Herr Gaddum gives his views on the challenges facing European central banks in the light of EMU Address by the Vice-President of the Deutsche Bundesbank, Herr Johann Wilhelm Gaddum, to the 32nd Conference of the Governors of South-East Asian Central Banks in Bangkok on 13/2/97.

I

I consider it a great honour to be invited to speak at the Conference of the Governors of South-East Asian Central Banks. Professor Tietmeyer was glad to receive your invitation and took it up with pleasure. He regrets very much that he is unable to be here.

We regard the contacts and dialogue within the global central bank community as being most important and valuable. In addition, I would rate your invitation as being a reflection of your interest in Europe, and in economic and monetary developments there. Conversely, I can assure you that European interest in Asia has increased tremendously in recent years.

We are full of admiration for your cultural and economic achievements. We Germans, in particular, are well aware that economic progress is neither a miracle nor a matter of luck. Economic success has to do with wise policy decisions. And it also has to do with the capabilities and industry of human beings.

The present day and age is distinguished by progressive economic integration. It is taking place on two levels. The one level is regional integration. In many parts of the world the regions are moving more closely together. This is mostly due to economic factors: creating larger markets and free-trade areas, and structuring the division of labour more effectively. In Europe the economic motives are combined with political ones. The peoples of Europe have learned from past conflicts.

Besides the economic merging, European integration is designed to help forestall tensions between countries and reconcile diverging interests. Incidentally, regional integration is celebrating anniversaries this year, both here in South-East Asia and in Europe. ASEAN will be thirty years old this year, and the European Union forty.

The other level of integration is globalisation, which is galloping ahead. Here, several factors are combining and mutually reinforcing one another:

- the internal decisions many countries have taken to open up their markets,
- the easing of restrictions on multilateral trade and,
- in particular, the huge technological advances in telecommunications and data processing.

Undoubtedly, one of the major challenges facing policy makers worldwide is that of fostering regional and global integration side by side, rather than in opposition to one another. It is a matter - as we say in German - of doing the one without failing to do the other. In the triangular global political relationship between Asia, North America and Europe, the transatlantic community between the European Union and North America, on the one hand, and Asia-Pacific Economic Cooperation (APEC), on the other, already have an important part to play. I hope and confidently expect that in future the Asian-European link in this triangle will increase in significance. An important initial step in this direction was the first European-Asian Summit Meeting of Heads of State and Government here in Bangkok just under a year ago.

II

The two levels of integration are currently determining to a very large extent the work of European central banks. The challenges posed by the global markets are affecting all central banks worldwide in much the same way. But the tasks faced in the context of regional integration in Europe are unique.

After all, under the Treaty of Maastricht Europe has set itself the target of a monetary union before the end of this century. The present year will be of crucial importance on the road to that goal. The timetable envisaged is as follows: the countries that will participate in the monetary union from the start will be ascertained in spring 1998. The participating countries will have to fulfil the following criteria, in particular:

- stable monetary conditions as regards the value of money, the exchange rate and the longer-term interest rate level,
- lastingly sustainable public finance, and
- an independent national central bank.

Which countries that will be, will become manifest after the examination and decision next spring. To date, there have been forecasts, as well as some wishful thinking. But decisions or preliminary decisions have not been taken yet.

Monetary union is due to begin in 1999. At that date the participating countries will irrevocably fix the exchange rates of their currencies and introduce the euro. From the first day onwards, the European Central Bank will assume full responsibility for monetary policy. National central banks will become members of the European System of Central Banks. On the basis of the decisions taken by the European Central Bank, they will then implement monetary policy decentrally (insofar as that is possible).

Whereas the financial markets are expected to use the euro from as early as 1999, retail business is likely to go on using national currencies at first. This is because banknotes and coins denominated in euros are not due to be issued until the beginning of the year 2002. Without any doubt, the monetary union is an ambitious project. It implies, from the first day onwards, irrevocably fixed exchange rates between the participating countries and a single monetary policy; that is to say, a common central bank, identical central bank rates for all countries, a virtually uniform arsenal of policy instruments and much more besides. The euro will be a supranational currency. The single monetary policy will apply - unlike the situation in most other monetary areas - to several states that in other respects remain sovereign.

On the one hand, the introduction of the euro will present new opportunities for integration. The economies of the participating countries will be able to grow more closely together. The Common Market will be afforded a new dimension. On the other hand, in order to realise the benefits, the euro area will have to fulfil two main conditions: First, the participating countries will have to be able (both economically and in terms of anti-inflation policy) permanently to relinquish the instrument of exchange rate adjustment relative to one another. And, second, the differing national traditions and structures which the countries bring into the monetary union will have to grow into a single whole. For instance, some countries have different policy traditions on issues such as:

- what part can and should monetary policy play in the real economy?

- which target has priority in the event of a conflict between domestic price stability and external exchange rate stability?

In addition, national central banks have divergent backgrounds as regards their relations with the government and their standing in the eyes of the general public. In some cases, they also have different policy instruments, deployed in different ways. By such means, they have taken due account of the differing structures of the domestic banking system.

Establishing a monetary union implies building sustainable bridges across these differences. The single currency calls for joint answers to the underlying issues of monetary policy. The prerequisites are being elaborated at three levels: First, the choice of the participants at the start of monetary union is vitally important. This is to ensure that the range of countries remains fairly homogeneous overall with respect to their maturity for anti-inflation policy. Second, the Treaty of Maastricht laid down the independence of the European Central Bank and of all the central banks participating in monetary union. The statute of the European Central Bank defines ensuring price stability as its priority target. In this way the Treaty gives an unambiguous answer to the question of the fundamental orientation of the future monetary union. It is designed as a community of stability. And third, the European Monetary Institute, as a forerunner of the European Central Bank, has been working in Frankfurt for three years now.

III

Under the auspices of the European Monetary Institute, we are preparing the organisational and technical framework for the decision on the single monetary policy and its implementation.

The preparatory work makes up a long list:

- First of all, a strategy for harmonised monetary statistics was drawn up.
- Central banks are working together with the European Monetary Institute on the introduction of a real time gross settlement system (TARGET).
- The EMI Council has already decided on the design of the future euro banknotes.
- In its Framework Report, the European Monetary Institute has recently mapped out a framework for the future strategy and the arsenal of policy instruments.

The policy instruments will be geared to market conditions, transparent and efficient. Open market operations will be at the centre of refinancing policy. Two standard tenders are envisaged: one tender running for two weeks (that will be the most important instrument), accompanied by a second tender running for three months. In the case of the longer-term tender, national central banks, when assessing the eligibility of collateral, are to have the option of taking national financing patterns into account. Two standing facilities are available for providing or absorbing overnight liquidity. They form a corridor for the rate for day-to-day money and signal the prevailing monetary policy stance.

In the shape of the Framework Report, the European Monetary Institute has already laid down a number of benchmarks for future European monetary policy. However, it cannot take all decisions away from the European Central Bank. This is because the ultimate decision on the strategy and the actual deployment of the policy instruments remains, of course, in the hands of the European Central Bank. After all, it bears the responsibility and must take the final decision. Hence, where there is still no consensus on the EMI Council, the decision remains pending for the time being. That applies, for instance, to the strategy. The Framework Report provides for an alternative between a two-tier strategy, with a monetary aggregate as the intermediate target, and the single-tier strategy of a direct inflation target.

The Bundesbank strongly advocates the monetary targeting approach. Needless to say, we also recognise that managing a monetary aggregate is becoming more difficult under the conditions presented by current financial markets. But the European Central Bank could demonstrate its responsibility more clearly and more transparently by means of the monetary targeting strategy. And the virtual adoption of the strategy of the erstwhile anchor currency Deutsche Mark would be a token of continuity.

Another unresolved question, for example, is the issue of minimum reserves. The European Monetary Institute is preparing the option. Then the European Central Bank will have to decide at a later date whether minimum reserves will be adopted, and in which form. In future, a great deal will depend on the European Central Bank. Many people are pinning their hopes and expectations of a stable euro on its independence and steadfastness.

The biggest challenge facing the European Central Bank lies in its need to earn the requisite reputation and credibility as quickly as possible. This is in order to justify people’s hopes of a stable euro. And to enable it to weather the test to be expected from the global financial markets.

IV

The environment in which central banks (and other economic policy makers, too) operate has undergone a radical change in the last decade.

- We are witnessing economic developments in the markets: professionalisation of investors, globalisation of financial markets.
- We are witnessing political reforms: deregulation of the domestic markets, liberalisation of border-crossing capital movements.
- We are witnessing technological breakthroughs in information and communications technology.

All these changes are interacting, reinforcing one another and constituting a new real world. This upheaval presents great opportunities. The international capital markets can operate more efficiently. Market transparency is increasing. Greater diversification of investment may help to allocate capital more effectively, in line with its marginal productivity. Risk management is becoming more efficient. The financial markets are better able to perform their transformation function. The markets are better able to reconcile savers’ and investors’ preferences with respect to maturities, batch sizes and risks.

Nowadays the financial markets perform a monitoring function all around the clock. Those markets test countries’ policies. They scrutinise the lasting sustainability of public finance. They scrutinise the gearing of monetary policy to stability. Where they register doubt, they are able to penalise massively by siphoning off capital and imposing high capital market rates. Hence the financial markets, in their monitoring and sanctionative capacity, figure as valuable allies of a monetary policy geared to stability.

At the same time, however, the financial markets often appear to give cause for concern. Many people are suspicious of the financial markets' power. For the financial markets increasingly seem to be divesting themselves of the "subservient role" they are supposed to play. Such fears apply, for one thing, to the relations of the global financial markets with national monetary, economic and fiscal policy. Anonymous market forces constrict policy makers' national room for manoeuvre. This may lead to tensions because domestic policy-making normally claims to be sovereign. But, at least insofar as the financial markets thereby lessen the scope for a monetary policy that is detrimental to stability and a fiscal policy that inflates debt, the economist will not deplore that fact unduly. For a policy that fosters inflation and exacerbates national debt widens scope, at the most, for a temporary period; in the longer run, any such scope is narrowed.

But there is a second dimension to the misgivings that the financial markets are no longer duly performing their subservient function. That relates to the relations with the real economy. In itself, a high volatility of financial market prices may affect real economic decisions. For example, enterprises may increasingly switch to hedging against the risk of sharply fluctuating exchange rates not only by means of financial contracts such as currency futures, but also by diversifying the locations, in terms of different currency areas.

Prolonged distortions, such as misalignments of exchange rates or bubbles in asset prices, are all the more problematic. It is not only that the financial markets distort real relationships. The relevant adjustments are often sudden and violent, as in the case of the European Monetary System early in the nineties, or of Mexico. It is precisely such crisis-like upheavals that prompt the question of whether and, if so, to what extent today's financial markets have become more unstable, and whether systemic risk has increased?

Some people fear that the advance of professionalism among fund managers and institutional investors, in particular, might increase the incidence of such dangers. Their thinking is determined primarily by the short-term performance of their portfolio. In certain situations, that may intensify the "herd instinct", triggering a "rush to the exit". At the same time, new financial instruments make it easier for them to incur higher risk positions. Swings in sentiment may then lead all the more easily to precarious situations.

On the other hand, the greater international diversification of investments makes the markets fundamentally more resilient today. Furthermore, owing to the increased significance of the funds, relative to that of the banks, the creditor pattern is nowadays much more heterogeneous and more diversified. That reduces the risk of chain reactions. If the banks are less heavily involved, the danger of a liquidity crisis impairing the viability of the payment and settlement system decreases. After all, not every liquidity crisis poses a systemic risk.

V

Central banks - like other economic policy makers - must adjust to the reality represented by the global financial markets. That applies to all policy areas: monetary policy, exchange rate policy, banking supervision. Problematic developments in the financial markets are not as a rule exclusively inherent in those markets. They often also have to do with current or earlier policy decisions. Monetary policy itself must not be an uncertainty factor that fosters volatility. It must focus on continuity, must build confidence. Continuity, consistency, credibility - the three Cs denote the right direction.

To be sure, a medium-term monetary policy geared to continuity is not always easy to pursue, with the present-day financial markets and their frequent volatility as a counterpart. But there is no alternative. By and large, a steady, sound policy stance is easier for an independent central bank, which is at least spared the turmoil of day-to-day politics. Its guiding principle for exchange rate policy must be: it must not set unrealistic objectives. It must take great care not to provide the markets with triggering points; that is to say, points on which the entire credibility of a system or a policy hinges. Then, the markets can undertake a test.

And its guiding principle for banking supervision must be: financial conglomeration and market globalisation, in particular, call for closer cooperation in the field of banking supervision between the responsible national authorities and between the international supervisory bodies for banking, insurance and securities operations. This applies even if a complete restructuring of a supervisory regime outside the existing patterns of supervision is unlikely to be implemented in the foreseeable future. Present-day supervision does not seek to push the market into the background, but rather to reinforce it. Competition is meant to discipline. Supervision is not intended to get bogged down in details, but to draw up a few key rules. Risks must be covered. A minimum of transparency must be present.

Above all, the sanctionative mechanism of the markets must continue to work. There must not be any bailing-out that fosters moral hazard. Banking supervision seeks to enhance competition. It is therefore not merely a matter of lessening systemic risk. It is also a matter of identical competitive conditions, along the lines of “same business, same risks, same rules”. I am glad that the banking supervisory authorities are now working together in Basle beyond the range of the G-10 countries alone. Although the responsibility will remain at national level in future, the closer international cooperation among national supervisory authorities will improve mutual information, in addition to devising common standards.

VI

Information and communication: these are the keywords for the interaction of the markets and for the globalisation of business. To my mind, information and communication must also be the keywords for collaboration among central banks; naturally at the regional level, and particularly at the global level, too. In this context, I continue to believe that the G-10 is a forum that is useful and has proved its worth. But, needless to say, global collaboration must be much more broadly based. It should encompass all major players. It is this conviction that has recently prompted the BIS to invite a number of central banks from South-East Asia to become new members.

Furthermore, the G-10 working parties - the Basle Committee on Banking Supervision, the Euro-Currency Standing Committee, and the Committee on Payment and Settlement Systems - have invited representatives of non-G-10 countries, in order increasingly to address questions connected with the emerging markets. At the same time, the Governors have enlarged their meetings in Basle. Non-members of the BIS are also being invited to take part in the informal discussions and make their views known.

The discussions in Basle cover a wide variety of topics:

- the instruments, strategy and environment of monetary policy,
- questions of foreign exchange reserve policy,

- recent developments in the markets, such as changes in financial intermediation or electronic money,
- and much else besides.

I am sure that such exchanges of views will enhance mutual understanding of the problems and the approaches to solutions. Needless to say, the conditions for central banks are heterogeneous all over the world. But even so - or precisely for that reason - collaboration at a global level may be fruitful. In any case, the globalised markets are pushing all central banks - regardless of their regional affiliation - in the same direction. Not in the sense that all central banks are forced to think or act in the same way. But no matter which actual policies a central bank may pursue, the globalised markets demand a high degree of solidarity. This is a current and future challenge facing every central bank in the world.