Mr. Gaddum discusses the euro, US dollar and the world economy Dinner speech by the Deputy Governor of the Deutsche Bundesbank, Mr. Johann Wilhelm Gaddum, on the occasion of the Joint Conference of Konrad-Adenauer-Stiftung and Aspen-Institut, Berlin in Washington DC on 6-8/5/1998.

There is no doubt about it. The European Central Bank will come into operation on July 1.

That also means that the euro is on its way, and that will bring about changes in Europe. But is it only Europe that will be affected?

I very much appreciate having this opportunity to explain the views of the Deutsche Bundesbank on this matter to such a well-informed audience here in Washington.

Recently, in a well-known US newspaper, I saw a cartoon which captured what - to my mind - is the widespread ambivalence concerning the future prospects of the euro.

The cartoon showed a group of experts (presumably economists) sitting at a round table and apparently discussing the future outlook for the euro. The chairman of this group finally gets carried away and exclaims: “I bet you 10 to 1 that the euro will be a success!” Each of the others at the table nods vigorously in agreement with this forecast, replying: “I think so, too.” Only one of the group adds somewhat timidly: “But in dollars.”

Begun as a foreign policy concept, the idea of European monetary union (EMU) has taken on economic significance during the past few years as a result of the globalisation of the markets. So far, there has been little discussion of this international dimension of EMU.

EMU will create a currency area which, when all 15 states of the European Union have become members, will have a population of approximately 370 million whose gross domestic product will represent about 38.3% of the GDP of all OECD states. This will change the respective importance of the world’s currencies.

It therefore seems reasonable to suppose that, when stating what we expect of monetary union, we have to explain, firstly, what the European Central Bank will mean for Europe and particularly for Germany and, secondly, what it may mean for our friends and partners in other parts of the world.

II

Konrad Adenauer always incorporated the idea of European cooperation into German policy, and since then - yes, right up to the present day - this has been a central feature of German policy.

All German governments have had this objective in mind. And the idea of a monetary union has always played an important role in this.

In the light of this it is not surprising that in Germany both the government and the opposition support the project of monetary union - despite the considerable reluctance of the population.

Both prior to and after the signing of the (Maastricht) Treaty the Bundesbank has outlined in its statements what monetary union will mean for Germany (and for the other participating states).

At the request of the Federal Government the Bank issued a further comment on March 26, that is to say, shortly before the decision taken last weekend.

It was only to be expected that the Bundesbank's analysis of the degree of convergence reached within the European Union incorporates light and shade, opportunities and problems. This comment by the Central Bank Council was anything but an excuse for euphoria.

The Bundesbank has <u>not</u> resolved to reject monetary union because of the inherent problems. In addition to making its analysis, it has nevertheless made it clear what responsibilities policy makers will incur as a result of monetary union.

First of all, I shall outline the positive points:

- Exchange rate tensions within Europe have declined appreciably.
- Inflation rates are very similar and are no more than somewhere between 1.0% and 2.0%.
- Capital market rates are now very close to the German rate.

The challenges, however, are as follows:

When their bilateral exchange rates are fixed irrevocably, the participants in monetary union are giving up not only an economically compensatory mechanism - the exchange rate - for ever. They have also to accept an adjustment over the long term of the different economic and political traditions in the member states to the new supranational framework and to put aside national interests in favour of this new dimension.

In a monetary union, which by definition transcends the sovereignty of the participating nation states, discrepancies may arise time and again that must be solved through national economic, fiscal and social policy measures and not through the monetary policy applying uniformly throughout the union.

EMU will increase the competition for inward investment in the participating states. The more flexible a country's goods, financial and labour markets are the better it will be able to compete.

For this reason, the policy of reform which has been in force over the past few years must not be abandoned or applied less vigorously. On the contrary, it must be intensified.

Fiscal policy has a particular role of responsibility in monetary union.

Fiscal policy, in contrast to internal and external monetary policy, which is a union-wide responsibility, will remain the responsibility of the member states. Consequently, it is particularly important that the public authorities can prove that their financial position is on a permanently sound footing.

If they are to fulfil this requirement, some member states will have to make a particular effort.

A permanently sustainable financial position on the part of member states is essential if conflicts between them are to be avoided and, moreover, if conflicts between the respective states and the single stability-oriented monetary policy are to be avoided.

So much for the Bundesbank's basic concern.

We have always thought it was important to make it clear that, if European monetary union was a worthwhile objective, it could not be achieved without a measure of sacrifice.

Monetary union provides all the advantages of a fairly large homogeneous market freed from exchange rate fluctuations. But from its participants it demands economic and political discipline.

The combination of monetary policy uniformity and political diversity poses problems.

It was in this connection that President Chirac spoke of an adventure.

The two largest member states of the union, Germany and France, have different traditions.

On the one hand, there is Germany's fortunate experience with a Bundesbank that is independent in its monetary policy decisions.

Conflicts with the government of the day, whether it be Adenauer's, Schmidt's or Kohl's, have done nothing to change that. In the event, they have actually strengthened the Bundesbank's standing.

France, on the other hand, sees monetary policy as an instrument of the government in power. The recent amendments to the statutes of the Banque de France represent a change in approach which was necessitated by the provisions of the Maastricht Treaty and which was largely unpopular.

The political compromise reached in the dispute concerning the appointment of the first president of the ECB has to be seen against this background.

The aim of the eight-year term of office which is laid down in the Treaty and which cannot be extended is to ensure the independence of the incumbent. The fact that it is precisely this ruling that has been called into question confirms fears that not all of the ramifications implied by an independent monetary policy have yet been finally accepted by the governments concerned. Like the independence of the Bundesbank, it is something that we shall probably still have to fight for.

III

Although the integration of the world economy began a long time ago, a significant acceleration occurred in the 1980s and 1990s.

This is seen in the trends in international capital flows and in the financial markets to an even greater degree than it is in foreign trade.

However, a gigantic step is now being taken with the introduction of a single currency in a large part of the global financial market.

The fragmentation into many national capital markets, a phenomenon which is particularly apparent in the case of the bond markets and which has arisen as a result of the existence of different currencies (and therefore of different interest rates), will be a thing of the past.

The national markets in Europe will compete with each other more intensively than they do now. They will gradually lose the specific national features that they now have.

The large cross-border euro capital market will accelerate the trend towards globalisation. This will encourage processes of concentration and yet provide opportunities to specialise in market segments which need a particularly intensive degree of management know-how.

The volume of transactions on the future euro bond market will approach the size of the undisputedly dominant US market today.

If today's US market is about six times larger than the German market, it will only be about 1.6 times larger than the euro market.

The euro will take over the role of the D-Mark. The tripolar world capital market consisting of the dollar, the euro and the yen is gradually emerging.

The depth and breadth of the euro market, which will be greater than the depth and breadth of the present national markets, will become more attractive to internationally operating customers for and suppliers of capital.

In contrast to the situation in the United States, we will have several sovereign issuers in one single currency area. This competition with respect to creditworthiness need not be a disadvantage.

The greater attractiveness of the European market will increase its efficiency and the professionalism of the market players. What does all of this mean for the German capital market?

With the loss of the D-Mark, Germany, and particularly the German bond market, will lose a major competitive advantage.

The currency which has been the anchor for the European Monetary System and which over a period of some decades has become the most important investment and reserve currency after the dollar will disappear.

We have been trying for some years now to make up for the approaching loss of the competitive advantage we have as a result of the D-Mark.

The German capital market had to be prepared for the euro. Structural weaknesses had to be removed.

The German capital market is now in a strong starting position and is equipped to meet the competition from other financial centres.

German bonds set the benchmark for the yield curve in Europe. Repo business has switched back from London to Frankfurt.

The German futures exchange now handles more than 70% of the Federal Government's contracts. The Bunds, too, have returned from London to Frankfurt.

However, one thing is clear to us: in the long run only a stable euro will have a good chance of taking over the role of a reserve, investment and transaction currency.

Only a stable single currency will provide the European Community with the opportunity to play a major role in the world economy and to do so with correspondingly greater influence than it has today.

IV

What does this mean for our friends and partners in other parts of the world? Many hardly showed any interest in the European debate on monetary union at first; then, in the end, when things had taken on a more concrete shape, they reacted in astonishment. For a long time the EMU project was regarded in non-European countries as having no chance of success.

A sarcastic but not at all untypical comment which I would like to quote may serve as an example of this attitude:

"It's a lunatic idea but, to be honest, one that I thought would collapse of its own stupidity. Unfortunately, it hasn't, and so here goes." (Samuelson, January 1997)

Even US economists for the most part reacted sceptically to the idea of a single currency in Europe when they considered its economic justification.

On the other hand, the European advocates of the EMU project were seldom prepared to answer this criticism.

Presumably the reason for this was that from the outset they had suspected that Americans were being particularly critical about European efforts at integration because they viewed this development through the eyes of competitors.

However, internationally successful currencies are not simply established by politicians by decree. They have to stand their own in competition with other currencies on the financial markets.

I am certain that it will take some time before the euro will be able to assert itself in the international markets and represent a genuine competitor for the US dollar.

At least in the past structural changes in the international currency pattern occurred only very slowly. One only needs to think of the time it took for the dollar to replace the pound sterling.

It was no different when the D-Mark was being established as an international currency: that took years, if not decades.

In its competition with the dollar the euro will have to acquire for itself a certain degree of trust. This is something it will not inherit.

However, Americans and Europeans alike can only benefit from the competition between these two major currencies for the confidence of investors.

The disappearance of exchange rate risks on the European market will provide interesting investment opportunities in Europe for US enterprises, too.

The increase in world trade that can be expected from EMU will also benefit the US economy.

The European economies which enter into this monetary union will be compelled to dismantle market rigidities (especially in the labour markets) if they want to survive in the intensified international competition and be able to meet the consequences of external shocks in the currency area.

The IMF is right in describing the labour markets as the Achilles' heal of the EMU project.

Politically, the development of a system of transfers between the participating states has no chance at the moment. The unsatisfactory situation in the labour markets therefore makes a change in policy inevitable.

This will ultimately have positive repercussions for Europe's trading partners, too, including the United States.

Another reassuring point is that the Maastricht Treaty rules out the possibility of policy makers using the exchange rate of the euro as a foreign trade policy instrument.

A more productive European economy with sound monetary and fiscal policies is likewise not only in Europe's interests but also in the United States'.

I am quite sure that the entire international monetary system will profit from more predictable monetary and fiscal policies in European monetary union.

V

In Washington it is naturally impossible to speak of the international monetary system without addressing yet another aspect of European monetary union, namely the impact of the imminent European monetary union on the debate that is currently being held - especially in the light of the east Asian crisis - in the United States (and elsewhere) on the future role of the IMF.

Now and again one hears fears voiced, especially in the United States, about the potential threat the EMU poses for the global leadership role of the Bretton Woods institutions. I agree with those who urge reforms at the IMF and the World Bank.

The need for reform may be due just as much to the structural changes in the financial markets as to the changes in the importance of world trading partners.

Europe still has to find its role in this process of reform. Where these partners are nation states, each of the member states of the EU acts in its own right; whenever central banks are concerned, the ECB acts as the European central bank.

I admit that this is a complicated arrangement. No easy answer has yet been found.

What is necessary in the interest of the international monetary system is a clear declaration of belief in an open world economy which does <u>not</u> attempt to support hegemonies through hidden regulations.

Surveillance and rules, however carefully they are fomulated, are no substitute for the self-imposed sense of responsibility of the market players themselves.

Instead, a promising approach may be to refrain, when attempting to reform, from giving the IMF a never ending series of new tasks to perform but to restore the role of the IMF to its original function, namely that of a catalyst.

VI

I hope that during the next two days this conference will provide you with many opportunities to take part in interesting discussions which will afford you additional information and new material for coming to your own conclusions.

When you leave Washington again at the weekend, you should be in no doubt - if I may return to the cartoon I mentioned at the beginning - at least about the currency you use when making a bet.