Berichte

An Assessment of European-American Monetary Relations

I. Introduction

European-American monetary relations are conducted through official and non-official channels, and involve a plethora of official institutions and markets. Official business is conducted by central banks (and monetary authorities) in the context of global, regional, and bilateral arrangements (i. e., IMF, the Group of Ten, the European Monetary System, etc.), whereas non-official or private monetary relations occur through the national banking systems, the Eurobanks, foreign exchange markets and non-bank sectors.

There is an interdependence between official and non-official or private behavior, whereby official arrangements are made and relations are developed with consideration for and affected by the non-official market. While non-official relations and transactions are conducted in the market place and account for the bulk of the international financial market activity, they are nevertheless subject to, implicity or explicity, official arrangements, regulations and activity.

Hence, official relations, in the main, set the stage and affect the environment of the financial and capital markets in which we operate. Therefore, a thorough understanding of official monetary relations and their historic trends could significantly improve our interpretation of the private international financial markets and assist us in anticipating future developments and prospects.

This paper examines European-American monetary relations, broadly and narrowly defined. The broad relations include, to a great extent, the primary aspects of the global monetary and financial environment: issues of the Eurocurrency market, international reserves and liquidity, recycling and external debt, and international coordination of economic policies. The narrowly defined relations pertain more particularly to foreign exchange relations and monetary policy cooperation.

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More specifically, European-American monetary relations are best reflected by the following areas (See Tables I and II):

A. *Broad Relations:*

I. International Capital Markets
   a) International bank lending
   b) Eurocurrency market control and international supervision

II. Global Monetary Issues
   a) The IMF substitution account
   b) International liquidity
   c) Multiple-reserve currency
   d) Recycling OPEC surpluses

III. International Channels for Coordination of Economic Policies
   a) OECD
   b) BIS
   c) IMF
   d) Summitry

B. *Narrow Relations:*

IV. Foreign Exchange Relations
   a) European Monetary System (EMS)
   b) Exchange intervention and official arrangements

V. Monetary Cooperation
   a) Interest rate
   b) Monetary growth

Section II examines the historical and political background; Section III summarizes the broadly defined relations; Section IV analyzes the narrowly defined monetary relations in terms of exchange rates; Section V treats the issue of Atlantic interest rate dispute between the U.S. and Europe; and Section VI provides closing comments.

II. The Historical and Political Background

In the post World War II era, the undisputed economic and military power of the United States enabled her to structure the free world into collective defense arrangements and design a liberal Bretton Woods economic system. In the 1950s, the Europeans (and the Japanese) have completed their post war recovery, thereby making the international system more pluralistic. This trend was sharply accelerated in the late 1960s and the early 1970s by the war in Vietnam and U.S. economic problems (i. e., high foreign energy dependence, high inflation, low growth and declining dollar), which caused the Europeans to become increasingly skeptical about American global leadership[1].

In the 1960s and 1970s European-American relations have been dominated by currency issues, although trade and investment relations were of prime concern. The U.S. had always supported EEC unification efforts in order to strengthen the Western Alliance. It therefore tolerated European regionalism and discrimination against American exports, and thus carried the financial burden of hegemony.

The U.S. reacted to the EMS positively and in a spirit of cooperation, despite its challenge to the U.S. dollar. Monetary cooperation was induced by several factors; (1) risk of a collapse of the monetary system have remained a heavy burden for the U.S. and the Europeans, (2) realization that a global trade liberalization policy cannot be successfully continued unless a stable currency system is also established, and (3) the European fear that either an aggressive on a passive American exchange rate policy could produce an overvalued dollar, thus rendering to America an advantage. An overvalued dollar gives an unfair advantage to American MNCs and encourages direct foreign investment, while an undervalued dollar renders its exports an unfair competitivenes in Europe and elsewhere.

Since the mid-1970s, industrial countries have been confronted with a prolonged economic crisis which has slowed down growth, created high unemployment and inflation, and has threatened the free international trade and financial system. The remedies are painful structural adjustments via difficult political decisions. As a result, manipulating the international system occassionally became the substitute for badly needed domestic adjustment. In addition to economic problems, the industrial countries are confronted with challenges in the areas of cooperation among themselves, as well as East-West and North-South relations[2].

In this environment, according to *Helmut Schmidt,* the most significant factor for global economic and political stability is the partner-

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[1] *David P. Calleo,* Inflation and American Power, Foreign Affairs, Spring 1981, pp. 781 - 812.

[2] *Helmut Schmidt,* A Policy of Reliable Partnership, Foreign Affairs, Spring 1981, pp. 743 - 755.

ship between Europeans and Americans.[3] The Europeans look forward to the increased responsibilities that will be fulfilled by American cooperation.

III. Broadly Defined European-American Financial Relations

1. International Coordination of Economic Policies

The increased interdependence between the U.S. and Europe has led to increased competition and the need for cooperation. However, the pace of interdependence has advanced faster than the means for managing it politically and institutionally have. It has been recognized that international coordination of domestic economic policies might be necessary for welfare and as a vehicle for coping with major economic and political changes. International coordination of economic policy is designed to influence business cycles, to affect long-term price trends, and to avoid inconsistencies among domestic policies. Such coordination could take several forms, including the setting of joint policy objectives and the adjustment of policies to those of other countries. International economic policy coordination faces several obstacles, the most significant of which are: (1) differing national objectives and economic priorities and (2) the desire to maintain national economic autonomy. Within the context of economic policy coordination, national (and regional) policies vis-a-vis major international monetary issues reflect both the degree of international monetary cooperation among the major countries and attitudes towards the major global issues. Table I provides a summary of European-American monetary relations by country/region as reflected by their positions on the major issues.

2. Institutions for Policy Coordination

Economic policy is coordinated through several channels or institutional settings; of which the most significant are: (1) OECD; (2) BIS; (3) IMF; and (4) Western Economic Summit conferences.

The Organization for Economic Cooperation and Development (OECD) and the Bank for International Settlements (BIS) deal with economic policy making in the industrial countries.[4] The OECD reviews

[3] Ibid.
[4] OECD members include Canada, U.S., Japan, Australia, New Zealand, Austria, Belgium, Denmark, Finland, France, W. Germany, Greece, Iceland,

current problems among the major industrial countries, focusing on domestic policies, balance of payments adjustment, and the interaction between them. On the other hand, the main concern of the BIS is with international banking and financial markets and the supervision of them.

The IMF provides a forum for international economic and financial cooperation through the Articles of Agreement and various conferences and meetings that it holds. For instance, the Interim Committee (on the international monetary system) of the Board of Governors of the IMF convenes annually to discuss, among other issues, the global economic outlook and the appropriate policies. The IMF has the responsability to exercise strict surveillance over foreign exchange policies. The Articles of Agreement allow member countries the freedom to choose their own exchange rate arrangements, but require them to cooperate with the Fund and with each other to assure orderly exchange market conditions. For this purpose, the IMF adopted principles and procedures for the guidance of and surveillance over members' exchange rate policies.

According to Article IV, the principles for guiding surveillance are as follows:

(1) members must avoid manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members,

(2) members have to invervene in the exchange market to counter disorderly conditions, however,

(3) they must consider the interests of other members.

The procedures for surveillance require the IMF to engage in periodic reviews of broad developments in exchange markets, and to keep in close contact with members concerning their exchange arrangements. Evidence to date shows that the Fund's surveillance over exchange rate policies, concerns whether there is consistency between a members balance of payments and exchange rate policies. According to the IMF, global surveillance is carried out in the context of the regular discussions of the world economic situation and outlook that take place

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Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, U.K. and Yugoslavia.

The Bank for International Settlements' membership includes the Group of Ten, Belgium - Luxembourg, Canada, France, W. Germany, Italy, Japan, the Netherlands, Sweden, U.K., and the United States, and Switzerland.

both in the Executive Board and at the meetings of the Interim Committee.[5] Upon the indentification of inappropriate exchange rate policies, the IMF holds consultations with individual members to rectify the situation.

The global economic difficulties of the 1970s induced the major industrial countries to seek more effective ways of managing economic interdependence through collective leadership in the form of Western Economic Summit meetings.[6] (The first Summit was held in November, 1975.) These summits represent a start in a new direction, involving the direction of national policies and national decision making towards recognition of greater interdependence in economic, political and security matters, and the need for collective leadership at the top level of governments. The economic summits are likely to continue at regular intervals, since the 1980s require major efforts among the key industrialized countries to solve economic and political problems independently at the collective level.[7]

According to official EEC policy, international cooperation is of vital interest to the Western world. Participation in the Western Economic Summits is beneficial to the entire economic community. The Western Economic Summits have experienced both shortcomings and successes. They have sometimes lacked focus and public impact and require a follow-up mechanism, a weakness which carries the risk of undermining confidence when leaders are seen to falter.[8]

The past summits have principally focused on problems of economic policy harmonization, which included issues of inflation, energy, trade, North-South relations, financial instability, and the need to manage economic recovery as the world emerged from the worst recession since the 1930s. In the 1980s, in addition to the above problems which remained unresolved, new difficulties are emerging. The challenges of the 1980s will require a higher degree of effective collective leadership among key industrial countries than has been previously established.[9]

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[5] IMF, Annual Report 1980, Washington, D.C.
[6] Bulletin of the European Communities (Bull. EC), No. 2, Vol. 13, 1980.
[7] *Harald B. Malmgren*, Summit Meetings And Collective Leadership in the 1980s, The Atlantic Council Working Paper on Political Affairs, Washington, D.C., April 1980.
[8] Ibid.
[9] Ibid.

3. International Reserve and Liquidity

In the foreseeable future, the dollar will continue to function as a key international concurrency, but other currencies will assume greater significance. The question of sharing the reserve burden of the international monetary system with the U.S. could become a major issue during the 1980s.

In recent years the DM, the Swiss franc and the yen have become secondary reserve currencies. This trend, together with the ultimate emergence of European Currency Units (ECUs) and Special Drawing Rights (SDRs) as reserve assets, is bound to have an impact on the composition of international reserves and liquidity. However, it is necessary and appropriate in the interest of long-term stability for these currencies to proceed in this direction in an accelerated manner.

Evolution of the German mark, Swiss franc, yen, the ECU and the SDR into reserve currencies and assets alongside the dollar could be helpful to the U.S. and the world monetary system if it leads to (1) a sharing of monetary responsibilities between the Europeans (and the Japanese) in managing international reserves and (2) ultimately, a world system based on multiple reserve assets.

Whether the ECU will serve as a reserve and intervention asset and compete with the dollar and the SDR, or if it will supplement the IMF's efforts to provide a wider choice to asset-holders is still uncertain. When the ECU becomes fully developed, it will compete with third world courrencies as well as EMS-member currencies. If the ECU becomes a reserve asset alongside the dollar (and perhaps the yen), bilateral or trilaterial monetary and economic coordination of policies would have to improve.

The potential reduction of the dollar's role may have significant effects on the dollar and on U.S. foreign exchange and balance-of-payments policy. Alternatively, this can be viewed as an opportunity to assist the U.S. and the entire world in resolving the dollar "overhang".

Several national currencies (U.S. $, DM, Swiss franc, yen, etc.) function as key international currencies, i. e., as international numeraires, as reserve currencies and as vehicle or transaction currencies. These functions are associated with benefits and costs that accrue to the international key currencies. Utility from a currency is derived from its function as a unit of account, a medium of exchange and a store of value. For instance, the U.S. benefits from the international use of the dollar as a medium of exchange or vehicle currency and as a primary international reserve asset.

The benefit accrued from the acceptance of a currency as an international medium exchange and reserve asset is known as "seignorage", and is derived from supplying the international community with dollars or DM liquidity for means of payments and international reserves. The benefit is equal to the difference between the cost of issuing and servicing these liabilities, e. g., interest rate, and the yield on the real financial assets acquired as a result.

Seignorage accrues from past and present liquidity creation and can be estimated by multiplying the outstanding stock of liquid liabilities by the appropriate interest rate differential. Hence, benefit from liquid dollar liabilities held by official foreigners could be viewed as a perpetual rent. The impact of the reduced global role of the dollar could be analyzed in terms of cost benefit. The benefits of the international role of the U.S. dollar are derived from (1) accessibility and credit availability to financial markets; (2) lower cost of credit and (3) freedom from exchange risk in the bulk of international trade and financial transactions. Costs are accrued due to the constraint on the pursuit of independent domestic economic policies, reduced exchange flexibility, the burden of supplying reserves to the world economy and the sharp increase in the cost of servicing foreign liabilities.

IV. Currency Relations

1. The Objectives and Performance of the EMS

The unpredictability of U.S. monetary policy in the latter half of the 1970s has led the Europeans to believe that the Americans were abandoning the leadership of the western world. This assessment combined with the instability of the dollar, EEC's dissatisfaction with floating exchange rates, and an effort to minimize the adverse effects of excessive exchange rate volatility on economic growth and employment, led to the establishment of the EMS.

EEC's international position was greatly strengthened by the introduction of the European Monetary System, although the system is incomplete without the participation of the United Kingdom, and its future development remains uncertain.[10] The EMS reflects a more self-reliant European Community; it is stronger, more cohesive and internationally more influential than at any time in the past. Accordingly, the Community is gradually outgrowing its regionalist approach and is engaging economically and politically outside its borders. The EMS is one aspect of an adjustment towards a greater global partnership.[11] Because of the high proportion of intra-EEC trade, the region forms a common currency area. Therefore, the establishment of the EMS and the adoption of the ECU as a common denominator for exchange rate quotations, stabilization, and adjustments are reasonable objectives.

Intra-Community trade ranges from 36 % to 77 % for individual countries, while trade with the U.S. ranges from a low of 3 % for the Netherlands, to a high of 9.6 % for the U.K. These percentages rise substantially when invisible transactions are also added. Hence, the U.S. is not a major trading partner for any member of the EEC; nevertheless, the role of the dollar in trade denomination, investment and financial transactions is most significant.

The EMS was designed to increase currency and price stability in the EEC through greater economic cooperation and the establishment of a monetary system with three major functions; (1) the creation of fixed but adjustable exchange-rate relationships and their management through intervention; (2) credit allocation and consolidation of credit mechanisms; and (3) reserve issuance and the management of the ECU as a parallel currency. The EMS is in an evolutionary phase whereby the present stage is a first step which could be followed, if conditions allow, by a series of additional developments. Further progress of the EMS will require consolidation of the existing provisions and procedures governing the exchange rate and credit mechanisms by the full utilization of the ECU as a reserve and settlement asset within the context of the European Monetary Fund.[12] However, the creation of this institution, as originally scheduled for two years after the start of the System was postponed. The monetary role of the EMS should include (1) the extension of the role of the ECU, and (2) coordinating monetary and exchange rate policies within the EMS and vis-a-vis the dollar.

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[10] Bull EC 2 - 1980.

[11] *Robert Triffin,* The International Role of the Dollar, Foreign Affairs, Winter 1978/79, pp. 269 - 286, and in the European Monetary Fund: Internal Planning and External Relations, Banca Nazionale Del Lavoro Quarterly Review, No. 134, Sept. 1980, pp. 307 - 396.

[12] Bank of Italy, Annual Report for 1979.

Progress of the system was adversely affected by disturbances in the world economic and financial markets. The second stage of the EMS, which was originally planned to be effective as of March 1981, has been delayed because of political and technical problems.

In the first three years, the EMS has performed relatively well and involved several small adjustments of central exchange rates. Evidence shows, however, that the system's cohesion was maintained through both interest rate policy and exchange market intervention in Community currencies and, on a larger scale, in dollars. Thus, the EMS has provided some valuable currency stability in Europe at a difficult time of turbulence, and has functioned relatively satisfactorily in terms of the narrowly defined objectives of providing greater exchange rate stability in the region. The broader goals of lower inflation and balanced growth have been met only partially.[13]

2. *Atlantic Monetary Cooperation*

Evidence shows, however, that the EMS failed to fully insulate the EEC from external developments and provide a zone of complete monetary stability. Wide exchange rate fluctuations and their inflationary consequences have brought the issue of global and Atlantic economic cooperation into sharp focus.

The Europeans have recognized that greater exchange stability and more orderly financial markets should be explicit objectives of policy matters. Since exchange rates are affected by economic and financial policies and performance, as well as by the psychological undercurrents of the market, official intervention is often required. However, effective exchange intervention requires close cooperation among major national central banks and monetary authorities.

The main issue is whether a formal relationship vis-a-vis the dollar would be consistent with: (1) the EMS objective of creating a zone of monetary stability in Europe; and (2) the U.S. objective of greater flexibility determined by free market forces.

The Europeans have realized that (1) the dollar will remain the principal international currency for the foreseeable future; and (2) in the medium term, a greater degree of currency management is necessary in order to avoid adverse repercussions from exchange rate over-

[13] Bull. EC 2 - 1980.

shooting. In this context, monetary relations should be effectively coordinated and managed to a relatively high degree on both sides of the Atlantic. The success of the EMS depends on both internal and external conditions. Internal variables include: (1) convergence of economic policies and performance within the EEC; (2) timely adjustment of central exchange rates, if economic performance does not converge; and (3) joint intervention in the exchange market to support central exchange rates. The external conditions required for successful EMS operation and survival, according to European experts are; (1) American cooperation; and (2) a stable dollar.

The relationship between the dollar and the EMS comprises the most significant and complex aspect of European-American monetary affairs. The need for a defined intervention policy vis-a-vis the dollar has been the subject of extensive debate both within the Community and with the U.S. To date, however, there has been no formal EMS-dollar policy. Instead, this has been left to the Bundesbank's dollar policy.

The question of whether a formal EMS/dollar relationship is feasible, necessary or viable can be formulated in several testable hypotheses:

(1) whether a defined relationship of the EMS vis-a-vis the dollar and other third currencies could help the stability of the European and the international monetary systems, or if failure to formulate such policy could jeopardize the survival of the EMS, and adversely affect the international monetary system;

(2) whether a common dollar policy of the EMS, designed to maintain the dollar rate within certain ranges, can be successful without U.S. cooperation, or if joint EMS/dollar policy is feasible without a formal agreement;

(3) whether the EEC's call for a dollar policy and closer monetary coordination with the U.S. is a cyclical or structural phenomenon;

(4) whether closer monetary cooperation between the EEC and the U.S. will require institutional changes and set the stage for a new era of greater cooperation;

(5) what the cost-benefit of a joint EMS/dollar policy is for individual countries, regions (EMS, EEC) and the world monetary system; and

(6) whether the adoption of a joint EMS/dollar policy will negate the principles of flexible exchange rates and, in effect, restore a highly managed currency system.

The comparatively smooth start of the EMS was assisted by the relative stability of the dollar. It is often asserted that the EMS would not have survived had it not been for the U.S. dollar support programs in 1979 and 1980. Accordingly, stability of the dollar/EMS currencies is a necessary (but not sufficient) condition for stability of the European Monetary System. This, in turn, requires succesful anti-inflation policies in both the U.S. and the EEC, and the avoidance of excessive interest rate differentials and fluctuations across the Atlantic.

Over the past several years, the DM (together with the Swiss franc and the Japanese yen) has grown in importance as an international currency, while the predominance of the U.S. dollar has diminished. In its role as the world's second most significant reserve currency, the DM has become highly sensitive to interest rate considerations as compared to other EMS currencies. As relative interest rate differentials between dollar and DM denominated assets increase, investors can shift funds between U.S. and German financial instruments, causing substantial movements in the dollar-mark exchange rate and, in turn, the EMS.

The depreciation of the German mark against the dollar has played a particularly important role in the interest exchange-rate trends in Europe because of the special position of the mark in the EMS and in international financial markets. The DM reacts more sharply to dollar fluctuations than the other EMS currencies which produces strains within the system. The sinking of the DM in the EMS pulls down the other EMS currencies due to the members' cumpulsory intervention to stay within the margins, causing them to depreciate against the dollar. The German mark has thus faced particular difficulties in the EMS because it is the only reserve currency within the group. When the dollar is strong, the mark "by definition" becomes weak, and vice versa when the dollar is weak.

The successful functioning of the EMS and its policy vis-a-vis the dollar may provide greater stability for global monetary relations. A common EMS/dollar policy could be implemented by the Europeans with or without U.S. cooperation, however its relative success and cost depend on mutual cooperation. Without it, Europe might face an exhorbitant cost in terms of the need to subordinate economic and financial policies to external goals as they intervene to protect their currency. A joint EMS/dollar policy could be successful without a formal agreement in the EMS or with the U.S., as long as, in practice, all parties behave as if a de facto agreement existed.

Whether the EEC's call for greater Atlantic monetary cooperation, in terms of a joint dollar policy and more reasonable interest rate level, is a cyclical phenomenon or a basic change in their policy is not clear. However, the Europeans have always advocated and followed a managed floating exchange rate policy, of which an implicit or explicit joint dollar policy is a major pillar.

While a joint European dollar policy was not formulized, it was largely practiced by the EMS members. Concerning cooperation on interest rates, it should be recalled that European-American relations, which are conducted through a number of existing institutions, have always dealt with broad macroeconomic issues. In this context, they have attempted to dictate policy to each other on similar issues, e. g., the locomotive approach of 1978. Hence, European desire for greater monetary cooperation has always existed, but its urgency has recently increased. Changing circumstances in the global economy could restore greater equilibrium in the international financial markets, thereby reducing the need for Atlantic monetary cooperation. In this respect, the issue of European-American monetary cooperation is, to a great extent, cyclically linked to global financial conditions.

Closer monetary cooperation between the U.S. and Western Europe could be conducted within the framework of the existing institutions (e. g., OECD, the Group of Ten, Western Economic Conference, etc.). Greater international cooperation in interest and exchange rates could, in turn, increase cooperation in other areas of international macroeconomic and business cycle management. The results of such a policy could be more synchronized business cycles around the world, increased interdependence, and greater intervention by governments in economic affairs in an effort to "fine tune" economic conditions. This approach requires a common economic philosophy and mutual political/economic interests among the major countries, both of which do not exist at the present time.

The adoption of a joint EMS/dollar policy (as well as a joint dollar/EMS policy) will transform the existing international exchange rate system from a managed float regime to a fixed but adjustable exchange rate system. While the Europeans are generally seeking greater fixity in the system and are, therefore, receptive to such a transformation, Americans wish to operate in a freely floating exchange rate regime. Hence fixity of the EMS/dollar relationship is unlikely to be accepted by the U.S. and could therefore not be implemented.

3. *EMS-Dollar Official Policy and Practice*

Relative to the dollar, the Community has neither established an official joint EMS policy nor pegged cross exchange rate targets in terms of it. It is, therefore, often asserted that there is no joint EMS policy with regard to the dollar. However, the EMS/dollar exchange rate is implicitly set by the foreign exchange intervention policy of the EMS members, particularly of West Germany. In this context, the Deutsche Bundesbank often undertakes large-scale intervention in the market.

Thus, coordinated policy vis-a-vis the U.S. dollar has broadly been followed by EMS participants, through intervention in U.S. dollars designed mainly to reduce fluctuations of EMS currencies vis-a-vis the U.S. dollar or to carry out necessary adjustments. Hence, while there is de facto an implicit joint EMS-dollar policy, the external position of the EMS is determined by the key currency of the system, viz. the DM.

Hence, the relation between the dollar and the DM is pivotal to the present international monetary system and has widespread implications. To the extent that other currencies accept such a domination and keep their relation to the DM stable, they follow the DM/dollar trend. Such an arrangement is not necessarily inefficient as long as the key relation is managed in a responsible manner. West Germany has a substantial responsibility for managing the dollar/DM rate which, in turn, affects the EMS/dollar rate. It is, therefore, of great importance how Germany resolves and institutionalizes the policies of stabilizing the dollar/DM rate within a fairly broad range. Such a policy could be handled in a decentralized way through more detailed consultations and concertations of intervention policies, based on agreed guidelines.

4. *EMS Proposed Radical Policy Shift*

The EEC summit of the Heads of State/Governments in Maastricht, held on April 23 - 24, 1981, called for close cooperation with the United States over monetary policy and exchange rates to ensure economic recovery and improve economic conditions.[14] This policy also intends

[14] BIS Press Release, March 26, 1981.

to make the best possible use of the intrinsic mechanisms of the European Monetary System.

The EEC Commission called on the U.S. government to make its contribution to the international community by taking special measures to bring interest rates down to a level that is compatible with growth and stability.

Mr. *Jacques Van Ypersels,* former chairman of the EEC Monetary Committee, advanced a four point program to improve the EMS:[15]

(1) bring Britain into the EMS:

(2) improve policy coordination towards the dollar by setting up a swap credit line between the European Monetary Cooperation Fund (EMCF) and the Federal Reserve, and replacing the existing arrangements of bilateral swap credits between the Fed and European central banks;

(3) enlarge the role of the ECU by eliminating limits on utilization by central banks and by encouraging its private use;

(4) induce greater convergence in the economic policies of the member states, in particular by devising a new indicator within the EMS to reflect diverging inflation rates.

5. Cost-Benefits of EMS/Dollar Policy

The adoption of a joint intervention policy by the EMS central banks vis-a-vis the dollar could result in considerable cost and difficulties. The more stability sought in the EMS/dollar exchange rate, the higher the cost of intervention as a result of: (1) diversity in the structural characteristics of the member countries; (2) the composition of trade, (3) currency denomination of trade and international reserve composition; and (4) economic policy. These factors could produce different repercussions from a dollar depreciation against the EMS members and loss of competitiveness for some members vis-a-vis third countries. Intervention, especially against the dollar, could result in a partial loss of control over exchange rate or monetary independence, and lead to conflicting internal requirements of containing inflation and countering the pressures within the EMS exchange rate mechanism, and against third currencies.

[15] Financial Times, February 18, 1981.

Variations in the cost of maintaining a stable relationship between the dollar and other third currencies may lead to difficulties within the agreed margins of fluctuation (i. e., ± 2.25 %, ± 6 %) or even to continual changes in the central rates. Hence, the cost of membership in the system could become prohibitive and the agreement to maintain fixed cross exchange rates could be jeopardized. The issue, therefore, is to prevent large fluctuations of the EMS with respect to the external monetary situation, and especially the dollar.

The adoption of a joint dollar/EMS policy could be costly to the U.S., and far exceed any forseen benefits because: (1) there will be a need to subordinate domestic policy to external requirements; and (2) there will be a reduction in economic independence and a likely need to trade off between domestic economic targets of inflation, employment and growth rates, for external goals of exchange rate maintenance. Thus, the need to maintain a given target of exchange rates might be too costly for the U.S. economy and outweigh the benefits of greater exchange rate flexibility.

V. Interest Rate Dispute

The West German Chancellor warned that current high interest rates in the U.S. and elsewhere in the world pose serious problems for the Western Alliance,[16] because in the long term they are inconsistent with attainment of full employment and higher economic growth. Mr. *Schmidt* called on the U.S. to reduce its high interest rate, since it forces Europe's central banks to set higher interest rates than is appropriate for their economies, which are in a recession.

The Europeans have the option of either following the upward trend in U.S. interest rates, thereby maintaining relatively stronger exchange rates, or maintaining relatively low interest rates which are suited for their recessionary economies, thereby experiencing depreciating currency rates. Both options, however, seem to be too costly. First, an excessively tight monetary policy would further exacerbate their recession. Second, a relatively loose monetary policy could adversely affect the exchange rate and have inflationary effects through imports. The growing awareness of the inflationary consequences of a weak currency has reinforced the desire to prevent exchange rate declines. To some extent, this portends a competitive appreciation of currencies through competitive interest rates.

[16] BIS Press Release, February 27, 1981.

This policy dilemma generated strong European demand for international coordination of interest rates and economic policies. Since the subordination of monetary policy for currency considerations is a costly option, a number of high ranking officials of the EEC have made urgent public calls for a reduction in U.S. interest rates. Thus, the demand for lower interest rates as a solution to the European dilemma has continued and at times has intensified. Lower interest rates abroad, especially in the U.S., would allow Europe to adopt a more appropriate monetary policy stance and stimulate their recessionary economies.

At a meeting held in Brussels on April 16, 1981, EEC Finance Ministers agreed to seek concerted action to cut interest rates in the U.S. and Europe. Additional proposals for joint international action to alleviate the situation have recently been made. According to a West German proposal, each nation's monetary policy would be aimed at lowering interest rates in such a way as not to disturb the existing exchange rate structure.

The OECD has considered this issue and it intends to present a plan for concerted interest rate reduction, whereby countries with high interest rates (e. g., U.S.) will be required to rechannel funds back to the countries of their origin, thereby offsetting the exchange rate impact of such flows. Furthermore, the IMF is reportedly formulating a similar plan that will require the U.S. to intervene in the foreign exchange markets in support of those countries that come under pressure as a result of an outflow of funds to the U.S.

The U.S. has replied negatively to the international demand for lower interest rates, since it is confronted with its own major dilemma: an easier monetary policy would further exacerbate domestic inflation, which is still running at double digits, thus leading to still higher interest rates in the long run. The Federal Reserve is strongly committed to its current monetary policy.

The interest rate controversy remains unresolved, thus adding to the growing problems arising from increased international interdependence, for which no easy solutions are apparent. In the aftermath of the French elections, the European currency market has become unsettled, and the French franc has depreciated considerably. Consequently, central bank intervention on a large scale, extremely high interest rates, and exchange rate controls have resulted. Subsequently, demand for lower interest rates has somewhat weakened in Europe.

VI. Final Comment

This dispute over closer European-American monetary cooperation is transitory and is expected to diminish as global economic and financial conditions improve and business cycles synchronize in the industrial world.

The French Presidential elections have introduced substantial uncertainty into the European Community and diminished the prospects of the European Monetary System's success. Unsettled currency debates could pose difficult problems for the Europeans and create a zone of monetary instability, with a significant effect on intra-European flows of trade and investment. Against this background, the reemergence of the U.S. dollar is well under way and the issue of transatlantic monetary cooperation becomes relatively insignificant for U.S. policy makers.

Differences in the cost and benefit of closer cooperation and management of international economic and financial affairs combined with significantly different economic philosophies, make closer European-American cooperation unnecessary and unlikely. American cooperation and co-responsibility for currency policies in Europe could diminish further in the 1980s. The need may arise for actions exclusively for the benefit of American interests, thereby contributing to greater international financial instability. Experience has shown that the present exchange rate system neither provides full insulation from external developments nor facilitates sufficient exchange rate stability. Large exchange rate fluctuations have at times led to instability and disorderly conditions in the markets, which required concerted action by the major economies.

However, considered in a global context, a reduction in the inconsistency between U.S. foreign/defense policy and international monetary/economic policy could be needed in order to enhance the American international position and strengthen its allies. Accordingly, the U.S. and Europe should negotiate a new transatlantic relationship for the 1980s based on the mutual recognition of the relative economic, and military significance.[17]

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[17] *Josef Joffe*, European-American Relations: The Enduring Crisis, Foreign Affairs, Spring 1981, pp. 835 - 851.

VII. Conclusion and Outlook

European-American international monetary relations are in a state of transition; they are indadequate, controversial, and lack both a common purpose and formal system or institutional framework for policy coordination.

At present, a significant divergence has emerged between U.S. and European attitudes towards narrowly defined international monetary cooperation (i. e., exchange and interest rates). Views about broadly defined financial relations (i. e., global monetary and financial structure, operation, environment) are, however, less divergent. Moreover, there is a significant inconsistency between American foreign policy and international monetary/financial policy vis-a-vis Europe, particularly in the narrowly defined monetary relations.

European-American monetary relations face several problems, which are excerbated because of (1) differences in economic philosophies (i. e., a free market approach versus a strategy of fine tuning with substantial government intervention in the economy); (2) significant diversities in economic structures, operations and performance; (e. g., degree of openness) and (3) asymmetry of international economic interdependence. These differences in turn affect the resultant costs and benefits of financial cooperation for individual countries and regions as well as coordination across the two sides of the Atlantic.

The theoretical economic orientation of official policies (i. e., Keynesian, monetarist, supply-side, etc.) influence the significance of monetary independence and the role of monetary policy in domestic stabilization. These differences also affect the perceived consequences of exchange rate volatility in the domestic economy, and the costs and benefits of international economic cooperation.

While the *Reagan* Administration advocates a free market approach towards the currency market and the determination of interest rates, the European government call for a greater degree of management through international cooperation.

The U.S. does not share the same aspirations or objectives as Europe (and the European Monetary System) nor does it face the same difficulties that arise from efforts to maintain quasi fixed but adjustable exchange rates by the EMS. Hence, different objectives and exchange-rate systems affect European and American economic policies and are reflected in conflicting attitudes towards the need for coordinated international economic policy. These divergent goals are translated into incongruent policy efforts on either side of the Atlantic.

Evidence suggests that Western Europe's strong demand for greater American cooperation in the targetting of interest and exchange rates is mainly a transitory phenomenon. It is a function of unsettled global economic and financial conditions, rather than a fundamental change in their economic approch.

The decline in currency volatility during 1979 - 1980 was primarily the result of a more common business cycle in America and Europe, rather than formal cooperation or a greater degree of exchange rate management. These conditions have also contributed to a more conducive environment for the successful operation of the EMS.

Therefore, as market conditions improve on both sides of the Atlantic, interest and exchange rates are likely to be at more equilibrium levels, and the European-American conflict will subside. Under these circumstances, it is doubtful that current U.S. international and domestic financial policy should be modified to accomodate European requests. Instead, it should be pursued primarily with an eye towards achieving the domestic goals outlined by the Administration.

Increased international economic and financial interdependence in trade, investment, and financial markets has reduced the insulating properties anticipated from floating exchange rates. This, in turn, has increased the need for cooperation on a regional and global scale in economic and financial management to limit extremes in exchange rate movements.

The costs and benefits of international monetary cooperation depend on economic structure, operation and policy which vary substantially between countries. Asymmetry in the relationship of the EMS members vis-a-vis the United States creates uneven consequences when dollar movements are excessive (over time and in magnitude), which, in turn, makes the EMS' stability sensitive to the dollar's position.

Uneven interdependence with U.S. foreign trade and investment in individual European countries and in the region as a whole causes recurrent mutual dissatisfaction with the economic policies followed by the major economies. Variations in the degree of openness and the directions of trade and investment subject countries to diverse economic consequences.

European-American Relations

Table I: **Broadly Defined Relations/Issues & Position**

Country & Region	International Capital Markets		Global Monetary Issues				International Coordination of Economic/Monetary Policy			
	Inter-national Bank Lending	Euro-currency Market Control & Super-vision	IMF Dol-lar Sub-stitution Account	Inter-national Reserve Liquidity	Multiple Reserve Currency	Recycling OPEC Surpluses	OECD	BIS	IMF	Sum-mitry
U.S.	+	*	*		+	*	*	+	+	*
Belgium/Lux.		+	+		+	*	+	+	+	
Denmark ...		+	+		+	*	+	+	+	
France		+	+		+	*	+	+	+	*
Germany ...	*	*	+		*	*	+	+	+	*
Italy		+	+		+	*	+	+	+	
Netherlands		+	+		+	*	+	+	+	
Switzerland		*	+		*	*		*		
U.K.	*	*	+		+	*	+	+	+	*
EEC										

Source: Compiled from various sources.
Notes: + in favor; * qualified support; – oppose.

Table II: **Narrowly Defined Relations/Issues & Policy**

Country & Region	European Monetary System & Dollar Policy	Foreign Exchange Relations: Exchange Inter-vention & Official Arran-gements	Surveil-lance IMF	Monetary Cooperation: Interest Rate	Monetary Growth
U.S.	—	—	*	—	—
Belgium/Lux.	+	+	+	+	+
Denmark	+	+	+	+	+
France	+	+	+	+	+
Germany	+	+	+	+	+
Italy	+	+	+	+	+
Netherlands ..	+	+	+	+	+
Switzerland ..	*	*	*	+	*
U.K.	*	*	*	*	*
EEC	+	+	+	+	+

Source: Compiled from various sources. — *Notes:* + in favor; * qualified support; — oppose.

Close management of the dollar exchange rate vis-a-vis the major European currencies would be too costly for the U.S. and greatly exceed any benefits that could be derived from such a policy. The European countries, however, could obtain net benefits from a joint dollar policy. Presently, Europe is in a position to derive more potential net benefits from such a change than the U.S. would.

European-American monetary cooperation is necessary, but not sufficient, for more effecient operation of the EMS and the EEC economies. (The necessary conditions are internal requirements.) Cooperation, however, is neither necessary nor sufficient for the dollar's stability and the welfare of the U.S. These asymmetries comprise the major source of conflict in the international policies pursued by both Europe and the U.S., which are inconsistent with broader Atlantic aspirations and objectives.

From a global point of view, close cooperation between Europe and the U.S. in exchange rate management could de facto restore a quasi fixed exchange rate, which could not provide greater stability than the present floating exchange rate system nor be sustained. It is important to bear in mind that relative exchange rates basically reflect underlying conditions and not vice versa.

The trans-Atlantic controversy concerning foreign exchange and interest rates remains unresolved, and the disparity between European-American monetary relations is expected to continue in the future. Efforts aimed at eliminating this gap or promoting common interests are neither likely nor warranted. Therefore, the forthcoming Western Economic Summit is not expected to resolve the U.S.-European controversy.

Finally, the outcome of the French Presidential elections has introduced substantial uncertainty into the European Community and diminished the prospects of the European Monetary System and its global impact. Currency issues could pose very difficult problems for the Europeans and create a zone of monetary instability with significant effects on intra-European flows of trade and investment. Against this background, the reemergence of the U.S. dollar is well underway and the question of Atlantic monetary cooperation has become relatively insignificant for U.S. policy makers.

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Zusammenfassung

Eine Bewertung der europäisch-amerikanischen monetären Beziehungen

Die europäisch-amerikanischen internationalen monetären Beziehungen befinden sich in einer Übergangsphase; sie sind unzulänglich, kontrovers und entbehren sowohl eine gemeinsame Zielvorstellung und ein gemeinsames formelles System als auch einen institutionellen Rahmen für die Koordinierung der Geldpolitik.

Zur Zeit hat sich eine bedeutungsvolle Abweichung zwischen den amerikanischen und europäischen Einstellungen zu einer eng umrissenen Zusammenarbeit (d. h. Wechselkurse und Zinssätze) bemerkbar gemacht. Meinungen über Finanzbeziehungen im weiteren Sinne (z. B. weltweite Geld- und Finanzstruktur, Arbeitsweise, Umwelt) weichen jedoch weniger voneinander ab. Ferner gibt es einen bedeutenden Widerspruch zwischen der amerikanischen Außenpolitik und der internationalen Geld-/Finanzpolitik in Europa, besonders bei monetären Beziehungen im engeren Sinne.

Die transatlantische Kontroverse über Wechselkurse und Zinssätze bleibt ungelöst und eine Fortsetzung der Disparität in europäisch-amerikanischen monetären Beziehungen kann erwartet werden. Bemühungen, diese Abweichung zu eliminieren oder gemeinsame Interessen zu fördern, sind weder wahrscheinlich noch gerechtfertigt. Es kann daher nicht damit gerechnet werden, daß der nächste westliche Wirtschaftsgipfel die amerikanisch-europäische Kontroverse lösen wird.

Schließlich hat das Ergebnis der französischen Präsidentschaftswahl erhebliche Unsicherheit in der Europäischen Gemeinschaft verursacht und die Aussichten auf ein europäisches Währungssystem sowie dessen globale Auswirkung verringert. Währungsfragen könnten die Europäer mit sehr schwierigen Problemen konfrontieren und eine Zone monetärer Instabilität schaffen, die die innereuropäische Handels- und Investitionsströme erheblich beein-

flußt. In dieser gegenwärtigen Situation befindet sich der US-Dollar im starken Aufwind, und die Frage einer transatlantischen monetären Zusammenarbeit ist für US-Politiker verhältnismäßig unbedeutend geworden.

Summary

An Assessment of European-American Monetary Relations

European-American international monetary relations are in a state of transition; they are inadequate, controversial, and lack both a common purpose and formal system or institutional framework for policy coordination.

At present, a significant divergence has emerged between U.S. and European attitudes towards narrowly defined international monetary cooperation (i. e., exchange and interest rates). Views about broadly defined financial relations (i. e., global monetary and financial structure, operation, environment) are, however, less divergent. Moreover, there is a significant inconsistency between American foreign policy and international monetary/financial policy vis-a-vis Europe, particularly in the narrowly defined monetary relations.

The trans-Atlantic controversy concerning foreign exchange and interest rates remains unresolved, and the disparity between European-American monetary relations is expected to continue in the future. Efforts aimed at eliminating this gap or promoting common interests are neither likely nor warranted. Therefore, the forthcoming Western Economic Summit is not expected to resolve the U.S.-European controversy.

Finally, the outcome of the French Presidential elections has introduced substantial uncertainty into the European Community and diminished the prospects of the European Monetary System and its global impact. Currency issues could pose very difficult problems for the Europeans and create a zone of monetary instability with significant effects on intra-European flows of trade and investment. Against this background, the reemergence of the U.S. dollar is well underway and the question of Atlantic monetary cooperation has become relatively insignificant for U.S. policy makers.

Résumé

Une évaluation des relations monétaires euro-américaines

Les relations monétaires internationales euro-américaines se trouvent dans une phase de transition; elles sont insuffisantes, frappées de controverses, et souffrent de l'absence tant d'une finalité commune et d'un système formel commun que d'un cadre institutionnel pour la coordination des politiques monétaires.

L'on constate pour l'instant une disparité significative entre les attitudes américaine et européenne à l'égard d'une coopération étroitement définie (c. a. d. sur les taux de change et d'intérêt). Les opinions sont cependant

moins éloignées lorsqu'il s'agit des relations financières au sens large (ex: structure monétaire et financière mondiale, méthodologie, environment). En outre, l'on observe une importante antinomie entre la politique extérieure américaine et la politique monétaire et financière internationale pratiquée en Europe, en particulier dans les relations monétaires stricto sensu.

La controverse transatlantique sur les taux de change et d'intérêt demeure sans solution et l'on peut s'attendre à la poursuite de la disparité dans les relations monétaires euro-américaines. Des efforts en vue d'éliminer cette contradiction ou de promouvoir des intérêts communs ne sont guère probables et ne se justifient même pas. L'on ne peut donc escompter la solution de la controverse euro-américaine du prochain sommet économique occidental.

Enfin, le résultat de l'élection présidentielle française a occasionné une grande incertitude dans la Communauté Européenne et réduit les perspectives d'un système monétaire européen et de son incidence globale. Les questions monétaires pourraient confronter les Européens à de sérieux problèmes et créer une zone d'instabilité monétaire qui influencerait puissamment les mouvements commerciaux et les flux d'investissements intraeuropéens. Dans la situation actuelle, le dollar US a le vent en poupe et la question d'une collaboration monétaire transatlantique est devenue relativement insignifiante pour les hommes politiques américains.

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