KARL OTTO PÖHL

A New Monetary Order for Europe

The 1992 Per Jacobsson Lecture

Washington, D.C.
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Foreword

The 1992 Per Jacobsson Lecture, entitled "A New Monetary Order for Europe," was delivered by Karl Otto Pöhl at the Shoreham Hotel in Washington, D.C., on Sunday, September 20, 1992. Mr. Pöhl is partner in Sal. Oppenheim Jr. & Cie., in Frankfurt. Sir Jeremy Morse, Chairman of the Per Jacobsson Foundation, presided over the meeting, the proceedings of which are presented in this publication.

The Per Jacobsson lectures are sponsored by the Per Jacobsson Foundation and are usually held annually. The Foundation was established in 1964 in honor of Per Jacobsson, the third Managing Director of the International Monetary Fund, to promote informed international discussion of current problems in the field of monetary affairs.

The lectures are published in English, French, and Spanish and are distributed by the Foundation free of charge. Through the courtesy of other institutions, other language versions are also issued from time to time. Further information may be obtained from the Secretary of the Foundation.

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Opening Remarks

Sir Jeremy Morse

Ladies and gentlemen, welcome once again to the Per Jacobsson lecture. It's very exciting to have such a huge audience here this afternoon.

Just to remind you of the order of play, our lecturer will speak for 45 or 50 minutes, and then we shall have a question and answer session. So we'll finish sometime between 4:15 p.m. or 4:30 p.m., at the latest, and after that you are all very cordially invited to the reception in the garden room next door.

We were last here two years ago, when Paul Volcker talked about the successful struggle to bring down inflation in the 1980s. Since then the lecture has been to Basle and to Bangkok, both successful occasions, and here we are back again with another distinguished lecturer in Karl Otto Pöhl.

I suppose he is perfectly equipped to give the lecture in any year, because he has been a student of economics, an economic researcher, an economic journalist, a senior government servant, and a very distinguished central banker, but he is particularly fitted this year, and has chosen the perfect title: "A New Monetary Order for Europe."

Some people have felt that the new monetary order hangs on the result of the French referendum. For those of you who haven't heard, it has been announced on French television, although the actual counting won't be completed for another two or three hours, that there has been a majority "yes" vote, by 51.3 percent or 51.5 percent—something like that.

I suppose all I can say, Karl Otto, is that the turbulent events of recent years have cleared the canvas for you, and we wait with great interest to hear what you have to say. Karl Otto Pöhl.

A New Monetary Order for Europe

Karl Otto Pöhl

It is a great honor for me to deliver this year's Per Jacobsson lecture, but after the hurricane which stormed over Europe's foreign exchange markets my task has become more difficult than I thought it would be.

When Jacques Polak and I agreed on the subject of my lecture "A New Monetary Order for Europe," I assumed that the parliaments of the member states of the European Community (EC) would ratify the Treaty of Maastricht. After the surprising vote in Denmark the situation presents itself in a new light. Any change of the Treaty of the European Community requires unanimity, which quite obviously does not exist, even after the French "yes" vote.

If one can believe the opinion polls, also in Germany a "yes" vote could not be taken for granted, even if the German Constitution would permit a referendum. The German people—probably the majority—today have even more doubts whether a European Central Bank (ECB) would pursue a policy which was just as successful as that of the Bundesbank and whether a European currency would have the same quality as the deutsche mark enjoys today.

Many people in Germany are embarrassed or at least confused about comments by the French President concerning the agreed independence of an ECB, which is a conditio sine qua non for Germany and which is enshrined in the Maastricht Treaty.

In Great Britain, too, it is at least doubtful whether the Parliament, if the matter comes to a decision, would accept a European currency and a European Central Bank after the failure of Britain's exchange rate policy. At any rate, for the time being the ratification process has come to a halt.

So the former French Finance Minister Edouard Balladur certainly was right when he described the whole exercise of economic and monetary union (EMU) "as somewhat unreal in character." In other words, whether the Maastricht Treaty will be implemented is unclear, to say the least. This is all the more true after the events of last week in the foreign exchange markets. The situation reminds me to an extent of the last days of the Bretton Woods system, which some of us have witnessed. Already at that time a blueprint for EMU existed.

At least like in the Maastricht Treaty, the essentials of monetary union were defined in the Werner Report of 1970:

- Unlimited and irreversible currency convertibility;
- Full liberalization of capital transactions and full integration of banking and financial markets;
- Elimination of fluctuation bands and irrevocable fixing of exchange rates.

Free convertibility among the then six Community currencies, irrevocable fixing of their exchange rates with one another, centralization of monetary and budgetary policies at Community level, a common external monetary policy, complete integration of the members' financial markets, and the adoption of regional policies were all parts of a program laid down in the Werner plan. The plan proved to be far too ambitious at the time. It never got off the ground, because events causing the breakdown of the Bretton Woods system (and other reasons) threw a spanner into the wheels, and today a collapse of the European Monetary System (EMS) could destroy the effort for creating an EMU in Europe.

The traumatic experience of the Bretton Woods system guided the Bundesbank when the EMS was established. Under the Bretton Woods rules, central banks had to purchase unlimited amounts of U.S. dollars when the intervention point was reached, which more and more undermined the policy of the Bundesbank. Changes in exchange rates were very difficult and took place only under dramatic circumstances (remember Smithsonian!). Finally, the system collapsed because the Bundesbank and other central banks were no longer ready to purchase unlimited amounts of U.S. dollars, which in fact undermined monetary policy and paved the way for the inflation of the 1970s.

So, when the EMS was established, the Bundesbank insisted that the original idea to center the EMS on the European currency unit (ECU) be abandoned in favor of a grid system; in other words, the system became "asymmetric." The original intention was to provide unlimited and obligatory intervention, financed by reciprocal central bank credit under the very short-term financing mechanism of the EMS agreement. This was to be backed up by substantial short- and medium-term credit facilities. Instead, it was resolved that asset settlement had to be in "hard currency" and in a relatively short period of time. This solution provided the necessary discipline of the system.

But even under the rules of the EMS interventions can reach orders of magnitude which are not only unbearable for the debtor country but could undercut the ability to pursue a monetary policy aimed at maintaining price stability also in the creditor country. This concern was obviously the reason why the Bundesbank insisted recently on a realignment in the EMS.

Looking from the outside and without knowing all the details one is tempted to say: This currency crisis was not very well managed (also very much like in 1973). I am convinced that a meeting of finance ministers and central bank governors last weekend could have reached an agreement which would have calmed the markets. Of course, it should have included other currencies than the lira and it should have been accompanied by a substantial cut in German interest rates. Instead, governments and central banks tried again to take on the markets. They should have learned that you cannot stop an avalanche. As long as we do not have a full monetary union, changes in exchange rates are unavoidable and even desirable from time to time.

In its early years, the EMS was exposed to exchange rate crises at approximately nine month intervals. It often proved extremely difficult to agree on the terms of a central rate realignment in order to deal with emerging imbalances and market tensions. Indeed, the EMS was at risk to fail just like its predecessor, the "snake," until France decided in 1983 to drastically reorient its economic policies to achieve overall economic balance and monetary stability. France became willing to accept the inherent logic of a fixed rate system which was quite in line with its long-standing preference and to abandon some of the glaring contradictions in its actual application. This eliminated the potentially most serious threat to the exchange rate mechanism (ERM) of the EMS. It prepared the ground for full participation of other Community members which did not enter the exchange rate mechanism from the start or opted for the wider 6 percent fluctuation band and even the de facto participation of non-Community members like Austria, Sweden, Norway, and Finland. This certainly made it easier for Germany to welcome the newcomers. France's change of mind also promised to strengthen the core group of stability minded partners, which without France consisted only of Germany and the Netherlands, with Belgium and Denmark slowly working their way into that group. But recent developments have drastically demonstrated that such a "zone of monetary stability" is only sustainable if economic fundamentals in the participating countries are highly convergent.

This was obviously not the case and—this is the only good news—some imbalances were corrected to a certain extent by the markets.

One should not put all the blame on the Bundesbank. I think it is generally acknowledged that the (in my view unnecessary) referendum in France caused uncertainty. It is also undeniable that the United Kingdom joined the ERM with the wrong rate at the wrong time. I said that two years ago. And, no doubt, Italy's decision to join the narrow band was very ambitious. In the light of the budget situation and the political crisis this was not sustainable, even with a central bank as tough as the Banca d'Italia. It is to be hoped that Italy will use the crisis to take the necessary measures.

One of the deeper reasons for the recent turmoil, I have to admit, is the economic consequences of German unification. It may have strengthened the political case for European integration; it has, however, made it more difficult in economic and monetary terms. To be fair, one has to admit that German unification has been very beneficial not only for west German businesses but for exporters in other countries as well, particularly in Europe. The demand push from the financing of German unification (huge deficit spending, a very generous conversion rate for east German savings, and so forth) has led to a strong increase in imports and a dramatic swing in the German balance of payments position without which, I am sure, Europe would have slid into a recession like the United States and other countries.

On the other hand, the enormous transfer of resources from west to east Germany—almost 5 percent of west German GDP eventually, wage settlements which by far exceeded the increase of productivity, and the unwillingness of the west German people to accept the economic consequences of unification have led to a deterioration of Germany's economic, financial, and political stability.

I have every confidence in the determination of the Bundesbank to correct undesirable developments by means of a tight monetary policy, as has been demonstrated. But a wrong policy mix and as a consequence extremely high interest rates can lead, and have already led, to a slowdown in economic growth, and the risk of a recession cannot be excluded. As experience from other countries shows, monetary policy can be overburdened and can correct policy deficiencies in other areas, only at a very high price, if at all. For the process of European integration, it is of crucial importance that Germany get its house in order.

Recent developments in the financial markets have demonstrated drastically that there is no substitute for the deutsche mark as the main European reserve and intervention currency, at least for the time being. It is an illusion to believe that the ECU could play this role in the foreseeable future. Even a future single currency will not automatically inherit the deutsche mark's role as the second most important international currency after the U.S. dollar for private investment portfolios and central bank reserves. A European Central Bank will have to gain the necessary credibility not only inside the Community but also outside. It will have to silence fears it will pursue an easier monetary policy, with lower interest rates when the Bundesbank would have refused to make this concession. If it does not succeed, international investors will quickly decide to move their funds into other currencies. (It would indeed be interesting to speculate what kind of policy an ECB would pursue under present circumstances. I think it is rather unlikely that it would focus on the internal German problems as much as the Bundesbank does.)

German unification has also substantially reduced Germany's ability to provide huge financial resources for the special funds set up for the poorer or less competitive members of the EC. Germany is by far the largest net contributor to the EC budget. This role can hardly be increased because of the need to transfer additional resources to east Germany. But it is at the same time crucial for the participation of poorer EC countries in EMU.

What should be done when the dust has settled? Actually, in my view, we do not have many options. A decoupling of European currencies from the deutsche mark as in the 1970s (with some exceptions of smaller countries) is no solution. It will not give the national governments the kind of freedom in fiscal and monetary policy they would like. European economies are already too much integrated for that. Benign neglect of the exchange rates may work to a certain extent between trading areas such as the United States and Europe. In Europe it could lead to a vicious circle of depreciation and inflation as we saw in the 1970s (all in one boat). And it would mean that we would give up many of the achievements of the EMS which we have enjoyed over the last ten years or so. In fact, Europe has come already very close to a kind of "quasi monetary union," more than people are aware of.

By quasi monetary union I want to describe a state of affairs with near-fixed exchange rates between the participants' currencies, liberalized money and capital markets, and de facto acceptance of an identical monetary policy by all participants as the inescapable consequence. Of course, today exchange rates in the ERM are not irreversibly fixed, since there are fluctuation bands within which rates can move, and realignments and even a temporary "opting out" as we have seen still remain an option in extreme situations. And key central bank interest rates and other monetary instrument variables are not identical as they would be under a single monetary policy and irreversibly fixed exchange rates. In particular, the fact that monetary policy in the Community is dominated by one national central bank rather than by a Community central bank underlines that full monetary union does not exist as yet.

However, for a growing number of Community countries—but also for others outside the EC and the EMS—formal adherence to or unofficial participation in the EMS mechanism amounted to open admission that the constraint of tying their currency to the deutsche mark offered greater chances of success in achieving price stability than insistence on the last vestiges of monetary autonomy in a world of closely integrated financial markets. For most countries which participate in the exchange rate mechanism of the EMS it has paid off to borrow the Bundesbank's credibility as a successful guardian of price stability. As a result, the Community as a whole has gone through an impressive process of greater convergence of inflation rates at substantially reduced levels, as well as a narrowing of interest rate differentials until recently.

Without this achievement the decision could not have been taken to move forward rapidly on the road to EMU. Indeed, success in achieving price stability in the Community (or among the participants of the exchange rate mechanism) was likely to increase pressure to introduce institutional changes in the EMS which would meet other partners' desire to share responsibility for the Community's monetary policy, rather than to leave decisions solely to one central bank.

In these circumstances, the decision to establish the institutional framework for a common monetary policy was a logical step. There seems to be a widely shared view that the institutional arrangements for a future single currency enshrined in the Maastricht Treaty meet the test of a modern monetary constitution. The yardstick commonly applied is the Bundesbank law. It is often pointed out that the statutes of the future European System of Central Banks (ESCB), and of the European Central Bank, match the Bundesbank's statute in the commitment to price stability as the overriding objective of monetary policy and also to independence from political interference. They also match it in the single-minded attention to the essentials of monetary policy and in providing the system with a complete set of instruments required to pursue its tasks. The statutes even exceed the Bundesbank law in other respects, for example, in the outright denial of central bank financing of government deficits or the refusal to grant government bodies preferential access to other sources of financing.

It is true that the Treaty has some shortcomings, at least from the German point of view. It does not, for instance, define price stability in very precise terms; national central bank governors are to be appointed for only five years as a minimum, rather than for eight years as in the case of Executive Board members of the Bundesbank; the rules on exchange rate policy vis-à-vis third countries leave room for ambiguity; and the use of reserve requirements of commercial banks will be subject to the Community's secondary legislation. But these are not points on which the Bundesbank law is tougher or more specific. On balance, as far as the monetary union side of the arrangement is concerned, the Treaty may not be a central banker's dream, but it is not a central banker's nightmare either.

Let me ask a crucial question: Why were the negotiating governments willing to enshrine in the Treaty firm commitments to price stability and central bank independence, backed up by strong elements of self-discipline, particularly in the fiscal area? After all, some of these commitments (for example, central bank independence) strongly contradict the views which some member countries hardly defended up to now at the national level (that is, central bank independence).

One explanation could be that the governors of Community central banks were given a free hand to prepare the ground for the final negotiations in the Intergovernmental Conference on EMU. It was the Committee of Central Bank Governors under my chairmanship which drafted the statute of the ESCB and the ECB without any outside interference by national governments or the EC Commission. But could this really explain the end result? Even if central bank governors could be expected to opt for an ESCB and ECB which were independent and wholeheartedly committed to sound money, would governments have allowed them to have it their way? Surely, something more was at work.

My explanation is that most politicians in power and their electorates have by now come to accept the basic arguments in favor of price stability and against debasement of the currency, and in favor of central bank independence and against political interference. Some may still believe that a quantum of additional growth and employment might justify tolerating an additional dose of inflation. But they could not ignore the statistical evidence which shows such gains to be doubtful and ephemeral, while the negative effects of uncontrolled inflation prove to be all too certain and long-lasting. There also seems to be a greater recognition of the structural and supply-side essentials of permanently higher growth and employment. These considerations combined must have raised governments' readiness to let their central bank governors find the necessary common ground at their own level of competence and to build on it when they negotiated the Treaty in the Intergovernmental Conference.

Germany's partners may also have realized that an agreement was only possible on a design which incorporated key elements of the Bundesbank model, with perhaps minor adaptations. In any case, if Germany was to give up its dominant position and share its monetary anchor role with others, a price had to be paid.

I am optimistic and believe that the basic consensus which I have described still exists, although some doubts may be allowed after what has happened.

So my suggestion is not to give up and blame each other for what went wrong but to pursue a forward strategy. European governments should get together as soon as possible in order to limit the damage which they have allowed to happen. They should tell the markets in a convincing way how they want to operate the economic and monetary system. This should include a strong confirmation that the common market will come into existence as scheduled and that they will stick to the basic principles and agreements of the EMS.

As far as the issue of an ECB and a single currency is concerned, I think it has become very clear that only a multi-speed approach has a chance to be realized, as I have already said some years ago.

EMU is still a realistic and desirable political goal. However, a minimum condition for success, or an insurance against disaster, is that participation should be strictly limited to members which fulfill a number of stringent conditions. They should offer adequate assurance that their inflation rate, their fiscal deficit, and their public debt, quite apart from other relevant factors, will not be a cause of discord and tension from the very outset. A core group could be allowed to move ahead in full confidence of success, while leaving others to join as they meet the necessary entry criteria. This formula was applied in the EMS, though without predetermined criteria for participation.

Recent developments have shown that these conditions cannot be ignored without causing tensions which can finally threaten the existence of the system itself.

On balance, I think, the unexpected crisis of the EC should be seen as an opportunity rather than as the end of the integration process which, I am convinced, is going to continue.

Questions and Answers

Following the formal presentation, Mr. Pöhl answered questions from the audience.

When the markets reopen this week, did you mean to imply that we should immediately start on a multi-tier, or two-tier at least, system, rather than try to get all the currencies back in?

MR. PÖHL: I cannot answer your question, because I don't know what the intentions of the British and the Italian Governments are, but as far as one can see, it's very likely that the EMS will remain a system in which not all member countries of the EC are going to participate.

This is nothing dramatic and nothing new. We have lived in the EMS that way for many years. Until two years ago, Britain was not a member of the ERM, Portugal was not a member, Greece is still not a member, and we have also had countries that had a wider band, such as Italy some years ago.

So this multi-speed approach, if I may call it that, is nothing abnormal. On the contrary, it's just what we have seen in the EMS, and in the EMS it has worked quite well.

Actually, the opting out clause is part of the EMS treaty, and even the Bundesbank, at the beginning, insisted on the right to opt out of the system, in case of a dramatic emergency, which would force the Bundesbank into a situation where inflation was generated and a stability oriented monetary policy was no longer possible.

Otmar Emminger wrote a letter to the Government at that time—it was published, so I can mention it—and the Government confirmed it. Fortunately, we have never been in a situation where we had to use it, but that is part of the system.

The EMS is not a monetary union, it's an exchange rate system. A monetary union, of course, is different. If you have two different groups, or three different groups, in that system, some having a common central bank and others not, well, it causes some problems. I understand that.

On the other hand, it would solve, among many other things, the problem of Denmark, because that could be done in a new treaty, beside the EC treaty. But your question was much narrower, and I don't want to go into the whole subject again.

In connection with your very interesting comments about what might have transpired a weekend ago that could have precluded the events of the past week, you mentioned exchange rate realignments and a somewhat larger interest rate reduction in your own country.

In that context, might you have contemplated, in retrospect, but more importantly in prospect, that the deutsche mark could have been upvalued—revalued—as part of an arrangement of that sort, so as to grease the political skids for some sort of an agreement?

MR. PÖHL: I think there was no reason and there is no reason to revalue the deutsche mark against all currencies. On the contrary, I think it would be really manifest nonsense, because France, for instance, has a lower inflation rate than Germany.

Denmark has a lower inflation rate—the lowest inflation rate in Europe—and a very stable currency. Why should they revalue against the deutsche mark? No reason for that—it makes no sense at all, in my view.

No, that is not what I had in mind. It's a very amateurish remark, of course, from my side, but I think if one would have got together and would have come up on Monday morning, or Sunday evening—better Sunday evening—with a convincing solution, not with this tiny little thing which actually happened, the markets would have been satisfied, and the animal called foreign exchange market would have got its food, and so the markets would have been calm again.

That I think would be very likely, and that is the experience of the past. As I said, we have had nine or ten realignments in the EMS until 1987—and unfortunately it was only a "minisolution," which obviously did not satisfy the markets.

You say that European countries cannot float, because they are too closely integrated, but Canada and the United States are much more closely integrated, yet no one suggests that the Canadian dollar cannot float to the U.S. dollar. Are the North Americans wrong?

MR. PÖHL: I have not said that they cannot float in Europe. Of course they could, but I have said it's no solution. Canada is a different case. I don't want to comment on that, I'm not so familiar with that.

But in Europe, and that is what I wanted to say, if all countries would let their currency float against each other, and that would give them the freedom to pursue policies which are focused only on their national interest—employment, lower interest rates, and what have you—then you immediately have a reaction in the exchange market of that currency, vis-à-vis the deutsche mark, which is the main reserve and intervention currency—the standard, so to speak—and that has immediate consequences for inflation in those countries which are letting their exchange rate go down the drain.

We have seen that in the 1970s. Remember what happened with Italy and Britain in the 1970s, and at that time we were floating. We tried to get the exchange rates together in the so-called snake, but it didn't work. France left the snake twice at that time.

And so I do not want to see a repetition of that experience. I think it was not a very desirable scenario, and I think the EMS has been a much more efficient system. Of course, also with some hardships and some shortcomings, that is for sure.

But it's more appropriate, in my view, and obviously also in the view, I am sure, of practically all European governments, that highly integrated markets, and markets which will integrate more and more in the future—will become one market, a single market—can live better with exchange rates which do not fluctuate too often and too strongly, which are not realigned and changed every six months or so. I'm not ignoring that there are many advantages of floating as well, but I think, on balance, it's better to have a system of cooperation.

I'm wondering what specific changes you would now recommend in the Maastricht agreement, in the light of the events of the last days, and of the important considerations you've put forward in your lecture. Would you, for example, change the rather strict timetable for the achievement of the monetary union? Would you change the definition of the convergence requirements? Are there other changes you would recommend?

MR. PÖHL: No, I think the Maastricht Treaty does not only consist, as you know of course, of the concept of a monetary and economic union, which I think is relatively consistent and well-prepared, and goes very much into details—a concept that is, basically, I think, is right. As I said, the statutes of a European Central Bank, that is like a law.

In comparison to this part, the other elements of the Maastricht Treaty are very vague, and I think it was a mistake to link these different things—very heterogenous things—together. One should have concentrated on the statutes of a European Central Bank, and maybe on the criteria for membership in such a central bank system.

My suggestion would be to forget about Maastricht, and to draft a new treaty, only for a European Central Bank and the European currency, which would be very much the same as it is in the Maastricht Treaty, but it would be a treaty only among countries which are ready and able to join such a system.

And if you find a critical mass for that—France, Germany, in particular, of course—you can start that very soon. You don't have to wait until 1999. But if you have to wait for the last ship in the convoy to perform as it is pretended in the entry criteria, the conversion criteria, I think we would never get a European monetary union, or a European currency—neither in five years' nor in ten years' time.

There are many things in the Maastricht Treaty which I don't like, which I would like to forget about—for instance, the provision about so-called industrial policy. It was awful that the German Government could subscribe to such a provision, which is only another word for planning—"planification" you could also say, because it was a French request to get that in.

And that is not all—when you make a compromise, you have to compromise on many other things, so I could give you more examples of things that are in that treaty which we should better forget about.

What role, if any, can or should the United States play in the reconstitution of the European Monetary System?

MR. PÖHL: I don't think that the United States should play a role in that very complicated game. It could make it even more difficult if it would interfere. The United States should concentrate on its own problems, which, as you all know, are big enough. It should think about the dollar and the budget deficit, and I think that's enough for the next president to deal with.

My question really relates to the timetable. You referred before to the events between west and east Germany, and my question really relates to Eastern Europe, and if one looks at the European monetary union, has the timetable of that in any way either been enhanced or possibly delayed because of changed circumstances that we find in Europe today, as opposed to the circumstances when the drafting of the EMU took place?

MR. PÖHL: I think the period of reconsideration and re-evaluation, when it comes, can be used as a chance to think about the future of Europe in a broader sense. Is it really the right concept to think about a political union, which in a sense is also a kind of isolation from others?

I myself would very much prefer a European process of integration which would include more countries, not only former EFTA [European Free Trade Association] countries, like Austria, for instance, and maybe Switzerland, maybe Sweden, Norway, Finland, and also, sooner or later—I hope sooner than later—some countries of the former Eastern bloc, like Hungary or Czechoslovakia, and maybe some others.

I think this is of utmost importance. I think it's even more important than thinking about a European Central Bank, and things like that.

We have to recognize—I didn't talk about that, because I wanted to concentrate on the monetary issues, but I think this is a more important aspect—we have to recognize that with German unification, and the collapse of communism, Europe has moved much more to the east and to the north. This is one aspect.

Germany has become much bigger—16 million people have been added to the EC. This is a country the size of the Netherlands, but this is only the beginning of that process.

And the other thing is, developments in the former Soviet Union are, as you all know, really embarrassing—chaotic, and whatever we are doing here at the World Bank and what have you, will not really solve the problems. They can do that only themselves, if at all.

Things are becoming very embarrassing, and I think it's very much in our interest, particularly, of course, from the German point of view, that we stabilize the eastern border, so to speak, of Europe, which is, as it happens, also the eastern border of Germany, first of all.

So, these are, in my view, using a phrase which was used by Ralph Dahrendorf after the Maastricht Treaty was signed, in an article in the *Financial Times* under the headline, "And Now to the Real Issues." I think the heads of state and government have missed the chance to deal with these real issues in Maastricht.

This is still a very open problem, and we cannot say that we can only talk about a widening of the EC when we have achieved the deepening of the EC—I think this is not a realistic concept.

You emphasized the importance of strict observance of the convergence criteria. One of the convergence criteria is that the fiscal deficit should be less than 3 percent of GDP, which would exclude Germany at the present time, which leaves rather few candidates for EMU right now.

I think that does tell one something important about the state of Europe, that Germany is atypical at the moment, and it has a need, therefore, for atypically high interest rates.

Now, one possible way to resolve that would have been the way that you already rejected, of an appreciation of the deutsche mark. An alternative way, perhaps a more natural one—it's the standard way in the literature—is to think of a widening of the band.

So what would you think of the possibility of a temporary, asymmetrical widening of the band, so that the deutsche mark could go a little higher, and thereby allow the rest of Europe to have lower interest rates, until German unification has been absorbed within the German system?

MR. PÖHL: I don't think that is a realistic solution, that we would widen the band, and then that would give us maybe 2 or 3 percent more room for maneuvering, and then we are again where we are. That's no solution.

The other point you mentioned—the budget deficit and the criteria, there's indeed a certain irony in that, that Germany, which has so much insisted on strict rules—the other country which insisted very much on that was Italy, by the way. (But that was only in the group of central bankers, where my Italian colleague insisted on very strict fiscal discipline. It helps him at home, of course.)

Now that is a delicate point in the case of Germany, because, as you rightly said, Germany now has a huge budget deficit. Depending on how you calculate it, it's between 4 and 6 percent of GDP.

And so, if you take the criteria seriously, Germany couldn't participate in a European monetary union, but that makes no sense, of course—the whole system wouldn't make much sense.

So, the only hope is, of course, that, until 1999 or whenever, the German budget deficit, by some miraculous events, will, if not disappear, at least be reduced to a more consistent level. Indeed, it would be very frightening if we had to expect a deficit of this order of magnitude in Germany for a long period of time.

On the other hand, the situation in east Germany is anything but gratifying, on the contrary. The hope that after a relatively short period of time we would see an upswing in that part of Germany has not become reality so far.

And there is not much probability that it will happen very soon, because what we have all underestimated, including myself, there is not much private investment flowing into east Germany. Wages have gone up by 50 percent, coming closer and closer to west German levels, and that is, of course, not an incentive for private investments.

And so, something could happen—I hope not, but it could happen, what I warned two years ago, I said we have to try to prevent a development in which we create a region which can survive only with lasting, extremely high, subsidies, as we have seen in Berlin.

Before the wall broke, west Berlin was getting DM 22 billion a year in subsidies; otherwise, the city couldn't have lived, and of course east Germany is much bigger, and gets now about DM 180 billion in one or another form of subsidies, transfer payments.

If we cannot change that, then we must be afraid that the budget deficit will remain very, very high, and we have seen, in this country and in other countries, how difficult it is, if you have reached a certain level of budget deficit, to change that—to reduce that. That's very, very difficult.

Germany today has already, I think, the highest tax burden, if you include social security taxes, maybe in the world. I don't think there are many other countries with a higher tax burden today, and all what that means for the long run for competitiveness. That limits the room for higher taxes, but we have an ongoing discussion in Germany every day about new taxes. The politicians have unlimited room for ideas on how to raise even more; all taxes with beautiful names you know—solidarity pact and whatever the names are.

But I think it's an embarrassing and a worrying development, and if you think a little further about that, you cannot take for granted that Germany will always play this so-called anchor role in the European Monetary System, but also in the European economies, which it has played in the past.

Might the recent currency crisis in fact accelerate the introduction of a common European currency, at least between France and Germany, and could this be done by May 1995, for the fiftieth anniversary of the end of the war?

MR. PÖHL: My answer is very short, very simple: My answer is yes. That was my suggestion when I talked about a multi-speed approach. I'm not saying it's very likely to happen, but I think it would be conceivable, and so maybe, as all crises do, this crisis has produced something good: it has given us a reason to rethink the whole issue, and maybe we will come up with a good solution.

Thank you very much.

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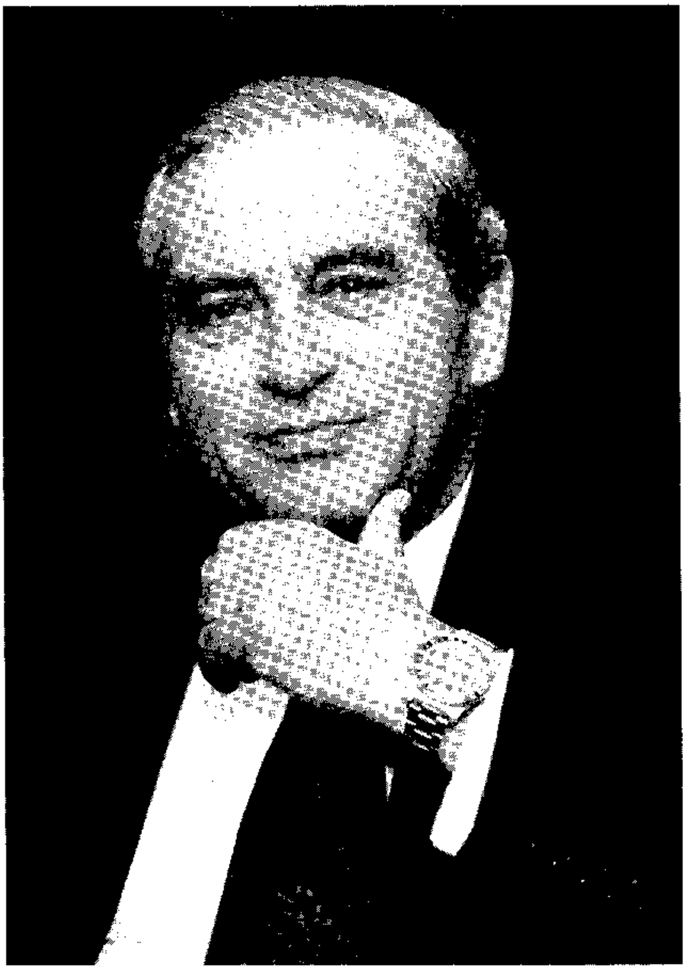
SIR JEREMY MORSE: Well, Karl Otto, many, many thanks to you again. I think you have a wonderful mixture of directness and tact, so that when we agree, it's marvelous to hear you say it, and when we disagree, we take no offense. Frankly, it was the most topical lecture in the Per Jacobsson series for many a long year, and we shall tremendously look forward to reading it.



Karl Otto Pöhl

Biography

Karl Otto Pöhl is partner in Sal. Oppenheim Jr. & Cie., in Frankfurt.

Mr. Pöhl was President of the Deutsche Bundesbank and Chairman of the Central Bank Council during 1980–91. From 1977 to 1979, he served as Deputy President of the Deutsche Bundesbank.

Mr. Pöhl entered government service in 1970, and from 1973 to 1977 he was State Secretary for Monetary Affairs in the Ministry of Finance. Prior to that, he was Member of the Managing Board, Association of German Banks (1968–69), and economic journalist (1961–67). From 1957 to 1960, he was associated with the Ifo Institute for Economic Research.

In the course of his distinguished career, Mr. Pöhl has held several other positions, including Chairman, EEC Monetary Committee (1974–77); Chairman, Group of Ten Central Bank Governors (1983–89); Chairman, EEC Central Bank Governors (1990–91); Governor of the International Monetary Fund for Germany (1980–91); and Member of the Board, Bank for International Settlements (1980–91).

Born in 1929, Mr. Pöhl was educated at Göttingen University, where he received his degree in 1955 (Dipl. Volkswirt). He has also received honorary degrees from Georgetown University (1984); Ruhr University (1985); University of Tel Aviv (1986); University of Maryland (1987); and University of Buckingham (1992).

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