The Economic Situation in Europe After the Introduction of the Euro and the Challenges for Economic Policy

Heiner Flassbeck
(Former Vice Minister of Finance
Federal Republic of Germany)

1. Introduction

Thank you very much Mr. Chairman. I'm very pleased to be here at this institute for the third time now, and Mr. Chairman just reminded that at both former times I talked about currency unions. The first time in 1990 about the German currency union, the second time about the preparation for the European currency union, and today about the European currency union after it has been accomplished. This is a series of speeches at this institute, which I'm very grateful to be invited to.

Today I'm going to talk about the first experiences with the European Currency Union. That the final stage of the currency union has been reached now obviously has to do with political factors on the one hand. But, on the other hand, there are some hard economic arguments for the currency union also which, too often in my opinion, are not given the adequate weight in the European and in the international debate.

The first point that I'm going to raise as an introduction to the relevant economic questions concerning the monetary union is the economic situation in Europe. I think this is a very good introduction to the crucial questions surrounding the currency union because it offers an example of how the currency union should work or should not work. This should be very interesting for you for two reasons. First, the economic situation in Japan is not so simple either. And, second, the currency question in a very broad sense has been in the focus of the Japanese discussion in the last years as I understood during this week in Tokyo.

2. Europe‘s Economic Dilemma

You all know that in both Europe and in Japan we have only quite recently been coming out of a long and lasting weakness of growth. In the midst of the 90s, we had a long period of weak growth all over the world. Just before that we had a recession in 92 and 93 following the German unification. Only in 1994 we had for Europe as a whole a quick but only short-lived acceleration of growth. In 1997, for the first time in the whole decade it seemed that Europe could experience a prolonged recovery of growth. But then the events which are sometimes called the „Asian crisis„ stopped again the first signs of an acceleration of growth.

Yesterday I was talking here with Parliament members and we were taking stock of the whole decade. Everybody had to admit that this decade was obviously not the European decade. And it was not the Japanese decade either. It was obviously the American decade. We have to talk about the reasons for that. I think this is very important because the next decade should not be the American decade again. This time it should be the European and the Japanese who take the lead. But we have to work hard and to think hard to achieve that. For Europe, I’m absolutely sure, fortune or misfortune has to do with a proper functioning of the Monetary Union.

As I said, since the summer of last year, everywhere in the world we are faced with a "new shock" that came upon us as the result of the Asian crisis, the Russian crisis, or, as we sometimes are tempted to call it the world financial crisis. All over the world policymakers

had to find quick answers to this shock. Unfortunately, it has been very difficult in Europe to find adequate answers to such a shock. That is one of the big problems with which we are confronted right now. So let me first of all talk a bit about the kind of shocks with which economies can be confronted in general and the kind of answers economists have found to deal with different kind of shocks.

There are supply and demand shocks like the ones we have witnessed after the increase of the price of oil in the midst of the 70s and at the beginning of the 80s. And there are demand shocks like those which are imposed on us, say, by restrictive monetary policy or, in this case, a dramatic fall in exports. The fall in exports that we in Europe have all witnessed in autumn of last year was obviously a negative demand shock.

Given this, when I took over a job in government the question was raised in autumn last year in Germany and in Europe: Which is the adequate response in the case of a negative demand shock? Economic theory offers a very simply answer. The answer is that the best and the first thing that you should do in such a case is to stimulate the economy with a relaxation of monetary policy. Monetary policy is the adequate instrument in case of a normal negative demand shock. That is to say that monetary policy lowers short term interest rates. And only if monetary policy does not work, then you should compensate the lack of demand with an expansionary fiscal policy, i.e., with higher deficits. Japan has done that several times, and you are doing that now.

This is a very simply „stylized„ description of the situation last autumn. There is a second point which is important to mention and which was made correctly by many economists in the course of the preparation of the European monetary union. It was the differentiation between "symmetric" and "asymmetric shocks." Economic literature all over the world agreed that in a Monetary Union in Europe (after the introduction of the Euro), monetary policy can only cope with the type of shock which is called the symmetric shock. This is a shock which affects all the members of the union at the same time, or which affects the union as a whole. All the members don't have to be affected to the same degree, but at least at the same time, and all in the same direction.

There is a second type of shock which has been identified -- the so called asymmetric shock. It is a shock which affects only one country or a group of countries but not the whole union. This can be an earthquake or a political event like the German unification at the beginning of the 90s. Of course, the assumption that not all are affected by that shock is a weak one. Indirectly everybody will be affected in all cases given the very close trade ties. Nevertheless, economists agreed again that shocks which emerge in one country and hit this country much more than the others should be the domain of fiscal policy. Thus, there's national fiscal policy on the one hand, and there is supra-national monetary policy on the other hand. This is the fundamental construction of the currency union.

And there is, this should not be forgotten although economic theory only rarely touches upon that question, wage policy or wages which are still determined in Europe on a national level. This is important because wages or wage policy cope with a quite different kind of shock which can emerge in a currency union. We have seen it in the case of Germany but most of the non-German observers have not taken it into account. That is why I think my experience is a rather unique one in Europe having intensely discussed at first a German Monetary Union, and then the European Monetary Union.

Wage policy has to avoid shocks which are able to disturb or even to destroy the competitiveness of the region. That is to say, nominal wages have to obey a very simple rule in a monetary union. But I should say that this rule is not specific for a monetary union, it applies to the whole world. The rule just says that wages, measured in an international currency, should adjust to national productivity and nothing else. If this rule is violated, then you are in trouble whatever your currency system is. But the probability that it is violated may

be different in different currency systems. The German unification, however, shows that it can be violated even in a currency union. Then you may experience a real appreciation of a certain „currency„ even inside a currency union and despite the fact that national currencies do no longer exist.

Appreciation and the loss of competitiveness are not exclusively features of national currencies but have to do with the free trade and the need in any system of free trade to protect the competitiveness of a certain region. If you have a violation of the wage rule upwards in a country with a flexible exchange rate, then you have to depreciate to restore your competitiveness. To depreciate in all cases means to envisage a real income loss or the restoration of the law that you can only consume what you produce and not more. This is even true in socialist, centrally planned economies of the world. Nevertheless, in my opinion, attempts to violate this law are at the core of most of the economic problems we have seen in human history.

The question I want to address now is whether we in Europe did it right or wrong in the course of this winter. Nobody could be absolutely sure to do it right or wrong. It was the first chance to deal with a problem like that on the pan-european level. Everybody should have at least a second chance to do it better. Any maybe we will learn from that. I think we have to learn from that and the question whether we learn from that has very much to do with the question I raised before; namely, whether the next decade is a European and Japanese one or not?

3. The Role of Monetary Policy

Theoretically, the role of the ECB in the game that began last autumn with the negative demand shock had been described clearly. But the ECB didn't accept that role. As a result, the demand shock hit Europe and we're facing a renewed slowdown of growth in the European economy. This is true for Europe as a whole. In Germany and Italy, economies with a strong export bias, the outcome is worst. In Germany the growth rate has weakened from 2.3% last year to 1.5% in 1999. Given the mature state of our economy, this is a very remarkable slowdown -- obviously a slowdown that is detriment to further improvements on the labor market.

So there is a grave danger in Europe that we are repeating exactly the errors of the mid of the 90s by not trying to stabilize the effects of the shock at an early stage. You should never let such a slowdown work its way through the economy. It seems that European policy makers and mainly monetary policy makers favor an approach in which you let the shock work two or three years and then expect that there will be a recovery. But what are the reasons, the acting forces, to bring the economy back to its former growth path? Will a miracle happen which leads us back to a high growth rate? I think this is a very risky policy approach. If I had to put the success of the American economy in the 90s in a nutshell, then I think it would be fair to say that the Americans have avoided exactly that kind of error and that kind of misguided policy.

Let me say it in a provocative way. If you asked in Europe today 100 professional economists whether it is feasible, in these days of globalization and open markets, to aim for fine tuning of the economy by monetary policy, 98 out of 100 will say: "No, that is the worst thing in the world. You should never try that, it can only lead to confusion in the markets without any real result. But if you look at the United States and look at what Alan Greenspan has done all over the 90s, then you will find that he has done just that. The Fed fine tuned the economy by interest rate cuts and hikes. But the Fed was extremely successful with that kind of short termism.

The Europeans on the other hand, have been obsessed by quite different ideas. They were and are obsessed by the idea that we have to fight structural weakness of our economy only and refrain from any kind of macroeconomic action. If policy makers, according to that idea, concentrate their efforts on removing all barriers to effectiveness in the economy growth will follow automatically. Europeans, since a very long time now, have ignored the short-term. They explicitly reject to fight an economic slowdown in the short-term. But the long-term and the medium-term consist of several short-terms. If you take into account that the medium-term consists of short-terms, then you will not be in danger to forget immediate action in case of a shock to avoid a short term slowdown. It is just the other way round: if there is no short term action the economy will not come back automatically to a growth rate which is sufficient to keep your labor market going or even to reduce unemployment.

Thus, monetary policy would have been available to fight the shock, but the ECB did not act at an early stage but lowered interest rates only in April. I doubt that this was adequate in timing and in the quantitative effect. Monetary policy had clear signals from the markets to react earlier and with a larger step downwards. Long-term interest rates had been coming down all over the world in the course of 1998. At the same time, short-term rates in most of our economies remained flat –i.e., remained at the level they had before the emergence of the shock. Thus, the spread between long and the short rates has declined. The spread at the beginning of '96 was around 2% in Europe, and it had come down to 0.5% at the beginning of 1999.

What do low falling long rates mean? Lower long rates mean that somewhere in the world, as is definitely the case in Asia, in Latin America and in Eastern Europe, there is less demand for long-term capital than there was before. We do not have clear indicators that there had been a change in supply of capital too, but there was definitely falling demand in the Asian countries, in Russia and elsewhere for long-term capital. But if long rates come down all over the world and if central banks keep the short rates stable, this will clearly exert a restrictive effect on the world economy. A reduction of the spread gives incentives for investors to switch from long assets to short assets. If you get 2.5% for an asset with a liquidity quite close to money, and 3.0% for a ten year bond it obviously makes sense to go short . The central bank, by keeping the short rate constant at a time of falling long rates destroys capital.

But what about the Fed? The central bank of the United States reacted promptly and cut rates in autumn last year. Nevertheless, the cut was only a small one and did not avoid a sharp reduction of the spread. But take into account that the United States were in a quite different economical and cyclical position than Europe. The United States economy was close to full employment. And to be close to full employment would have implied without the Asian crisis that the United States, respective Alan Greenspan would have done what he did two weeks ago, namely to raise interest rates.

That was adequate for the U.S. economy at that time, but he didn't do that. Again, in his fine tuning approach, he lowered interest rates for the time being, thereby giving signals that the expansion of the economy could go on, and indeed, the expansion went on for the time being. Whether this is sound in every respect or not is a different question. I think this time they have overdone their fine tuning, and the bubble on the stock market will burst sooner or later. Nevertheless, the overall situation in the U.S. up to today is much better than in Europe. The growth rate of the United States economy has risen after the financial crisis, whereas in Europe there is a sharp deceleration.

From that point of view, I think, the first test of the ECB has gone wrong. And the second instrument of economic policy, fiscal policy, was not available too. Although a symmetric shock, all over Europe we could have used fiscal policy at least in the sense of „automatic stabilization„. But Europe has more or less given up that instrument. In the treaty

of Maastricht we have committed ourselves not to use that instrument anymore, at least not in circumstances of such a rather weak slow down. As a rule, only in the case of a deep recession we should use the instruments of fiscal policy.

4. Challenges for Economic Policy

This can be a reasonable assignment of policies. But this is only true if monetary policy is prepared to act in all cases. If monetary policy reacts in time, then it is clearly the best instrument to fight demand shocks. However, monetary policy in Europe has not yet assumed this role. And fiscal policy is even accelerating the consolidation of budgets, and destabilizes the economy. Is there any other instrument around?

One could say, well if you have fallen demand from all over the world, then lower your wages so that you regain competitiveness, then you regain market shares and this is a compensation for the fall of demand. But, let us think a moment whether this is really a solution for the world as a whole. I have my doubts. If you think a moment about the reasons for the Asian and the Russian crisis, then in one way or the other, the main reason for the collapse of these economies was an overvaluation of the currencies and a loss of competitiveness for these economies. We observed a real appreciation of these currencies over a long time and we should have known that this can only lead to a sharp depreciation. If now the Western industrialized world tries to respond to this crisis and the depreciation with a new round of depreciation in terms of falling wages, where would we end up? A second new round of depreciation in the developing countries, and then a second new round of cutting wages in the industrialized world? This is obviously no solution for the kind of problem we are confronted with.

This is true for wage adjustments as for exchange rate realignments. A real depreciation of a currency, that is to say an improvement in competitiveness, can be achieved either by falling wages or by a falling nominal rate which is not compensated by higher wages. This is exactly the situation where we are in Europe. We didn't have falling wages, but we had a falling exchange rate. The Euro is coming down. Many people in Europe, in my opinion too many people, now share the short sighted view of saying, "This is wonderful. This is a good solution for all of our economic problems. This is the stimulus that we needed for our economy. We didn't have a stimulus from the monetary side, no stimulus from the fiscal side, no stimulus from the wage side. Now let's take the exchange rate. Wonderful, this is the solution."

But again, I have my doubts whether this is really the solution for Europe. And I fear that it is in the least analysis not only no real solution for Europe, it will be definitively a bad solution for the rest of the world and for Europe, because a real depreciation in the industrialized world can only provoke renewed retaliation from the other countries trying to fight back to keep their market shares.

No solution around? What are we going to say about the European Monetary Union in ten years time? When I was here in 1990, talking about the German Monetary Union, I was rather skeptical and rather pessimistic. Unfortunately, I would say, I was not wrong. It turned out to be a very difficult and costly affair. And again, the question is, will this European Monetary Union (and I think this is an important question for you too, and for everybody who is engaged in Europe) be a failure or not? This is a bit more complicated question than the one I've just asked. The answers up to now are only on the first stage and on the first test for the European Central Bank. I still hope the first one is not the definite one. So, give me five minutes to tell you what I think is right about the European Monetary Union, and what is

wrong. Not everything is wrong, only the point we have been discussing up to now is wrong, but many others are right.

This morning I gave a lecture and somebody asked me, "Well, why were so many economists not only in Europe but all over the world so critical about the Monetary Union? And are they not all justified now by the development of the Euro and your criticism of the central bank?" I said no, absolutely not. This fundamental criticism is not justified although I'm very critical concerning the first test. This is a difficult point, so let me try to explain.

Why do we have a monetary union in Europe? Let me say this in principle here. The answer to this question is not only interesting for Europe, but it is interesting for a much broader audience. The principal question is, "what kind of exchange rate regime is adequate for economies with open goods and capital markets?" "What kind of currency regime is adequate for Asia, for example?" "Could there be something like a nucleus of a monetary union in Asia created at a certain time which grows up to something like a currency union or not?" This is really a good question, and a very important question. It may even be the most important question we have to address in the world economy today.

Why was the European Monetary Union necessary although the first test was not a positive one. We have experienced different exchange rate regimes all over the world. The Americans now say, and it is indeed a kind of new ideology, that only corner solutions work. You have either an absolutely fixed rate, or you have an absolutely flexible rate. I still do not see that the world is so simple. What have we done in Europe? We never opted for totally flexible exchange rate (no country, virtually no country in Europe opted for a fully flexible exchange rate, not even the United Kingdom). All countries opted for certain kinds of exchange rate mechanisms or at least for managed floating. Mainly the smaller countries were clearly in favor of a controlled flexibility, or a system that did not give the market the full right to determine exchange rates but gave government a chance to intervene and to keep a certain amount of control over currency developments.

The European Union is a very, very important example. The Europeans have much more experience in that field than the United States. The United States' experience begins with Mexico in 1994. That is the first major example that the United States had to deal with a currency crisis in a neighboring country. We have 30 years now of crisis time and again and we have a lot of experience with that kind of problem.

In Europe, we obviously had one major problem when we started with the experiment of a currency system. We had differing inflation rates. We had high inflation rates in most of the larger members of the European Union and we had traditionally low inflation rates in Germany and its smaller neighbors. Whereas the smaller countries quickly adopted a policy of „anchoring the D-Mark„ the larger ones followed only at a later stage. Twenty years after the collapse of Bretton Woods even those countries with traditionally higher inflation rates used Germany as an anchor for their currency. And with the help of the anchor they brought down their inflation rates.

If you opt for such an anchor policy, you will always end up with a real appreciation time and again because you have higher inflation rates, you peg your currency, and then you earn a real appreciation and a loss of competitiveness. Reasonably, you adjust your exchange rates from time to time, but nevertheless, you keep it for a certain time fixed to your anchor country. This is the famous model of fixed but adjustable rate. That is no corner solution but it has been a very reasonable kind of arrangement in Europe for a very long time.

But then, sooner or later, you reach a point where you have the same inflation levels as your anchor country. You have achieved convergence of inflation rates. What are you doing then? Then you are in a new situation. And this is exactly the situation in which we were at the beginning of the 90s in Europe when everybody had the same inflation rate and everybody had the same growth rate of unit labor costs. What are you doing then? If you are level with

the anchor, who's the anchor then and why? This problem is the most important one if you want to understand the logic of monetary unions. All systems with an anchor or a hegemony currency have one major defect: The monetary policy of the anchor country is de facto monetary policy for the whole region which has pegged its exchange rate to the anchor. But the anchor country normally pursues a monetary policy which is adequate for its own country. The Bundesbank monetary policy may have been an adequate policy for Germany, but it was definitely not systematically an adequate policy for the whole of Europe. And in countries like France it was extremely difficult to understand after a certain time that they had the same inflation performance as Germany but they had to follow the monetary policy of the Bundesbank. For France there had to be a change sooner or later because they could not follow the Bundesbank policy forever. There had to be a fundamental change in the system.

The same thing happened in the Bretton Woods System. Why did the Bretton Woods System collapse? Exactly for the same reason: The U.S. monetary policy in the 50s and the 60s was de facto monetary policy for the world, or more or less the industrialized world. But at a certain point of time some countries considered it not adequate anymore to follow blindly US monetary policy and opted out. Germany was one of the first to say, "Th US policy will lead to inflation. We do not want that kind of policy, so we have to appreciate vis a vis the US-Dollar. We'll be responsible for our own monetary policy." At that time, the world was divided into at least two blocks. The other block came to enter the world economy a bit later, and now we are living in a tri-polar world.

For Europe it was unavoidable sooner or later to end up with a currency union. You cannot go on forever with a hegemonial system, because the hegemon‘s policy will never be adequate for everybody. This is a simple point which has to be made for monetary unions, and I do not see that there is any argument around which could replace it, given the inherent logic of these systems.

Two things are extremely important and should be taken as a lesson from this European experience. The first is that "there is no such thing as a simple solution for the exchange rate problem. There are only difficult solutions ahead." But you have to choose one. And crises is unavoidable in one area or another, time and again. This is a very important issue for Asia. Do not just leave it to some invisible hand. There are no reasonable invisible hands anywhere. Either you find solutions or nobody finds solutions or you end up in a mess like competitive devaluation and begging your neighbors, and this cannot be a reasonable solution. The „markets„ are too strong to leave small, open economies alone in this globalized world. They have no chance to compete and play a fair game with the big players in the market. Take for example Austria. Austria is the best example. Austria from the first minute after the collapse of Bretton Woods pegged its exchange rate to the D-Mark. The experience of Austria was, although the Bundesbank was sometimes wrong in her policy, a very positive one.

The second lesson is on structural events, on deregulation and regulation. Politicians and economists should permanently work on better solutions in this field to improve efficiency and the allocation of resources. But they should take this as a permanent task of economic policy and not as a substitute for short-term policy, for fine tuning of the economy. Otherwise, as I said before, the concentration on the medium and long-term may lead you to forget the short-term. You may tumble from one short-term slowdown to the next. In Europe again, if we are not successful to fight this slowdown now, then the next slowdown may follow, e.g., because the American economy enters a recession or the Dollar begins to slide. It may happen because Russian is in new strains or a country in South America declares default.

There are a lot of events around and a lot of risks around which may quickly lead to a renewed slowdown. As a rational policy maker you have to use every moment to stimulate your economy and to make it as independent from the international disturbances which are bombarding you as it is possible. This is really the short-term view. If I say something like

that in Germany, everybody would say, "Oh boy, you never should say something like that because mainstream economists say that this is definitely wrong." I'm, however, definitely sure that this is the right lesson that we have to learn. Think hard about it to get a better answer than the one we in Europe have up to now. Thank you very much.

5. Discussion

(Prof. Tanaka)
There are several questions I'd like to ask Dr. Flassbeck. The Euro is now a reality. Some ten days ago, I visited ECB and talked with chief of the monetary division of the ECB. According to him, the biggest problem for the Euroland today relates to the fact that monetary policy if focused on Germany and Italy where growth rates are extremely low, whereas Ireland, Spain, and Portugal are showing very strong growth at 2.5%. If those things aren't addressed, those three countries will experience overheating of the economy. However, ECB currently lacks any effective means to counter that.

He said that there are no means they can use to counter this potential overheating of these three countries because the monetary policy is focused on the conditions in Germany and Italy. Dr. Flassbeck talked about the short-term fine tuning, but for the Euroland, what does short-term fine tuning entail? What specifically does it mean? If the monetary policy is really targeted or tuned to Germany, it might mean even lower interest rates. But if the interest rates were to be lowered further, then either Ireland or Portugal will suffer from even more overheating. So the current situations in Euroland cannot be addressed just through this short-term fine tuning.

I wrote about this many times in articles, and this has been repeatedly discussed before the start of a monetary union. This is the first point on which I would like to invite Dr. Flassbeck's opinion.

(Dr. Flassbeck)
I'm very happy that you have been with the ECB, because it gives me the opportunity to show what is right or wrong on that argument. This week I had a meeting here with Mr. Christian Noyer who is the vice president of the ECB. He said in his statement two things: On the one hand, we cannot deal with things which happen in one country. This is absolutely right. The ECB can only deal with things that happen everywhere, or better, in the „average„. That is why I stressed the difference between symmetric and asymmetric shock.

On the other hand, Christian Noyer would say, as you said (you cited correctly), Ireland and Spain may have a problem. I do not understand that problem. Well, why should it be a problem? If the ECB cannot deal with a certain country, why does she care about Ireland? Ireland is nothing. I said it in Ireland too, so I'm allowed to say it here in the same way. Ireland is nothing. Ireland will not be able to move the European inflation rate. Why do they care about Ireland on the one hand, but on the other hand, they say that they cannot deal with a small region or country -- or even Germany and Italy. They cannot deal with Germany and Italy but they fear that Ireland brings inflation to Europe. It is ridiculous, it's really ridiculous.

There is "an asymmetry" in the argument again, which is not justified. This demonstrates exactly the dangers that I was talking about. Namely, that the ECB tends to play a waiting game or the same game that the Bundesbank has been playing for a long time. The game is to say that "we refrain from doing anything for the real economy because we have no influence over the real economy. We only deal with price stability." This is the ideology or theory behind it. But this is a disastrous and non-viable theory. There is no economy around in which

prices and quantities are independent. And I do not wish that we would live in an economy in which prices and quantities are independent. Because that would be what economists call a stationary world in which we never have quantity movements. A world in which we have no real growth, no improvement of living standards, and not one of the things we praise the market economy for.

As soon as we have all that, then prices are not fully flexible. And if prices are not fully flexible, then monetary policy has an influence on the real world. Monetary policy has to acknowledge that it has an interest in the real world, and they have to realize, and they have to take care of it. This is the critical point. And to say quite concretely, and it's said by Christian Noyer too, if monetary policy doesn't assume that kind of role in Europe, then we will not be successful.

The Bundesbank could play that kind game all the time because Germany was a much smaller and much more open economy in which we could try to fight our real problems by improving our competitiveness, and by government policy. And the Bundesbank could more or less refrain from steering the real economy. This is no longer possible in Europe as a whole because Europe is a large closed economy. In this economy, you have to act to stimulate domestic demand. To stimulate domestic demand, this is the only solution around, not only for the global, but for the European problem too. As we have such a coincidence of interest we should act.

Coming back to your example and to make it crystal clear: If Ireland has a growth rate of not only eight, as they have, but 20%, and they are terribly overheating, it will be impossible for them to generate inflation. They will never get inflation for Irish reasons anymore in this world as long as they are a member of the Currency Union. That is impossible.

<Graph Unit Labor Costs in Germany and Europe >

We had one big attempt to produce inflation in Europe in the last years, so to say, to be even more provocative. We have one big attempt to increase inflation in a certain region of Europe, but even that did fail. That was the attempt by the East Germans to increase their real wages to an extraordinary way. If you look at the difference in the growth rate of unit labor costs in Europe, measured in national currency, you see that the region is East Germany.

You see that the East Germans tried hard to increase their inflation rate by pushing for extremely high wages (unit labor costs) but they failed to do so. And so will Ireland. They can do whatever they like, but they will never bring inflation to Europe. There is a certain mechanism that works in the case of East Germany as well as in Ireland. If they go for inflation nobody will buy their goods, but everybody will buy imported goods. It is very simple. That happened in East Germany. They couldn't produce their own goods anymore, and if it happens that in Ireland the economy is overheating, then there will be much more goods shipped into Ireland, and so there will never be inflation in Ireland. This is one of the big illusions or prejudices around in Europe – to believe that Ireland or Spain still have, under the conditions of a monetary union, a chance to increase their inflation rate. Their inflation rate may increase a bit reflecting scarcity in real estate or other domestically traded goods. But they will never have inflation in the real sense of the word.

The only thing you are able to produce as a small open economy in the currency union is unemployment. You can produce unemployment, it is true, in a currency union. If you misbehave, if your unit labor costs overshoot permanently as in the case of East Germany, then you will „earn„ unemployment, but never inflation, that's not true. If somebody says something like that seriously, this is in my opinion clearly inconsistent. The ECB should not talk about Ireland or Spain or any other countries. They should talk about the Euro area as a whole.

(Prof. Tanaka)
Dr. Flassbeck talked about the unavoidable need for a monetary union. You earlier mentioned that Bundesbank's monetary policy was not the monetary policy for the entire European region, and that was not acceptable to other countries. That's why the monetary union was absolutely necessary. However, currently, the ECB's monetary policy is still focused on conditions in Germany, and therefore, monetary policy has not changed in substance. Of course currently, peripheral countries like Spain are enjoying very high growth, and they are not complaining. But eventually, as their economy overheat and some bubble takes place, eventually bubbles will burst.

Ireland may be nothing but Spain is not nothing. Should the Spanish bubble burst, then the recession will be quite deep and the Spanish will complain vehemently. And the Spanish will say, I'm sure, that this ECB monetary policy was focused on German conditions and that is why Spain is now suffering from the bursting of a bubble. Some measures should be taken. I'm sure Spanish people will start saying that. And on that point, the solidarity of the entire Euroland will be required and called on. How does Germany intend to respond to such criticisms coming from Spain? Or, how is ECB prepared to tackle such complaints coming from the Spanish?

Unless those possibilities are considered, the currently favorable conditions for some peripheral countries will go away, and those peripheral countries will start suffering from economic conditions. I'm sure they will start complaining about the monetary policy of the ECB. You do have a stability and growth pact, but some countries might start demanding the extensive use of fiscal policy for the purpose of gaining some increase in fiscal deficit.

(Amb. Yoshino)

With respect to your question Professor Tanaka, allow me to make one comment or follow up question. When Mr. Lafontaine became the finance minister of Germany, the regime of ECB was considered to be too strong. Unless that is weakened somewhat, the ECB's stance would not be favorable to Germany either, as mentioned. And if ECB were to follow what was mentioned by Lafontaine right away, (ECB waited for awhile till after Lafontaine resigned) the base rate was lowered from I think 3% to 2.5%, or somewhere in that level. ECB waited for a while after the resignation of Mr. Lafontaine.

Of course ECB is not Bundesbank, but at least on that occasion ECB did show that kind of flexibility to respond to the problems. I guess the problems may be the same. But if Spain finds itself in a similar situation, will ECB follow suit and do the same thing? All in all, the issue is whether ECB is flexible enough in managing its own policy.

(Prof. Tanaka)
The ECB may not be as rigid as we might think. The ECB was willing to intervene in the market swiftly using Japan's account according to Japan's request. And Mr. Sakakibara gave very high credit to ECB cooperation.

I personally feel that a monetary union, if it contained only eight core countries without the participation of Ireland, Spain, and Portugal, would be much successful. But because these three or four countries are also now a part of the monetary union, the job of a central bank has been made much more difficult. This is because these countries' specific response would be required depending on the economic conditions. The Maastricht Treaty, I think, was based upon the assumption that the monetary union would start only with the advanced

countries participating in a monetary union. But because those three or four countries are now a part of the monetary union, some structural quality response is required. May I invite Dr. Flassbeck to comment on that?

(Dr. Flassbeck)
I see this problem is a protracted one. Let me use some more words to explain my position. Again, as I said before, the German experience is a very good one to understand what is happening in a monetary union. Some countries are lagging behind in real terms, East Germany was the best example. Nevertheless, it would have been possible for East Germany to join the monetary union with West Germany if it had not had this huge jump in unit labor costs. If it would have remained on the same line as West Germany in terms of unit labor costs the situation would have been quite different.

And now back to Spain. What is the Spanish bubble about? Spain has an unemployment rate of 18%. Spain has two years of a bit higher growth than the rest of Europe, around 3% or something like that. If you compare Spain with the United States in terms of overheating, well, one cannot even talk about a slight overheating in Spain. But even if it were in a situation like the United States or Ireland, what does this mean? It means that Spain and Ireland have to reduce their high current account surpluses. Ireland has a current count surplus of more than 5% of GDP and Spain of 2%. With long-lasting overheating they will import more and export less. That is quite simple. In this way any kind of potentially inflationary development in Ireland will be stopped - by importing additional goods from the rest of Europe or from the rest of the world.

In Ireland there is an additional aspect. Ireland has been fighting hard all over the last decade for this surplus by means of beggar-thy-neighbor-policy. They have been tightening their belt all the time. They fixed their exchange rate but at the same time policy forced unit labor costs to a lower growth rate as in the rest of Europe. By this policy they increased their current account surplus. If they have some overheating now, well they'll lose some of the competitive advantage they had been gaining since the mid of the 80s. This is the normal way in which competitive positions balance out in an open economy. If Ireland and Spain would have been a region of Germany or Europe (United Europe) from the beginning, it would have been absolutely the same. In the same way as East Germany has lost all of its competitiveness, you can gain competitiveness in the union by tightening your belt. But if you then get overheating that’s necessary and justified, because it comes to the balancing effect that you lose competitiveness and you lose your current count surplus. So that's very simple.

And for East Germany, we should do it now the other way around. You see, what East Germany has to do now is very simple. East Germany now, to balance out what was mistaken development before, has to move down here, below this. Europe goes on like this, and East Germany has to go below that to produce a gap that is as large as the amount in here. After ten years, then you have a balancing out of the mountains and the valleys, and then you have a balanced approach. Yes, that is what would be necessary. But when that happens it is quite clear because we are paying transfers to them. But if you don't pay transfers, if nobody pays transfers, that's the only way to really break your economy. You go below as long as you have been above.

And now, it's the other way around. Ireland has been here, so what they're doing now is overheating, so they'll go above. And that is the way in which the whole thing is in equilibrium. You don't need an exchange rate for that. Not at all. You don't need an exchange rate. It's all happening through unit labor costs in national currency. That's all in national currency. So you do not need the exchange rate at all for that. But if you would have an exchange rate system, it would be more or less the same thing. Then Ireland would

appreciate along as they have lost all their competitive gains, and so they would turn around to current accounts. So there's no overheating anywhere.

It's just a mysterious picture that is painted by the ECB officials because, you see, this is the asymmetric approach that I mentioned. They always are much more focusing on expense effects and inflation effects rather than deflation effects. That's a built in symmetry of central bankers in these states. They have to learn the other lessons that there can be deflationary developments which are at least as dangerous as inflationary ones. But in the past, they have always focused on inflationary developments, and that is why they are really inconsistent if they talk about the ECB unable to deal with Spain and Ireland. That is not their point. They should not care about Ireland. They have an average for Euro lands, they have an average GDP, they have average prices. And look at the average GDP for Euro lands. It's coming down. Look at average prices, they're coming down.

So these are the indicators, not Spain and Ireland. Not even Germany. And to make an even more extreme example, if we would take the United Kingdom immediately, now, tomorrow, there would not be a problem at all. There would be no overheating in the United Kingdom. The interest rates would go down. They would have a bit more expansion. But then, imported goods would come in even more than they do now, and that would be the break for that kind of acceleration of growth. And there's no problem at all. This is really a problem of an asymmetric view of the people there. They have to learn the lesson that we learned in Germany with this extreme experience.

This is an absolutely extreme experience that would never happen in Europe with any other country, because it is quite clear that this could only happen because they had a big brother who was paying for them all the time. But, the other students have big brothers, and that is one politically important thing. We have to prevent the existence of big brothers. That is to say that we should not have a transfer system in Europe which leads to the fact that somebody tries to exploit the freedom to act because he expects to receive transfers from the richer ones. This is not a reasonable set of incentives, so we should be careful with transfer systems.

One last word concerning Amb. Yoshino's question. Well the ECB did cut interest rates in April, you're right. But if you compare again the behavior of the Fed and of the ECB, and given the quite different situation of both, namely in the United States where they were not in danger of getting into a deep slump last autumn. But the Fed reacted. And given the situation in Europe where the leading indicators were pointing downward to a much larger degree, the ECB did not react. That is what I mean. They reacted, but it was again too little, too late. And that is the usual Bundesbank behavior. That is what I mean when I say that we have to learn the lesson. Whether that has something do with Mr. Lafontaine's resignation, I don't know. Maybe.

This is such thing too. In Germany everybody said you should not talk about monetary policies. You talk about monetary policies behind the scenes and in internal circles, and nothing happens. Then somebody asks you out there, "What is Europe going to do to fight this slow down in growth." What are you going to say? "I cannot talk about it?" If you think it is right that monetary policy should act, well. I would not say that the ECB is acting like that. It would be really childish behavior if the Bundesbank would not act although she thinks it's right, because one politician in one country says she should not.

(Mr. Nakahira)

I have five comments to make.

Number one. This is where I agree with Dr. Flassbeck. That is the structural measure. Although this is important mid- to long-term, this can never replace short-term adjustments that are necessary. I agree with you entirely on that point.

The second point I would like to make has to do with the exchange rate raising. In the emerging market economies in the developing countries, there should be many options for raising of the exchange rate. Floating should not be the only option. We should not force that on those people. I agree with that also.

For example, in Asia, I believe that a basket of several currencies should, in some cases, be the option of linking to that basket. And also, even between vast economies or major currencies, for the stability of exchange rate, monetary authorities should talk to each other closely. I agree with the need for continued coordination among authorities. But, we don't want a fixed system among the advanced countries. I question whether that would help stabilization of the currency rate.

And from that point of view, I do not fully agree with what Dr. Flassbeck said. Between 92 and 93, during the European currency crisis, I did have some personal experience. To have exchange rates in an attempt to try to place currency rates within a narrow target zone could lead to weakening of the monetary authorities' position in the market.

My third comment has to do with the following. The European countries' macroeconomic policies leading up to the introduction of the Euro was, I believe, successful (much more so than had been expected by many). Maastricht criteria was put in place. Also with the double digit unemployment rate in the background, it was felt by many that it was going to very difficult if not altogether impossible to meet Maastricht criteria. But, not only did European countries that are members of the union meet them, they were recovering quickly until the summer of 1998, although we did have a negative demand shock.

More recently, it is true that shift to a single currency situation did take place more or less in the recovery period of the economic conditions. So from that point of view, the European Monetary Union did well -- much better than what most had anticipated. From that point of view, I felt that perhaps I disagreed to an extent with what Dr. Flassbeck said.

Now the next point. I do fully agree with what you said about Alan Greenspan being successful, but it seems that his series of successes has been quite unusual and exceptional. Exceptional success through monetary policy. Past experiences show that if we try to use monetary policy for fine tuning, we didn't necessarily succeed. This is because there is a time lag about the recognition of a real situation in the economy. There's always a time lag, so making small shifts quickly did not succeed necessarily in the past, although Greenspan has been successful. What I want to say is that I am somewhat skeptical as to that kind of fine tuning always working in the future. I don't believe that we can take that assumption for granted.

The next one is that more recent weaknesses in the Euro are the result of two things. I don't know if the monetary policy implementation delay was the cause, but the real European economy has been weaker than that of the United States, and that is being reflected in the Euro's rate.

But I believe there is another cause, and that is the supportive system of the new Euro. People are not confident as to whether that kind of supporting system will work. In monetary policy, as well as national fiscal policies of the member countries under the growth and stability pact, will they be successful in making the right mix of policies in that kind of framework? In other words, people are not confident and many feel that there are still uncertainties.

And for those uncertainties, I'm sure there was a brief discussion between Dr. Flassbeck and Dr. Tanaka. And I have a feeling that the situation may not be as simple as you indicate

Dr. Flassbeck. Should there be among European countries greater variations of inflation and other economic conditions? The question is, will there be automatic convergent forces? Will higher inflation countries automatically attract goods and level the situation? I don't think so. I think there will always be the need for supplementing monetary policies with fiscal policies. But fiscal policies will continue to be bound by the pact, which means that it is going to be very difficult arriving at the best policy mix among those countries. So, there's a big question mark attached as to whether this going forward will work.

This however is naturally a process that you need to go through. I'm sure that European countries will eventually demonstrate that this system will work, through experience. But until that's fully demonstrated, I believe that confidence towards the Euro will not be fully established. And that lack of confidence may from time to time act as pressures to weaken the Euro. Thank you.

(Dr. Flassbeck)
Thank you for your comments and questions. Let me try to answer them as briefly as possible. First of all, let me make the point that I mentioned several times with another example. You said that the experience of the U.S. in the 90s is exceptional. That's right in many respects, but we do disagree a bit about which respects are exceptional, not the fact that it is exceptional. One of the points that I think is most important is that in the 90s, the U.S. were the only big region in the world with such a big boom. This played again an important role in the question of how the constraints for such a boom are then showing up in real life.

If you look at the discussion in the United States, the interesting thing is that all the time, every year in the whole recovery, there was a broad discussion coming up in the world and in the United States saying now inflation is around the corner. Now we have to be careful. Now we have to start restricting. And it never appeared. Up to now it did not appear.

And why didn't it appear? Because the United States economy was the only economy with a boom. What did happen? Which were the constraints for their growth? Their current account were into deficit to a very large extent. And that is, I think, in this new open global world in which we live, the new mechanism which we have to take into account. This is much more important than inflationary accelerations in the course of the boom. As in Europe this is the most important adjustment mechanism. The current accounts are the major adjustment mechanisms. This is the case because the supply of goods all around the world, globally, is extremely elastic. You can supply everybody, every time, at every place in the world within more or less minutes or days, and it's no problem to get it there.

This is extremely important. Even in the German case, in the case of the German unification, you will not see in my graph from the unit labor costs that there is a steep acceleration, an inflationary acceleration, in West Germany. There is more or less nothing. So what happens, the only thing that happens is, that we had a huge swing in the current account, which is not attributable to the fact that we have a huge loss of competitiveness -- not at all. In West Germany, not at all. Only in East Germany. But in West Germany, we had no loss of competitiveness. Thus the swing in the current account is only to be attributed to the fact that we had much higher growth rate than the rest of Europe and the rest of the world, and so all these goods rushed into Germany in a very short time.

But there was no inflationary danger ever. Not even for Germany as a whole in the course of unification. This is an extremely important lesson that we all have to learn, and that is why I said that it has nothing to do with exchange rates. The exchange rates are just random phenomena in this developments. It's not the most important thing. The globalization and the openness of the market leads to these effects on the current account and the balance of payment. Bottlenecks in national production are a rare exemption. National production is not

important anymore. I overdo it a bit, but it's not that important, not even for the United States. And this was for me, I think, one of the major lessons we have to learn from the 90s.

So, in this way, the U.S. experience was exceptional. And here you're right again. This effect did help the Fed to do that kind of fine tuning because there was never any real inflationary danger. In the case of a real inflationary danger, they would have had more problems. I fully agree with you that there are time lags and that there are recognition lags. But nevertheless, one of the Fed governors, I think it was Alice Rivlin, said three months ago, "I never understand the European fear of inflation." She didn't understand what we call in Europe "preemptive action" on inflation. She said, "When inflation comes up, we'll fight it." If it is coming up, we have leading indicators for inflation. We look at unit labor costs as one of the most important indicators. When inflation comes up then there is time enough to fight it. Then relax, and although you won't be absolutely perfect, you can do it.

But it never came up, and that is the main problem of the Fed. There was never inflation, so they overdid their expansion policies, they did not take into account this enormous global elasticity of supply and the huge current account effect. But a current account deficit of 300 billion dollars annually is not sustainable, even for the United States. They have overdone now. That's a pity. I like Alan Greenspan very much, but this time I fear that his place in history is in danger because at the end everybody will say, "He did well for ten years, but then at the end he's overdone his fine tuning and he went too far in trying to bring the economy slowly down."

Then I would like to comment on the question of the Maastricht conditions where you say that we disagree. I'm not quite sure whether we disagree. I think most of the Maastricht conditions are OK, and they led to what they should have led to, namely, a conversion of the European economy. I have one other graph here, which shows again unit labor costs in national currency.

Graph International Comparison of Unit Labor Costs

This time it's not an index like it was before, but annual growth rates. The growth rates in the Euro area without West Germany and in West Germany are more or less the same. You see the kind of conversions that emerged during the last years. You see, that there has been a big problem in the beginning of the 80s when Germany came down very quickly, and the other states faced difficulties to follow.

And you see, all during the 80s, Germany was around say 2%, and only in the course of the unification it went up, but it was not remarkable. Unit labor cost increases always around 2%, that was the anchor role that Germany played. Germany was the anchor that everybody adjusted to. You see the convergence at the level of 2% increase annually. That was the main achievement. Given this, the other criteria are not so important. I think for example the question of public deficit has been overdone in many respects, and I think I understood you right when you said even now fiscal policy is without room to maneuver, and that could be a problem for Europe, I agree.

Let's to come to another point that you made, the weakness of the Euro. I think fundamentally that there is no reason for the weakness of the Euro. Most of the explanations are not very valid in my opinion. For example, the growth differential. Why should growth differentials between the United States and Europe be a reason for Europe to devaluate the currency? I do not see that. I think that current accounts are much more important. Seen from the current accounts, it's just the other way around. The Euro should appreciate. The only thing that I see which is a valid explanation for the short-term, but for the very short-term, is the interest rate differential that we have with the United States. But no such thing as, say, higher fiscal

deficits. That would be really an absurd interpretation because we have lower long-term interest rates despite much higher fiscal deficits for example than the United States.

And because we have lower long-term rates, that is why the Euro is weaker than it should be. That is for me, a chain of events that makes sense despite the Japanese paradox of low interest rates an d a strong currency. But the other way around, saying people do not trust us as much as the United States, doesn't make sense. I'm not sure whether you said that, but if these interpretations are on the market too, saying, "Well, you're not solid and not sound," that should show up in the long-term rates, but not in the exchange rates. From that side, I think the Euro is sound and reasonable and there is no problem to worry about.

Then the question comes again that you mentioned, whether the degree of convergence is sufficient. As I said, for me, this convergent is the necessary and sufficient condition for a currency union. And take the other example. One should not forget that many of the European countries which we have certain structural divergences have been members of the European monetary system, and have kept their exchange rate absolutely stable against the mark for a very long time. Even France has managed to do that since 1987. Why was this? Because at that time, 87, France was exactly on the line with West Germany. They managed to keep their unit labor costs increasing exactly on line with West Germany.

Italy didn't. Italy at that time was still far above West Germany, but France managed to do that. So, this was the main point. They could keep their exchange rate through all the exchange rate crises that we had. That is the interesting thing. France was able to keep their exchange rate absolutely stable, even in 92 with the big crises. They extended the range in which the exchange rate could fluctuate, but de facto, it always remained exactly on the same level. So this was, I think a big achievement that shouldn't be forgotten. That shows (in my opinion) that even in countries with huge divergences in structural terms, this convergence is sufficient for membership in the union. All the structural questions have to be dealt with on a national level. That is quite clear for me. There is no such thing or there should not be an extended European policy as far as structural problems are concerned. There is structural European policy, but up to now, I don't think it has been too important. And it should not be too important. You can do a lot of things on the national level. And if you look at the United States, there are big differences, structural differences, between the North and the South and the West and the East, but it has no direct or indirect consequences for the currency regime -- the currency union that they have had between the states for 200 years.

Then, the other question about what we should do in the G3, that's really the critical point. Here we come to the point where it's really difficult to find points to compromise between the G7 or the G3. It is quite clear that mainly the Americans do not like any kind of compromise. I think it is nevertheless necessary to think hard about these things. Because, as we have seen, even between these big more closed economies more than the smaller economies, huge exchange rate changes can lead to disastrous results.

I mentioned over lunch already that the German case of 80 to 85 was such an event. At that time, it was disastrous for the U.S., and the U.S. were prepared to talk about it because they were suffering. And the Japanese appreciation of the 90s was such an event and the U.S. was not prepared to talk about it because they were not suffering so much. It is always the country suffering which appreciates not depreciates. Depreciation is rather easy. Not easy, but you can live with it. With appreciation, it's much more difficult. And I think in Japan especially, and I've written it down in my short paper for IIES Newsletter „Kudan Square„, it really was a disastrous result and you're still suffering mainly from that, although the exchange rate has normalized. But this has huge structural effects on the economy and on the banking sector.

So, I think there is no way out. If you ask me about the future of the international system, then I would say that what we will see in ten years time is three big blocks in the

world surrounded by satellites, so to say. At least two by satellites. The third I do not want to make a forecast, that is your job to achieve that. But for Europe and the United States, I'm rather sure. The Americans will get closer together. They will all peg their exchange rates based on the dollar. They have had a bad experience, but they will do it again because I'm absolutely convinced that floating is no solution.

In Europe it's quite clear that the Eastern Europeans will all attach, as they do attach already, their exchange rate in one way or another to the Euro. There are different methods, and I do fully agree with the basket approach, with preannounced crawling pegs as an absolutely reasonable approach. And they will all do that. They will not leave it to the market because, as I said already, these small open economies cannot deal with Mr. Soros and his friends because they are simply too big for them. So they will not leave their currencies just moving around playing games with these guys.

The question is whether there will be a third block of satellites -- the Asian block. I don't know. I cannot make a forecast, but I think the evolution is here too going in that direction. And then, if that happens, step by step, we will have to permanently talk about exchange rates within these three blocks too. Because, as we have seen in Asia again, if there are major misalignments between the big currencies, there will be major misalignments between the small ones too, or for the whole word, with disastrous results. So there is no way out in my opinion.

And the Americans will learn that lesson as soon as they suffer again. As I said today over lunch, let the Euro fall down to 80 or something and they will see their current account deficit inflate and they will have to learn the lesson again. At the same time their economy comes down because consumer spending is reduced. Then they will learn the lesson very quickly and they will be absolutely prepared to talk about this.

Last point, structural measures in Japan and elsewhere. As I said, I'm absolutely not against structural measures. To work on structural problems and inefficiencies is a permanent and most important part of the government's work. I think here we agree that it's not a substitute for macroeconomic policy. And this is the main problem. And this is the main fault, in my opinion, of European policy in the last ten years. We thought it was a substitute for macroeconomic policy, and it is not. You should be careful in Japan to avoid that kind of solution. Either have structural policy or macro policy. You should find a way in the middle of the road. For example, that was the way that Germany pursued policies all over the 50s and 60s, and at that time we called it social market economy, which was policy for an effective order of the economy. That is exactly the task that you have to pursue permanently.

(Question)

This, I believe, is more or less related to the structural side of the discussion. If you compare U.S. and Europe, a big problem is that EU economy continues to be slow despite relatively low interest rates. This has to do with the low number of entrepreneurs, as well as relatively high minimum wage. In the United States, wages are lower at the lowest side. We don't have entrepreneurs, and there are fewer people who would work at the lowest wages, leading to difficulty in having new businesses created, which means that the shift towards more services and information oriented industry will become difficult.

We have some related issues in Japan too. Probably we are closer to Europe than the U.S. for that matter. I believe that Europe will continue to move closer to the United States in future. Which do you think German government will support the global trend towards a more American type, or they you will continue to have an independent European direction for the future?

(Dr. Flassbeck)
Thank you. I fear they will believe that if you do that, you can again forget about the rest. If you have all these measures concerning new business, more services, and low wages, you can forget about the rest. That will be their excuse for not doing macroeconomics. But if we do that, we'll end up at the end of the next decade, and we'll have to say again that it was an American decade and not a European one. I fear that this is the point. This is a very good question because it shows exactly what is at stake. Let me give a very simple example.

You say minimum wage. We do not have a minimum wage in Germany. The U.S. have a minimum wage. There is no minimum wage in Germany -- not by law. There are wages which are negotiated by the social partners, but there is no such thing as a legal minimum wage. And now if you compare -- if you say not by law but by contract of social partners. Well, compare the development of the wage dispersion between the United States and Germany, and you'll find out that wage dispersion in the U.S. has stretched since the beginning of the 80s very strongly up to the beginning of the 90s. In Germany it is absolutely flat, no more dispersion than at the beginning of the 80s. What is the popular conclusion from that? The conclusion is that, well, if Germany would have stretched its wage structure as the United States, then they would be much better off.

I think that the conclusion is totally wrong. Why is it wrong? Because this is not a question that has to do with overall unemployment, it's just a question of the structure of unemployment. So, one must be fair and look at the structure of unemployment. But if you look at the structure of unemployment, you'll find out surprisingly that the unemployment rate of the low-skilled is lower in Germany than in the United States, or in the United Kingdom where you had an increase of the wage dispersion too.

So why is it that despite an additional stretching of the wage structure in the United States, there unemployment for low-skilled is higher than in Germany? Well, it's very simple. It has to do with the supply of labor. Because they are putting into the labor market every year an enormous amount of fully uneducated people. Not only uneducated people, but people who do not even speak the language of the country in which they live and earn their money. They do not even speak the language. They cannot write, they cannot speak, and they cannot read. Nothing. And even out of the U.S. primary school system, you get so many people who are illiterate every year. That is incredible. If you would try to employ these people in Germany, they would get lower wages than in the United States and we would need a minimum wage too. This is the simple but only consistent explanation.

You will hardly find somebody in Germany who is fully illiterate or has no education or who cannot speak the language. There are some around. Turks or asylum seekers now, but not very many. And this is the main problem. If you educate your people well and give them the training, you cannot to stretch the wage structure in an artificial way. Not even in a full market economy would you be able to do that. Wages are determined by the market, and that means by scarcity. And if you put into the labor market every year an enormous amount of immigrants and people who are illiterate because you have a bad education system, well then, it's quite clear that your wage structure is stretched. But, at the same time, your unemployment rate for these groups of people is high because they are so badly educated that they cannot even be employed for the minimum wage of five dollars.

So, the only thing I want to say is be very careful if you just deduct from some phenomena that you see in the United States compared to our system, to your system and to my system. These systems work differently, and one should very, very carefully analyze what is going on, and not just take the first impression as the result of what is happening. Or, if you look at the number of new businesses, it is quite clear that if you have an economy with a growth rate of more than 3% over seven or eight years, much more new business is created

than in an economy with 1.5%. But, the question is one of causality. Is there more business because they have higher growth rate, or do they have higher growth rate because there is more business? At least this question has to be answered. I'm not so sure about it.

I think it is the other way around. They have more business because they have a higher growth rate. And if this is the causality, the conclusion for economic policy is quite a different one. That is not to say you should not work at that. We have enormous schemes for creating small and medium enterprises in Germany. But you can clearly see, the evidence is quite clear, that these schemes work quite well when you have high growth rates, and they do not work at all if you have slumps. If you avoid slumps, then you get more businesses. And this, I think, is the right causality.

So, we should be really careful when doing those things. And that is why in all my presentations here in Tokyo, I've been emphasizing the point of these macro shocks overlying all the many structural things, because you're in the same danger that we were in the 90s. Namely that everybody is talking about structural problems. There are structural problems. There are always structural problems in each economy -- in the United States' economy too. But they are overlaid by other effects which can dominate them. And if you do not differentiate very carefully, then you are quickly on the wrong path for economic policy. You forget the one, and you emphasize only the other one.

(Question)

Thank you very much for a very stimulating discussion. I fully agree with your analysis up until the 1980s. Not only in the United States and Europe, but probably throughout the world, high growth. Ended in inflation which caused the slow down of the expansion. Usually it was the substantial increase in the wages which somehow decelerated the expansion. That was a structural element.

However, since the beginning of the 1990s, the increase in labor cost which could really trigger the deceleration of the growth, seems to have disappeared. Rather, as you pointed out in your presentation, the negative demand shock was at the very basis so to speak.

What we see now is the over supply of labor. So in that sense, out of fear of inflation, the macro policy has been managed in the past. But in the current period, the most important focus of the macroeconomy would be how to create demand I think.

From that perspective, I was very encouraged by your remarks in the presentation. I would like to ask you to foresee somehow how the ECB is likely to behave going forward by the end of this year. Or, what would be the likely level of Euro?

And you mentioned that from the fundamental viewpoint, the Euro should not be weak. Now if that is the case, how is the Euro going to be reevaluated by the market? How is the market going to look at the Euro from a new perspective?

(Dr. Flassbeck)

That is a very interesting question. Indeed I fully agree, but I would like to emphasize this one more time. You are absolutely right about what happened at the end of the 80s -- why high growth rates that weren't stopped had very much to do with the acceleration of wages and the acceleration of inflation. That is why I think it is even more important to learn the lesson of the 90s. Namely, that you can have a very long phases of high growth rates if you are able to contain the increase of nominal wages. This is to avoid an acceleration of unit labor costs.

That is why I always point to unit labor costs, because those are nominal wages minus productivity. If you are able to keep that, as in Germany in the past, around 1% to 2%, then you avoid any kind of serious inflation or acceleration, and then you can go on with growth

for a really long time. The unit labor costs for the United States in the 90s exactly in line with Germany's. They are exactly on par with Germany. But this shows on the other hand that Germany was –for other reasons- not able to gain sufficiently much from that stability of the unit labor cost. Unfortunately, there we have to ask why is it? Why was it possible with 2% unit labor cost increase in the United States to have a growth of 3.5% and in Germany of only 1.5%? Labor costs cannot be the reason for that. Then, we come to the questions that I mention before.

This is really a very important point, but I would like to make one other point if you allow me, which has to do with the current situation in Japan. We have made an attempt in Germany (and this I can show you) in the last three years to do even more than that -- to do more than to keep unit labor costs stable. Look here. Look at the graph again. You see, we have gone beyond that point. We have gone below zero. Here's the zero line, so we have overdone our point, our solidity so to say. We have overdone our solidity. All of the 80s were extremely solid and reasonable, but then we have overdone the point by going below zero. And then it's getting dangerous because then it's getting deflationary. Then you get a deflationary effect from wage development.

And that is extremely dangerous. If you lower nominal wages (and I fear in Japan at the moment that wages are falling, even nominal wages), and at the same time you do not have rising employment, then there is no problem. But if nominal wages fall and employment is falling and then you get negative effect on consumption. And then employers and companies will try to pass on the lower cost into prices, and then you get falling prices. So you have to be very careful to avoid that kind of spiral downward as well as you have to be careful to avoid the spiral upwards, which is inflationary. Again, the symmetric view is reasonable -- not an asymmetric view.

This is something that I fear could happen in Japan now. I think the government and everybody has to look quite carefully at the data and see whether this danger exists or not. According to the data I have, it exists.

Your question now is, what about European economic policy at this point of time? You should not be too optimistic that my view is the majority view in Europe. When Mr. Lafontaine was in office we always had Italy, France, and Germany more or less on the same line -- that is 75% of Europe. But the problem is that every small country in the European legacy can raise it's hand and say no. So you do not only need a majority, but you need a consensus, which is much more difficult to achieve. And there is no consensus about the approach I presented here. There is huge disagreement, and the only thing I can say today is that I can only hope that Europe is learning its lessons quickly. By the beginning of next year we have to act and not just let things happen. Let me give you two examples. To wait and see may be reasonable if nothing changes in the United States. But if, for example, the long-term rate all over the world goes up more much more than it did up to now, and it already went up remarkably, and if the Fed goes on tightening policy, then just to stay at that level would be dangerous for Europe. Because then we have to play the game of de-coupling from the United States. This is much more difficult for Japan because there is no room to maneuver downwards anymore. But for Europe there is some room to maneuver, and I think we have to use that room to maneuver.

Then we should try to de-couple, as much as possible, our long-term rates from the long-term rates of the United States. You can do this to a certain degree, but you can never fully de-couple, that's quite clear. The experience, if you look at the graph that is in my paper, you see at the beginning of the 90s, for example, the U.S. had de-coupled to a very large degree, but it was short-term. For the long-term, it was a much smaller degree. But you can do something , there is room of maneuver.

The question is whether the ECB will use that room. Given my experience with the Bundesbank, I am not so optimistic. The Bundesbank did not see that problem and did not act in 1994. You may remember: The Fed increased rates and decelerated growth all over the world? At that time the Bundesbank did not act at all. If nothing dramatic happens in the United States, then I think the ECB will remain rather reasonable on a very low level for a longer time and then we have the chance to accelerate growth in the course of the next year.

As regards the Euro, I do not like that slowdown although up to now it has been in reasonable ranges. But if it would go further, I think there's a big danger of a big turn around later on. This is because, as I said before, it would increase the imbalances on the current accounts between Europe and the United States even more. And then, sooner or later, the markets will realize that there's something going wrong in the States as soon as their growth falters, and then the Euro could come down rather quickly. Or the dollar could come down rather quickly, and then we have the same disastrous effect that we had all the time. Then we will have recession repercussions from the United States on Europe. And then we will have a new moderation or slow down of growth.

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