Ernst Welteke: Europe and the euro - an insider's view

Ernst Welteke, President of the Deutsche Bundesbank, at the Arthur Burns Memorial Lecture at the American Council on Germany in New York on 18 April 2000.

*   *   *

Preface

It is a privilege and an honour for me to hold this Arthur Burns Memorial Lecture. I am very happy to be able to add my name to the list of such distinguished speakers as Karl Otto Pöhl, Alfred Herrhausen, Alan Greenspan, Kurt Biedenkopf, Hans Tietmeyer and Rolf E Breuer. It gives me an opportunity to pay tribute not only to a high-grade economist but also to an elder statesman who did a great deal to foster US-German relations.

When Arthur Burns was appointed Chairman of the Board of Governors of the Federal Reserve System in 1970, he already had an impressive academic career behind him, and the status of a first-class international expert on economics. Richard Nixon, one of five US presidents for whom Arthur Burns acted as advisor, expressed his high opinion of him in these words: "Shortly after he joined my cabinet in 1969, he demonstrated why I was right in selecting him as my first White House Counselor. At our first meeting in the Oval Office, he explained his role. He said: "Mr President, most advisors tell a president what he *wants* to hear. I believe it is the responsibility of an advisor to tell you what you *need* to hear." He never failed to meet this standard."

The ability always to say and do what he thought essential likewise characterised his term of office as Central Bank Governor.

The incidental conditions for that office could hardly have been more difficult. The collapse of the Bretton Woods exchange rate system, the global oil crisis and recession, accompanied by strong inflationary pressures. But Arthur Burns set to work resolutely and persuasively; he made it clear that central banks could not be expected to bear the entire burden of fighting inflation on their own. Without the support of other policy areas, after all, a monetary policy geared to price stability soon encounters its limits. Incidentally, this perception is just as true today as it was then.

Finally, Arthur Burns made an invaluable contribution to US-German relations during the four years when he served as US ambassador to Germany. In 1985 he expressed his love affair with Germany in these words: "I've fallen in love with Germany; that's not difficult." But notwithstanding that love - it was he who analysed and pinpointed the structural weaknesses of the German economy back in the early 1980s.

Arthur Burns, who always regarded his assignment in Germany as a "mission among friends", knew that friendship can also tolerate criticism, provided that it is constructive - indeed, it actually needs such criticism. Against this background, I should like to pay tribute today to a great friend of - and authority on - Germany.

I

In his famous textbook "Economics", Paul Samuelson, winner of the Nobel Prize for Economics, quotes the American actor Will Rogers, who allegedly said that "There have been three great inventions since the beginning of time: fire, the wheel and central banking."

As a central banker, I do not wish to make any further comment on my profession being mentioned in the same breath as fire and the wheel.

I only want to remark that we can now add a further creation - the euro - to those great inventions.

There are some of you who will doubtless feel that adding the euro to that list is a slightly provocative statement to make - especially in the United States with its strong dollar at present.

In point of fact, the adoption of the euro has introduced a currency for which monetary policy has been communitised but not the other areas of economic policy. That has no parallel in history and has created a situation to which many still have to become accustomed.

- How will the participating countries manage to cope without their own monetary and exchange rate policies on a permanent basis?
- And conversely: how will a single monetary policy cope with the fact that it is now faced not with just one but with 11 different national economic policies?
- How is a currency of that kind assessed on the international currency and financial markets?

Those questions are far from easy to answer.

The financial markets are apparently having particular difficulties in recognising the new currency's potential.

I am aware that there are no prizes for originality to be won at the moment by insisting that the euro has the potential to appreciate. But that statement nevertheless remains correct, as I would like to explain in detail shortly.

In passing, I should like to call to mind the situation a few years ago when the dollar was hitting all-time lows. When our American colleagues made assurances at that time that they were interested in a strong dollar - assurances which they, too, often repeated - scarcely anyone in the markets seemed to notice at first either. Many of them probably came to regret that later.

II

It is nevertheless interesting that it is certainly not doubts about the anti-inflationary resolve of European monetary policymakers that is currently perceived by the public to be the reason for the euro's weakness.

At present, many market players are probably focusing more on the long-term outlook for growth and the expected differences in that respect between the United States and Europe.

Barry Eichengreen, professor of economics at Berkeley, said recently that the explanation for the weakness of the euro lies in a changed perception of the revolution in information technology and its implications for productivity and competitiveness in Europe and the USA.

Such assessments ignore two things:

- First, the strong growth in America undoubtedly also has its risks. These lie in the high level of the stock market, the large current account deficit and the low saving ratio.
- Second, the positive stimuli to growth that exist in Europe are frequently underestimated. It is not just that all the forecasts predict that Europe will emerge from the shadow cast by the US economy. Even the longer-term stimuli are not noticed sometimes.

III

That applies, not least, to those stimuli that are being generated by the euro itself.

That is because monetary union is a classic example of the proposition that a merger produces greater value than the sum of its individual parts.

With regard to Europe and the euro, this means that the countries participating in the European monetary union have greater opportunities for growth now that they have a single currency than they did before on their own.

The euro has, in fact, created a large monetary and economic area with a considerable purchasing power which is exceeded only by that of the United States.

Altogether, the 11 countries of the euro area account for around 15½% of global GDP. This share is roughly double that of Japan and 6% below that of the USA, which has around 21%. By contrast, Germany, as the largest country in the euro area, on its own has only a share of about 4½% of global GDP.

The euro area also has the largest share in global trade. Its share of total global exports is around 19½%, compared with a figure of 15% for the USA and 8½% for Japan.

It is scarcely possible to overstate the impetus to competition and growth that can be given by a single large market - a phenomenon which has existed in the USA for a very long time: on the one hand, enterprises in the euro area can grow to a size that makes them globally competitive, the key words in this context being mergers, acquisitions, strategic alliances, joint ventures.

Secondly, internal competition - within the euro area - will also increase, as it is still the case that the bulk of the individual euro area countries' trade is with other participating countries. This trade is now domestic trade for the euro area as a whole, in which exchange rates no longer enter into the equation.

Both factors - a single large market and the intensification of internal trade - will tend to enhance what economists call the growth of potential output in the euro area. At least on the supply side, these factors are likely to boost productivity and growth in the euro area over the longer term as well.

Admittedly, fiercer competition will mean that the challenges become greater. Competition exerts pressure:

- on enterprises, to restructure if profit margins are shrinking;
- on both sides of industry, to stay within the available scope for productivity and to dismantle rigidities on the labour market;
- and on national policymakers, to create underlying conditions that are conducive to investment, to consolidate budgets, to put the social security systems on a sound basis, and to provide the right incentives on the labour market.

If the countries sidestep this pressure to reform, a strain will be placed on the euro.

Alternatively, this pressure may mean the euro becomes a catalyst for devoting more energy to pressing ahead with necessary reform projects that have either been neglected or tackled only half-heartedly up to now.

To that extent a stimulus exists for the euro area to develop into - shall I say - a "new economy".

I hesitate to use that term in this context as I know how difficult it is to identify - let alone, forecast - such shifts in the trend-growth of economies.

But there is also another reason why I hesitate to use that term: it is often used as a synonym for the proposition that all the laws of economics have now supposedly been suspended. That is nonsense, of course. Technology changes, markets change, but economic laws do not. And, even in this brave new world, the rate of inflation will go up if monetary policy is overly expansionary.

Whatever one may make of the "new economy" - one thing is certain: the euro has enhanced Europe's potential for growth.

And this was lent additional support by the declaration of intent of the Heads of State and Government of the European Union at their summit in Lisbon, where they set the new strategic objective of making the Union the most competitive and dynamic knowledge-based economic area in the world.

Admittedly, general declarations of intent alone have never made anyone more competitive.

In a comparative study, the OECD comes to the conclusion that the share of knowledge-based industries in Germany is similar to that in the United States at over 50%. Germany's highest growth in investment is in software.

And, for creating a knowledge-based economy, it is undoubtedly a significant factor that the labour force in Germany is generally highly qualified. That makes it easier to adopt new technologies.

IV

That takes me on to the question of whether the opportunities on offer are also actually being used.

I do indeed have the impression that the necessary restructuring of the European economy is under way.

The changes are perhaps most clearly visible in the financial markets, where Europe is currently being confronted with a massive surge of initial public offerings on the stock market. More than 200 new innovative enterprises are now listed on the *Neuer Markt* and investment in venture capital in Germany rose by DM 5 billion in 1999.

A lot is happening at the moment on the mergers and acquisitions front.

The process of concentration is going beyond national frontiers and traditional market segments, and is helping to open up the global market.

Operational efficiency is being enhanced. Costs are falling. And resources can be saved at the macroeconomic level as well.

Since the mid-1990s, when German industry ran into competitive difficulties due to the exchange rate, internal reforms have been taking place in German enterprises - in some cases, accompanied by a considerable number of redundancies. I firmly believe that German industry is now highly productive and competitive.

What is sometimes also underestimated abroad is the extent of reforms in the public sector, for example, in Germany. Certainly, there is still a lot that can be done in that area.

But what is occasionally overlooked is that large-scale privatisations of telecommunications, postal services, the electricity industry and the railways have taken place or are planned, and that industry is using the opportunities which this presents.

V

Things are also moving in the field of fiscal policy - including in Germany. The deficit ratio has been falling since 1997 - not least owing to the convergence criteria stipulated by the Maastricht Treaty.

Even though the public finance situation is less than ideal when measured against the objectives of the Stability and Growth Pact, notable progress has still been made.

The Federal German government has resolved to pursue a strict course of consolidation, making savings of DM 30 billion in 2000, and is aiming for a deficit ratio of 0.5% in 2003.

At first glance, that may not seem particularly impressive. However, tax cuts are accompanying the consolidation process.

This dual strategy - fiscal consolidation on the one hand and tax reductions on the other - will give back financial scope to the private sector. The reform of corporate taxation will make Germany more attractive as a location for investment. A lowering of corporation tax to 25% is envisaged.

Capital gains from the disposal of participating interests are to be tax-free. This will make restructuring of the corporate landscape easier in future. As a result, Germany might also become interesting as a location for holding companies.

There are some aspects of the planned reform to which objections could perhaps be raised from the point of view of the overall tax structure, but, all in all, the proposals point in the right direction.

So you see, there are a lot of encouraging signs.

There is thus no reason to fear that the euro will be persistently weak on account of Europe's enterprises lagging behind in productivity and competitiveness.

The available opportunities for growth will have to be seized, however. Enterprises must press on with reorganising the economy. Policymakers will have to go ahead with the necessary structural reforms in public finance, the social security systems and on the labour markets.

VI

What part can European monetary policymakers play in this?

Trying to set targets for growth is certainly not the answer. That would surely be counterproductive.

The best way that monetary policymakers can contribute to sustained growth is by pursuing a monetary policy that is consistently geared to the objective of stability.

With a stable currency prices provide an undistorted reflection of the conditions of supply and demand. Efficiency is increased. Valuable resources are saved. With a stable currency investors do not have to pay risk premia on the interest rate. Investment is stimulated. All of that fosters growth.

What is the situation in terms of price stability in Europe?

The euro has a very positive record in that respect.

Despite the recent stronger upside risks to price stability, the internal value of the new currency in its first year was impressively stable.

In the first 12 months the rate of price increase was in some cases well below the 2% mark, which is the definition of price stability adopted by the Governing Council of the European Central Bank (ECB). The rate of price increase in the euro area was 1.1% - a dream result even by German standards.

In January of this year, the inflation rate hit the 2% mark. But it is expected that it will be below 2% for the year 2000 on an annual average. By its policy, the Governing Council of the ECB is making it absolutely clear that it will go on conducting a monetary policy oriented to internal stability in future. That monetary policy strategy is based on two pillars.

Monetary growth - on which the first pillar of the ECB's strategy rests - has been above the reference value of 4½% for some time. Lending to the private sector, too, has been persistently strong. Both indicated that liquidity in the euro area was more than adequate.

The second pillar of the strategy is a broad assessment of the outlook for future price developments. Latterly, most of the relevant indicators having been pointing upward over the medium term - undoubtedly due in part to the rise in oil prices and, of course, also to the downward movement of the euro exchange rate

This exerts pressure on import and producer prices. And, because of second-round effects, they can in turn affect consumer prices. Happily, the pay agreements recently concluded in Germany have been quite within the scope for national income distribution. To that extent, the risk of second-round effects has been reduced. The same applies to OPEC's decision to step up production of crude oil.

In line with its monetary policy strategy, the ECB Governing Council has now raised its key interest rates three times. Those decisions to raise interest rates took account of the existing upside risks to prices. They were taken to ensure continuing tension-free economic growth in the euro area, which is the basis for a sustained development of economic growth.

There is thus no doubt about the ECB Governing Council's resolve to safeguard price stability. That is significant because the future outlook for internal price stability - in other words, inflation expectations - are of major importance for a currency's potential - perhaps even more important, in fact, than the current stability situation. That is because it is primarily the future that is traded in the foreign exchange markets. On the monetary side, the future for the euro looks decidedly good.

Experience has shown that, ultimately, the internal stability of a currency is invariably also reflected in its external value. Naturally, the adjustment must not be in the sense that internal stability follows a weak external value. Rather, the external value will follow a strong internal value. The current scepticism in the financial markets concerning the euro is undoubtedly exaggerated. From a medium-term perspective, certainly, there are no grounds at all for a weak euro.

Europe has all the opportunities and conditions needed. And I am confident that Europe will also make use of those opportunities.