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The European economy between global markets and internal challenges

**Jean Monnet Lecture before the European University Institute in Florence on
November 28, 1996**

I

World economy and globalisation, efficiency and innovation -these are the key terms of economic debate these days. The spirit of Florence once opened the way to the global and rational-economic thinking of our times.

Florentine thinkers extended the European horizon to encompass the world which surrounds Europe.

- Amerigo Vespucci came back with news of the New World to which he finally gave his name.
- Leonardo da Vinci drew the first map of the world which included America.
- Galileo Galilei produced the first detailed heliocentric picture of the world.

Again, Florence was a leading centre of the early commercial revolution; today's global markets have emerged as the late successors of that revolution.

In the 13th century Florentine merchants began to develop a close network of branches far from their domestic offices. They no longer purchased and sold their goods at trade fairs but direct at the places of production and sale.

Two revolutionary innovations accompanied this at the time: double-entry bookkeeping and - as a financial instrument -the bill of exchange.

The double nature of each financial innovation became evident even at that time:

it facilitated the financing of production and trade. At the same time, it constituted a financial market in which lucrative arbitrage was possible because whoever was well informed about the prices of bills of exchange in the individual trading centres - as indeed the Florentine merchants were through their agents - was able to realise substantial profits.

Economic integration - whether within Europe or worldwide -is not an invention of our days.

The American economist Paul Krugman suggested that the year 1869 should be chosen if one wanted to mark the start of modern globalisation, i.e. the year in which both the Suez Canal and the Union Pacific railways were completed.

It is a fact that the world experienced a period of intensive integration between the middle of the 19th century and the First World War. The sharp growth of world trade after 1950, which in some cases continued well into the seventies, can be interpreted as the restoration of the previously existing wave of integration.

In this light, international economic integration - whether during the Renaissance period or the 20th century - is old hat.

II

What makes it possible, then, to suggest with the term of globalisation today that a new quality, a new reality has been achieved or is about to materialise?

Modern globalisation is characterised mainly by three innovative structural features:

The first feature is the distinct increase in intra-industrial trade.

The traditional foreign trade of an industrial nation in earlier times was conducted essentially according to the classical pattern: industrial finished goods in exchange for raw materials.

Today the industrial countries are largely trading among each other in products which are highly sophisticated but basically similar. The generally popular example from the motor industry: Italians drive VW and Porsche cars, Germans Fiat and Ferrari cars.

The second feature is the close integration of economies even at the production stage.

Today, enterprises, or even entire industries, are largely able to split the chain of value added geographically. They thus consistently make use of regional locational advantages.

This splitting-up gives the developing countries the opportunity of competing not only in the traditional labour-intensive industries, such as textiles. Some of them are also involved in the manufacture of high-tech products, such as computers.

And this brings us to the third feature: the rapid economic rise of a number of newly industrialising countries.

There are two groups of factors behind these new structures.

Firstly, political factors:

Trade in goods, services and capital has been liberalised within regional areas, and increasingly also at the global level. And, above all, many developing and newly industrialising countries in Asia and in Latin America as well as in the countries in transition in central and eastern Europe have adopted, internally, market-economy systems.

Many Asian countries are forming high domestic savings. They are therefore able to make sizeable investments to build up their economy and to maintain a high export ratio at the same time.

Secondly, globalisation is also being based on technological factors at an increasingly rapid pace:

The costs of transport and communication have fallen in the past few years, in some cases dramatically. Enterprises are therefore able to coordinate production processes efficiently at different locations. Employees on different

continents can even work simultaneously on one and the same project. At the same time, technical know-how has become more sophisticated.

Above all, expertise and know-how are spreading essentially faster and more comprehensively than ever before. And this process will accelerate, if anything, in future.

Where is all of this leading us?

First of all, locational competition has become much fiercer worldwide and will probably intensify even more. It is not only enterprises which are competing with one another, but regions, too. The entire political setting, above all the tax and social security systems, play an evermore important role as a locational factor.

Having an edge on your competitor does not last for ever. Regions and industries have to look continually for new ways of gaining an advantage. Flexibility is what counts in the end: that is to say, the ability to adjust and to cope with the never-ending task of making structural changes.

III

The most radical change has, no doubt, occurred in the international financial markets.

The financial markets exploit technical progress in data processing and in telecommunications, in particular. Today they are able to transmit huge amounts around the globe in fractions of a second.

The technological potential has brought new structures to fruition within a few years.

- New complex instruments, such as derivatives, revolutionise trade in risks.
- The professional fund manager crowds out the private investor as a player in the financial markets on a considerable scale.
- This means a change in behaviour. The fund manager is oriented more to the short-term performance of the portfolio than to the longer-term one.
- Today the markets record and process a virtually infinite flow of information.
- This increases the role of expectations in investment decisions.

The financial markets channel the capital flows rapidly and efficiently to productive uses. They thus raise the global economic growth potential.

At the same time, however, the markets are largely able to channel the capital flows past a particular country or to withdraw capital from that country.

The reason for this is that the financial markets assess a country. They do not only analyse current data but try to estimate to what extent a country is able and willing to deal with its longer-term problems. It is their expectations regarding these points which count.

The markets start to distrust a country if they receive signals that the longer-term problems are being neglected there. Indicators of this may be, above all, a monetary or fiscal policy which gives rise to doubts about a longer-term anti-inflation course.

In this way, the financial markets assume the role of supervisors. They may punish even the first signs of an easy monetary policy and an undisciplined budget policy. They withdraw capital from that country and demand a high premium on capital market rates.

Certainly, the financial markets may misjudge the situation which then leads to exaggerated reactions. In most cases, however, these exaggerations are only of a short-term nature.

Over the longer term, the fundamentals are decisive. In most cases it is credibility which is particularly important.

IV

On balance, globalisation has the following repercussions for national policies:

- The entire economic constitution, i.e. the social security systems, regulations on the goods and labour markets, tax policy, the legal system, all these are subject to locational competition.
- And monetary and fiscal policies are permanently tested by the international financial markets.

Globalisation therefore limits the sovereignty of national policy-makers. As is the case whenever competition increases, suppliers have to be guided more strongly by the market.

However, practically all countries are subject to the rules of a global economy. Why - and this is the core of the problems - why is it that Europe seems to find it particularly difficult to accommodate these rules?

This probably owes something to the fact that precisely in Europe the consequences of globalisation coincide with existing structural economic weaknesses, that they aggravate these weaknesses and thus make their solution all the more urgent.

Firstly, the fiercer worldwide locational competition, which demands a high degree of flexibility and willingness to make structural change, coincides with a rigid labour market and an inflexible social security system in many countries of Europe.

Globalisation often meets with inflexible internal structures. This leads to high unemployment, primarily among the less qualified.

In the United States, by contrast, globalisation meets with a labour market which is much more flexible by tradition. In the States this leads to a high growth in employment although this means that there is a greater differentiation in incomes.

Secondly, the narrower scope of tax and fiscal policy in Europe often meets with a government which is largely overburdened with claims and tasks.

This overburdening is reflected in high government debt, but also in the pension system which, in the light of demographic changes, will find it difficult to keep its promises to the younger generation.

Past internal mistakes and globalisation are linked.

On the expenditure side, the public authorities today have to spend sizeable funds to service the accrued debt. At the same time, the financial markets critically question the size and sustainability of the deficits at any time. A negative judgement would result in a further surge in the interest rate burden.

On the receipts side, an erosion of the tax base might be threatening. The increasing burden of taxes and social security contributions tends to foster the shadow economy at home.

At the same time, enterprises have become more flexible regarding locational competition as a result of present technology and modern transport. It is easier for them to shift earnings and to avoid taxes. And the global markets are legally capable of frustrating national regulations.

The internal structural weaknesses in Europe do not have their origin in globalisation. But globalisation aggravates the weaknesses and makes them evident.

This means a loss of competitiveness and attractiveness for new investment and a loss of employment.

And this causes unease.

V

Europe must not try to run away from these challenges. Fiercer competition is a reality.

One may hope to harmonise one or two parameters of locational competition - say, in the field of taxation - within Europe. One may also hope to improve some of the rules of the game through worldwide cooperation.

Nobody should believe, however, that Europe will be able to impose "its" rules or its welfare state model on the world.

This is shown by the discussion in the WTO under its Director-General Renato Ruggiero about the extent to which the WTO rules can be extended to encompass labour and social standards. The first WTO conference of ministers in Singapore in two weeks' time will probably deal, *inter alia*, with this sensitive subject.

Many WTO members object. They fear that the industrial countries mainly wish to impede cheap imports by imposing standards. In the world of today the industrial countries cannot simply ignore the political vote of the others.

Globalisation is irreversible.

Europe cannot do anything to prevent other countries from orienting themselves increasingly to the market economy and thus raising their efficiency. Nor can Europe cut off existing integration either worldwide or within the single market without weakening its own economy considerably.

Europe cannot reverse technical progress either. On the contrary, this cannot be stopped and will accelerate, if anything

And, above all, policy makers in Europe cannot raise themselves - as recently suggested by a French sociologist - above economic realities and establish a European welfare state in a constitutional act, so to speak.

High-flying constructivism invariably comes crashing to the ground.

That approach overlooks the economic conditions of global markets and the inherent contradictions of a welfare state that is getting out of hand. Above all, the approach overlooks the force with which economic reality may crush faulty political constructs.

All this is reality - whether we like it or not.

This reminds me of the well-known anecdote of the three Florentine envoys. When introducing themselves to a foreign duke, they said: "We are citizens and envoys of Florence if you like it."

Afterwards the three were terribly annoyed about this meaningless phrase. So they revised their address and said: "Whether you like it or not, we are both citizens and envoys of Florence."

Today the envoys of globalisation visit the European economy; but they will certainly not add "if you like it

VI

What role can the currency play in coping with the enormous challenges? Of course, the currency, whether it is called D-Mark, franc, lira or euro, cannot solve the structural problems as such.

There is no alternative for Europe but to reform the welfare state so as to preserve it in substance. This includes more self-responsibility, more initiative of the individual, more subsidiarity on the part of citizens.

But policy makers can demand this legitimately only if stable money gives the citizen a chance to provide for himself and to make sensible forward-looking decisions.

And stable money is important for creating jobs.

The reason for this is that it helps enterprises to obtain the capital required for investment on favourable terms. The citizens have stronger incentives to save. The domestic capital supply increases. And the international financial markets consider a stable currency as an advantage in their investment decisions.

Therefore it can basically be said that the participants in monetary union will only have a chance to solve their problems if the euro is lastingly stable.

Carlo Ciampi recently put this as follows:

"It is in the interest of Europe to have a strong euro. We cannot afford to replace the strong D-Mark by a weak euro. This would be a bad thing for Europe as a whole."

I can only agree with this.

VII

But the monetary union envisaged in Europe does not relieve us from economic constraints. On the contrary, even more so than globalisation, monetary union means a restriction of national sovereignty, of the national room for manoeuvre and of "do-it-alone" approaches.

The participating countries will lose the instrument of exchange rate adjustments among each other. This increases the pressure for internal flexibility.

But a single currency demands even more.

In a monetary union the countries participating must tackle and solve their economic problems and challenges in a similar way and at a similar pace. Severe problems will arise if each country gives a fundamentally different response from that of its partners.

Firstly, an economic problem will arise if the various countries actually respond differently in their basic stance. Countries which energetically implement the right solution will soon be more competitive than countries which react incorrectly or hesitantly. There will no longer be an exchange rate to absorb this. Economic developments would diverge. Internal tensions would result.

Secondly, a political problem will arise to the extent that individual countries are unable to realise their desire for a different policy because their integration in the monetary union prevents them from doing so. Political tensions would result. Europe might soon become the scapegoat.

Thirdly, whatever tensions were to arise, the international financial markets would hold the euro liable for them.

A monetary union needs similar responses from the participating economies and states to major economic questions of the time.

This is no academic, abstract requirement because the economic challenges facing these countries will not arise some time in the distant future. They are on their doorstep.

How can Europe achieve the necessary congruence?

One solution would be a far-reaching, formally constituted political union, the road to a common government authority.

The individual countries would more and more restrict their sovereignty. Although the diversity of Europe would at all events require a federal structure, the responsibility for giving a general direction to policies as a whole would be borne by a centralised state.

As you know, the Maastricht Treaty takes a different road. Monetary union will start without a constitutionally established political union, let alone a federal state. And there is no generally accepted timetable on the drawing board for achieving that goal.

But if there are no *explicit institutions* which ensure the necessary congruence in monetary union, there must be *implicit common features*: a common assessment of situations, a similar feeling for values and priorities.

Monetary union according to the Maastricht Treaty requires a sort of implicit political "quasi-union". This means

- firstly, a tested common stability culture
- and, secondly, the willingness, particularly on the part of fiscal policy makers, to commit themselves to rules and to set up effective barriers - even if they do not wish to abandon sovereignty.

VIII

And it is precisely these two elements which matter today: meeting the criteria and the stability pact.

The criteria are used to check how far a given country has advanced on the road to a permanent stability culture. All criteria specified in the Treaty are important for this. The countries which wish to participate must meet the criteria on a lasting and sustained basis.

This also applies to the fiscal policy criteria. In its recent convergence report the European Monetary Institute stated the following:

"... the improvement of the deficit by measures with a one-off effect does not ensure sustainable consolidation and great attention will have to be paid to the substance and not only to the accounting methods used in measuring both deficits and debts ..."

Monetary union requires an additional rigid stability pact. And, as the European Monetary Institute puts it, such a pact

"cannot be a substitute for convincing fiscal consolidation prior to monetary union."

It is the necessary supplement. The stability pact raises the question of whether the countries concerned are willing to pay due regard to the stability of the single currency in their own fiscal policy.

This is no German "megalomania". On the contrary, in a monetary union it is precisely the large countries that may harm the community through fiscal slippage. The stability pact protects the small countries from mistakes made by the large countries.

That is why it is regrettable that the proposals so far submitted by the EU Commission on the stability pact lag behind the consensus reached in Dublin.

The euro needs sound economic and political foundations to ensure that it has the confidence of the citizens and the markets from the outset and that monetary union is permanently sustainable.

Every country which fulfils all the criteria and is prepared to accept the consequences of the single currency will enrich the monetary union.

But virtually all countries still have to make considerable efforts. The Maastricht Treaty rightly does not provide for a discount for the founder members.

This applies to Germany as well. In 1995 the public sector deficit in Germany clearly exceeded 3 % and will do so again in 1996. In these two years, Germany has therefore clearly failed to meet the Maastricht criteria.

And Italy, too, has no doubt a lot to do although it has made considerable progress, and this is seen and appreciated elsewhere.

I am pleased that the Italian lira is again participating in the EMS exchange rate mechanism. The lira is warmly welcome. Incidentally, Germany would have welcomed it in the autumn of 1992 if the lira had remained in the exchange rate mechanism. At the time Italy took a different decision.

Italy is on the right track. And much of this is due to two members of the Banca d'Italia, Lamberto Dini and Carlo Ciampi.

I hope that Italy will consistently follow the course adopted. Last Tuesday Carlo Ciampi rightly stated the following before a senate committee:

"We must be very aware of the fact that re-entry into the exchange rate mechanism is something completely different from entry into monetary union."

Europe needs a stable and a strong Italy. And Italy needs lasting soundness and a stable currency.

IX

An orderly monetary system is an essential factor and at the same time a mirror of the economy and the culture.

At the start of my lecture I forgot to mention one superb cultural achievement of medieval Florence.

In 1252 Florence minted the first gold coin of the middle ages, the *fiorino d'oro*.

Florence thus introduced a new stage in the history of Europe's monetary system: the turn of the western world to the gold standard. The gold florin - like any successful innovation - was copied elsewhere, including Germany and its *gulden*.

Today the history books report the following on the *fiorino d'oro*:

- Owing to its high quality, it was accepted in all market places without hesitation.
- It became a standard of value that was accepted everywhere.
- It provided new stimuli to trade.

Today the question as to the extent to which the euro will introduce a new stage in Europe's monetary system may be of very little relevance.

But if at some later date historians were to report the same on the euro as they report today on the *fiorino d'oro*, this would no doubt be to the benefit of Europe.