Mr Tietmeyer focuses on economic convergence and EMU

Lecture by the President of the Deutsche Bundesbank, Prof Hans Tietmeyer, in the series “Builders of the Millennium” in celebration of the 750th anniversary of the foundation of University College, Oxford in Oxford on 3 June 1999.

I

First of all, I should like to express my sincere gratitude for honouring me with your invitation. I am delighted and indeed honoured to be here. Oxford: the university, its colleges and facilities stand, on the one hand, for achievement and competitiveness in the modern world and, on the other, for history, tradition and heritage. They are part of Britain’s history and part of its future. And that means — I would quite expressly like to add — that they are also part of Europe’s history and its future. Great Britain and Europe are not separate, mutually independent entities — either economically or culturally.

That leads me straightaway to the subject of Europe and its future. I am naturally aware that this country is in the middle of a major process of clarification. How does it perceive its future position in Europe? How can it influence future developments in Europe? And, not least, what are the conditions of, and prospects for, future entry into monetary union? Like many others in Europe, I am following this process with keen interest. And I have the impression that this debate in the United Kingdom has made significant progress over the past two years. Of course, it is ultimately only the British themselves who can decide how they wish to shape their relations with Europe and European integration. Even so, I do not wish to conceal the fact that I have a great deal of sympathy with the idea of the United Kingdom playing a crucial role in the future development of Europe and of it bringing not only its great traditions but also its criticism and economic performance to bear in a constructive role in Europe and, hopefully, one day also into monetary union.

But that is a prospect on which the United Kingdom — its government, its parliament and its people — must take its own sovereign decision. I do not presume to be able to offer you advice on that matter. Instead, what I would like to do today is to draw your attention, in particular, to those aspects of monetary union which have played — and, in some cases, are still playing — a major role in our debate in Germany. There will probably be very little of this that is really new to you. However, it might be valuable for you to know the points on which particular emphasis was — and is still being — placed in the German debate. Perhaps there will be some aspects which might provide a stimulating talking point for your own discussion.

II

Let me start with a simple, but fundamental, analysis: What does monetary union mean? What kind of environment does it create? It seems to me that it possesses three essential characteristics: Firstly: membership of monetary union implies relinquishing monetary sovereignty. Monetary policy becomes European. Naturally enough, that concerns the level of the official interest rates. But it goes further than that. European monetary policy includes the framework in which monetary policy is conducted, embracing not only its structure and the way in which the central banking system perceives its own role, but also the strategy and instruments used, as well as much else besides. Secondly: the monetary union is designed to last. Entry into it is a road on which there is no turning back. In monetary union, a “trial marriage” is no longer possible. Reversing that decision would entail incalculable economic and political costs. No one ought to place any faith in that being a realistic option. And thirdly: the euro area is unlike every other currency area, which is defined — at least usually — by the area of a single sovereign nation state. There is a single monetary policy for the euro area. However, the other areas of policy, such as budget, tax and social policies, are still largely decentralised. Fiscal policy, in particular, must abide by the rules set down in the Maastricht Treaty and in the supplementary Stability and Growth Pact.

These three characteristics appear straightforward and self-evident. But they have important implications: One key implication is that the euro area requires lasting economic convergence — convergence in the sense that each single country must be able to keep up with the others on a permanent basis, without recourse to national monetary policy or changes in the exchange rate. That necessity of lasting convergence has to be seen against the backdrop of unrestricted capital movements and supranational monetary policy. A traditional nation state with its own currency has several options available for fostering convergence within its own currency area. There are largely uniform economic and taxation policies to prevent excessive deviations in politically-induced conditions for investment. There is a national budgetary policy which can give financial support to regions which are lagging behind the general trend. And there is a largely similar and similarly funded system of welfare. These are all things which the euro area does not have at a supranational level — or, at least, not to anything like the same extent.

There are some — mainly on the continent — who regret this because it means that economic convergence cannot be created or, at least, actively promoted by a centralised policy. Others — and I suspect that the overwhelming majority of the British people belong to this camp — believe this to be a good thing. Europe should not be a dominant centralised entity, nor should it have an egalitarian public-sector system of adjustment. It should be decentralised, organised on the principles of subsidiarity and geared to competition. Your Prime Minister put this in a nutshell: “Integrate where necessary. Decentralise where possible.” I would add that I have a great deal of sympathy for that position.

However, one also has to see the other side of the coin. One problem remains: how can a politically decentralised monetary union safeguard the necessary lasting convergence of all its member states? Ultimately, there is only one way of doing this. Safeguarding lasting convergence in a politically decentralised monetary union must rest on two pillars: firstly, on each country’s own sustained competitiveness and on each country’s own efforts; and, secondly, on a fundamental willingness to accept certain binding rules and abide by them on a permanent basis. That is the only way in which a monetary union with a decentralised political structure can succeed — not only economically, but also politically: in other words, without excessive conflict among the participating countries.

III

The competitiveness of each single country is obviously initially one economic condition for a kind of optimum currency area. Basically, an optimum currency area means that, in the longer term, there is no need for adjustment of the nominal exchange rate because other adjustment mechanisms are effective, say, as a result of internal flexibility or a high degree of labour mobility.

That is clear in theory. In practice, there is a fundamental problem: how can the ability to “keep up” be assessed? And how is it possible to safeguard that ability and the willingness to utilise it on a lasting basis? Now, in some way or another, the track record and the basic situation in the countries concerned have to be taken into account. The Maastricht Treaty does that and stipulates convergence criteria for that purpose. These may not have been the final pearl of wisdom in the strict economic sense, but that should not make us overlook what fundamental pillars the convergence criteria represent in terms of the logic of a politically decentralised currency union.

I am aware of the fact that we Germans, by insisting on a strict interpretation of those criteria, have not always been given a good press internationally in the past. It may also be the case that the debate in Germany did not always take the best possible course, especially when somewhat too much emphasis was being placed on the decimal place in the budgetary policy for the test year, for example. But the key element — taking the convergence criteria seriously — was — and still is — correct. The criteria were, and remain, a test of ability and political will, at least at the time of entry. Basic conditions for passing a test are undoubtedly the abilities to keep the internal value of the currency stable and to maintain the exchange rate without tensions — an exchange rate, moreover, which is determined *a priori* as a central rate, not one which is defined at a later stage. For that reason, the Treaty calls — and, in our opinion, unquestionably calls — for a two-year membership in ERM without tensions.

In this interpretation of convergence — which has determined the German debate — there are two ideas which play a key role: the idea of the permanence of sufficient convergence and the idea that the present and the past are a test of the future ability to stay the pace on a lasting basis.

Perhaps you feel the debate in Germany has a different emphasis from the one here. In the United Kingdom, convergence is sometimes understood more in the sense of convergence in the business cycle. By no means do I wish to disparage that. Naturally enough, I am aware of the current economic background in the United Kingdom. And we do already have this problem in the euro area at the moment. The cyclical position of Ireland, for instance, is obviously different from that in some countries on the continent. There can be no question at all: if a country believes that it is in its own longer-term interests to enter, it will look for a time which it feels to be opportune. That is no more than an act of human reason.

I would only like to point out that what we have here is a case of the debate being weighted somewhat differently. And, naturally, one has to perceive the backdrop to this: in other words, the fact that the tie which is created is a permanent one. It is not least for this reason that it is right for the British government, in particular, to place repeated stress on the subject of internal flexibility.

I believe that there is unanimity in the debate both in the United Kingdom and in Germany that economic convergence does not imply uniformity.

Firstly: it does not imply uniform structures. It is true that competition — precisely in a monetary union — exerts pressure to find efficient solutions, but they do not have to be the same everywhere. Even in monetary union, there will still be room for different economic traditions and styles. However, the competitiveness of all the participating economies must be ensured on an enduring basis.

Secondly: convergence does not imply uniform policies in all areas. On the contrary: a decentralised monetary union calls on national policy to exercise its own responsibility for maintaining competitive economic structures. In key areas, too, powers can indeed remain with the nation states. Nevertheless, individual approaches, say in the area of taxes, must not lead to distortions on the markets.

Thirdly: convergence least of all implies uniform living conditions or equal prosperity in all the participating countries and regions. It may very well be that the way in which the single market and the single currency work will assist less well-developed regions that face up resolutely to competition in catching up quickly and sustainably. But that must happen on the basis of competition. There can be no *a priori* guarantee of that.

IV

Lasting economic convergence based primarily on market forces is one fundamental precondition for a politically decentralised monetary union. The second fundamental precondition is that the participating countries agree binding rules for certain areas and are prepared to abide by them on an enduring basis. There are rules of this kind — in addition to the general rules for the single market — principally for budgetary policy, where it has a particular direct relevance to the financial markets.

Some of the rules for budgetary policy are: Firstly, the central banks must not finance the budgets. Secondly, there is a no-bail-out clause. The Community is not liable for the commitments of individual member states. Thirdly, the governments have committed themselves to avoiding excessive deficits and, where they exist, to reducing them immediately. Fourthly, in normal circumstances the deficit should be close to balance.

These rules are not undisputed. Some ask whether the no-bail-out clause is not sufficient. Is the reference to the inherent responsibility of national budgetary policy not enough on its own? In my view, these objections put matters too simply. Firstly, we do not know under what financial market conditions a financial crisis in one EMU country might break out. (To be honest, I hope that is something we shall never learn.) However, we can tell from the recent national financial crises in other regions that systemic risk can easily arise. Or, at least, the argument is advanced that there is the possibility of systemic risk — and who would want to let it come to that? Of course, the markets are aware of that, too. For that reason, there is always likely to be a certain problem of credibility with regard to the no-bail-out clause.

Secondly, it is true that a single currency does not imply the same long-term interest rates for all issuers. Certainly not. The quality of the borrowers and liquidity aspects also play a role. But, naturally, the foreign exchange risk is shared equally by all the participating countries. For that reason alone, there exists an interdependence among the participating countries. And there naturally also exists an interdependence in macroeconomic terms. If the budgets of individual participating countries — especially the large ones — have excessive recourse to the capital markets, this will obviously be a burden on the other countries. An excessive government deficit eats up private savings. That is a factor which uses up internal capital resources and/or has an impact on the euro's external relations — quite apart from an overburdening of monetary policy as a result of an excessively expansionary fiscal policy.

For these reasons, there is undoubted justification not only for a no-bail-out clause but also for defining limits for the national budget deficit and for the general government debt ratio. I wish that the national budgetary policymakers in the participating countries would perceive these rules not merely as a constraint but also as an opportunity of pursuing a rational policy on a sustained basis. One thing is clear, of course: setting the rules is not enough. The rules also have to be accepted by the countries involved. And they have to be enforced if the need arises. That is not an easy matter, as we learnt only last week in Brussels.

V

The second area in which rules are set is within the framework of monetary policy. One of the key elements of monetary union as provided for in the Maastricht Treaty is, without doubt, the independence of the European Central Bank and of the participating national central banks: in other words, the independence of the Eurosystem. The economic rationale for a central bank which is independent of the instructions and influence of political bodies is rooted in the finding that it is generally easier for such a central bank to keep the value of the currency stable on a lasting basis.

That higher degree of monetary stability benefits the economy and society in various ways. It increases planning certainty in the economy, which fosters a culture of long-termism. It makes it easier for enterprises to fund investment decisions in the longer term. That generally results in a stronger long-term orientation in economic decision-making. Incidentally, that was one of the key considerations when the new government gave greater autonomy to the Bank of England two years ago. A stable currency is, at the same time, an element of social policy. It is often precisely those who are not so well off in economic terms who find it difficult — or impossible — to protect themselves against inflation. Finally, money which has a stable value is also a factor of political philosophy. Confidence in the currency is, to some extent, confidence in the state and its institutions. That is, at least, the case in Germany; partly owing to our experience of galloping inflation in the first half of this century, but also partly on account of the ideas of economists such as Alfred Müller-Armack and Ludwig Erhard, who introduced into German economic policy the leitmotif of the social market economy, with a stable currency as one key element. This economic rationale has now resulted in a trend towards greater central bank independence outside of Europe as well. That is perhaps also one factor — among others — which helps to explain the high degree of price stability that prevails worldwide at present.

One fundamental objection to central bank independence raises the question of democratic legitimacy. Is a central bank which is independent of political instructions and influence in keeping with a democracy? I believe that there are two preconditions which have to be fulfilled for an independent central bank to be unquestionably compatible with a democratic system.

Firstly: the assigning of independence and the mandate has to have been arrived at democratically: at the least, by virtue of an implicit consensus and on an explicit foundation provided either by law, a constitution or by a treaty — like that of Maastricht — to which the parliaments have given their consent.

Secondly: the mandate of the independent central bank must be unambiguous. Political value judgements among various competing aims may be made only by those who have acquired direct democratic legitimacy as a result of elections. It is precisely for that purpose that elections give a mandate. The decision-making body of an independent central bank, which is not elected directly, may not make any autonomous value judgements among various competing aims. An overriding objective has to be specified in advance. That is precisely what the Maastricht Treaty does. It specifies the primary objective of price stability. Hence, the independent central bank remains anchored in the democratic structure of the state.

In my view, the limitedness of the central bank's mandate is thus a corollary of its political, democratic and constitutional legitimacy. For that reason alone, I believe that broadening the mandate would lead to problems for the European System of Central Banks. That applies, for example, to the idea of extending the scope of the central bank's mandate beyond price stability to include growth and full employment as additional objectives. That is quite apart from the fact that I do not perceive any trade-off between those aims — at least in the longer term. Assigning other tasks can also cause difficulties for an independent central bank, however. Assigning sole responsibility for banking supervision or a lender-of-last-resort function, for instance, may give rise to difficulties. Such a plurality of mandates might give rise to a situation in which the independent ECB has to choose among different objectives, say between the objective of stable prices, on the one hand, and the consolidation of individual financial institutions, on the other. Fundamentally, that would be a political value judgement. Therefore, caution — at least — should be exercised in terms of delegating additional tasks to the ECB.

In addition to those two basic preconditions — the democratic assignment of tasks and an unambiguous mandate — tying the independent central bank into a democratic system naturally requires something more: it calls for transparency and accountability. Independent monetary policy cannot and must not be remote from the general public.

In saying that, it is essential to distinguish precisely what is meant by transparency. Does transparency mean full disclosure of the deliberations, arguments and motives behind a decision: in other words, transparency of the <u>situation</u> in which a decision is taken? Or does transparency principally aim at disclosure of the <u>process</u> by which is a decision is made?

In terms of the transparency of the overall <u>situation</u> in which a decision is taken, the ECB endeavours to do this by a comprehensive disclosure of its judgements and the assessments which determine its decisions. Of course, I do not rule out the possibility of improvement in one respect or another. It is not yet even six months that the ECB has borne responsibility for monetary policy. We are therefore all still involved in a learning process. Incidentally, I personally would have nothing against also identifying arguments pointing to a decision other than the one that was ultimately taken but which happened to be rejected after taking other arguments into account.

Transparency concerning the internal <u>process</u> of consultation and decision-making is another matter, however. I regard that as problematic since it may ultimately imperil the efficiency of monetary policy decision-making. Why? Firstly, it puts the frankness and confidentiality of the discussion at risk. It can, at least, lead to confidential discussions being shifted to other circles. And that undermines the unity of the decision-making body. Secondly, it may endanger the credibility and standing of individual members, who are open to argument and, on account of new insights, may alter their position during the discussions. I therefore feel that this second approach to greater public transparency is not without problems. And I also have doubts as to whether it really introduces more clarity and calculability in monetary policy for the markets.

I admit that my reservations also have to do with the idea that the decision-making body should have a feeling of collective responsibility. And that also includes the attempt to seek an internal consensus and demonstrate it externally. Now, it may be that some people find the desire to seek consensus stuffy and old-fashioned. In the final analysis, I believe it is not. Allow me to make a few remarks in this connection: I come from a central bank which — together with its predecessor institution, the *Bank deutscher Länder* — has been independent for over 50 years. During that period, it was necessary to fend off several attacks from the political field. In saying that, it has to be borne in mind that a simple parliamentary majority would have sufficed for a legislative amendment to remove the Bundesbank's independence.

In situations of conflict, an independent central bank needs the support of as broad a segment of public opinion as possible. That will also be the case for the ECB, even though its independence is anchored in the Maastricht Treaty. But to be given that support, a central bank needs more than just a good record over the longer term. What is also important is that it can demonstrate a minimum degree of unanimity. That applies anyway in the event of a conflict. In that situation, if the central bank gives disparate signals to the outside world, the general public does not know at all what it is actually supposed to be supporting. Admittedly, it is comparatively easy to create unanimity in the event of a conflict. But the central bank's standing with the general public, which is intended to be a protection in the event of a conflict — that is something which it has to have earned and built up beforehand. And it has that standing only if the general public is aware of what the central bank stands for. If the general public asks what the bank's standpoint is, it wants a clear-cut answer and not a response enumerating the various possibilities of position 1, position 2, position 3, and so on. A central bank must be identifiable by its basic stance. That can scarcely be achieved without a minimum of collective awareness.

I fully understand the objection that this must not lead to individual responsibility becoming lost in the decision-making bodies. There is something in that. I wish, however, that critics who have never had to withstand a serious attack on the independence of the central bank would have somewhat more respect for the concepts of consensus and unanimity.

VI

Finally, allow me to indulge in a reflection of a fundamental nature. We are certainly all in agreement that the euro has to be a success. And that is a permanent challenge. Whether the euro becomes a success story is something on which it is impossible to make a final judgement after less than six months. The euro certainly has a great potential. Recent exchange rate movements have not altered that fact.

Clearly, the decline in the euro's external value over the last few days has not been good news. We shall study developments carefully. Yesterday the Governing Council had a serious discussion on that. We came to the following conclusion which was presented to the press after the meeting by President Duisenberg: "The euro is a currency firmly based on internal price stability and therefore has a clear potential for a stronger external value. Since the start of Stage Three of EMU the euro has become the second most important international currency in the world, and the policy of the Eurosystem will safeguard its internal purchasing power, thereby also supporting the international role of the euro."

But in making a reasonable assessment of the opportunities and risks inherent in the project of monetary union, we shall maintain a longer-term perspective. In the eyes of future generations, the ultimate test of the success of monetary union will one day consist of three questions: Has monetary union been able to safeguard lasting monetary stability? Have the participating economies coped with the conditions of monetary union? And: has the euro brought the people and peoples of Europe closer together?

The answers to those questions have a lot to do with convergence, although not only with economic convergence in the narrow sense of parallel trends in the hard data on productivity, labour costs, or whatever. It also has much to do with convergence in values, in beliefs and in aims. That is something which cannot be measured mathematically, but it is nevertheless important. I feel that it is precisely this convergence in thinking which has increased over the past few years between the United Kingdom and Germany, with both sides having learnt from each other. That is not intended to be a sixth test for your entry into monetary union, but no harm can come from it either.