

**For Release on Delivery  
8:00 p.m. DST  
April 14, 1999**

**EMU AND THE ROLE OF THE  
NATIONAL CENTRAL BANKS IN THE EUROSISTEM**

Remarks by

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prepared for the

Cornelson Lecture in Economics  
Davidson College  
Davidson, North Carolina

April 14, 1999

## **EMU and the Role of the National Central Banks in the Eurosystem**

### INTRODUCTION AND BACKGROUND

It is a pleasure to be with you tonight here at Davidson. I have counted a number of Davidson alumni as good friends and colleagues over the years, but for some reason this is the first opportunity I have had to visit the Davidson campus. I am happy to have the chance to do so this evening even though I have to make a speech to earn it!

As the new millennium approaches, a significant part of Europe has embarked on a bold monetary voyage. This voyage could help determine the course of Europe's economy and the success or failure of its efforts at greater political cooperation and political integration in the 21<sup>st</sup> century. The new European Monetary Union (EMU); its institutions known collectively as the Eurosystem, which include a new European Central Bank (ECB) and the national central banks (NCB) of the 11 member countries; and its new currency, the Euro, have all been launched successfully. Whatever the outcome of this initiative, there can be no doubt that EMU represents a major milestone in the long journey toward greater economic, social, and political integration that began with the establishment of the European Payments Union in 1950 and the European Coal and Steel Community in 1951. Speaking from the perspective of one who studied the early pan-European movement at the University of Strasbourg in France in 1961 and 1962, EMU seems genuinely extraordinary, even though it has taken nearly 40 years to achieve it.

There also can be little doubt that EMU offers participating countries at least the hope and perhaps the prospect of greater economic efficiency and stronger growth over the long haul. The aggregate population of the 11 founding EMU nations (known collectively as the Euro area, the Euro zone or "Euroland"), at close to 300 million, exceeds the U.S. population by approximately 10 percent. And the area's combined GDP – about \$5.7 trillion in 1997 – is only slightly below that of the U.S. Cross-border trade among these countries is already largely open due to earlier steps in the process of European integration. The addition now of a unified currency, and the consequent elimination of exchange rate movements and risk, may well permit European capital markets, now dominated by government debt, to broaden and include much deeper markets in private corporate bonds and equities. Stronger capital markets, in turn, should stimulate structural reform and greater efficiency in the banking system, the traditional source of capital for many European companies. These changes in European banking and financial markets would help sustain the consolidation and restructuring that is already occurring in many European manufacturing industries and some service industries. These structural changes, and the greater competition likely to result from them and from the larger, now monetarily unified market, in principle could benefit ordinary Europeans enormously. The most optimistic supporters of EMU speculate that the greater competitive discipline introduced by the unified currency may force some countries to modify some of their more aggressive income maintenance policies, which in turn could ease fiscal pressures and reduce traditionally high unemployment rates.

But while the prospective benefits of EMU are exciting to contemplate, most

dispassionate observers recognize that the risk of serious economic and political problems in the transition to a unified currency and monetary policy is high. The Euro area clearly does not meet the standards of what economists refer to as an optimum currency area.<sup>6</sup> The economies of the Euro area member nations are quite disparate. The members' respective business cycles are not particularly synchronous, and the economic and social philosophies underlying their respective macroeconomic policies are hardly harmonious.

While these conditions pose risks for EMU, however, by no means do they foreordain failure. The process of convergence<sup>7</sup> prescribed by the Maastricht treaty was explicitly designed to reduce some of the most glaring economic differences among member nations, and adherence to this prescription was quite rigorous. In particular, traditionally high-inflation, high-budget-deficit countries like Italy were forced to fall into line with traditionally low-inflation, low-deficit countries like Germany – and they did so to a remarkable degree during the transition period. Beyond this, many of the world's historically successful monetary unions – with the United States a prime example – do not correspond to anything approaching the theoretical specifications of an optimal currency area.

As has been frequently observed, though, the absence of optimal currency area conditions may be more problematic in practice in the Euro area than it has been, for example, in the U.S. The structure of the Euro area economy remains quite rigid, despite the relaxation of most trade barriers, and this rigidity, as long as it persists, will hinder adjustment to the differential impacts of economic shocks. While capital mobility has increased substantially in recent years, labor mobility remains much more limited

than in the U.S., due to legal, language, and cultural barriers. Moreover, European wages and many final prices are less flexible than their counterparts in the U.S. And the automatic interregional fiscal transfers that accompany and mitigate many "Asymmetrical" economic and financial shocks in the U.S. do not exist to any significant extent in the Euro area and are not likely to be instituted there anytime soon, given the political climate. Finally, and perhaps most importantly, there is only limited popular support for EMU and its institutions at this time. Many Europeans are skeptical about EMU at best, and some are openly hostile since they see EMU as an elitist development designed to benefit primarily corporations and financiers.

Against this background, it seems obvious that if EMU is to succeed, its principal institution, the Eurosystem of national central banks and the new European Central Bank, must operate with high efficiency and effectiveness. And where possible, the Eurosystem must work to neutralize the risks to EMU's success – particularly the lack of broad public support. Tonight I would like to address some features of the Eurosystem that may restrict its ability to strengthen and reinforce EMU and in a worst case scenario could even cause it to undermine EMU. Most of these shortcomings have been recognized by others. I hope, however, to add value to the dialogue by bringing the perspective of a regional Federal Reserve Bank to some of these issues. The Federal Reserve System has confronted many of the challenges that the Eurosystem now faces. I believe – perhaps parochially, but I think accurately – that regional Fed Banks like ours in Richmond have played an important role in meeting many of these challenges and avoiding the unnecessary creation of others.

A DIGRESSION ON THE FED

With this in mind, let me make a few remarks about the Fed, our structure and the way we operate that may be helpful in thinking about the Eurosystem and its prospects. The Fed's structure and functioning, even today, are certainly not flawless. But since the end of the "Great Inflation" of the 1970s and early 1980s, the Fed has built considerable public support and credibility. This credibility has helped the Fed provide a sound monetary foundation for the approximately stable price level the U.S. now enjoys, despite the absence of an unambiguous legislated mandate for price stability.

How has the Fed accomplished this? In my view essentially we have done it by fine-tuning our unusual and, on paper at least, rather ungainly mixture of (1) central and regional elements and (2) public and private elements. Several points need to be made here. First, while the Federal Reserve's structure is indeed federal, the balance of power clearly resides at the center. The Chairman of the Board of Governors, who is appointed by the President of the United States and confirmed by the Senate, is one of the most visible public officials in the country and is clearly the dominant figure in the System. Internally, the Chairman commands and has direct access to the substantial resources of the Board of Governors' permanent professional staff, which positions him to set the broad analytical framework in which monetary policy decisions are made by the Federal Open Market Committee (FOMC), the principal monetary policy-making body in the Fed. Externally, the Chairman can use his frequent appearances before Congress to frame and essentially preside over public debate on monetary policy issues. Experience suggests that the Chairman must be a highly competent professional economist or experienced financier to perform his role effectively, a

condition met for the most part in the U.S. in recent decades. The other members of the central Board of Governors unit, while generally less prominent than the Chairman, also are appointed by the President with Senate confirmation. Like the Chairman, they are permanent voting members of the FOMC and are well positioned to be strong contributors to monetary policy and to play leadership roles in banking and payments system policy formulation and System administration.

In my judgment, the clear mandate given the Chairman and the Board by Presidential appointment, and the ability of the Board to fund its own operating budget outside the regular Congressional appropriations process and without interference from the regional Reserve Banks, are prerequisites for effective central banking in the rough- and-tumble political environment of the U.S. and, more broadly, in the extraordinarily diverse U.S. economic and political system. It is also apparent, I believe, that while a strong and independent Chairman and Board are necessary conditions for Fed success, they are not sufficient. Located “inside the beltway,” the Chairman and the Board, while highly respected, are generally perceived by the public as part of the Washington political establishment. With their necessarily national, aggregate perspective, they may seem remote to dairy farmers in Wisconsin or shopkeepers in Lynchburg, Virginia, despite their efforts to avoid this perception. Because of this, if the Federal Reserve consisted solely of the Board of Governors and its staff, sooner or later, fairly or unfairly, I believe the Fed would be seen as losing touch with rank-and-file Americans and their economic concerns, which could result in a loss of legitimacy in our democratic society.

*The Federal Reserve Banks and Reserve Bank Presidents*

This is where the regional Reserve Banks come into play. To be sure, Reserve Banks are in close and continuous touch with the Board of Governors. But they are also in close touch with their own boards of directors, made up of private citizens who reside in their respective geographic Federal Reserve Districts. Further, Reserve Bank officials regularly address regional and local chambers of commerce and civic groups and participate in sundry community and civic activities, which provide them opportunities to build relationships with private business people and community leaders. These relationships enable the Banks to maintain a fairly comprehensive grasp of economic, banking, and broader financial conditions in their regions that goes well beyond published regional and local statistics. The Reserve Bank presidents summarize this information at FOMC meetings, which nicely complements the aggregate national analysis and data presented by the Board's staff and prevents discussion from becoming unduly abstract. At the same time, however, each Bank maintains a professional economic research staff, many of which include nationally and in some cases internationally recognized economists who publish regularly in leading professional journals and in Reserve Bank Economic Reviews and other publications. The national and international focus of most of these staff members gives credibility to the Fed presidents' comments on national and international as well as regional developments in FOMC discussions.

In the context of the implications of Federal Reserve experience for the Eurosystem, and at the risk of sounding self-serving, I would venture to say that the position and role of the Reserve Bank presidents in all of this is pivotal. The presidents are voting members of the FOMC only every second or third year (with the exception of



the New York Reserve Bank president, who is a permanent voting member), but all attend and participate in all meetings whether they are voting members or not. They are appointed by their local Reserve Bank boards, but their appointments must be approved by the national Board of Governors, and their focus as policymakers tends to be primarily national rather than regional. While the presidents represent their regions in FOMC meetings in the sense of bringing regional information and in some cases their constituents' views to the meetings, they do not typically feel obligated to advocate particular regional points of view or interests. To build on a recent comment by former Federal Reserve Board member Larry Lindsey, because the Reserve Bank presidents are oriented as just described, the FOMC is able to function decisively, as it must – more like a corporate board than a legislature. Since they are geographically dispersed, however, and in direct contact with markets, business leaders, and the general public, the presidents help ensure that decisions are fully informed by the most recent developments and concerns in specific regions and industries as well as by aggregate national data. This dimension of the American monetary policy-making process may appear superfluous from a theoretical perspective, but it is a necessary condition for success in a country that spans a continent and has a sizable number of distinct, not to mention diverse, regions.

In addition to the balance they bring to the internal dynamics of Fed policy-making, the Reserve Banks and their presidents are well positioned to help build and reinforce the credibility of Fed policy in the public mind. Reinforcing credibility is essential in the U.S. environment. While the Fed enjoys a high degree of independence, its legislative mandate for policy is quite ambiguous, particularly with

respect to the weight it should accord price stability versus other macroeconomic goals. Public support for price level stability as a policy goal is only moderately firm in the U.S. Many Americans worry that what they regard as excessive Fed concern with price stability may impose undesirable constraints on the growth of output and employment. What many economists might describe as a naive Phillips Curve mentality seems to be a permanent feature of public attitudes towards macroeconomic policy in the U.S.

It is essential, therefore, that the Fed inform the American people clearly and authoritatively of the benefits of price level stability and the need at times for short-term policy actions to maintain it. Public statements by the Chairman and other members of the Board of Governors obviously play the greatest role in providing this understanding. But through public speeches, publications aimed at non-professional audiences, and newspaper and television interviews, the Reserve Bank presidents and senior members of their policy support staffs can reinforce pronouncements from Washington and clarify them. Reserve Bank officials can tailor their advocacy of price stability to local and regional audiences that often are primarily concerned with local and regional prospects. In addition to speeches, interviews and publications, staff economists at the Richmond Fed and other Reserve Banks actively support private sector and public efforts to improve the quality of economic education in secondary schools and elsewhere.

*Reserve Bank Research Staffs*

Additionally, one of the most important roles the Reserve Banks play in the Fed's overall policy process is bringing alternative analytical models and perspectives to bear on strategic and tactical policy issues. Reserve Banks offer their professional

staffs a fairly unique combination of (1) direct exposure to the national monetary policy-making process through the presidents' participation in FOMC meetings and (2) the opportunity to produce independent basic research on monetary and banking policy issues that can be published in the Banks' Reviews, which are high quality repositories of monetary and banking policy literature. The Reserve Banks are well placed within the System to sponsor longer-term basic research because they are removed from the intense focus on immediate problems and day-to-day interactions with Congress and the Administration that necessarily characterize much of the staff work at the Board of Governors. As a result, Reserve Banks are able to attract capable economists from top graduate programs. Moreover, most Reserve Banks have formal or informal relationships with leading university economists.

The upshot is that many Reserve Bank research departments are dynamic centers of innovative monetary and banking policy research and debate. Through their publications and Systemwide meetings, senior Reserve Bank staff play a crucial role in keeping the FOMC abreast of relevant research in the economics profession at large. Conversely, via their publications and direct contacts, they build credibility and support for Fed policy in the profession. At first blush it might seem that this highly diverse professional research structure and the plethora of Fed spokesmen might undermine the coherence of Fed strategy in the public's mind. This has not been a significant problem in practice. First, the public recognizes that the Chairman is the dominant figure in the System and that only he speaks with full authority for the System as a whole. Second, most informed citizens recognize that the complexity of monetary and banking policy naturally produces diverse views even among experts. Consequently,

they are generally comforted rather than alarmed that most of these views are known to the Fed, since this reduces the probability of major policy mistakes.

## IMPLICATIONS FOR THE EUROSISTEM

Europe has a long and in many respects distinguished central banking history, and Americans like me should offer it advice with considerable humility. On the other hand, the Federal Reserve has 86 years experience conducting central banking operations in a broad and diverse economy approximately equal in scope to the new Euro area economy. Moreover, at least at a superficial level, the Eurosystem's structural combination of central and dispersed elements resembles the Fed's structure. So it seems reasonable to draw on the Fed's experience to suggest ways in which the new Eurosystem may enhance its prospects for success.

### *Eurosystem Essentials*

Perhaps the most striking features of the Eurosystem are its unambiguous mandate to achieve and maintain price stability and its high degree of independence. The Maastricht Treaty states unequivocally that "The primary objective of the Eurosystem should be to maintain price stability." The Treaty permits other goals, but stipulates that their pursuit is to be "without prejudice to the objective of price stability."

In addition, the Treaty prohibits the NCB governors (who are comparable to the Fed Chairman in their respective institutions) from taking instructions from their governments in discharging their Eurosystem responsibilities, and states that the signatories have "undertaken" to respect this principle.

As one commentator put it, this is "independence with a vengeance." What remains a question, however, is whether the Eurosystem's institutional structure and

public support will allow it to exploit this independence effectively in practice over the longer run and provide the Euro area with a solid foundation for growth and prosperity.

The Eurosystem's structure – at least on paper – might reasonably raise concerns about its future prospects. In fairly sharp contrast to the Fed, the Eurosystem's central unit, the ECB and its Executive Board – again, on paper – appear relatively weak within the structure. The system's principal monetary policy-making body is the Governing Council, comprised of the six-member ECB Executive Board (which includes the ECB president and vice president) and the governors of the 11 member country NCBs. Unlike the FOMC, where voting Reserve Bank presidents are in a permanent minority, all 11 NCB governors are permanent voting members of the Governing Council and are therefore a permanent majority on the Council. Further, the NCB governors set the salaries, benefits, and other conditions of employment of the members of the Executive Board. Of particular importance, in my view, the NCB governors determine the ECB's operating budget and hence its access to staff and other resources. With these points in mind, some might argue that, in fairly sharp contrast to the Fed, the balance of power in the Eurosystem rests with the dispersed elements rather than the central element.

Finally, in contrast to many other central banks including the Fed, the ECB does not play a role in either bank supervision and regulation or emergency credit extensions, which remain the province of the NCBs. While the Reserve Banks participate importantly in each of these areas, the Board of Governors has final authority and exercises it actively. (As an aside, the Board has taken a keen interest

recently in ensuring that Reserve Banks effectively coordinate their examinations of the emerging large megabanks that operate in two or more Federal Reserve Districts. This is an issue the Eurosystem may confront as EMU stimulates additional cross-border bank merger activity.)

The relative weakness of the ECB within the Eurosystem, at least from a formal structural perspective, has prompted some observers to compare the Eurosystem to the early Federal Reserve System where power was lodged in the Reserve Banks – especially a subset of them led by the Federal Reserve Bank of New York. Milton Friedman and Anna Schwartz famously attributed the Fed's ineffectiveness during the Great Depression to this leaderless structure following the death of the great New York Fed president Benjamin Strong. My colleague Marvin Goodfriend has suggested that this comparison may cast the Eurosystem in too harsh a light. As Goodfriend points out, the Eurosystem does, after all, have a truly unambiguous price stability mandate enshrined in a prominent international treaty. Further, partly because of the experience of the Depression and the analysis it stimulated, there is now a much richer body of knowledge about monetary policy and its pitfalls.

Still, the Eurosystem structure is worrisome. In particular, some of the NCBs have limited experience in conducting independent monetary policy. Managing this risk well, as I see it, is one of the keys to success.

#### *Conditions for Success*

The Eurosystem must – in my opinion – reinforce some of its institutional features and adopt certain routine operating practices if it is to meet the challenges it will face with full success. Permit me to list some of the more important of these in

closing. Again, I offer these suggestions with humility; but I also offer them with the conviction born of nearly 30 years of service at a regional Federal Reserve Bank.

First, the Governing Council and its NCB governor majority must act to strengthen the real authority of the ECB and its president. It is difficult to see how the Eurosystem can build credibility for EMU and its monetary policies unless the Euro area public has a clear sense of affirmative leadership at the center. Moreover, if the Governing Council is to meet the challenge of producing a viable monetary policy for all of the Euro area, it will have to function effectively, which means achieving consensus within a group virtually certain to reflect a wide range of conflicting viewpoints.

If FOMC experience is any guide at all, achieving consensus will be challenging. This is all the more likely in that the NCB members of the Council represent sovereign nations. While the Maastricht Treaty, as noted earlier, proscribes member government efforts to influence their NCB representatives, only the very naive will be sanguine about the effect of this stricture in practice. Two steps that would facilitate consensus building at any particular point in time would be (1) establishing a highly competent and adequately manned professional ECB research staff and (2) using this staff to develop, in conjunction with existing NCB staffs, a state-of-the-art analytical framework for Eurosystem policy deliberations. Above all, the Governing Council should allow the designated Eurosystem leader, the ECB president, to be the leader in fact, both internally in Governing Council deliberations and externally as the System's dominant spokesman in relations with other European organizations, member governments, and the Euro area public.

Second, in addition to strengthening the ECB and its president, I respectfully

suggest that the NCBs and their representatives on the Governing Council need to function more like Federal Reserve Banks and their presidents than they might naturally be inclined to. I say this not out of excessive pride in the role of the Reserve Banks and the presidents, but simply because the NCBs and their leaders now confront circumstances quite similar in many important respects to those the Reserve Banks confront. In no sense does this imply that the NCBs should become fundamentally weaker elements of the Eurosystem. On the contrary, NCBs must continue to monitor and analyze economic conditions in their respective member nations, and they must present this information accurately and objectively in Governing Council meetings. Beyond this, however – and this may be the most challenging part – the NCB governors will need to develop a Euro area-wide perspective that transcends narrow national interests and focuses on the determination of policies in the best interest of the Euro area economy as a whole. The unified analytical framework I suggested earlier would facilitate this transition. Further, the NCB governors should present this perspective and “sell it” to their respective national governments and publics. In short, the NCB governors, like the Reserve Bank presidents, must not only represent their respective regions – in their case countries – in the Eurosystem, they must also represent the Eurosystem and its policies in their countries.

Finally, I believe a greater degree of transparency would strengthen the Eurosystem and its public support. Federal Reserve transparency has increased in recent years and has served us well. We now announce FOMC policy changes immediately after they are made. We release relatively complete minutes of FOMC meetings, including individual member votes, about six weeks after a meeting. The



Chairman testifies before Congress more frequently and on a wider array of topics than in years past. And with the rapid growth of new financial news media, the public comments of Fed governors, Reserve Bank presidents, and other senior Fed officials are much more widely disseminated than before. Even so, an argument can be made that still greater Fed transparency, such as earlier release of the minutes, is desirable.

As is well known, the Maastricht Treaty imposes only limited reporting requirements on the Eurosystem – namely quarterly and annual reports to the European Parliament. This appears to reflect in part a laudable desire to insulate the NCB representatives from political pressure from their respective governments. The cost, however, could be a broad perception among member state publics that the ECB and its monetary policy process are remote, secretive, and elitist. Ultimately, such sentiment may be the greatest single threat to the success of EMU. The ECB president currently holds a press conference immediately following the first Governing Council meeting each month, which helps clarify and explain Eurosystem policy decisions – a highly useful practice in my judgment. There are no plans, however, to publish minutes of Governing Council meetings nor to make public the votes of individual members. In my opinion, the latter two steps would help convey to the public a reassuring sense of the reasoning and debate in the Governing Council.

At the beginning of my remarks I pointed to the broader economic and political challenges EMU will have to meet if it is to succeed. As daunting as many of these challenges are, I am optimistic that the Eurosystem and EMU *will* succeed, if only because at this late date a reversal of the steady progress toward greater European integration would be a highly undesirable development from any number of

perspectives. Almost a century of Federal Reserve experience demonstrates that attention to the suggestions I have offered would accelerate the process of achieving a smoothly functioning Eurosystem and make the transition considerably less risky and difficult.