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The European Central Bank:

National Systems Compared and Possible Options

(Note for the attention of the Monetary Committee)

1. Introduction

This note is intended to aid the Committee's discussions on the form of a European System of Central Banks (ESCB) in Stage Three of EMU. First, various central bank systems are compared, in order to bring out the main differences between national monetary authorities existing now. Next, the note looks at different questions concerning the form of the future European central bank, setting down a series of options for the principal open issues, together with some of the relevant arguments for and against.

2. Various central bank systems compared

This section contains a short overview of the situation regarding central bank legislation and practice in Community and certain other countries (US, JAP, CAN, AUS, CH). It looks at central banks' degree of autonomy from government, their role in formulating monetary policy, macroeconomic objectives, their relations with Parliament or socio-economic groups, the representation of government in their decision-making process, the process for appointment of their governor and other senior members, and finally their role in financing the government's budget. There is a short comment on the interesting special case of New Zealand where legislation concerning the central bank has recently been revised.

2.1 Elements of central bank autonomy

The independence in law of a central bank may be assessed against three principal criteria.

(i) *Operational Independence*

- Is monetary policy formulated by the Government or by the Bank? In the latter case: what, if any, are the provisions in case of conflict?

- May the Bank:

  = decide alone over the use of monetary policy instruments?
  = decide on some instruments, but not on others?
  = refuse to finance the budget deficit directly or indirectly?
  = participate in exchange rate policies?

- How are the macroeconomic objectives of central bank policy defined?

  = Not at all.
  = General objectives (welfare, growth...) and monetary stability on equal footing.
  = Priority for monetary stability.

(ii) *Independence of personnel*

- Who proposes/nominates/appoints decision-making personnel and on which criteria?

- What length of tenure, financial security and is dismissal possible?

- Is the Government represented in the decision-making organ? With/without voting rights?

(iii) financial independence

- Legal status of Bank, right to establish the Bank budget independently, administrative/financial accountability.

Comparison shows that there is a great variety of answers to these questions in national legislation of different countries. It is also evident that any judgement about the independence of a central bank has to take into account all the legal criteria, not just some of them. Even this will not necessarily indicate the true situation regarding independence because the political balance, the personalities involved and, above all, public opinion will also influence a central bank's de facto autonomy.

The overall picture which emerges concerning the legal position is that nowhere does the central bank enjoy independence to such a degree that it could for long implement monetary policy counter to the overall economic objectives set by the Government. In fact, in such a case any bank would be preparing the ground for a change in its statute. On the other hand, there is no country where the central bank does not enjoy some degree of "separateness" from Government.

2.2 Appointment of Governor and members of decision-making bodies

In all countries the Government reserves the right to determine directly or indirectly (via shareholders) the decision-making personnel of central banks. Usually more than one public authority is involved. The full sequence of actions by different bodies would include the proposal, the nomination, an opinion and the appointment. The direct involvement of Parliament is exceptional (DK).

2.3 Relations with Parliament or socio-economic groups

In some countries representatives of socio-economic groups are present in central bank organs or organs close to monetary policy (B, F, NL). Arrangements for relations with Parliament may be distinguished in four respects:

- formal or informal obligation for the Governor to appear before Parliament or parliamentary commissions (among those countries are GR, E, I, UK, US, JAP, CAN);

- formal or informal obligation to present annual or other reports to Parliament (among them are DK, UK, US, JAP, AUS, CH);

- direct influence of Parliament on composition of central bank organs (DK);

- obligation to inform Parliament in case of conflict between Bank and Government (CAN, AUS).

2.4 Representation of Government in decision-making process of the central bank

Various provisions may be found in the different countries:

- one or several Government representatives in decision-making organ with right to vote (E, IRL, AUS);

- Government representative without voting and veto right (D: right to defer taking of decision, JAP, CAN);

- Government commissioner with right of veto (B, GR, F);

- Government commissioner for Bank supervision or safeguarding flow of information (DK, I, NL);

- the most notable exception to the rule that Government representatives are formally involved in some way or the other in central bank decision-making is the US Federal Reserve System.

2.5 Reference to macroeconomic policy objectives in central bank laws.

The countries may be grouped as follows:

- no explicit reference (B, GR, F, I, P, UK, US);

- both kinds of objectives (monetary stability and other general objectives like prosperity and employment) are mentioned, but no clear priority is set (E, IRL, NL, AUS, CAN, CH);

- priority for monetary stability over the Government's other policies (D);

- only reference to monetary stability (DK, JAP).

2.6. Who formulates monetary policy?

Four approaches may be distinguished:

- at the discretion of the Bank (D, US, CH);

- ultimate responsibility of Government, but considerable degree of autonomy for the Bank with obligation for Government to make public any conflict (NL, CAN, AUS);

- Bank may formulate policy within broad Government guidelines (B, DK, IRL);

- Bank implements Government policy but may sometimes have considerable technical influence on formulation of policy (GR, E, F, I, P, UK, JAP).

2.7 Financing the public sector deficit

In no country considered is the central bank forbidden to grant cash advances to public authorities. However, ceilings based on formal rules exist in most of them, either fixed in absolute amounts (B, D, NL) or expressed as a percentage of budgetary income or expenditure (GR, E, I, P). In France, the ceiling is a combination of a fixed amount and the gains/losses on foreign reserves.

Quite naturally, limits to indirect financing are more difficult to define efficiently in legal texts. Some central banks have managed in the past to reach a formal agreement with the Government on restrictions (DK, US), others have made unilateral declarations to restrict indirect financing with the Government's tacit agreement (I) or have announced a target for non-monetary financing (GR). The Bundesbank Law includes some formal safeguards against indirect financing.

2.8 Responsibility for exchange rate policy

In no country considered is the central bank responsible for fixing exchange rate parities. However, in the absence of declared parities, some central banks have de facto considerable powers in the determination of exchange rate policy since they own and manage exchange reserves (D, CH). In other countries the central bank is responsible for the implementation of exchange rate policy, and is generally consulted to a greater or lesser degree by the Government.

2.9 New Zealand: an original approach

The present revision of central bank legislation in New Zealand offers some interesting food for thought. The new legislation is intended to give that country's central bank more independence and to make fighting inflation its sole responsibility. The Bank will no longer be subject to day-to-day ministerial direction as long as it pursues the inflation objective that has been laid down in common. The Government will still be able to override the Bank if it disagrees with the latter's policy to attain the agreed inflation rate or if it wishes to redirect monetary policy towards a different inflation target. But any such formal directive will have to be tabled in Parliament. In addition, the legislation also includes a financial incentive for the Board members to match the inflation objective!

3. Open Issues concerning the form of the future European central bank

3.1 Federative or centralized structure

The Delors Committee outlined a new monetary institution organized in a federal form (the ESCB) for formulating and implementing Community monetary policy. Assuming that a single monetary policy in the Community is necessary for monetary union, then a federal ESCB would have the advantages of making national central banks part of the system and of corresponding best to the political diversity of the Community. A totally centralized form does however remain a theoretical possibility.

There are, however, options regarding the degree of centralization within a federal framework. It may be desirable for the centre to outweigh the regions in the ESCB Council (similar to the Fed FOMC), or vice versa (as for the Bundesbank). The former would probably require some kind of rotation (constituency) system for the representation of the national central bank governors in the ESCB Council.

Consideration should also be given to the possibility of a three tier structure in which a Council of Governors would supervise and give general orientations, a Board would be responsible for the day-to-day running of the ESCB and implementing policy, and an Open Market Committee (combining the two above groups) would direct the monetary policy.

The voting procedure in the ESCB Council could also be adapted to different degrees of centralization and of regional balance by using weighted voting systems.

Another open issue concerns the financial structure of the ESCB. The Delors Committee proposed that the ESCB be given the status of an autonomous Community institution. This would appear to exclude the possibility that its capital be owned by the national central banks. The sharingholdings, and hence distribution of profits or losses between its owners, could made be according to a certain key related to the share of foreign exchange reserves first contributed, for example, or linked to GDP, if the Member States are shareholders. The distribution of the gains from seignorage is related to such matters.

3.2 Autonomy and accountability

The Delors Committee states that the ESCB Council should be ***independent*** of instructions from national governments and Community authorities. The advantage of such independence, it is argued, is that it avoids the potential conflict between short-term political pressures and the medium-term orientation of monetary policy towards price stability. It would not, of course, be sufficient to guarantee success but it appears necessary, although the Bank of Japan is a counter example. Also independence may be particularly appropriate in a federal framework; certainly the various examples available show that central banks with a federal structure do tend to display considerable autonomy from government.

It is also necessary to consider the issue of ***democratic accountability.*** It could be argued that a fully independent ESCB would effectively be able to carry out a monetary policy that is against the democratic wishes of voters in the Community. The ESCB would not be subject to democratic control through national or the European parliament. The ultimate sanction of a change in the statute of the ESCB would be the unwieldy procedure of a change in the Treaty.

The options to be considered for the ESCB thus range from complete independance from the political process and total lack of accountability, to full accountability and therefore no autonomy.

Concerning, in particular, **the autonomy in law** of the ESCB, there are a series of areas in which different options could be examined:

- *No instructions from national governments or Community institutions.* Could ESCB decisions, however, be delayed in certain circumstances, as in the case for the Bundesbank?

- *Independence of ESCB Council members:* Should independence apply to ESCB Board members alone, or also to national central bank governors (who will also be represented on the ESCB Council)? Should national central banks be similarly independent of their national governments if they join the ESCB?

  The degree of independence will depend to some extent on the length of tenure, salary and pension, procedure of appointment and provision for dismissal of the ESCB Council members and national central bank governors.

- *Operational autonomy.* What tools of monetary policy should be at the disposal of the ESCB? Clearly, for there to be one monetary policy, the ESCB should have the monopoly of base money creation. The ESCB should have control of a sufficient array of market instruments and regulatory powers to do its job, but would those include non-market instruments such as the ability to apply direct credit controls?

  Although it is generally agreed that direct financing of public deficits is undesirable, how should this be implemented (should it be zero or be subject to a ceiling)? Some room for discretion could be left to the ESCB Council. To what extent should there be room to trade in government securities as a means of conducting monetary policy? How would such securities be chosen? What balance should be kept between the securities used of the various Community countries?

  The ESCB's accounts would need to be audited by a body such as the European Court of Auditors or by other independent auditors.

Also in the specific area of **democratic accountability**, there are a series of areas to look at.

- ***Representation of Commission and ECOFIN Council on the ESCB Council.*** Should there be such members, should they have voting rights, speaking rights, should they be able to influence the agenda of a meeting? Such representation could be reciprocal in the case of the Council.

- ***Involvement of European Parliament (EP) and other socio-economic groups.*** A procedure of EP confirmation hearings for nominations to the ESCB Board could be considered. The EP's economic and monetary committee could become involved, through regular contacts with ESCB officials or Board members; the Economic and Social Committee (ESC) as well. Annual EP hearings of the ESCB President and invitations to appear if special circumstances so warrant would appear to be broadly agreed.

- ***Public Information.*** Should an annual report be published, what should it contain? Should proceedings or results of ESCB Council meetings be published, after what delay?

- ***Sanctions.*** Could sanctions from other Community institutions be considered, other than the ultimate one of changing the Treaty, such as dismissal of the entire Board (similar to the statute of the Commission).

3.3 The objectives of the European central bank

Price stability should be the objective of the ESCB. It should also support the general economic policy set at the Community level by the competent bodies.

How should price stability be defined? One can think of many different definitions of price stability (zero CPI, PPI, tradeable goods, etc), each with advantages and disadvantages. Should one particular definition be chosen or should this be left to the discretion of the ESCB? Considerations of flexibility and efficiency would seem to point to the latter solution.

3.4 Responsibility for exchange rate policy

Although it seems clear that the implementation of exchange rate policy (foreign currency interventions) will be carried out by the ESCB, it remains to be decided ***where the responsibility for the Community's exchange rate policy vis-à-vis third currencies will lie.***

One option would be to ***give the ESCB also the power to determine the Community's exchange rate policy.*** This would be consistent with the ESCB's independence with respect to monetary policy. On the other hand, no central bank has such a power.

Other possibilities of leaving the responsibility for exchange rate policy with a Community body such as the Council would, assuming the ESCB is independent from national and Community authorities, lead to situations of potential conflict because exchange rate policy and the interventions involved have the capacity to undermine domestic monetary policy.

Various working methods to resolve potential conflicts could be used if the responsibilities were split in this way.

- The ESCB could be allowed to refuse to implement a particular exchange rate policy if it put its monetary policy objective of price stability in danger.

- The ESCB and the Council could be left to resolve their differences without a particular rule. This is the situation, de facto, in most countries with an independent central bank.

- The Council could be given the right to impose an exchange rate policy on the ESCB. Such an arrangement could theoretically compromise the ESCB's independence and its duty to aim for price stability. It is nevertheless the US solution, where exchange rate policy has only a small influence due to the size of the domestic economy. The external trade of the Community would be similar to the US in EMU.

3.5. Responsibility for banking supervision

At present many, but by no means all central banks are involved in banking supervision. The exceptions are in Germany and Belgium. The rationale behind such involvement is that, being the lender-of-last-resort to the banking system, the central bank is therefore interested in the health of the system as a whole. Against it is the argument that there may be conflicts between banking supervision and the objective of price stability.

If the ESCB were completely excluded from banking supervision this may add strength to the price stability goal but it may also lessen the credibility in the banking system as a whole.

At the other extreme, the option would be to give the ESCB the entire responsibility for banking supervision, however this would not be in line with the principle of subsidiarity.