Mr Stark discusses regional integration and stability in the context of global markets

Speech by the Deputy Governor of the Deutsche Bundesbank, Dr Jürgen Stark, presented at the Central Bank of the Argentine Republic in Buenos Aires on 24 March 1999.

1. Introduction

Globalisation of markets and competition has been a major driving force for the economic development and policies of Latin America's economies.

The decisive impetus for today's degree of globalisation came at the beginning of the nineties when communism finally failed and the door was opened worldwide to a market-oriented economic system.

As a key element of an efficient system of allocating resources, the free movement of capital has provided the precondition for increased prosperity. In a growing number of countries the restrictions on trade in goods and on the provision of services have been reduced; the efforts of the WTO have yielded fruit on a global scale.

Finally, the enormous technical progress made in transport, telecommunications and data processing have radically changed the international division of labour.

However, the real momentum exerted by the process of globalisation can only be seen through the interaction of the various factors. At the same time the retention of national barriers has become more and more difficult technically and more and more expensive economically.

2. Aspects of globalisation in Latin America

Latin America has used the changes in the underlying global conditions for an economic reorientation. At the beginning of the nineties, if not before, a complete about-turn in economic policy was made on this continent, spurred by the economic setback during what was termed the *decada perdida*.

Many countries in the region implemented consistent macroeconomic stabilisation measures and opened themselves up to the international goods and capital markets. The state retreated progressively from economic life, and substantial parts of the economy and the infrastructure were privatised. To that extent, the term *emerging market* may also be seen as an offshoot of globalisation.

The enormous economic potential of Latin America, especially of the Mercosur countries, became a magnet for international investors seeking higher yields for their capital; direct investment flows multiplied during the past ten years. Public donors of capital were largely replaced by private investors. The growing number of multinationals in Latin America, the *multilatinas*, as they are called, is a clear indication of the new business landscape in the region.

The technical progress that accompanied the liberalisation of capital movements helped to diversify foreign trade structures and, as a result of greater efficiency, to improve the competitiveness of Latin America on the world market. The substantial dismantling of tariff and non-tariff trade barriers under the Mercosur agreement and other regional and international agreements fostered the integration of Latin America into the world economy – even if there are still significant differences from country to country.

The question as to whether the change of tack in economic policy and the extensive degree to which the economies of Latin America have been opened up have paid off must certainly be answered in the affirmative, given the trend in the real growth rates of GDP and the rise in per capita income.

However, one must also face the fact that globalisation also entails new challenges apart from opportunities and advantages. Market participants – either in the public sector or the private sector – must prepare themselves for the consequences of the changed environment.

One of these consequences is more intensive competition – and that applies not only to the corporate sector. In the course of globalisation a discernible degree of competition has likewise emerged between the economic, monetary and social systems of the various countries. This concerns foreign investment and jobs.

Consequently, globalisation requires smoothly operating markets that, in turn, ensure the efficient allocation of the factors of production. The structural change that is necessary to overcome rigidities cannot be postponed for long under the conditions of global competition.

Another factor is the growing degree of interdependence worldwide. It is no longer the real sectors that are primarily affected by this; instead, it can be seen first and foremost in the integration of the financial markets. The effects of this interdependence are increased by the huge volumes of readily investible capital, new financial instruments and intermediaries as well as comprehensive computerisation.

3. Financial market crises and the danger of contagion

In view of the recent financial market crises in South-East Asia, Russia and Brazil and their detrimental effects on the real economy, globalisation and the market-oriented economic system have now run into criticism in some quarters. There is no doubt that the changed environment has increased the potential risk of contagion even though it is sometimes difficult to draw the dividing line between contagion and political shortcomings.

The reassessment of a country's opportunities and risks, of its potential and weaknesses by the international financial markets, can result in a sudden reversal of international capital flows. Market participants all around the world react to events with lightning speed – they pump money into a country and then withdraw it again just as quickly.

Under the conditions of open capital markets and a high degree of capital mobility the punishment for unsound policies is more rapid and severe than has been the case in the past.

The trend towards short-termism, which in the event of a crisis ensures that it is possible to retreat from the market concerned, and the dominance of institutional investors, which encourages a certain degree of herd behaviour, magnify the withdrawal of capital.

Nowadays, investors take the emergence of crises in one country as a signal to revise their investments in other countries or regions of the world as well, even when macroeconomic structures are comparable only to a very limited extent. At the same time the markets have become extremely sensitive to expectations. Credibility and confidence play a dominant role.

Nevertheless, market response should not be seen in an entirely negative light. It may actually have a stabilising effect if this response induces economic policy makers to correct undesirable trends in good time.

However, the markets are often prone to exaggerations which are not justified by the economic fundamentals. In my opinion, this also applies to the spillover effects which have been triggered by the Russian crisis in particular. Markets now seem to differentiate more between emerging market countries than after Russia's unilateral moratorium and devaluation in August 1998.

What is to be done to mitigate the severity of such global crises and to minimise the risks of contagion? There are no simple solutions or ready-made remedies.

On the one hand, the causes of the recent financial market crises are too diverse, even though there are a few common features, such as comparable macroeconomic situations or similar exchange rate systems, which always seem to play a role.

In Asia it was primarily the inefficient banking system that encouraged the inappropriate allocation of short-term capital inflows. The abrupt withdrawal of funds ultimately led to the collapse of the currencies.

Russia's problems were due not only to the weakness of the banking sector but also to the completely inadequate implementation of existing legal norms. Owing to its short-term public debt and its excessive budget deficit, Brazil mainly had problems with its credibility following some unsuccessful attempts at reform. On the other hand, it is very hard to identify the effective transfer channels as a result of the many hybrid instruments and diverse financial intermediaries involved. One thing is certain, however. In the interests of the longer-term outlook for growth, the idea of turning back from globalisation, that is to say, reinstating control mechanisms, is not a sensible alternative. The re-introduction or maintenance of administrative controls in an otherwise liberal environment is fundamentally problematical.

Firstly, market participants will always contrive to avoid these controls and, if anything, they are more imaginative than the controlling authorities.

Secondly, capital restrictions are very expensive to implement in most cases. To be effective they must be applied on a comparatively broad front and could therefore also hinder desirable capital movements. What is more, they may also delay the necessary development of an efficient financial sector.

This is illustrated by what is now happening in Malaysia. The desperate measure that President Mahathir took in introducing restrictions on capital movements in the middle of the crisis to stop capital outflows did bring a certain degree of stability in the short term. In the longer term, however, this had an adverse effect on the confidence of foreign investors. However, this does not rule out considering in individual cases the opening-up of the domestic financial market based on a sensible sequence that takes account of the given financial sector's ability to cope with volatile financial flows. Controls to alter the volume and composition of capital inflows can help to prevent crises by limiting from the outset the potential withdrawals in the event of a change of mood in the markets. Chile has devised a successful approach to limiting short-term capital imports in this respect. In addition to that there is a strong argument that Chile owes its stability to improved and sounder banking regulations.

The route of limiting short-term capital imports can only be taken, however, if the right direction is followed, if it is an interim measure and if it is complemented by strong and well designed prudential regulations. Otherwise, market confidence will be put at risk. And the breathing space "bought" in this way must actually be used to achieve the structural change. Permanent controls entail the danger of undesirable developments in the banking sector and in the economy as a whole.

Payment moratoriums are not a feasible option either. In the wake of the Russian crisis the mere announcement of no more than a 90-day moratorium by the Brazilian region of Minas Gerais vis-à-vis the central government shook the confidence of market participants for quite some time and provided the initial spark for the present currency crisis, whose spillover effects have hit your country particularly hard.

These examples show that the particular challenges posed by global markets cannot be mastered by re-regulation and coercive measures but, in the longer term, only by measures and political strategies that are in keeping with market conditions.

4. Challenges of globalisation

Although a structured account of what is a necessarily incomplete set of options is not easy owing to the large number of interdependent components, I would like to identify three different levels of action: the international level, the national level and the regional level.

a) International level – new financial market architecture

Considerations at the international level can best be characterised by the term "strengthened international financial architecture for the 21st century". To say it upfront: this term should in no way encourage expectations about the introduction of a completely new and comprehensive set of rules for the financial world. The flexibility of the markets and the heterogeneity of interests are too great for that.

The key components of the present multilateral efforts to prevent crisis and to promote the stability of the international financial system are, first, the improvement of financial market transparency and, second, a more efficient form of financial market supervision.

(1) For improving financial market transparency, it is important that financial market information already available to the various national and international authorities be analysed centrally and comprehensively. The data have to be evaluated first and foremost with systemic risk in mind and must naturally be made available both to the countries concerned and to market participants.

The disclosure of data relevant to the financial markets will make an enormous contribution to stabilising the global financial system. The operational efficiency of the markets will be strengthened. Investors will be able to make an appropriate assessment of risks. The risk of contagion and the herd instinct associated with this will be greatly reduced.

(2) Ways must be found in the course of supervising the financial markets to safeguard the global implementation of internationally agreed standards, especially the fundamental principles of the Basle Committee and IOSCO. Owing to the enormous dynamics of the markets, these requirements must be continuously reviewed to ensure their adequacy and, if needed, adjusted.

In view of the large number of diverse financial intermediaries and the difficulty of distinguishing between various financial transactions, improvements are needed in the cross-sectoral supervision of financial markets.

The future "Forum for Financial Stability", which has been proposed by President Hans Tietmeyer and which initially is to be composed of representatives of the G-7 countries and various international organisations, is to take on the task of evaluating the problems and weaknesses that emerge and to help to strengthen the global financial system by closer coordination among regulatory bodies.

Having learned from the experience and the specific requirements of the emerging markets I think it will be essential to include representatives of the emerging markets in the discussion at as early a stage as possible.

One thing must be made clear, however: improved supervision can never, and must never, release the private agents from their responsibilities.

Role of the IMF and of the private sector

The term "strengthening the international financial architecture" has to include the role of the IMF in combating crises and the question of involving the private sector.

No matter how important short-term financial assistance from the IMF is in the event of a crisis, both for the countries directly affected and, as a result of contagion, for the rest of the world, it must not lead to a bail-out of the private sector. We know from experience that excessively generous financial packages have a detrimental effect on the risk awareness of private investors and encourage moral hazard.

Those who run greater risks in the expectation of higher yields ought also to be ready to bear any consequent losses. The modified economic programme newly agreed with the IMF for Brazil has taken a step in the right direction by tightening the involvement of the banking sector.

With regard to the avoidance and solution of crises, the IMF should again concentrate more on its catalytic role. Appropriate involvement of the private sector will tend to increase rather than reduce the IMF's effectiveness.

b) National level – stability of the economies

Whatever form the "strengthened international financial architecture" takes, it must be built on the solid foundations of consistent and thereby credible national economic policies.

Sound macroeconomic data, a healthy system of public finance, an appropriate monetary system, an efficient banking sector and, above all, the ability to correct any undesirable developments create confidence and credibility.

These two qualities determine the expectations of market participants.

Confidence, credibility and expectation are three factors which seem to determine the international capital markets these days. Sound fundamentals are therefore part of the essential tools needed to meet the challenges posed by globalisation.

With the establishment of the Currency Board Regime in 1991 Argentina opted for a very consistent market-oriented economic policy. The salient features of the successful strategy were the statutory pegging of the peso to the US dollar at a rate of 1:1, deregulation, privatisation and the introduction of competition into economic life. Argentina has left the period of hyperinflation (1989: almost 5,000 %) far behind it. Its present rate of inflation is less than 1 %, and the economy has been restored to a sound path of growth despite the current downturn.

Yet I would like to refer briefly to three general points which have aroused greater public interest as a result of the recent currency crises:

one, the importance of the banking sector;

two, the choice of exchange rate system; and

three, the short-termism in financial transactions.

(1) As the financial crises in a number of east Asian countries have clearly illustrated, the smooth transformation of capital is primarily dependent on a sound and efficient national banking sector. Furthermore, it is advisable to create an appropriate safety net as an additional buffer against domestic or external financial shocks.

The Argentinian central bank has been very successful in this respect. You have built up a Contingent Liquidity Facility, which is backed by international banks and multinational organisations, and the banking sector maintains high liquidity reserves with the central bank.

(2) I would like to make only a few brief comments on the very interesting fixed-versus-floating debate. This is an issue for which there are no simple yes or no, or fix or float, answers. The choice of exchange rate system can only be judged with reference to a country's state of development, its economic benchmarks and its political circumstances.

Nevertheless, there is a fund of experience of a fundamental nature. There is no doubt that stable exchange rates are desirable for economic agents. In some cases exchange rate pegging can be extremely useful for getting domestic inflation under control and for maintaining financial stability.

Over the longer term, however, a country must ascertain whether or not its internal flexibility is sufficient to enable it to make any necessary adjustments to its real exchange rate by means of a strict budgetary or labour market policy.

This applies all the more when what is involved is not simply the firm pegging of the exchange rate of the domestic currency to an anchor currency but, instead, the abolition of the domestic currency and the adoption of a foreign one.

Triggered by the recent financial market turbulence, such a step, known as "dollarisation", has now become the topic of intense debate in your country.

Giving up the peso would eliminate the foreign exchange risk and tend to lead to a lower interest burden. Moreover, adopting the US dollar — as a major transaction currency — could make the further integration of Argentina into the world market easier.

It must be remembered, however, that making a dollarisation strategy successful permanently places severe demands on the flexibility of a country's economic policy. The reason for this is that the adoption of a stable currency alone cannot guarantee market confidence on a lasting basis. It is precisely because domestic and external monetary policy will disappear as an option for absorbing undesirable internal and external influences that it is particularly important to maintain in the long term the efficiency of the domestic banking sector, sound public finance and the flexibility of the labour market.

The introduction of the dollar therefore requires both a comprehensive economic cost-benefit analysis and a very broad political consensus which takes account of the longer-term national and international implications of such a step.

The success of a fixed exchange rate system or of a floating system as well as the adoption of an anchor currency are all dependent on the consistency and credibility of domestic economic policy.

(3) When financial markets are strained, short-termism may present those responsible for monetary policy and exchange rate policy with a dilemma. While an increase in interest rates does stabilise the exchange rate up to a point and hence asset prices, too, it can result in a virtually unbearable interest rate burden if short-term debt is substantial, and vice versa. In my opinion, the only effective means of countering the general trend towards short-termism is pursuing a medium-term-oriented stability policy that induces investors to make longer-term investments.

c) Regional integration

With globalisation and economic recovery at the beginning of the nineties, the integration process in Latin America was also given a fresh impetus as a means of economic and political consolidation.

There is no doubt that Mercosur has been the most important factor at the regional level. Within a short period a customs union has been developed among the member states which in the long term is to be extended to form a common market.

Encouraging interregional and intra-regional trade in the sense of an open regionalism is playing a major role in achieving greater integration. It can make a crucial contribution both to regional and global stability. The creation of a free trade area between Mercosur and the EU will contribute greatly to this. Its rapid establishment was strongly recommended by entrepreneurs from both regions at the first Mercosur/EU business forum in Rio de Janeiro at the end of last month.

I would now like to report on the lessons we have learned so far from the European integration process.

5. European integration

a) European monetary union: a new scenario for all parties

The process of regional economic and political integration that began in Europe with the signing of the Treaty of Rome in 1957 recently reached a decisive point. On January 1, 1999, European monetary union was launched by introducing the euro as the single currency in 11 of the 15 member states of the European Union. At the same time, the European System of Central Banks, consisting of the European Central Bank and the central banks of the participating member states, assumed responsibility for conducting monetary policy.

Monetary union sets up a new economic architecture in Europe with far-reaching consequences for the strategic behaviour of all parties. The delegation of national powers to an independent monetary authority certainly requires a new common understanding of policy making within the countries of the euro area. Owing to the abolition of national currencies, it is no longer possible for member states to resort to individual monetary and exchange rate policies. Interest rate differentials and currency fluctuations, hitherto devices for readjusting economic competitiveness in the event of asymmetric shocks, will have to be replaced by more market flexibility.

At the same time, we are seeing signs of an ever-increasing degree of economic concentration in terms of large-scale transnational mergers and acquisitions in virtually all sectors of the European economy. There is also an open contest between regions for corporate investors. Even at national level, governments worry about the effect of fiscal policy on their country's competitiveness.

These developments are closely linked to the beneficial characteristics of the single currency. Exchange rate risks and the cost of foreign exchange transactions have ceased to burden European economies. In combination with fundamental structural reforms this will prove a stimulus to investment and economic growth as well as help to ease the ailing labour market situation in Europe. In addition, the exclusive use of the euro on most financial markets in Europe will make capital allocation more efficient, thereby reducing volatility and enhancing the stability of a more integrated European financial market.

b) The road to the euro in a historical perspective

On the road towards the single currency legal and economic hurdles had to be cleared. Besides the necessary ratification of the amended Treaty by national parliaments, a process of economic convergence indispensable for exchange rate stability had to be initiated. The so-called convergence criteria embedded in the Treaty provided a clear incentive for national governments to exercise fiscal restraint. Specifically, four economic criteria had to be met before joining the single currency:

the achievement of a high degree of price stability,[1] a sustainable government financial position, that is to say, the absence of an excessive deficit,[2] membership of the European Monetary System for at least two years without devaluation while keeping the exchange rate within the fluctuation margins and, finally, a moderate long-term interest rate level.[3]

No doubt, for some member states economic convergence has represented a long and painful process that required a stronger dedication to improving and maintaining government budget discipline. In the end, however, those continuous efforts are bearing fruit. We are now seeing unprecedentedly low levels of inflation and interest rates throughout the euro area. Preserving this state has become the responsibility of the ECB, the European Central Bank.

c) Strategic approach of the ECB

The ECB Governing Council, consisting of the President, the Vice-President and the four other members of the Executive Board as well as the governors of the national central banks of the euro area, has adopted a monetary policy strategy in accordance with its primary objective of maintaining price stability as mandated by the EU Treaty.

Besides a quantitative definition of price stability – consumer prices in the euro area should over the medium term on a year-on-year basis increase by less than 2 % – two main pillars were established:

One, a reference value for the growth rate of broad money is announced in advance — at present a rate of 4½ %.

---

[1] Average inflation rate no more than 1.5 % above the inflation rates of the three member states that achieved the highest degree of price stability.

[2] Reference values are 3 % of GDP for the general government deficit and 60 % of GDP for general government gross debt.

[3] Average long-term interest rate no more than 2 % above the respective rate in those three member states that achieved the highest degree of price stability.

Two, a broadly based assessment of the outlook for price developments and risks to price stability in the euro area as a whole is conducted on an ongoing basis.

This approach to monetary policy reflects a medium-term orientation and by no means a willingness to fine-tune the economy. The ECB acknowledges that during the first few years of monetary union it will not be sufficient to rely exclusively on the development of broad money. Initially, the transmission mechanism may vary because of differences in the process of financial intermediation. In other words: it is not yet clear whether there is a stable relationship between the broad money aggregate and price developments in the euro area. The ECB therefore considers a number of general economic indicators.

d) Apparent tension between centralised monetary policy and decentralised fiscal policies

There is an apparent tension between centralised monetary policy and decentralised national fiscal and structural policies. With a single currency, it is crucial for maintaining price stability that monetary policy is denationalised and depoliticised. That means that the monetary decisions of the ECB Governing Council are implemented by using the same instruments and methods in all countries participating in monetary union. At the same time, fiscal and structural policies remain the responsibility of the member states. While this, in principle, leaves room for disparate policies, the EU Treaty mandates coordination in these policy areas to ensure a proper functioning of the common market. Greater centralisation of fiscal and economic policies is not desirable because it would undermine the possibility of beneficial institutional competition within Europe and the notion of subsidiarity.

However, closer coordination is necessary. According to the Maastricht Treaty national sovereignty in fiscal policy must not lead to excessive deficits of more than 3 % of GDP, possibly creating financial difficulties that may spill over to other member states and may undermine monetary policy.

While the selection of participating member states by the European Council was a “once-and-for-all” decision, maintaining fiscal discipline is and must be an ongoing process. To continue preventing member states from running excessive deficits, a Stability and Growth Pact was enacted in 1997. Under the Pact, euro area countries will aim for medium-term fiscal positions close to balance or in surplus so as to allow an adequate safety margin. It is hoped that the Stability and Growth Pact will serve as a stabilising device, keeping member states from pursuing countercyclical fiscal policies which — if effective — would most likely compromise the price stability goal of the ECB.

6. Is European integration a model for Latin America?

Integration in Europe promoted by the establishment of its own institution has been a rather lengthy process that also had to deal with setbacks along the way. Integration in South America is in my view on a promising path as trade flows within Mercosur have been enlarged over recent years. It must be remembered that in its founding period the EU was also primarily concerned with removing barriers to trade before further integration steps could be taken.

The tensions currently evident within Mercosur should not lead to protective tendencies. This holds true not only in view of our experience with European integration but also in the light of the benefits that political and economic integration brings in the form of greater stability in the region and ultimately in other parts of the so-called global village.

I would like to encourage all parties to Mercosur to stay on the path towards the desired goal of a common market. Specifically, unhampered mobility of capital, goods and services would likely lead to more growth and employment in the region.

Could monetary union serve to foster the ongoing integration process, as has been suggested recently? There is no single answer to that. In Europe, we have chosen to bring about a high degree of economic convergence before introducing a common currency. In general, each country or region has to decide for itself what the “best way” is. The decision to adopt a single currency is inevitably a political one.

The necessity of a sound and consistent economic policy does not diminish whatever the particular currency or exchange rate arrangement. This becomes obvious when we consider the strenuous efforts that were necessary on the road from the Maastricht Treaty to the establishment of the European System of Central Banks. There should be no doubt that monetary union represents the final stage in a long-lasting process of modified economic behaviour. Only if the underlying philosophy becomes second nature to all concerned will the desired outcome be attained.

7. Conclusion

Despite the current difficulties, the prospects for Latin America and, more especially, for your own country are good. With its enormous primary resources and the highly motivated population, the continent has tremendous economic potential and has embarked on an economic policy course that is worth pursuing.

I am certain that Latin America, and above all Argentina, will meet the challenges of globalisation and be well equipped for the 21st century.