Thirty Years in Central Banking

Erich Hoffmeyer

Group of Thirty, Washington, DC
Occasional Papers
No. 48

Thirty Years in
Central Banking

Erik Hoffmeyer

Published by
Group of Thirty®
Washington, DC
1994
## Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Introduction</td>
<td>1</td>
</tr>
<tr>
<td>II. Thirty Years in Central Banking</td>
<td>3</td>
</tr>
<tr>
<td>The Old Framework</td>
<td>4</td>
</tr>
<tr>
<td>The Transition</td>
<td>4</td>
</tr>
<tr>
<td>The New Framework</td>
<td>5</td>
</tr>
<tr>
<td>Assessment</td>
<td>7</td>
</tr>
<tr>
<td>III. Preparatory Steps Toward Economic and Monetary Union</td>
<td>9</td>
</tr>
<tr>
<td>How did it Happen?</td>
<td>10</td>
</tr>
<tr>
<td>Why Did It Happen?</td>
<td>12</td>
</tr>
<tr>
<td>How Can Cooperation Be Reestablished?</td>
<td>14</td>
</tr>
<tr>
<td>IV. After Maastricht</td>
<td>17</td>
</tr>
<tr>
<td>A Sense of Vision</td>
<td>17</td>
</tr>
<tr>
<td>The Context of EMU</td>
<td>18</td>
</tr>
<tr>
<td>What is the Path Ahead?</td>
<td>19</td>
</tr>
<tr>
<td>The Direction is Clear</td>
<td>21</td>
</tr>
<tr>
<td>V. Economic and Monetary Union and Danish Economic Policy</td>
<td>23</td>
</tr>
<tr>
<td>The Impact of Real Integration on Policy</td>
<td>24</td>
</tr>
<tr>
<td>Instruments of Adjustment</td>
<td>25</td>
</tr>
<tr>
<td>Performance Criteria for Phase One</td>
<td>26</td>
</tr>
<tr>
<td>Criteria for Transition to the Final Stage</td>
<td>27</td>
</tr>
<tr>
<td>VI. Is There Over-Optimism on European Financial Integration?</td>
<td>29</td>
</tr>
<tr>
<td>The Blueprints</td>
<td>30</td>
</tr>
<tr>
<td>Experience with Markets</td>
<td>32</td>
</tr>
<tr>
<td>Experience with Policy Decisions</td>
<td>34</td>
</tr>
<tr>
<td>Conclusions</td>
<td>35</td>
</tr>
<tr>
<td>Group of Thirty Members</td>
<td>37</td>
</tr>
<tr>
<td>Group of Thirty Publications</td>
<td>39</td>
</tr>
</tbody>
</table>
I. Introduction

For its thirty-first plenary in the spring of 1994, the Group of Thirty was invited to Copenhagen by the Danmarks Nationalbank. One of the highpoints of that meeting was a speech given by Governor Hoffmeyer on his experience as a central banker. This is the first of the five speeches which are published here.

For some time, Erik Hoffmeyer has been the senior central bank governor in the world. His experience stretches back to the naïve Keynesianism of the 1960s, the inflations of the 1970s, the short heyday of monetarism and the subsequent rise of central bank independence and price stability as laudstones of monetary policy. And, of course, he has been in a unique position to witness the developments in European monetary integration. He was Chairman of the Committee of Governors of the Central Banks of the Member States of the European Economic Community on three occasions, from March 1975 to April 1976, from December 1979 to the end of 1980, and from September 1991 to the end of 1992. This Committee was the forerunner of the European Monetary Institute, which was established in January, 1994.

The first speech in this volume, given in May 1994, deals with this broad sweep of recent economic history. The subsequent four speeches, all given in the last six years, have been selected to show how Governor Hoffmeyer's thinking on European economic integration has evolved. All five have been edited for publication but, of course, no attempt has been made to modify them in the light of subsequent developments. They are in reverse chronological order.
II. Thirty Years in Central Banking
(Group of Thirty Plenary; Copenhagen, May 6, 1994)

It is a frightening fact that I have been in central banking for thirty
years—in fact more than forty if I include my work as a staff
member. What kind of lessons can be distilled from such long
experience?

It is difficult for me to draw worthwhile conclusions because
my position has made me, to some extent, the prisoner of conventional
wisdom. It would be wonderful if I could break free by yelling like
the boy, Oskar, in Günter Grass' *Tin Drum* or write like one of the
favorite authors of my youth, Voltaire, who so effectively demolished
the hypocrisy and stupidity of the conventional wisdom of his age
in the four days he took to write *Candide*. But I can do neither. So my
tone will be more moderate and less biting.

Let me describe three phases of central banking through which
I have lived:

- The old framework;
- The transition; and
- The new framework.

By “framework,” I mean the frame of reference we have worked
with regarding macroeconomic policy: in particular, the prevailing
policy priorities and institutional assignments of the times.
The Old Framework

A dominant objective of Post-War economic policymakers was that full employment should be achieved and maintained. This was included in national legislation and international treaties like the US Employment Act of 1946 and the Articles of the International Monetary Fund. There was no doubt that our first priority was a high and stable level of employment.

It was generally believed that fiscal policy could be used as a fine-tuning instrument to determine the optimum level of employment. Trade unions would be cooperative in containing costs, while monetary policy should be geared to securing the financing of full employment by keeping interest rates low. Thus monetary policy played a subordinate role and could be used mainly to direct credit for specific purposes.

In those days, it seemed as though a new world had been created where macroeconomic policy was as predictable as mechanics. As a young student, I had met Alvin Hansen, Seymour Harris, and Paul Samuelson who had taught this "science," and as Governor I had the pleasure of meeting the politicians who were their pupils' pupils. Cheap financing was a dogma: you were almost considered a traitor if you doubted it.

I recall that a cabinet member once called me on the phone and complained that long-term interest rates were increasing too fast. I expressed my sympathy, but took it for granted that he would not suggest that the central bank should support the market. He answered that it was not his domain—but the Central Bank Act would be in danger if interest rates continued to increase!

From the early 1960s, however, real pressures and imbalances began to mount. This had already started in the United States in connection with the Korean War, but increased gradually and spread to other nations in the 1960s and the early 1970s. Developments were, of course, not completely parallel in different countries. Due to our weak balance of payments position, Denmark was among the first countries to abandon any commitment regarding long-term interest rates and, in 1969, we also stopped targeting short-term rates. Inflation had started to increase in the late 1960s long before the first oil price increases in 1973 and gradually, throughout that decade, monetary policy was tightened.

The Transition

The next phase was characterized by uncertainty. Politicians were bewildered because inflation, unemployment and interest rates had all increased. Nothing worked. They had thought that macro-economic
policy was a magician's wand, but instead they discovered that the wand was being carried away by the markets. It was a dark time when leaders were groping for consistent policy instruments. There were four major unpleasant facts which they had to come to terms:

- Fiscal stimulus to maintain or increase employment—even in the short-term—had become largely ineffective. In technical terms, the multiplier turned out to be close to one which was much smaller than expected, partly because the income difference between the employed and the unemployed became so small as welfare systems developed.

- Fiscal deficits became very expensive as interest rates increased and made the burden of expansionary policies long-lasting.

- The trade-off between unemployment and inflation proved to be an illusion. Incomes policy was not strong enough to prevent inflation rates ratcheting up.

- Credibility became a problem as markets came to routinely doubt what politicians said.

It was a period in which macroeconomic models lost almost all of their value as policy implementation became a game between policymakers and markets. The reaction pattern of the players was difficult to describe and analyze, and models remained primitive and clearly inadequate. The assumption that economic policymaking was easy to perform had to be abandoned. Increasingly, what was at stake was not the sophistication of the analysis—there wasn't any—but the credibility of the commitment of the authorities to a declared stability-oriented policy.

The old policy prescriptions were attacked on various grounds but most fundamentally for their inability to offer a satisfactory solution to the problem of inflation. Politicians sensed that price stability had become the first priority of the markets and, consequently, of the population at large. This provoked a complete change in our framework.

The New Framework

Today, the approach of fine-tuning has been discarded and medium-term policy targets have been introduced. Fiscal policy has been abandoned as an instrument to determine the level of employment. Monetary policy now has center stage and is expected to determine the development in nominal GDP. Incomes policy has been relegated
to a minor role and, instead, societies seem to have accepted a rather high level of so-called non-inflationary unemployment (NAIRU)—a somewhat apologetic concept.

These are fundamental changes. Roles have been reversed: monetary policy has moved from a subsidiary role supporting employment goals to become the centerpiece of macroeconomic policy. Today, many take the view that independent central banks are better and more reliable policymakers with respect to medium-term policy strategies than governments, who are thought to have shorter time horizons.

But I am not so sure we central bankers know enough to do the job expected of us. From my days as a university teacher, I remember our uneasiness about how the transmission mechanism worked; that is, the relationship between primary money and money supply (the various Ms) and between money supply, the price level and nominal GDP.

From our central banks, we have all developed close working relationships with academics, and in our own staffs we all have access to equally capable economists. Nevertheless, I am afraid that I do not feel that I know much more about the transmission mechanism than I did 30 years ago, in spite of the proliferation of elasticities and correlation coefficients. Neither am I sure about the time-path nor about the direction of causation. Even the Bundesbank can be astonished at the development in money supply!

I am skeptical about the validity of the many new models based on refined definitions of money supply. I am not inclined to accept the policy advice that is often presented with so much sophistication and with so few reservations by academic economists. I suspect that they are trying to act as the priesthood of spurious quantification and that is not a religion to which I will ever belong.

I am also uneasy about the analyses of the relationship between central bank independence and price stability. Independence cannot be calculated like a price or a production index. Ordinary indices are based on market values and we all know that, even in that context, an ideal index does not exist. Independence is a radically more difficult thing to measure. There are many interrelated dimensions, and there is no reference system, except the researcher's subjective judgement. And yet researchers have tried to create indices of independence and apply them the most advanced statistical techniques. One recent study concludes that I—having had my job for 30 years—must have been subservient to successive Danish governments. The fact is that, in reality, I could not be dismissed!
Whatever the difficulties of knowing what the transmission mechanism is or in assessing the independence of central banks, I must come out in favor of the proposition that independent central banks reduce the risk of excessive monetary expansion. But I would let that stand as a judgement, and not assert it was an empirically proven fact.

Assessment

I have tried to illustrate how conventional wisdom during the first phase until, say the beginning of the 1970s, was based on assumptions that did not work. The attraction of fine-tuning full employment with fiscal policy at the center was a mirage, a dream. Then came the transition during the upheavals of the 1970s, which paved the way for the new framework, the new conventional wisdom that assigns such enormous importance to monetary policy. This framework is—to my mind—also based on a shaky foundation.

Of course, I do not deny that monetary policy has an important role to play, but it has to be judged in a wider setting.

Monetary policy operates in a universe of continuous interaction with a variety of different policy interests—the cabinet, government agencies, trade unions and the like. These institutional arrangements cannot be described in simple economic terms.

However, I can illuminate them with a favorite story of mine. In 1977, there was a big party to honor Karl Klasen who retired as President of the Bundesbank. Helmut Schmidt, the Chancellor, gave a speech in honor of Mr. Klasen and finished by stating, that if an Oscar—not a Günther Grass Oskar, but a Hollywood Oscar—for German stability had to be presented, Mr. Klasen deserved it. Responsibility for German price stability was handed from the government to the central bank, which was fair enough, even though Helmut Schmidt might later on have had second thoughts. Mr. Klasen responded that in all fairness, however, he would pass the Oscar on to Mr. Vetter, the leader of the trade unions. Mr. Vetter, sitting just opposite to me, seemed somewhat embarrassed to be commended by the central bank. I asked him: “Who should commend whom?” But I did not receive an answer.

In some ways, the change in the attitude of the majority of ordinary people about inflation has been the most important change during my period in office. It is a point that is often neglected in the debate. Let me cite Otmar Emminger’s memoirs where he makes a
reference to a remark by Paul Volcker, when he expressed envy about the stability consciousness of the German population and thus of their confidence in the Bundesbank. Paul's remarks lead to the question, to what extent is monetary policy a sign of stability rather than the cause of stability?

I am not able to determine for sure where the Oscar should go, but I do know that I would hesitate to receive it!
III. Preparatory Steps Toward Economic and Monetary Union

(European Currency Conference, the European Parliament; Strasbourg, September 15, 1993)

I am indeed honored to be asked to address this most distinguished “European Currency Conference”—even though I could imagine circumstances more favorable to this particular topic.

I want to talk about exchange rate bands. These have been central to the idea of European monetary cooperation for a good while. In fact, a European preference for a narrow, fixed exchange-rate system goes back as far as 1958. In that year the European Monetary Agreement adopted narrower margins than those prescribed by the IMF system, and in 1972, the narrow 2 1/2 percent margins became the cornerstone of EC monetary cooperation, although there have been periods—particularly in the middle of the 1970s—when it seemed that these margins were honored more in the breach than their observance.

This fundamental building block for EC monetary cooperation was destroyed during the night of August 1st this summer. It was then, following the attack on the French Franc and other currencies, that decisions were taken to broaden the ranges dramatically.

Now it is natural to ask three questions:

• How did it happen?
• Why did it happen? and
• How can cooperation be reestablished?
How did it Happen?

It may be useful to outline the most important phases that led up to that fateful August decision.

The first phase lasted until the late spring of 1992, during which the markets were widely convinced that EC monetary cooperation was steadily growing more effective. More and more member countries joined the exchange-rate mechanism (ERM) and non-members associated themselves on a unilateral basis with the system. The Maastricht Treaty was signed early in 1992, and it was expected by many that the path toward Economic and Monetary Union (EMU) would be a smooth one. This confidence led to a substantial increase in capital flows to the weaker EMS currencies, since the attraction exerted by the higher interest rates their official paper offered was not offset by any caution about possible devaluation. Little attention was paid to the development of economic fundamentals. Exchange rate parities had held since 1987 and were generally expected to continue to hold indefinitely.

Widespread but transient optimism is not a new phenomenon. History provides many examples of markets advancing too far and then reversing abruptly. Just recall the debt crisis panic of 1982 following excessive bank lending to developing countries in the 1970s and early 1980s, and the enormous increases in land and asset prices later in the 1980s in several industrial countries.

With the markets so benign at the beginning of the year, the ERM authorities were inclined to believe that there was ample time to undertake the adjustments needed to meet the EMU conditions. Late in the spring of 1992, the markets did react to poor Italian economic performance and some uncertainty developed around the lira. But on the whole, market participants kept faith in the system.

The second phase started in the summer of 1992. Adverse political reactions to the Maastricht Treaty in Denmark, France, Germany and the United Kingdom led increasing numbers of market participants to reconsider the outlook for EMU. The markets became sensitive to even quite small differences in national economic performance, recognizing that, where they persisted, these could create powerful strains among exchange rates. Increasingly, it became obvious that basic economic performance differences did indeed exist between the United Kingdom and Italy on the one hand, and the rest of the ERM on the other. So it was not altogether a surprise when, that September, an explosion of trading caused the Mechanism to disintegrate. The lira and the pound floated. Finland and later
Sweden and Norway suspended their ECU pegs. A series of devaluations, with some currencies devaluing two or even three times, resulted.

That was a serious setback, made worse by overshooting. The September turmoil led market participants to be too pessimistic about the stability of the system as a whole. So several countries accepted an excessive depreciation of their currencies.

The so-called "core" currencies were, however, protected. A joint German-French statement issued on September 23rd was instrumental in calming the markets. This was an innovative way to express concerted resolve and the markets took note. The statement said that:

...in view of developments in foreign-exchange markets, the governments and the central banks of France and Germany have surveyed the data on their economies. They came to the conclusion that current exchange rates between their currencies correctly reflect the underlying situation of their economies and that a change of these rates is not justified. They will act in accordance with the rules of the EMS.

This statement, which was repeated on two later occasions, was taken as evidence of a strong commitment by France and Germany to the Deutschmark/French Franc exchange rate. Even if it would take time to restore reasonable confidence in the system as a whole, the fundamentals in the two core countries were close to meeting the Maastricht conditions of convergence. And it was generally thought that France and Germany could, and would, defend their bilateral exchange rate with monetary policy changes if necessary.

The third phase started the spring of 1993 when the credibility of the system improved. Interest rates declined outside Germany—both long and short-term—a development that was considered highly desirable, given the sluggishness of economic growth in most of Europe. In some countries, rates even went below the German level—for instance, in France—a development that the Bundesbank welcomed publicly. Both markets and authorities believed that tensions were declining and the situation stabilizing.

Then, in June 1993, there was a dramatic deterioration in market sentiment about the French Franc and some other currencies. Market confidence in the determination of authorities to defend the system collapsed. Pressure increased throughout July, which led to the decision announced on August 2nd, to widen margins to ±15 percent.

In effect, this put the exchange-rate system out of operation for the time being. Such wide exchange rate bands are like having no bands at all. The ERM may not be dead, but it is definitely in deep
freeze. The August decision was taken by Germany, who asked for
the meeting, and France, who insisted on wide margins. The other
participants did not agree initially. But, eventually, it became clear
that the choice was between a complete suspension of the system
and its maintenance in this quasi-operative condition, from which
eventual resuscitation might be easier and they fell in behind the
French position.
So much for the chain of events.

Why Did It Happen?
When any cooperative system breaks down, the first question to ask
is whether there is something wrong with its rules. In this case, the
ERM rules in question dealt with intervention and other policy
responses to exchange rates pressures. They are codified in the so-
called Basle-Nyborg Agreement which calls on the European national
monetary authorities to cooperate actively and flexibly using three
instruments: interest rate changes; exchange rate movements within
the band; and intervention in the markets. In addition, there are
rules on the repayment of currencies when one central bank has
borrowed from another for intervention purposes. Only when exchange
rates are out of line with fundamentals and corrective domestic
policy action cannot be taken, is recourse to parity rate changes
allowed.

These rules were discussed in many different forums even before the exchange rate crises of the last two years. Did they
adequately reflect the realities of domestic political interests? Should they be modified in any way to strengthen the stability of the
system? While questions like these were raised and discussed,
generally speaking, these rules stood up to scrutiny very well and,
since the crises, I think they still have. The conclusion to most of
these discussions—with which I agree—has been that the rules are
well designed and that significant technical improvements are not
really needed.

A second possible explanation of the breakdown is inherent
market instability. Certainly, capital flows have increased enormously
in recent years and the capacity of markets to create pressure on
currencies has expanded correspondingly. Could disruptive currency
transactions be reduced in force or frequency or prevented altogether
by controls or taxes of some kind?

Under present circumstances, I would judge that such measures
would not work. Besides, it would be a mistake to assume that
markets are dominated by speculators or gamblers. Such people
enjoy media attention when they win, but we do not hear anything
from them when they loose. It is not easy to identify that small
group of market participants who have an interest in market instability
and, moreover, they are not strong enough by themselves to damage
the system.

The real strength of the market resides in the vast number of
participants that, as changes in exchange rates become imminent,
take action to hedge themselves. Most of them are portfolio managers
investing internationally, and corporations buying and selling goods
and services across borders. They act on behalf of all segments of
our societies, including households. They are motivated not only by
economic fundamentals but also what they expect the market as a
whole to do. And for this reason behavior is often dominated by the
"asymmetric hedge effect" that is, for a corporation or fund manager,
it is often better to pay for hedging than to risk a sudden currency-
related loss, even if hedging was likely to cost more over the long
haul. This effect arises because fund managers and treasurers find
it difficult to evaluate risk accurately and explain losses to their
boards and shareholders.

The wave-like pressure that develops periodically in currency
markets is closely connected with this asymmetry and, as we know,
the resultant flows have on occasion been too big for the authorities
to rebuff. So the inherent instability of markets is an important
factor, but it does not arise in a vacuum. Market expectations are
heavily influenced by the behavior of the monetary authorities
concerned.

The third possible explanation of the collapse in the ERM
hinges on this point, focusing not so much on the roles themselves
as on the determination of authorities and the way in which they
expressed it to the markets.

Much has been said about the behavior of authorities during the
1992 and 1993 crises and it is tempting to blame one period of
indecisiveness or, say, a Bundesbank decision reducing interest
rates too little, or a French decision to raise them too late. But such
an explanation is superficial to say the least. If uncertainty had been
low—that is, if the credibility of the system had been high—the risk
of triggering a wave of speculation would have been small. But
uncertainty was high and credibility was low, despite the fact that
there was a genuine political desire to defend the system, and
policies basically conformed to the Basle-Nyborg codex. In those
circumstances, any incident would have triggered the speculative
waves of September 1992 or July 1993.

That leads us to the fundamental issue, of why the general level
of uncertainty has fluctuated so much. This is a difficult subject. The
analysis of expectations has generally been unsuccessful in economics,
and I have no special approach to suggest. Expectations are influenced by so many elements, and measurement poses enormous problems. During these two crises it seems that, in the end, the markets were not convinced that the authorities were willing and able to defend the system—and, as it turned out, they were right. Uncertainty gradually permeated the expectations of market participants. It was fed by a multiplicity of events and grew to overwhelming proportions. It was, however, impossible to predict the timing and strength of the eventual pressure on the markets.

I am sorry to have to admit that it does not seem possible to analyze the role of expectations with any rigor—a rather unsatisfactory conclusion.

How Can Cooperation Be Reestablished?
After the defeat in August, it is not surprising that the defenders have lost their breath. So much political capital was invested in the system, both as an instrument of cohesion in Europe and as a stepping stone to Economic and Monetary Union. Now we have to consider possible ways to reestablish monetary coordination in a fixed-rate system.

During the turbulent period since the summer of 1992, there were two underlying problems: the divergent course of recession in different member states; and the conflict between German monetary policy and its intervention obligations.

The unification of Germany created boom conditions there with inflationary pressures building up, while France and the smaller countries in the ERM were heading for a recession. Domestic policy priorities were therefore quite different with Germany needing to restrict aggregate demand while the other member countries wanted to adopt more stimulative policies.

But by the fall of 1992 it was becoming apparent that this conflict of interests was only temporary, because Germany was heading for a recession too. It too began to relax monetary policy. Today, prospects for development in economic activity are almost parallel in Germany and France and in the other core countries. From that point of view, the obstacles to a return to the system have diminished.

But the other barrier to reestablishing it—the internal German conflict between monetary policy and intervention obligations—remains a factor. The DM is still the anchor currency and intervention has a strong tendency to create DM by foreign drawings on the Bundesbank. This is unavoidable under present circumstances, but there are two ways we could change the rules which would help.
First, by letting member central banks accumulate reserves in DM acquired from the market. Intervention by using such deposits does not affect German money supply in a dangerous way.

Second, by tightening up the settlement rules. If debtor central banks settle their intervention debts with the Bundesbank quickly and in DM the monetary policy impact of DM-intervention must be negligible.

To sum up, the basic rules of the monetary system are sound. The crises of 1992 and 1993 owe a great deal to the build-up of negative sentiment in the markets, which itself was the product of many different factors. At the moment, with wide bands, the system is dormant. With some technical reforms, it could be resuscitated. All that is needed is the genuine political will to return to close economic cooperation within what has been, for the better part of twenty years, a very effective exchange rate system.
IV. After Maastricht
(International Banking Congress; Frankfurt, May 18, 1992)

I welcome this opportunity to address such an expert audience in the financial center of Germany and to do so on a topic that has been so important for all Europeans.

Sometimes it is difficult to keep our sense of perspective when coping with the distractions and tensions of daily life. Events pass us like the countryside seen from a rapid train, each demanding our attention for a moment, and it is hard to keep our long-term view in focus. And yet, to make sense of a subject as broad as mine today, a sense of vision is needed. For this reason, I have decided to start with a brief account of how my own vision has developed, and that really stems from my experiences during the Second World War.

A Sense of Vision
When I was young, my country was occupied by Germany. I had to spend the last year of the war as a refugee in neighboring Sweden. I remember vividly how during that time we were deeply engaged in debates on how to change European behavior so as to prevent European nations from marching against each other with weapons in hand. During the post-war period, there were many plans that were intended to encourage the peoples of Europe to work together in harmony. The decisive breakthrough came with the formation of the European Coal and Steel Community which was later expanded to become the European Economic Community.

It has been a genuine relief to all of us that our energies can now be turned towards building a European system that is based on
cooperation, mutual respect and understanding instead of animosity, suspicion and rearmament. We have replaced the defensive objective of the Coal and Steel Community—namely to prevent war in Europe—with a constructive one of building up an integrated Europe. Such changes are quite rare in history.

It is of crucial importance to keep this perspective in mind when evaluating the Maastricht Treaty and the ensuing debate.

The Context of EMU

These constructive efforts to integrate Europe have advanced on two parallel tracks. The first has been the integration of European politics and of the real economy. Gradually and pragmatically, we have moved forward to the point where today we can move freely in Europe, and goods, services, and capital can cross European borders largely unimpeded, to our mutual advantage.

The second track has been Economic and Monetary Union—a most ambitious undertaking. It started with the Werner Plan of 1970. That called for both monetary and fiscal policy to be centralized in Community bodies. Although it was abandoned soon after it was formulated as too ambitious for the times, the plan marked the beginning of the effort to unify European policymaking. It undoubtedly contributed to the formulation of the European exchange rate systems, starting with the so-called "Snake" of 1972 and continuing with the European Monetary System. And then its broader approach was taken up again when the Delors Committee produced a plan for economic and monetary union that came to form the basis of the Maastricht Treaty.

However, there are two ways in which the Maastricht model deviates considerably from previous thinking: the weight that is placed on so-called stability-oriented economic policy; and the subsidiarity principle.

It is often argued that a stability-oriented economic policy is a condition imposed by Germany on other Community members for joining Economic and Monetary Union. It is true that Germany has an especially good record of stability—at any rate, until now—and that Germany is not willing to be a part of Economic and Monetary Union if that might put its stability at risk. The performance conditions in the Treaty reflect German caution on this issue.

But it would be misleading to represent this as a German dictate. Support for an emphasis on stability was widespread within the Community in recent years and came from the change in attitudes in many countries following the stagnation and inflation of the late 1970s and early 1980s. Today, no sensible government would consider
it a burden to pursue a stability-oriented policy that so obviously serves long-term national interests.

In Denmark, we chose such a policy from the beginning of the 1980s. Previously, the Danish economy was hamstrung by huge internal and external imbalances. Economic performance improved considerably and, by the early 1990s, Denmark was in full compliance with the Maastricht convergence criteria. That change in Danish policy, like the change in France a little later, was a national decision that was not in any way imposed by other members of the European Monetary System.

Experience has shown us that the advantages of stability are substantial. Now we are in a position to realize higher than average growth without giving up stability. Since our adoption of a stability-oriented policy, we averaged economic growth rates equal to the other OECD-countries in Europe. Critics of the Maastricht Treaty cannot argue convincingly that economic stability influences growth negatively.

What is the Path Ahead?

There is, however, a legitimate question about the way in which stability conditions can be met. There are two schools of thought. One prefers to fix dates at the outset for each step in the entire process of convergence toward EMU; the other would like to see the conditions fulfilled at each step before embarking on the next step. In the debates since the Delors Committee was established, I have taken the latter position like the Germans and some other countries. It is well known that France, Italy, and others have taken the first view. The Maastricht Treaty is a compromise between the two schools of thought in the sense that reference is made both to fixed dates and to obligations to abide by certain convergence criteria.

What will happen in 1999 if the performance criteria are not fulfilled by a number of countries? Will the date or the criteria prevail? I think the criteria will. The political commitment to EMU must be present and must be apparent in economic performance. Otherwise, union will not work and I cannot imagine that Germany will enter a system if the fundamental conditions are not fulfilled by all the participants.

The second place where the Maastricht Treaty deviates from the old Werner Plan is in fiscal policy, which is governed in the Treaty by the notion of subsidiarity. The Werner Plan prescribed centralized decisionmaking for both monetary and fiscal policy, but the Maastricht Treaty contains rules regarding centralization for monetary policy only. National parliaments retain authority over
fiscal policy. The Treaty specifies that as much as possible shall be determined at the national level, provided there are no adverse repercussions on the cohesion and functioning of the EMU.

In Goethe's native town, I cannot resist the temptation to quote Mephistopheles. Asked for "meaningful concepts," Mephistopheles said, just stick to words, words that have the power to destroy or create even when they are not properly defined or understood. For I am not sure how well thought out the word "subsidiarity" is. Still, it may prove possible to create a viable system for formulating fiscal policy within the EC on the basis of "subsidiarity."

As you know, according to the Maastricht Treaty, there will be a single European monetary policy handled by the European Central Bank, but fiscal policy will continue to be conducted by 12 separate national administrations. Monetary policy will, so to speak, operate without a clear counterpart. On various occasions, I have argued that this counterpart problem may represent difficulties, if fiscal policies are not effectively coordinated.

Presently, monetary policy at the national level is not formulated in a vacuum, but by an interplay with other policy elements. There is an interaction between monetary policy measures and, for instance, fiscal policy and wage policies. It may not surprise you if I cite German monetary policy today as an example, since it is being shaped very much in response to German fiscal policy and trends in wage formation.

Political priorities are also important in the sense that monetary policy decisions have to take them into account. Most observers recall how stability considerations had to yield somewhat in face of the sudden opportunity of the so-called "wonder from Caucasus" that quite unexpectedly paved the way for German reunification.

In the two areas I have discussed—stability-oriented policy and subsidiarity—the Maastricht Treaty is not entirely perfect. In both cases, it is tainted by the compromises that are the hallmark of any real-world agreement among nations. This imperfection may well account for much of the debate that the Treaty has engendered, since the skeptical and timid can place on the text unfavorable interpretations that can support all manner of adverse outcomes. This is a pity. They lose sight of the basic vision of the document in a welter of minor details.

As I see it, the centerpiece of the Treaty is the formation of EMU and the idea that it should be oriented toward economic stability. That grows out of the core commitments of the present ERM-system. And, as a result, I cannot imagine that any of us will enter the Third Stage of EMU unless the agreed convergence conditions are clearly fulfilled.
The Direction is Clear

We continue to build on the positive experience of the last 25 years. The Maastricht Treaty does not represent a break with this past, but continuity.

In this discussion, I have stressed the political aspects more than I usually do. The economic aspects are important, but they have to be understood in a deeper context. There is no need to go into details of our dismal European political history earlier in this century. Let me just hint at the fate of the Jews as described by André Schwarz-Bart: the atrocities were sometimes so extreme that, according to Hassidic legend, the Creator advanced the clock determining the Day of Judgement by one minute. Or the fate of the defeated, for instance those who at the end of the War travelled from Gdansk to Steiltz, described in Die Bleichrommel.

The politics of Europe since the War has put that and earlier conflicts behind us. For the first time in many centuries, we have developed a vision of a united Europe based on mutual respect among nations. The aim is no longer for one country to dominate another, but to build a prosperous and humane community of democratic European nations.

The Maastricht Treaty should be judged against this background and not by picking over relatively minor problems of interpretation; growing political cohesion will solve them. In time, the vision of European unity embodied in the Maastricht Treaty will prevail.
V. Economic and Monetary Union and Danish Economic Policy
(Copenhagen, May 3, 1990)

It is widely recognized in Denmark that it is an advantage to be a member of the Common Market, for both economic and political reasons. In economic terms, advantages have flowed from the EEC's policy of creating a market for manufactures and general economic policies that share similar attitudes towards EEC. In political terms, it is reassuring to be a member of a group of similar countries that share similar attitudes towards the Common Market.

The notion of economic policy integration—can also be found in that Treaty—and it is about the need to make the legal principles which are the basis of EMU workable and effective. This means economic policy integration that is about the need to make the legal principles which are the basis of EMU workable and effective. This means economic policy integration that is about the need to make the legal principles which are the basis of EMU workable and effective. This means economic policy integration that is about the need to make the legal principles which are the basis of EMU workable and effective.

The instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
- Performance criteria for Phase One:
- Criteria for transition to the final Phase:
- Instruments of adjustment:
- The impact of real integration on policy:
The Impact of Real Integration on Policy

One must first realize what real integration means. According to generally accepted economic theory, integration is fully achieved when goods, services, labor, and capital move freely around a system where allocation and prices are determined in a free market. In such an ideal state, prices of goods as well as wages and interest rates are identical throughout the system. This is the theoretical objective of the Single Market and if it were to be fulfilled, it could be said that a kind of optimum had been reached.

In recent years, tremendous effort has been expended in an attempt to reach this optimum. The Commission deserves credit for this. But cultural, language, and institutional differences remain as lasting obstacles to completely free mobility within the Common Market.

Now, I should note that there is an inverse relationship between mobility and "policy variance". By purpose, I use the expression "policy variance" instead of the unclear and value-loaded concept "policy independence." Policy is a shorthand for variance in economic performance as well as policy—prices, wages, growth and interest rates, as well as policies like those that directly influence the fiscal structure and deficit. The scope for policy variance is reduced if mobility, and thereby real integration, is increased. This is true, of course, both within the Common Market and between Common Market countries and countries outside.

It has taken a long time for European politicians to recognize this inverse relationship and the corollary that real integration necessitates policy convergence. But they have come around to understanding this point, particularly since the beginning of the 1980s when the EMS entered a period of stability. Convergence is now understood to be a necessary precondition for EMU.

Another important consequence of the variance/integration relationship is that, once real integration has proceeded as far as possible, no further real economic advantages can be obtained by, for example, creating new European economic institutions. In other words, if Phase One towards EMU were completely successful in achieving convergence, a transition to the final Phase would not produce further real economic integration. For that reason, the transition to the final Phase may turn out to be primarily a test of political cooperation rather than an important development from the economic policy viewpoint. At least, that is generally what I expect would happen following real convergence and integration in Phase One. But one potentially significant effect of the final Phase
would be to maintain or secure this convergence by creating common institutions and governed by majority decisions.

If the final Phase is ever completed, certainly it will not be a minor achievement; but in the main its value will be to conserve economic benefits that have already materialized.

**Instruments of Adjustment**

Growth rates can differ from one region to another within the same country and this is, of course, also true between neighboring countries. In itself, this does not give rise to great difficulties—provided it does not persist. Serious trouble can arise, however, if the level of costs in one country gets significantly out of line with its main economic partners and those cost differences last for some time.

Then we are confronted with the difficult problem of economic adjustment. One approach is the textbook solution of changing the exchange rate. It might be labelled the "switch-method" since the exchange rate is switched to another level and then relative prices can return to a sustainable relationship. The alternative approach is what has been called "the long steady pull" by which is meant a set of policy adjustments in the high inflation country that reduce the growth of total internal demand until the cost level returns to that of its foreign competitors. It is a basic feature of the plans for EMU that exchange rate adjustment has to be abandoned and, consequently, adjustment is only possible through "the long steady pull."

Is that a loss? The "switch-method" looks so easy—as confession looks so easy for Catholics. The reality, however, is that neither is that simple. Experience suggests that great reliance on exchange rate change creates many problems. It distorts immediately income distribution which gives rise to unrest on the labor market, and it has a destabilizing impact on expectations which in turn places a heavy burden on monetary policy. This is the reason why more and more countries avoid using this instrument.

Denmark is one of these countries. After having experimented with exchange rate changes over several years, we took a firm decision early in the 1980s not to use the instrument. It has paid off and we are now—after difficulties in the middle of the 1980s—pursuing a stability-oriented policy successfully. So I, therefore, think that it is safe to conclude that the economic loss that goes with giving up of maneuvering room on exchange rates is very limited indeed. On the contrary, I consider it an advantage.
Performance Criteria for Phase One

The main task in Phase One towards EMU is convergence of economic performance.

As I have pointed out on other occasions, in Denmark, we have succeeded in formulating a stability-oriented policy, which at present places us in the nucleus of countries within the EMS. Our cost performance is such that price increases are estimated at about 3 percent on an annual basis. Growth is low, but increasing to a level of 2 percent. The persistent balance of payments deficit is still there, but the order of magnitude is only about 1-1/2 percent of GDP.

The public sector deficit is, I am afraid, a little too high, but still manageable—about 1 1/2 percent of GDP. Unemployment is still much too high, but there seems to be general agreement that the best way to reduce unemployment is by structural means—in particular by measures intended to promote education and flexibility in the labor market. With this background, it does not seem difficult for us to enter the various schemes for policy convergence and control envisaged in Phase One.

One exception concerns the structure of taxation in our country. It is so different from that of the other members of the Community that it will take us time to harmonize our tax regime. An important difference is that in most countries, levies are put on production in the firms (the employer contribution) whereas in our country levies are put on goods when they leave the firms. It is not clear to me how the ECOFIN is going to practice surveillance of general economic policy and achieve economic convergence on issues like taxation. But in the monetary policy field, the outlook is more encouraging.

With our support, the Committee of Central Bank Governors embarked on a scheme late summer that is now taking shape. The ideal is simply to establish performance criteria and targets for the participating countries, and by monitoring and discussions to work in common towards improved performance and convergence.

There is broad agreement regarding this procedure. It is a natural extension of the way the Committee of Governors has operated over many years. In essence, the idea is to discuss monetary policy measures before they are adopted or decided by national authorities. Each single central bank governor must be willing to discuss possible measures in his own country and probable consequences for other countries. In the last 12 months, we have achieved much more open and frank discussions within the Committee—not least on the aspects of German unification.

I have stated that at present we have no difficulties in cooperating, but at the same time, I have to admit that it will take a long time
before most countries can achieve the agreed performance criteria I have mentioned. It is a question not of months, but of years for there are long time-lags between decisions to launch stability-oriented economic policies and the results.

Criteria for Transition to the Final Stage

The Delors Report had, as I have often pointed out, several loose ends—a price that had to be paid for the speed of producing the Report and for achieving unanimity.

One loose end is that an obscure Phase Two was introduced where part of the decision-making authority was transferred to a common institution.

I did not feel this made operational sense, but as time passes and Phase Two operates, it may turn out to be workable after all. Phase Two may very well become a period in which common policy measures are negotiated and clearly agreed while decision-making authority is still lodged at the national level. In other words, without any formal transfer of sovereignty, agreement on policy issues will have to be made ex ante. This will constitute a significant development.

Another of the loose ends was how exactly to define the conditions for moving from Phase One to the Final Phase. The devil is in the details.

If we assume that convergence is improving in line with the agreed performance criteria, there is still the sacred moment where individual countries have to hand over large parts of their formal sovereignty. The conditions that have to be fulfilled are likely to be modelled on German priorities and targets, which stem from the fact that Germany has been the most successful European economy over the last 30 years. I can easily imagine some tough conditions:

- Price stability must have overwhelming priority;
- National central banks must be proved to be independent;
- Exchange rates must be irrevocable fixed; and
- Fiscal policy must be under firm control.

I do not think I am exaggerating. And I see problems connected with proving that you robustly and reliably fulfill these conditions. An applicant might easily feel the need for assistance from supernatural forces in order to be able to give a definite proof that the conditions are fulfilled.
Let me make some brief remarks on these four conditions. First, on price stability, consider Germany’s experience. With its awful experience of hyperinflation before World War II as background, it has shown the best performance in Europe over the last 30 years. And yet its inflation reached between 6 and 7 percent in two different periods. Other countries do not have such a record. How many years are necessary for them to prove that they have conquered inflation?

Second, central banks must be independent. But how can this be proved? We have an independent constitution in our country, but rules on credit to the government are unclear. We have an understanding which has worked for more than 15 years, that there must not be central bank financing of the government. Is that enough?

I am afraid that some people will laugh when I come to the third condition of irrevocably fixed exchange rates. I have struggled with the concept with my colleagues from other European countries. I argued that it was meaningless, but I was overruled. And I still think it is impossible to define an irrevocable exchange rate. There is no historical precedent. Nevertheless, it is an important condition.

Finally, we have the problem of firm control over fiscal policy. All of us know that it is impossible to establish clear definitions, but all the same, we have to admit that the problem is serious. Some countries are clearly out of balance and might create great difficulties if they continued with this policy in a unified system.

With all this in mind, the question of speed inevitably appears—a problem that was swept under the carpet in the Delors Report. Do we have to wait for all countries to fulfill the conditions, or should we begin with a nucleus and then recognize or accept a Europe with two or more speeds. If we have to wait for all countries, I can easily imagine that it will take quite some time. If we start with a nucleus, how do we organize the necessary institutional arrangements?

I have, of course, no clear answers to all these questions, but I think that much of the discussion is too unrealistic about the problem of transition, and the realities I have mentioned will appear before long. To sum up, I want to make the following points.

We are interested and fully prepared to promote monetary policy cooperation. It may be more difficult to find constructive means to promote general economic policy convergence. A remodeled Phase Two may develop from negotiations in which policy measures are negotiated ex ante, but without transferring sovereignty formally. And the conditions for moving to the final stage will present far-reaching challenges and probably lead to a Europe with different speeds.
VI. Is There Over-Optimism on European Financial Integration?
(Copenhagen; December 1, 1988)

Let me start by decrying the tendency to debate the current steps toward integration within the Common Market in terms of some overarching vision of the future. Some feel that when they put on the mantle of vision, they acquire a special wisdom superior to the rest of us. They assume that vision is a rare quality—whereas in fact the opposite is actually the case. Vision is in abundant supply, from the coffee table to cabinet desk, but most of it is unrealistic and comes to nothing. Only when strong forces move in the same direction does a visionary’s view of the world materialize. As Bismarck said: “The statesman can do nothing of his own. He has to perceive God’s footsteps through world history and then jump and try to catch the edge of his mantle.”

Occasionally, it seems, we can in fact discern God’s footsteps. Over the last 50 years, we in Europe have witnessed at least two important visions that have succeeded: the Marshall Plan; and the establishment of the Common Market. Both concentrated on economics—although it would be unjust for us not to acknowledge that politics played a part in their conception. They were both highly successful in fostering a market economy, with free choice and fairly efficient production. (It is often overlooked by economists that freedom of choice is an important aspect of welfare. This should be especially apparent since the veil was lifted from the Soviet economy by the present government in that country.)
However, our market economy does not function perfectly and European integration is not completely satisfactory. Its shortcomings include continuing strong tendencies towards increasing protectionism. The vision of a Common Market has not been perfectly realized.

In the political field, reality has also fallen short of the ideal. The Common Market Treaty was meant to create a system where decisions were taken “in common”, but the arrangements through which this should work were not defined and I would submit that this has some connection with the very strong forces of nationalism. Some think that nationalism will gradually diminish or can be greatly reduced by institutional or technical devices. Others are more doubtful.

With this sense of the economic and political limitations to our vision of European integration in mind, I want to consider two subjects under three headings. The subjects are the prospects of further financial market integration and monetary policy decisionmaking. The three headings are:

- The blueprints;
- Experience with markets; and
- Experience with policy decisions.

The Blueprints

The driving forces during the last four years has been the Commission White Book of 1985 and the Cecchini Report of 1988.

The White Book was adopted in the Brussels decision on the Single Act of 1986 which instituted new procedures in the decision-making process of the Common Market. Majority decisionmaking replaced unanimity in many areas that were not considered of in the vital national interest to individual members. The Commission presents proposals for directives to the Council of Ministers. If the Council adopts them, the decision becomes law in all member states. In the financial field, it is expected that banking, insurance and security transaction rules will be harmonized and that this will lead to a more competitive system, lower prices and higher economic growth. The fundamental principles are that the country of origin has responsibility for controlling basic rules on capital requirements, the host country controls market performance, and financial firms should have free access to each others’ markets.
If these changes are indeed to lead to economic benefit, excessive profits in some countries will have to lead to an inflow of cheaper services from other countries, or economies of scale will have to produce larger entities with lower unit costs which will then, hopefully, be passed on to end users of financial services. The analytical material in the Cecchini Report that supports this claim was provided largely by the accounting firm Price Waterhouse, and is based primarily on comparative static analysis. This analysis suggests that there are price differentials—often huge ones—between national markets in financial services.

There is no doubt that the analysis is sober and is stated with appropriate precautions and reservations. However, although the analysis illuminates actual price differences, it does not provide much evidence on two important aspects. The first is the distinction between retail and wholesale transactions. This is important because individuals with connections only to a single branch of a single financial institution have far fewer opportunities for substitution than big firms with a broader range of contacts. The second is the shape of the "penetration curve" or "P-curve" which depicts how the effect of opening up for more competition increases with time. Let me illustrate this with a figure (Exhibit 1).

Exhibit 1. The "P-Curve" for European Banking Integration

\[
\text{Price Ratio} = \frac{p_2}{p_1}
\]
It shows competitive penetration from country i to country j. It is assumed that the price of the service $p_i$ is lower than $p_j$. The opening of frontiers may increase competition and narrow the price differential. National barriers—language, culture, legal systems, etc.—may, however, prevent full equalization of prices. The Cecchini Report does not pay much attention to this aspect. The British experience with the “Big Bang,” which increased competitive possibilities, but did not eliminate price differences, is mentioned but not discussed thoroughly.

The Cecchini Report then assumes that Common Market GDP over a period of few years will increase by more than one percentage point as a result of financial harmonization measures giving free access to all national markets. It argues, however, that foreign exchange rate risk will be a strong barrier to financial integration and that one should therefore work on a second line of policy in order to reach a higher level of integration. This second line is described as economic and monetary union, but the essence of it is really to create a single monetary area, where exchange rate risk is non-existent.

In terms of my diagram, the key questions are how elongated is the graph and how close to unity is the curve of relative prices likely to reach?

**Experience with Markets**

The Price Waterhouse study did not include Danish data which I fully understand. Nevertheless, I will use our own experience with our markets as I presume that these economic forces work in much the same way in small countries as in large.

During the past 20 years, we have gradually liberalized our foreign exchange rules and have, as a matter of fact, recently abolished all remaining restrictions. It has not generally been recognized that a presumably weak currency could take such a step without serious repercussions.

Financial services have been gradually liberalized. In the particular field of banking, there has been freedom of entry for foreign banks since the beginning of the 1970s. Although we have never considered reciprocity rules—and we hope we never will get entangled in that thorny concept—our attitude has been that, if we have liberal rules allowing Danish banks to establish themselves abroad, we should have similarly liberal rules to allow foreign banks to operate in Denmark.
Over the years, foreign banks have established nine branches or subsidiaries in Denmark, operating under exactly the same rules as indigenous banks. Two broad characteristics of their performance stand out. First, they have not been able to win much market share. In fact, after more than 10 years of free entry, their balance sheet is less than one percent of the total, even though Danish interest rate margins are rather high compared with other countries. Although these are partly offset by more services, one would have expected foreign banks to do well. But it has been virtually impossible for them to penetrate the retail market, despite a price discrepancy that should have given them abundant motive and means to establish a major foothold.

The second characteristic of foreign bank performance in Denmark is that their profits have been rather low. Mostly they have had to specialize in services like foreign exchange and securities transactions. They have had to work hard to make profits. German data support this conclusion (Exhibit 2). The profitability of branches of foreign banks is below the average, whereas the banks majority-owned by foreign banks earn a profit in line with the average. Compared to establishment, penetration through take-overs or mergers seems to be more advantageous.

<table>
<thead>
<tr>
<th>Exhibit 2: Profitability of Foreign Banks in Germany (pre-tax profit as a percent of the volume of business)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
</tr>
<tr>
<td>All Banks</td>
</tr>
<tr>
<td>Foreign Branches</td>
</tr>
<tr>
<td>Banks majority-owned by foreigners</td>
</tr>
</tbody>
</table>

Source: Monatsberichte der Deutschen Bundesbank.

There is almost no discussion in the Price Waterhouse study on the optimal size of financial institutions. It is an enormously difficult field and I cannot give a definitive view since the variables are many: leadership, technological economies, market recognition and culture among others. But perhaps the Cecchini Report should have
given some evidence on this point, given the weight that economies of scale and scope play in their arguments for the economic integration.

In our case, in Denmark, penetration into our domestic financial markets has been negligible. Does that mean that I do not believe that competition works? Not at all. For it has worked for many years in the wholesale field. Strong competition has developed between Danish and foreign banks on services to medium-sized and big firms, both regarding foreign exchange transactions and lending arrangements. And rates have gone down as a consequence of liberalization. It is just that this has not affected retail banking services the same way. Perhaps the benefits of increased competition will have to come through existing institutions competing most vigorously rather than through the establishment of new ones, often in markets that are already well developed.

Of course, that does not rule out take-overs as a means of effective foreign penetration of retail banking markets. But this is a strategy which presents its own problems. Let me just note that, in a service field like this, it is not easy to make hostile take-overs work, and the opportunities for friendly acquisitions are few and far between.

To summarize, I have no specific estimate of what I called the P-curve of financial integration, but our own experience with opening our banking market suggests there may be two curves: one which is elongated and unable to come very close to price parity in retail banking; and a second which is more compressed and reaches closer to price equality for wholesale banking. The biggest impact—on wholesale transactions—has already occurred. Penetration into retail transactions will probably be extremely slow, even if take-overs begin to play a significant role.

Experience with Policy Decisions

During the years, I have been fairly close to policymaking in the Common Market and have come to appreciate the need for closer convergence of economic and financial policy. I do not think it is useful to go into detail analyzing how far policy decisions in one country may have been influenced by similar decisions in other countries. It is probably impossible to obtain a clear opinion on that. Certainly, there has been a great increase in frank discussions and exchange of information on economic performance and prospects, but how much impact this has on decision-making in individual countries is hard to say.
One can, however, define four steps on the road to common decisions:

- Exchange of information
- Information before decisions are taken
- Debate before decisions are taken
- Common decisions by majority

These steps apply to both fiscal and monetary policy.

At present, in the Common Market, we are somewhere between the first and second step, in the sense that so-called monitoring is planned to play and increasing role during discussions. But this is comparatively easy. It will be much harder to go one step further and discuss measures before decisions are taken, or to take the final step and leave decisions to the majority.

I have not yet discovered signs that there are strong inclinations to take the final step. It is even doubtful whether the third step can be accomplished in the foreseeable future.

Let us take the concrete example of German growth policy. I reveal no secret when assuming that in Germany the preference for price stability relative to growth is higher than in my country or, say, in Italy. I know that there is no clear trade-off between price stability and growth in principle, but one has to be made in practice. Step four would imply that the German preferences would be partly overruled. And it is difficult for me to imagine that this would be acceptable in Germany where national support for price stability is so deep-rooted. I doubt that it would be politically acceptable.

I have to stress that I am not at all criticizing the Germans. They have a genuine and historically explainable preference which is atypical. In principle, they might compromise on a specific decision if there were discussions before it was taken, but it is far more difficult to conceive of them accepting a system where their preferences could be overruled by the majority on any policy decision that arose.

This is another way of saying that it is hard to imagine that institutions can be established that definitely take over such decisions on a common basis. At any rate one has to try step three seriously before embarking on step four.

Conclusions

Many advocates of Common Market integration hold out the model of the United States as one that Europeans should strive toward.
Personally, I am very much in favor of further European integration, but I have argued that the model we aim for may in fact be different.

In the financial field, a lot of integration has already taken place, and further integration will probably be slow. This is largely due to language and cultural barriers that are still an enormous obstacle to European financial integration. Full economic and monetary union implies that monetary and fiscal policies should be decided in common. This means, for example, that we have to establish a common central bank. Much of the debate concerns the road to this goal and the timing of creating new institutions both in the monetary and the fiscal fields, with the establishment of a common central bank and a common currency.

I have no firm view on the best route. Some propose an embryonic institution that can, over time, develop into a genuine European central bank, whereas others would prefer cooperation between independent national institutions until the time is ripe for jumping to a fully-fledged European institution.

Regarding other aspects of economic policy, my judgement is that we will have to wind our way through further negotiations for a while yet, and a leap to common decisionmaking is not yet in view.

I wish it were possible to move ahead more quickly, but my sense of reality suggests that common decisionmaking is a long way off. While it is a vision that may ultimately be fulfilled, it may not be within the grasp of this generation.
Group of Thirty Members

Rt. Hon. Lord Richardson of Dunrisbourne KG  
Honorary Chairman, Group of Thirty

Mr. Paul Volcker  
Chairman, The Group of Thirty  
Chairman, James D. Wolfensohn Inc.

Dr. Pedro Aspe  
Secretario de Hacienda y Crédito Público, México

Mr. Geoffrey Bell  
Executive Secretary, Group of Thirty  
President, Geoffrey Bell & Company

Sir Roderick Carnegie  
Hubson Carnegie Limited, Australia

Sr. Domingo Cavallo  
Minister of the Economy, Argentina

Mr. E. Gerald Corrigan  
Chairman, International Advisors, Goldman Sachs and Co.

Mr. Richard Debs  
Advisory Director, Morgan Stanley

Sr. Guillermo de la Dehesa  
Consejero Delegado, Banco Pastor

Professor Gerhard Fels  
Director, Institut der Deutschen Wirtschaft

Dr. Jacob A. Frenkel  
Governor, The Bank of Israel

Dr. Wilfried Guth  
Member of the Supervisory Board, Deutsche Bank
Mr. Toshio Gyohten  
Chairman, The Bank of Tokyo

Mr. John Heimann  
Treasurer, Group of Thirty  
Chairman, Global Financial Institutions, Merrill Lynch

Mr. Erik Hoffmeier  
Chairman of the Board of Governors, Danmarks Nationalbank

Professor Peter B. Kenen  
Director, International Finance Section, Department of Economics, Princeton University

Professor Paul Krugman  
Professor of Economics, Massachusetts Institute of Technology

Mr. Yeh Kurossawa  
President, The Industrial Bank of Japan

M. Jacques de Larosière  
President, European Bank for Reconstruction and Development

Mr. Shijuro Ogata  
Senior Advisor, Yamaichi Securities Co., Ltd.

Dr. Sylvia Ostry  
Chairman, Centre for International Studies, The University of Toronto

Dr. Tommaso Padoa-Schioppa  
Deputy Director General, Banca d’Italia

Mr. Rupert Pennant-Rea  
Deputy Governor, Bank of England

Mr. Karl Otto Pühl  
Partner, Sal Oppenheim Jr. & Cie. KGaA

Mr. William Rhodes  
Vice Chairman, Citibank

Sir William Rytie  
Director, Baring Brothers

M. Jean-Claude Trichet  
Le Gouverneur, Banque de France

Mr. Rodney B. Wagner  
Vice Chairman, J. P. Morgan & Co.

Sir David Walker  
Deputy Chairman, Lloyds Bank PLC

Dr. Marina v N. Whitman  
Distinguished Professor of Business Administration and Public Policy, University of Michigan
Group of Thirty Publications since 1988

Reports:

International Macroeconomic Policy Co-ordination
Policy Co-ordination Study Group. 1988

Perestroika: A Sustainable Process for Change
John P. Hardt and Sheila N. Hedin, with commentary by Oleg Bogomolov. 1989

The Risks Facing the World Economy
The Risks Facing the World Economy Study Group. 1991

Financing Eastern Europe
Richard A. Debs, Harvey Shapiro and Charles Taylor. 1991

The Summit Reform Study Group. 1991

Sea Changes in Latin America
Pedro Aspe, Andres Bianchi and Domingo Castillo, with discussion by S.T. Rea and William Rhodes. 1992

EMU After Maastricht
Peter B. Kenen. 1992

39
The William Taylor Memorial Lectures

   E. Gerald Corrigan. 1993

Special Reports:

Clearance and Settlement Systems in the World's Securities Markets
Steering & Working Committee of the Securities Clearance and Settlement Study. 1988

Clearance and Settlement Systems: Status Reports, Spring 1990
Various Authors. 1990

Conference on Clearance and Settlement Systems; London, March 1990: Speeches
Various Authors. 1990

Clearance and Settlement Systems: Status Reports, Year-End 1990
Various Authors. 1991

Clearance and Settlement Systems: Status Reports, Autumn 1992
Various Authors. 1992

Derivatives: Practices and Principle
Global Derivatives Study Group. 1993

Global Derivatives Study Group. 1993

Global Derivatives Study Group. 1993

Occasional Papers:

25. 1992: The External Dimension
    David Henderson. 1989

26. Japan's Savings and External Surplus in the World Economy
    Masaru Yoyotaomi. 1989
27. Reciprocity and the Unification of the European Banking Market
   Douglas Croham, 1989

28. Financial and Monetary Integration in Europe: 1990, 1992 and Beyond
   Tommaso Padoa-Schioppo, 1990

29. Implications of Increasing Corporate Indebtedness for Monetary Policy
   Benjamin M. Friedman, 1990

30. Europe in the Nineties: Problems and Aspirations
    Wilfried Guth, 1990

31. Two Views of German Reunification
    Hans Tietmeyer and Wilfried Guth, 1990

32. Interdependence of Capital Markets and Policy Implications
    Stephen H. Axilrod, 1990

33. Foreign Direct Investment: The Neglected Twin of Trade
    DeAnne Julius, 1993

34. Privatization in Eastern and Central Europe
    Guillermo de la Dehesa, 1991

35. International Trade in Banking Services: A Conceptual Framework
    Sydney J. Key and Hal S. Scott, 1991

36. The Economic Transformation of East Germany: Some Preliminary Lessons
    Gerhard Fieß and Chrus Schmuel, 1991

37. Are Foreign-owned Subsidiaries Good for the United States?
    Raymond Vernon, 1992

38. Why Now? Change and Turmoil in U.S. Banking
    Lawrence J. White, 1992

39. EMU and the Regions
    Guillermo de la Dehesa and Paul Krugman, 1992

40. The New Trade Agenda
    Geza Feketekuty, 1992

41. The Threat of Managed Trade to Transforming Economies
    Sylvan Osty, 1993

41