Future Prospects for the World's Foreign Exchange System: Political Design versus Evolution

Remarks by
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1) Bretton Woods from 1944 to 2014

Bretton Woods is a kind of mythical sound. There is hardly any other place in the world which stands in the same way as a symbol for a new international order in the monetary and financial sphere. Seventy years ago representatives of 44 countries met here to design a global monetary system. The conference was organized at a time when the world was still torn apart by bitter fighting during World War II. In the middle of the ongoing war, people met here to design the order for peace. As a German, the year 1944 reminds me of a time when my country was increasingly ruined materially and mentally by the terror of the Nazi regime. In these months we spent most nights in a shelter and nobody could imagine that not so many years later, in 1952, Germany would become a member of the IMF and – beyond that – belong to the democracies of the western world.

Compare 1944 Bretton Woods with 1918. When the First World War ended Britain believed it would still be the super power in the world; the US was not ready to take leadership, yet; and anyway, all countries were convinced that the best way forward would be to return to the previous system, the gold standard. As we know, this ended in disaster – for many reasons, but also for the lack of a functioning international monetary order.

For me coming to this place has a special attraction as I wrote my so-called "Habilitationsschrift" (professorial dissertation) on key currencies and the international monetary order. I am grateful to Larry Goodman for inviting me to this fascinating conference. The conference in 1944 was enlightened by the intellectual brilliance of John Maynard Keynes, but as a diplomat, he was rather a disaster. And his disappointment explains why he once called the meeting "the most monstrous monkey house assembly assembled for years." I'm sure nobody would characterize this meeting of so many eminent researchers and practitioners in such a way. Whereas, it will be hard, if not impossible to match Keynes' brilliance, reading the impressive list of the participants, I think this conference will be a full success.

What I want to do is to build a bridge between past and present, between 1944 and today. I will also give a view on the future and speculate somewhat on what might happen. We know this conference

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here 1944 in this hotel was marked by the discussion – conflict, fight or whatever you want to call it – for the future, between the US and the UK, between White and Keynes. And the result was US dominance, i.e. the dollar standard which would have emerged anyway, but it was legalized in the context of the IMF statute. The result was a regime of fixed but adjustable exchange rates and two institutions – the IMF and World Bank. And the system worked quite well until the days when capital flows were freed from controls.

This started in 1958, and in the '60s it became obvious that there is a monetary trilemma. The monetary trilemma states that out of the three objectives fixed exchange rate, capital mobility, and an independent monetary policy, only two of them are feasible at the same time. And with further increases in capital flows, a financial trilemma emerged, which I think is just paying tribute to the integration of capital markets. De facto it is a dilemma because financial stability is the goal and financial integration and national financial policy are the elements which contribute to this goal or impede it. Financial integration can foster or endanger financial stability – depending above all on the soundness of domestic financial markets and institutions.

2) The current exchange rate regime

Since the collapse of the Bretton Woods system in 1971/73 countries are free to choose their exchange rate system. They only have to notify the IMF of their decision. There are not even recommendations to be expected from the IMF aside from special cases with programs. The choice is between many variants: we have the two corner solutions, hard pegs and free-floating, and we have soft pegs, managed float, and many variations of these different approaches.

The last Report of the IMF on exchange arrangements and exchange controls gives an overview of the practice of the 188 member countries. As of April 30, 2013, 13.1 percent of the member countries have adopted hard pegs, 42.9 percent soft pegs of all kinds, and 34 percent floating with 18.3 percent managed float and 15.7 percent free float (and the rest with other arrangements).
This survey is I think misleading because it just counts country by country. An overview which would acknowledge the different economic weight would show a different picture as all the major countries belong in the last category of free-floaters. And it is also misleading as it does not properly characterize the European monetary union.

The corner solution free-floating seems to be a clear case guaranteeing the conduct of a national monetary policy with the objective to maintain monetary stability, i.e. price stability, and financial policy to guarantee financial stability. But in practice, it is not so easy. The control of the national inflation rate by an independent monetary policy might come at a high price – high volatility of exchange rates with all implicit consequences. So it is the privilege of a group of more or less large countries which can fully exploit the advantages of this approach. For small open economies, a free floating exchange rate might not be the optimal solution. The price could be too high. So we have to distinguish between the situation in large economies and small economies. And as we have seen, for capital controls which for a time were banned officially and also more or less in theory, the situation has changed. There are now even studies showing that the contribution of free capital movements to domestic growth delivers mixed results. So it is not as simple as it might seem. For example, when Germany in 1973, changed to a floating system, it detached itself from the dollar peg. As a consequence the Bundesbank could conduct an independent monetary policy and adopt a strategy of monetary-targeting. This was a relatively straightforward case, and at that time it seemed clear that free-floating would allow any country to realize its monetary preference. But, in practice there are now many intermediate solutions and, again, capital controls are not a taboo anymore. I think we all know very bad cases of capital controls in the past, but we also have seen disasters triggered by floating systems combined with inefficient national financial systems.

The corner solution free-floating comprises the US dollar, yen, pound, the Australian dollar, Canadian dollar, and the euro. But the euro is a special case. To the outside world, the euro is a floating currency. Inside, countries having joined the euro have established the hardest peg one can imagine. The idea was that countries by giving up their own currencies, would adopt an irreversible peg. History tells us that other hard pegs in the past survived only in a few cases of small countries. The majority of hard pegs was abandoned over time; take e.g. the case of Argentina. To the outside world the euro is a kind of a double corner solution: Hard peg inside, free floating to the outside world.

3) European monetary union

The European monetary union is characterized by one currency, one central bank, but 18 sovereign states. As of January next year, Lithuania will have joined the euro as the 19th country. European monetary union is an institutional arrangement which consists of member states which have transferred their sovereignty and monetary policy to the European Central Bank, a true European institution. And at the same time, member countries continue to be sovereign states in many respects. For this institutional arrangement the no-bailout clause which means that every country is responsible for its own policy mistakes and benefits, is an indispensable prerequisite. No country should be bailed-out by member states and the Union. However, this principle has been heavily violated time and again. The big question now arises, whether the European monetary union will go back to the pure system of sovereign states with the single currency or will evolve into a political union.

The causes of the crisis of the European Monetary Union are manifold. Diverging competitiveness is on top of the list. Within the first eight years, just to take one example, unit labor costs in Portugal rose in relation to Germany by 30 percent. The country acted as if the instrument of devaluation were still at their disposal. And now internal devaluation is a hard way to go and takes time.

Macroeconomic imbalances, especially the collapse of the housing bubble in Ireland and in Spain, which caused first the banking crisis, and then as the state had to bail out banks triggered a crisis of public debt. Private and public sector debt rose in some countries to extreme heights. And finally, the stability and growth pact which was intended to establish a European control of national fiscal policies did not deliver what was expected of it.

So the question is now where will the European monetary union go from here? Economic union is, let's say, 80-90 percent established. The single market for services is far from being completed. Banking union is just about to develop. The ECB will now take over the competence for banking supervision and become the single supervisor for major European banks. Will fiscal union follow? If this implies that decisions on taxes and public expenditure are taken at the European level, then this cannot go without political union because you need democratic legitimation for that. Otherwise, we have a system of taxation without representation, and in this country, we know where it ended. This would undermine the democratic accountability of the multi-country union, a way which should not be taken. But it is attempted almost every day.

Political union for the time being will remain a vision or whatever you would call it for the more distant future. Almost no country in Europe is ready to give up its full sovereignty. I am afraid that we might enter into a mixture, that is to say a mess of fiscal union, undemocratic decisions on fiscal policies, which will certainly not foster the way to political union. For some time to come, this will remain a very complex situation.

There was a time when European integration and even monetary union was seen as an approach which might be a model to follow also in other parts of the world. However, as long as Europe has not found a convincing response to the crisis this has lost any appeal and acts rather as a discouraging example.

4) The role of international currencies

In 1944 the dollar was legally established as the leading currency in the world. To be precise this applied only to the Western part as the USSR did not join and forbade also its satellites to participate in the Bretton Woods regime. Considering the leading position in the post-World War II environment, the US dollar would have taken this position anyway.

From history and theory we can identify a few prerequisites for a currency to play an international role. In the first place, it requires domestic financial markets which are deep, broad and open. As the next crucial element the currency must be stable and there must be confidence in the future stability of the currency. When this credibility comes into question, the system gets into trouble. We see volatility increasing, et cetera. There are some currencies for which the first two elements would apply. Take, for example, Switzerland. But nobody would expect the Swiss franc to become a leading international currency because it is a small economy.

The domestic real economy plays a major role, its size, strength, and the international linkages. If we study the development of leading currencies over centuries, we see that the incumbent has a dominant role for a while. Network externalities arise from the simultaneous use of a currency for exchange reserves, financing and invoicing trade, for bond issues, et cetera, these are all connected. It is normally a slow process in which one leading currency is gradually substituted by another one. Look how long it took until the British pound lost its leading position to the US dollar.

The international role of the US dollar in relative terms has somewhat declined, but it is still the dominant currency in reserves, trade finance, and foreign exchange. The share of the dollar in currency reserves has declined from almost 72 percent in 2001 to 61 percent today. The euro has more or less established its role as the second international currency. For the euro, the numbers are somewhat misleading because before the euro was introduced, the European countries belonging to the fixed exchange rate system held their foreign reserves mainly in DM. And when the DM disappeared, these foreign reserves became own reserves. So the share in Europe of reserves in euros compared with those in DM, suddenly declined. It had nothing to do with mistrust in the euro, it was a pure technical effect. The British pound has recently won some share. The Japanese yen does not play a major role.

With respect to bonds and notes, the position of the euro is rather strong, but this is a mixed pleasure because behind this development is the strong increase in public debt. The renminbi is still far away, but there is a slight increase in its importance for world trade financing.

5) Speculation on the future

Let me now turn from the past and present to – more or less "informed speculation" about the future. The gold standard was still the benchmark after the First World War. Returning to the gold standard (at the former parity) was a disaster for the UK, remember the famous controversy between Churchill and Keynes. Between the World Wars we had almost everything – e.g. strong exchange controls in countries dominated by Germany. Then in 1944, we had this very conference here in Bretton Woods. The exchange rate system collapsed in 71/73 with the detachment of the dollar from gold and with the change to floating exchange rates. Since then, we are living in a post-Bretton Woods system. There are quite a number of people who say this is not a system at all. Whatever it is, the situation is characterized by a great variety of exchange rate systems. All potential options are practiced, and the question is where we will go from here. Is it very surprising that quite a number of people still believe that the gold standard might be the future – for me, this is just very odd.

There was a time when people expected special drawing rights becoming some kind of bancor realizing Keynes' idea back in 1943. I think this is also off the table. What about a new Bretton Woods conference? Can you imagine that now 188 members of the IMF would agree on a new system? They would not only need a bigger hotel. I think it is very unlikely. It could happen only in case of tremendous disasters, big wars or whatever. If you abstain from that, I think the idea, with all the sympathy Larry has given to the founders back in 1944 with their good intentions, of having a repetition of such an approach with an agreement worldwide is past our hopes.

The question is: how will the world look tomorrow? The dollar should still be in a leading position. But a bipolar, tripolar or even multipolar world might emerge. Will this bring an end to the "exorbitant privilege" of the dollar (Barry Eichengreen)? It was already Giscard d'Estaing, being finance minister under Charles de Gaulle in the '60s, who said it was an unimaginable privilege of the US that they could finance a current account deficit with their own currency. And the French at that time tried to torpedo the dollar standard by presenting their dollars to get gold from the US at 35.00 dollar for one ounce. At that time they insisted that the Germans, which had much higher dollar reserves, should join them. This would have, of course, led to a big conflict and probably the collapse of the system. The Germans for many reasons did not join. They kept their dollars and restrained from changing them into gold. So this system survived for a while (until 1971).

Lately, the French side started a new attack on the exorbitant privilege. Already when the euro project was still in the pipeline, many voices from France said we need the euro to have a counterpart to the dollar; Europe should not be dependent on the US. So the euro would be, some said, "our weapon against the dollar." I think this is a very strange view.

As a central banker I was always strongly against overburdening the monetary project with such political ambitions which are futile, anyway. If you do not create the conditions for an internationally leading currency, then you will not be successful. The position of the European Central Bank from the beginning was: we will not do anything to promote the international use of the euro nor to hinder it. We will leave it to a market-driven process.

So what will happen? I think a bipolar, tripolar, or even multipolar system might emerge combined with the formation of currency zones around the leading currencies. For me what is hard to predict is what the middle-sized countries and currencies will do in the future. Free floating?