Mr. Tietmeyer considers the challenge of the euro for Europe Special address by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, at the conference on "The Challenge of the Euro for Emerging Markets", convened jointly by the National Bank of Poland and the European Economics and Financial Centre in Warsaw on 12/2/98.

Europe is facing major challenges. Not only will it have to take important decisions affecting the course of future integration. Above all, Europe must also stand up to the test of global competition while preserving its basic values of freedom and solidarity.

The immediate task facing the countries of central and eastern Europe is economic transformation - making their economies internationally competitive and open on a sustainable basis.

Jumping into the "deep water" of international competition with privatised enterprises and banks has set off radical reforms having far-reaching implications.

One of the great thinkers of the Enlightenment, Immanuel Kant, said that the true philosophers are those who carry conviction through their teachings and by setting an example.

Poland may be said to be one of the most successful countries in transition so far. For years now, it has been achieving notable rates of growth. The central bank is doing a good job under its president. It is universally recognised that the rate of inflation has been brought down sharply and that this has been a crucial factor underpinning the restructuring of the economy.

Furthermore, important steps have now been taken towards autonomy for the Polish central bank; they are reflected in the Central Bank Act which recently came into force.

Germany congratulates Poland on the progress that has been achieved. And we are pleased that many different contacts exist at all levels - including, of course, the field of central banking.

I should also like to mention the notable scale of direct investment in Poland by German enterprises. It is gratifying to see that particularly small and medium-sized enterprises are involved in that area.

But, where there are many points of light, some things inevitably cast a shadow. According to the OECD, one of the major risks is that the expansion of the current account deficit cannot be sustained at a manageable level. Furthermore, the OECD experts are calling for the acceleration of restructuring, especially in the areas of privatisation and pension reform. I am certain that the responsible decision-makers in Poland are taking that advice seriously.

II

The EU countries are also facing a problem of transformation.

Increasingly fierce worldwide competition is setting great challenges for most of the EU-countries, too. They must subject their systems of public finance to a critical examination, adjust their welfare systems and make the labour market more flexible. The high level of unemployment - not least in Germany - calls for far-reaching reforms quite independently of the euro.

But the changeover to the euro also calls for transformation.

At the beginning of May, the European Council will take the decision on the countries which are to be members of monetary union from January 1999. For the future participating countries it is a question of transition to the single currency and merging national monetary policies to form a single monetary policy.

These are no longer distant, visionary goals but projects on which a decision is imminent in the next few months.

Admittedly, that decision also involves giving up monetary sovereignty to a new supranational institution - the European Central Bank (ECB). In most countries, this will not be an easy step to take, since in some cases it will represent a permanent departure from long-standing and cherished national traditions. Entry into monetary union is a road on which there is no turning back.

European monetary union (EMU) is not a new project, however. Economic and political integration has been an established policy aim in Europe since the end of the Second World War.

As early as 25 years ago, there was a serious attempt to set a monetary union in motion, although it did not meet with success at the time. In 1991, the Maastricht Treaty revived the idea of monetary union and enshrined the goal of creating a new currency.

The key element of the Treaty is the Statute of the European System of Central Banks with the European Central Bank at its apex. According to the present schedule, the ECB is to be officially inaugurated in Frankfurt on June 30. It will have the legal task and duty of maintaining the price stability of the new European currency. In doing this, the Maastricht Treaty expressly provides that the ECB shall take its decisions without being subject to any influence on the part of political decision-making bodies.

The new single currency undoubtedly deserves a good starting position with an operationally viable supranational central bank. That is because a euro which is stable on a sustainable basis offers great advantages and opportunities:

- The euro will save conversion costs.

- It will eliminate exchange rate risks between the euro participants.

- The euro will improve the functionality of the single market. That will, above all, benefit consumers.

- Above and beyond that, the euro has the potential to build on the international role of the former European currencies (and the D-Mark, in particular) and to become an international reserve and investment currency.

- And the euro can lend a further boost to European economic and political integration.

The national central banks of the participating countries will become integral parts of the European System of Central Banks. The Bundesbank is working all-out to stay on

schedule for putting the technical, organisational and institutional framework in place. The other European central banks, too, must conclude their preparations on time so that the European System of Central Banks can begin its work punctually in compliance with the terms of the Treaty.

The spirit and letter of the Maastricht Treaty require a euro which is a single currency in the true sense of the word. That means more than just having the same currency in the participating countries. A single currency requires:

- that monetary policy uses the same set of instruments and pursues a common objective and a common orientation - not national interests and orientations;

- that fiscal, economic and social policies - which will remain the responsibility of the individual nations - are consistent with stability and do not come into conflict with one another.

A monetary union without adequate and sustained joint stability might become a “union of conflict”. Further political integration in Europe, too, would be subjected to severe strain.

To prevent that happening, it will be crucial to make the right choice of participating countries. They must have the economic capability and the political will to participate in monetary union on an enduring basis without excessive tensions.

Demonstrating that the convergence criteria enshrined in the Maastricht Treaty have been met on a lasting basis is an important factor in the decision on the countries to be selected. This decision is meant to ensure that only those countries will participate which are ready for economic union in terms of their economy and anti-inflationary policy.

I shall not make any forecasts here about the prospective participants. That is because I have too much respect for the procedure enshrined in the Treaty and for the decision-making prerogative of the Heads of State or Government - a right which they will exercise at the beginning of May. The preparations for this are likely to start as soon as the Commission and the EMI (the forerunner of the ECB) have presented their Convergence Reports on March 25.

Why is the decision on the countries chosen to be in at the start of monetary union so important? In monetary union, all the participating countries must be in a position to stay the course unaided. They must be able to secure economic competitiveness and efficiency, above all, by virtue of their own internal efforts. If they are not in a position to do that, not only will they encounter difficulties themselves but other countries of the EMU area will, too.

In contrast to the United States, for example, there will be no supraregional safety net, no revenue and burden sharing arrangement or a union-wide social security system in the future euro area. Regional divergences in economic development will still have to be cushioned at the national level.

Moreover, EMU is not - and, according to the provisions of the Treaty, should not be - a “transfer union”. Instead, the Maastricht Treaty and the “Stability and Growth Pact” call for autonomous fiscal policy stability on the part of all member states. In particular, excessive national budget deficits and high levels of government debt may create the potential for conflict,

which would result in political pressure to provide transfer payments or to conduct a soft monetary policy.

That must not be allowed to occur, however. That is because, in a monetary union, differences over the course of policy can quickly lead to political conflict and confrontation.

III

For the present countries in transition in central and eastern Europe, the most relevant topics to start with are future EU membership and participation in the single market.

It is not yet clear when they will be able to participate in EMU. This is likely to require a lengthy process of convergence.

It was, not least, precisely at the insistence of the German representatives at the Luxembourg summit that the Heads of State or Government agreed to start discussions in March of this year on EU membership with six countries - including Poland. I hope that this discussion process will bring positive results in the none too distant future.

For that purpose, however, the present EU countries must also ensure that the EU is well prepared for the demands of an enlarged community. In particular, a reform of agricultural policy and the structural funds of the Community are on the “Agenda 2000”.

As part of a possible EU membership, joining the fixed exchange rate mechanism of the reformed European Monetary System (ERM II) will then probably also be on the agenda for the currencies of the new member countries.

I can imagine that - if there is a positive decision on Poland’s EU membership - the Polish zloty would be a potential candidate. In principle, all EU countries have the right to participate in ERM II if they fulfil the necessary economic conditions - in particular, full currency convertibility, application of the relevant single market legislation, and stability-conscious monetary, fiscal and economic policies.

Given successful monetary and economic policies, many people will perhaps ask whether unilaterally pegging the exchange rate to the euro in advance might not be a sensible strategy for advanced emerging economies - which would be more ambitious and demanding than the crawling peg strategy which is being pursued here at present.[1]

However, a strategy of this kind initially presupposes that the euro will indeed be a stable, and internationally attractive, investment and reserve currency, and hence a serious competitor for the US dollar.

If that is the case, emerging economies can, of course, use exchange rate pegging to import credibility for an anti-inflationary stance which has yet to be established.

Nevertheless, as was shown by the ERM in 1992-93 and latterly by developments in South-East Asia, this kind of pegging must not be too rigid, especially if there are

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1 The Polish zloty is currently linked to a basket of five currencies (including, primarily, the US dollar and the D-Mark) in the form of a crawling peg.

shortcomings in economic policy and economic divergence from the anchor currency. Exchange rate pegging which has become obsolete can be made worthless overnight by the financial markets. Importing credibility by means of pegging exchange rates must be underpinned by a corresponding domestic policy. If that is not achieved, pegging the exchange rate can become very dangerous.

Far-reaching and sustained anti-inflationary and institutional convergence should therefore come before an exchange rate pegging of this kind, and not the other way round.

That is especially true for later entry into monetary union.

Sustained convergence towards a European stability union is the stated objective of the central and east European countries in transition. In this regard, I share the view of the OECD that Poland has decidedly good prospects of converging over time with western Europe.

We in Germany would very much welcome a sustained stability convergence. I am certain that this would be an advantage for both countries in the long run.

Important as the political will to become more closely involved in the process of European integration may be, the key to its success will be a permanently sustainable economic base.

Good politics needs good economics; in the final analysis, there is no way of getting round that fact.