Mr Tietmeyer looks at the euro and the challenges ahead

Address by the President of the Deutsche Bundesbank, Prof Hans Tietmeyer, at the Frankfurt International Banking Evening, in Frankfurt on 20 May 1999.

This year's Frankfurt International Banking Evening is a special occasion for me. It's the last one I shall attend as President of the Bundesbank.

And what is the consequence of that to me? Well, this time I must hold the lecture myself.

Up to now, I have always had the pleasure of delivering the shorter supplementary address. It seems that the Bundesbank President was regarded - at least by the organisers of this meeting - as particularly suitable for that purpose, being the local "Frankfurt" central banker.

Seen in those terms, Wim, it is noteworthy that this evening that is your privilege. Since you appear to be performing the role of the "Frankfurt" central banker tonight.

I hope, by the way, that you will occupy the position of a central banker in Frankfurt for a long time to come. I shall be watching from the sidelines of my retirement, and shall be delighted if you remain "in the best of health" for a long time yet.

If we combine "de facto monetary union" and "official monetary union", we can look back today not only on almost six months of the euro, but actually on an entire year - even if the formal launch in January marked a particular watershed.

At all events, already in 1998 some crucial decisions were taken affecting the credibility of the new currency:

- on balance, a number of convincing personnel decisions,
- a credible monetary policy strategy,
- effective and easily comprehensible policy instruments,

and some major technical preparations, not to be underrated in terms of the credibility of the euro.

And, as a matter of fact, the interest rate decision taken last December was virtually the first interest rate measure adopted by the Governing Council of the ECB.

Not least on account of this thorough preparatory work, the Eurosystem was happily able to assume full responsibility for monetary policy at a time of low inflation rates and favourable medium-term prospects for stability, thus linking up pretty smoothly with the monetary policy pursued by the national central banks.

Indeed, the medium-term price outlook appeared so favourable to the Governing Council that we were actually able to lower central bank rates by a further 50 basis points in April.

The technical side of the transition to the euro went off better on the whole than some financial market players had expected. At any rate, the media expressed surprise that no major mishaps were to be reported. A steep rise in equity and foreign-exchange-market prices seemed to bear that out.

Some people actually believed that the longer-term potential of the euro could be exploited in full in the first few days. A few apparently thought that

- global investors would quickly switch a large proportion of their assets into euros, and that

- central banks would rapidly diversify their reserves in favour of the euro.

In the meantime, a rather more cautious assessment - at least, as compared with the initial euphoria - has won through in the markets, especially as regards the pace of any such assumption by the euro of the role of a major investment and reserve currency.

Exaggerated short-term expectations have thus inevitably been followed by a certain disillusionment, and even disappointment, which has ultimately been reflected in the external value. Political developments in the Balkans have likewise played (and are still playing) a role, at least in the short run.

However, there is no reason at all to write off the enormous potential of the euro - which some people have seemingly been tending to do of late. The potential is there. Yet the markets should not be too short-term in their orientation.

The international attractiveness of the euro will hinge crucially on the extent to which it manages to gain investors’ long-term confidence, and to which it succeeds in accumulating credibility of its own.

Of course, that will owe a great deal to the economic and political setting. That has likewise been the case in the past six months:

- in the economic setting, it has transpired that - contrary to some fears expressed during the past year - the US economy continues to be marked by an exceptionally buoyant growth process.

In a number of euro countries, by contrast, the impression of a certain short-lived slackening in growth has been confirmed. In the meantime, however, there are signs of activity starting to pick up again soon.

And as far as the political setting is concerned, a number of euro countries are still rather far away from the medium-term objective of the Stability and Growth Pact, namely a balanced budget, as is mentioned in the recent Monthly Bulletin of the European Central Bank.

That forms a distinct contrast to the United States, which is in the enviable position of being able to think about what it can do with its budget surpluses. In the process, it is reaping the fruits of an investment-friendly tax system and of vigorously pursued longer-term reforms.

In a number of euro countries, on the other hand, investment-friendly tax systems and resolute reforms of the labour market and social security systems remain obligations that policy makers urgently need to fulfil.

Now that the Governing Council of the ECB has done its bit to create an environment in which price stability is largely assured on the monetary side, and in which the considerable growth potential of the euro area can be exploited more effectively, such reforms are particularly necessary.

A preliminary outcome therefore reads as follows: alongside a number of expectations met, particularly in the area of stability prospects, there is also a certain degree of disappointment over some decisions still outstanding on the part of policy makers and over the stance of the parties to pay settlements in some countries.

Only after the requisite reforms have been implemented is the die cast as to whether and when the monetary union actually culminates in a successful and durable Community of Stability with an inherent dynamism of its own which can live up both to the expectations of growth and employment prospects placed in it and to the idea of an internationally attractive investment and reserve currency that can stand up to competition from the dollar.

Making a lasting success of monetary union is and will remain the ongoing task of, ultimately, all policy areas - not just of the single monetary policy, but likewise of fiscal and economic policy, which have largely remained national responsibilities.

Member states must recognisably discharge their obligations and make that perfectly clear for all to see. Only in that way can lasting credibility be achieved.

And credibility is the name of the game.

For that will convince the markets, too, of the long-term determination and long-term capacity of the Community to ensure stability.

Nobody can simply lean back, or perhaps seek to instrumentalise the euro for one purpose or another.

The yardstick of monetary policy is, and will remain, lasting internal stability. In the long run, it is on such stability that the external attractiveness of the currency will depend. Happily, that is generally agreed in the Governing Council of the ECB. And that objective is clearly expressed in the monetary policy strategy we are pursuing.

True enough, monetary policy has not exactly become any easier since the turn of the year. How the transmission mechanisms of monetary policy operate over the euro area as a whole is not yet known beyond dispute. This is why we do not know very precisely just what the monetary indicators are telling us. Above all, it is not yet manifest just how far the financial markets and consumers have changed their habits as a result of the introduction of the euro.

Altogether, therefore, monetary policy in the euro area is in a position in which it can rely less than it used to in the Federal Republic of Germany on the old relationships, laws and experience familiar from national monetary policy.

That, of course, confronts it with new, serious challenges. Incidentally, the Governing Council foresaw that development and formulated its monetary policy strategy accordingly.

In the light of past experience - not least that of the Bundesbank - it assigned a special place in its analysis to the money stock.

At the same time, however, it is also trying to estimate inflation prospects and inflation risks direct, on the basis of an analysis of a broad range of the factors determining prices.

Needless to say, these factors include (besides foreseeable movements in costs) real economic trends. They likewise include the exchange rate. We cannot, and must not, ignore either the one or the other.

But we are not thereby pursuing the objective of activist demand management. Nor are we pursuing an exchange rate target.

Instead, we are analysing these factors very carefully, along with the money stock, and evaluating them in the light of their implications for the objective - that is the logical consequence of the strategy we have chosen.

Of course, I know that this seems too "discretionary" to some people; it smacks too much of "muddling through" to them, and seems to require too much confidence in persons and too little in rules.

And I know that some people would best like a strategy that could easily be expressed in terms of mathematical formulae, so that monetary policy could be forecast by computer or actually computerised.

Perhaps those mathematically oriented watchers will be glad to hear that there are some people in the Governing Council who are pretty good at maths - for instance you, Wim. At all events - as I have recently read in the magazine "Focus" - the Dutch Ministry of Education has recently been advertising for young teachers, using a nice picture of you, Wim, in your youth. The caption below the photo reads:

"Wie heeft Wim Duisenberg leren rekenen? - Mooi werk, juf."

And for all those who are not so conversant with Dutch as Wim and I, here is the English translation:

"Who taught Wim Duisenberg maths? - Well done, teacher."

But, to be serious: a rule-bound approach entails too great a knowledge of the relationships involved for us to be able simply to hand over monetary policy to a computer.

If need be, the computer would have to be reprogrammed if the structural relationships and laws changed over time. And considering that every player in the markets anticipates the potential fallibility of mechanistically applied rules, such rules are beset by credibility problems of their own from the outset.

Rules are naturally important and useful for orientation purposes, but they must not degenerate into automatic responses. They cannot be a substitute for the responsibility of decision-makers in a concrete situation - although they can provide an orientation for such responsibility.

Incidentally, the Bundesbank has never applied its monetary targeting policy in mechanistic fashion, especially not during the nineties. And the experience it gained of that approach was excellent.

The point of properly understood strategies - not wrongly understood automatic responses - is to provide longer-term orientation. They should certainly have a binding character - in the sense that the central bank is required to justify the extent to which actual decisions are compatible with the strategy.

That gives rise to transparency. The ship needs both a course and a helmsman. Both together result in credibility.

Has not the strategy of the Governing Council already contributed substantially to the accumulation of credibility by the euro?

I, at all events, do not rate the criticism voiced here and there about the last interest-rate decision as being negative. After all, it gave rise to a need for the central bank to justify how far the decision was compatible with monetary growth. That indicates to me that the strategy has already attained a major objective. A debate on that point cannot but foster the accumulation of credibility by the euro.

A different matter is the, in my view, mistaken criticism that the decision constituted a paradigm change. That is unequivocally wrong. Certainly, there were many arguments to be weighed up. But the crucial yardstick was the long-term safeguarding of internal stability. That was and remains the main thing that monetary policy can contribute to the movement of growth and stability.

One of the fathers of the Reichsbank, the member of the Reichstag from Mainz, Ludwig Bamberger, rightly said (back in the last century) something about the proper relationship between people and rules that is no less valid today:

"There is one thing that neither an Act of Parliament nor a Statute - be they never so perfect - can accomplish: namely, the right application of the right regulations. Final perfection must be ensured by individual human ability. A bad rule of the road can do much damage and a good one can prevent many mishaps, but even with the best rule of the road a good coachman is indispensable."

In the same sense, responsibility for the euro is ultimately likewise borne by those who, while not monetary decision-makers, shape the political and economic setting of the euro by their actions. For what Joseph Schumpeter once rightly said about the "Nature of money" still applies today:

"(...) that a people's monetary system reflects everything that that people wants, does, suffers, is (...) The state of its monetary system is a symptom of all its states."

It is not immaterial for a currency's lasting ability to be stable

- whether its public finances are in good shape, whether unemployment is consistently being reduced,
- whether the social systems in the euro countries are based on firm foundations, or
- whether the conditions for a sustained, dynamic growth process in Euroland are met everywhere.

According to Schumpeter, all these factors are also reflected in the state of a country's monetary system, implying in this country today: in the state of the euro.

Thus, all those responsible in the various policy areas must constantly ask themselves whether everything is really in order in their own sphere of responsibility, or whether improvements are not needed, indeed, badly needed - in the interests of the currency, and also in their own interests.

To that end, there is no need for "ex ante coordination". On the contrary, that only blurs the responsibility, and not infrequently endangers a medium-term-oriented anti-inflation policy. What is necessary, rather, is the discharge of one's own responsibility.

And since we have to deal with eleven countries in the monetary union, the euro reflects the ability of all those countries to settle the outstanding question.

Nobody should adopt a "free rider" position, in the hope that his own failure will be counterbalanced by the others. That would endanger the lasting stability of the euro and jeopardise its international attractiveness. That would be bound to sap its credibility. It would also result in political tensions.

This is why the euro is an "ongoing challenge and task" for all those who currently bear responsibility in business and politics.

And the euro will likewise be an "ongoing challenge and task" for those who will assume that responsibility in the future.