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<u>KARL OTTO PÖHL, THE FURTHER DEVELOPMENT OF THE EUROPEAN MONETARY SYSTEM: SUMMARY, COMMENT AND COMPARISON WITH AN EARLIER VERSION</u>

In substance, Mr Pöhl's text is identical to the Bundesbank's paper of 25 May 1988 ("Weiterentwicklung des Europäischen Währungssystems", French translation : "Poursuite du développement du Système Monétaire Européen"). The differences between the two texts are listed in the annex.

<u>Summary</u>

The strategy proposed by the Bundesbank is based on the principle that before any further steps towards economic and monetary union are taken the final objective and its implications should be elucidated as carefully as possible. Accordingly, the first part of the paper is devoted to the analysis of the needs for harmonization in non-monetary policy areas. It is claimed that there must exist a central authority for fiscal and economic policy parallel to the European central bank system (p. 7). Within this authority, agreement needs to be reached on the policy mix (fiscal and monetary). Furthermore, the regional disparities would require "an extremely large volume of funds" (p. 10). As for wages, the necessary differentiation among countries/regions is expected to meet difficulties. Hence, "everything will therefore ultimately depend on a credible and vigorously pursued monetary policy that limits the scope for passing on cost increases and hence prevents excessive increases in nominal wages from occurring" (p. 11). In sum, although complete political union is not considered by the Bundesbank to be absolutely necessary in a monetary union, something quite close to it is nevertheless regarded as indispensable (p. 12).

The principles of the European monetary order advocated in the text are the usual ones : price stability, independence of central bank, federal structure, no financing of public deficits. Besides, voting power should be weighted according to economic importance of countries, the policy instruments should not include quantitative controls, and banking supervision should be integrated with the central bank (p. 12-14).

The main elements of the future order being fixed in this way, the paper examines three different strategies towards the achievement of the final goal : a European Monetary Fund, a European parallel currency, a European monetary authority via the strengthening of the Committee of Governors.

The first approach is rejected because a Fund is not seen to contribute anything to convergence of monetary policies. This contribution would only be felt when conditional balance of payments credits were granted - but in this case, insufficient convergence would already have become evident. Besides, the Fund approach is at square with the claim for an independent monetary authority (p. 15-16).

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The parallel currency approach is examined at some length and equally turned down. It is claimed that the basket ECU is unable to crowd out national currencies in a durable and especially in a symmetrical way. At best, it is given a chance for becoming a "compromise currency" in intra-EC trade in the Bundesbank's view. For this reason, worry is expressed that central banks would be obliged to stabilise the exchange rate of the ECU through unlimited purchases, which would be tantamount to undertaking unlimited purchases of partner currencies without any settlement procedure (p. 24).

The "abstract ECU" idea is also rejected because the risk is seen that the issuing policies were too expansionary and that eventually national central banks would have to support the parallel currency. In conclusion, the Bundesbank contests that the parallel currency approach would avoid the political decisions which have to be taken in alternative strategies towards monetary union.

A European Monetary Fund and the parallel currency approach being dismissed, the strengthening of the Committee of Governors is the only alternative left, because other Community bodies lack independence from political institutions. The Bundesbank likes to see the Committee's functions develop both in monetary policy coordination and in exchange rate policy.

In choosing the Committee of Governors as embryo for a common monetary authority, integration may develop step by step, without the need to make a big leap at the start. Before decision-making responsibilities are transferred, it may for example be conceivable to transform present ex post exchange of information (on intermediate targets, individual decisions or use of monetary instruments) into ex ante information. A further step could be to change the character of this ex ante information into obligatory advance consultations. Finally, the nature of the consultations would turn into directives issued by the Committee, whose name could be changed in the process in order to reflect its new responsibilities. In exchange rate policies as well, the Committee's charges might develop smoothly : from the coordination of the intervention policies of the individual central banks to full responsibility for policies vis-à-vis third countries, but also for parity changes in the Community (p. 33).

Mandate (maintaining the stability of money) and status (freedom from instructions) should however be assured from the start. This implies in particular that the Committee's members "would need to enjoy personal independence from bodies that appoint them, which admittedly also presupposes corresponding independence in their functions at the national level" (p. 37). Besides, at any degree of integration, the next step should only be made if qualitative progress towards convergence in economic and monetary policy has been made.

Final considerations are devoted to the questions of two-speeds-integration and integration within or outside the Treaty. Preference is given to full participation of all EC countries, and to a once-for-all amendment of the Treaty.

Comments

The paper offers a comprehensive analysis of the core questions related to economic and monetary integration. It has the merit of showing an intelligible way towards this objective.

However, it is difficult to see how the text could alleviate the task of agreeing on concrete steps. It offers fundamental reasoning and develops a systematic approach. There is no room left for pragmatic steps. The essence seems to be to restate the principles of the European monetary order as claimed earlier by the Bundesbank and to demonstrate at the same time that the time is not ripe for implementing this order. The following points desserve particular attention :

- Principles of the final monetary order

The text is as categorical as earlier statements by Mr Pöhl or Mr Stoltenberg : commitment to price stability, independence and the ban on financing public sector deficits are defined as necessary elements of the European central bank legislation. The earlier claim that European monetary policy should not be less stability-oriented than today in Germany is also reiterated (p. 2).

- Monetarism versus economism

In recent articles and interviews, Mr Pöhl has carefully avoided to be classified under one of the two schools. Neither does the present text give preference to any side. Instead, the weight is shifted towards the necessity to achieve parallelism between monetary and economic integration. Consequently, the "crowning theory" is also (implicitly) discarded, at least in the sense that it considers monetary union as the final step in a sequence of events. In the structural sense however, monetary union is still seen as "the monetary superstructure" of the economic union (p. 4). Parallel progress as understood by the Bundesbank will not be easy to achieve : in the transition period, institutional changes should be made dependent on qualitative progress towards convergence in the field of economic and monetary policy (p. 38). Apart from this, it follows from the text that monetary and non-monetary institutions should develop in parallel; in particular, the text suggests that the central authority for fiscal and economic policy, which is considered indispensable for the final state, should develop in line with closer cooperation in the Committee of Governors.

In sum, it is concluded that "a monetary union presupposes considerable shifts in the responsibility for economic policy to a central authority and hence a far-reaching reshaping of the Community in political and institutional terms in the direction of a broader union. ... it would probably be bearable only in the context of extremely close and irrevocable political integration" (p. 12). This wording in Mr Pöhl's paper is not significantly different from the condition formulated in Mr Stoltenberg's memorandum of last March : "Economic and monetary union... must be founded above all on a far-reaching political and institutional reorganization of the Community towards a more comprehensive union" (p. 8).

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- Independence

Mr Pöhl prefers to develop the Committee of Governors because it is de jure free from instructions. One should ask why the Committee is independent. The answer is probably because it was set up as an advisory body and has never been given decision-making responsibilities. Independence has not been granted to the Committee by a political act, because this question has not yet arisen until now. However, if the Committee is entrusted with independent operational responsibilities for monetary policies and if it is to retain its status as a "Community body", important institutional issues arise since, under Community law, all actions taken at the Community level must tie in, one way or the other, to the existing institutions.

A particularly sensitive point is the question of independence of national central banks. Although it is not clear whether from now on any progress in monetary integration shall be subject to the granting of more independence by national governments to their respective central banks, it is obvious that the Bundesbank wants to link these two subjects.

- What could be done now ?

Taken literally, the strategy proposed by the Bundesbank bars the way for further pragmatic or "ad hoc" progress. Any future improvements in the EMS like the Basle/Nyborg agreement or any closer cooperation in the Committee of Governors would have to be scrutinized in the light of the principles fixed for the final state before they are adopted. Moreover, these principles - which are those of the present German institutional and legal monetary order - needed to be agreed upon by the Community at the outset. What should be done next in the Bundesbank view is thus to commit all Member States to these principles, either in a Treaty revision or in another binding context.

- Rejection of the ECU strategy

The rejection of the basket ECU is based on rather weak arguments : first, it is assumed that its attractiveness is not assured; second, it is derived from this judgment that central banks would be obliged to stabilize the ECU's exchange rate. If it is true that the ECU would never play a significant role on private markets, the worries about an official involvement of the Bundesbank in the ECU exchange markets seem overdone. Similarly, with respect to an "abstract" ECU issued by a monetary authority, the refusal is essentially based on the suspicion that politicians would abuse the currency for deficit financing. The relevant question would instead have been how to design an efficient and stability-orientated structure for issuing the abstract ECU.

ANNEX

MODIFICATIONS OF TEXT IN THE PAPER PRESENTED BY MR PÖHL COMPARED TO THE PAPER OF THE DEUTSCHE BUNDESBANK OF 25 MAY 1988

The changes mainly concern passages in the earlier text which formed instructions or recommendations to the Bundesbank with respect to its attitude in the debate and which have been dropped. The numbering refers to the French translation of the German version of 25 May.

P. 4 : 10 lines of summary dropped.

P. 12 : reference to Stoltenberg memorandum dropped.

P. 13 : 15 lines of description of German interests in EMU dropped.

P. 15 : banking supervision : changed from "central bank should not be involved to "should be responsible".

Pp. 33/34 : proposals that central banks should mutually assist in meetings and that the Committee's secretariat should be expanded have been dropped.

P. 34 : safeguard against monetary financing of public deficits : has been dropped here, probably because it was repetitive.

P. 35 : parity changes : the limitation that the Committee should "at least be given an important role of advicing" has been dropped. It should thus have unconditional competence in deciding parity changes.

Pp. 36/37 : 1 1/2 pages on details about the structure of the Committee of Governors have been dropped.

Pp. 48/50 : 1 1/2 pages of suspicion that the French government uses the discussion on EMU as a pretext for abolishing the dominant position of the DM have been dropped.

Pp. 50/51 : reference to the organizational structure of the Committee of Governors has been dropped.