

PAPER FOR THE TREASURY SELECT COMMITTEE ON THE EUROPEAN CENTRAL BANK

Introduction

This paper is a contribution by HM Treasury to the Treasury Select Committee's inquiry "to review the workings of the Economic and Monetary Union since January 1999 with particular reference to the Stability and Growth Pact and the European Central Bank, and examine the implications for United Kingdom membership of the Single Currency; and examine the basis for the Chancellor's current assessment of the five economic tests". It focuses on the European Central Bank, and supplements the paper submitted to the Committee on 6 September 2002 on HM Treasury's approach to the preliminary and technical work, and the paper submitted by HM Treasury today on the Stability and Growth Pact.

The role of the European Central Bank

2. Chapter 18 of HM Treasury (2002)¹ summarises the operation of monetary policy within EMU, and sets out the functions of the European Central Bank (ECB).

3. From 1 January 1999, the National Central Banks (NCBs) of the 11 Member States (12 from 1 January 2001 when Greece joined) of the euro area pooled responsibility for the conduct of monetary policy in the ECB.

4. The EC Treaty sets out the legal basis for the operation of the European Central Bank (ECB), as well as for the European System of Central Banks (ESCB), which consists of the ECB together with the NCBs of all EU Member States. Given that not all EU members participate in EMU, the body which consists of the ECB and the NCBs of the participating Member States is known as the "Eurosystème". The "Eurosystème" carries out the tasks of the ESCB while not all Member States participate in the single currency.

5. Articles 105 (ex 105) to 112 (ex 109a) of the EC Treaty, together with the Statute of the ESCB and of the ECB (in a Protocol to the EC Treaty), set out the framework within which the ECB operates, and define the governance arrangements for the ESCB. As noted in HM Treasury (2002), the Treaty also provides for the independence of the ESCB from the Community institutions, governments of Member States or any other body. Member States and the Community are also expected to respect this principle of independence, and undertake not to seek to influence the members of the decision-making bodies of the ECB or the national central banks in the performance of their tasks².

¹ *Reforming Britain's Economic and Financial Policy, Towards Greater Economic Stability*, HM Treasury, 2002 (eds Ed Balls and Gus O'Donnell)

² Article 108 (ex 107) of the EC Treaty, and Article 7 of the ESCB Statute, state that, "when exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the ESCB, neither the ECB, nor a national central bank, nor any

Functions of the ECB

6. The ECB has been established as the core of the Eurosystem, with overall responsibility to ensure that the tasks of the Eurosystem are carried out either by its own activities or those of the participating NCBs. These are set out in Article 105(2) of the EC Treaty and Article 3 of the ESCB Statute, as follows:

- To define and implement the monetary policy of the Community;
- To conduct foreign exchange operations;
- To hold and manage the official foreign reserves of the Member States;
- To promote the smooth operation of payment systems.

7. This note focuses on the aspects of the ECB relating specifically to monetary policy.

Decision-making bodies

8. Figure 1 gives the organisational structure of the ESCB and the Eurosystem. The ESCB has no legal personality of its own and its operation is governed by the decision making bodies of the ECB – the *Executive Board*, the *Governing Council* and, as long as there are Member States outside EMU, the *General Council*.

The Executive Board

9. The Executive Board of the ECB consists of six individuals who are appointed by common accord of Member States' Heads of State or Government, on a recommendation from the ECOFIN Council of EU Economic and Finance Ministers, after it has consulted the ECB Governing Council and the European Parliament. The Executive Board's posts are non-renewable, and the individuals are selected on the basis of their recognised standing in the banking and monetary field (Article 112(2)(b) of the EC Treaty). The primary responsibility of the Executive Board is in the *operation and implementation of the Eurosystem's monetary policy*.

10. Article 112(2)(b) of the EC Treaty notes that, after the initial staggered set of terms, the terms of office for members of the Executive Board shall be eight years and shall be non-renewable.

Governing Council

11. The Governing Council consists of the six Executive Board members and the Governors of the participating NCBs. The Governing Council is the

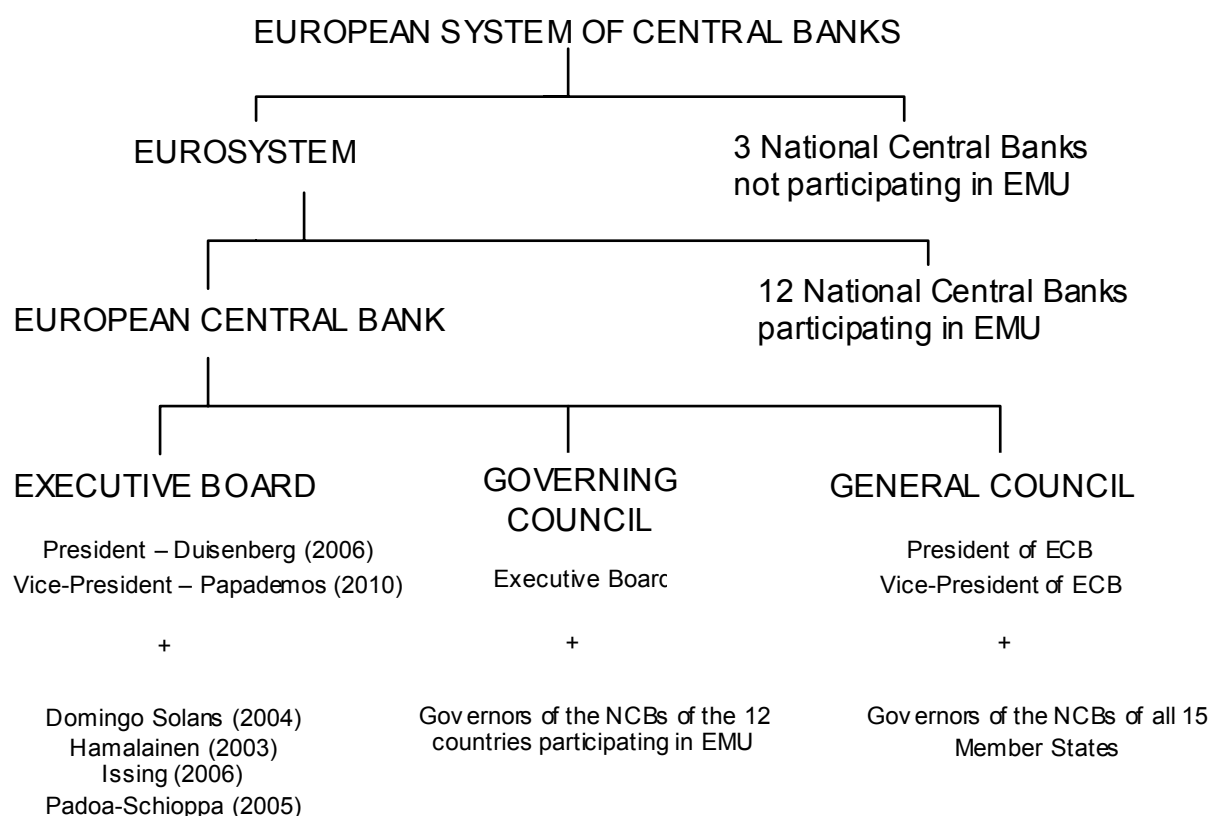
member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. The Community institutions and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the national central banks in the performance of their tasks."

primary *policy decision-making body* of the ECB. Each member of the Governing Council has one vote, and decisions are taken on the basis of a simple majority, if a vote is taken. Current practice is for the Governing Council to meet every two weeks in Frankfurt, with decisions on interest rates being taken at every other meeting³. At its meeting on 5 December 2002, the Governing Council chose to reduce euro area interest rates by 50 basis points, to 2.75 per cent.

General Council

12. While there are still EU Member States not participating in EMU, a General Council has also been established which consists of all 15 NCB Governors and the President and Vice-President of the Executive Board. This body has taken over some of the functions of the European Monetary Institute (which was the forerunner to the ECB) that are still required for Member States at the second stage of EMU, and contributes to the ESCB's advisory functions, the collection of statistical information, and the preparations for irrevocably fixing the exchange rates of the currencies of Member States with a derogation.

Figure 1: Organisational structure of the ESCB⁴



³ This has been the case since November 2001; previously, interest rates were considered at every meeting of the ECB Governing Council.

⁴ Figures in parentheses show the year Executive Board members' terms are due to end. The current President, Wim Duisenberg, has announced that he will take early retirement, and will step down in July 2003. Christian Noyer held the position of Vice-President until June 2002, when he was replaced by Lucas Papademos.

Formulation and implementation of monetary policy within EMU

13. Article 105 of the EC Treaty sets down the objectives of monetary policy within EMU, namely that the ECB's primary objective is to "maintain price stability" and, without prejudice to that, "to support the general economic policies in the Community, with a view to contributing to the objectives of the Community".

14. In line with Article 3 of the ESCB Statute, the ESCB is also officially mandated "to define and implement the monetary policy of the Community". The Governing Council is mandated with formulating the monetary policy of the Community including, as appropriate, the decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB. As noted in ECB (2001)⁵, on 13 October 1998, the ECB announced the strategy that it would follow in carrying out its remit to maintain price stability in the euro area.

15. As set out in Box 18.3 of HM Treasury (2002), the ECB announced a quantitative definition of "price stability" and set out a two-pillar approach to monetary policy to achieve this within EMU:

- A quantitative reference value for the growth of a broad money aggregate, the 'first pillar';
- A broadly based assessment of the outlook for price developments and the risks to price stability in the euro area as a whole, the 'second pillar'.

Price stability

16. The ECB Governing Council defined price stability as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2 per cent". At the same time, the Governing Council also stated that price stability "is to be maintained over the medium term".

Monetary aggregates

17. The reference value announced is for M3 (which includes currency in circulation, short-term bank deposits plus financial market securities) and is for 4.5 per cent growth⁶ (measured on a three-month moving average of the 12-month growth rate). Any deviations from the reference value are investigated further to see if the series is giving a signal of inflationary pressures in the euro area which would help inform monetary policy decisions. The reference value was last reviewed in December 2002, and was left at 4.5 per cent.

⁵ *The Monetary Policy of the ECB* (p38), European Central Bank, 2001

⁶ See ECB (2001), Box 3.3, for an explanation of the reference value.

Outlook for inflation

18. Under the 'second pillar', a wide variety of alternative economic indicators are assessed by the Governing Council, including wage developments, exchange rates, bond prices and the yield curve, fiscal policy indicators, price and cost indices, business and consumer confidence surveys. It also considers the inflation forecasts of independent agencies such as the OECD and produces its own assessment of the future outlook for inflation. The ECB has, since December 2000, published bi-annual staff economic projections.

Developments

19. At the ECB press conference on 5 December 2002⁷, President Duisenberg said that, "we will make a serious assessment and evaluation of the monetary policy strategy in the course of ... the first half of next year."

20. As the Chancellor said to the House of Lords' Select Committee in January 1999, "... the symmetry of the inflation target, which [has] proved to be central to the success of the United Kingdom's new monetary policy framework, will also be [an] issue[s] for future debate in Europe."

Reporting requirements

21. HM Treasury (2002) sets out the reporting arrangements currently followed by the ECB. Although the ESCB has been granted a high degree of independence, the Treaty (Article 15 of the ESCB Statute) establishes a set of minimum legal reporting requirements to explain how the ESCB is carrying out monetary policy for the euro area. It must publish quarterly reports on its activities, and must address an annual report to the European Parliament, ECOFIN, the European Commission and the European Council on its activities in the previous and current year. A presentation must also be made to the Commission and to the European Parliament. The European Parliament is also entitled to hold a general debate on the basis of the ECB's report (Article 113(3) of the EC Treaty) and request a hearing of the President or other members of the Executive Board at any time.

22. There is also a formal mechanism built in for developing contact between the ECB and ECOFIN. The President of ECOFIN and a member of the European Commission may participate, but without the right to vote, in meetings of the Governing Council of the ECB. The President of the ECB can also be invited to participate in meetings of ECOFIN when the Council is discussing matters relating to the tasks and objectives of the ESCB.

23. These are the minimum reporting requirements laid down in the Treaty. Within this framework, the ECB is left a considerable degree of discretion

⁷ *ECB Press Conference, Transcript of the questions asked and the answers given by Dr Willem F Duisenberg, President of the ECB, Dr Lucas Papademos, Vice-President of the ECB, ECB, 5 December 2002*

about how much of its decision-making processes and activities are made public. To date, short press releases are made available after the monthly Governing Council meetings at which interest rates are considered. Transcripts of the ECB's press conferences, held after the Governing Council meetings at which rates are considered, are publicly available. Monthly bulletins, in addition to the annual report, are also published by the ECB. As already noted, in December 2000, the ECB published for the first time, its bi-annual staff macroeconomic projections for the euro area. The President of the ECB appears before the European Parliament's Economic and Monetary Affairs Committee each quarter to report on the ECB's monetary policy; transcripts of the hearings are made available to the public. In addition, members of the Executive Board make frequent speeches throughout Europe and the world, which are generally made available to the public via the ECB's web-site. Research results of a technical nature and policy-related studies of general interest are also published by staff members in the ECB's Working Paper and Occasional Paper series respectively. Finally, statistical data collected by the ECB, with the help of the national central banks, including on money and banking, balance of payments, international investment position and financial accounts statistics covering the euro area, is published by the ECB.

24. As the Chancellor said to the House of Lords' Select Committee in January 1999, "the issues of transparency in decision making, which we dealt with in our reform of the Bank of England ... which have proved to be central to the success of the United Kingdom's new monetary framework, will also be issues for future debate in Europe."

Enlargement

25. The Nice Treaty includes an enabling clause to allow for changes to the voting structure of the ECB Governing Council, as set out in Article 10.2 of the ESCB Statute, to deal with enlargement.

26. The enabling clause is to be inserted as paragraph 6 of Article 10 of the Statute of the ESCB, and reads as follows: "Article 10.2 may be amended by the Council meeting in the composition of Heads of State or Government, acting unanimously either on a recommendation from the ECB and after consulting the European Parliament and the Commission, or on a recommendation from the Commission and after consulting the European Parliament and the ECB. The Council shall recommend such amendments to the Member States for adoption. These amendments shall enter into force after having been ratified by all the Member States in accordance with their respective constitutional requirements. A recommendation made by the ECB under this paragraph shall require a decision by the Governing Council acting unanimously."

27. The clause was accompanied by a political declaration stating, "The Conference expects that a recommendation within the meaning of Article 10.6

of the Statute of the European System of Central Banks and of the European Central Bank will be presented as soon as possible.”

28. On 20 December, the ECB issued a press release⁸ announcing the unanimous agreement of the Governing Council on the content of its proposal on the future adjustment of its voting modalities. As the press notice makes clear, the final decision of the Governing Council will be formally adopted as an ECB Recommendation as soon as the Treaty of Nice enters into force – expected for 1 February 2003 – and then submitted to the EU Council. As stated in the enabling clause, the final decision will be made by unanimous agreement of all fifteen Heads of State or Government.

**HM Treasury
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⁸ *Governing Council prepares for enlargement*, ECB Press Release, 20 December 2002