

**The European Central Bank**

*Canon*

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**1. Introduction**

The power of the European Central Bank (ECB), like that of other supranational authorities, stretches far and wide; the combination of influence, authority and monetary tools at its disposal allow it to drastically affect economic conditions throughout Europe. This is something that has never been more accurate given the rise of globalisation that has resulted in highly interdependent economies across the continent. Therefore, it is essential to understand the structure, objectives and challenges of the ECB in order to critically reflect on Europe’s current economic climate and contribute sound arguments to on-going political debates. This is highlighted by high-profile cases such as the continuing debt crisis in Greece that prompted the ECB to impose strict austerity measures on the country in an attempt to stabilize the region back in 2010.[[1]](#footnote-1) More recently, the result of the June 2016 referendum in the UK – that has the country exiting the European Union by the spring of 2017[[2]](#footnote-2) – has raised concern within the ECB about banking sector vulnerability and could spark a response to maintain stability in Europe.[[3]](#footnote-3) These examples make it clear that any well-rounded opinions on major issues require a strong foundationally knowledge of the ECB and its potential responses to price stability risks.

**2. The formation and structure of the European Central Bank**

*2.1 A short history*

The creation of the ECB as a supranational authority is the result of a process that hoped to minimize future instability in post-war Europe. This process started in 1951 with the Treaty of Paris, which resulted in the creation of Europe’s first supranational authority coined the European Gold and Steel Community. The concept was simple: connect major industries – in this case primarily France and Germany’s steel industries – to deter them from engaging in war. The process of creating a more united and interlinked Europe continued during subsequent years with the establishment of a European Currency Unit in 1979 and the Single European Act in 1986 in which a true internal market, together with free circulation of goods, people, services and capital, was created. Ultimately, the Delors report of 1998 set the basis for a concrete, 3-step strategy to establish an Economic and Monetary Union. Its first steps originated in 1990 and included the strengthening of the cooperation among national central banks (NCBs). Only two years later, in 1992, the heads of European member states signed the Maastricht Treaty, creating the European Monetary Union. What followed was the process of economic convergence of member states, which were forced to meet specific and strict criteria in order to become members of the Monetary Union. This was followed by the creation of the European Monetary Institute, which was replaced by the ECB on June 1st 1998, together with the European System of Central Banks (ESCB), as the role of overseeing the new Euro currency became a primary responsibility. Currently, the ECB and ESCB are together known as the Eurosystem.

*2.2 Basic structure*

Today, the ECB is a supranational institution based in Frankfurt am Main, Germany, and is responsible for European monetary policy according to the “Treaty on the Functioning of the European Union” and the “Statute of the European System of Central Banks and of the European Central Bank,” both dated 1998. In effect, the ECB’s decision-making is in the hand of four main bodies: the Executive Board, the Governing Council, the General Council and the Supervisory Board. The Executive Board is responsible for the daily work of the ECB and the implementation of monetary policies as designed by the Governing Council, as well as giving instructions to NCBs. The Executive Board is composed of the President of the ECB – currently Mario Draghi – the Vice-President and four other members who are all appointed by the European Council. The main decision-making body is the Governing Council, formed by the members of the Executive Board and the governors of the 19 Eurozone NCBs. Among other tasks, the Governing Council is responsible for the formulation of guidelines for the implementation of monetary policies, including interest rates and reserves supply. The General Council is a transitional body linking the original European Monetary Institute to a not-yet achieved complete monetary union in which all European countries are part of the Eurozone. Its members are Mario Draghi, the Vice-President and the governors of NCBs of the 28 European countries. Finally, supervision is entrusted to the Supervisory Board, consisting of the Chair, the Vice-Chair, four ECB representatives and representatives of national supervisors.

**3. The purpose of the ECB**

*3.1 Primary objective*

The main goal of the ECB and the Eurosystem is to maintain price stability, which is defined by the Governing Council as “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%.”[[4]](#footnote-4) The main reasons behind this objective are the following arguments: price stability allows consumers to make better-informed decisions on consumption and investment due to the ability to recognize relative price changes. This subsequently allows the market to allocate resources more efficiently, which enhances an economy. Another advantage of price stability is that it reduces the investment risk for investors; reducing risk premiums increases the incentive to invest, which has been well established to lead to economic growth.[[5]](#footnote-5) Furthermore, avoiding significant price inflation or deflation minimizes distortions and promotes social cohesion by limiting an arbitrary redistribution of wealth and income. It has also been recognized that price stability contributes to financial stability. In extreme cases such as hyperinflation in the Weimar Republic in the early 20th century and hyperdeflation during the more recent Argentinian crisis at the start of 21st century make abundantly clear.[[6]](#footnote-6) These reasons make price stability the ECB’s most significant priority as it promotes higher employment, balanced economic growth and financial stability.

*3.2 Influence in the Eurozone*

In order to ensure price stability within the Eurozone, the ECB[[7]](#footnote-7) first engages in economic and monetary analyses to better understand the risks associated with this primary objective. The single monetary policy strategy based off of these analyses is then applied through a set of monetary policy instruments and procedures available to the central bank. This set forms the operational framework under which the ECB functions and aims to reach and maintain its price stability.

First and foremost, the monetary policy strategy revolves around the fact that the ECB (strictly speaking the Eurosystem) is the monopoly supplier of money within the Eurozone. This allows it to manage liquidity and influence interest rates. Similar to other central banks such as the US Federal Reserve, the ECB’s ability to print money creates sufficient funds for it to buy assets in the economy and in doing so increase liquidity. Although this form of direct purchasing is less conventional in Europe compared to the US, the on-going bond buying program, which will be elaborated on in section 3.3, highlights its increasing importance as a monetary policy tool.

Historically, the primary tool used by the ECB to manage liquidity has been repo contracts. The concept behind repo contracts is that eligible banks receive short-term financing by providing the ECB with collateral in the form of debt. The stringent application process to qualify for membership in the EU – i.e. countries need to be in good financial health – is supposed to ensure that debt offered to the ECB by the countries it governs as collateral for repo contracts are, in theory, protected from the risk of inflation. Ultimately, the minimum bid rate signals the ECB’s monetary policy stance and influences interest rates and the liquidity within the market. [[8]](#footnote-8)

Additionally, the ECB oversees foreign exchange operations by intervening in the foreign exchange market. According to Article 111 (1&2) of EC Treaty: “the EU Council may conclude formal agreements on an exchange rate system for the euro vis-à-vis currencies outside the EU” “in the absence of such an exchange rate system, the EU Council, acting by qualified majority, may formulate general orientations for exchange rate policy.” [[9]](#footnote-9) However, these institutional measures must always consider the primary objective of the ECB and their actions may only be initiated on a recommendation from either the ECB of the European Commission. In order for these institutional bodies to make exchange rate agreements, the ECB has to ensure that it has sufficient liquidity to do so. The ECB administers its liquidity through its foreign reserves portfolio, which consists out of US dollars, Japanese yen, gold and special drawing rights (a form of international money). The main objectives for the management and the perseverance of the ECB’s foreign reserves are liquidity, security and returns.

The ECB’s last task is to promote smooth operations of payment systems, by establishing oversight policies that collect relevant information regarding large-value payment systems, retail payment systems and payment instruments. Subsequently, the ECB assesses this information and effectively induces change in order to maintain price stability.

*3.3 A real world example: the Public Sector Purchase Programme (PSPP)*

The ECB is able to pursue price stability through the use of a quantitative easing (QE), given its status as the sole creator of money. Although this is not one of its most conventional tools, asset purchasing is not a novel idea as the ECB has previously purchased sovereign debt from countries such as Greece, Spain and Italy from 2010-2012 under the Asset Purchase Programme (APP). The persistent economic downturn throughout the Eurozone prompted the ECB to expand on the APP by announcing the Public Sector Purchase Programme (PSPP) on January 22, 2015. The ECB had previously attempted to spurt a recovery by using its influence to decrease interest rates and thus incentivize investment in the economy. However, after applying this monetary tool to the point of cutting one of its main interest rates below zero in 2014, without the desired result, the ECB pursued this more ambitious strategy. Under the PSPP, the ECB committed to an increase in sovereign bond purchases, which started in March of the same year with the hope of stabilizing the region.

The response to this policy is ambiguous given its potential effects on household and company investment. Namely, basic economic theory tells us that negative interest rates reduce borrowing costs for households and companies, driving demand for loans up. However, in extreme cases, negative interest rates imply that depositors need to pay the bank to hold its money, potentially limiting the banks’ funding as depositors look for better places to put their funds. On the other hand, negative interest rates negative interest rates squeeze the profit margin for banks as lending becomes cheaper. This could induce banks to scale back their lending operations. Other potential results include less elastic and smaller financial markets, as the source of primary funding for EU nations changes from bonds to loans.[[10]](#footnote-10) There are also worries that QE will increase asset bubbles as money flows into stocks and housing markets rather than companies and households.[[11]](#footnote-11)

Ultimately, no significant effect has been detected after two years of negative interest rates and these QE experiments.[[12]](#footnote-12) However, it possible that it is too early to say whether these two policies are effective measures to return the Eurozone to stability.

**4. Challenges and concerns**

*4.1 The ECB’s relationship with NCBs*

Given its supranational status, the ECB presides over countries that often have different interests, which complicates the monetary policy strategy which is aimed at price stability in the region. This is highlighted by the relationship between the ECB and the national central banks of those countries; the ECB, which coordinates the operations, has a primary objective of price stability in the Eurozone, while the national central banks, which execute the policies, care mostly for the welfare of the countries they represent. [[13]](#footnote-13) This decentralised implementation of monetary policy is thus difficult to navigate, as interests are not always aligned. For example, the optimal result is not always attained when the ECB uses its ability to manage liquidity in order to influence interest rates. For example, when interest rates are set at an optimal level based on Germany’s credit rating or economic health; this means that countries such as Spain and Italy with lower credit ratings are able to borrow at a rate which is too low and that subsequently does not fully capture the risks associated with those countries. Ultimately, problems arise when the collateral, provided in return for this ability to borrow, is not of high enough quality (this can be masked using accounting techniques). In the Netherlands, it is believed by some national bank representatives that low interest rates threaten the stability of the country.[[14]](#footnote-14) However, the national central bank has no influence to change this rate with only one seat on the Governing Council. The Nederlandsche Bank then needs to enhance the resiliency of their banks through a number of methods to prevent major damage in case of crises. The combination of these two examples highlights the difficult nature of the relationship between the ECB and the national central banks.

A recent hopeful example epitomizing this relationship is the Single Supervisory Mechanism (SSM), which is a new system of banking supervision for the Eurozone.[[15]](#footnote-15) In this system, the ECB and NCBs coordinate the supervision of the banking systems to ensure that there is a sufficient safety net able to withstand shocks in the system.

*4.2 The exit of Eurozone member countries*

Another noteworthy challenge to stability within the Eurozone is the possible exit of one of its member states. The common monetary union for these different types of economies (central Europe, southern Europe and Eastern Europe) makes the convergence of their interest difficult. As there is no legal path to the exit of one member, the possible withdrawal remains uncertain.

The possibility of an exit of a country or the breakup of the Euro surfaced during the European debt-sovereign crisis in 2010. This exit could occur in two different ways. First, the cost competitiveness of a low-income country such as Greece (in 2010 and again in 2015) would increase, likely resulting in a boost in exports. This could significantly inconvenience countries with high levels of debt, as depreciation would increase their debt amount in real terms.

The other option would be the exit of a high-income country such as Germany or the Netherlands, which would raise concerns over an expensive ECB policy that could lead to high inflation. The main trouble for these countries would be losing their leading role in a monetary union in which they are the most competitive countries. Especially their surplus in the trade of goods would be threatened[[16]](#footnote-16).

Another important issue that arises with the withdrawal of one country is the domino effect, which will eventually lead to the total break-up of the monetary union. Naturally, for a domino effect to occur, the size and influence of the member state leaving the European Monetary Union (EMU) is important. Although not a member of the EMU, the recent UK decision to leave the EU could potentially spark this effect.

*4.3 Value of the Euro*

During some phases of the previous financial crisis, the monetary policies of the Federal Reserve of the United States of America were quick and aggressive, causing the American dollar to drop in value in relation to the Euro. This relative increase in strength by the Euro made goods and services produced in the Eurozone more expensive. Eventually this hurt the least competitive economies as their goods are more sensitive to changes in price[[17]](#footnote-17).

Furthermore, the optimal value of the Euro has no definite answer. Once again, not all interests align: while less competitive countries would prefer a weaker Euro as it would increase of exports, other countries such as Germany or the Netherlands prefer a stronger currency to avoid a loss of purchasing power. This makes the ECB’s policy stance in regards to its currency a tricky one.

**5. Conclusion**

The hope is that this canon highlighted some of the key foundational aspects of the European Central Bank, while concurrently elaborating on its influence in the Eurozone and the challenges that arise given its position as a supranational authority. From having to navigate its relationship with the national central banks to the possible exit of Eurozone member, the ECB clearly has a difficult task when it comes to maintaining price stability in the Eurozone. Lastly, it is worth noting that the ECB is by no means an old institution and is therefore still adapting. This is highlighted by hopeful new policies such as the SSM that hopes to better regulate the banking industry in the future.

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