

EUROPEAN CENTRAL BANK – OBJECTIVES AND INSTRUMENTS OF MONETARY POLICY

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Introduction

The creation of Economic and Monetary Union, (hereinafter EMU) with a supranational monetary authority and a common currency is a key point of the Maastricht reforms, which came to the forefront of attention also in connection with Slovakia's accession to the European Union and with preparations for joining EMU. Responsibility for monetary policy in the framework of the European Union lies with two institutions (pursuant to Article 8 of the Treaty), the European System of Central Banks (ESCB) and the European Central Bank (ECB). The legislative framework for their activity is contained in Title VI of the Treaty – Economic and Monetary Policy and in the Protocol on the Statute of the ESCB and ECB¹.

The European System of Central Banks (ESCB) (Article 107 of the Treaty) has, from the formal aspect, two levels, the European Central Bank and the 15 national central banks of the member states of the European Union. The European Central Bank, together with the 12 national central banks of the eurozone, constitutes the "eurosystem". The ESCB is governed by decision-making bodies of the European Central Bank.

The European Central Bank (ECB) is responsible for an area that comprises 12 various countries with their own history, culture and economic background. For achieving the aims of the ECB, it is important to transparently and comprehensively inform the public of steps taken by the ECB and the tasks it sets itself. The Maastricht Treaty creates a mechanism for ensuring that monetary union, together with the single currency, forms a stable alignment.

The institutional predecessor of the ECB was the European Monetary Institute, which operated from 1 January 1994. It drew up and prepared the legal regulations relating to the transition to the third phase of EMU's creation, primarily in the financial and monetary field, as well as planning the transition to a common currency, drawing up a report on co-operation between the eurozone and other EU member states and a report on the preparedness of EU member states for participation in EMU. Through the establishment of EMU on 1 January 1999 responsibility for monetary policy passed from the national central banks of member states to the ECB.

¹ In this article we work from the consolidated versions of the Treaty on the EU and the Treaty establishing the EC, including changes ensuing from the Amsterdam Treaty, which entered into effect on 1 May 1999, and from the new numbering of individual articles contained in the stated treaties.

The European Central Bank as the successor institution to the European Monetary Institute officially began its activity in July 1998. The ECB shall have a legal personality. Its first President was the Dutchman Willem F. Duisenberg and on 1 November 2003 the office passed to the Frenchman Jean-Claude Trichet. The ECB is situated in Frankfurt am Main in Germany.

Objectives, tasks and organisation of the European Central Bank

In Article 105 of the Treaty on the European Union it is stated that "the primary objective of the ESCB is to maintain price stability." Without prejudice to this objective the ESCB shall support "general economic policies in the Community with the objective of contributing to achieving the Community's aims", which are defined in Article 2 of the Treaty. Through such a normative delimitation of the objective, the stability of the euro's purchasing power has been made an absolute priority. The Governing Council of the ECB has quantitatively defined price stability as "a year-on-year increase in the harmonised index of consumer prices (HICP) in the eurozone of less than 2%."

Pursuant to Article 105 of the Treaty the ESCB is the means for defining and implementing the Community's monetary policy, conducting foreign exchange operations, holding and managing official foreign exchange reserves of member states as well as promoting the smooth functioning of the payment system. The ECB submits opinions in the scope of its competence to the respective institutions, these being Community or national bodies. It also holds consultations with national authorities in drafting legislative measures and in all draft acts of the Community in the scope of its competence.

On the basis of Article 106 of the Treaty the European Central Bank has the exclusive right to authorise the issue of banknotes in the Community. Banknotes issued by the ECB and national central banks are the sole banknotes in the Community having the exclusive status of legal tender. Member states may issue only coins in a certain volume approved by the ECB.

The supreme decision-making body is the Governing Council of the ECB, whose members are representatives of the Executive Board of the ECB and governors of the national central banks². The Governing Council sets the main objectives and adopts decisions for ensuring tasks entrusted to the ESCB by the Treaty on the EU and the



Statute of the ESCB and ECB. The Governing Council formulates the Community's monetary policy, including monetary aims, key interest rates, and monetary reserves of the ESCB, adopts the rules of procedure, performs advisory functions, etc.

Unless the Statute stipulates otherwise, the Governing Council of the ECB decides on the basis of a simple majority, where in the case of an evenly split number of votes, the chairman has the casting vote. In the case of deciding on an increase in capital, a transfer of monetary reserves to the ECB, the distribution of monetary incomes of the national central banks, the distribution of profits and losses, etc, votes cast on the Governing Council are weighted according to the shares of the national central banks in the subscribed capital of the ECB.

Responsibility for the day-to-day running of the ECB, the preparation for meetings of the Governing Council and for the implementation of monetary policy lies with the Executive Board of the ECB, which gives instructions in this field to the national central banks. Through a decision of the Governing Council certain other powers may be transferred to the Executive Board of the ECB. The Executive Board has a president, vice-president and four other members, whose term of office is eight years and who may not be re-elected. At the beginnings of the ECB's operation the members had varying terms of office so that the changeovers in personnel in the subsequent period were appropriately spread over time and their activity was not disrupted.

The General Council of the ECB has the role of co-ordinating monetary policy and co-operating in the field of exchange rate policy. While there remain countries outside the eurozone, the General Council of the ECB will also be involved in the preparation of their entry to EMU. The board comprises the President of the ECB, the Vice-President of the ECB and the governors of all the national central banks of the EU member states³.

In connection with the European Union's enlargement the number of members of the ESCB has also been increased. Through the signing of the Treaty of Accession the governors of the national central banks of the acceding countries

² At present the members of the Governing Council of the ECB are J.-C. Trichet (President of the ECB), L.D. Papademos (Vice-President of the ECB), E. D. Solans, G. Tumpel-Gugerell, O. Issing, T. Padoa-Schioppa (Members of the Executive Board of the ECB), G. Quaden (Governor of Banque Nationale de Belgique), A. Weber (President of Deutsche Bundesbank), N. C. Garganas (Governor of the Bank of Greece), J. Caruana (Governor of Banco de Espana), C. Noyer (Governor of Banque de France), J. Hurley (Governor of the Central Bank and Financial Services Authority of Ireland), A. Fazio (Governor of Banca d'Italia), Y. Mersch (Governor of Banque centrale du Luxembourg), N. Wellink (President of De Nederlandsche Bank), K. Liebscher (Governor of Österreichische Nationalbank), V. M. Ribeiro Constancio (Governor of Banco de Portugal), M. Vanhala (Governor of Suomen Pankki)

³ The members of the General Board of the ECB are also the governors of the central banks of non-euro countries: B. N. Andersen (Governor of Danmarks Nationalbank), L. Helkensten (Governor of Sveriges Riksbank), M. King (Governor of the Bank of England).

began participating in meetings of the General Board of the ECB as observers. Through the accession of the countries to the EU on 1 May 2004 these countries' governors became full members of the General Board, increasing the number of members to 27.

An important precondition for maintaining any stable currency is for the central bank to have independence. It has been proven many times in the past that the influence of a government on a central bank's decision-making almost always leads to inflation. The independence of the central bank is provided for in the legislation of the Treaty. This independence has four dimensions: institutional, operative, personnel and financial.

The institutional independence of the ECB is formulated in Article 108 as follows: "In exercising the rights and fulfilling tasks and obligations ensuing from this Treaty and from the Statute of the ESCB and the ECB, the ECB, a national central bank or any member of their bodies with decision-making powers shall not solicit or accept instructions from bodies of the Community, nor from any government of a member state or other body."

From the operative aspect the ECB Council has sufficient room for manoeuvre in decision-making as regards the selection and use of the range of monetary policy instruments. Primary position is held by open market operations and credit operations, otherwise minimum reserves, and other monetary policy instruments may be used. The eight-year term of office of members of the Executive Board of the ECB, without the possibility of re-election, ensures independence as regards personnel. Financial independence is ensured by the fact that the sole shareholders of the ECB are independent national central banks.

Without affecting its independence, the ECB is subject to the obligation to provide information to the public and political institutions. In connection to this it submits an annual report on the activities of the ESCB and a report on monetary policy for the past and current year to the European Parliament, the Council of Europe and the European Commission. The European Parliament may hold a general debate on the basis of it. The ESCB prepares and publishes on at least a quarterly basis activity reports, and publishes a consolidated financial statement every week.

Monetary policy

The Governing Council of the ECB at its meeting on 13 October 1998 agreed on a monetary policy in which there would to the maximum degree possible be maintained continuity in the monetary policy strategies of the individual central banks of the eurozone. The single monetary policy of the ESCB is oriented exclusively on achieving price stability over the medium term. Its strategy comprises three main elements:

- the quantitative definition of the basic aim of the single monetary policy, i.e. price stability by means of the HICP index;
- the primary task of money supply, which is expressed by



quantifying the reference value of the rate of growth of the broad money aggregate;

- the outlook for the development of prices and the risks to price stability in the eurozone.

The HICP index was created for measuring price convergence in the second stage of creating monetary union and a high degree of harmonisation has been achieved in the eurozone countries. In its construction special attention was given to minimising errors in measurement so that a deviation from the "real" rate of inflation does not arise. Through the HICP⁴ index the error in measurement is allegedly smaller than in the national price indices of the eurozone countries⁵.

A primary role in the realisation of the single monetary policy is played by money supply, the growth reference value of which in the eurozone is defined as the broad money aggregate M3, which includes currency in circulation, short-term deposits (financial instruments with a maturity of up to two years) and short-term securities. The evaluation of price development, besides being based on an analysis of the money aggregate M3, is also based on the monitoring of other economic indicators, such as wages and salaries, long-term interest rates, the exchange rate, price indices, business and consumer opinion polls. The eurosystem publishes also its own prognoses and evaluates the inflation prognoses of all international organisations. The objective of the single monetary policy is not simply to mechanically adapt to short-term deviations in the real development from the values set, but also to identify, in a timely manner, disruptions to economic development in the eurozone on the basis of multilateral analyses and to select appropriate instruments not requiring the correction of monetary policy.

For achieving its objectives the ESCB has available a whole range of monetary policy instruments. It performs open market operations, provides standing facilities and requires credit institutions to hold minimum reserves. Another objective of the range of instruments available to the ESCB is to influence market interest rates and liquidity in the banking system and thereby signal the direction of monetary policy. Decision making lies with the ECB, whereas implementation lies in the competence of the national central banks. In the field of exchange rate policy, the ECB can use foreign exchange interventions, which it performs by means of reserve funds transferred from national central banks, in total at maximum in the amount of 50 billion euro (Article 30 of the Statute of the ESCB and the ECB).

The most important role in the ESCB's monetary policy is played by open market operations. These are used for managing interest rates and market liquidity. They are a sort

of signal of the direction of the single monetary policy. Open market operations can be divided according to frequency and the manner of trading into four types:

- main refinancing operations,
- longer-term refinancing operations,
- fine-tuning operations,
- structural operations.

The most frequently applied instrument in the eurosystem are reverse operations, which may be used in the case of all four types of open market operations. The issuing of debt certificates is used in the case of structural operations for absorbing surplus liquidity. For performing fine-tuning operations the ESCB has a further three instruments available, namely direct trades (purchases or sales), foreign exchange swaps and fixed-term deposits.

Direct trades are irregular operations performed by national central banks, or the ECB. Final purchases and sales on the open market are used only for influencing structural liquidity and for fine-tuning. The right of ownership to assets (financial assets) passes from the seller to the buyer without any agreement on a repurchase.

The ECB can issue debt certificates with the aim of influencing market liquidity. Debt certificates are a liability of the ECB in respect of their owners and there is no limitation on their transfer. They are issued at a value lower than the nominal value. The difference between the revenue from the issue and the nominal value of the issue corresponds to the agreed interest rate. Debt certificates of the ECB may be issued regularly or irregularly and their maturity is less than 12 months. The issues are performed by the national central banks in the form of standard tenders.

Foreign exchange swaps are used for fine-tuning and serve to influence liquidity and interest rates on the market. They are irregular and non-standardised trades performed by the national central banks and the ECB by means of quick tenders. The eurosystem purchases (or sells) euro for foreign currency and concurrently sells (or buys) it at a time agreed in advance. The eurosystem performs foreign exchange swaps as a rule in common currencies and according to generally valid practices. In each trade the ESCB agrees with its trading partner the swap interest rate, which corresponds to the difference between the current and term interest rate.

Term deposits provide the possibility of storing term deposits in the national bank of the eurosystem in which the respective branch of a credit institution is located. They bear interest at a fixed interest rate. It is an irregular and non-standardised instrument of national central banks performed in the form of quick tenders.

Credit financial institutions have available two types of standing facilities from the ESCB which enable them to ensure or absorb overnight liquidity, among which are included marginal refinancing facilities and deposit facilities. The interest rates of both facilities create limits within which the interest rates of overnight money moves. More detailed information on the individual types of monetary operations is given in the following table.

⁴ HICP (Harmonized Index of Consumer Prices), is a weighted average of the prices of a basket of consumer goods and services in the eurozone on the basis of homogenous statistics of the individual countries in the EMU. In.: Indizes zur Messung der Kerninflation in Euro-Währungsgebiet. Monatsbericht ECB, July 2001.

⁵ For further information see: The stability Oriented Monetary Policy strategy of the eurosystem. ECB. Monthly bulletin, January 1999, pgs 43 – 56.

**Monetary policy operations of the ESCB**

MP Operation	Types of transactions		Maturity	Frequency	Procedure
	Provision of liquidity	Absorption of liquidity			
Open market operations					
Main refinancing operation	– reverse transactions	–	– 2 weeks – 1 week (from 10 March 2004)	weekly	standard tender
Longer-term re-financing operations	– reverse transactions	–	3 months	monthly	standard tender
Fine-tuning operations	– reverse transactions – foreign exchange swaps	– foreign exchange swaps – fixed-term deposits – reverse transactions	non-standardised	non-regular	quick tender / bilateral procedures
	– outright purchases	– outright sales	–	non-regular	bilateral procedures
Structural operations	– reverse transactions	– issue of debt certificates	standardised / non-standardised	regular / non-regular	standard tender
	– outright purchases	– outright sales	–	non-regular	bilateral procedures
Standing facilities					
Marginal lending facility	– reverse transactions	–	overnight	acces at the discretion of counterparties	
Deposit facility	–	– deposits	overnight	acces at the discretion of counterparties	

Source: Die einheitliche Geldpolitik im Euro-währungsgebiet. Allgemeine Regelungen und Verfahren des Eurosystems. ECB, April 2002, p. 7.

The ECB requires from credit institutions that pursuant to the ESCB regulation they hold in an account of the respective national bank minimum reserves. In using this instrument, the ECB is obliged to act in accordance with the aims of the ESCB, as codified in Article 105(1) of the Treaty on the EU and in Article 2 of the ESCB Statute. Uniform conditions apply throughout the eurozone for using minimum reserves. The fulfilment of minimum reserves is intended to contribute to the stabilisation of interest rates, the creation of structural liquidity, and its expansion on the money market.

All credit institutions and branches with a registered office in the eurozone whose parent company does not have a registered office in it are subject to the obligation to create minimum reserves. The ECB issues and administers a list of these institutions, as well as institutions that have been freed from this obligation on the basis of criteria defined in advance. This may concern various special types of institution that do not perform any banking functions in competition with other banks or may be institutions whose deposits are intended for national or international development programmes.

Conclusion

This article has presented the European System of Central Banks as a two-level system, comprising the European Central Bank and the national central banks. It has a two-level organisational structure, in which the ESCB oversees the joint existence of the ECB and the national central banks. The ECB has a legal personality status, which enables it to realise the aims and tasks of monetary policy and

to use a range of monetary instruments for achieving them.

For achieving its aims the ESCB has available a whole range of monetary policy instruments, including open market operations, the provision of standing facilities and the creation of minimum reserves, and others. The aim of these is to influence market interest rates and liquidity in the banking system and guide monetary policy. The ECB has decision-making power, but realisation lies in the competence of the national central banks. In connection with the accession of Slovakia and other countries to the European Union, it is essential to analyse the development of this institutional system, the aims and instruments of monetary policy, taking account of the tasks and possibilities of appropriate incorporation into the ESCB.

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