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Introduction

Chairman John M. Hennessy

Welcome to the 350th meeting in the 89th year of the Economic Club of New York. We are delighted to have a very, very special program for you tonight. Central bankers have been known for many years as the high priests of world banking and finance, but in the latter part of the 20th century they are clearly the key players in the world economy. Their every comment, every twitch in their eyebrow is interpreted by the marketplace and billions of dollars flow depending upon what they ate in the morning (laughter) and tonight we are especially lucky to have two of the leaders...actually the two most powerful central banks in the world. Our first speaker is Dr. Hans Tietmeyer, the President of the Deutsche Bundesbank, the premier central banker of Europe. At a very, very crucial time as you all know on the decisions, on the future economic of the community and monetary union. Dr. Tietmeyer brings a wealth of experience and perspective to his present post. He was the second of 11 children, born in a German town on the border with Holland. He actually had a good early life experience. He harvested crops; he planted trees, so this is not some ivory tower economist. And he really took this thing of being a high priest seriously. He started out studying for the priesthood. He even wrote a university thesis on Catholic ethics but then he shifted his focus from religion to finance and went on to take a PhD in economics at the University of Cologne and in 1962 he joined Germany's Economic Ministry. He rose there very quickly through the ranks. At various times heading the different directorates responsible for the European Common Market in its early days, his third country relationships

and the overall economic policy. And following the election of Helmut Kohl in 1982 as Chancellor, Dr. Tietmeyer was chosen as his Top Deputy in the Ministry of Finance. He served as a key advisor to the Chancellor at Summit Meetings. He took an active part in the Maastricht talks and the Treaty itself and he was responsible for the basic issues of financial policy in the economic communities and international monetary policy. He joined the Deutsche Bundesbank in 1990, was named as Vice President in 1991, and President two years later. Besides guiding the central bank during this critical period, he was tapped by Chancellor Kohl to help manage the two Germany's reunification of an extremely delicate and difficult process. And going back to his own roots, he has also been serving as a financial advisor to the Vatican. A long time outspoken critic of the growing power of the welfare state, Dr. Tietmeyer is also known for his very strong ideas about European Union, and what is needed to achieve it, and make it work. The two persons regarded as the most powerful figures in Germany today are Chancellor Kohl and Dr. Tietmeyer. So it is a special pleasure for us in the Club to present one of the true giants of world finance, the President of the Deutsche Bundesbank, the Honorable Hans Tietmeyer.
(Applause)

The Honorable Hans Tietmeyer
President, Deutsche Bundesbank

John thank you very much for this nice introduction. I will not comment on that, but let me start in saying how much I am honored to be invited to speak to this distinguished audience and this is

even more the case when I looked at the list of speakers which appeared before this audience and looking at this, I saw especially two names which impressed me, I am not referring to Maggie Thatcher which has impressed me too, but I am especially impressed by the name of Dr. Ludwig Erhard who was my first Minister and who was the one who introduced the social market system into Germany, and I have to say, that I am very happy to see there the name of one man who played a very important role in Germany which is not so much known, that is General Lucius D. Clay. Let me start in telling you the story which was the important one. When the Diem was introduced in Germany after World War II it was on the 20th of June 1948. On the next day, Ludwig Erhard who was then Director of the Administration Responsible for Economic Affairs, decided to abolish all price controls within one step. He was then called to then General Lucius D. Clay, the High Commissioner, or you could say the High Commander in Germany who had the real power in his hands. And he told Ludwig Erhard, why you are intending to do so, all my advisors are telling me this would be the wrong thing. And Ludwig Erhard answered, General, I can tell you, all my advisors are doing the same, but I am convinced it has to be done, and he could convince General Lucius D. Clay to give him the authority for doing so and this was in my view the real, you could say, the real date of birth of the German miracle. So the General Lucius D. Clay played a decisive role in creating the new German economy and that means creating the currency and now responsible for, that means Diem. And that I would like to mention to you. (Applause)

So there were, I can congratulate you to the speakers you have invited in previous times. I am not

so sure whether I have to congratulate too that you have invited me to come here. I am just coming from Washington, and the financial community there has been listening to a lot of speeches but many of them were delivered more in a political than in a financial spirit. Now I am happy to be here in New York, the real financial center of the world. No matter, where the eyes and ears of the financial community may sometimes be focused, it is here that its heart beats.

In his famous textbook, Economics, Paul Samuelson quotes the American actor, Will Rogers, who said, “There have been three great inventions since the beginning of time; fire, the wheel, and central banking”. (Laughter) As a central banker, I can neither confirm nor deny this perception. Not even if the question arises as to why in the sequence, fire, the wheel, and central banking, we central bankers only occupy the third place.

I should like to share with you tonight a few thoughts on the subject of central banking in today’s world. Many people say that today’s world has two pieces of news for central bankers, a good piece and a bad one. The bad news, central banks cannot accomplish anything more. In a globalized financial system, they are increasingly reaching a final state of impotence. The good news is, while it is true that central banks cannot accomplish anything more, that doesn’t matter. Inflation is dead anyway. In my address tonight I intend to argue that the story behind these two pieces of news has much in common with a good science fiction novel; it is interesting, it contains a grain of truth, but the real world is really different. Technological progress in the real world is mostly labor saving, often capital saving but never central bank saving. If anything, the

opposite is the case.

My first argument is a technical one. In today's highly efficient and globalized financial markets, the central bank has the ability to control inflation. And it has to control inflation because inflation is never dead. Inflation can, of course, have a lot of courses and origins, but in the end it is always a monetary phenomenon and for controlling inflation, a central bank needs its monopoly of central bank money creation and also sufficient demand for such money.

This demand arises if only because known banks want to use cash, and because banks have to maintain minimum reserves on the bank deposits. In Germany, both of these conditions continued to be fulfilled. New instruments such as derivatives have not made any fundamental changes there.

And my second argument relates to the way in which present day financial markets work. Or more precisely to the underlying forces driving market participant transactions. The entire business of gathering, processing, and integrating information in the decision making process has changed dramatically. This change is characterized by an increase in the significance of expectations. Markets have become more sensitive to any potential change in the stance of a countries monetary and fiscal policy. In this context, central banks credibility has become a vital asset, contributing to lower interest rates and less undue price volatility in the financial markets. But it takes two to tangle. A country's credibility depends not only on its monetary policy but

also on its economic and fiscal policy stance. And it is only credibility on both these counts that helps to keep volatility at bay, especially exchange rates volatility. And this is why it is gratifying for the international community to recognize that today's United States has not only the economic potential and credibility to maintain a strong dollar, but also the political will to do so.

In present day financial markets, credibility is a prerequisite for any successful policy. That must also be the criterion for assessing any proposal of closer international cooperation in macroeconomic policy.

There is no point in leaning against the wind in exchange markets. The markets are well aware of that. The objectives of international cooperation must therefore be realistic. There may well be situations in which coordinated joint action, say in the foreign exchange market, makes sense. When on account of a countries enhanced anti-inflationary policy markets are prepared in principle to change their expectations and affect reevaluation, in such cases a signal from outside may help. But these are specific situations. They are not the normal case. After all, keeping exchange rates within a particular target zone is quite a different matter. Without adequate convergence in economic performance and economic policy, central bankers are all too quickly overextended. Markets love to probe into fixed exchange rates. A lot of money can be earned whenever central banks try to defend unrealistic rates. We in Europe have special experience on that score which we should not so easily forget. At least under the present day conditions we

cannot revert to a system of globally fixed exchange rates on the pattern of Bretton Woods. The necessary economic and political convergence can hardly be achieved worldwide, let alone maintained.

Needless to say, that does not rule out useful cooperation with the objective of improving policies in the countries concerned in the interest of all nations. On the contrary, such cooperation makes sense and is valuable.

Under present day conditions, however, international cooperation for the sake of influencing market trends make little sense and has little prospect of success. In the normal case, policy makers can influence markets only very indirectly, namely with adequate and credible domestic policies.

And Bill McDonough was quite right when he once said, and I quote, "International cooperation is not a coded phrase for central bankers and Finance Ministers telling market participants what to do. The evolution and expansion of financial markets over the last 30 years has moved too far for anyone to believe that central bankers alone have the wisdom or power to absolutely control markets or behavior." Those were his words.

Present day international cooperation is more a matter of setting conditions. Endangering efficient markets and as far as is necessary agreeing on rules of the game in the process.

Precisely that is what central banks are trying to do. For instance, at their monthly meetings in Basel the rapid pace of integration in the financial markets also calls for increasing cooperation in market supervision, between the responsible national authorities and between the international supervisory bodies for banking, insurance, and securities. New complex instruments are constantly being added. However, it is not only the supervisory authorities that are faced with the task of controlling but also first and foremost the private financial institutes themselves. Present day supervision is designed to reinforce the controlling function of the markets and not to supersede it. Competition is a most important mechanism for insuring discipline. And supervisors are well advised not to try to regulate everything in great detail. They should focus on a few key issues, risk, must be covered with sufficient capital, furthermore the sufficient degree of transference must be assured and above all policy makers must take care to preserve the sanction mechanism of the markets. Competition penalizes errors by causing loss. That is part and parcel of a market economy. Government bailouts on the other hand pose more hazardous problems. Central banks should make clear that they are only the lender of last resort to insure the provision of adequate liquidity for the banking system of their respective country as a whole. But they should never be put in the awkward position of being a lender of first resort for a bank in trouble. And the same is true for a monetary institution like the IMF.

Nevertheless it is certainly right to counteract the danger of systemic risk. But not every liquidity crisis involves a systemic risk. This may hold true even if a bigger country on the American continent is concerned. In this context, I read with great interest that the Institute of International

Finance, some days ago wrote to the Chairman of the Interims Committee and I quote, "Market participants do not consider official bailouts a realistic or desirable alternative". I cannot agree more. (Applause) I thought there should be more applause. (Applause)

Present day financial markets have not become more vulnerable all around. On the contrary, various changes have made the financial system more robust, if anything, in the event of liquidity crisis. For instance, the overall pattern of creditors today is more heterogenous and more highly diversified, whereas in the past, it often used to be a handful of banks that were mercifully affected. That lessens the danger of chain reactions. In case of default, however, it might turn out to be more difficult to solve our problems because of the shear diversity of investors. The Governors of the G10 central banks, in Basel are also addressing a new topic, I mean the electronic money. We are all agreed how important it is. The sort of information center is to be set up at the BIS in Basel to enable global developments to be monitored more accurately. It is of course difficult to aim at definitive regulations at this early stage. The evolution of electronic money is only in its infancy. But it is a characteristic feature of today's world that tomorrow's world will be upon us in no time.

Central banks are affected in two chief respects. First, electronic money tends to crowd out currency and deposit money. That may increase credit institutions potential for creating money. And second, electronic money may impair the oversight function of a central bank in its function of insuring the integrity of payments. That would increase the risk of crisis in one country

spreading out to engulf payment systems worldwide. That is why the central banks of member states of the European Union have agreed that only banks should issue multifunctional prepaid cards. In our opinion, the same should definitely also apply to network money.

Notice, the industrialized countries are enjoying a high degree of price stability by historical standards. I think the globalized markets have contributed to that. The financial markets are exercising strict control and may severely penalize any lack of discipline on the part of monetary and fiscal policy makers. And the global competition on the merchandise markets limits enterprise scope for setting prices. It may also have an impact on wages especially in places where labor markets are flexible and operate under conditions of competition. The extent to which these forces can actually control the known monetary sources of inflation is certainly an interesting question. But for all the legitimate speculation on this issue, one must not overlook the fact that central banks are responsible for the prohibition of money and as I said at the beginning, in the long run, inflation is a monetary phenomena and its monetary policy does indeed matter very much.

Two factors have resulted in monetary stability assuming higher priority in this context. First, a learning effect, monetary policy makers in many countries have drawn inappropriate conclusions from the adverse experience of an accommodating policy stance in the 70's. For the cost of disinflation was very high as a new IMF outlook as just described in detail. And second, an institutional effect, a number of countries have granted their central banks more independence.

Here we have what may appear at first sight to be a surprising historical coincidence. In the same decade in which democracy and Parliamentarism are increasing their influence worldwide, the institution of independent central bank for monetary policy is simultaneously making headway. Is that not a contradiction? Two factors have to be born in mind. First such independence is based on a democratic decision. The independence of the planned European Central Bank for instance is laid down in a treaty which has been approved by all relevant national Parliaments. Greater independence on the part of the central bank may ultimately enhance the accountability of monetary policy to the general public. When the inflation rate rises in Germany, as it did say at the beginning of the 90's, all eyes are instantly focused on the Bundesbank, regardless of what it was that triggered the inflation. No Bundesbank president can then say, steady you guys, we have more important things to do at the moment than combating inflation.

Monetary policy is the sole objective of Bundesbank policy because the German legislature, rightly assumes that a stable currency is an indispensable basis for lasting growth, economic prosperity and social equity. And in practice the central bank dedicated to price stability is confronted with the following problem. How to make the theoretical notion of price stability an operational target. We in the Bundesbank think that measured consumer price inflation should be as close as possible to zero, and not higher than two percent, but be in line with the notion of price stability.

The Bundesbank's primary objective of safeguarding the currency market, it will be all the easier

for the general public to monitor the success of monetary policy. Furthermore, an independent central bank with a definitive stability mandate is in my opinion not a foreign body in a democratic constitution. Independent central banking fits very well in today's world of more democracy and more freedom. And experience starts to show that at least in the long run, the performance of countries with an independent central bank is better than of nations in which central banking is subject to direct or indirect influence of political bodies. Incidentally, we in Germany are very satisfied with the experience we have had of separating the location of our political headquarters from the seat of the central bank. This is why our legislatures have decided that the Bundesbank will remain in Frankfurt, even when the government and Parliament have moved in a few years time to Berlin.

And the planned ECB, European Central Bank, will also be located in Frankfurt, when Europe will move into a European Monetary Union. Needless to say, I do not wish to derive from that circumstance any recommendation for the United States. But I am quite sure that New York will remain the U.S. financial center, and that Wall Street will remain independent from Main Street. Thank you very much. (Applause)

John M. Hennessy, Chairman: Thank you very, very much Dr. Tietmeyer. Perhaps I should explain, philosophically I think everyone in the room was on your side on no more bailouts but a lot of people own rowboats here, without bailing cans. (Laughter)

Our second speaker tonight, Bill McDonough feels very much at home. He is not only a member of the Economic Club; he is one of our more active Trustees on the Board. As President of the New York Fed, Bill occupies a unique post in the countries Federal Reserve System. Other than Regional Bank Presidents, rotate membership on the Feds key policy making open market committee, the New York Fed's President serves as his permanent Vice Chairman. When Dean Acheson was Secretary of State he was once quoted as saying, "Don't ask me who sets policy, just tell me who writes the cables". The operating arm of the Fed is the New York Fed. In the conduct of domestic monetary policy, in the conduct of foreign market operations or foreign exchange intervention, it is the New York Fed. So we also have this separation as between the political center and the financial center and who carries out the policy and it is an extremely important distinction even in our own system here and we hope it doesn't change.

Bill came to the Fed three years ago after a long and distinguished career first in government, and then in the private sector. While he didn't study for the priesthood, he is a graduate of both Holy Cross and Georgetown; he almost qualifies as a priest. He did serve in the Navy, and then spent six years in the State Department. He left government in 1967 and then began a 22-year career with the First Chicago Corporation and its Bank, the First National Bank of Chicago, where he rose to the position of Vice Chairman and was one of the Directors of the Holding Company. Upon retirement from First Chicago he did serve as an advisor to both the World Bank and the Inter-American Development Bank and then he joined the New York Fed as an Executive Vice President in 1992. And in 1993 he succeeded another one of our distinguished

members, Gerry Corrigan who was then President of the New York Fed. And Bill is only the 8th person to hold this role since the foundation of the Fed in 1913. So it is a great pleasure for me to present to you the President of the Federal Reserve Bank of New York, Bill McDonough.

William J. McDonough

President, Federal Reserve Bank of New York

Thank you Jack, it is a great pleasure to be here this evening, sharing the podium with my good friend and colleague, Hans Tietmeyer. It is often said that there is a worldwide community of central bankers. I certainly feel that way. President Tietmeyer is actually also Chairman Tietmeyer. He is Chairman of the G10 Central Bank Governors. So since I have Chairman Greenspan in Washington and Chairman Tietmeyer in Europe, I will not surprise you that I am planning to speak about price stability this evening.

While central bankers may differ in the ways that they seek to achieve price stability, differences grounded in our respective histories, customs and institutions, the goal we all strive for is no less important. This evening, recognizing that no one country's central bank has a monopoly on the right answers. I would like to share my views on why I believe price stability is so important and what approaches can be taken to achieve this goal. Before turning to these issues, however, we must first be clear about what we mean by price stability and how to recognize it when we see it.

A goal of price stability requires that monetary policy be oriented beyond the horizon of its immediate impact on inflation and the economy. This immediate horizon is in the order of two to three years. But the purpose of today's policy actions should be to lay the foundation for price stability and sound economic growth over the coming decade. This orientation properly puts the focus of a forward looking policy on the time horizon over which households and businesses will do most of their planning. This is the horizon that is relevant for the definition of price stability, articulated by Chairman Greenspan. That price stability exists, when inflation is not a consideration in household and business decisions.

What is critical in the operation of such a definition is that inflation expectations are anchored over the longer term by some transparent commitment by the central bank to an articulated standard. Unavoidable deviations from the longer term goal of price stability may then be explained with reference to that standard. For these purposes a consistent measure of price stability is more important than what that exact number is.

A central bank's commitment to price stability over the longer term, however, does not mean the monetary authorities can ignore the short term impact of economic events. It is important to recognize that, even if we set ourselves successfully on the path to price stability, and even if, as a result, price expectations are contained, we still will not have eliminated all sources of potential inflationary shocks. The reality is that monetary policy can never put the economy exactly where we want it to be. For example, supply shocks that drive prices up sharply and suddenly such as

the two oil shocks of the 1970's are always possible. In such an eventuality, the appropriate monetary policy consistent with a goal of price stability would not be to tighten precipitously, but rather to bring inflation down gradually over time as the economy adjusts to the shift in relative prices.

As you can see, I believe that monetary policy must be exercised cautiously. Now why say that? Because contracts, especially wage contracts can outlast a good part of or even exceed short term shocks in duration. In the short term therefore, monetary policy must accept as given the rigidities in wages and prices that these contracts create. Abrupt shifts in policy, given these rigidities, especially a monetary tightening in the face of wages that are unlikely to be cut, can cause unacceptable rises in unemployment and drops in output.

Now before considering some of the specific ways central banks have sought to achieve price stability over the longer term, I would like to make clear why I believe price stability is so important and so desirable. A key principle for monetary policy is that price stability is a means to an end. To promote sustainable economic growth, price stability is both important and desirable because a rising price level, inflation, even at moderate rates, imposes substantial economic costs on society, all countries incur these costs. They entail, for example, increased uncertainty about the outcome of business decisions and profitability. Negative effects on the cost of capital resulting from the interaction of inflation with the tax system. Reduced effectiveness of the price and market systems and in particular distortions that create perverse

incentives to engage in nonproductive activities.

One thing that can happen is a tremendous overinvestment in the financial sector. If you look at the super-inflation in Europe in the 1920's or in some of the western hemisphere countries in later times, the financial sector has grown enormously with inflation. Because people are spending more and more of their time devoted to financing their transactions and changing money than of doing something that has a greater purpose. It has been estimated that up to 100% with each 10% rise in inflation, 1% of GDP will shift from manufacturing, agriculture or services, to the financial services sector. You can really reach the ridiculous point that there is a bank branch on every corner which means that there is a corner store in none of them.

Now the cost of overinvestment in the financial sector, like the cost of all inflation induced nonproductive activities, such as tax cost dodges, decrease the resource space available to the economy for growth. A move to price stability would give these economies the necessary incentives to shift resources back to productive uses. In the case of the financial sector in a high inflation economy, the transfer of resources to productive uses could be as large as a few percentage points of GDP. This can be serious money indeed. And this is just one of the benefits of regaining price stability.

Rapid moves toward price stability from high inflation, however, do have their costs under certain circumstances. The overdevelopment of a sector, for no reason other than the inflation

rate, is precisely one of those circumstances. The removal of the distortionary incentive leads to a rapid transfer of resources out of that sector, causing unemployment and business failures to follow. What was boom, goes bust. In those very same countries where we saw the overexpansion of the financial sector, we have seen the sharp contraction of that sector when inflation was finally brought down. This implies an additional argument for price stability. In a low inflation environment these boom/bust cycles created by distortionary incentives are less likely to emerge and can be more easily contained when they arise. The avoidance of such unnecessary boom/bust cycles, also limits the serious social costs that inflation can impose.

For one, inflation may strain a countries social fabric, pitting different groups in a society against each other as each group seeks to make certain its wages keep up with the rising level of prices. Moreover as we all know, inflation also tends to fall particularly hard on the less fortunate in society. Often the last to get employment and the first to lose it. These people do not possess the economic clout to keep their income stream steady or even buy necessities when a bout of inflation leads to a boom followed by a bust in which they also suffer disproportionately.

Some would argue that establishing price stability is the primary goal of monetary policy. Means that central banks will no longer be concerned about output or growth. So I hope I have made clear, I believe this view is simply wrong. A stable price in financial environment, almost certainly will enhance the capacity of monetary policy to fight occasions of cyclical weaknesses in the economy. Over the long run, price stability is the one sustainable contribution, monetary

policy can make to growth. And this applies to all countries, especially including our own.

Over the past 20 years there has been an emerging consensus among policy makers and economists that an activist monetary policy to stimulate output and reduce unemployment beyond its sustainable level leads to higher inflation, but not to lower unemployment or higher output. Moreover, although some countries have managed to experience rapid growth in the presence of high inflation rates, often with the help of extensive indexation, none has been able to do so without encountering severe difficulties at a later stage.

It is thus widely recognized today that there is no long run trade-off between inflation and unemployment. As a result, we have witnessed a growing commitment among central banks throughout the world to price stability as the primary goal of monetary policy. Now how central banks sought to achieve price stability? Some countries have begun to commit their central banks statutorily to pursuing the objectives of price stability and are granting them a high degree of independence.

That is why so many governments, particularly among the emerging market countries, have been providing their central banks with increased autonomy. Believing, as President Tietmeyer suggested, that it will result in low inflation. In this they are following examples set by among others, both the Bundesbank and the Federal Reserve.

Now once a commitment has been made to price stability, as the goal of monetary policy, and that commitment has been entrusted to an independent central bank, there are several possible approaches to implementing that goal.

First, they focus on a long-term time horizon, and second they provide a transparent standard for the assessment of policy. For many of these approaches what guides monetary policy is an announced target. Such a target is one proven means of credibly conveying to the public the commitment to price stability and therefore locking in inflationary expectations. Now there are a number of possible targets for monetary policy. One of those is locking in an exchange rate. President Tietmeyer has discussed the pros and cons of that. If you have a country that is very, very similar economically to a major country with a good monetary policy, dedication to price stability, it can work. As long as your domestic political realities make the maintenance of that connection believable. If it becomes suspect, the market attacks. So there is a very, I think, mixed record of whether fixing an exchange rate works, but clearly it has for some countries, and not for others.

Targeting monetary aggregates is another approach many central banks used in the 1970's and 80's. This approach has been successfully maintained by a few prominent countries, one of which is Germany. Now given a dependable relationship between the targeted monetary aggregate and the goal of price stability, where movement in the monetary aggregates predicts movements in prices, the framework offers a number of advantages. Like exchange rate targeting

an announced monetary target is easily understood by the public. In fact, it conveys more information than an exchange rate target, because it shows where monetary policy is, and where inflation is likely to be going. The targeting of monetary aggregates has the additional advantage of focusing policy on a quantity that a central bank can control quickly, easily, and directly.

However, working through monetary aggregates is completely dependent upon the predictability of the relationship between the money target and the inflation goal. If fluctuations in the velocity of money, perhaps due to financial innovation, weaken that relationship, the framework will not bring price stability.

In the United States, these relationships are not sufficiently stable for us to use monetary aggregate targeting, at least at this time.

Now a third approach to price stability is to target inflation itself. That approach has been adopted by a number of central banks over the past several years, and the initial results appear positive. The advantage inflation targeting shares with exchange rate and the monetary targeting is its transparency to the public. The commitment to price stability is made clear in policy terms, and deviations from pursuit of the inflation target over the longer term are obvious.

The main drawback of inflation targeting is that inflation itself is not directly or even easily controllable by the monetary authorities. Furthermore, policy moves in pursuit of the inflation

target only take affect with a lag. So that success in hitting the target is not quickly apparent. This is a problem that is not present in either the exchange rate or monetary aggregate targeting. These difficulties may mean that the inflation target cannot strictly be met at times, which at a minimum could lead to a rise in inflation expectations.

This is an area where I believe there is sufficient promise that it is worth very seriously looking at, and debating as a matter of public policy. I don't believe we have reached the point quite where it is the clear alternative.

I believe there is strong support within the United States today for a rigorous and consistent anti-inflation policy. We in the Federal Reserve are pleased by the credibility that the Fed appears to have earned in controlling inflation over the past several years, while encouraging both growth of the real economy and financial market stability. Let us imagine what could happen if we could have the kind of inflation performance over the next five years that we have had over the last five years. The principle benefit that might, emphasis, might be achieved, is that inflation expectations then could become so low, so virtually nonexistent, that the difficulty of using monetary policy because of the inflexibility in wages and prices, might well be removed. We really don't know if that could be the case because all of the learned studies done on this subject have been over periods in which there have been recurrent bouts of inflation, even though the general trend line has been down. It is something, fondly to be desired.

The commitment to price stability as the principle goal of monetary policy, I would like to stress, in no way implies that the health of the economy should be sacrificed. On the contrary, what is important to bear in mind is that by insuring a stable price environment, monetary policy helps foster economic growth. This is a key point and it is often overlooked. Therefore, while its one explicit goal must be price stability, monetary policy can and must also maintain the broad environment for sustainable economic growth. In my view no central bank can maintain price stability over the longer term without public support for the necessary policies.

Moreover, today's globalized markets leave central banks with no margin whatsoever for complacency. Only with the confidence of the public and their policies, and their own vigilance in implementing these policies, can central banks and democracies ultimately succeed in achieving a goal of price stability. This is the goal that we, at the Federal Reserve work toward each day. Thank you. (Applause)

QUESTION AND ANSWER PERIOD

JOHN M. HENNESSY, CHAIRMAN: We now will move to the questioners. We have two questioners tonight, Peter G. Peterson, the Chairman of the Blackstone Group. And Bob Hormats, the Vice Chairman of Goldman Sachs International. Pete won the toss and he will kick off.

PETER G. PETERSON: Thank you. I have a question for both of you since I think the issue I would like you to discuss is present in both countries. I am referring to the vast unfunded liabilities for the public senior benefit retirement programs. As you may know, Dr. Tietmeyer in the United States, for the retirement programs alone, not healthcare, these unfunded liabilities are now approaching $10 trillion. You will not be shocked...I was, to see a recent IMF report that suggests that the unfunded liabilities in Europe, as a percent of the GDP are much larger even than ours. Now if you try to imagine how to confront this dilemma, you could say, well we might just try financing these deficits, but they are approaching a trillion dollars or more in this country, after the boomers retire. I wouldn't want to be the person trying to finance those kinds of deficits. Or one might try to think of tax increases to cover it. But to cover these deficits, the official projection suggests we would probably have to double payroll taxes which is quite unthinkable. We have a saying, Dr. Tietmeyer in our country, that if your horse dies, we suggest you dismount. So I guess the question, I put before both of you, do you agree we need to dismount? What will happen to the financial markets and the global economy if we don't reform these programs? And yet given the daunting political problems, 34 million members of the American Association of Retired Persons in America, and the labor unions in your part of the world, how do you see this problem getting resolved? (Laughter)

THE HONORABLE WILLIAM MCDONOUGH: Pete went to a basketball game recently and at half time he asked that question. (Laughter) I believe that peculiarly we in the United States have an advantage in that other major countries in Europe and in Japan, have a population which is

aging more rapidly than ours, it is pure demographics. And consequently they will confront that problem before we do, so we have a little more time. And it may be that some of the difficulties they will have will provide the shock value that I think in part you are looking for. I do not believe that it is possible for us to go into the second decade of the next century with the present levels of benefits. I will be happy to volunteer to work well past the age of 65 and suspect most other people really would prefer that as well. That is certainly one of the fixes, but I think that what we have to do is to get started rather quickly and one would hope that December or January, that people might think that it would be appropriate perhaps in a bilateral commission or some other method of bringing people together to study this very serious problem.

THE HONORABLE HANS TIETMEYER: First of all it is even a more serious problem in our country than in your country, no doubt about that. And we don't have the time for waiting for solution till the beginning of the next century. We have to do it directly, because of the fact that our demographic development is as you mentioned, much more delicate and problematic in that sense, and we have no foundation in our pension system, capital foundation. According to our estimates the present system can only work, let's say, probably ten years or so. And that is the reason why it is necessary to decide now and the government has introduced and to some extent the first step is accepted two weeks ago by the Parliament to change the system as far as especially the pension age is concerned. That means, there is now a prolongation already for being active but that is not enough. The next is that the government has mandated a special working group which has to present till the end of this year a reform plan which will work over

the next 30 or 40 years. And the only thing I can say because the Bundesbank is represented in that committee by an expert, as an advisor, that there is now a growing willingness to address this problem, and to introduce into our system an element which is really reflecting the change in the demographic, we call it inter-generation development, the demographic development. And that means de facto to change the present rule of increasing the pensions year by year. That means we need a change in our system. That means that the increase in the pensions have to be lower than the according to the present system. How it is precisely done, I cannot tell you now, but I am only telling you that it is really seen in our country now as a serious problem and that it will be addressed and I am sure it has to be addressed and I personally have put the finger into that question since some years and now the politicians are reacting.

ROBERT HORMATS: I would like to address my first question to Bill McDonough. Bill you have made a very cogent argument regarding price stability and I would like to follow that up. In particular, by discussing the remarkably subdued inflationary pressures in the U.S. economy over the last couple of years. As you well know, in the post-World War II period, long expansions coupled with very low rates of unemployment have traditionally led to considerably higher rates of inflation, yet, in the current environment inflation remains very low and wage pressures in particular are quite low, excepting for the fact that part of this very effective inflation performance by the United States has been based on the skillful work of the Federal Reserve Board. In addition to that, do you believe that there are a number of fundamental structural reasons for this, are these enduring reasons such as a more flexible work force, the globalization

of the U.S. economy or perhaps transitional phenomena such as American workers being willing to settle for lower wages because they are concerned about job security.

THE HONORABLE WILLIAM MCDONOUGH: I think there are two possible interpretations, both of which are transitory. First of all we have to remember that the affects of monetary policy, the lags, are long and varied. So we may have something going on that is quite simple. That is, that the economy is still functioning exactly as it has in the past, and we are living through an unusually long lag in a monetary policy period, and that is all that is happening. If that is the case, then it is very clear that the gorilla of inflation is alive and well and out there and anybody who thinks that he or she is likely to be able to skate through without being caught by that gorilla is living, in my view, in a dream world. Now there is another interpretation which is also transitory, but it is a little more interesting, and that is, have we had a probably one time downward shift in the supply curve of labor. That is, are people sufficiently concerned about what is going on in the technologically driven revolution in American work places, be those automobile factories or steel mills or banks or even central banks, that they are sufficiently more worried about job security now than they used to be and therefore, the tradeoff between job security and higher wages has shifted downward. If that is so, and we don't know whether that is so, it is a nice interesting theory, but nobody knows whether it is true, but if it is true, it is likely to be a onetime downward adjustment as we go from the higher supply curve to the lower one, there will be a period in which you will be able to run the economy without inflationary pressures at a lower unemployment rate and you would also expect it to be accompanied by a

greater share of profits of GDP. All of those we are seeing. But even if it is this second phenomenon, it still is that onetime adjustment. So we still in the area of monetary policy have to be very seriously concerned about the danger of inflation. Now, the fact that you are concerned about the gorilla of inflation, doesn't mean that every time you see a shadow that you shoot at it because you might shoot some poor soul who is just trying to find a job. And it isn't the gorilla at all. On the other hand, it is very, very important that nobody, but especially central bankers fall into the wonderful world of make believe which is that inflation is dead. It is clearly not.

PETER PETERSON: Dr. Tietmeyer, can the European Monetary Union's new central bank, I believe it is called the European Monetary Institute, effectively keep inflation in check in all 15 culturally diverse EMU countries? Won't it be extremely difficult to contain price pressures when each of the EMU countries have differing work habits, widely varying rates of productivity growth, and diverse cultural and political attitudes toward the amount of inflation that can be tolerated? How does the EMI propose to effectively discipline money and credit growth in each of these countries? And what incidentally do you do if one of the countries persistently misbehaves?

THE HONORABLE HANS TIETMEYER: First of all I could have asked that question too. (Laughter and applause) Let me start in saying first of all you mentioned 15 countries, you are right, all countries which are willing to join the EMU and which are able according to the criteria, could become a member of the European Monetary Unit. Whether all countries are

willing is a completely open question. I know at least one country which is debating in a lively way whether it in the end will join or not because it has a right for opting in or opting out. That is one country. There is another country, which I can name, that is Denmark, which has already decided not to join but it has a right for revising this decision and for deciding to join later on. That is the two countries which have not clarified their political will. Now I am coming to the treaty itself. The treaty is saying only countries among the 13 are allowed to come in, if they are meeting the criteria from the beginning, and that will be examined in 1998, on the basis of the figures especially of the year 1997. Today I cannot predict which country, and there are no words to predict because the French President, just yesterday or two days ago made the comment which was not very well received in another country (laughter) so you can be sure that I am avoiding naming any country. But this will be decided in 1998. So that is the first part. But this is for me, not enough, because meeting the criteria at one point you can dispute whether the criteria is appropriate, I could go into the details, but I will not do so. But meeting the criteria in one year is not clearly a full basis for a decision whether the country is really able to meet the criteria in the long run. So in my view, already in that examination in 1998 we have to look whether there is sustainability, enough sustainability in meeting the criteria. We in the EMI, that means European Monetary Institute, where the governors are sitting, we will present at the end of the year a report clarifying what the criteria mean, and I am insisting that the examination has to be done on the basis of the question whether there is a sustainable situation in this country. This is one. The other point is, and that is, the German demand, and that is now accepted in general terms by all, that it is not enough to have only that in the moment moving into a European Monetary Union,

but that it is necessary that the countries are signing a contract, that they will follow fiscal discipline, also in future times. The discussion that negotiation has made progress but it is not already at the end. The decision, or let's say the, I hope that we can come to the end of the year to a solution. But this is important for the future, but you mentioned, what is the question if a country, after five or ten years or so, is not going that way. First of all, then the sanctions must apply for that country. We have sanctions in the treaty that means for example that they have to pay fees to the budget of the EC, whether that is enough or not, that is a question which has to be seen. But according to the treaty, there is no way for moving out. And in my view, if a country would move in, and then later on would move out, I am pretty sure that the financial markets then will punish that country, for a long time, and a long period. So a country should at the beginning be very careful for demanding to come in if it is not qualified in the long run. So my conclusion is we need the monetary union with countries which are willing and political and able, able in the economic sense, to move in the same direction and this is...and let me add another point, I am always making in Europe today, that it is not enough to have fiscal discipline, on the other hand, everybody has to be aware that the flexibility of the markets must be there because there will be in future times a situation where the shock is coming into one part of the union. They are coming from outside or internally because of structural changes because of changes of technologies and so on. And different parts of the area will be affected differently. And the question is then, whether this part is able to adjust on its own resources and on its own flexibility and ability to adjust. That is precisely the point, and I am making that point to the unions and telling them, you should know a monetary union means that you have to be more

flexible, that the competition inside the area is growing because there is no exchange rate protection more. That there will be a growing competition and that means you should be aware that if you are not behaving appropriately then we could end in more unemployment in at least specific areas. That is what we have to teach...sorry, teach...high priests should not do so, I have heard that I am a high priest, I am not really, that is a new thing. But, I think that is necessary to tell them that now. And I am trying to tell them that even if some politicians in Germany are thinking that this is not let's say favoring the movement to EMU. I am interested in having an EMU which is a lasting one, which has a lasting basis for stability and not creating European Monetary Union which will come into conflict in a short time. So I am insisting as long as I am taking the opportunity for doing public speeches, I am insisting in having all people that, all people are aware, and all the unions and all of the industries should be aware what it means to be in the monetary union. More competition, more flexibility, if that is not the case, the EMU could turn out for them as a bad thing.

ROBERT HORMATS: I would like now to turn to the German economy for a moment and read you a quote by a distinguished colleague of yours. "The German economic engine has lost steam quite considerably, the virtues which characterized the first postwar period encouraged to liberalize and to accept full competition, a firm belief in the free-market model are still accepted as basic principles but often neglected in practice". That statement was made by Wilfried Guth, former Chairman of the Vorstande of the Deutsche Bank in 1987. Today Germany faces new competitive challenges from the East as well as competitive global challenges from the rest of

the world. In your judgment, is Germany rising to these competitive challenges fast enough and if not, how can Germany do so more effectively particularly through liberalization of factor markets, labor markets, the kind of changes you underscored, vis-a-vis the European Union as a whole?

THE HONORABLE HANS TIETMEYER: First of all, Wilfried Guth is right, even if he is not the central banker. He is a Deutsche banker which is not the Deutsche Bundesbank. That is a small difference. But it is. (Laughter and Applause) But, it is true what he is saying, that means that in principle free-market behavior is accepted in Germany but de facto we have a lot of rigidities in our country, in the labor market and in a lot of other markets too. And we have tried in the 80's to come back to more competition. We did privatization, we reduced taxation, we tried to have a first step in the pension reform, and, and, and, but then Germany was faced with a special challenge at the beginning of the 90's. That means the Germany unification. And this period, in the first four or five years focused...the whole public attention focused on the question of dealing with this problem. And in my view, the German public was not...and the politicians were not enough, taking into account the changing competition coming from the globalization. So I have once said that the first five years were insofar last five years. But, now and that is a change of the last one and a half years in Germany, now there is a growing awareness in Germany among politicians, also inside the unions, they are very much challenged in their structure, but especially in the public, a growing awareness that change is unnecessary. Of course it is easy to accept the necessity for changes, but if it is coming to you, then it is difficult to

accept. But since this 12 months, now a lot of changes are on the way in Germany. First, labor regulations, in the first package in the Parliament there was an element of changing labor law for firing and hiring. That is not comparable with the United States but it is for German standards already a way in the right direction. In Germany there is now a package adopted by the Parliament for reducing a lot of social benefits. Which discouraged the willingness to accept the job. Thirdly, the wages are now, the last wage contracts are not only much more moderate but also they increased the flexibility because, for example, in the working time, in having more flexibility in the working time, and even having more flexibility in the wage structures, but I could go even further. In East Germany we can realize that already maybe half of the wages are decided on the firm level and not so much on the industry level as it is a German system. That means it is much more down to the Earth or you could say down to the situation in the firm. And this process is now going on. And in East Germany it is already very advanced. In West Germany it is just starting. So I could go on in telling you, what I am saying is, in Germany there is now a growing awareness and a lot of steps are already done and others are on the way. But that does not mean that we are already at the end of the road. We are at the first part of the necessary road for increasing flexibility in our market economy. That is absolutely necessary and unavoidable.

JOHN HENNESSY, CHAIRMAN: Regrettably we just have time for one more question. Pete.

PETER PETERSON: Mr. McDonough, recently a broad group of economists achieved

unanimity, that fact alone should probably terrify us. But they agreed that the CPI overstates inflation by a half percent to 1.5 percent. What do you think the implications of this are in how we measure the growth of the economy, how we measure the growth in incomes and perhaps more relevant, how the Federal Reserve is now viewing monetary policy. For example, is this lower implicit inflation rate one reason that you have been less hawky lately and more dovey? (Laughter)

THE HONORABLE WILLIAM MCDONOUGH: Pete I thought we have known each other far too long for you ever to accuse me of being a dove or even thinking like one. Gerry, do you know this guy? We have done a good deal of work at the Federal Reserve and especially at the New York Fed regarding which price indicators are the most reliable and probably the best to guide policy. And have come to the conclusion that the core CPI is in fact the best. Now I believe that there is general agreement, as you suggested among practicing economists that it has a bias. The bias, you have it all over the place, my own view is that it is somewhere between half of one percent at the low side and two percent at the high side. Now, one can make adjustments for that sort of thing. There has been a suggestion that for example, in putting the inflationary correction into social security and other index benefits that there could be a core CPI minus X that is obviously something that has to be the subject of a political debate in a democracy. But it would be a reasonable one. In looking at monetary policy, certainly one would have to think that if there is an upward bias and if you want pure price stability, in my view, the number on it is not zero. Because if you assume, just to make the math easy, that the bias is plus 1, well then zero

inflation is actually minus 1, it is deflation. That is where you get into a situation of a countries traditions and history and its own pathology. The main problem that we had in this century in the United States if you are as old as I am you remember it, is the Great Depression. The problem with the Great Depression was deflation. So I think that in our country we would wish to have a monetary policy which clearly would not want to run the risk of deflation. Now you can still have a monetary policy that very ardently pursues the goal of price stability. As I mentioned in my prepared remarks, exactly what number you put on that is a good deal less important than reaching the point using the Greenspan definition where we as business people and also we as householders do not think about inflation when we decided how to run our businesses or what to buy for ourselves or hour homes. Then you have achieved price stability and the getting into the advanced theology and how much error there is in the CPI, I think becomes a good deal less important.

JOHN HENNESSY, CHAIRMAN: Dr. Tietmeyer, Bill, (Applause) thank you very, very much. I am sure we are all going to sleep much better tonight, even if we don't have a bailing can in our rowboats. Thank you all very much for being with us tonight. (Applause)