From Bretton Woods to Monetary Union: Monetary Policy in European Perspective

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Bretton Woods – EMS – European Monetary Union:

Three attempts/approaches to achieve economic and financial stability

A comparison in 5 dimensions:

| Run-up | Setup | Weaknesses | Crisis | Lessons |

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Specific Origin/Background of Bretton Woods initiative:

- Reconstruction of Europe after World War II
- Decline of British Empire
- Search for a new global economic ordering
- Foster long term trade, employment and growth
- Promote exchange rate stability and financial stability
Bretton Woods System: Result of Conflicting Interests?

Harry Dexter White

- Prevent competitive devaluations and trade protectionism
- Prevent balance-of-payments crises
- Establish a fund to automatically reverse destabilizing capital flows

John Maynard Keynes

- Prevent shortage and misallocation of global liquidity
- Establish an International Clearing Union
- Establish a world reserve currency „bancor“
Bretton Woods (Vintage 1944) Compromise of 44 Countries

International Monetary System:

- USD as international reserve currency, tied to gold
- Adjustable peg system with independent monetary policy and capital controls

Establishment of IMF, World Bank and IBRD
Bretton Woods System mirroring the Impossible Trinity

- Pure float
- Full financial integration
- Monetary union

- Monetary independence
- Exchange rate stability

Full capital controls
Bretton Woods from the European perspective

- Successful in avoiding financial crises
- Dominant role of the USA
- Triffin Dilemma
- Asymmetric adjustment system
- USA reaps all seignorage revenues
(Long-term?) Unsustainability of the USD-Gold Convertibility

Source: IMF, Federal Reserve, Guggenheim Investments.
1973: The Breakdown of a System
The Day After – What Next? Which Options and Why?

• **USA:** free float, USD remains major reserve, pricing and settlement currency

• **Europe:** Snake: „an island of stability in an ocean of instability“

• **Austria:** Hard Currency Policy
Austria‘s Hard Currency Policy

Exchange rate of Austrian Schilling to D-Mark, 1952 to 1999

Source: Thomson Financial
Inflation Rates in Austria and Germany compared (1960-2006)

Source: Thomson Financial.
Real and Nominal Effective Exchange Rate of ATS (1961-99)

Bretton Woods:  Run-up       Setup       Weaknesses       Crisis       Lessons

Source: WIFO
European (Monetary) Integration: Windows of Opportunity Used?

CONSUMER PRICES (annual percentage change)
European Monetary System (EMS)

Characteristics:

- **Initial members (1979):** Germany, France, Denmark, BeNeLux, Ireland, Italy
- Fixing of central rates
- Fluctuation band of +/-2.25% (Italy: +/-6%)
- Suspension of interventions if in conflict with price stability
- Realignments only by common agreement

Initially weak system, several realignments

Full opening of capital markets: no further realignments 1987-92
Monetary Integration and The Impossible Trinity

EMS: Run-up Setup Weaknesses Crisis Lessons

Monetary independence

Exchange rate stability

Increased capital mobility

Full capital controls

Pure float

Full financial integration

Monetary union
EMS crisis 1992/93
Sweden: fighting for the peg

*Interest rate differential for three-month treasury bills relative to ECU and DEM*
Weekly averages, 1992

*SEK exchange rate with theoretical ECU and DEM*
Weekly averages, 1992
The DEM/FRF Exchange Rate during ERM
Which Theoretical Options for (further) Integration?

1. Preferential Trading Area (reduced customs tariffs)
2. Free Trade Area (no custom tariffs on some or all trade)
3. Customs Union (same external tariffs plus common trade policy)
4. Common or Single Market (free movement plus common product regulation)
5. Economic and Monetary Union (Single Market plus common currency and monetary policy)
6. Complete Economic Integration (all plus harmonized fiscal and economic policies; plus supranational institutions and organization?)

▶ European Union is most advanced form of Economic Integration globally already (more or less stage 5)
▶ Why not move from 5 to 6? (Political Union?)
▶ Main open issue: how much coordination of policies is possible?
Three Camps of US Commentators on the Euro Project

(Taxonomy developed by Rudiger Dornbusch, 2001)

1. It can‘t happen
2. It‘s a bad idea
3. It can‘t last

Friedman (2007): „I think it‘s highly unlikely that it‘s going to be a great success … But it‘s going to be very interesting to see how it works.“
Mundell (1961), McKinnon (1963), Kenen (1969)

An OCA is an optimal geographic domain of a single currency or of several currencies whose exchange rates are irrevocably pegged to one another.

Multiple criteria: in general, countries will profit more from joining a currency area

- the more open they are,
- the closer the trade links are,
- the higher the degree of business cycle synchronization is
- the more flexible the economy is
Robert Mundell (1973):

„The European countries could agree on a common piece of paper, … they could then set up a European monetary authority or central bank. … This is a possible solution, perhaps it is even an ideal solution. But it is politically very complicated, almost utopian.”
### 3 Stages of (and Leading to) Monetary Integration

<table>
<thead>
<tr>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
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<tbody>
<tr>
<td>Completion of the Internal Market</td>
<td>Enhanced economic and monetary co-operation</td>
<td>Common currency</td>
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<tr>
<td>Integration of financial markets and</td>
<td>1994: European Monetary Institute (EMI)</td>
<td>– Irrevocable fixing of exchange rates</td>
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<td>liberalisation of capital movements</td>
<td>– Independence of NCBs</td>
<td>– Euro as non-cash currency</td>
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<td>1998: ECB</td>
<td>2007: Slovenia</td>
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<td>Selection of 11 initial euro area members</td>
<td>2008: Cyprus, Malta</td>
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<td>(Greece follows in 2001)</td>
<td>2009: Slovakia</td>
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<td>2011: Estonia</td>
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</tbody>
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Benefits of a monetary union

- Exchange rate stability
- Integration in other areas
- Price transparency ↑
- International role of the euro
- Interest rate ↓
- Transaction costs ↓
- Competition ↑
- Seignorage revenues
- Financial stability
- Growth ↑
- Trade and FDI ↑
- Price level convergence

Euro: Run-up  Setup  Weaknesses  Crisis  Lessons
Effects of European integration for Austria (Breuss, 2010)

Annual change of real GDP in %

Euro: Run-up Setup Weaknesses Crisis Lessons
EMU: An Incomplete Monetary Union in Reality

- No common fiscal policy
- No common banking supervision
- Financial fragmentation
- Weakness of supervisory mechanisms
Effect 1: Adverse Feedback Loops

Lower growth

More Consolidation or stabilizers held back

Worsen fiscal balance Lower bank asset quality

Public Support Needs

Sovereign risks increase

Deleveraging & Less bank lending

Euro: Run-up Setup Weaknesses Crisis Lessons
**Effect 2: Increased Burden on Central Banks**

- **Households and firms**
  - Sectoral imbalances and high debt
  - Provide monetary stimulus
- **Central bank**
- **Government**
  - Unsustainable fiscal trajectory and deteriorating creditworthiness
  - Ease fiscal strains
- **Financial sector**
  - Inadequate capital and dependence on public support
  - Ease funding strains

- Consolidation lowers income growth
- Necessary deleveraging slows growth
- Overindebtedness leads to defaults
- Tight credit weakens growth
- Loss of risk-free status weakens banks
- Banks’ capital needs increase fiscal burden
Effect 3: Monetary Transmission Mechanism Hampered
Why symmetric shocks may have asymmetric effects?

Multiple criteria for integration benefits: in general, countries will profit more from economic integration…

► the more open they are,
► the closer the trade links with the integration area are,
► the higher the degree of business cycle synchronization is
► the more flexible the economy is

Symmetric shocks may have asymmetric effects: because of…

► different labor market institutions (e.g. wage bargaining)
► different legal systems (mortgage markets)
► different fiscal systems
► different preferences about inflation, unemployment…
► different institutional/structural settings of all kinds…

Historical experience(?) : Small open economies with a successful currency peg history seem to be better prepared for integration
From Monetary Policy to Central Bank Policy?

- Implicit broadening of objectives („multidimensional policy“) has taken place already
- Relevant distinction between traditional monetary policy and a much broader „Central Bank policy approach“

- Macro-prudential responsibilities (= New Jackson Hole consensus = ESRB)
- How to coordinate „central bank policy“?
- How to deal with unavoidable trade-offs?
Some Lessons to Learn?

- Need for a new economic theory?

- Central banks have (to use) more than one instrument

- Responsibility of central banks for financial stability

- Microprudential banking supervision is not sufficient
Banking Union Completes EMU

- Single Supervisory Mechanism (SSM)
- Single Resolution Mechanism (SRM)
- European Deposit Insurance System

Euro: Run-up  Setup  Weaknesses  Crisis  Lessons
Finally:
The International Monetary System (IMS) - Then and Now

Robert Mundell: „The optimal number of currencies in the world is like the optimum number of gods – an odd number, preferably less than three.“

Today: A new IMS needs to account for:
- Multi-polar global economy (emergence of China)
- Increased economic and financial interconnectedness
- Need for a multilayered global financial safety net
- Need for sovereign debt restructuring
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