

THE MONETARY POLICY OF THE EUROSISTEM

Prof. Marius HERBEI, PhD

West University of Timișoara

Assist. Prof. Florin DUMITER, PhD Student

West University "Vasile Goldiș" of Arad

1. Introduction

Central banking in Europe always used to be the tantamount to issuing and managing national currencies: a national currency became an indispensable ingredient of national sovereignty; national banknotes, which occupied an increasingly important role in the circulation of money and eventually replaced par-value gold and silver coins as legal tender, communicated national cultures and symbols. Concurrently with increasing role of banknotes as a means of payment in modern economic life, their issuers, the central banks, grew in importance and the conduct of monetary policy became an essential part of the nation's economic politics.

Again this historical background, the realization of European Economic and Monetary Union at the end of the 20th century was unique in that it introduced a new monetary regime with a single currency for a large part of Europe. The 12 Member States of the European Union have so far adopted euro represents two-thirds of the European Union total population and the extension of the euro area to other European Union Member States is expected in due course.

The transfer of monetary policy to the Community level has required substantial changes to the European central banking framework. The establishment of a new supranational monetary organization, the European Central Bank, and the integration of the NCS's into a European central banking system, the European System of Central Banks (ESBC), and its sub-set, the

Eurosistem, are representative of the supranationalisation of European central banking. To date, no other policy area of the European Community has reached the same depth of integration as the single monetary and exchange rate policy. Nowhere else has the Community developed its own identity more convincingly than in euro and the European Central Bank.

The European Central Bank (ECB) is also the embodiment of modern central banking: the overriding objective of its monetary policy is price stability: it is independent within a clear and precise mandate and it is fully accountable to the citizens and their elected representatives for the execution of this mandate. These features are not necessary the result of purely European developments; they are in line with the worldwide trend. However, almost nowhere are these feature spelled out so clearly and firmly than in the organic law of the ECB, the Statue of the ESCB and of the ECB. Their embodiment in the European Community Treaty, with quasi-constitutional status, underlines their importance in the new monetary regime of Europe. The codification of central bank law in the European Community Treaty and the Statue of the ESCB is likely to serve as a benchmark for central bank law outside the European Union: Switzerland, for example, has recently revised its National Central Bank Act along the lines of the Statue of the ESCB.

2. Eurosystem monetary policy instruments

In order to achieve its objectives, the Eurosystem has at its disposal a set

of monetary policy instruments; the Eurosystem conducts open market operations, offers standing facilities and requires credit institutions to hold minimum reserves on accounts with the Eurosystem.

Open market operations

Open market operations play an important role in the monetary policy of the Eurosystem for the purposes of steering interest rates, managing the liquidity situation in the market and signaling the stance of monetary policy. Five types of instruments are available to the Eurosystem for the conduct of open market operations. The most important instrument is the *reserve transaction* (applicable on the basis of repurchase agreements or collateralized loans). The Eurosystem may also use outright transactions, the issuance of debt certificates, foreign exchange swaps and the collection of fixed-term deposits. Open market operations are initiated by the ECB, which also decides on the instrument to be used and on the terms and conditions for its execution. They can be executed on the basis of standard tenders, quick tenders or bilateral procedures. With regard to their aims, regularity and procedures, the Eurosystem's open market operations can be divided into four categories:

1. *The main refinancing operations* – are regular liquidity-providing reverse transactions with a weekly frequency and a maturity of normally one week. These operations are executed by the national central banks on the basis of standard tenders. The main refinancing operations play a pivotal role in pursuing the objectives of the Eurosystem's open market operations.

2. *The long term refinancing operations* – are liquidity providing reverse transactions with a monthly frequency and a maturity of normally three months. These operations are aimed at providing counterparties with additional longer term refinancing and are executed by the national central

banks on the basis of standard tenders. In these operations, the Eurosystem does not, as a rule, intend to send signals to the market and therefore normally acts as a rate taker.

3. *Fine-tuning operations* – are executed on an ad hoc basis with the aim of managing the liquidity situation in the market and steering interest rates, in particular in order to smooth the effects on interest rates caused by unexpected liquidity fluctuations in the market. Fine-tuning operations may be conducted on the last day of a reserve maintenance period to counter liquidity imbalances which may have accumulated since the allotment of the last main refinancing operation. Fine-tuning operations are primarily executed as reverse transactions, but may also take the form of either foreign exchange swaps or the collection of fixed-term deposits. The instruments and procedures applied in the conduct of fine-tuning operations are adapted to the types of transactions and the specific objectives pursued in the operations. Fine-tuning are normally executed by the NCB through quick tenders or bilateral procedures. The Governing Council of the ECB can decide whether, under exceptional circumstances, fine-tuning bilateral operations may be executed by the ECB itself.

4. *In addition, the Eurosystem may carry out structural operations* through the issuance of debt certificates, reverse transactions and outright transactions. These operations are executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis – á – vis the financial sector. Structural operations in the form of reverse transactions and the issuance of debt instruments are carried out by the national central banks through standard tenders. Structural operations in the form of outright transactions are executed through bilateral procedures.

Standing facilities

Standing facilities are aimed at providing and absorbing overnight liquidity, signal the general stance of monetary policy and bound overnight market interest rates. Two standing facilities are available to eligible counterparties on their own initiative, subject to their fulfillment of certain operational access conditions:

- *Counterparties can use the marginal lending facility* to obtain overnight liquidity from the national central banks against eligible assets. Under normal circumstances, there are not credit limits or other restrictions on counterparties' access to the facility, apart from the requirement to present sufficient underlying assets. The interest rate on the marginal lending facility normally provides a ceiling for the overnight market interest rate.

- *Counterparties can use deposit facility to make overnight deposits with the national central banks.* Under normal circumstances, there are no deposit limits or other restrictions on counterparties access to the facility. The interest rate on the deposit facility normally provides a floor for the overnight market interest rate.

Minimum reserve

The Eurosystem's minimum reserve system applies to credit institutions in the euro area and primarily pursues the aims of stabilizing money market interest rates and creating a structural liquidity shortage. The reserve requirement of each institution is determined in relation to elements of its balance sheet. In order to pursue the aim of stabilizing interest rates, the Eurosystem's minimum reserve system enables institutions to make use of averaging provisions. Compliance with the reserve requirement is determined on the basis of the institutions' average daily reserve holdings over the maintenance period. Institutions' holdings of required reserves are remunerated at the rate of

the Eurosystem's main refinancing operations.

3. The preparation of the monetary policy decisions*Regular preparations*

When setting the interest rate, the Governing Council of the ECB applies a monetary policy strategy (figure 1), consisting of a definition of price stability and an economic and monetary analysis of the risks to price stability. The ECB's monetary policy strategy was the outcome of intense discussions at all working levels of the ECB and NCBs, and has been tailored to the needs of a large currency area. This stability oriented policy strategy was adopted by the Governing Council in October 1998. It is based on two main elements: a quantitative definition of price stability, and a two pillar framework which is the ECB's own approach to organizing, evaluating and cross-checking the information relevant for assessing risks to price stability in the euro area.

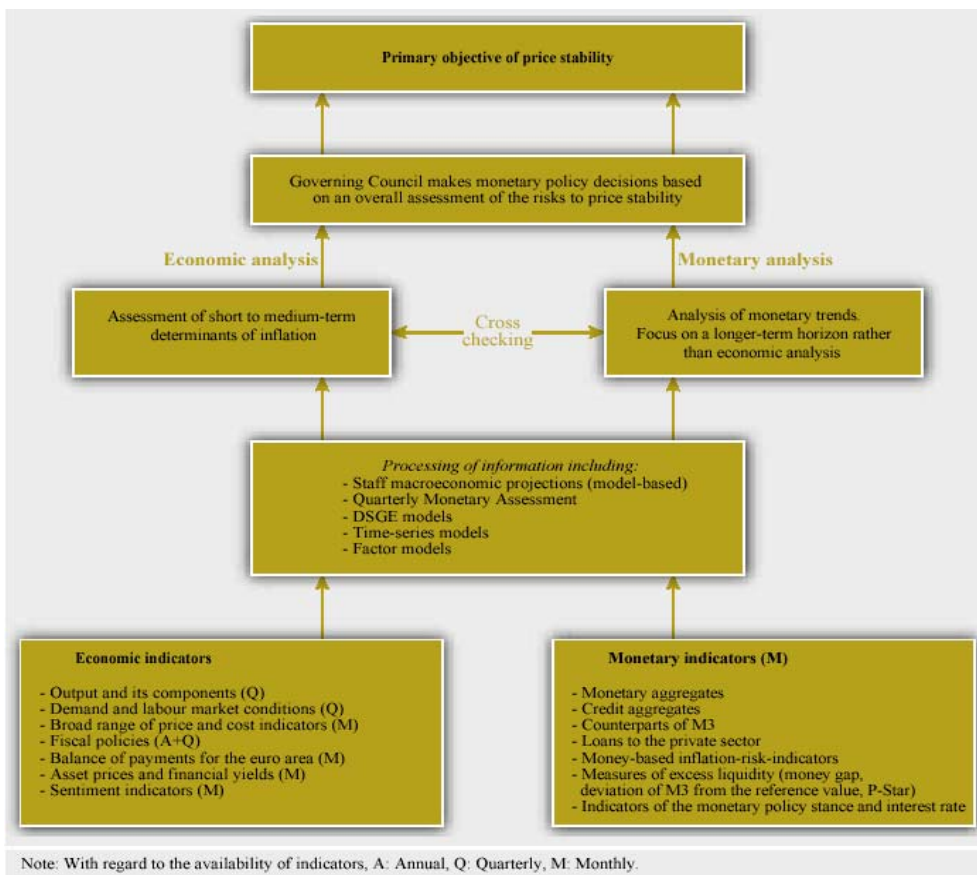
The Governing Council regularly carries out two analyses, namely an economic analysis to identify the short to medium term risks to price stability and a monetary analysis to assess medium to long term inflation trends. These two analyses are known as the *two pillars*.

The governing council has indicated that, for practical purposes it is important to ensure the robustness and to avoid major policy errors. It has therefore assigned monetary analysis the role of cross-checking, from a medium to long-term perspective, with the short to medium term indications being suggested by its economic analysis. The economic and monetary analyses include a large number of relevant indicators that are monitored regularly, and a set of briefing documents discussing their evolution and addressing specific topical issues is made available to the Governing Council at its first meeting of every month. This ensures that the policy makers systematically receive all relevant

information in a systematic manner. All these documents are prepared by the ECB staff. This information is usually

reflected in the monthly bulletin of the same month after the Governing Council has made its decision on policy rates.

Figure 1 The ECB’s monetary policy strategy



Source: European Central Bank

The Eurosystem’s projection exercises

Macroeconomic projections play an important role in economic analyses of the ECB’s monetary policy strategy but, they are only one input among others. These projections for euro area inflation, output and other macroeconomic variables are produced jointly by experts from the Eurosystem and the ECB on a biannual basis, the other two times by ECB staff only, and are published every quarter in the ECB’s Monthly Bulletin.

Information about the economic outlook of the euro area is a vital component of the policy making process. Before a decision is made, the Governing Council analyses a large amount of economic, financial and monetary data with regard to their implementations for the future risks to price stability. The constraints faced by the Governing Council are determined by the structure of the economy and economic disturbances. Before every Governing Council meeting, the Executive Board circulates documents prepared by ECB staff summarizing its latest assessment of the indicators monitored within the

economic and the monetary analyses. Every third month, the briefing material includes the results of the Eurosystem/ECB staff macroeconomic projections, as agreed by the Eurosystem Monetary Policy Committee and its working groups.

The Eurosystem/ECB staff macroeconomic projections are a convenient analytical tool for considering a broad range of information on current and future economic developments. They provide a scenario for the euro area economy that will most likely materialize over a horizon of two years. Based on a set of assumptions, they combine the use of conventional models with economic experts' judgment. Discussions among Eurosystem staff, as well as other tools, ensure the consistency of the results. The projection exercises are a regular source of information for the deliberations of the Governing Council. They do not, however, incorporate the Governing Council's judgment with the result that, in practice, the Governing Council's assessment can deviate from the staff assessment.

The forecasting process

It is important to concentrate also on the Eurosystem staff macroeconomic projections in order to illustrate the interactions of the Eurosystem's committees with other technical levels. This involves a series of relatively complex interactions between various business areas of the ECB, including Directorate General Economics (DG-E), Directorate General International and European Relations (DG-I) and Directorate General Research (DG-R, which maintain the models), as well as the NCBs. The Eurosystem Monetary Policy Committee which is composed of senior staff representatives of the ECB and the NCBs, takes the lead, regarding all technical matters. It provides the necessary guidance for producing the projections and the internal report on the Eurosystem staff projection exercise.

Twice a year, a fully pledge projection exercise is conducted involving experts at the technical level from the ECB and NCBs, while on two other occasion the ECB releases projections that are updated by the ECB staff only. The aim of the exercise is to provide the Governing Council with detailed quantitative information on the economic outlook for the euro area. This information is summarized and explained in a Eurosystem staff macroeconomic projections report. This report is not a genuine inflation report, as issued by the Bank of England for example, or a monetary policy report as issued by Sveriges Riksbank, although its structure and content are nevertheless fairly similar. It contains detailed information about the projection assumptions and the economic outlook for the euro area as a whole. There is also a detailed assessment of price trends for a shorter term horizon. However, it does not contain any information on longer term price trends derived from monetary or credit aggregates; this is instead prepared by ECB staff within the monetary analysis.

4. Conclusions

In this paper we present the procedures of the mechanism through which consensus of monetary policy decisions is achieved within the Eurosystem. We suggest that the federal structure of the Eurosystem and committee work at the various hierarchical levels are crucial for the smooth functioning of the monetary policy process and ultimately for the maintenance of price stability in the euro area. The committee structure of the Eurosystem and the close cooperation between the ECB and NCB staff contributes to the fulfillment of the Eurosystem's task and to the smooth running of the organization.

We think that an important aspect of the Eurosystem's monetary policy preparations is the committee in all functional areas process information by

fully exploiting the expertise of ECB and NCB experts. The level of interaction between the ECB and NCBs in the preparation, decision and the implementation of the decision making process vary, but in the light of the decentralized structure of the Eurosystem, the NCBs play an important role.

Working through the Eurosystem's committees and its substructures boosts the efficiency of the deliberation of the Governing Council,

which sets interest rates based on consensus. The cooperation in the Eurosystem through its committee structure fosters operational efficiency and will, at some stage, contribute to the realization of a *system of identity* as well as the sharing of common values. Furthermore, the fully-fledged committee structure has contributed to the smooth integration of the non-euro Member States into the Eurosystem's monetary policy decision process.

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