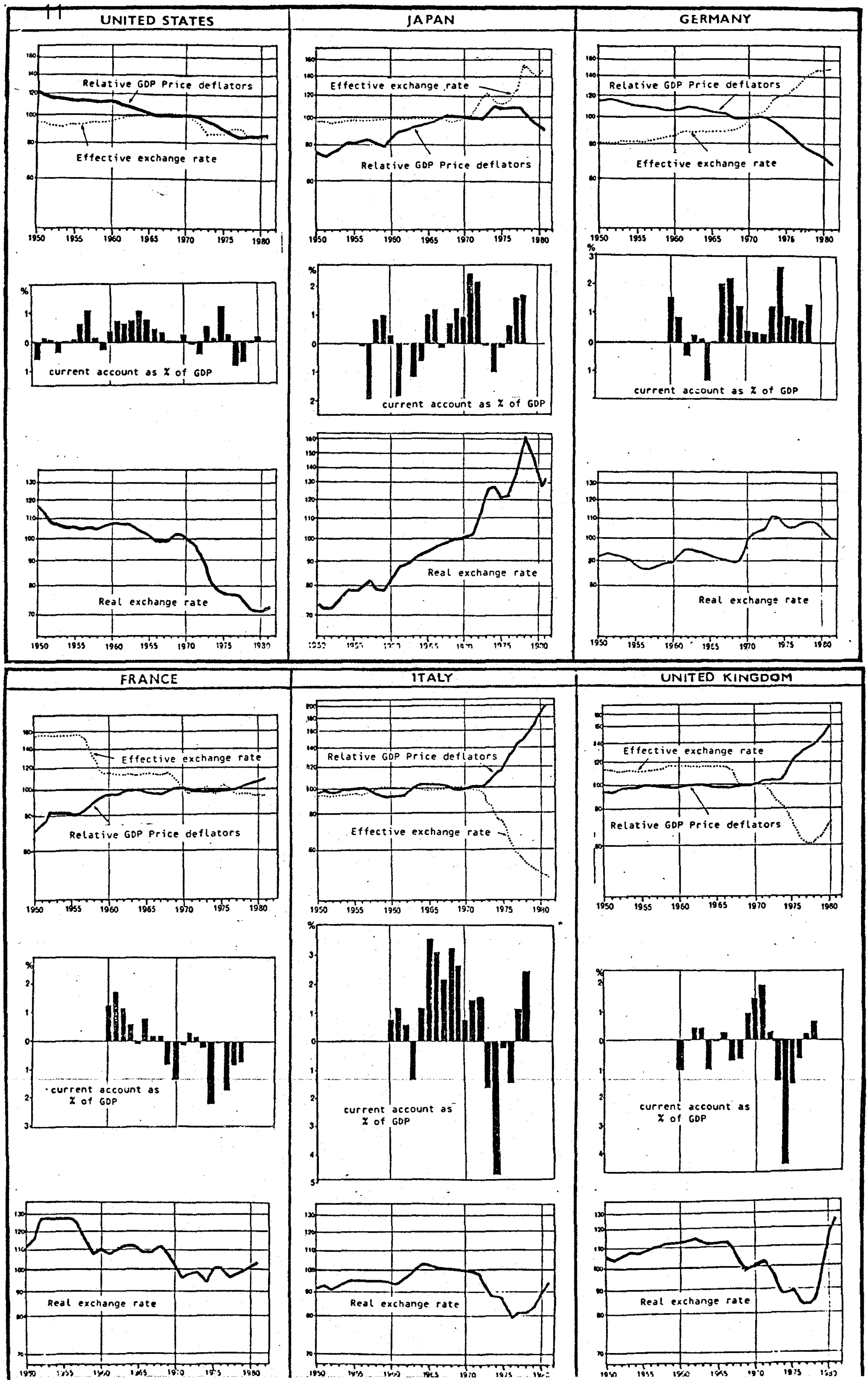
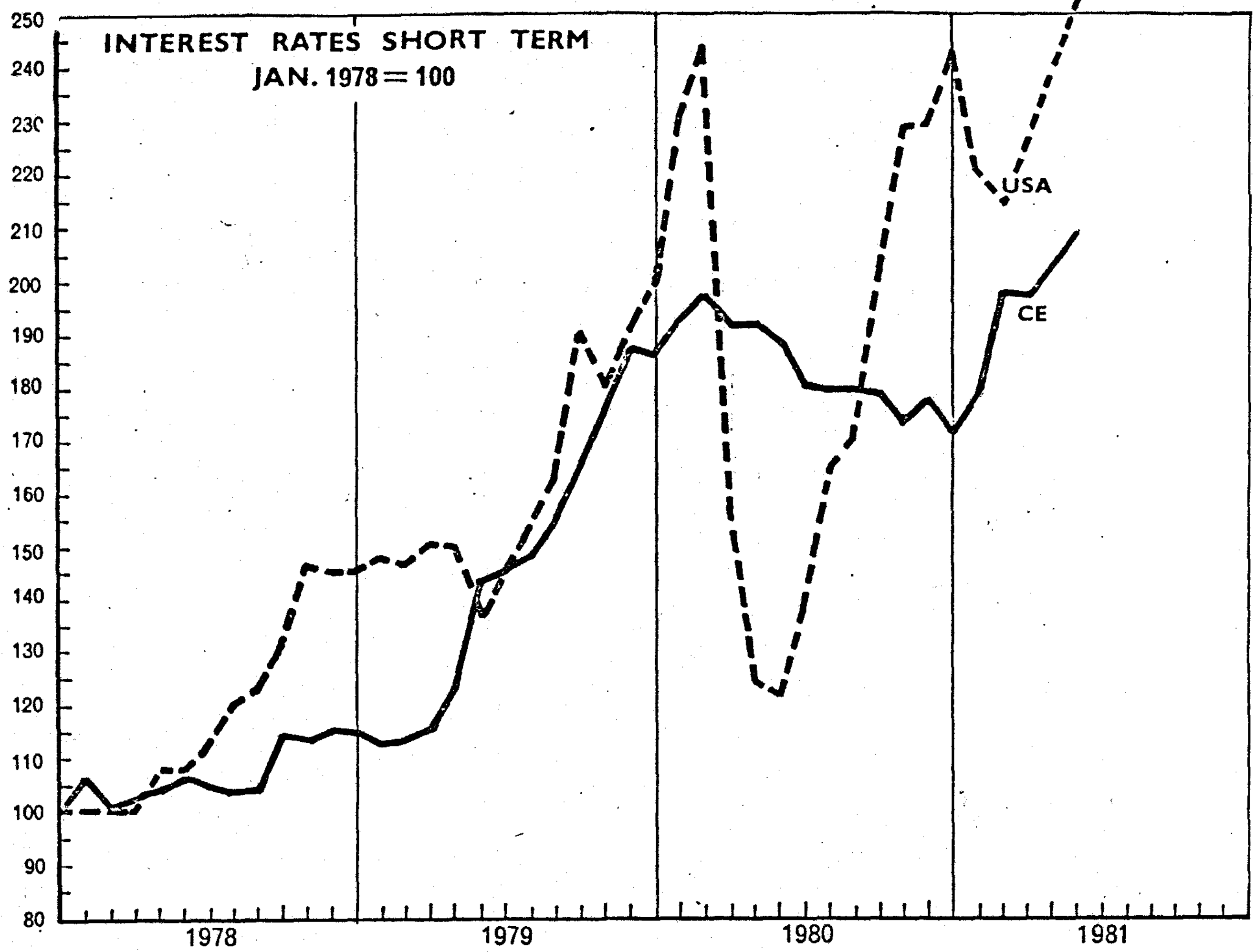

UNITED STATES
Relative GDP Price deflators
Effective exchange rate
current account as % of GDP
Real exchange rate
JAPAN
Effective exchange rate
Relative GDP Price deflators
current account as % of GDP
Real exchange rate
GERMANY
Relative GDP Price deflators
Effective exchange rate
current account as % of GDP
Real exchange rate
FRANCE
Effective exchange rate
Relative GDP Price deflators
current account as % of GDP
Real exchange rate
ITALY
Relative GDP Price deflators
Effective exchange rate
current account as % of GDP
Real exchange rate
UNITED KINGDOM
Effective exchange rate
Relative GDP Price deflators
current account as % of GDP
Real exchange rate
1950
1955
1960
1965
1970
1975
1980

CHART III


INTEREST RATES SHORT TERM
JAN. 1978 = 100
USA
CE
250
240
230
220
210
200
190
180
170
160
150
140
130
120
110
100
90
80
1978
1979
1980
1981

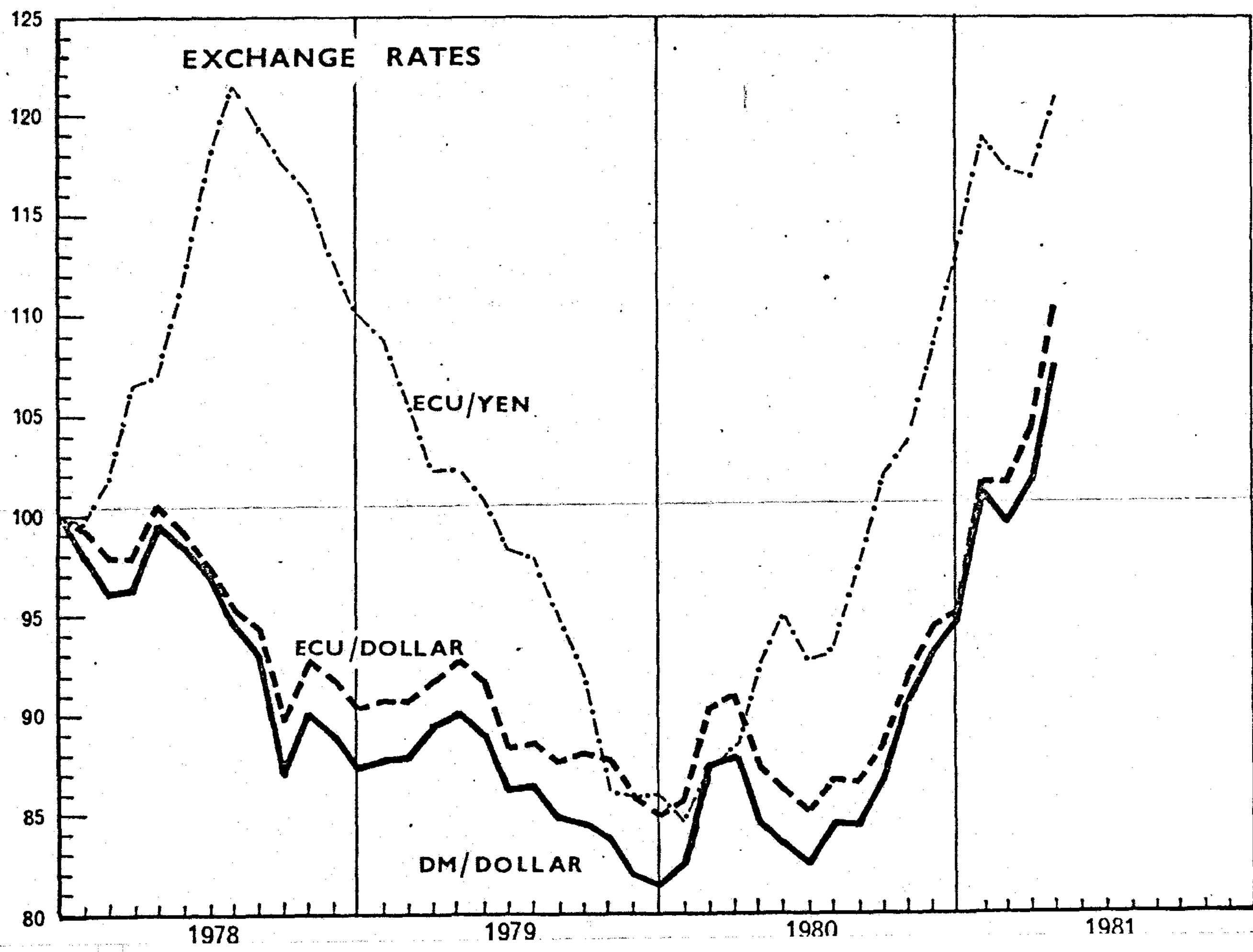

EXCHANGE RATES
ECU/YEN
ECU/DOLLAR
DM/DOLLAR
125
120
115
110
105
100
95
90
85
80
1978
1979
1980
1981

CHART IV

FLUCTUATIONS OF THE DM AGAINST THE DOLLAR AND IN THE EMS BAND

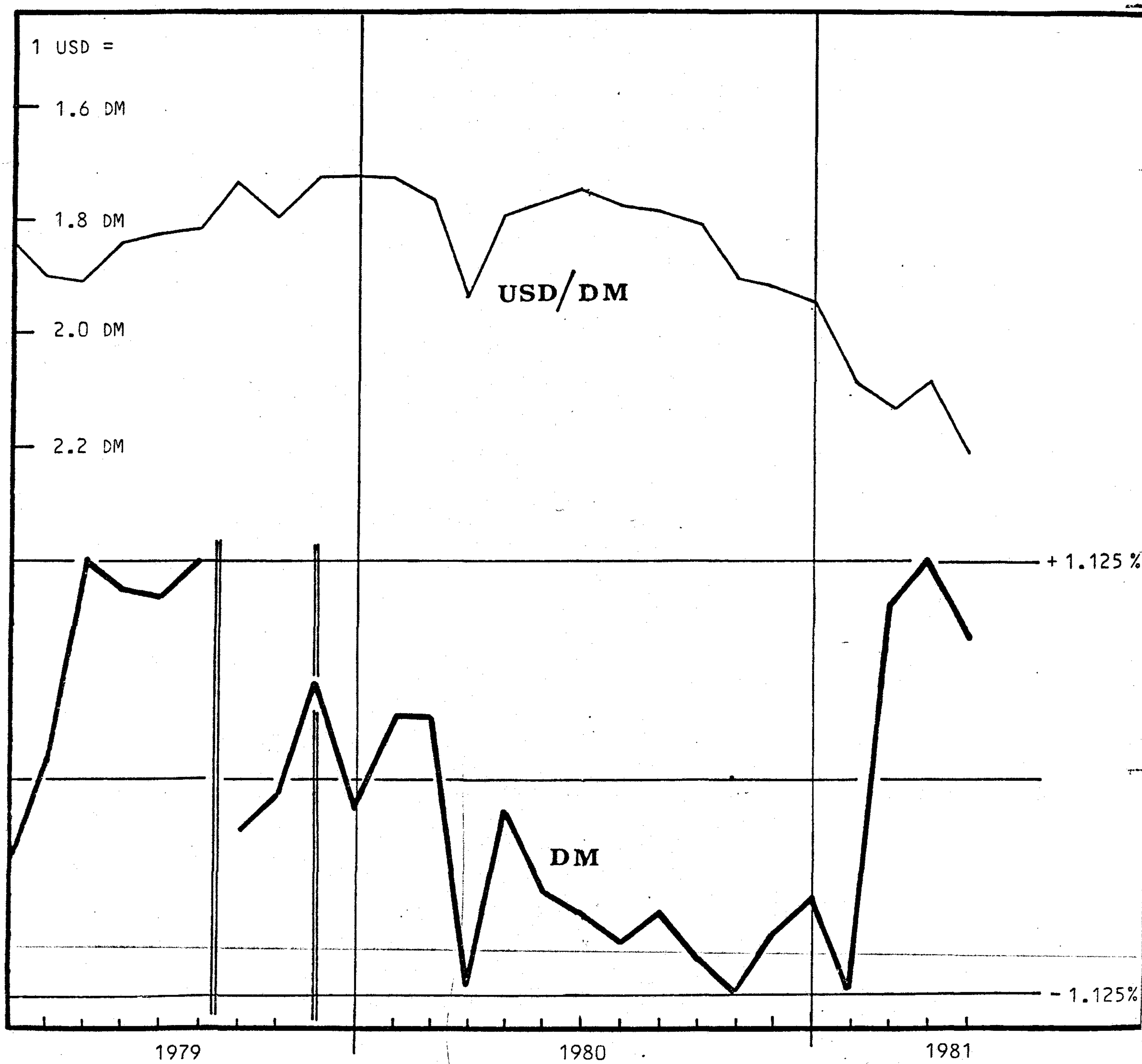


CHART V — CONSUMER PRICES AND SHORT TERM REAL INTEREST RATES