Mr Welteke's following address on Europe and the euro: the view from Asia

Co-speaker's address by Mr Ernst Welteke, President of the Deutsche Bundesbank, following the lecture held by Joseph C K Yam, Chief Executive of the Hong Kong Monetary Authority, at the XII International Frankfurt Banking Evening, held on 14 March 2000.

* * *

I

Mr Yam,

First of all I would like to thank you for coming here and for giving us a very interesting Asian viewpoint of Europe and the euro.

As Chief Executive of the Hong Kong Monetary Authority, you have successfully steered your way through some turbulent times in the financial markets since the Authority was set up in April 1993.

We Europeans also need a perspective from outside so that we can objectively assess our ambitious historic project of monetary union. For that reason alone, I feel it would be arrogant of me to offer a "reply" to your evaluation because the very concept of a "reply" implicitly suggests disagreement - even if that is not intended. And so the organisers of this event and I have agreed that, in future, the reply from the Bundesbank President will be dropped from the agenda.

In the field of economic and financial policy there is no "ideal path" which should be followed by all countries in all circumstances. The economic and political settings in individual countries are simply too diverse. The cultural and social conditions also often differ widely.

That is why it is so important to compare notes and to learn from one another.

II

The respective economic developments in Europe and in Asia have likewise been characterised by very different conditions in the past few years.

Whereas in Europe various national currencies, supported by convergent economic and monetary policies, were increasingly harmonised and finally moulded together in a monetary union, some of the exchange rate pegs in Asia were strained to breaking point.

Hong Kong was and remains one of the exceptions. Even during the financial and economic crises in South-East Asia in 1997/98, it managed to maintain its exchange rate peg to the US dollar.

Hong Kong was like a rock in a stormy sea. For many foreign investors at the time it was - and remains - a firm anchor in the Asian markets.

But in fact, defending the currency board regime was by no means an easy task. In mid-1998 many investors were wondering whether Hong Kong really would defend its exchange rate come hell or high water. For many this was the key question during the Asian currency crises.

Mr Yam, the successful defence of your currency succeeded not least because of your partly unconventional policy. This entailed breaking the golden rule that a monetary authority should not intervene in the equity market.

You successfully intervened in the equity and futures markets with large official purchases amounting to about 15 billion US dollars, or 6% of market capitalisation at the time, in order to put an end to the speculative "double market play" in the equity and foreign exchange markets.

In the process Hong Kong put its free-market reputation on the line. But the intervention achieved its aim. It resulted in an easing of interest rates and a levelling-off of the drop in equity prices. The dollar peg was maintained. And Hong Kong remains a liberal and open market economy.

This monetary policy success also had, I believe, an important psychological impact: the “small” Hong Kong Monetary Authority showed the global financial markets that speculating against the monetary authorities can be unsuccessful.

Central banks are not a helpless prisoner of global financial markets - even if they have tied their hands through a commitment to an exchange rate target. The initiative - in the monetary field as in other areas - remains with the policymakers.

Naturally, the respective situations in Hong Kong and in Euroland are not directly comparable. Hong Kong is a small open economy for which the existing exchange rate regime is the sole option “to counteract large, unexpected shocks from the global capital movement”, as you, Mr Yam, constantly point out.

By contrast, the euro area is one of the largest currency areas in the world. Together, the participating countries account for more than 15% of global GDP.

This aggregate volume has given the European countries a new responsibility for the stability of the global economic and financial system. They can and should face up to this challenge with self-confidence - including when it comes to occupying top posts in international organisations such as the IMF.

Obviously, the question of the appropriate exchange rate regime for the euro area is posed in a completely different context.

The idea of establishing a system of fixed exchange rates between the major currencies - the dollar, the euro and the yen - is a non-starter under present circumstances. Economic and cyclical developments in the various currency areas are too diverse, but so, too, are the political priorities. None of the three regions I just mentioned is willing to subjugate its domestic policy to a fixed exchange rate.

Exchange rates need a certain room to manoeuvre so that they can equalise differences between different economies.

The ESCB therefore does not pursue an exchange rate target. Its monetary policy is oriented exclusively to the risks to internal price stability. The exchange rate does play a certain role, however, because key import goods - such as raw materials and energy - are invoiced in dollars.

The decisive factor, however, is always the overall monetary policy setting. This is something which the Governing Council of the ECB will analyse thoroughly at its next meeting on Thursday.

III

Mr Yam, another factor which has doubtless contributed to your successful monetary policy track record is the proximity to the market of the Hong Kong Monetary Authority, which is also responsible for supervising the financial markets and the banking sector.

Monetary authorities must have their finger on the pulse of the financial markets. After all, monetary policy decisions have direct implications not only for the money market but also for the foreign exchange and capital markets - both nationally and globally.

Today, given interlinked markets and internationally active credit institutions, instability can spread more easily. This tendency is being reinforced by the fact that some credit institutions are acquiring new, truly global dimensions - as is illustrated by the announced merger of Deutsche Bank and Dresdner Bank here in Germany.

Hence there is a much greater onus on central banks than in the past to take on responsibility for the financial stability of the financial markets, too. They have to focus their efforts in this context on crisis prevention.

Central banks need to monitor the markets constantly so that they can detect crisis signals at an early stage. For this they require prudential supervisory information on system-relevant individual institutions at first hand. This is why they also have an oversight function for the payment system, for that could pose substantial systemic risks to the banking sector if major market players were to experience disruptions in their payment operations.

In Germany it is the Bundesbank which, by virtue of its involvement in banking supervision or as the government's fiscal agent, is able to inject the necessary market competence and market proximity into the monetary policy decision-making process.

In all the discussion about the tasks and future structure of the Bundesbank, therefore, it must be assured that the German central bank remains anchored in the financial markets.

The reform of the Bundesbank must lead to more streamlined structures and to a strengthening of the Bundesbank within the ESCB. Germany, as one of the major industrial nations in the world and the largest economy in Europe, has a vested interest in having a potent and efficient central bank which is able to represent German interests effectively, both within the ESCB and internationally.

A reorganisation of the Bundesbank must not fritter away the high esteem and trust in which this institution has been held by the general public for many decades. The Bundesbank must remain an anchor of stability and trust for the German public - particularly during the period of changeover to a new currency. Its effectiveness depends on the quality of its arguments and on having a strong organisation that carries a great weight.

I assume that these aspects will be given due consideration by the politicians. One thing is certain, at any rate: the Bundesbank's work in the fields of banking supervision and debt management stands up well to international comparison.

I believe that proposals to outsource functions from the Bundesbank fail to take due account of the expertise and considerable synergies that exist within the Bundesbank.

In banking supervision, for example, we are closer to the market, we have a nationwide network of branches and we have the experts needed - not to mention an ideal location in the banking centre of Frankfurt.

The tasks of exercising microprudential oversight of banks and ensuring the stability of the banking system are ideally combined if the central bank is also involved in supervisory activities. So there are many good reasons for concentrating banking supervision operations within the Bundesbank.

Regarding a cross-sector coordination between banking supervisors, securities trading supervisors and insurance supervisors, I think that a national "Joint Forum" is a solution that would be both cost-effective and capable of being rapidly implemented.

In the field of debt management, too, the Bundesbank has a rationally structured system of interlinked functions.

Like every fiscal agent, we currently advise the issuer, manage new issues, carry out market smoothing and price management operations on all German stock exchanges and oversee both the cash and securities legs of securities settlements. A debt agency, however, would have to be supplemented - over and above the new department at the Federal Ministry of Finance - by a body that performs the banking functions.

IV

Mr Yam, the introduction of the euro just over a year ago truly marked an historic turning point, both for the global financial markets and for Europe.

The euro has rightly triggered a debate on the future responsibilities and structures of the national central banks in the Eurosystem.

But the policymakers responsible for those areas of policy which remain in national hands must likewise adapt to the new setting.

Competitive pressures are being intensified by the growing transparency on the goods and labour markets in the euro area. This is turning an even brighter spotlight on differences in the government-defined operating framework and on national structural problems.

Divergent economic and employment trends now have to be accommodated primarily by the national economic, financial, wage and social policies. That requires greater overall flexibility on the respective goods and labour markets.

And in view of the fact that government debt remains high, all levels of government should continue to step up their efforts aimed at reducing their deficits. Not least, that will enable them to enlarge their freedom of action in fiscal matters. The Stability and Growth Pact is the yardstick for the euro-area countries in this respect.

These are not monetary policy tasks - they have to be tackled by the other policymakers in their respective fields.

By pursuing its goal of ensuring internal price stability, European monetary policy is supporting the other policy fields and, in the process, is laying the basis for sustained economic growth and employment.

The Hong Kong Monetary Authority is pursuing a quite different aim, namely safeguarding the external value of the currency, that is the stability of the exchange rate, in which you, Mr Yam, have a successful track record over a number of years.

The Eurosystem has completed its first successful year. The inflation rate was well below 2%.

And I hope that the Hong Kong Monetary Authority will likewise continue its successful performance in the years to come.

I would like to close by thanking you once again, Mr Yam, for attending the Twelfth International Frankfurt Banking Evening and for delivering your interesting speech.