Mr Tietmeyer looks at the euro as a stabiliser in the international economic system

Speech by the President of the Deutsche Bundesbank, Prof Hans Tietmeyer, given at the conference of the Luxembourg Institute for European and International Studies and the Pierre Werner Foundation in Luxembourg on 4/12/98.

I

There are just 28 days left until the start of monetary union, which is perhaps the most important monetary event since the end of the Bretton-Woods system.

Some people may be thinking: 'Just another 28 days, and then we've done it!' before heaving a sigh of relief as they relax in their armchairs.

That is a very human reaction, especially when one considers the great efforts and obstacles, all the advances but all the reverses on the way to greater monetary cooperation in Europe as well.

Thirty years ago the subject of monetary union was already a topic on the agenda of the European Community, which in those days consisted of just six member countries. It was at that time that the road to monetary union was first jointly mapped out by you, Pierre Werner, and the Werner Group named after you – in which I myself had the honour of working.

Luxembourg and its political representatives were always advocates of progress towards further-going but clearly stability-oriented integration.

Important insights which were gained at that time are still highly relevant today. For example, the currencies of the participating states can be welded together to form a permanently stable monetary union only

- if there is an adequate degree of ongoing economic convergence between the countries,
- if there are common preferred structures in monetary policy and the same priorities prevail, and
- if there is broad agreement on the basic political stance.

The way forward proposed at that time was different to some extent than the path actually charted in Maastricht. It was envisaged that political integration would develop parallel to economic integration.

However, the consultations following the submission of the Werner Plan showed clearly that the politicians at that time were not prepared to abandon national sovereignty on the quite considerable scale demanded. So the first attempt to launch monetary union fell at this hurdle.

On January 1, 1999 monetary union will therefore be launched at the second attempt. A number of conditions have changed in the meantime:

- Eleven countries will be taking part, as opposed to just six at the time of the first attempt.
- These 11 countries are only part of the overall European Union. Hence there will be differences in the level of monetary integration within the EU.
- And the political framework for integrating the single currency is a rather loose structure.

The euro will have to cope with this as best it can.

For the goal is not merely to ensure that the euro is stable at the beginning. The goal is to ensure that the euro remains stable over the long term. And in the long term it is highly probable that the euro will need a stronger political underpinning.

II

It is gratifying that the financial markets already seem to have largely accepted the euro.

At any rate, the euro has passed its first test.

The markets apparently have confidence in the preannounced exchange rates. So far there have been no marked tensions between the exchange rates of the future participating currencies.

And the euro has already begun to show the first benefits. In the context of problematical developments in the financial markets which in some cases reached crisis-like proportions, the euro has acquired the reputation of a safe haven – even before the actual launching of monetary union – which has led to correspondingly low capital market rates in the future euroland.

None of these things should be taken for granted. They are the result of

- the rigorous stability orientation of the Maastricht Treaty,
- the large degree of convergence that has already been achieved in the monetary stability policies of the central banks,
- the careful preparatory work, and
- the determined efforts that have been made to date to achieve greater convergence in fiscal policy, too.

The safe haven function which the euro area has performed so far clearly demonstrates that the introduction of the new currency is undoubtedly a ‘global event’. And a lot of hopes are being placed on the future international role of the euro.

Clearly, the enlarged financial market in euroland will result in a wider range of products and a broader choice of investment opportunities.

To what extent these greater opportunities will actually be used – especially by enterprises – depends on other conditions as well.

These include the legal framework laid down by the EU and by the national parliaments of the countries concerned, the different traditions in respect of financial market structures and also questions of taxation.

It remains to be seen just how quickly traditional financial market structures move closer together.

And another thing which remains to be seen is the use to which enterprises will put the enlarged capital market. For example, will there be a tendency towards greater concentration as firms seek to exploit ‘economies of scale’ in euroland?

And what about the other question which central bankers are often asked in connection with the international role of the euro:

How fast and to what extent will the euro become a major international investment and reserve currency? Can the euro take over the D-Mark’s role as the second most important investment and reserve currency?

Naturally, the euro will play a significant international role as an investment and reserve currency. If this does not turn out to be the case, it will be an enormous – and scarcely conceivable – surprise as well as a bitter disappointment.

The fact that the euro area is already regarded as a safe haven confirms this assumption. It is simply a fact of life that major international currencies are used by investors from time to time as a safe haven.

However, this can also be a problem in certain situations, especially for the exchange rate.

But it is the *future* stability of the euro that will determine its actual role in the concert of world currencies. And two key criteria for this will be

- sensible monetary policy decisions by the ECB Governing Council, and
- stability-oriented behaviour in those aspects of economic policy which remain a national responsibility, especially fiscal and wage policies.

Given such a policy mix, the euro can assume a major international role – in line with the size and economic importance of euroland – and also make its contribution to global stability.

III

And that brings me to the subject of this conference: ‘The euro as a stabiliser in the international economic system.’

This title expresses great expectations of the future single currency.

- In what sense – if at all – does the international economic system need a stabiliser?
- And if it needs one, how can a currency help to meet such a need?

Let me begin with the second question: as a general principle, currencies cannot solve structural problems relating to the global real economy.

And as far as the first question is concerned, it must be said that, while the world economic setting is difficult at the moment, there is certainly no cause to talk of a fundamental instability.

In recent weeks the financial markets have at least calmed down a little. The world financial crisis which many people predicted looks unlikely to occur at the moment.

It is true that a number of countries are currently suffering crises entailing considerable local growth losses:

- In the South-East Asian countries this is a direct consequence of the financial crisis. But at the moment there are some encouraging signs of an improvement in certain countries.

- Japan continues to suffer, in particular, from the structural problems which have accumulated in its financial sector. Happily, it has now taken steps to put its financial sector in order. These now need to be implemented resolutely.

- In Russia the transformation of the centrally planned economy into a market economy has virtually come to a halt.

- And in Latin America contagion effects manifested themselves in the wake of the uncertainty in the financial markets. Fortunately, the financial markets are showing renewed confidence and are tending more to reward the marked structural advances made in a number of countries.

Nevertheless, these regional crises have clearly left their mark on the global economic growth process.

On the one hand, that does not mean that an overall world economic crisis is looming. The robust state of the US and European economies clearly contradicts such gloomy views.

On the other hand, it is becoming more apparent that the international setting has created some extraordinary risks and uncertainties which are beginning to retard the pace of economic expansion in the industrial countries.

There are some indications that the euro area, too, cannot fully escape the global downward pressure.

Fortunately, this comes at a time when the internal monetary conditions in Europe are rather favourable. The goal of price stability has largely been achieved. Moreover, there seems to be no obvious threat to maintaining price stability in the foreseeable future.

That has given European monetary policy the opportunity for a further round of cuts in central bank interest rates.

As you know, for some weeks now the euro area as a whole has already experienced a period of considerable decline in the average interest rate. This is the result of the so-called process of convergence of central bank interest rates.

At the beginning of this week the Council of the European Central Bank made a comprehensive assessment of the monetary and economic situation in the euro area. This very thorough analysis on the ECB Governing Council, as well as yesterday's discussion on the Bundesbank's Central Bank Council, came to the same conclusion: an additional coordinated rate cut is appropriate which clears the horizon for a level of 3% for the start and the first stage of the euro.

Therefore, this cut also has to include those currencies whose interest rate already lies at the bottom of the current range. The Bundesbank's decision to cut the repo rate by 30 basis points is our contribution to that coordinated action.

The decision is compatible with both the monetary situation and the overall economic conditions. The early announcement of the interest rate level for the launch of the euro may help stabilise expectations in the financial markets. But of course, the rate cut cannot solve the severe structural problems in most of the euro countries. This is particularly true of the structural problems on the labour markets.

IV

Naturally, it is not only Europe that is suffering structural problems and, therefore, facing tough challenges.

To a large extent, it was structural problems occurring in the monetary and banking sector which played a major calamitous role in the outbreak and course of the regional crises.

- Many of the countries affected had excessively rigid exchange rate pegs.
- Many of the countries affected placed their own monetary policy too much at the service of these problematical exchange rate pegs.
- Many of the countries affected have structural deficiencies in the area of financial market supervision, in particular.

These structural problems in the monetary sector have to be solved first and foremost through suitable policy measures in these countries themselves.

How else could these internal structural problems be solved than

- through a confidence-building economic policy,
- through a greater measure of realism in the exchange rate pegs,
- through a stability-oriented central bank policy, and
- through an overhaul of the financial sector and an improvement of banking supervision?

Naturally, international cooperation can also help, but not so much through currency arrangements like the euro as through strengthening the overall functioning and viability of the financial markets. This entails above all

- improving international cooperation in the field of supervision,
- involving private sector creditors in the task of overcoming crises, and
- improving the transparency of the financial markets.

All this will sharpen the markets’ risk awareness and strengthen their functioning and viability.

But considerable structural problems exist in the industrial countries, too.

In the USA the already low private saving ratio has fallen further in recent years, actually showing a negative ratio of late. Despite the country’s balanced budget, the imbalances in foreign trade have not therefore been reduced.

And in most of the euro countries unemployment remains too high. The euro will not be able to solve this problem on it own. Instead the euro requires flexibility and competitiveness in the real economy.

It is the politicians who must tackle these internal structural problems. In the longer run this is the best contribution that can be made towards achieving sound financial markets and a prospering world economy.

V

Boldly undertaking the necessary reforms in the euro area will at the same time prepare the ground for sustained favourable growth and employment prospects.

Given more flexible structures in the markets, a lastingly stable euro will be able to fully exploit the undoubtedly large potential for economic benefits, and then it will also be able to foster political integration.

To sum up: the euro is not the final aim of European integration. Even in 28 days' time it will remain a future-oriented project.

For it is not just a question of introducing the euro. The euro also requires ongoing monetary stability. And the euro requires a sufficient degree of political consensus on the basis of economic dynamism and flexibility. Only in this way can potentially dangerous political conflicts be avoided in the long run.

We are investing great hopes and expectations in this future-oriented project associated with the euro. All those involved are responsible for doing what is necessary to ensure that these hopes and expectations are fulfilled.