Embargo:

Thursday, November 8, 1990

7.00 p.m.

"Monetary Integration
and the European Revolution"
Speech by Karl Otto Pöhl
at the AMEX Bank Review Awards Dinner,
Banqueting House, London
November 8, 1990

Ladies and gentlemen,

Since the days of Karl Marx hundreds of books have been written on the revolutionary transition from capitalism to socialism. However, when in the course of the year we were faced with the transition of the so-called "real existing socialism" to a market economy, we had very little to draw on - neither historical experience nor theoretical reasoning. Thus I appreciate all the more the fact that several of the prizes which I have the honour to present here today are in acknowledgement of economic analysis directed at the tremendous problems which all Eastern European economies face in that transition.

I also think it is laudable that AMEX Bank organised such a competition. It is the competition of ideas that we all depend on, especially if they are clearly organised and legibly presented like those of today's prize winners.

I.

Ralf Dahrendorf in his latest book calls 1989 the year of the European revolution, similar to that of 1688 in England, 1789 in France and 1917 in Russia. One could hardly agree more. The total collapse of an oppressive and economically unproductive system within months, especially the lifting of the iron curtain that

revolution was largely peaceful, but no less profound. And it did not happen in only one country but in half a continent. In most countries it is not even finished.

To economic policy-makers in Western Europe this revolution is presenting the greatest challenge for decades. The "open society" - the victorious model of the revolution - has already granted political freedom and human rights to the peoples of Eastern Europe. But, moreover, freedom in the political, as in the economic, sphere is a productive force. It can bring the prosperity which these nations have long been waiting for. Right now, all the former socialist economies are in a state of dereliction. For us Germans this is clearly illustrated in the former GDR, where almost every sector of the economic and administrative system will now have to be reorganised from scratch.

However, the eastern part of the newly united Germany has one big advantage. It has a wealthy "brother" from whom it can borrow almost everthing it lacks: a strong and stable currency to start with, a successful legal and constitutional system, administrative manpower and know-how, a massive inflow of private investment and last but not least large transfers of public funds designed to set the process of economic revitalisation in motion and to cushion it socially.

In the light of experience drawn from German monetary union I think two remarks are pertinent. Both also apply to current discussions on the second stage of a European monetary union. Firstly, the institutional question of who was to bear sole and undivided responsibility for monetary policy in the extended currency area was clearly answered. The Bundesbank was given this

[illegible]

smoothly and did not have the inflationary effects which so many commentators had anticipated.

Secondly, it has become clear that monetary union between highly unequal economies - I admit Germany in this respect is an extreme case - does necessitate huge financial transfers if unacceptable social and political consequences in the weaker part of the united currency area are to be avoided. Official estimates have tended to understate these financing needs. In the case of Europe similar needs would arise and they would probably greatly exceed the resources even of the more prosperous net contributors to the Community.

Still, the establishment of the new Länder is an unprecedented challenge for us. It is a national task of hitherto unknown dimensions. But we are also fully aware that the changes in Germany are a model for central and eastern Europe. Thus, we carry a double responsibility: we want to succeed for our own sake. But we also have to prove to our eastern neighbours that the revolution has been "worthwhile" not only politically but also with respect to their economic recovery. After all, the open society not only means a state based on the rule of law and human dignity but also signifies an efficient economic order.

I think the Chairman of your House of Commons Select Committee on Foreign Affairs, Mr David Howell, very aptly remarked in a recent article in the "Wall Street Journal" (and I quote):

> "The intensive West German commitment to the transformation of East Germany needs to be mirrored by the same degree of commitment by the West as a whole to East Germany's neighbours."

I do not know whether a precise "mirroring" is possible, but the least we in Western Europe must do is to keep our markets open to our Eastern European neighbours. That is the only way in which the economies of a long-divided continent can grow together again. It is the only chance Eastern Europeans have in narrowing the prosperity gap that exists between them and us today. The economic integration of Eastern Europe into the free world economy will, in my view, be the overriding task of the next two decades. It will also be crucial to achieving political stability in the new democracies. It could also help to dampen the nationalistic conflicts which are presently reemerging. The revitalisation of eastern economies should be one of our main concerns at the European level.

I do not want to contribute to the controversy over whether we should have a wider or deeper European Community or whether we may have both. But whatever its future shape, the European Community

East Germany needs to be mirrored by the same degree of commitment by the West as a whole to East Germany's neighbours."

I do not know whether a precise "mirroring" is possible, but the least we in Western Europe must do is to keep our markets open to our Eastern European neighbours. That is the only way in which the economies of a long-divided continent can grow together again. It is the only chance Eastern Europeans have in narrowing the prosperity gap that exists between them and us today. The economic integration of Eastern Europe into the free world economy will, in my view, be the overriding task of the next two decades. It will also be crucial to achieving political stability in the new democracies. It could also help to dampen the nationalistic conflicts which are presently reemerging. The revitalisation of eastern economies should be one of our main concerns at the European level.

I do not want to contribute to the controversy over whether we should have a wider or deeper European Community or whether we may have both. But whatever its future shape, the European Community must be an economically open community. After all, it is through free markets - not only within the EC but also worldwide - that the western world has prospered over the past 40 years. In this context I would also express the hope that despite all difficulties the Uruguay Round of trade negotiations within GATT can eventually be made successful.

is at odds with the economic and political integration which has made such gratifying headway in the past few years. Quite the contrary: liberalisation in the east and dissolution of the military and economic blocs have tended to stimulate interest in European cooperation among European countries which do not belong to the EC.

This also applies to monetary policy cooperation, as reflected, for example, in the recent announcement by Norway that that country intends to behave as if it were already a member of the EMS, and the fact that the United Kingdom has joined the EMS exchange rate mechanism may perhaps also be interpreted in this light. Austria has long pegged its currency to the D-Mark, i.e. it, like Norway, virtually a member of the European Monetary System without formally belonging to it, and I venture to forecast that other countries, too, will follow suit. This is to be welcomed, because it warrants hopes that the "zone of monetary stability" which intentionally was to be created through the EMS will grow progressively, and also increase in international standing and weight, as is suggested by the valuation of the EMS currencies in the foreign exchange markets. From the very beginning the concept of the EMS was not that of an exclusive "closed shop", and this should not be changed by the more far-reaching plans on Economic and Monetary Union.

Progress on the road to EMU did not beginn with the so-called first stage on July 1st. The decisive impulses are coming from the integration of the markets. Full freedom in the exchange of goods, services, people, money and capital - that is, the creation of the single market - has in the end been forced through markets in the context of the international division of labour. This freedom is in fact one of the pillars of EMU. The recent liberalisation of money and capital movements by France and Italy is not the least noteworthy example of this. Yet a lot still has to be done before the single market becomes reality. Let me remind you of the necessary harmonisation of indirect taxes, of industrial standards and of legal and administrative regulations, as well as of the creation of a uniform financial and banking market. Moreover, the tendency towards protectionism is still great, as we have seen recently.

Secondly, considerable progress has also been made with regard to the second pillar of EMU, the stabilisation of exchange rates within the EMS. Italy has adopted the narrow margin of fluctuation of the EMS (although it has taken more than ten years to do so), and the UK has joined the ERM, albeit with a wide margin. But most noteworthy of all is the fact that there has been no further realignment in the EMS since 1987. This would not have been possible if the "hard core" of the EMS - i.e. the countries which allow their currencies to fluctuate only within the narrow margin - had not achieved a high degree of "convergence". This, however, is the most important precondition for the proper functioning of a fixed exchange rate system, as was shown by the experience of Bretton Woods, as well as by the history of the EMS, which in the first few years of its existence had to cope with as many as ten realignments, and was on the point of collapse in March 1983.

The third element of EMU is the most difficult to achieve. It is the transfer of decision-making power in the field of monetary policy to a supranational institution which ensures a common, consistent monetary policy. After a transitional period with irreversibly fixed exchange rates it could be empowered to issue a single currency. As Milton Friedman said: " a truly unified currency would make a great deal of sense. But to achieve it requires eliminating all central banks in Europe... except one ...". This single currency could be called the ECU but - as the

Delors Report has already stated - it will be different from the basket ECU; in other words, it has to be a currency sui generis. The legal preconditions for the transfer of decision-making powers to a European central bank are to be created at the intergovernmental conference which is due to start in Rome in December. The Committee of EC Central Bank Governors, which I have the honour of chairing, will shortly be submitting the draft statute of a European central bank, which in my view should be an integral part of the envisaged amendment of the EEC Treaty. Public discussion on the basic principles of the European Central Banking System has led to a high degree of agreement not only among central bankers but also among governments.

Most importantly, a high degree of agreement was reached on four crucial points, that is, price stability as the prime task of the new monetary institution, secondly, independence of that institution from political instructions, and thirdly, the assurance that full reponsibility for monetary policy will be given to its central organ. The latter is a precondition for a central and undivided monetary policy. It also implies that the new European central bank will be given all the necessary monetary instruments. Fourthly and finally, any monetary financing of budget deficits should be precluded.

These elements, in a nutshell, are the basic prerequisites for a viable monetary order in Europe. There remains a lot to be done to translate this design into practical policy. The train towards European Economic and Monetary Union has been set in motion. I hope it will reach its right destination.