Commentary: Global Implications of Trade and Currency Zones

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Allan Meltzer's paper on "U.S. Leadership and Postwar Progress" is a comprehensive description and comparison of inter-war and postwar political and economic developments in the Western world. At the same time, it is a lucid analysis of the factors that were, and were not, at work in both periods. His paper is both interesting and informative.

I find myself in broad agreement with most of what Professor Meltzer says about political stability, trade rules, and monetary stability. I also share Professor Meltzer's conclusion that in a world where the relative positions of the United States and other countries have changed markedly—not least as a result of the beneficial, somewhat hegemonic role which the United States played over many years in the postwar period—the maintenance and enhancement of stability may require new or revised rules and a system of sharing costs and responsibilities more fully.

The time available to me can perhaps be used best by focusing largely on one matter. Is the world moving toward a more balanced tripolar monetary system involving the dollar, the' yen, and the deutsche mark or a future single European Community (EC) currency? What are the monetary policy and financial implications of the trend toward currency zones?

Politically and economically, the United States is still the strongest

power in the world today, but the days of its solitary dominance, which characterized the world economy until the second half of the 1960s, are gone. This development is by no means surprising. In the long postwar period of peace and security, the formation of further centers of dynamic economic power was to be expected, after the reconstruction of the Western world economy had been accomplished.

However, the end of the period of reconstruction coincided with a distinct rise in the U.S. rates of inflation after the mid-1960s, thus bringing to an end the long period in which a domestically stable dollar had served very usefully as an anchor of stability for the whole international monetary system. Without the prerequisite of a stable dollar, the Bretton Woods system had to come to an end.

In all probability, the change in the economic positions within the world economy was sure to have some impact on the role the dollar had gained as a reserve and investment currency. But inflation in the United States has caused the international role of the dollar to be impaired more than would otherwise have been the case. The international position of the dollar was, of course, never really in danger—in contrast to what happened to the pound sterling in the sixties when it largely lost its quality as a reserve currency. Given its share of close to 60 percent in international reserves, the dollar is still by far the most important reserve currency, and continues to be the key investment currency in the international financial markets. In both functions, however, the dollar now has to compete with other currencies. Monetary authorities and investors, in general, now have attractive alternatives to choose from.

Although expectations of interest rate movements and political developments play a role in this competition, domestic price stability is the most decisive factor here—in the long run, at any rate.

I fully agree with Professor Meltzer when he predicts that the dollar will remain a principal reserve currency, and most likely ***the*** principal reserve currency, provided the United States achieves and maintains domestic price stability, so that dollar assets continue to be a store of value.

Domestic price stability is even more important in the case of the other, smaller reserve currencies. Let us take a look at Germany in this respect: Monetary authorities throughout the world are now holding about 20 percent of their reserves in deutsche marks. At the end of 1990, total deutsche mark reserves equalled $160 billion. Quantitatively even more important are the other deutsche mark investments, by non-residents. Including deutsche mark investment in the Euromarket, and excluding double counting, assets denominated in deutsche marks totalled just under DM 900 billion at the end of 1990, with the major proportion being invested in the short term or in liquid form.

German authorities have at times attempted—unsuccessfully—to curb the development of the deutsche mark into an international currency. The deutsche mark's current role in the international sphere can be viewed as proof of the confidence market participants have in the conduct of a non-inflationary economic policy. The consequences of any loss of this confidence could be very serious for a medium-sized economy such as that of Germany's. Foreign investors' assessments of economic policy, therefore, have to be taken into account by economic policymakers, especially by the central bank. This holds true of all countries whose currencies are widely used for investment by non-residents, but particularly true of countries whose currencies have developed into a significant reserve currency.

The high dependence of economic policy on the assessments of non-resident investors could be a strong incentive for policymakers --especially in the reserve currency countries—to resist a policy that produces inflation, erodes the confidence of market participants, and causes serious economic problems through capital outflows to currencies of countries that are behaving better.

High volatility in the exchange markets and fundamentally changing exchange rates were part of the process that led to the multi-currency system we have today. Now that the multi-currency standard is firmly in place, I believe that we can perhaps rely more than before on'the self-interest of all the main players involved to prevent major divergences in inflationary behavior and to encourage the pursuit of

stability-oriented domestic economic and monetary policies. If this occurs—as I hope it will—a multi-currency system, too, could again produce—also under a regime of flexible exchange rates—a more stable economic environment throughout the world, an environment similar to that provided by the Bretton Woods system, with the United States playing a hegemonic role, until the mid-1960s.

Let me now turn to the subject of currency zones and the view that the world economy is moving toward a tripolar monetary system. This would imply an increase in monetary coherence within both Europe and eastern Asia, the dollar being already a strong pillar in such a system, an increase based on the continuation of the process of growing economic interdependence among countries in these respective areas. Monetary coherence could be supported strongly if one or more countries of sufficient size were to pursue a policy aimed at forming a core of monetary stability, thus providing the whole area with an anchor that would result in exchange rate stability within that area.

Europe seems to be well on the way toward developing into such a clearly defined monetary zone. The process of monetary integration there is based on age-old trade relationships between countries with a high degree of economic homogeneity and with a common social, historical, and political heritage. And it rests on the political will to create a single market and ultimately to move toward a political union.

Developments in eastern Asia will take a different line. I doubt whether monetary coherence will become strong enough in the foreseeable future to form a homogeneous currency block. The yen will, of course, continue to gain importance as an international currency, mainly as a means of payment and a reserve currency for countries in eastern Asia. But will this be enough to convince Japan's trading partners to tie their currencies to the yen and to establish a regional system of fixed exchange rates with the yen as the dominant currency? The pattern of trade in eastern Asia differs markedly from that in Europe. More than 60 percent of the international trade transactions of EC member countries is accounted for by intra-Community trade; despite a rapid growth of intraregional trade in

the last few years, this can certainly not be said of eastern Asia. The degree to which goods markets there are integrated is thus significantly lower than in Europe, and the exchange rates vis-à-vis trading partners outside this area are correspondingly more important. But there are also other reasons for doubt. Without analyzing them in detail, let me merely quote Mr. Gyohten, Japan's former vice minister of finance, who said that—as opposed to North America and Europe—"East Asia is still more divergent and less convergent. In terms of its stage of development, the structure of trade and industry, the social and political constitution, the region of East Asia is full of diversity. East Asia has not yet reached the stage where we can seriously consider it as a homogeneous and convergent economic group."

In my final remarks, I would like to say a few words about the monetary policy and financial implications of the trend toward currency zones. In doing so, I will concentrate on Europe.

One consequence of integrating the European economies into a large single market, and its culmination in a monetary union, will be a substantial reduction of the foreign trade sector. The share of foreign trade and capital transactions in the EC's combined GDP and financial markets will be considerably smaller than the sometimes extremely high proportion in individual member economies. At present, total exports to third countries account for about 10 percent of the EC's aggregate GDP. This share roughly equals the corresponding U.S. ratio.

This means that fluctuations in the foreign exchange rates will have a smaller impact than hitherto on the EC's real economy. These effects have already been mitigated noticeably since the creation of the exchange rate mechanism and the gradual stabilization of exchange relationships within the European Monetary System (EMS). Even under the recently more stable intra-European exchange rate conditions, however, the various EC currencies were still affected to differing degrees by moves into and out of the dollar, in most cases of which the deutsche mark was the main counterpart. This movement has been a constraint on the individual member countries' monetary and interest rate policies. Such pressures on internal

monetary cohesion will disappear once the EC has irrevocably fixed the intra-Community exchange rates or has gone even further by establishing a single currency and, as a logical consequence, pursued a uniform monetary policy. And while major dollar fluctuations will continue to influence the overall situation in the EC, their immediate adverse effects will—if they occur—become more tolerable than under present conditions. This does not mean pleading for a policy of "benign neglect" with respect to the exchange rate. But as is proved by the United States with its repeated pursuit of a policy of "benign neglect" in the past, a large domestic market is able— at least to some degree and for a certain period of time—to absorb the impact of exchange rate movements better than economies with large foreign trade sectors. International cooperation would nevertheless remain necessary, and should be based on the primary goal of keeping prices stable.

The draft statutes of the future common monetary authority of the EC, which is now under discussion in the intergovernmental conference on the European Monetary Union (EMU), include a strong commitment to price stability as the primary objective: By pursuing such a policy, monetary authorities in an economically unified Europe will be less likely to be confronted with the well-known dilemma of domestic versus exchange rate stability, as has often been faced by the smaller member economies. This does not necessarily mean that the EC will become a hesitant participant in international monetary cooperation. The scope for influencing,exchange rates through intervention in the foreign exchange markets may become even larger, their impact on liquidity and the financial markets being relatively smaller than hitherto in smaller economies. But even close cooperation will not always exclude the possibility that an attempt to stabilize exchange rates via intervention and interst rate policy could impair the conduct of monetary policy geared to domestic stability. There remains a need for some elasticity of exchange rates between these currency areas in order to cope with remaining differences in inflation behavior, interest rate movements, and the impact of political events.

But on account of their size, these currency zones would, as I have already mentioned, be better able than smaller economies to cope

with such exchange rate movements, and this even more so, if they succeed in keeping their currencies stable in terms of domestic price levels.