Mr. Tietmeyer discusses EMU – after the Brussels Summit Address by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, at the spring meeting of the Institute of International Finance in Rome on 7/5/98.

I

In Brussels last weekend some momentous decisions were taken.

Now we can be sure about

- the participation of eleven countries,
- the bilateral rates at which the participating countries will irrevocably fix the exchange rates of their currencies upon the start of monetary union, and
- the candidates for the offices of the President, Vice-President and the other four members of the Executive Board. This means that the composition of the ECB Governing Council, in future comprising 17 members, is likewise clarified.

It is, I think, advisable to distinguish between the substance of the decisions and some of the events in Brussels. Not everything that happened last weekend in Brussels contributed to the necessary expectation that the euro will be a really supranational and depoliticised currency. I hope, however, the learning process will go on and some of the things accompanying the weekend decision will be forgotten shortly. For the future what counts most is the substance of the decisions.

The suggestions with regard to the nominations of the Executive Board of the ECB are to be viewed favourably overall. The persons involved are acknowledged experts on monetary and banking issues, and for the most part have many years of experience in the field of monetary policy. And the reactions by the markets were clearly positive. Some analysts are even talking of a “dream-team”. But, of course, even the most promising dream-team has to make the big points in reality.

The EMI has already endorsed the nomination. And we are sure: the European Parliament will do the same in the next few days, so that the ECB can be established as scheduled on the first of June.

II

In several respects, the Brussels decisions already alter European monetary policy-making today (and not merely in January 1999). The policies of the national central banks - although national responsibility still reigns, formally speaking, until the end of this year - are from now on influenced even more by European considerations.

The phrase of “de facto monetary union” was used sometimes in the past. After all, many observers spoke of a “de facto monetary union” in connection with the EMS back in 1991-92 - a notion that soon turned out to be an illusion. But during the seven-month interim period until the start of formal monetary union, there is certainly far more justification for the phrase than there was then.

Firstly, subject to the well-known time-lags, the monetary policies of all the participating national central banks exert an impact on the entire euro area. Hence it is essential not to introduce any national inflationary pressures into the monetary union.

Secondly, upon the entry into monetary union at the end of the year, if not before, uniform money market rates will pertain. On account of the increase in mutual interdependence in Europe, monetary policy cooperation between the national central banks will have to be reinforced, even though final responsibility will rest with the individual national central banks.

There will presumably also be a further convergence of central bank rates. However, such convergence need not take place at the very beginning of the interim period. Limited interest rate differences and exchange rate movements may well continue to exist for some time.

It cannot yet be predicted where the common level of central bank rates will actually be by the end of the year. That depends primarily on monetary and anti-inflationary policy developments throughout “euroland”, with the larger countries naturally bearing particular responsibility on account of their greater economic weight.

In this connection, the future course of the “mix” of fiscal and monetary policy in the individual countries will certainly play a part. After all, in future undesirable developments will not only exercise an impact on the domestic economy. From now on all “euroland”-central banks have to take that into account.

III

As soon as the European Central Bank has been set up, the ECB Governing Council will have a number of important decisions to take before the start of monetary union. For, needless to say, European monetary policy must be fully operational from the very first day of monetary union. In particular, that calls for

- a forward-looking, empirically-backed strategy, and
- an effective arsenal of instruments.

The European Monetary Institute has already done a good deal of preliminary work on both those subjects. Although a consensus has been reached on most issues, a number of options and details are still unresolved. It is on these that decisions are still required - if need be, majority decisions. In any case, the new ECB Governing Council will in part be composed differently from the existing EMI Council.

As regards the monetary policy strategy, two models have emerged from the EMI’s preliminary work: the strategy of direct inflation targeting and that of targeting the money stock. We at the Bundesbank believe that our proven monetary targeting strategy is appropriate in principle for the euro area, too. At all events, studies suggest that the demand for money in the euro area is actually likely to be even more stable than that in national markets.

Above all, a monetary targeting strategy has the advantage that it involves an inherent commitment on the part of the central bank, and sets a standard by which the central bank must let itself be judged. Hence a monetary targeting strategy may be a major element in building up the European Central Bank’s reputation. Moreover, a monetary targeting strategy provides a dependable framework to which the markets' expectations can be geared. It is forward-looking and indicates unwelcome developments at an early stage. However, initially it may not be possible to rule out major volatilities in the movement of the money stock. That owes something to the existing differences in countries' financial market patterns.

Hence it no doubt makes sense to supplement the monetary targeting strategy by some features of direct inflation targeting. Then the European Central Bank would have to elucidate its policies against the background of its money stock target and its price expectations. Such a twofold transparency, in which it seems to me the money stock target should have a certain primacy, could help the single monetary policy to build up a reputation swiftly in the initial phase.

The European Monetary Institute has also elaborated some proposals relating to the range of policy instruments and its structure. The central banks are broadly agreed on a number of instruments. That applies in particular to

- the marginal refinancing facility,
- the deposit facility, and
- the open market instruments in the form of repo transactions (with fixed maturities).

Repo transactions have meanwhile been accepted by all the national central banks as an effective policy instrument consistent with market conditions.

The marginal refinancing facility is intended as a safety valve in the event of short-term liquidity bottlenecks in the money market. It restricts upward swings in money market rates and thus steadies the money market. The deposit facility likewise has a steadying effect, by offsetting short-term liquidity surpluses. It constitutes a floor for money market rates. Hence the two facilities virtually lay down the limits of the interest rate corridor.

I know that the topic of minimum reserves is no favourite of the banks. Even so, I advise the ECB to make limited use of minimum reserves, not so much as a management instrument but rather as a basis instrument. Minimum reserves, as a durable basis instrument, enhance the responsiveness of money demand to changes in interest rates, and thus can make monetary policy more effective.

So as to guarantee the uniformity of the money market in the euro area, the monetary policy operations of the central banks in "euroland" should be settled on a same-day basis. For that purpose, a cross-border large-value payment system - known as TARGET - is being set up. Since TARGET is attractive to the private sector as well, a disagreement has arisen about the conditions of access. In the main, it revolves around the conditions on which banks and central banks outside the euro area are to be granted intra-day credit.

There are good reasons for arguing that participants in another monetary area cannot be granted the same terms of access in every respect as participants within the monetary union. It seems to be only logical that those who wish to benefit fully from the advantages of TARGET will also submit to the monetary policy constraints imposed by the euro area. At all events, the monetary policy of the euro area must not be undermined by recourse to the TARGET system.

Viewed as a whole, there are signs that the instrumental prerequisites for a euro monetary policy consistent with stability will soon all be met. Although that is not a sufficient condition, it is certainly a necessary condition, for a stable euro. And the euro must be stable if it is to unfold in full its undoubtedly great potential for economic benefits. It is only as a stable currency that in future it will be able to play a major role as a global reserve and investment currency, alongside the dollar. And it is only as a stable currency that the euro will make its due contribution to the stability of the international financial system.

IV

But the stability of the international financial system also depends on developments outside Europe. At the moment, after all, international organisations, governments, central banks and private financial institutions (such as the IIF) as well are engaged in drawing conclusions from the dramatic course of events in South-East Asia. Some observers are debating these conclusions in the rather imprecise terms of a radical reform of the structure of the international financial system, with ideas ranging from the abolition of the IMF and World Bank - without replacement - to illusionary notions of a new Bretton Woods system or even a World Central Bank.

I am sure that all these extreme positions do not stand a chance in the real world. In point of fact - as the discussions three weeks ago at the spring meeting of the IMF and World Bank in Washington showed - the key issue is how and in which direction the existing system can be strengthened.

Unfortunately, the crucial importance of well-functioning markets for sound international finance is often underrated. In South-East Asia, at any rate, the functioning of the markets was obstructed in two respects:

- externally, by clinging too long to exchange rate parities which had become unrealistic, and
- internally, by investment decisions which were not geared adequately to sustained profitability.

Any contribution to the prevention and solution of such crises cannot but enhance the markets’ ability to function. And in this context it is not very helpful if the IMF unduly emphasises its financing role and steps in at an early stage with overly large financial packages. That only creates moral hazard problems. This is because such financing may easily be misconstrued as an invitation to the countries concerned, as well as to other endangered countries, to refrain from undertaking essential structural reforms.

Private investors, too, are tempted to pay less heed to the risks. Charles Dallara was quite right to draw attention to these moral hazard problems in his recent letter to the chairman of the Interim Committee.

In my opinion, improving surveillance is a much more promising approach. Besides macroeconomic data, financial market data should be monitored more closely than has been the case hitherto. What we chiefly need, in my view, is more, and more up-to-date, data on countries’ foreign currency debt. This is a challenge addressed to borrowers and lenders alike.

The IMF should endeavour to obtain more, and above all better, data especially from the debtor countries. For the markets’ ability to function, it is essential that the business data collected should be more transparent, more complete and more up-to-date. It is only on this basis that the IMF can perform its primarily catalytic task. That strengthens the structure of the international financial system. And it should also be considered whether governments that fail to comply with such transparency requirements should be publicly admonished.

The challenge extends to creditors, too. At the BIS we are discussing at the moment how the time-lags in the provision of data can be substantially reduced. In particular, the crises in South-East Asia have demonstrated how important timely information on the maturity and the currency of loans may be.

I greatly appreciate the fact that the Institute of International Finance actively buttresses efforts to bring about greater transparency among creditors. After all, this also implies a certain extra workload on creditor banks. But the responsibility for crisis prevention naturally rests on both sides - on the multilateral organisations and the private financial institutions alike. And if a crisis does erupt despite all the efforts at prevention, it can mostly only be overcome if private investors, too, pull their weight - pull their weight, that is, in a spirit of enlightened self-interest.

Charles Dallara was therefore undoubtedly right when he wrote:

> “In this era of globalization, both market participants and multilateral institutions have crucial roles to play; the more they understand each other, the greater the prospects for better-functioning markets and financial stability.”

Of course, both sides have their own rules and responsibilities. But they have their common interests and responsibilities too.

In the market-based financial world of today and tomorrow multilateral institutions can only play a limited role. Bailing out the private investors would not only be beyond the limits of the available reserves; it would - and this is even more important - undermine the proper functioning of the private markets. I am happy to mention that the IIF-members seem to share this view.