OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

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**

Special thanks go to Maria Silgoner (Foreign Research Division) for excellent research assistance!

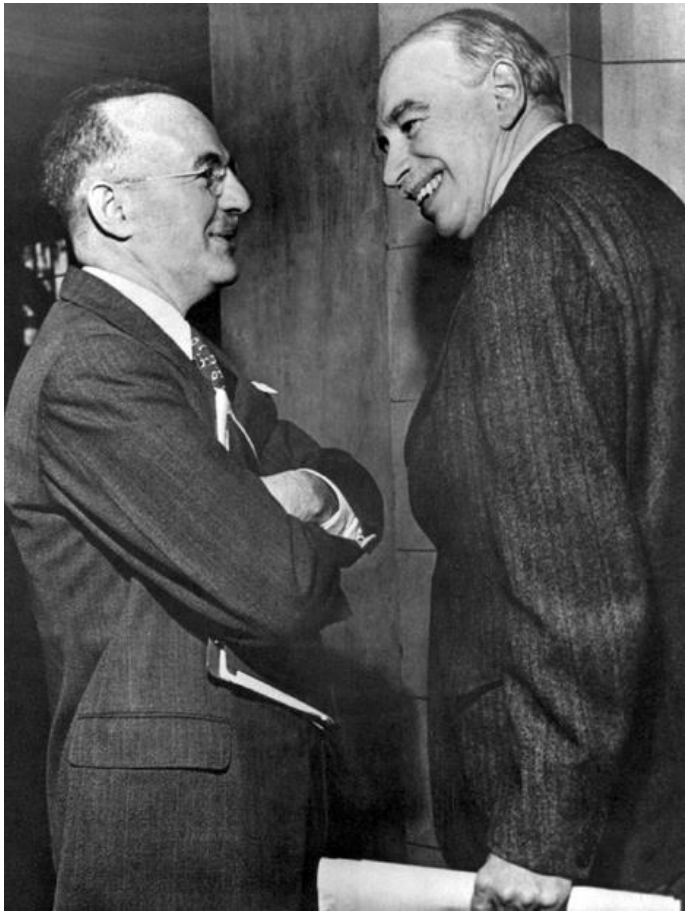
Specific Origin/Background of Bretton Woods initiative:

- **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**



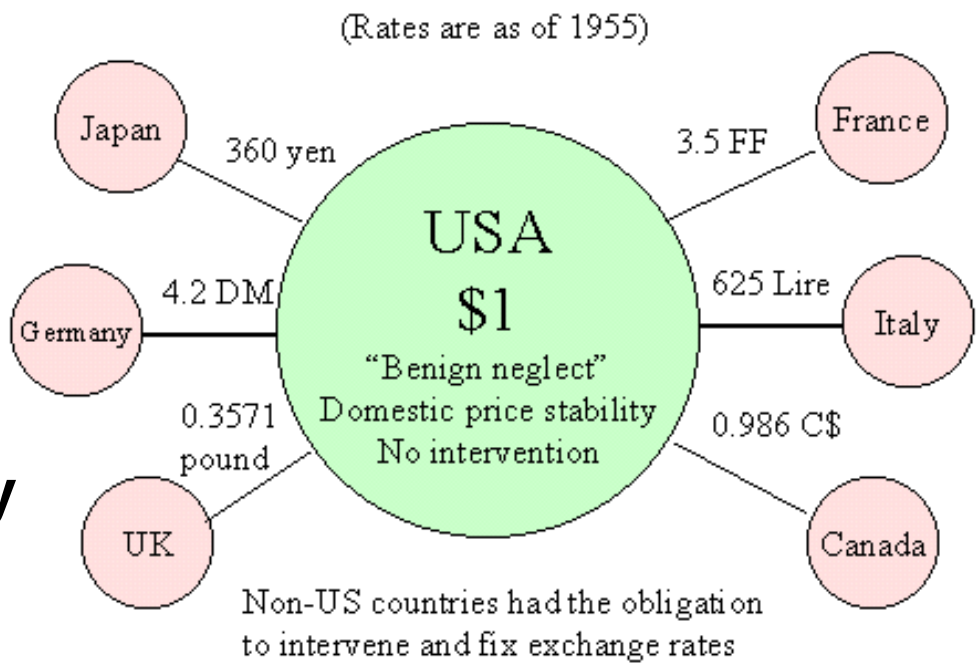
John Maynard Keynes

- **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

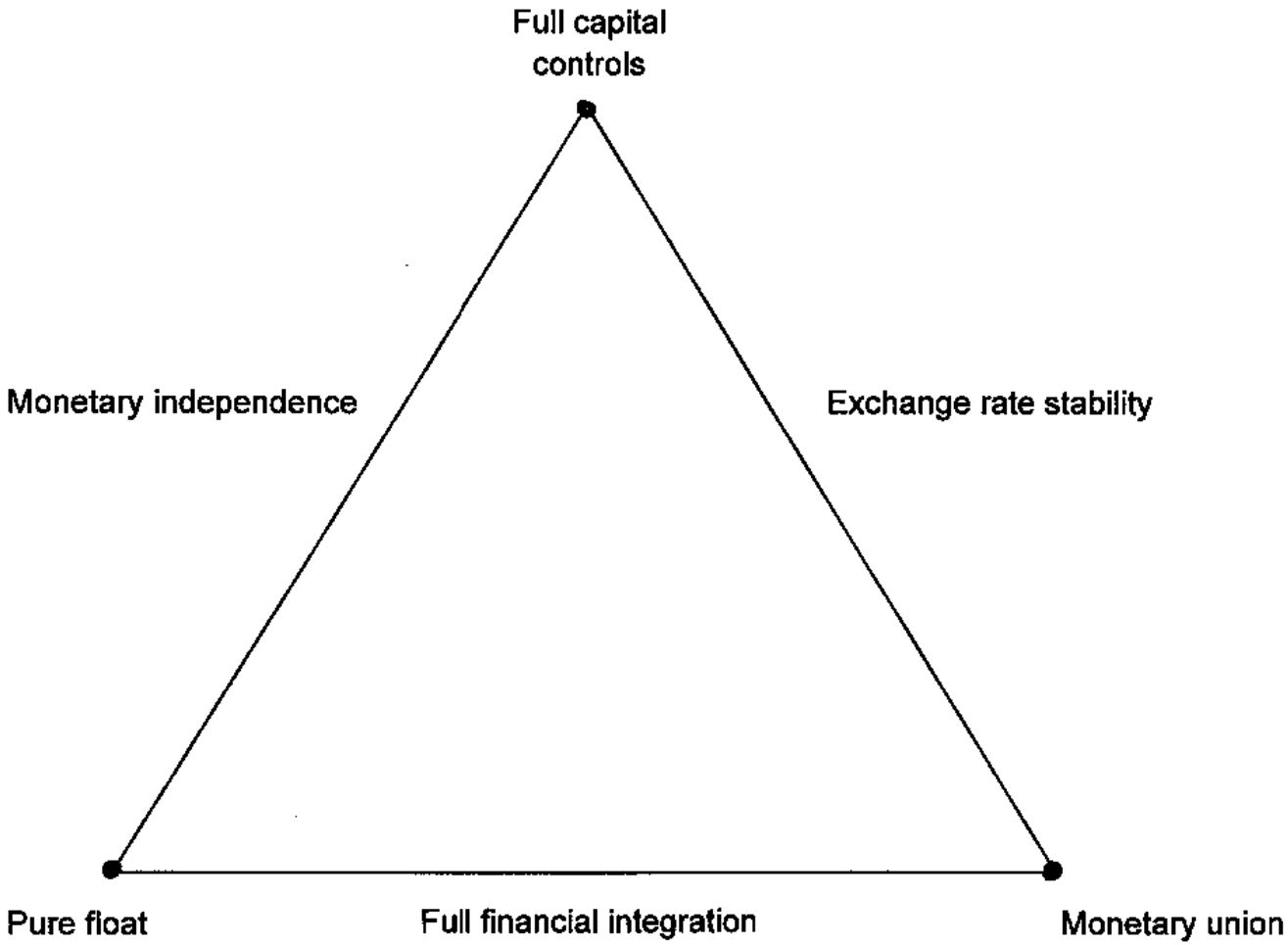
International Monetary System:

- **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

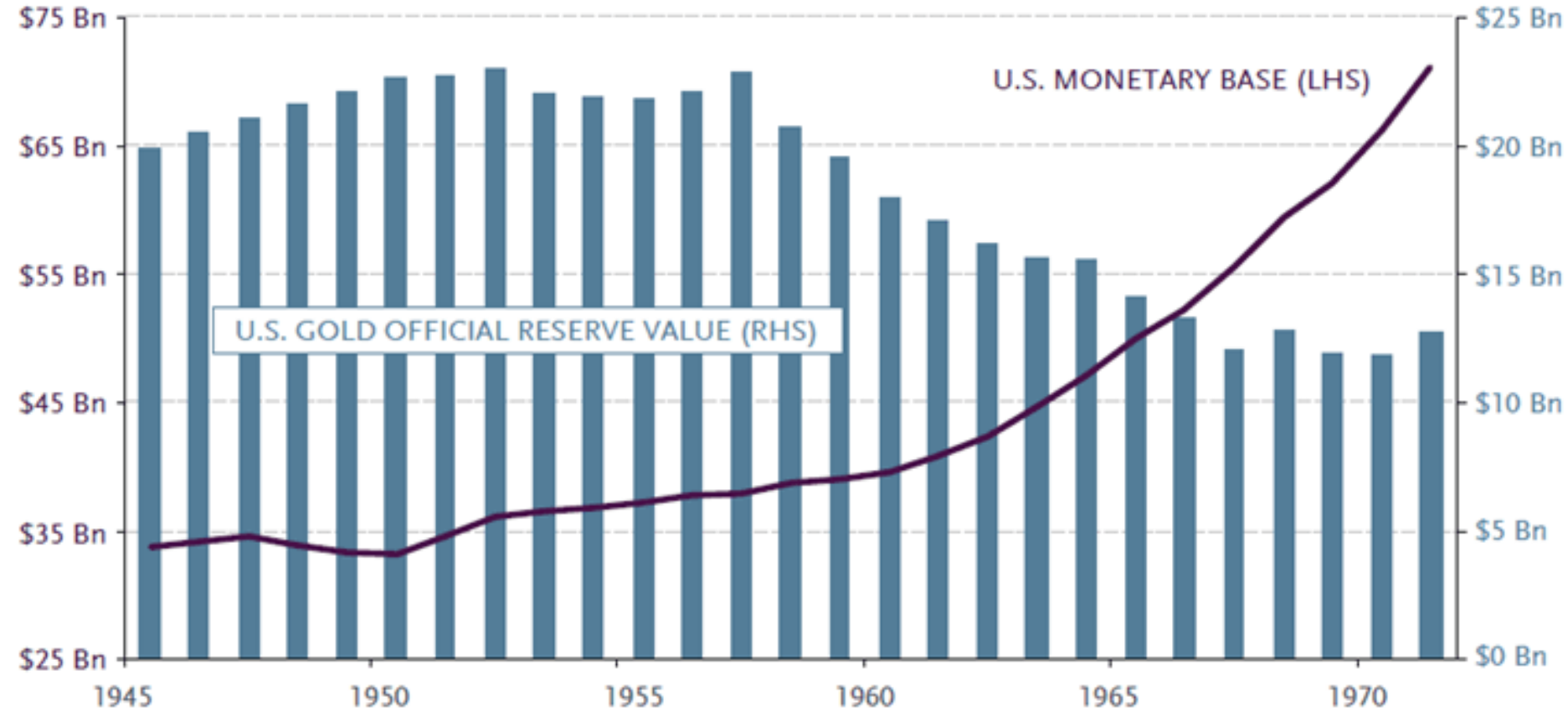
Bretton Woods System mirroring the Impossible Trinity



Bretton Woods from the European perspective

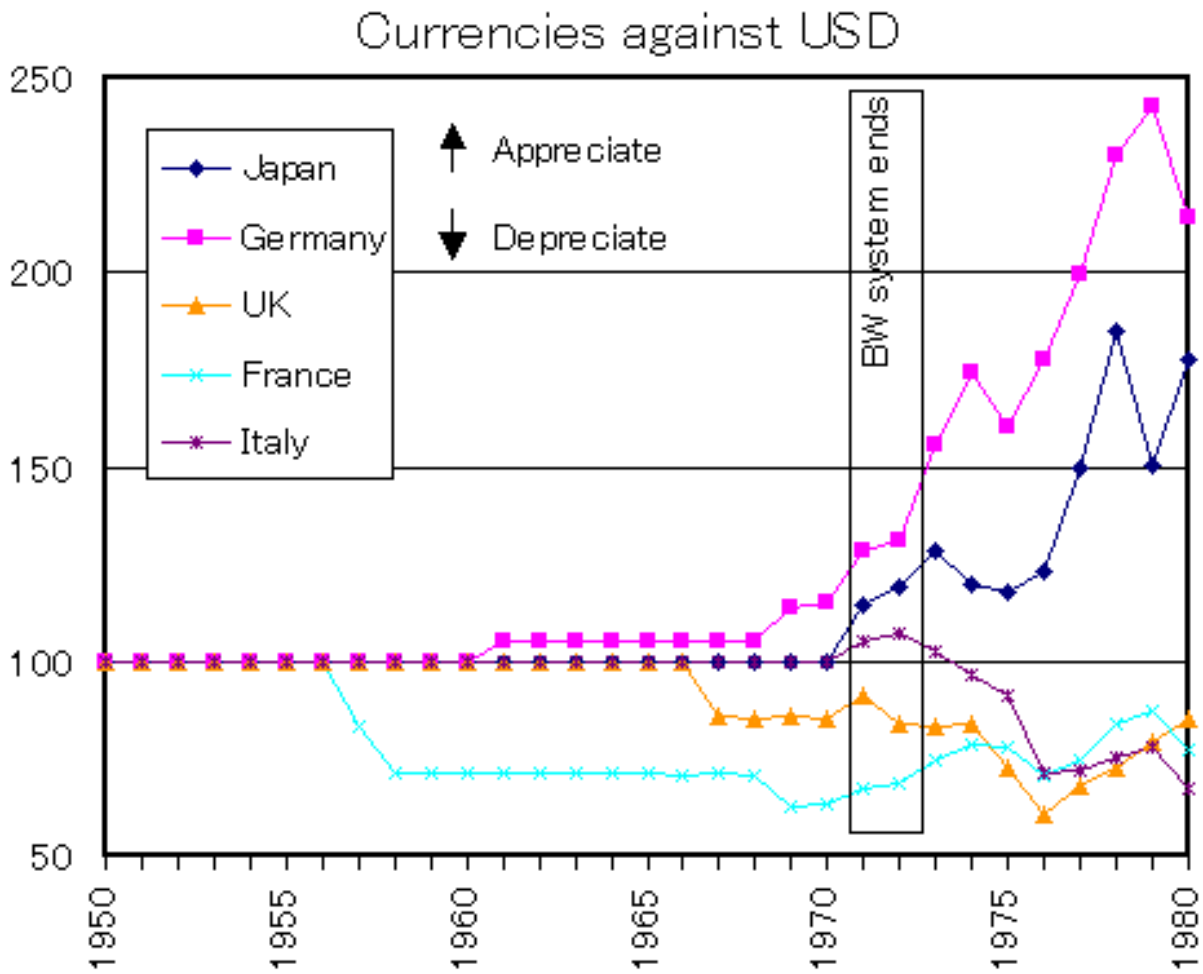
- **Successful in avoiding financial crises**
- **Dominant role of the USA**
- **Triffin Dilemma**
- **Asymmetric adjustment system**
- **USA reaps all seignorage revenues**

(Long-term?) Unsustainability of the USD-Gold Convertibility



Source: IMF, Federal Reserve, Guggenheim Investments.

1973: The Breakdown of a System

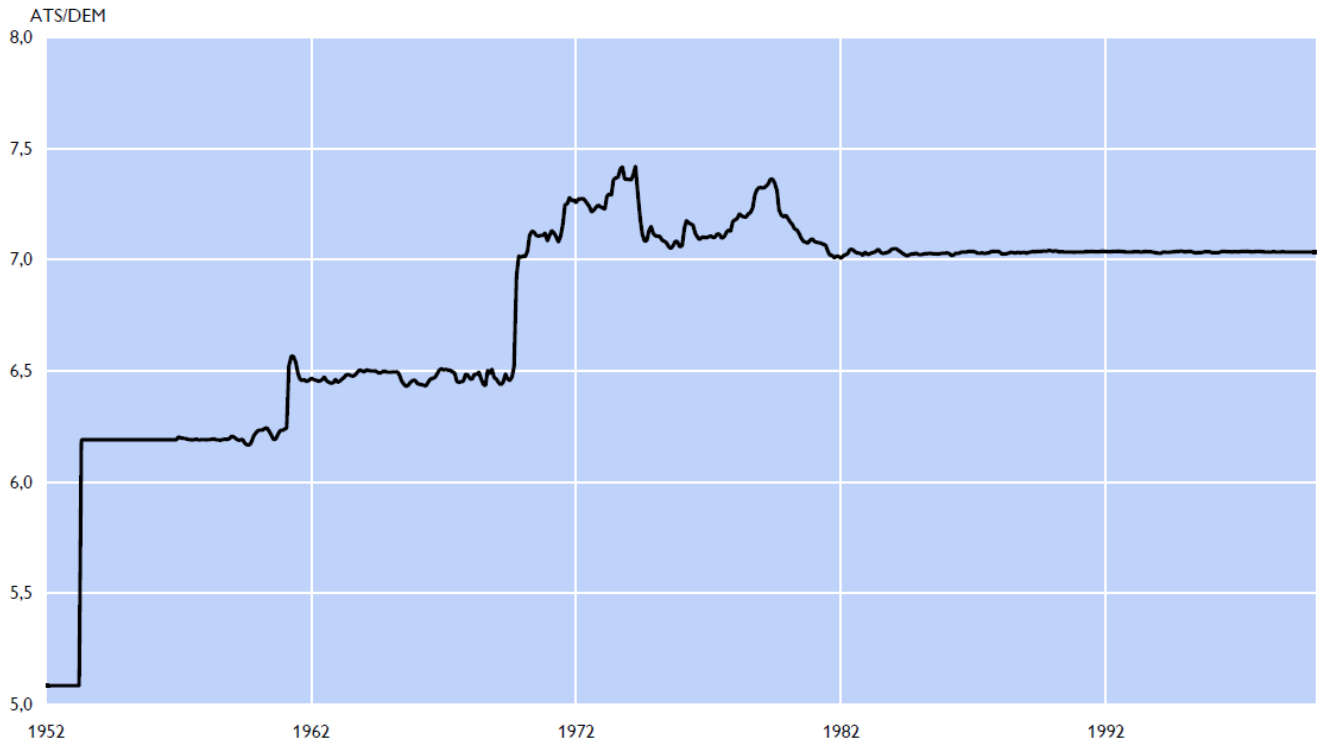


The Day After – What Next? Which Options and Why?

- **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**

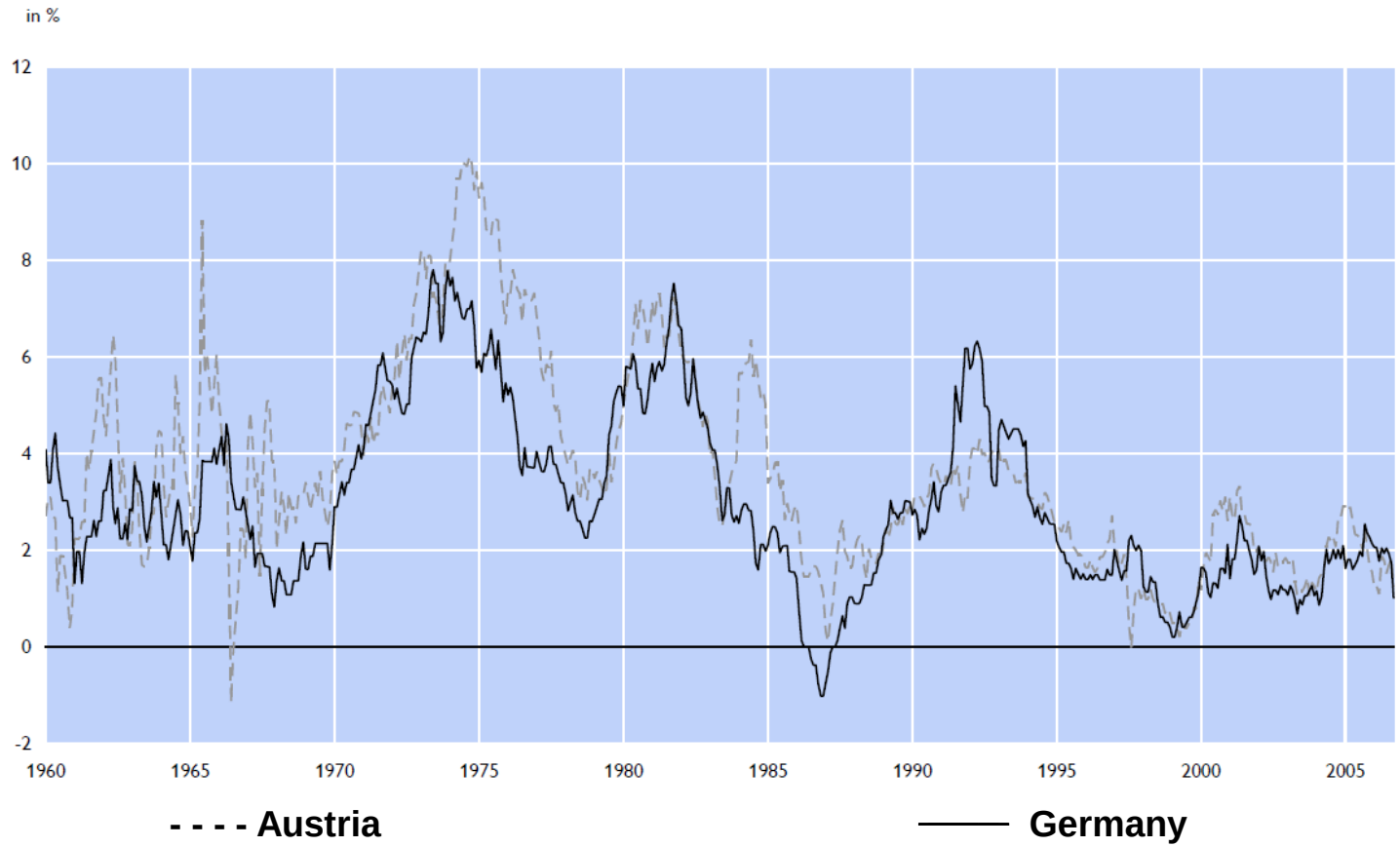
Austria‘s Hard Currency Policy

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



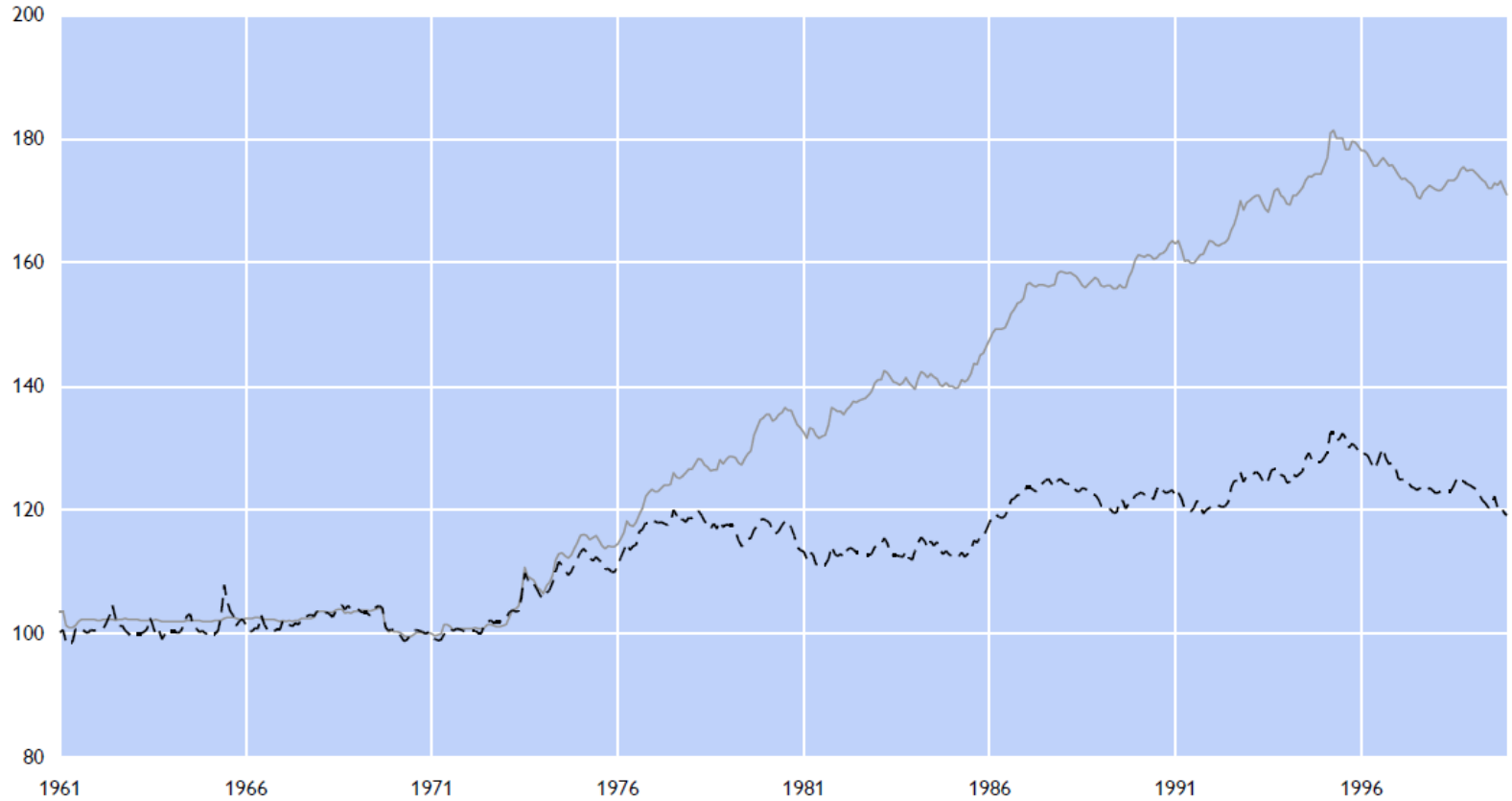
Source: Thomson Financial

Inflation Rates in Austria and Germany compared (1960-2006)



Source: Thomson Financial.

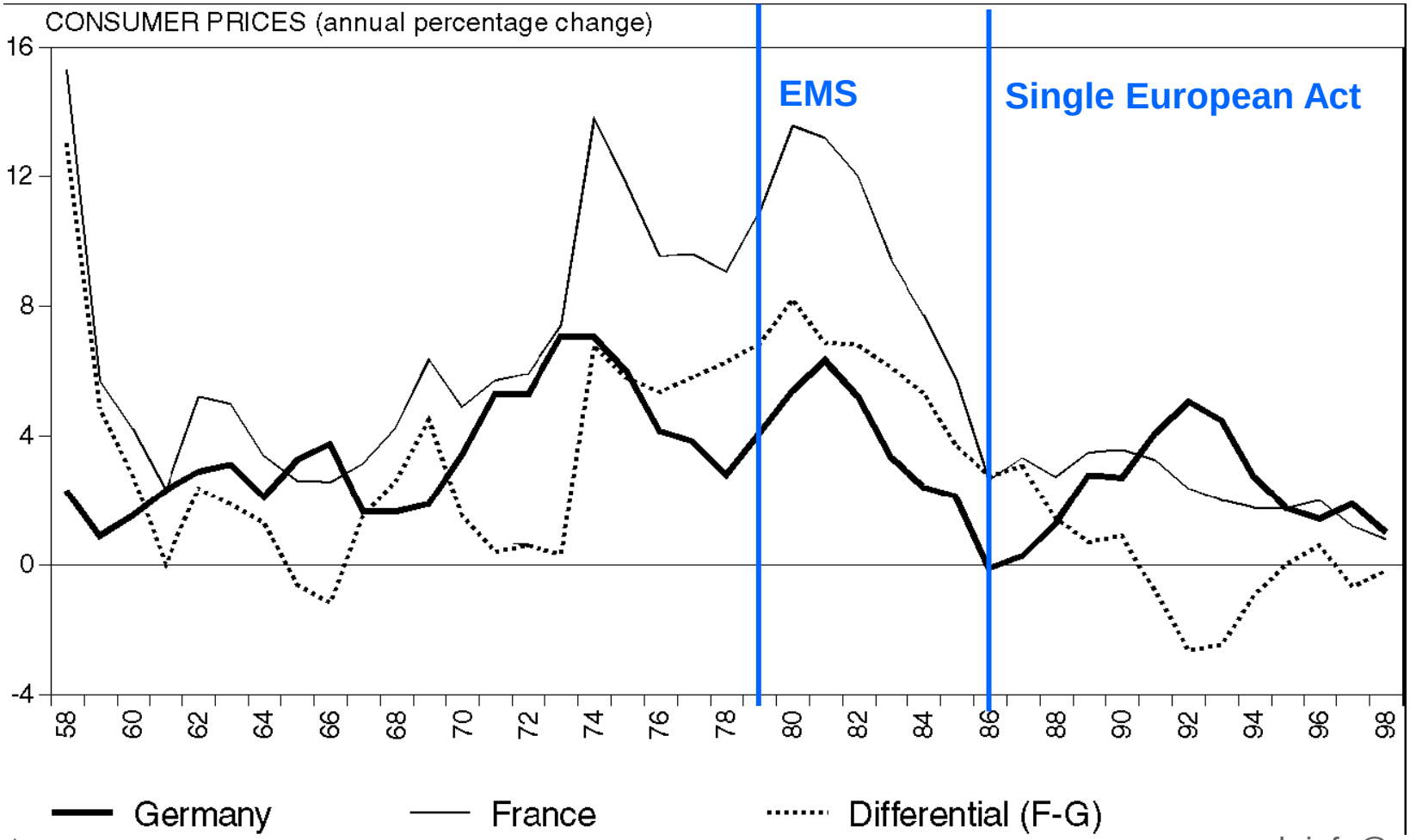
Real and Nominal Effective Exchange Rate of ATS (1961-99)



——— nominal exchange rate index - - - - real exchange rate index (1992=100)

Source: WIFO

European (Monetary) Integration: Windows of Opportunity Used?



European Monetary System (EMS)

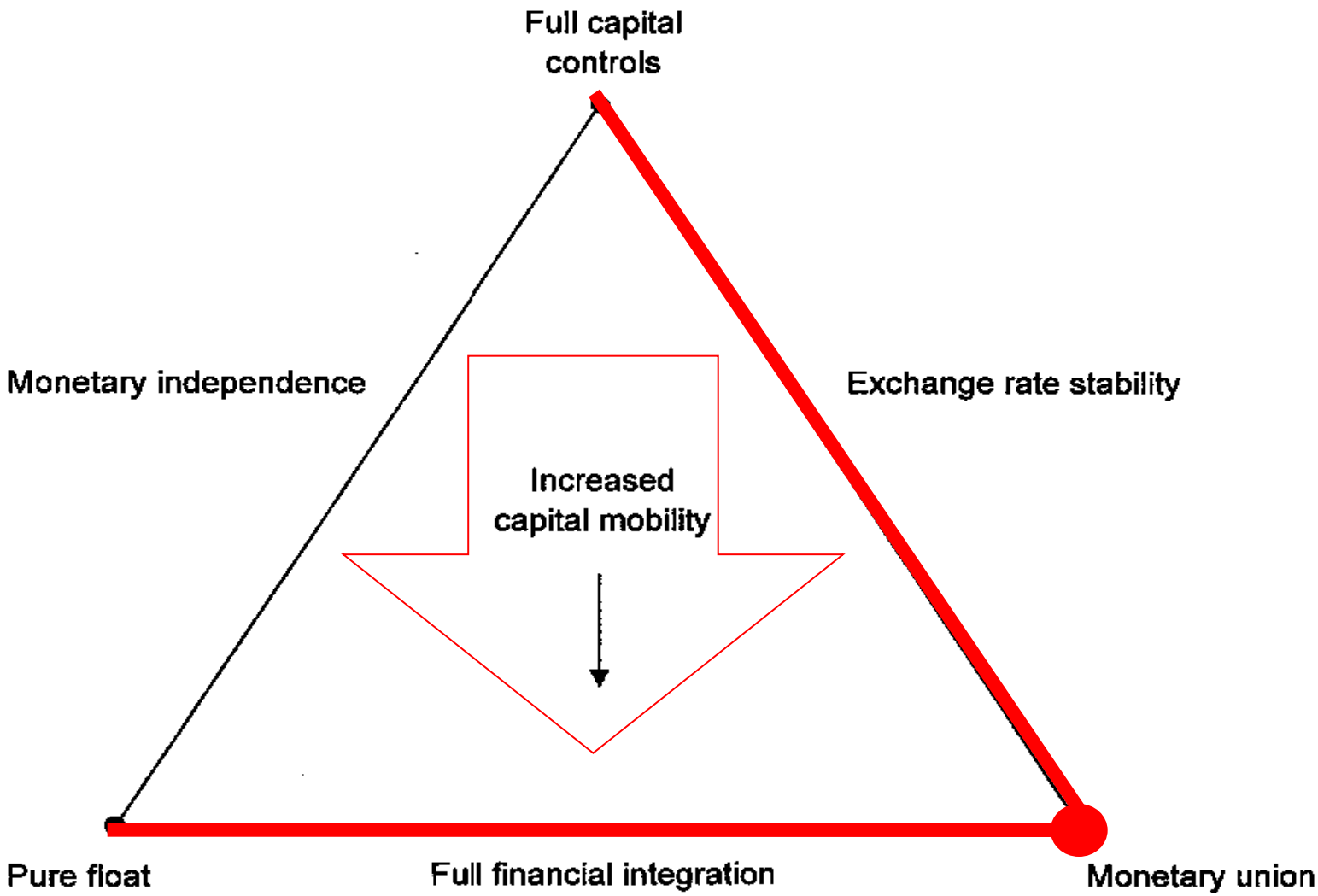
Characteristics:

- **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**

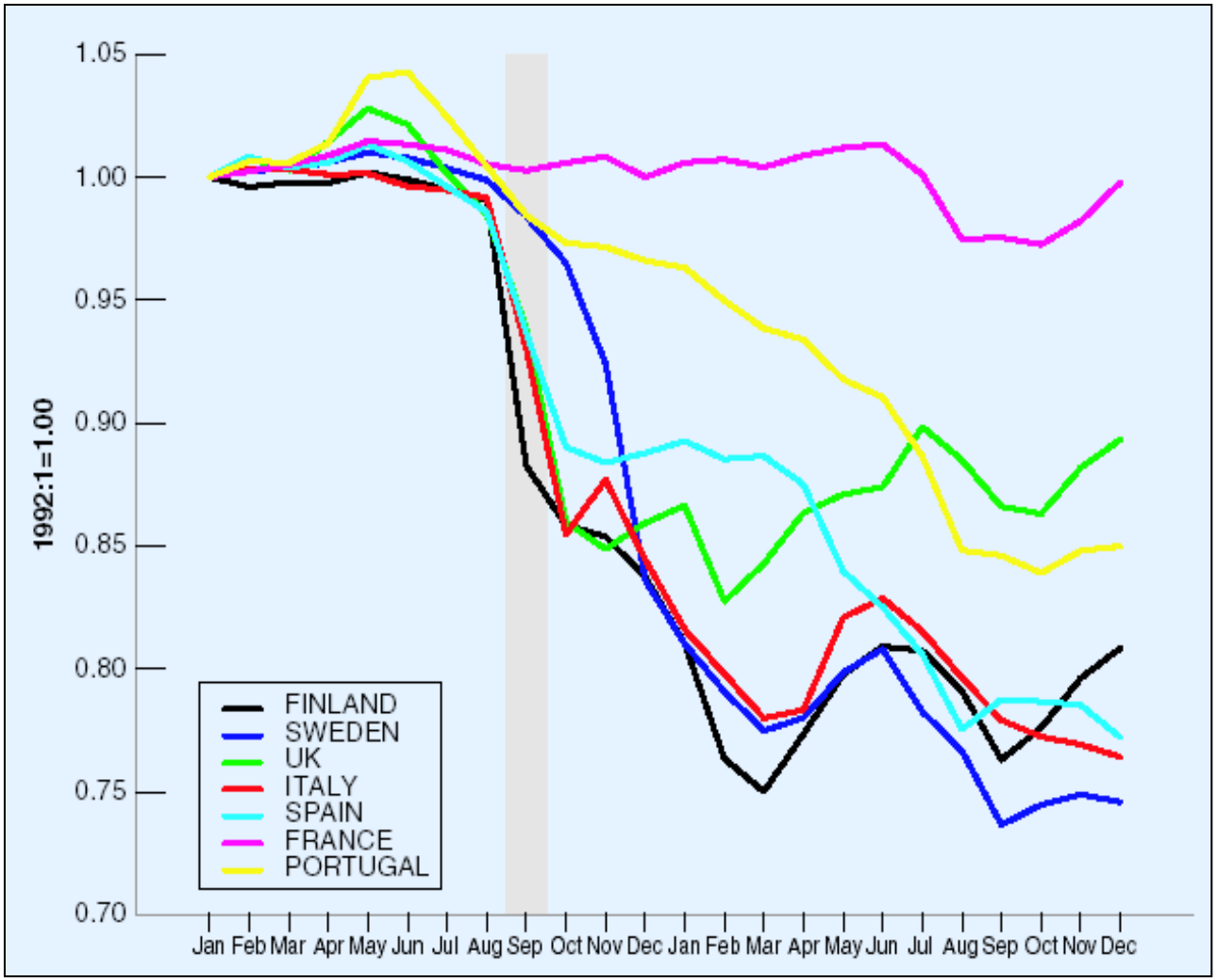
Initially weak system, several realignments

Full opening of capital markets: no further realignments 1987-92

Monetary Integration and The Impossible Trinity



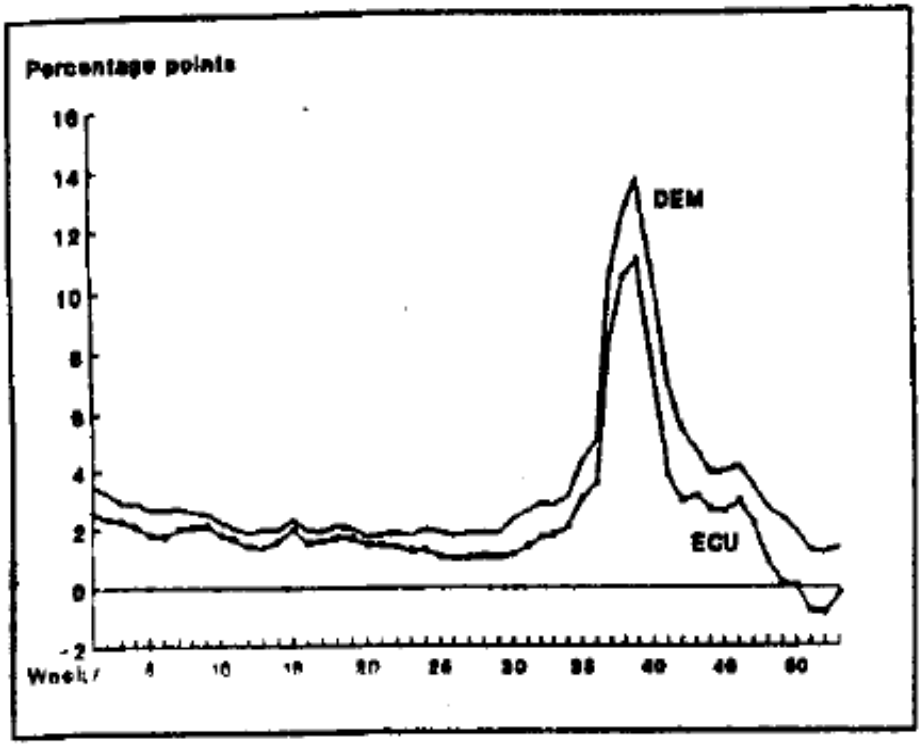
EMS crisis 1992/93



Sweden: fighting for the peg

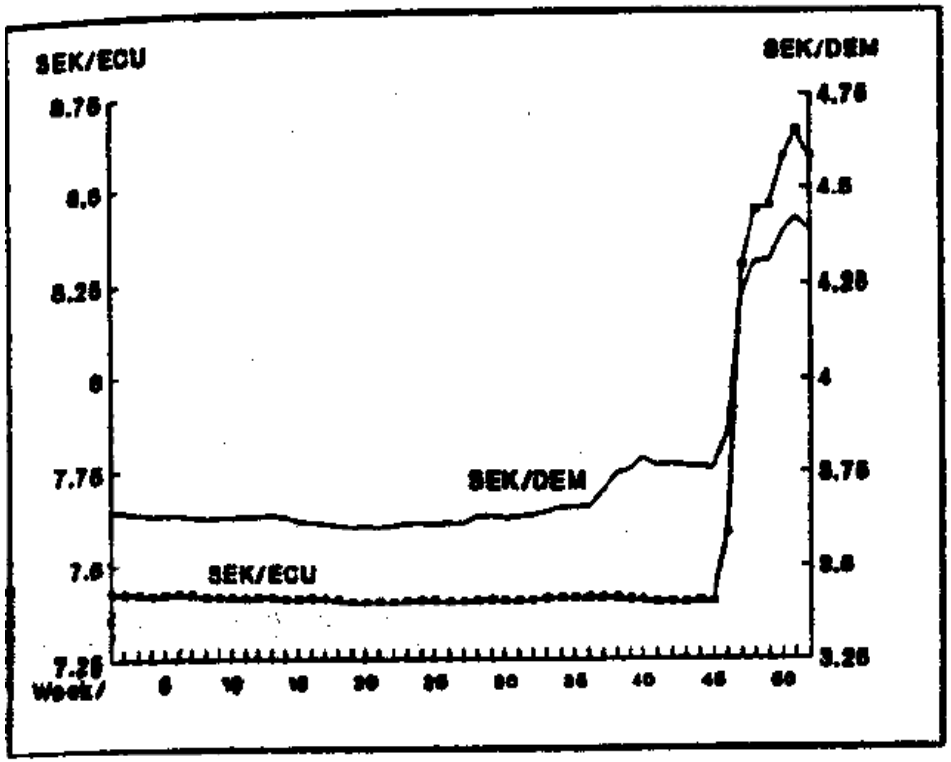
Interest rate differential for three-month treasury bills relative to ECU and DEM

Weekly averages, 1992

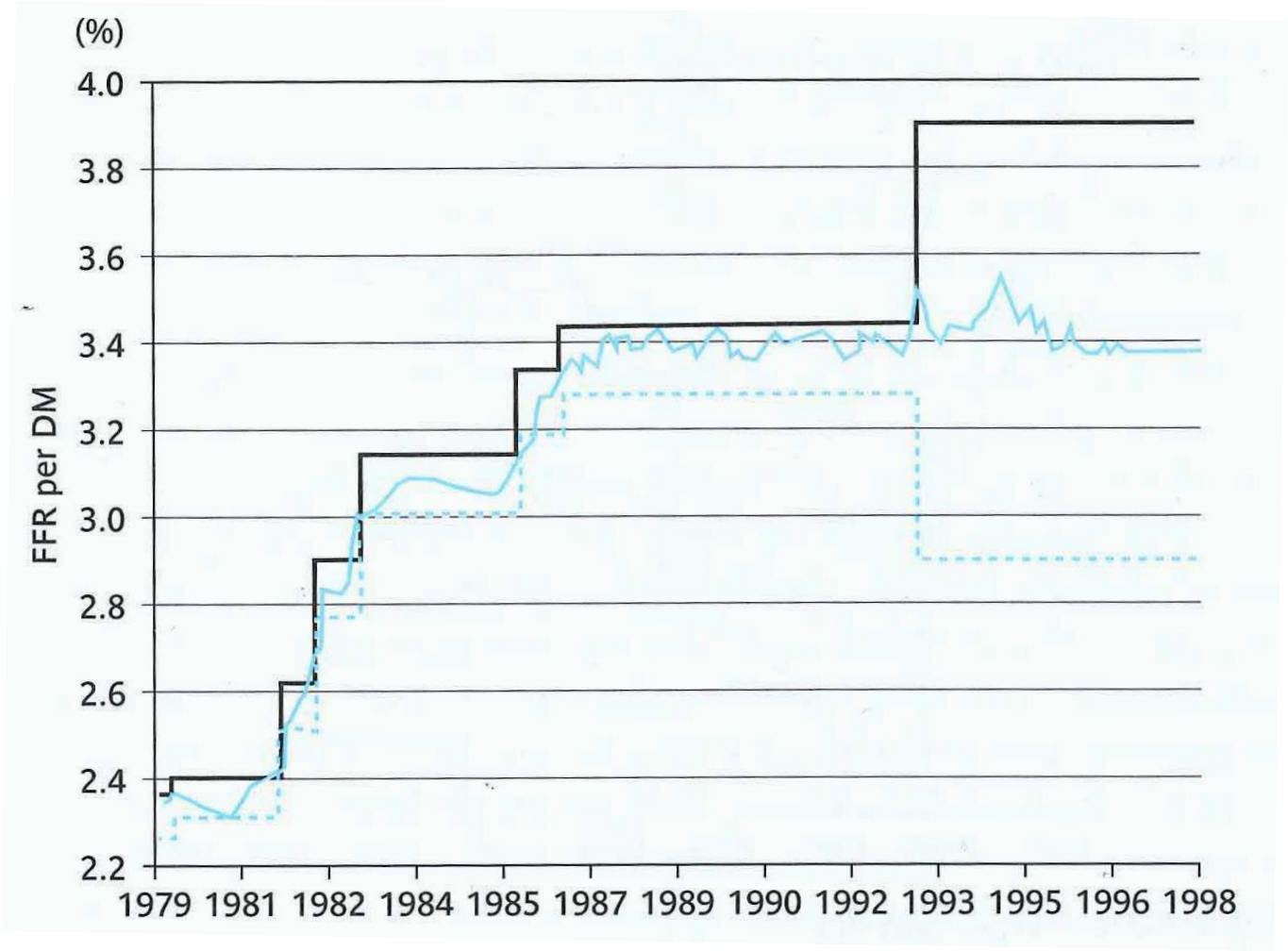


SEK exchange rate with theoretical ECU and DEM

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.“*

OCA: The Theory of an Optimum Currency Area

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.

<u>Multiple criteria</u>: 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**

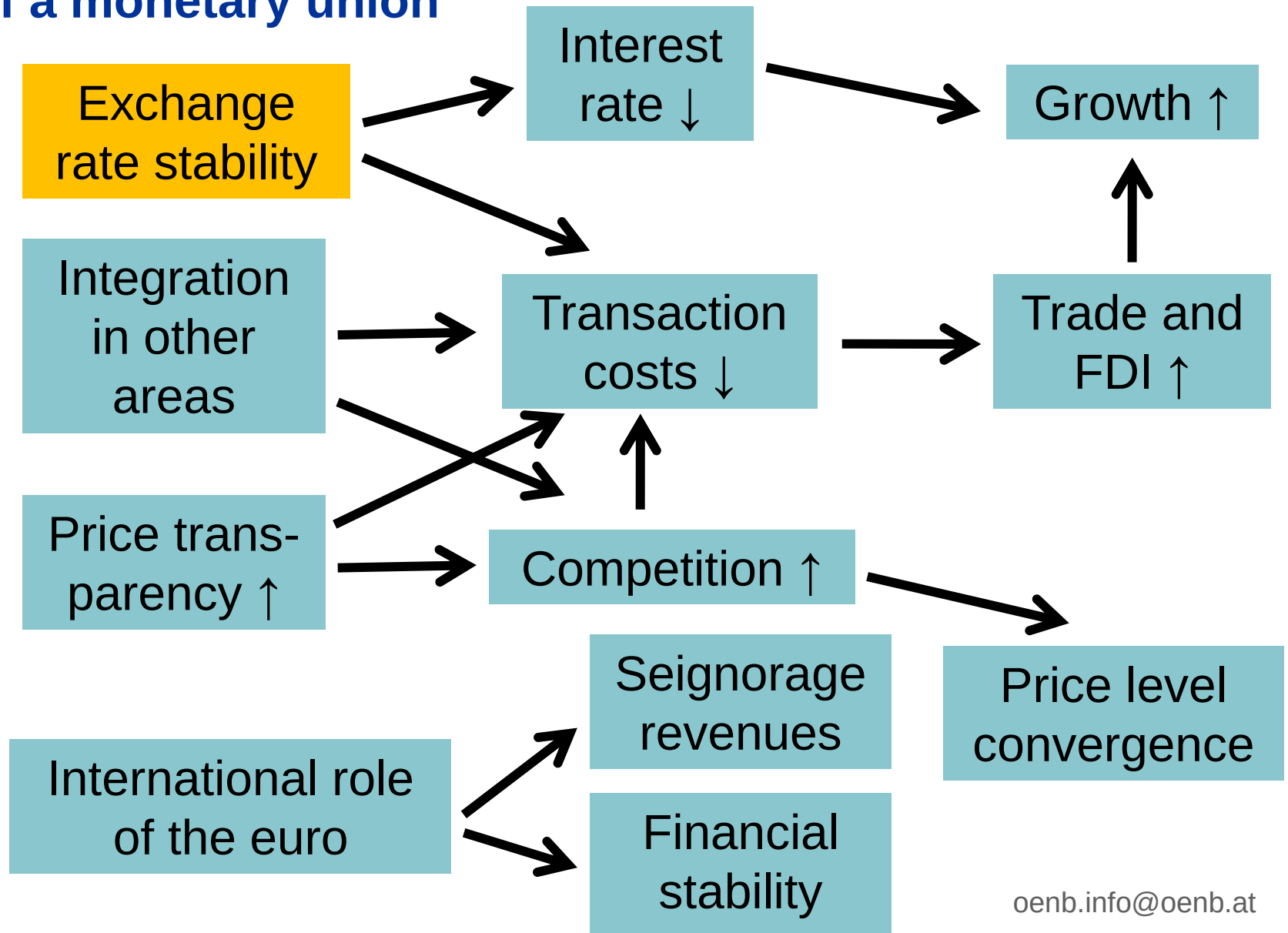
Robert Mundell (1973):

„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."

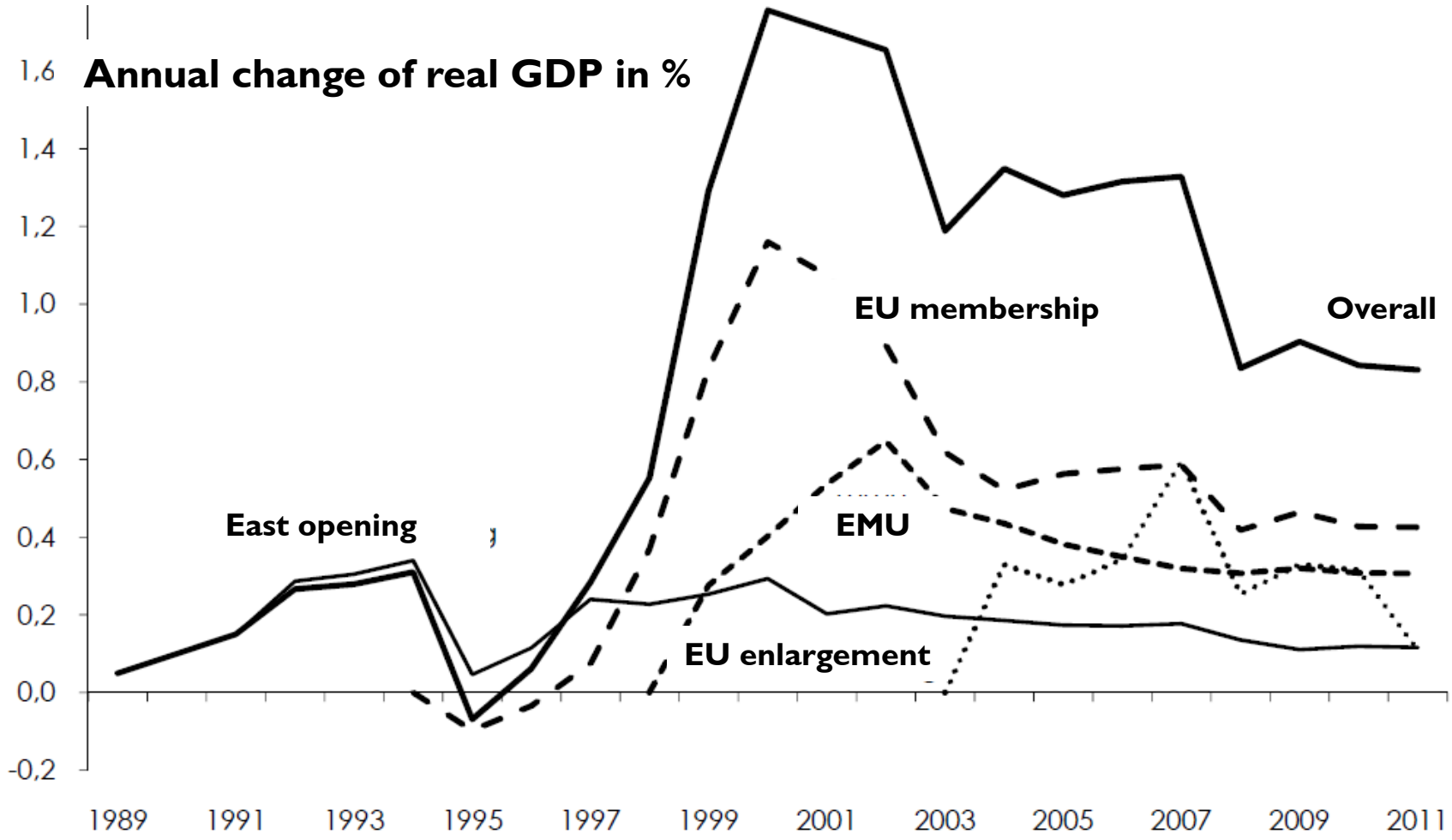
3 Stages of (and Leading to) Monetary Integration

Stage 1 **Completion of the Internal Market**	Stage 2 **Enhanced economic and monetary co-operation**	Stage 3 **Common currency**
1990–1993	**1994–1998**	**1999–2012**
Integration of financial markets and liberalisation of capital movements 1992: Maastricht treaty 1992/93: EMS crisis	1994: European Monetary Institute (EMI) – Independence of NCBs – Co-ordination of monetary and fiscal policy 1996: Stability and Growth Pact 1998: ECB Selection of 11 initial euro area members (Greece follows in 2001)	– Irrevocable fixing of exchange rates – Euro as non-cash currency – Single monetary policy 2002: Cash changeover 2007: Slovenia 2008: Cyprus, Malta 2009: Slovakia 2011: Estonia

Benefits of a monetary union

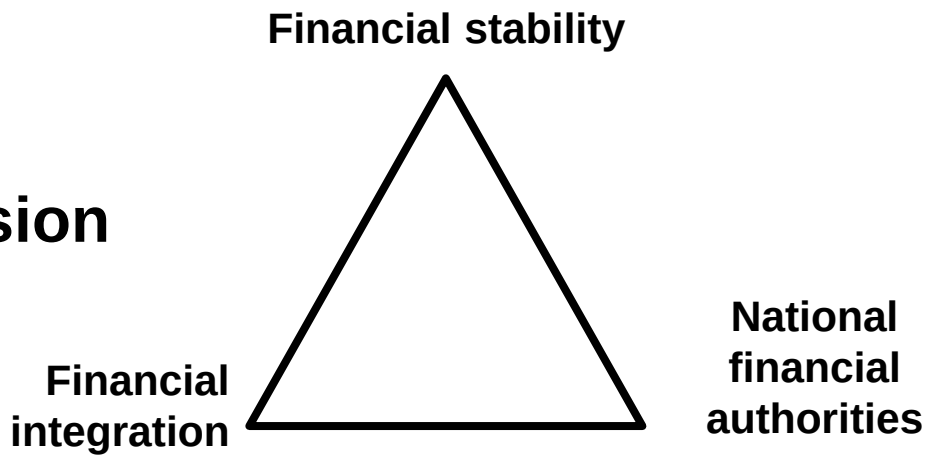


Effects of European integration for Austria (Breuss, 2010)

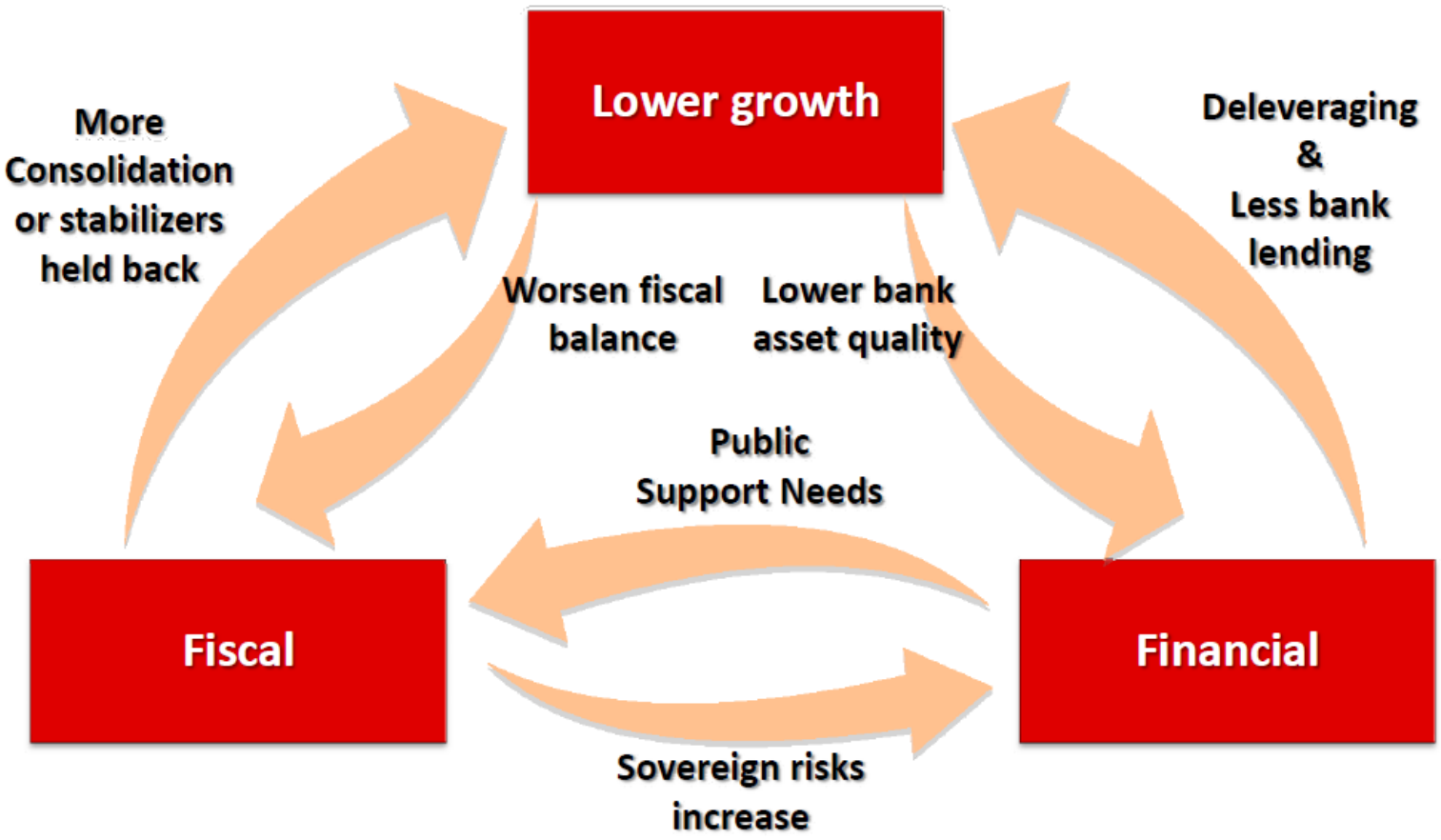


EMU: An Incomplete Monetary Union in Reality

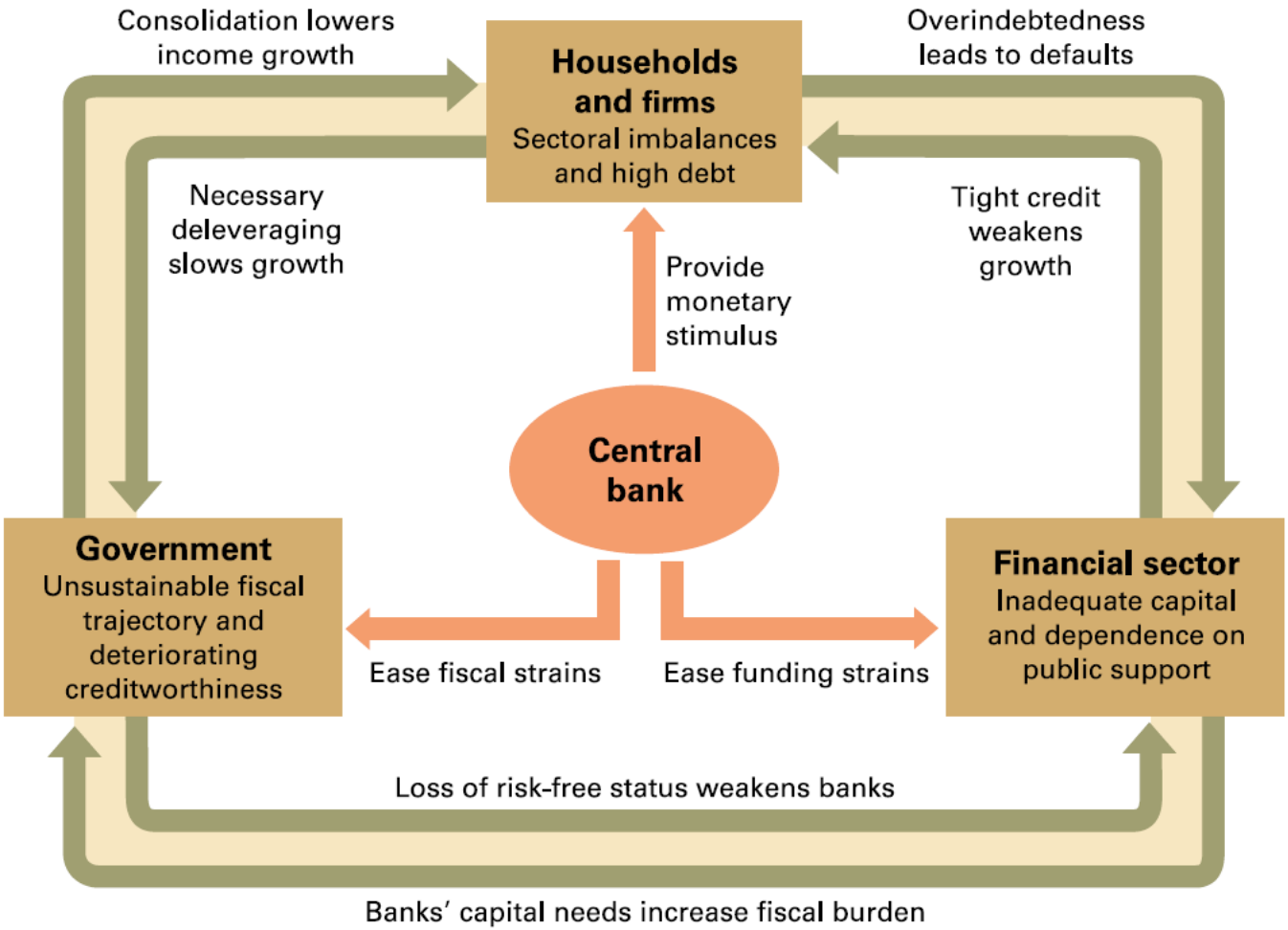
- **No common fiscal policy**
- **No common banking supervision**
- **Financial fragmentation**
- **Weakness of supervisory mechanisms**



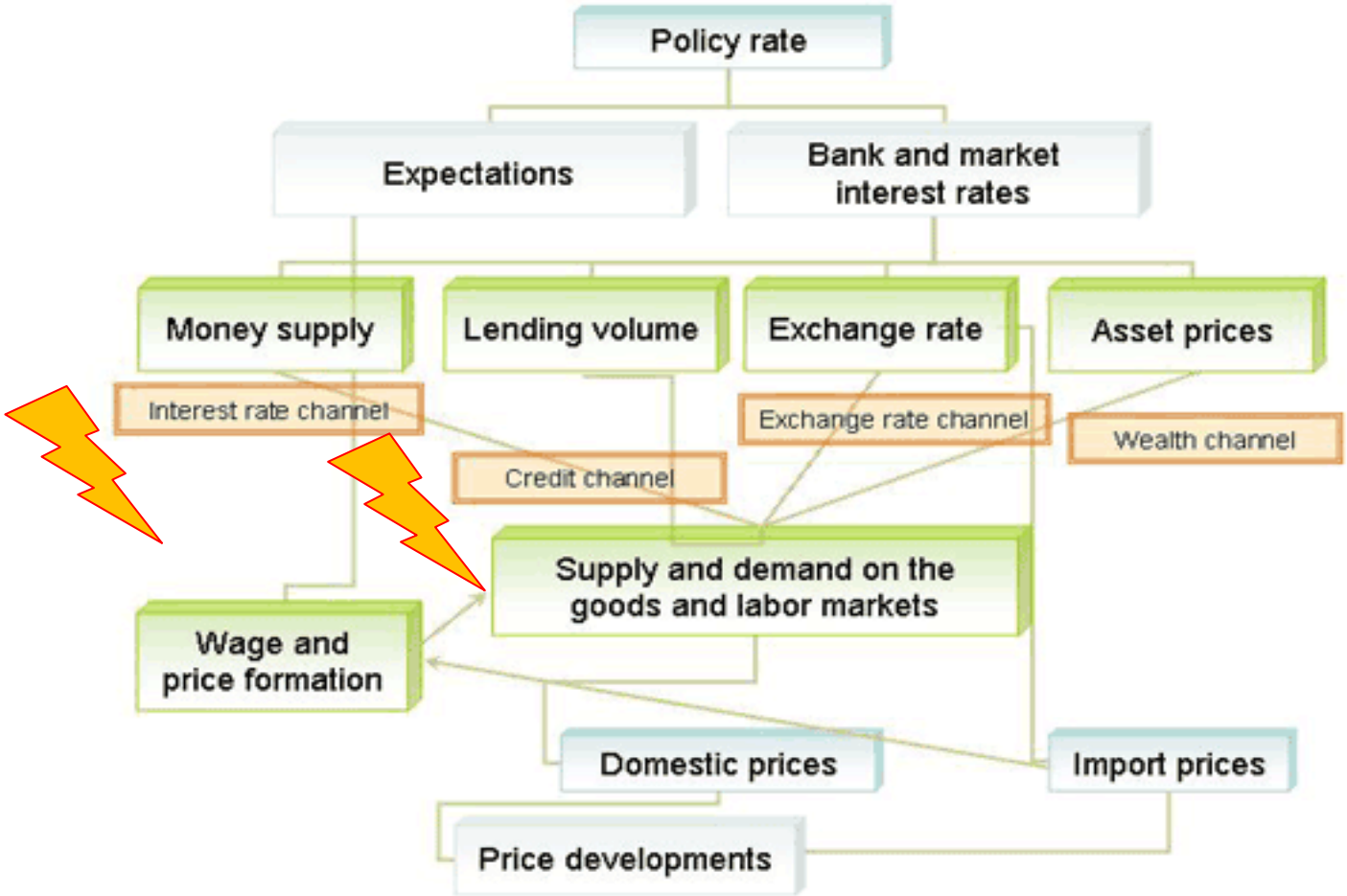
Effect 1: Adverse Feedback Loops



Effect 2: Increased Burden on Central Banks



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**

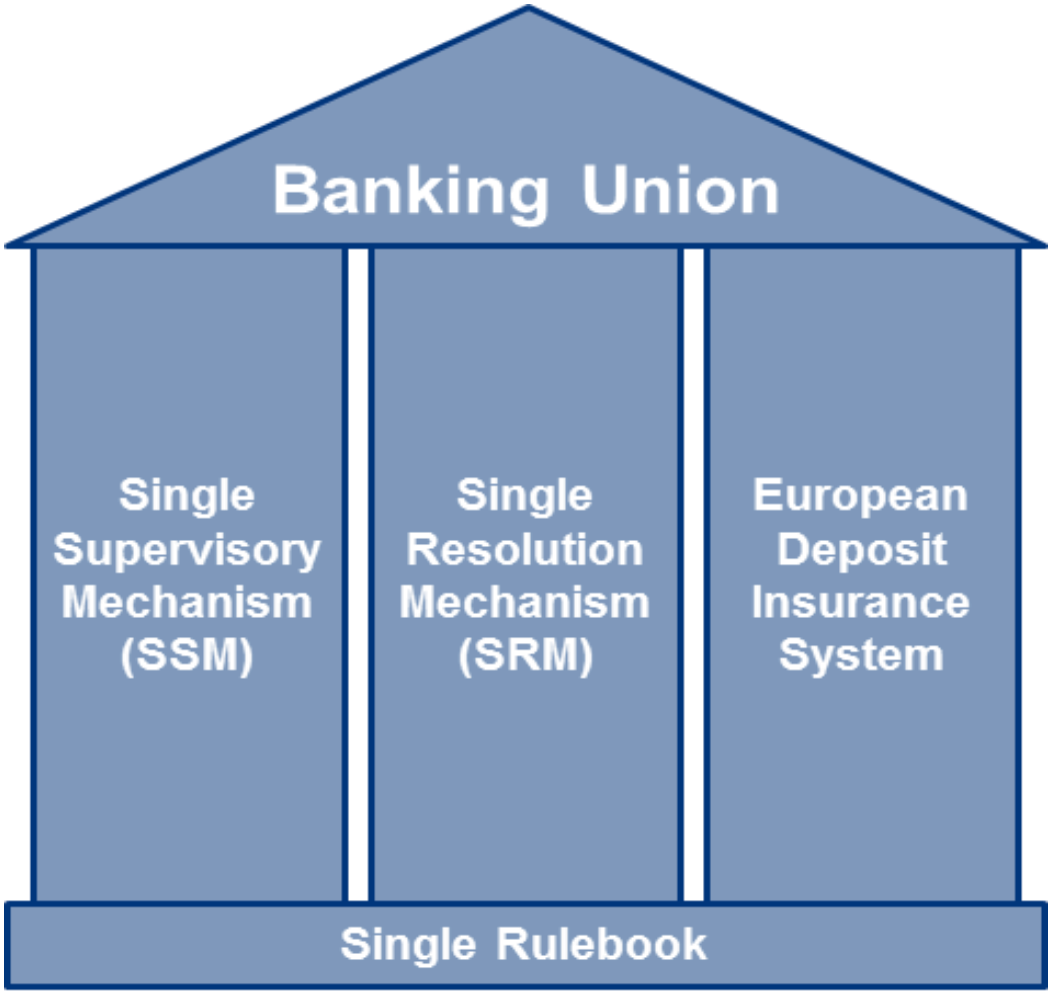
- **Relevant distinction between traditional monetary policy and a much broader „Central Bank policy approach“**

- ***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



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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