Mr. Leigh-Pemberton considers the future of monetary integration in Europe and the role of the hard ecu Speech by the Governor of the Bank of England, The Rt. Hon. Robin Leigh-Pemberton, at the Deutsche Bank/Ecu Banking Association Conference in Berlin on 25/10/90.

APPROACHES TO MONETARY INTEGRATION IN EUROPE

It is a very great pleasure to be here today for a number of reasons. This is my first visit to Germany since unification, and what could be a more appropriate venue than Berlin? It is my first major public speaking engagement in another Community country since the UK joined the Exchange Rate Mechanism. And, although it is hardly the first time I have shared a platform with Karl Otto Pöhl, it is a pleasure to do so again; central bankers see a good deal of each other but rarely get the chance to share thoughts in a public forum.

Sterling's entry into the ERM just over two weeks ago was hardly as momentous as German unification - but perhaps a little more so than my being here with Karl Otto and was certainly an extremely important step in the UK's economic life. It was something we had been committed to for a very long time. That commitment was, I am very well aware, widely doubted. Those doubts could only be put to rest by the actual act of joining, and yet the commitment was qualified - and had to be qualified - by prudence. It was absolutely essential - for the UK and for the existing members of the system - that we waited until the inflationary pressures in our economy were abating - as I am confident they now are.

We joined only when we judged that we could make a success of membership. And for similar reasons we have joined the wide band rather than the narrow band because our present economic circumstances require us to maintain substantially higher short-term interest rates than the narrow band countries. But we will move to the narrow band when that too can be done with confidence of success. So far, the reaction in the markets has been positive, and we have successfully negotiated the transition from the initial and welcome euphoria to a more stable and perfectly suitable trading range.

Given some of the recent speculation about our motives for joining, I should perhaps make it clear that we wanted to be part of the Community's anti-inflation club. Joining therefore has two elements: it signals our determination to defeat inflation in the UK and also to participate fully in a key Community institution.

This commitment is also seen in our whole-hearted support for the Single Market, which is based on the principles of open markets and free trade that have traditionally been at the heart of UK economic policy.

But while we are strongly committed to the 1992 project and the disciplines of the ERM, it is hardly a secret that the UK has doubts about the approach of many countries to Economic and Monetary union.

Even so, there are here many more points of agreement than are perhaps appreciated. All of us, for example, are agreed that greater convergence of economic performance in the Community must be an objective. Without it, we cannot have a true Single Market, in which business decisions can be taken on a rational and long-term basis. Without it, we will certainly not see the sustainable non-inflationary growth across the Community which the German authorities have so successfully sought over the years and for which we in Britain are equally keen.

I think it is also common ground - at least between President Pöhl and myself - that convergence is still far off in the Community, although much has been done, particularly among the narrow band ERM members. For example, in the year to July (the latest period for which full information is available), there were three countries in the Community with three or more times the rate of consumer price inflation ruling in Germany. Even among the members of the narrow band, over the same period retail price inflation ranged from 2.3% in the Netherlands to 5.7% in Italy.

If you look at other key economic indicators, the same lack of convergence is evident. In the last full fiscal year, the public sector's financial position ranged from a surplus (as a percentage of GDP) of about 1.8% in the UK to a deficit of 10.4% in Italy, and as much as 20.9% in Greece. Current account positions also vary widely, though here it is harder to be sure what is appropriate and sustainable.

We have to recognise that all the countries of the Community may well not complete this convergence within the time-scale that some have proposed - that is to say, by 1993 or 1994. This appears to me to be a reality that we need to recognise. But equally it should not cause distress. Indeed, we have perhaps become a little dismissive of just how much is being attempted in the Single Market programme and of just how much is involved in the commitment for all EC members to join the Exchange Rate Mechanism with narrow margins.

More generally, it is clearly possible to hold widely different views about EMU. Frankly, I am surprised that so many people can hold such precise views at this early stage as to the exact nature of the union they wish to see and the route they wish to take. Of course we need to think ahead about ways in which we <u>might</u> move forward and to establish the consequences of particular institutional and other steps. And, it is in that very spirit that I have taken an active part in the discussions of the Central Bank Governors on possible future central banking structures in the Community.

But it would be unnecessary, and highly undesirable, to rush into premature commitments which would deny us the flexibility that unknown future developments will undoubtedly require. Further changes must be soundly based in economic reality and have the widest political support. If not, those who wish to make the most haste may in the end undermine their own cause. The Community is not subject to the political or economic imperatives which lay behind German economic and political unification.

In particular, I am concerned that proposals for a quick move towards a single currency would involve giving up a tried and trusted system - that of the Exchange Rate Mechanism based on the anchor of the deutschemark - for an untried system - that of a new European System of Central Banks. The ERM, with its deutschemark anchor, has been instrumental in bringing about the remarkable anti-inflationary convergence that has been achieved so far in some countries (though, as I suggested earlier, there is still a long way to go in others). Monetary stability is so absolutely important to our economic prosperity that we need to be sure that any new institutional mechanism is strong enough to deliver it before we abandon the existing arrangements.

It may be asked - perhaps, if I may say so, particularly here in Germany - why the Community cannot simply establish a new institution in the mould of the Bundesbank and allow it to operate as the Bundesbank has done, with effective political and operational autonomy. There would be two problems with this approach. First, it is not at all clear that such a high degree of autonomy would be politically acceptable in the Community as a whole. Secondly, it would fall into the trap of assuming that if we simply created an independent central bank, with a mandate to pursue price stability, we would necessarily achieve our objective. This seems to me to be unduly simplistic. However independent a central bank is in principle, it cannot be impervious to the pressures of public opinion or indifferent to public support. It must rely for its legitimacy on the public's aversion to inflation, and to the public's trust that potentially unpopular short-term measures of restraint will be justified by longer term benefits. The aversion of the German people to inflation - an aversion born of historical experience - has been augmented by a realisation that price stability provides the best basis for sustained and stable economic growth. But the Bundesbank has acquired its reputation as an inflation fighter after a long period of skilful monetary management, and it is this that gives the Bundesbank its credibility and legitimacy.

A new institution would begin with no such inherited credibility or legitimacy. If, in addition, it began its life in circumstances where there were significant divergences among member countries in inflation performance and budget deficits, as well as in underlying living standards, it could be faced by very great pressures. There is a point beyond which a central bank, however independent in formal terms, cannot ignore such pressures if it is to retain its political acceptability. It would be unfortunate (at best) and disastrous (at worst) if a new Community central banking institution was required from its inception to play a critical role in the Community, without having established counter-inflationary credentials.

The British proposals, based on a Hard Ecu managed by a European Monetary Fund, are designed to address some of these difficulties. They would enhance economic convergence in the Community without prejudging the final goal. But equally the Hard Ecu could eventually lead to a single currency if that was what governments, peoples and markets wanted.

The proposals are intended to achieve a number of objectives. First, they acknowledge the desire of many Community countries to maintain the momentum of institutional development by establishing, at a relatively early date, a Community monetary institution with meaningful powers. Secondly, they seek to avoid the risks that would flow from a premature locking of parities before adequate convergence in economic performance. But at the same time, thirdly, they are designed to promote further convergence in economic performance beyond Stage 1. Fourth, they allow the establishment of a new common Community currency which could eventually become a single currency for Europe if market developments made that economically feasible and desirable and if such a thing emerged as the wish of people throughout the community. Finally, this way of going forward would give the Community an opportunity to gain invaluable experience in joint management of a common money, without abandoning the tested system of the ERM, and without confusing, in the process, the responsibilities of national and Community monetary authorities.

But over and above all of these advantages is the fact that "the Hard Ecu" would have firm anti-inflationary credentials. The UK's overriding concern in proposing the scheme was that it should not fall foul of the criticisms levelled at previously-mooted parallel or thirteenth currencies. I can understand that, before a careful examination of our proposals had been undertaken, they might have been felt to suffer the same pitfalls - pitfalls which would, I totally agree, make the Hard Ecu a non-starter. But it avoids those pitfalls. And if I may say so, I would not be here arguing for it if the Bank of England were not totally persuaded of that point. The Hard Ecu would be a sound currency.

Obviously, I cannot just assert that, however, so I shall explain some of the proposal's details. First, the Hard Ecu is defined so that its central rate vis-a-vis other Community currencies could never go down. In other words, in any realignment of exchange rates within the ERM, its value would match that of the strongest currency.

Furthermore, the European Monetary Fund, the institution established to manage the new currency, would be given a mandate to pursue and attain price stability and would therefore plainly need to enjoy the necessary operational autonomy to fulfil that mandate. The EMF would be empowered to issue ECU liabilities, on demand, when holdings of national currencies were surrendered to it. Intervention techniques for the EMF would be devised to ensure that Hard Ecu were created as a substitute for, and not in addition to, national currency assets.

Initially, the main role for the Hard Ecu would be as a monetary standard. One can view it as playing a role not dissimilar to gold under the gold exchange standard, or that which the deutschemark has played within the ERM. The Hard Ecu might well not immediately enter into ordinary retail transactions on a large scale; indeed its development in this role is likely to be gradual. But, from the outset, it could exert an important influence on monetary policies throughout the Community. This is because, in order to ensure that the introduction of the Hard Ecu did not lead to excess money creation, the EMF would have the right to sell any national currency it had acquired back to the issuing central bank in exchange for hard currency. A rise in Hard Ecu interest rates would tend to attract balances out of national currencies - initially, one would expect, from those countries at the bottom of the ERM band - into Hard Ecu. And, if the EMF then exercised its right to present national currencies back to the issuing central bank, the issuing central bank would experience reserve losses, and would therefore need to take policy action to remedy the situation.

The reserve loss mechanism under the Hard Ecu proposal would be broadly similar to the way the discipline of the ERM is transmitted into national monetary policies. However, there are certain features of the Hard Ecu mechanism which, in my view, would make it preferable to the existing arrangements. First, the anchor role for Community monetary policy would - and I think should - be played by a Community monetary instrument, and not by a national currency. That would increase its acceptability in the Community as a whole. It would also avoid the risk of the anchor currency central bank's policy being inappropriate for the Community as a whole. In that sense, there would be an extra safeguard against inflationary pressure.

A question that is often asked about the Hard Ecu proposals is whether they are consistent with eventual moves to full monetary union as described in the Delors report. A subsidiary question is whether, even if they are so consistent, they would slow down the process towards progressive union. I hope the answers to these questions are now clear. The Hard Ecu proposals are not only consistent with phased progress toward a single monetary policy and a single currency if in due course that was the wish of peoples and Governments. But by promoting greater economic convergence, they would actively help to create the conditions that are essential for a monetary union. They do not,on the other hand, in themselves mandate a single currency or carry any implications as to its timing.

Concerning the effects of the Hard Ecu on the speed of progress toward monetary union, it is of course true that the proposal holds little attraction for those who believe that one could move directly towards a single currency within the space of a few years. For those who believe that more time will be required, and that care will be needed to ensure that the foundation of progress are solid, the proposals should hold more attractions. You will, by now, be in no doubt where my own sympathies lie.

Conclusion

Let me conclude by emphasising one point. The Hard Ecu proposals address a number of genuine difficulties that will be encountered if the Community attempts to force the pace towards full monetary union and a single currency and monetary policy; difficulties that cannot be wished away. I believe, though, that the UK proposals offer a consistent and coherent way of addressing these issues. Indeed, we have yet to hear objections which strike at the heart of the technical aspects of the proposal.

It would be unrealistic, however, to claim that, in their detail, the Hard Ecu proposals are the only possible way of approaching the problems of convergence and transition. UK representatives in international meetings have consistently emphasised that the proposals should not be regarded as "cast in stone". And we therefore look forward to a continuing dialogue with our Community partners designed to find a way forward which is equitable across the Community and soundly based.

M. Camdessus and Mr. Wilson give their views on a variety of issues subsequent to the September 24 meeting of the IMF's Interim Committee IMF SURVEY, 15/10/90.

Following are excerpts from the joint press conference held in Washington, D.C. by Interim Committee Chairman Michael H. Wilson and IMF Managing Director Michel Camdessus after the Interim Committee meeting on September 24:

QUESTION: *There does not appear to be any reference to special drawing rights in this communiqué, to which special attention was drawn by the G-24. And secondly, will the aid to the countries hard hit by the Gulf crisis be under special conditions, under subsidized interest rates, or under the normal terms?*

MR. WILSON: The Committee invited the Executive Board to expeditiously develop the modalities of these adaptations referred to above and to tailor members' access to Fund resources, including ways to address the problems of certain members in servicing the debt that is incurred under these facilities.

On the question of SDRs, I think it was recognized that we are not in a position as an organization to achieve the required degree of consensus, so there was really not an awful lot of discussion of it.

MR. CAMDESSUS: It is clear that the issue of the level and adequacy of international liquidity was not . . . the center of our debate. But the Interim Committee is not losing sight of that. And you will see in paragraph four of the communiqué, which deals with the prospects for the international monetary system and the work continuously developed by the Executive Board on this matter, that you have several avenues we are invited to continue exploring. And you will see there a mention in particular of the Fund's readiness to alleviate global liquidity shortages should they arise. Behind that, of course, there is this reference to the SDR, as an element of our possible strategy.

QUESTION: *There is a reference that members in a position to do so will collaborate to help other members in the Middle East. Could you identify member countries that will be giving this assistance and what form it will take?*

MR. WILSON: That will be up to those countries to identify themselves. We have expressed a desire here. We are saying we hope that all members that are in a position to do so will collaborate. There are some countries that have expressed some interest in helping in this regard, and what we are doing here is encouraging these countries to come forward and participate in discussions with the Fund and, through the Fund, with countries that might be helped.

QUESTION: *The communiqué talks about the need to support the East European countries and the Central European countries. However, there seems to be nothing other than generalities in terms of dealing with their particular problem with oil. Do you have anything further that might be done for those countries?*

MR. CAMDESSUS: As far as the Fund is concerned, we are not at all dealing in generalities and nice words, but in very substantial contributions. You are well aware [that] our programs with Poland, Yugoslavia, and Hungary are working very well, and the experience of Poland [was] examined yesterday in some detail by the Committee. Now we have new members—Czechoslovakia and Bulgaria—and we know that they have problems of the same kind. What I know is that we will step in there with the same determination to help. And we know, also, and the point has been made strongly by the members of the Committee, that this is not a business for a few months, or a stand-by arrangement of one year or two. We will have to help them probably with a process which will take several years; one could expect, for instance, a kind of sequence for some of these countries, possibly Poland, that after the support through the immediate stand-by arrangement, support over the medium term could be required, such as through an extended Fund facility, and we stand ready to do that. Add to that the very substantial amount of technical assistance, as far as the Fund is concerned, in particular in the field of central banking, accuracy of statistical collection, fiscal policy, and their modern instruments; these are not generalities. These are quite concrete things, and when we see the commitment of these countries to expedite their reforms—all the measures during this transitional period—there is the distinct feeling that members of the Committee want to match this commitment of these countries by the readiness to support.

QUESTION: *It looks like the Camdessus proposal for using the CCFF [compensatory and contingency financing facility] for helping out countries most affected by the Gulf crisis has not really got through the Committee, in the sense that you have not really spelled out how this facility is going to be used, what interest rates are going to be used, and the level of quota utilization. Is there a disagreement? If not, then what is the time frame in which this particular proposal is going to be implemented?*

MR. WILSON: No disagreement here. I think what the Committee wanted to do is give the Managing Director and the Executive Directors the flexibility to move forward in a way that encompasses this range of activities. Each country, then, has to negotiate with the Fund and develop a particular program in a way that is most appropriate to that country.

MR. CAMDESSUS: I have really nothing to add to that. In front of this crisis, which is of limited size compared with those of the past, and in view of what are now the relations between the membership and the Fund, with so many countries already in programs with us, I suggested that we should not lose time in designing a new grandiose instrument, the cathedral of a new facility, but should try to utilize our instruments as they are now, and the resources as they are now increased by the quota increase or, for the poorest countries, the ESAF [enhanced structural adjustment facility] as it stands. This strategy has clearly been endorsed by the Committee, and I have been given the mandate to work expeditiously with the Executive Board, to see what we have to do "to best support" members' efforts to deal with recent developments; not to support, more or less, but to *best* support, noting that we are well equipped for doing that, provided the country formulates appropriate and strong adjustment policies.

QUESTION: *Is it true that you proposed some sort of solidarity scheme whereby countries that benefit from the latest rise in the oil price put money to one side for other countries to mainly help with their interest payments to the Fund? And, on a second, totally different, issue, I wonder if you could give us perhaps some of the flavor of where we are on the debate on the international monetary system.*

MR. CAMDESSUS: As far as the first question is concerned, I have put the problem to the membership, not particularly to the Interim Committee, but to the Executive Board, about the cost of our resources. Because if we want to be effective, and if we want all the flexibility with the CCFF, with access limits and so on, to be utilized according to our Articles, with adequate safeguards and with due consideration to the capacity of repayment of members, then we have to make sure that our financing is not part of the problem, but is part of the solution. The Interim Committee itself had no discussion in detail on that. Several members have expressed to me some willingness to support an initiative in this respect.

I feel quite encouraged by the reference in the text to the need to address the problem of certain members in servicing such new debt. And then you have the reference to the hope that "all members that are in a position to do so will collaborate in these efforts to assist."

As a matter of fact, this is not a problem for the universality of countries affected by the Gulf crisis. It could particularly be a problem for those who are not ESAF eligible. With the ESAF we have, for the sixty poorest countries in the world, a very concessional window. But when analyzing the situation of those who are among the poor but not the poorest, we see countries where we could have this problem of servicing new debt. And it is with these countries in mind that I have urged the membership to see how to take care of this problem. We have received a mandate now to continue to work on that, as well as on all the other modalities of this financing in the Executive Board, expeditiously. We will do that. We have started.

MR. WILSON: On the second question, what this paragraph [four] observes is that "the Committee welcomed the continuing examination" and "the Committee emphasized the central responsibility of the Fund for evaluating continuously." So it was an attempt on the part of the Committee to give encouragement to the Board, and to the management, to continue doing the analysis work that relates to the international monetary system, the progress towards European Monetary Union, the things that are referred to in this paragraph. There was not extensive discussion at the Interim Committee on these matters, but simply an encouragement to keep on with the work.

QUESTION: *Is there a preliminary estimate as to what it would cost as a result of the Gulf crisis? The other day the Managing Director indicated the Fund staff may give a preliminary estimate before the Interim Committee of the impact of the Gulf crisis on the affected countries.*

Two, whether the current increase in the quota would be adequate to meet the demand caused by the Gulf crisis because, in the early round, the Managing Director was seeking more than a 50 percent increase to meet certain eventualities. Now that there is an eventuality, would it be adequate?

MR. CAMDESSUS: My answer is yes. We think the quota increase will be adequate. Remember, it was increased 50 percent, but for the period up to March 1993. And after that we enter normally into a new phase in the history of quotas. And we have also the possibility to start a new negotiation, if we are really confronted with a shortage of resources at any time, but I do not think it will be necessary. As the time for this quota increase is relatively short, we can deal with the quotas as they have been increased, provided that the membership ratifies this decision rapidly, and implements rapidly the quotas and the associated Third Amendment of our Articles for suspension of members noncooperating with us. I have the hope that this will be the case, and then that we will, as it is said in this communiqué, be well equipped to deal with the problem.

You asked about the magnitude, how much it will be, and so on. No, the Committee had no time, and it was not the level of its discussion to look to amounts. And it is extremely difficult to give an exact figure for many reasons. One will be the real size of the shock, for how long we will have a shock. And second, what will be the mix of adjustment and financing we will have. It will be different according to the situation of each country. And so, we will know how much it costs only when we will have seen in some detail the programs of the countries, and we are not at that stage. Possibly within a few months we will be more explicit on that.

QUESTION: *Perhaps we could clarify the time frame. Mr. Conable was suggesting to reporters last week that by early next year we should see increased flows from the World Bank to some of these countries impacted by the Middle East crisis and higher oil prices. Could we, therefore, anticipate that the IMF would also be having increased flows in this new context by early next year?*

MR. CAMDESSUS: Yes, certainly.

QUESTION: *Sooner?*

MR. CAMDESSUS: Let us see.

QUESTION: *A clarification about the mention of "attempts to insulate domestic energy prices or compensate for higher oil prices," etc. Could that mean, just to give us an example, that the Interim Committee is urging countries which have wage indexation schemes, for instance, either to cancel them or to suspend them, or at least to sterilize them from the effect of the oil price increase or oil-related products?*

MR. CAMDESSUS: Well, as the Chairman told you, this is not the job of the Interim Committee. To design policies with members is the job of the staff of the Fund, and then of the Executive Board. As Managing Director of the Fund, I am extremely happy to have this sentence here, because one of our obsessions in the last few weeks has been to avoid repeating the mistakes of the 1970s. And one of the major mistakes was these desperate attempts to mitigate, to cushion, to pay for the shock, well, *mañana, bukra*, later on. We know the cost of that. The cost of that included the debt crisis we are still dealing with at the beginning of the 1990s.

So here you have for me possibly one of the key sentences of this communiqué, because an attempt to insulate domestic energy prices through subsidies or price controls or to compensate for higher world oil prices and so on would lead later, and probably under more adverse circumstances, to tighter fiscal and monetary policies. So we recommend a rapid pass-through of higher oil prices to the consumer.

QUESTION: *I want to ask a particular question about Egypt. You know there is a problem concerning an agreement to be reached between Egypt and the Fund, and you have this kind of peculiar case where you have the problem of the Gulf now. Do you feel that Egypt can reach an agreement with the Fund soon and whether cancellation of the military debts of Egypt will help in reaching this agreement?*

MR. CAMDESSUS: We are at the present time discussing with the Government of Egypt the possible support by the IMF for the adjustment efforts of this great country. We are discussing that in an extremely good spirit of collaboration. We are particularly mindful of the severe difficulties in which Egypt has been for a long time and of the added complications and strains imposed by the Gulf crisis. This is part of the problem we have to tackle. But if the conditions are extremely severe, we are also encouraged by the significant, very diversified support Egypt could get from its friends.

You have referred to the U.S. government initiative to consider forgiveness of part of the public debt. If it were to materialize, this would be a significant alleviation of the financing problem of Egypt, and it would probably make easier a global solution to its financing problem. But what is basic, indeed, is the economic policy the Government of Egypt will be able to implement. We are discussing that with the authorities, and it is my hope that we could find a good agreement allowing us to be part of this international effort in support of Egypt.