

Address given by Wim Duisenberg on the European System of Central Banks (Davos, 30 January 1998)

Caption: On 30 January 1998, in Davos, Wim Duisenberg, President of the European Monetary Institute (EMI), presents the new European System of Central Banks (ESCB) which is scheduled to replace the EMI from 1 January 1999, the date on which commences the third stage of Economic and Monetary Union (EMU).

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The role of the future European System of Central Banks

Speech delivered by Dr. Willem F. Duisenberg,
President of the European Monetary Institute,
at the World Economic Forum
Davos, 30 January 1998

I. Introduction

With the single European currency moving from a distant dream to a virtual certainty, participants of this year's Davos World Economic Forum are devoting a considerable amount of time to the evaluation of the various implications of the introduction of the euro. The agenda quite rightly suggests that the start of Stage Three of European Economic and Monetary Union (EMU) is likely to trigger profound changes to the economic, political and social systems of the participating member states and inside the EU as a whole. Moreover, it is no exaggeration to state that the imminent merger of some European currencies into the euro will rank among the most important events that have influenced the international monetary system during the post-war period.

The closer we come to the starting point, the more people are becoming aware that with the unprecedented simultaneous transfer of monetary sovereignty to an independent, supra-national European System of Central Banks (ESCB) we are entering uncharted waters. But that in itself does not preclude the rationality of the project. It only means that in such an environment great attention must be devoted to the preparatory work in order to avoid the ship running aground and the potential benefits of the expedition being offset.

Obviously, the start of the necessary preparatory work could not await the establishment of the European System of Central Banks (ESCB) in May 1998. Therefore, a specific transitional body, the European Monetary Institute (EMI), has been set up at the future site of the ECB in Frankfurt in 1994. Its task is, inter alia, to specify the regulatory, organisational and logistical framework necessary for the ESCB to perform its tasks right from the start of Stage Three on 1 January 1999. In other words the EMI will provide the draft screenplay which, subject to the approval and amendments by the ECB, will be rehearsed during the second half of 1998. Moreover, the ECB will be able to build on the internal infrastructure of the EMI as the latter goes into liquidation immediately after the establishment of the ESCB.

II. The three roles of the ESCB

The preparations are well under way, facilitated by the fact that the institutional framework for the ESCB enshrined in the Treaty and spelt out in the Statute of the ESCB and the ECB contains very precise rules for the swift and smooth take over as the central bank of the euro area. As this will be the most important role to be played by the ESCB, I shall first concentrate on it. Subsequently, I would like to devote some minutes on the system's functions outside the euro area, acting as an anchor for the monetary and exchange rate policy of the EU Member States not yet participating in the euro area and progressively playing a role on the international monetary stage.

1. The ESCB as the central bank of the euro area

In the dual layer central bank system ...

But before developing these three roles of the ESCB further, it seems to be necessary to briefly introduce you to this new actor on the monetary scene. Whilst the name of the new currency, the euro, is today fairly widely known throughout the European Union, far fewer European citizens can name the central bank responsible for its management. This is certainly also due to the fact that the adopted concept of a dual layer central bank system differs substantially from the organisational structure of most national central banks. The ESCB consists of the national central banks of the Community and - at its decision-making centre - the

ECB with the Governing Council as the supreme decision-making body for the euro area.

... the ECB can effectively and efficiently implement a single monetary policy ...

The decision to opt for a federal system was taken because it corresponds best to the requirements for the new central bank and reduces the overhead to the minimum. With only some 500 staff members, the ECB can serve as a role model for a strong but efficient European administration. What is crucial is that the System will provide a monetary policy as a unified whole. The set of monetary policy instruments and procedures being prepared by the EMI will ensure that the Governing Council of the ECB and - for the day-to-day management - the ECB Executive Board are in a position to control the overall stance of monetary policy at all times, in conformity with the decision-making framework of the ESCB. Decisions will thus always be taken at the ECB level, whereas implementation will, to the extent deemed possible and appropriate, be executed in a decentralised manner by the participating national central banks.

... taking due account to differences between national financial markets ...

Reliance on the infrastructure and operational experience built up by the national central banks will undoubtedly prove a valuable asset. The ESCB needs to be cognisant of the historically grown and substantial differences between national financial markets in the EU if it wants to successfully provide a level playing field for a broad range of counterparties throughout the euro area. This holds especially for the foreseeable period of rapid changes in market participants' behaviour also triggered by EMU itself.

... and ensuring the necessary continuity with European central banking experience ...

An additional feature of the ESCB structure is that - despite some important institutional changes - it provides the necessary continuity with European central banking experience. The creation of the ECB follows an evolutionary process which has led to convergent views on the role and functions of monetary policy among central bankers and that conditions not only the structure of the system but also the way it will operate in practice. The progressively closer co-operation of monetary policy authorities during past years will be fostered further following the pre-announcement of the bilateral conversion rates in May 1998. The same Governors who are conducting monetary policy co-operation today will be members of the ECB Governing Council determining the single monetary policy in Stage Three. The ECB as the focal point of best European central bank traditions can inherit the track record of the best performers entering the System.

... thereby fostering its credibility.

This statement seems to be confirmed by financial markets' expectations. Judging from long-term interest rates, market participants seem to be convinced that inflation will remain low in the euro area. Moreover, convergence of long-term interest rates towards the lowest level rather than the average indicates that a credible single monetary policy is expected.

Without any national bias ...

The decentralised structure of the ESCB is not inspired by the principle of subsidiarity which is often quite rightly "en vogue" elsewhere in the European integration process. The principle of subsidiarity applies only in areas which do not fall within the Communities' exclusive competencies, and is thus not applicable to the ESCB tasks. The national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. Hence, the decentralised *modus operandi* of the system is based on the assumption that the single monetary policy is best executed locally.

... the single monetary policy will be implemented ...

Moreover, the Governors of the participating central banks will not act as the representatives of their respective country or national central bank, but will act in a personal capacity with a responsibility for the entire euro area. This is, inter alia, reflected in the general voting rule -one person, one vote - which stresses the supra-national character of the ESCB's tasks the most important of which are

- to define and implement the monetary policy of the Community with the primary objective of maintaining price stability;
- to conduct foreign exchange operations;
- to hold and manage the official foreign reserves of the Member States; and
- to promote the smooth operation of payment systems.

Outside the framework of the ESCB - and acting as national agencies - national central banks may perform functions other than those specified in this Statute - for instance providing fiscal agent services to the government - unless these interfere with the objectives and tasks of the ESCB.

... with the primary objective of maintaining price stability for the euro area as a whole.

I do not want to dwell on the crucial importance of the primary objective of maintaining price stability. It is now widely accepted - not only in the central banking community but also in the academic world and among financial market practitioners - that only a monetary policy geared towards price stability can create the conditions for sustainable economic growth. An important element that may be worth mentioning, nevertheless, is that for the ESCB the objective of price stability concerns the whole euro area. It is the price level of the whole euro area that the single monetary policy will aim at stabilising. There will not be, and there could not be, differentiated policies for each region or country in the euro area depending on the prevailing inflationary conditions.

The high degree of independence of the ESCB ...

It is recognised that the ESCB has been granted a high degree of institutional, personal, functional and financial independence, consistent with the desire of the political authorities that signed the Maastricht Treaty to put the ESCB in the best possible position to achieve its primary objective. The Treaty also requires that the Statutes of the national central banks be adapted to conform with that of the ECB. This process is under way and the Statutes of the NCBs, even those that were recognised as being among the most independent, are being upgraded to satisfy the Treaty's requirements.

... does not preclude good co-operation ...

However, a high degree of independence will and should not seduce the ESCB into enclosing itself in an "ivory Eurotower", thereby also running the risk of violating its second objective established by the Treaty which is - "without prejudice to the primary objective of price stability - to support the general economic policies of the Community." The harmonious economic development of the Community in Stage Three will call for a fruitful dialogue between the ECOFIN Council - which is at the centre of the economic decision-making process for the Union - and the ECB as the body responsible for the monetary policy of the single currency area.

The Maastricht Treaty already provides for a number of formal communication channels between both, for instance the Economic and Financial Committee, bringing together senior officials from the national central banks and the ECB as well as from the finance ministries. In addition, I would like to mention the right of the President of the ECOFIN Council and a member of the European Commission to participate - without

having the right to vote - in meetings of the Governing Council of the ECB. The Treaty provides in turn for the ECB President to attend ECOFIN Council meetings when it discusses matters relating to the objectives and tasks of the ESCB. Moreover, last month, in a resolution on economic policy co-ordination in Stage Three of EMU it was agreed that the finance ministers of the States participating in the euro area will meet informally - as the so-called Euro X - to discuss related issues with the participation, when appropriate, of the ECB.

Formal and informal communication channels enabling both sides to explain to one another the policy actions for which they are respectively responsible are fully compatible with the independence of the ESCB. Moreover, they can prove very helpful for the participating member states to find the appropriate fiscal policy stance vis-à-vis a single monetary policy which, by definition, cannot accommodate specific national needs. I therefore very much appreciate that the European Council acknowledged the specific responsibilities of the member states of the euro area for the single currency. This will be helpful in order to avoid the ECB becoming a scapegoat for a wrong policy mix at an individual national level.

... and the necessary accountability vis-à-vis the EU-Institutions ...

The Treaty also provides for a comprehensive list of reporting commitments. The ECB shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and the current year to the European Parliament, the EU Council, the European Commission and the European Council. On the basis of that report, the European Parliament may hold a general debate. In addition, the ECB President and the other members of the ECB Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament. These reporting lines vis-à-vis EU institutions do not preclude the maintenance of well-established communication channels at national level. However, the respective political bodies involved should respect the fact, that in the EMU environment "their" central bank governor now has a responsibility for the whole euro area.

... and ultimately the European people.

Beyond these very precise reporting procedures one should not overlook the fact that, ultimately, the ESCB will be accountable to the European citizens on its ability to defend the purchasing power of their money holdings. If the ESCB does not perform a good job with respect to its primary objective, it will be penalised by the citizens, as savers, who will reduce their holdings of money balances in euro and ask for higher returns to compensate for the depreciation of their currency. The stability of the euro is the ultimate judgement of savers on the performance of the central bank. Communication with the general public will, therefore, involve the public announcement of a quantified definition of what the ESCB understands to be price stability; the publication of specific targets and details of their derivation - against which its policy performance can be assessed; and the explanation of deviations from the target and concomitant policy responses by the ESCB. This will increase the transparency of the ESCB's actions and thereby enhance its accountability. The ESCB should be as transparent as possible.

2. The ESCB providing an anchor for the "pre-ins"

Let me now briefly turn an eye on the external tasks of the ESCB, starting with its role as the anchor for the monetary and exchange rate policy of the Member States not yet participating in Stage Three of EMU, the so called "pre-ins". Not all EU Member States will initially participate in the euro area. Some have opted out - hopefully only for a relative short period of time; others might not yet have reached the necessary degree of economic convergence. In this context the question arises how the ESCB can help to avoid a division between those participating in the euro area and those outside giving rise to foreign exchange movements which could potentially endanger the internal market.

I would like, first, to remind you that, except formally for the two opt-out countries, the Treaty establishes a political commitment for all EU countries to join the euro area and to adopt policies consistent with this aim.

In particular, in stipulating that member states with a derogation shall continue to treat their exchange rate policy as a matter of common interest the Treaty provides for a further means for avoiding that exchange rate developments create distortions within the EU. This, by itself, will create a strong drive towards adopting sustainable economic policies that ensure stability and macroeconomic convergence. In this respect, the creation of the euro represents a catalyst, a force of attraction, that should foster stability also in the other EU countries.

In addition, the Treaty foresees a number of explicit mechanisms for monitoring and co-ordinating Member States' economic policies in which the ESCB is involved. Such co-ordination aims at promoting economic convergence, thereby contributing to exchange rate stability.

The third decision-making body of the ECB - the General Council - which includes the Governors of the central banks not initially participating in the euro area, will serve as an appropriate forum within the ESCB to discuss related issues and to monitor the functioning of the new exchange rate mechanism between the euro and the currencies of the other EU countries. This so-called ERM2 has been designed in order to supplement the aforementioned Treaty provisions and should - like a powerhouse - help current and future EU Member States to find their course to adopt the euro. As regards the main features of the system, I would only like to stress, that if they were to be in conflict with the primary objective of maintaining price stability, the ECB could suspend automatic interventions at the margins and that the ECB, too, will have the right to initiate a confidential procedure aimed at reconsidering central rates.

3. The ESCB becoming a major actor on the international monetary stage

The ESCB will play its role inside the EU, with of course extra-european repercussions. The international dimension of the euro and its potential as a major reserve and transaction currency are certainly more than a detail of EMU. I am convinced that, in the long run, a stable euro will prove to be an attractive investment opportunity. However, the valuation of a currency by the financial markets as expressed in the exchange rate cannot be administered but should be seen as the outcome of all other economic policies. Recent experience has repeatedly shown that exchange rate policies that are out of line with economic fundamentals eventually end in a major set-back with negative consequences for the ability of the country in question to attract international investors for quite some time.

Article 109 of the Treaty, which deals with the external policies of EMU, provides some safety precautions against such failures which were spelt out further in the Resolution of the European Council meeting in Luxembourg one month ago. According to this Resolution, the Council may only under exceptional circumstances formulate general orientations for exchange rate policy in relation to non-EU currencies. These orientations will always have to respect the independence of the ESCB and be consistent with its primary objective of maintaining price stability.

According to the Treaty, the competence to represent the Community internationally should follow the internal allocation of responsibilities for monetary, exchange rate and economic policy between the ESCB, the Council and the national Member States, respectively. However, representation in international organisations has to take account of those organisations' rules. Hence, many issues such as the ESCB's representation in the International Monetary Fund - where membership is confined to individual states and not open for the group of euro area countries as such - still have to be clarified.

The ECB for its part will be well equipped to ensure that the euro area speaks consistently with one voice, which is a major asset in international fora.

III. Conclusion

In conclusion, I am confident that the ESCB in conjunction with the other elements of a stability-orientated policy framework outside the realm of monetary policy - especially the strict implementation of the Stability and Growth Pact with its accompanying Council Regulations - will act as a credible guardian of a stable euro, a reliable anchor for future participating countries, and thereby will contribute to the stabilisation of

the international monetary scene.