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Prime Minister

An important speech by Karl Otto Poehl.

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"Basic features of a European monetary order"

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I.

The European Council took a decision in Strasbourg last December which will have far-reaching implications. Before the end of this year an intergovernment conference is to be convened which is to discuss, and to decide on, the future road to European economic and monetary union and its institutional structure. It is to provide the legal basis for the necessary responsibilities which now rest with the national authorities to be transferred to Community bodies. Monetary policy will be affected most. The ruling EC treaty does not provide for any Community responsibility for monetary policy, which sufficiently explains why institutional steps towards monetary integration require an amendment to the treaty. Article 102 A, which was added to the ruling EC treaty by the Single European Act in 1986, expressly reaffirmed this requirement by stating: "In so far as further development in the field of economic and monetary policy necessitates institutional changes, the provisions of Article 236 shall be applicable." Pursuant to that article, such amendments shall be "ratified by all the member states in accordance with their respective constitutional requirements".

In most other aspects of economic policy there is no comparable requirement to establish new institutions for economic and monetary union and to transfer responsibilities to them. However, better use must be made of the existing instruments and bodies in order to achieve more convergence in economic policy and its results and to establish these permanently. The progress made so far, for example, the liberalisation of the movement of goods and capital, must not be called into question again if economic and monetary union is to last. Additional binding arrangements will therefore be necessary in major sectors which make unilateral action more difficult or impossible for member states and which set a minimum standard of "good conduct" for them, particularly i fiscal policy. This will necessitate the surrender of sovereignt by the individual member states, but this need not mean corresponding gains in Community authority, that is, by the Council and the Commission, provided the subsidiarity principle respected. As is well known, this principle provides for everything which need not be decided on at the higher levels to decided on and implemented at the lower levels. Incidentally, th control functions of the European Parliament are to be
7 strengthened systematically, particularly in relation to the Commission and the Council; this was a condition made by the German Federal Chancellor in Strasbourg.

II.

The most important issue in the menu of questions and problems which the intergovernment conference will face is no doubt the European central bank system (ECBS). Its structure must satisfy the high expectations which a future economic and monetary unic arouses in the member states, namely, in the countries with stable currencies the expectation that monetary stability will not be lost in an economic and monetary union; and in countries where the value of money is being eroded to a greater of lesser degr that an end will be put to this erosion once and for all.

None other than Walter Hallstein himself, the first President of the EC Commission, saw monetary policy as the touchstone for the Community. He wrote that "monetary stability is a value of great importance, a fundamental requirement".[1] The fact is that only when those responsible in all member states are prepared to concede monetary stability this priority can the project of an economic and monetary union succeed. Only then will it be possible in the foreseeable future to fix the exchange rates between the national currencies permanently and finally to replace the national currencies by a common currency.

This ambitious goal certainly cannot be achieved in a revolutionary act, in a great leap forward, but only in an evolutionary process which, however, should be determined by the same principles that must apply in the final stage of a European monetary order. This means that the monetary policy of the countries participating in this process must now concentrate on the task of maintaining monetary stability and of preventing inflationary pressures, a task which can be pursued with the greatest chance of success.

III.

The EMS did not stabilise either until major member states accorded monetary stability the importance which was necessary for the satisfactory functioning of the system. There were no fewer than seven realignments by March 1983, which in itself is a sign of instability and divergence in terms of economic development. The decisive turnaround in the stabilisation of the EMS occurred in March 1983 when the French government radically changed its economic policy objectives. It is probably not an exaggeration to say that at that time the existence of the EMS was in the balance

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1 Walter Hallstein, "Die Europäische Gemeinschaft" (The European Community), Düsseldorf, Vienna, 1973, p. 133.

Since then the EMS, or at least its "hard core", has come increasingly closer to the original objective, namely to create a zone of internal and external monetary stability, which is all the more remarkable as the dollar rate was subject to extreme fluctuations in that period. The D-Mark no doubt played an important part in this. It provided the stability standard which every fixed exchange rate system needs. This is a widely held belief today. The Delors Report states, for example: "Moreover, the system has benefited from the role played by the D-Mark as an 'anchor' for participants' monetary and intervention policies."[1]

The D-Mark has increasingly become the most important intervention and reserve currency in the EMS, not because the Bundesbank sought this role but because the D-Mark is regarded by the markets and the central banks as a stable currency which can be used internationally without restriction. Outside the EMS, too, the D-Mark is today the second most important currency after the dollar. About one-fifth of all foreign exchange reserves world-wide are held in D-Mark.

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1 Report on economic and monetary union in the European Community (Delors Report), 1989, section 5.
See also the remark made by the Governor of the Bank of England Leigh-Pemberton before the Treasury and Civil Committee on June 19, 1989: "One has to acknowledge that the Bundesbank does exercise a very strong influence over the ERM at the moment. Quite honestly, we must acknowledge, too, that the successes of the ERM are due to a large measure to what one might call the anchoring role of the D-Mark." Again, Italy's former Central Bank Governor and present Minister of Finance Guido Carli said: "The European Monetary System in its present form centres on the D-Mark and thu on the most stable currency; if one tried to let it break away ..., one would endanger the process of achieving monetary union." (La Repubblica, July 13, 1988).

The D-Mark is becoming more important in several eastern European countries as well, and this importance is likely to increase even more, if anything. In their efforts to make their currencies convertible and to stabilise them, the central and eastern European countries will probably increasingly orientate themselves towards the D-Mark. This applies particularly to the GDR. If, after May 6, a freely elected government decides in favour of the free market economy and creates the necessary preconditions for investment capital from the Federal Republic of Germany and other countries, it could become the target of an enormous inflow of funds. This, together with an appropriate monetary and exchange rate policy, would provide the opportunity to introduce convertibility step by step. It is clear that the D-Mark must be seen as the "anchor" in such a development. In fact, the D-Mark i: already a kind of parallel currency in the GDR and other central and eastern European countries.

Particularly during the seventies the Bundesbank actually resiste seeing the D-Mark forced into the function of a reserve currency as the monetary policy implications are not always very convenient. We would therefore welcome it if other currencies wer to share this burden with the D-Mark as a result of the "competition of currencies" recommended by our British friends o: perhaps it would be better to say: "competition of policies". Th pound sterling, which has a long tradition as a reserve currency could perhaps win back something of its old glory if the United Kingdom succeeded in solving its inflation and balance of paymen problems. But particularly the French franc has in my opinion th potential of playing a far greater role in Europe and world-wide The determined policy of the French government and the Banque de France to contain inflation could contribute to this just as muc as the elimination of the last controls on capital movements and the development of Paris into one of the most important Europear financial centres.

[Not helpful]

On the other hand, I believe that the potential of the ECU in its present form as a basket currency is fairly limited. The private ECU has had a successful career on the financial markets, but basically it has only played a minor role in monetary integration in Europe, and as a numéraire for exchange rates its significance has at best been symbolic. During realignments it is the changes in bilateral central rates which matter, and new ECU central rates are merely derived as a second step from the changes in bilateral exchange rates. Viewed as a whole, the experience of the past ten years confirms the fact that, while an exchange rate system such as the EMS requires an agreed set of rules, its functioning depends primarily on the willingness of the partner countries to satisfy the requirements underlying stable exchange rates. These include above all the safeguarding of domestic monetary stability in all participating countries.

IV.

How can this basic condition of monetary union be ensured if the responsibilities for monetary policy are transferred from nationa institutions to a Community body? Historical experience has shown that this can best be expected of a system which is independent o political interference. This applies to the EC to an even greater extent than to national states because in a confederation such as the EC there is always a tendency to orientate oneself towards averages and compromises, but that is the worst possible compass for monetary policy. Only an independent institution is in a position to resist the ever-recurring wishes of politicians to prescribe monetary policy targets which are often inconsistent with the objective of stability, such as the stabilisation of exchange rates or the promotion of growth and employment or the balancing of regional disequilibria.

If only for practical reasons a modern, efficient central bank system must be independent of the instructions and pressures of national governments and European institutions. Protracted consultation and concertation processes are not consistent with the requirements of the financial markets which need fast and flexible reactions by the central bank, as was the case, for instance, on the outbreak of the debt crisis in 1982 or after the crash in October 1987.

What is more important, however, is that only an independent central bank is in a position to pursue a monetary policy geared to longer-term requirements.[1] We know that an increase or decrease in the money stock works through to the economy only with a substantial time-lag. Interest rate measures do not affect the money stock for several months, and price movements take even longer to react to the money stock. These delays must be taken into account when monetary policy measures are being drawn up. An independent central bank is in a better position to do so than any government as it is not so much subject to the temptation to neglect the basic requirements of anti-inflationary monetary policy for the sake of short-term effects or election tactics. William McChesney Martin (Fed Chairman 1951-70) expressed this rather vividly when he said: "The Fed's job is to take away the punch-bowl just when the party gets going".

Of course, even an independent central bank cannot alone guarantee monetary stability. The financial behaviour of the public authorities and the behaviour of management and labour must make their contribution. But the decisions of an independent central bank about the width of the "monetary cloak" which it is prepared

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1 Alan Greenspan in a speech before the Subcommittee on Domestic Monetary Policy on October 25, 1989: "... independence enables the central bank to resist short-term inflationary biases that might be inherent in some aspects of the political process. The Federal Reserve must take actions that, while sometimes unpopular in the short run, are in the long run in the best interests of the country."

to provide gives an important signal for a realistic assessment of the available opportunities by all economic agents.

V.

If it is agreed that a future European central bank system (ECBS) must be independent of governments, the Council and the Commission, the question arises of how this independence can be ensured. A corresponding legal regulation which guarantees the ECBS's independence of instructions is only one element of its independence. In addition, it requires the personal and professional independence of the members of the governing bodies of this system, that is, of both the governors of the national central banks and the members of the supreme governing body, that is to say, of the European "central bank council".

The personal independence of the members of the governing bodies can be ensured if the officials nominated by the governments (central bank governors) and the Council (members of the Board) are appointed for a sufficiently long period (14 years in the United States, eight years in the Federal Republic of Germany) and if their appointment cannot be terminated during that period. Moreover, and this goes without saying, they must have excellent expert knowledge to enable them to make independent judgements. The qualities of personal independence naturally include adequate financial arrangements during and after their term of office. This is, after all, what Professor Adolf Weber called "the continuity of responsibility and the continuity of expertise" in the discussion about the new Bundesbank Act at the beginning of the fifties.[1]

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1 Erich Achterberg, Volkmar Muthesius, "Die Bundesbank - Aufbau und Aufgaben" (The Bundesbank - structure and functions) in Schriftenreihe der Zeitschrift für das gesamte Kreditwesen, Frankfurt am Main, 1950, p. 14.

It is important that nationality takes second place to the task with which these officials are entrusted. As there can be only one self-contained monetary policy for the Community as a whole, and not a monetary policy which takes account of the special requests of individual states and regions, the central bank governors and the members of the Board must be committed to the common task and not to the interests of individual countries or regions, and this must be clear when they cast their votes.

VI.

Above all the instrumental independence of the system must be guaranteed, i.e. its ability to fulfil its function of safeguarding monetary stability without restriction by using the necessary instruments. The instrumental independence of the ECBS must be ensured by providing it with a sufficient array of market instruments whose application is not hampered by administrative regulations and measures. These should be instruments which are linked to the markets and which use market processes to achieve their ends instead of eliminating them or falsifying them in an undesired way. It is obvious that interest rates as the price of money and credit must be of central importance. But this set of instruments should also include all the other tools of modern central bank policy, irrespective of whether they are being applied in the individual countries at present or not.

I cannot deal in greater detail with these rather technical questions in this lecture (some proposals are contained in the collection of papers submitted together with the Delors Report), but one thing should be clear: a future ECBS which is to satisfy high expectations must have the weapon which every efficient central bank must have: the monopoly of money creation. Monetary policy is not divisible, not even in a basically federalistic system such as the Fed or the Bundesbank. Without the monopoly of money creation, the ECBS would be a "tiger without teeth".

A system which is used only to "coordinate" monetary policy but leaves the right to decide on the price and the quantity of money in circulation to the national governments and/or central banks would be "half baked", as Alan Walters called the EMS. "Coordination" must not be orientated towards a European inflation average or any exchange rate targets, which would amount to restricting the Bundesbank's room for manoeuvre without providing a convincing alternative. Attempts of this nature have often been made in the last few years, as all those involved know. Such a system would be less efficient for achieving stability than the present regulatory framework of the EMS. It would therefore be unacceptable to us and no doubt to other EC countries as well. This has always been the German position, and a German government which gave it up could not count on the support of the German general public which reacts very sensitively to matters of price stability. This has become very clear in the sometimes most critical reactions to the Delors Report, particularly to the proposals on "stage two", which in fact remained fairly vague and left more questions open than they answered. Not without reason is it said of "stage two" (and I quote): "At this juncture, the Committee does not consider it possible to propose a detailed blueprint for accomplishing this transition",[1] that is, for the transition from stage one to stage two in the monetary sphere. I will revert to this problem later when I describe the work programme of the Committee of EC Central Bank Governors.

[4et.pl] With their decision to start negotiating an agreement on a European central bank system as early as the end of this year, the governments undertook to put their cards on the table and to say whether they were in fact prepared to transfer the decision on future monetary policy to an independent Community institution. In my opinion, it would have been better to gain a few years'

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1 Delors Report, section 57.

experience with "stage one" of economic and monetary union and to implement first what has already been decided on, particularly the single market, the liberalisation of capital movements, the harmonisation of taxes, etc., before envisaging further-reaching institutional steps. But naturally I accept the decision of the Heads of State and Government and I understand the political motivation behind it.

VII.

If a basic consensus on the structures of a European central bank system can be achieved in the way just outlined, a number of other important questions remain to be decided on, and I would like to mention just a few of these.

First of all, what is to happen if not all governments and parliaments agree to an amendment to the treaty because of economic and monetary union as is required under EC legislation? In this case, which cannot be ruled out from the outset, there are two possibilities. One could proceed in the same way as with the EMS, which legally is an agreement between the central banks of the Community. This would give rise to a second treaty, in addition to the EC treaty. I would think this highly questionable for the cohesion of the EC and would prefer an arrangement based on the EC treaty even if it cannot be implemented by all contracting parties at the same time, as was the case with several regulations of the EC treaty some of which have still not been implemented.

Another question which is frequently raised, particularly by the French and the British, seems to me to be easier to solve: the "democratic control" of an ECBS. There is no need to wait for complete political union, a European government and a parliament with real responsibilities before an ECBS is set up even though historical experience would suggest this. Historically, central banks have always been established after the formation of states.

Naturally the integration of Europe cannot be confined to monetary policy. Progress in other fields, such as the German Federal Chancellor demanded for the European Parliament, is necessary. But an independent ECBS would, in my opinion, be conceivable before the completion of political union if the governments want this and if they are prepared to surrender the corresponding sovereignty as they have done in other, albeit less important, fields. The system would have an adequately democratic legal base if it came about by an agreement between democratic governments, if the agreement were ratified by democratically elected parliaments and if the system were provided with a clearly defined mandate. In addition, the members of the Board could be appointed by the ECOFIN Council and the members of the Council by the national governments. The accounting (not the monetary policy!) could be audited by an impartial court of auditors. In my opinion it would be quite consistent with the independence of the system if the president regularly reported to the European Parliament, albeit not as frequently as is the case in the United States, and if the Chairman of the ECOFIN Council and the President of the EC Commission could attend the meetings of the European central bank council (without voting rights) just as, conversely, the chairman of the ECBS would be invited to the relevant ECOFIN meetings. In addition, the general public should be comprehensively informed, as is customary in the United States and the Federal Republic of Germany, for instance. As for the rest, the system would be measured by its success.

It is much more difficult to answer the question of which functions national central banks should retain than to answer the question of "democratic control".[1] Here, too, the subsidiarity

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1 Milton Friedman, "The case for floating rates" in Financial Times, December 18, 1989. "A truly unified European currency would make a great deal of sense. But to achieve it requires eliminating all central banks in Europe ... except one ...".

principle should apply, that is, only those functions should be transferred to the Community body which cannot be satisfactorily fulfilled at the national level unless this affects the requirements of a consistent, self-contained monetary policy. In the first place, these are all decisions on interest rates, liquidity and the money stock, that is, monetary policy in the proper sense. This must necessarily include decisions on purchases and sales of third currencies (mainly dollars) because these have direct effects on liquidity and the money stock. It also involves the difficult problem of a transfer of foreign exchange reserves to Community institutions and the decision on who is to receive the proceeds.

In spite of these far-reaching powers, the ECBS could function with a comparatively small staff, say, a number similar to that of the Board of Governors of the Federal Reserve System, as executive functions could largely be transferred to the well-established systems of the national central banks which would then act on behalf of the Community. The settlement of payments, open market operations with the banks, business on behalf of government institutions and the like could well be taken care of by the national central banks - according to the guidelines and instructions of the ECBS. In addition, the national central banks should, in my opinion, be responsible for bank and stock exchange supervision unless this is already the case as, for example, in the Federal Republic of Germany. This means that the national central banks would play a role similar to that of the Federal Reserve Banks in the United States or the Land Central Banks in the Federal Republic of Germany. However, they (and/or the finance ministers!) would have to give up their right to formulate independent national monetary policies. Particularly for Germany this would have far-reaching implications. The Central Bank Council, which today is the supreme decision-making body in the monetary policy field, would lose its most important function, a consequence which may not have become quite clear to every advocate of an ECBS in the Federal Republic of Germany.

Numerous other questions have to be answered, such as: how the voting rights are to be determined in a European central bank council; where the ECBS is to have its domicile; and how the profits are to be distributed, and so on. In this lecture I cannot deal with these questions in detail. There is one aspect, however, which I would briefly like to highlight.

VIII.

Even a strong and independent central bank can only fulfil its functions if its policy is not counteracted by fiscal policy. The agreement must therefore stipulate that the effective use of central bank instruments is not hindered or influenced undesirably by the nature and scale of public borrowing. Recourse to central bank credit must be ruled out from the outset or reduced to a minimum; in view of modern and free financial markets it is basically no longer up-to-date. Even if government functions are financed through the market within the appropriate limits, both the effects on the use of monetary policy instruments and the overall economic implications must be taken into account. The greater interest rate resistance of the public authorities compared with that of private borrowers must be corrected by an adequate degree of self-discipline if a crowding-out of private financing is to be avoided. And monetary policy must not be condemned to facilitate or ensure the satisfaction of the "inevitable" public borrowing needs, possibly at the expense of its proper function, the safeguarding of monetary stability.

An adequate degree of self-discipline at all government levels could reduce the necessity of binding rules for fiscal policy to minimum or even make it superfluous. As is well known, such binding rules, with limits for the budget deficits of individual member countries, were considered necessary in the Delors Report in order to guarantee "a coherent fiscal/monetary policy mix" in the Community. There are not yet very clear ideas as to where suc binding rules should come into force, how they should be determined and how they could be implemented. And, as I said before, they should not lead to all powers and control authoritie being concentrated in Brussels in future. Judging by all experience, the idea that fiscal discipline will come about quasi automatically with the aid of market mechanisms appears not to be very realistic, however.

IX.

Experience in Germany has shown for years how important it is the the government at all levels, as well as management and labour, are willing to act responsibly under realistically assessed conditions so that the central bank can fulfil its function without undue frictional loss and safeguard the value of money, both internally and externally. As early as in the first stage of economic and monetary union it will be found out whether this willingness exists in the larger European context. It will depend on this willingness whether and when further steps are possible, including the establishment of a European central bank system. Even without amending the treaty the European Community has already an adequate institutional framework for establishing a convincing common economic and monetary policy. We have among other things the Council of European Finance Ministers and the Council of European Central Bank Governors, as well as the Monetary Committee in which our alternates work. Within this framework progress towards coordinating economic, fiscal and monetary policies is already possible and necessary today, that is, without waiting for the result of the presumably protracted intergovernment conference.

As far as monetary policy is concerned, the Committee of Central Bank Governors agreed at its January meeting on a reorganisation of its work, with respect to both staffing and scope of its deliberations. Its staffing was affected in that the Chairman wa elected for three years, instead of one year, thus ensuring greater continuity. Furthermore, to support the Committee, a research team consisting of competent economists will be set up; this team is to prepare problem-related studies on questions which must be answered for a common assessment of monetary trends within the Community and in relation to third countries. It will also draw up well-researched comments on relevant questions which are to be addressed to the Council or to the governments.

Regarding the content of its work, the Committee will work towards a higher degree of convergence "with a view to achieving domestic price stability, which is at the same time a necessary condition for stable exchange rates".[1] That higher degree of convergence was the aim of the amendment to the Council decision of 1964 on the cooperation between the central banks of the Community. A starting point for this is the closer coordination and convergence of the annual monetary targets of the individual national central banks. So far the most varied aggregates have been used and differing assumptions have been taken as a basis. A common monetary target for the Community will not be the result of these discussions in the foreseeable future, but it should be possible to converge the concepts and to give the Committee of Central Bank Governors the opportunity to use consistent yardsticks when consulting about the basic stance of its monetary policy. This will be of great use even if individual member countries continue to gear their monetary policy, particularly their interest rate policy, essentially to the objective of defending the exchange rate relations agreed upon within the EMS. The significance of monetary targets is thus qualified in individual cases. As a control variable the money stock nevertheless retains its significance as a money stock getting out of hand would have to be interpreted as a sign of unwelcome developments even if the exchange rate of the currency concerned remains stable.

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1 See Council Decision, Doc. 10128/89, of December 4, 1989, p. 1.

The cooperation among the EC central banks has contributed much to the progress towards convergence in the ten years or more which have passed since the EMS was established, and it is this progress which opens up the prospect of an implementation of economic and monetary union. Compared with this, there is a considerable need to catch up in other fields, not least in fiscal policy. The Committee of Central Bank Governors will therefore not hesitate to fulfil its mandate "to express opinions to individual governments and the Council of Ministers on policies which might affect the internal and external monetary situation in the Community and, in particular, the functioning of the European Monetary System."[1]

The Committee will also comment on questions concerning the further progress towards economic and monetary union. In their capacity as members of the Delors Committee the central bank governors have created an important basis for the debate. In the meantime further considerations and ideas have come to light. The final decision naturally rests with the governments and parliaments, but it must be as well-founded as possible. The Committee of Central Bank Governors will contribute its expertise, and I am convinced that we shall thus make an important contribution to achieving European economic and monetary union. There is no way back. The task before us is to set the points correctly so that the European train reaches the destination we all want to arrive at.

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1 See Council Decision, Doc. 10128/89, of December 4, 1989, p. 4.