

The role of national central banks within the European System of Central Banks: The example of De Nederlandsche Bank

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Abstract:

This paper considers the position of national central banks within the ESCB. The fundamental framework underlying the ESCB is that of a system of central banks in which component institutions are individually and collectively responsible for carrying out various tasks. Within this framework, we evaluate the current division of labour between the ECB and NCBs using the concept of efficiency (which subsumes cost-consciousness as well as effectiveness), along with that of subsidiarity. In contrast to most of the existing literature, the focus is not exclusively on monetary policy, but takes into account a broader array of tasks performed by central banks. Taking a long-run perspective, it is argued that while some tasks are likely to be centralised, fundamental changes in the role of NCBs in the ESCB are linked to further political integration within Europe and the development of supranational institutions in other policy areas.

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1 Introduction

Monetary policy is one of the few areas of European integration where there is a genuinely supranational policy. In considering the role of central banks in general, the main focus of authors is typically on monetary policy (e.g. Fischer, 1995). The same focus is evident among those who have considered the role of national central banks within the European System of Central Banks (ESCB).¹ Seen from this perspective, the transfer of monetary policy sovereignty from individual countries to the European level since 1999 has raised questions about the ongoing role of national central banks (NCBs). However, central banks also have a number of other tasks. This paper takes a broader perspective and considers the position of NCBs in the context of the ESCB with respect to the full range of tasks carried out.

In analysing the distribution of ESCB tasks between the European Central Bank (ECB) and NCBs, We set out a number of criteria to evaluate the division of ESCB tasks, review the current assignment of tasks and consider how they are likely to change in the future. Moreover, NCBs also fulfil non-ESCB tasks. For De Nederlandsche Bank (DNB), these non-ESCB tasks span a wide range of policy areas that are indirectly related to our ESCB responsibilities and occupy around 50% of staff.² These tasks are not specified by the Maastricht Treaty, but are agreed upon with the respective national governments. The role of NCBs in carrying out these other tasks is discussed, using the example of DNB.

To preview the conclusions, our current system is likely to continue to evolve over coming years as we gain experience with monetary union and efficiency gains are exploited. As long as nation states remain in existence, it seems unlikely, for various reasons, that the role of national central banks will alter completely.³ Although major changes in the way in which the system is organised can be expected, most of them are only likely in the long term, by which we mean more than a generation.

The paper continues in Section 2 with a discussion of the criteria proposed for evaluating the distribution of central banking tasks within the European context. Section 3 discusses the current role of

¹ See, for example, DNB, 2000 and Goodfriend, 1999. For convenience, and consistency with the Treaty, the paper refers to the ESCB (which includes all EU central banks), even though some EU countries have not adopted the euro.

² In this regard, we also count tasks such as banking supervision as 'indirectly related' to monetary policy, as is explained below in Section 4.2. Note, however, that not all NCBs perform this task.

³ The conference theme concerns a Europe of regions. Regions can obviously be defined in different ways. Regions which are economically integrated need not necessarily correspond to the geographic boundaries of nation states (which form political regions). However, NCBs are linked to nation states. Given that, the regional analysis in this paper is linked to political regions.

NCBs within the ESCB and the possible future evolution of these tasks. Section 4 discusses the non-ESCB tasks that DNB is responsible for and Section 5 summarises the main findings.

2 A framework to analyse the division of tasks

Ideally, a ‘normative literature’ on central banking would provide guidance on what central banks should be doing, including (i) the tasks the Eurosystem should be fulfilling and (ii) an optimal division of these tasks between a centre (the ECB) and national central banks. Such a normative literature on central banking is, however, lacking. Instead, we establish some criteria against which the current division of tasks can be assessed. In the European context, the Maastricht Treaty forms the basis for the current assignment of tasks. It is based on the idea that the ESCB as a system shares a number of tasks. Given this common responsibility, all participating central banks – be it the ECB or NCBs – have to be involved in all relevant policy areas. In addition, all participating central banks have to have the means to fulfil these tasks for which they are collectively responsible. Within this overriding framework, the Treaty refers to two broad principles: first, the idea of subsidiarity, i.e. the current system was created out of respect for national sovereignty within some basic rules set by the EU, and not on the basis of better co-ordination or centralisation per se. This also reflects the heterogeneity of the member states. Consequently, any task should be performed at the lowest regional level possible and there are limits on the extent to which national tasks can be centralised. Second, the Treaty emphasises the idea of efficiency, i.e. where can the task be effectively undertaken at the least cost?⁴ There is a relationship between both principles, in that subsidiarity (and the benefits that come with it – see below) should prevail, but gross inefficiencies should be prevented or eliminated.

The Maastricht Treaty specifies the tasks to be carried out by the system, but in most cases is not specific about which part of the system should undertake them. The following sections consider the extent to which the allocation of tasks conforms with the subsidiarity and efficiency criteria proposed. The concept of effectiveness subsumed in the efficiency principle includes, inter alia, the following aspects:⁵

- A system of checks and balances form part of ensuring the accountability of independent central banks. Because the ESCB independence is contained in an international treaty, unlike other central banks where independence can be overturned by a parliamentary majority, accountability arrangements are particularly important as a counterpart to this independence. The lack of credible

⁴ This principle has also been stressed by the ECB. See European Central Bank, (1999), p. 57. A framework based on similar considerations has also been proposed for the re-organisation of the Bundesbank after the adoption of the single monetary policy. See Koesters et al. (2001) and Deutsche Bundesbank (1999).

⁵ Note that not all of the aspects of effectiveness discussed here are relevant for every task carried out by NCBs.

accountability arrangements could undermine public and political confidence in the monetary union and therefore the effectiveness of monetary policy.

- One of the key ‘ingredients’ for monetary policy is the accurate assessment of market sentiment and expectations, and of economic developments. A system of NCBs spread across Europe can potentially provide a better picture of sentiment within the entire euro area than a single, centralised body.
- NCBs are important channels for ESCB communication, as they are more closely linked to their national audiences. They are more aware of national traditions, cultures and histories, and can therefore potentially better tailor communication to the needs of the local population. Moreover, it may be particularly ‘reassuring’ for the public in countries where economic developments diverge from the euro area average if ‘their’ NCB governor is seen to participate in the formulation of the single monetary policy, even though the governor’s decisions are based on euro-wide considerations. These national governors are then better able to explain the consequences of European monetary policy.

The above-mentioned framework can be used to assess the allocation of Treaty tasks between the ECB and NCBs. Throughout the analysis we first examine the current situation and then consider likely changes in the future.

3 The division of ESCB tasks between ECB and NCBs

3.1 *Monetary policy decisions*

Monetary policy making covers a number of aspects. This sub-section discusses the role of NCBs in decision making, in research activities underpinning those decisions and in the communication of decisions.

The Treaty provides that the meetings of the ECB Governing Council (which formulates monetary policy) are to be prepared by the Executive Board of the ECB. The main task of the ECB in this respect is to lay the groundwork for the monetary policy decisions of the Governing Council. NCB governors (together with ECB Executive Board members) decide on monetary policy, requiring the NCBs to brief their governors (and this briefing has to be an interactive process) so that they can carry out this joint responsibility. NCBs are therefore involved in research and the preparation of monetary policy decisions.⁶ That is, the need to conduct independent research *inter alia* arises from the obligation NCBs have to fulfil their role in carrying out the tasks the ESCB as a system has been assigned. Cer-

⁶ NCBs are also involved in the preparation of monetary policy via their participation in the ESCB Monetary Policy Committee, which *inter alia* prepares the economic projections of the euro area.

tainly for NCBs such as DNB, which prior to EMU had maintained a fixed exchange rate vis-à-vis the Deutschmark, monetary policy preparation has become more complex. It now requires the analysis of economic variables and monetary indicators for the euro area as a whole.⁷

These current arrangements are explicitly set out in the Treaty, so are fixed for the time being. However, the composition of the Governing Council has been the subject of debate, with some arguing for limits on the number of NCB governors. It has been argued that decreasing the numbers of national governors may increase effectiveness, since having 12 NCB governors participating may exceed the optimal 'club size' for monetary policy decisions.⁸ This could make it difficult for the Council to engage in effective debates over policy decisions and hamper the development of a cohesive decision-making body. A further argument against including all NCB governors is that the Eurosystem has to guard against the perception that European monetary policy could be sub-optimal for the following reasons (e.g. Baldwin, 2001):

- National interests could dominate decision-making.⁹ This could be the case if NCBs governors regard themselves as representing the monetary policy requirements of their home country, rather than basing their decisions on the euro area as a whole.¹⁰
- If euro area countries are very heterogeneous, competing national interests could offset one another and result in a bias against changing interest rates. This could make it difficult to reach a decision to change interest rates in the Governing Council.¹¹

Despite the above arguments, we consider a Governing Council without adequate representation of NCB governors as unwarranted for a number of reasons. First of all, NCB members of the Governing Council do not consider themselves to be representatives of their home country. Second, their removal runs counter to the criteria set out in Section 2. In particular, it conflicts with the notion that all NCBs must contribute to the maintenance of price stability and the other tasks of the ESCB. Broad participation in decision-making is a part of the checks and balances that are a necessary counterpart to the

⁷ See also De Nederlandsche Bank (2000), p. 26.

⁸ This holds all the more in an enlarged EMU with more than 20 member states.

⁹ Berger and de Haan, 2002 and Meade and Sheets, 1999.

¹⁰ In fact, small, open countries have a natural inclination to make decisions on the basis of the euro area as a whole – possibly more so than large countries. A strong and successful European economy is of particular importance for smaller members of the euro area. For example, if euro area decisions were based only on Dutch circumstances, this would eventually have negative consequences for the euro area as a whole and therefore for the Netherlands.

¹¹ See Aksoy et. al. (2002).

independence of the ESCB. Third, the quality of policy debates in the Governing Council could be adversely affected if the number of NCB governors was to be reduced. The argument runs as follows: economic theory suggests that competition typically leads to higher efficiency. Competitive pressure on the centre (ECB) regarding research and the preparation of monetary policy decisions is provided by the NCBs to ensure that monetary policy remains innovative and e.g. incorporates the latest academic insights. It also ensures that decision-makers are exposed to alternative academic paradigms: 'Every research department ... is at risk of developing a dominant 'in-house' view that is intolerant of challenges to the local orthodoxy. It would be unfortunate for the citizens of Euroland if all ... Council members drank only from the same fount of economic wisdom.'¹² Finally, as noted above, monetary policy requires the accurate assessment of market sentiments and expectations. Here NCB members of the Governing Council play a vital role, as they have a 'regional information advantage' and can – helped by the fact that they have at their disposal established organisations – typically provide a better assessment of the situation in their home country.¹³ This local knowledge is also important in the communication of monetary policy decisions to the public. Here there is a role to be played by national central banks, as communication is facilitated by a better knowledge of languages, regional institutions and particular circumstances.

In summary, monetary policy decision making within the ECB Governing Council should therefore be characterised by a team effort with a strong, but not dominant centre. Interest rate decisions are based on input provided by both the ECB and NCBs. At the same time, to ensure that the public understands that monetary policy is based on the entire euro area, NCBs must be careful not to overemphasise country-specific needs.

It is possible that in the long run, integration and trade links within the enlarged EU will reduce diversity and reduce the argument for NCB input in decision making based on their regional information advantage. However, even if this were to occur, in our view, the argument for reducing NCB input so as to improve efficiency is outweighed by the benefits provided via competition, the contribution to the checks and balances of the ESCB and their role in communication.¹⁴ Also, to a large extent it re-

¹² See Buitter (1999).

¹³ See Goodfriend (1999).

¹⁴ This does not exclude the possibility that, for practical reasons, the number of NCB Governors in the Governing Council may be limited at any point in time (e.g. subject to some form of rotating scheme) following euro area enlargement. Nevertheless, were this to occur, it would be important for NCBs to continue to participate in the Council to the fullest extent possible in order to be able to effectively contribute to the tasks of the ESCB.

sembles the setting in the US, which indicates that in other monetary unions regional participants also play an important role.¹⁵

3.2 Monetary policy implementation

The Treaty requires the ECB's Executive Board to 'implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council.'¹⁶ Consistent with the subsidiarity principle, monetary policy operations are co-ordinated by the ECB and the transactions are normally carried out by the NCBs (European Central Bank, 2001a). The decentralised operation also reflects a philosophy of allowing broad participation in monetary policy operations: all financial institutions subject to minimum reserve requirements in the euro area are able to participate in standard open market operations and access our standing facilities.¹⁷ For the Netherlands, this means that around 85 institutions can participate in tenders, and around 5–10 regularly do so. Within the euro area as a whole, between 300–400 banks currently participate. This contrasts with the system operated in other countries (such as the US), where participation in open market operations is limited to a few large players. In the latter systems, the transmission of monetary policy to a broad range of financial institutions occurs mainly via the money market. Both systems are possible. Perhaps the most important difference is that the system used by the Eurosystem differentiates less between types of market participants. Financial institutions are able to decide for themselves whether or not to access funds from the central bank or the market. This also allows monetary policy to more directly influence a greater number of financial market participants, without being completely dependent on the interbank market.

At the same time, the decentralised implementation ensures an element of continuity for counterparties to the operations in that they continue to hold accounts at their national central banks. The decentralised approach also embodies an element of insurance against disasters, by ensuring that the system has the ability to implement policy from locations across the monetary union. Finally, the approach fosters ongoing contact between NCBs and market participants which is useful in the formulation of monetary policy and, in the case of some NCBs (including DNB), can assist in the exercise of the supervisory responsibilities.

Given the philosophy underlying the system, we do not see any scope for significant changes here in the short-term. This would also run counter to some of the criteria set out previously, notably the need to accurately assess market sentiment and the relevance of NCBs for communication. In the long term,

¹⁵ See, for example, Goodfriend (1999).

¹⁶ Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 12.1.

¹⁷ See ECB, 2000.

if there is increasing consolidation within the banking sector that reduces the total number of banks, as well as an increase in cross-border mergers, the usefulness of implementing policy from every central bank may diminish. If that occurs, it is possible that operations might be centralised in one or a few locations.

3.3 *International co-operation*

With regard to international co-operation, it is necessary to distinguish between ‘European’ and ‘national’ responsibilities: European responsibilities relate to matters that are of importance to the entire Eurosystem, whereas national responsibilities are linked to national institutions or governments. The Treaty states that the European Central Bank should be the system’s representative vis-à-vis third parties. The Governing Council, as the key decision-making body of the ECB, decides how this is arranged in practice. For most European issues, the ECB president would normally fulfil this role. But, the Council can decide that others should also act as the representative where this is desirable, or that national representation is more appropriate.

However, not all external representation involves European issues. National central banks are the agents of governments, and to the extent that international responsibilities are linked to national sovereignty, these responsibilities remain at the respective NCB. An example is IMF membership: nations are members of the IMF, represented by their central banks and/or finance ministries, so NCBs are often involved in the preparation of IMF-related activities. The international network that NCBs have can in turn be beneficial for other tasks. Given the fact that national interests can diverge across EMU members, this set-up can be regarded as appropriate. NCBs are also represented directly at (and are shareholders in) the Bank for International Settlements (BIS). The BIS is not only a bank, but also provides a forum to discuss a range of issues, including those relating to financial stability. As is discussed below, this is a national responsibility. Given that we are a shareholder in the BIS, and that the topics discussed in BIS forums relate to our areas of responsibility, it is logical for NCBs to remain actively involved in BIS forums.

In the long run, as European integration proceeds, European interests will increasingly replace national interests. There will be less need to pursue purely national policies vis-à-vis the outside world in some areas. The speed at which this internationalisation occurs will probably vary across issues. If European integration also moves towards political union, it makes sense to de-couple representation of the member states from the nations and to transfer it to an European institution. That is likely to mean that the ECB, and therefore its president, would have an increasing role as the public face of the ESCB. If national representation were to be centralised at the European level, governance arrangements of some international organisations may need to be adjusted to reflect this. A single European representative in the IMF, for example, would imply that both the European and the US representatives have blocking votes. Such an arrangement could hamper the effective working of the IMF.

3.4 Foreign exchange operations and reserves management

The Treaty provides that the ESCB is responsible for conducting foreign exchange operations and managing the official foreign reserves of member states. To avoid conflicting policy messages, the Treaty also provides that foreign exchange transactions should take place within a common framework.

Key reasons for central banks to hold foreign reserves are to ensure that they have the ability to intervene in foreign exchange markets if necessary – e.g. to smooth exchange rate fluctuations or in reaction to financial crises. All members of the ESCB own foreign reserves. Those of the ECB are managed on its behalf by NCBs.

Foreign reserves and a central bank's net worth represent a part of the wealth of a nation and are therefore owned by the nation. Accordingly, there is no particular need to transfer the ownership of these assets. However, the question of who should manage these funds on behalf of a country is open to debate. Currently NCBs are responsible for managing these funds and do so according to their own risk preferences. Nevertheless, these reserves could in principle be centralised and managed by the ECB (or a private sector asset manager). The ECB (or a private sector manager) would then effectively be acting as an agent for NCBs.

However, there are economic arguments against the complete centralisation of reserves management: given the substantial value of these reserves, a common reserves management is not necessarily optimal. The risks of pooling such a large fund can be spread if each NCB manages its own reserves. The potential benefits from the reduction in risk may therefore outweigh the additional costs of the decentralised reserves management (consistent with the concept of effectiveness set out in Section 2). Moreover, managing reserves deepens our knowledge of financial market developments, which assists in carrying out our other tasks. However, this argument should not preclude co-operation with another NCB or the ECB where an NCB lacks sufficient economies of scale to carry out the task efficiently. NCBs currently also manage the reserves of the ECB – this involves only marginal additional costs for NCBs and means that the ECB does not need to duplicate the reserves management expertise that already exists in the system. However, at some point, it is likely that the ECB will manage its own reserves, thereby gaining the benefits of additional market contacts. In making decisions on this issue, the Governing Council will consider the costs and benefits for the system as a whole.

In the long run, the arguments against centralisation of all reserves are likely to remain valid. Scope for complete centralisation therefore seems small.

3.5 Statistics

According to the Maastricht Treaty the ECB ‘...shall collect the necessary statistical information’ to fulfil its tasks, but the Treaty stipulates that the tasks should be decentralised ‘... to the extent possi-

ble'.¹⁸ Monetary statistics are collected by NCBs, as the collection of data typically involves close contacts with commercial banks. In a situation where NCBs are responsible for both the implementation of monetary policy and prudential supervision, the efficiency criterion of Section 2 implies that it is clearly more efficient for the NCB to collect monetary statistics. Otherwise, another statistical agency would also have to establish and maintain contacts with commercial banks. To the extent that NCBs collect statistics on national data, it seems reasonable that this should remain a national task.¹⁹ There seems little scope for gain from centralisation.

Some NCBs also collect or compile non-monetary national statistics. DNB does this for balance of payment statistics as most of these data are also obtained from commercial banks. Although this task could in principle be transferred to the national statistics institution, there is no indication that they would be any more cost-efficient than DNB, given the natural links we have with commercial banks.

Over the long term, if national borders become less important from an economic perspective, the arguments for national collection of data diminish. It seems, however, unlikely that all statistics collection activities could be efficiently centralised in one location (given the size of the bureaucracy implied), but some clustering into regional groupings could occur. Closer political union would also presumably result in some clustering or centralisation of statistics gathering, as some countries might wish to centralise their statistical activities.

3.6 Operational tasks: Payment systems and banknotes

Operational tasks remain within the domain of the NCBs. As the banker to banks, central banks have typically provided facilities whereby banks can settle debts amongst themselves. Payments to and from the government are also often channelled through the central bank (as banker to the government). A further reason why central banks provide services in this area is to ensure financial stability. Because payments systems form a link between financial institutions, there is a risk that instability can be transmitted via these systems. By providing payments systems, central banks minimise that risk.

Payments systems differ across the euro area. In this context, it is useful to make a distinction between wholesale and retail systems. An integrated wholesale system was necessary for the introduction of the common monetary policy. To meet this requirement, the Eurosystem has developed the TARGET system. Each NCB has its own wholesale payment system, based on their existing technologies, and the European payment system TARGET provides a common interface. TARGET works effectively as one pan-European system, but national differences remain. There is also a link in this area to monetary

¹⁸ See Art. 5 of the Protocol on the Statute of the European System of Central Banks and of the European Central Bank.

¹⁹ Language differences also play a role here.

policy implementation. Institutions subject to reserve requirements are required to hold reserves at the NCB in the country in which they are established. Similarly, they participate in monetary policy operations via that NCB. This necessitates the provision of some form of payments system by NCBs.

Looking ahead, further harmonisation of the TARGET system is likely in coming years, although the exact form that this will take is not yet clear. In this respect, there are three important factors that will determine how payments systems are organised in the long term: (i) the desires of customers (i.e. commercial banks), (ii) competition and (iii) technology.

- i. Customers' wishes differ somewhat. Some large banks that operate across Europe are keen to see the introduction of a completely centralised system. That reduces their need to deal with different national central banks and different payments systems. On the other hand, those banks which focus mainly on national markets are less interested in seeing greater European harmonisation that would entail (potentially costly) changes.
- ii. Competition is less of an issue with wholesale payments, given the need for systems that ensure financial stability (implying a continued role for central banks). However, we do need to ensure that the services we offer to banks do not take advantage of any monopoly power that we have.
- iii. Although we cannot be precisely sure how the wholesale payments system will develop, it is clear that technology provides us with increasing options. For example, it is possible to envisage a system that is more harmonised than the current system, but nevertheless allows for some national variation to reflect the different desires of customers in different countries.

Using the criteria of Section 2, it seems likely that, in the long term, the efficiency argument would imply a further consolidation in the area of wholesale payment systems. An important determinant of the speed of this process is trends in the banking and finance system. To the extent that there is a significant consolidation of banks, and increasing numbers of banks operating across the euro area, there may be less demand for national differences in payments systems. Integration of stock markets and other exchanges also increases the demand for harmonisation. These factors could eventually lead to some or all NCBs ceasing to offer payments systems.²⁰

In contrast, central banks are often not directly involved in the provision of retail payments systems. Instead, they typically act to promote market solutions. Cross-border retail payments in the form of credit transfers are made via correspondents (sometimes in a multilateral context in the form of 'club' arrangements), or the commercial banks' own networks. These payments are relatively expensive, especially for small amounts.

²⁰ That could also have implications for the decentralised implementation of monetary policy.

For the future of retail systems, the role of central banks is less relevant as they do not provide the systems here. On the other hand, competition may play more of a role. That is already evident in the Netherlands where currently a single provider of clearing services operates between banks, although another provider is considering entering the market. There is clearly more scope for cross-border services to develop. That is beginning to occur. The EU has recently decided that cross-border payments within the euro area must be provided for the same price as payments within a country. This decision is likely to stimulate the provision of cross-border services. Here commercial banks need to consider how to balance the competing demands of those customers predominantly interested in making payments within a country and the costs that are incurred to accommodate those wanting cross-border payments. To be cost-efficient, a completely integrated clearing system would require countries' payments systems to be more harmonised (e.g. with regard to the use of instruments such as cheques and giro payments). Reaching agreement on how to proceed will take time and the ESCB has a role to play in encouraging and supporting further progress.

Finally, it is also important to consider the more physical side of the operational tasks, i.e. the production and distribution of banknotes. It is clearly not efficient to centralise all operations in one location, for instance with regard to the sorting of banknotes. On the other hand, the production of banknotes is an area where further rationalisation is possible and where considerable efficiency gains can clearly be achieved for the system as a whole, as can be seen by a comparison between the number of staff involved in this task in Europe and the number involved in the US. In addition, the introduction of a common currency suggests that the distribution of banknotes can be rationalised across the monetary union as a whole, rather than being based within individual countries. Market participants are already calling for discussions on this issue and we need to continue to work with them to arrive at sensible solutions.

4 National tasks – responsibilities of DNB outside the ESCB

As is the case for other national central banks within the ESCB, DNB carries out a number of tasks that do not fall under the provisions of the Treaty of Maastricht. Cross-country differences between NCB activities in this area reflect different preferences and traditions regarding the organisation of these tasks and whether they have been allocated to the central bank or not. Although emanating from a national responsibility, these other tasks are generally related to monetary policy and allow synergies between the various tasks to be exploited.

In this Section we use DNB as an example to illustrate national duties. The key non-ESCB tasks of DNB cover financial stability, prudential supervision and our role as an independent economic advisor

to the Dutch government.²¹ As noted above, some of our statistical functions and parts of our role in international co-operation also fall outside the framework of the ESCB.

For these non-ESCB tasks, the relevant question to consider is whether these national tasks can best be carried out by a (national) central bank or by another national and/or international institution. This Section will focus on financial stability, banking supervision and our role as an independent advisor.

4.1 Financial stability

The Treaty specifies that ‘the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities related to the ... stability of the financial system.’²² Financial stability is a responsibility that brings together a number of the key tasks of central banks – including monetary policy, banking supervision and payments systems.²³ Because monetary policy is implemented via financial markets, financial stability is required for the effective implementation of monetary policy. Payments systems also have an important link with financial stability in that they can be a transmission channel for financial instability. For those NCBs with an involvement in banking supervision, there is a further link, as the soundness of individual financial institutions is obviously relevant for the stability of the entire financial system. Given these links, all NCBs have a competence in the area of financial stability – even where that is not explicitly set out in national legislation. In fact, central banks are unique in that they are entrusted with an array of interrelated tasks that gives them a broad oversight of the financial system from these various perspectives. That implies that they have a competitive advantage in ensuring the stability of the financial system.

In some countries, authorities other than central banks also have a responsibility for financial stability. Given the Treaty requirement that the ESCB is also involved, those non-central bank institutions have a responsibility to work together with the ESCB to ensure that we can fulfil the task allocated to us. The increasing integration between financial systems (both cross-sector and cross-border) requires close co-operation and information exchanges between all institutions with a responsibility for financial stability.

At present the financial stability task is mainly national in character, with countries taking responsibility for markets in their jurisdiction. At the same time, international meetings and ESCB networks provide the opportunity to exchange information and views. Where necessary, international co-operation

²¹ Additionally, together with the Minister of Finance, DNB provides reinsurance of foreign payment risks for exporters and importers.

²² Protocol on the Statute of the European System of Central Banks and the European Central Bank, Article 3.3.

²³ These issues are discussed in more detail below. Note that although not all central banks have explicit banking supervision tasks, their involvement in financial stability means that they have to take a close interest in it.

can be readily arranged to ensure the stability of the financial system, as was evident in September 2001. But, as globalisation of financial markets and financial institutions continues, the international character of this task will become increasingly apparent. As internationalisation continues, we will have to consider whether some form of European financial stability forum, or a broader co-ordination mechanism such as a world-wide forum, is the most effective way forward. At the moment, such international forums provide for the exchange of information, but they respect national responsibilities in this area. Whether and how that might change in the future is unclear.

4.2 Banking supervision

As with financial stability, the Treaty provides that the ESCB shall contribute to the conduct of policies pursued by the competent authorities relating to prudential supervision.²⁴ In contrast to the situation for financial stability, not all NCBs are the leading authority for prudential supervision in their countries. But, by explicitly assigning a role to the ESCB, rather than to the ECB, the Treaty gives all parts of the system a role in contributing to prudential supervision. This institutional set-up requires a creative solution to allow the various players to each fulfil their role.

This sub-section briefly reviews two issues: (i) the arguments surrounding whether supervision should be a task for a central bank, and (ii) the issue of the integration of supervision across Europe. Clearly, countries have made different decisions regarding their choice of the lead banking system supervisor. Moreover, those choices have recently been reviewed in a number of countries, including the Netherlands, where the decision was made that the central bank should continue to be the prudential supervisor.²⁵ To evaluate the potential long-term development of banking supervision, We briefly review the factors that determined the decision to retain the supervision function for the Netherlands within the central bank: first, the function was already in place in the central bank. In order to justify a change, there need to be clear efficiency gains from moving to another allocation of tasks. That was not judged to be the case. Second, there is a close link to our role in financial sector oversight, meaning that we can exploit synergies between the two functions. Third, there is a link to our role as lender of last re-

²⁴ Again, the Treaty does not give the ESCB primary responsibility in this field. Article 105 (6) does provide that, in the event of unanimous agreement by the European Council, acting on a proposal from the Commission and after consulting the ECB, could confer on the ECB specific tasks relating to prudential supervision. There is no indication that this is likely to happen in the foreseeable future.

²⁵ The recent changes have resulted in a division of tasks of along functional, rather than sectoral, lines. Organisational links between DNB and the insurance supervisor have been strengthened. This facilitates an integrated approach with respect to the prudential supervision of financial conglomerates who may be active across a range of financial products. These prudential supervision tasks have been separated from tasks associated with overseeing the conduct of business of these companies and consumer protection.

sort. Having the supervisor in-house makes the communication channels shorter in the event of a crisis where it is necessary to judge whether problems relate to only one institution or to the system more broadly, and to assess whether they reflect solvency or liquidity difficulties. For small countries, the need to ensure a strong and viable institution (including its ability to attract high-quality staff) is an additional argument in favour of combining supervision with monetary policy.

There are also arguments against combining supervision and monetary policy in the same institution. Prominent among these is the argument of a conflict of interest: for example, monetary policy may not be tightened sufficiently to offset an inflation risk for fear of undermining the position of parts of the banking system (see Sinclair, 2000). In practice, however, the risk of a conflict of interest is rather limited (see Goodhart, 2000 and European Central Bank, 2001b regarding the relevance of this point).²⁶ Advocates of removing the supervisory function from central banks also argue that agreements to exchange information can ensure that there are sufficient information flows between the central bank and the supervisor. However, apart from carrying risks in terms of timeliness and completeness, information exchanges are no substitute for hands-on responsibility in the field. The impetus to keep fully up-to-date with new developments in financial instruments, and their implications for risk management, diminishes if the central bank has no involvement with prudential supervision. Even when the central bank is not ultimately responsible for supervision, some involvement in supervisory tasks is important. These arguments illustrate that there may not always be a single correct answer to the issue of where primary responsibility for supervision should lie. However, for the Netherlands at least, it is not obvious that alternative arrangements would be preferable.

The second issue concerns the centralisation of supervision within the euro area. The key argument in favour of a more centralised supervisory framework is the increasing internationalisation of the financial sector. These intensified links between institutions and markets have increased the risk that contagion could extend beyond national borders. Euro area centralisation would also reduce the scope for competition between regulators and align prudential supervision with the geographic boundaries of the monetary union.²⁷

²⁶ This holds in particular for Europe. Monetary policy is supranational, implying that there is little conflict, as no single NCB is in a position to determine European monetary policy. More generally, even if banking supervision is delegated, the risk of a conflict of interest (albeit between different institutions) could still result in monetary policy reacting inappropriately to external pressure. Having banking supervision and monetary policy under one roof might allow a better solution because any trade-off can be explicitly made. It is not the existence of conflicts of interest that is the issue, but how they are dealt with. Here the solution is good monetary and prudential policies, not the physical separation of institutions.

²⁷ See van der Zwet, 2002, for a discussion of these issues.

Clearly, although the increasing internationalisation of banks will determine supervisory arrangements in the future, it is not obvious that the establishment of a single European supervisor is the most effective response to increasing internationalisation. First of all, financial structures currently differ across Europe and can therefore better be supervised by national institutions. Second, such an institution (which should be independent in order to function effectively) would be very powerful and a system of checks and balances would be necessary.²⁸ Finally, the absence of any fiscal union also plays a role here, as any major financial crisis is likely to have implications on national budgets. Currently it is not clear to what extent sovereign countries are willing to bear the financial consequences of the failure of institutions in other countries.

What is required (and already occurs) is that the setting of basic rules of conduct takes place at the European level, and the practice of supervision is more harmonised, so as to ensure a level playing field within the single market and beyond. In addition, cross-country agreements between supervisors are established as banks expand across borders. These can be tailor-made for the specific banks' circumstances. Out of these arrangements a more co-ordinated system might evolve organically over the coming years, and we should encourage this to ensure that there truly is a level playing field for banks from different parts of the EU. This is preferable to attempts to impose a top-down European solution.

The Dutch situation might serve as an example: unlike other major European banks, our larger banks have tended to expand into the Americas, rather than into other parts of the EU. A common European solution may therefore not be the most efficient from the Dutch perspective, since our banks have different interests and needs than those from other euro area countries. The issue is currently under active consideration, with various proposals circulating for increased European co-ordination. What is important here is that all central banks are actively involved, regardless of whether or not they have primary responsibility for supervision.

4.3 National economic advisor

In a number of countries, national central banks have a formal role as an economic advisor to the government. In the Netherlands, for example, the president of De Nederlandsche Bank is an ex officio member of the Social and Economic Council (the SER). This council is made up of members nominated by employers and unions, along with independent members appointed by the crown. The SER provides advice to the government across various social and economic issues. An advantage of this council is that its members represent various segments of society, ensuring that its advice is based on a range of perspectives (a variant of the checks and balances argument of Section 2). DNB plays an

²⁸ The US achieves these checks and balances via the existence of a number of supervisors. For small countries, the importance of achieving checks and balances may be outweighed by the need to ensure a strong and effective institution.

active role in the SER. To some extent, the input that DNB provides reflects our insights stemming from our role in monetary policy formulation. This includes highlighting the implications of the common monetary policy for national economic policy in the Netherlands. The issues covered by the SER are, however, considerably broader than those where there is an obvious connection to monetary policy. Moreover, DNB's role as an advisor on economic issues extends beyond participation in the SER. What, then, is the value-added of DNB on issues unrelated to monetary policy?

The most important point is that it can be valuable for governments to receive objective advice from an independent organisation. At times, the advice from such an independent organisation may be unpalatable for a government. On the other hand, governments are also able to 'hide behind' such independent organisations in order to advance policies that are seen as necessary but unpopular. Such a role as independent advisor does not have to be fulfilled by a central bank, but because of our historic involvement in these issues it makes sense. We have established a reputation and are perceived as credible by the public. This reputation is important if we – and our advice – are to be taken seriously. We also have the necessary infrastructure and are able to exploit synergies with some of our other tasks. This implies that we are able to undertake this task at relatively low costs (i.e. relatively efficiently).

An alternative to the national central bank would be to involve research institutes in this field. In the Netherlands there are already a number of such institutes and they fulfil a valuable role. But the comparative advantages of DNB in economic policy advice more generally include the fact that we are actively involved in policy making which helps ensure that our advice is realistic. Moreover, the fact that we are not an academic institution also makes it easier for us to speak with one, relatively consistent, voice across a range of topics. Our involvement in policy-making ensures that we do not operate in an ivory tower but are part of a world-wide network that gives us access to a wide range of policy-relevant information. As a result, if we criticise some specific economic policies, the government cannot dismiss our comment as readily as is possible with an academic research report. It would also take time and substantial investment before other institutions were able to build up the credibility and networks necessary to effectively carry out this role. It is therefore not evident that there would be any efficiency gains in transferring this role to another institution.

So our role as policymaker provides a counterpart to the valuable contributions of academic research. Our involvement in euro area monetary policy formulation strengthens our voice at the national level. At the same time, our knowledge of country-specific factors is higher, compared to a situation where the ECB would fulfil such a role. We are able to take relatively controversial positions, because of our high degree of statutory independence. Therefore it is highly likely that DNB will continue to fulfil this function even in the long run.

5 Concluding comments

The history of European integration was politically motivated, but shows quite clearly that economic integration preceded political integration at times. Monetary policy (and in particular exchange rate arrangements) have tended to be at the forefront of these efforts.²⁹ Despite deep economic integration, political integration still has a long way to go, as is *inter alia* evidenced by the rather weak role of the European parliament and the fact that the role of the Commission is not completely clear. One of the guiding principles of European integration is its co-operative nature. This is reflected in the Maastricht treaty, which entrusts the ESCB as a system with policy tasks. This implies that all participating central banks, i.e. both the ECB and the NCBs, must jointly fulfil the roles assigned by the Treaty.

The unique history of the ESCB – formed when a group of sovereign countries surrendered their monetary policy autonomy to form a monetary union – goes a long way towards explaining why that is so. The central banks within the system operate together as a team. While a strong centre is important for the team to perform well, the various national central banks are also crucial parts of the system. This is particularly important in the formulation of monetary policy, where public confidence in the policies of the system (and therefore their effectiveness) also depends on our communication skills and our knowledge of country-specific factors.

The European preference for subsidiarity reinforces the tendency for decentralisation. This preference yields a number of benefits, but at the same time entails certain costs. In particular, it has consequences regarding the extent to which efficiency gains can be achieved through centralisation. Viewed purely from an cost-consciousness point of view, there would appear to be scope for centralisation or greater regional specialisation in a number of areas. For example, increasing cross-border activity by financial and non-financial companies is likely to result in further harmonisation of payments systems and co-ordination in financial stability. A more harmonised payments system would in turn facilitate greater specialisation in the implementation of monetary policy. Banknote production and distribution is also an area where we can look for more efficiency gains.

Inefficiencies need to be eliminated where they exist, without undermining the fundamental principles upon which monetary union has been founded. Looking ahead, it seems likely that the basic structure of the system will remain intact for the foreseeable future. More substantial changes are linked to the need for further political integration within Europe and the development of supranational institutions in other policy areas. As long as Europe remains a community of nation states, national tasks are likely to remain a key part of the work of NCBs, as the example of prudential supervision shows. Further

²⁹ For a more detailed discussion on the history of European monetary union, see European Commission (2002) and Houben (2000). Houben also discusses the different monetary policy traditions in the various EU countries.

economic and political integration would also allow a more centralised approach to be taken in areas such as international representation.

Even in a full-fledged political union, regional identities continue to be an important factor. Shared histories, cultures and, in particular languages, are fundamental in shaping identities. These factors will remain in place for generations. Institutions tend to be related to these feelings of identity, and may even outlive them. National central banks are therefore likely to remain in place, albeit in a different form, for a long time to come.

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