European Central Bank

The Monetary Policy of the Eurosystem

On January 1, 1999, Europe entered a new era with the adoption of a single currency—the euro—by 11 of the European Union's 15 member states. In this article, a member of the European Central Bank's Executive Board describes the framework for conducting monetary policy in the euro area.

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IN ACCORDANCE with the treaty signed in Maastricht on February 7, 1992, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain replaced their national currencies with the euro on January 1, 1999, based on conversion rates irrevocably fixed on December 31, 1998. In preparation for this moment, the 11 countries had implemented policies enabling them to achieve a high degree of economic convergence while putting in place the institutional and legal frameworks for conducting a single monetary policy—the task of the Eurosystem, which comprises the Frankfurt-based European Central Bank (ECB) and the national central banks of the 11 euro area countries.

The new structure

The ECB was established on June 1, 1998 (in succession to the European Monetary Institute, which had carried out preparatory work), together with the European System of Central Banks (ESCB)—which comprises the ECB and the 15 national central banks of European Union (EU) member countries. The Eurosystem is governed by two of the ECB's decision-making bodies—the Executive Board and the Governing Council.

The main task of the Executive Board, which consists of the ECB's president, vice-president, and four other members, is to implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council, by giving instructions to the national central banks. In addition, it is responsible for the current business of the ECB.

The Governing Council, which is responsible for formulating the single monetary policy and setting guidelines for its implementation, comprises the Executive Board and the governors of the national central banks of the 11 euro area countries. Each member has one vote. The president of the EU Council and a member of the European Commission can also participate in the meetings but do not have the right to vote. Most decisions, including those on monetary policy, can be taken by simple majority. However, votes for decisions that affect the positions of the national central banks as shareholders of the ESCB (for example, relating to the capital and the foreign exchange reserves of the ECB) are weighted by the share of each national central bank in the ECB's capital (the votes of Executive Board members are given a weight of zero).

So long as not all EU member states participate in the euro area, the General Council, the third decision-making body of the ECB, will govern the ESCB. It consists of the president and vice-president of the ECB and the governors of the national central banks of all 15 EU member countries. As the central banks of the EU countries that have not (yet) adopted the euro (Denmark, Greece, Sweden, and the United Kingdom) continue to pursue national monetary policies, they will not participate in decisions related to the single monetary policy for the euro area. They will, however, have the opportunity to discuss monetary policy issues and their exchange rate relations with the euro. In this context, the General Council contributes to the necessary preparations for fixing the exchange rates of the currencies of the four nonparticipating countries to the euro.

Objectives and tasks

The Statute of the ESCB is an integral part of the Maastricht Treaty. Article 2 of the ESCB Statute states that "the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community. . . . The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources. . . ." This mandate gives clear priority to the maintenance of price stability as the basis of economic conditions that foster sustainable output growth, a high level of employment creation, and better living standards, all of which are listed in the Maastricht Treaty as objectives of the European Community.

The Eurosystem's basic tasks are directly related to achieving price stability and consist in defining and implementing the euro area's monetary policy; conducting foreign exchange operations consistent with Article 109 of the Maastricht Treaty; holding and managing the official foreign reserves of participating EU countries; promoting the smooth operation of payment systems; and contributing to the smooth conduct of the policies of the authorities responsible for the prudential supervision of credit institutions and the stability of the financial system. In addition, the Eurosystem has important advisory functions with respect to new EU and national legislation within its field of competence.

Article 107 of the Maastricht Treaty and Article 7 of the ESCB Statute guarantee the independence of the ECB, the national central banks, and the members of their decision-making bodies in exercising their powers and carrying out their duties. They are not allowed to seek or take instructions from the government of any member state, any organization of the European Community, or any other body. Moreover, these governments, institutions, and bodies are obliged to refrain from trying to influence the ECB or the national central banks in the performance of their tasks. Furthermore, Article 10.4 of the ESCB Statute, which states that the proceedings of the meetings of the Governing Council of the ECB are confidential while allowing for publication of the outcome of its deliberations, reinforces the independence of members of the Governing Council in the decision-making process.

This independence should allow the ECB's decision-making bodies to concentrate on fulfilling their mandate and to adopt a forward-looking, medium-term orientation, undisturbed by short-term political considerations. For a new institution without a policy record, this is crucial to establish a high degree of credibility, which, in turn, is vital for a successful monetary policy. In a democratic society, the independence of central banks or other institutions in achieving particular objectives must go hand in hand with accountability to the public. The Maastricht Treaty contains several provisions that ensure the ECB is accountable for its actions.

To start with, it has several reporting commitments (Article 15 of the ESCB Statute). First, it must publish a consolidated financial statement of the Eurosystem each week. Second, it must produce and publish quarterly reports on the Eurosystem's activities. Third, it must prepare an annual report on the Eurosystem's monetary policy and other activities, to be presented to the European Parliament by the President of the ECB.

In practice, the ECB will go far beyond these legal reporting requirements, reflecting its commitment to informing the public of its decisions and the economic rationale on which they are based. Since the ECB came into existence, the president has regularly issued public statements disclosing and explaining the Governing Council's decisions. Beginning in January 1999, immediately following the first Governing Council meeting of every month, a press conference is held at which the president and the vice-president present the Governing Council's view of the economic situation and the arguments for its monetary policy decisions and take questions from the press. The text of the president's introductory statement is released immediately following the press conference.

The ECB also publishes a detailed evaluation of economic developments in the euro area and an assessment of the monetary policy stance in its *Monthly Bulletin*, along with articles on issues relevant to the euro area economy and euro area statistics (the monetary statistics are also available on the ECB's web site). In addition, the ECB publishes working and occasional papers to disseminate its thinking and stimulate debate on relevant policy issues.

Finally, the president of the ECB will be invited to the meetings of the EU Council of Ministers of Economic Affairs and Finance (ECOFIN Council) whenever matters relating to the objectives and tasks of the ESCB and the Eurosystem are discussed. He has also been invited to participate in the meetings of the newly established Euro-11 Council, which brings the euro area members of the ECOFIN Council together for an informal exchange of views.

Monetary policy strategy

An essential element in the preparatory work of the European Monetary Institute and the ECB was the design of a stability-oriented monetary policy strategy and the development of instruments and procedures for its implementation.

To promote accountability and transparency, the ECB's Governing Council has provided a clear, quantitative definition of price stability: "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 percent." The reference to price increases

Monetary policy operations of the Eurosystem

Monetary policy operations	Types of transactions: Provision of liquidity	Types of transactions: Absorption of liquidity	Maturity	Frequency	Procedure
Open market operations					
Main refinancing operations	Reverse transactions		Two weeks	Weekly	Standard tenders
Longer-term refinancing operations	Reverse transactions		Three months	Monthly	Standard tenders
Fine-tuning operations	Reverse transactions	Foreign exchange swaps	Nonstandardized	Nonregular	Quick tenders
	Foreign exchange swaps	Collection of fixed-term deposits			Bilateral procedures
		Reverse transactions			
	Outright purchases	Outright sales		Nonregular	Bilateral procedures
Structural operations	Reverse transactions	Issuance of debt certificates	Standardized/ nonstandardized	Regular and nonregular	Standard tenders
	Outright purchases	Outright sales		Nonregular	Bilateral procedures
Standing facilities					
Marginal lending facility	Reverse transactions		Overnight	Access at the discretion of counterparties	
Deposit facility		Deposits	Overnight	Access at the discretion of counterparties	

indicates that deflation is also regarded as inconsistent with the objective of price stability. The Governing Council has further stated that "price stability is to be maintained over the medium term," indicating that it will not respond to short-run deviations (for example, those that are due to shocks to energy prices or specific fiscal measures) from a level of inflation deemed compatible with price stability. In these cases, monetary policy will not correct for the one-off change in the price level, but will focus on avoiding second-round effects.

The Eurosystem's monetary policy strategy consists of two additional key elements. First, *money has been assigned a prominent role,* based on the empirically well-founded view that inflation, at least in the long run, is a monetary phenomenon. The Governing Council has announced a quantitative reference value of 4½ percent—a rate of monetary expansion that is consistent with and contributes to the maintenance of price stability while allowing for a sustainable pace of output growth—for the three-month moving average of the annual growth rate of the broad monetary aggregate M3. This reference value is not regarded as an intermediate monetary target, however, in order to avoid an automatic monetary policy reaction to fluctuations in M3 growth that may not be associated with inflationary pressures but that may result, for example, from the introduction of the euro and financial innovations.

Second, the Governing Council will make a broadly based assessment of the risks for price stability *using a wide range of economic and financial indicator variables*—for example, long-term interest rates and the yield curve, indicators of consumer and business confidence, measures of output growth, wages and unit labor costs, import prices for commodities, and the external value of the euro insofar as it affects prices in the euro area. This assessment is carried out with care, given that the euro area statistics are newly constructed, the relevant data from national sources are not always fully harmonized, and the underlying behavioral relationships may change with the introduction of the single currency.

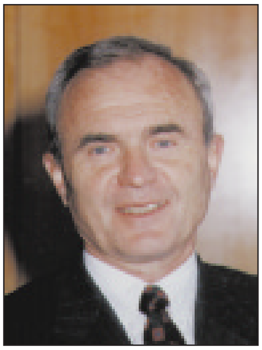
Monetary policy instruments

The Eurosystem has a range of instruments at its disposal for implementing monetary policy. To manage liquidity in the money market and steer short-term interest rates, it will use open market operations through which liquidity is provided to the banking system against adequate collateral. In addition, two standing facilities will allow eligible counterparties to invest their daily liquidity surpluses or to cover their overnight liquidity needs. Furthermore, credit institutions are required to hold a minimum amount of reserves on their account with the national central banks of the Eurosystem.

Open market operations can be conducted in the form of reverse transactions, outright transactions, the issuance of debt certificates, foreign exchange swaps, and the collection of fixed-term deposits. They are initiated by the ECB, but are normally carried out through the national central banks. There are four categories of open market operations. First, the main refinancing operations are executed as standard weekly tenders for liquidity-providing reverse transactions with a two-week maturity. The weekly tender rate is thus a key variable with which the Eurosystem signals its monetary policy stance to the public. Second, the longer-term refinancing operations, which are executed as standard monthly tenders for liquidity-providing reverse transactions with a three-month maturity, have the purpose of fulfilling the additional, longer-term refinancing needs of the financial system. Third, fine-tuning operations will be executed as needed to smooth the effect on interest rates of unexpected shocks in money market liquidity. Fourth, the Eurosystem may issue debt certificates and carry out reverse or outright transactions whenever it wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector.

The two standing facilities are the *marginal lending facility* and the *deposit facility*. At their own initiative, counterparties can use the former to obtain overnight credit from the national central banks against eligible assets. This implies that the marginal lending rate normally determines the ceiling for the overnight market interest rate. Counterparties can use the deposit facility to make overnight deposits with the national central banks. As a result, the deposit rate normally represents the floor for the overnight market interest rate. Taken together, the marginal lending rate and the deposit rate constitute a corridor around the weekly tender rate and the overnight market interest rate.

The minimum reserve system serves two main purposes: to contribute to the stabilization of money market interest rates and the creation of sufficient structural demand for central bank money. Interest rates are stabilized by allowing credit institutions to use averaging provisions—that is, to comply with reserve requirements on the basis of average daily reserve holdings over a one-month maintenance period. Because credit institutions do not have to maintain their required reserves on a daily basis, they have an incentive to smooth the effect of temporary liquidity fluctuations on money market interest rates. An adequate structural demand for central bank money is ensured by applying a reserve ratio of 2 percent to specified liabilities of the credit institutions. At the same time, care has been taken to avoid creating competitive distortions relative to financial institutions that are not subject to minimum reserves. For this reason, required reserves are remunerated at a level corresponding to the weekly tender rate, broadly in line with market conditions.



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Challenges for economic policies

As part of the European Union, the economic territory represented by the euro area has enjoyed a free flow of capital, labor, goods, and services since 1992. With the introduction of the euro, the economic weight of this single market has risen to a level matching that of the United States. This historical event has far-reaching implications for the conduct of economic policies in the euro area. The challenge is, in particular, to make a success of the euro in a unique European setting.

This relates in the first place to the single monetary policy carried out by the Eurosystem. Even though it will be marked by a high degree of continuity in comparison with the previous national stability-oriented monetary policies, the Eurosystem will have to establish a good track record to show it deserves the credibility it has inherited from the national central banks. The Eurosystem is ready for this challenge. However, all of the other fields encompassed by economic policy must contribute their share to creating the conditions for a stable euro. These tasks can be summarized in three points.

First, for the single monetary policy to succeed in maintaining price stability, it will need the unequivocal support of sound national fiscal policies and responsible wage settlements. This will enhance the credibility of monetary policy by preventing undue inflationary pressures. The framework for fiscal discipline is given by the Stability and Growth Pact, under which all EU governments have committed themselves to maintaining a budgetary position of close to balance or in surplus under normal economic conditions. This should give sufficient room for maneuver to allow fiscal deficits to rise if the economy slows down, without exceeding the deficit limit of 3 percent of GDP set in the Maastricht Treaty (Protocol No. 5). Wage increases should correspond to the growth of labor productivity, but will also have to take account of the high level of unemployment in the euro area.

Second, a single currency goes hand in hand with a single monetary policy. The Eurosystem will focus exclusively on the outlook for euro area price developments and respond accordingly. This implies that the single monetary policy cannot play any role in countering economic shocks in individual countries. In the new environment, country-specific or regional economic problems will need to be addressed by implementing appropriate national fiscal policies and improving cost competitiveness. This could also alleviate possible asymmetric impacts of monetary policy actions on individual member countries.

Third, by maintaining price stability, the monetary policy of the Eurosystem fosters output and employment growth in the long run. Moreover, in specific cyclical circumstances, monetary policy can play some role in stabilizing output and employment growth, provided that price stability is not endangered. However, it can make only a limited contribution to alleviating unemployment. The solution to this problem lies in structural reforms aimed at deregulating labor and product markets and creating stronger incentives for job creation. Greater flexibility would allow wages and prices to adjust to changing economic conditions and make investors more responsive to new opportunities.

On the basis of these principles, economic policymakers in the euro area could realize an appropriate national and area-wide policy mix conducive to sustainable noninflationary growth, a high level of employment, and better living standards. As it enters a new era, Europe has an unprecedented opportunity to realize these common objectives. F&D

Suggestions for further reading:

European Central Bank, 1998, The Single Monetary Policy in Stage Three—General Documentation on ESCB Monetary Policy Instruments and Procedures *(Frankfurt).*

The European Central Bank's web site may be found at ***http://www.ecb.int***