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THE INDEPENDENCE PRINCIPLE AND ITS REALISATION IN THE POLICY OF THE EUROPEAN CENTRAL BANK

Abstract

This paper highlights a role of the European Central Bank's independence in the process of monetary policy realisation in euro-area. It also includes an analysis and evaluation of the ECB powers.

Key words:

The European Central Bank; monetary policy of ECB; functional, institutional, personal, financial independence.

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1. Introduction

The European Union is an example of advanced level of regional integration. The EU member states function in the system of highly developed economic interdependence, which has appeared since common internal market establishment. The EU has been created as a result of small steps in the European integration process and there are some events of strategic and historic significance[1]. The Rome Treaty on the European Economic Community establishment signed on 25 March 1957 was of fundamental importance. The first successful achievement in the process of the European integration was acceleration in integration of markets of the European Communities' member states in the second half of the 1980s and the official introduction of the European Single Market on 1 January 1993 named as «Free Frontier Europe» project. Second success, which would not have been possible without earlier creation of the common internal market, was the introduction of the common currency - Euro.

Due to market and monetary integration, the EU member states operate in economic system, which is governed by the EU institutions. At the same time, the Council of the European Union (main decision-making body) takes decisions along with the European Commission, and the European Parliament. The Council of the European Union is an intergovernmental institution, while the Commission and Parliament have a supranational character. The intergovernmental model implies participants of the decision-making process represent views of their governments and then seek a common solution to a problem. The member states of the intergovernmental model are able to influence final decisions. Since middle of 1990s policies on the EU level have been described by the term «multilevel governance», because supranational, national, regional and local bodies participate in the decision-making process.

Many specialised institutions, which have clearly defined functions, participate in the implementation of the EU policy. The most important institution is the European Central Bank. This paper would analyse and evaluate the ECB policy-making powers. It would describe formal and legal competencies of the ECB and its independence in the process of monetary policy realisation within euro area.

[1] The effect of small steps method in the European integration process is often mentioned by one of the most renowned creators of the EU-Jacques Delors.

2. Legal and institutional bases of the monetary policy in the euro area

The EC Treaty of 7 February 1992, with its Protocols 1 and 2, is the legal basis for monetary policy in the euro area. The Treaty and the Charter of the European System of Central Banks and the ECB are main sources of law, which established an institutional ground for monetary union. The European System of Central Banks includes the European Central Bank and national central banks of all member states[2]. The member states, which introduced common currency, created the euro area. The Great Britain, Denmark, Sweden, and Greece – member states of the EU have not joined the single EU currency market (Greece joined the single EU currency market January 1st, 2001). Their central banks function in the European System of Central Banks but do not take part in decision-making process concerning monetary policy for the euro area. Since the last EU enlargement (1 May 2004) the number of countries beyond the euro area has increased to thirteen.

The European Central Bank and the national central banks of the euro area constitute the «Eurosystem». According to article 105 (2) of the ESCB Treaty and article 3 of the ESCB Charter, the main objectives of the Eurosystem are following [12]:

1. Defining and implementing monetary policy within euro area.
2. Conducting foreign exchange operations.
3. Maintaining and managing official foreign reserves of the member states.
4. Ensuring liquidity operations in payment system.
5. The ECB is the only body to issue banknote in the euro area.
6. The ECB, in co-operation with the Eurosystem national banks, collects statistical data necessary for implementation of the monetary policy.
7. According to article 6 of the ESCB Charter, the ECB and the national central banks may participate in the work of international institutions.

The European Central Bank is the independent body, which has been stated in the article 108 of the Treaty (earlier article 107) and the article 7 of the ESCB Charter. The ECB independence and its decision-making bodies provide other regulations – concerning, for instance, the ECB budget and creating its capital from subscriptions of national central banks.

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[2] The European Central Bank has a legal status given by the Maastricht Treaty, but national banks have legal status established on the basis of national law of member states.

The European Central Bank's decision-making bodies are the Governing Council and the Executive Board. The head of both is the President of the ECB. In case of his/her absence the Vice-President is in charge.

The Governing Council has following responsibility [5]:

1. To adopt guidelines and to take decisions for smooth functioning of the Eurosystem tasks.
2. According to article 12 (1) of the ESCB Charter to formulate principles of monetary policy in the euro area. Adopting principles of monetary policy includes intermediate monetary objectives, such as interests rates and reserves of the Eurosystem. The Governing Council also prepares guidelines to implement these decisions.

Another decision-making body of the European Central Bank is the Executive Board. The Executive Board has the following duties:

1. To prepare meetings of the Governing Council.
2. Implementation of monetary policy based on guidelines and decisions of the Governing Council, and to pass necessary instructions to national central banks of the euro area.
3. To manage current activities of the ECB.
4. To fulfil activities delegated by the Governing Council including issue of legal acts.

Formally the ECB decision-makings body (the article 45 the ECB Charter) consists of the General Council and the presidents of the national central banks of the EU member states. The General Council, from its side is made of the ECB President and Vice-President. Nevertheless, actual participation of the General Council in the decision-making process is rather symbolic. The Council is not responsible for decisions concerning monetary policy in the euro area. According to article 123 of the European Community Treaty, the Council had been created because a group of member states remained beyond the euro area. They did not adopt the common currency due to various reasons[3]. The General Council is a temporary body and it will function until certain states remain beyond the euro area. It fulfils the role of a forum-facilitating co-operation and link between the euro area and other EU states. General Council also supports the ECB in statistical data collection, as well as determining norms concerning accounting and information procedures in the operations of the national central banks [4].

[3] Since May 1st, 2004 this group includes 13 countries

3. The main objective of the bank

The main objective of the ECB is to maintain a stable price (article 105 of the Maastricht Treaty). However, this Treaty does not clearly define a term «price stability» and how this aim should be attained. The Governing Council on 13 October 1998 has taken a strategic decision on this matter. Along with guidelines of the European Monetary Institute, the Governing Council defined the task of price stability in numerical value. It approved that annual increase in prices, measured by Harmonised Index of Consumer Prices cannot exceed 2% all over the euro area [8]. The percentage indicator of price stability has made the ECB policy more transparent. Now all economy in the EU has a clearly defined medium-term inflation level that gives them stability in their actions and their policy of prices. Thus, it means that the European Central Bank is responsible for controlling long term annual inflation.

A measure of price stability – Harmonised Index of Consumer Prices (HICP) is an indicator introduced in January 1995 in order to harmonise national indexes of consumer prices. The European Commission (Eurostat), national statistical institutes and the European Central Bank (earlier the European Monetary Institute) work together on this issue. The construction of HICP is still being improved, which can be shown by significant differences in its components in the years 2001 and 2003 (see Appendix, Table 1).

4. Formal and real independence of the European Central Bank

4.1. The formal independence

One of the most important issues on drafting the Treaty for the European Union was the degree of the ECB independence. It was a condition of the Federal Republic of Germany to be a part of the monetary union. Karl Otto Poehl (President of Bundesbank) and other members of the Delor's Committee (Committee worked on a project of the economic and monetary union) considered independence of the ECB as guarantee for low inflation rate and stability of the future common currency. They drew conclusions from experiences of countries, where central banks led their own independent monetary policy. On the contrary, inflation level was considerably higher in those countries, where central banks were controlled by government, e.g. France. The adopted model of the European Central Bank showed a significant role of Bundesbank`s President Karl Otto Poehl, because his suggestions were included into the ECB Charter attached to the Maastricht Treaty [2]. We may find many analogies to Bundesbank in organisation and functioning of the ECB. Likewise, German *Laender* were owners of Bundesbank, the national central banks became owners of the European Central Bank [10]. The member states had been obliged to change own banking regulations according to German law, in order to guarantee independence of all central banks.

K. Dyson (Bradford University professor) – a well-known author of publications on monetary integration and common currency of the EU has expressed his opinion on the monetary union and the ECB creation with the following words: «The Maastricht Treaty was a symbol of German monetary power and a success in Europeanization of a German model for an independent and strong central bank». [3]

However, the ECB functions differ from Bundesbank. German Central bank maintains strong relations with its government, while the European Central Bank is an institution of a group of governments. There is more independence for the ECB because there is no obligation to keep regular contact and to negotiate co-ordination of budget policy issues [10].

The Maastricht Treaty has defined four types of independence for the European Central Bank and the European System of Central Banks. These are functional, institutional, personal, and financial [1]. The functional independence of the ECB is independent development and implementation of monetary policy and also performance of other tasks from the Charter. There are articles on definitions of functional and political independence of a central bank. J. Woolley, for instance, explains political independence as competence of a central bank to choose and follow directions of its own functioning, despite any pressure to change them [14]. The functional independence, according to J. Woolley, is the ability of a central bank to reach definite goals without an influence of other bodies [14]. It is worth to note that functional independence does not refer to monetary policy, because there are factors that affect it. These are fiscal policy, banking regulations, and events of private business sector [9].

P. H. Loedel does not give much importance to functional independence. He concentrates on political independence, which is related to formal and legal competence of the ECB with regard to its choice of functioning and without a pressure from other bodies [9]. In case of the ECB, political independence should also pertain to monetary policy. Most scholars share this point of view.

A broader meaning of political independence includes institutional independence, which is explained by article 108 of the Maastricht Treaty and article 7 of the ESCB Charter. According to the Treaty and the ESCB Charter, neither ECB nor national central banks and any other member of decision-making body cannot undertake or accept instructions from the Community institutions, governments of member states or other officials [1].

In fact, politicians of various member states had attempts to influence the ECB policy, because its primary objective – ensuring price stability – does not exempt bank from supporting economic policy of the EU. Independence of the ECB is not threatened because of this issue, as the chairman of Ecofin[4] and a member of the European Commission from the Governing Council do not have right to vote. However, there is an informal group (called Euro-group) consisting of finance ministers of 12 member states of the euro area. National interests are discussed there and this group exerts pressure on the authorities of the European Central Bank.

There was a well-known conflict between the President of the ECB W. Duisenberg and the finance minister of the Federal Republic of Germany O. Lafontaine, who retired after five months of holding his position. Chancellor G. Schroeder also thinks that the European Central Bank cannot limit its responsibility only to price stability but it should also pursue policy, which would influence economic growth and employment in a rational way. Member states, which have difficulties with reducing unemployment, tend to use fiscal and monetary policy instruments to accelerate economic growth and employment. The Federal Republic of Germany and France have failed to maintain budget discipline, which is obligatory for countries in single EU currency market.

Another important factor related to national interests of member states of the euro area and that has to be analysed in the European Central Bank is export competitiveness of member states on the global market. Nowadays, when liberalisation level of the world trade is high and tariffs no longer act as a barrier to imports, the role of exchange rate as a trade policy instrument has risen. It is worth to remind that participants of the Monetary Conference in Bretton Woods (1–22 July 1944), during which it was decided to create the International Monetary Fund, accepted fixed exchange rates as a basis of the international monetary system and these rates were observed in monetary policy of states-signatories of the Bretton Woods Agreement until 1971[5]. Adoption of the fixed rates system in the international monetary order was caused by a need to create a basis for liberalisation of trade and in order to avoid disturbances that might result from manipulating exchange rates to enhance competitiveness of exports.

Personal independence of the ECB is closely related to political independence and also to the procedure of appointing members to decision-making bodies and safety of their term in office. Personal independence means that the term in office of the Governing Council members lasts 8 years and cannot be prolonged. Presidents of central banks are appointed for 5-year terms, but they can be re-elected by national authorities. A person may be dismissed from

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[4] Ecofin – Economic-Financial Committee functions since 1999. It was created on the basis of article 114 of the Treaty establishing the European Community. This Committee replaced the Monetary Committee. Ecofin has a broad range of activities – among its duties there is analysing monetary policy, financial market and flow of capital, situation on exchange market, etc. The European Commission and the European Central Bank each have the right to appoint two members to Ecofin.

[5] In 1973 most countries declared to abandon a policy of fixed exchange rates and to adopt floating exchange rates.

his/her position only in circumstances enumerated in the Charter of the ESCB, i. e. when he/she committed serious offences or is no longer able to fulfil duties.

Financial independence means that central banks functioning in the European System of Central Banks should have such financial sources that would ensure correct and safe performance of tasks connected with participation in the ESCB. Financial resources of the ESCB are excluded from the budget of the European Community. The European Central Bank is equipped with an initial capital of 5 billion Euro and currency reserves 50 billion Euro [1]. The only subscribers and owners of the capital are national central banks. An important feature of the financial independence of the European Central Bank is a lack of obligation to finance internal debt incurred by governments. The representatives of the Council of the European Union are entitled to carry out negotiations with governments of countries outside the EU and to make formal and informal arrangements, and also to respect opinions of the ECB through consultations.

P. H. Loedel compared formal independence of the European Central Bank and the former central bank of the Federal Republic of Germany. Results of this analysis are given below (see Appendix, Table 2).

The following conclusions may be drawn from the comparison presented:

1. The European Central Bank has more clearly defined powers with regard to maintenance of price stability.
2. «Freedom» of the ECB and independence of Bundesbank are similar.
3. Provisions of the Maastricht Treaty are difficult to change and simple majority of voice can change the Bundesbank Act.
4. Personal independence of Bundesbank was related to policy priorities of the Chancellor of the Federal Republic of Germany, political party, and the President of the Bank.
5. Eight-year terms in office of both banks.
6. The ECB, like other central banks, is in charge of price stability, but not as strong as in case with Bundesbank.
7. Conflict with W. Duisenberg should not influence on the ECB independence
8. Both the ECB and Bundesbank have to cope with government spending.
9. As far as government spending is concerned, the ECB has had to implement procedures similar to Bundesbank since the introduction of convergence criteria.
10. When the European Monetary System operated, Bundesbank was under larger pressure than the present ECB as regards to policy of exchange rates.

To sum up, from a formal point of view political independence of the ECB is even greater than of Bundesbank. Personal independence has been already undermined by a conflict concerning election of the first President of the European Central Bank Mr. W. Duisenberg. There is a strong probability that similar conflicts, connected with elections for the most important positions can occur in future. As significance of the EU institutions in decision-making process increases, a political maneuvering for the highest posts becomes more and more important. Financial independence of the ECB is formally similar to that of Bundesbank, but how real it is in practice will become clear after years of experience and according to a situation in the world economy and in the international foreign exchange market.

4.2. Independence of the ECB in implementation of the monetary policy

Assessment of the ECB monetary policy shows that the policy is largely influenced by world economy. First of all, it depends on growth in the world trade. First years of the 21st century will be remembered as a period of economic and political destabilization.

Countries of the European Union and the euro area experienced an economic downturn in the years 2001–2003. Since the beginning of its existence, the European Central Bank has been pursuing an anti-inflation programme. The most important instrument of monetary policy, which is concern for market participants, is the change of interest rates. The Governing Council of the ECB came out with an initial level of interest rates on 22 December 1998. In the first quarter of 1999 inflation remained on a low level below 1%, but slowdown in economic growth, at the end of 1998, was even worse than the earlier assessments. At the end of 1998 exports from the EU countries were declining. This situation was closely related with the financial-economic crisis in Asia (1997) and Russia (1998) [12]. In a situation when inflation was much lower than accepted limit of 2%, on 8 April 1999 the Governing Council took first decisions concerning changes in interest rates. It lowered main refinancing rate on the 50 basis points to 2.5% and, as a consequence, marginal lending facility to 3.5% and deposit facility to 1.5% [11, 12]. Table 3 shows specific data concerning changes in interest rates of the ECB (see Appendix).

In the second half of 1999 the economic situation had changed – there was a considerable upturn in the economy of euro area states. Credits for private sector rose by 10% [12]. From July until the end of 1999 inflation level was approaching the limit of 2%. The European Central Bank reacted then, raising interest rates on 4 November 1999. The ECB continued this policy throughout 2000. During that year the ECB raised interest rates 6 times, aiming to restrain inflation [11]. Meanwhile, increase in prices in the euro area exceeded 2%, which is maximum level for an inflation norm. In October 2000 interest rate of main refinancing operations was already 4.75% (from 2.5% in April 1999) [12].

Prices of oil (which grew constantly) and unprocessed food products had a substantial influence on the increase of inflation level from July 1999 until the end of 2000. Still higher inflation level in the euro area occurred in the second half of 2000. At that time, the EU currency was rapidly losing its value in relation to other currencies, especially to dollar, British pound and Swiss franc. The European Central Bank depreciated the euro many times on the international foreign exchange market, and declining exchange rate of the euro stopped at the end of 2000. However, inflation was growing – reaching 3.4% (then corrected to 3.1%) in May 2001 [13]. Wages had a considerable influence on increase of HICP. This short-term inflation tendency contrasted with the economic situation in the world and in the euro area itself, because at the end of 2000 signs of an economic downturn appeared. A decline in economic growth lowered inflationary pressure. In the second half of 2001, HICP returned to a level of 2%, but this took place during an economic downturn due to increased risk after the attack on World Trade Centre in New York (11 September 2001).

The European Central Bank changed interest rates four times from May to November 2001, systematically lowering them (see Appendix, Table 3). Similar policy was maintained throughout 2002, when the ECB changed interest rates only once on 5 December 2002, where interest rate of main refinancing operations were reduced by 50 points from 3.25% to 2.75%. In 2002, role of the ECB was very difficult, because during the economic downturn inflation remained on a comparatively high level - over 2%. Economic downturn points to the need of stimulating economic growth by reducing interest rates, and at the same time continuous increase in prices seems to require strict monetary policy. The European Central Bank adopted a different policy than the U.S. Federal Reserve System, which during 2002, in order to stimulate economy-lowered interest rates many times [11].

Main causes for inflationary trends in 2002 were generally the same: rise in oil and food prices (because of weather conditions). Moreover, an increase in prices was partially caused by introduction of the Euro.

Next reductions of interest rates were carried out by the ECB twice in 2003 (6 March and 5 June). Since then until 6 May 2004 interest rates remained on the same level: 2% – the rate of main refinancing operations, 3% – marginal lending facility, 1% – deposit facility [6]. In 2003, very weak economic situation, contrasting with economic expansion in the U.S. and Japan, was a problem in the EU. Forecasts for 2004 predict a long-expected economic upturn in the euro area – GDP growth of 1.7%, and in 2005 to 2.3% [7].

According to the adopted definition of price stability, inflation in the euro area in 2003, remained on the level around 2 %. HICP remained below 2% in the first quarter of 2004 (1.6% in February and 1.7% in March) [6]. Inflation rate was less in February 2004 due to lower oil prices, in comparison to the correspondent month of the previous year. Although, another increase in oil prices started soon, inflation forecasts according to HICP for 2004 – 2005 are favourable: 1.8% and 1.6% respectively [7]. It should be emphasised that indicators of increase in prices, in particular member states shape average inflation level in the euro area. There are countries, where inflation is very low and countries where stabilisation of prices is still a problem. The lowest inflation level in 2004 is expected in Finland (0.4%) and the highest in Greece (3.4%) [7]. Other countries with inflation higher than average rate is (apart from Greece): Spain, Ireland, and Italy[6]

Conclusion

The authors conclude that the issue of independence of the European Central Bank is more complex than the scope of problems analysed in this paper.

1. Existence of the ECB is not long enough to assess its independence in implementation of monetary policy. Moreover, the common currency was in full circulation no sooner than in 2002, because from 1 January 1999 until the middle of 2002 the economic and monetary union was being introduced. In the first half of 2002 national currencies were being removed from circulation and replaced by the common currency.

2. Nevertheless, taking into consideration decisions taken since 1 January 1999 the European System of Central Banks and the ECB have pursued an aim indicated by the Maastricht Treaty, by ensuring stability of prices in the euro area. The European Central Bank has effectively restricted inflation to avoid so-called inflation spiral: rise in prices – rise in wages and then again rise in prices.

3. The European Central Bank has led a cautious policy so far, without radical steps, and it did not participate in the policy of stimulating an economic upturn (e.g. in 2002).

4. To sum up, it may be interpreted that the ECB implements its monetary policy according to the law that governs working of the ECB. However, there is a risk that as the euro area will grow, including economically weaker states, greater differentiation of price increase in particular member states will hinder the policy of the ECB which aims at maintaining the average level of price stability all over the euro area.

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[6] According to forecasts for 2004., in 2005 – Greece, Spain, Ireland and Portugal will join this group. Ibid.

Appendix

Table 1.

A structure of the Harmonised Index of Consumer Prices (HICP) in years 2001 and 2003 (in percentages)

Components	Years	
	2001	2003
Overall index	100	100
Price of goods	61.9	59.1
Unprocessed food products	8.2	7.6
Processed food products	12.3	11.7
Industrial products (without energy)	32.1	31.6
Energy	9.5	8.2
Services:	38.1	40.9
Housing		10.4
Transportation		6.3
Communication		2.9
Recreational and personal		14.9
Miscellaneous		6.4

Sources: The Monetary Policy of the ECB, European Central Bank 2001, p. 40; The Monetary Policy of the ECB, European Central Bank 2004, p. 52.

Table 2.

Comparison of independence of the ECB and Bundesbank

	ECB	Bundesbank
Political	1. Main goal – price stability. 2. Free from «instructions» of the European Community and member states. 3. Competence defined by the Maastricht Treaty. 4. Independence threatens by Ecofin.	1. Competence more general in order to ensure monetary stability. 2. Independent from the government. 3. Law of Bundesbank is not guaranteed by constitutional security. 4. Prone to pressure from government, as well as employment and business centres.
Personal	1. Executive Board elected by a compromise of member states. 2. Presidents of national central banks elected by member states according to accepted procedures. 3. Eight-year term in office in the Board that is not prolonged. 4. Important role of the President of the ECB.	1. Board of Directors with eight-year term in office and strong position of the President of the Bank. 2. Presidents of Laender banks were the majority in the Board. 3 Federal structure. 4. Important role of the German cultural factor in monetary policy. 5. Stabilitaetsgemeinschaft –significant role of the stabilisation factor.
Financial	1. Not supposed to finance government debt. 2. Has to discipline budgets of member states. 3. Non centralisation of the EU budget. 4. No formal and direct responsibility for external monetary policy. 5. Possible pressure concerning exchange rates, because of control from Ecofin.	1. Bundesbank was not obliged to finance government debt. 2. Had to restrict government expences. 3. Was obliged to handover profits to government. 4. Exchange rates controlled by the Ministry of Finance. 5. In its monetary policy Bundesbank frequently had to take into account limitations resulting from participation in Bretton Woods Agreement and the European Monetary System.

Source: P. H. Loedel, Multilevel Governance, *op. cit.*, p. 138.

Table 3.

ECB interest rates

Date of the Governing Council decision	Deposit facility	Marginal lending facility	Main refinancing operations
22 December 1998	2.00	4.50*	3.00**
8 April 1999	1.50	3.50	2.50
4 November 1999	2.00	4.00	3.00
3 February 2000	2.25	4.25	3.25
16 March 2000	2.50	4.50	3.50
27 April 2000	2.75	4.75	3.75
8 June 2000	3.25	5.25	4.25
31 August 2000	3.50	5.50	4.50
5 October 2000	3.75	5.75	4.75
10 May 2001	3.50	5.50	4.50
30 August 2001	3.25	5.25	4.25
17 September 2001	2.75	4.75	3.75
8 November 2001	2.25	4.25	3.25
5 December 2002	1.75	3.75	2.75
6 March 2003	1.50	3.50	2.50
5 June 2003	1.00	3.00	2.00

* From 4 to 21 January 1999 this rate was temporarily 3.25%.
** From 4 to 21 January 1999 this rate was temporarily 2.75%.

Source: L. Oręziak, Finanse Unii, *op.cit.*, p. 23.

Note: Until 6 May 2004 interest rates remained on the level decided on June 5th, 2003; information based on European Central Bank, Monthly Bulletin, May 2004.

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