Mr. Tietmeyer considers the euro: a challenge to, and opportunity for, the financial markets Speech by the President of the Deutsche Bundesbank, Prof. Hans Tietmeyer, on the occasion of the 21st Colloquium of SUERF and CFS, delivered in Frankfurt on 15/10/98.

I

"Educational institutions - explicitly including universities - are not philanthropic islands of abstract debate." This maxim of the German President's is borne out by this colloquium. For this is not merely an "abstract debate". The subject is of great practical relevance: "The euro: a challenge to, and opportunity for, the financial markets." And there can be no talk of an "island", either. For this is a cross-border, joint meeting of SUERF and CFS.

Incidentally, the motive is the exchange of knowledge with the financial community (including central banks), thus avoiding all suspicion of insular ivory-tower erudition. There can be no doubt that the financial community will likewise benefit from an exchange of knowledge. After all, the euro was and is an intellectual challenge for all those concerned with it. An interesting exchange of views is therefore to be expected. And a debate based on two fundamental perceptions may be fruitful: A consistent monetary policy, committed primarily to the target of stability, is the best contribution a central bank - no matter whether the Bundesbank or the European Central Bank - can make to the viability of the financial markets. Without stable money, the financial markets cannot function properly. Conversely, it must also be said: monetary policy needs an efficient, highly competitive and stable financial system. In the first place, a financial sector that is susceptible to disruption poses risks to the entire monetary system, and thus also to the safety of the currency. Secondly, in a stable environment monetary policy impinges on economic activity more smoothly. That was and is true of the Bundesbank's monetary policy. It is bound to apply to the ESCB's monetary policy as well.

II

Clarity now obtains in some matters of significance to financial market players concerning the euro. The future framework for economic policy action is now emerging ever more clearly.

Since its constitutive meeting in June, the ECB Governing Council has taken a multitude of important decisions. There is broad clarity today about the arsenal of instruments with which the ESCB will operate. The primary buttress of refinancing will be repo transactions, which have been so successful at the national level. The interest rate for this main source of finance will lie within the corridor whose ceiling and floor are marked out by the interest rates for the marginal lending and deposit facilities. These principal elements of the range of instruments have been designed with the intention of the money market developing as steadily as possible, so that recourse to fine-tuning instruments can be relatively rare.

The same purpose is served by minimum reserves, which are often criticised in banking circles. At a rate of 2 %, the cost burden is kept within very narrow bounds - especially considering that, owing to the envisaged payment of interest on minimum reserves, the banks' working balances, which will have to be held anyway, will yield interest. In the envisaged form (a reserve to be maintained as a monthly average) they will act as a buffer in the money market. They can therefore largely cushion unforeseen fluctuations in the demand for liquid funds without any major central bank intervention.

A very important step on the way to a single monetary policy is the agreement on the main elements of the monetary policy strategy which was reached in the ECB Governing Council two days ago. These elements comprise: the quantitative definition of price stability as the primary objective of the single monetary policy: “Price stability shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area of below 2 %.” And this price stability is to be maintained over the medium term. Money will be assigned a prominent role, with a reference value for the growth of a broad monetary aggregate. This reference value will be derived in a manner consistent with - and will serve to achieve - price stability. Under normal circumstances, deviations of the current monetary growth rate from the reference value signal risks to price stability. This concept of a reference value, of course, does not imply a commitment to mechanistically correct deviations over the short term, as it was not the case in the Bundesbank policy. Besides this prominent reference value for the growth of broad money, a broadly-based assessment of the outlook for price developments and the risks to price stability will play a major role in the ESCB’s strategy. However, a forecast figure will not be published.

By this decision, the ECB Governing Council is following up to a large degree on the Bundesbank’s successful strategy while at the same time taking due account of the specific conditions prevailing in the euro area, especially at the start of EMU. By and large, the institutional and technical preparations are making substantial progress. On January 1, 1999 the ESCB will certainly be fully operational. Happily, there is broad agreement in the ECB Governing Council on the basic orientation of anti-inflation policy. And, economically speaking, Euroland has been in a *de facto* monetary union anyway since the eleven participating states were determined and the bilateral entry rates defined.

Not later than January 1, 1999, central bank interest rates must be running at a single level. But where that common level will be, cannot, of course, be said with any certainty today - some eleven weeks before the start of monetary union. However, given our current knowledge of monetary trends and other economic prospects, the interest rates are likely to converge towards the lower end of the current range in the euro area. In the past few weeks, a number of central banks of the future Euroland whose interest rates are still relatively high have undertaken significant interest-rate cuts. That process will continue in the course of the next two months.

On the average, such convergence will result in a further not inconsiderable reduction in interest rates in Europe.

With its “steady-as-she-goes” interest-rate policy, the Bundesbank has contributed to a stable monetary and economic situation in Germany and Euroland as a whole. That is why the IMF expressly “commended” the Bundesbank a month ago “for having led the way in establishing price stability in Germany as well as through out much of the European Union”. In the process, it had created favourable conditions for the introduction of the euro. The Bundesbank’s monetary policy was even characterised at that time as “somewhat accommodative”. Gratifyingly, the target of price stability has virtually been reached in Germany and Europe alike. For the immediate future, neither particular inflation risks nor particular deflation risks are detectable at present. That must remain so. But the Bundesbank still remains vigilant. Vigilant as to the extent to which new constraints might arise. And, of course, vigilant as to the extent to which new room for manoeuvre might materialise.

And monetary policy must always pay heed to the specific conditions prevailing. For instance, the conditions for monetary policy in the future euro area differ to some extent from those in the United States and also in the United Kingdom. Besides the different levels of central bank rates, there are differences in the position in the business cycle and in the intensity of the trade relations with the crisis regions, not to mention the specifically European subject of the convergence of central bank rates.

III

However, there can be no doubt that the global environment has become harsher and more turbulent for Germany and Europe as well in the past few weeks and months. A number of East Asian countries are beset by a deep-seated, persistent financial crisis. Happily, in some countries that have initiated far-reaching adjustments, encouraging signs of consolidation are meanwhile to be seen. Russia is in the grip of a profound economic crisis, which naturally has a very worrying political dimension. In Latin America, despite considerable efforts at adjustment in some countries, there are still latent risks of contagion, and the markets have, alas, so far not taken sufficient account of the differences in conditions. And in Japan a severe crisis of confidence still prevails, involving substantial potential risks to the world economy. The recent measures to remedy the weaknesses in the banking sector might, however, constitute an important step towards overcoming the difficulties.

On the continent of Europe, by contrast, conditions have so far been distinctly more favourable. The economic upswing in the future euro area is now more broadly based. Internal expansionary forces are in the ascendant. Our trade relations with the crisis regions are not so close that the crises there are bound to trigger a recession in Europe. But besides the comparatively reassuring perception that those crises are unlikely to spill over to us (at least in the short run) through the channel of trade relations, there is increasing concern that the crises might, instead, come right into our “front room” through the channel of financial relations, via the global financial markets. That concern also owes something to the fiasco of the Hedge Fund *Long-Term Capital Management* and to the response it triggered. Many people are wondering whether the greater part of the problem is not still floating below the surface, as with an iceberg.

And many people fear that the present crises might result in a structural weakness of the financial system with regard to appropriate risk transformation. The first aspect concerns the emerging countries. There is a danger that, as it were, the financial markets will now withdraw from a whole category of countries without distinguishing sufficiently carefully to what extent individual countries have made structural progress. A second aspect - albeit very vaguely - might be seen in the fact that banks may be less willing to run risks in extending credit, especially to enterprises. But it is not only the financial markets that should differentiate appropriately when taking investment decisions and assuming risks. The responsible politicians and central bankers should likewise make adequate distinctions in their analyses.

For general panic is unwarranted. And there is no reason for lapsing into an apocalyptic mood. A dispassionate analysis shows that there are a number of factors stabilising the world economy. They certainly include the high degree of monetary stability world-wide. They also include the favourable overall performance in the future euro area. And they likewise include the still favourable course of business activity, by and large, in the English-speaking area. What is more, many analysts make far too little distinction between developments of crisis proportions, on the one hand, and adjustments, which may even be desirable in the medium run, of previous exaggerations, on the other hand. That applies, for instance, in part to some equity markets. And, by the way, it is also wrong to regard the recent Annual Meetings of the IMF and the World Bank - as has widely been claimed - as a failure. It may be true that certain incautious statements in the wings aroused some unrealistic expectations. But the results achieved in Washington should not necessarily be judged by that. Distinct progress was definitely made in Washington with regard to the future work of those organisations. And I hope very much that in the near future the US Congress will clear the hurdle and remove the obstacle to a better financial endowment of the IMF.

IV

Unwarranted though panic in the assessment of the situation is, blind political hyperactivity, with the aim of inordinately large financial programmes, would be equally undesirable. For the essential prerequisite for steering a country out of a crisis of confidence is sound domestic policies. After all, it cannot be denied that some of the emerging countries affected by the turmoil had previously made certain serious domestic mistakes. Not infrequently, the public and private sectors are interlinked. Foreign investors, as well as domestic financial institutions, could therefore take it for granted that they would be bailed out by the state or by IMF programmes in the event of a crisis. Unfortunately, moral hazards and the lack of financial supervision have in the past often prompted overly risky behaviour. Asset prices - especially those of real property and equities - have sky-rocketed in some cases. Investments were made which were not duly geared to the return that could realistically be expected.

Moreover, many countries had overly rigid exchange rate links. Such links may be dangerous. After all, they obstruct monetary policy. And, under such a system, massive current account deficits may accumulate if a persistent inflation differential exists and one's own currency therefore appreciates sharply in real terms. Some countries have also shown unsustainable budget deficits. All these weaknesses of domestic policies are points calling for action. And the therapy and conditionality of the IMF must likewise make appropriate distinctions and take action to deal with the actual causes of the problems. In some countries, investors' confidence can only be regained by a sustained consolidation of the national budget. In other cases, it will be necessary to settle a domestic banking crisis. And in some places, that may entail, not least, the creation of a stable legal system, with a clear dividing-line between the private and public sectors. And in very many, if not in all, cases, domestic financial market supervision must be improved. It must at least meet international standards, such as have been laid down by the G-10 in its *Core Principles.* Enhanced and efficient surveillance is likewise necessary in this context.

Not blind political hyperactivity, but action in steps, albeit target-oriented action, is on the agenda, because there have for some time been a number of sound and promising approaches at the level of international cooperation. Those approaches must be implemented. That builds more confidence in the markets than all new announcements of generous financial programmes. There are likewise reasonable approaches to making what many people regard as over-sensitive financial markets more resilient again. It is generally agreed that the global financial markets need greater transparency in order to improve their viability. Firstly, more transparency at the national level: besides macro-economic data, financial market data must be monitored more carefully than before. Above all, more, and more up-to-date, particulars on national debts in foreign currencies, and on maturities, are required. This is a challenge to borrowers and lenders alike. Secondly, more transparency at the level of market players. The experience of the past few days has shown that there seems to be a particular need to take action in the case of Hedge Funds. How this is to be done can still be discussed. An indirect solution has been proposed: banking supervisors monitor the lending of an individual bank to a Hedge Fund. The data are then compiled through an international credit register. Taking Hedge Funds as the starting point has been proposed. It may well be true that they are so flexible that they can elude direct supervision whenever they want to. But when it becomes apparent which Hedge Fund discloses data and which does not, then the market can discipline itself. Then it is competition that determines the degree of transparency. Be that as it may, if Hedge Funds are so important for the overall system as those responsible in the United States judge them to be, then they cannot remain exempt from supervision. Thirdly, more transparency about the financial instruments posing risks. That applies, for instance, to derivatives in bank balance sheets. And fourthly, more transparency about the activities of the international financial institutions themselves can do no harm. On the one hand, it is true, the confidentiality of discussions must be upheld. On the other hand, the recipients of public funds must likewise be subject to a strict assessment of performance.

V

A cool head rather than a hot heart; that would, by the way, even be appropriate - or would be particularly appropriate - if the crises in the global financial system were to spread further (though I sincerely hope, and believe, they will not). That goes for the IMF. There must be no more panic-stricken rescue operations in which private creditors are not involved. It also goes for the countries concerned. Thus, debt moratoriums announced unilaterally - i. e. without including the creditors - are highly questionable. After all, a country beset by a crisis has to try to regain investors' confidence as soon as possible. Utmost caution is required on the subject of controls on capital movements, too. Trying to control, let alone to limit, the outflow of capital *ex post* in a crisis is extremely risky. Quite apart from the limited technical options, the far-reaching effects of such controls must also be borne in mind. On this point, Rudi Dornbusch has rightly said: " In a global setting *ad hoc* capital controls in one country will immediately cause contagion not only to the "usual subjects" but even beyond. Fearful that the crisis might spread, investors will act pre-emptively everywhere. They will pull out their money without waiting for more bad news."

A clear target-oriented stance, rather than hyper-activity - that motto likewise applies to monetary policy. A relaxation beyond the degree that is consistent with domestic stability is beneficial to nobody. In the medium and long run, it actually does harm, not only to the country itself but to the global economy as a whole. That is a lesson taught by the current problems in Japan. They are due not least to the overly expansionary monetary policy pursued in the late eighties. At the time, Japan regarded that policy as a contribution to international cooperation, and it was actually called for by the United States. That does not mean that monetary policy should bury its head in the sand. In the Communiqué of the Interim Committee, it says: "Should there be a worsening of the crisis or a further slowdown in economic activity, additional action on both domestic and international grounds would be required by both emerging market countries and industrial countries." However, upheavals in the financial markets cannot be tackled by monetary policy instruments alone. Monetary policy in the industrial countries must preserve the high level of confidence and credibility it now enjoys in the financial markets. Otherwise, any measures could back-fire.

VI

Without any doubt, given the crises besetting many parts of the world, the euro has passed its first acid test. That is gratifying. The markets regard the euro as a safe haven. In that respect, it has already become a serious rival to the dollar. And exchange rates in the EMS between the future euro currencies have remained stable. That demonstrates two things: The markets have accepted the transition to monetary union as being irreversible. And the euro and the independent European Central Bank are enjoying a high degree of confidence in investors' eyes.

The continuous and sometimes exasperating insistence on the achievement of the necessary stability conditions has thereby borne its first fruit. However, maintaining those conditions for success is a long-term task. The role of the euro as an international investment currency, anchor currency and reserve currency is inseparably associated with its internal stability. The markets will focus their attention on that. And that is the criterion whereby the markets, and also the man in the street, will judge European monetary policy at the end of the day. It is this anti-inflationary basic orientation by which the Governing Council of the European Central Bank will be guided; that emerged very clearly again from the debate we held on strategy two days ago. However, for a durably stable monetary union, European monetary policy also needs the support of the other areas of economic policy - not only at the start of monetary union but also in the future.

In that case the euro has a good chance of becoming a lastingly stable currency, respected by the markets and the population alike. And domestic stability is at the same time the best contribution the euro can make to a sound, viable and stable global financial system in which the financial market players can act in a spirit of responsibility.