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"Two monetary unions - the Bundesbank's view"

Lecture by Karl Otto Pöhl,
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at the Institute for Economic Affairs,
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As I speak to you today two important, even historic, events are unfolding before our eyes: the Economic, Monetary and Social Unification of the two Germanys (GEMSU), and the start of stage one of the planned European Economic and Monetary Union (EMU). Accident, not design, has these two events falling on the same date. But they are not wholly unrelated, since the unification of Germany is likely to speed up the European integration process. It is also true, however, that the two operations each have their own very distinctive features and will for the most part move forward under their own momentum.

What we see happening now in the GDR is the introduction of the D-Mark in all its currency functions under the sole responsibility of the Bundesbank, and the adoption of market mechanisms in place of central planning. The introduction of the

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D-Mark is rightly seen as a powerful stimulant and at the same time as the trade-mark and token of success of the unification process. European Economic and Monetary Union, by contrast, will imply the eventual replacement of all national currencies, including the D-Mark, by a single European currency issued, and its value controlled, by a common institution. These are two very important distinguishing features.

Like most economic experts, including those of the Federal Government, I would have preferred a step-by-step approach to the German unification. But the urgency of the situation dictated otherwise. With hindsight, there can hardly be any doubt now that German economic, monetary and social unification was at the same time inevitable, necessary and desirable: inevitable, because the opening of the Berlin Wall left those looking for a better economic future with a chance to leave the GDR, thus burdening both states with incalculable costs without any corresponding benefits in sight; it was necessary, because only economic, monetary and social unification offered the prospect of a rapid and irreversible process of economic and social improvement in the GDR; and it was desirable, because it became clearer every day that economic and monetary unification would soon be followed by political unification.

The main elements of German Economic, Monetary and Social Union as they are incorporated in the State Treaty concluded between the Federal Republic and the GDR are public knowledge by now. From the point of view of the Bundesbank, two features are central:

First, from July 1 the Bundesbank will be in full control of monetary conditions in the GDR as well as in the Federal Republic of Germany. The necessary institutional and technical arrangements are in place. Even if the pursuit of our monetary target will prove somewhat more difficult initially, this should not materially affect the Bundesbank's ability to stay its course of price stability.

Second, the conversion arrangements finally adopted have effectively reduced the risks of entering the new phase with a large monetary overhang. The various conversion rates translate into an overall conversion factor of about 1.8 to 1, which is very close to what the Bundesbank initially proposed. The latest indications are that people will not spend too large a proportion of their new D-Mark holdings right away. This will clearly help to keep inflationary dangers in check. Monetary expansion in the Federal Republic is currently well under control, with M3 in the Federal Republic expanding at an annual rate of about 4 per cent. We calculate that M3 will increase by about 10 per cent initially

through introducing the D-Mark in the GDR; this corresponds well to the added economic potential.

You will not expect me to stress the risks of the exercise unduly. We are condemned to success in a situation such as this. The initial costs will be substantial, but the benefits to be gained after a difficult, perhaps even turbulent initial phase will be well worth the effort. The benefits will not only accrue to my own countrymen and women, but to others as well, especially in Europe. The European Commission and others have raised their growth estimates for the German economy, but also for the Community as a whole, by a substantial margin. The long-term benefits to other countries could well be enhanced if the invitation to participate in the process of economic and political reconstruction that is under way in the GDR as well as in Eastern European countries is taken up by firms in our partner countries. Indeed, what will happen in the GDR is likely to serve as a model for other countries in Eastern Europe that are embarking on the transformation from planned economies to market-type economies. Their own efforts will be crucial to the success of the process, but success will also depend on the willingness of their Western partners to assist them.

Returning briefly to some of the implications of German Economic, Monetary and Social Union, you will recall that already months ago financial market analysts made their back-of-the-envelope calculations and quickly concluded that German interest rates would have to rise substantially, and that this would pull up global interest rates. As so often, markets reacted ahead of time, long before the costs could be estimated with any precision. We know now that the net public sector borrowing requirement in Germany will increase substantially. For the whole of this year, it is estimated at about 80 bn D-Mark, and for 1991 at about 100 bn D-Mark. These totals include deficits incurred by public authorities in the GDR, to be financed through borrowing in the German capital market either directly or through the German Unity Fund. (They exclude certain items relating to the future operations of the new Trust Fund set up to re-organize and re-privatize state-owned companies and other state property.) Altogether, on this basis public sector borrowing will grow to the equivalent of about 3.5 per cent of GNP, starting from the very low level of less than 1 per cent of GNP in 1989. However, the totals must be judged in relation to the size of our capital market and the high saving propensity of our household sector. Total net savings in Germany amounted to some 310 bn D-Mark in 1989, 100 bn D-Mark of which had their counterpart

in our large current account surplus. Nevertheless, public sector borrowing of the size envisaged for 1990 and 1991 can only be justified temporarily and in the light of the exceptional circumstances in which it will arise. The Bundesbank has repeatedly emphasized the potential implications for interest rates of sharply higher borrowing by the public sector. It is our strong view that the large, unavoidable transfer of public funds to what is now the GDR should at least in good part be offset by restructuring public expenditure. The unification process offers ample scope for cuts in certain expenditure areas that relate to the division of Germany in past decades.

If interest rates, both nominal and real, in the industrial world are currently at very high levels, this is, of course, not only the consequence of a larger demand for capital in Germany. Other reasons as well account for this, as is well known. Indeed, the fact that interest rates are as high as they are should in my view not be a matter for undue concern. The industrial world is on a sound growth path. Real growth is proceeding at very satisfactory rates not only in Japan and the rest of the Asian economy, but also in Europe. If it is somewhat more moderate in North America, this seems to be quite in line with adjustment needs. The world's savings/investment balance is likely to remain under strain. Relatively

high interest rates, both nominal and real, are in these circumstances largely unavoidable. They are indeed a means of ensuring that non-inflationary economic balance is maintained.

Greater calls on available financial and real resources in the context of German Economic, Monetary and Social Union are likely to reduce our large trade and current account surpluses. This would clearly be in our own interest, as it would help to keep inflationary pressures under better control. But it would also be desirable from the point of view of international payments adjustment.

Most experts expect the decline of Germany's huge current account surplus to be relatively slow. Indeed, German exporters will not want to give up hard-won world markets lightly, and they will be even less inclined to do so if export orders keep coming in as before. This is one reason why a good response on the part of imports to the additional consumer and investment demand generated by German economic unification would be highly desirable; indeed, rising imports should ideally make the major contribution to reducing our surpluses. But this too depends on demand pressures in the potential exporting countries being reduced. In not a few cases, the needed policy responses would seem highly appropriate in any case to avert the risk of domestic inflation accelerating again.

There is a wide measure of agreement, based on sound economic analysis, that the exchange rate of the D-Mark should be strong in the period ahead, so as to facilitate the adjustment that is called for. A strong D-Mark has been our aim all along, even though we have not pursued specific exchange rate targets as part of our economic or monetary policy. It was to be expected that the D-Mark would fluctuate up and down, as news relating to the unification process is being evaluated from day to day in the exchange markets. But we have not been unduly concerned about the short-term behaviour of the D-Mark in recent months, even though it has at times been tending to move in a lower range within the ERM band than we might have liked to see, while remaining relatively strong against many other currencies, including sterling. The increase in our market interest rates has helped the relative strength of the D-Mark, as has the "pre-emptive" rise in our official rates and the decline in short-term rates in some partner countries.

I am confident that home-made price and cost pressures will remain well under control even in the more difficult circumstances confronting us. On present indications, the inflation rate in Germany will remain below 3 per cent p. a. in 1990, as it was in 1989. This I think is a remarkable result, given that we are now in the eighth year of an

economic expansion, with real growth of about 4 per cent p. a. in 1989 and 1990.

I do not see any likelihood of a sharp price acceleration in 1991. I am, however, somewhat concerned that on this basis the inflation differential in our favour vis-à-vis some other countries will continue as before, or may even grow somewhat wider again as inflation rates tend to rise here and there. Inflation rates are ranging at present between 2 per cent and 7 per cent p. a. within the Exchange Rate Mechanism, and between 2 per cent and 18 per cent p. a. within the EMS taken as a whole. These large inflation differentials are clear evidence of manifest shortfalls in economic policy performance in a number of Community countries. With exchange rate adjustments being effectively constrained, not only within the Exchange Rate Mechanism, serious policy dilemmas are bound to arise. The virtual absence of any exchange rate risk over long periods tends to attract capital flows to countries with relatively high nominal interest rates, thus strengthening their exchange rates, but also frustrating efforts to contain home-made inflationary pressures through monetary policy action. In time this will result in a loss of competitiveness for parts of their

industry that may prove difficult to reverse. In the low inflation countries, the inflexibility or - even worse - a real depreciation of the exchange rate risks causing inflationary impulses being imported from abroad. This must be a matter of concern, for partner countries individually and for the system as a whole.

In recent years, a strong D-Mark, and the economic and monetary policy that stands behind it, has served as an anchor of stability for other partner countries' economic and monetary policies in the EMS and beyond. This anchor role has been bestowed upon us, it is not ours by design, even though it was to be foreseen that the D-Mark would play a major role as an intervention currency and as a reference point for other currencies participating in the system. It is the consequence of policy choices made elsewhere as a matter of convenience. The recent decision of Belgium to tie its currency even closer to the D-Mark than before is only the latest example. I take it as a vote of confidence in our own ability to see the D-Mark continue in its role as a stability anchor in Europe. Our partners in the EMS, and particularly those participating in the Exchange Rate Mechanism, have recognized all along that anchoring to the D-Mark does not amount to a soft option. This will, of course, also hold true for Britain, once sterling comes under the rules of the

Exchange Rate Mechanism, which I expect to be the case soon - "when the time is right". The Governor of the Bank of England has rightly stressed recently that this should not be seen as a soft option.

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Taking a somewhat longer view, I would also warn against all temptations to incorporate into the project of European Economic and Monetary Union elements that would amount to a soft option. The Delors Report stressed three principles to be respected: plurality, subsidiarity and parallelism. The report saw a need to take account of the diverse social, cultural and political conditions in the member countries; to limit Community responsibilities to those essential to the functioning of economic and monetary union; and to advance in parallel on the economic and monetary front. These are sound principles.

I am concerned that parallel progress towards economic and monetary union may not be assured, as commitments in the area of budgetary policy remain vague. Fiscal discipline supported by clearly formulated rules of behaviour, especially in so far as they relate to the size of fiscal deficits and their financing, are at the centre of the issue. If such rules of budgetary discipline prove superfluous

at some future stage because self-discipline together with market discipline prove effective, all the better for it. But experience so far in the Community and elsewhere does not justify overly high expectations.

I am even more concerned that the principle of subsidiarity should not be applied in areas where it would clearly be misplaced. Subsidiarity definitely has no place in the realm of monetary policy. Monetary policy cannot be subdivided; it has to be of one piece. Responsibility for it can only be placed either at Community level, that is with a European Central Bank System (ECBS) - or whatever is to be its name - empowered to pursue price stability as its primary objective, or with the competent national authorities, that is, with national central banks. As you know, the European Council has already decided in favour of the establishment of a European Central Bank System, and the Intergovernmental Conference which is to start in December will have to agree on a Statute for this new Community institution as part of its negotiating tasks.

I welcome the fact that the Committee of EEC Central Bank Governors has been asked to submit a blueprint for a Statute of the future ECBS. There is already a wide measure of agreement among the Governors that the ECBS would have to be fully in charge of

monetary policy in the Community if it is to attain its primary objective, price stability. The notion of a European Central Bank determining the broad guidelines for monetary policy in the Community, and national central banks implementing them with a large degree of freedom in accordance with the special circumstances of their national economies and the needs of their financial markets, would in my view be unacceptable as a basis to build on. What would be the guidelines laid down at European Central Bank level? What powers to see them properly implemented would the European Central Bank have, if this is to be called a European Central Bank System worthy of the name?

Even though, for well-understood reasons, the ECBS would in all likelihood have a federal structure, with one central bank per member, the central element would have to be strong enough to assure policy consistency and operational efficiency. A strong central element would also underpin the independence of the system from Community and Government interference. As members of the Governing Board of an ECBS, the national central bank governors will be expected to act without any national mandate, responsible only to the objectives laid down in the ECBS Statute and to its rules-book. It would nevertheless be wise to have a strong central element, call it a Directorate or otherwise,

whose members would be an integral part of the Governing Board and would in the nature of things give added force to the system's autonomy in the day-to-day performance of its task.

The framework of the ECBS as outlined in more detail in my Paris lecture¹⁾ and the distribution of tasks does not rule out the possibility that certain responsibilities that are not central to the pursuit of a consistent monetary policy could be left in the hands of national central banks acting as the operational arm of the system. 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 - acting in accordance with the guidelines and instructions of the ECBS. In addition, the national central banks should, in my opinion, be made responsible for bank and stock exchange supervision where this is not 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

1) "Basic Features of a European Monetary Order", Paris, January 16, 1990.

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.

I am aware that the issues relating to the status of a future European Central Bank system are hotly debated in this country. I believe I understand the arguments put forward against central bank autonomy, based as they are on the fact that your unwritten constitution vests all power ultimately in Parliament, including that over monetary policy. Experience in my own country and in not a few other countries clearly supports the case for central bank autonomy in its special area of competence.¹⁾ It seems to me that in the context of European Economic and Monetary Union an even stronger case can be made

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 interest of the Country."

for the political autonomy of a future ECBS than at our own national level. For one thing, a number of factors working in favour of monetary discipline, including those deriving from past experience of inflation and its evil consequences, may be less strong in the Community, for a variety of reasons. For another, the constant need for compromises to be sought at the political level would work to the detriment of an effective and stability-oriented monetary policy, if it were allowed to force its way into the area of central banking. I believe a high degree of autonomy bestowed upon an ECBS in its sphere of competence should not be equated with lack of accountability. If there is agreement that inflation is democracy's enemy No. 1, success in ensuring price stability should be taken as adequate testimony to the central bank's accountability.

I believe that the future ECBS should also be responsible for the management of the foreign currency reserves and for intervention in the exchange markets, subject to any agreements that may be concluded at government or Community level involving the exchange rate regime. The ECBS would, of course, have an important role in any such agreement for the simple reason that commitments in the area of exchange rates and intervention have direct implications for monetary policy. It is important that operations in foreign exchange

markets should not undermine the central objective of price stability.

Allow me to use this opportunity to comment briefly on the debate about what has become known as integration at two speeds. I was surprised that a brief remark I made after the last ECOFIN Council meeting in Luxembourg attracted much greater attention than it deserved. I merely recalled some of the conclusions of the Delors Committee with respect to those countries that may not initially be prepared, or be in a position, to subject their monetary policies to the strict discipline of a European Central Bank System. Without questioning the consensus on the final objectives of the Community, as well as full participation by all members in the same set of institutions, the Delors Report stated that a degree of flexibility should be maintained concerning the date and conditions on which some member countries would join certain arrangements. In fact, this statement only confirms what has been practised so far within the European Monetary System and in other EC areas. The agreement reached at Schengen on border controls and related matters is only the latest example. It was in this context that I mentioned France, the Benelux countries and my own country as an example of the high degree of economic convergence which has meanwhile been reached among them. It goes without

saying that this convergence is an essential prerequisite for the final fixing of exchange rates, which is a *conditio sine qua non* of monetary union.

I should also like to take this opportunity to say a word about another subject, which is that of the ECU and its role. I shall not comment at length on the detailed proposals made recently by the British authorities, as these will be discussed in the appropriate fora in the coming weeks. I have, of course, taken note of them with great interest. Whatever the reactions of other partners to the proposals, the mere fact that they have been put on the table for discussion should be welcomed. Indeed, no idea put forward should be dismissed outright. So, with this introduction allow me to make a few remarks on the ECU issue of a more general nature.

The ECU was created as a basket of currencies. This helped its development as a hedging instrument in the private ECU area, so long as exchange rates proved to be extremely volatile both within the EMS and against the U.S. dollar. The ECU has also gained some prominence as an instrument for other financial market purposes. It is widely viewed as a currency by market operators, even though it still lacks some of the essential features of a currency. The ECU has, by contrast, not assumed an important role as an official reserve and settlement instrument. It

surely is not at the centre of the EMS. This has been a cause of disappointment and regret on the part of ECU enthusiasts, as well as of others.

The Delors Report gave the ECU little space, though it acknowledged its financial market role and its potential for being developed into the common currency of a final EMU, provided it could be adapted to the new role. This would mean giving up its basket character in favour of an ECU *sui generis*. This, I understand, is what the new British proposals aim at, although at the outset they could also be applied to the existing ECU.

As the Delors Report pointed out, there are potential dangers to monetary policy in creating an additional currency that would circulate alongside national currencies as a parallel currency. One danger would lie in the pressures that would undoubtedly arise to expand the issuance of the ECU currency over time to give it greater prominence. The constant demands made for the promotion of the existing ECU and its role provide enough indication of the kind of pressures to be expected. So do - in another context, that of the IMF - the constant demands to create SDRs in the expectation that reserve holdings in national currencies would then be reduced by a corresponding amount.

The key element in the management of a currency must be the maintenance of its value, not the promotion of its use. The present ECU's role in the financial market no doubt has been enhanced by the help it receives from Community and national authorities, some of it at the expense of the tax-payer and without any clearly demonstrated benefit, except to the operators in the market. Indeed - all other things being equal - assuming that private issuers and investors in ECU instruments pursue their profit incentives, the pace at which the market for such instruments expands must in good part be a function of the willingness of Community or national public issuers to offer attractive conditions, at least at the margin, relative to those available in national currencies.

The most recent proposals would see ECUs issued as a dual currency by a European Monetary Fund (EMF) owned by the national central banks. Central banks would be obliged to ensure convertibility of their currencies into the ECU on demand and at exchange rates that would be either fixed from the start or allowed to move only within very narrow bands. This would be expected to impose discipline on monetary policies in the participating countries, with the ECU serving as a European standard in much the same way as the old gold standard is said to have worked. At the same time, national central banks would

remain accountable to national political authorities. The authors see it as an advantage that their proposal would preserve the principle of subsidiarity, enhance the prospects for price stability and maintain competition among national monetary policies, in fact adding a new element to such competition through the ECU currency.

Nevertheless, in some key aspects, the new proposals follow the original ideas underlying the concept of a second "institutional phase" of the EMS: creation of ECUs against national currency, establishment of an EMF with tasks of its own, including intervention in third currencies etc. With the adoption of European Economic and Monetary Union as a Community objective and its inclusion in the EEC Treaty under the "Single Act" we have moved far beyond the concept of a second "institutional phase" of the EMS.

The revised "Council Decision on Closer Cooperation between Central Banks of Member States" adopted in March 1990 recognizes price stability as the primary objective of monetary policy, and as being essential to the permanent achievement of exchange rate stability. The closer cooperation among Community central banks which we are now organizing is to serve this objective. I consider this a major new crossroads from which to move forward to Economic

and Monetary Union. Without it, the main focus would remain on the stability of exchange rate relationships. This would confront countries seeking greater price stability than others with familiar monetary policy conflicts that could only be resolved by parity changes from time to time. If Economic and Monetary Union is to be the goal, the commitment to price stability is indeed essential and must be vested in a European Central Bank System empowered to pursue it independently of instructions from Community or national authorities. Without a clear assignment of responsibilities, the commitment to price stability would lack credibility.

It has been rightly argued that a common currency is not an essential element of monetary union. In my own view a common currency would in the end still be desirable to demonstrate the irreversibility of the process and give the Union its own identity. It will be some time yet before we come to that point.

Rather than adding to the problems that we will have to overcome on the way to that final step, we should seek to ensure that cohesion between national economies and their currencies will be strengthened, so as to prepare for the moment when exchange rates can be fixed permanently. Then is the time to decide on the creation of the new common currency that will replace the national currencies. Then will this be the logical step to take, with the new ECBS firmly

installed to exercise the necessary control over a common monetary policy.

As the President of the Dutch central bank, Wim Duisenberg, stated in his written contribution on the subject of a parallel ECU currency to the work of the Delors Group: "Economic and monetary union requires economic convergence and the acceptance of the loss of sovereignty implicit in the abolition of the exchange rate as an adjustment instrument. The development of the ECU into an international currency used in parallel to national currencies cannot enable us to avoid this requirement nor can it facilitate its realization."¹⁾

1) W.F. Duisenberg: The ECU as a parallel currency, Delors Report, p. 189.