

Address given by Wim Duisenberg on the EMI and progress towards EMU (Hong Kong, 22 September 1997)

Caption: On 22 September 1997, at the International Banking Seminar in Hong Kong, Wim Duisenberg, President of the European Monetary Institute (EMI), delivers an address in which he outlines the tasks and the role of the EMI in the implementation of the European System of Central Banks (ESCB) with respect to the preparations for Economic and Monetary Union (EMU) and to the introduction of the euro.

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The European Monetary Institute and progress towards monetary union

Speech delivered by Dr. W. F. Duisenberg, President of the European Monetary Institute at the International Banking Seminar in Hong Kong on 22 September 1997.

The start of Economic and Monetary Union (EMU) is only around fifteen months away. In March next year the EMI and the European Commission will present their reports on the state of convergence among EU Member States. Without prejudging this final assessment, it may be concluded that important progress has been made over recent years as regards the convergence of inflation and interest rates. In addition to that, generally speaking, exchange rates among EU currencies have been stable. Although efforts still have to be made to ensure the sustainability of sound public finances, the overall movement in this area is also in the right direction.

The commitment to the EMU process was also clear in the announcement made in Luxembourg by the EU Finance Ministers just a week ago that they will pre-announce in May next year the bilateral exchange rates at which the currencies participating in the euro area will be irrevocably fixed, at the same time as the decision on which Member States will adopt the euro. This "pre-pre-announcement" was well received by financial markets and had an impact on interest rate differentials and the position of some currencies in the ERM.

Since its establishment in 1994, the main task of the European Monetary Institute (EMI) has been to translate into a coherent plan, and to implement, the political commitment to establish a monetary union that the European countries made in signing the Maastricht Treaty.

There was no historical precedent for achieving such an objective. What monetary theory and practice suggest, however, is that a new currency cannot be introduced only by means of an act of law. In modern economies, the role played by money is the result of the interplay between authorities' actions and the behaviour of market participants. Money cannot develop without a market in which supply and demand conditions can be expressed. Without a market for the euro, it will not be possible for it to become the European single currency. Therefore, the move to a single currency requires action by the monetary authorities and by market participants.

The work conducted by the EMI over the past three and a half years has reflected this dual approach, and I should like to discuss it further. I shall first explain how the EMI has organised and conducted its preparatory work for establishing the European System of Central Banks (ESCB). I shall then explain the ways in which the EMI has been operating to ensure that a euro market will also develop from the start of Stage Three of EMU. I shall close with some personal views on the outlook for the euro.

Let me start with the preparation of the ESCB for the conduct of the single monetary policy.

The Maastricht Treaty specifies a clear timetable for the preparatory work to be undertaken by the EMI. Taking 1 January 1999 as the first day of Stage Three and 1 July 1998 as the deadline for the establishment of the European Central Bank (ECB), the key decisions to be taken by the EMI concerning the selection and adjustment of the key monetary policy instruments and procedures have been scheduled on the basis of the lead times estimated for the implementation of those decisions. According to this schedule, the EMI devoted its first three years to the definition, assessment and comparison of the various options available. On this basis, at the end of 1996 the EMI Council took the main decisions concerning the principal instruments and the supporting infrastructure that the EMI would have to prepare and make available to the ECB. These choices are described in detail in the EMI document entitled "The single monetary policy in Stage Three: Specification of the operational framework", published in January 1997.

The second phase of the preparatory work started at the beginning of this year and will go on until mid-1998. It comprises the technical specification of the operational framework and its implementation. Two recent EMI publications ("The single monetary policy in Stage Three: General Documentation on ESCB monetary policy instruments and procedures" and the "Second Progress Report on the TARGET Project")

describe the further technical specifications of the ESCB's operational framework. Implementation is under way in most areas, both at the EMI, in preparation for the ECB, and at the national central banks (NCBs).

The third and final phase of the preparatory work will start in mid-1998 with the establishment of the ECB. It will comprise the final choice of certain options that have remained open and the testing of all the technical and operational procedures. The conduct of the testing work will be integrated with a view to ensuring that the ESCB will be in a position to perform its functions in full as of 1 January 1999.

Although I do not wish to describe the preparatory work in greater detail, I should nevertheless like to recall the main principles and the main choices that have been made.

The first main, overriding principle on which preparatory work has been based is that the ECB will conduct the single monetary policy with a view to achieving its primary objective of maintaining price stability. This principle is derived directly from the Treaty. Second, monetary policy instruments have been selected on the basis of their operational efficiency and their conformity with market principles. The third important principle that has guided the preparatory work is that monetary policy will be implemented - "to the extent deemed possible and appropriate" - in a decentralised manner, with a view to taking advantage of existing infrastructures at the NCBs.

On the basis of these guiding principles, four main characteristics of the ESCB's operational framework should be underlined.

First, the ESCB will operate in the money market mainly through standard market-oriented operations, such as open market operations. Two standing facilities and the possibility of imposing reserve requirements have also been prepared. Administrative instruments that may create distortions or subsidies for some categories of operators have been discarded.

Second, the monetary policy operations of the ESCB will largely be executed in a decentralised manner by the NCBs. It has been agreed that the ECB will be entitled to conduct fine-tuning operations, under exceptional circumstances, and occasional foreign exchange intervention.

Third, in defining eligible assets for monetary policy operations, existing differences in Member States' financial structures, which are of particular importance for national financial markets and banking systems, have been taken into account in the preparatory work with a view to ensuring some continuity for market participants in the different countries.

Finally, the monetary policy framework has been designed with a view to ensuring that homogeneous conditions are applied to all counterparties, irrespective of their location in the euro area. For instance, although regular tenders for central bank money will be implemented in a decentralised manner, they will be decided and organised centrally by the ECB, thereby ensuring equal treatment for counterparties.

The EMI has also conducted preparatory work in a range of other areas relevant to monetary policy, such as statistics, accounting and payment systems, with a view to ensuring that the ECB will have all the necessary instruments available to implement the single monetary policy from the start of Stage Three.

I should now like to turn to the issue of how market participants have been preparing for the single currency.

The EMI has taken the view that market participants should determine their own ways and means of adapting to the single currency. On the other hand, a well-functioning and efficient euro financial market is a prerequisite for a credible changeover to the single currency. The EMI has thus encouraged initiatives aimed at fostering the creation of a large, liquid and transparent euro financial market from the start of Stage Three. In particular, the EMI has been prepared to provide guidance or to take action on this matter when asked to do so by market participants.

The EMI has made contributions in four main areas:

- the definition of the changeover scenario;
- the legal framework for the introduction of the euro;
- the payment system infrastructure;
- the adoption of market standards.

Let me briefly address each of these issues in turn.

I should like to start with the changeover scenario, which was approved by the European Council in Madrid in December 1995 on the basis of the contribution made by the EMI. Such a scenario was necessary for market participants to co-ordinate their actions with a view to a smooth changeover to the single currency. The adopted scenario lays down the starting dates and deadlines for the main phases of the changeover to the euro, within which market participants are free to make personal adjustments.

There will be sufficient time, around three years after the irrevocable fixing of the conversion rates, to complete the final move to the new currency. Ultimately at that moment banknotes and coins of the former national currencies will be withdrawn from circulation. During this period, market participants will be neither compelled to use nor prohibited from using financial instruments denominated in euro or in national currencies, as those in different currencies will be deemed to be *ex lege* equivalent.

What is clear is that from January 1999 onwards the single monetary policy will be conducted and implemented in euro; new sovereign debt in all participating Member States will be denominated in the single currency; and most European governments have already announced that they will also re-denominate outstanding stocks in the single currency.

The second area in which the EMI has contributed in order to ease the transition to the euro concerns the legal framework, which some market practitioners considered to be essential to avoid confusion and future litigation. On the basis of background work conducted by the EMI and the European Commission, the Council approved a Regulation on 17 June 1997 which reaffirms, *inter alia*, the principle of the continuity of contracts and gives an assurance to financial markets that "the introduction of the euro shall not have the effect of altering any term of a legal instrument or of discharging or excusing performance under any legal instrument, nor give a party the right unilaterally to alter or terminate such an instrument". It is worth recalling that a similar rule came into force in the Illinois and New York State legal systems as of July 1997, thereby ensuring respect of the principle of the continuity of contracts in the Chicago and New York markets.

The third area in which the EMI has supported the process of market integration concerns payment systems. The EMI has developed a new payment infrastructure, known as TARGET, which will enable market participants to effect large-value payments across the EU in real time. TARGET is based on the national real-time gross settlement (RTGS) systems, which are connected to one another by an Interlinking mechanism. Free, unlimited and collateralised intraday credit will be made available to participants to smooth payment flows. The availability of such a payment system will enable market participants to conduct arbitrage operations and to take advantage of profit opportunities arising from any discrepancies in money market rates in the euro money market both swiftly and at low cost. This will ensure the uniformity of monetary conditions across the euro area. The ECB will have its own payment mechanism being part of TARGET.

Finally, let me turn to the definition of common market standards, which will be essential for the development of a truly EMU-wide market. At present, each national financial market has its own standards concerning day-count interest rates, settlement times, operating days and fixing procedures in particular. For this reason, efforts geared to achieving harmonisation were deemed to be necessary.

In March 1997 the EMI invited EU-wide banking and financial associations to take the lead in defining market conventions for the euro market. In July ten of the major banking and financial associations in the EU, including those active at the world-wide level, published a joint statement on market conventions for the euro, which should be inserted into all terms and conditions of new financial instruments after the start of EMU. The EMI publicly supported and welcomed this agreement, which sets the basis for common European standards.

The work conducted by the EMI in all these areas has supported the preparations made by the banking and financial industry. In most countries, banks have made great progress in their preparatory work, and not only in the wholesale financial area. As a matter of fact, several banks are even preparing to offer their retail customers financial services in both the national currency denomination and in euro as from 1 January 1999.

Very briefly, this is the state of the art in the preparatory work for the single currency, as it appears from both the authorities' and the market perspective.

Stage Three of EMU will start in around fifteen months' time and the picture is becoming clearer every day. What emerges, and I should like to close with some personal views, is that the interplay between market forces and the authorities' actions are helping to create a strong euro financial market. Through the initiative demonstrated by market participants and in co-ordination with the authorities, what is currently being shaped could potentially be the largest financial market in the world if measured according to outstanding stocks of assets. The improvements in terms of the size, liquidity and transparency that this market will experience with the changeover to the euro will create the basis for strong world-wide demand for euro-denominated assets. The pace of developments cannot be forecast, but the direction is clear: the euro will be a major player in the international monetary and financial system.

What role will the ESCB play in this new context?

To some extent the answer is very simple, as it is given in the Treaty. The role of the ESCB will be to implement the single monetary policy with a view to achieving the overriding objective of maintaining price stability.

I do not wish to enter into any of the sterile debates on a weak euro versus a strong euro which are currently taking place in some newspapers and journals. It is important to realise that the preparatory work that has been conducted to date, not only at the EMI, but also within the broader European political forums, will have enabled an ESCB to be established which will be able to operate fully and independently in order to maintain price stability in the euro area.

I say that not only because, as a central banker, I am convinced of the virtues of price stability as a pre-condition for sustainable growth, but also and especially because, as a European, a stable euro will be essential for Monetary Union to create (and I quote) "an ever closer union among the people of Europe", which is the ultimate goal of EMU as laid down in the Treaties of Paris (1951) and Rome (1957), and more recently reiterated at Maastricht (1992) and Amsterdam (1997).