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Monetary cooperation and monetary policy in the EU

The ECB and the common monetary policy

Lecture 3

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The ECB and the common monetary policy

Lecture 3

In this lecture you will learn about:

- The European Monetary Institute
- The European Central Bank (mission, organisation, responsibilities)
- The common monetary policy in the Eurozone
- The role of the ECB in crisis management

The European Monetary Institute (1994-98)

In 1992, the Treaty on European Union, better known as the Maastricht Treaty, laid out a road map to a common currency and central bank for the EU. As part of this, the **European Monetary Institute (EMI)** was **established in January 1994** and was an **intermediate**, but crucial step towards establishing the European Central Bank (ECB). Unlike the Committee of Governors before, the EMI got its **own legal personality** and quickly grew as an organisation and in terms of staff numbers.

The EMI had **two Presidents**: first **Alexandre Lamfalussy** and then **Willem Frederik Duisenberg** from July 1997. Duisenberg also became the first President of the ECB in 1998. The EMI's main focus was on establishing the **European System of Central Banks (ESCB)**, including the ECB, and the **new currency**. It also dealt with some operational tasks, such as replacing the **European Monetary Cooperation Fund (EMCF)**, which had come before.

The EMI aimed to:

- better **coordinate monetary policy** in the EU
- enforce **financial stability**
- improve (cross-border) **payment systems** in the EU
- develop a **regulatory**, **organisational** and **logistical framework**
- develop a **common monetary policy strategy** for the euro
- **prepare** a **single money market**.

The ECB

On **1 January 1999** the **third and final stage of EMU** commenced with the **irrevocable fixing of the exchange rates** of the currencies of the **11 member states** initially participating in monetary union and with the conduct of a **single monetary policy under the responsibility of the ECB**.

Thus the ECB is the **central bank of the Eurozone**.

The **capital** of the ECB **comes from the national central banks (NCBs)** of all EU member states. The NCBs' shares in this capital are calculated using a key which reflects the respective country's share in the total population and gross domestic product of the EU. Its **large part is provided by euro area countries**; however, the EU's eight **non-euro area NCBs** are also required to contribute to the operational costs incurred by the ECB in relation to their participation in the European System of Central Banks (ESCB) by **paying up a small percentage** of their share in the ECB's subscribed capital.

EUROPEAN CENTRAL BANK

EUROSYSTEM

The ECB's mission

The **European Central Bank (ECB) and the national central banks (NCBs) together** constitute the **Eurosystem**, the central banking system of the euro area. The **main objective** of the Eurosystem is **to maintain price stability**: safeguarding the value of the euro.

Inflation-targeting monetary policy roots in German economic history (-> tackling post WWI hyper-inflation) and thinking (low inflation is important in economic stability). The ECB's monetary policy was based on that of the Bundesbank.

Inflation-targeting monetary policy is active when there is inflationary pressure in the economy. The response is: increasing the interest rate. The consequences are: credits become more expensive while investments less attractive (compared to saving money) -> less money in circulation -> inflation is reduced. Side-effect: cooling down of economic growth.

This became a problem during the financial economic crisis because 1) prioritising inflation to economic growth resulted in the passivity of the ECB when there was a need to fuel growth, 2) in normal times, interest rate is fairly low so there is not much room to provide monetary stimulus when a recession hits the economy.

ECB increases interest rate to prevent high inflation. The common monetary policy in the Eurozone had been working flawlessly until the global financial crisis of 2008.

How can inflation levels diverge in different member states?

Because there are different economic performances but a common monetary policy. Prices of goods and services are not fixed so differences in competitiveness can result in different inflation rates.

The ECB is responsible for the **prudential supervision** of credit institutions located in the euro area and participating non-euro area Member States, **within the Single Supervisory Mechanism (SSM)**, which also comprises the national competent authorities. It thereby contributes to the safety and soundness of the banking system and the stability of the financial system within the EU and each participating Member State.

Organisation of the ECB

The ECB is an official EU institution at the heart of the Eurosystem and (since 2014) the Single Supervisory Mechanism. It is located in Frankfurt am Main, Germany.

The **decision-making bodies** of the ECB are:

- **Governing Council**
- **Executive Board**
- **General Council**
- **Supervisory Board**

Governing Council: The Governing Council is the **main decision-making body** of the ECB. It consists of **the six members of the Executive Board**, plus **the governors of the national central banks of the euro area countries**.

Responsibilities:

- to adopt the guidelines and **take the decisions** necessary to ensure the performance of the tasks entrusted to the ECB and the Eurosystem;
- to **formulate monetary policy** for the euro area – this includes decisions relating to monetary **objectives**, key **interest rates**, the supply of **reserves** in the Eurosystem, and the establishment of **guidelines** for the implementation of those decisions;
- in the context of the ECB's **new responsibilities** related to **banking supervision**, to adopt decisions relating to the general framework under which supervisory decisions are taken, and to adopt the complete draft decisions proposed by the Supervisory Board under the non-objection procedure.

The Governing Council **usually meets twice a month** at the ECB's premises in Frankfurt am Main, Germany.

Executive Board: The Executive Board consists of the President, the Vice-President and four other members. All members are appointed by the European Council, acting by a qualified majority.

Responsibilities:

- to **prepare Governing Council meetings**;
- to **implement monetary policy** for the euro area in accordance with the guidelines specified and decisions taken by the Governing Council – in so doing, it gives the necessary instructions to the euro area NCBs;
- to **manage the day-to-day business** of the ECB;
- to **exercise certain powers delegated to it** by the Governing Council – these include some of a regulatory nature.

General Council: The General Council can be regarded as a **transitional body**. It carries out the tasks **taken over from the EMI** which the ECB is required to perform in Stage Three of Economic and Monetary Union **on account of the fact that not all EU Member States have adopted the euro yet**.

The General Council comprises the **President of the ECB**; the **Vice-President of the ECB**; and the **governors of the national central banks (NCBs) of the 27 EU Member States**. In other words, the General Council includes representatives of the euro area countries and the non-euro area EU member states. (The other members of the ECB's Executive Board, the President of the EU Council and one member of the European Commission may attend the meetings of the General Council but do not have the right to vote.)

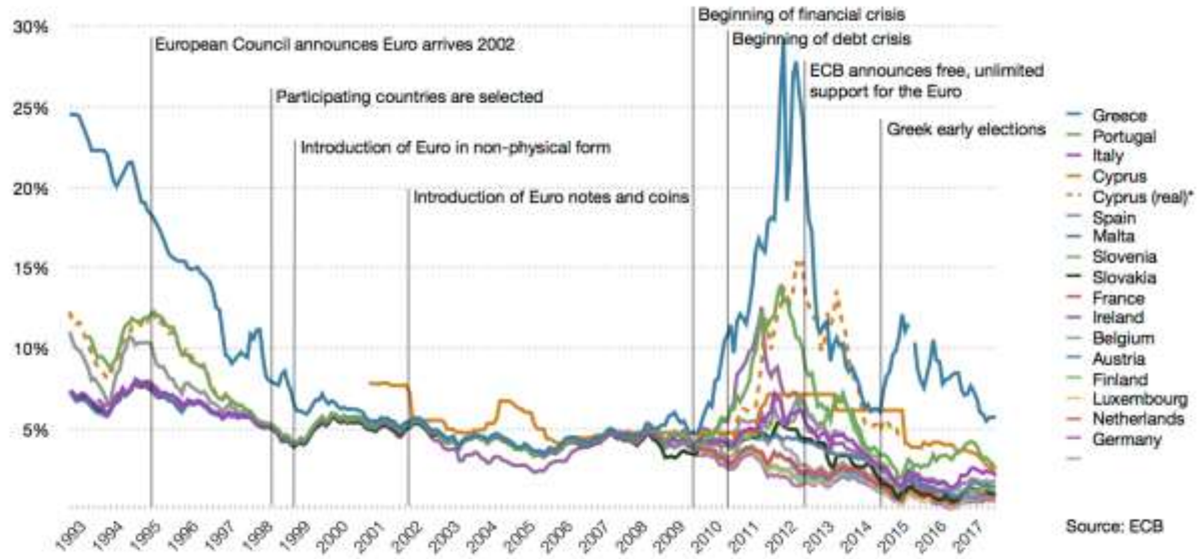
Responsibilities: The General Council contributes to:

- the ECB's **advisory functions**;
- the collection of **statistical information**;
- the preparation of the **ECB's annual report**;
- the establishment of the necessary **rules** for standardising the **accounting and reporting** of operations undertaken **by the NCBs**;
- the taking of measures relating to the establishment of the key for the **ECB's capital subscription** other than those laid down in the Treaty;
- the laying-down of the **conditions of employment** of the members of staff of the ECB; and
- the **necessary preparations for irrevocably fixing the exchange rates of the currencies of the "EU Member States with a derogation" against the euro**.

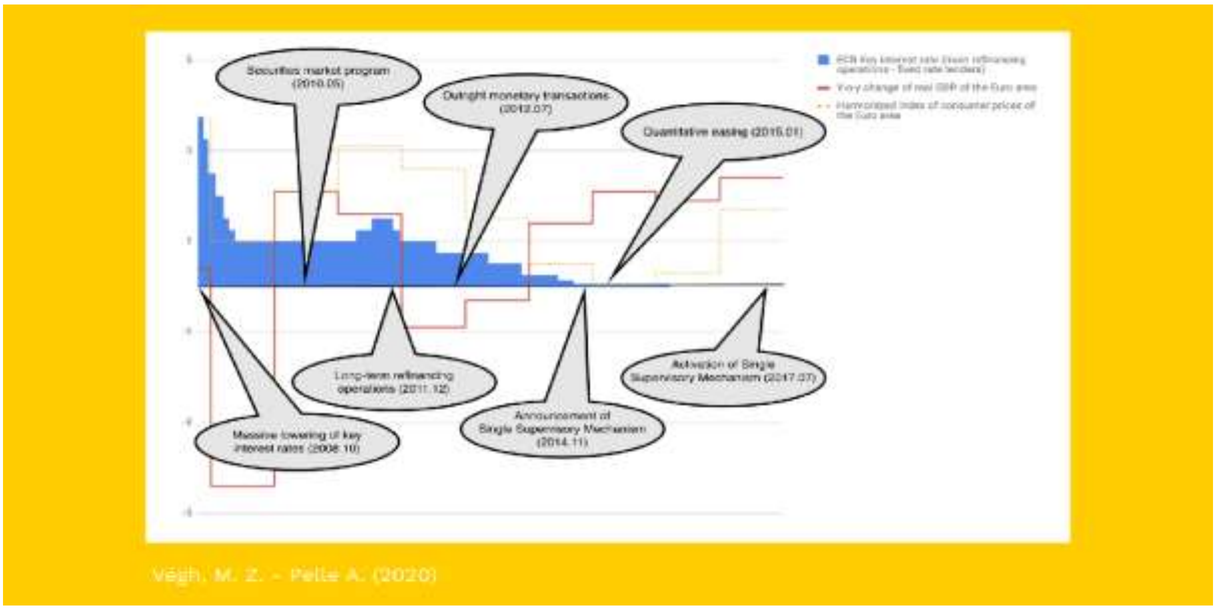
In accordance with the Statute of the ESCB and of the ECB, the General Council will be dissolved once all EU Member States have introduced the single currency.

Supervisory Board: The Supervisory Board **meets every three weeks** to **discuss**, **plan** and **carry out** the **ECB's supervisory tasks**. It proposes **draft decisions** to the Governing Council under the non-objection procedure. It is composed of a **Chair** (appointed for a non-renewable term of five years), a **Vice-Chair** (chosen from among the members of the ECB's Executive Board), **four ECB representatives**, and the **representatives of national supervisors**.

The ECB in the crisis

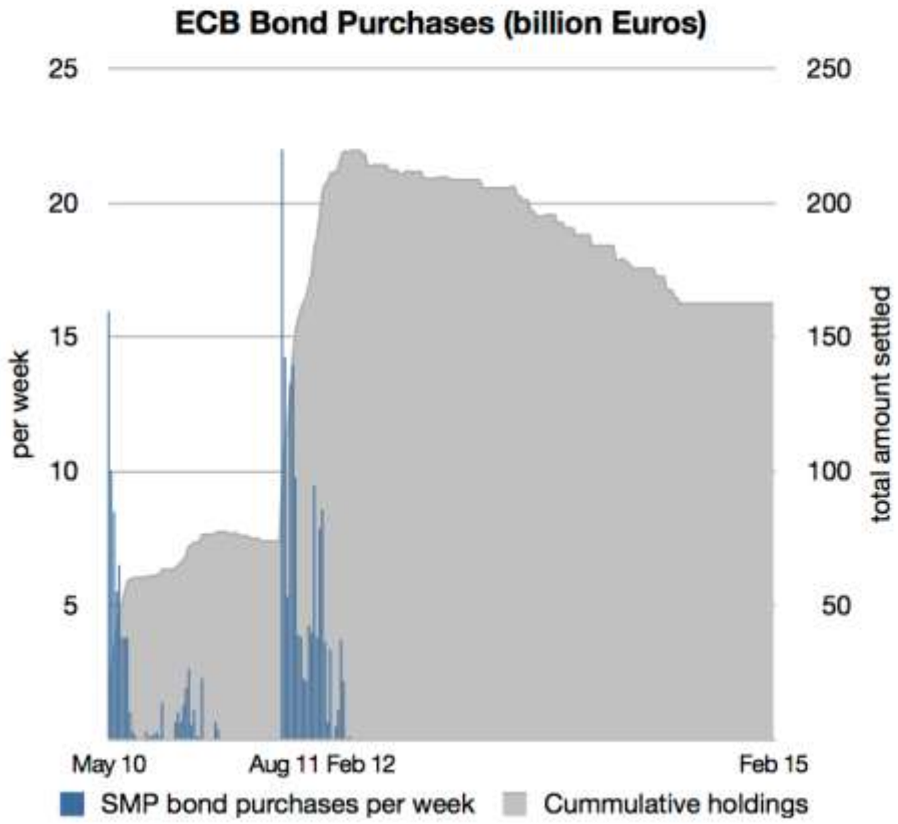


https://commons.wikimedia.org/wiki/File:Long-term_interest_rates_of_eurozone_countries_since_1993.png

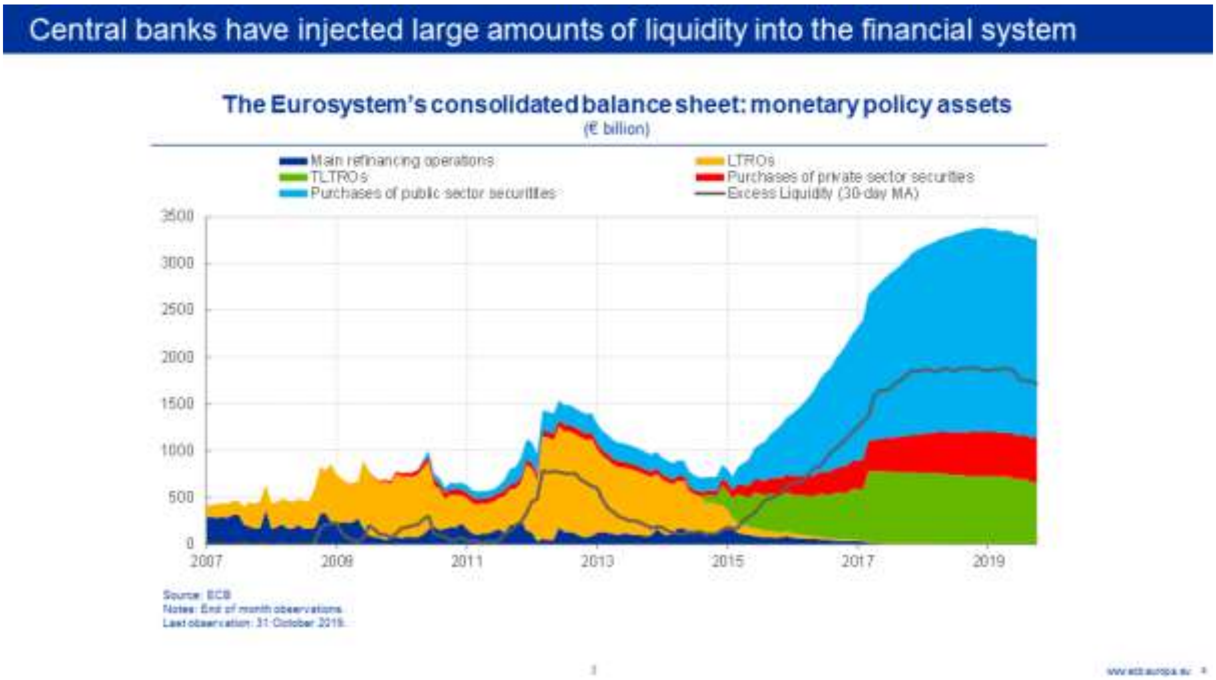


How has the role of the ECB changed during the crisis?

ECB has become one of the most important institutions to fight the effects of the global financial crisis in the Eurozone. Its original mandate (price stability) was extended, new measures were introduced to safeguard the financial stability of the Eurozone. Various threats were needed to be addressed: bank liquidity, refinancing problems in several member states, deflation, financial stability and then Brexit.



https://en.wikipedia.org/wiki/European_debt_crisis #/media/File:ECB_SMP_Bond_Purchases.png



https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp191112~5808616051.en.html

QE

Quantitative easing (QE) is a **form of unconventional monetary policy** in which a central bank purchases longer-term securities from the open market in order to increase the money supply and encourage lending and investment. Buying these securities adds new money to the economy, and also serves to lower interest rates by bidding up fixed-income securities. It also expands the central bank's balance sheet. (Investopedia)

Thus QE adds new money to the economy (/increases money supply), encourages lending and investment, serves to lower interest rates.

Questions for self-study

1. Which institution was the predecessor of the ECB? What was its role?
2. Which are the main bodies of the ECB and what are their roles in the design and implementation of the common monetary policy?
3. What is the main objective of the European common monetary policy?
4. How did the ECB perform with respect to price stability during the first decade of its operation?
5. Who are the shareholders of the ECB?
6. Which are the intellectual roots of the common monetary policy? In what way did those become an obstacle in crisis management after 2008?
7. How can inflation levels diverge in different member states?
8. How has the role of the ECB changed during the crisis?

9. What measures have been taken by the ECB to combat high interest rate spreads in the periphery countries?
10. What are the positive expected consequences of quantitative easing?

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https://www.investopedia.com/terms/q/quantitative-easing.asp

Further readings and multimedia resources:

https://www.ecb.europa.eu/explainers/topic/html/index.en.html