**Prof. Tietmeyer discusses the relationship between economic convergence and EMU** Speech by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, delivered to the Boersen Executive Club in Copenhagen on 14/3/97.

I

The Boersen Executive Club has asked me to speak about "Economic Convergence and EMU". I shall be pleased to do so, especially as I can well imagine that you here in Denmark are able to adopt a somewhat more relaxed and calmer approach to the subject of "Convergence and EMU".

There are two obvious reasons for that. Firstly, Denmark itself has made distinct progress in economic convergence during the past few years. That progress was documented in the European Monetary Institute's recently published Convergence Report.

- The Danish krone has been stable internally for a good number of years.

- It is unlikely that Denmark will have any problem with the exchange rate criterion either. Happily, participation in the ERM - as in Germany - has never been at issue here.

- And there has been notable progress in consolidating public finance.

The assessment of Denmark in the European Monetary Institute's Convergence Report was therefore decidedly more positive than that of Germany.

The second reason why you in Denmark can be rather more relaxed on the subject of "Convergence and EMU" is, of course, self-evident. Denmark has announced that, for the time being, it is not going to participate in the third stage of monetary union.

Naturally, we in Germany respect Denmark's sovereign decision, even if we at the Bundesbank are not unreservedly happy about that decision. That is because it is precisely in the initial phase that we shall need stable partners in EMU. But the door is open. The terms of entry are known on all sides. What has not happened yet can, of course, take place at some point in the future. It goes without saying, however, that this is a matter for the Danes themselves to decide. Whatever decision Denmark ultimately takes on participating in the third stage, I hope that exchange rate stability is maintained as before.

It is likely that the Danish krone will belong at least to the exchange rate mechanism of "EMS II" from the outset. That would, at any rate, imply the existence of close bilateral links between the Danish krone and the euro. For the rest, it is precisely the economic and stability record of countries not wishing to belong from the outset which represents a challenge to and a commitment for the euro area. In this way, Denmark can play a part, at least indirectly, in the anti-inflationary orientation of the euro, even if it does not join EMU at once.

Naturally enough, the setting-up of an "EMS II" will, at the same time, enhance the responsibility of the European Central Bank. A stable euro is an essential precondition for the operation of an intra-European exchange rate system. I am convinced that the European Central Bank will be fully aware of precisely that international responsibility for the euro as the anchor currency.

There will also be other links between the Danish central bank and the European Central Bank:

- The Governor of Danmarks Nationalbank will be a member of the enlarged Governing Council of the ECB.
- And the central banks of the countries with a derogation are also invited to participate in TARGET, the planned large-value payment system for the euro.

In saying that, I would ask you to understand why there has to be a minimum of divergence in the terms of participation in TARGET. Those terms have to take account of the differing commitments of the central banks inside and outside the euro area.

II

In order to explain the relationship between economic convergence and EMU, there is, in the first place, a fairly simple textbook answer. By definition, a monetary union abolishes, once and for all, the instrument of exchange rate adjustment between the participating economies. The countries taking part must be able to do without that instrument for ever - even if structural changes occur. That calls for the ability on the part of each participant to keep up with the others in terms of economic and anti-inflationary performance, or - if it does fall behind - the ability to remedy a worsening of its competitive position by its own domestic efforts.

These general requirements of a single currency area apply to the euro to a quite special degree. There are three reasons for this: <u>Firstly</u>, in the supranational euro area - in contrast to the usual national environment of a currency - there will be hardly any fiscal policy mechanisms that would be able to counterbalance regional disequilibria. There will not be a dominant central budget. At the Community level, there will be no network comparable to an internal, national system of income redistribution. The public financial systems and social security will remain in the national domain.

<u>Secondly</u>, any regional disequilibria in the euro area would scarcely be mitigated by high labour mobility. Linguistic and cultural barriers will continue to exist. Furthermore, high labour mobility within Europe might even provoke opposition. In Germany, we have witnessed something of that kind in the construction industry, owing to the fact that it depresses wages.

And <u>thirdly</u>, the increased need for internal flexibility resulting from the irrevocably fixed exchange rates must be seen against the backdrop of current economic conditions in Europe. Most countries in Europe are faced with an enormous need for adjustment anyway

- as a result of the fiercer competition in the single market and in a global economy
- and as a result of a number of domestic problems which are probably home-grown: on the labour market, in public finance, in provision for old age.

The setting prefigured for the next decade is therefore a highly dynamic one. That will, of course, not make it easier for any country to perform the task of holding its own economically in a monetary union.

Bearing that in mind, it will be extremely important for the euro area to restrict entry to those countries which are ready in terms of their economic and anti-inflation policies.

That is to prevent a lack of anti-inflationary convergence from being transformed into real economic divergence. Any split in real economic trends would, naturally, exert pressure in the direction of a transfer and social union, or even of a European “super-state”, which you in Denmark - if I understand it correctly - do not want, and which we in Germany - I can assure you - do not want either.

Adequate and lasting convergence is in the individual countries’ own interests, however. That is because a country which is unable durably to pursue the same course as the others in the euro area will itself get into difficulties - all the more so if the other countries are not prepared to enter into a permanent burden-sharing arrangement, with all its attendant political implications.

III

Besides that textbook answer to the question of the relationship between convergence and EMU, there is another aspect. What a monetary union needs is not just convergence in terms of the hard economic data. It also needs a convergence in terms of thinking. That implies convergence in objectives and in how we interpret and explain the interaction of economic forces. Monetary union will not just abolish the exchange rate instrument domestically. It will of necessity also call for a single domestic and external monetary policy, and thus a common stance in a key policy area.

For the euro area, however, achieving and maintaining a common stance of this kind will undoubtedly be more difficult than for a traditional national currency area. Whereas the currency will be supranational, it will generally remain the individual governments that will be taking the decisions on economic and social policy. That is all the more reason why the euro needs dominant patterns of preference which are common to all participants. That likewise implies the affirmation of major fundamental positions.

<u>Firstly</u>, maintaining the value of money is the best contribution that monetary policy can make to economic growth and employment. Price stability is the foundation on which society and policy-makers can and must carry out the necessary adjustments. <u>Secondly</u>, in the event of conflict, internal price stability must have priority over external exchange rate stability. <u>Thirdly</u>, experience has shown that a central bank which is independent of the vagaries of day-to-day politics, and committed solely to the goal of price stability, helps to safeguard that indispensable price stability. By the way, that might be even more important in a supranational union than in a purely national context.

These three basic convictions are essential to a durably stable currency. That is why they have rightly been enshrined in the Maastricht Treaty.

- Article 107 lays down the European Central Bank’s independence of instructions.
- The Statute of the European Central Bank requires it “to maintain price stability” as its primary objective.
- And Article 109 (1) and (2) require the EU Council to pursue external exchange-rate policy without prejudice to the objective of maintaining price stability.

Any calls for the political control of the European Central Bank or for different objectives were thus firmly rejected five years ago, when the Treaty was signed.

But it is, of course, not only the legal position created by the Maastricht Treaty which argues in favour of the primacy of price stability and its safeguarding by means of independent monetary policy. Past experience and economic reason argue in its favour, too. It is important that this is perceived - and lastingly perceived - to be the case in all the participating countries. Otherwise, political conflicts might impose a heavy burden on monetary union at a later date.

The task of preserving a durably stable currency is, however, one which has to be faced in other policy areas, too. It cannot be a matter for the monetary policy of the European Central Bank alone - particularly since the ECB still has to establish its reputation and credibility in the first place. However great a contribution an independent central bank can make to a stable currency, monetary policy is never conducted in a political vacuum or under laboratory conditions. And, in the long run, a currency's fate can never be divorced from the political and economic trends in the area in which it is used. That is why there is yet another item on the list of common features needed for a durably stable monetary union.

The Euro requires, fourthly, a sense of and a willingness for shared responsibility for the currency in all the participating countries and in the various policy areas. That applies to wage rate policy, for example. Above all, however, it applies to fiscal policy. It is the resolute and lasting pursuit of sound policies that will be of crucial importance in that respect - and not any one-off measures.

An effective stability pact is extremely important, too, for the same reason - a stability pact being, incidentally, precisely in the interests of the smaller countries. After all, any undisciplined behaviour on the part of a large partner country of substantial economic weight could have a severe adverse impact on interest rates and on confidence in long-term stability, thus hampering the economic growth of its partners. The pact on stability and growth agreed in Dublin is an important reminder and assertion of the need for that shared responsibility. Its details are to be set down in legal texts during the next few weeks. What will be absolutely crucial at this juncture is for the requirements laid down in Dublin to be spelled out in precise terms. Failing this, there might easily be unnecessary conflict later on. And, of course, at a later date it will be necessary to apply those provisions consistently if excessive budget deficits are incurred.

## IV

EMU being able to build on sufficient convergence in economic performance as well as on sufficient convergence in the thinking of all the participating countries, would undoubtedly open up major opportunities for Europe. The economic advantages are obvious:

- Exchange costs will cease to exist in trade within the euro area.
- Exchange rates against the US dollar and the yen could become more stable.
- The financial markets could expand and intensify, to the benefit of creditors and debtors.

But, above all - and this is the key factor - overall competition will increase. A stable common currency will give the single market a new dimension. Admittedly, that does not by any means imply that the euro will solve the structural problems besetting a large number of European countries at present or in future. On the contrary, the pressure to adjust deriving from the single market and from globalisation will, if anything, tend to grow stronger rather than weaker.

Incidentally, the increasing competitive pressure by no means implies that all countries have to pursue the same economic and social policies. Under the conditions obtaining now and in the future, policy-makers will, in fact, have different options available to them to satisfy their own preferences. But there is one precept that holds true for everyone, whether they like it or not. Whatever policy a country may pursue, the economy must be viable, and compete, in an international setting on a durable basis.

One gains the impression that, at the moment, the smaller countries in continental Europe are having slightly less difficulty in adapting to changed competitive conditions. Perhaps that is because it has always been more necessary for smaller countries to be flexible and prove themselves in foreign markets. Obviously, it is a case of “small is beautiful”. At any rate, both the Netherlands and Denmark appear to be already a little way ahead of the larger countries on the continent. Hence Germany is looking here towards Denmark with growing interest. The German press reports on the “job miracle in the north” - especially as the fall in unemployment and resilient growth is being accompanied by a marked course of consolidation in public finance.

Last autumn, for example, the present Governor of the Dutch central bank and future President of the European Monetary Institute, Wim Duisenberg, was in a position to say:

> “I do not believe that there is a contradiction between fiscal consolidation and creation of employment and economic growth. Evidence from ... Denmark supports my view. In Denmark, the general government’s net borrowing will be reduced to almost a balanced budget in 1997, while the unemployment rate is expected to decline to almost 9 % of the working population, compared with the all-time high of more than 12 % in 1994.”

Admittedly, public finance is precisely the area in which Denmark has to be ambitious. The provisional “no” to entry into the third stage of monetary union may be playing a certain role in the international financial markets. At least, that was how the OECD saw it in its 1996 Economic Survey:

> “... the increase in Danish risk premiums seems high compared with other ERM members. Since the main feature that separates Denmark from those countries is the discussion not to participate in stage III of ERM.”

Denmark can now point to a positive interrelationship between higher employment and sound public finance. In that respect, Denmark is a model for us in Germany.

Our country is at present in the process of rethinking, and facing up to these difficult challenges. That is not a simple matter, especially as the structural inflexibilities existing in Germany have arisen over a long period. Our own adjustments are all the more important, seeing that we shall have to cope with the economic implications of German reunification for some considerable time to come.

It is my hope and wish that we shall soon be able to make the progress that is needed, and achieve positive results. That will undoubtedly be the case if we follow the path taken by our neighbours in the north and north-west. At all events, the Netherlands and Denmark are setting important signposts, not only for us in Germany, but also for the road to EMU and beyond.