Mr Duisenberg presents a few observations about the challenges facing the European Union in the years ahead

Speech given by Dr Willem F Duisenberg, President of the European Central Bank, at the Edmond Israel Foundation in Luxembourg on 11 November 1999.

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Dear Mr Israel, dear Mr Waigel, Ladies and Gentlemen,

It is a great honour to be here today to receive the prestigious “Vision of Europe” award. It is with great pleasure that I accept this honour. I perceive this award as encouragement for the continued work of the European Central Bank (ECB) towards making our new common currency a success and delivering its benefits to business, consumers and to European citizens in general.

As a central banker, my business is the conduct of monetary policy which is an inherently forward-looking task. Given the long time-lags with which monetary policy decisions impact on price levels, the very essence of our work is to estimate *today* what risks there will be to price stability *tomorrow* - and to act accordingly. While it appears that the Governing Council of the ECB has so far shown sound judgement and a steady hand in the conduct of its forward-looking policy, as central bankers we do not pretend to be able to see into the future. What we *can* do is to assess future trends and their potential impact on price stability on the basis of a thorough examination of past and current developments, using a comprehensive range of analytical and empirical tools. It is with this acute awareness of the limitations of our ability to discern future developments, not only in the monetary and economic spheres, but also in the political realm, that I shall present to you some observations about the challenges facing the European Union in the years ahead. Using the “central banker’s toolkit”, I shall attempt to make a modest contribution to the endeavour which gave its name to this award - to shape a “Vision of Europe”.

The European Union today - integration in “small steps” and “great leaps”

The European Union at the end of this century represents an unprecedented, imaginative and successful model for the management of international relations. Not only have the original objectives of European integration so far been achieved, namely to ensure peace and prosperity in what has historically been a conflict-ridden part of the world, but also the European Community - and later the European Union - has managed to adjust to the manifold challenges of its more than 40-year history. Such is its attractiveness that there are now many non-member countries keen to join, and it now represents the predominant European framework to such an extent that the European Union has almost become a synonym for “Europe”.

Of course, “Rome was not built in a day”, and likewise the progress of European integration has been a long and gradual process, with many obstacles, detours and setbacks on the way. I do not have time to recall the entire history of European integration from Winston Churchill’s famous Zürich speech to the most recent decisions at the Tampere European Council. However, allow me to share with you a few observations about the method and manner in which European integration has moved forward and, in this way, joined together European states and their economies. It is by discerning past trends and developments that we can shed light on the prospects for Europe in the coming years.

The Treaty establishing the European Community stipulates an “ever closer union of the peoples of Europe” as one of its principal objectives. In doing so, the founding fathers of the Community formulated a dynamic, comprehensive, and purposely equivocal “vision of Europe” as the centrepiece of the integration project. In pursuing this objective, Europe has often followed a process of incremental steps. Having placed the ambition to create a common market without frontiers at the heart of the integration project, the European Community has made continuous progress, frequently in response to the functional needs of the integrating economies. In this way, the EC has now reached an advanced stage of economic integration, with a functioning Economic and Monetary Union (EMU) and a common currency, the euro.

Throughout this process, national policymakers, economic actors and the general public have had to undergo a learning process, a change of perception, whereby the previous, narrowly defined, national perspective had to be gradually superseded. This did not mean an end to conflicts of interest, but the structures and policies of the Community have helped to build a climate of mutual trust and understanding, allowing differences to be resolved in a spirit of compromise, albeit not always easily.

At times, however, the integration process was propelled forward in "great leaps", as in the case of the agreement on the Treaty on European Union. Who knows whether the ECB would exist today, had it not been for the far-reaching institutional changes agreed at Maastricht. External developments have repeatedly galvanised Europeans into bold moves. In the early 1990s, for instance, the historic changes in Central and Eastern Europe, and in particular the unification of Germany, undoubtedly contributed to focusing the minds of European leaders on the Maastricht project.

In retrospect, it appears that the complementarity of these two methods - continuous *incremental change* and exceptional *bold steps* - has been a recurring element in the integration process so far. By using these insights from the history of European integration and by observing the behavioural and institutional patterns established over the past decades, one can endeavour to identify the challenges ahead and assess the EU's capacity to deal with them.

Allow me to turn now to these very challenges faced by the Europe of the future. From a central banker's perspective, three main challenges can be identified, and I shall address them in turn. I should like to begin with the challenge closest to the heart of the President of the ECB, namely that of making Economic and Monetary Union a success. Thereafter I shall turn to the challenge of extending the "European project" within Europe, and finally touch upon Europe's role in the wider world.

1. Making Economic and Monetary Union a success

Economic and monetary union as set out in the Maastricht Treaty transfers the competence for the conduct of a single monetary policy into the hands of a new supranational institution, the Eurosystem, with the ECB at its centre. At the same time, economic policies have essentially remained the competence of the Member States. With this particular distribution of responsibilities, all involved - central bankers, governments, businesses, and trade unions - indeed face a very special challenge.

The Eurosystem, for its part, contributes to the success of EMU by pursuing its Treaty mandate, which is to maintain price stability in the euro area over the medium term. While we can look back on the first 10 months of the operation of our monetary policy with considerable satisfaction, we cannot afford to sit back in idle contentment. The ECB is a novel and unique institution, and in the performance of its tasks it is still navigating uncharted waters. The ECB must formulate a single monetary policy for an economic area made up of 11 distinct national economic policy jurisdictions. Our monetary policy decisions must thus always be oriented towards the conditions of this ***currency zone as a whole***, since monetary policy by its nature is one and indivisible. Precisely this is our Treaty mandate. The ECB must develop into a truly European institution and we are making good progress in that direction.

EMU has already proved to be a success in the financial markets. A unified, euro area-wide money market, which is essential for the smooth functioning of the Eurosystem's monetary policy operations, was successfully established right from the start of Stage Three of EMU. In this process, the successful operation of cross-border transfer and payment systems has certainly contributed to the proper functioning, depth and liquidity of the unified money market. We are also witnessing a widespread acceptance of our new currency in the bond markets, where both sovereign and corporate borrowers are making use of the more favourable financing conditions created by the introduction of the euro. Thus, the emergence of a deep and liquid bond market is already well advanced. Furthermore, the new currency appears to be lending urgency to the increasing integration of equity markets, where the ongoing process of consolidation in the financial services and banking industries is exerting pressure to cut costs and enhance liquidity.

While the financial markets have adapted relatively quickly and successfully to the reality of EMU, this complex adjustment process will necessarily take longer in some other areas of economic policy. The new conditions brought about by the single currency - where monetary policy is exogenously set by the Eurosystem - will demand a steep learning curve on the part of policymakers, businesses, trade unions and the public at large. In this context, it has often been questioned, also from within the central banking community, whether EMU can be made a success in the absence of some form of "political union".

Can EMU work without a "political union"?

From the very outset, monetary union in Europe has been conceived as a complement to the Single Market, a logic neatly encapsulated in the title of the Delors Report study: "One market, one money". Europe's Single Market already represents a remarkable degree of economic integration. A plethora of common rules govern economic life in the 15 Member States and create, to a large extent at least, a unified market serving more than 350 million people. The realisation of the free movement of goods, services, capital and people has integrated national economies and rendered national borders increasingly obsolete. A common competition policy works towards creating a level playing-field, and common norms and standards guarantee Europe-wide market access. Certainly, Europe's Single Market is yet to be fully completed and a number of sectors have yet to be fully liberalised and brought into the remit of common rules. Nevertheless, the notion of a unified "European economy" has undoubtedly acquired real substance.

A functioning Economic and Monetary Union will require an increased awareness on the part of all Member States of the spillover effect of their national policies, especially their budgetary policies. In order to anchor responsible policies in the EMU rule book, the Treaty itself contains stipulations which oblige Member States to treat national economic policies "as a matter of common concern" and subject them to a multilateral surveillance procedure. More specific and detailed rules apply to budgetary policies, such as those enshrined in the 1997 Stability and Growth Pact (the existence of which is to a considerable degree due to the impetus of Theo Waigel). These provisions derive additional force from the existence of sanctions in the event of persistent excessive deficits.

Our first experiences with these EU-level economic policy instruments show that the consolidation of public finances has indeed become a priority for all Member States, and that efforts, although as yet not always sufficiently ambitious, have been undertaken to achieve balanced budgets in the medium term. Given Member States' high overall debt burden, the Eurosystem continues to call for heightened efforts to this end, especially in times of cyclical upturn such as that which we are experiencing at the current juncture.

One of the main challenges for the longer-term success of EMU - and the European integration project as a whole - is to achieve a significant and lasting reduction in unemployment, which remains persistently high in large parts of the euro area. While the current upswing should help to cut cyclical unemployment, the euro area economy will only create more employment in the longer term - and achieve sustainably higher rates of non-inflationary growth - if the necessary structural reforms are enacted. However, it is encouraging to see a growing recognition among policymakers in Europe that over-regulation of labour markets, perverse incentives created by certain elements of the welfare systems and rigidities throughout the economy urgently need to be addressed. In so doing, Member States are increasingly willing to learn from each other, to accept "peer pressure" and to follow examples of "best practice". Ultimately, EMU will be a success if all policymakers learn, in their areas of competence, to pursue policies which respect the common rules, and take full account of their responsibility for the euro area economy as a whole. If we understand the somewhat indeterminate notion of "political union" in terms of such a comprehensive system of common principles, rules and commitments, then the future success of Economic and Monetary Union can already be said to rest on a solid foundation.

While central bankers and politicians can make a weighty contribution to the proper functioning of EMU, our common currency will only become a long-term success if it is accepted by European citizens. For this to happen, the Eurosystem will have to acquire a track record of stability which clearly demonstrates to the public the benefits of stable prices. As a new generation grows up without the experiences of the detrimental effects of inflation on growth, employment, savings and investment the Eurosystem will have to communicate effectively the significance of maintaining price stability and explain how monetary policy operates towards achieving this goal.

A currency is a powerful symbol of identity. In order to make our common currency a symbol of a shared European identity, all policymakers involved will have to make efforts to demonstrate its benefits to all citizens. This will be especially important when a particular region of the euro area suffers an economic downturn. In such circumstances, it might become a difficult political task to maintain public support for EMU and to explain its fundamentally positive effects. The Eurosystem will for its part continue to make its contribution by providing stable money for the euro area as a whole.

Learning to live under the new conditions of Economic and Monetary Union is necessarily a gradual process. However, momentous changes in Europe and in the wider world might well require the EU to undertake bolder endeavours in order to successfully meet the challenges ahead. I am referring in particular to the forthcoming enlargement of the EU on an unprecedented scale.

2. Taking on the responsibility for the "Greater Europe"

The principal objective of European integration remains as valid today as it was 50 years ago, although the dimensions of this endeavour have certainly changed. Today, the European Union faces the challenge of "exporting" to the eastern half of our continent its model for a zone of peace, stability and prosperity.

The fall of the Berlin Wall 10 years ago prepared the ground for the countries of Central and Eastern Europe to "return to Europe". The clearest expression of the redirection of the foreign policy of those countries was their application for membership of the European Union. This intention was supported by the dynamics of increasing trade integration with the EU, and - I should like to add - the moral force of the historical and cultural claim of those countries to regain their place in the family of Europe.

Creating the right economic and political conditions, preparing the European institutions and adjusting common policies in anticipation of the eventual integration into the European Union of up to 12 countries from Central, Eastern and Southern Europe is a task of great historical magnitude. It will require great efforts and sometimes difficult adjustment both on the part of the EU itself and on the part of the applicant countries.

The greatest challenge which the accession countries in Central and Eastern Europe are facing is certainly the transformation of their formerly centrally planned economies to functioning market economies able to withstand the competitive pressures of European and global markets, while at the same time establishing stable and democratic political systems. While a successful mastering of these challenges is certainly a desirable goal in itself, their importance has been reinforced by the fact that the EU has stipulated their attainment as conditions for accession in the so-called "Copenhagen criteria". The third of these criteria relates to the capacity of the applicant countries to adopt and implement the *"acquis communautaire"*. On the latter issue, the Eurosystem naturally has a particular interest in the provisions relating to the activities falling within its field of competence.

EU enlargement and the Eurosytem

Upon accession to the EU, the new Member States will have to comply with the EMU-related *"acquis"*. In fact, they will join EMU with the status of a "Member State with a derogation". From this point onwards, they will be expected not only to treat their economic policies as a matter of common concern, but also to be committed to the eventual adoption of the euro, which should be an objective both of monetary and of other economic policies. The new entrants would be expected to participate in the exchange rate mechanism (ERM II) which will link their currencies to the euro as soon as their economic and financial situation allows. Once the new Member States are judged to have fulfilled the Maastricht criteria in a sustainable manner, they would become full participants in EMU.

As these explanations already indicate, the Eurosystem takes an open and positive attitude towards the accession of new Member States and their eventual adoption of the euro. Over and above its aforementioned interest in the applicant countries' EMU-related accession preparations, the Eurosystem stands ready to provide technical assistance. The actual accession process should be guided by the principle of equal treatment, whereby objective and uniform criteria should apply to accession, to participation in ERM II and adoption of the euro. In this regard, a plurality of approaches should be feasible without compromising equality of treatment. Given the accession countries' different starting-points and degrees of economic transition, they could justifiably apply differing approaches to the timing of EU accession, to ERM II membership, to their monetary and exchange rate strategies and the necessary development of sound financial market infrastructures.

Internal reform and deepening of the EU as a precondition for enlargement

While the accession preparations certainly constitute an extremely demanding adjustment and reform programme for the applicant countries, there should be no denying that the European Union, too, will have to reform its institutions and decision-making structures in order to be able to welcome the new Member States. By agreeing to convene an Intergovernmental Conference next year, the Member States have taken the first steps in this direction. However, it remains to be seen whether this forthcoming renegotiation of the Treaty will be an example of the aforementioned incremental change with a strictly limited scope for reform; or, alternatively, whether Member States opt to take a "leap forward", by embarking on an ambitious root-and-branch overhaul of institutions and procedures in order to prepare the Union for a large-scale enlargement and guarantee its capacity for action way into the next century.

More fundamentally, in an enlarged Community, all Member States will have to recognise that they form part of a multi-layered system of commitments and interdependencies, of rights and obligations, now reinforced by the introduction of the single currency. The immense body of common legislation, EMU and the euro, the financial transfers through structural funds and, more recently, ambitious plans to cooperate more closely in foreign and security policies as well as on justice and home affairs represent the "cement" which safeguards the European Union as a whole against the centrifugal forces which are likely to increase as it grows wider and more diverse. In this context, past experiences - such as the use of the EMU convergence criteria as a means of exerting "peer pressure" - might provide lessons for the successful pursuit of ambitious integration projects in other areas.

Allow me now to turn to challenges which lie beyond the borders of a future enlarged European Union. The recent conflict in Kosovo raised an acute awareness of the EU's responsibility to project stability onto more volatile regions of Europe and beyond. As set out above, it was again the force of external events which led European leaders to reach a new consensus on the necessity to give the Union effective capacity for action in the foreign policy and security fields. A number of political initiatives and institutional innovations are being prepared in this context. Extending the European zone of stability and prosperity also requires sound economic and monetary conditions, including a functioning financial system in the regions concerned. The Eurosystem has noted the unilateral decision of the Montenegrin government to introduce the Deutsche Mark - effectively the euro - as a parallel currency in its territory, following on from a similar decision by the United Nations Administration in Kosovo. In this context, I should like to make it absolutely clear that such unilateral action in no way commits the Eurosystem. It is rather the case that in our monetary policy decisions we will always follow the precise mandate given by the Treaty - namely to maintain price stability *in the euro area* over the medium term.

In the past, the European Union has often been accused of being "obsessed with its own internal dynamics" and having little regard for the outside world. However, not least as a result of the introduction of the euro, the EU must increasingly look beyond the confines of the European continent and shoulder its responsibilities with regard to securing a well-functioning world economy. It is to these external challenges that I shall now turn.

3. Europe and the Eurosystem in the world economy

The euro is the currency of an economic area with a population of nearly 300 million people and one-sixth of the world's gross domestic product. Both figures will increase as new countries adopt the euro. After the US dollar, but ahead of the Japanese yen, the euro is the second most widely used currency on a worldwide scale. With these facts in mind, it can be expected that the euro and the Eurosystem will hold a significant position in the world economy. What is more, I believe it would not be an exaggeration to state that, with its single currency, the European economy is set to play a role of systemic importance.

That said, the Eurosystem does not actively promote an international role for the euro, nor do we seek to hinder it. There is and shall be no policy of challenging the position of the dollar, nor that of any other currency. By adopting this neutral stance, the development of the euro into an international currency is left to market forces. If the Eurosystem is successful in maintaining price stability it will almost automatically foster the euro's international role. It is difficult to predict precisely at what pace the euro will acquire its international role. If history is any guide, it may well be a rather gradual process, although I would not rule out that this time it may well evolve faster than historical experience might suggest. As a consequence, European policymakers will have to recognise that this newly found global importance also brings with it new responsibilities and challenges.

Europe can and should be a strong advocate of a functioning world economy. This entails a credible commitment to trade and capital account liberalisation. While it is not for me to comment on the EU stance with regard to the forthcoming Millennium Round on trade liberalisation, it is obvious that it is in the interests of the European Union that the various international organisations devoted to the management of the world economy function smoothly. Given its economic and financial weight, the EU should play a constructive role in, *inter alia*, the World Trade Organisation (WTO), the International Monetary Fund (IMF) and the Group of Seven (G7). As for the Eurosystem, the institutional changes brought about by EMU have made it possible for the first time for Europeans to speak with one voice on monetary and financial matters. As the President of the ECB, I participate in parts of the G7 meetings; the ECB will be represented at the newly established G20, and we also enjoy observer status at the IMF. In addition, we are to become a shareholder of the Bank for International Settlements (BIS).

The Eurosystem considers the various fora for international cooperation as important instruments for managing the increasing trend towards globalised economy and finance. The high degree of international capital mobility and technological advances have created interdependencies which call for new forms of global "governance". In this vein, we support efforts to improve the international financial system and to enhance the transparency of financial institutions as proposed, *inter alia*, by the IMF, to coordinate the work of banking supervisors as advocated by the Bank for International Settlements, and to work towards greater systemic stability with emerging countries as instituted by the G20.

As already mentioned above, EMU is set to propel the EU economy into a role of systemic importance. Assuming this new responsibility for the stability of the international financial system as a whole, however, should not be misinterpreted as a move towards managing exchange rates between the world's three leading currencies. In our view, exchange rates are primarily the outcome of current and expected monetary, fiscal and structural policies as well as cyclical and other economic developments, rather than an objective or target of monetary policy. Having said that, the Eurosystem does not regard the exchange rate with "benign neglect". The external value of the euro is an important policy indicator insofar as it influences the outlook for price stability in the euro area.

I shall now come to a conclusion.

4. Conclusion

As has become clear from my observations, the EU is facing a demanding but equally exciting agenda for the years and decades to come. I am confident that Europe will cope with the challenges ahead by continuing its clearly focused but nevertheless flexible approach. While some bold, integrative steps may at times be required in response to external developments, Europe's policymakers, economic agents, and most importantly, its citizens must be given the time to gradually adapt to the conditions brought about by the single currency, to cope with the dynamics of the "Greater Europe" and to realise the increased responsibility of an integrated Europe in the wider world. It is in this way, and with a substantial effort on the part of all those involved - bodies, institutions and citizens alike - that Europe will be ready to face the challenges ahead.