

Per Jacobsson
Lecture



The Road to European Monetary Union

**Lessons from
the Bretton Woods Regime**

Alexander K. Swoboda

**The Aula
Basle University
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Foreword

Alexander K. Swoboda, Director of the Graduate Institute of International Studies at Geneva and Board Member and Executive Director of the International Center for Monetary and Banking Studies, also at Geneva, delivered the first of the two Per Jacobsson lectures held in 1991. The title of his lecture was "The Road to European Monetary Union: Lessons from the Bretton Woods Regime." The lecture was held at the Aula of Basle University, in Basle, Switzerland, on June 9, 1991. Sir Jeremy Morse, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

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Opening Remarks

Sir Jeremy Morse

Good afternoon, ladies and gentlemen, and welcome once again to the Per Jacobsson lecture. This is the twenty-eighth lecture and the seventh time that we are in Basle. We are once again immensely grateful to the Basle University for allowing us to use this magnificent Aula for the occasion. We are privileged to have with us the Rector of the University, Professor Pestalozzi, and I would now ask him to say a few words to us.

Professor K. Pestalozzi

Sir Jeremy Morse, Professor Swoboda, ladies and gentlemen: I welcome you to our University for the twenty-eighth Per Jacobsson lecture. It is being delivered for the seventh time in Basle, where Per Jacobsson worked and where he is buried. In a sense, these lectures are a substitute for the service as honorary lecturer at Basle University which Per Jacobsson had hoped to provide, but did not live long enough to render. Hence, this hall is an appropriate venue. As you know, Basle shares the Per Jacobsson lectures with other cities throughout the world, mainly Washington, but also Rome, Rio de Janeiro, and Tokyo; the next one will be delivered in October in Bangkok. These lectures thus document how internationally connected Basle is in some ways. This point is undoubtedly so obvious to you, ladies and gentlemen, that there is no need to dwell on it. But I bring it up because I am experiencing it personally today, together with the way that the relaxation of international tensions relates to national attachments and local traditions. Our grand assembly, the Parliament of the Basle Town canton, held a commemorative session this morning on the seven-hundredth anniversary of the Swiss Confederation, followed by a commemorative service at the cathedral and a public feast for the townspeople on the cathedral square. This morning, with its political, religious, social, and culinary events, was national; the afternoon, with its scholarly reflection on the functioning of the abstraction known as

money, will be international. It would be hard to imagine a more striking expression of the tension we are experiencing and which we as Swiss people must now deal with in ourselves and in public life.

The University today is especially subject to this tension. Scholarship, or, more precisely, the various disciplines, live by worldwide dialogue, for which no borders are permissible. The measure of scholarly quality in research and training is the recognition it achieves in the international republic of scholars, however difficult it may be to quantify this recognition. The unity of teaching and research on which a university must insist to avoid becoming a grammar school is intended, among other things, to enable it to maintain international standards. But the university has a local sponsor as well; in Switzerland, the cantons are the universities' sponsors, and in our particular case that means the cantons of Basle Town and Basle Country. The sponsors are entitled to a say in what the university teaches and researches. This is especially true of Basle, for Basle is a citizens' university, founded by the people, supported by the people, and existing for the people. I shall merely note in passing that the local people are now working to expand the role of the Country canton. But the university, at the present moment in history, is asked not only to serve these two masters—international scholarship and the local sponsor—but also to help achieve a balance between them. A major effort is now under way to draw Swiss universities into the international student exchange programs, especially ERASMUS, organized by the European Community, thus making the universities crucibles of a European international awareness. At the same time, we of course recognize that the exchange programs make sense only if the individual universities preserve their local and national characteristics. If things are the same all over, exchanges are senseless.

Ladies and gentlemen, the institution that you represent can contribute to this equilibrium from the other side—the international side. That is the way I interpret the fact that the Per Jacobsson lectures keep returning to Basle, their starting point, where Per Jacobsson worked. If I understand the subject that Professor Swoboda is going to discuss today, it has to do with getting from national egoisms to European and, ultimately, world unity. This is the spirit in which I welcome you to today's event. [Delivered in German.]

Sir Jeremy Morse

Thank you very much, Professor Pestalozzi, for your welcoming words. I am sure that the combination of the civic strengths of the University with the national celebration of 700 years and the international themes we're about to discuss would have appealed very much to Per Jacobsson.

In addition to the University, we also have to say a quick, but nonetheless sincere, word of thanks to the Bank for International Settlements. Not only does the Bank feed our bodies most beautifully, it also made all the arrangements to allow us to feed our minds this afternoon. We thank you very much, Alexandre Lamfalussy, for these arrangements.

Our lecturer this afternoon is Professor Alexander Swoboda. You have his biography in the program. He was born in 1939. As you can deduce, his family roots were in Eastern Europe, but he has lived in Switzerland since his infancy. His university studies were in the United States and he has been active all over the world in discussing exactly those macroeconomic questions which would have delighted Per Jacobsson. The title of his lecture, intriguingly, blends two such major areas of questions—"The Road to European Monetary Union: Lessons from the Bretton Woods Regime." We will follow our usual format—a lecture of 40 to 45 minutes and then some 20 minutes or so for questions. You have at the back of your program a sheet for written questions, but I shall give preference to questions from the floor because I think it will be more interesting if you stand up and ask your question. There will be a roving microphone when we come to the question period. Professor Swoboda.

The Road to European Monetary Union: Lessons from the Bretton Woods Regime

Alexander K. Swoboda*

The Delors Committee's *Report on Economic and Monetary Union in the European Community* has given renewed impetus to an idea that dates at least as far back as the Werner Report of 1970 (and in fact much further back). Following the Werner Report, the member states of the European Community (EC) affirmed, in March 1971, their "political will to establish an economic and monetary union." It has thus taken some twenty years for that political will to find expression in a concrete plan to move toward European monetary union (EMU) in three relatively well-defined stages and according to a calendar on which a measure of agreement is beginning to emerge.

The collapse of the Bretton Woods regime in August 1971 was, or so it has been claimed, in good part responsible for the failure of the Werner Report to give birth to more than the ill-fated snake and thus for its failure to usher in an early monetary union in Europe. It is also often claimed that the Bretton Woods experience casts doubt on the ability of a fixed exchange rate regime of the EMU (or most any other) variety to function properly in today's circumstances. When Jacques Polak asked me to choose a theme for this lecture, I therefore thought it appropriate to try to reassess the functioning of the Bretton Woods regime and to draw some lessons for the prospects and proper design of a European economic and monetary union. It seemed all the more appropriate to do so in a lecture honoring the memory of Per Jacobsson who, in his many years as economic adviser to the Bank for International Settlements, was intimately involved in the European payments union and, as Managing Director of the International Monetary Fund, presided over the return to external convertibility by ten European

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countries in 1958, which marked the beginning of the full-blown functioning of the Bretton Woods regime.

However, I also realize that my choice of topic was rather reckless in view of today's audience. Who am I to address such a distinguished group of central bankers on a topic they live with from day to day, commenting on the history of a system that they have had a major influence in shaping? So it is with a sense of awe, magnified by the overly kind words of introduction of Sir Jeremy and Professor Pestalozzi and by the majesty of this hall, that I broach my topic.

I will begin with a brief review of the major issues that arise on the road to EMU. I then proceed to an analysis of the monetary regime that characterized the 1960s before drawing some tentative lessons for EMU. In providing a further assessment of the prospects for monetary union in Europe, however, one would be remiss today not to ask whether the experience of German monetary union should not raise a serious cautionary note as to the desirability of a rapid transition to EMU. I do so before concluding on a more general note.

I. ISSUES ON THE ROAD TO EMU

It is perhaps not surprising that there should be little disagreement as to where the road should lead: full economic and monetary union with one currency within the EC. After all, we are all for good and against evil. Though even here, some argument may arise: would it not be better to aim for a universal worldwide money or, on the contrary, for a world in which there is no very large currency bloc? But let us grant the final aim of EMU. It is about the layout of the road, the means of transportation, and the speed at which we should travel that questions arise.

The Delors Report, together with subsequent documents such as the EC's "One Market, One Money" study, maps out one path to EMU and provides one set of answers to these questions. The essentials are simple. The end point is one market, one money for all member countries. There are three intermediate stages. The first, which formally began on July 1, 1990, foresees the completion of the single internal market by the end of 1992, increased policy coordination to achieve greater convergence of economic policies and performance, and participation by all member countries in the narrow band of the European exchange rate mechanism (ERM).

Member countries, with the exception of the United Kingdom, seem to have agreed that the second stage could begin on January 1, 1994, subject, however, to further real and monetary convergence and ratification of the appropriate amendments of the Treaty of Rome. That second stage would mainly see the establishment of the European system of central banks whose role would be to strengthen the coordination of monetary policies and to develop "the instruments and procedures needed for the future conduct of a single monetary policy." At the same time, there would be a continued narrowing of the band of permissible exchange rate fluctuations within the ERM. This would serve to usher in the third stage, the irrevocable fixing of parities and, eventually, the move toward a single currency. In the third stage, the European system of central banks would in essence become the European central bank, whose responsibility it will be to conduct what by then will be the Community's single monetary policy.

Let me regroup the numerous questions this scenario raises into three broad sets of issues.

There are, to start with, four questions that concern adjustment within the Community once exchange rates have been irrevocably fixed and, therefore, national monetary policies are no more. First, will there exist appropriate adjustment mechanisms, that is, mechanisms that are not overly costly for member countries in terms of internal balance, once the exchange rate instrument is no longer available? Part of that first question is whether fiscal policy can substitute for the exchange rate as an instrument. Second, there is the issue of whether, and how, EMU can provide for fiscal discipline in the sense of avoiding an explosion of the debt-to-income ratio of member countries. Third and related to the first two, one must ask whether coordination, and in what form, can ensure an appropriate fiscal stance for the Community as a whole. Finally, does monetary union call for reinforcement (and greater centralization) of regional and distributional policies?

There is, second, a series of questions that concern the design of the European system of central banks and of the European central bank as well as the common external policy of the monetary union. Third and finally, many questions arise regarding sequencing and the speed at which it would be desirable to travel on the road to EMU. Should convergence of economic performance precede the narrowing of exchange rate margins (the old economists versus

monetarists controversy)? Should setting up of the European central bank take place during the second stage or only at the beginning of the third, and so forth? What exactly should the nature of that second stage be and, more generally, how fast should one proceed through the various stages identified in the Delors Report? Do remaining differences in inflation rates and in economic structure argue for a two- or even three-speed approach to EMU?

Obviously the experiences of Bretton Woods and German monetary union cannot provide answers to all these questions. Nevertheless, on the basis of those experiences and of more general considerations, I will try to answer some of them. I will argue that the Bretton Woods experience suggests, contrary to conventional wisdom, that there are appropriate adjustment mechanisms in a fully fixed exchange rate regime but that, as German monetary union suggests, measures aimed at convergence of social and distributive policies are the very thing that is not needed. I will also argue that the required degree of further "convergence" in inflation rates and macroeconomic policies of the core ERM countries is minimal, but that there may be a case for a two-speed approach to monetary union. I will further argue that there is a case for keeping stage 2 short and devoted to institution building, and that, more generally, monetary union in Europe, if it is to proceed according to the Delors plan, will have to take place sooner rather than later.

To buttress some of these conclusions, let me turn first to a reading of the experience of the Bretton Woods regime.

II. THE BRETTON WOODS REGIME

The Conventional View

By the Bretton Woods regime I mean here the way in which the industrialized country core of the international monetary system actually functioned from the return to external convertibility of the major currencies in 1958-59 to the breakdown of the system in August 1971. The standard view of how that system functioned is that of a gold exchange standard with fixed but adjustable parities. In that system, the International Monetary Fund played the role of guardian of parities and of current account convertibility, of grantor of credits to facilitate adjustment, and of monitor of adjustment policies when severe external disequilibria arose. The special place

of the United States in the system arose from that country's role as dominant supplier of foreign exchange reserves to supplement a growth in the stock of gold that was insufficient to meet a growing need for international reserves.

Critics of the regime found that it did not adequately solve what by then had become the standard trilogy of problems of any international monetary system: adjustment, liquidity, and confidence. In the absence of downward flexibility of wages and prices and with domestic policies targeted to internal balance, exchange rates were far too rigid to supply the needed instrument for external adjustment. The burden of adjustment was, in any event, deemed to fall unjustly on the deficit countries by some, on surplus countries by others. The supply of international liquidity was inadequate, too large for those who feared inflationary pressures on the world economy, too small for those who feared deflationary pressures. And, in any event, there was no adequate mechanism for ensuring its growth, which had to depend on the vagaries of gold production and hoarding, on the irregular increase of Fund quotas and later SDRs, and mainly on the state of the balance of payments of the United States, whose deficits were the main source of growth in international reserves. Finally, confidence crises could, nay would, arise whenever the parity between different reserve assets was put in doubt by shifts in relative demands or supplies of those assets. These three problems were of course intimately linked. Thus, the very fact that a strong currency becomes used as an international reserve asset weakens confidence in it. This is the classic "Triffin dilemma," which arises as the center country's ratio of owned international assets (for example, gold) to external liabilities (for example, dollars) declines: Either the growth of international liquidity is lowered in order to prevent a further deterioration of the gold-dollar ratio, thereby threatening a deflationary crisis, or dollar holdings are allowed to expand, thereby threatening a confidence crisis.

To explain the breakdown of the Bretton Woods regime, conventional accounts emphasize these and other more specific defects of the system. According to these accounts, the explosion of the U.S. balance of payments deficit between 1969 and 1971 signaled the end of Bretton Woods. The breakdown of the system was brought about by overvaluation of the dollar due to nominal exchange rate rigidity which, combined with divergent inflation trends, created

mounting disequilibria in real exchange rates and lasting trade imbalances. Speculation set in and, with huge amounts of capital floating around freely in the Euromarkets, resulted in an explosion of dollar liabilities to foreigners, loss of confidence in the U.S. currency, and the crisis of August 1971. Note that these accounts emphasize the role of disequilibrium real exchange rates, brought about by persistent inflation differentials in the face of rigid nominal exchange rates, in generating unsustainable trade imbalances and the role of "speculative" (somehow autonomous and irrational) capital movements in magnifying balance of payments disequilibria.

An Alternative View

In the alternative (though not necessarily antithetical and in some ways complementary) explanation of the breakdown of the Bretton Woods regime that I would like to put forward, the emphasis is on other factors. That explanation finds its roots in a modified global monetarist view.

In that view, the international monetary system functioned, between 1959 and 1971, like a monetary union. Parity changes were relatively few, inflation rates converged to the world average, monetary disequilibria were rapidly reabsorbed by changes in the world average rate of inflation and by international reserve flows (the counterpart of payments deficits and surpluses), goods and capital markets became closely integrated. Capital flowed not in response to the irrational whims of speculators but in economically correct response to the incentives provided by the trends in the national macroeconomic, and more specifically monetary, policies of the times.

What needs explanation in that alternative view is the determination of the fixed exchange rate industrialized world's average rate of inflation. Indeed, convergence of national inflation rates was sufficient, this view asserts, to be able to speak of a world rate of inflation. Moreover, under fixed exchange rates and at least in that part of the world that is economically closely integrated, it makes sense to think of "world" variables such as the world price level, rate of inflation, nominal income, or nominal interest rate as being determined by world aggregates such as the world money stock. The latter is defined as the aggregate of national money stocks converted into the same currency at the prevailing parities. In turn,

the specific institutional arrangements of the prevailing fixed exchange rate system, most notably international reserve holding patterns, play a crucial role in the determination of the world money stock.

More specifically, it is goods arbitrage, reinforced by changes in aggregate spending brought about by reserve flows, which will ensure in the medium run a high degree of convergence in national inflation rates. This does not mean that there will be no observed difference in national inflation rates but that there will be a strong common trend in these rates. Observed deviations from the common trend would then reflect one or several of the following four factors: nominal exchange rates that are not strictly fixed (occasional changes in parity and movements within intervention margins); statistical discrepancies in the collection and construction of price indices across countries (so-called errors of measurement); changes in equilibrium real exchange rates (so-called real disturbances); and temporary disequilibrium changes in real exchange rates due to divergent macroeconomic (especially monetary) policies eventually inconsistent with maintenance of a fixed parity. The common trend in inflation rates, the world rate of inflation for short, then, is determined by the evolution of the world money stock, in analogy with the determination of the national rate of inflation in the long run (or the rate of growth of nominal national income in the medium run) by the trend rate of growth of the national money stock in a closed economy. Determination of the world money stock, however, is a somewhat more complex affair than determination of a national money stock.

Roughly speaking, one can think of the world money stock as the product of a money multiplier times a monetary base consisting of the sum of the domestic components of national monetary bases plus the total of international reserves available in our fixed exchange rate world. Things are relatively simple if these international reserves are "outside" reserves (nobody's liability) such as gold or SDRs that are fixed in quantity or at least whose growth does not depend on national monetary policies. Consider, for instance, a system in which gold is the only international reserve asset, but where national monetary authorities need not keep a strict proportionality between their gold reserves and their domestic assets. Divide that world into two countries, or regions, the United States and Europe. Imagine that the United States decides to increase its money supply by an open market purchase of bonds.

This results, at first, in an increase in the U.S. money stock equal to the increase in the monetary base times the U.S. money multiplier. But it also creates an excess supply of U.S. dollars, which tends to depreciate that currency on the foreign exchange market and, when the gold points have been reached, result in an outflow of gold from the United States toward Europe. This reduces the initial increase in the U.S. money supply and increases the European money supply by the inflow of gold into Europe times the European money multiplier. The process will continue until the initial equilibrium distribution of the world money stock into its U.S. and European components has been re-established. In the end, the world money stock will have increased by the amount of the initial increase in the domestic component of the U.S. monetary base times the world money multiplier, itself a weighted average of the two regional money multipliers; at the same time, the gold stock of the United States will have decreased and that of Europe increased by the same amount; and the increase in the world money stock will have resulted in an increase in world money income sufficient to reabsorb the initial excess of money in the world created by the monetary expansion. One remarkable feature of this scenario is its symmetry: had it been Europe that had made an initial open market purchase of bonds of the same size as that of the United States, the end result in terms of the world money stock and price level would have been exactly the same; the only difference would have been that Europe would have lost, and the United States gained, gold.

This symmetry and simplicity is lost when international reserve assets are composed, at least partly, of "inside" assets, that is of national currencies. Consider the polar case of a dollar standard where Europe's central bank holds U.S. Treasury bills as a reserve asset. Consider, first, the effects of an open market purchase by the Federal Reserve. As before, this results in an initial multiple increase in the U.S. money stock and an excess supply of dollars and a U.S. payments deficit. The latter, as the European monetary authorities intervene to prevent the appreciation of the European currency unit (ECU) beyond the intervention margin around parity, translates not into a loss of gold for the United States and gain for Europe but only in an increase in the U.S. Treasury bills held by Europe's central bank, whose money stock witnesses a multiple expansion as a consequence. The end result is therefore an increase in the world money stock of greater magnitude than that which occurs under the gold standard since there are no interna-

tional reserve losses by the United States to moderate the increase in the U.S. money stock. The European money stock bears, as it were, all the burden of adjusting to the initial increase in the U.S. monetary base. The monetary policy of the United States is singularly powerful in that instance and the increase in world nominal income will be similarly magnified. Will the power of European monetary policy also be magnified under a dollar standard? On the contrary, that power tends to vanish. To see this, consider an expansionary monetary policy in Europe. The initial effect is similar to the gold standard case: an increase in the supply of, say, ECUs and a payments deficit for Europe. The consequence of that payments deficit is now simply a reduction in the U.S. Treasury bills held by Europe but with no impact on the U.S. monetary base and money supply. Europe's payments deficit will last as long as its money supply has not returned to its initial level, and with it the world money stock and price level. All that will have changed in the end (which admittedly may come after a while only) is the composition of the European monetary base: the European central bank's holdings of U.S. Treasury bills will have declined by an amount equal to the increase in its holdings of domestic bonds.

Under a dollar standard, then, European monetary policy is robbed of any long-run effectiveness whereas U.S. monetary policy becomes singularly effective. These conclusions, in their extreme version at least, are based on a number of restrictive assumptions such as perfect substitutability between European and U.S. bonds and hold only for the long run. But the qualitative results regarding the strong asymmetries that arise in an inside reserve system are very robust. My argument is that the way in which the Bretton Woods regime actually functioned in the 1960s closely resembles the hypothetical dollar standard that I have just sketched. That argument is buttressed by empirical evidence.

Some Empirical Evidence

Some of that evidence has been supplied in various research projects carried out since the 1970s, notably at the Graduate Institute of International Studies in Geneva, particularly in a number of papers by my colleague Hans Genberg and myself.¹ The evi-

¹See, for instance, Genberg (1977), Swoboda (1978), and Genberg and Swoboda (1977b and 1982).

dence pertains to the world of industrialized countries for the period 1959 to 1971. Of particular relevance here is, first, a fairly close link between movements in world nominal income (and eventually prices) and movements in the world money stock a number of quarters earlier; in addition, causality clearly runs from money to income and prices and not vice versa, in contrast with the case of small countries where the causal link is, as the theory predicts, more ambiguous.

Second, inflation rates in individual countries tended to remain fairly close to the world average during the heyday of the Bretton Woods regime. Some casual evidence to that effect can be found in Table 1, which is reproduced from Genberg and Swoboda (1977a,

Table 1. Yearly Rates of Inflation, 1950-75

(In percent)

Year	Ten Countries		Standard Deviation ² (3)	United States (4)
	Weighted ¹ (1)	Unweighted (2)		
1950	-1.2	0.5	5.1	-1.5
1951	7.9	7.5	8.4	7.9
1952	3.2	3.7	3.6	2.2
1953	0.7	0.7	2.7	0.7
1954	1.0	1.8	1.7	0.4
1955	0.4	1.0	1.5	-0.3
1956	2.1	2.5	1.4	1.5
1957	2.9	2.7	1.8	3.4
1958	3.4	3.5	4.0	2.8
1959	1.0	1.1	1.7	0.9
1960	1.9	2.0	1.1	1.6
1961	1.6	2.2	1.3	0.9
1962	2.3	3.4	1.8	1.2
1963	2.5	3.8	2.2	1.2
1964	2.2	3.5	1.4	1.4
1965	2.7	3.8	1.5	1.6
1966	3.3	3.9	1.0	3.1
1967	2.8	3.1	0.7	2.8
1968	3.9	3.5	1.3	4.2
1969	4.9	4.5	1.7	5.4
1970	5.6	4.8	1.4	5.9
1971	5.1	5.7	1.8	4.3
1972	4.4	5.7	1.3	3.2
1973	7.3	8.4	1.7	6.2
1974	12.5	13.3	4.5	11.0
1975	10.9	12.1	5.3	9.1

Source: Genberg and Swoboda (1977a), p. 308.

¹Change over previous year of an index of ten countries' consumer price indices weighted by 1963 nominal GNP. Uncorrected for exchange rate changes.

²Standard deviation of inflation rates averaged in Column (2).

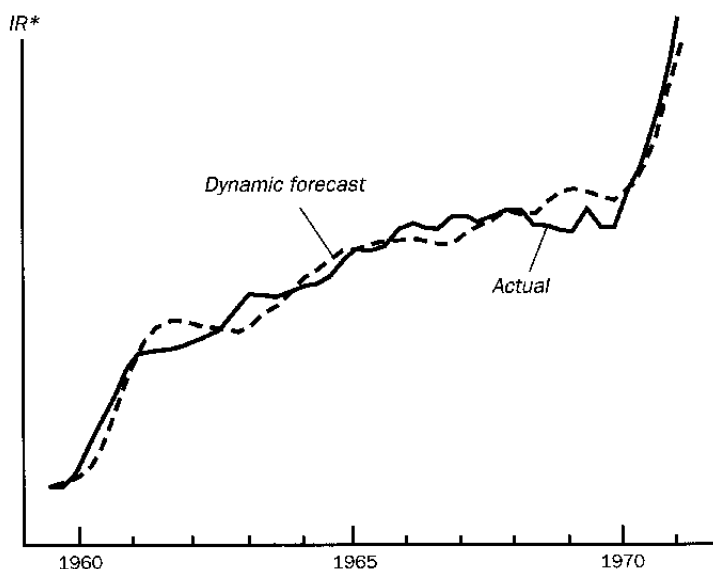
p. 308). It is based on data for the Group of Ten countries minus Sweden plus Switzerland. The table shows that for the period 1959-71, with the possible exception of 1963, the dispersion of national inflation rates stayed within a range compatible with the range of nominal exchange rate fluctuation permissible within intervention margins around parity. Remember here that the range of fluctuation of any two non-U.S. currencies in terms of each other was 4 percent with the IMF margins of 1 percent for any individual currency in terms of the dollar and 3 percent under the European monetary agreement which allowed for an individual margin of plus or minus 0.75 percent. The table also shows that the definite collapse of the fixed exchange rate regime in 1973 allowed the dispersion of national inflation rates to increase very significantly in 1974 and 1975. As mentioned earlier, exchange rate variations, within margins or otherwise, are only one of four sources of divergence among national rates of inflation. In this context, a number of studies have shown that the order of magnitude of the standard deviations of inflation rates across countries recorded in Table 1 is not significantly higher than that which one finds across regions in one large country or among some main components of, for instance, the U.S. consumer price index.² It thus would seem to make sense to speak of a "world" rate of inflation under fixed exchange rates and to seek to explain it as well as national deviations from that rate.

Third, the evidence is consistent with the view that the Bretton Woods regime actually was much closer in its operation to a pure dollar standard, with its strong asymmetries, than to a gold or gold exchange standard. Thus, Genberg and Swoboda (1982) estimate reduced-form world money supply equations that clearly show a much stronger influence of U.S. monetary policy than of rest of the world monetary policy on world monetary aggregates. The same authors, in an earlier study (Genberg and Swoboda (1977b)), specify and estimate a simple dynamic simultaneous equation model of the joint determination of the world price level, the world money stock, and the distribution of international reserves between the United States and the rest of the industrialized world (an aggregate of the 13 largest industrial countries outside of the United States) and hence of the two regions' official settlements balance of payments. That model incorporates the maintained hypothesis that the

²See, for instance, Genberg (1977).

world behaved in line with the simple model of the dollar standard sketched above. The model turns out to fit the data quite well for quarterly observations extending from the beginning of 1958 to the end of 1971. As an example of its tracking ability, consider Figure 1,

Figure 1. International Reserves Held by European Central Banks



Source: Genberg and Swoboda (1977b), p. 34.

which compares the actual path of the international reserves held by rest of the world central banks with the model's dynamic forecast, where only the initial value of the endogenous variables is used. Remarkably, the model adequately captures the large jumps in "European" international reserves in 1960 and 1970 as well as the general shape of the movements in between. It thus seems able to "explain" the explosion of the U.S. balance of payments deficit that brought about the downfall of the Bretton Woods regime on the basis of a simple version of the alternative monetary view of the functioning of that regime.

Fourth and finally, that same model also sheds some light on the important question of the speed and adequacy of the international

adjustment mechanism under Bretton Woods. This is an important question for at least two reasons. In the first place, fixed exchange rate regimes have often been criticized for not providing adequate payments adjustment mechanisms because of elasticity pessimism, irrational capital flows, or whatever. Second, the theoretical arguments advanced above are of a "long-run" nature: it is only after full adjustment has taken place that "European" monetary policy loses all effectiveness and that the effectiveness of U.S. monetary policy is fully magnified. How far away the long run in which we are all dead actually is or, if you prefer, how rapidly or slowly adjustment actually takes place is therefore of crucial importance. It turns out, in the model Genberg and I estimated, that adjustment is quite rapid. It thus takes only slightly more than two quarters for two thirds of a discrepancy between the actual and equilibrium distribution of international reserves to be eliminated. Similarly, although the impact effect of a European open market purchase of bonds on the world money stock is positive (though much less than that of a similar U.S. purchase), Europe's subsequent loss of reserves eliminates over 50 percent of that effect within one year and almost all of it within a span of two years. The dollar standard nature of the Bretton Woods regime is thus relevant in a relatively short span of chronological time.

The Breakdown of Bretton Woods Re-Interpreted

These findings are relevant to one's interpretation of the causes of the breakdown of the Bretton Woods regime. That breakdown did not occur because adjustment was sluggish or functioning badly in an economic sense given the nature of the prevailing international monetary regime. On the contrary, the system was adjusting all too well and very speedily to the shocks to which it was subjected, adjusting in a way that was entirely consistent with its inner logic. That logic gave preponderant influence to U.S. monetary policy over the determination of the course of the world money stock. In other words, monetary policy in individual countries outside of the United States had effectively lost most of its independence under Bretton Woods and the Federal Reserve was effectively the industrialized world's central bank.

The basic cause of the breakdown of Bretton Woods was that the predominance of the United States came under attack. The reconstruction of Europe and the emerging power of Japan meant that

the relative economic and political strength of the United States had declined from its height at the end of the Second World War, paving the way for a political challenge to its dominance. On an economic plane, U.S. policy began to run counter to the interests of some of its major partners. U.S. monetary policy, which until the mid-1960s had been broadly consistent with the interests of the periphery, turned excessively lax thereafter. On this point, turn back to Table 1: the U.S. rate of inflation, which had been below the average "world" rate of inflation until 1965, began to rise toward that average in the next two years and rose above it after 1967. (In this sense, the Federal Reserve played, until 1965, the role that the Deutsche Bundesbank has played in the European Monetary System (EMS) until today.) The anchor was loose and a number of countries looked for other moorings.

The timing, and the more immediate causes, of the breakdown are to be found in the explosion of the U.S. payments deficit in 1970. That explosion, in turn, can be attributed to the tug of war between an expansionary monetary policy in the United States and, on average, a restrictive one in the rest of the industrialized world, together with and partly because of a desynchronization of the business cycle in the two regions. That conclusion is entirely consistent with the predictions of the econometric model referred to above which forecasts the explosion of the U.S. deficit on the basis of the two regions' actual monetary policies, on the basis of well-behaved demand for money functions and, implicitly, capital movements that correctly respond to interest rate incentives rather than to the irrational whims of speculators. What went wrong was that national monetary policies were being assigned to internal balance (to fighting national business cycles) rather than to external balance, thus destabilizing the fixed exchange rate regime.

That the crisis resulted in a profound institutional change rather than a return to the old system is of course due to other factors. Among these, let me only mention again the fact that U.S. monetary policy was seen as being chronically inconsistent with the interests of the periphery, that the geopolitical power of the United States was declining in relative terms, and that gold purchases could no longer effectively be used to restrain U.S. monetary policy and hence to share in the setting of the fixed exchange rate world's macroeconomic policy.

Some Tentative Implications for EMU

The two contrasting views of the functioning of the Bretton Woods regime and of the origins of its breakdown have substantially different implications for the prospects of EMU and for the best road to follow toward that goal.

The conventional view bodes ill for a rapid approach to monetary union. In that view, a fixed exchange rate system of the Bretton Woods or of the EMS variety is bound to break down unless some very stringent conditions on the convergence of the participating countries obtain. Moreover, before it breaks down such a system will lead to severe cumulative payments disequilibria in view of its inability to provide enough real exchange rate flexibility without creating dire internal balance problems for the member countries. That view basically vindicates the position of the "economists" (versus the "monetarists") in the long-standing debate about EMU: only after a very high degree of convergence in the inflation rates, business cycles, and macroeconomic policies of potential members—and a substantial convergence in their degree of development and socioeconomic institutions—has been reached should one proceed to fixing exchange rates irrevocably. That these conditions were not respected is one main reason for the collapse of the Bretton Woods regime and would be one main reason why an attempt at rapid monetary unification in Europe would fail today.

My interpretation of the Bretton Woods experience is more optimistic for the prospects of EMU and would tend to favor a rapid approach to that goal. It is thus in line with the position of the "monetarists" rather than that of the "economists" in the debate on monetary union. The industrial country core of the Bretton Woods system functioned as a monetary union or a quasi-monetary union with the Federal Reserve as its effective central bank. That experience shows that a fixed exchange rate system can, in a number of respects at least, function effectively and satisfactorily.

To begin with, it can function effectively in the sense that the tendency to return to external, meaning overall balance of payments, equilibrium is quite strong and adjustment rapid. At the same time, the dispersion of inflation rates was low, compatible with that found within regions of a same federal state. The record of the EC since the beginning of the EMS, at least for the core ERM countries, is as satisfactory on that count as Table 2 shows. The

Table 2. Yearly Rates of Inflation, 1980-90¹
(In percent)

Year	ERM Countries		EC Countries		Inflation Rate in Germany
	Average inflation rate in 7 countries	Standard deviation	Average inflation rate in 12 countries	Standard deviation	
1980	9.3	4.4	12.7	5.6	5.3
1981	10.0	4.4	12.6	5.2	6.1
1982	9.2	3.6	11.8	5.0	5.1
1983	6.8	2.7	9.8	5.9	3.3
1984	5.5	2.0	8.9	6.5	2.3
1985	4.0	1.3	7.2	5.2	2.1
1986	1.6	1.6	5.0	6.0	-0.1
1987	1.6	1.8	4.1	4.4	0.2
1988	1.9	1.2	4.2	3.6	1.3
1989	3.1	1.1	5.6	3.6	2.7
1990	3.0	0.4	6.2	4.9	2.6

Source: International Monetary Fund, *International Financial Statistics*.

¹Annual changes in the consumer price index.

table documents the strong decline in the area's average inflation rate after 1982 and especially since 1986, with a slight rise again since 1989. It also shows that Germany consistently remained the low-inflation country toward which the other members of the EMS adjusted. It further shows that since 1984 the dispersion (standard deviation) of inflation rates within the ERM was as low or lower than that noted in Table 1 for the Group of Ten countries under the Bretton Woods regime in the 1960s, in spite of the fact that the ERM allows for wider exchange rate margins than do the charters establishing the IMF and the European monetary agreement. The record is less encouraging if one adds Greece, Italy, Portugal, Spain, and the United Kingdom to the sample. This suggests to me that there is currently, and that there has been for some time, enough convergence of inflation rates for a rapid move to EMU to be both feasible and desirable for the narrow-band ERM countries. That first conclusion is reinforced by the fact that two sources of divergence in national inflation rates, nominal exchange rate changes and the buildup of disequilibrium real exchange rates due to divergent national monetary policies, will disappear once a common currency is adopted. The record also suggests, but this argument will need to be developed further later on, that in current circumstances a two-speed approach to EMU may be desirable.

One could still argue that Bretton Woods made, and EMU would make, for the building up of disequilibrium real exchange rates that

are difficult to correct with nominal exchange rates fixed. Such disequilibrium real exchange rates would be the result of differences in inflation rates that are admittedly small on a yearly basis but cumulate into large disequilibria if the differentials are persistently in the same direction. I would argue that the once-and-for-all and trend changes in real exchange rates that occurred under the Bretton Woods regime probably reflected adjustment toward, rather than away from, changing equilibrium real exchange rates. The same can probably be said of the changes in real exchange rates observed in EMS Europe. Some critics of the EMS argue that such changes have been insufficient as witnessed by the much larger swings in real exchange rates observed in the post-Bretton Woods world outside the EMS. To which I would answer that such larger swings in real exchange rates are typical of a floating rate exchange rate regime and are not needed under a fixed exchange rate system.

Finally, the Bretton Woods record shows that a large number of countries with highly diverse economic structures, social policies, and fiscal policies managed quite respectable macroeconomic performances without having recourse to the "exchange rate instrument." This suggests that there is little reason to seek a high degree of "convergence" of structures and policies in moving toward monetary union, however much the record may suggest that convergence of inflation rates is needed, and that national monetary policy should be devoted to the maintenance of external balance.

The similarities between Bretton Woods and EMU should, however, not lead us to overlook some important differences. I will mention only a few here. First, the degree of capital and goods markets integration is higher today than in the 1960s, both in general and in the EC of 1992 in particular. This lessens the likelihood of country-specific shocks and should make a rapid move toward monetary union both easier and more urgent. Second, the role of Germany in the EMS, though it shows some similarities to that of the United States in the Bretton Woods regime, also shows at least two differences. On the one hand, the deutsche mark is not the major reserve currency that the U.S. dollar was and is; exchange rate stabilization by EMS countries does not result in large, sometimes involuntary, accumulation or decumulation of deutsche mark balances. In other words, there is, because of the desire to import German monetary stability, a much higher degree of voluntary consent to the dominating role of Germany in setting monetary policy

within the EMS than there was to the role of U.S. monetary policy under the Bretton Woods regime. On the other hand, and as noted before, Germany has consistently been the low-inflation country in the EMS, unlike the United States under Bretton Woods. This should ease the transition to an EMU that adopts German norms for its central bank.

On the whole, then, the Bretton Woods regime suggests that a quasi-monetary union can function effectively in spite of a high degree of diversity in the economic structure of member states and in the absence of any explicit fiscal policy coordination. Such a regime brings about a high degree of convergence in inflation rates, a degree that is not dissimilar to that reigning among the ERM countries today. It shows, however, that an appropriate monetary policy by the union's effective central bank is of the essence lest the fixed exchange rate area break down.

III. GERMAN MONETARY UNION: A GRAVE MISTAKE?

These relatively optimistic conclusions for the prospects of European economic and monetary union have been challenged on the basis of German experience with monetary unification.

Massive and rising unemployment and sluggish investment in the eastern part of Germany and difficulties in privatization of state assets have been at least partly blamed on the fixing of the parity of the former east German mark with the deutsche mark at one to one. The message for EMU is taken to be the following: ensure much greater convergence in economic performance between the members of the Community before proceeding to monetary union lest the (east) German unemployment disaster be repeated. In addition, some imply, the German experience lends weight to arguments for greater fiscal coordination, enhanced redistributive policies, and strengthened harmonization of social policies within the Community, preferably before or at least simultaneously with monetary union. Both arguments, it seems to me, sorely miss the point.

The root cause of the massive unemployment in eastern Germany (and of some of the other problems mentioned above) is the high and rapidly rising level of real wages in eastern Germany, combined with very low productivity arising from an obsolete capital stock, inadequate infrastructure, and an uncertain definition of property rights. In addition, there has been a severe negative shock to the demand for the goods traditionally produced in the eastern

part of Germany. Fixing the exchange rate has little to do with it, although it is true that an initial exchange rate of more than one east German mark to one deutsche mark might have slowed down the rise in real wages somewhat.

To generalize that last argument, the buildup of a severe real exchange rate disequilibrium in the past is not an argument against fixing the exchange rate; it is, however, an argument, when entering a monetary union, for setting the presumably irrevocable nominal exchange rate at a level that is as close as possible to that required to achieve the "medium-run" equilibrium real exchange rate given the prevailing price and wage levels and given the expected inflation differentials between member countries. These expected differentials in price and wage inflation must be small if the move toward monetary union is to be credible. This is why a minimum degree of inflation convergence is needed before embarking on that course and one reason why a two-speed approach to monetary union in Europe may be desirable.

The real problem in German monetary union, however, is nationwide wage bargaining and the import into eastern Germany, which can ill afford it, of costly and excessively rigid west German social policies. It is thus sheer folly to argue that social and wage policy should be further harmonized in the EC. On the contrary, diversity in social and regional policy should be preserved lest adjustment among economically different regions of the same currency area be hindered.

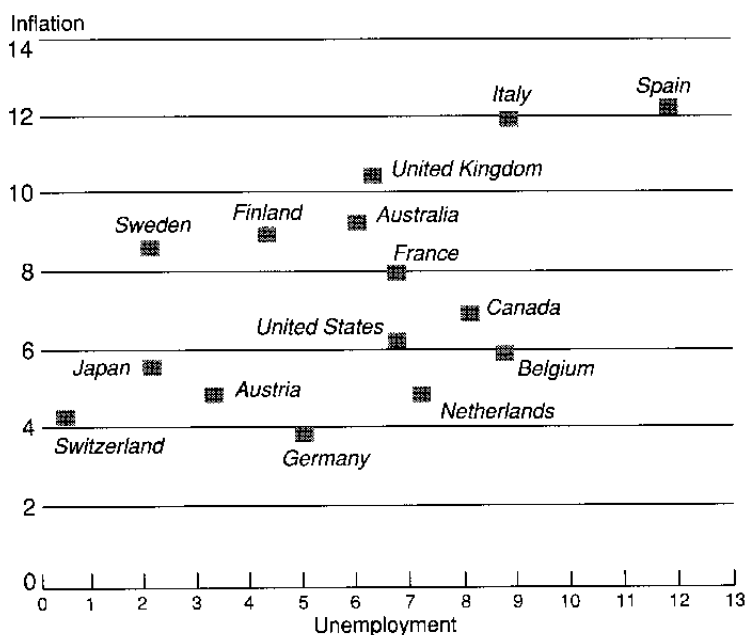
IV. IMPLICATIONS FOR EUROPEAN ECONOMIC AND MONETARY UNION

I will conclude by considering, in the light of past experience with fixed exchange rate regimes, three sets of issues that arise with respect to the Delors plan for EMU in three distinct stages. The first concerns adjustment without the exchange rate instrument; the second, the design of the future European central bank; and the third, the sequencing of policy steps and the speed of travel down the road toward monetary union.

Consider first adjustment without the exchange rate as an instrument of macroeconomic policy. There are two basic questions here: exactly what is it that is being lost and what was it worth? The answer to the first question is simply that member countries in a strictly fixed exchange rate area can have no individual national

monetary policy. Hence, what they lose is their monetary autonomy, of which in any event not much is left at least for the narrow-band ERM countries. The answer to the second is more contentious. I would argue, however, that to the extent national monetary policy today mainly influences the national rate of inflation (or its deviation from the average in a monetary union), except in the very short run, not much is lost and something may be gained by joining a monetary area with a stable noninflationary monetary policy. All the more so as the influence of monetary policy on real variables such as employment, real exchange rates, and real rates of interest is in any event quite limited and often short-lived (and will become increasingly so) in a world of integrated goods and capital markets. Figure 2, reproduced from the IMF's May 1991 *World Economic Outlook*, provides some cross-country evidence on the long-run relationship between inflation and unemployment, which

Figure 2. Inflation and Unemployment, 1971-90¹



Source: International Monetary Fund, *World Economic Outlook*, May 1991 (Washington, 1991), p. 107.

¹Consumer price inflation is measured in percent a year; the unemployment rate is measured in percent of the labor force.

appears to be, if anything, positive and not negative as short-run Phillips curves would have us believe. In short, monetary autonomy may not be worth much, especially in an economically integrated area and provided that the common monetary policy emphasizes price stability.

Still, one may ask, what if there is a severe external demand shock for the goods of one member country? In the first place, this type of shock is becoming less likely, especially with increasing economic integration; shocks are more likely to be Community or even industrialized-country wide. In the second place, national fiscal policy can still be used to cushion shocks to individual countries, provided that the full-employment budget is consistent with long-run solvency, that is, that it does not imply a steadily increasing debt-to-GNP ratio. Indeed, some means of enforcing long-run fiscal discipline on the part of member countries within EMU would seem highly desirable. Here, it may well be appropriate to supplement market discipline with both some limit to the debt- (or possibly deficit) to-GNP ratio and tough conditions imposed on members of the monetary union at the time of their joining.

One last point concerning adjustment without the exchange rate instrument is worth reiterating here. Flexibility in relative prices and in regional real wages is important for that purpose and social and regional policy measures that hamper such flexibility are to be avoided. There is such a thing as too much convergence.

On the second issue, the design of the future European central bank, analysis of the Bretton Woods system as well as plain common sense strongly suggest that it should be fiercely independent and that its charter specify price stability to be its primary and overriding objective. But experience with Bretton Woods suggests a further lesson. The effective autonomy of the European central bank in pursuing its objective depends also, and largely, on the external exchange rate regime and the precise institutional setup with respect to the growth and composition of international reserves. This suggests that it is the European central bank that should be responsible to set exchange rate policy and the exchange rate regime at least until such time as a universal reform of the international monetary system, and possibly the creation of a world central bank and currency, takes place. Otherwise, a conflict may arise between the European central bank's objective of price stability and the requirements of keeping the ECU's external value within some imposed band.

The issues connected with the sequencing and speed of introduction of a common European currency are those that are most debated today. Two points are worth singling out here. First, to insist on greater convergence before proceeding to monetary union is largely unwarranted. The degree of convergence in inflation rates that has already been achieved is quite sufficient, even though an ultimate realignment before irrevocably fixing parities may be warranted to correct real exchange rate disequilibria built up in the past.

Second, there is a strong case for moving fast, once the basically political decision to proceed with EMU has been taken. The decision to move to monetary union in Europe, like currency unification in Germany, is indeed a basically political decision. Whatever the economic costs and benefits, whatever the technicalities, the adoption of a common currency is a highly political act. After all, the currency is one of the most important symbols of nationhood. One economic reason for proceeding swiftly to monetary union once the political will and decision is there is that you do not want to allow further disequilibria to build up. Another, perhaps more important reason is that delays and hesitations will put in question the credibility of the commitment and of the approach, threatening the viability of the monetary union and prolonging the existence of unnecessarily high real interest rates and exchange risk premiums in some countries. The problems created by a slow approach to monetary union in Europe are similar to those of moving slowly to economic and political reform in the Soviet Union. It is in this context that *perestroika* has been said to be akin to changing the traffic rules from driving on the left side to driving on the right side of the road—but gradually.

The necessity of moving fast implies, among others, that a two-speed approach to EMU may well be warranted, however difficult it may be politically. The core ERM countries could move to monetary union rapidly, other countries joining when they have solved both their inflation and their fiscal discipline problems, possibly according to an explicit calendar. Such an approach would have the advantage of credibility and of motivating the commitment of the slow joiners to eventual and full participation in the monetary union.

The desirability of a speedy, credible and committed approach to EMU also implies that stage 2 in the Delors scenario should be kept quite short and consist mainly in installing the European central

bank that will have been planned in stage 1, with the latter possibly being prolonged to allow for the planning. Should a two-speed approach to EMU be adopted, stage 2 could more easily be shortened with its end marked by the creation of a core-ERM European central bank to be joined gradually by the remaining members of the EC during stage 3. In any event, it makes little sense to design an elaborate scheme of further collaboration and coordination among national central banks over a lengthy stage 2 if the ultimate aim is to vest their powers in a common European central bank.

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Questions and Answers

Following the formal presentation, Professor Swoboda answered questions from the audience.

Sir Jeremy Morse: Thank you very much, Professor Swoboda, for that fluent round of ideas and arguments, with plenty of provocation blended in it. And now I would be grateful to have questions or comments from the floor on what Professor Swoboda has said.

It struck me that the argument was extremely optimistic in relation to Bretton Woods in two ways, because what we are aiming to build in the European monetary union would be even stronger than that under Bretton Woods. First, there was no element of political union in the Bretton Woods system. And second, I remember very well being rather proud of a sentence that I put in the report to Mr. Heath in 1971—where to get the message home we said, “We are on the dollar standard, and the dollar is weak.” It looks as though the numeraire of the EMU ought in principle to be fairly strong.

Do people want to challenge this optimism or ask questions in any other form? Who will begin? Wolfgang Rieke.

Wolfgang Rieke: My name is Rieke from the Bundesbank. Before somebody thinks of a question on your main theme, I would be curious about your answer to the following question. With regard to the German unification, you identified the sharp rise in real wages as the main cause of difficulties. There have been proposals in the press and by academics that one should introduce some kind of a wage subsidy. As a professional economist what would be your answer to this?

Alexander K. Swoboda: I am not familiar with the details of the wage subsidization plan of Akerlof and others. That plan, however, makes a good point, which is that it is better to subsidize employment than unemployment. And what seems to be occurring at the moment is that it is unemployment that is being subsidized. Now, whether the particular form that is being proposed is appropriate

or not, I don't know the details well enough to give an answer. I suspect that it probably is not (for instance, in terms of labor mobility or removing the subsidies), that there are some better ways of doing it, but it at least attempts to deal with a very serious problem.

Just one remark, though. What is striking about the German situation is that the whole heavy subsidization of people in the former GDR was based on the idea that you would have to discourage them from moving. That if one didn't do that, then given wage differentials and so on, there would be a large flocking of east Germans to west Germany. It seems that this is not occurring as fast as might have been feared. People would prefer to stay within their region. Subsidized housing might be one reason for that. But, and I think that is a point made by Akerlof et al.; one of the problems is that large unemployment (whether subsidized or not) in eastern Germany will drive people out more quickly than otherwise would be the case.

In addition, the current situation is such that very few people want to actually take over existing firms and invest in east Germany. And, of course, the only way to keep people in the long term occupied in eastern Germany at a higher real wage is to get a large flow of productive capital into eastern Germany.

Sir Jeremy Morse: Of course, I'm not confining your questions to the comparison with Bretton Woods, with the comments on issues in the current EMU negotiation. Andrew Crockett.

Andrew Crockett: Thank you, Mr. Chairman. Andrew Crockett, Bank of England. I will rise to your invitation to challenge Alex Swoboda, if only to avoid the implication that silence means acquiescence. It seems to me that what the last years of the Bretton Woods system illustrated was the difficulty of combining across the system low and more or less similar rates of inflation with a desirably high level of employment. And the system gradually succumbed to that difficulty as attempts to maintain employment at acceptably high levels lead to rising and differently rising rates of inflation. Now, it seems to me that one of the challenges that we will face in EMU is to make sure that we can combine those two desiderata, that is to say a common (and low) rate of inflation, which we obviously will have following a single currency, with an acceptable level of economic activity. And, I would submit, one can't simply dismiss that problem by saying it's like moving from driving on the left to moving to driving on the right.

I would be interested in any elaboration of the argument that Alex suggested (which was not so obvious as not to need putting specifically and formally), because it does seem to me that we have a situation now in which many countries in the Community have had for quite some time fairly high rates of unemployment. We are subjected to different kinds of pressure, different kinds of outside shocks. I believe quite strongly that we need to be convinced that we've got convergence—convergence not only to low and more or less similar rates of inflation, but also convergence toward economic structures that deliver acceptably low rates of unemployment, before it's going to be wise or prudent to take the step of jumping to a single currency, a step we may say is irrevocable, but if it creates political and social tensions, may be very hard to sustain.

Alexander K. Swoboda: On that let me first say that I haven't revealed anything about whether I personally would like to live in a world in which there was a single European currency. And my answer to that is partly—well, it depends on whether that particular currency bloc is protectionist or open, which is a somewhat different issue from what we're talking about here.

But I mention it because I think first and foremost when we talk about monetary union, we talk about a profound political, social, and cultural type of change. The first and foremost thing is that there has to be a political will to do it. It is a political act. As economists, we think of whether such a union would be technically feasible or not, we try to evaluate its economic benefits and costs on the assumption that it has structures that make it function approximately appropriately, but the basic decision is, I still think, a political one.

But on your specific question, I don't think that giving up the inflation tool is going to get you much more employment. You seem to argue that the tension is between those countries that want a low rate of inflation and those countries that want high employment, and presumably high employment means a higher rate of inflation. Now, even though that may work in a short-run sense if it hasn't been used too often, the evidence—and this is where the table from the IMF's *World Economic Outlook* comes in—the evidence is that that trade-off in the long run doesn't exist, and if it exists, it is negative.

As for the greater convergence in economic structures, I think one has to be very careful about that. This is the argument that has

been used year after year in the tug of war between the “economists” and the “monetarists,” where your position, Andrew, could maybe be put as that of an “economist” and mine more on the side of “monetarists,” but I think neither of us would like to be pegged into either one or the other extreme of these categories. I think the problem with the convergence argument is that there will never be enough convergence for the ideal world. So we can at each stage say, well, there hasn’t been enough convergence, these guys are still too poor, they haven’t caught up. And these others are still relatively too rich. Now, that argument could go so far as to say—although this is a bit absurd, but goes back to the spirit of the optimum currency area discussion—we should break up countries. And yet, it seems to me that there are individual countries that have lived perfectly well, while being very different from each other, within a currency union. There are a number of countries, which might not have been the fastest growing countries in the world, like Panama, Haiti or the Dominican Republic, that have had fixed exchange rates, or adopted another country’s currency, for very long periods, and I don’t think they have necessarily suffered too much from that. What I would say then is, don’t harmonize too much, don’t converge too much beforehand, or even thereafter, because otherwise you will get into the sort of problem that even west Germany has had between the north and the south, where the application of the same methods of wage bargaining, social security and so on, have tended to create local pockets of unemployment.

Now, if a consequence of monetary union is to harmonize at that level, then I would look at monetary union three times before engaging in it.

Alexandre Lamfalussy: I would like to put a question to Alexander Swoboda on his argument concerning the speedy implementation of a monetary union. One of the points you made is that one argument in favor of speedy implementation is the convergence of inflation rates already observed. If you take Table 2 in your hand-out, that indeed is very convincing if you take the ERM countries. It doesn’t seem to be very convincing if you take the other countries. What is your response in regard to that?

Alexander K. Swoboda: I’m glad you brought that point up! In addition to differences in inflation, there are also the well-known differences in terms of debt-GDP ratios (of Italy and a number of

other countries) which raise the question of whether one should indeed have a two-speed approach to European monetary union. Now, the economic answer would seem to me to argue strongly for a two-speed approach. Let the core ERM countries enter a monetary union, make it open, let the others join at later stages, perhaps already taking some steps to pave the way. Let them, as it were, crawl into a full monetary union. That is an economic answer, but I don't have a good political one to your question.

One additional argument for speed (an argument that has been made by several people) is that once you've decided, you might as well move fast if you want your decision to be credible. If your decision is not believed by markets, then you will get risk premia built into interest rates, possible unemployment problems and so on, which could have been avoided by making the transition fast.

Michael Hutchinson: Bank for International Settlements. I wanted to ask one question on the Bretton Woods regime and comparing it to the potential European central bank. One advantage of the asymmetries that you noted in the Bretton Woods dollar standard is that at least if the central currency is the strong currency, then the countries need to converge to that lowest common denominator in inflation. Now, looking at the present ERM system, it seems that Germany has about the strongest currency in the system and as a consequence the convergence is to the lowest common inflation currency. If you move to a common currency, what would you see as the pitfalls in moving toward more of an average European inflation rate? The asymmetry of the system in one sense pushes it to the lowest common denominator; would you see a potential European central bank moving away from that?

Alexander K. Swoboda: First, a preliminary remark. One difference between the Bretton Woods regime and the EMS is that within the EMS there is little holding of deutsche mark reserves, and in that sense, a convergence onto the German inflation rate is a more voluntary exercise, which is reassuring, than it was in the Bretton Woods regime, especially after 1965; the way that system was set up, it forced U.S. monetary policy on the rest of the world, which might not have liked it. In the case of the EMS, there is more of a voluntary convergence to the German inflation rate.

The question you raise, of course, is a very difficult one to answer: how do you measure the price level that you want to stabilize if you have a European monetary union? What price level target

should the common European central bank have? Now, there are, as you know better than I do, arguments for not targeting a price level, but having a money income target, or at least an intermediate target in terms of some sort of money income measure. There are as well arguments for stabilizing some average of wholesale prices, of CPIs, and so on. Once EMU is complete, and one actually has one currency or irrevocably fixed exchange rates, then one will probably be able to target a Europe-wide CPI, a Europe-wide wholesale price index, and so on; perhaps what one should do is just try and stabilize such a Europe-wide index. I don't know if that answers your question.

Sir Jeremy Morse: Time, I think, for one more question, or perhaps two. Yes.

Jean Jacques Rey: Jean Jacques Rey, National Bank of Belgium. You mentioned that the European central bank should not only be independent and strongly attached to price stability but it also should be allowed to set the EMU's exchange rate policy. I understand very well the logic of this. The problem is that when you build a new system, you have to rely not only on logic but also some time on precedents, and in drafting the statute of the future European central bank it was found that we didn't have really a precedent in this field. We relied very much on the Bundesbank, but it seems our friends in the Bundesbank are not so happy with this practice and that this logic is not really agreed to by the Bundesbank. Can you help us with providing a precedent?

Alexander K. Swoboda: If I may I would also ask Wolfgang Riecke to comment on this.

The logic of my argument is, obviously, very simple. It is that once you have a fixed exchange rate, once you peg the value of your currency on the foreign exchange market, you basically give up monetary policy. So it is rather strange to build up a European central bank to whom you give the responsibility to maintain price stability, and at the same time to tie its hands by saying you have to peg, or stabilize, the value of the ECU in terms of a number of other currencies on world markets.

I am not arguing that a central bank should not peg. Far from it. But that is a choice of a particular form of monetary policy. You cannot both say you should have an independent monetary policy and pursue a particular price level or inflation rate objective, and at

the same time say you want to intervene in foreign exchange markets. Or, if you do that, you have to have a much more explicit system of cooperation among, in that case, the three main blocs, the yen, the U.S. dollar, and the ECU, in order to stabilize the exchange rate between those three, which means finally moving toward a world currency.

Now, how do you resolve that in terms of enabling legislation? I don't know—I have never taken a course in law in my life.

Sir Jeremy Morse: Wolfgang, did you want to comment on that?

Wolfgang Rieke: I was rather unhappy with the way the debate on speed was left, because it forced me to agree with you and to disagree with you at the same time. I would have to agree with you if you mean that by moving fast the transfer of power over monetary policy from the national level to the European level would have to be done really in one step, and not gradually. To that extent, I would agree with you. But I would certainly want to disagree if you were to say that this should be done regardless of the status of convergence. Just looking at your own table, it shows that, if anything, convergence seems to be going backward at the moment, a little bit. So what it all boils down to, to my mind, is that if we were wise, we would adopt a process where we allowed a little more time for the first stage, probably a very short time for the second stage, and then move into the third stage—very quickly—but only when the time is right, as Mrs. Thatcher used to say, in terms of convergence.

Sir Jeremy Morse: Thank you very much. Yes, now a question over here.

Kombo J. Moyana: Reserve Bank of Zimbabwe. I was wondering, Professor Swoboda, whether or not the lessons of monetary unification in Germany are that from purely an economist's point of view, if you have higher real wages in west Germany and also less unemployment, and you have better equipment and capital, and since you have less of these in east Germany, that you should, in fact, as a good economist, allow the unemployed people in the east to move to the west, which will put in train a lowering of the west German real wage rate and that will also increase the shortage of manpower in east Germany, which will, of course, raise the productivity of labor in east Germany and raise the real wage rate there. The question of inequality of capital will be sorted out in a

similar fashion as west German investors move eastward. So why couldn't we allow that normal adjustment process to take place? Why pay people when they are sitting at home? Thank you.

Alexander K. Swoboda: I think that what you've just described is exactly the type of adjustment process that is desirable and one would expect to happen when labor and other factors of production are mobile within a particular currency area, and that is precisely what should facilitate the adjustment process. This case is a bit different. One reason why this is not happening as smoothly as the textbook model says is simply because of the policies I mentioned earlier—which I don't necessarily approve of—which are designed to prevent people from moving. Now, that is partly a political decision taken for social reasons—the idea that the west German society would not be able to absorb the east Germans so quickly—and partly a policy advocated by the German unions, which are dominated by the west German unions, for precisely the reason you mention, viz., that the best way to keep the people in eastern Germany is to make them totally uncompetitive in western Germany and to give them high wages in eastern Germany so they won't have much of an incentive to come to western Germany. I think the union tactic in that is perfectly clear. But, again, you're absolutely right.

Sir Jeremy Morse: Yes. A question, yes, please.

Ariel Buira: Bank of Mexico. In making the case for a European monetary union, I think the arguments have been developed in a very general form that would seem to have universal application. Perhaps the one exception that you identified for not having a monetary union would be that of an external demand shock that would lead a country to perhaps have an independent exchange rate policy to adjust to external demand shocks. I don't know if I have understood your argument correctly, but would you recognize other arguments or other cases in which you would not favor a monetary union? That is, would there be any other argument for not having a North American monetary union or an East Asian monetary union?

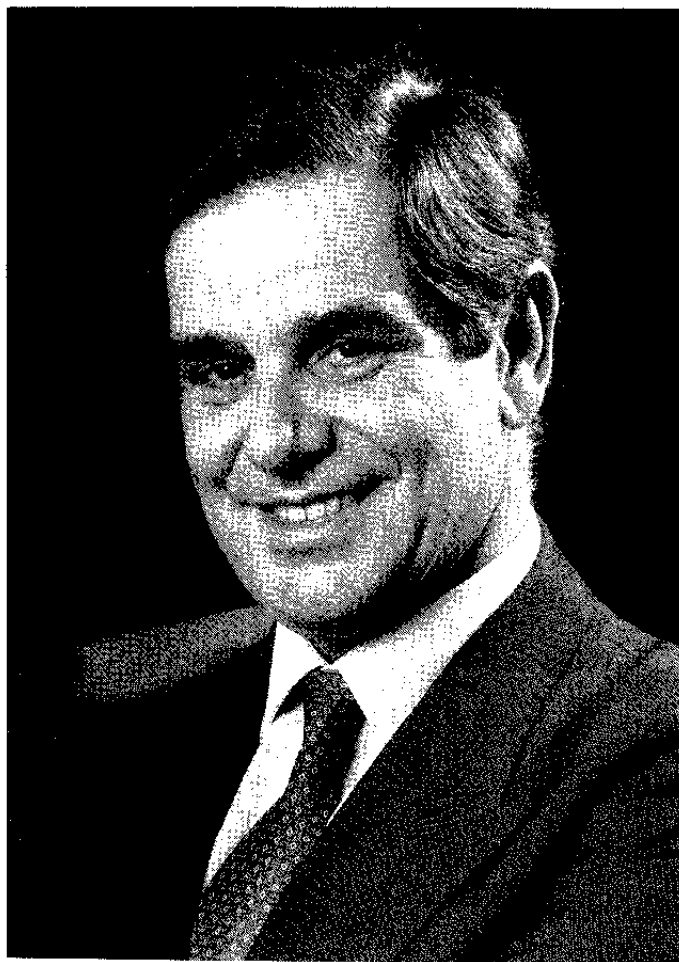
Alexander K. Swoboda: Well, probably if one stays at a simple level of generalities, one can always make this sort of argument for monetary union: a monetary union saves you transactions costs; makes information about prices better; may lead to a lower vari-

ance of individual inflation rates. All the economic arguments that are made in Brussels for a monetary union are universal. By that criterion, one should have a world money.

Now, how come we don't have one or how come we don't even want one? There are more important reasons than adjusting to asymmetric shocks. One reason is, do you trust your banker? You may trust your own central banker better than you would trust the central bank of whatever union you are contemplating. That is one reason for not wanting a monetary union. Second, there are some tax reasons, for instance, seigniorage considerations and so on. Third, there are basically political and social reasons. A monetary union will almost necessarily imply an economic union. I think there are very few cases where you have a monetary union without some form of or move toward an economic union. And there may be some reasons, protectionist or other, maybe even rational ones, why you don't want the economic union.

And fourth, monetary union is something that will mean a lot politically. You're surrendering one symbol of nationhood as well as an instrument of national monetary policy and you're committing that for what is likely to be a very long time. And I think some countries will hesitate a long time before surrendering that symbol and that instrument.

Sir Jeremy Morse: Unless there is any other burning question, that is a very good answer to finish on. We've run slightly over our time, but the interest of the questions and your answers show why it has been a very good session. And now I would ask everyone to applaud Professor Swoboda.



Alexander K. Swoboda

Biography

Alexander K. Swoboda is Director of the Graduate Institute of International Studies at Geneva, where he is also a Professor of International Economics. In addition, he is Professor of Economics at the University of Geneva and a Board Member and Executive Director of the International Center for Monetary and Banking Studies, of which he was one of the founders in 1973. After receiving his B.A., M.A., and Ph.D. (1966) from Yale University, Professor Swoboda was awarded the Postdoctoral Fellowship in Political Economy at the University of Chicago for the academic year 1966–67. He has taught at the Graduate School of Business of the University of Chicago and has been visiting Professor of Economics at the Johns Hopkins School of Advanced International Studies in Bologna, the London School of Economics and Political Science, and at Harvard University.

Professor Swoboda is a leading specialist of international and financial problems, about which he has published numerous articles and edited several books. His research has been both theoretical and applied and has centered on macroeconomics, international finance, international adjustment theory, and the international transmission of inflation and business cycles. He is also a well-known analyst of Eurocurrency markets and of international banking issues. His recent work includes studies of international development and debt issues. He has been the recipient of several research fellowships and grants and has directed a number of major research projects, notably a project on “National Economic Policy and the International Monetary System,” financed by the Ford Foundation.

A Swiss national, Professor Swoboda was a member of the governing board of the Swiss Economic Association and of the Academic Panel of the Group of Thirty. He regularly gives seminars and lectures at leading universities throughout the world, as well as at international organizations. An occasional consultant to public and private institutions (including the International Monetary Fund and the World Bank), he is a regular participant in major international monetary and financial conferences.

His recent publications include: *Threats to International Financial Stability*, edited with Richard Portes (Cambridge University Press, 1987); “Policy and Current Account Determination Under Floating Exchange Rates,” coauthored with Hans Genberg and published in the IMF’s *Staff Papers* (March 1989); “Swiss Banking after 1992,” in *European Banking in the 1990’s*, edited by Jean Dermine (Basil Blackwell, 1990); and “Financial Integration and International Monetary Arrangements,” in *The Evolution of the International Monetary System*, edited by Yoshio Suzuki, Junichi Miyake, and Mitsuaki Okabe (University of Tokyo Press, 1990).

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