Mr Tietmeyer considers the impact of the single European currency on economies in transition

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I

It is a great pleasure for me to be in Prague today. I am both delighted and honoured to be invited here to accept the annual prize of the Liberální Institute for 1999 and to hold the annual lecture. I would like to express my profound gratitude for being awarded this distinction.

I nevertheless have to admit that I was a little surprised to receive this prize for "an exceptional contribution to the development of liberal thinking".

Certainly, I stand in the tradition of liberal thinking and owe a great deal to Friedrich August von Hayek, for example, who was born one hundred years ago this month, as well as to the other great liberal thinkers.

But my specific economic beliefs have been shaped more by the concept of the social market economy, which was mainly elaborated in western Germany after the Second World War, and then translated - with considerable success - into practical policy under the leadership of Ludwig Erhard, under whom I had the honour of working for a time. However, subsequent policy in the period following Erhard moved away in several major respects from the original concept.

Certainly, the German concept of the social market economy is rooted in basic core liberal ideas. But the ordo-liberalism of what is known as the Freiburg School, on which that concept is based, itself goes beyond classical liberal thinking. In both instances, emphasis is placed on the key role of competition. However, the members of the Freiburg School surrounding Walter Eucken were already stressing in the late forties that free competition also needs rules.

They called for an overall market economic system which safeguarded competition, in particular, on a lasting basis - for example, by means of a fundamental prohibition of cartels and the smashing of unjustified monopolies, because they believed that this was the only way in which competition could actually perform its functions of safeguarding liberty and promoting economic prosperity.

In addition to these tasks of the competitive system, the German concept of the social market economy expressly incorporates elements of social compromise into the overall system.

One of my neoliberal university teachers, Professor Alfred Müller-Armack, who was from the start a close associate of Ludwig Erhard, once rather pointedly expressed this as follows:

"It was a momentous error on the part of economic liberalism to regard distribution by the market as already being intrinsically satisfactory in social and political terms, and thus to combine the question of the appropriate technical form of exchange with the question of what is socially and governmentally desirable."[1]

For me, the market economy is more than just the appropriate technical form of exchange. It already includes major elements of the safeguarding of liberty and of social compromise. But it is the conscious objective of the social market economy expressly to combine market freedom with more far-reaching elements of social compromise, too.

[1] Müller-Armack, A.: Wirtschaftsordnung und Wirtschaftspolitik, Freiburg 1966, p. 106

In saying that, social measures should nevertheless be consistent with market conditions. They must not impair the forces of competition or the functional viability of production in a free market.

To that extent, the concept of the social market economy that was elaborated in post-war Germany is definitely based on core liberal values such as individual freedom, private property, competition, and the rule of law - indeed it relies on these values for its existence.

But it also stands in the tradition of Christian social ethics, which recognises personal freedom <u>and</u> social responsibility, as well as subsidiarity <u>and</u> solidarity, as its core principles.

However, indisputably the most important liberal thinker of this century, Friedrich August von Hayek, tended to take a sceptical view of efforts to create a comprehensive economic and social system.

He believed - and I share this view - that one could ultimately never be quite certain of having found the best solution. Hence, the social system should rather develop as the product of a spontaneous, evolutionary competitive process.

There is undoubtedly much validity in that. As I see it, the concept of the social market economy, too, must always remain an open system - open to new ideas and open to new preferences in society. That is precisely one of the practical problems which we are facing in Germany at present.

Much of what has arisen over the past few decades must now be reviewed and altered in the light of the new conditions set by technology and the economy. The main yardstick for this must be the restoration of the German economy’s inherent momentum and a sustained improvement in economic competitiveness.

Hayek likewise rightly emphasised that the high liberal regard for the market applied not to competition *per se* but to competition within a suitable framework. At that framework includes, above all, a suitable monetary framework.

II

It is therefore no coincidence that both the advocates of classical liberalism and the advocates of the social market economy agree in emphasising the crucial importance of stable money for a modern competitive economy.

For Ludwig Erhard, the first German Economics Minister in the post-war years, who is also regarded as the architect of the German “economic miracle”, stable money was a *sine qua non*.

As long ago as 1950, he wrote:

“Experience and history alike teach us that sound and stable currencies can exist only under market-economy conditions and that any centrally planned economic system therefore leads to the destruction of the currency. Even though the currency is certainly not an end in itself, we know well enough from bitter experience that economic prosperity can only be achieved on the foundation of a sound currency.”[2]

At that time, the countries of central and eastern Europe were still subject to an imposed system of a communist centrally planned economy, in which the currency played only a subordinate role.

As a matter of fact - despite all the unsuccessful efforts at reform, such as the “Prague Spring” of 1968 - it was to be another four decades before the planned economic system finally collapsed here.

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[2] Erhard, L.: Marktwirtschaft und gesunde Währung, in: Industriekurier, June 26, 1950, quoted from Erhard, L.: Gedanken aus fünf Jahrzehnten, p. 232 f.

The results of this, - a lack of international competitiveness, - patterns of production which failed to meet the needs of the population - and an erosion of the domestic and external value of their currencies, are something from which the countries of central and eastern Europe have, to this day, only partially been able to recover. Some, however, have already travelled a considerable distance towards creating a modern market economy. Despite all the problems, your country is one of them.

A modern economy based on the division of labour undoubtedly functions best on the basis of individual decisions and by means of “competition as a process of discovery”.

Monetary incentives give the market players the necessary information on the changing conditions of supply and demand and on changing requirements. But prices, wages and interest rates are really meaningful only if the currency is stable. Only then can investment, output and labour be channelled into the areas which society wants and which therefore promote prosperity.

By contrast, inflation leads in the long term to serious disruptions of the economic process, resulting in misallocations and expensive avoidance strategies. It is mainly the economically weaker groups in society which suffer from that - those who are unable to evade the creeping erosion of money. Those groups mainly include the recipients of wages, pensions and government transfer payments, as well as those who hold savings accounts. The safeguarding of stable money is thus also, at the same time, enlightened social policy.

Ludwig Erhard made the same point as follows:

“The social market economy is unthinkable without a consistent policy of price stability. Only such a policy also guarantees that individual groups in society do not enrich themselves at the expense of others.”[3]

That is one of the major reasons why price stability has played such an important role in post-war west German history. Maintaining the stability of the D-Mark was, and has always been, an aim of German policy during the past 50 years.

III

It is for good reason that enduring stability is now also the aim and yardstick for the new European currency, the euro.

For that purpose, a regulatory framework that is binding in international law was laid down in the1992 Maastricht Treaty.

The mandate to maintain price stability has been assigned as its primary objective to the European System of Central Banks (ESCB), which is independent of political instructions.

The ESCB has been equipped with all the powers and instruments needed to pursue an effective monetary policy. At the same time, the ESCB is prohibited from any monetary financing of public-sector budgets.

This means that a regulatory framework - precisely as called for by ordo-liberalism - has been put in place, with which - in the light of all past monetary policy experience - it may indeed be possible to safeguard stable money on a lasting basis.

Happily, the euro was launched at that start of this year in a setting characterised by a high degree of price stability in all the participating countries. At all events, their inflation rates were - and remain - at an all-time low. The same applies to their long and short-term interest rates.

3 L. Erhard: Wohlstand für alle, Düsseldorf, Vienna 1964, p.15

At the beginning of April, in fact, the Governing Council of the ECB - in line with it stability-policy orientation - made a further cut in official interest rates. The reason for this was that the monetary data and the price outlook continue to suggest a high degree of price stability in the euro area.

This means that monetary policy now has an interest-rate level at a record low, which - taking due account of the low longer-term interest rates and the high degree of price stability - creates a sound foundation for sustained economic growth in the euro area. Whether - and how quickly - new dynamic economic activity develops and new employment is created on that basis will mainly depend on whether the other areas of national policy, and pay policy, provide adequate scope for this, and on the will to undertake the necessary structural reforms.

By safeguarding the stability of the euro, the ESCB is also taking account of the fact that there is now greater responsibility for the global monetary system.

That is because an internally stable euro represents a major contribution to the stability of the international financial markets. - It gives certainty to investors for their planning and decision-making, - it encourages longer-term investment decisions - and it can thus reduce short-term volatility.

Only if the euro remains stable on a lasting basis can it also perform its role as an anchor in the new ERM II (European Exchange Mechanism II) and serve as a benchmark for the countries in transition.

However, a euro with a fluctuating internal value and which lacks international confidence and credibility could easily become a strain on the process of European integration. The enduring stability of the euro is therefore a matter of common interest for all the countries in Europe.

IV

But, in the long term, price stability cannot be safeguarded by monetary policy alone. Monetary policy must, above all, be supported by other policy areas.

In the European monetary union, however, these other policy areas are operating in what is, from the historical perspective, a new kind of environment.

On the one hand, in the euro area we now have a single supranational monetary policy, with identical conditions in all the participating countries. On the other hand, there are 11 - and, in a few years, probably even more - largely sovereign nation states - with differing regulatory and social systems, - and with differing legal and tax systems.

In future, even more than before, each country participating in monetary union will have to be able to cushion differing movements in the business cycle and in growth and employment by the strength of their own efforts and will have to be able to make appropriate adjustments.

More flexibility in the product and labour markets is essential for that, particularly as the euro introduces more transparency, and therefore more competition, for all parties involved - not just in business but also in politics.

Solving persistent structural problems in the public-sector budgets and the social systems, or reducing structural unemployment, are tasks where monetary policy cannot do the work of other policy areas.

In this respect, fiscal policy bears a particular responsibility in the participating countries. Compliance with the Stability and Growth Pact is important - and not just for safeguarding the enduring stability of the euro. Above all, it is in the participating countries’ own interests to exercise sustained fiscal discipline and to regain scope for action in the public-sector budgets.

The other areas of policy - economic, social and pay policies - are also faced with a challenge, however. They have to adapt the underlying conditions to the new era of the euro.

V

The countries in transition, too - especially those which are preparing for EU membership and, later on, also for EMU membership - must adapt to the euro.

Without doubt, they will also be able to benefit in the long term from a successful euro that stimulates the economy in the euro area. After all, trade with the EU countries is of paramount importance for the countries of central and eastern Europe. The broader and more liquid euro financial market may create more favourable financing conditions for those countries.

Above and beyond that, persistently favourable interest-rate trends in the euro area may also reduce the cost of servicing foreign debt.

However, it is difficult to assess what will be the actual impact of the euro on individual countries. That depends, not least, on the extent to which the countries manage to adapt to the more intense competition and the increased competitive pressure within the euro area.

In the same way as the euro makes greater demands on the countries directly involved, in terms of eliminating their structural problems, the countries of central and eastern Europe must not slacken in advancing the transformation of their economies.

That applies all the more, the sooner and the more explicitly a more extensive integration with the EU is aimed for.

Without doubt, this process of transformation is not easy. That is something we, too, have learnt in eastern Germany - despite all the assistance from western Germany.

In many places the restructuring and rebuilding of a globally competitive economy has proved to be more arduous than expected. And undoubtedly, even after ten years, many people still do not find it so easy to adapt to the new conditions and changed demands.

I dare say there is scarcely anyone in western Europe who can fully understand the feeling of existential uncertainty which that situation evokes for many people.

For that reason, I have all the more profound respect for the willingness and resolve of those who courageously face up to those challenges and actively participate in the process of change - here in Prague, in the Czech Republic as a whole, and also in the other countries.

There is no theoretical model of optimum transformation. In future practice, too, it will not generally be possible to avoid mistakes. After all, the transformation of an economic system is one of the most difficult economic topics there is, particularly as neither the business sector nor the policymakers were able to prepare for the radical historic change ten years ago.

There are nevertheless a number of insights and findings which should not be dismissed lightly. For example, in his work this year’s winner of the Nobel Prize for Economics, Armartya Sen, has demonstrated convincingly that social development and functioning markets are mutually dependent and supportive.

As long ago as 1982, the US economist Mancur Olson, who died last year, referred in his book “The Rise and Decline of Nations” to the growth-curbing influence of long-entrenched vested interests.

The experience of ten years of efforts at transformation in central and eastern Europe are, not least, confirmation that the market economy is superior to any type of “Third Way”- for which there is no clear definition in any case, by the way.

Anyone wishing to reap the benefits of the market economy, however, also has to accept its functional principles and ensure that there are consistent rules to follow.

In the monetary sphere, this also involves the question of whether a close pegging of the exchange rate to the euro can assist the process of transformation.

Admittedly, that is not an easy question to answer. It is likely that each country will have to find its own solution.

There is no disputing the fact that a linkage to other currencies can bring more credibility for the financial markets and can make it easier to implement domestic reforms. But the borrowed credibility then also has to be paid back in the form of appropriate internal adjustments and actual domestic stability policy. If that does not happen, there may well be dangerous crises one day. There are many examples to illustrate that.

The monetary crises of the past few years have generally sharpened awareness of the risks of a too rigid exchange-rate pegging and the resultant overburdening of domestic policy. For that reason, also any premature decision on the adoption of the euro could have severe repercussions on a country’s competitiveness and trigger painful economic adjustments.

After all, in addition to the fundamental alternative of flexible exchange rates, there are also intermediate solutions such as basket pegs or even crawling pegs.

Given global financial markets, international investors and the free movement of capital, exchange rates are nowadays - even more than before - “bridges” between the economies.

These bridges may be fixed or movable. What is crucial, however, is that they are strong and sustainable.

Pegging to another currency must therefore be given very careful consideration, and the economic setting and internal adaptability must also be taken into consideration.

VI

In his novel “The Unbearable Lightness of Being”, Milan Kundera, the well-known Czech writer, also wrote about the burden of taking decisions. In other words, people can never know what they ought to want, because they only have one life and that life cannot be compared with earlier lives nor can it be corrected in later ones. Therefore, it is impossible to tell what is the right decision because there is nothing to compare it with.

There are no comparisons for the euro, either. It is a unique project in Europe’s history. And much depends on its lasting success.

A number of nation states, which in other respects are largely sovereign, are giving up their own currency in favour of the euro, and thus also relinquishing a major element of national sovereignty.

Given global integration, this historic change in the economic policy has an impact going far beyond the participating countries which affects neighbouring countries and trading partners. Everyone must now adapt their future decision-making on regulatory policy to the changed environment.

Unlike Tomas, the character in Kundera's novel, those bearing responsibility must not avoid making the necessary decisions. And I am also sceptical as to whether it will be enough - after taking the decisions in favour of monetary union and the euro - to rely on the emergence of a "spontaneous system", as called for by Hayek.

Certainly, the risk of "constructivist error", which Hayek warned against with the planned economy in mind, can never be dismissed out of hand. In other words, one should not overestimate what is possible in each given case.

Nevertheless, it is precisely in the area of regulatory policy that there are sufficient lessons to be learnt from the past. This means that there are also guidelines suggesting the approach to follow, a few of which I have tried to point out.

It is my firm belief that it will be possible to master the new challenges posed by the euro

- with humility as well as respect for the freedom of the individual and for the decisions of the individual,

- on the basis of open markets and economic competition,

- given a stable currency and a viable price system,

- and with social compromise that is consistent with market conditions.

I wish your country, and mine alike, every success in that. For all of us, the ongoing integration of Europe is an abiding challenge.