EUROPEAN ECONOMIC AND MONETARY UNION

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Foreword

This booklet provides a comprehensive overview of European economic and monetary union (EMU). It tracks the progressive realisation of the project from its historical beginnings through to the legal provisions and operational procedures applicable in EMU today. The information contained in this booklet focuses on issues of particular relevance to central banks.

Frankfurt am Main, April 2008

Deutsche Bundesbank

Historical overview

Since the establishment of the European Communities (EC), there has been a considerable intensification of the integration of the member states' economic and monetary policy and, as time has gone by, the original integration objectives have been expanded. The Common Market, for instance, was transformed into a single European market and European economic and monetary union (EMU) has been established in a series of stages.

The EC Treaties of 1951 and 1957 considered the primary integration objective to lie in the establishment of a common market. Overall economic and monetary policy was regarded only as a "matter of common concern" which was to be coordinated through "recommendations to the member state concerned", for instance. The "Monetary Committee with advisory status" was set up with the task of monitoring the monetary and financial situation in the member states and the Community. At that time, the possibility of conferring national competences for monetary and exchange rate policy, and hence central political powers, on a supranational institution seemed remote.

In 1962, in the context of its Action Programme for the second stage of the Customs Union, the European Commission made the first proposals with regard to establishing an economic and monetary union. At that time, the Bretton Woods system of fixed exchange rates, which safeguarded exchange rate stability, was still in place. For this reason, as well as for political ones, the member states were unwilling at the time to take up the European Commission's proposals. Then, in 1964, the Committee of Governors of the Central Banks of the Member States of the European Economic Community (Committee of EEC Central Bank Governors) was set up; this committee was to play a major role in the coordination of monetary and exchange rate policy in the Community.

As tensions in the world monetary system increased, also affecting the Community in the second half of the 1960s and encroaching to a considerable extent on the free movement of goods and capital, closer economic and monetary policy cooperation in Europe appeared more urgent than ever.

Following on from a new memorandum by the European Commission dating from February 1969 (Barre Plan), a working party led by the then Prime Minister of Luxembourg, Pierre Werner, developed a plan to establish EMU (Werner Plan). On the basis of this plan, the Council took a decision of principle in March 1971 that EMU was to be achieved progressively by 1980. This resolution focused on the measures to be carried out in the first stage and did not deal with major elements of the plan

put forward by the Werner Group – including, notably, the precise form that the intermediate and final stages should take.

The central banks of the EC member states were requested as far back as 1 January 1971 (start of the first stage of EMU as per the Werner Plan) to endeavour to keep exchange rate fluctuations between their currencies within a maximum range of ±1.2%. Coordinated dollar interventions were to be used to keep exchange rates within this range.[1] The 1971 dollar crisis, however, prevented the implementation of a formal resolution by the EC Council of Ministers. Some countries, including the Federal Republic of Germany, temporarily abandoned the fixed link to the US dollar and allowed their currencies to float freely. With the Washington monetary agreement of December 1971 (Smithsonian Agreement), an attempt was made at an international level to restore stable exchange rate parities. However, the disadvantage of this agreement for the EC was that, following the general widening of the fluctuation margins against the US dollar to ±2.25%, exchange rates between the EC currencies could possibly fluctuate within ±4.5%, ie an overall range of 9%, in the extreme case of a complete turnaround of the positions over time. This widening of the margins and its implications for the EC's agricultural policy, for instance, gave fresh impetus to efforts to create a special arrangement with narrower margins within the EC.

On 21 March 1972 the EC Council of Ministers adopted a resolution which, *inter alia*, established the European "currency snake"[2] and the European Monetary Cooperation Fund (EMCF). In the "snake", the EC member states were to undertake to allow their currencies to fluctuate against one another within a range of ±2.25% only. The linked European currencies could move freely against other currencies, especially the US dollar, which was floated in 1973. The resolution of the Council of Ministers was given concrete form in the Basel Accord of 10 April 1972 concluded between the EC central banks; it entered into force on 24 April 1972.

Initial experience with the stabilisation of intra-Community exchange rates showed that in the long term a system of fixed exchange rates can only work between countries with sufficiently similar approaches to economic policy and a corresponding degree of economic convergence. In its April 1973 appraisal of the first stage, the European Commission therefore reached the conclusion that only some of the envisaged progress towards integration had been made. In particular, it considered

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1 Until then currency parities had been maintained solely by interventions against the dollar within a fluctuation range of roughly ±0.75%. As time went by, exchange rate deviations between the EC currencies of twice that amount therefore became possible, up to a maximum of roughly ±1.5%.

2 For further information, see Deutsche Bundesbank, The European system of narrower exchange rate margins, *Monthly Report*, January 1976, pp 22-29.

it necessary to transfer real economic policy powers to the Community bodies. However, since the member states found this unacceptable, it was impossible to reach a decision on the start of the second stage of EMU in line with the Werner Plan. Ultimately, however, the EMU project of that time failed because of fundamental differences of opinion regarding the objectives to be pursued through EMU and, in particular, the EC countries' unwillingness to subject themselves to a common stability objective. Consequently, their economic policy responses to the first oil crisis also differed greatly.

Departures from the "snake" left the Community split into two groups at the end of 1978 in terms of exchange rate policy: a bloc of hard currencies concentrated around the Deutsche Mark together with the Benelux currencies and the Danish krone, as opposed to the other four freely-floating currencies, with the Irish pound pegged to the pound sterling. In order to counter the risk of disintegration, economic stabilisation in the EC in 1977 and 1978 was used as a reason to develop a concept of monetary and, in particular, of exchange rate policy cooperation which would be applicable to the Community as a whole. In the spring of 1979, these efforts led to the creation of the European Monetary System (EMS), with a bilateral parity grid and maximum fluctuation margins of 2.25% above or below the central rates of the participating currencies.

The primary aim of the EMS was to strengthen monetary policy cooperation with a view to creating an area of stability in Europe. Originally, the EMS was to be transformed into a definitive monetary system following a preparatory stage of no more than two years. This system was to be characterised by the merger of the existant short and medium-term EC credit systems into a European Monetary Fund and unrestricted use of the European Currency Unit (ECU) introduced with the EMS as a reserve asset and settlement instrument. Owing to differences of opinion regarding the structure of the final stage as well as economic divergences, however, it proved impossible to set up a comprehensive system of this kind. Nevertheless, the EMS helped to initiate far closer currency cooperation between the member states and also reinforced the growing willingness over the course of the 1980s to see a closer convergence of economic policy among the member states. The EMS prompted most member states to gear their economic and monetary policies to developments in the most economically stable countries in the European Community.

The success of the EMS helped to create a situation in which the concept of EMU experienced a renaissance from the mid-1980s onwards. In June 1985, for the first time, the Commission published a White Paper outlining the measures needed to

complete the single market. These efforts led to the Single European Act (SEA), which was signed in Luxembourg on 17 February 1986 and in The Hague on 28 February 1986. It entered into force on 1 July 1987 after being ratified by the member states and constituted the first fundamental reform of the Treaty establishing the European Economic Community (EEC Treaty). It was of particular significance that the member states undertook to complete the single market by the end of 1992. Furthermore, the SEA first gave specific expression to the idea that the European Union was considered the final goal of European integration. In the field of economic and monetary policy, the SEA also obliged the member states to work together more closely in order to achieve the convergence needed to enable the Community to develop further.

In June 1988 the European Council commissioned a working party to examine the actual stages needed to achieve European Union. As a result, the working party, which was chaired by Commission President Jacques Delors and included the EC central bank governors and three independent experts, produced a report in April 1989 (referred to as the Delors Report) which proposed that EMU be achieved in three stages. This project was approved by the European Council, which decided that the first stage of EMU should begin on 1 July 1990 and that an intergovernmental conference should be convened to prepare the amendments to the Treaty needed to ensure the implementation of the further stages. In mid-December 1990, therefore, two intergovernmental conferences were convened in Rome. The task of one conference was to advise on the Treaty amendments needed to complete EMU. The other conference was to deal with the further development of the Community, transforming it into a political union. After a year of discussion the two conferences engendered the Treaty on European Union, which was approved by the Heads of State or Government in Maastricht in December 1991. This Maastricht Treaty (as it became known), which entered into force on 1 November 1993 with the completion of the national ratification procedures, wrote a new chapter in the history of European unification. It turned the Community into a Union based on three pillars. The main pillar consists of the Treaties on the European Communities (EC Treaties), in which the Treaty establishing the European Community (EC Treaty), deriving from the earlier EEC Treaty, is of central significance.[1] In addition to the provisions on the internal market, Community policies and the institutions of the Community, the EC Treaty contains provisions on EMU and on Union citizenship. The two other pillars of the Union, the common foreign and security policy

1 The EC Treaties also include the Treaty establishing the European Atomic Energy Community (Euratom Treaty). Until it expired in mid-2002, the Treaty establishing the European Coal and Steel Community (ECSC Treaty) was also an integral part of the EC Treaties. The ECSC Treaty (1952) was the only Community treaty to be adopted with a term of 50 years.

and police and judicial cooperation in criminal matters, are also regulated in the EU Treaty. However, this leaves the development and integration of the EU very far from completion. The main challenges currently facing the EU involve, above all, the implementation of the further steps towards European integration provided for in the Treaty of Lisbon.

The progressive establishment of European economic and monetary union

I The first stage of European economic and monetary union

The first stage of economic and monetary union (EMU) began for the European Community on 1 July 1990 in accordance with the conclusions of the Dublin European Council.[1] This stage on the path towards a single currency in Europe was primarily concerned with gearing the national economic and monetary policies more closely to the requirements of monetary stability and budgetary discipline in the European Community. This was to be achieved primarily by greater coordination of national economic and monetary policies. This project was realised within the existing legal framework of the Community, to which only two legal acts were added.

The Council Decision on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union[2] introduced multilateral surveillance as a new coordination instrument for the Community. This surveillance covered all aspects of economic policy, both short and medium-term, with particular emphasis being placed on budgetary policy. It was carried out at least twice a year by the Council of Economic and Finance Ministers (Ecofin Council) and was based on reports and surveys by the European Commission which had been examined and discussed in advance in the Monetary Committee, the Ecofin Council's central preparation body in economic and fiscal policy matters. In addition to the regular surveillance procedures, the Council was also able to make use of ad hoc consultations if economic developments within a member state or outside the Community posed a risk to economic cohesion. All in all, the new coordination procedure was intended to initiate a learning process which would increasingly lead to compatible economic policies with corresponding specific obligations on the part of the member states. The success of this process hinged crucially, however, on the willingness of the member states to comply. The Council had – apart from the freedom to publish its economic policy proposals and rulings – no means of applying pressure to make the member states subject their economic policy to the interests of Europe as a whole.

The second major innovation in the first stage of EMU was the new perception of monetary policy cooperation. The tasks of the Committee of Governors estab-

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1 Press and Information Office of the German Federal Government, Bulletin No 84, 30 June 1990.
2 Council Decision 90/141/EEC of 12 March 1990 on the attainment of progressive convergence of economic policies and performance during stage one of economic and monetary union (Official Journal of the European Communities (OJ) L 78, 24 March 1990, pp 23-24).

lished in 1964 were expanded by virtue of the Ecofin Council decision of 12 March 1990 on cooperation between the central banks of the member states of the European Economic Community.[1] On the basis of a new mandate in which the objective of price stability was expressly prioritised, the Committee of Governors was now able both to formulate opinions on the orientation of monetary and exchange rate policy and submit them to the national central banks and to express opinions to the Council of Ministers or individual governments on policies which might affect the internal or external monetary situation in the Community and, in particular, the functioning of the European Monetary System. Once a year the Committee submitted a report on its activities and on the monetary and exchange rate policy situation in the Community; the report was sent to the European Council, the Ecofin Council and the European Parliament. In this way, the work of the Committee of Governors was also conveyed to a wider audience, thereby heightening public awareness of the fact that price stability is an indispensable precondition for stable economic growth. As well as coordinating national monetary policies more closely, the Committee of Governors carried out important preparatory work for the final stage of EMU, in which monetary policy in the EU was to be harmonised by the introduction of a single currency. It thus helped to pave the way for the European Monetary Institute (EMI), established in the second stage of EMU, which placed cooperation between the central banks on a new institutional footing.

II The second stage as a preparatory and transitional phase

The Maastricht Treaty entered into force on 1 November 1993 as the new legal foundation for the later stages on the path towards EMU. For the first time there was now a binding schedule for the establishment of EMU. The Treaty provided for the second stage of EMU to begin on 1 January 1994. It envisaged that, if a majority of member states fulfilled the necessary criteria for the introduction of a common currency and if, over and above this, entry into the third stage of EMU was considered appropriate for the Community, the Council meeting in the composition of the Heads of State or Government would be able, by 31 December 1996 at the latest, to set the date for the start of the third stage. Pursuant to the Treaty, the single currency was, however, to be introduced at the latest on 1 January 1999 in those member states which at that time met the necessary criteria for its adoption.

1 Council Decision of 12 March 1990 amending Council Decision 64/300/EEC on cooperation between the central banks of the Member States of the European Economic Community (OJ L 78, 24 March 1990, pp 25-26).

This binding schedule, in conjunction with the convergence criteria set out in the Treaty,[1] ensured that there was considerable pressure on the member states to pursue stability-oriented economic and monetary policies.

In keeping with the Treaty, the second stage began on 1 January 1994 and served to prepare the transition to the final stage. It pursued two primary goals. First, the surveillance and coordination of economic policy were to be further intensified in order to achieve the high degree of long-term convergence within the Community considered a necessary prerequisite for entry into the final stage. Attention was focused in this context on budgetary policy, since the convergence criteria established in the Treaty could be met only if the member states complied with a sound budgetary policy. Second, the legal, institutional and organisational preconditions were to be created for the completion of EMU in the third stage.

1 More intensive surveillance and coordination of economic policies

New regulations aimed at enhancing budgetary discipline were added to the existing procedures for coordinating economic policy and entered into force at the start of the second stage. Pursuant to Article 104 of the EC Treaty[2] read in conjunction with Article 116 of the EC Treaty, the member states were to endeavour in the second stage to avoid excessive government deficits. However, there were still no

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1 A country's eligibility for joining EMU, pursuant to Article 121 of the EC Treaty read in conjunction with the Protocol on the convergence criteria referred to in Article 121 of the Treaty establishing the European Community, is to be assessed on the basis of the following criteria.

- The member states must demonstrate sustainable price stability. The average rate of inflation, observed over a period of one year before the assessment of convergence, may not exceed by more than 1½ percentage points that of, at most, the three best performing EU member states in terms of price stability.
- The government budgetary position, in relation to the reference values set in the Treaty, must be sustainable in the long term. The reference values set in the Treaty require that the planned or actual government deficit should not exceed 3% of GDP measured at market prices (deficit criterion) and that the cumulative level of government debt should not as a rule exceed 60% of GDP (debt criterion). This is to be demonstrated in the convergence assessment by the fact that the member state is not the subject of a Council decision that an excessive deficit exists.
- The states must have participated in the exchange rate mechanism of the European Monetary System (EMS) for at least two years before the convergence assessment and must have observed the normal fluctuation margins without severe tensions and without devaluing. Since the replacement of the EMS by the exchange rate mechanism in the third stage of EMU (ERM II), the latter has superseded the EMS with regard to the exchange rate criterion.
- Over a period of one year before the convergence assessment, long-term interest rates may not exceed by more than 2 percentage points the reference value of, at most, the three best performing EU member states in terms of price stability.

2 In this booklet, quotations from relevant provisions of the European treaties are based on the Treaty of Nice (including the 2005 amendments). Articles from the Treaty establishing the European Community are referred to as taken from the "EC Treaty" and articles from the Treaty on European Union as taken from the "EU Treaty".

real sanctions available[1] to enforce this regulation. Nevertheless, the Ecofin Council was able in the second stage to exert a certain amount of pressure on the member states by publishing its specific recommendations on sound budgetary policy if the member states in question did not comply with them within a given period.

The entry into force at the beginning of the second stage of provisions prohibiting central banks from lending to the public sector and the government's renunciation of privileged access to financial services institutions were likewise intended to strengthen budgetary discipline. Pursuant to Article 101 of the EC Treaty, overdraft facilities or any other type of credit facility with the European Central Bank (ECB) or with the national central banks (NCBs) in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law or public undertakings of member states are prohibited, as is the direct purchase from them by the ECB or the NCBs of debt instruments. Furthermore, the member states are prohibited from introducing measures giving them a competitive advantage in the financial markets ("privileged access") over other borrowers (Article 102 of the EC Treaty). As a result, these provisions, which continue to apply after the introduction of the euro, force the public sector to raise funds on market terms in the credit and capital markets. This is intended to strengthen budgetary discipline and thus eliminate a potential source of inflation. These restrictions regarding the financing of the public sector's credit needs are rounded off by the Community's liability exclusion ("no bail-out rule"). Pursuant to Article 103 of the EC Treaty, neither the member states nor the Community shall be liable for or assume the commitments of another member state. This regulation is intended to add weight to each individual country's responsibility for its public finances. It increases awareness of the fact that the burden of excessive debt cannot be alleviated by communitisation.

2 Preparation by the European Monetary Institute for the establishment of the Eurosystem

The establishment of the EMI in Frankfurt am Main[2] on 1 January 1994 placed cooperation between the central banks in the European Community on a new

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1 Pursuant to the Treaty, sanctions cannot be imposed until the third stage. See "Economic union", section III.2 "Coordination of the national fiscal policies in the context of the European Stability and Growth Pact", pp 37-39.

2 Pursuant to the Decision of 29 October 1993 taken by common Agreement between the Representatives of the Governments of the Member States, meeting at Head of State and Government level, Frankfurt am Main was established as the seat of the EMI and the ECB (OJ C 323, 30 November 1993, pp 1-5).

institutional footing. Pursuant to Article 2 of its Statute, its function generally consisted of contributing to the realisation of the conditions necessary for transition to the third stage of EMU. To this end, the EMI was entrusted with three comprehensive tasks. First, it was responsible for strengthening the coordination of national monetary and exchange rate policies with a view to ensuring price stability. Second, it was given the central role in the technical preparation of monetary union; it was to prepare the ground for the ECB, as the successor to the EMI, to be able to assume the full range of its activities from the start of the third stage. The tasks ranged from harmonising the monetary policy instruments and the monetary statistics and developing a monetary policy strategy for the future single monetary policy with its necessary instruments and procedures through to organisational and technical preparatory work, such as planning for the production of euro banknotes.[1] Third, the EMI was to monitor the functioning of the European Monetary System, facilitate the use of the ECU and oversee its development.[2] Moreover, by virtue of its opinions given in accordance with Article 117 (6) of the EC Treaty, the EMI monitored the process of legal convergence in the individual member states. The focus here was on making the statutes of the national central banks compatible with the provisions of the EC Treaty relating to the independence of the European System of Central Banks (ESCB) (Article 109 of the EC Treaty). The EMI's governing body was the Council of the EMI, which consisted of the President of the EMI and the governors of the national central banks. Despite the fact that the national monetary authorities continued to have full responsibility for monetary and exchange rate policy until the transition to the final stage, the Council of the EMI exercised its monetary policy coordination function in its regular meetings, of which there were at least ten a year. The members of the Council of the EMI were to act on their own responsibility, having been ensured the greatest possible independence by virtue of Article 8 of the EMI Statute. For instance, the members of the Council of the EMI were not permitted to seek or take any instructions from Community institutions or bodies or governments of member states. Conversely, Community institutions and bodies as well as the governments of the member states undertook to respect this principle and not to seek to influence the Council of the EMI in the performance of its tasks. Guaranteeing this independence was essential to ensuring the smooth fulfilment of the EMI's tasks.

In carrying out its tasks, the Council of the EMI was supported by a staff of EMI employees as well as by a number of committees, sub-committees and working

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1 The organisational, regulatory and logistical framework of the work of the ESCB was prepared in cooperation with the national central banks as part of an extensive "master plan".

2 The Council of the EMI replaced the Committee of Governors and hence took over its task of administering the European Monetary Cooperation Fund (EMCF).

groups composed largely of experts from the national central banks. Pursuant to Article 7 of its Statute, the EMI submitted a report on its work once a year, commenting, in particular, on the state of the preparations for the third stage of EMU. Overall, the EMI was able to advance the difficult, complex preparatory work required to harmonise the monetary policy framework in Europe and to complete it in good time. The EMI thus made a significant contribution to ensuring a smooth transition to the third stage of EMU.

3 Determining the scenario for transition to the third stage of European economic and monetary union and the introduction of the euro

In the other fields, too, the legal, institutional and organisational preconditions for entry into the third stage had to be drawn up in the course of the second stage. The European Council set the course for this in Madrid in December 1995. It agreed that the third stage of EMU should begin on 1 January 1999 and decided to designate the single currency that was to be used from that time onwards the "euro". Furthermore, it agreed to strictly apply the convergence criteria stipulated in the Maastricht Treaty when deciding which member states fulfilled the necessary criteria for the introduction of the single currency.[1] Finally, it defined the benchmark data and ground rules for the changeover to the euro in a "changeover scenario". This scenario was largely based on the corresponding preliminary work carried out by the EMI. It subdivided the process of replacing the national currency units by the euro into three phases, the first of which was a transitional period which lasted from the date of the decision on which member states qualified to participate until the start of the third stage on 1 January 1999. This phase was to be used, in particular, to set up the ECB and to incorporate the national central banks into the ESCB as well as to prepare for the tasks of the ESCB. The second phase of the changeover began on 1 January 1999 with the introduction of the single currency, the euro, as scriptural money and the implementation of the single monetary policy in those member states qualified to introduce the euro (euro area). This phase lasted until the end of 2001 and continued into the third and final phase of the changeover process, at the start of which the euro banknotes and coins were introduced.

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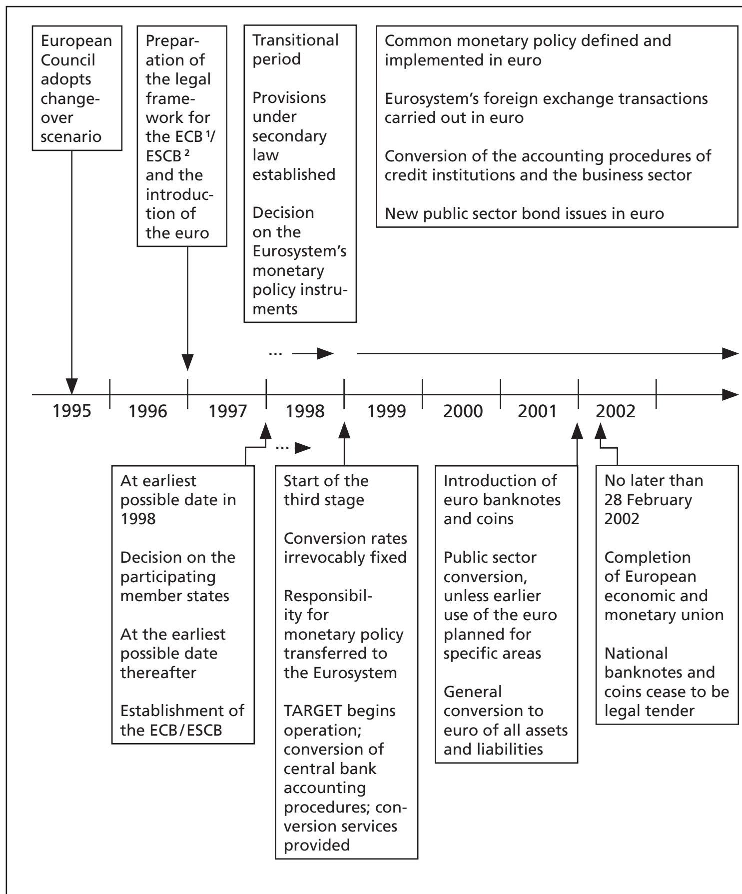
1 This agreement was reached against the background of a debate on whether some discretionary leeway should be allowed when interpreting the convergence criteria laid down in the Treaty. It helped to maintain the atmosphere of confidence necessary in the period prior to the start of the third stage of EMU.

Timetable for the changeover to the euro

Chart 1



1 European Central Bank. — **2** European System of Central Banks.

Deutsche Bundesbank

The changeover scenario was a major milestone on the path leading to the introduction of the euro. It established a clear framework for the use of the new European currency and ensured that the changeover process was relatively simple and competitively neutral.[1]

1 For additional information on the changeover scenario, see Annex 1 to the conclusions of the European Council held in Madrid on 15 and 16 December 1995 (OJ C 22, 26 January 1996, pp 2-5) and Deutsche Bundesbank, Scenario for the changeover to the single European currency, *Monthly Report*, January 1996, pp 53-60.

4 Establishing the legal basis for the introduction of the euro

With the start of the third stage of EMU, monetary sovereignty in the EU member states in which the euro was introduced was transferred to the European Community, which was granted exclusive competence in this respect. The European Community accordingly issued the necessary regulations in two separate legal acts: Council Regulation (EC) No 1103/97 on certain provisions relating to the introduction of the euro[1] and Council Regulation (EC) No 974/98 on the introduction of the euro.[2] The first Regulation, which the Council of Ministers adopted on the basis of Article 308 of the EC Treaty, entered into force on 20 June 1997 and regulated at an early stage matters which appeared to be significant in the period preceding the third stage, especially in terms of the financial markets. These included replacing the ECU currency basket cited in legal instruments with the euro, confirming the principle of the continuity of contracts, and technical aspects of converting the national currencies into euro (exchange rates and rounding rules to be applied). The provisions of this Regulation and the date of its entry into force helped to enhance legal certainty and transparency for market participants in the context of the introduction of the euro.

The key monetary and conversion criteria for the changeover were laid down in the second Regulation, the legal basis for which is Article 123 (4) of the EC Treaty. It entered into force on 1 January 1999 and provides that the euro replaces the currencies of the participating member states from that date onwards at the conversion rates set by the Council and that one euro is divided into 100 cent. At the same time, it contains provisions for the coexistence of the euro and the national currencies during the transitional period until the end of 2001. It thus provided a clear legal basis for the principle of the free use of the euro without compulsion. Finally, the Regulation also established the principles concerning the introduction of the euro banknotes and coins and drew up a framework under Community law for the dual currency phase which followed the transitional period; during this period the national and euro monetary tokens circulated in parallel for a limited period of up to two months from 1 January 2002.

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1 OJ L 162, 19 June 1997, pp 1-3.
2 OJ L 139, 11 May 1998, pp 1-5.

III Selection of the countries participating in the third stage and transition to the final stage; establishment of the European Central Bank

In the second stage of EMU, the economic policy of most member states of the European Community focused on meeting the convergence criteria laid down in the Maastricht Treaty. The pressure exerted by these criteria as preconditions for entry into the third stage on those member states wishing to participate, combined with the decision that the third stage of EMU would begin on 1 January 1999, led to a notable convergence of the economic key data in most EU member states. As a result of this development, the Council of Ministers of Economics and Finance determined on 1 May 1998 – taking account of the convergence reports of the EMI and the European Commission – that according to its assessment eleven member states[1] met the preconditions for the introduction of the single currency. It recommended introducing the euro in these eleven member states on 1 January 1999. On the basis of this recommendation and of the European Parliament's opinion to that effect, the Council meeting in the composition of the Heads of State or Government confirmed on the following day that the member states named in the Council's recommendation fulfilled the necessary conditions for the adoption of the euro. It also stated that Greece and Sweden did not meet the conditions for the introduction of the euro at that time. The Council did not examine the convergence situation for Denmark and the United Kingdom. On the basis of an exemption,[2] Denmark had notified the Council that it would not participate in the third stage of EMU with effect from 1 January 1999. The United Kingdom of Great Britain and Northern Ireland – likewise on the basis of special regulations[3] – had not informed the Council that it intended to proceed to the third stage.

In connection with the selection of the countries participating in EMU, the Ministers of Finance also confirmed in a declaration – drafted at the initiative of the German Minister of Finance – the commitment they had made in the context of previous decisions to achieve budgetary consolidation and to promote growth and employment. This stability declaration of May 1998[4] was linked in particular to the

1 Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

2 The Protocol on certain provisions relating to Denmark contains a right to give notification of non-participation.

3 The Protocol on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland provides that the United Kingdom shall participate only if it gives notice of its intention to do so.

4 Printed in Bulletin No 30 issued by the Press and Information Office of the German Federal Government, 11 May 1998.

intention to reaffirm existing stability obligations in respect of fiscal policy – specifically with regard to the countries with particularly high levels of government debt. Furthermore, the ministers and central bank governors of the member states adopting the euro, the Commission and the EMI issued a "Joint communiqué on the determination of the irrevocable conversion rates for the euro". This pre-announcement of the method to be used for setting the euro conversion rates on 31 December 1998 with effect from 1 January 1999 gave market participants clear directional guidance and hence stabilised market expectations and exchange rate developments during the transitional period.

Another crucial decision concerning the introduction of the euro, namely the political agreement on the members of the Executive Board of the ECB, was also reached by the Heads of State or Government during the first weekend in May 1998. The appointment by common accord of the persons nominated for the Executive Board of the ECB pursuant to Article 112 of the EC Treaty took place shortly after this (following prior consultation with the EMI and the European Parliament) by the governments of the participating member states at the level of the Heads of State or Government. Consequently, the ECB was established on 1 June 1998 and was able to take all the necessary decisions and preparatory steps for the start of the third stage of EMU on the basis of the preliminary work undertaken by the EMI. The EMI – as the precursor to the ECB – was liquidated upon the establishment of the ECB.

On 1 January 1999 the euro became the single currency in the euro area, ie initially in the eleven member states of the European Community which had qualified by fulfilling the convergence criteria. At the same time, responsibility for the single monetary policy in the euro area was transferred to the Governing Council of the ECB. Immediately prior to this, the Ministers of Economics and Finance of the participating member states irrevocably set the respective conversion rates between the currencies of the participating member states and the euro by means of Council Regulation (EC) No 2866/98 on the conversion rates between the euro and the currencies of the member states adopting the euro.[1] These corresponded to the central rates in the exchange rate mechanism of the European Monetary System. For the EU member states which had not yet introduced the euro, the new exchange rate mechanism in the third stage of EMU (ERM II) was established enabling them to link their currencies to the euro.[2]

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1 OJ L 359, 31 December 1998, pp 1-2.
2 See "The exchange rate mechanism in the third stage of European economic and monetary union", pp 74-81.

IV Introduction of euro banknotes and coins

When the preparations for the cash changeover were complete, the euro could also be introduced "physically" – on 1 January 2002 – in the form of banknotes denominated in euro and coins denominated in euro or cent. The legal basis for this was Council Regulation (EC) 974/98 on the introduction of the euro.[1] In addition to establishing the introduction of euro banknotes and coins on 1 January 2002, this Regulation provided that the national currency units should remain the sole legal tender in their respective area until the end of 2001 and subsequently could retain their status of legal tender for a maximum of six months from the end of the changeover period. However, the EU Ministers of Economics and Finance agreed on 8 November 1999 to limit the period of the parallel circulation of euro cash and national currency units to a maximum of two months.

In Germany, the Deutsche Mark Termination Act (DM-Beendigungsgesetz), which is a part of the Third Euro Introduction Act (Drittes Euro-Einführungsgesetz),[2] governed the changeover from Deutsche Mark to euro cash. Accordingly, banknotes and coins denominated in Deutsche Mark ceased to be legal tender at the end of 2001. The euro became the sole legal tender in Germany on 1 January 2002. A "modified reference date arrangement" for the introduction of euro cash agreed with the national associations representing banks, shops and similar service providers as well as the vending machine industry made it possible to continue to use D-Mark banknotes for a limited period until 28 February 2002. However, the Deutsche Bundesbank – following its past exchange practice when introducing a new series of banknotes – will exchange unlimited amounts of banknotes and coins denominated in Deutsche Mark for euro free of charge for an unlimited time at the conversion rate set by Community law (EUR 1 = DM 1.95583).

V Accession of further member states

On 1 January 2001, Greece became the twelfth member state of the European Union to introduce the euro, following confirmation in the relevant reports by the European Commission and the ECB that Greece had achieved the required degree

1 See also section II.4 of this chapter, "Establishing the legal basis for the introduction of the euro", p 23.
2 The First, Second and Third Euro Introduction Acts in Germany governed the key amendments to national legislation which were necessary or appropriate for the introduction of the euro on 1 January 1999 and the introduction of euro cash.

of convergence. Slovenia joined the euro area at the beginning of 2007, followed by Malta and Cyprus at the beginning of 2008. The outcome of the convergence assessment for Lithuania, which had aimed to join on 1 January 2007, was negative owing to insufficient sustainability in the area of price stability.

Economic union

I Coordination of economic policy in the European Union and its member states – necessity and legal basis

At the start of the third stage of European economic and monetary union on 1 January 1999, the euro-area member states introduced the euro as the single currency. The ECB pursues a single monetary policy for the euro area with the primary objective of maintaining price stability. By contrast, responsibility for other major policy areas has largely remained with the EU member states at national level. This leads to an asymmetry of political responsibility, which can result in tensions with fiscal policy. In the context of monetary union, if one member state pursues a misguided fiscal policy, this can make the task of monetary policy, that is of ensuring price stability, more difficult. The associated negative consequences are felt by all the member states in the monetary union. Unwelcome developments in other fields of a member state's economic policy may also have negative external effects on the partner countries because of the close integration of the national economies within a monetary union. For this reason, the mutual exchange of information, the agreement of common guiding principles and cooperation between governments in the field of economic policy are particularly significant in a monetary union.

The authors of the Maastricht Treaty were already convinced of the need for greater economic policy coordination in EMU. Therefore, the EC Treaty and secondary legislation derived therefrom contain important provisions for monitoring and coordinating the economic and fiscal policy of the member states and the Community which relate both to the role of the coordination bodies and to the procedures in detail. The most important legal basis is constituted by Article 99 of the EC Treaty, pursuant to which the member states are to regard their economic policies as a matter of common concern. Against this background, economic policies are coordinated in the context of the broad guidelines of the economic policies of the member states and the Community (Broad Economic Policy Guidelines). The implementation of the Broad Economic Policy Guidelines is monitored by the Council meeting in the composition of the Ministers of Economics and Finance. Additionally, for particularly important areas of economic policy, such as employment policy and structural policy, there are further coordination processes. National fiscal policies are coordinated within the framework of the Stability and Growth Pact. Given the principle of an open market economy with free competition, the European Community strives to fulfil the aims established in Article 2 of the EC Treaty, which

include non-inflationary growth and a high level of employment, by means of economic policy coordination.

II Economic policy coordination bodies

1 European Council

The European Council brings together the Heads of State or Government of the member states of the European Union (EU) and the President of the European Commission (Article 4 of the EU Treaty). The European Council provides the impetus for the further development of the EU and defines the political objectives for the general economic policies, employment policies and structural policies in the Community. This occurs, in particular, at the European Council's annual spring meetings, which are devoted specifically to the economic, social and environmental situation. The European Council examines and approves the evaluations of the Commission and the Council regarding the measures taken by the member states and the Community to tackle outstanding tasks.

2 Council of Economic and Finance Ministers

Economic and fiscal policy matters, and in some cases Community monetary issues (with the exception of the single monetary policy), fall within the competence and decision-making remit of the EU Council of Ministers. Pursuant to the Treaty, the Council meeting, in the composition of the Ministers of Economics and Finance (Ecofin Council), is the central body coordinating the member states' economic and fiscal policies. Notably, it is the only body empowered to formulate and adopt the Broad Economic Policy Guidelines.[1] In keeping with the provisions of the Treaty and of the European Stability and Growth Pact,[2] it may present opinions or make recommendations to the member states. The Ecofin Council normally meets once a month. Pursuant to Article 113 (2) of the EC Treaty, the President of the ECB is to be invited to participate in Ecofin Council meetings when the latter is discussing matters relating to the objectives and tasks of the ESCB.

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1 This special position is expressly emphasised in the Resolution of the European Council of 13 December 1997 on economic policy coordination in stage 3 of EMU and on Treaty Articles 109 and 109b of the EC Treaty (Luxembourg Resolution, OJ C 35, 2 February 1998, pp 1-4).
2 See section III.2 of this chapter, pp 36-39.

The Ecofin Council may also meet in a smaller composition (each country represented only by the relevant Minister and one further participant) if the implementation of multilateral surveillance, the evaluation of stability and convergence programmes, budgetary developments or structural matters are being addressed. This smaller group is intended to provide a forum for a frank and open discussion.

In addition, informal Ecofin meetings are held twice a year. They bring together the Ecofin Council, the President of the ECB, the governors of the central banks of all Community countries and the EU Commissioner for Economic and Monetary Affairs. The confidential nature of the discussions at these meetings serves to facilitate a dialogue between the political decision-makers in the Community. These discussions generate important stimuli for the meetings of the European Council. The informal Ecofin Council is not empowered to take decisions that are binding on the Community.

The meetings of the Ecofin Council are prepared by the Economic and Financial Committee (EFC), the Economic Policy Committee (EPC) and the Permanent Representatives Committee,[1] among others. The EFC is of paramount importance in this respect since this is where most economic and fiscal policy issues are prepared and analysed for the Ecofin Council. Its mandate is governed by Article 114 (2) of the EC Treaty, which is also where the composition of the EFC is defined as consisting of no more than two representatives from each of the member states, the European Commission and the ECB. In accordance with its statutes, the EFC meets in two participant groups of different sizes.[2] In its full composition, ie including representatives from the Commission, the ECB, the governments and the NCBs[3], the EFC generally meets six times a year. At these meetings, issues relating to financial market stability, IMF issues or matters relating to the general economic situation are discussed. Since 2003, aspects of economic and fiscal policy coordination have been discussed in the "restricted" EFC composition, ie without representatives from the NCBs. However, the representatives of the NCBs from the member states concerned are invited to participate in EFC meetings which deal with the stability

1 The Permanent Representatives Committee is an advisory committee made up of the Permanent Representatives of the EU member states at the EU. The Committee normally meets once a week in order to prepare the meetings of the Council (with the exception of the meetings of the Ministers of Agriculture, which are prepared by the Special Committee on Agriculture).

2 The breakdown of the committee into two configurations took effect on 1 July 2003 by virtue of the Council Decision of 18 June 2003 on a revision of the Statutes of the Economic and Financial Committee (OJ L 158, 27 June 2003, pp 58-60). With this adjustment of its working methods, the committee's intention was to preserve its efficiency when ten new members joined the Community whilst continuing to use the expertise and analytical insights of the representatives of the NCBs.

3 The Deutsche Bundesbank's representative on the EFC is the Executive Board member responsible for international relations.

or convergence programmes or matters relating to an excessive deficit procedure in their respective member states.

The Economic Policy Committee (EPC) supports the work of the Commission and the EFC. The EPC comprises two representatives from each of the member states, the European Commission and the ECB.[1] The EPC's close cooperation with the EFC is laid down in the EPC's statute. They share a secretariat at the European Commission and there are regular consultations between the chairs of both committees regarding their work. In particular, the EPC supports the EFC in analysing short and medium-term macroeconomic developments in the member states and in the Community. It also examines, for example, the longer-term sustainability of public finances. The EPC cooperates closely with the EFC when reporting to the Council.

3 The Eurogroup

The Eurogroup is an informal body established at the December 1997 Luxembourg European Council. In the Eurogroup, the Ministers of Economics and Finance of the euro-area member states meet to discuss issues "connected with their shared specific responsibilities for the single currency". According to the wording of the resolution of the Luxembourg European Council, the European Commission and, where appropriate, the ECB are to be invited to the meetings of the Eurogroup, and in practice this is usually the case. The Eurogroup's meetings have been chaired by an elected president since 1 January 2005. The Eurogroup president is elected by the group's members on the basis of his or her qualifications and experience for a period of two years.[2] The Prime Minister and Finance Minister of Luxembourg, Jean-Claude Juncker, was elected as the first president of the Eurogroup. In September 2006, his mandate was extended until the end of December 2008. If the Eurogroup president is unable to attend the meetings, they are generally chaired by the president of the Ecofin Council[3]. The Group's meetings normally take place prior to the monthly Ecofin meetings. In substance, they primarily permit a more in-depth discussion of the economic and budgetary trends in the euro-area member states. Thus, for example, horizontal euro-area fiscal policy issues are discussed around mid-year. Furthermore, the Eurogroup formulates common positions on

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1 Council Decision No 2003/475/EC of 18 June 2003 on a revision of Decision No 2000/604/EC regarding the composition and Statute of the Economic Policy Committee (OJ L 158, 27 June 2003, pp 55-57).
2 Prior to 1 January 2005 the presidency of the Eurogroup generally changed every six months (as did that of the Ecofin Council).
3 However, this only applies if the country in question is a member of the euro area. Otherwise it is chaired by the next Ecofin president whose country is in the euro area.

issues relating to the global economy, multilateral surveillance and financial market developments, which the Group's president presents to international bodies. Owing to its informal nature, the Eurogroup also offers a suitable framework for dialogue between ministers, the European Commission and the ECB, in the course of which regular assessments of the economic situation in the euro area and opinions on possible future economic policy challenges can be exchanged.

Since it was set up, the Eurogroup has endeavoured to enhance its public profile and presence, as reflected, notably, in the election of a president for a period of two years. The regular press conferences which the Eurogroup holds after its meetings also serve this purpose. Discussions on the definitive shape and work of the Eurogroup have not yet been concluded. However, the sole decision-making competence of the Ecofin Council and the independence of the ESCB as defined by the Treaty must always be respected.

4 Other coordination bodies

The Employment Committee operates at a working level as a special coordination body for employment-related issues.[1] This committee, whose mandate is laid down in Article 130 of the EC Treaty, monitors the employment situation and employment policies in the member states and the Community. The member states and the European Commission each appoint two members of this Committee.

III Economic policy coordination procedures

1 Coordination of economic policy

The "broad guidelines of the economic policies of the member states and the Community" were introduced by the Treaty of Maastricht in 1993 as a new coordination instrument within the Community. This instrument was intended to improve the effectiveness of economic policy coordination and thus the harmonisation of economic developments in the EU member states in the run-up to, and in particular in the third stage of, EMU. The Broad Economic Policy Guidelines, legally established by virtue of Article 99 in conjunction with Article 98 of the EC Treaty, are at the heart of the EU's economic policy coordination. They point the way for

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1 It replaced the former Employment and Labour Market Committee in 1999.

economic policy in the individual member states and the Community. They thereby also provide guidance for employment and structural policies for which individual coordination procedures – termed the Luxembourg and Cardiff processes – were put in place in 1997 and 1998 respectively.

The interplay between the various aspects of economic policy coordination was changed in the summer of 2005 without, however, altering the central role of the Broad Economic Policy Guidelines. The aim was to gear economic policy-making more closely to the growth and employment goals laid down in the Lisbon Strategy, which the European Council launched in the year 2000.[1] The Broad Economic Policy Guidelines have since been merged with the Employment Guidelines (to be drawn up pursuant to Article 128 of the EC Treaty) to form the "Integrated Guidelines", which highlight the entire spectrum of necessary economic policy measures for promoting growth and employment within the Community. The "Integrated Guidelines" are drawn up by the Commission to cover a three-year period and – following approval by the European Council – are then adopted by the Council.[2] On the basis of these Guidelines, the member states regularly present "national reform programmes" in autumn. At the beginning of the three-year coordination cycle, these documents describe economic policy strategies and planned measures; in the subsequent years the main focus is on the implementation of these plans.

The Commission – after evaluating all of the national reform programmes – draws up a progress and/or strategy report at the start of each year, in which it assesses national priorities and successes in implementating measures with regard to achieving the Lisbon objectives from a European and national point of view. The Commission can thereby also propose amendments to the "Integrated Guidelines" to the Council before the end of the three-year coordination period.

The "Integrated Guidelines" are among the "soft" coordination instruments as the Council has no real sanctions enabling it to enforce the economic policy recommendations adopted. However, because they are approved by the European

1 The Lisbon Strategy is aimed at achieving stable economic growth, a reduction in unemployment, an increase in prosperity and a strengthening of social cohesion within the European Union. Its original intention was to make the Community the most competitive and dynamic economic area in the world within a decade. The Strategy was subjected to a mid-term review in spring 2005. Given the limited implementation results, the European Council decided to alter the Strategy's focus. Its key priorities are now growth and jobs. The Commission and the member states were requested to relaunch the Lisbon Strategy on the basis of the approaches centred on growth and employment adopted by the European Council in March 2005 (see the Presidency Conclusions of the Brussels European Council of 22 and 23 March 2005).

2 The Council adopted the "Integrated Guidelines" for the first time (for the 2005-2008 period) on 12 June 2005.

Council, considerable political weight is attached to them. Moreover, the Council's annual implementation review and the peer pressure exerted thereby contribute to the effectiveness of this coordination instrument.

2 Coordination of the national fiscal policies in the context of the European Stability and Growth Pact

Sound, sustainable public finances are of major importance in European economic and monetary union. For one thing, fiscal policy decisions in one member state will also have an impact on the other member states. For another, the task of the single monetary policy, namely that of ensuring price stability in Europe, is made unnecessarily difficult if it is not supported by disciplined economic and fiscal policy in the member states. Finally, sound government budgets are the precondition which enables fiscal policy to respond flexibly and effectively to economic fluctuations.

Against this background, the EC Treaty contains special provisions for coordinating the fiscal policies of the EU member states. The most important provision is Article 104 of the EC Treaty, which obliges the EU member states to avoid excessive government deficits.[1] In addition to the provisions relating to the coordination of economic policy in the context of the Broad Economic Policy Guidelines (Articles 98 and 99 of the EC Treaty), Article 104 of the EC Treaty is preceded by a number of special restrictions on financing government credit needs (Articles 101 to 103 of the EC Treaty).

The European Stability and Growth Pact (SGP), which was adopted in 1997, fleshes out the provisions contained in the EC Treaty on the surveillance and coordination of the economic and fiscal policies. Its aim is to ensure permanent fiscal discipline on the part of all the countries participating in monetary union. For this purpose, the Pact supplements the provisions of the EC Treaty, in particular by adding a requirement for government budgets to be close to balance or in surplus over the medium term, thus encouraging the creation of a safety margin below the 3% reference value for the government deficit in any given year. Moreover, an "early warning system" was created to help prevent the reference value from being exceeded. The preconditions for initiating an excessive deficit procedure were also clearly laid down. Furthermore, the duration of such excessive deficit

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1 The obligation to avoid excessive government deficits does not apply to the United Kingdom unless it notifies its intention to enter the third stage of EMU (Article 5 of the Protocol to the EC Treaty on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland).

procedures was regulated, as were the nature and scope of any sanctions. In legal terms, the Pact rests on three pillars: the Resolution of the European Council on the Stability and Growth Pact of 17 June 1997[1] and two regulations on the basis of Articles 99 and 104 of the EC Treaty, namely the Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[2] and the Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.[3] In the Resolution of the European Council on the Stability and Growth Pact, the member states, the European Commission and the Ecofin Council undertook to implement the provisions of the Pact in a strict and timely manner.

In view of the increasing problems experienced by a number of EU member states in complying with the deficit provisions in the Treaty and the Pact after the start of stage three of Economic and Monetary Union, extensive amendments to the SGP were put into force in July 2005. A positive factor in the preventive arm of the Pact is the general obligation for member states to correct the structural budget position by an annual minimum of 0.5% of GDP if they have not achieved their medium-term budgetary objective or have deviated from the adjustment path. The call for more ambitious consolidation in favourable economic phases is also to be welcomed. At the same time, however, a number of the Pact's originally more strict rules were weakened and the scope for discretion available to the respective decision-making bodies was expanded considerably.[4] For instance, the uniform obligation for member states to maintain a budgetary position close to balance or in surplus over the medium term has been replaced by the possibility of having country-specific medium-term deficit targets of up to 1% of GDP. Moreover, deviations from the targets are permitted in the event of certain structural reforms. The possibility of citing negative growth rates or persistently weak growth as exceptional circumstances justifying deficits in excess of the reference value also represents a watering-down of the previous rules, which would have required a "severe recession" for such a deviation. In addition, "other relevant factors" which the member states can put forward as justification for a temporary overshooting of the 3% reference value include the implementation of measures in the context of the Lisbon Strategy, measures to foster research and development as well as innovation, fiscal consolidation efforts in "good times", public investment, the quality of

1 OJ C 236, 2 August 1997, pp 1-2.
2 OJ L 209, 2 August 1997, pp 1-5.
3 OJ L 209, 2 August 1997, pp 6-11.
4 The provisions regarding the Pact in Council Regulations 1466/97 and 1467/97 were amended by means of Council Regulations 1055/2005 and 1056/2005, both dated 27 June 2005 (OJ L 174 of 7 July 2005, pp 1-9).

public finances or burdens resulting from financial contributions to fostering international solidarity and to achieving European policy goals, notably processes for the unification of Europe. Finally, the deadlines within the procedure and those for correcting the deficits once an excessive deficit procedure has been initiated have been significantly extended.[1]

The multilateral procedure for monitoring the budgetary situation takes place in an annual cycle. This commences every year from mid-October with the submission of the updated stability and convergence programmes, in which, *inter alia*, the member states present the policies by which they aim to achieve their medium-term budgetary objective and describe the underlying assumptions for economic development.[2] On the basis of assessments made by the European Commission and the EFC, the Ecofin Council examines whether the economic assumptions on which the programmes are based are realistic and the outlined fiscal policies are suitable for achieving the Pact's goals. If the Council concludes that the budgetary situation deviates considerably from the medium-term budgetary objective set in the stability programme or from the concomitant adjustment path or is at risk of doing so, it issues a warning in good time, ie prior to the occurrence of an excessive deficit, to the member state in question and recommends corrective measures. This warning must be given on the basis of a corresponding Commission recommendation. If the Council determines that the critical budgetary situation persists or is worsening, it once more recommends the member state to take corrective measures immediately. It may publish this recommendation.

If the government deficit of a member state exceeds the reference value of 3% of GDP, the Commission prepares a report on which the EFC comments within two weeks.[3] If the Commission concludes that the deficit will exceed the reference value not only exceptionally and temporarily, it addresses an opinion and a recommendation to the Ecofin Council, thus initiating the excessive deficit procedure. The Ecofin Council must then decide within four months after the biannual deadlines for reporting the budget data whether the deficit is actually to be regarded as excessive, taking account of comments made by the member state concerned. If its decision is positive, the Council makes recommendations for correcting the deficit to the member state concerned, pursuant to Article 104 (7) of the EC Treaty.

1 See also Deutsche Bundesbank, The changes to the Stability and Growth Pact, *Monthly Report*, April 2005, pp 15-21.

2 In the context of the multilateral surveillance procedure, in addition to adherence to the rules of the Stability and Growth Pact, the consistency of the economic policy of the member states with the recommendations of the Broad Economic Policy Guidelines is also reviewed.

3 The European Commission appraises adherence to budgetary discipline in the member states on the basis of the budget data regularly submitted to it by the member states on the reporting dates of 1 March and 1 September.

The country is initially given a period of six months to take effective measures. Furthermore, the correction of the excessive deficit should, as a matter of principle, be achieved in the year following the ruling that an excessive deficit exists. Under special circumstances – determined on the basis of the "other relevant factors" – the deadline for correcting the deficit can be extended to two years following the ruling that an excessive deficit exists. If the member state takes corrective measures and the Council considers these to be suitable and effective, the procedure is held in abeyance. If in the opinion of the Council the member state fails to take effective action, the Council may publish its recommendations immediately on expiry of the six-month period. If the member state still fails to take effective action, it can be given notice to take measures to reduce the deficit within two months. If it acts accordingly, the procedure is again held in abeyance and the measures are monitored. Otherwise, and in the case of measures that are not effective, the imposition of sanctions within four months is provided for. It is possible to repeat certain procedural steps if the member state has taken action which, however, proves to be insufficient in the light of unfavourable economic developments which have arisen in the meantime. As a rule, sanctions are ultimately imposed in the form of a non-interest-bearing deposit, which is converted into a fine after two years if the excessive deficit continues to exist.[1] For each individual sanction, however, there is a ceiling of 0.5% of the GDP of the country in question.

1 The provisions relating to sanctions apply, in accordance with the EC Treaty, only to those EU member states which have introduced the euro.

Monetary union

I The institutional framework for the implementation of the single monetary policy in Europe

1 The European System of Central Banks and the Eurosystem – definitions, legal basis and organisation

As mentioned above, the European System of Central Banks (ESCB) was established on 1 June 1998 as a network of the European Central Bank (ECB) and the national central banks (NCBs) of all the member states of the European Union (EU). "Eurosystem" is the term used to describe the arrangement between the ECB and the national central banks of the member states which have already introduced the euro. With the introduction of the euro on 1 January 1999, responsibility for the single monetary policy in the euro area was transferred to the Eurosystem. The Eurosystem thus constitutes the core of the ESCB in which it carries out its basic tasks, in particular defining and implementing the single monetary policy in the euro area. NCBs from those EU member states which do not yet belong to the euro area are an integral part of the ESCB but not of the Eurosystem. This means that they continue to bear sole responsibility for national monetary policy in their respective member state and do not participate in the single monetary policy of the Eurosystem.

The ESCB derives its legal basis largely from Articles 105 to 110 of the EC Treaty read in conjunction with the Statute of the European System of Central Banks and of the European Central Bank (referred to below as the Statute).[1] This is where the goals, tasks, organisation and the legal status of the ESCB are defined. The ESCB, like the Eurosystem, has no independent legal personality. Rather, it is an international structure comprising two constituent elements, the ECB and the NCBs, which are united by common goals, tasks and rules.[2] The ESCB is therefore able to act only via its members, meaning the ECB, which is an independent special organisation of the European Community, and the NCBs, which have legal personality under national law. Pursuant to Article 28 of the Statute, the national central banks are the sole subscribers to the capital of the ECB. The capital share of each national central bank is calculated according to a key established in accordance with Article 29 of the Statute and geared to the economic output and population of the member state in question.

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1 Pursuant to Article 311 of the EC Treaty, the Statute of the European System of Central Banks and of the European Central Bank is, as a Treaty protocol, an integral part of the EC Treaty.
2 Dieter Haferkamp, *Der Wandel der nationalen Zentralbanken in der Europäischen Union*, in: Deutsche Bundesbank, *Auszüge aus Presseartikeln*, No 47, 24 October 2001.

Pursuant to Article 107 of the EC Treaty and Article 8 of the Statute, the ESCB and the Eurosystem are governed by the decision-making bodies of the ECB, ie its Governing Council and Executive Board. Pursuant to Article 45 of the Statute, the General Council of the ECB will exist as a third decision-making body as long as there are member states which have not yet introduced the euro.

The Governing Council of the ECB is the supreme decision-making and legislative body of the ECB and – within its sphere of responsibility – also of the Eurosystem. It comprises the six members of the Executive Board of the ECB and the governors of the NCBs of the euro-area member states (Article 112 of the EC Treaty and Article 10 of the Statute). Pursuant to Article 12.1 of the Statute, the Governing Council of the ECB formulates the monetary policy of the Community, establishes the guidelines and takes the decisions necessary for its implementation. The Governing Council of the ECB generally meets every two weeks. However, it normally discusses possible monetary policy measures only at the first meeting in the month.

Unless otherwise provided for in the Statute, the Governing Council acts by a simple majority. Each member of the Governing Council has one vote and, as a rule, casts his or her vote in person. In the event that the number of members of the Governing Council exceeds 21, ie if more than 15 national central bank governors belong to this decision-making body, the provisions of Article 10.2, first to sixth indent, of the Statute of the ESCB shall become relevant. They stipulate that, as from that time, each member of the Executive Board shall have one vote and that the number of governors with a voting right shall total 15. This new rule, born of a decision adopted by the Council meeting in the composition of the Heads of State or Government on 21 March 2003, entered into force on 1 June 2004 following ratification by all EU member states. The intention is to ensure that the Governing Council of the ECB can continue to take decisions in a timely and efficient manner even after a large-scale enlargement of the euro area. The allocation and rotation of the voting rights among the national central bank governors is laid down in accordance with the general principles contained in Article 10.2 of the Statute of the ESCB. Pursuant to Article 10.2, sixth indent, of the Statute of the ESCB, the Governing Council must adopt the necessary implementing provisions[1] and can decide to postpone the start of the rotation system until the date on which the number of governors exceeds 18.[2] As a result of these rules and also of

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1 This has not yet occurred.
2 For details of the new voting system in the Governing Council of the ECB, see European Central Bank, The adjustment of voting modalities in the Governing Council, *Monthly Bulletin*, May 2003, pp 73-83.

the new provisions concerning the voting system in the Governing Council, the votes of the Executive Board members and the governors of the national central banks fundamentally carry equal weight, irrespective of the economic significance of any member state.[1] The method of voting in the Governing Council of the ECB thus reflects its supranational responsibility. It facilitates the elaboration of a denationalised single monetary policy in Europe, with monetary policy decisions being taken in the light of the situation obtaining in the euro area as a whole.

As a decision-making body, the Executive Board of the ECB is subordinate to the Governing Council. It comprises the President and the Vice-President of the ECB and four other members (Article 112 (2) (a) of the EC Treaty and Article 11 of the Statute). The main task of the Executive Board is implementing monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so it may give the necessary instructions to the NCBs. In addition, the Executive Board is responsible for preparing the meetings of the Governing Council and manages the ECB's day-to-day business.

Notwithstanding the provision that the Executive Board implements monetary policy, Article 12.1 of the Statute stipulates that the ECB shall have recourse to the NCBs to carry out operations which form part of the tasks of the Eurosystem where this appears possible and appropriate. This division of duties set out in the Treaty gives equal ranking to the principle of centralised decision-making and that of the decentralised execution of tasks in the Eurosystem, an essential element of co-operation between the ECB and the NCBs. The two principles ensure a flexible institutional framework tailored to the circumstances of the single currency area in Europe. Centralised decision-making ensures that the single monetary policy is determined in such a way that it is geared to the circumstances of the overall euro area. Decentralised implementation of the decisions makes it possible, given the different financial market structures in the member states, to use the comparative advantages of the NCBs in the operational sphere. Moreover, the centralised and decentralised aspects of this network are brought together in the various committees of the Eurosystem. The committees, which contribute to the Governing Coun-

1 Exceptions to this rule are the financial matters of the ESCB (capital, transfer of foreign reserves, distribution of the monetary income). In such cases, the votes in the Governing Council of the ECB are weighted according to the shares of the national central banks in the ECB's subscribed capital. The weight of the votes of the members of the Executive Board is zero (Article 10.3 of the Statute).

cil's decision-making, are set up by the Governing Council.[1] Their members are high-ranking representatives of the ECB and the NCBs.[2] The committees report to the Governing Council of the ECB, normally via the Executive Board. It is within the committees, to which in turn a large number of project and working groups report, that most of the coordination within the Eurosystem takes place. The committees are of key significance for the NCBs since the committee work enables them to make a significant contribution to the Eurosystem's policy at the decision-making stage. The smooth implementation of the monetary policy decisions in the euro area is also ensured largely by the successful cooperation between the ECB and the NCBs in the committees. Nevertheless, it is not always easy in practice to strike a balance between centralisation and decentralisation in the Eurosystem. The EC Treaty provides considerable discretionary leeway in this area.

The General Council is the third decision-making body of the ECB. It comprises the President and Vice-President of the ECB and the governors of all NCBs of the EU member states and functions as a link between the Eurosystem and the ESCB. Its responsibilities derive primarily from the tasks which the ECB took over from the EMI in connection with the fact that there may be one or more member states not participating in the euro area. For instance, the General Council discusses the co-ordination of the single monetary policy of the ECB and the monetary policy in the non-euro-area member states. Furthermore, discussions take place there on developments in the European exchange rate mechanism. Additional functions of the General Council derive from Article 47.2 of the Statute. Accordingly, it is involved, for example, in collecting statistical information, in the ECB's reporting activities

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1 Pursuant to Article 9 of the Rules of Procedure, the Governing Council of the ECB has currently established the following committees:
- Accounting and Monetary Income Committee (AMICO)
- Banknote Committee (BANCO)
- Banking Supervision Committee (BSC)
- Committee on Cost Methodology (COMCO)
- Eurosystem/ESCB Communications Committee (ECCO)
- Internal Auditors Committee (IAC)
- International Relations Committee (IRC)
- Information Technology Committee (ITC)
- Legal Committee (LEGCO)
- Market Operations Committee (MOC)
- Monetary Policy Committee (MPC)
- Payment and Settlement Systems Committee (PSSC)
- Statistics Committee (STC)

Moreover, a Budget Committee (BUCOM) (pursuant to Article 15.2 of the Rules of Procedure) and a Human Resources Conference (HRC) (pursuant to Article 9a of the Rules of Procedure) have been established.
The committees are chaired by high-ranking representatives of the ECB or the NCBs.

2 As a rule, only representatives of the NCBs from the Eurosystem, unless issues are addressed which concern the ESCB as a whole. In that case, representatives of the non-euro-area NCBs also take part in the committee meetings.

and in laying down the conditions of employment of the staff of the ECB. The General Council will remain in existence as long as there are EU member states which do not participate in the single currency area.

2 Price stability, the Eurosystem’s primary objective

Pursuant to Article 105 of the EC Treaty and Article 2 of the Statute, the primary objective of the Eurosystem is to maintain price stability in the euro area. Without prejudice to the objective of price stability, the Eurosystem is to support the general economic policies in the European Community. Clearly, therefore, the goal of price stability enjoys priority. This clear allocation of tasks acknowledges a stable price level to be the most important contribution that monetary policy can make towards promoting a positive economic climate and high employment. Without price stability, the central functions of money as a means of payment, a unit of account and a store of value are jeopardised. As a result, the transparency of the price mechanism is also lost and price distortions occur. This makes it impossible to allocate the available resources efficiently, which in turn causes losses of growth. Such growth losses also occur if, as a result of a lack of price stability, the inflation risk premium contained in long-term interest rates increases. This leads to higher nominal long-term interest rates accompanied by lower investment and hence decreasing growth. Finally, mention should be made of the distributional effects on assets and income that occur when prices are not stable, together with corresponding negative economic and social consequences. The awareness of the aforementioned advantages of price stability grew progressively within the EU member states in the course of the gradual establishment of EMU, leading increasingly to a “stability culture”. Pursuant to the provisions of the Maastricht Treaty, the central banks of the participating member states were given a clear mandate to pursue the primary objective of price stability and granted maximum independence.

The Governing Council fleshed out the objective of maintaining price stability – which is not specified in the Treaty – on 13 October 1998 by defining price stability as “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%”. This goal must be respected in the medium term to allow account to be taken of short-term price fluctuations which cannot be steered by monetary policy. Defining the upper limit for an increase in the HICP as just below 2% allows for the fact that a slight measurement bias in the price index means that HICP-measured inflation may marginally exceed actual inflation. Setting this value at well above zero has also established a safety margin to guard

against risks of deflation. The Governing Council of the ECB made this explicitly clear in its review of the monetary policy strategy in May 2003 and stressed that, within the given definition, the aim of its endeavours to maintain price stability was to keep the inflation rate below, but close to, 2% in the medium term. Overall, quantifying the objective of price stability makes a significant contribution to the transparency of monetary policy in the euro area.[1]

3 The Eurosystem's tasks

Pursuant to Article 105 of the EC Treaty and Article 3 of the Statute, the basic tasks to be carried out by the Eurosystem consist of defining and implementing the monetary policy of the Community, conducting foreign exchange operations consistent with the provisions of Article 111 of the EC Treaty, holding and managing the official foreign reserves of the member states, and promoting the smooth operation of payment systems. Within its fields of competence, the Eurosystem also has advisory tasks in connection with the adoption of legal provisions of the Community or the member states. Furthermore, tasks relating to the prudential supervision of credit institutions and other financial institutions may be conferred on the ECB. Pursuant to Article 106 of the EC Treaty and Article 16 of the Statute, the ECB Governing Council also has the exclusive right to authorise the issue of banknotes within the Community. Both the ECB and the NCBs are entitled to issue European banknotes.

Since the Eurosystem has no independent legal personality, it can act only through its constituent elements. This requires a division of duties between the NCBs on the one hand and the ECB on the other. The EC Treaty does not regulate in detail how operational tasks are to be distributed between these institutions. Instead, Article 9.2 of the Statute gives the ECB overall responsibility. Accordingly, the ECB must ensure that the tasks conferred on the ESCB[2] under Article 105 of the EC Treaty and Article 3 of the Statute are implemented either through its own activities or by the NCBs. This gives the ECB a prominent position within the ESCB, as is manifested in a number of further provisions. For one thing, the many managerial and supervisory powers exercised by the ECB in respect of the NCBs in the

1 For background information and a description of the most important aspects of the ECB's definition of price stability, see European Central Bank, The outcome of the ECB's evaluation of its monetary policy strategy, *Monthly Report*, June 2003, pp 79-92.
2 Article 105 of the EC Treaty refers to the ESCB. In practice, however, its provisions apply only to the Eurosystem since in accordance with Article 122 (3) of the EC Treaty, the provisions of Article 105 (1), (2), (3) and (5) do not apply to the member states with a derogation.

Eurosystem are shared by the Governing Council and the Executive Board of the ECB, and the ESCB's decision-making bodies are housed at the ECB.[1]

In addition, pursuant to Article 14.3 of the Statute, the NCBs are an integral part of the ESCB. In implementing the tasks of the ESCB, they act in accordance with the guidelines and instructions of the ECB in order to ensure the uniformity of the single monetary policy. The corresponding guidelines and decisions are issued by the Governing Council of the ECB on the basis of Article 12.1 of the Statute, as mentioned above. In practice, the single monetary policy is discussed and established centrally in the Governing Council of the ECB. By contrast, operational activities – in line with the principle of decentralisation – are implemented by the NCBs on the basis of the aforementioned Article 12.1 of the Statute. This means that in the framework of monetary policy operations the NCBs carry out the main refinancing operations[2] and also play a major role in the execution of foreign exchange transactions and in payment operations.[3] Notwithstanding their functions within the Eurosystem, the ECB and the NCBs are autonomous in terms of their administration and organisation, whereas the NCBs, as shareholders of the ECB, are *de facto* the sole decision makers in the Governing Council when it comes to the finances of the ECB (Article 10.3 of the Statute).

Given its position vis-à-vis the Community bodies and the member states, the ECB plays a prominent role within the Eurosystem with regard to international cooperation. Pursuant to Article 12.5 of the Statute, the Governing Council of the ECB decides how the Eurosystem is represented in the field of international cooperation.[4]

The ECB is also responsible for reporting to the general public on the Eurosystem and the ESCB (Article 113 (3) of the EC Treaty and Article 15 of the Statute) and for carrying out advisory functions for Community institutions and the EU member states (Article 105 (4) of the EC Treaty and Article 4 of the Statute). Pursuant to the Treaty, it is also the sole Eurosystem body entitled to draft legislation autonomously within the Community. Article 110 of the EC Treaty and Article 34.1 of the Statute empower the ECB to issue general, directly applicable regulations where this is necessary for carrying out the tasks of the Eurosystem and of the ESCB. Further-

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1 Weber, Martin, Das Europäische System der Zentralbanken, in *WM Zeitschrift für Wirtschafts- und Bankrecht*, No 29, 18 July 1998.

2 See section II.2 "The Eurosystem's monetary policy instruments and procedures", pp 59-60.

3 On the role of the NCBs in the Eurosystem, see also section I.5 "The Deutsche Bundesbank as an integral part of the Eurosystem", pp 53-56.

4 On the respective arrangements, see section III "Exchange rate policy and international cooperation", pp 69-71.

more, it can take decisions concerning individual cases, make recommendations and express opinions.

4 Independence and democratic legitimacy of the European System of Central Banks

Today central bank independence is generally regarded as a crucial precondition for the sustainable maintainance of price stability. The authors of the Maastricht Treaty were also convinced of this and granted the ESCB maximum independence – guaranteed under international law. Pursuant to Article 109 of the EC Treaty and Article 14 of the Statute, the national legislation of all member states, including the statutes of their central banks, had to be compatible, by the time of the establishment of the ESCB at the latest, with the Treaty and the Statute of the ESCB and hence also meet the requirement of independence (criterion of legal convergence).

Article 108 of the EC Treaty and Article 7 of the Statute lay down the institutional independence of the ECB and of the Eurosystem. The articles provide that when exercising the powers and carrying out the tasks and duties conferred on them by the Treaty and the Statute, neither the ECB, nor the NCBs, nor any member of their decision-making bodies shall seek or take instructions from Community institutions or bodies, from any government of a member state or from any other body. Conversely, it obliges the Community institutions and bodies and the governments of the member states to undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the NCBs in the performance of their tasks.

Institutional independence is underpinned by means of regulations governing the personal independence of the members of the decision-making bodies of the ECB and NCBs. Pursuant to Article 112 (2) (b) of the EC Treaty and Article 11.2 of the Statute, the term of office of the members of the Executive Board of the ECB is eight years and is not renewable.[1] Pursuant to Article 14.2 of the Statute, an NCB governor may not be appointed for less than five years; his term of office may be renewed. The governors of the NCBs, as well as the members of the Executive Board of the ECB, may be removed from office only if they no longer fulfil the conditions required for the performance of their duties or have been guilty of ser-

1 When the first members of the Executive Board of the ECB were appointed, the terms of office for the new members were staggered pursuant to Article 50 of the Statute so that the members of the Executive Board were replaced successively. This gave rise exceptionally to shorter terms of office.

ious misconduct. Such removal from office may be effected only by the European Court of Justice at the request of the Governing Council or the Executive Board of the ECB. As a result, the duration of the term of office of the members of the governing bodies and the procedure for their removal from office are so designed to allow them to exercise their office independently and without political influence.

In functional terms, too, the Eurosystem's independence is ensured through an extensive range of monetary policy procedures and instruments. The Eurosystem can take autonomous decisions regarding its operational framework and the use of its instruments and the Governing Council of the ECB can issue regulations and take decisions needed to implement its tasks (Article 110 of the EC Treaty and Article 34 of the Statute). Additional protection against political influence is provided by the prohibition on lending to the public sector (Article 101 of the EC Treaty)[1] and the provision that the volume of coins issued by the member states must be approved by the ECB (Article 106 of the EC Treaty). The provisions of the Treaty governing exchange rate policy were, as a whole, also designed in such a way as to ensure that monetary policy is not put at risk.[2] In the exchange rate mechanism in the third stage of EMU (ERM II) sufficient provisions have also been made to ensure that the stability-oriented monetary policy of the ECB is not jeopardised by intervention obligations.[3]

Finally, the Eurosystem is also financially independent. Pursuant to Article 28.1 of the Statute, the capital of the ECB is €5 billion.[4] [5] The NCBs are – as already mentioned – the sole subscribers to the capital of the ECB, although only the Eurosystem NCBs have fully paid up their subscription as determined in accordance with Article 29 of the Statute. Pursuant to a decision of the General Council of the ECB, NCBs from non-euro-area member states pay only 7% of the planned capital share in order to cover part of the operating costs incurred by the ECB in respect of the non-euro-area NCBs.[6] Furthermore, right at the start of monetary union

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1 See "The progressive establishment of European economic and monetary union", section II.1 "More intensive coordination and surveillance of economic policies", pp 18-19.

2 See section III "Exchange rate policy and international cooperation", pp 68-69 for details.

3 See "The exchange rate mechanism in the third stage of European economic and monetary union", p 76.

4 The protocol on the Statute of the ESCB and the ECB (which has not been changed since it was ratified along with the Maastricht Treaty) still refers to the "ECU". This was the previous designation of the common currency, which was replaced with the name euro. (See "The progressive establishment of European economic and monetary union", section II.3, pp 21-23.)

5 On the basis of Article 28.1 of the Statute, the Governing Council of the ECB may increase the capital of the ECB by a further €5 billion. (See Council Regulation (EC) No 1009/2000 of 8 May 2000 concerning capital increases of the European Central Bank (OJ L 115, 16 May 2000, p 1)).

6 See Decision of the European Central Bank (ECB/2006/26) of 18 December 2006 laying down the measures necessary for the paying-up of the European Central Bank's capital by the non-participating national central banks, OJ L 24 of 31 January 2007, pp 15-16.

the ECB was provided with foreign reserves by the Eurosystem NCBs. The ECB is entitled to call for foreign reserves up to a maximum of €100 billion,[1] over which it has an unrestricted right of disposal in the context of the Statute. The Treaty does not explicitly prescribe budgetary independence for the national central banks. However, it follows from the provision of Article 109 of the EC Treaty and Article 14.1 of the Statute that the NCBs, as an integral part of the ESCB, must have the means necessary to be able to carry out their functions within the framework of the ESCB without budgetary constraints.

Overall, the Eurosystem has thus been granted what is probably a uniquely broad degree of independence. However, the considerable independence of the Eurosystem does not mean that the system is free of all control. Since the Eurosystem's decisions affect both the general public and the financial markets, the position of an independent central bank, in view of its democratic legitimacy, calls for it to demonstrate transparency and accountability for its actions. Independence and accountability are not opposites but complementary. Owing to the Eurosystem's clear statutory mandate and the clear objective conferred on it, the Eurosystem's independence cannot be undermined by democratic accountability. On the contrary, accountability provides the Eurosystem with an opportunity to build up credibility by making clear, convincing statements to the public on the objectives and use of monetary policy. All in all, the Eurosystem convincingly meets the requirements of transparency and accountability. It is now one of the most transparent central bank organisations in the world. This holds true despite the repeated calls, for instance from individual academics or indeed from the European Parliament (EP), for the minutes of the meetings of the Governing Council of the ECB to be published. The Eurosystem rejects these calls on the basis of its independence, since, in particular, it fears that this would jeopardise the openness of the discussions within the Governing Council of the ECB.

The Eurosystem – as a comparatively young central bank organisation – has a keen interest in communicating with the public in a manner which is clear and transparent. The Treaty contains a series of provisions to this effect and in practice a large number of media are available for this purpose. Thus, for instance, the consolidated financial statement of the Eurosystem is published weekly. Furthermore, directly after the first Governing Council meeting each month, which is primarily devoted to discussing monetary policy, the President of the ECB holds a press con-

1 The maximum amount of €50 billion originally provided for in the Treaty and the Statute (see Article 30 of the Statute) was increased by €50 billion by virtue of Council Regulation (EC) No 1010/2000 of 8 May 2000 concerning further calls for foreign reserve assets by the European Central Bank. Pursuant to Article 30.4 of the Statute, the ECB may make further calls for foreign reserve assets within this limit provided there is a need for the further call (OJ L 115, 16 May 2000, pp 2-3).

ference at which he gives detailed explanations of the Governing Council's assessment of the economic situation and prospects for price movements and then answers journalists' questions. This is supplemented by the ECB's *Monthly Bulletin*, which contains a detailed assessment of the economic situation as well as articles on the structure of the economy and on topics that are relevant to the single monetary policy. Other important sources of information for the public include the ECB's *Annual Report*, speeches held by members of the Governing Council of the ECB and Eurosystem working papers.

The Eurosystem's accountability obligation is also reflected in its relations with the Community institutions and bodies. The European Parliament assumes a particularly important role in this context as the sole directly elected Community institution. For instance, the European Parliament is consulted when the members of the Executive Board of the ECB are appointed. Moreover, in accordance with Articles 113 (3) of the EC Treaty and Article 15.3 of the Statute, the President of the ECB submits the *Annual Report* to the European Parliament, which may hold a general debate on that basis. The President of the ECB and the other members of the Executive Board may, at the request of the European Parliament or on their initiative, be heard by the competent committees of the European Parliament. The ECB's *Annual Report* is also forwarded to the European Council, the Ecofin Council and the European Commission.

Further relationships between the ECB and the Community institutions and bodies exist with the Ecofin Council and the European Commission. Article 113 (1) of the EC Treaty provides that the President of the Council and a member of the European Commission may participate, without having the right to vote, in meetings of the Governing Council of the ECB. The President of the Council may submit a motion for deliberation to the Governing Council of the ECB. Conversely, the President of the ECB is invited to attend Council meetings on a regular basis (Article 113 (2) of the EC Treaty). Furthermore, the ECB and the NCBs are members of the EFC, the most important body preparing the meetings of the Ecofin Council on economic and fiscal policy issues. Moreover, the Eurosystem maintains contact with various European bodies such as Eurostat, the statistical service of the Commission, via working groups and groups of experts.

As indicated above, the ECB takes part in the political dialogue (for instance, in the framework of the meetings of the Ecofin Council and the informal Eurogroup). It

also takes part in the macroeconomic dialogue.[1] The aim of these dialogues is to facilitate an exchange of information and views. Recognising the respective tasks and positions as defined in the Treaty, the aim is to promote a broader understanding of the various tasks and of where the problems lie. Inclusion of the ECB in these dialogues is also in the interest of monetary policy itself since the implementation of a stability-orientated monetary policy is a necessary – but not sufficient – precondition for achieving the objective of price stability. Rather, monetary policy relies on all economic players acting in a manner that is conducive to stability. In this sense, the political dialogue may build confidence in monetary policy provided that full recognition is given to the ECB's independence.

5 The Deutsche Bundesbank as an integral part of the Eurosystem

Like all NCBs in the Eurosystem, the Deutsche Bundesbank, being the national central bank of the Federal Republic of Germany, helps to carry out the tasks of the ESCB with the primary objective of maintaining price stability in the euro area. Overall, the Bundesbank currently has the following core tasks in the Eurosystem.

Monetary policy continues to be the Bundesbank's primary core business area. Since the transfer of monetary policy decision-making sovereignty to the Governing Council of the ECB, one of the Bundesbank's most important tasks is to advise its President – who is a member of the Governing Council *ad personam* – to the best of its ability in preparation for the Governing Council's meetings. The Executive Board and units across the Bundesbank accordingly brief the President of the Deutsche Bundesbank on all issues to be discussed at the meetings of the Governing Council of the ECB. Bundesbank representatives also carry out important preliminary work in the various ESCB Committees. In order to successfully bring its expertise and experience to bear in the forum of competing ideas and concepts within the Eurosystem, the Bundesbank must meet the highest standards in its economic and monetary analyses and research. In addition, the Bundesbank has the task of implementing the monetary policy decisions of the Governing Council of the ECB in Germany. To this end, the Bundesbank relies first and foremost on its branches, with which every credit institution in Germany holds an account. The Bank supplies the central bank money required for refinancing credit institutions

1 This dialogue between representatives of the governments of the member states, the European Commission, the EU-level social partners, the ECB and a non-euro-area national central bank is intended to enable the participants to gain a better understanding of the policy requirements implied by EMU and thus to improve the interaction between wage developments and monetary, budgetary and financial policies within the EU.

via these accounts. These accounts are also where the credit institutions maintain their minimum reserves.

Another of the Bundesbank's key business areas is also closely linked to monetary policy: ensuring a stable national and international financial and monetary system. In order to achieve its desired objectives, monetary policy is dependent on stable markets. The Bundesbank has therefore paid great attention to this area of work for a long time already. Its analyses in this field have been published in the annual Financial Stability Review since November 2005[1]. The increased importance of this area and the close integration of the international financial markets was made abundantly clear by the crisis in the credit markets which emerged in summer 2007.

In cooperation with the German Federal Financial Supervisory Authority (BaFin), the Bundesbank's supervisory tasks include responsibility for safeguarding the soundness of German credit institutions. In particular, the Bundesbank is responsible for the ongoing supervision of individual financial institutions (microprudential supervision). In this area, the Bundesbank generally benefits from its market proximity and the presence of its Regional Offices in the different regions of Germany. With the increasing integration of financial markets in the EU, there has been significant progress in the convergence of banking supervisory practices over the past few years.

Another aspect that is closely linked to the Bundesbank's responsibility for monetary policy is the security and efficiency of cashless payments, which are of great importance in modern economies. Pursuant to Article 3 of the Bundesbank Act and the provisions of the EC Treaty in conjunction with the Statute of the ESCB, payment systems are one of the Bundesbank's core areas of responsibility. In this area, too, the Bundesbank contributes to the ongoing process of integration of Europe's financial markets. The Bank played a key role in the further development of the TARGET network, which facilitates the rapid and secure settlement of large-value, cross-border payments and ensures the smooth distribution of liquidity in the money market. TARGET2, the new single shared platform, became operational in November 2007. Furthermore, the first SEPA[2] payment instrument for cross-border customer payments – the SEPA credit transfer – was launched at the end of January 2008. SEPA is designed to make cross-border cashless payments as simple and efficient as domestic ones.

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1 These studies were previously published in the Bundesbank's *Monthly Report* in December 2003 and October 2004.
2 Single Euro Payments Area.

The Bundesbank also continues to make an important contribution towards providing an efficient supply of cash in Germany. Banknotes and coins are put into circulation via its branch network and, when they return, are checked for authenticity, damage and soiling. The Governing Council of the ECB decides on the design and security features of the banknotes. The ECB also coordinates the process of determining banknote requirements, in which the Bundesbank (along with all other NCBs in the Eurosystem) naturally participates.

The Bundesbank is represented in numerous international institutions and committees which deal with issues relating to international economic and monetary policy and the global financial systems. For example, the Bundesbank, together with the Federal Government of Germany, assumes the rights and duties arising from Germany's membership of the International Monetary Fund (IMF). The President of the Bundesbank is the German governor on the Board of Governors of the IMF. Other important examples include membership of the Bank for International Settlements (BIS) and participation in the committees of the Organisation for Economic Co-operation and Development (OECD). The Bundesbank is also involved in various informal groups. Particular mention should be made of the cooperation between the G10 central bank governors, the participation of the central bank governors in the G7 and G20 meetings, and the Financial Stability Forum.[1] At a European level, in addition to the Bundesbank's aforementioned membership of the EFC and its activities on various EU statistical committees, its participation in EU committees concerned with banking supervision is of key importance.

The Bundesbank also carries out many other tasks. For example, pursuant to section 13 of the Bundesbank Act, it advises the Federal Government on "monetary policy issues of major importance". In addition, the Bundesbank continues to be the German government's fiscal agent. It carries accounts for public administrations or institutions of equal standing and offers services in the area of cashless payments to these customers. The Bundesbank also continues to manage the monetary reserves of the Federal Republic of Germany as well as the monetary reserves transferred from the Bundesbank to the ECB. Furthermore, the Bundesbank compiles and publishes a wide range of statistical data and thus provides an important basis for decisions on economic and monetary policy. For example, the Bundesbank compiles the German balance of payments statistics on behalf of the Federal Government. One relatively new field of work for the Bundesbank is technical central bank cooperation. In this area, the Bundesbank works alongside cen-

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1 For details on the Bundesbank's work in international organisations and forums, see Deutsche Bundesbank, Weltweite Organisationen und Gremien im Bereich von Währung und Wirtschaft, Special Publication, March 2003.

tral banks from developing countries and emerging economies and, in particular, transition and EU accession countries, and shares its experience and expertise through training and advisory services.

II The Eurosystem's monetary policy strategy and operational framework

1 The Eurosystem's stability-orientated monetary policy strategy

One of the essential features of monetary policy is that its impact is transmitted to the economy and the price level through various channels in the medium term only. This complex transmission mechanism needs to be borne in mind when the Eurosystem's monetary policy is determined and implemented.[1] Like other central banks, the Eurosystem cannot influence the rate of inflation directly. A forward-looking monetary policy is therefore required to ensure that the primary objective of maintaining price stability is achieved. In line with the mandate laid down in the EC Treaty, the Governing Council of the ECB pursues a stability-oriented monetary policy strategy.[2] The Eurosystem's monetary policy strategy has two principal functions. First, it serves the Governing Council as a cogent analytical framework for deciding on the use of the monetary policy instruments in the light of the available information and analyses. Second, the monetary policy strategy is used as a means of communicating the Governing Council's monetary policy decisions to the general public. In this context, it is crucial that the strategy's formulation and implementation are transparent and readily comprehensible to outsiders. In conceptual terms the Eurosystem's monetary policy strategy comprises three main elements: a quantitative definition of the objective of price stability and the "two pillars" of the strategy which serve to achieve this goal. The ECB's strategy centres on publicising the quantitative definition of the objective of price stability. Price stability is defined in the Eurosystem as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". By endeavouring to maintain inflation rates below, but close to, 2%, the Governing Council of the ECB provides a sufficient safety margin for guarding against deflationary risk. The

1 On monetary policy transmission in the euro area, see European Central Bank, Monetary policy transmission in the euro area, *Monthly Bulletin*, July 2000, pp 43-58, and various Working Papers published by the ECB, which can be downloaded from the ECB's website (http://www.ecb.int).

2 In October 1998 the Governing Council of the ECB announced the main elements of the ECB's stability-oriented monetary policy. After more than four years, this concept was reviewed in 2003 and the main elements confirmed (see ECB Press Release of 8 May 2003, The ECB's monetary policy strategy, and European Central Bank, The outcome of the ECB's evaluation of its monetary policy strategy, *Monthly Bulletin*, June 2003, pp 79-92).

Eurosystem strives to maintain price stability over the medium term. Short-term price fluctuations cannot be influenced by monetary policy.[1] By publishing the quantitative target for price stability, the Eurosystem gives the public a point of reference concerning future expectations regarding price developments and hence helps to stabilise those expectations. At the same time, it gives the public a benchmark for assessing the performance of monetary policy.

The monetary policy strategy adopted by the Governing Council of the ECB at its meeting on 13 October 1998 and reviewed in 2003 contains two pillars. They constitute the framework within which the wide range of extensive analyses which underpin the Governing Council's monetary policy decisions are structured. Following the review of the monetary policy strategy in May 2003, the first pillar of the strategy is now economic analysis. Here, the ECB evaluates a broad range of economic and financial market indicators. The main aim is to identify and evaluate the impact of factors affecting price stability predominantly in the short and medium term. The analysis focuses, in particular, on the interplay between supply and demand in goods, services and factor markets. To this end, the ECB uses, *inter alia*, macroeconomic projections in order to consolidate the available information. In May 2003 the ESCB's monetary analysis was named as the second pillar. The money stock plays a prominent role in this context. The analysis is based on the long-term stable relationship between the money stock and prices and takes account of the fact that inflation is ultimately a monetary phenomenon. The special role of the money stock was underlined by the announcement of a quantitative reference value for the growth of the broad monetary aggregate M3. The reference value serves as an aid in analysing and presenting monetary developments and is an important benchmark for assessing the risks to price stability. In May 2003, in the course of evaluating its monetary policy, the Governing Council of the ECB decided to stop conducting a review of the reference value on an annual basis as experience has shown that the trend assumptions on which it is based change only gradually. Furthermore, in so doing the Governing Council wished to underscore the longer-term nature of the reference value as a benchmark against which to set monetary developments.

Since the above-mentioned review of monetary policy strategy in 2003, the President of the ECB first outlines the economic analysis in his introductory statement at the monthly press conference. He then proceeds to monetary analysis. The monetary analysis serves primarily as a check of the data stemming from the economic analysis, which focuses more on the shorter term. Finally, the full set of informa-

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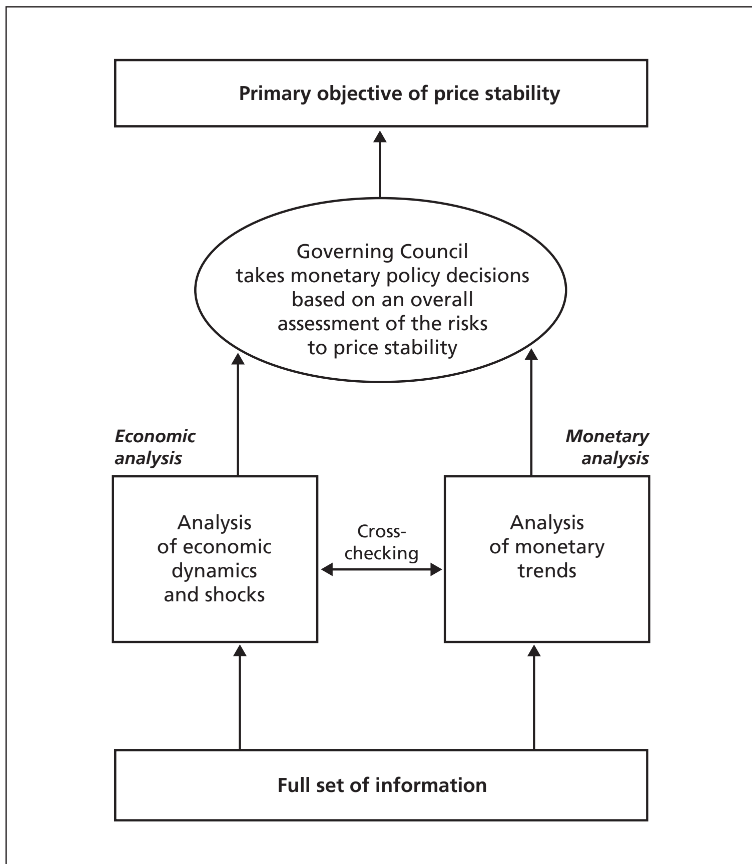
1 See also section I.2, "Price stability, the Eurosystem's primary objective", pp 46-47.

The stability-oriented monetary policy strategy of the ECB

Chart 2



Source: ECB (2004), The monetary policy of the ECB, p 66.

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tion from both perspectives is used to provide an overall assessment of the risks to price stability.

In essence, therefore, the Eurosystem pursues a comprehensive and diversified approach in its monetary policy strategy, combining a variety of methods of analysis and elements of both inflation targeting and monetary targeting. This two-pillar approach, which takes all relevant information into account, provides the Governing Council of the ECB with a broad basis for its decision-making.[1]

1 For a detailed description of the ECB's monetary policy, see European Central Bank, *The Monetary Policy of the ECB*, January 2004.

2 The Eurosystem's monetary policy instruments and procedures

(a) The money market, the first link in the monetary policy transmission chain

In operational terms, the Eurosystem seeks to achieve the goal of price stability by influencing the interbank money market. It can use its monetary policy instruments there to steer liquidity and interest rates since the banking system in the euro area is largely dependent on the provision of central bank money by the Eurosystem. This reliance of the credit institutions on the central banks, which arises from the national central banks' privileged position in supplying banknotes (monopoly on banknote issuance) and credit institutions' obligation to hold minimum reserves on accounts with Eurosystem central banks, enables the Eurosystem to use the money market as the first link in the monetary policy transmission chain and as a starting point for the expansion of the money stock.

The Eurosystem has a wide array of possible means of steering liquidity and interest rates in the money market comprising various instruments and procedures which can be employed both to inject and to withdraw liquidity. The principal operational tools are open market operations, standing facilities and a minimum reserve system.[1] Decisions on the use of the instruments and procedures are taken by the Governing Council of the ECB, whereas the transactions are executed in a decentralised manner through the national central banks.[2]

(b) Open market operations

The key role in the Eurosystem's monetary policy operations is played by open market operations. They are carried out exclusively on the initiative of the Eurosystem and are used to manage the liquidity situation and to steer interest rates in the money market. Open market operations can be subdivided into four categories depending on the particular aim, time frame and procedures applied. The main refinancing operations and the longer-term refinancing operations constitute the Eurosystem's regular open market operations. If necessary, the Eurosystem may also resort to fine-tuning operations and structural operations. The Eurosystem's regular open market operations are carried out as reverse transactions, through which it buys eligible assets in the context of repurchase agreements or rather

1 For a more detailed description of the Eurosystem's operational framework for the single monetary policy in EMU, see European Central Bank, *The implementation of monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures*, September 2006.
2 The Governing Council of the ECB decides whether, in exceptional cases, bilateral reverse transactions are carried out by the ECB itself for fine-tuning purposes.

grants loans with these assets being assigned or pledged as collateral. In addition, the Eurosystem has further instruments at its disposal: for conducting fine-tuning operations, it has, for example, foreign exchange swaps and the collection of fixed-term deposits, and for structural operations, it has the issuance of debt certificates and the outright purchase or sale of securities. Open market operations are normally conducted in the form of tenders, of which there are two different types. The standard tender is used for regular open market operations, with a maximum of 24 hours elapsing between the announcement of the tender and the confirmation of the allotment. The standard tenders are complemented by quick tenders, which are used solely for executing fine-tuning operations in the market. Quick tenders are normally executed within a time frame of 90 minutes. Both tender types can generally be offered as fixed rate tenders or as variable rate tenders. In a fixed rate tender, the Governing Council of the ECB specifies in advance the interest rate at which the operations will be executed. The participating counterparties bid only the amount of money which they are willing to commit to the transaction. If the total bids exceed the desired allotment volume, the bids are allotted on a pro rata basis. In a variable rate tender, by contrast, participants indicate both the volume and the interest rate at which they wish to enter into the transaction in question; in this case the Governing Council of the ECB generally sets a minimum bid rate. Depending on what is specified in the tender announcement, allotment in a variable rate tender may be either at a uniform rate (Dutch auction) or at the credit institutions' individual bid rates (American auction). Bids which are above the single allotment rate (Dutch auction) or above the lowest accepted rate (marginal rate of allotment; American auction) are allotted in full, whereas bids at those rates may be only partly allotted.

In practice, the main refinancing operations constitute the most important group of open market transactions. They play a key role in the pursuit of monetary policy objectives through open market operations and are used to supply the bulk of the market's refinancing requirements. These liquidity-providing reverse transactions are executed weekly as standard tenders. They have a maturity of one week. Since mid-2000, the ECB has executed its main refinancing operations as variable rate tenders in the form of American auctions, specifying a minimum bid rate. The specified minimum bid rate functions as a monetary policy signal to the money market.

By contrast, longer-term refinancing operations are the means of providing the banking system with longer-term resources – as the name suggests. Longer-term refinancing operations are conducted at a monthly frequency and with a maturity of three months as reverse transactions and, like the main refinancing operations,

are carried out as standard tenders. The Eurosystem does not seek to send monetary policy signals via these longer-term refinancing operations; hence it normally conducts such operations as variable rate tenders with preannounced allotment volumes and without a minimum bid rate, thus operating as a rate taker. During a review of the Eurosystem's monetary policy framework, which was carried out in 2002 with the involvement of the credit institutions, banking associations and financial market groups in the euro area, the ECB proposed suspending longer-term refinancing operations because the target group originally envisaged – smaller institutions not active on the money market – was not being reached. However, virtually all of the credit institutions participating in the public consultation procedure were in favour of keeping these refinancing operations. First, longer-term refinancing operations were said to play an important role in terms of basic refinancing within the framework of a balanced maturity structure. Second, attention was drawn to the fact that neither longer-term money market operations nor the interbank repo market could be considered entirely viable substitutes for longer-term central bank refinancing.[1]

Fine-tuning operations enable the Eurosystem to offset the effects of unexpected liquidity fluctuations in the market. The decision to resort to such transactions is taken on an ad hoc basis. Liquidity-providing fine-tuning operations take the form of reverse transactions and liquidity-absorbing fine-tuning operations are conducted by collecting fixed-term deposits. These operations are conducted as quick tenders.

The Eurosystem can resort to structural operations in order to adjust its structural liquidity position vis-à-vis the financial sector. They can be structured as needed as either liquidity-providing or liquidity-absorbing transactions. In practice, however, such transactions have played no major role to date.

(c) Standing facilities

The Eurosystem offers credit institutions two standing facilities, a marginal lending facility and a deposit facility, which are designed to provide or absorb liquidity until the next business day. In contrast to the open market operations, recourse to the standing facilities is on the initiative of the credit institutions and their volume is, in principle, unlimited.

1 See also Deutsche Bundesbank, The Eurosystem's monetary policy framework – experience to date and measures to improve its efficiency, *Monthly Report*, March 2003, pp 15-26.

Eurosystem monetary policy operations

Table 1

Monetary policy operations	Types of transactions		Maturity	Frequency	Procedure
	Provision of liquidity	Absorption of liquidity			
Open market operations					
Main refinancing operations	– Reverse transactions	–	– One week	– Weekly	– Standard tenders
Longer-term refinancing operations	– Reverse transactions	–	– Three months	– Monthly	– Standard tenders
Fine-tuning operations	– Reverse transactions – Foreign exchange swaps	– Reverse transactions – Collection of fixed-term deposits – Foreign exchange swaps	– Non-standardised	– Non-regular	– Quick tenders – Bilateral procedures
Structural operations	– Reverse transactions	– Issuance of debt certificates	– Standardised/ non-standardised	– Regular and non-regular	– Standard tenders
	– Outright purchases	– Outright sales	–	– Non-regular	– Bilateral procedures
Standing facilities					
Marginal lending facility	– Reverse transactions	–	– Overnight	– Access at the discretion of counterparties	
Deposit facility	–	– Deposits	– Overnight	– Access at the discretion of counterparties	

Source: European Central Bank, *The implementation of monetary policy in the euro area*, September 2006, p 9. In September 2007, the Governing Council of the ECB decided that it would no longer permit outright purchases or sales for fine-tuning operations. They are therefore no longer listed here.

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The monetary policy functions of the standing facilities consist mainly in setting an upper and a lower limit for the development of the overnight interest rate. The interest rate ceiling on the overnight money market is based on the rate on the marginal lending facility. This facility enables credit institutions to obtain overnight liquidity from the national central banks at a pre-specified rate against eligible assets. By contrast, the floor of the interest rate channel is based on the rate on the deposit facility. It permits credit institutions to invest surplus liquidity until the next business day, earning interest at the rate pre-specified by the Governing Council of the ECB. The credit institutions have little recourse to these two facilities as a rule owing to the relatively unfavourable conditions compared with the rates on the interbank money market.

While the Governing Council of the ECB sets the terms and conditions for the standing facilities for the whole of the euro area, the facilities are managed by the national central banks, in other words in a decentralised manner. The Eurosystem reserves the right to change the conditions governing the use of the facilities or to temporarily suspend their use at any time.

(d) Counterparties and eligible assets in the context of open market operations and standing facilities

All credit institutions which are subject to minimum reserves[1] and are financially sound may participate in the monetary policy transactions of the Eurosystem. The counterparties must also fulfil certain operational criteria specified in the contractual or regulatory arrangements applied by the relevant national central bank. For instance, at the Deutsche Bundesbank, participation in the open market operations is possible only if a counterparty also has a collateral account with which to collateralise the transaction. The general admission criteria are normally defined in such a way as to allow a wide range of institutions to participate in the open market operations and use the standing facilities.

A precondition for participation in the open market operations, as well as for accessing the marginal lending facility, is the posting of adequate collateral by the counterparties in accordance with Article 18.1 of the Statute of the ESCB. This is intended to protect the Eurosystem against losses arising from its monetary policy transactions. For collateral to be considered eligible, certain acceptance criteria must be fulfilled.[2] The Eurosystem's collateral model is designed in such a way that

1 See section II.2 (e) "Minimum reserves", pp 66-68.
2 Detailed information can be found in European Central Bank, *The Implementation of Monetary Policy in the Euro Area*, September 2006, pp 34-40.

Eligible assets for Eurosystem monetary policy operations

Table 2

Eligibility criteria	Marketable assets	Non-marketable assets	
Type of asset	ECB debt certificates Other marketable debt instruments	Credit claims	RMBDs[1]
Credit standards	The asset must meet high credit standards. The high credit standards are assessed using ECAF[2] rules for marketable assets.	The debtor/guarantor must meet high credit standards. The creditworthiness is assessed using ECAF rules for credit claims.	The asset must meet high credit standards. The high credit standards are assessed using ECAF rules for RMBDs.
Place of issue	EEA	Not applicable	Not applicable
Settlement/ handling procedures	Place of settlement: euro area Instruments must be centrally deposited in book-entry form with central banks or an SSS[3] fulfilling the ECB's minimum standards.	Eurosystem procedures	Eurosystem procedures
Type of issuer/ debtor/ guarantor	Central banks Public sector Private sector International and supranational institutions	Public sector Non-financial corporations International and supranational institutions	Credit institutions
Place of establishment of the issuer/ debtor or guarantor	Issuer: EEA or non-EEA G10 countries Guarantor: EEA	Euro area	Euro area
Acceptable markets	Regulated markets Non-regulated markets accepted by the ECB	Not applicable	Not applicable
Currency	Euro	Euro	Euro
Minimum size	Not applicable	Minimum size threshold at the time of submission of the credit claim. Between 1 January 2007 and 31 December 2011: – for domestic use: choice of the NCB – for cross-border use: common threshold of €500,000 As from 1 January 2012: common minimum threshold of €500,000 throughout the euro area.	Not applicable

Source: European Central Bank, *The implementation of monetary policy in the euro* area, September 2006, p 40. — **1** Retail mortgage-backed debt instruments. — **2** Eurosystem credit assessment framework. — **3** Securities settlement system.

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Eligible assets for Eurosystem monetary policy operations (continued)

Table 2a

Eligibility criteria	Marketable assets	Non-marketable assets	
Governing laws related to credit claims	Not applicable	Governing law for credit claim agreement and mobilisation: law of a member state of the euro area. The total number of different laws applicable to – the counterparty, – the creditor, – the debtor, – the guarantor (if relevant), – the credit claim agreement and – the mobilisation agreement shall not exceed two.	Not applicable
Cross-border use	Yes	Yes	Yes

Source: European Central Bank, *The implementation of monetary policy in the euro area*, September 2006, p 40.

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the technical execution of the operations can be conducted as smoothly as possible and that equal treatment of the counterparties is ensured. As a result, the Eurosystem accepts a broad range of marketable and non-marketable assets. The total volume of eligible collateral is many times greater than the credit institutions' refinancing needs. In May 2004 the Eurosystem decided to gradually introduce a "Single List" of collateral,[1] a process which was completed at the beginning of 2007. Since then, credit claims (bank loans), for example, have been accepted as eligible collateral throughout the Eurosystem. In addition, the Eurosystem credit assessment framework (ECAF) came into operation at the beginning of 2007. In accordance with this framework, all eligible collateral must fulfil high credit standards. Furthermore, all eligible collateral is subject to certain valuation principles and risk control measures (for example, valuation haircuts or safety margins). All eligible assets may also be used by the Eurosystem's counterparties on a cross-border basis.

1 This list replaced the former two-tier system of eligible collateral.

(e) Minimum reserves

The legal basis of the minimum reserves instrument is established by Article 19 of the Statute of the ESCB, which states that the ECB may require credit institutions established in member states to hold minimum reserves on accounts with the national central banks. The Governing Council of the ECB has availed itself of this possibility and opted to use the minimum reserve instrument in the context of the Eurosystem's single monetary policy. The specific design of the minimum reserve instrument is contained in secondary legislation in the form of the Council Regulation concerning the application of minimum reserves by the European Central Bank and the ECB Regulation on the application of minimum reserves.[1]

As a key component of the Eurosystem's monetary policy framework, the minimum reserve requirement essentially fulfils two functions. The first consists in enlarging the structural liquidity shortage in the banking system. The obligation to maintain minimum reserves thus ensures that credit institutions are dependent on the central bank for refinancing. This enhances the overall efficiency of the monetary policy.

The second monetary policy function of the minimum reserves consists in the stabilisation of money market interest rates. This derives from the requirement that the minimum reserves are to be maintained at an average level determined for the credit institutions subject to minimum reserves over the reserve maintenance period.[2] This period lasts around one month. Since March 2004, the reserve maintenance period has begun on the settlement day of the first main refinancing operation following the Governing Council meeting in which the monthly monetary policy discussions are held. Owing to the synchronisation of the maintenance period with the monetary policy meeting of the ECB Governing Council and the restriction of the maturity of the main refinancing operations to one week, central bank rates generally remain unchanged within a maintenance period and, consequently, interest rate expectations do not affect credit institutions' bidding behaviour in the main refinancing operations.[3]

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1 Council Regulation (EC) No 2531/98 of 23 November 1998 concerning the application of minimum reserves by the European Central Bank (OJ L 318, 27 November 1998, pp 1-3) as amended by Council Regulation (EC) No 134/2002 of 22 January 2002 (OJ L 24, 26 January 2002, p 1) and Regulation (EC) No 1745/2003 of the European Central Bank of 12 September 2003 on the application of minimum reserves (OJ L 250, 2 October 2003, pp 10-16) including the amendment of 26 February 2004.

2 No later than three months before the start of each calendar year, the Executive Board of the ECB publishes an indicative calendar of reserve maintenance periods. The calendar is published in the Official Journal of the European Union, on the ECB's website and on the NCBs' websites.

3 See also Deutsche Bundesbank, Initial experience with the new monetary policy framework and the Bundesbank's contribution to liquidity management by the Eurosystem, *Monthly Report*, July 2004, pp 49-66.

Reserve base and reserve ratios	Table 3
A. Liabilities included in the reserve base and to which the positive reserve ratio is applied	
Deposits	
Overnight deposits	
Deposits with an agreed maturity of up to two years	
Deposits redeemable at notice of up to two years	
Debt securities issued	
Debt securities with an agreed maturity of up to two years	
B. Liabilities included in the reserve base and to which a zero reserve ratio is applied	
Deposits	
Deposits with an agreed maturity of over two years	
Deposits redeemable at notice of over two years	
Repos	
Debt securities issued	
Debt securities with an agreed maturity of over two years	
C. Liabilities excluded from the reserve base	
Liabilities vis-à-vis other institutions subject to the Eurosystem's minimum reserve system	
Liabilities vis-à-vis the ECB and the national central banks	

Source: European Central Bank, *The implementation of monetary policy in the euro area*, September 2006, p 60.

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The reserve requirement of the credit institutions subject to minimum reserves[1] is computed by applying the reserve rate[2] set by the Governing Council of the ECB to the reserve base, calculated as the sum-total of certain positions in credit institutions' balance sheets at the end of the month.[3] The requirement that credit institutions must maintain the minimum reserves as an average holding enables them to smooth out day-to-day liquidity fluctuations; for instance, if the minimum reserve requirement is undershot on one day, this can be offset by overshooting it on another. This liquidity buffer function of the minimum reserves leads to a stabilisation of the money market rates, which in turn enables the Eurosystem to concentrate its open market operations, as a rule, on the main refinancing operations and the longer-term refinancing operations. Discretionary fine-tuning operations remain a rare exception. The fact that credit institutions have relatively little recourse to the standing facilities is likewise largely attributable to the liquidity buffer function of the minimum reserves. For the banks this leads overall to a reduction in the cost of liquidity management. The balances that credit institutions hold on accounts with the national central banks in order to fulfil the minimum reserve requirement are remunerated at the average interest rate for main refi-

1 The ECB keeps a list of those institutions which are subject to minimum reserves and of those institutions which, for various reasons, are exempt from having to maintain minimum reserves. These lists are available to the general public on the ECB's website (http://www.ecb.int).
2 Since the start of EMU, a reserve rate of 2.0% has been applied to deposit liabilities and debt securities issued with an agreed maturity of up to and including two years.
3 See table above.

nancing operations concluded in the maintenance period. However, this applies only to balances up to the level of the reserve requirement. Therefore, credit institutions in the euro area do not generally incur costs as a result of the minimum reserve requirement. The minimum reserve requirement is thus competitively neutral.

Overall, the monetary policy framework of the Eurosystem has proven successful. It has enabled the Eurosystem to manage liquidity and short-term interest rates in a relatively smooth and targeted manner since the start of EMU.

III Exchange rate policy and international cooperation

1 Exchange rate policy

In its fundamental principles, the EC Treaty determines that, as for monetary policy, the primary aim of the exchange rate policy of the European Union is price stability.[1] Price stability is thus also to be given primacy in the Community's exchange rate policy. This provision is laid down in Article 111 of the EC Treaty. Article 111 (1) refers to "formal agreements on an exchange-rate system (…) in relation to non-Community currencies". Since the fixed exchange rate system was abandoned in 1973, however, the world monetary system features flexible exchange rates among the major world currencies. The conditions necessary for such "formal agreements" are therefore unlikely to be fulfilled at present.

The key provision for the EU's exchange rate policy is thus Article 111 (2) of the EC Treaty. This states that "the Council, acting by a qualified majority (…) may formulate general orientations for exchange-rate policy". At the same time, however, it stipulates that "these general orientations shall be without prejudice to the primary objective of the ESCB to maintain price stability". These provisions in the EC Treaty thus secure the "external flank of monetary policy". They are underpinned by corresponding resolutions of the European Council. For instance, according to the resolution of the European Council of December 1997, "in general exchange rates should be seen as the outcome of all other economic policies".[2] In this resolution, the exceptional character of the "general orientations" is emphasised as it is stated that, "in exceptional circumstances, for example in the case of a clear

1 Article 4 (2) of the EC Treaty requires "the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability."
2 OJ C 35, 2 February 1998, p 3.

misalignment" the Council may formulate general orientations for the euro area's exchange rate policy in relation to non-Community currencies. No actual use has yet been made of this option.

In today's floating exchange rate regime, the Ecofin's competences in the field of exchange rate policy pursuant to the EC Treaty are certainly limited on the whole. Nevertheless, exchange rates are also the subject of discussions between the Council and the ECB as exchange rate developments can, of course, occasionally be of great importance to the countries affected by them. These discussions, including evaluations of developments in the forex market, mainly take place within the Eurogroup, however. Decisions on possible foreign exchange interventions are the sole responsibility of the Governing Council of the ECB (see also Article 105 (2) of the EC Treaty). The President of the Eurogroup and the President of the Ecofin Council are, of course, promptly informed of such interventions and their effects. In the EEMU's almost ten-year history, the ECB has intervened only once, during the weak phase experienced by the euro in autumn 2000, in order to support the single currency. These interventions were initially coordinated with the US and Japanese monetary authorities and then implemented unilaterally by the ECB.

2. International cooperation

The transfer of monetary policy sovereignty to the Community level naturally also had implications for cooperation with international organisations and bodies. This is regulated by the provisions in Article 111 (4) of the EC Treaty. They stipulate that the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, shall decide on the position of the Community at international level as regards issues of particular relevance to EMU. The same is true of the international representation of the Community, although the allocation of responsibilities stipulated in the Treaty must be taken into account.

As monetary policy authority was transferred to the Community, it now has sole responsibility for international representation in the field of monetary policy. In respect of monetary policy issues, the Community is generally represented by the ESCB on an international level. Pursuant to Article 12.5 of the Statute of the ESCB, the Governing Council of the ECB decides on how the ESCB is represented in terms of international cooperation.

Conversely, as economic policy competences remain largely the responsibility of the member states in accordance with the EC Treaty, they generally represent their

own position on these matters at an international level, including within the EEMU. However, it should be noted that, pursuant to Article 99 (1) of the EC Treaty, the member states are to "regard their economic policies as a matter of common concern" and to coordinate them within the Ecofin Council.

The Ecofin Council addressed the practical implementation of these provisions in a report to the European Council for its meeting at the end of 1998. With regard to external representation, the report stated inter alia that in the Council's view, "a pragmatic approach might be the most successful which could minimise the adaptation of current rules and practices".[1] The Council was in favour of a relatively broad spectrum of subject areas and considered it "useful" to develop pragmatic solutions "on matters which do not belong to the Community competence, but on which it may be appropriate for member states to express common understandings".[2]

At the beginning of EMU, the main issue was ensuring that the President of the Eurogroup and the President of the ECB were able to participate in relevant discussions on an international level. In order to better meet the needs of EEMU external representation, the G7 meetings of finance ministers and central bank governors have been held in two different formats since the second half of 1999. In the first part of these meetings, matters pertaining to the global economy, multilateral surveillance and exchange rate issues are discussed. Alongside the finance ministers, the President of the Eurogroup and the President of the ECB[3] attend this part of the meetings. The latter represent the euro area. The governors of the national central banks attend the second part of the G7 meetings, in which all other issues regarding the international financial system are discussed.

The ECB was given observer status at the IMF as early as the beginning of 1999. The ECB's designated observer at the IMF is invited to all IMF Executive Board meetings in which matters of direct relevance to the Eurosystem are discussed. Examples include the surveillance of the euro area's common monetary and exchange rate policy, multilateral surveillance by the IMF and the role of the euro in the international monetary system. Furthermore, the President of the ECB is invited to attend, as an observer, the meetings of the International Monetary and

1 Bulletin of the Federal Government of Germany No 7, 17 February 1999, p 83.
2 Ibid.
3 He thereby replaces the President of the Deutsche Bundesbank, the Governor of the Banque de France and the Governor of the Banca d'Italia.

Financial Committee (IMFC).[1] The position of the Council is presented to this Committee by the President of the Ecofin Council.

Over the past few years, there has also been growing cohesion in the EU stance vis-à-vis the IMF in the field of economic affairs – for which, as mentioned above, the member states are generally responsible but which are coordinated by Ecofin. In particular through intensive coordination of relevant issues on the agenda at the IMF, the euro-area countries have managed to achieve a high degree of cohesion in the stance of the corresponding IMF Executive Directors.

1 The main tasks of this committee are to monitor the international monetary and financial system and advise the supreme decision-making body of the IMF, the Board of Governors.

The exchange rate mechanism in the third stage of European economic and monetary union

I Background and legal basis

The exchange rate mechanism in the third stage of European economic and monetary union (ERM II) entered into force on 1 January 1999. It replaced the European Monetary System (EMS) which had become obsolete when the euro was introduced.[1] Non-euro-area member states can peg their currencies to the euro via ERM II. The euro is at the heart of this system. The establishment of this exchange rate system was in the interests of all concerned. ERM II is intended to prevent the single market in the EU from being jeopardised by excessive fluctuations in the nominal exchange rates of the currencies involved or by longer-term distortions in their real exchange rates, which would be even more serious. Through ERM II, the EU member states which did not introduce the euro from the outset have access to a stabilising exchange rate system. Furthermore, pegging their currencies to the euro is intended to help these countries to achieve the convergence necessary for subsequent accession to the euro area. To this end, ERM II, in contrast to its predecessor, the EMS, has deliberately been set up asymmetrically. Currencies are geared towards a central currency which is designed to meet the objective of price stability, the euro. This gearing of monetary policies to that of the Eurosystem, together with the undertaking by all EU countries to avoid excessive budget deficits, encourages the convergence of the underlying economic conditions in the EU. This, in turn, promotes exchange rate stability within the European Union. Finally, ERM II also helps to ensure that the principle of equal treatment is upheld when the euro is introduced in other EU member states. This means that the convergence criterion laid down in Article 121 (1), third indent of the EC Treaty – in accordance with which accession to the euro area must be preceded by at least two years of tension-free participation in the exchange rate mechanism – will also apply to newly acceding countries.

In legal terms, ERM II is based on two pillars.

The first pillar is formed by the Resolution of the European Council on the establishment of an exchange rate mechanism in the third stage of economic and monetary union of 16 June 1997.[2] It contains the principles and objectives as well as

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1 From 1979 until the introduction of the euro, the European Monetary System (EMS) regulated the foreign exchange relationships in the European Community. Its exchange rate mechanism was conceived as a fixed rate system in which the currencies of the participating EU member states were allowed to fluctuate within a fixed band around bilateral central rates. In the almost twenty years of its existence the EMS made an important contribution to the creation of a stable currency area in Europe. For further information on the EMS, see "Historical overview", p 12, and Deutsche Bundesbank, The European Monetary System, *Monthly Report*, March 1979, pp 11-18.
2 OJ C 236, 2 August 1997, pp 5-6.

the basic characteristics of the system. The second pillar is the Agreement of 1 September 1998 on the operating procedures for an exchange rate mechanism in stage three of economic and monetary union, concluded between the European Central Bank and the national central banks of the member states outside the euro area. This Agreement has since been amended several times, owing, in particular, to the various accessions to the euro area. It lays down the operational elements of the system.[1]

II Structural features of the system[2]

1 Central rates and fluctuation margins

As mentioned above, ERM II is a system of fixed exchange rates which may fluctuate within specific margins. First, the official central rates of the non-euro-area currencies are set vis-à-vis the euro. Unlike the exchange rate mechanism of the former EMS, this approach deliberately avoids the alignment of bilateral central rates between the participating non-euro currencies. The central rates were set for the first time, with effect from 1 January 1999, for the Danish krone and the Greek drachma.[3] The standard fluctuation band within which the non-euro currencies may float freely against the central rate is ±15%. Adding the 15% margin to or subtracting it from the central rate gives upper and lower marginal rates for each currency, and these rates essentially have to be defended. The stabilisation of exchange rates is to be achieved primarily by the pursuit of convergent economic and fiscal policies in the non-euro-area countries to ensure that tensions do not arise in the exchange rate system in the first place.

In addition, use of the interest rate instrument is envisaged as a means of support. It is also possible for the central banks, on a voluntary basis, to conduct smoothing interventions in the foreign exchange markets between the upper and lower marginal rates, referred to as intramarginal interventions. Automatic and compulsory interventions are made by the central banks involved whenever the upper or lower marginal rates (intervention points) are reached (see section 2 below).

1 See OJ C 345, 13 November 1998, pp 6-12, OJ C 73, 25 March, 2006, pp 21 and OJ C 319, 29 December 2007, pp 7-9.
2 For a more detailed description of ERM II, see Deutsche Bundesbank, Operational features of the new European exchange-rate mechanism, *Monthly Report*, October 1998, pp 17-23.
3 They corresponded to the central rates in the former exchange rate mechanism of the EMS.

Countries with a correspondingly high degree of convergence have the option of formally agreeing narrower bands than the standard band of ±15%; these must then likewise be defended. The initiative for a closer peg of this kind is to come from the member state in question. In addition to these formal agreements on narrower bands, informal agreements (which are not published) may also be made bilaterally between the ECB and the central bank in question.

2 Interventions and intervention financing

As already mentioned, the rates at the upper and lower margins serve as intervention points for the central banks involved. When these points are reached, the ECB and the non-euro-area central bank in question are obliged to intervene automatically and to an unlimited extent in the foreign exchange markets. In each case the weak currency is bought against the strong currency. Interventions are to take place in euro and in the participating currencies and not in non-Community currencies such as the US dollar.

The essentially automatic interventions, however, come up against limits whenever they endanger the stability-oriented monetary policy of a central bank. For a central bank selling its own currency, every intervention means creating money, which – carried out automatically and to an unlimited extent – can quickly conflict with the objective of price stability. For this reason, a protection clause was included in ERM II permitting the central banks involved to suspend the interventions if such a conflict appears likely. In taking this decision, however, due consideration must be given to all relevant factors, including the credibility of the overall system.

In order to give credibility to the system and to the obligation of automatic and unrestricted intervention at the fluctuation margins, it was supplemented by financing facilities. This means that the ECB and the central banks involved grant one another short-term credit lines if needed. In line with the intervention obligation, this "very short-term financing facility" can also be drawn on automatically and to an unlimited extent. Before resorting to this form of financing, however, the borrowing central bank is obliged to make appropriate use of its own foreign reserves. The outstanding very short-term financing balances are to be remunerated at a representative domestic three-month money market rate. Very short-term financing – with approval from the lending central bank – may also be used for intramarginal interventions but may not exceed a defined ceiling.

3 Decision-making procedures

Exchange rate tensions may be avoided, *inter alia*, through the timely adjustment of the central rates when the need for adjustment emerges. In the light of the lessons learned from delayed central rate adjustments in the exchange rate mechanism of the EMS, all parties involved in ERM II – expressly including the ECB – have been granted the option of initiating a procedure aimed at reviewing and adjusting the central rates. This is intended to avoid significant rate distortions and to depoliticise the rate adjustment procedure. A realignment of the central rates is implemented in accordance with a precisely specified joint procedure. The central rates are set by the governments of the participating member states, ie those which have introduced the euro and those which have pegged their currency to the euro. In addition, the involvement of the ECB and the central bank governors of the non-euro-area member states which have joined ERM II is required. The Economic and Financial Committee is consulted and the European Commission is involved in the procedure. The decision to set the central rates must be taken by mutual agreement. The fluctuation margins are also set in accordance with the same procedure.

III Previous experience with and current developments in ERM II

ERM II has demonstrated its stabilising effects from the outset. For instance, the system has ensured that the exchange rates of the participating currencies have moved within the stipulated margins even in periods of instability in the foreign exchange markets. In the case of new entrants to the euro area, ERM II has helped to ensure that the process of joining has run smoothly.

In principle, ERM II is a transitional system which will become obsolete once the euro has been introduced in all EU member states. As things currently stand, however, ERM II is likely to exist for some time to come. It – also and especially – enables (and enabled) the most recent entrants to align their economic and monetary policies with those of the euro area in the period preceding their entry into economic and monetary union.

Prior to the new accessions to the EU (in December 2003), the Governing Council of the ECB agreed on a policy position – which remains valid – on exchange rate

issues pertaining to the acceding countries.[1] In the Governing Council's view, the standard fluctuation band of ±15% is appropriate for member states engaging in a convergence process. Flexible exchange rates, crawling pegs or pegs against other currencies other than the euro are incompatible with the ERM. The question of whether currency boards[2] may be retained as a unilateral commitment within the ERM is to be assessed on a case-by-case basis. In its policy position, the Governing Council stresses that participation in the ERM is voluntary and possible without the fulfilment of any preconditions, but that membership is a prerequisite for the eventual adoption of the euro. To ensure tension-free membership of the ERM, the new member states should undertake the necessary transformation and adjustment processes prior to participation in the mechanism. In particular, budgetary policy should be set on a credible consolidation path. The EC Treaty sets out a minimum two-year period of participation in the ERM prior to the convergence assessment for the adoption of the euro. In the Governing Council's view, however, membership of ERM II should not be seen as merely a "waiting room" for the quickest possible introduction of the euro but rather as an independent integration stage which can help to further the convergence process. The length of participation in the ERM should therefore be guided not by the minimum period of two years required by the treaty, but rather by the ability to fulfil the convergence requirements on a sustainable basis.

According to the Treaty, new member states must adopt the euro as soon as they meet the convergence criteria – particulary those relating to price stability, the sustainability of the government financial position, the convergence of interest rates and exchange rate stability – on a sustainable basis.[3] In addition to these criteria, the corresponding reports assessing the durability of the convergence achieved also take into account "…, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices" pursuant to the provisions of Article 121 of the EC Treaty. The convergence assessments are carried out according to the principle of equal treatment. Consequently, a relaxation or tightening of the criteria for the new member states is out of the question. With regard to the exchange rate criterion, this means that, prior to the convergence assessment, a member state must have participated in the ERM for a period

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1 The policy position is available in full along with a corresponding press release on the ECB's website (http://www.ecb.int).

2 In a currency board, a currency's exchange rate is pegged to an anchor currency and, at the same time, all of the money in circulation is backed by foreign reserves.

3 Legal convergence is still required pursuant to Article 109 of the EC Treaty. In particular, the corresponding central bank laws and statutes must guarantee the independence of the central bank in question.

of at least two years without a downward realignment of the central rate or severe tensions. The assessment of exchange rate stability will focus – as in the past – on the question of whether the exchange rate has been close to the central rate without any tension. The chosen width of the fluctuation band is irrelevant in this respect.

Shortly after accession to the EU in 2004, Estonia, Lithuania and Slovenia applied for membership of ERM II. They joined with effect from 28 June 2004. The standard fluctuation band of ±15% was applied. Estonia and Lithuania retained their existing currency board arrangements pegging their currencies to the euro. At the same time, upon the new member states joining ERM II, differentiated, country-specific unilateral commitments with regard to consolidating convergence were made. These are aimed, in particular, at further fiscal consolidation and structural reforms as well as at containing inflationary and current account risks.

On 2 May 2005, Latvia, Malta and Cyprus also became members of ERM II with a standard fluctuation band of ±15%. Latvia and Malta entered into a unilateral commitment to restrict the fluctuation margin to ±1% (Latvia) and ±0% (Malta). Upon accession to ERM II, Latvia, Malta and Cyprus also made differentiated, country-specific unilateral commitments to fiscal consolidation and structural reforms.

On 28 November 2005, Slovakia also joined ERM II with a standard fluctuation band of ±15%.

These new member states' membership of ERM II has also been free of tension so far. Interventions have therefore remained within relatively tight bounds. The central rate of the Slovak koruna was raised by 8.5% in March 2007.

In terms of the further monetary policy integration of these member states, it is important that they resolutely implement the agreed unilateral commitments regarding economic policy.

At the beginning of January 2007, Slovenia became the first member state that had acceded to the EU in 2004 to introduce the euro (thus leaving ERM II). Malta and Cyprus followed at the start of 2008.

Participants in the exchange rate mechanism II (ERM II)

Table 4

Country and currency	ERM II entry	Arrangement	Central rate 1 EUR =	Intervention rates 1 EUR =	Key unilateral commitments
Denmark Danish krone (DKK)	1 January 1999	– Fluctuation band of ±2.25%	7.46038 DKK	Upper: 7.62824 DKK Lower: 7.29252 DKK	–
Estonia Estonian kroon (EEK)	28 June 2004	– Retention of currency board arrangement pegging currency to the euro[1] – Standard fluctuation band of ±15%	15.6466 EEK	Upper: 17.9936 EEK Lower: 13.2996 EEK	– Continuation of the consolidation and convergence process and implementation of structural reforms – Limitation of domestic credit growth and commitment to effective financial market supervision to reduce external debt – Moderate wage policy
Latvia Latvian lats (LVL)	2 May 2005	– Pegged to the euro since 1 January 2005 – Standard fluctuation band of ±15%	0.702804 LVL	Upper: 0.808225 LVL Lower: 0.597383 LVL	– Latvia has made a unilateral commitment to restrict the fluctuation band to ±1% – Continuation of the consolidation and convergence process and implementation of structural reforms – Sustainable cut in inflation and substantial reduction in the current account deficit – Limitation of domestic credit growth and commitment to effective financial market supervision to reduce risks in the financial industry

1 Currency’s exchange rate is pegged to the euro without any room for fluctuation.

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Participants in the exchange rate mechanism II (ERM II) (continued)

Table 4a

Country and currency	ERM II entry	Arrangement	Central rate 1 EUR =	Intervention rates 1 EUR =	Key unilateral commitments
Lithuania Lithuanian litas (LTL)	28 June 2004	– Retention of currency board arrangement pegging currency to the euro[1] – Standard fluctuation band of ±15%	3.45280 LTL	Upper: 3.97072 LTL Lower: 2.93488 LTL	– Continuation of the consolidation and convergence process and implementation of structural reforms – Limitation of domestic credit growth and commitment to effective financial market supervision to ensure a sustainable current account – Balanced budgetary position in the medium term
Slovakia Slovak koruna (SKK)	28 November 2005	– Standard fluctuation band of ±15 %	35.4424 SKK	Upper: 40.7588 SKK Lower: 30.1260 SKK	– Slovakia has made a commitment to keep wage development in line with productivity developments – to pursue a sound fiscal policy – to be vigilant to risks resulting from strong credit growth

1 Currency's exchange rate is pegged to the euro without any room for fluctuation.

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