



Task Force on
Economic and Monetary Union

Briefing 27

The European System of Central Banks

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*The opinions expressed are those of the author and do not necessarily
represent the view of the European Parliament*

The new European System of Central Banks (ESCB), with the European Central Bank (the ECB) at its heart, will come into existence once the decision on participation in Stage 3 of Economic and Monetary Union has been taken.

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KEY WORDS

Treaty. The Treaty establishing the European Community (or EC Treaty). It includes the original EEC Treaty (Treaties of Rome, 1957) as amended by the Treaty on European Union (TEU, signed in *Maastricht* on 7 February 1992).

Stage III. The final stage of a process leading towards Economic and Monetary Union (EMU). It will start on 1 January 1999, as provided in the Treaty.

EMU. Economic and Monetary Union: a single market and a single currency - the *euro* - in the European Union (EU).

Euro. The start of Stage III will not entail the immediate introduction of the single currency: on 1 January 1999 “irrevocably fixed” exchange rates between the existing EU currencies will be introduced. Euro notes and coins will not be in circulation until three years later, on 1 January 2002.

Member States. The countries which form the European Union (EU countries). In early 1998 the EU Council of Heads of State or Government will decide which Member States fulfil the necessary conditions for the adoption of a single currency¹. This means that, after 1 January 1999, a certain number of EU countries could be left outside the “euro area” and join it only at a later date, when they meet “the necessary conditions”.

- EU countries which do not participate in the euro area: *non-euro area Member States* or *Member States with a derogation*.
- EU countries which participate in the euro area: *euro area Member States* or *Member States without a derogation*.

EMI. European Monetary Institute. The Maastricht Treaty establishes the EMI as the predecessor to the European System of Central Banks (ESCB) and the European Central Bank (ECB). The EMI began its operations at the start of Stage II of EMU, on 1 January 1994. The EMI is headquartered in Frankfurt am Main, Germany.

Counterparty. The opposite party in a financial transaction (e.g. in a transaction with the central bank).

¹ For a short but comprehensive explication of the “necessary conditions”, refer to: “The Single European Currency: a short background brief”, Briefing 8, PE 166162.

The European System of Central Banks

The *European System of Central Banks (ESCB)* is due to come into being in mid-1998, following the decision on participation in Stage III of Economic and Monetary Union. Its function will be to oversee the introduction of the Single Currency, the euro; and subsequently to manage the internal monetary policy of the euro area.

The ESCB will be composed of the *European Central Bank (ECB)*; and of the *national central banks (NCBs)* of all Member States¹ (even Member States which do not participate in Stage III). The ESCB will *not* have separate legal personality.

The European Central Bank

The European Central Bank, however, *will* have legal personality and will enjoy in each of the Member States the most extensive legal capacity accorded to legal persons under the respective national laws. It may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings².

As soon as the members of the ECB's Executive Board are appointed - i.e. not later than July 1998³ - the ECB and the ESCB will both come into existence. They will only begin to exercise their powers fully, however, when EMU Stage III begins: i.e. on 1 January 1999.

As soon as the ECB is established, it will take over the residual functions of the European Monetary Institute (EMI), which will cease to exist. The seat of the ECB, as that of the EMI, will be Frankfurt am Main, Germany.

The National Central Banks

All EU national central banks will be an integral part of the ESCB. There will nevertheless be differences in status. *If the country in question participates in the euro area*, its NCB will be required to act in accordance with the guidelines and instructions of the ECB. All NCBs will of course continue to have separate legal personality.

The decision-making bodies

The ESCB will be governed by the decision-making bodies of the ECB: the Executive Board and the Governing Council⁴. The *Executive Board* will comprise between four and six members, nationals of euro-area Member States. The *Governing Council* will comprise the members of the

¹ Article 106 (1) TEU.

² Art. 106 (2) TEU.

³ Art. 109 1 (1) TEU.

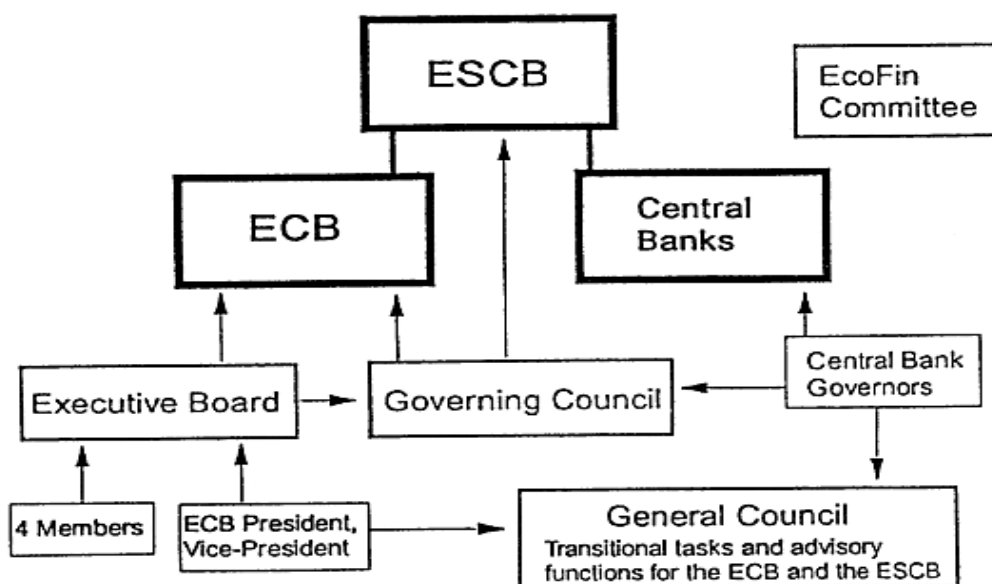
⁴ Art. 106 (3) TEU.

Executive Board and the governors of the NCBs of euro area Member States. The *General Council* will comprise the President and Vice-President of the ECB and the governors of the NCBs of all Member States, *including non-euro area Member States*.

Each of these bodies has specific responsibilities⁵:

- The **Governing Council** will adopt the guidelines and take decisions necessary to ensure the performance of the tasks entrusted to the ESCB. It will formulate the single monetary policy including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and it will establish the necessary guidelines for their implementation.
- The **Executive Board** will implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council and will give the necessary instructions to NCBs to this end.
- The **General Council** will perform the tasks deriving from the possible non-participation of some Member States in the euro area. More specifically, it will take over the as yet uncompleted tasks of the EMI and will give advice on the abrogation of derogations, particularly for irrevocably fixing the exchange rates of the currencies joining the euro area.

Structure of the Central Bank System in Stage III



⁵ Art.12 and 47 Statute of the ESCB and of the ECB (Stat.).

Objectives

The primary objective of the ESCB will be *to maintain price stability*. Without prejudice to that objective, the ESCB will support *the general economic policies of the EU*. The ESCB will act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources within the single market area⁶.

Tasks

The *basic tasks* to be carried out through the ESCB will be⁷:

- to define and implement *the monetary policy* of the Community;
- to conduct *foreign exchange operations* consistent with the provisions of Article 109 of the Treaty on European Union (TEU);
- to hold and manage *the official reserves* of the Member States; and
- to promote the smooth operation of *payment systems*.

Advisory functions. The ECB will be consulted on any proposed Community act in its fields of competence and on any draft legislative provision in its fields of competence originating from national authorities, within the limits and conditions set out by the EU Council. The ECB may also submit opinions to the appropriate Community institutions or bodies or to national authorities on matters in its field of competence⁸.

Supervision. The ECB will contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system⁹.

Banknotes and Coins. The ECB will have the exclusive right to authorise the issue of banknotes within the Community. Only banknotes issued by the ECB and the NCBs will have the status of legal tender within the Community. Subject to approval by the ECB of the volume, the Member States may also issue coins¹⁰.

Collection of Statistical Information. The ECB will collect, with the assistance of the NCBs, the statistical information needed for the conduct of the single monetary policy of the Community and

⁶ Art.105 (1) TEU.

⁷ Art.105 (2) TEU.

⁸ Art.105 (4) TEU.

⁹ Art.105 (5) TEU.

¹⁰ Art.105a TEU.

of foreign exchange operations¹¹. The EMI has, in consultation with the European Commission, prepared the statistical requirements for the euro area.

Legal Instruments. The ECB will have available a range of legal instruments to carry out the tasks entrusted to the ESCB: regulations, decisions, recommendations and opinions.

- A *regulation* has general application: it is binding in its entirety and is directly applicable in all Member States.
- *Recommendations* and *opinions* have no binding force.
- A *decision* is binding in its entirety upon those to whom it is addressed.

If the obligations imposed on undertakings by ECB regulations and decisions are violated, the ECB is entitled to impose on them fines or periodic penalty payments, within the limits and under the conditions established by the EU Council¹².

Independence. The Treaty states that, when exercising their powers and carrying out their tasks and duties, neither the ECB, nor a national central bank, nor any member of their decision-making bodies, will seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body¹³.

Accountability - The role of the European Parliament

This *operational independence* of the ECB will be balanced by *accountability* for its actions to the directly-elected European Parliament. In particular:

- The European Parliament must be **consulted before the President of the ECB, and the other members of the ECB Executive Board, can be appointed** (TEU, art.109a (2)). Rule 36 of Parliaments' own Rules of Procedure outline in detail how this consultation is to take place.¹⁴

¹¹ Art.5 Stat.

¹² Art.108a TEU.

¹³ Art.107 TEU.

¹⁴ "1. The candidate nominated as President of the European Central Bank shall be invited to make a statement before the committee responsible and answer questions put by members.

2. The committee responsible shall make a recommendation to Parliament as to whether the nomination should be approved.

3. The vote shall take place within two months of the receipt of the nomination unless Parliament, at the request of the committee responsible, a political group or at least twenty-nine Members, decided otherwise.

4. If the opinion adopted by Parliament is negative, the President shall request the Council to withdraw its nomination and submit a new nomination to Parliament.

5. The same procedure shall apply for nominations for Vice-President and Executive Board Members of the European Central Bank and for President of the European Monetary Institute."

- The President of the ECB will be required to present an **annual report** to the European Parliament, meeting in plenary session. This will cover the conduct of monetary policy in both the current and the previous year..
- The President of the ECB, and other members of the Executive Board will from time to time **appear before the competent committee of the European Parliament**. A request for such an appearance may come *either from the ECB itself, or from the European Parliament*. (TEU, art.109b (3)).

The *assent* of the EP is required to the conferring upon the ECB by the Council of specific tasks concerning the prudential supervision of credit institutions (TEU, art.105 (6)).

Parliamentary *assent* is also required to amend certain articles of the Statute of the ESCB (TEU, art.106 (5)). On other provisions Parliament must be *consulted*.

The Single Monetary Policy¹⁵

Strategic aspects

In the pursuit of the final objective of maintaining price stability, the ESCB will need to develop a monetary policy strategy. The EMI in its recent report (see note 14) has proposed two "potential candidate strategies": *monetary targeting* and *direct inflation targeting*.

In practice, a combination of the two is likely to emerge. Indispensable to any strategy will be:

- a quantified definition of the final objective of price stability;
- the availability of indicator variables to help assess the risks to future price stability;
- detailed information on monetary aggregates; and
- tools to allow forecasts for inflation in the euro area.

Implementation

The EMI Council has defined a set of monetary policy instruments that will be made available to the ESCB for the implementation of its monetary policy strategy. The ESCB will mainly use open market operations. Two standing facilities, and minimum reserve requirements will be provided.

Four types of *open market operations*¹⁶ will be at the disposal of the ESCB:

- main refinancing operations (regular liquidity-providing reverse transactions with a weekly frequency and a maturity of two weeks);
- longer-term refinancing operations (liquidity-providing reverse transactions with a monthly frequency and a maturity of three months, intended to cater for a limited part of the global refinancing volume);
- fine tuning operations (adapted to the prevailing circumstances and to the specific objectives of managing the liquidity situation in the market or of steering interest rates);
- structural operations (intended to affect the structural liquidity position of the banking system *vis-à-vis* the ESCB).

Two standing facilities will be available to provide (in the case of the marginal lending facility) or to absorb (in the case of the deposit facility) overnight liquidity. These facilities will bind overnight market interest rates; and the interest rates applied to them will help in pointing out the general stance of monetary policy.

¹⁵ For more details, refer to "The Single Monetary Policy in Stage Three". EMI, Frankfurt, 10 January 1997.

¹⁶ See art.18 Stat.

The *minimum reserve system*¹⁷ may serve the purpose of stabilising money market interest rates, creating or enlarging a structural liquidity shortage in the money market and possibly contributing to the control of monetary expansion. Many banks, however, are opposed to the introduction of a minimum reserve system, which tie up funds and which they therefore see as a kind of tax.

Eligible counterparties and assets

An appropriate legal instrument will cover the uniform conditions under which a broad range of *counterparties* will participate in the ESCB's open market operations and standing facilities.

The EMI has worked out common eligibility criteria, both for the counterparties and for the assets to be used by those counterparties in their operations with the ESCB.

With regard to the actual choice of *assets* eligible for use in the ESCB's liquidity-providing monetary policy operations, the ESCB will establish two types of lists.

- The *tier one list* will consist of marketable assets which fulfil uniform euro area-wide eligibility criteria specified by the ECB.
- The *tier two list* will consist of additional assets, either marketable or non marketable, which NCBs consider particularly important for their national financial markets and banking systems.

Foreign exchange intervention¹⁸

In addition to intervening on the domestic financial market, the ESCB will also have the capacity to conduct foreign exchange intervention¹⁹. It will do this by means of the *foreign reserves transferred from the NBCs to the ECB, up to an amount of EURO 50 billion*. The management of foreign reserve assets not so pooled will be the subject of *guidelines issued by the ECB*.

An **exchange rate mechanism** (ERM-2) is being elaborated by the EMI as part of future exchange rate policy cooperation between euro area Member States and non-euro area Member States. The EMI view is that intervention should be used only as a supportive instrument, in conjunction with appropriate fiscal and monetary policies conducive to economic convergence and exchange rate stability within the EU.

Preparatory work is being conducted by the EMI and the NCBs to ensure that the ESCB will be in a position to use either a centralised or a decentralised arrangement for the conduct of its foreign exchange intervention operations.

¹⁷ See art.19 Stat.

¹⁸ For a fuller treatment, see Briefing 29, "Exchange Rate Policy under EMU" (to be published)

¹⁹ See art.23 Stat.

The TARGET system²⁰

To support the integration of the money market and the unitary nature of monetary policy, the EMI and the NCBs are developing an *interbank funds transfer system*, called TARGET, that will be able to process cross-border payments denominated in euro as smoothly as if they were domestic payments.

TARGET means “Trans-European Automated Real-time Gross settlement Express Transfer”. Such a payment system consists of one real-time gross settlement (RTGS) system²¹ in each of the euro area Member States at the start of Stage Three of EMU. The national RTGS systems will be interconnected through the Interlinking mechanism; that will allow same-day cross-border transfers throughout the euro area.

RTGS systems of non-euro area Member States may also be connected to TARGET, provided that they are able to process the euro.

²⁰ For a fuller account of TARGET, see Briefing 32 (to be published)

²¹ A settlement system in which processing and settlement take place on an order-by-order basis (without netting) in real time (continuously).