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Luncheon Remarks by Michel Camdessus
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I see that it was some 20 months ago, in November 1990, that I last had the pleasure of addressing the European Institute.

A lot has happened since then, including a speeding up of the two historically important processes that have a bearing on your conference;

- the social and political transformations that are under way in the former Soviet Union and in Eastern Europe; the tearing down of the Iron curtain, and the ending of the Cold War;

- and the progress within Western Europe toward political and economic integration, highlighted by the Maastricht treaty.

We all have to operate in a global economic framework that is undergoing fundamental change, while coping with the more traditional agenda of dealing with cyclical swings, debt, and poverty and the other problems of the Third World.

What I would like to do today is to offer you some thoughts on the process of economic integration in Europe (including the prospects for the EMU), how these affect the international monetary system, and what they may mean for our task of supporting the countries of Eastern Europe and the former Soviet Union.

At the outset I would like to stress one basic point. Namely, the macroeconomic policy strengthening required by Maastricht-type convergence is highly desirable in itself. Indeed, these policies would be fully consistent with the kind of sound and coherent medium-term strategy, aimed at sustainable growth with low inflation, that the IMF recommends for all countries. These policy commitments, effectively implemented, should improve the prospects for a healthy economic performance by the European countries themselves <u>and</u> help them to continue to play their proper role as "good international citizens" in the international economy.

Let us consider the main areas of policy.

Monetary policy, first. One can regard the Maastricht agreement, in its monetary aspects, as building on and attempting to consolidate the considerable achievements of the EMS. The success of the EMS can be assessed in terms of the much lower average rate of inflation for its member countries than before, the smaller inflation differentials between them, and, related to this, the reduced degree of exchange rate variability among the member currencies. All this has been mainly due to a more effective policy coordination, and because the participating countries have drawn a judicious balance between rules and discretion. They have used the discipline of the EMS to produce a gradual convergence of policies and ultimately of their economic performance. And this convergence has, in turn, contributed to the successful operation of the EMS itself as a workable system of fixed but adjustable exchange rates. An additional reason the EMS has worked well is that it has been linked to the commitment of its members to the larger integration objectives of the European Community.

With this as background, one can view the economic aspects of the Maastricht agreement, (including its objectives of monetary integration and a single currency, its emphasis on reduction of inflation, and its process of bringing about a convergence of policies and performance) as basically a logical but more ambitious extension of the approach that has made the EMS a success.

For Maastricht to succeed, it will be necessary for each of the member countries to maintain very firm monetary discipline. But monetary discipline must go hand in hand with budgetary consolidation. And this brings me to:

Fiscal policy. The European countries face an urgent need to improve their fiscal performance. By this I do not only mean a reduction in budget deficits. In addition there is a need to improve the quality of public expenditures--by cutting unproductive spending, by reducing subsidies that distort production, and by channelling public resources in ways that most effectively promote the key priorities of society--and to improve revenue systems in ways that minimize economic distortions. Moreover, for each government the fiscal policy instrument will become more prominent, as the scope for independent monetary policy is reduced in the progress toward a monetary union; and the need for firm fiscal discipline in Europe as a whole will highlight the importance of carefully designed systems to protect the poorer and weaker regions.

But allow me to insist on one thing. This budgetary consolidation will be of major importance in a medium-term perspective, to strengthen the capacity of the European countries to face the ups and downs of the economic conjuncture. One of the unfortunate features of the recent cyclical slowdown in many industrial countries was that they had little scope for discretionary fiscal action, because they had failed to take advantage of the long expansionary phase during the 1980s to undertake sufficient fiscal consolidation. They had little room for maneouvre.

Turning to structural policies, I would include all those policies that tend to improve the long-term efficiency and productiveness of economies, in particular through enhancing the working of markets. This also will be required by what I call the logic of Maastricht, and here also there is considerable scope for improvement in most European countries. Which of us, for instance, would deny the importance--or the difficulty--of steps to improve labor markets, to reduce the barriers to labor mobility, and to improve job training, in light of the continuing serious problem of unemployment in many European countries? Which of us would deny the importance of reforms to improve the functioning of capital markets, through a judicious combination of liberalization in the area of financial intermediation and reinforcement of prudential supervision? And which of us would dare to underestimate the importance of achieving, soon, a significant liberalization of foreign trade? This is desirable both as an internal measure--to strengthen competition and promote efficiency--and to create better markets for Europe's trade partners. It is particularly important that Europe become more open to imports from Eastern Europe than it has been so far.

These three aspects of structural policies--labor markets, financial sector reforms, and trade--are not the whole story. But they illustrate the range and importance of measures that will be needed in the period ahead to improve the adaptability and flexibility of the European economies. They will be an essential complement to the firm fiscal and monetary policies that are needed to establish and maintain the stable and non-inflationary basis for a strong economic performance.

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In looking at these aspects of European cooperation from the point of view of the IMF, which is the guardian of the international monetary system, I am struck by the fact that they both entail a careful balancing and reconciliation of national and international interests. The IMF's Articles of Agreement incorporate a kind of "code of conduct" of good international behavior in economic relations (especially in the related areas of monetary and exchange rate relations). The IMF's "policy surveillance" over all its member countries takes the form of periodic reviews and assessment of each countries' policies by its peers. Central to this process is a concern to help countries manage their own economies in ways that help, rather than hinder, the achievement by other countries of their own sound economic objectives. With this in mind, I would like to turn now to how good management of Europe's economy should have beneficial consequences for the rest of the world, including the economies that are in transition from a planned system to a market economy.

First and most important, the emerging market economies (those of Eastern Europe as well as those of the former Soviet Union) are in the process of setting up markets, establishing effective economic and political institutions, and rethinking the role of the State. They will have much to learn from the experience of Europe over the past decades and all that is under way at present--in establishing a single market, in reducing barriers to the movement of goods, labor, and capital, and in devising effective means of economic cooperation. In the monetary field, one could easily imagine that, as Europe moves closer to a single currency, some of the countries undergoing economic transformation might choose to link their own currencies to the ECU as a monetary anchor. More broadly, these countries are attempting to achieve a closer integration into the world economy; the experience of Europe is highly relevant to them, and it will be important for them and for Europe to establish close and mutually beneficial trading and financial relations. This raises, indeed, the question of the formal relations between the emerging market economies and the European Community--which might take the form of association agreements or in some cases membership for some of the East European countries.

Second, the rest of the world, including the emerging economies would benefit from an improved economic performance of Europe. I will highlight only three aspects of this.

- Like many others, I was initially worried that the process of convergence might cause Europe to exert a deflationary impact on the world economy over the next few years. But we are coming to believe more and more, in the IMF, that this risk has been overstated. In particular, strong and credible adjustment efforts will allow interest rates to fall markedly (in part reflecting a narrowing of interest rate differentials as markets become convinced that there will be no need for exchange rate realignments). This reduction in interest rates could offset any deflationary effects from fiscal consolidation. This leads me to suggest that early and decisive action on convergence will improve the prospects for growth, by bolstering public confidence.

- Next, the whole world should benefit from the fact that a stronger economic performance by Europe will increase the scope for mutually advantageous trade. Of course it is imperative that Europe demonstrate a clear outward orientation.

- Also, significant progress toward fiscal consolidation in the European countries should contribute to an increase in national savings, and help re-establish a more appropriate balance of payments situation for Europe as a whole, in which Europe will be a substantial net supplier of savings to the rest of the world. I need hardly add that similar action is needed in the United States.

And third is the provision of official financial assistance on an adequate and timely basis. You may be surprised that I mention this last.

In part this reflects my conviction that trade and technical assistance are more important than financial assistance.

It is clear that the investment needs of the emerging economies will be very substantial in the years ahead, and particularly during the difficult period of transition. They will need to invest heavily in improved infrastructure, and above all in productive capacity. They will find, like other countries at all stages of development, that the bulk of their investments will have to be financed from their own savings. They face a formidable challenge, in mobilizing domestic resources and channelling them efficiently to the most productive uses. Capital from abroad can only play a supplementary role, though doubtless an important one. And with respect to foreign capital, I would suggest that the main need of these countries will be for private sector capital inflows, whether in the form of joint ventures, direct investment, portfolio investment, or in other forms. These economies have a strong human and natural resource base that should permit rapid progress; they should be regarded as appropriate candidates for increased flows of private capital.

This is not to deny the important role of official financial assistance. This can only be seed money, to be sure, but it can act as the indispensable catalyst of systemic change, if channelled effectively and used wisely. That is why it is so essential that public financial assistance be made available to them promptly, in the early stages of the transformation process (without prejudice, of course, to a strengthening of Europe's support of the Third World, which is also essential).

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Mr Chairman, I have attempted to cover a lot of ground in a brief period. Clearly we face some important challenges in the period ahead. I consider that the basic approach of Europe, as it seeks closer integration, also serves well the key international obligation that the members of the Community accepted when they became members of the IMF, namely to foster cooperative solutions to the major global economic problems. So, at a time when the IMF faces immense challenges,--challenges that we will not be able to cope with unless our strong members become even stronger--we can only applaud the Maastricht process. It will help Europe to play an even more positive role in the international monetary system. And this is all the more essential now that the system has become the universal monetary system, and here I allude in particular to the IMF's work with our new friends in Russia.