Mr. Tietmeyer emphasises that monetary stability is a perpetual challenge

Speech given by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, at the 1st European Equity Traders Convention of the Federation of European Stock Exchanges in Frankfurt/Main on 19/6/97.

I

The old German folk tale about the stars that fall from the sky as thalers is a dream that, on the European stage, has largely come to an end. The single currency will not fall into the lap of the nations of Europe - at least not as a stable payment medium.

The arduous struggle for strict and lasting compliance with the convergence criteria - precisely here in Germany, too - shows that a stable euro is more like a valuable treasure buried in a field. At present, some work is still needed to uncover it. And it will require further energy to guard the euro's stability on a lasting basis. In saying that, the realisation that it is not possible to make good policy with bad money has, in fact, gained some ground over the past few years.

There has been a growing general recognition of the fact that as stable a general price level as possible is an indispensable precondition for long-term growth which promotes employment and fosters social cohesion. Stability and employment are not mutually exclusive. Indeed, I am pleased that the Amsterdam summit seems to have realised this.

The encouraging increase in price stability in Europe is also a result of the preparations for monetary union, however. In 1996, the average rate of inflation in the EU countries was no more than 2.5 %, for example, and is likely to be even less in 1997. The financial markets react very sensitively nowadays to political and economic changes that herald risks of inflation. It is possible that higher interest rates and exchange rate reactions will then quickly follow. As a consequence, the globalised financial markets are increasingly also becoming guardians of stability. Since price stability is simultaneously making headway worldwide, too, there are some commentators who already go as far as pronouncing inflation to be "dead". Does that mean that safeguarding monetary stability is not a perpetual challenge after all?

II

An animated debate is taking place, not only in the United States, on the question of whether moving even closer to a stable price level might do more harm than good in macroeconomic terms. The losses in output and employment during the course of a further reduction in inflation might, in the view of some, be higher than the gains in stability that are still to be achieved. It is also argued that a moderate inflation rate might promote employment, given, say, that the labour markets are not very flexible and that nominal wages show a certain ratchet effect. It might additionally contribute to lower real interest rates.

From my point of view, these arguments point in the wrong direction. Firstly, the rightly deplored distortions due to time-lags in wage and price formation are seldom long-term in nature. And, secondly, attempting to use monetary means to solve problems in the real economy inevitably leads to an inflationary dead end. Such an attempt overrates the ability of economic policy to control real processes and, at the same time, unwarrantably underestimates the controllability of inflationary processes once they have been set in motion.

The advantages of lasting price stability are obvious, however. Fundamentally, they accrue without any time limit and every year. That is also true when a high degree of stability has already been achieved. Overall economic costs arise, even in the case of inflation that is fully anticipated. That is because any monetary erosion has the effect of a tax on cash held. Prices and contracts, too, have to be adjusted regularly. Even a moderate rise in the general price level may imply appreciable uncertainty for economic agents. It is only with difficulty that the future rate of inflation can be assessed. The risk involved in long-term nominal contracts increases. An inflation premium is added to interest rates in the capital market.

In a system of taxation that is based on nominal variables, moderate monetary erosion also makes the tax burden rise. With increasing rates of taxation, even growth in revenue that is merely inflation-induced is subject to increasingly higher taxation (so-called “cold” progression). And the nominally constant exemption limits lose their value in real terms. Above all, that places a strain on capital income and leads to significant growth losses as a result of lower savings, as has been established by Martin Feldstein, for instance.

The costs associated with hedging financial transactions against inflationary risks is likewise considerable. For you, as players in the financial markets, that may be a lucrative business. You will probably agree with me, however, that - in macroeconomic terms - there are definitely more productive ways of investing money. In addition, stable money avoids the negative consequences for income and wealth distribution and hence the risk of societal conflict. Whereas, given inflation, creditors make arbitrary and unearned gains, it is the recipients of transfer income and the owners of monetary assets who are the losers. I am thinking, in particular, of the small savers who wish to make additional provision for old age. Given 3 % inflation over a period of ten years, their monetary assets lose no less than one quarter of their purchasing power, for example.

Thus, looked at over a longer period of time, attempts to moderate a high standard of stability are not at all worthwhile. Internal stability is and remains the sole genuine seal of approval for a good currency. That is the sole basis on which confidence in the monetary system will grow, on which millions of efficient processes of exchange in the goods, factor and financial markets can be organised every day, and on which economic relationships that are sustainable in the long term can be established. For that reason, monetary stability is - and will remain - a perpetual challenge even in the age of moderate rates of inflation.

III

That applies quite particularly with a view to European monetary union. If the euro is not given the stability seal of approval by the financial markets and the general public from the outset, the project of monetary union will be standing - economically and politically - on feet of clay. But how can the euro be given stability from the start, apart from the future ECB pursuing a consistent and stability-oriented monetary policy?

I wish to highlight three aspects.

1. Fiscal policy in the participating countries must regain its room for manoeuvre.

A glance at the public sector budgets in the majority of member states shows how narrow the financial scope has become everywhere following the many years of accumulating debt and the expansion of the public sector. The vicious circle of growing indebtedness and of ever-higher interest burdens pushes other tasks into the background and calls for higher and

higher taxes and levies. That is especially the case in those countries with retirement provision and health care based on the "pay as you go" principle, and which are faced with considerable demographic challenges. In a large number of European countries, the government ratio and the taxes and social security ratio have now reached such orders of magnitude that they are threatening to strangle the economy's power of innovation, and putting more and more jobs at risk. This process must be corrected if prospects for growth and employment are to be improved on a lasting basis.

For that reason - irrespective of monetary union - sustained consolidation is a pressing need. Short-term one-off actions or a relaxation of the Maastricht fiscal criteria would, in may view, give the wrong signals. That would only encourage the disastrous illusion that the financial position is still bearable or that it will improve automatically at a later date. Moreover, it would reduce the salutary pressure to reform exerted by the Maastricht process. Urgent adjustments would then probably continue to be put on hold - and place an even heavier burden on the future.

An unsound fiscal policy and a strict monetary policy do not go together in the longer term. The distortions in the shape of economic costs, due to higher interest rates, employment and growth losses, may become very large. That is the reason why, under Article 109j of the Maastricht Treaty, all the European countries must make efforts to achieve "the sustainability of the government financial position" beyond the starting date. In all probability, the supranational monetary policy of the ECB will, in the event of a conflict, find it difficult enough as it is to withstand the political pressure of fiscal, economic and pay-rate policies which remain national in Europe.

For that reason,

2. the independence of the European System of Central Banks enshrined in the Maastricht Treaty must not be infringed.

By dispensing with the exchange rate, the participating countries will be doing without the mechanism which they were previously able to use to cushion differences between countries in terms of inflation, productivity or the growth of government debt. In the euro currency area, there will be no comprehensive financial adjustment scheme in support of economically weaker countries. The countries lack the money and probably the willingness for large-scale transfer payments. The burden of adjustment in the case of changes in productivity and demand will lie almost exclusively with national labour costs. Wages and wage-related levies must be geared to differences in productivity, otherwise unemployment will easily occur. If wages are not sufficiently flexible, however, there will be a great danger that pressure for actionism will soon be directed to the single monetary policy. That is because experience teaches us that policy makers easily fall prey to the temptation to side-step the pressure of structural problems by means of a little extra inflation. Given differing trends between countries, however, that could also easily lead to conflicts between them.

In Germany, the Bundesbank has always been able to rely on its anti-inflationary policy having the broad support of the general public, and to defend its independence against any political pressure. That has become apparent again during the past few weeks. And the confidence which the markets have always shown in the Bundesbank is based on such experience. The European Central Bank still has to earn that confidence, however. As I understand things, this will be all the easier, the greater is the stock of confidence introduced by the national central banks from their own countries. In other words: the more persistently policy

makers in all the participating countries champion the independence of the European Central Bank and then also respect its monetary policy decisions.

For the euro to be successful, however, it is also important for

3. the European countries to solve their structural problems and to face up to the new challenges.

The resolution of the European Council on growth and employment states that

> "... it should be a priority aim to develop a skilled, trained and adaptable workforce and to make labour markets responsive to economic change. Structural reforms need to be comprehensive in scope ..."

That statement is actually true. Apart from that, it has little to do with monetary union *per se*. Those problems and challenges exist anyway:

- persistently high unemployment, for example, which - even with a cyclical upturn - is unlikely to fall significantly without structural changes;
- in a large number of countries, the welfare state is increasingly reaching - or has already reached - the point where it cannot go any further in terms of funding;
- demographic trends call for timely adjustments in health care and retirement provision;
- advancing economic globalisation is intensifying competition and calls for new thinking and action.

Those are undoubtedly only some of the tasks. We are all aware of the pressing problems in our own countries.

Each country must find its own, nationally appropriate solution. For it is certain that the euro will, if anything, further intensify competition to win inward investment within Europe. At the same time, Europe's structural weaknesses will be revealed more starkly in an international comparison. No one should indulge in any illusions. The euro cannot pay off past debts nor can it eliminate unemployment that has already been created. On the contrary, increasing demands will be placed on the participating countries as a result of them dispensing with their own exchange rate and interest rate policies. The problems that exist must therefore be solved, if possible, before entry into monetary union.

It is precisely in the case of economic divergence in the euro area that each participating country must be adaptable enough to manage without the emergency escape route of altering the exchange rate. It is only if each participating country is competitive on its own terms that the single Europe will be able to assume a leading role as an economic region in the future.

In Germany, the realisation that change is necessary is gradually beginning to gain acceptance. The road which leads from realising that to the necessary reform is still an arduous one at times, however - especially during the run-up to the elections:

> "We do not have a problem of perception,
> but rather a problem of implementation."

That statement by the Federal President, Roman Herzog, puts the present situation in Germany in a nutshell.

What we now need more than anything, therefore, is the courage and the determination to redefine the priorities of government and the public sector. Reliable underlying conditions politically in the longer term are important for giving investors certainty. Further steps must also be taken towards labour markets that are more flexible, even if management and labour have already made some moves in that direction. And, overall, we need a greater degree of personal responsibility and private initiative in order to find innovative solutions to structural rigidities.

Without doubt, those countries under the umbrella of a single currency that act quickly and fully on the basis the lessons that have been learned will be those which are best able to hold their own. Anyone who puts off the necessary reforms might easily fall behind even further in competing as an industrial location. I hope that all the countries which are pushing for entry into monetary union are aware of that fact.

IV

The European financial markets are under pressure to adjust, too, of course. Some countries - such as Germany with the D-Mark as the second most important reserve and investment currency in the world - will lose their currency-related “bonus”, whereas others will strengthen their position, which was weaker hitherto because of their currency.

In the monetary union, the formerly national European capital markets will draw much closer together. Currency and interest rate differentials will no longer matter.

Despite that, it is unlikely that a completely uniform market will come into existence. Certain special national regulations will still be in force - in the case of taxation of investment income, for instance. Nevertheless, I still hope that there will be a growing recognition that further progress in harmonisation is an urgent necessity. In practice, issues having the same terms are still likely to show limited differences in yields. Yield differentials will then mainly be due to the differences in the standing of the issuers and the differing liquidity of the issues.

Higher demands will be placed on public sector national debt management because currency will no longer act as a “screen”. Even now, the globalisation of the financial markets is calling for a widespread application of international standards. The euro is likely to encourage that trend. A reliable political regulatory framework and an efficient structure in the national financial markets will then become crucial assets in competing for capital that is in short supply.

What implications do these developments have for the European financial markets? At present, there are still a large number of stock markets and futures exchanges in the European Union which have a wide variety of market models and trading systems. As in the financial industry as a whole, the pressure of competition and advances in communication technology will lead to a process of adjustment and concentration. But the debate on the future of Europe’s financial centres is also connected with questions concerning the set of instruments that the European System of Central Banks will have at its disposal.

The Bundesbank attaches great importance to the monetary policy strategy - including the instruments belonging to it - being implemented in a way that leaves competition unaffected, and which does not discriminate against any financial centre in the euro area. We do not want any privileges for Frankfurt, but we do not want any disadvantages either. Along with the national central banks, which will carry the main weight of operational activities, the European Central Bank must itself have its own limited field of operations. That is because, from our point of view, competition between the stock market centres and trading systems which are not bound locationally is the best means of finding the appropriate financial market structure for the larger currency area.

The greater breadth and depth of the euro market compared with the former national markets can also bring new business, of course. The euro - especially if it is enduringly stable - is likely to be particularly attractive for internationally operating demanders and suppliers of capital. The euro, however, will still first have to earn its position in the portfolio of public and private investors by competing with other currencies. In saying that, it ought to be beyond dispute that a euro which is weak inwardly in terms of its purchasing power will not be able to take a leading position externally. For that reason, too, safeguarding monetary stability is a perpetual challenge for the euro.

V

Policy makers must now create confidence by taking credible decisions so that the general public and the markets accept the future euro. The aim must be a smooth changeover from the national currencies to the euro. Turbulence in the financial markets due to volatile exchange rates or to institutional investors abruptly adjusting their portfolios might place a considerable strain on the euro at its inception.

In Dublin, the European Council made a major contribution to planning and legal certainty for all concerned with the two regulations on the adoption of the euro. Happily, the Amsterdam summit endorsed those drafts. But it is also necessary for the markets to know in good time how the final exchange rates are fixed. That is something which is still under discussion at present. It is very much my hope that the ministers of finance and central bank governors will arrive at a common opinion on this question at the next Informal Ecofin in Luxembourg in September.

The choice of the countries starting with monetary union will naturally be of crucial importance. In accordance with the schedule, that decision will be taken in spring 1998 on the basis of the economic data for 1997. In my view, speculating now about the group of participants is inappropriate. Such speculation could ultimately do more harm than good, because it increases overall uncertainty. For that reason, I shall also continue to refrain from engaging in it. In my opinion, neither political calculation nor short-term success in meeting the criteria should decide the choice of participants to be made, ultimately, by the heads of state and of government acting by a qualified majority. Rather, sustained convergence and credibility in terms of anti-inflation policy will be crucial. It will undoubtedly be possible to gauge how credible that decision is by how the financial markets behave, too.

VI

A stable euro will indeed be a valuable treasure. That is why the architects of monetary union must not forget that monetary stability is a perpetual challenge. And on no account must they forget that confidence in a currency is established only with difficulty, but

squandered incredibly quickly. Even if the euro will not fall into the European nations’ lap like a star falling as a thaler from the sky, at least the efforts undertaken to obtain it must not be in vain. Monetary union must not be achieved by gaining the euro and losing stability. Instead, we need a euro which - like the D-Mark now - is a byword for lasting stability.