Mr. Tietmeyer discusses the benefits, opportunities and pitfalls of financial and monetary integration Address by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, at the 1998 Mais Lecture at the City University Business School, in London, on 18/5/98.

First of all, I wish to thank you very much for your kind invitation. I am pleased to have the opportunity to give this year's Mais Lecture and to share with you some of my thoughts. It is a great honour for me to be invited to continue the sequence of outstanding personalities who have established and maintained the tradition and reputation of the Mais Lecture with their talks.

At the same time, I am happy to be here in London once again. For every visitor London is a wonderful city full of culture and history. For a central banker, London is, in addition, a large and efficient financial centre. Its strong points include, not least, the academic infrastructure in economics and business. The City University Business School is making an important contribution to that.

I should of course like to add: I come from a financial centre on the continent which likewise has some strong points. And experience shows: competition is always stimulating for both sides. Thus, the two financial and monetary centres, London and Frankfurt, go some way towards symbolising tonight's topic: Financial and Monetary Integration: Benefits, Opportunities and Pitfalls.

I

I should like to begin with the hypothetical question: What will historians of the future regard as the most important, forward-looking features of the close of the twentieth century? Perhaps they will point to the following three features: Firstly: following the outcome of the competition between the political systems, the competition of the economic systems between a market economy and a centrally planned economy likewise seems to have come to an end. At any rate, the state socialist model as a competitor of the free market economy has foundered - not only because it was dissolved in and together with the Soviet Union and its former sphere of influence; what is more, it is no longer a serious reference model for the development of emerging economies; not even for China.

Secondly: economic historians may, later on, perhaps see the present time as a period of dramatic technical and economic upheaval - of "creative destruction" in Schumpeter's phrase. In particular, basic innovation in microelectronics is being reflected in lots of procedural innovations which are now more and more reaching application status and in many product innovations becoming increasingly marketable.

And thirdly: we contemporaries are speaking more and more of an era of progressive economic integration, at both a regional and a global level. Globalisation is the keyword in today's discussion.

These three features are of course interlinked. The victory of the market economy system and the decline in transportation and communication costs are fuelling global integration. Global competition, in turn, is fostering the search for new applications of the technical possibilities. And especially in a dynamic period with large adjustment requirements in almost all sectors of the economy, a centrally planned economy is especially inferior to a market economy.

All three features have a common thrust. They work in the direction of overcoming national frontiers and administrative barriers. The old dream of internationalism therefore holds out the promise of coming true.

But the more this open, increasingly barrierless world becomes reality, the more evident it grows that this is not a perfect or simple world. On the contrary: in the wake of the former east-west conflict, conflicts within countries or in individual regions have not become less common. Indeed, some conflicts which had previously been obscured have only now come to light. And the technological changes and economic globalisation are not only a source of greater prosperity. They at the same time pose huge challenges. The developed industrial countries are particularly feeling the need for reform in their labour markets and social security systems. This is especially true of countries in continental Europe.

II

Progressive economic integration is, of course, not a new phenomenon. But there are many indications that this process has accelerated and intensified in the last ten years, both quantitatively and qualitatively.

Economic integration is a comprehensive process. It is increasingly affecting the real economy. The international interdependence of national economies is increasing. A new quality is emerging. For the growing interdependence is no longer based solely or primarily on trade in finished products or commodities. Especially, the process of developing and producing goods is being increasingly split up internationally. This is possible because national frontiers have become increasingly permeable and communications have become more intensive, because transportation and communication costs have fallen sharply, and because, in particular, the emerging economies have likewise become more integrated in the world economy; this, above all, markedly facilitates direct investment there.

The front runners of such integration are of course the global financial markets. They are able to take the best advantage of the disappearance of transaction barriers and the new technological options. In a world of increasing real economic interdependence, and with global financial markets, the question of monetary integration is also becoming more urgent.

The calculability and appropriateness of monetary relationships is becoming more important. Globalisation therefore increases the overall pressure to pursue a stability-oriented monetary policy everywhere. If a country, especially a bigger one, drops out, this may lead, in an integrated world economy, to serious damage due to volatile financial market prices. And this is why many countries are switching over to monetary cooperation, or even to pegging their exchange rates.

One part of Europe is now going a radical step further. Eleven EU countries will enter into monetary union on a durable basis at the end of this year. That union will then pursue a single supranational monetary policy decided by a supranational and politically independent central bank.

A number of countries will closely watch the outcome of this experiment, which may change Europe considerably. This is true in particular of those countries of the European Union which do not wish to join the monetary union as yet. Accession candidates in central and eastern Europe, too, will of course watch developments with keen interest. But countries in other parts of the world as well will focus their attention on the euro area. This is because some countries in South America or Asia are beginning at least to contemplate the option of a monetary union. Even if they still have a long way to go.

III

What is it that prompts sovereign states to follow this basic trend towards economic integration, even if of course it does not always lead as far as is planned for Euroland?

Essentially, three more or less major benefits may be derived from any form of economic integration: <u>Firstly</u>, more integration leads to more competition. Competitive pressure enhances efficiency. <u>Secondly</u>, integration changes market structures. Markets become larger. Enterprises are able to exploit economies of scale. National economies can specialise to a greater extent. Resources are fed into a larger pool, from which they can be allocated more efficiently. And market breadth increases. The consumer can choose from a wider range of products offered. <u>Thirdly</u>, integration reduces information and transaction costs. This applies in particular to monetary integration, too.

But - what is invariably true is also true of economic integration: there is no such thing as a free lunch.

First of all, it is helpful to distinguish between market integration and policy integration. Market integration mainly implies dismantling barriers and obstacles. Then national markets can grow together. Policy integration goes further. It also implies that countries coordinate or even harmonise the general direction of movement in individual sectors of national policy, or individual parameters.

The countries which join an integration process must clearly appreciate three potential problem areas:

<u>First problem area</u>: market integration going beyond national borders poses increased domestic challenges. For instance, integration in the international division of labour accelerates structural change and calls for more internal flexibility, especially on the labour market. And liberalising capital movements places demands on the domestic financial sector, which must be able to handle international capital flows that may rapidly change direction.

<u>Second problem area</u>: to be really efficient, market integration with the elimination of barriers may require a minimum of policy integration. This applies, for example, to some protection provisions for products and in the production process. Different tax systems may of course likewise distort cross-border goods and financial flows. And if capital markets are globalised, different approaches to monetary policy may contribute to volatility. Such volatility may have a strong impact on financial and real investment.

But, and this is the <u>third problem area</u>: policy integration is itself a two-edged sword. It may make markets more efficient. But it can also contribute to curbing policy competition. That may involve risks: an excessive tendency towards centralisation may arise which does not take sufficient account of diverging conditions. The delineation of responsibilities may become blurred if mixed responsibilities arise with undue bureaucracy. In the worst-case scenario, efficient policy solutions may no longer be implemented. Policy innovation is blocked.

Countries must be able to come to terms with these three risks and problem areas in their efforts to coordinate or integrate their policies, if they are to secure the benefits of integration. Striking the right balance here is not always easy.

IV

The financial markets are something like the flywheels of globalisation. Free capital movements and efficient financial markets greatly facilitate direct investment. They provide the basis for transactions and for the safety of payment flows, which are the financial equivalent of real integration.

The global financial markets promote and strengthen market structures. They also make it possible for investment in emerging economies to be funded privately, rather than officially, today on a much greater scale than previously. Capital is allocated today, more than it used to be, in accordance with economic, rather than political, criteria.

Conversely, the integration of the emerging economies into the global financial markets provides new investment outlets for savings. This must also be seen against the backdrop of the ageing populations in most industrialised countries. They in particular must accumulate and invest capital today so as to be able to maintain their relative standard of living in the future, too.

And the global capital markets have assumed a role which is bearing fruit in the disciplining of national policies. They offer opportunities, but also pose a risk, to countries which fail to follow the economic constraints. Nowadays they are an effective part of the checks and balances.

These important benefits of the international capital markets are sometimes wrongly disregarded in the ongoing debate.

But the financial crises being encountered by some east Asian countries have, of course, highlighted the risks, too. A number of emerging economies have become swiftly integrated in the global financial markets. Not all of those countries have adjusted their internal structures at the same pace and as thoroughly. That makes them vulnerable. Two weaknesses, in particular, may become their Achilles heel: a domestic financial sector which is unable to handle large capital flows in a sufficiently sound manner, and an overly rigid exchange rate pegging to one or more other currencies.

Exchange rate pegging can in some cases and for some length of time produce positive effects. An overly rigid exchange rate peg, however, can have problematic consequences: It may jeopardise the competitiveness of an economy, and especially exports. It may fetter domestic interest rate policy. It thereby makes it more difficult to fight inflation in periods of heavy capital inflows. And it may tempt residents to borrow in foreign currencies at relatively favourable nominal interest rates. These consequences may make a country vulnerable, as we have seen already in the Mexican case in 1994-5.

In addition, some risk factors are inherent in the market. The international financial markets mostly have a tendency towards short-termism. A major part of international lendings and borrowings is at fairly short term. And they quite often tend to follow a self-reinforcing herd instinct in periods both of euphoria and of scepticism.

Both factors, any domestic weaknesses and the properties of the international financial markets, may cause a potential for a reversal in sentiment for a currency to build up. Mostly triggered by some special economic or political change or other, the exchange rate of a currency may go down very fast, in many cases to an overly low point. An “undershooting” of the appropriate relationship occurs. Such a slump in the value of a currency can hit the economy of the country concerned with a massive force, especially if that country is heavily indebted in a foreign currency.

What is to be done? Two points in particular are important:

Firstly, the functioning of the financial markets must be maintained or strengthened. On the one hand, to this end the markets need more, better and more up-to-date information on the level, maturity and denomination pattern of the debts of potential risk countries. Sufficient transparency is of particular significance for the functioning of the financial markets. On the other hand, the IMF must not encourage moral-hazard attitudes on the part of investors and recipient countries by bailing out private investors. Losses caused by misjudgements and enforced adjustment in the event of wrong behaviour are as much an integral part of a functioning market as are profit opportunities. And crises should not invariably lead to a rollback on the part of private investors. Private funding of investment is in principle superior to public funding. Ways must be found to safeguard the long-term interests of private investors. Though there is probably no panacea, various approaches are being considered, and rightly so. The IMF above all has to act as a catalyst maintaining or restoring countries’ access to private capital. A policy of bailing out private investors is heading in the wrong direction.

Secondly, it is important for countries to eliminate their domestic weaknesses or prevent them from arising in the first place. This includes: being careful about overly rigid exchange rate pegs, strengthening domestic supervision of the financial system, and above all, strengthening domestic competitive structures in the goods markets and in the financial sector.

V

Cynics might now say that Europe should make sparing use of the advice: “Be careful with exchange rate pegs”. After all, eleven European countries are actually on the road towards monetary union. And hitherto they have also largely linked their mutual exchange rates, though not always without any problems in the past.

Monetary union does in fact represent a maximum of policy integration in the monetary field. Monetary policy is not merely coordinated, but unified. And that will be for good, because in practice this step cannot be reversed.

There were of course also some other options. With the European Monetary System, Europe’s approach has for a long time been that of an exchange rate arrangement with fixed but adjustable parities; at times there have been some considerable difficulties, but in the end the system has proved largely successful. That goes in particular also for the period after the widening of the fluctuation margins. Nevertheless, this approach falls short of full monetary integration and the strategy of a single currency.

At the time, your country above all proposed another, less ambitious solution than full monetary union; I am referring to the adoption of a parallel currency, to be used as a common currency. That would probably have triggered a currency competition. Depending on its design, that solution could, however, also have adversely affected the scope for monetary action of the central banks of the existing hard currency countries and thus jeopardised their anti-inflation policy. A parallel currency would presumably have got stuck. It might perhaps have been able to crowd out weaker currencies, but whether also a currency of the D-mark's standing would at least be doubtful. This is true, at any rate, of the specific form of monetary policy activities discussed at the time.

Be that as it may, in the Maastricht Treaty a more far-reaching solution was adopted. A large majority in the EU opted not merely for a common currency. It also wanted a single currency. There are sound economic reasons in favour of a single currency; incidentally, also sound political reasons, at least, if a more thorough-going political integration is being sought.

Above all, the single currency makes it possible fully to exploit the economic benefits of integration. Competition will be given maximum encouragement in the single market by the complete transparency of prices. Factor allocation will no longer be impaired by domestic exchange rate uncertainty. Exchange-rate-related information and transaction costs will be minimised by a single currency. The euro financial markets will have an optimum depth and breadth.

But what applies to economic integration in general also applies to monetary integration in particular: These benefits will not come automatically and not without corresponding challenges.

How can monetary union secure the benefits? What risks are looming?

Monetary union is faced with three major challenges: <u>Firstly</u>, the aforementioned benefits for the goods and financial markets will materialise only if the euro remains lastingly stable. Only then will the euro lead to full price transparency, reduce costs and become an attractive investment currency. <u>Secondly</u>, monetary union must not trigger or exacerbate economic tensions. Broadly speaking, an essential requirement that must be met is: one size fits all. And, <u>thirdly</u>, monetary union must not give rise to political tensions between the participating states.

These challenges arise against the backdrop of the specific conditions presented by monetary union. The euro will be legal tender in an area which consists of largely sovereign national states whose policies - other than monetary policy - will largely remain their responsibility. That may lead to a dilemma between the requirements of a supranational currency, and the political pattern in Europe, which will continue to be determined by the national states and their policies.

The euro needs a high degree of flexibility in the economies of the participating countries. But there is no European economic and structural policy which can ordain such necessary flexibility from above. And even if there were a responsibility at the European level for doing so, the possibility could not be ruled out that, ultimately, the result would be more rigidity, rather than more flexibility. At the same time, there is no regional revenue equalisation scheme, comparable to the systems operated in a national state. A social and transfer union cannot and must not make up for any lack of flexibility and competitiveness, for the upshot would probably be not only less flexibility, but possibly also more political disagreement.

At the same time, however, the euro needs discipline on the part of national fiscal policy, at least as far as fiscal deficits are concerned. Otherwise there is a risk of conflicts, because large debts in some countries will attract the savings of the euro area as a whole, and contribute to higher interest rates for everyone. Fiscal policy, however, will largely remain a national responsibility. That is why it is so important that the Growth and Stability Pact should prove to be effective in the future.

How can the euro function against this background? The "classical" answer of the Werner Group in the early seventies (of which I was a member at the time) was: Europe must set up a political union parallel to the monetary union. Thus, supranational political structures were supposed to ensure that Europe met the requirements of a supranational currency.

Maastricht adopted a different approach. It left the rift between supranational money and national policy structures. To that extent, it has sometimes been dubbed "a construct with a limp". If, however, there is no supranational political authority to meet the requirements of a supranational currency, then the participating countries must do so on their own initiative, of their own accord or in their own interest.

The Maastricht Treaty therefore also set important rules for the fiscal discipline of member countries. And compliance with those rules is likewise jointly monitored. However, what ultimately will be crucial for the functioning of the Stability Pact will, above all, be the countries' ability and willingness to abide by those rules on a sustained basis.

A monetary union, under the Maastricht Treaty, therefore needs a large measure of common "stability culture" in all participating countries. And another point: the euro can function as a depoliticised currency only in this specific form. The ultimate monetary target, i.e. monetary stability, must not be subordinated on a discretionary basis to other goals. And monetary policy must be conducted by a politically independent central bank.

That may be considered in some quarters to be an overly German postulate. But in my view this is implied not only by the requirements of a lastingly stable currency, but also by the logic of a monetary union comprising several countries. For if <u>one</u> country subordinates its <u>own</u> currency to political objectives other than stability, that may have unpleasant consequences for other countries, given globalised financial markets. But still, one could live with that. If, however, <u>eleven</u> countries try subordinating their <u>common</u> currency to their respective primary political objectives, things will really get pretty chaotic in the union.

That way, the euro would gain the confidence neither of the citizens nor of the financial markets. The upshot would, rather, be all too likely to be permanent political conflict. The euro must not come under the influence of the <u>domestic</u> interests of individual countries. Monetary policy must be geared to the situation in the euro area as a whole, taking responsibility for maintaining stability of the common currency. Some of the incidents in Brussels during the first weekend in May may in this context have been a timely warning, and a lesson to be learned by all.

VI

There can be no doubt that monetary union implies the irreversible loss of the sovereignty of the participating countries in the monetary sphere. Some loss of identity and of the symbolism of a nation state will of course also be associated with giving up the national currencies. In Germany, this also means the loss of a symbol of economic reconstruction after the war.

Monetary union thus reinforces an overall trend towards global economic integration, especially also as a consequence of the global financial markets: the nation state forfeits some of its freedom to shape events. In some countries and some quarters there are also fears about the immediate forfeiture of sovereign rights, as in the case of the currency, and also about an uncontrolled dynamic integration process which will - automatically, as it were - relegate the nation state into the background.

Here in the U.K. (but not only here) there seems to be some concern about an uncontrolled *political* integration drive in Europe: the fear of a “superstate of Europe”. Even if this fear is manifest to some extent in continental Europe, too, there is, at the same time, rather, more concern about an uncontrolled *economic* integration drive caused by increased competition. In Germany, there is, in addition, concern that the stability of the euro might not match that of the D-mark.

At all events, the common underlying question is similar: If European integration and/or globalisation reduces the economic and social management capacity of the nation state, and if the citizens’ democratic “say” in events remains tied to the institutions of the nation state, does it follow that a democracy problem is emerging?

This question is of course much too sophisticated to be answered in a few sentences. I only wish to note two points:

Firstly, regarding the fear of a superstate of Europe. It is without doubt important that monetary union must become a success. This means that in the distant future, too, it should not generate crisis situations which then - of necessity - will give rise to tendencies towards overly strong centralisation which actually no one wants. The lasting functionality and stability of monetary union is a prerequisite for political subsidiarity in Europe. Just as stable money is and will remain an essential prerequisite for internal subsidiarity in society. Even with further political ties, that by no means is bound to lead to a superstate of Europe.

And secondly: the extent to which cross-border integration and globalisation are seen as a democracy problem depends, not least, on one’s understanding of democracy. It is correct that open frontiers make reallocation more difficult. Anyone who regards reallocating income and wealth as the essence of democracy must indeed consider integration and globalisation to be a threat. If, however, democracy is seen rather as a control mechanism against undesirable political developments, then the international financial markets will be regarded, rather, as a supplement and less as a threat to democracy.

Thus, the financial markets may often penalise an undisciplined fiscal policy quickly and massively. The burden arising from a long-term unsound policy therefore becomes evident much more quickly. Democracy in the sense of control can then function better.

VII

The global financial markets are certain to test the euro, the political and economic conditions in the euro area and the stability orientation of the European Central Bank as well. Basically, they are already doing so today, even though the euro and the European Central Bank do not exist yet. It would be an illusion to believe that the global financial markets look critically only at the emerging countries.

The vital asset of a central bank is credibility. The decisions taken in Brussels to fill the vacancies on the Executive Board of the ECB essentially enhanced that credibility, if anything.

Actual independence from the influence of political bodies is essential for the future credibility of the European Central Bank. In my view, independence does not at all conflict with the requirements of democracy as long as the European Central Bank abides by its mandate.

Of course, adequate transparency of its decisions in the sense of explaining them to the general public and stating the reasons for them, is important. Accountability in this sense vis-à-vis the European political bodies, and especially vis-à-vis the European Parliament, is useful and right. However, accountability must not undermine the largely apolitical character of the euro or its supranationality. Accountability vis-à-vis the national parliaments would not, in my view, be consistent with the euro's supranationality.

From the very outset, it will therefore be essential for the European Central Bank to gain and retain the necessary confidence of the markets.

Credibility normally develops gradually, on account of one's own track record. To that extent, it seems to be a privilege to be able to inherit credibility from the national central banks. In this context, the Bundesbank, as the guardian of the D-mark (the long-standing anchor currency of the EMS) naturally plays an important part. This legacy, too, is of course not without obligation. Rudi Dornbusch, Carlo Favero and Francesco Giavazzi recently wrote in an article: "The capital markets will be unforgiving if they see anything less than Bundesbank policy."

In various respects the D-mark and the Bundesbank have acted as the model for the euro and the ECB. Seen from a historic perspective, however - and in conclusion I should like to come back to that point - there are some far more impressive models. As far as longevity and historical consistency are concerned, I hope that the euro and the European Central Bank will also try to emulate the pound sterling and the Bank of England. This is true, at least, if one disregards some periods in the Old Lady's history which were not quite so successful. Viewed over the longer term, anyway, the U.K. has had more success with its currency than Germany, which saw two hyperinflations and the collapse of its currency in the first half of this century.

But - if I am rightly informed - in this country, too, the question of whether your currency may one day disappear and be replaced by the euro is no longer completely unthinkable. But that is of course your decision; specifically - if I have got it right - the decision of your government, Parliament and the British people.