

## **Klaus Liebscher: The role and functioning of the European System of Central Banks (ESCB)**

Speech by Mr Klaus Liebscher, Governor of the Austrian National Bank, at the 5th Legal Alumni Web of the Salzburg Seminar (LAWSS) Symposium, Salzburg, 6 July 2004.

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### **1. Introduction**

I gladly accepted the invitation of the Alumni Web of the Salzburg Seminar to speak to you about the architecture and the functioning of the European System of Central Banks, addressing, in particular, the role of the OeNB in this framework.

In early 1999, the adoption of the single monetary policy by the ECB marked the successful transition to Stage Three of Economic and Monetary Union (EMU). The introduction of euro banknotes and coins as legal tender concluded the process of establishing a single monetary area, which at that point finally became a tangible reality for all European citizens. It is no exaggeration to say that the birth of the euro was a truly historic event. For the first time in history, a group of independent countries has relinquished its sovereign power to issue money to a newly created supranational institution and given up its national currencies to adopt a common currency. Virtually over night, the euro became the single currency for 11 - and since 2001, when Greece introduced the euro, for 12 - sovereign Member States of the European Union. Together, these countries with a population of some 300 million represent an economic area comparable in terms of economic power to the U.S. market.

Economic and Monetary Union and the euro have been a success story: exchange rate risks between the Member States of EMU have been eliminated and there has been considerable progress in disinflation and economic convergence in the euro area. The euro is well on its way to firmly establish itself as an internationally renowned currency, thus becoming a solid cornerstone of the international monetary system.

Looking back, we can say that Austria's accession to monetary union represented a major step for the OeNB, just like for all central banks of the participating countries. The integration into the ESCB with the European Central Bank (ECB) at its helm was an entirely smooth process.

The national central banks of the euro area countries thus formally relinquished their monetary sovereignty. Since January 1, 1999, the sole responsibility for the single monetary policy has been vested in the Governing Council of the ECB, which is independent and not bound by any instructions. Let me underline at this point that the division of responsibilities as stipulated by the Treaty establishing the European Community clearly removes any doubts that have been raised from time to time about the purpose of national central banks in the framework of a common monetary policy.

### **2. The institutional framework of the European System of Central Banks**

I would like to start by giving you an outline of the institutional setup of the European System of Central Banks.

The establishment of the European Central Bank in June 1998 also marked the creation of the European System of Central Banks. According to the Statute of the ESCB and the ECB, the European System of Central Banks consists of the ECB and the national central banks of the 25 EU Member States.

The monetary policy of the euro area is of course only determined by the ECB and the 12 national central banks of the euro area. Accordingly, the concept "Eurosystème" refers to the ECB and the 12 national central banks of the Member States which have adopted the euro presently. The national central banks of the Member States which do not participate in the euro area, that is, the United Kingdom, Denmark, Sweden and the 10 new Member States, however, are members of the ESCB with a special status. While they are allowed to conduct their respective national monetary policies, they do not take part in decision making with regard to the single monetary policy for the euro area and the implementation of such decisions.

Since the beginning of Stage Three of EMU, the Eurosystème has been exclusively responsible for the single monetary policy of the euro area. The Eurosystème is independent from taking instructions from

any external political body; its primary objective is to maintain price stability. Without prejudice to this objective, the Eurosystem supports the general economic policies in the Community and acts in accordance with the principles of an open market economy.

As to exchange rate policies, a rather complex division of responsibilities between the ECOFIN Council (i.e. the Council of economics and finance ministers) and the ECB is set out in the Maastricht Treaty. The division of responsibility between these two bodies hinges on the exchange rate regime in place. The free-floating regime pursued since the onset of monetary union implies that the exchange rate policy is indirectly governed by the relative interest rates set by the central banks of the leading world currencies; besides, the Eurosystem has intervened in the foreign exchange markets or controlled the exchange rate by statements made by members of the Governing Council whenever they felt that the exchange rate of the euro had moved too quickly or too far.

### **3. The key tasks of the Eurosystem**

Let me now turn to the key tasks of the Eurosystem.

The Treaty establishing the European Community (Article 105.2) clearly defines the Community responsibilities in the area of monetary policy. Accordingly, the basic tasks to be carried out by the Eurosystem are

- to define and implement the monetary policy of the euro area;
- to conduct foreign exchange operations consistent with the monetary policy of the euro area;
- to hold and manage the official foreign reserves of the Member States; and
- to promote the smooth operation of payment systems.

In addition, there is a very strict rule prohibiting the monetary financing of the public sector that makes clear that monetary policy and fiscal policy should be two separate areas of policy. Furthermore, the Eurosystem contributes 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 system. Moreover, the national central banks may continue to carry out other tasks and activities, provided that they are in line with the single monetary policy.

The decision-making bodies of the Eurosystem are the Executive Board and the Governing Council of the ECB. The General Council is constituted as a third decision-making body of the ECB for as long as there are Member States which have not yet adopted the euro.

The Executive Board of the ECB comprises the President, the Vice-President and four other members, all chosen from among persons of recognized standing and professional experience in monetary or banking matters. As you know, former OeNB Deputy Governor Tumpel-Gugerell is a member of the Executive Board of the ECB. The members of the Executive Board of the ECB are appointed by the EU heads of state or government after a hearing before the European Parliament. The main responsibilities of the Executive Board are to implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council of the ECB and, in doing so, to give the necessary instructions to the national central banks.

The Governing Council comprises the six members of the Executive Board and the governors of the national central banks of the Member States which have adopted the euro. The Governing Council takes decisions with a simple majority according to the "one member, one vote" principle. The responsibilities of the Governing Council are:

- to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the Eurosystem;
- to formulate the monetary policy of the euro area, including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the Eurosystem; and
- to establish the necessary guidelines for the implementation of the single monetary policy.

The Eurosystem is independent. When performing Eurosystem-related tasks, neither the ECB, nor a national central bank, nor any member of their decision-making bodies may seek or take instructions

from any external body. The Member States and the Community institutions and bodies, in turn, may not seek to influence decision makers in the Eurosystem (Art. 108 EC Treaty).

In the past five years, European policymakers have repeatedly attempted to put political pressure on the Eurosystem. Only a few weeks ago, two high-level politicians from large EU countries called upon the ECB to cut interest rates. There were even threats to establish a political committee of government representatives to exert influence on the Eurosystem's decision making. In the history of central banking, we have seen such attempts of interference time and again. And that is precisely why governments made their central banks independent - to protect their currencies from their own and their successors' influence.

It would be wrong to simply dismiss such threats. In my opinion, they prove that first, central bank independence is a vital institutional provision to guarantee continued price stability; and second, support for a stability-oriented policy must be gained, sustained and strengthened anew every day. Central banks play a key role in educating and informing both the general public and economic policymakers. In other words, central banks are the guardians of the generally agreed importance of a permanently stable currency.

#### **4. The architecture of the Eurosystem**

The architecture of the Eurosystem rests on the principle that decisions are made at the central level, that is, at the ECB; more precisely, the Governing Council of the ECB decides all key issues. This is the only way to ensure that the monetary policy of the euro area is uniform. Monetary policy implementation, which usually absorbs the better part of a central bank's capacities, takes place at the subsidiary level and is coordinated by the Executive Board of the ECB. In other words, the national central banks are responsible for the operational aspect of the single monetary policy. This approach - central decision making and adoption of guidelines as well as decentral implementation - is a common thread that runs through all areas of activity of the Eurosystem.

At this point, I would like to draw your attention to the following two details: The *first* concerns the legal nature of the Eurosystem. The Eurosystem does not have legal personality, but its components - the ECB and the national central banks - do.

The concept "Eurosystem" solely refers to the fact that the ECB and the national central banks are integral parts of an entity that is characterized by common rules, goals and tasks which apply to both internal and external relations. The concept highlights the Eurosystem's federal nature and the equal institutional role of the national central banks within this system.

The second concept I would like to elucidate is the concept of "subsidiarity." The principle of subsidiarity stipulates that all responsibilities in society be distributed in a way that is in the general interest and that ensures maximum freedom. Responsibilities that can be exercised at lower levels should not be taken on by higher-level bodies.

The assignment of monetary policy from the national to the supranational Community level stems from the conviction that it is in the Member States' general economic interest. Monetary policy operations, however, continue to - and should - be carried out at the, if I may say so, subsidiary level, by the national central banks to the extent deemed possible and appropriate.

#### **5. Tasks and responsibilities of the national central banks**

What are the key tasks and responsibilities of the national central banks against this background? The structure and idea of the Eurosystem I described before clearly assigns the national central banks the task of implementing the monetary policy formulated by the Governing Council of the ECB. In practice, the national central banks have substantial room for maneuver, which is embedded in their various tasks.

Roughly speaking, we can identify the following five key tasks and responsibilities of the national central banks:

- *First*, the governors of the national central banks participate in the decision-making process in the Eurosystem by attending the meetings of the Governing Council of the ECB and exercising their voting right in a personal and independent capacity.

- *Second*, the national central banks act as a communication hub between monetary policymakers at the European level and national economic policymakers as well as the general public in their respective countries.
- *Third*, the national central banks play the operational role within the Eurosystem - they implement monetary, foreign exchange and payments policy and contribute to or compile monetary and balance of payments statistics.
- *Fourth*, while being part of the Eurosystem, the national central banks remain independent institutions that have the right to pursue activities in their own responsibility beyond monetary policy, e.g. financial market supervision.
- *Fifth*, the national central banks are investors in the ECB; together, they own shares of the ECB and are thus entitled to equivalent shares of the ECB's profit.

### **5.1 Shaping the single monetary policy and the primary objective of price stability**

I would now like to go into more detail in explaining the national central banks' five key areas of responsibility. As I mentioned before, the national central banks participate in shaping the single monetary policy in the EU.

To ensure that the ambitious goals of monetary union are accomplished, the Maastricht Treaty sets out a clear and transparent framework for the institutional implementation of monetary policy in the euro area. As Article 105 of the Treaty establishing the European Community stipulates, "The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community."

In other words, the maintenance of price stability is the most important guiding principle of the architecture of the European System of Central Banks. The clear hierarchy of objectives that the Treaty establishes for the Eurosystem reflects decades of practical experience and a large number of economic studies which suggest that monetary policy will contribute most to improving economic prospects and raising the living standards of citizens by maintaining price stability in a lasting way.

To communicate the objective of price stability in a clear and comprehensible way to the general public, the Governing Council of the ECB defined price stability as the year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below, but close to 2%. In line with this definition, price stability "is to be maintained over the medium term." The announcement of this definition is supposed to provide a firm anchor for expectations of future price developments.

To achieve its price stability objective, the Eurosystem has devised a monetary policy strategy. The approach to organizing, evaluating and cross-checking the information relevant for assessing the risks to price stability is based on two analytical perspectives, referred to as the two "pillars". The first perspective, also called the pillar of "economic analysis", is aimed at assessing the short to medium-term determinants of price developments, with a focus on real activity and financial conditions in the economy. The second perspective, referred to as the "monetary analysis", focuses on a longer-term horizon, exploiting the long-run link between money and prices. The two-pillar strategy enables the Governing Council to identify potential inflation risks and take appropriate action and at the same time provides a framework which permits the general public to understand and assess the monetary policy decisions made by the Governing Council.

As I mentioned earlier on, the Governing Council of the ECB takes monetary policy decisions with a simple majority. Members of the Governing Council have one vote each regardless of the size and economic importance of the country they represent. The "one member, one vote" principle reflects the spirit of the Treaty according to which Governing Council members are obligated to place the Community interest before the interest of their countries or institutions when taking monetary policy decisions.

They are obligated to fulfill the Eurosystem's tasks and must center their considerations on the monetary policy requirements of the euro area as a whole rather than taking into account national or regional factors, such as inflation rates.

Accordingly, central bank independence - as mentioned before - has a particularly high priority in the Treaty. There are three levels to which independence applies: the institutional, the personal and the financial level.

Under the Treaty provisions, neither the ESCB nor any member of its decision-making bodies may seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body ( *Article 108 Treaty* ). Moreover, the Statute of the ESCB and of the ECB contains precise stipulations to ensure the personal independence of ECB Executive Board members and national central bank governors - such as of a minimum term of office (5 years), the prohibition of seeking or taking instructions and protection against dismissal prior to fulfillment of their terms. Additionally, the central banks must have sufficient funds to adequately fulfill their statutory tasks in the ESCB.

ECB and Eurosystem independence was sometimes criticized, especially at the beginning of EMU. The ECB was decried as too powerful, as undemocratic, as devoid of adequate transparency and accountability. I, for one, do not share this opinion. The independence of the ECB, the Eurosystem and of its decision makers certainly does not mean that these bodies and people are not answerable to society or the general public. In fact, this independence calls on these bodies to explain monetary policy decisions, strategy and motives to the general public, that is, it calls for transparent communications.

Central bank independence is one side of the coin; accountability and transparency the other. In a democracy, accountability is owed to those whose interests an institution is obligated to represent. However, accountability for an independent institution makes sense only if that institution's mandate is clearly defined and delimited.

For the Eurosystem, this clear mandate is established by the provisions of the Treaty, which designates the maintenance of price stability as its primary objective. In addition, the Treaty provides for a number of concrete accountability duties for the ECB, such as appearances of the President of the ECB at hearings of the European Parliament or the obligation to publish a detailed annual report. Furthermore, the President of the Council and a member of the Commission may participate in the meetings of the ECB-Council. This institutional arrangement shall guarantee for a necessary flow of information between the Eurosystem and the political institutions of Europe. It should not, however, interfere with the independence of the Eurosystem, thus these two representatives have of course no voting right in the decisions of the Governing Council.

The Eurosystem's external communications activities up to now - press conferences, the publication of e.g. the Monthly Bulletin and the Annual Report, the comprehensive information provided on websites and the hearings of the President of the ECB in the European Parliament - have in fact accomplished a high degree of transparency.

## **5.2. Conveying information about the single monetary policy**

Accountability and transparency for European monetary policymaking is the perfect starting point for the discussion of the *second* important role that the national central banks have to fulfill: they represent the interface between the single monetary policy and the general public as well as economic policymakers in the Member States. Like every central bank, the Eurosystem depends on effective communications with the general public and with economic policymakers for the success of its monetary policy.

Just like any other central bank, the Eurosystem has assumed the task of regularly informing the public about its strategy and about the motives for its monetary policy measures. These activities ensure that policymakers, business and the general public understand monetary policymaking and lend their support and cooperation. For a number of reasons, the national central banks play a central role in this context: they are aware of the issues to which the citizens of their countries are sensitive or which are considered especially touchy; they and the general public speak a common language; they have enjoyed the confidence of the general public for many years. Moreover, they have built up a tight network of contacts and communication channels. Hence, the national central banks are ideally placed to perform the Eurosystem's communications work at the national level. Of course, in pursuing their external communications activities at the decentralized level, the national central banks must observe a clearly uniform concept, the so-called "single voice principle".

Another core aspect of the national central banks' interface function is the exchange with national economic policymakers. After all, one of the typical features of a monetary union is that regionally different economic developments and various structural problems cannot be offset any longer by applying economic policy instruments such as adjusting domestic interest rate levels or the exchange

rate. Rather, monetary union member countries must employ economic policy instruments which have remained in their national competence, such as fiscal, income or structural policies.

While these economic policy domains are not within the competence of central banks, the central banks are nevertheless obligated to inform national policymakers and the general public what important adjustments a monetary union requires. Only in this fashion can the euro area countries fully benefit from monetary union and keep disadvantages to a minimum. Thus at the euro area level, it is imperative to resolutely continue work toward consolidating public finances as agreed in the Stability and Growth Pact and toward making economic structures more flexible.

### **5.3. Operating arms of the Eurosystem**

Let me move on to the *third* important function that national central banks have. The national central banks act as the operative arms of the Eurosystem and as such are responsible for monetary policy implementation.

The subdivision of monetary policy into centralized decision making and decentralized implementation has obvious advantages. The decentralization of central banking operations enables the Eurosystem to use the national central banks' infrastructure and benefit from their experience in handling monetary policy operations. The national central banks have acquired valuable experience and knowledge about their national financial markets and are thus best placed to continuously observe changes in market participants' behavior.

The national central banks are indispensable intermediaries between the policymakers at the ECB and the Eurosystem counterparties in that they ensure that all of the many Eurosystem counterparties have equal and equitable access to central bank liquidity. Additionally, the national central banks' proximity to the home financial and banking sector guarantees that the Eurosystem's monetary policy instruments retain their effectiveness and efficiency even in a rapidly changing environment.

Therefore, the tasks the national central banks handle on behalf of the ECB include the execution of open market and other monetary policy operations. In addition, the national central banks intervene in the foreign exchange market if required, they are in charge of manufacturing and issuing euro banknotes, they are responsible for payment systems oversight and they assume specific supervision responsibilities for large-volume payments (e.g. in the TARGET system, whose Austrian component is ARTIS). As part of the operational tasks they fulfill for the Eurosystem, the national central banks also hold the minimum reserves of the commercial banks in their respective countries, collect statistical data, draw up economic analyses and take part in international monetary policy cooperation, e.g. within the IMF and the BIS.

### **5.4. Specific national central bank functions**

This leads me directly to the *fourth* function of the national central banks. In addition to their role as an "integral part of the Eurosystem", the national central banks have assumed a number of specific tasks with which they have been entrusted over time.

It is the intention of the Statute of the ESCB and the ECB to preserve the structures within which national central banks have established themselves in the course of time. What is clear, however, is that every national central bank must handle such additional tasks on its own responsibility and at its own cost, that these tasks must be consistent with the requirements of the single monetary policy and that they must not burden the Eurosystem.

These national responsibilities include, above all, obligations of a supervisory nature, with most national central banks either fully responsible for financial market or banking supervision or in some cases providing support.

### **5.5. The NCBs as ECB shareholders**

What is the national central banks' role as shareholders of the ECB? How is this *fifth* key function of the national central banks organized? The capital of the ECB comes to roughly EUR 5.5 billion in total, with each of the national central banks of the 25 EU Member States holding a share of this capital.

50% of the national central banks' capital shares are calculated on the basis of the population share of the respective Member State, 50% on the basis of the respective Member State's share in the gross

national product of the Community. The OeNB's share is about 2%, which corresponds to a capital volume of around EUR 115 million. The difference between EU member countries which have introduced the euro and those which have not is that the euro area national central banks pay up 100% of their capital share whereas the non-Eurosystem national central banks transfer only a small portion - 7% - of their capital share to the ECB. The interest earned on this contribution is to cover the operational cost of these national central banks' participation in the ESCB.

Among other things, paying up the capital share of the ECB entitles the national central banks to a share of the ECB's profit. In addition to profit distribution, the capital key also governs the distribution of the income from euro banknotes (seigniorage income).

## **6. Experience and outlook after more than five years of success with EMU**

To conclude, ladies and gentlemen, let me turn to the outlook for European monetary policy.

Now, having completed this round of EU enlargement, it is time to look ahead. I am convinced that all parties involved in the enlargement process are going to benefit from this further integration in Europe.

The new Member States will certainly gain most from their new status, but also the current EU Member States, especially those with strong trade links towards the enlargement area as for example Austria, will experience positive effects.

Upon entering the European Union, the ten new member states - as I already mentioned - became members of the Economic and Monetary Union. While they will not yet take part in EMU to the full extent, as they cannot adopt the euro immediately, this certainly is the next step the countries are aiming for. From the point of view of a country that already enjoys the benefits of the common currency, it is essential that the next step of European integration, the adoption of the euro in the acceding countries, is as well prepared as all past integration steps.

The Treaty with its convergence criteria provides the right guidance in this direction and the appropriate framework to assess whether a country shows a record of stability-oriented monetary and fiscal policy (low inflation, low deficits) and therefore can be regarded as ready for monetary integration.

One important convergence requirement in this process is the Exchange Rate criteria. The exchange rate criterion requires formal participation in the Exchange Rate Mechanism (ERM) for at least two years linking the specific currency to the Euro with no devaluations and without severe tensions. This framework is designed to provide for flexibility and adjustability as well as for enough stability to help anchor expectations. In this view, participation in ERM II should contribute to real and nominal convergence. To ensure a smooth participation in ERM II which is envisaged by all acceding countries it is essential that major policy adjustments are undertaken prior to participation in the mechanism and that a credible fiscal consolidation path is being followed. At the end of June - just two weeks ago - this first step in the direction of the adoption of the Euro was successfully completed by Estonia, Lithuania and Slovenia. Now these three countries participate together with Denmark in the ERM II framework.

Let me conclude with expressing my conviction that the enlargement of the European Union and the economic and monetary integration of the acceding countries will not only strengthen the role of the European Union as a global player in the long term, but also make a sustainable contribution to stability, peace and welfare in Europe. Therefore, I am looking forward to this new era that lies in front of us, characterized by a larger number of Member States and, in terms of ideas, by an even larger potential of human beings.