

MR. SCHULMANN: Thank you, Mr. Chairman.

I am delighted to have this opportunity to talk to you about the current world economic and monetary situation in general and about the plans to create a zone of monetary stability in Europe in particular. You are all only too well aware of the interrelated problems besetting the world economy -- unemployment, inflation, exchange rate instability, growing protectionism -- and therefore no doubt more interested in policy prescriptions than in yet another essay in economic analysis. I shall try to bear these preferences in mind in what I am going to say. And since we who have gathered here are particularly interested in those problems which bear on the relationship between the United States and the European Community, I intend to spend the bulk of my time on how the European Monetary System whose outline was agreed upon at Bremen but the details of which are still on the drawing board might affect our currencies and our economies.

There are few -- if any -- analysts who are content with the state of affairs in the Summer of '78. It is three years since we have passed through the trough of the current world business cycle but our economies are still not behaving in the way they used to in previous cyclical upswings. In most of them the recovery has been slow and zig-zagging; the rate of inflation, though on a downward trend in most countries, is still high by the standards of the 50's and 60's and unfortunately it seems to be on an upward trend in the United States; payments imbalances have remained large; employment -- outside the United States -- is either below prerecession levels or barely holding its

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own. This is the background against which exchange rate movements of a magnitude are taking place which nobody would have been able to conceive of a decade ago. There is probably agreement that exchange rates have to reflect differentials in inflation rates between countries, changes in terms of trade and persistent payments imbalances; very few of us would recommend to go back to Bretton Woods' fixed exchange rates. Nevertheless the disillusionment with flexible exchange rates is growing. Disorderly exchange rate movements, i.e. exchange rate movements going far beyond what would be justified by underlying economic trends, seem to have become a regular feature of the system rather than the exception. There is a widespread feeling that we are not only experiencing wide swings around an inevitable trend but that these swings are having an impact on that trend itself. Moreover, the incidence of this exchange market disorder is distributed rather unevenly, being concentrated on some key currencies rather than spread across the board. Also, disorder seems to be most pronounced if and when it originates in changing expectations about the U.S. dollar which remains by far the most important currency in the system as a whole. Because of the high degree of integration European economies are particularly vulnerable in this respect. As a matter of fact, intra-Community exchange rate changes have been even greater than, say, those between the Yen and the dollar or the dollar and the DM.

This is the broad background against which the European Council of Bremen instructed the Council of Ministers of Economics and Finance early in July to elaborate the necessary provisions of a scheme leading to a zone of monetary stability in Europe -- the European Monetary System (EMS). This task is currently pursued by several Community committees with a view of putting a definitive proposal before the European Council in early December. I assume that most of you are familiar with the terms of reference of these committees. Essentially, they relate to

the nature of the future EC exchange rate system and the means to support this system. Since the details of the scheme are still under discussion it would make little sense to deal with them at this stage. Instead I propose to address the broad implications such a system might have on economic and monetary relationships between the United States and the European Community as seen from Bonn.

This seems all the more appropriate since some concern has been expressed on this side of the Atlantic about the effects the EMS might have on the dollar. In the German view this concern is unwarranted. It could be summarized in the following two arguments:

- (1) The Europeans are launching the EMS to challenge the role of the US-dollar as an international means of payment and store of value. This would be detrimental to the world economy because the co-existence of several reserve currencies would increase further still the instability of exchange rates between the major currencies.
- (2) The Europeans are trying to get round obligations outlined in Article IV of the IMF Articles of Agreement; the system would have a contractionary<sup>1)</sup> effect on the world economy because it puts stability before growth, and it might cause erratic fluctuations of the dollar exchange rate.

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1) I have been told by my British friends that this term does not exist in the English language. If it does not, there is nevertheless a need for it. Economists should be able to distinguish between matters which affect the 'real' economy and those which bear 'only' on money and prices. In my mind it is highly desirable to pursue policies which are, in Keynesian parlance, 'deflationary' if they result in more (real) growth over the medium term. Let 'inflationary' and 'deflationary' stand for measures that increase or decrease the supply of money and credit. But let 'expansionary' and 'contractionary' stand for measures that affect the 'real' economy in a positive or negative sense.

These arguments are obviously in stark contrast to the intentions of the initiators of the EMS, which is to create in Europe a zone of monetary stability and thus lay the basis for adequate and stable growth. In other words, we want to help restore world economic equilibrium by bringing more order into the system of intra-Community exchange rate relationships than we have had since 1973. It really goes without saying that - in agreement with our partners in North America and North East Asia - we also want to maintain orderly monetary relations throughout the world.

Let there be no mistake about this: We in Europe want a strong dollar, a dollar which derives its strength basically from the strength of the United States economy. We want a strong dollar because we have felt the repercussions of its weakness virtually almost without interruption since the end of the sixties'. Even after the general transition to floating exchange rates our central banks have had to buy dollars in huge quantities to keep erratic exchange rate movements within limits, i.e. movements out of line with longer-term market trends. But even if it was only because of the consequences for our domestic price stability, this is not a policy which we can afford to pursue in the long run. A weak dollar also tends to disturb intra-Community exchange rate relationships, even if the overall economic situation gives no cause for this. In our view it is primarily through United States action to reduce energy imports and to combat domestic inflation that the dollar will regain its strength. In other words, the strength or weakness of the dollar is not conditional upon the existence or non-existence of the EMS.

In any case concern that the European Currency Unit (ECU) might become a competitor of the dollar, is to say the least, very premature. Reserve currencies are not created by politicians at the stroke of a pen; they are made, in the final analysis,

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by the market. Like the dollar, therefore, the ECU could only grow into such a role if European economic policies, in the eyes of potential investors, proved to be more successful than its competitors' over a period of time; it would therefore be a very gradual process. We are certainly not seeking such a role. In any case it would be pure guesswork to try and predict what the consequences of such a development would be. For the time being it is only envisaged that the ECU would become the instrument of settlement among EC central banks.

We would expect, however, that the EMS will have a stabilizing impact on the exchange rates between the dollar and the European currencies. For the exchange rate between two large monetary areas is less prone to disturbance than the exchange rate between one large and many small currency areas (and compared with the dollar area the DM zone is also small) because we are dealing with larger and therefore more inert masses. Yet it will no doubt be necessary from time to time to counteract erratic fluctuations by interventions on both sides of the Atlantic, as envisaged in the joint German-American statements of January and March this year.

The fear has been expressed in various quarters that the EMS would if anything hamper rather than accelerate growth in the European Community. This fear is based on the assumption that the rules of the EMS - especially the conditions for changing the central rates and for obtaining balance-of-payments support - might be tilted, i.e. have a 'deflationary bias'. Several EC committees are currently engaged in the task of elaborating these rules, and without wishing to anticipate the outcome of their discussions it can already be said quite clearly that this fear is unwarranted. First of all the initiators of the EMS do not presume that beginning on January 1, 1979, exchange rates within the system will be fixed for ever. This

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is the starkest difference between the EMS and what or European Monetary Union would imply; the latter would mean that exchange rate within the EC would be irrevocably fixed. Indeed, in the plans published at Bremen, provision has specifically been made for changes in central rates. Thus occasional upward or downward adjustments will be able to allow for continuing differences in cost, price and productivity trends between participating countries, as has already been the case for a good number of years within the snake. What will be ruled out, however, are short-term fluctuations in intra-Community exchange rates which bear no relation to medium-term trends ('over- or undershooting'). The overall result of such an exchange rate policy promises to be greater stability of expectations and steadier and higher private investment in participating countries and hence more growth. It is a fact that many small and medium-sized - even multinational - enterprises have, as a result of the monetary turbulences in recent years, become rather cautious as regards their investment decisions. This is to the detriment of those economies which - unlike the US economy - are not primarily oriented towards the domestic market. Up until 1973 intra-EC trade grew more rapidly than world trade; since then the opposite has occurred.

Second, the communiqué issued after the Bremen European summit already contains a reference to the effect that surplus countries, too, in shaping their internal and external policies will have to take into account the interest of the Community as a whole if the EMS is to be durable and effective.

Third, it is somewhat ironical that exactly the opposite fear is being expressed in the Federal Republic, namely that the EMS will have an 'inflationary bias'. Naturally, we in Europe want to establish neither a system that has an 'inflationary bias' nor a system that has a 'deflationary bias'. On the contrar

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What we need is more growth and (hence) less inflation than over the last five years. We are firmly convinced that both can be achieved through the European Monetary System because the exchange rate instability that has prevailed since the Bretton Woods system broke down has been one of the major factors, though definitely not the only one, responsible for the low growth rates and the inflation proneness of the European economies.

The fear that the EMS might provoke erratic fluctuations of the dollar rate is presumably based on the assumption that a currency basket would become the system's numeraire. As a result, the numeraire itself would vary with each intervention. In the German view this would lead to a number of undesirable consequences<sup>1)</sup>.

Furthermore, the question has been raised whether the establishment of the EMS, even if not violating the spirit and the letter of the IMF Articles of Agreement, would not tend to weaken the Fund's role in the international monetary system. In this context it should be noted first of all that the European economies, and especially the EC economies, are much more closely intertwined than, say, Japan in relation to North America or North America in relation to Europe. Hence it is quite appropriate for these countries to strive for closer cooperation in the field of monetary policy as well. The IMF Articles of Agreement certainly do not rule out such schemes. The 'snake in the tunnel' which followed the Smithsonian Agreement was considered an integral part of the world monetary system, and the same is true of the block-floating of the Community currencies in relation to the dollar after the breakdown of the Bretton Woods system in March 1973.

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1) Subsequent events have led to a situation where there is a virtual certainty that intervention obligations will be unequivocally fixed in a 'snake-type' parity grid.

If the EMS promotes growth and reduces inflation in Europe as intended, this would at the same time help considerably to stabilize the world economy, and thus to achieve the objectives laid down in the IMF Articles of Agreement and also to strengthen that institution. In this connection one may legitimately point out that the EC has for some time now been speaking with one voice in trade matters. It would be difficult to understand why an economic region of approximately the same weight in the world economic system as the United States should not speak with one voice, or at least one-and-a-half voices, in monetary matters as well instead of seven or nine voices.

It has also been argued that the partial pooling of the member countries' gold and foreign exchange reserves as well as the creation of additional credit facilities within the EMS would excessively increase global liquidity. Those holding this view suspect the EMS of generating inflationary impulses, but this contradicts the fear that the EMS would have a 'deflationary bias'. To argue that the partial pooling of gold reserves would once more assign a more important role to gold within the international monetary system is hardly more convincing; already today it is left to every IMF member country to value and use its gold reserves in whatever manner it seems appropriate. Moreover, the scale of the EMS support mechanisms must be seen in relation to the task they are to perform. It could be argued that unlike the IMF, the EMS has not so much been assigned the role of a 'lender of last resort' in case of persistent balance-of-payments difficulties as that of a 'day-to-day-guarantor' of stable but adjustable central rates among the participating countries. To that extent comparisons between the scale of the support mechanisms envisaged for the EMS and the volume of quotas in the IMF is less relevant and may even be misleading. Furthermore, there is little to suggest that the EMS countries will take no account whatsoever of the pre-1973 experience and stick to central rates which would in the long run be out of step with the market forces. By

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the same token, the EMS should foster the dismantling of existing restrictions on capital movements.

From all this it should not be concluded that the initiators of the EMS are seeking to play down the role of the IMF in maintaining a workable world monetary system. The EMS countries will continue to participate fully in the activities of the IMF. From a practical point of view the IMF may, however, be better qualified to solve global rather than regional monetary problems. The EMS could help relieve the Fund of some of its burden at a focal point of international monetary relations and thus enable it to deal even more effectively with the global problems. These certainly include the monetary relations among the three major industrialized regions which are the mainstay of the world monetary system: North America, North East Asia and Europe. The Fund would thereby take account of the multi-polarization of the world economy which has occurred since its founding fathers met at Bretton Woods.

In my view, one of the most -- if not the most -- important criteria by which the success or failure of the EMS will have to be judged is the contribution it will make towards the solution of the world economy's major problems: How to restore growth and high employment under conditions of internal and external economic stability.