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Prime Minister

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Prospects of the European Monetary Union

This is the speech

Address by

main Karl Otto-Pöhl referred to today.

Karl Otto Pöhl,

President, Deutsche Bundesbank

It is:

at the conference

i) a defence of EMS

Britain and the EMS

as a concept independent of EMU.

London, November 9, 1990

ii) a critique of the

hand-ecu plan;

iii) but also a set of

conditions for going along with the Delors Plan.

I.

1. I suppose in April, when you invited me to attend your conference, you did already expect that the meeting would take place after Britain had joined the ERM of the EMS and that an EC-summit would announce that stage II of EMU would start in January 1994. So the topic of your conference "Britain and the EMS" could not have been more to the point.

BHP

8/14

2. The opening-up and extension of Europe is not at odds with the economic and political integration which has made such gratifying headway in the last few years. Quite the contrary: liberalisation in the east and the dissolution of the military and economic blocs have tended to stimulate interest in European cooperation among European countries which have so far not belonged to the EC.

3. This also applies to monetary policy cooperation, as reflected, for example, in the recent announcement by Norway that de facto 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 is likewise 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, for it warrants hopes that the "zone of monetary stability" which was intentionally 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 (EMU).

4. On the way to EMU progress has not been made only since the beginning of the so-called first stage on July 1<sup>st</sup>. The decisive impulses are coming from the integration of the market. 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. Not least the recent liberalisation of money and capital movements by France and Italy is noteworthy in this regard. Yet a lot still has to be done before the single market become's 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.

5. 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 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.

6. Without the success of the EMS, current plans for Europe's further monetary integration would not be more than mere visions. The D-Mark has played a significant role in the EMS success story. This is generally acknowledged today, different from a few years ago, when we heard a lot of complaints about the asymmetry of the system. It is not by accident that the pound sterling, when entering the ERM, fixed its exchange rate versus the D-Mark. It did so because this gives more credibility to the anti-inflationary stance in Britain. John Major, the British Chancellor of the Exchequer, recently put it this way: "Increasingly it (i.e. the ERM) has functioned like a modern gold standard, with the D-Mark as the anchor".
7. The D-Mark grew into this anchor role in the EMS not by design, but by virtue of its position as the most important international currency after the dollar and owing to the inclination shown by our partners to use the D-Mark as their preferred intervention currency within the system. As a consequence, their central banks' holdings of D-Mark reserves have grown significantly over the years, a development which we resisted rather than supported but in the end could not prevent. The most important consequence of these developments is, of course, that the Bundesbank's monetary policy determines to a certain extent not only monetary conditions in Germany, but those in other European countries that peg their monetary policy to that of the Bundesbank, most obviously those countries participating in the Exchange Rate Mechanism of the EMS.

8. By contrast, the European Currency Unit (ECU) has never been able to assume the role for which it was originally designed. The ECU has had quite an impressive career, it is true, in the private financial markets, though almost exclusively in the Euro-market and in countries with relatively high rates of inflation and (until recently) foreign exchange controls. On the other hand its monetary policy importance and its contribution to the proper functioning of the EMS have remained negligible to date. Although there have been some attempts to encourage its use, the ECU is of very little significance today as a reserve and intervention instrument among central banks.
9. Some of you may feel that as a result the ECU has not been given a proper chance to play its role at the centre of the system. But, in that case, the EMS would have been anchored to a basket unit which represents the average of members' inflation rates rather than that of the best performer. This is why the central banks - contrary to their original intentions - rejected an ECU-based intervention system from the outset, and opted for the parity grid.
10. That was the correct choice, as the history of the EMS has shown. It avoided placing responsibility for intervention or monetary policy adjustment on the central bank whose currency deviated from the average, regardless of the type and causes of the deviation. It would have forced better-

than-average performers to accept a less rigorous monetary policy. In all probability this would have caused average inflation rates to rise, making it easier for the bad performers to continue with their easy monetary policy. So it is no surprise that the ECU's role in the EMS has remained marginal, because, as a basket, and lacking a central bank with full responsibility for it, it could not be expected to assume a central role.

## II.

11. Can the ECU play a more significant role in the development of EMU in future? Some advocates of a European currency believe that the existing ECU can be gradually developed to perform this function. Proponents of this strategy see this as the easiest and most elegant route towards monetary unification in Europe. The ECU would simply crowd out national currencies over time, one after the other. The Delors Committee, i.e. the 12 EC central bank governors adopted a very clear position in this respect. It called for the removal of all impediments to the private use of the ECU. But it also firmly rejected the idea of transforming the existing basket ECU into a "parallel currency", which would circulate all over the Community alongside national currencies. The Delors Committee did not succumb to the charms of this approach for two main reasons. "Firstly", it stated, "an additional source of money creation without a

precise linkage to economic activity could jeopardise price stability. Secondly, the addition of a new currency, with its own independent monetary implications, would further complicate the already difficult effort of coordinating different national monetary policies".

12. The British Government's recently launched "hard ECU plan" sought to avoid the shortcomings of the basket ECU. Essentially, three new elements would be brought into the European Monetary System: (1) a thirteenth currency in the form of the hard ECU, (2) new terms and conditions for the settlement of balances (in the form of a "repurchase obligation" for the national currency by the issuing central bank) and (3) a European Monetary Fund. As things stand today, it cannot be said whether this would amount more to a modification of existing rules or to a substantial further development of the system. In both cases there are certainly chances of a stronger stability orientation of the system as a whole, and also of greater convergence. However, quite a number of considerable problems must likewise be taken into account. Could the "hard ECU" crowd out national currencies in its money functions as means of payment, unit of account and store of value? What would be the consequences for the monetary policy of national central banks and for the functioning of the EMS etc.? I cannot go into these details on this occasion.

13. The main problem, in my view, is which role the European Monetary Fund could assume and which conclusions are to be drawn therefrom for its institutional structure. As long as the Fund acts as a pure monetary authority and virtually copies the monetary policy of the most stable country, it ultimately makes no autonomous contribution to integration. Sooner or later, however, it is to be expected that this institution will develop ideas of its own about the appropriate interest rate level and interest rate pattern in the Community, and about exchange rate relationships between Community currencies. This does not necessarily depend on the widespread use of the hard ECU, but hinges ultimately on the functions of the Fund and the policies of its management. Judging by past experience, it cannot be ruled out that the Fund will be the body in which "peer pressure" is exerted. And in that case past experience suggests that the objective of stabilising exchange rates will be preferred to that of monetary stability. "Interest rate leadership" in the EMS, in the direction of an increase in interest rates, is held by the Fund anyway, but it is uncertain whether, as a Community institution, it will be able to exert any pressure towards an interest rate reduction on stability-conscious countries over the longer term. Conflicts over these questions are by no means ruled out, and the "indivisibility of monetary policy" is not assured. If in the extreme case an "acid test" between the ECU and the strongest national currency is to be avoided, "compromises" in monetary policy are preprogrammed. But this is the worst possible recipe for monetary policy.

14. It is these imponderables, in particular, which would require a clear-cut and stability-enhancing organisation of the Fund. The appropriate criteria - commitment to the goal of monetary stability, independence, distribution of voting powers, etc. - need not be spelled out here. It is obvious, however, that the regulations must not be any softer than those proposed for the European central bank system in the Delors Committee Report. The parallel currency strategy, at any rate, offers no advantages over the Delors version in the question of the necessary institutional agreements, but it has the disadvantage that an indeterminate area of monetary policy responsibilities might emerge.

15. For all these reasons, the British "hard ECU" proposal has met with little support so far. The Monetary Committee of the EC, which is composed of representatives of the finance ministers and central bank governors of the EC, has rejected the proposal by a large majority. This does not mean that it does not contain some positive features. In particular, we endorse the idea of a "hardening" of the ECU, which might be achieved by dispensing with basket revisions in future and by not devaluing the ECU in future realignments. This might increase the attractiveness of the ECU for central banks, too. On the other hand, for the reasons I have mentioned, we are unable to support the proposal to create a new monetary institution because this could lead to the establishment of a grey area in monetary policy. But responsibility for monetary policy decisions is indivisible.

III.

16. This can only be achieved if the decision-making power in the field of monetary policy will be transferred to a supra-national 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. This single currency could be called ECU but - as was said already in the Delors Committee Report - it will be different from the basket ECU; in other words, it has to be a currency sui generis. 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 ...".

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 to chair, 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. The public discussion on the basic principles of the European Central Banking System has led to a high agreement not only among central bankers but also among governments.

17. In particular, there is thus general agreement that price stability has to be the most important task of monetary policy. This actually sounds somewhat trivial, but it certainly cannot be taken for granted. The temptation to subordinate central bank policy to other goals - in particular to exchange rate stability - is often strong.
18. The conflict between "domestic" and "external" stability is woven into the fabric of German monetary policy like a scarlet thread: the transition about the revaluation of the D-Mark in 1968, the change to floating exchange rates in 1973, the establishment of the European Monetary System (EMS) in 1979 as well as the events in October 1987 are all milestones in the course of this conflict. In my view, it would therefore be desirable to embody in the statute of an ECB a clause to the effect that domestic stability must have priority over exchange rate stability.
19. The successful pursuit of a policy of keeping prices stable is most to be expected of an independent central bank. This is so in the United States<sup>1)</sup>, and is even

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1) " ... 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 interest of the country".

more necessary for a Community Institution. Members of the European Central Bank Council who are bound by instructions from their governments would represent national interests. Therefore the principle of "one man, one vote" in this body can only be implemented if the members of the European Central Bank Council are really independent, not only in their capacity as council members but in their domestic functions as well. Basically, this is generally acknowledged, but it needs changes in national law in some countries to implement this principle. The democratic authorisation of an independent European Central Banking System derives from the fact that the Treaty on which it is based has been negotiated among democratically elected governments and ratified by all the national parliaments of the countries involved. Moreover, the members of the European Central Bank Council (Board) should be appointed by the European Council.

20. The functioning of European monetary policy requires a clear division of responsibilities between the European Central bank, on the one hand, and the national central banks, on the other; they form the two tiers of the European Central Banking System. Although the underlying principle is that of subsidiarity, this principle cannot be applied to monetary policy. Monetary policy decisions can only be taken by a single entity. Even under a federative system, monetary policy must remain indivisible, the "monopoly of money creation" must be retained. In the

European Central Banking System, therefore, it will not be possible for the national central banks to have any autonomous monetary policy powers of their own: they will only be the operational arm of the European Central bank.

21. Even an independent European Central Banking System cannot guarantee price stability alone, as monetary policy does not operate in a vacuum but rather has close links to other fields. Monetary policy must in particular not be obstructed by fiscal policy. The close correlation between monetary policy and fiscal policy is entrenched not least by the temptation to finance budget deficits, allegedly without pain, via the central bank. But monetary financing of budget deficits is something that cannot be allowed. It would probably be in the interests of all the countries involved if binding budget rules were laid down and if the Community institutions were given the option of imposing sanctions if these rules were contravened. If one is realistic, one can not expect the market enforcing the necessary degree of budgetary discipline.

22. This is a rough outline of the concept of a European Central Bank Constitution which will hopefully be submitted soon to the intergovernment conference in the form of a detailed draft statute by the Committee of EC Central Bank Governors.

In my opinion, that text should be an integral part of the EEC Treaty so that the goal envisaged is completely clear in every detail.

23. Clarity about the goal is absolutely essential before we can dare to go over to the so-called stage two. The Heads of State and Government of the EC have already fixed a date and, gratifyingly, also the conditions which must be fulfilled for its inception. So far, the contents of stage two are not clear, however. Above all, I think it is unclear which functions the "new Community institution" is to have which is to be established with the inception of stage two according to the "Conclusions of the Presidency". In the Rome Communique it says that, in particular, it will make it possible

- to strengthen the coordination of monetary policies;
- to develop the instruments and procedures needed for the future conduct of a single monetary policy;
- to oversee the development of the ECU.

In my opinion, all this does not require a new institution, let alone an ambitiously defined ECB, as this can be done just as well in the already existing, smoothly functioning institutions. On the contrary, there is the danger that an institution which will be merely an "empty shell" without

any monetary policy functions for years will not be credible from the outset.

An only partial transfer of monetary policy functions on the other hand should also be ruled out. There are plenty of ideas on this, as can be seen, for instance, from the Delors Report, particularly its Annex. But we shall not come to like them in future either, for monetary policy responsibility is indivisible and cannot be transferred in slices. Nor is monetary policy in any way suitable for experiments with an uncertain outcome.

24. I therefore think that the European Central Bank should not be established until it has been clearly decided which countries are prepared and able, on account of their economic performance, to irrevocably fix the exchange rates of their currencies and to transfer monetary policy responsibility to the Community. The time, too, must be set unequivocally for all. This would by no means imply a delay of the process of integration, on the contrary. It would, however, prevent the creation of a grey area of monetary policy responsibility for an indefinite period.

The intergovernmental conferences which are to start in December bear great responsibility for the future of Europe. I hope that the correct signals will be sent.