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The Monetary Policy of the European Central Bank

The European Central Bank (ECB) began operations in January 1999. This paper describes the objectives of its monetary policy, its institutional framework, the procedures for determining monetary aggregates, ECB monetary-policy operations and monetary control. The principal documentary source is the ECB's own monthly bulletin.

The institutions involved in the design and implementation of monetary policy under European Economic and Monetary Union (EMU) are as follows:

a) The *European System of Central Banks* (ESCB), comprising the *European Central Bank* (ECB) and the fifteen *National Central Banks* (NCBs) within the European Union.

b) The so-called *Eurosystem*, made up of the ECB and the eleven NCBs of the euro zone[1] member states.

[1] This distinction is necessary because monetary policy only applies to the eleven EMU member states (the euro zone), while the fifteen member states of the European Union form part of the ESCB.

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These institutions are governed by the following:

a) The General Council of the ESCB, comprising the president and vice-president of the ECB and the governors of the fifteen NCBs.

b) The Governing Council of the ESCB, comprising the ECB's Executive Board and the governors of the eleven NCBs within the Eurosystem. This is the body which establishes EMU monetary policy.

c) The ECB's Executive Board, comprising the president, the vice-president and four members.

Implementation of ESCB decisions is the responsibility of the NCBs, and is always carried out in a coordinated and uniform way in all EMU countries.

1. Monetary-policy objectives

The mandate of the ECB[2] is that of "maintaining price stability" [article 105 (1) of the European Union Treaty]; in this, the ECB is similar to the Bundesbank, the Bank of Spain (since 1994) and other European central banks and differs from the United States Federal Reserve, whose mandate is that of "achieving the highest level of employment compatible with price stability". However, the same article 105 (1) indicates that "without prejudice to the objective of price stability, the European System of Central Banks shall support the general economic policies of the Community"; these include "a high level of employment and social protection" (article 2).

As regards exchange-rate policy, the Council of Ministers (or part of it, since the Council of Ministers includes all the countries of the European Union, whether they are EMU members or not) offers "general orientation" (article 109.2 of the Treaty); the ECB is, of course, responsible for its implementation, given that it centralises the system's foreign currency reserves.

Price stability is defined as the maintenance of a year-on-year growth rate of above 0% and below 2% in the harmonised index of consumer prices (HICP), calculated since 1995 by Eurostat, the European Union's statistics office. The HICP from which the ECB works covers the eleven countries of the euro zone, and is established as a medium-term objective. Short-term variability, which could be due to a wide variety of uncontrollable causes, is not considered important.

Given that monetary-policy measures take effect with a varying but not inconsiderable period of delay (from six to eight quarters in the case of Spain for example), it is very important to establish the variables on which the ECB will concentrate in order to predict future movements in the HICP sufficiently in advance. Since there are significant differences between the economies of EU member states, the ECB has

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[2] To be precise, the Governing Council of the ESCB decides monetary policy, the Executive Board applies it and the national central banks implement it. To simplify matters, we shall refer to the ECB as if it were the body that formulates and implements policy.

adopted an eclectic strategy under which reference is made to intermediate variables which will guide monetary policy:

a) *Preferential attention will be given to changes in the amount of money in the system (M3)* (an explanation of the calculation used to reach this aggregate is given at a later point)[3]. Prolonged and substantial deviations in M-3 growth from the reference value will be interpreted as a warning of instability of future prices, although the ECB has not undertaken to react to transitory changes in M3, even where they are significant.

b) *At the same time, there will be a monitoring of a certain number of variables that might be considered advance indicators* of price trends: salaries, interest rates –including the yield curve–, exchange rates, fiscal-policy indicators and indicators of business and consumer confidence. The ECB will also take into account the inflation forecasts made by other institutions and bodies; it has not been decided whether it will publish its own forecasts.

The ECB cannot achieve its objective in terms of inflation directly, but must attempt to do it indirectly. The basis for this form of action constitutes the *strategy for monetary policy:* the combination of criteria and procedures by which the ECB takes decisions aimed at achieving its ultimate objectives. This strategy has an internal dimension (procedures for formulating objectives, gathering and processing information and taking decisions) and an external dimension (putting these decisions into practice, with the inclusion of communication processes, so that the strategy generates credibility and confidence in the economic agents involved). What the ECB tries to do is manipulate certain instruments that it controls in order to modify the behaviour of other agents (the monetary financial institutions to which we shall refer at a later point). To do this, its strategy must be clear and comprehensible for everyone concerned, as well as being transparent, subject to procedures for the rendering of accounts by the European System of Central Banks and consistent with the institutional independence of this system.

2. The institutional framework

The amount of money in the euro zone is composed principally of certain liabilities issued by the monetary financial institutions (MFIs). This sector comprises the following:

a) The Eurosystem, i.e. the part of the ESCB formed by the ECB and the eleven NCBs of the EMU member states.

b) Credit institutions resident in the euro zone.

c) Other financial intermediaries, especially money-market funds (MMFs), whose liabilities have the status of monetary liabilities.

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[3] For the time being, a reference value of 4.5% per annum has been adopted (in a quarterly moving average of the year-on-year growth rate, in order to smooth out fluctuations from one month to another), resulting from a hypothetical growth in real GDP of 2-2.5%, an increase in prices of below 2% and a decrease in the velocity of circulation of 0.5-1% per annum (it is estimated that, in the short term, the decrease in the velocity of circulation could be somewhat smaller).