



BANK OF ENGLAND

Speech

Alice in Euroland

Speech given by

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ALICE IN EUROLAND¹

Introduction

Economic and Monetary Union has arrived *de facto*. While it will not start *de iure* until January 1, 1999, the co-ordinated rate cut by all Euroland central banks on 3 December 1998, was truly the first monetary policy decision of the ECB. The UK, true to its tradition of joining new European institutional developments late and reluctantly, will not participate in EMU until further notice.

The launch of EMU is a global political and economic event of the first order. Love it or hate it, it will profoundly affect the lives of all those in Euroland, on the fringes of Euroland and in the world at large.

The adoption of a common currency by 11 of the 15 EU members is an act without precedent. While there are some analogies with the creation of a German monetary union in the 19th century, with the Latin Monetary Union and indeed with the pre-World War I Gold Standard, the differences far outweigh the similarities.

The common currency will have important technical, economic consequences for both participants and outsiders. First and foremost, however, EMU is a major step on the road to 'ever closer union' in Europe. It represents the opening of a new chapter in the European federalists' agenda, a significant transfer of national sovereignty to a supra-national institution. The federal European super state, however, is still quite some distance away. Not only is the EU, or even Euroland, not a federal structure, it is not even a confederacy. Calling it a proto-confederal structure would probably be as close as one could get.

While few if any technical economic implications for further European co-ordination, Cooperation, harmonisation and institutional development follow from the act of monetary union, the political imperatives will give momentum to a whole range of such developments. For example, the European Parliament, the body charged with the political oversight of the ECB, will, for the first time, get a major role in supervising a body with an important executive responsibility. I expect that the European Parliament will sharpen its teeth on this oversight function, that it will like the sensation of being involved in true Parliamentary oversight, and that it will use the leverage acquired this way to extend its power throughout the domain of European supranational competence.

¹ Ian Begg has drawn my attention to a paper by Klaus Gretschmann with a similar title to mine: "European Monetary Union; Alice in Wonderland or Malice in Blunderland? (Gretschmann [1991])"

* The opinions expressed are those of the author alone. They do not necessarily represent the views and opinions of the Bank of England or of the other members of the Monetary Policy Committee.

In this lecture, I will focus mainly on the institutional arrangements and emerging operating practices of the ECB, the ESCB and the emerging fiscal Cooperation and co-ordination arrangements such as the EuroXI. I will approach these issues by asking whether EMU will and be a success, and what institutional and operational features contribute to or threaten its survival and success.

The Perils for EMU and the Perils of EMU

The recent Asian crisis, and its spill-overs as far away as South Africa and the Russian Federation provide a useful reminder of the validity of my long-held view that, with unrestricted international mobility of financial capital, a common currency becomes the only exchange rate regime that is viable and permits the potential gains from capital market integration to be realised in full. Fixed-but-adjustable pegs are accidents waiting to happen. Market-determined or freely floating exchange rates are viable in the technical sense that they can survive, but only at the cost of excessive volatility and persistent misalignment inherent in the juxtaposition of a technically efficient financial market with sluggish price and wage adjustment in key parts of the real economy. The Euro was very well timed indeed.

Technical Survival Issues: Speculative Attacks and Voluntary Quits

EMU will survive almost surely. It cannot be brought down by speculative attacks among member countries, either between January 1, 1999 and the date of the final demonetisation of the national currencies (no later than July 1, 2002), or afterwards. A speculative attack among EMU currencies could no more cause a collapse of EMU than a switch from £5 notes into £10 notes could cause a collapse of UK monetary union. Like any currency union, it could be brought down by one or more of the constituent member states or regions choosing to leave the currency union. A country could e.g. find the lack of a national monetary instrument prohibitively costly in the face of a particularly unpleasant country-specific shock to its output market. While the Maastricht and Amsterdam Treaties do not provide any mechanism for leaving EMU (or indeed any other of the EU institutions and arrangements), a country that truly wished to leave would no doubt be able to do so. The likelihood of this happening, in the absence of a major economic or political calamity, is very remote, however. The sudden emergence of massive unbalanced positions in foreign currencies alone would cause nightmares to businessmen and policy makers and would provide bankruptcy experts and lawyers with decades of gainful employment.

EMU will survive despite a poor start, with the shenanigans surrounding the appointment of its first President. I am not referring to the fact that the French government insisted on making the appointment of the first ECB President a *political* issue. The presidency of the ECB *is* a political issue. It is quite proper that the Euroland central bankers who thought they had settled the issue among themselves, were reminded of their proper place by the elected politicians. What was depressing was that the French president chose to make the presidency a *nationality* issue. This violated the letter and the spirit of the Treaties. The gentlemen's agreement that Mr. Duisenberg would serve for only four years and would be succeeded by 'a Frenchman' (any Frenchman?) was truly a rogues' agreement. It is my hope and expectation that the first incumbent will treat it with the respect it deserves.

Legitimacy, Openness and Accountability

The only real threat to the continued existence of EMU will be the popular perception that the ECB lacks political legitimacy. This lack of legitimacy has two dimensions: first, the lack of openness and accountability of the ECB and second the problem of monetary integration being ahead of general political and institutional integration.

The lack of openness, transparency and accountability written into the statutes of the ECB and apparently about to be reinforced by the ECB's own 'common law' operating procedures could yet undermine the viability of the whole enterprise. It is to be hoped that a culture of openness will nevertheless be established. The '16 year rule' for the publication of the minutes of the ECB (as close to 'not now, not ever, never' as one can get) does not bode well, however.

Mr Duisenberg is of course quite correct to refuse to testify before any of the national parliaments. He (and the other members of the Board) should be answerable, collectively and individually, to the European Parliament alone. Mr. Duisenberg could spend the best part of the year on a travelling road show around the Euroland capitals if he were to take that particular (French) request seriously. National central bank governors should of course be answerable to their national parliaments, although they too are mandated by the Treaties to act for the Union as a whole, and not as agents for their national constituencies.

Publication of Individual Voting Records

In the Financial Times of 21 September, 1998, Dr. Otmar Issing asserts that the Maastricht treaty specifies that the ECB's Governing Council may decide to make public the outcome of its deliberations, but not the voting behaviour of its members. In fact, in the Protocols annexed to the Maastricht treaty it is stated that (10.4) 'The proceedings of the meetings shall be confidential. The Governing Council may decide to make the outcome of its deliberations public'. This is perfectly consistent with publication of the individual voting records, provided the individual votes are defined to be part of the outcome of the deliberations, rather than as part of the proceedings. The legal fig-leaf for non-publication of the individual votes does not appear to be attached securely.

Dr. Issing points also states: "The real issue is whether making the votes known to the public effectively contributes to accountability". I agree. He goes on to say that "Making individual member's voting behaviour public would encourage undesirable scrutiny of members' voting patterns. This, in turn, would encourage external pressures on the Council members, arising from local interests. Independence, granted by the Treaty, would be at risk.' The same argument has been made by Mr Duisenberg. In an interview published Monday, 29 June 1998 in the Frankfurter Allgemeine Zeitung, Mr Duisenberg is reported as saying "*If the vote of the national representative were known, there would be unpleasant questions with the aim of pressuring*" him in future votes. I consider this argument to get it exactly backwards.

National political authorities and other interested parties will undoubtedly try to put pressure on 'their' nationals serving on the ECB Board as well as on 'their' national central bank governors. This is against the spirit and letter of the Treaty, but it will

surely happen. The question is how the ECB Board members and national governors can be most effectively shielded from such pressures.

Whatever the formal confidentiality of the ECB Council meetings and votes, the national heads of government will know exactly who voted in favour of what, within five minutes of a vote being taken. Six Executive Board members, eleven national governors, countless staff and possibly a member of the Commission and the President of the Council, will be present at the ECB Council meetings. Leaks, and even open breaches of confidentiality arrangements will be the rule rather than the exception. Extensive selective leaking and competitive briefing of the media by individual Council members, behaviour characteristic of some influential continental European central banks in the past, are poor substitutes for proper accountability.

The information required to bring effective pressure to bear will be available, de facto, to the national political insiders. That information will not however, be formally available to the bodies charged with supervising the ECB (the European Parliament in the case of the ECB Board, and the national parliaments in the case of the national central bank governors of the Euro area). Council members will be able to hide behind the cloak of confidentiality, and to avoid having to justify or defend their yielding to local political pressures. The exercise of undue influence is not deterred by secrecy and confidentiality, but only by openness. Smoke-filled rooms and confidentiality are more likely to allow the ECB mandate and independence to be perverted by national political pressures than openness and the occasional short-term embarrassment that this entails.

Confidentiality of the votes also destroys any vestige of individual accountability of ECB board members. It encourages excessive consensus-seeking and compromise. If enforced, it is likely to greatly enhance the power of the President relative to that of the other members. The only defence of the other Board and Council members against a complete Presidential monopoly of decision-making power is the extensive selective leaking and competitive media briefings that have been a characteristic in the past of the Bundesbank. It is a poor substitute for proper accountability.

There can be no effective accountability if the individual votes are not in the public domain.

Publication of the Minutes

While I believe that the individual voting records should be in the public domain as soon as possible, I also believe that the minutes should be on a non-attributed basis. The reasons for this are practical. Verbatim transcripts, or even selected but attributed opinions of individual members, would kill the usefulness of the Council meetings. Members would come with prepared positions and statements which they would read into the record. There would be no scope for open-minded discussion of alternative courses of action, for 'what-if', counterfactual thought experiments. The formal meetings would become set-pieces, for the record only. The real discussions would move elsewhere, defeating the purpose of the publication of the minutes.

The foregoing is not a valid argument against a form of minutes that presents the key facts and considerations that determined how each of the members voted. The ECB

has decided not to publish the minutes to avoid false signals to financial markets. In the words of Duisenberg: *“If we would do this (publish the minutes), we would influence expectations of the markets ahead of the next meeting. We do not want to do this.”* (Frankfurter Allgemeine Zeitung, Monday 29 June, 1998). By not publishing (non-attributed) minutes that offer a fair summary of the Council meetings, all that is achieved is that informed speculation by market participants is replaced by uninformed speculation. While there are neat examples in non-co-operative game theory of circumstances under which the release of more information worsens welfare, it is very difficult to think of conditions relevant to the setting of monetary policy by the ECB that would cause better and more timely information to worsen economic performance. The argument is wholly unconvincing.

Transparent Outcomes vs. Transparent Procedures

It is not sufficient that the monetary policy actions, that is, the outcomes of the monetary policy process, be transparent. The process itself, that is, the inputs, must be transparent for proper democratic accountability. One sometimes hears the opinion that while the Bundesbank’s procedures are completely non-transparent, the policy actions, or the policy rule adopted by the Bundesbank were completely transparent, and that it is only the actions that matter. I disagree with this conclusion. One cannot have this kind of paternalistic approach to economic policy making in a democratic society. Monetary policy is entrusted to independent central banks as a safeguard against opportunistic behaviour by elected politicians. An independent central bank is a commitment device to ensure that the flexible and powerful monetary stabilisation instrument is not used in the pursuit of short-term electoral or other party-political advantage. The objectives of low inflation, financial stability and sustained growth and employment are best served by removing the interest rate instrument from the rough and tumble of partisan politics. By establishing an independent central bank, executive responsibilities are delegated by the elected political authorities to an unelected body. In a democratic society, such decision making by technocrats is only acceptable and viable if the institution to which these decisions are delegated is accountable to the public at large and to its elected representatives. Accountability is a good in itself, as well as an important instrument for quality control.

The ECB will have to learn that independence, far from being inconsistent with openness and accountability, cannot, in a democratic society, survive without these two awkward customers. The attitude of the ECB is typical of a central banking tradition that views central banking as a sacred, quasi-mystical vocation, a cult whose priests perform the holy sacraments far from the prying eyes of the non-initiates. This mystique of the central bank, and the excessive clubbishness and clannish behaviour, it sometimes encourages, is both entirely unwarranted and a threat to the legitimacy of the purposes the central bank is intended to serve: price stability, preventing and coping with systemic financial risk and minimising the output and employment gaps. The UK arrangements for central bank independence, while far from perfect, are in most respects superior to those likely to be operated by the ECB.

There are signs, however, that the climate of opinion at the ECB may already be changing. While still resolutely opposed to publication of the individual voting records, Mr. Duisenberg has recently expressed his willingness to consider the publication of a summary of the discussion at the ECB Council meetings, a procedure

that could well end up looking rather similar to the way the MPC minutes are prepared at the Bank of England

The Legitimacy of the Transfer of National Sovereignty to the ECB.

Monetary union involves a transfer of national sovereignty to the central or Federal level. Unless this transfer of power is perceived as legitimate by the residents of Euroland, the authority of the institutions of the ECB and the ESCB will be questioned and challenged by those who perceive themselves to be adversely affected by it. Generally in the past, central banks have been created when a stronger and more legitimate Federal governance structure was in place than is currently the case in the EU. There have been exceptions. The seven provinces that formed the Dutch Republic established a monetary union with only the weakest (con)federal political institutions and with almost completely decentralised fiscal authority. Belgium and Luxembourg have been in a monetary union since 1922 without far-reaching political integration.

I have considerable sympathy for the long-standing German position that further political integration should have accompanied (or even preceded) monetary union. On the other hand, the whole European integration experiment, from the Coal and Steel Community on, has been a political wolf dressed in economic sheep's clothing. It has been successful so far, and it could continue to do so. It is essential, however, that the European Parliament act as an effective watchdog over the ECB. Accountability starts there.

The Size of the ECB Governing Council

The ECB Council currently has 17 members, 6 executive board members and 11 NCB governors. If all current EU members join EMU in due course, and if the current rule of a seat for each Euroland NCB governor remains, there will be 21 members. With enlargement to up to 25 EU members in prospect sometime during the next decade, membership would top 30. A group of 17 is already too large for the serious and productive exchange of views, discussion and group decision taking. A squad of 21 will be quite unwieldy. Thirty would be a mob. In contrast, the Bank of England's MPC has 9 members, the FOMC has 12, the 7 Board Members and 5 regional Reserve Bank Presidents. The Bundesbank Council also has 17 members, 8 Board (Directorate) members and the Presidents of the 9 Land Central Banks. This number increased (by 2) with German unification. To remain an effective deliberative body, the one country-one-vote principle will have to be given up sooner rather than later. This of course would require an amendment to the Treaty.

The Lender of Last Resort Vacuum

The words 'lender of last resort' do not occur in the Treaties. Systemic stability issues are not addressed. That is the bad news. The good news is that the Treaties do not rule out the ECB and the ESCB fulfilling the lender of last resort function. There is a tradition among some central banks not to mention the existence of the lender of last resort. Recognising its existence would create additional moral hazard. Bank executives would be encouraged to engage in imprudent and excessively risky financial operations in the knowledge that, should their bets succeed, they will get the reward, while if their bets fail, the central bank and, ultimately the tax payer (including those who pay the inflation tax) will pick up the tab. This seems unduly coy. Bagehot's

lender of last resort only intervenes when there is systemic risk. Individual institutions that are not large or strategic enough to cause systemic risk, can fail. For those too large to fail, the second half of Bagehot's dictum 'in times or crisis, lend freely but at a penal rate' should act as a sufficient deterrent. With liquidity crises that are not also insolvency crises, all central bank financial assistance should be priced painfully. When insolvency is the issue, all private equity must go out before any public money goes in, and all senior management in the rescued institution should have much diminished career prospects in the financial sector.

The information necessary for effective lender of last resort support is likely to be decentralised. The authority to provide financial support must, however, be centralised in Frankfurt. Any action by any ESCB member that has monetary consequences has to be authorised in the centre. This tension between informational decentralisation and centralised authority to extend funds is unavoidable. It will be felt especially acutely during a financial crunch, when decisions have to be made at very short notice. It should not be insurmountable. The Fed, after all, seems to be coping reasonably well.

I hope and expect, that even if they are not telling us about it, the ECB and ESCB are creating the informational and authority chains to effectively implement the lender of last resort function at the level of Euroland as a whole.

The Tension Between Centralised Authority, and Operational and Informational Decentralisation

In the ECB and ESCB there is no role for national central banks in the formulation, design and implementation of monetary policy. Monetary policy will be made by the ECB Council. The 11 NCB governors may get analytical back-up from their NCBs, in order to arrive at a more informed opinion about the decision that is to be made centrally. Similarly, the ECB staff will provide support for the 6 Board members. The fact the NCB governors outnumber the ECB Board members 11 to 6 does not in any way alter the fact that monetary policy is made centrally, and that all policy actions that have monetary consequences (open market operations, foreign exchange sales and purchases, changes in lending and borrowing rates) have to be authorised centrally. The role of the NCBs is reduced to that of providing research support for the national governors and to act as national branch banks of the ECB for the operational implementation of some of the decisions taken at the centre. Mr Fazio's wish for a continued substantial role of the NCBs is an illusion.

The history of the Federal Reserve System provides a warning of what happens when monetary policy authority is decentralised. The proto-confederal structure of the original Federal Reserve System created by Congress in 1913 was replaced through the Banking Act of 1935 by a substantially centralised structure. It took the banking crises of the Great Depression to convince even the Americans of the need for a centralised, unified monetary authority. The most recent example of a supranational monetary system under which substantial policy autonomy resided with the 'regional' or national central banks was the rouble zone of the early CIS. This cannot be said to have been a promising role model.

Why do a number of Euroland NCB governors appear to wish to retain substantial national autonomy in a number of dimensions?

Personnel management issues. One perfectly understandable but quite unacceptable reason is a natural reluctance to contemplate the large-scale redundancies among NCB employees that would seem to be the logical implication of the loss of national monetary policy.

The central banks of most Euroland members appear grossly overstaffed. Figures from the Morgan Stanley Central Bank Directory for 1999 show that the 11 NCBs of Euroland employ more than 53,200 staff. This is 2 percent down on a year ago. The ECB currently employs about 550 staff, but this number is growing quite rapidly. BY comparison, the Bank of England currently employs 25 percent fewer staff than two years ago, at just over 3,100. The reduction in numbers reflects the loss of the Bank of England's regulatory and supervisory functions since 1997. The US Federal Reserve system employs just over 23,200 staff. Only 17,00 of these are Washington based. The rest is employed by the 12 Regional Reserve Banks. Most of the staff is engaged in the Fed's substantial regulatory and supervisory tasks. The ECB of course has none of these.

Some of the central banks of the smaller EMU members (the Netherlands, Austria, Ireland and Luxembourg) have actually increased the size of their staffs in the past years. This is not surprising. In all except Ireland, there has been no national monetary policy and no need to think about monetary policy for many years, with the Netherlands and Austria effectively 'on the D-mark' and Luxembourg in a currency union with Belgium. Now their governors have to contribute to the debate about monetary policy in a large economy that is rather closed to international trade. The experience of a small economy that is very open to international trade is poor preparation for that task. Some serious learning curves will have to be climbed.

National Financial Centre Protection and Patronage

By decentralising the administration of certain monetary policy functions of the ESCB, NCBs can maintain some operational capabilities. National financial centres may benefit from close physical proximity to the NCB charged with these tasks. This form of operational decentralisation is likely to be somewhat inefficient, but otherwise harmless.

Informational Decentralisation for the Lender of Last Resort Role.

Some NCBs have domestic supervisory and regulatory functions. These will be retained. To the extent that the proper exercise of these functions requires actions that have monetary implications (financial support, bail-outs, recapitalisations), the authority for these actions cannot reside with the NCB but must be exercised by the ECB. Information will often be local, and decentralised. Authority will be centralised at the ECB. Over time, as Euroland-wide regulators and supervisors develop and replace the national supervisors and regulators, this problem will become less acute. Note, however, that whenever the central bank and the regulator/supervisor are distinct entities, co-ordination between the agency with the firm-specific information (the regulator/supervisor), the agency with the short-term deep pockets (the central bank) and the agency with the long-term deep pockets (the ministry of finance) will be essential and not straightforward. This will be as true in Euroland as it is in the UK today.

Co-ordination of Monetary and Fiscal Policy

Co-ordination between monetary and fiscal policy in Euroland is likely to be a problem at first. The Germano-Dutch wing of the ECB mistrusts the EuroXI as an attempt to undermine the independence of the central bank. While this concern is certainly not without merit, there appears to be little awareness among the ECB top that independent agents can choose to co-ordinate their actions and that co-operation is possible, and fruitful, even when the co-operating parties have non-coincident, divergent objectives.

Getting the balance or mix between monetary and fiscal policy right is a challenge at the best of times, even when there is a single monetary and a single fiscal authority. Co-ordination between the ECB and eleven national finance ministries will be as much a logistical challenge and a political problem.

The use of fiscal policy for cyclical stabilisation will be severely circumscribed in Euroland until the average budgetary position of the member states is sufficiently below the Stability and Growth Pact ceiling, to allow counter-cyclical increases in public sector deficits to perform their normal cycle-amplitude dampening function. The only alternative would be the non-enforcement of the budgetary ceilings. While some shading will no doubt occur, I anticipate they will be a binding constraint on a number of Euroland governments in the next two years.

Action to ward off an unexpected downturn will therefore have to be taken by the only player with both bow and violin: the ECB. It is therefore most encouraging that its recent action has demonstrated that this new institution can be serious about price stability without suffering from rigor mortis.

Conclusion

EMU will succeed in generating greater Euroland-wide prosperity than would have been likely under any alternative monetary arrangement. As regards macroeconomic stability it will make a modest positive contribution, provided the national countries redesign their automatic fiscal stabilisers to generate more strongly anti-cyclical deficits.

Lower transaction costs and greater price transparency will help complete the single market, limit price discrimination and other restrictive practices. These are worthy and worthwhile gains, but it is unlikely to add up to a hill of beans.

A key issue for the continental EMU members is whether the impetus for structural reform of labour, product and financial markets that was so noticeable in the run-up to EMU will fizzle out now that the prize has been won. There are signs of PMF syndrome or Post-Maastricht-Fatigue syndrome in a number of countries.

EMU does not create a technical, economic case for a greater degree of harmonisation of regulatory, tax and subsidy policies, nor for a larger Federal European budget. The greater market integration due to the gradual implementation of the Single European Act will force national policy makers to harmonise taxation and regulation of highly mobile factors of production. To the extent that EMU is indeed the next step in the

European Federalist agenda, it may create a political momentum towards a greater degree of centralisation or harmonisation of certain aspects of economic and social life. Mr Lafontaine's recent calls for greater harmonisation of taxes on savings and enterprises are unlikely to be silenced. Fundamentally, though, it is the real economic integration delivered by Margaret Thatcher when she signed the Single European Act that will deliver greater tax harmonisation through the markets. Margaret Thatcher as the mid-wife of a federal Europe. Who would have thought it?

References

Klaus Gretschmann [1991], European Monetary Union; Alice in Wonderland or Malice in Blunderland? *Futures*, September.