THE ROLE OF CENTRAL BANKS IN A GLOBAL MARKETPLACE: EXCHANGE RATES AND POLICY COORDINATION

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It is certainly an exciting time to be a central banker and involved in policy making. As we move toward a global marketplace, the formation of economic and monetary unions and their implications for what have heretofore been known as domestic economic policies become of paramount importance. The strategy that is being pursued by the European Community (EC) as the several nations prepare for full economic integration contains lessons for other areas of the world where nations are beginning to develop similar goals.

In the recent evolution of that strategy, the announcement of economic union for the EC in July 1985 was a logical first step beyond the trade liberalization achieved through the Common Market and the Treaty of Rome. Then, in a second move at the end of last year came the Maastricht Treaty, which called for, among other things, monetary union and a single central bank by the end of this decade.

Many of us believe that this effort to move quickly from economic to monetary union is an appropriate and achievable goal. At the same time, we saw considerable pressure on the exchange rate mechanism (ERM) several weeks ago. Financial markets came to the conclusion that the initial bands established for exchange rates were not realistic for some nations. Italy realigned its currency, and the United Kingdom cut itself loose from the mechanism altogether.

While attacks on the French franc were successfully defended, it took massive central bank intervention to accomplish this stability. Some countries even felt obliged to strengthen, reinstate or impose capital controls, measures which I hope and believe will turn out to be temporary. During the turmoil, interest rates rose substantially in some European countries, even though many of their economies were weak. Rates have since declined, across Europe generally, as the situation stabilized.

While these gyrations were disturbing, I do not believe they indicate that the goals set by the EC are not achievable. Rather, they point out that the road to economic integration is not always a smooth one. Economic integration does not take place in a vacuum and this fact should not surprise us. Nations continue to deal with cyclical pressures. In the current case with regard to Germany, that nation faces a substantial diversion of resources for unification. All of this is taking place while the stage is being set and the needed steps are being taken to bring about economic and monetary union. Thus the drive toward monetary union is not a laboratory experiment, nor can it be one.

I would like to add my perspective to the situation and take a look at some lessons that we have learned. I will illustrate them by referring to a little bit of United States history, although the analogies are not perfectly applicable in the highly technological environment of today. The three main points I would like to make are these: First, monetary union is an important and worthy goal for the EC. At the same time, economic integration is a process that takes place along a continuum and one that essentially culminates with monetary union. Second, for monetary union to take hold in a lasting way, it must be preceded by the removal of restrictions on and a substantial move toward the free mobility of factors of production: capital and, to a lesser extent, labor. The dismantling of barriers to flows of goods, services, and factors of production is a necessary and logical first step in the path to integration. As factor mobility becomes a normal process, it sets the stage for monetary union. At the same time, many of the benefits of full economic integration can be realized during this period. One reason is that more rapid economic growth is likely to occur. Such growth makes it easier to deal with the transmission of economic shocks that arise in one country and that ultimately affect all in an integrated environment. My third point is that, although the ability to control inflation is one reason often cited for pursuing monetary union, there are, unfortunately, no guarantees that price pressures will be held in such abeyance that they are not a factor in business decisions. As central bankers, we know that short-run pressures--often political in nature--can make it difficult for nations to achieve the low inflation that is best for their citizens in the long run.

The Importance of Factor Mobility for the United States

To begin this discussion, let me digress briefly into U.S. history and a few recent developments. Monetary union in the United States came a good while after economic union. Although the ease arising from modern telecommunications and other important technologies can shorten this process substantially, I believe some important lessons can still be learned from history.[1]

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[1]I would like to acknowledge Sheila L. Tschinkel, Senior Vice President and Director of Research at the Federal Reserve Bank of Atlanta, who originally suggested the analogy of U.S. history to the European situation.

One problem was that individual states were unwilling to cede some of their powers to the federal government. Although states no longer issued money, and we had achieved a single currency shortly after the Civil War in the mid-1800s, we did not have full monetary union until the establishment of a central bank, the Federal Reserve System, in 1913.

The catalyst that hastened full economic integration in this country was the mobility of factors of production. Whenever rates of return rose in newer, less-developed parts of the nation, labor was fairly quick to move in response. Our gold rush in the mid-1800s was an example of that phenomenon, as was the advice of New York Tribune editor Horace Greeley, who said, "Go West, young man." As areas or regions developed, they generally traded with each other. Even with some exceptions and distinct regional differences in the United States, trade was generally open, and factors of production--most notably labor and capital--moved freely. This factor mobility came before monetary union. In fact, one of the first mandates to the Federal Reserve in 1913 was to ensure that all checks drawn on banks would be cashed at par. Hitherto, banks had paid a discounted amount relative to the face value of a check because of their uncertainty in collecting funds from the payor bank. It was as if checks drawn on different banks were moneys of different value. Even after the Fed was founded with its 12 Reserve Banks, the United States did not have a common discount rate for some time. Each Bank would attempt to adjust its rate in response to the perceived needs of its own Reserve District. But different discount rates quickly faded as integrated financial markets generated capital mobility across the nation in the 1920s. Reserve Banks could not make individual monetary policies for their Districts, and states lost the ability to make fiscal policies for their citizens.

It would be difficult to imagine today a United States with different interest rates in our various regions. It would be equally difficult to picture each of our 50 states being able to adjust their own fiscal policies in response to the perceived needs of their citizens and then financing this adjustment by printing their own money or issuing considerable debt. When Hurricane Andrew struck Florida and Louisiana in August, these states did not issue substantial amounts of debt to help rebuild. They did not see themselves in a position to raise taxes substantially, for to do so would have weakened their economies considerably. Rather, the federal government helped in financing much of the rebuilding, and our Congress enacted an aid package that was signed by the President.

While I do not want to extend this analogy too far, I have dipped into a little bit of American history to illustrate my first and second points--that economic union typically precedes monetary union as increased factor mobility sets the stage for monetary union. U.S. history also suggests that monetary union requires independent political units within that union to exercise significant, if not complete, fiscal discipline--a point that I will expand on later.

I view EC 92 as a major step in the achievement of full economic union and thus setting the stage for monetary union. While European financial markets are becoming increasingly linked--some might think a little too much after recent events--a significant problem that remains is that language and cultural barriers make labor mobility more difficult. It is true that these countries often "import" labor to do jobs that domestic citizens do not want to hold or in areas where they are unwilling to move. At the same time, they do not always absorb these workers into their labor supply. Still, by dismantling the remaining barriers to movements of goods, services, and capital, Europe will experience substantial gains in the years ahead. In fact, many of the gains from economic union will make monetary union easier to achieve.

The Benefits and Costs of Full Economic Integration

This observation is an important adjunct to the examples I have given you from U.S. history in support of my argument that economic and monetary union are part of a continuum. While the benefits of monetary union are indeed significant, many benefits often attributed to such a union actually arise when national barriers to flows of resources and capital are removed. Monetary union is thought to eliminate the cost of currency conversion, exchange rate risk, and volatility. Doing so brings about substantial benefits. Aside from expediting trade in goods and services, eliminating foreign exchange volatility and the like fosters a more rapid pace of capital formation, bringing with it more economic development and a faster pace of economic growth.

At the same time, these benefits can nearly be achieved as a result of economic union alone. That is, if capital is truly free to flow across national boundaries and assets can be held in any currency, it is likely that most business transactions would end up being made in the currency that has the most stable value. Remember that with economic union, there are no constraints on where and in what currency assets can be held. The pertinent analogy here is the use of gold as a medium of exchange when the value of other forms of money was difficult to determine or other money was less acceptable. In more recent times, rapidly developing economies like Taiwan have chosen to peg their currency for a period to the U.S. dollar. In the current economic setting, it appears likely that the Deutsche mark would initially be the currency of choice, and transacting for cross-border flows of capital and assets would thus be denominated in marks. This tendency to gravitate toward a single currency reduces the risks associated with variations in exchange rates and the costs associated with conversion. This process illustrates another, more contemporary way in which economic union sets the stage for monetary union.

The achievement of full monetary union and a single currency also involves some costs, which cannot be ignored in analyzing the path from economic to monetary union. Not the least of these costs is the loss of flexibility in fiscal policy.[2] The fact that monetary and fiscal policies are inextricably linked is a basic tenet of the Maastricht Treaty. The need to put their fiscal houses in better order by significantly reducing deficits is placing considerable pressure on some countries right now. This loss of fiscal policy flexibility means that individual countries must be willing to bear the transmission of shocks from the country of origin to their own. The example I gave earlier in regard to Hurricane Andrew is germane. The U.S. federal government--actually all U.S. citizens--are providing the funds to pay for the rebuilding after Hurricane Andrew--not just the citizens of the states that were affected. This situation parallels how members of the EC must also absorb similar shocks under a monetary union.

We can actually see a shock being absorbed in Europe today. The particular mix of monetary and fiscal policy that Germany has adopted reflects the fact that it has chosen to defer

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[2]I would like to acknowledge Eric Leeper, Senior Economist at the Federal Reserve Bank of Atlanta, who has developed this concept.

raising the tax revenues needed to service and reduce the debt it issued for East-West unification. Consequently, interest rates in Germany are historically high, even though they have softened recently. Since European countries have committed to pegging their currencies to the mark, their interest rates are higher than they may want in view of domestic weakness. Attempts to use fiscal policy to cushion this blow would cause their inflation rates to diverge from the ones foreseen when the initial currency bands were set, thereby placing their currencies under pressure. Thus, they are left with essentially no macroeconomic policy to achieve their stabilization objectives. This European situation exemplifies how, when currencies are linked, a costly shock in one country is transmitted to all the other countries.

Still, I am not disheartened by recent events. The term economic "shock" refers to an unforeseen event or source of pressure. In fact, not all shocks are bad. They are simply not predictable. And while I am not predicting this, there may be other shocks that occur as Europe moves toward full economic integration. If they are major, their transmission may be met with some resistance. Such resistance could at times lead to turmoil in markets as relative currency values are reassessed. Still, I do not want to place too much importance on occasional market disruptions. While markets are efficient, we have certainly learned that they are not always right.

In any case, economic union, with its absence of barriers to factor mobility, will be leading to faster growth and healthier economies, thereby making it easier to withstand the impacts of negative shocks if and when they occur. While a target date of 2000 may be exerting significant pressure on EC nations as far as fiscal discipline is concerned, I am confident that the forces are in place for full economic integration. The various nations have shown a desire to do more than coordinate their policies. They have been trying to look beyond policy coordination and harmonization to the point where national macroeconomic policies are a thing of the past. If we do not see it by the turn of the century, we will soon afterward.

Economic Integration and Inflation

This would not be a speech by a central banker if it did not include some discussion of inflation, and, as you will recall, my third and final point about monetary union involves inflation. The process initiated by EC 92 and Maastricht leads to a convergence of inflation rates among member countries as they move to the single currency that is required by monetary union. The importance of national fiscal, monetary, and exchange rate policies recedes as policy formulation and implementation takes place in a centralized environment. While inflation rates converge, there is no guarantee that the result is low inflation.

The European central bank, as it is now envisioned by Maastricht, uses the simple majority vote of representatives from each member country and six common accord members of the Executive Board. This configuration suggests that, over time, the majority vote could dilute the influence of those countries with the lowest long-run inflation rates. While I do not believe that a central banker from any country has high inflation as a goal, it is often difficult to resist short-run pressures that more often want to push nominal interest rates lower and rarely want them raised. This pressure typically occurs in response to a negative supply shock to activity that is leading to higher unemployment in the short run. In fact, economics tells us that such a situation is better dealt with by fiscal as opposed to monetary policy. However, economic lessons are often hard for politicians and voters to accept in times of high unemployment and excess capacity. Another way of putting this observation is to recognize the need to create a European central bank that is reasonably independent of the day-to-day political environment.

History has taught us that countries whose central banks are independent have enjoyed lower inflation than those where the bank is linked to politics. While we have seen politicians in many parts of the world expand fiscal initiatives and increase debt levels, we must be careful to shield the central bank from the pressures to monetize the debt that invariably surface in this situation. This is an important lesson.

Summary and Conclusions

In conclusion, I would like to emphasize that this brief analysis of the process that is leading from economic to monetary union in Europe in no way questions the substantial gains to a marketplace that is becoming increasingly global. As I have noted, this process essentially means that Europe will gradually replace national fiscal and monetary policies with centralized ones. Exchange rate policies will recede in importance in a single currency environment. This is the ultimate goal of current efforts at policy coordination and harmonization.

The removal of barriers to trade and factor flows that is coming with EC 92 is a critical step, and it will help pave the way for monetary union, if not exactly by 2000 then shortly thereafter. While economic integration means that shocks arising in one country must necessarily be transmitted to all others, the steps associated with EC 92 should facilitate that transmission. This mitigation occurs because differentials in standards of living are whittled down by the greater factor mobility that EC 92 puts in place. Although labor mobility may remain sluggish, due to cultural and language barriers, its effects can be partly offset by the free movement of capital. At the same time, there is no guarantee that inflation will be eliminated in Europe. This will require a central bank that is reasonably independent and shielded from political pressure.

As a central banker, I would end on a note of praise for the far-sighted leaders of Europe for launching this sometimes difficult process. Their efforts will benefit not only the countries of Europe but all nations seeking to raise their standard of living and to strengthen their economies.