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INFO ROUTINE WASHINGTON, UKDEL OECD, TOKYO
INFO SAVING CGS IN THE FRG AND BERLIN

FRAME ECONOMIC

MY TELNO 519: EUROPEAN MONETARY COOPERATION.

SUMMARY

1. BUNDESBANK PRESIDENT POEHL TELLS ME THAT HE WELCOMES PUBLIC DEBATE ON EUROPEAN MONETARY UNION AND EUROPEAN CENTRAL BANK, SINCE IT SHOULD BRING OUT THE DIFFICULTIES AND FOSTER REALISM. HE EXPECTS KOHL AT THE HANOVER EUROPEAN COUNCIL TO PROPOSE A STUDY OF FURTHER MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A EUROPEAN CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND ALL THE IMPLICATIONS. STUDY PROBABLY TO BE DONE BY COMMITTEE OF CENTRAL BANK GOVERNORS. POEHL'S VIEWS ON HARMONISATION OF TAXATION NOT FAR FROM OURS. HE AGREES THAT SOME STIMULATION OF DOMESTIC DEMAND IS DESIRABLE IN FRG.

2. POEHL'S DOUBTS ON MONETARY UNION AND EUROPEAN CENTRAL BANK ELABORATED IN A MAJOR NEWSPAPER ARTICLE (SEE MIFT).

DETAIL.

3. POEHL, WHOM I VISITED ON 31 MAY, SAID THAT HE WELCOMED THE PUBLIC DISCUSSION OF MONETARY UNION AND A CENTRAL BANK, SINCE IT WOULD SHOW UP THE MANY DIFFICULTIES AND FOSTER MUCH NEEDED REALISM. WHEN HE HAD EXPLAINED THE SUBJECT AT A RECENT MEETING IN THE FEDERAL CHANCELLERY, KOHL HAD SAID THAT HE HAD NOT PREVIOUSLY REALISED THAT THE MATTER WAS SO COMPLICATED OR THAT THE IMPLICATIONS OF A CENTRAL BANK WERE SO FAR REACHING.

4. POEHL TOLD ME THAT HE DID NOT BELIEVE THAT GOVERNMENTS WERE READY TO ACCEPT THE CONSEQUENCES OF A CENTRAL BANK. FINANCE MINISTERS, STOLTENBERG INCLUDED, WERE NOT EVEN WILLING TO LEAVE DECISIONS ON EXCHANGE RATE CHANGES IN THE ERM TO THE COMMITTEE OF CENTRAL BANK GOVERNORS. MONETARY UNION WOULD GO FAR BEYOND THAT. BUT COORDINATION

OF MONETARY POLICY IN THE EMS, WITH AGREED TARGETS, MIGHT BE POSSIBLE AS A FURTHER STEP. IN ANY DEVELOPMENT OF THE ROLE OF THE CENTRAL BANK GOVERNORS, THE INDEPENDENCE OF THE LATTER MUST BE FULLY UPHELD. THERE COULD BE NO CONVERGENCE IN THEIR ROLES THAT WOULD REDUCE THE INDEPENDENCE OF THE BUNDESBANK.

5. POEHL SPOKE IN FAVOUR OF ''HORIZONTAL DEVELOPMENT'' OF THE EMS, NOT ONLY THROUGH BRITISH PARTICIPATION IN THE ERM BUT ALSO THROUGH ASSOCIATION OF AUSTRIA AND PERHAPS SWITZERLAND.

6. WHEN I DESCRIBED OUR POSITION ON HARMONISATION OF TAXATION, POEHL AGREED THAT FREEDOM OF CAPITAL MOVEMENTS WOULD EXERT PRESSURE TOWARDS SIMILAR LEVELS OF TAXATION IN SOME FIELDS AND THAT DIFFERING LEVELS IN OTHER FIELDS WOULD NOT PREVENT A SINGLE MARKET FROM FUNCTIONING (AS TODAY IN USA AND SWITZERLAND). HE THOUGHT HOWEVER THAT CENTRAL DIRECTIVES MIGHT BE NEEDED IN A FEW TAXATION MATTERS, TO NUDGE THE MARKET TOWARDS REDUCTION OF DIFFERENCES IN TAXATION AND THUS HEAD OFF UNWANTED DISTORTIONS.

7. POEHL EXPECTS THE FEDERAL CHANCELLOR AT THE EUROPEAN COUNCIL IN HANOVER TO PROPOSE THAT A STUDY BE COMMISSIONED OF FURTHER STEPS IN MONETARY COOPERATION INCLUDING WHETHER MONETARY UNION AND A CENTRAL BANK ARE DESIRABLE, WHAT THEY WOULD INVOLVE AND WHAT ALL THE MANY IMPLICATIONS WOULD BE. THE MANDATE MIGHT BE IN GENERAL TERMS OR MORE SPECIFIC. THE FORUM DOING THE STUDY MIGHT BE THE COMMITTEE OF CENTRAL BANK GOVERNORS. ECOFIN WAS UNSUITABLE, SINCE THE COMMUNITY AS SUCH HAD NO COMPETENCE IN MONETARY MATTERS AND THE COMMISSION MUST NOT BE LET IN ON THE SUBJECT.

8. ASKED ABOUT THE MEETING OF THE FRANCO-GERMAN ECONOMIC COUNCIL ON 30 MAY, POEHL SAID THAT BEREGOVOY WAS NOT INTERESTED IN A EUROPEAN CENTRAL BANK. FRANCE WAS INTERESTED IN ''SYMMETRY'', WHICH IN EFFECT MEANT, AMONG OTHER THINGS, REDUCTIONS IN IMBALANCES IN TRADE IN THE EC, WHICH IN TURN MEANT STIMULUS OF GREATER DOMESTIC DEMAND IN THE FRG. IN POEHL'S VIEW DECISIONS CONCERNING FRENCH IDEAS FOR MUTUAL SUPPORT OF CURRENCIES IN THE EMS COULD NOT LEGALLY OR APPROPRIATELY BE TAKEN BY THE EUROPEAN COUNCIL - ONLY BY THE CENTRAL BANK GOVERNORS.

9. I TOOK UP THE QUESTION OF STIMULATING DEMAND IN THE FRG, SUGGESTING THAT TAKING A SAW TO THE FOREST OF REGULATION IN THE ECONOMY WOULD BE A POSSIBLE APPROACH. POEHL SAID THAT HE SAW FORCE IN THE ARGUMENT THAT THE FRG WAS NOT GROWING FAST ENOUGH. THE UK WAS THE MODEL. GERMANY COULD NOT ACHIEVE 3-4 PERCENT GNP GROWTH PER

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ANNUM. BUT THE D-MARK WAS LOSING VALUE IN REAL TERMS, FUELLING THE IMBALANCE IN TRADE EG WITH FRANCE. I DREW ATTENTION TO THE FRG'S SURPLUS OF DM 17 BILLION IN TRADE WITH UK IN 1987.

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THE VISION OF A EUROPEAN CURRRENCY AREA

What would have to be done

by Karl Otto Pohl

We are currently undergoing a phase of new initiatives in the European Community spearheaded by the intention to create a European internal market by 1992, for which the generally favourable economic and monetary situation offers good pre-conditions. Monetary stability is not only widely recognised as the primary goal of monetary policy but also achievable in Europe more than ever before; notwithstanding existing differences such as those on financial policy, there is widespread convergence between economic policy and economic developments. By 1992, we will therefore hopefully have made considerable advances along the road towards economic union in Europe. It is worth supporting this goal if only for purely economic reasons. A single internal market is likely to be a source of considerable economic growth in Europe. Beyond this, however, the realisation of a European currency union is doubtless a political goal of great significance.

There are good reasons for the fact that plans for the European internal market go far beyond trading considerations. The establishment of an integrated financial market appears imperative. Free transfer of capital and unrestricted convertibility of all European currencies are essential components of a single internal market and would also provide a foundation for future monetary union. A further decisive criterion for monetary union is the final and irrevocable fixing of exchange rates. The 1970 Werner Report contained the following definition of monetary union, which is still valid today: "Monetary Union requires the complete and irreversible convertibility of currencies, the elimination of exchange rate bands, irrevocably fixed parities and the complete liberalisation of capital movements."

A monetary union based on this definition would have far-reaching consequences for economic development in Europe. It would be the monetary superstructure of an economic union in which the movement of goods, services, labour and capital took place more or less unrestricted. This does not necessarily presuppose the harmonisation of all policies; continuing differences in tax systems, collectively agreed arrangements and other areas would lead to advantages or disadvantages for particular locations. Although the market would enforce a certain degree of harmonisation, basic political consensus, a functioning system of financial compensation and a high degree of cooperation on economic, financial and monetary policies would be necessary to avoid an increasing imbalance in the economic development of the Member States resulting, finally, in the complete breakdown of the system.

It would then only be a small step from monetary union to a single currency. Although national currencies could, in principle, be kept, the introduction of a single currency unit in place of the national currencies would probably imbue the monetary union with a "monetary identity" which would eliminate the residual risk of parity changes between national currencies and thus create a symbol for the perpetuation of a single currency area. Replacing national currencies with a Community currency would put the final touch to the process of monetary integration.

But this final situation is still a long way off. That is why the concept of a parallel currency has been discussed since the 1970s as an alternative to the step-by-step achievement of a European monetary union as defined in the Werner Report. This concept implies the idea of bringing an EC currency into circulation in addition to the national currency, as a vehicle for monetary agreement. Those who support this idea assume that this European currency will gradually displace the franc, guilder, and deutschmark and evolve into the sole and general means of payment and store of value in Europe.

In comparison to the task of transferring national responsibilities to the Community which has proved difficult in past experience, the concept of parallel currencies may indeed appear to be an "elegant" solution at first sight. Upon closer inspection, however, it becomes clear that this concept also requires far-reaching institutional adjustment measures if the "currency race" it sets in motion is to take its course in a manner acceptable to all Member States.

Currencies must prove their worth on the market

Parallel currencies will not abolish the necessity of taking those political decisions necessary for the creation of a monetary union. The idea that official preference shown for a parallel currency will give it the edge over national currencies is not very realistic. The market decides upon the acceptability of a currency according to interest and exchange rate considerations; attempts to disturb the functioning of the market with official measures hold few chances of success as the development of the private and official Ecu has shown which becomes less attractive when capital transfer restrictions, foreign exchange controls and convertibility restrictions are eliminated and exchange rates become more stable.

Using the ecu as a parallel currency - or simply as a currency - will meet with difficulties, not least because of its particular construction. A basket-ecu constructed on the basis of a weighted average of national currencies cannot exercise an insistent and especially not an evenly distributed displacement pressure on national currencies and cannot therefore be regarded as an additional means of integration. The basket-ecu cannot develop an independent quality of its own. If one disregards some slight indifference margins, it is bound to mirror the weighted average of the interest and exchange rates of those currencies contained in the basket.

An independent European currency must be able to maintain the same high standards as the best of the national currencies. If this were not the case, the EC central banks would have to be obliged to safeguard the parallel currency's exchange rate through unrestricted buying. Such intervention obligations would have considerable monetary consequences amounting, in the last analysis, to a constant creation of the relatively strong currencies to finance purchases of the European currency.

A parallel currency strategy demands a functioning market displacement procedure. The well-balanced substitution of all EC currencies (that means the deutschmark as well) with the parallel currency which necessity demands would only be possible, if the parallel currency

- were accorded the same status on the internal market as every other EC currency;

- were able to compete with the strongest EC currency as an investment currency subject to interest rate and exchange rate developments; and

- were burdened with the lowest possible costs in its role as transaction currency which would virtually only be possible if it were guaranteed by sufficiently firm exchange rates with the other national currencies.

All this, however, more or less defines the final situation to which the parallel currency itself should lead. Why take the costly detour via the parallel currency? Europe would gain little whilst having to put stability at considerable risk if it were to realise the concept of a parallel currency.

The creation of a monetary union does not necessarily demand a European system of central banks. It is also possible to imagine successful cooperation on monetary policy between the national central banks if a high degree of convergence is simultaneously achieved in other policy areas. A minimal institutional framework would, however, afford greater reliability for a monetary union and, above all, for a single currency.

Taking this step towards the institutional phase of cooperation on monetary policy with the aim of creating a European central bank system presupposes that answers - the clearer, the better - have been given to a series of questions, so as to avoid going in the wrong direction from the very beginning.

Such a system requires a clearly defined mandate. It should be in line with the aim of the Deutsche Bundesbank Act, namely, "to secure the currency", ie to see to it that prices remain stable. This might appear self-evident for a central bank, but in practice, there is always a tendency to burden monetary policy with additional tasks such as stabilising exchange rates or assisting with regional structural policies, employment or other tasks, which could conflict with the real aim of a central bank of securing the currency.

Priority for keeping prices stable does not mean that a European central bank would have a deflationary "bias" from the word go. Experience gained in the 1970s - not only in the Federal Republic - has rather more shown that one cannot, as it were, buy a little more inflation for a little less unemployment. On the contrary, countries with a low inflation rate generally had a lower unemployment rate and vice versa. The large majority of those Germans haunted by the memory of two traumatic inflations who know what price stability means for prosperity and social justice would hardly be willing to accept a central bank system which accords this aim less importance than the Deutsche Bundesbank Act does.

The task of looking after price stability would at least be facilitated, if not made possible, if a European Central Bank were independent in its decision-making and opinion-forming processes; independent not only of national governments but also of the EC institutions, ie the Commission and the Council of Ministers. This would demand considerable amendments to the existing constitution of central banks in several Member States - probably also that in the Federal Republic of Germany; in its current, more or less two-tier system with eleven Land central banks and the directorate in Frankfurt, it is doubtful whether this system could be maintained.

According to our concept, the monetary instruments at the disposal of a European central bank would be set up so as to enable it to manage money supply effectively without having to resort to quantitative controls (or other direct interventions in the finance markets). The machinery must therefore provide interest policy instruments as well as liquidity policy instruments with which it will be possible to exercise general as well as detailed control of the European money market.

A European central bank system can really only be organised as a decentralised, federal system, ie on a subsidiary basis according to which only the necessary minimum is centralised and as much as possible left to national competence. A European central bank system should therefore be more akin to the Bundesbank system or the Federal Reserve system in the United States than the centralist system in most European countries.

Finally, we believe that such a European central bank system must not be entitled to finance national deficits by creating money. This is by no means self-evident in all countries. In the Federal Republic of Germany the Bundesbank is forbidden to do this by the Deutsche Bundesbank Act.

<u>All foreign currency reserves in one large pot?</u>
We must also find an answer to the question of the extent to which a European central bank should be responsible for exchange rate policy vis a vis third currencies, ie in the first place dollar and yen. Monetary stability requires safeguards against external influences, as we saw with the Bretton Woods system. The stabilisation of exchange rates cannot and should not be the main aim of monetary policy, especially in an inflationary environment. Within this framework, however, there is by all means room for cooperation on monetary policy with countries outside the Community. This may also include intervention on the foreign exchange markets. A European central bank would be

responsible for such activities and would therefore have to purchase and administer at least part of what are now still national currency reserves. This was foreseen when the European Monetary System was set up, but foundered due to the unwillingness of practically all the countries concerned (not the Bundesbank, which only insisted on a statutory regulation) to transfer part of their foreign currency reserves irrevocably to the supranational institution.

There are also a number of apparently less fundamental problems, whose relevance one should not, however, underestimate. Where for example should a European central bank be located - in Frankfurt, in Paris, in Brussels or in London?

An infinite number of difficult questions still have to be answered in connection with the creation of a European currency and a European central bank system. One problem arises from the fact that four members of the European Community - Great Britain, Spain, Portugal and Greece - are not even members of the current exchange rate system, the EMS and that there are exceptional rules for Italy in the form of an extended band for the lira. Under these circumstances, one does not have to be a defeatist to have certain doubts as to whether the political environment is really ripe for such far-reaching decisions and for the relinquishment of sovereign rights as the creation of a European central bank and a European currency would demand.

In the meantime, however, developments have not stood still. We have made considerable progress towards monetary integration in the course of the last few years. Monetary cooperation in Europe has become more intensive since the foundation of the European Monetary System. The Bundesbank has made a considerable contribution to this process ie with its approval on two occasions to the extension of the EMS rules, most recently with the Agreements reached in Basle and Nyborg in September 1987. Economic development in the member states has reached a high level of convergency. Exchange rates in the European Monetary System are relatively stable. The coordination of intervention vis a vis the dollar is already well developed, at least among the countries which are members of the EMS exchange rate system.

The Committee of EC Central Bank Governors plays an important role in this process of monetary cooperation. It has proved itself a useful institution for coordinating monetary and currency policy in the European Monetary System. I believe that it could be given more extensive powers in managing the monetary system, especially as the system is founded on an agreement between the central banks. For example, the EC Central Bank Governors could make the necessary exchange rate corrections professionally, at the proper time and without creating a stir. The Finance Ministers, however, have rejected such proposals.

The European Monetary Cooperation Fund (EMCF), on the other hand, is not suitable as the nucleus of a European central bank system. The EMCF lacks one important feature, namely independence of the institutions of the European Community. It is a creation of the EC Council of Ministers and would therefore, at least in principle, be dependent on the decisions of this body.

The commitment to keep the European Monetary System operational has increased the need for closer cooperation. In the nine years since the EMS was founded, the Bundesbank has made considerable contributions to the smooth and successful operation of this regional monetary system. The deutschmark has thereby - unintentionally - slipped into the role of the most important intervention and key currency. It has become the stability factor within the European Monetary System and thus forms the decisive basis for the successful functioning of the system. The weight of the economy of the Federal Republic within the European Monetary System has also contributed to the success of German economic and monetary policy in securing the stability of the deutschemark and maintaining it as the most stable currency within the European Monetary System. It would be disastrous not only for the Federal Republic but equally for the other European partners if one were to loosen the moorings of the European Monetary System without knowing what should take its place.

Dangers to the European exchange rate mechanism

Some of our partners refer to the loss of economic and monetary freedom which they have to face as a result of the dominating role of the deutschemark within the European Monetary System. They see themselves restricted in pursuing independent growth, employment and stability objectives to the extent to which they have accepted exchange rate links with the deutschmark. They demand a "symmetrical" division of burdens in protecting exchange rates within the European Monetary System. This discussion has been going on since the creation of the European Monetary System. Lengthy negotiations were necessary before the Central Banks were able to reach an agreement on intervention obligations. Both those countries whose currencies reach the lower intervention point as well as those whose currencies reach the upper intervention point are obliged to sell or purchase foreign currency as the case may be. The system is in this respect by all means "symmetrical". There are not contractual obligations as far as so-called intra-marginal interventions are concerned. These are intended to keep exchange rates within the limits. Intra-marginal interventions do, however, require the approval of the central bank whose currency is used for intervention. The Bundesbank has usually approved the use of the deutschmark when this has not clashed with its own monetary objectives.

The Basle/Nyborg Agreements extended the already generous credit facilities partially - and under certain conditions - to include intra-marginal interventions. One must realistically expect that the Bundesbank will have to provide the major part of this financial commitment whenever substantial intra-marginal interventions are necessary. This can mean a considerable burden on monetary policy, particularly as the Bundesbank is also expected to intervene within the framework of cooperation with the United States. It is not because we are unwilling to cooperate that we refuse to accept intervention commitments in excess of our contractual obligations.

There are other more serious reasons. Should the bundesbank begin to include EMS currencies in its reserves, as it has been urged to do, this would not strengthen the European Monetary System but would in fact weaken it, since countries with a weak currency would no longer be obliged to make appropriate adjustments. The Federal Republic is of course committed to contributing towards equilibrium within the monetary system, ie in the present situation to reducing its current account surpluses. However this should not take place by means of weakening monetary discipline but by pursuing a policy aimed at increasing domestic demand, as the recent tax reductions set out to do. Finally, interventions cannot be a permanent substitute for timely adjustments to exchange rates as long as economic developments in the member states continue at different rates. Happily this is not the case at the moment but cannot be ruled out entirely in the future.

The study presented by Gros and Thygesen at the beginning of the year on the functioning of the European Monetary System in the past years emphasises the positive key role of German monetary policy and demonstrates that the claimed "asymmetry" has not hindered the cohesion of the system but has in fact secured it: "The advantages of the Bundesbank's leading role could be lost if the European Monetary System becomes symmetrical and the Bundesbank's ability to control the monetary aggregates in the Federal Republic is reduced without establishing credible rules for joint money creation."

A European monetary union is a desirable political and economic objective. Some considerable progress has already been made in this direction. The directive to liberalise capital transactions within the Community proposed by the European Commission, which I hope will be approved in the near future, possibly at the next meeting of the Council of Ministers of Finance on 13 June, would be a milestone in this development. Participation by all member states in the exchange rate mechanism of the European Monetary System would be a further important step. The question of whether further institutional changes aimed at a monetary union can be introduced depends on the governments and parliaments concerned. Realism and moderation are more useful than wishful thinking.