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Chairman, Citicorp

Karl Otto Pöhl
President, Deutsche Bundesbank

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Questioners: Dennis Weatherstone, Chairman
J.P. Morgan & Co.

Henry Kaufman, President
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Introduction

Chairman Rand V. Araskog

...tremendous turnout for the Economic Club of New York, our 329th meeting in our 83rd year. Tonight our first speaker is the Chairman of Citicorp, Mr. John S. Reed. Citicorp is the largest banking institution in the United States – over $200 billion of assets in 40 different states of the United States and about 90 different countries around the world. John Reed is an unorthodox banker. He was the first to step forward with significant write-offs of Third World debt. He was one of the only CEOs in the country to step up to the marketplace and buy $2 million worth of his corporation's stock.

He has worked in almost all aspects of Citicorp. He's worked on the back room. He's worked on the consumer business, and in 1984, after he was named chairman; he rapidly went into a major acquisition program in several countries in investment banking. He is a former Army member who served in Korea. He's also an unorthodox banker in that he's an engineering graduate from MIT. He got his education in Argentina and he retains a very considerable interest there. (Laughter) Would you please welcome John Reed. (Applause)

John S. Reed

Chairman of Citicorp

Rand, thank you very much. And President Pöhl, ladies and gentlemen, thank you very much for being with us tonight. It's a great pleasure for me to have an occasion to be a part of your program. New York obviously is the home for Citibank and it's fun to see so many friends. And very frankly, it's a great honor for me to appear at the same time as President Pöhl of the Bundesbank who, of course, is one of my many bosses around the world.

Clearly we're here tonight at a time when lots is going on in the world, and I think it captivates the attention of all of us. I've said on prior occasions that from the point of view of the United States, I think it's probably fair to say that World War II ended for us economically in 1973 and probably politically in 1989. I'm not tonight going to talk about the global situation and what, to the United States, I think is a new and quite challenging world. But instead, because of this particular occasion, I'm going to try to make some comments about what Europe looks like – the main body of Europe, Central Europe, the Union of Soviet Socialist Republics and Russia itself – because clearly I think that this is central to some of the changes that captivate us all.

In making these comments, I do so from the point of view of an American banker looking across the ocean at the European continent and at some of the changes taking place. And I thought that it might be worthwhile to share the perspective which I suspect is different than that which might be expressed by a European looking at the same scene. In doing so, I would make the point that I think that this is one of the central issues, understanding what is happening in Europe and responding to it here in the United States. There's no question, but that we are witnessing the unfolding of some very important events.

I would also say that I believe that most of us here in the United States look at these unfolding events in Europe from a variety of points of view and our reaction to these reflect sort of a mixing, if you will, of these different points of view. One is the perspective of the last 40 years – the perspective of a Cold War, the remnants of the Second World War. Secondly, we look at Europe from an historical perspective. To a very large degree, many of the opinions in the United States have been formed by people who come and are culturally from Europe, and we look at Europe from an historical perspective recognizing both the history of the European continent and indeed our own history. And finally, I think that we look at what's happening in Europe from the point of view of current events and current realities. And I think our response to what's going on is a mixture of this Cold War, this historical perspective, and a set of current realities.

Let me touch on some of these different views. Clearly, the last 40 years, our view of what was going on in Europe was dominated by the split, by the Soviet Union, by the Western allies, by the formation of those alliances, by the economic development which clearly has done so much for the body of Europe, for the formation of the European Community. And our inter-relations and our point of view with regard to things European have been heavily influenced by the existence of this Cold War, by the Iron Curtain, by the threat to the mainland of Europe of another war, and by our role in this.

And I think it's fair to say that as we look at what's going on today in Europe, that's not totally behind us. There still is the concern that these changes have taken place very quickly. Few of us understand them. The Soviet Union, to an American, is an opaque society. We do not understand the process by which change takes place. It's difficult to see the institutionalization of change and to try to forecast where things are going. And I think that it's fair to say that from a banker or from an industrial or from a private sector point of view, as you look at opportunities to invest, to participate in Central Europe, or indeed in Russia itself, this question of political risk, of the hangover of the Cold War, the question as to whether there could not be a reversion, I don't think anybody would argue that there could be a reversal. It's not likely that you could imagine a rebuilding of the Berlin Wall, but there certainly could be a change that would not be hospitable to short-term business interests, and I think that that is a reality.

I think from a banker's point of view, if we look at extending credits across, into Central Europe, into some of the emerging economies there, into the Soviet Union, political risk dominates the considerations. And as a banker speaking from the United States, it's very clear from recent history that you cannot count on participating in international flows of capital with any support from our government or indeed any guarantees from our customers who would ask us to help finance plant investment and other things in these countries.

And so you've seen, I think, a tentativeness with regard to the response of American industry to opportunities to invest, and American bankers with regard to opportunities to lend money. And I think that that's likely to continue because of this question with regard to political risk. And I don't argue that that's incorrect.

Historically, we also have a feeling for Europe. And it's interesting that we could sit here this evening and we can talk almost at the turn to the year 2000 and you can look back at a history of Europe that stretches 1,000 years which I think is indeed the time frame that one has to think about in terms of some of the changes taking place. And from the point of view of an American, almost 500 years, which is a long time for us.

What do we see if we look at Europe with that really long cultural perspective? If you look at the world in that long kind of time frame, Europe has been marked by instability. If you compare the evolution of society in Europe to that in Asia, in China, in the Middle East, in India, you will find that the changes, the ups and downs in Europe have been dramatic over the years as contrasted to those other societies that from a social and a geographical point of view have, in fact, been more of a continuum.

And the reason is that there's been tension in Europe and there's tension that still exists and there's tension that we've seen and will see for a while. There's been tension between the notion of a nation state and the notion of a more universal authority – 700, 800 years ago, that authority was the church. After the French Revolution, the Rights of Man, more recently Communism as we've seen it, and attempts to recognize a universal authority that was in contrast with the claims of a nation state for the alliance of the people.

We've seen in Europe the tension between towns, villages, and the state itself, indeed historically between violence and the law, and for many years, for virtually 1,000 years, national balances of powers. Different countries have attempted over this 1,000-year period to find a solution to what might be thought of as anarchy by having one power subdue the rest. And this has been proposed historically over and over in the history of Europe. And we've also had this notion of a universal authority that could somehow overshadow individual states and deprive them of their sovereignty. And indeed, current in the United States, the talk today is the question as to whether some kind of liberal, political market economy isn't that universal authority that will wash away the reality in some way of the nation state. And indeed there is something of that in the kernel of the European Community.

But this tension, this flux between nation states, between towns and villages, and countries themselves, the changing borders and this perpetual motion has been something which for 1,000 years has characterized European society. It probably contributes to the reality that it is indeed the European culture which is the dominant global culture in the world today and has been the richest, the most productive, but not necessarily the most stable. And we're seeing a continuation of that, and as we look to Europe, in some vague way we remember our history and some of those tensions and some of those realities are translated into our understanding of what's going on today.

In America, in much of America, much of the opinion making in America, was formed by people who exited Europe as a part of some of these fluxes – the conflict between church and state, the conflict between states. In America, there's been a tendency and a history of isolationism. The people who came here said in many different voices, in many different times, that we wanted to withdraw in one way or another from these conflicts in Europe, from the changes, and build a different type of society. Obviously this is more characteristic of North America and indeed of the United States – the continent as a whole – but America has evolved as an isolated society. And as we respond to this post-World War II era and set of realities in Europe, we still see some of these trends in the American response.

There is, in this country, some feeling that says, hey, we do not understand what is happening today in this conflict, this liberation of human spirit, liberation of national spirit, and this change that is sweeping across central Europe and indeed Russia and the Union of Soviet Socialist Republics. And there is some feeling that we shouldn't necessarily understand to the same degree that a German or a French would be a part of that.

And I think that that is a part of the response that you see to these changes. But there's a final reality, and that is in this century – the century in which we live – twice, the United States has intervened in the balance of power, in the affairs of Europe, and probably in a decided way in the sense that it changed European history.

And this speaks not to the politics of that intervention, but it speaks to the linkage that exists globally. None of us live in individual continents anymore. We are indeed globally interlinked. And that indeed is the modern reality and it is very much the reality of things economic. As we in the United States look around, and we say to ourselves, what are we trying to do? How do we respond to a post-World War II, a post Cold War era? We obviously look into ourselves and say what is our national interest in this different world? How do our national interests align themselves against the forces at work? And how should we respond?

And I think it's clear that our national interest is economic. And if it's economic, we're linked. Our national interest is political, value-laden. We care about liberty. We care about individual expression. We care about what is called democracy. And we care about markets and freedom. And so we have a national interest that touches on the fundamental of what's going on in Europe. So I think that one of the responses that we have today to these changes is the responses that say we have been partners with Europe in a post-World War II era. We have supported, and we feel importantly, for our own self-interest, the development of this European Community and the strengthening of it which we've seen in the last years. We care, together with the Europeans, about the rules of trade and something called GATT and a GATT agreement that is supposed to be reached at the end of this year involving our partners in Europe and also our trading partners around the world, both in the Pacific Area, developed nations, and underdeveloped nations – a set of trading rules that we and the Europeans, I think, share an interest in broadening and strengthening.

We care about coordination. After 1973, we found that coordination with regard to interest rates, with regard to exchange rates, and with regard to things economic, it's not by chance I think that the heads of state meet annually on one subject and one subject alone. It's called an Economic Summit. And the fact that they do causes a lot of work to happen, and the fact that that work happens is because there's a vested interest in the United States in coordination and in continued coordination with Europe and with the European Community. And I think that if we were to look at the national interest of the United States in a post-Cold War period, we would list a role for the United States within these coordinating councils as an important thing for the well-being of our own society and for the interests of this country as a member of the global nation states.

We care about liberal democratic values. I suppose in our own way historically we're trying to say that that is some kind of universal authority that should blur the claims of nationalism. But if you read history, there's no reason to believe it will be anymore successful than the prior. But we care about that.

So I guess I would say to you tonight, as we talk about what's going on in the world, we would start out by saying it clearly is changing. That change is forcing us to reexamine our basic interests. As we look to what's happening in Europe, we do so not totally without recognizing what's happening in terms of the Cold War, not totally comfortable that we understand how the Union of Soviet Socialist Republics will evolve and what form it will take. But I think probably, convinced that we have a vested interest in the continued evolution of the Western European group in this European Community and its continued development and its partnership with us in terms of things economic, in terms of things political and culture, in sharing a commonality with regard to the rules of trade, the nature of trade relations between the major as well as the developing countries in the world, and we call those rules, things like GATT agreements.

And we have a very strong vested interest in continuing this economic cooperation that is manifest by the G-7 meetings and by the annual meetings of the heads of state, even as we probably do not share quite so closely as our European friends the day to day effect, the changes to their economies, to their business perspectives of the opening up of what is central Europe and Russia itself.

In that sense, I think that the American community views these changes as similar to changes that have taken place in other developing countries. If it's difficult for Brazil to write a constitution, to hold elections, and to learn how to govern itself, it's difficult to believe that it won't be equally difficult for societies where anybody who is under 50 has never shared in that experience. If it's difficult for an Argentina or a Mexico to find the economic formula when there are all sorts of claims and no history, there's no reason to believe that it won't be equally difficult for the central Europeans and indeed the Russians to find this kind of formula.

So from that point of view, as looking across the Atlantic, I think that we probably recognize that this is going to be a long process – one with opportunities but with risks – and I think seen rather differently than by many of our colleagues in Europe who frankly are much closer, possibly much better informed, but who see it, I think, rather differently. And I think that this is a reality, and I think it reflects the views that exist in the United States, but I must say that all of us share the optimism and the sense of opportunity that has come with the changes that have taken place not only in Europe, but indeed in the global economic system that has so changed the face of the world. Thank you very much. (Applause)

Chairman Rand V. Araskog: Our second guest of honor tonight is Karl Otto Pöhl, the President of Deutsche Bundesbank. His pronouncements from the Bundesbank affect stock markets, bond markets all over the world and there is no one more sensitive to that fact than he.

Since 1980, as president of the most powerful central bank in Europe, he has presided over a strengthening of the economy and system of the Federal Republic of Germany that has been unprecedented and is really the envy, I think, of many in the United States. He was born in Hanover just before the great worldwide Depression. He graduated from the University of Göttingen. And after spending a brief period of time as an economic writer, entered the public banking community and finally emerging as the president of the Deutsche Bundesbank. He has also served as chairman of the Council of Ten or the Group of Ten and as chairman now of the Central Bankers for the European Economic Commission.

He comes to us at a time when tremendous American interest is focused on financial and economic developments in Europe. We're grateful for his being here now and it gives me great pleasure to introduce the president of Deutsche Bundesbank, Karl Otto Pöhl. (Applause)

Karl Otto Pöhl

President of Deutsche Bundesbank

Thank you. Mr. Chairman, ladies and gentlemen, I am very pleased and honored to have the opportunity to talk to such a distinguished audience here. Tonight I was asked to talk about the economic situation at the start of the 90s which is a short view, short-term view more than a long-term view, but I think we are at a very historic junction. And from my point of view, from a European – and particularly from a German point of view – I think there are convincing reasons to believe that the next decade will open up encouraging prospects for the industrialized countries, especially for Europe and even more particularly for my own country, for Germany.

There are at least three reasons which I want to mention for this expectation. The first is, of course, developments in the east. Eastern Europe is in the midst of a revolutionary process in which there will certainly be setbacks, but which – and I agree with John Reed – is irreversible. It is surely inconceivable that Soviet tanks would once again go to Bucharest, Budapest, or to Prague, or that the war will be erected again. And even in the Soviet Union, I think even in the worst thinkable scenario, it is inconceivable that this process of reform can be reversed.

What used to be known as the Eastern Block is in a state of utter disarray. In most, if not in all, Eastern European countries, apart from the Soviet Union, Communism is no longer regarded as a serious alternative to the economic and social system of the Western world. Since the day of our famous father of the German economic miracle after the war, Ludwig Erhard – who also was once a speaker here at this occasion, I learned tonight – since his days in Germany, we call this system, so-called Social Market Economy, it is to be understood in principle as a capitalist system which has been provided with a human face, so to say, by a strong element of social welfare and more recently also of ecological concern. This system has demonstrated its superiority in a dramatic and conclusive way. And I think this is particularly true of West Germany where almost 400,000 people from East Germany proved the superiority of our system compared to the system in East Germany.

But, of course, this exodus cannot be continued indefinitely. So I think the East German government – East Germany government, if it's elected – has to implement reforms rather quickly because time is running out. There is a long list of reforms necessary. I want to mention only a few. Private ownership of the means of production, particularly important unlimited investment of West Germany and other foreign countries, decontrol prices and rents, introduce one realistic, one realistic exchange rate.

Today, just as a footnote, I want to mention there are not less than four different so-called exchange rates. They don't have really a currency in our understanding. It's very manipulated artificial currency they have. Four different exchange rates from one to one with D-Mark West, one to three, one to five, one to ten, for different purposes. And it goes without saying that that is not very efficient, saying the least. So from there to a convertible currency is maybe a long way, but there is no alternative to that if the country wants to stop the exodus of their people.

The first free elections are already scheduled for March 18 of this year. This date has been advanced because the situation in East Germany is becoming more and more critical. Still each day, some 2,000 people are leaving the country. They are not regarded as foreigners in West Germany of course. Unlike the other way around, we are regarded as non-citizens of the GDR in East Germany, but in West Germany, citizens of the GDR are regarded as Germans which means that they get automatically a West German passport, that they take advantage of all social, our very generous Social Security system, etc. And there is a discussion now in Germany saying that this is kind of additional incentive for these people to leave East Germany which is in nobody's interest, neither in the interest of the GDR nor in our interest.

So time is running, and it's particularly running for the GDR. I think the next few weeks in East Germany will become very crucial. Any slowdown of the process of liberalization in East Germany, let alone a return to the old methods of repression, would result in an even larger exodus of East Germans to the West. The upshot of that would necessarily be the economic collapse of East Germany.

But having said that, if a freely elected government takes the necessary decisions in the near future, which is what I expect, the situation could change dramatically. East Germany could become the destination of a tremendous inflow of Western capital. West German companies are already on the starting blocks waiting to set up factories in the east. Many of them already have by tradition close links with the eastern half of Germany. If this were associated with a strong improvement in the foreign exchange position, as a result of these capital inflows, a gradual linking of the Eastern German Mark to the Deutschmark to the West German Deutschmark, D-Mark, would be conceivable. The process which I have outlined here would undoubtedly be strongly supported by West Germany – the government, by business, etc, even by the Bundesbank I would say, for instance, by means of long-term loans, new____ transfer, and the like.

So all in all, I believe that in a relatively short time, East Germany could have the potential and the opportunity to enjoy, so to say, an economic miracle, comparable to that experienced by West Germany from 1948 onwards. But only, I have to repeat that, only if East Germany is prepared to change its economic structures soon. And as I said, there is no alternative to such a policy because different from all other countries; the alternative would be an exodus of the people. If the capital is not allowed to come to the people, the people will come where the capital is, where the jobs are, where the higher standard of living is.

A unification of the two German economies in a relatively short period of time seems to me conceivable under the circumstances. It is certainly easier to achieve an economic unification and it's also more realistic, I think, than any political reunification, which means a centralized government and something like that. It depends on the definition what one understands on the reunification which is so much discussed these days. But I think an economic integration of the two states, but one nation, is much more likely and much more realistic to expect.

This scenario would, of course, have far-reaching implications for other Eastern European countries particularly for Hungary and Poland, which are developing along similar lines with the aid of the IMF and the World Bank, and for Czechoslovakia which will soon be following suit.

The Soviet Union is a different story. As regards the potential for reform, there I am, frankly speaking more pessimistic. Nearly all the preconditions for such a radical economic reform leading to a free market system are lacking in the Soviet Union. And the implications of the Soviet Union's ever-more profound economic decline for its superpower status are a fascinating subject which should be analyzed by somebody who is more qualified for the purpose than I am.

This, on the development in the East – in brief – the second reason why I am rather optimistic about the economic outlook for the 90s is based on the developments in Central and based on the developments in Western Europe which are easier to forecast of course. The creation of an European economic and monetary union has been approved in principal by all European governments. I do not think this process will be slowed down by the upheavals in the East. On the contrary, it is my conviction that these developments in the East make Western European integration even more urgent. We are under a downright obligation to offer an alternative to people who have been and still are fighting for their freedom which includes, not at least economic freedom. Such an alternative should demonstrate what a free economic system open to influences from all over the world and fostering prosperity can look like.

Moreover, there’s another reason why Western European integration must not only continue, but actually gain their pace. It goes without saying that no country will benefit more from the opening up of the East than West Germany which is already the dominant economic force and whose currency is the key currency of the European monetary system.

So our Western neighbors will view, and that’s understandable, these developments very carefully and sometimes with mixed feelings, understandably. I suppose they would accept and support a political, as well as an economic, reunification or unification; however you call it, if it takes place under a European umbrella. The planned European Economic and Monetary Union is, in my view, the appropriate framework for this. For sure it cannot be created in a single revolutionary act but only in a steady evolutionary process. Yet this process has already gone further than most people realize.

What is an economic and monetary union? To make a long story short, there are three elements. The first element is complete freedom of the movement of goods, services, labor, and capital.

This part, the first pillar of an economic and monetary union, is substantially to be realized during the next three years. The full liberalization of capital movements is to be implemented as early as the middle of this year already. And in most European countries, this requirement is already met. France has just lifted its last remaining restrictions on capital movements. Italy will soon follow suit. Transitional periods have been provided for the economically weaker countries.

The common internal markets, including the very important common market for money and capital, is already proving an extremely strong stimulus to economic growth, investment, and employment, not least owing to the acceleration of European integration. Europe, and particularly West Germany, are enjoying a boon which nobody would even have considered possible only two or three years ago. No end is in sight in the years ahead either.

I think the United States is not the least among the countries benefitting from these developments. Happily there is more or less an equilibrium in our bilateral trade with the United States, very different from the bilateral U.S. and Japanese trade. EEC and the United States are or more less in equilibrium. We have even a little small deficit in our trade with the U.S. now. And West Germany's growing trade surplus, roughly $70 billion in 1989 is increasingly the result of internal EEC trade. A slowdown of domestic demand in the United States and at the same time strong growth in Europe and Asia is exactly the kind of scenario which would lead to an adjustment of trade imbalances which we have aimed for at the Group of Seven. Of course, U.S. industries have to take advantage of this favorable scenario and their efforts have to be supported by an appropriate monetary and in particular fiscal policy. But the chance for improvement is better than ever in my view.

The second cornerstone of a future economic and monetary union is the European monetary system, EMS – a system of fixed, but in principle adjustable exchange rates which has increasingly developed as planned into a so-called zone of internal and external stability. This seems all the more remarkable if one considers the volatility of the dollar rate during this period. The D-Mark has played a major part in this development. It has provided the stability standard that every monetary system requires. In other words, countries which have been unwilling to devalue their currency against the D-Mark have had to gear their monetary, economic, and fiscal policies to this exchange rate target, i.e. to pursue at least the same kind of anti-inflationary, stability-oriented policies as West Germany. It is the D-Mark and, by the way, not the famous ECU which plays only a subordinate role in monetary policy and has only been of some importance as an asset in the financial markets. It has been the D-Mark that has developed into the most important reserve and intervention currency in the European Monetary System – very much like the dollar in the old days of the Bretton Woods system.

Incidentally, the D-Mark is playing this role also internationally, after the dollar of course – very much behind the dollar still. But nevertheless, the D-Mark is in second place, and foreigners with financial assets in D-Mark on the order of 700 billion D-Marks. This, I think, is a sign of confidence in our monetary policy and it also urges us to continue our anti-inflationary course.

Almost 20% of the official reserves in the world are held in D-Mark by central banks. One reason for this is, if I may say that in passing, is the fact that the United States has accumulated substantial monetary reserves – I hope I do not divulge secrets here – but it's more than 40 billion D-Marks – for the first time in, if I'm not wrong, in American history. This is a consequence of its active intervention policy in recent years. And the days are past when a Secretary of the Treasury long ago, I think it was John Connolly at that time, said the dollar is our currency, but it's your problem.

The third cornerstone of the development into an economic monetary union is the least developed and the most delicate and complicated one, and that is the creation of the institutional framework for common decisions, especially in the field of monetary policy. This is why the European heads of state and government have decided to call an inter-governmental conference at the end of this year at which the statutory conditions for transferring to community bodies some powers which are currently still in the hands of national authorities are to be defined. This is a decision of exceptional importance particularly for monetary policy. I am, frankly speaking, I'm on record for that, would have been happier if we had first gained at least a few year's experience with the so-called first stage of the economic and monetary union before embarking on such ambitious new targets. I also have some doubts as to whether the European governments are already prepared at this stage to give up sovereign rights of this quality, particularly monetary policy, to community institutions. That still remains to be seen.

But if – and it's still a big if – but if one day a European central bank system will be created and that's the objective of this inter-governmental conference, it must be assigned in our view the unambiguous mandate of maintaining price stability rather than other targets as let's say full employment or stabilizing exchange rates vis-a-vis third currencies. The temptation for politicians to try to use monetary policy for these kinds of objectives is always very strong in all countries, but the true function of a central bank, a prudent central bank, must be to take a longer term view as the former chairman of the Federal Reserve System, William McChesney Martin, made that drastically clear when he said the Fed's job is to take the punch bowl away just as the party is getting going. That is a drastically, but I think a very clear and a very convincing, definition of the function of a prudent central bank.

In order to perform the task of ensuring price stability and to meet the high expectations entertained, the European central bank system should be, I think must be, independent of instructions from governments, the EEC Commission, the EEC Council of Ministers, etc. That means it must have a status similar to that of the Federal Reserve System or the Bundesbank in Germany which is very similar to the Federal Reserve. This includes, besides the personal independence of the members of its governing bodies, above all sole control over the instruments of monetary policy, interest rates, liquidity, and presumably also exchange market interventions which also have a bearing on monetary policy of course.

The European governmental, intra-governmental as it is called, negotiations on such an ambitious project will certainly last a long time. In the meantime, we should try in the framework of the existing institutions which are there in the EEC, to elaborate a consistent fiscal, economic, but in the first place monetary policy which is geared to the objective of price stability and which hopefully is buttressed by fiscal and other policies as well.

This leads me to my third point why I am rather optimistic about economic developments during the next couple of years. Without entertaining any illusions about the possibilities of economic policy, monetary policy fine-tuning, I do believe that we have learned a good deal in the last 20 years about the possibilities and the limits of economic management and international coordination, which as everybody knows did not start with the Plaza Agreement in 1985, much earlier in '73 really, after the collapse of the Bretton Woods system, but which has made progress over time. There will be fluctuations in economic activity in the future of course. I am sure that we are not seeing the onset of everlasting prosperity, but after two oil price explosions, the debt crisis, the '87 stock market crash, and some other events; I have some confidence in the flexibility of an open, virtually deregulated, capitalistic economic system. That is, of course, no guarantee for the future and certainly no reason for complacency, but some confidence does seem to be well-founded if all players in this game stick to the rule which I think they will do.

The central banks of the industrialized countries, and in particular the leading countries, and international organizations such as the IMF, the World Bank, have fostered these tendencies and strengthened market confidence at critical junctures. I am particularly happy that such profound agreement, including what I would call the basic philosophy of monetary policy, prevails between the Federal Reserve System and the Bundesbank in particular. Our basic philosophy – and I'm sure Alan Greenspan and my friends at the Fed would agree with that simple, but nevertheless, I think clear and sound definition – this philosophy is based on the following consideration. Sound money and price stability are not an obstacle to growth and employment as many of us thought in the 70s with very, very negative results, but the main precondition for it, as well as for stable exchange rates. With this agreed philosophy, which is being shared in more and more countries today, I believe we have laid a good basis for continuation of economic expansion, prosperity, and stability in the last decade of this century. Thank you Mr. Chairman. (Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN RAND V. ARASKOG: Thank you very much to both John Reed and Karl Otto Pöhl. Our questioning procedure tonight will be as usual. We'll alternate questions from our two distinguished questioners, Dennis Weatherstone, the Chairman of J.P. Morgan and Company, and Henry Kaufman, President of the company that bears his name. And we'll begin with Henry.

HENRY KAUFMAN: I'd like to address my first question to John Reed. And I would like to take John back to pure banking a little bit. John, as you know, in recent years there have been some problems in the banking system with LDC loans. There seemed to be some problems with real estate loans. And there are, or may be some problems with some heavily indebted business corporations. As a very distinguished banker, how do you view this development? Is this a problem of banking supervision? Is it a problem, for example, of too liberal credit accommodations in the banking system? Is it a governmental problem? Is it a problem of shareholder lack of responsibilities and so on? (Laughter) And as the biggest banker in the United States, I think it's very important to have your view.

JOHN S. REED: I can tell that Dennis did not ask that question. (Laughter) You know my point of view is very simple. It seems to me that the banking system's function within society is to act in some sense as a shock absorber. We provide, hopefully, time for adjustments to take place. The fundamental social purpose, I think, of a banking system is to seek to avoid to propagate shocks, but instead to absorb them. There's no question in my mind that when we freed up interest rates Reg Q, which as you know my institution very much favored and still does, we certainly took some of the social sort of benefit that had accrued to the banking system away. The SNLs clearly manifest a difficulty in living in a world without that sort of cushion that had provided some stability. And so you've seen tension in the U.S. banking system. You have not, I would argue, seen equivalent tension in many other banking systems around the word including, I would point out, our neighbor to the north, the Canadians, who have gone through the same kind of oil shocks and problems with agricultural lending. Even if they have not had the more recent one, they certainly have shared with us, maybe even to a greater degree, the so-called debt problem types of things. And the reason is, I think, that their systems are inherently more stable because they're national and not compartmentalized. The United States, for historic reasons, has tended, and perfectly valid social reasons, I think President Jackson vetoed the Banking Bill, not wanting to see for social reasons the development of a national banking system in the United States. And so we have a highly compartmentalized banking system, both by geography and by line of business. And I think it is simply engineering-wise correct that such a system has less absorptive capability. I do not think that the banks that went bankrupt in Texas were particularly poorly managed. I think they simply were a captive of the economic circumstance of 100% of their customer base just like a bank in Des Moines, Iowa is going to be pretty exposed to farm loans. So I think that the tensions that you see are real. I think they reflect the function that banks have in society which is to absorb some of the shocks that take place in our economic system. Our economic system is much more flexible and robust than many – it is a much freer system in many ways – and we do get carried away with things from time to time. And, you know, we have a system in which these problems can be seen to fall on special parts of the system. On the other hand, the total system itself seems to work reasonably well. We're liquidating the SNL industry. That's unfortunate. It should not ever have been so isolated as to cause that. And we certainly have liquidated parts of the Western banking system which again was isolated and captured in that way. So my sense of it is the problems you point out are clearly real. They are predictable. They reflect what's going on in the society. They clearly reflect bad judgment, because getting into these kinds of problems, I think are things you should try to avoid. But they are highly likely to occur given the fragmentation, as opposed I might say, to the universal type banking system which is more characteristic of Europe and which over the years has absorbed shocks in very different ways and I think with possibly socially more beneficial results.

DENNIS WEATHERSTONE: President Pöhl, a question for you. You seem quite comfortable with the role of the Deutschmark as a reserve currency – even though in the past, the Pound Sterling has had a few problems, the Swiss didn't like to see their currency used that way, and the U.S. has had some discomfort – and quite pleased with the role. Should we be looking forward to the Deutschmark being the currency of both Germanys and in due course, if we have a European central bank, the common currency in some more formal form of Europe?

KARL OTTO PÖHL: Well, Dennis, I think we have to live with this role as a reserve and intervention currency. We haven't aimed for that role. On the contrary, as you know, the Bundesbank in the 70s was rather reluctant to accept that role, but we couldn't avoid it. And if you can't avoid it, as you know, it's always good to relax and enjoy yourself. (Laughter) It's not always fun to be responsible for a reserve currency. It puts some burden on the central bank as you have seen in your country on many occasions when the dollar was the main reserve currency in a fixed exchange rate system. But so far I think it has, the D-Mark and the Bundesbank in a sense, has made a positive contribution to the functioning of the European Monetary System which is more and more recognized and admitted by our partners in the EMS. So technically speaking, theoretically speaking, of course, you could imagine a system which is run by one central bank where one currency in Europe would be the currency. But this is not very realistic politically speaking because that would not be accepted in the longer perspective by the other partners of the system which also want to have a say in monetary policy. And that's the real background of this discussion over central bank system, of European Monetary Union, of common decision making in monetary policy that our partners in the ECC also want to participate in the decision making process, more than they can do today. And so I think we have to think about that but it would be an illusion to eat the cake and to keep it because monetary policy cannot be divided, and it cannot be transferred to a community institution in pieces. That is something which is not always understood, I think, that if you transfer the decision making in monetary policy to a community institution, you have to transfer it all. You have to make it an efficient institution, an institution which is able to pursue the kind of policies which are necessary to get stable prices and an environment which is favorable for growth and stable exchange rates, etc. That is the background of the discussion of a European Monetary System. But as I have said in my speech, in brief of course, this will take a long time. It has many political, legal, and other implications. And some people think that it's inconceivable to transfer sovereignty rights of these kinds to an independent European institution. So for the time being, answering your question, Dennis, I think we will have to live with a system in Europe, a European Monetary System in which the D-Mark has to play – in the interest of the functioning of the system, has to play this role as a kind of an anchor and as a standard for the stability of the system. We have to live with that role. We can live with that role. And our contribution, of course, as a central bank, has to be to keep the currency stable in order to keep the anchor firm. If we were given and would allow more inflation, in our country I think it would be very, very disastrous for the economic and the monetary system of Europe as a whole.

HENRY KAUFMAN: While you're on your feet, President Pöhl, I would like to ask you a question concerning currency developments. As you know, in recent months the Japanese yen has been weak against the dollar and the Deutschmark has been generally strong against the dollar. And in terms of the yen-Deutschmark relationship, the Deutschmark has been very strong against the yen. How do you view, as an important central banker, this kind of a development?

KARL OTTO PÖHL: Well, Henry, that's a very delicate question which you should never ask a central banker, but I'll try to answer as honest as I can. First of all, it was agreed at the last G-7 meeting in September that a certain change in the exchange rates, dollar-D-Mark, which means dollar-European currency rates, dollar-yen rate, would be desirable, would be in the interest of the international adjustment process. Or in other words, that a further appreciation of the dollar against these currencies would not be in the interest of the adjustment process. And so far I think we have succeeded. We have achieved more or less what we had in mind at that time, and the markets of course helped us. And the fact that the interest rate differential between dollar and D-Mark has practically disappeared also helped us to achieve this objective which was a common objective, an agreed objective, between the United States on the one hand and the European countries on the other hand. We, of course, included the yen in these intentions. We thought that the yen would move in parallel with the European currencies because as everybody knows the imbalances in particular between the U.S. and Japan and much less between the United States and Europe, but it didn't happen, and the reasons are very known. I think the main reason was the fact that contrary to the Europeans, the Japanese didn't raise their interest rates. We raised our interest rates, not in order to strengthen our currencies against the dollar – that was not the main objective and the first purpose – but because of the very strong expansion of our economies. But as a by-product, the European currencies, not only the D-Mark, also the French Franc and other European currencies appreciated against the dollar. And it was welcomed; I have to say that at least from our point of view, it was a welcomed by-product. The Japanese didn't raise their interest rates; at least they hesitated very long. They've done it only recently and not to the same extent as we have done it in Europe. There were also other reasons well known – political reasons, etc. – which have led to this development which I think is not consistent with the imbalances which we still have in trade and in our current accounts, particularly between the United States and Japan. And so if the Japanese yen would follow the European currencies against the dollar, I would not be opposed to such a development. But this is not a forecast, it's only a statement.

DENNIS WEATHERSTONE: John Reed, I have a question for you. You mentioned that Brazil and the Argentine were having some difficulty in reshaping economic policies and so looking there gave you some idea of the problems that we could expect perhaps in Eastern Europe. Another factor that we've just spoken about is Japan, and Japan has been an important source of funds, both to the lesser developed countries of Latin America and the United States. We've got a little competition coming along now with Western Europe which we all knew about and now we have Eastern Europe. Do you have any thoughts as to what that's going to do to the U.S.

situation and the Latin American situation now that there's new competition for Japanese funds?

JOHN S. REED: Well, I think it's very clear that if you took a look at the map of the world in the last five, six years and plotted fund flows, you would find that the United States was absorbing the great bulk of the capital of the world in the form of flight capital from some of the troubled economic countries. I believe it would not be wildly inaccurate to say that the flight capital from these countries is a very substantial portion of their outstanding debt and one of the fundamental economic problems that they have is their savings aren't within their own economy. And you simply can't get economic growth under those circumstances. And, of course, the by-product of the U.S. trade deficit has been indeed that we've seen the mathematically-equivalent flow of funds into the United States in the form of investments. My own sense of it is that due to a combination of the management of the debt problem and the continued troubles associated with indebted countries, that they indeed are in a competitive disadvantage. There's no question in my mind that the interest of the world does not lie in investing in Africa or in Latin America or in some of the heavily indebted countries. Part of this is economic realism. Part of it is tiredness and just a fact of life. And I think this is a brutal and difficult fact of life which increasingly is understood, I believe, by the governments of these countries, but it's going to have a real cost. With regard to the United States, we clearly have a severe deficit which I think we all understand has to, over some period of time, be corrected. And there's nothing that I'm aware of that suggests that the means of correction will be any different than an economist would predict. It is true that since trade takes place in our currency, that we are in a unique situation where as we run a trade deficit, those who have the surplus find themselves with our currency in their hands. And they are forced either to invest it without exchanging it and maintaining the existing exchange rates or choosing to move it into a different currency which will have the wonderful automatic effect of changing the exchange rate. And so I am somewhat less concerned than many that the United States is at any great risk that there all of a sudden will be no way for us to finance our trade deficit. I think the arithmetic of the situation will provide for its financing. On the other hand, I don't think there is anybody who believes that the current situation is sustainable over the long term. And therefore, I think the types of adjustments that apparently the G-7 had agreed to and certainly the situation that President Pöhl referred to of having the U.S. with relatively low economic growth while our principal trading partners are sustaining rather good economic growth is exactly the desirable circumstances that we would hope for. And my own sense is that we're going to have to see an adjustment that translates itself through into easing of these tensions and a long-term resolution of the deficit. I think GATT is important in this. I mentioned it. I think it's an important ingredient. My belief – I don't have the number at the top of my head but I think total world trade is in the general area of $2.5 trillion and you're talking about a necessary adjustment on the part of the United States of something in the area of $150 billion to $200 billion. So you're talking about almost 10% of world trade as an adjustment. And so it's much better to occur in a growing situation. But I think for the developing countries, it's a serious and not likely to be resolved problem. For the U.S., it's a serious but I think much more likely to be resolved within the conventional structure.

HENRY KAUFMAN: John, could you address yourself a little bit to the Glass-Steagall Act, and my question is perhaps in three parts. First, what else would you like to see in terms of unwinding of the Glass-Steagall Act? Number two, would you be in favor of commercial and industrial enterprises owning commercial banks such as IBM making a bid for Citicorp? (Laughter) And number three, if we unwind the Glass-Steagall Act completely, would you then be in favor of letting the market fully exert itself by those who do poorly just have to fail, no matter what their size, and by those who do well, profit?

JOHN S. REED: Well, with regard to Glass-Steagall, I think it's down to the point where it's somewhat academic. The change in marketplace reality has been so profound that it's difficult to see the border as between what is called investment banking and commercial banking. And my own feeling is that we should simply face reality and abolish the division. And I might argue that my belief is that that would be at least as much to the benefit of investment banks who would then be able to take on the characteristic of, you know, more universal banks as it would be for those of us on the other side. In other words, I don't think it's a one-way door. I think it's equally attractive regardless of which way you happen to be coming. I happen to favor the idea of permitting industrial firms to own financial companies, banks, although I must say I can't claim that I've really thought about it at great length. My sense of it is that there's no inherent evil that I could put my finger on that is so large that it says, hey, that's a no-no. I understand that the Fed, as a matter of religious principle, feels that this is something that should not be contemplated. But I must say there are a lot of societies around the world where you see perfectly healthy banking systems where these prohibitions seem not to have been necessary. And so my own sense, and I think Jack Welch, a man that I have a lot of respect for who runs GE, has argued publicly, and he certainly should know because he has a very large financial institution embedded in GE, that he feels that there are some natural benefits that flow out of having these kinds of associations. With regard to the third point, you know, I think that there is a public interest here. Those of us who take public deposits have to do so within some kind of safety net idea. I don't think it's in the modern day acceptable to ask the small saver in the public to be without a safety net. And so I think we need deposit insurance. I don't think it should be institutional insurance. And as I have testified in front of Congress, I believe that above some level, there should not be full insurance but substantial insurance. In other words, say the first $40,000 - 100% insured. And from $40,000 to $100,000 you insure 90% of the remainder or something, and that 10% would cause people to begin to take some marketplace reaction. But I would not simply close my eyes and say let the market work and let's bankrupt everybody who happens to get caught short. I think there has to be a mechanism to provide for the industry to come together to move from the structure that has existed over time into a more acceptable long-term structure without creating a severe credibility gap with what, after all, is our real constituency and that is the customer. I don't think it would be fair to simply say to hell with it and walk away. But I do think there has to be an orderly process by which the industry can come together. And as I say, I would not myself draw a line as between industry and banking.

DENNIS WEATHERSTONE: President Pöhl, could you give us your impressions of the current

U.S. banking scene and any advice that you might have along with it?

KARL OTTO PÖHL: Definitely no. (Laughter and Applause) I think we all have our traditions and our cultures and we have a completely different banking system in Germany. But I'm not going to say that our system is better, it's only different. The only advantage maybe is that we have not the kind of critical developments which you have seen here in this country on some occasions, in the financial system. We have this universal banking system and I can assure you it also has some problems. That the biggest bank owns the biggest industrial company is not, it's criticized in Germany by some people at some occasions. But on the other hand, one has to, one has to recognize that the banks in our system have really played the role as a shock absorber as you have indicated, John, have defined the role of banks. It's a new definition. I've never heard that before, but I think it's a good definition. I like it, and I will refer to that definition at given occasions. The banks have been, our banks have been very supportive and helpful. For instance, in the Great Depression in the 30s, when they got most of the participations which they now own, and the fact that they have enormous hidden reserves in the form of stocks of industrial, retail businesses, etc., was very helpful at the time when the banks were in trouble because then they could sell these assets and could compensate losses in other areas. And they were also helpful at the time, in the 70s, when we were very afraid about takeovers of German companies – national monuments, so to say, like Rockefeller Center or something like that, (Laughter) by at that time oil-producing countries. Maybe that was slightly exaggerated, looking from hindsight, but at that time we were very much concerned, for instance, that Daimler-Benz could have been taken over by the Shah of Iran. That was discussed at that time. And so the Deutsche Bank stepped in and that's the reason why they now own 28% of that company. This universal banking system is not only defined by the permission to own industrial participations – I'm rather critical about that – I have to say that – but also, and that I think is more crucial, that we don't have the distinction between commercial banks and investment banks. It's all under one roof. And that has contributed to the rather stable financial system in Germany and in other European countries as well – Switzerland, etc., Holland, etc. Because if there were losses in one department, there were profits in the other departments so on balance the profitability of the German banks is still very good. And they were able to depreciate most of their third country risks much earlier than even Citibank started to do it. And it's not a problem anymore for German banks. I have to admit that the exposure was also much smaller and so it was easier. And what was also very important, the tax treatment was very much more generous because all these provisions were fully tax-deductible. So on balance, we are quite happy with the stability of our financial system – thanks to all these very generous treatments. But I do not hesitate to admit that our banks are very powerful and that there's an ongoing political discussion in Germany about this very fact, that the banks have a such strong influence on not only banking institutions but also on other industrial companies, etc. And there have been already attempts in Parliament to change that. So far, these attempts have not been successful, but I think the discussion is still going on. We have to, of course, also take into account the fact, and that makes it a little less problematic, that our banks, like you and others, are not only operating in a single, national market anymore, but that they are in an international competition, a very heavy and a very strong international competition that they have to compete with Japanese banks and with American banks, etc. And so from the point of view of a central banker, I think it's reasonable to say that we have of course an interest to keep our banks as strong as possible. And this universal banking system, I think, makes the banks less sensitive for shocks, and shocks also in the future cannot be excluded. So I'm, if you would ask my advice, I would be in favor to change the Glass-Steagall Act, but I don't know what relevance this advice will have to the _____.

DENNIS WEATHERSTONE: It's very helpful.

CHAIRMAN RAND V. ARASKOG: Ladies and gentlemen, we certainly want to thank our distinguished speakers and questioners tonight. It's been a most interesting evening and safe home. (Applause)