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Euroland,

Euro and Dollar - Trilogy or Trilemma?

Dr. Elke Muchlinski

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Dr. Elke Muchlinski[1]

1 Freie Universität Berlin (FUB), Fachbereich Wirtschaftswissenschaft (FB 10, WE 02), Institut für Wirtschaftspolitik und Wirtschaftsgeschichte, Boltzmannstrasse 20, Germany 14195 Berlin, ☎ +49/030/838-2690 💻 Elke.Muchlinski@wiwiss.fu-berlin.de oder 💻muchlin@mail.zedat.fu-berlin.de

Content

ABSTRACT

This paper has argued that Euroland is a representation of a monetary union with a heterogeneous capital market, tax system, regulation of consumer savings, and methods of financing investments. Contrary to that, the Dollar represents a homogeneous capital market. The establishment of Euroland and the Euro as an anchor currency depends first of all on the monetary policy of the ECB. Nevertheless Euroland and the Euro as an anchor currency will not be a representation of a unified economic performance, as for instance the Dollar was in 1944 implemented by the Bretton Woods Agreements. According to a trilogy composed three parts of a work as a whole, the relationship between Euroland, Euro (as an anchor currency) and Dollar could be interpreted as a workable unity. This required the perception of the inherent fragility of this triad. It is the result of all the different functions held by each part.

I. INTRODUCTION

It has been generally accepted that the work of the European Central Bank (ECB) and European System of Central Banks (ESCB) will be accompanied by a special exchange rate mechanism, known as "ERM II". This mechanism will replace the current system by January 1, 1999. ERM II contains rules and commitments for the ECB to manage the integration of the existing EU member states which are not adopting the single currency from the outset. To foster the convergence progress of these "Pre-Ins" the intention of ERM II is to provide definite arrangements. Furthermore it is to be understood as a guide to those "Outs" today which are going to join the European Union (EU) and the European Monetary Union (EMU) as "Pre-Ins" later. The ERM II states that the Euro should hold the function as an anchor currency for all "Pre-Ins". This is a significant difference between the present European Monetary System (EMS) and the EMU. Contrary to the existing EMS, there will be no more reciprocity of interventions obliged by the central banks of the member states.

Some authors within the current debates focused on the positive impact of the Euro for Europe as a whole.[2] There will be fewer reasons and less motivation for destructive speculation or attacks on currencies. The volatility of exchange rate movements will be presumably low providing a more stable environment for investment decisions and their realization. Positive results are also to be found in a fundamental refinement of the European and international capital market (Gros 1998a, 1998b).[3]

My thesis is that the intended purpose of the Euro as an anchor currency implemented by the regulative framework of the ERM II will have to be accepted by the European financial markets as well as by the global financial markets unless it does not function. This unavoidably shed light on the role and statute of the ECB. My paper deals particularly with problems of the new exchange rate regimes between (a) Euroland, that is to say "Euro 11" and (b) the "Pre-Ins" or those countries which are bound to the Euro as an anchor currency and (c) the Dollar. Will this triad provide a stability in the exchange rate regimes between Euroland, Euro as an anchor currency and Dollar or increase the fragility of it - *ceteris paribus (c.p.)*?[4]

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2 Alogoskoufis/Portes (1997), Frenkel/Sondergaard (1997), Issing (1998), Masson/Krueger/Turtelboom (1997).

3 Others emphasize more skeptical views or negative consequences: A new transatlantic crisis, particularly between the USA and Europe, or different conflicts on trade policy and monetary or exchange rate policy (Feldstein 1997a, 1997b). I am not going to discuss these theses here.

4 Therefore I am going to abstract from impacts of the EMU on South and East Asia and Latin America. Whether the Euro will displace the Dollar as an anchor currency in those regions is an important question which is discussed in the research of McCauley (1997, pp. 25ff); McCauley/White (1997).

The problems arise out of the formal construction of ERM II between the Euroland and the Euro as an anchor currency for "Pre-Ins", at least for the present "Outs", and the Dollar. What are the consequences for the "Pre-Ins", i.e. those who anchor their currency to the Euro, if the Euro comes under pressure of expected appreciation or depreciation? The exchange rates between Euroland, Euro as an anchor and Dollar could be subject to high volatility and misaligments. How, then, will the ECB cooperate with the Federal Reserve System (USA) which issues the key currency Dollar in Asia, the Persian Gulf, Australia, New Zealand and which will dominate the vicinity of the Euro? As many authors within the debate point out the prospective rule of the Dollar, it is unlikely that the Euro will soon substitute the Dollar in its function as a unit of account, medium of exchange and a store of value (see Salvadore 1998a, 1998b, McCauley 1997).[5] Therefore any prospects on the Euro are hardly to be seperated from the Dollar. Whether the Euro will be part of and surrounded by a Dollar Zone which is "far from breaking up since the collapse of the Bretton Woods system" as Ilzkowitz (1995, 93) wrote will not be part of my investigation. But still it is an interesting question.

My paper is concerned with the following questions: (1) What exactly are the issues and intention of the ERM II? How likely is the emergence of the Euro as an anchor currency for the present "Pre-Ins" and "Outs" ? (see part II.1.) (2) Are the rules given in ERM II sufficient to reject attempts of speculation attacks against the countries which are going to join to the Eu-

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5 On the grounds of the conceivable increase of the size of the Euroland, at least the "Euro 15", and therefore the size of GDP and international trade, some other authors expect a displacement of the Dollar by the Euro *in the long run*. Others use a theoretical framework of transaction costs analysis and conclude that increasing size of GDP, international trade and progress on integrating the European capital markets, increasing liquidity, breadth and depth, leads to a displacement of the Dollar *in the short run* (f.i. Portes/Rey 1998).

ropean Monetary Union? (see part II.2.) (3) How likely is it that the ECB will be able to refuse claims for a further intervention to support "Pre-Ins"? (see part II.3.) (4) What can be inferred from past events concerning the exchange rate between the Dollar and D-Mark for the future? (see part III.1.) (5) Could it happen that the Euro emerge as the anchor position by regulations? (see Part III.2.)

II. The Exchange Rate Mechanism II - Sound Circumstances?

1. Issues and Intention

The issue and intention of the ERM II has been announced as the emergence of stage three of European Economic Monetary Union (EMU). The principles of it are based on the terms in the agreement (Art. 109j). The objectives of the ERM II are to govern the present "Pre-ins" (Denmark, Greece, Sweden and United Kingdom) on their way to convergence and therefore to the membership of the EMU. Furthermore the intention of ERM II is to avoid speculation attacks. "Equally, the new reference system is likely lastingly to counteract possible speculative exchange-rate fluctuations that are unwarranted, given the economic fundamentals".[6] According to the Maastricht Treaty, Art. 109m, exchange rate policy is to be interpreted as a com-

[6] The complete text is reprinted by the Deutsche Bundesbank, Monthly Report (MR), October 1998, Frankfurt/Main, pp.17-23; for particular preparations for economic and monetary union, see MR, May 1998, pp. 17-25.

mon commitment of all members. Therefore members of the European Union which are going to join the EMU have the rights for support against speculation attacks by the ECB.

There is no strict obligation for "Pre-Ins" to participate in the new exchange-rate mechanism. For instance, Denmark and Greece are going to enter on January 1, 1999. Denmark will participate with a fluctuation band of ± 2 ¼%; while the Greek drachma's fluc tuation band's will be of ± 15%. All countries who want to join the EMU must fulfill the precondition of a period without currency devaluation and remain within the 'normal' fluctuation margins for at least two years before the joining date (Art. 109j). It is to be expected that the exchange rates between these "Pre-Ins" and Euroland can be subject to volatility, at least subject to speculation because such an arrangement of rules and obligations is able to provoke a particular market response (for a further investigation, see part II.2.).

The issues and intention therefore is to regulate the participation of the current "Pre-Ins" as well as the prospective "Pre-Ins". How can this be done? With respect to the "Pre-Ins" the ERM II leaves no doubt upon the suggestive function of the Euro. "Although the D-Mark has often been assigned the function of an anchor currency, in ERM II, the Euro has expressly been given the role of the anchor currency" (Bundesbank 1998, 19). How likely is the emergence of the Euro as an anchor currency for the "Pre-Ins" and prospective "Pre-Ins" on the basis of formal arrangements, like the ERM II"? (for further investigations, part III.2.) Besides that intention of the treaty, the future certainly will give more clarity upon the question of whether the Euro achieves the market function and the role as an anchor currency.

In so far as the Euro is the anchor currency there will be consequences to be expected for the prospective "Pre-Ins", which are the "Outs" at the moment. The rules of ERM II explain that only the anchor currency is the reference for judging upon exchange rate stability. Whereas the Euro is defined as an anchor currency by particular rules of the treaty, the D-Mark evolved into this function by market processes. This might be the reason why the members of the EU voted for the following regulation:"For future participants, a further implication of the new system is that the assessment of their currencies' exchange-rate stability within ERM II depends only on the relation to the Euro" (Bundesbank 1998, 20). This citation demonstrates that the ERM II is not only addressed to the current "Pre-Ins", but to all other prospective participants of the EU and at least of those of the EMU. In this sense this regulation is of an importance which often has been overseen within the debates on the future of EMU.[7]

Therefore any exchange rate movements of the Euro against the Dollar, any appreciation or depreciation, in case the Euro is accepted as the anchor currency for the present "Outs", will affect those countries. Euroland is to be seen as the gravitational force for these countries adapting the Euro as an anchor.

Who are these "Outs" exactly? First of all there are the countries of Central and Eastern Europe (CEEC), the countries of the CFA-Zone, and countries of the "Euro-Mediterranean Partnership" which adopted the "Barcelona Declaration" in 1995.[8] Consideration of the pre-

[7] There are indeed a few exceptions, see for instance Bénassy-Quérés et al (1997), Berrigan/Carré (1997) and Szapáry (1997, 136ff.); DeGrauwe (1997)

[8] For an analysis of the exchange rate arrangements between the EU, CEEC, CFA-Zone and the group of Mediterranean countries, see Berrigan/Carré (1997, 122ff.).

sent exchange rate regimes between Central and Eastern Europe Countries (CEEC) provides clarity on how great those impacts could be. As McCauley outlined, the CEEC linkage of its currencies to the forthcoming Euro can be explained on the basis of the current role of the D-Mark and Dollar. More precisely, it depends on a currency basket. The exchange rate regimes of the Czech Republik, Hungary, Poland, Slovak Republic are linked to a currency basket, in which the D-Mark and US-Dollar are dominant, therefore they share the movements of these currencies. For instance: Poland's currency basket (1997) contains 45% US$, 35%DM, 10%£, 5%FF, 5%SF (McCauley 1997, 23). Only Bulgaria's exchange rate regime is based solely on DM. It follows from these statistics and researches, which should not be reprinted as a whole in my paper, that for the CEEC the exchange rate regime against the Euro is still an open question; they have to be prepared for the worst case. This view is also relevant for the other countries which want to join the EU and the EMU.

The Czech Republic has a system of managed floating rates based on the following currency basket: DM 45%, Sch 12%, SF 7%, £4%, US-$ 31% from Jan. 1991 to May 1993; 65% DM, 35% US-$; until May 1997. Hungary has changed its currency basket as follows: 70% DM, 30% US-$ (1991 to July 1993); 50% ECU, 50% US-$ until August 1994; 50% DM, 50% US-$; until January 1997: 70%ECU, 30% US-$.[9] Without going into much detail in presenting combinations of currency baskets of the CEEC, or at least the non-EU Mediterranean countries or the countries of the CFA-Franc, one should have a vision of the surroundings of the ERM II, which will have without a doubt feedback consequences for those "Outs".

2. Problems

In Euroland speculation attack will not occur anymore because the EMU does not contain any exchange rates. The group of the "Pre-Ins" which have been already announced at the moment, the Danish Krone, the British Pound, the Swedish Krona and the Greek Drachme, are identified to be protected from speculation attacks by regulations of the ERM II. "To enhance the credibility of the intervention commitments assumed, automatically accessible 'very short-term financing facilities' are being established between the ECB and the centralbanks of the 'Pre-Ins' participating in the exchange rate mechanism" (Bundesbank 1998, 22). The fluctuation bands of Denmark and Greece have now been published. Furthermore information is given on how the ECB is going to defend those countries through interventions and central rate adjustments against speculation attacks "This very short-term financing facility may also be used in the event of intramarginal interventions, but only up to specified ceilings fixed for the central banks of the 'Pre-Ins'"(ibid). The adjustments will depend particularly on the exchange rate of the Euro against the Dollar.

Are the rules given in ERM II sufficient to refuse attempts of speculative attacks? As the crisis of the EMS in the years 1992/93 showed, formal agreements on commitments leads to a "test by markets" proofing stability and credibility. The wide range within the targets for Denmark and Greece is due to the unforgotten events during the speculative crisis in the EMS in those days. Moreover the rules of ERM II want to exclude the worst case that the ECB could be in-

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9 See McCauley (1997, 23); Berrigan/Carré (1997, 124ff.).

volved in commitments of intervention in the exchange rate market to foster a non-credible exchange rate parity. "The new exchange-rate mechanism was designed to be more flexible in a number of areas. The underlying motive here was that the objective of maintaining price stability, which will be given priority by the ECB and the national central banks, must in no circumstances be jeopardised" (Bundesbank 1998, 19). Such speculation attacks perhaps intend to give a proof of the non-conformity of market rules with the ERM II. Given this formal arrangement one could be unconcerned about all these issues if there were not the uncertain status of the present "Outs" and the fragility of the ERM II. The ERM II explains where the restriction of such a defense strategy is to be found: jeopardy of the primary goal of price-stability.

One has to tackle the question of why there has been only little attention drawn to the wisdom of open macroeconomies. The *common sense* knowledge within the community of science is the "triad of inconsistency".[10] This basic axiom of international macroeconomics focuses on the incompatibility of full international capital mobility, autonomy of national monetary policy and fixed exchange rates. This *wisdom* created by Mundell (1961) in the early years of the Bretton Woods Agreements (1944) can be studied once again in the crisis in the EMS during 1992/93, in which speculation attacks led to a modification of the EMS.[11]

The history of exchange rate policy shows that volatility of exchange rates is often determined by expectations of market participants. Given that insight, it is important to anticipate that a

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10 See Wyplosz (1997)

11 See Eichengreen/Wyplosz (1993)

choice of monetary regimes to be implemented in the EMU will produce a response by market participants. Fundamental changes in market regimes are able to force speculation. Reconsidering the September crisis in EMS in 1992 two theoretical explanations are to be distinguished. First: Speculation attacks can occur on exchange rates since they are interpreted as incompatible with the so-called "fundamental data".[12] Therefore it can happen if there is an inconsistency in the balance of payment or exchange rate peg and the present domestic policy. In this view speculation attacks are motivated by unavoidable prospective regime changes, monetary policy or a realignment. Market traders anticipate the regime choice.

Second: From the point of market participants speculation attacks are reasonable if a regime choice *after* the speculation attack can be anticipated. For it is possible to anticipate a regime choice as a result of a speculative attack, i.e. the attack is self-fulfilling. This phenomenon is known in the literature as a *self-fulfilling prophecy*. Its application to the foreign exchange market was taken up by Obstfeld (1986). This explanation was of great importance for the crisis in September in 1992 in the "old" ERM. According to the Maastricht Treaty, which provides an intrinsic cause for such attacks, it was clear that "a speculation attack forcing a devaluation might disqualify a country from EMU participation" (Eichengreen/Wyplosz 1993).

Although there is no historical example for what will happen in Europe, theory is able to capture scenarios of what could happen. In light of theories of determinations on expectations, it is possible to conclude that expectations of market participants are guided by expectations of

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[12] DeGrauwe points out that exchange rate movements are at least in the short run largely disconnected from their fundamental value (1994).

other market participants. Therefore *conventional judgement* is important for an assessment of the market situation (Muchlinski 1998). The implication of the hypothesis of self-fulfilling prophecy is without doubt relevant for the ERM II. If the precondition to join the EU or finally the EMU is a particular monetary policy (say 'tight money policy'), the market traders presume an 'easy money policy' as a result of the attacks. The traders anticipate therefore capital mobility as an expression of a regime choice after the attack has occured.The expected shift in the monetary regimes from tight money policy (before the attack) to easy money, as a result of it, leads to the fact itself (*self-fulfilling prophecy)*.

The distinguishing characteristic of the second model is that the *self-fulfilling prophecy* forces the attack. Consequently a balance of payment disequilibrium or 'wrong' exchange rate are due to that *prophecy*. As Eichengreen/Wyplosz outlined in their investigation the constitution of the central bank in question, either a "wet " or "dry central bank" is important (1993, 37ff.). Given the premise of perfect foresight, two equilibriums can be discussed: (a) In case of a speculative attack the "wet" central bank will decide for an easy money policy which leads to capital outflow and a depreciation of its exchange rate. The new equilibrium will be along that new path, therefore the exchange rate regimes follows the attack. "The currency is weak because of the monetary authorities' lack of credibility in reacting to the attack" (Eichengreen/Wyplosz 1993, 38). (b) The second equilibrium illustrates the case of a central bank with credibility counteracting a speculative attack. Again, this equilibrium will be stable on a new path. Because of the premise of perfect foresight, the new stable equilibrium will not be observable because of the *self-fulfilling prophecy*. The implications of this model is the occurance of "multi equilibria" and exactly this phenomenon is due to an intrinsic cause of such a *self-fulfilling prophecy*. For it has been studied in the current history the Maastricht Treaty itself contains such an intrinsic cause. In so far as all present "Pre-Ins" and prospective "Pre-Ins" intend to join the EU and the EMU they have to act on and be governed by certain rules and commitments. Any divergence from this process of convergence will force a negative response by EU or EMU and therefore leads to an abandonment of those rules.

As Eichengreen/Wyplosz describe the typical situation for a *self-fulfilling prophecy* concerning the Treaty arrangement: "If only a minority of EC countries do so (meet the convergence criteria, EM), Stage II continues until January 1, 1999, the last possible date for the inauguration of EMU. Again, the Commission and the EMI (European Monetary Institute) must report in 1998 on which countries satisfy the conditions and will form the initial nucleus of the monetary union" (1993, 40). Now, the EMU starts with a majority group, nevertheless, the validity of this argument is out of question.

There is another aspect which is worth outlining here: The exchange rate system between Euroland and the Euro as an anchor currency contains an analogy to the old EMS arrangement, known as the "hypothesis of asymmetry". According to the debate, current "Pre-Ins" and prospective "Pre-Ins" (present "Outs") are greatly interested in exchange rate stability (Szapáry 1997). The implication is that the ECB and the national banks of those countries have to coordinate their monetary policies. The intention of the ERM II leaves no open question to the reader that interventions by the ECB to support the "Pre-Ins" are part of the monetary integration, but they are seriously bound to the primary goal of ECB price stability. In case the Euro will be implemented as an anchor currency, what are the consequences of the policy of the national banks of the "outs"? This implies an asymmetry regarding the commitment of intervention; the ECB will give up its obligation at a particular point, whereas the interested national bank has to carry the burden of the adjustments. Their restrictions are limited to their share of international reserves they possess. The implication of asymmetry reminds of the structure of the "old" ERM and the mechanisms of interventions and adjustments caused by the "hidden" function of the D-Mark as a key currency. Within the ERM II the national banks of the "Outs" have to pay for a policy of stabilization of the exchange rate around a central parity of the ERM II. No doubt, the reader will not find any specific remarks on that issue or intention. These considerations of prospective asymmetry between the ECB and national banks of the "Outs" are essential for the process of monetary integration in Europe.

3. Monetary Policy under Pressure?

The ECB is acting within a new historical circumstance from January 1999 on, but more or less on the paradigm of the Bundesbank.[13] Dornbusch describes the tightrope walk as follows: "The ECB has to tread the narrow path between an institutional revolution and uninterrupted continuity with the Bundesbank. The capital markets will be unforgiving if they see anything less than Bundesbank policy. But the political community will be unforgiving if they do not see a genuine preoccupation with being European, creating a language and constituency that goes beyond German savers and monetary hawks" (1998, 52). I want to add that the real challenge of the ECB is to find its own way transforming the paradigm of the Bundesbank into a non-national monetary policy strategy which also transforms nationally dependent institutions.

How likely is it that the ECB will be able to refuse claims for a further intervention to support forthcoming "Pre-Ins"? An inception of the EMU and the implementation of the ERM II, protecting the "Pre-Ins" against speculation attacks will depend on the success of the ECB as a credible central bank. No doubt, the ERM II captures in a broader sense some possible problems of the enlargement of the EU. "Its (ERM II, EM) benefits will lie primarily in supporting the convergence efforts of those EU member states which are seeking to join the Euro area in the medium term. However, the new exchange-rate mechanism is also likely to be of significance in the light of the expected enlargement of the European Union to include a number of countries in central and eastern Europe. Once these countries have joined the EU, they will be able in principle to adjust their currencies to the Euro by participating in the exchange-rate mechanism. It remains to be seen how fast the individual countries will be able to adapt their economic and monetary policies to conditions in the Euro area, thus meeting the requirements for adapting the Euro at a later stage" (Bundesbank 1998, 23).

The process of establishing the Euro in the role as a key currency which will be held by market participants depends particularly on the policy and credibility of the ECB. Gros (1998 b) insists on the highly problematic distribution of power and responsibilities between the ECB

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[13] The decision on the monetary policymaking now has been published: The ECB decided to steer a modified aggregate (M) and not an inflation targeting.

and the national central banks which could lead to a failure to achieve price stability. Rose (1998) raises the question of whether the "Ins" are running too hot and how likely is a non-trivial tightening of monetary policy during the early, fragile part of the EMU. A systematic divergence of preference between the Governing Council and Executive Board of the ECB provides a fragile situation of decision making and therefore an impediment for the need to act as a market trader.

From its inception the ECB will be faced with the problem of a non-uniform interest rate throughout the European countries; furthermore national differences in price and wage rigidities, economic structures and performance. There has been much success on a convergence of interest rates in Europe until now. Kenen points out to the preferences of the national governors which have become homogeneous (1998). This optimistic view has not been shared by other authors; divergences between the national inflation rates will still remain after the time the ECB will have started work to shape monetary policy in Europe (Fratianni et al 1999; Mussa 1997). Compared with the highly integrated financial market in the USA, the European markets are more segmented. A further monetary integration in Europe needs to be guided and accompanied by a powerful central bank. Therefore two issues of the coming ECB need to be resolved: (i) Differences in the structure of the economies have to be arranged with a uniform interest rate determined. (ii) The ECB has to establish its low-inflation credibility to convince the market. This not solvable in the *short run* since monetary policy will produce differentiated impacts on the countries in the "Euro 11".

Although there are often made objections against a comparison between the financial markets in the USA and Europe in the literature since they are *incomparable*, it is helpful to shed light on the structural differences. One notable difference of the monetary union in the USA is the absence of different regional capital markets. In the EMU one will find national or regional capital markets a long time after the EMU will have started. This is due to national regulations of consumer savings; mortgage or saving accounts regulated by national laws. Even the sectoral distribution of monetary aggregates are different, e.g. in France and Germany. At least the methods of financing investments and enterprises are different and very much dependent on the national tax system.[14] Regarding the wholesale level it can be argued that the emergence of commercial paper by Euro non-financial enterprises could lead to a refinement of the financial market. Therefore it is hardly convincing to infer a further monetary intergration from the inception of the EMU.

Let us have a short look on the American monetary policy. How does the Fed act in the daily process of monetary policy and practice? Because of the impossibility of knowing the "true model" (Krugman 1995; Blinder 1998, 1997), the model of the Fed is more or less the actual monetary policymaking. It has long been common sense in academic discourse that a central bank has to decide between steering a monetary aggregate *(M*) and an interest rate (*r).* Both views of the concept of monetary policy are certain knowledge in textbooks, but irrelevant for all major central banks nowadays. They use the overnight interbank rate, in the United States, the Federal Funds Rate (FFR), as their central policy instrument (Greenspan 1993, 1998).

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14 Gros (1998a, 26) presents an investigation of the "national idiosyncrasies for monetary policies".

The Fed's monetary policy is in some sense important for the forthcoming ECB. Focusing on a uniform interest rate, the Fed is confronted with the emergence of different inflation rates throughout the fifty states of the USA. The committment to price stability by the Fed is analogous to that of the ECB. The significant distinction between them is the procedure of obtaining a uniform monetary policy. The decision-making of the Fed is carried out by the Board (seven members), which has unanimous authority over the Federal Open Market Committee (FOMC). Their decisions govern the FOMC consisting of twelve presidents of different Federal Reserve Banks, but only five of them having permission to vote. Only the Board is allowed to make the decision on the Federal Funds Rate and the minimum reserves of the Fed.

A brief comparison of the ECB and the Fed provides clarity which is required for judgement. The ECB and the ESCB will be an untested institution compared to the Federal Reserve System. The structure of the ECB is divided in the Executive Board and the Governing Council.[15] The Board of the ECB contains six members. The Governing Council comprises the Board members (six) and the governors of the national central banks (11 members or "Euro 11"). The ECB Board will be determined by the national central banks. The regulation of the Protocol No. 3 outlines a hierarchy of the statute as a whole (see Art. 12, *Responsibilities of the decision making bodies*). Under the present statute, the ECB Board having six votes, will retain as authority but become less representative as the Governing Council during the process of EMU enlargement.

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[15] For a further reading, see Protocol (No. 3) on the Statute of the European System of Central Banks and of the European Central Bank. In: http://www.ecb.int

To summarize this point: The ESCB operates in a decentralized manner. Decentralization is an impediment to achieving the goal of price stability as well as credibility of the ECB. In order to realize this goal, the ECB needs to act as a participant *in* the market and not as a spectator *of* the market. For the realization of price stability the ECB is compelled to provide the required liquidity to the banking system as a whole (*Lender of Last Resort Function)*.

III. Euroland, Euro and Dollar

1. Trilogy or Trilemma?

The prospective exchange rate regime between the Dollar, Euroland and the Euro as an anchor currency will affect primarily those candidates of the monetary integration which are going to anchor their currency to the Euro or take the Euro into their currency basket. Therefore the question, "Euroland, Euro and Dollar - Trilogy or Trilemma?" draws attention to a relationship which is to be created in the coming years. The analysis in the literature can be classified into two main groups:

Diversifications of the Portfolio

I.	DM	→	Euro
II.	DM	→	Euro, £, $ and others

Group one (I) is inclined to deduce a positive demand for the Euro among most of DM holders; group two (II) holds the view that current DM assets will be diversified into different currencies, like Euro, Pound, Dollar and others. The consequences of this classification are not as simple as the classification itself suggests. It only provides a theoretical approach to the unknown future depending both on (i) the private preferences and (ii) the capability of the ECB to act as a market participant. These consequences lead above all to considerations of the exchange rates between Dollar and Euro. The relationship between both Euro and Dollar can be characterized as an ambiguous one. Policy arguments point in the direction of 'benign neglect' the forthcoming ECB will pursue and therefore to a proposal for a fixed exchange rate system (e.g. Bergsten 1997, 1997a). Another policy argument focuses on fixed exchange rates between Euro and Dollar. But this conception is not one of *common sense* and as the discussion goes at the moment, not desirable. Furthermore target zones are discriminated as not desirable and acceptable by the markets and policymakers.

The problems with target zones are well known and shall not be repeated in detail in this paper (see initially Krugman 1991)[16]. There are still controversies on two important assumptions of the model: (a) the hypothesis that central banks intervene only right before the exchange rate reaches the end of the target and (b) the credibility of the commitment to defend the target zone. Problems are not only due to the realm of a target zone, nevertheless, wide targets can be identified as the cause for speculative attacks.[17] Wide target zones imply a reduced commitment of intervention by the central bank. On the other hand narrow bands would require unlimited interventions and are therefore not convincing. The reaction to the EMS crisis in 1992/93 was to concede wide fluctuation bands as a better way for the interim period than attempting to achieve the monetary union on a tightrope. The question needs to be asked how much support for "Pre-Ins" under pressure is required. The intervention of the central banks

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[16] Fundamental works derive from Williamson (1985).

[17] Different proposals for the interim period have been made by Begg/Giavazzi/von Hagen/Wyplosz (1998); DeGrauwe (1997).

between Euroland, Euro as an anchor for "Pre-Ins" and prospectives Ins" has to be managed in an asymmetric manner. This support cannot be seen as a unilateral task.

Which conclusions can reasonably be drawn from this consideration to the forthcoming exchange rate regime of Euroland, Euro and Dollar? Let me first explain my intended analogy to "trilogy or trilemma". A trilogy consists of three tragedies, which form an integrated whole. Tragedies in the classical meaning are interpreted as a form of serious theatre or production, in which sentiments and emotions determine the interactions of the actors and govern their destiny. It focuses on unbridgeable contrasts between the member of a group or community and usually does not show the way out of the worst case. In a modified meaning, a trilogy contains three stages of a work belonging together, in which not only the worst case is depicted.

Trilemma is a conception of logic.[18] For example: "(i) Either you have paid your taxes or you have bad conscience. (ii) You have not paid your taxes. (therefore) (iii) You have bad conscience".[19] But, the proposition (ii1) "If you have paid your taxes. (therefore) leads not to the conclusion that you have good conscience. One has to be recognized, that the choice of a monetary regime is not a question of logic, since logic is "dry bones" (Keynes).[20] Regarding Euroland ("Euro 11"), Euro as an anchor and the Dollar, it must be recognized that all three parts have different functions within the trilogy and are moved by their own dynamic. This

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[18] It is a form of reasoning within the distributive syllogism.

[19] In short: (i) $p \vee q$ (ii) $\neg p$ (therefore) (iii) q
(i1) $p \vee q$ (ii1) p (therefore) (iii1) q

[20] Keynes critised formal logic explicitly of limited relevance as "dry bones, until finally it seemed to exclude not only all experience, but most of the principles, usually reckoned logical, of reasonable thought" (C.W., X, 338); for a further investigation, see Muchlinski (1999).

implies an inherent fragility of the new exchange rate regime. It has to be asked if a trilogy in the classical meaning could be avoided if serious attempts to integrate unsolved problems were undertaken to build a comprehensive one.

Many authors draw attention to the expected volatility of the exchange rate between Euroland and the Dollar (f.i. McCauley 1997, Martin 1997). Given empirical evidence of the volatility between the Dollar and D-Mark, it is to be expected that the volatility of the exchange rate between Euroland and the Dollar will be somewhat higher than the exchange rate between the Dollar and D-Mark has been. This view then often leads to the conclusion that the regime change in Europe manifests itself in a distinguished monetary policy, for instance a policy of "benign neglect". Regarding the size of the economy of EMU, the unified market of "Euro-15" will be at the level of the USA and Japan. Given that economic performance, the ECB and ESCB will not be interested in a stabilization of the Euro-Dollar exchange rate since it is of less importance than it was before. This conclusion that a larger economy in Europe provides a higher tolerance to movements of exchange rates is fundamentally based on a non-convincing comparison of the USA with Europe. In the eighties Europe accused the USA of practicing the strategy of "benign neglect".

What can be inferred from past events concerning the exchange rate between Dollar and D-Mark to the ERM II? A judgement on past events has to be distinguished from what will or could happen. A Dollar appreciation or depreciation affected first of all the D-Mark exchange rate and the German economy and causes the policy decisions in Germany which hurt the other European countries. For instance, the economic situation in Germany around 1995 was restricted not only by a weak Dollar, but also by weak European currencies. Therefore all interdependencies between the exchange rate of the Dollar and D-Mark have to be seen in a broader context of the function the D-Mark as a "key currency" has within the "old" ERM.

2. The limits of frameworks

Could it happen that the Euro emerges as an anchor currency by regulations? To answer this question the characteristics of a key-currency needs to be discussed, i.e. the emergence of the functions of money as a unit of account, a medium of exchange and a store of value. The Euro will be accepted as an international currency if it fulfills the expectations of both private and official agents as a secure medium. The potential gains of using such a currency as an international medium are found in reduced transaction costs and uncertainty. Specifically the persistence of uncertainty and the fragility of knowledge calls for the requirement of a stable medium. Three criteria in particular can be used to point out the characteristics of a vehicle currency: (a) the economic performance, (b) the degree of integration in the financial market and (c) the expectation of the inflation rate. Given these prerequisites a currency becomes a vehicle since it is used to denominate and execute international trade and capital transactions without referring to the country which issued the currency.

It is indeed likely that the Euro will displace the Dollar in its function of a unit of account throughout Europe as soon as European financial markets have developed (Gros 1998a). It has been observed in the current literature, that it is unlikely that the Euro immediately will displace the Dollar in its function as a medium of exchange and store of value throughout the world economy.[21] The reason is that the current statute of the ECB and the absence of a federal government in the EU, such as in the USA, are drawing ceilings on the European monetary integration process. It is therefore likely that the Euro will probably have some weight as the D-Mark has today but somewhat less than the relative weight that the EU has in international trade and finance in the world economy.

On the basis of simulated research, made by Masson and Turtelboom (1997), the incentives to hold foreign exchange reserves in Euro for store of value purposes should be somewhat greater than for the D-Mark which could lead to a diversification away from the Dollar. Nevertheless, judging on the basis of the present data and discussion, a dethronement of the Dollar is unlikely. All the indicators outlined above more or less stand for long and not for short term developments, i.e. not for changes immediately after the ECB has started to act.

Today the dollar is accepted by the market because of its dominant role in finance and trade, nevertheless its superiority has been reduced since Bretton Woods. According to an important research of the *Bank for International Settlements* (BIS 1996) the academic debate focuses on the possible change in the superiority of the dollar in case the Euro emerges as a strong currency. Will the USA accept losing the benefits it has gained throughout more than five decades until now? The main benefit of the Dollar being used as a vehicle currency is indisputably the seignorage. It implies an interest-free loan by foreign nations. One main disadvantage of having a vehicle currency is the potential loss of some degree of control over the domestic money supply. For the USA it has been observed that the advantage gained outweighs this disadvan-

[21] Salvadore (1998), (1998a), (1998b), (1997)

tage because of America's huge domestic economy in comparison to its involvement in international trade and finance. Therefore the USA will defend the great benefit of its having a vehicle currency against the emerging Euro.

Not only the history of the Pound Sterling and Dollar has told us that formal arrangements are not sufficient to establish a key currency. A competition between the Euro and D-Mark will not occur because the D-Mark will be displaced by January 1999 through law and regulations. The competition between the Pound Sterling and the Dollar was decided by economic and political performance, not by legal criteria. In the 1920's the overvaluded exchange rate of the Pound against the Dollar was the reason for gold export from Great Britain to the United States and the starting point for building the reputation of the Dollar (Spahn 1997). [22] Beyond that, the U.S. market wasn't devastated by the First World War, a circumstance not to be neglected, which provided a successful emergence of the Dollar. It has to be noticed that history can teach us what happened but it cannot teach us what will happen. Concepts or categories like key currencies are not definable by so called real facts. Therefore it is necessary to refer the concepts to representations of the empirical world. If the Euro should be accepted by market participants somewhat more is required to be successful. The emergence of the Euro as an anchor currency will depend not on the ERM II but on the market response. The important figure therefore is a ECB acting as a market participant and not as a speculator of the market.

IV. Preliminary Conclusions

According to a trilogy the relationship between Euroland, Euro (as an anchor currency) and Dollar could be interpreted as a workable unity. Nevertheless the perception of the inherent fragility of this triad is required. It is the result of all the different functions held by each part. Euroland is a representation of a monetary union with a heterogeneous capital market, tax system, regulation of consumer savings and methods of financing investments. Contrary to that, the Dollar represents a homogeneous capital market. The establishment of Euroland and the Euro as an anchor currency depends first of all on the monetary policy of the ECB. Nevertheless Euroland and the Euro as an anchor currency will not be representations of a unified economic performance, as for instance the Dollar was in 1944 as implemented by the Bretton Woods Agreements. The challenge for the Euro is to *become* a medium of exchange, store of value and unit of account within the coming years, and to represent most of these functions from the outset.

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[22] See Keynes (1925) *The Economic Consequences of Mr. Churchill*.

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