**Mr Schieber looks at the significance of the euro for Germany and the Bundesbank**

Speech by Mr Helmut Schieber, a Member of the Board of the Deutsche Bundesbank, at the Euro-Forum hosted by the Club de Banqueros, Mexico, on 10 March 1999.

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The entry of eleven countries into Stage Three of European monetary union on January 1, 1999 has introduced a new era of monetary policy in Europe. Germany is one of the initial participants and has, since the beginning of the year, subordinated itself – abdicating a sovereign right in the process – to the single monetary policy of a supranational central bank.

In the following, I will look at the opportunities as well as the problems and risks of monetary union from the German point of view, and especially from the point of view of the Bundesbank.

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The decision to participate in European monetary union was especially difficult for Germany. On the one hand, the European unification process has had Germany's broad political support since the end of World War II. The integration successes achieved in Europe since the 1950s were mainly in the economic sector. From the development of the European Coal and Steel Community in 1951 to the founding of the European Economic Community and the creation of the single market to the establishment of the European Monetary System and the signing of the Maastricht Treaty, Germany has always been a motor of European union.

On the other hand, Germany found it very difficult to part with the Deutsche Mark. The Deutsche Mark was a symbol of the "economic miracle" of the post-war era and of Germany's self-image as a nation. Germany's increasing importance in Europe and the world is reflected in particular by the ascent of the Deutsche Mark to the second most important international reserve, transaction and investment currency after the US dollar. This explains the particularly critical dialogue among politicians, in public as well as in business and finance in Germany, concerning the path to EMU laid down by the EC Treaty. The debate centred around concerns that monetary stability would be jeopardised. Stability ranks extremely high in Germany's order of priorities, with hyperinflation having wiped out the currency twice this century, followed by currency reforms and their horrible political, social and economic consequences.

Against this background, the debate on economic and fiscal convergence and the group of participating countries was especially heated in Germany.

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Now, a good two months after the changeover to the euro, initial experience with the new currency in the international financial markets can be evaluated. The changeover to Stage Three of EMU, which posed an extraordinary technical and operational challenge to all financial market participants, was an unqualified success. Despite the technically complex task at hand, there were no serious malfunctions. Much to the relief of the financial market participants, the convergence of interest and exchange rates took place even before the euro was launched. The speculative attacks against the euro which many people were afraid would happen did not come to pass. The money market rates converged towards the low level of the core countries, which was set by means of the coordinated interest rate reduction by the central banks of the Eurosystem in December 1998. All in all, the smooth transition from the national currencies to the euro can be regarded as a sign of the high quality of the preparations made by the central banks and the private financial market participants – and as public recognition of the hitherto successful convergence process of the partner countries.

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Confidence in the role and the work of the ECB is rising within the German population. The decision to locate the European Central Bank in Frankfurt and the composition of the Governing Council with Wim Duisenberg as President stand for a tradition of stability-oriented monetary policy. After all, the institutional regulatory system of the Eurosystem was modelled on that of the Bundesbank. The establishment of an independent European System of Central Banks unmistakably dedicated to the goal of price stability was of the utmost importance for German residents and politicians. Like the Bundesbank Act, the Maastricht Treaty only envisages supporting the general economic policy of member states provided this does not prejudice the objective of price stability.

The Governing Council of the ECB has thoroughly discussed its monetary policy approach and subsequently presented and explained the results in detail to the public. The ECB has made it plain that – in line with its mandate – it shall pursue neither an exchange-rate-oriented monetary policy nor an anticyclical monetary policy. Exchange rates and the business cycle will certainly be carefully observed, analysed and taken into consideration in the decision-making process, but they do not determine the general orientation of the ECB's monetary policy. Rather, monetary stability as the primary goal of the ECB shall be ensured by regulating the growth of the money stock, with the aid of interest rate policy, in a way that, on the one hand, enables the full exploitation of the available scope for growth and, on the other, prevents inflationary developments.

Here, it becomes evident that as far as the intention of the ECB is concerned, the strategy chosen is similar to that of the Bundesbank. In the light of the uncertainty prevailing in the new currency area, at least at the beginning, however, the Governing Council of the ECB has not set an explicit monetary target, but rather confined itself to determining and releasing a somewhat less binding reference value. Anyway, and as a reassurance to the politicians worried about the business cycle, this type of monetary policy has an automatic and clearly anticyclical component.

Looking at the Eurosystem's monetary policy instruments and procedures, there are also strong parallels to the instruments of the Bundesbank.

All in all, it is apparent that both the institutional and organisational structure of the Eurosystem and the choice of the monetary policy strategy and instruments have contributed to achieving continuity in monetary policy. The stock of confidence gained by the ECB has helped to limit the prevailing fears and doubts concerning EMU, especially in Germany, so that today more and more residents are regarding the European Central Bank as a worthy successor to the Bundesbank.

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What, then, are Germany's expectations of the transition to a single currency in Europe? Much has been written and debated about the opportunities and risks of this step: the introduction of the euro is certainly more than simply exchanging one medium of payment for another. The euro will no doubt also have real economic consequences, and it constitutes a new element in the international monetary system.

European monetary union eliminates exchange rate fluctuations among the currencies of the participating countries, thus doing away with a substantial element of volatility and uncertainty. Costly hedging operations against exchange rate fluctuations and high exchange costs have become obsolete; cross-border trade can expand without being held back by currency market uncertainties, therefore stimulating the real economy. Large enterprises and financial institutions, in particular, are hoping that the elimination of foreign exchange rate risks and the direct price comparison of input and output factors will present new market opportunities. This home base free of monetary uncertainties presents great advantages, especially for the German economy, because more than half of all German exports go to our European neighbours.

It is therefore somewhat difficult to understand why a new debate has erupted just now in the euro area on the fixing of foreign exchange rates between the large currency blocs. Stable exchange rates are the result of a stability-oriented monetary and fiscal policy and cannot be achieved by interventions. If the central banks were assigned an exchange rate target in addition to the objective of price stability, considerable conflicts could arise between these two objectives, a point that has been proved especially by events in Asia and Latin America over the past few years.

Of course, this does not imply that exchange rate developments must not be carefully monitored and taken into consideration while shaping monetary policy. The exchange rates are an important element of inflation forecasting because they help determine the climate of stability through the import prices, and the state of business activity through foreign trade. Therefore exchange rates must be taken into account when considering monetary policy (alongside the dominant role of monetary growth), yet must not serve as an end unto itself.

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Whether the introduction of the euro will, over the medium term, result in a rearrangement of the international currency interrelations depends considerably on whether the euro will be able to achieve a stronger position in the international monetary system than the sum of the eleven member currencies. From the present perspective, it is not possible to give a definite answer to this question. In terms of population, economic performance, and their respective share of world trade, the euro area and the US are very similar. Only the use of the euro as a transaction, investment and reserve currency will indicate future developments. This area presents a large scope for growth for the euro because the previous European currencies were relatively underrepresented, in comparison to the US dollar, in all of the above uses.

The creation of a common European financial market, in particular, promises a huge potential for the euro's growth. Broader and deeper market structures, high levels of liquidity and transparency and expected increases in efficiency are attracting international investors and issuers. To be sure, the rupturing of monetary segmentations will not automatically create a fully harmonised capital market in Europe. There will continue to be differences regarding the established structures. However, the innovation process begun in the past few years at financial institutions and in the financial markets shows that all parties concerned have recognised the challenge and are rising to it.

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The introduction of the euro alone is no guarantee, however, of the positive developments I have described. Rather, this raises the question of what problems and risks monetary union harbours, seen from the German perspective. Extraordinary developments in economic activity or structural circumstances such as different cost trends for wages, taxes and social security contributions, different manufacturing structures, diverging trends in corporate financing and differences in the national transmission channels of monetary policy can alter the effect of monetary policy measures on the real economy. In future, under a common exchange rate and monetary policy with identical official interest rates and an identical liquidity supply, these differences among the participating countries can only be countered by means of flexible national fiscal, structural and wage policy measures.

It is, of course, tempting for the politicians and social partners, caught up in their many daily conflicts and confrontations, to call for a more expansionary monetary policy, as this will seemingly enable an easier solution of conflicts. Yet monetary stability is – especially from the German perspective – precisely the purpose and worth of an independent central bank insulated from the multitude of political conflicts, as has been so convincingly laid down in the Maastricht Treaty. Solving problems at the expense of monetary stability is invariably an exercise in self-deception, with many counterproductive results. Inflationary monetary policy exacerbates growth and employment problems instead of solving them, at least over the medium term.

The unbearably high unemployment rate in large parts of Europe presents the key economic policy problem from the German perspective, too. A full employment equilibrium in the participating countries is characterised by varying national labour costs corresponding to national labour productivity. Thus, a rapid equalisation of the nominal wages in the participating countries is not realistic, as the unemployment rate threatens to continue rising in countries which raise the wage level above the level of labour productivity. Increases in negotiated wages and settlements should therefore conform to the national employment situation and the growth rate of labour productivity. These considerations lead to the conclusion that it does not make sense to harmonise the pay-rate policies within Europe. This would complicate the necessary variation of wages in the euro area and impair the necessary flexibility of wage structures.

Thus, for the euro to be a success, it is imperative that these inevitable consequences of the single currency be understood and accepted by all participating countries and that the necessary measures be carried out. A single European monetary policy which cannot make exceptions for special national developments and interests must be accepted and taken into consideration in the shaping of national economic and fiscal policy. The implementation of a supranational European monetary policy will be all the easier the more the independence of the European Central Bank is respected by the European bodies and especially by the residents of the euro area. To a very large extent, the basic conditions for a stability-oriented monetary policy and an independent central bank in Europe have been fulfilled. It is now up to those taking action to determine how this framework is filled out and implemented. There is certainly cause for optimism. The governors of the participating central banks and the Members of the Board are in accord that they must, from the beginning, operate as representatives of the euro area and its single currency and not as advocates of their nations.

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All in all, the euro has had a relatively smooth and promising start. Despite a trend to weakening on the foreign exchange market – due mainly to an increase in the spread of interest rates between Europe and the US – it has increasingly gained acceptance on the financial markets, but also among the residents.

However, the range of questions and risks presented above shows that European monetary union, which does not go hand in hand with an adequate political union, is an unparalleled experiment. For it to succeed, it will require a high degree of political discipline on the part of all participants. Only the future can show whether giving up the Deutsche Mark for the euro was, in the long run, the right decision.