

## **Mr Duisenberg offers his view on the role of the European Central Bank in a united Europe**

Speech by the President of the European Central Bank, Dr W F Duisenberg, at the National Bank of Poland in Warsaw on 4 May 1999.

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### **Introduction**

First and foremost, I should like to congratulate the National Bank of Poland (the NBP) on its 75th anniversary. The age of the NBP already suggests that as the President of the European Central Bank (ECB), an institution that is even less than one year old and has only been conducting monetary policy since January this year, I should be modest. I am aware that the role of the NBP has not been constant over these 75 years and that in the past decade, in particular, the NBP has gone through a remarkable restructuring process. My previous central bank, de Nederlandsche Bank, has, together with the International Monetary Fund and many national central banks, been involved in assisting the NBP in its efforts to adapt to the role of a central bank in a market economy. Of course, the real work had to be done by you yourselves and I believe you can be proud of what has been achieved over the past decade.

Today in my speech I should like to focus on the role of the ECB, as a truly European institution. First of all, I shall explain the background against which the introduction of the euro and the establishment of the ECB should be considered. Thereafter, I shall discuss the main features of the institutional structure that determines monetary policy-making. I shall then turn to our monetary policy strategy and the role of accountability and transparency in this strategy. I shall conclude by briefly addressing the issue of EU enlargement.

### **The process of European integration**

On 1 January of this year the euro was introduced in 11 countries with a combined population of almost 300 million. The ECB started to conduct a single monetary policy for the so-called euro area. Former national currencies, such as the French franc and the German Mark are no longer autonomous currencies, but subdivisions of the euro. Euro banknotes and coins will only be introduced in 2002.

The voluntary transfer of monetary sovereignty from the national to the European level is unique in history. However, it should not be seen as a single, isolated event. The introduction of the euro is part of the process of European integration. This process started shortly after the second World War and has now been under way for more than half a century. The aims of European integration are not only, or even primarily, economic. Indeed, this process has been driven and continues to be driven by the political conviction that an integrated Europe will be safer, more stable and more prosperous than a fragmented Europe. It is true that economic integration has been the main engine of this process and that, although it has had its ups and downs, integration has delivered important economic benefits. On balance it has been successful.

The introduction of the euro and the establishment of the ECB are important new steps in this process of European integration. They are not the completion of this process, for at least two reasons. First, the launch of the euro can be compared to the launch of a rocket. A good launch is crucial, but only the beginning of the mission. The euro has been launched successfully. The challenge now is to make it a success. This will not happen automatically, but will require effort on the part of many authorities, institutions and people. Second, four EU Member States have not (yet) introduced the euro. I hope that this will happen in the future. Moreover, as you are aware, the EU itself is likely to increase its membership over time, also to include Poland. Ultimately, this is bound to extend the euro area. This process, too, is already requiring and will continue to require great efforts: no pain, no gain, as is often the case.

## **The institutional framework of the single monetary policy**

Let me now turn to the institutional framework for the conduct of the single monetary policy. This was laid down in the Treaty establishing the European Community, the so-called Maastricht Treaty, and the Statute of the ESCB, which is an integral part of this Treaty. According to the Treaty the ECB has the primary objective of maintaining price stability. Without prejudice to this objective, it is to support the general economic policies in the Community, with objectives such as economic growth and high employment.

Decisions on monetary policy are made by the Governing Council of the ECB. This body comprises the six executive directors of the ECB and the 11 governors of the national central banks (NCBs) of the Member States which have introduced the euro. These 17 people meet every fortnight at the ECB, in Frankfurt am Main. Decision-making on monetary policy is fully centralised. All members of the Governing Council have one vote, whether they come from Germany or Luxembourg. This is because of an important principle. They are not representing their country, but are obliged to take decisions on the basis of euro area-wide considerations. Regional or national monetary policy does not and cannot exist in the euro area. There is only one, single monetary policy for the euro area as a whole. Therefore, the ECB should develop into a truly European institution. This is a process that will inevitably take some time, but my feeling is that we are already making good progress.

The execution of monetary policy is to a great extent decentralised. It is in large part carried out by the NCBs. The ECB and the 11 NCBs together are referred to as the Eurosystem. If we refer to the ECB and the 15 NCBs of all EU Member States, we speak of the European System of Central Banks (ESCB). The General Council of the ECB meets quarterly and comprises the President and Vice-President of the ECB and the 15 governors of the NCBs of all the EU Member States. This body does not make decisions on monetary policy, but discusses issues concerning the relationship between the “ins” and the countries I prefer to call “pre-ins”, such as exchange rate issues. The third decision-making body of the ECB is the Executive Board of the ECB, comprising the six executive directors of the ECB. The Executive Board is responsible for current business and the implementation of monetary policy as decided by the Governing Council. The staff of the ECB will, in the course of this year, reach a level of between 750 and 800 and is likely to grow further in the years ahead.

The ECB is one of the most, if not the most, independent central bank in the world. Its independence and that of the participating national central banks are firmly enshrined in the Maastricht Treaty. Members of the Governing Council are not allowed to take or seek instructions from anybody, politicians included. Politicians are not allowed to give such instructions. Members of the Governing Council have a term of office of at least five years. The ECB is financially independent.

The independent status of the ECB fits into the recent worldwide trend of granting independence to central banks. This tendency is evidenced by both practical experience and academic research. By shielding monetary policy decisions from political interference, price stability can be maintained without having to give up economic growth. Indeed, in that sense having an independent central bank is a good thing for all concerned. The reason for central bank independence is that monetary policy-making under the influence of politicians tends to focus too much on short-term considerations. This can easily lead to temporary, non-sustainable increases in growth, but inevitably results in lasting increases in inflation with no lasting gains in growth and employment at all. Politicians all over the world have come to realise this and have decided to remove the temptation to pursue short-term gains and to make their central bank independent. It should be underlined that granting this independence is, as it should be, a political decision. An independent central bank needs a clear legal mandate.

## **The monetary policy strategy**

The ECB has, as I mentioned earlier, such a mandate. However, the Treaty does not specify how the ECB should pursue its primary objective of maintaining price stability; in other words: it is silent on what is called the monetary policy strategy. The ECB therefore formulated its strategy in the second half of last year. That was no easy task. The introduction of the euro constitutes a structural break, which may change the behaviour of firms and individuals and make it less predictable. To a certain extent it is comparable to what Poland experienced when it embarked on its reform process. The rules of the game change and this makes policy-making more complicated. Our monetary policy strategy has taken these specific circumstances into account. It is tailored to this unique period of the introduction of the euro, although it has elements of both monetary targeting and inflation targeting.

In the context of this strategy the ECB has provided a quantitative definition of price stability. Price stability is defined as a year-on-year increase in the harmonised index of consumer prices (HICP) of below 2% for the euro area as a whole. Price stability is to be maintained in the medium term.

The strategy consists of two pillars. The first pillar is a prominent role for money. Ultimately, inflation is a monetary phenomenon. It is in the end result of too much money chasing too few goods. Therefore, we have formulated a reference value for the growth of a broad monetary aggregate, M3, of 4 ½% on an annual basis. Growth of the money stock at this pace would provide the economy with sufficient liquidity for growth in activity in line with trend growth, without inflation. At the end of this year this figure will be reviewed. It should be emphasised that we did not define a target for money growth. The reason for this is the structural break that the introduction of the euro creates. By calling this a reference value, it is made clear that money is one variable which we look at very carefully in order to examine whether inflationary or deflationary pressures are tending to emerge. We do not, however, react mechanistically to changes in money growth.

The formulation of the second pillar is also prompted by the potential changes in economic behaviour on account of the introduction of the euro. It is a broadly based assessment of the outlook for price developments on the basis of an analysis of monetary, financial and economic developments. In this context interest rates, the yield curve, wage developments, public finance, the output gap, surveys of economic sentiment and many other indicators are analysed. Use is also made of forecasts produced by other bodies and internally for inflation and other economic variables.

This brings me to the role of the exchange rate of the euro in our strategy. Since our primary objective is price stability and since the euro area as a whole is a relatively closed economy with an export share of 14% of gross domestic product, we do not have a target for the exchange rate of the euro, for example, against the US dollar. This does not mean, and it is good to underline this once more, that the ECB is indifferent to the external value of the euro or even neglects it. The external value of the euro is one of the indicators we look at in the broadly based assessment of the outlook for price developments. Within that framework, we constantly monitor exchange rate developments, analyse them and shall act on them, if and when this becomes necessary. However, such action will never be mechanistic, nor will it be isolated. The external value of the euro and its development are analysed and considered in the context of other indicators of future price developments. The ECB also tries to assess international confidence in the still very young euro. Of course, the level of international confidence in the euro is not the only factor determining its external value, nor is the exchange rate the only indicator of confidence in the euro. It is, for instance, encouraging to see how the euro has been received on the international money and capital markets. I am sure that an internally stable euro will also strongly underpin international confidence in this currency, as it has for other currencies in the past.

As the currency of a very large area, the issue of the international role of the euro naturally arises. The ECB takes a neutral stance regarding this role. It will neither be stimulated, nor hindered. On the one hand, an international currency has advantages for citizens in the euro area, on the other, it may sometimes complicate the conduct of monetary policy when a large amount of euro is circulating outside the euro area. We shall leave the development of the international role of the euro to market

participants and market forces. If history is a guide as to what will happen, there will be a gradual process whereby the euro will have an increasingly international role. Such a gradual development would also be a welcome development, if only to prevent the euro from becoming too strong externally at some point in time. It is likely and understandable that interest in the euro is already considerable in those countries aspiring to join the EU, including Poland. I shall elaborate on this issue at the end of my speech.

Coming back to our monetary policy strategy, I should like to point out that it is important to make clear what monetary policy can and cannot do. Monetary policy can maintain price stability, but only in the medium term. In the short term prices are also influenced by non-monetary developments. Moreover, monetary policy measures only have an impact on prices with long, variable and not entirely predictable time-lags of between 1.5 and 2 years. Therefore, monetary policy-making should have a forward-looking character. Today's inflation is the result of past policy measures, and current policy measures only affect future inflation. The uncertainty of the economic process in a market economy is another reason for policy-makers to be modest. The ECB does not pursue an activist policy. Precise steering of the business cycle or a cyclically-oriented monetary policy are not feasible and are likely to destabilise rather than stabilise the economy. Some commentators have interpreted our recent interest rate reduction as a change to a more cyclically-oriented monetary policy strategy. This is not true. Our strategy was, is and shall remain medium term-oriented and firmly focused on maintaining the price stability which currently prevails in the euro area.

Monetary policy should be supported by sound budgetary policies and wage developments in line with productivity growth and taking into account the objective of price stability. Otherwise, price stability can only be maintained at a high cost in terms of lost output and employment. This also explains why independence should not mean isolation. It is important to have a regular exchange of information and views with other policy-makers. The Maastricht Treaty stipulates that the President of the ECB is invited to meetings of the EU Council meeting in the composition of the Ministers of Economy and Finance whenever there are issues on the agenda which are relevant to the ECB's tasks. The President of the Council of Ministers and a member of the European Commission may attend meetings of the Governing Council, although they do not have the right to vote. The President of the Council of Ministers may submit motions for deliberation. Apart from these formal contacts, there are many informal contacts, for example in the context of the so-called Euro-11 group of finance ministers from the euro area countries. I regularly attend meetings of this group.

Monetary policy cannot be used to solve structural problems, such as the unacceptably high level of unemployment in the euro area. Structural problems call for structural solutions, in this case measures targeted at making labour and product markets work more flexibly. The best contribution the ECB's monetary policy can make in this context is to maintain price stability. In this way one of the conditions for sustainable growth in incomes and employment is created. As important as this is, it should be realised that jobs are created by firms which are confident about the future and not by central banks.

### **Accountability and transparency**

Accountability for policies is the logical complement to independence in a democratic society. The Maastricht Treaty includes a number of provisions in this respect. First, there is the mandate to pursue price stability. This provides a qualitative measure against which the ECB's performance can be measured. As I have already mentioned, we have decided to enhance this by providing a quantitative definition of price stability. One of the aims of publishing our monetary policy strategy is to make our policy decisions transparent.

The ECB has to publish an annual report in which, inter alia, the monetary policy of the previous and current year are discussed. I present this Annual Report to the EU Council and to the European Parliament, which may hold a general debate on the basis of it. The President and other members of

the Executive Board of the ECB may be heard by the competent committees of the European Parliament. I have agreed to appear before the European Parliament at least four times a year. The ECB has to report on its activities at least quarterly. It has been decided to go beyond this requirement and to publish a monthly bulletin.

It is my view that the main way to achieve accountability is through being transparent and open. In passing, I should like to note that transparency also enhances the effectiveness of a central bank. The better it is understood, the more successful a central bank is. Apart from the activities I have already mentioned, transparency is achieved in several ways. Every month, after the first meeting of the Governing Council, the Vice-President and I give a press conference. I start the conference with a comprehensive introductory statement, in which I explain the decisions taken by the Governing Council and the underlying analysis and arguments for and against. This introductory statement is published immediately on the ECB's Internet Web site. This is followed by a question and answer session attended by several hundred journalists. The questions and answers are also published on the Internet shortly afterwards. All the members of the Governing Council frequently make speeches, give interviews and contribute to journals and books. Thousands of people visit the ECB and the national central banks each year and, for our part, we and our staff attend many conferences and other public events.

### **EU enlargement**

The European integration process continues. The euro should be made a success. I have already explained how we have started the process of doing that. Some observers have criticised the EU for its "obsession with its own internal dynamics", in particular in the context of European Economic and Monetary Union (EMU). With all energies focused on meeting the convergence criteria and the preparation for the launch of the euro, Europeans outside the EU have wondered whether EMU and enlargement are not mutually exclusive objectives.

Let me briefly comment on this issue. After the historic decision to complete the European Single Market in the 1980s, it was felt that economic integration should not stop at that point. To fully reap the rewards of economic integration within the Community, a single currency was felt necessary; a logic pointedly encapsulated in the title of one report: "One market, one money".

Hence, the underlying idea of EMU was to advance European integration and to ensure that full use would be made of the economic potential of the Single Market. This idea continues to be the focus of European policy-makers, as evidenced by the association agreements and the ongoing accession negotiations with a number of European countries, Poland among them. Good and mutually beneficial economic relations with third countries in Europe and further afield are a pillar of EU policy orientation. Recognising this, the principles of an open market economy with free competition are enshrined in the Treaty on European Union. EMU will not weaken this commitment, but rather reinforce it. Closer co-operation in Europe and the respect of common principles in the political, economic and social fields are likely to form the basis for further integration. The ECB shall contribute to this process within the scope of its responsibility.

Countries wishing to deepen their monetary co-operation to the ultimate extent possible by forming a monetary union will have to adapt their economic and legal systems to the standards required by the Treaty and aim at a sufficient degree of economic convergence. In the absence of these conditions, adjustment costs for both current and new participants could be high. Any premature decision on the adoption of the euro could have severe repercussions on a country's competitiveness and trigger painful economic adjustments. Therefore, implementation of the necessary institutional reforms and of a sufficient degree of convergence should not be considered as an obstacle preventing further integration in Europe, but rather as an essential means of ensuring the lasting success of EMU, for existing and new participants alike. Looking at the impressive progress made in a relatively short time

in this country, there is no reason to be pessimistic about Poland's chances of meeting these standards and convergence criteria. I shall not venture, however, to predict when this will be the case.

Even at the current juncture, though, EMU in one part of Europe is already having an impact on the whole region. Let me briefly mention two aspects:

- If the euro emerges, as I believe it will, as a strong and stable currency, it will provide the countries in the region with an important reference currency, an anchor towards which, should the intention arise, monetary policy could credibly be oriented.
- Furthermore, EMU is set to bring about the development of a truly unified European financial market, close to that of the United States in depth and sophistication. The competitive pressures of this euro area financial market will create more favourable financing conditions for borrowers. A number of central and eastern European countries have already successfully tapped this market.

In view of these effects, it is altogether natural that the ECB has started to follow with great interest economic and financial developments in the wider Europe, particularly in those countries which have applied for EU membership. Moreover, the ECB monitors closely the exchange rate developments with those countries which have established some form of exchange rate link to the euro.

The euro has the potential to become more than just a new currency for almost 300 million people in 11 countries. It may also become a unifying symbol, standing for all that the peoples of Europe have in common. Consequently, the public perception of the euro could endow the single currency with a role in the European integration process reaching beyond monetary policy in the strict sense. May the euro contribute to the establishment of what the preamble to the Treaty Establishing the European Community calls: "an ever closer union among the peoples of Europe" .