Mr Schieber looks at the stability of the euro as an economic and political challenge from the perspective of the Deutsche Bundesbank

Lecture given by Mr Helmut Schieber, Member of the Board of the Deutsche Bundesbank, at the invitation of the America-European Community Association in London on 23 September 1999.

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At first glance, the title of my lecture seems to be a "non-subject", or at least a completely anachronistic subject: given an inflation rate of 1.1 percentage points in July, the absolute limit of under 2% set by the ECB Governing Council still looks far away. Hence, despite a number of risk factors (such as the steep upturn in oil prices) the stability of the euro is presumably not currently in jeopardy. This optimistic conclusion is suggested by the following factors:

(1) the low interest-rate level by historical standards. The recent rise in longer-term interest rates no doubt mirrors more favourable expectations for business activity; it is rather to be regarded as a rejection of the spectre of deflation than as a reflection of latent inflation expectations;

(2) the keen competition on the factor and goods markets (due to globalisation and the launch of the euro) results, on the one hand, in a substantial growth of productivity but, on the other, also in strong downward price pressure in some sectors (in Germany, for instance, in the areas of telecommunications and electricity);

(3) In view of the substantial unutilised capacity, the emerging revitalisation of business activity may well make non-inflationary growth possible for the production factors capital and labour alike.

Regardless of the prevailing macroeconomic setting, the excellent underlying institutional conditions for the euro should always be borne in mind in any discussion of the stability of the euro: to enable it to perform its primary task of maintaining monetary stability, the ECB was endowed, under the Treaty of Maastricht, with a high degree of independence. Notwithstanding a number of dissenting voices, especially from the English-speaking area, the ECB has a convincing monetary policy strategy. In addition, the Eurosystem possesses a comprehensive, up-to-date and market-oriented range of monetary policy instruments, which have already proved their worth in the short period since the euro was launched. Finally, it is worth pointing out that the ECB Governing Council has swiftly grown into a body with common convictions and perceptions; in the process, it has increasingly generated a European "stability culture" distinct from particular national interests.

In view of these auspicious underlying economic and institutional conditions, it appears completely misplaced to worry about the stability of the euro. And yet, it is a long-standing experience of the Bundesbank that inflation has often been declared dead, but has never actually died. Nothing is more dangerous than complacency and slackening vigilance.

Where might any future risks to the stability of the euro lie? Well, in the first place, a number of unavoidable problems arise in connection with the transition to a larger common monetary area.

It is doubtful, for instance, whether the demand for, and the velocity of circulation of, money in the new monetary area will be sufficiently stable from the outset. What will be the impact of, say, structural changes in the financial sector (catchwords are: the trend towards securitisation and towards disintermediation)? What will be the implications for the monetary policy of the ECB of the differing monetary policy transmission channels within the eurozone?

These transitional difficulties should not be made light of, by any means. Even so, they will diminish in significance – albeit not in the short run – as increasing experience is gained within the Eurosystem.

It will certainly be interesting to see how the ECB responds the first time that it feels a “head wind”. It is a long-standing experience of the Bundesbank that the acid test of monetary policy comes when a restrictive policy stance has to be pursued. In this context, the prevailing structure of the Eurosystem naturally raises a variety of special questions:

1. Will the ECB Governing Council act quickly and resolutely even if it were to be confronted with massive political opposition?
2. Will the general public in Europe support the ECB just as unreservedly as German citizens backed the Bundesbank, i.e. will the ECB enjoy comparable backing for its stabilisation policy?
3. Will the ECB Governing Council abide by its orientation towards the euro area even if that policy no longer seems appropriate for particular parts of that area?
4. How will the monetary policy of the ECB respond if the ECOFIN Council exercises its powers under Article 111 of the EC Treaty, for instance by formulating general orientations or exchange-rate policy? Will the stability reservation laid down in that clause actually hold up?

In my opinion, the ECB deserves our full confidence in all of these questions. But on the other hand, it is obvious that the ECB, as a new institution, initially has to earn public confidence (and thus at the same time due scope for the formulation of current monetary policy), even though it is likely to have inherited a certain “advance” of confidence from the Bundesbank.

But the crucial issue affecting the stability of the euro will be that of how the relationship between **national** fiscal, economic, structural and wage policy, on the one hand, and **supranational** monetary policy, on the other, will evolve in the euro area.

The fundamental problem is the same as in every country. A central bank can control the expansion of the money stock, at least over the medium term. But it depends on the other policy areas whether the leeway thus gained is exploited

- for real economic growth at stable prices, or
- for raising prices, accompanied by stagnating or even declining economic performance.

Thus, for preserving monetary stability, a central bank is always dependent on the cooperation of the government in power and of the parties to wage settlements; it is only by means of a policy-mix that is compatible with stability that non-inflationary growth can ultimately be achieved.

In the euro area we are now facing a special problem: a single monetary policy for eleven member states is accompanied by national responsibility for wage policy, fiscal policy and economic policy.

It is true that a closer coordination of fiscal and economic policies is envisaged by Articles 98, 99 and 104 of the EC Treaty, and by what is known as the Stability and Growth Pact (i.e. above all: decisions on common features of economic policy and mutual budget surveillance), but these coordination mechanisms still have to prove their worth in practice. A great deal will depend on policymakers behaving with sufficient discipline in the interests of the stability of the single currency.

In order to shed more light on this dilemma, permit me briefly to address a particularly ticklish problem: assuming that a restrictive policy is being pursued, an increase in interest rates would have widely differing effects on the budget situations of the various member states, since the levels and maturity patterns of public debt diverge vastly. As this naturally also affects compliance with the rules of the Stability and Growth Pact, a restrictive monetary policy also involves additional conflict potential.

In this context, the important question of the durability of the internal cohesion of the euro area must not be disregarded, either.

On the one hand, in view of the continued convergence and integration of the eurozone, optimism certainly seems warranted: that is suggested by the increasing cyclical synchrony, the progressive integration of the financial markets (and especially of the European money market), and the completion of the single European market. On the other hand, substantial regional differences and divergences cannot be ruled out (just think, for instance, of the North/South divide in Italy, and the East/West divide in Germany due to reunification). The range of possible causes could not be wider, for example

- asymmetric external shocks,
- divergent pay settlements,
- differing national policy priorities, or
- diverse national structural conditions.

Generally speaking, it is true to say that, the more flexible national goods, services and labour markets are, the lower will be the demand for compensatory measures on the part of national fiscal, economic and structural policies. But precisely market flexibility is a weak link in many European member states (and that goes particularly for Germany). In many cases there is a considerable need for reform, e.g. with respect to reducing the government expenditure ratio, deregulation, restructuring of social security systems or adjusting tax legislation.

There are, however, good grounds for hoping that the pressure exerted by the single currency will greatly foster the reform process. Yet even if major steps are taken towards flexibility, the risk of national or regional special developments can never be ruled out altogether.

Whereas it used to be possible, at least to a certain degree, to respond to special national problems by modifying the interest rate and/or the exchange rate, this option is no longer available in the monetary union. The consequence is that the demands made on political compensatory measures, on the willingness and ability of national policymakers to respond, and on the European coordination process have definitely risen. National failure, especially on the part of a major country, may have a pronounced impact on the common interest-rate level and/or on the external value of the euro.

Finally, this state of affairs also gives rise to the question of the suitability of the underlying institutional conditions, i.e. of the EC Treaty. Considerable doubts exist as to whether, in the light of the demands described above on a policy compatible with the euro, the demarcation of responsibilities between the European level and the national level, the rules for coordinating Community decisions and the structures of the European institutions are appropriate and efficient. That is particularly true if the planned enlargement of the EU, and also of EMU, is taken into account. There is a lot of evidence suggesting that the latest amendment of the EC Treaty by the Treaty of Amsterdam (known as the Maastricht II Treaty) has failed to solve these major problems.

All this makes two things very clear:

1. The launch of the euro is a political act, and far more than a mere technical development. It has substantial implications for economic and political structures and responsibilities in Europe.
2. The stability of the euro is a major challenge not only to the Eurosystem but likewise to the economic and fiscal policies of member states and to the coordination of those policies.

To sum up, I should like to emphasise once again that, all in all, the euro has got off to a good start, also in the light of the counterinflationary policy setting. But the acid test still lies ahead. The major opportunities afforded by the euro are accompanied by corresponding risks and challenges. The fate of the euro in the years ahead will hinge crucially on whether member states become aware of this task, and on how they address it. This issue will certainly also play a major role in the forthcoming debates in the UK and other countries on joining the Eurosystem. I very much hope that the behaviour of the euro member states will make it easier for the nations and governments in question to reach a favourable decision.