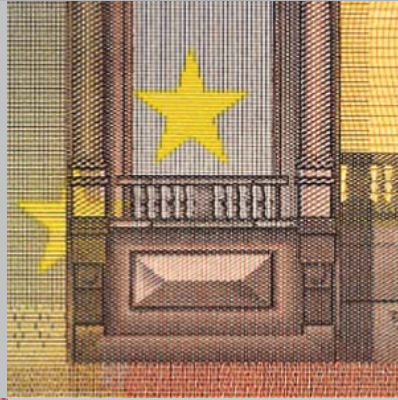
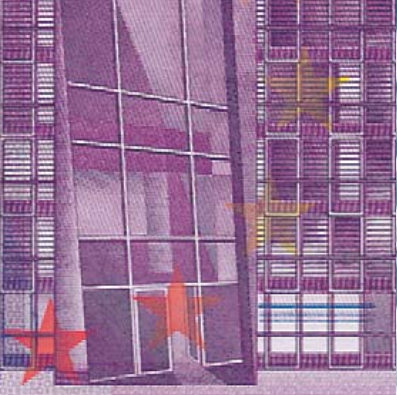




EUROPEAN CENTRAL BANK



THE EUROPEAN CENTRAL BANK  
THE EUROSISTEM  
THE EUROPEAN SYSTEM  
OF CENTRAL BANKS



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# FOREWORD



When speaking of a "central bank", the first idea which probably comes to mind is that it is the institution that issues money. And money is the instrument we use as a unit of account, a means of payment and a store of value. Granted, the key objective of any central bank is to ensure that the value of money is preserved over time. But there are many other lesser-known aspects of modern central banking. One of them is communication. A central bank should not only do what it says it does but also explain what it is doing, thereby increasing the public's awareness and knowledge of the policies and services it provides.

This brochure forms part of our communication on the activities of the European Central Bank (ECB) at the heart of the European System of Central Banks (ESCB), along with the national central banks of the 25 European Union Member States. Since not all Member States have adopted the euro as their currency, the term Eurosystem is used to describe the entity composed of the ECB and the national central banks of those Member States that have adopted the euro, currently 12. Most of the tasks conferred upon the ESCB by the Treaty on European Union are handled by the Eurosystem.

This brochure can also be downloaded from the ECB's website ([www.ecb.int](http://www.ecb.int)). The electronic version will be updated more frequently than the printed version.

I hope that you enjoy reading the brochure, whether in printed form or online.

Frankfurt am Main, April 2006

Jean-Claude Trichet  
President of the European Central Bank

# THE ROAD TO ECONOMIC AND MONETARY UNION



## ■ EUROPEAN INTEGRATION

The idea of establishing an economic and monetary union in Europe goes back more than half a century. It was a vision of the political leaders who, in 1952, founded the **European Coal and Steel Community (ECSC)** ■, which consisted of six countries – Belgium, Germany, France, Italy, Luxembourg and the Netherlands.

### Gradual expansion of the European Union

Further steps were taken towards European integration in the 1950s and thereafter. The same six countries established the **European Economic Community (EEC)** ■ and the European Atomic Energy Community (EURATOM) in 1958. This network of relationships strengthened and deepened over the years, becoming the European Communities (EC) and then, with the adoption of the Maastricht Treaty in 1993, the European Union (EU). The number of member countries increased too. Denmark, Ireland and the United Kingdom joined in 1973, followed by Greece eight years later. Portugal and Spain became members in 1986; Austria, Finland and Sweden joined in 1995. This expansion continued on 1 May 2004, when the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia became the latest members of the European Union.

### Criteria for accession to the EU

The conditions to be fulfilled before entering the EU are the **Copenhagen criteria** ■. These require the prospective members (i) to have stable institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities, and (ii) to have a functioning market economy as well as the capacity to cope with competitive pressure, in order to be able to take on the obligations of membership, including the aims of political, economic and monetary union.



■ see Glossary



## The road to Economic and Monetary Union

- 1.1 European integration
- 1.2 Economic integration
- 1.3 Convergence criteria
- 1.4 Key characteristics of the euro area

## 1.5 Benefits of the euro Milestones



### Structure and tasks



### Monetary policy



### The TARGET system



### Euro banknotes and coins



### Banking supervision



## ECONOMIC INTEGRATION

The first attempt to create an economic and monetary union was described in the Werner Report<sup>1</sup> of 1970, which envisaged three stages to be completed by 1980. However, these first plans for an economic and monetary union were never realised amid the considerable international currency unrest after the collapse of the Bretton Woods system in the early 1970s, and the international recession in the wake of the first oil crisis in 1973.

To counter this instability, the then nine Member States of the EEC created the **European Monetary System (EMS)** in 1979. Its main feature was the **exchange rate mechanism (ERM)**, which introduced fixed but adjustable exchange rates among the currencies of the nine countries.

In the second half of the 1980s the idea of an economic and monetary union was revived in the Single European Act of 1986, which created a single market. But it was realised that the full benefits of a single market could only be reaped with the introduction of a single currency for the participating countries. In 1988 the **European Council** instructed the **Delors Committee** to examine ways of realising **Economic and Monetary Union (EMU)**. The 1989 Delors Report led to the negotiations for the **Treaty on European Union**, which established the European Union (EU) and amended the Treaty establishing the European Community. It was signed in Maastricht in February 1992 (so it is sometimes called the Maastricht Treaty) and entered into force on 1 November 1993.

Progress towards EMU in Europe took place in three stages. Stage One (1990–1993) was characterised mainly by the full achievement of a single European market through the dismantling of all internal barriers to the free movement of persons, goods, capital and services within Europe.

Stage Two (1994–1998) started with the creation of the **European Monetary Institute**, and was dedicated to the technical preparations for the single currency, the avoidance of excessive deficits, and enhanced convergence of

<sup>1</sup> Named after Pierre Werner, then Prime Minister of Luxembourg.



## Maastricht Treaty signed in 1992

### Three stages towards EMU:

- I. Single European Market
- II. European Monetary Institute
- III. ECB and the euro

# THE ROAD TO ECONOMIC AND MONETARY UNION




the economic and monetary policies of the Member States (to ensure stability of prices and sound public finances). Stage Three began on 1 January 1999 with the irrevocable fixing of exchange rates, the transfer of monetary policy competence to the ECB and the introduction of the euro as the single currency. On 1 January 2002 euro banknotes and coins became legal tender in the participating countries and by the end of February 2002 national banknotes and coins ceased to be legal tender.

Stability-oriented economic policies and independent central banks

## 1.3 CONVERGENCE CRITERIA

Countries wishing to adopt the euro as their currency must achieve a high degree of “sustainable convergence”. The degree of convergence is assessed on the basis of several criteria in the Maastricht Treaty, which require a country to have:

- a high degree of **price stability** 
- sound public finances
- a stable exchange rate
- low and stable long-term interest rates.

The criteria are designed to ensure that only countries with stability-oriented economic policies and a track record in price stability are admitted to Stage Three of EMU. The Treaty also requires the central bank of the respective country to be independent (see Article 108 of the Treaty).

12 Member States have adopted the euro

In May 1998 an EU summit meeting in Brussels confirmed that 11 of the then 15 EU Member States – Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland – had met the criteria for the adoption of the single currency. On 1 January 1999 these countries adopted the euro as their common currency. Greece joined this group of countries on 1 January 2001 after fulfilling the criteria.



One member state, Sweden, did not fulfil all criteria. Moreover, Denmark and the United Kingdom are “Member States with a special status”. In protocols annexed to the Treaty establishing the European Community, the two countries were granted the right to choose whether or not to participate in Stage Three of EMU, i.e. to adopt the euro. They both made use of this so-called “opt-out clause” by notifying the **EU Council** [ ] that they do not intend for the time being to move to Stage Three, i.e. they do not yet wish to become part of the euro area.

The ten new Member States and Sweden count as members with a “derogation” since they have not yet met all the requirements to adopt the euro. Having a **derogation** [ ] means that a Member State is exempt from some, but not all, of the provisions which normally apply from the beginning of Stage Three of EMU. It includes all provisions which transfer responsibility for monetary policy to the **Governing Council** [ ] of the ECB.

Like Sweden, the ten new Member States of the EU have no “opt-out” clauses, such as those negotiated by the United Kingdom and Denmark.

This implies that, by joining the EU, the new Member States commit themselves to ultimately adopting the euro when they fulfil the **convergence criteria** [ ]. The ECB and the **European Commission** [ ] prepare reports every other year – or at the request of a Member State with a derogation – on progress made towards fulfilling the convergence criteria. These convergence reports also take account of other factors that might influence the integration of the country into the euro area economy. The reports provide the basis for the EU Council’s decision on whether to allow a new country to become part of the euro area.

**Two Member States have “opted out”**

**New EU Member States are committed to ultimately adopting the euro**

#### **4 KEY CHARACTERISTICS OF THE EURO AREA**

The individual countries that now comprise the euro area were relatively open economies before they joined the euro area. However, they are now part of a larger, much more self-contained economy. The size of the euro area makes it comparable with major economies such as the United States and Japan.

# THE ROAD TO ECONOMIC AND MONETARY UNION



One of the world's largest economies

The euro area is one of the largest economies in the world, with a population of 312 million in 2004. The European Union as a whole has 25 Member States and a population of 460 million. By comparison, the United States and Japan have 294 and 128 million inhabitants respectively.

In terms of **gross domestic product (GDP)** <sup>■</sup> expressed in **purchasing power parities** <sup>■</sup>, the United States was the largest economy in 2004, with 20.9% of world GDP, followed by the euro area with 15.3%. Japan's share was 6.9%. The shares of the individual euro area countries are significantly smaller: the largest accounted for 4.3% of world GDP in 2004.

Limited dependence on foreign trade

Although the euro area can be significantly affected by developments in the global economy, the fact that the euro area has a less open economy means that movements in prices of foreign goods have only a limited impact on domestic prices. However, it is more open than either the United States or Japan. Euro area exports of goods and services as a share of GDP were significantly higher in 2004 (19.4%) than the corresponding figures for the United States (9.8%) and Japan (13.6%).

A real single market for goods and services

## 1.5 BENEFITS OF THE EURO

With the establishment of **Economic and Monetary Union (EMU)** <sup>■</sup>, the EU has made an important step towards completing the internal market. Consumers and firms can now easily compare prices and find the most competitive suppliers in the euro area. Moreover, EMU is providing an environment of economic and monetary stability all over Europe which is favourable to sustainable growth and job creation, and the single currency has done away with disruptions caused by sharp movements in the exchange rates of the former national currencies.

The introduction of euro banknotes and coins on 1 January 2002 has made travelling simpler within the euro area. Prices for goods and services can be compared at a glance and payments can be made with the same money in all the countries.

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<sup>■</sup> see Glossary





With the birth of the euro, foreign exchange transaction costs and foreign exchange risks were eliminated within the euro area. In the past, these costs and risks hindered competition across borders. Increased competition makes it more likely that available resources will be used in the most efficient way. With a single currency, investment decisions are much easier, as fluctuations in the exchange rate can no longer influence the return on investment across national borders within the euro area.

### Foreign exchange risks and transaction costs eliminated

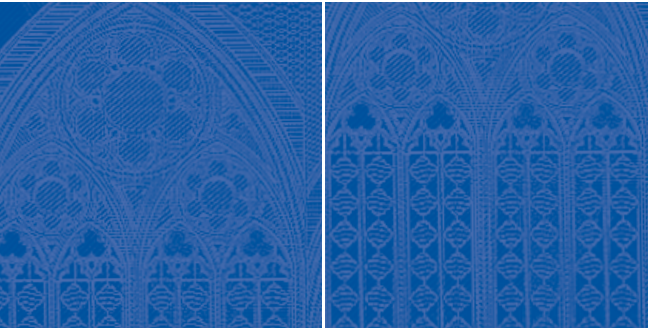
Before the introduction of the euro, financial markets were, as a rule, national in character. Financial instruments, such as government bonds and shares were denominated in national currencies. The launch of the euro was a major step towards the integration of the financial markets in the euro area. It will continue to influence the structure of the euro area economy. Evidence of integration can be found, to varying degrees, in all parts of the financial structure:

### Integration of financial markets

- The euro area's **interbank money market** is fully integrated.
- The euro-denominated **bond market** is well integrated, deep and liquid, and provides a wide choice of investments and funding.
- The euro area **equity market** is increasingly viewed as a single market.
- Domestic and cross-border mergers and acquisitions have increased among banks in the euro area.

The depth and quality of an integrated financial market facilitate the financing of economic growth and thereby the creation of jobs. People have a broader range of choices for their decisions on savings and investments. Companies can tap a very large capital market to finance their business and use new financial instruments to protect themselves against various financial risks and to enhance the management of their investments.

# MILESTONES



**1952**



European Coal and Steel Community (ECSC) is established by Belgium, Germany, France, Italy, Luxembourg and the Netherlands.

**1958**

Treaties of Rome enter into force; European Economic Community (EEC) and European Atomic Energy Community (EURATOM) are set up.

**1967**

Merger Treaty combines three existing Communities (ECSC, EEC, EURATOM).

**1970**



Werner Report, first "blueprint" for a monetary union, is presented.

**1973**

Denmark, Ireland and the United Kingdom join the European Communities (EC).

**1979**

Establishment of European Monetary System (EMS).

**1981**



Greece joins the European Communities.

**1986**

Spain and Portugal join EC.

**1987**



Single European Act enters into force, paving the way for the single market.

**1989**



Delors Committee presents report on Economic and Monetary Union.

## 1990

Start of Stage One of EMU.

## 1993

Treaty on European Union (Maastricht Treaty) enters into force.

## 1994



Start of Stage Two of EMU. European Monetary Institute (EMI) is established in Frankfurt am Main.

## 1995

Austria, Finland and Sweden join EU

## 1998

EMI is liquidated; European Central Bank is established in Frankfurt am Main

## 1999



Start of Stage Three of EMU with 11 participating countries; introduction of the euro as a single currency.

Amended Treaty on European Union (Treaty of Amsterdam) enters into force.

## 2001

Greece joins euro area as 12th country.

## 2002



Euro banknotes and coins are put into circulation.

## 2003

Amended Treaty on European Union (Treaty of Nice) enters into force.

## 2004



Ten more countries join EU on 1 May.

# STRUCTURE AND TASKS



## 2.1 THE EUROPEAN SYSTEM OF CENTRAL BANKS AND THE EUROSISTEM

The **European System of Central Banks (ESCB)** <sup>1</sup> was established in accordance with the Maastricht Treaty and the Statute of the European System of Central Banks and of the **European Central Bank** <sup>2</sup>. It comprises the European Central Bank (ECB) and the national central banks (NCBs) of all EU Member States.

The **Eurosistem** <sup>3</sup> comprises the ECB and the NCBs of the EU Member States which have adopted the euro (currently 12).

The ECB's decision-making bodies are the **Governing Council** <sup>4</sup> and the **Executive Board** <sup>5</sup>. The ECB's monetary policy decisions are taken by the Governing Council. The Executive Board implements the decisions and is responsible for the daily management of the ECB. The third decision-making body of the ECB is the **General Council** <sup>6</sup>, which will continue to exist as long as there are EU Member States which have not yet adopted the euro as their currency.

The ECB is a supra-national organisation

## 2.2 THE EUROPEAN CENTRAL BANK

The ECB was established in June 1998 in Frankfurt am Main, taking over from its predecessor, the European Monetary Institute (EMI). It is a supra-national institution with its own legal personality. In 2002 the ECB launched an international architectural competition for its future permanent headquarters, for which a site in the eastern part of Frankfurt has been acquired.

The staff of the ECB is truly European; its members come from all 25 countries of the European Union.

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<sup>1</sup> see Glossary



The road to Economic and Monetary Union



Structure and tasks

- 2.1 The European System of Central Banks and the Eurosystem
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- 2.4 Independence
- 2.5 National central banks
- 2.6 Decision-making bodies of the ECB
- 2.7 ESCB Committees



Monetary policy



The TARGET system



Euro banknotes and coins



Banking supervision



## 2.3 TASKS OF THE EUROSISTEM

The Eurosystem has four main tasks. The first task is to carry out the monetary policy adopted by the Governing Council of the ECB – e.g. decisions on the key ECB interest rates (the **minimum bid rate** on the **main refinancing operations** as well as interest rates on the **marginal lending facility** and the **deposit facility** and, where appropriate, decisions relating to monetary objectives and the supply of reserves). The Executive Board is responsible for implementing the monetary policy, a responsibility it exercises by giving instructions to the NCBs. For example, the Executive Board decides once a week on the allotment of liquidity to the banking sector via the main refinancing operations.

Governing Council decides on key interest rates

The second and third tasks of the Eurosystem are to conduct **foreign exchange operations** and to hold and manage the official reserves of the euro area countries.

Foreign reserve assets held by the ECB and by NCBs

The Eurosystem NCBs have transferred foreign reserve assets to the ECB totalling some €40 billion (85% in foreign currency holdings and 15% in gold). In exchange, the NCBs have received **interest-bearing claims** on the ECB, denominated in euro. Eurosystem NCBs are involved in the management of the ECB's foreign reserves: they act as agents for the ECB, in accordance with portfolio management guidelines set by the ECB. The remaining Eurosystem foreign reserve assets are owned and managed by the NCBs. Transactions in those reserve assets are regulated by the Eurosystem. In particular, transactions above certain thresholds require prior approval from the ECB.

A fourth main task of the Eurosystem is to promote the smooth operation of payment systems. Furthermore, the Eurosystem contributes to the conduct of financial supervision: it advises legislators in its field of competence and it compiles monetary and financial statistics.

The Treaty also specifies that the ECB has the exclusive right to authorise the issue of euro banknotes.

# STRUCTURE AND TASKS



## 2.4 INDEPENDENCE

When performing Eurosystem-related tasks, the ECB and the national central banks must not seek or take instructions from Community institutions or bodies, from any government of an EU country or from any other body. Likewise, the Community institutions and bodies and the governments of the Member States must not seek to influence the members of the decision-making bodies of the ECB or of the NCBs in the performance of their tasks.

### Personal independence

The Statute of the ESCB and of the ECB provides for security of tenure for governors of NCBs and members of the **Executive Board** <sup>(1)</sup> as follows:

- a minimum term of office for NCB governors of five years;
- a non-renewable term of office of eight years for members of the Executive Board of the ECB;
- removal of the Members of the Executive Board from office only in the event of incapacity or serious misconduct; in this respect the **Court of Justice of the European Communities** <sup>(2)</sup> is competent to settle any disputes.

### Functional independence

The Eurosystem is also functionally independent. The ECB and the NCBs have at their disposal all instruments and competencies necessary for the conduct of an efficient monetary policy and are authorised to decide autonomously how and when to use them.

The Eurosystem is prohibited from granting loans to Community bodies or national public sector entities, which further enhances its independence by shielding it from any influence exercised by public authorities. Moreover, the ECB's **Governing Council** <sup>(3)</sup> has the right to adopt binding regulations to carry out the tasks of the ESCB and in certain other cases, as laid down in specific acts of the **EU Council** <sup>(4)</sup>.

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<sup>(1)</sup> see Glossary

# 2



Nationale Bank van België / Banque Nationale de Belgique



Deutsche Bundesbank



Bank of Greece



Banco de España



Banque de France



Central Bank and Financial Services Authority of Ireland



Banca d'Italia



Banque centrale du Luxembourg



De Nederlandsche Bank



Oesterreichische Nationalbank



Banco de Portugal



Suomen Pankki  
Finlands Bank

# STRUCTURE AND TASKS



## 2.5 NATIONAL CENTRAL BANKS

The national central banks of the Eurosystem have a legal personality (under the law of their respective country) which is separate from that of the ECB. At the same time, they are an integral part of the Eurosystem, which is responsible for **price stability** in the euro area; they operate in line with the ECB's guidelines and instructions in the performance of the Eurosystem's tasks.

### NCBs carry out monetary policy operations

The NCBs are involved in conducting the single monetary policy of the euro area. They carry out monetary policy operations, such as providing central bank money to **credit institutions**, and they ensure settlement of cashless domestic and cross-border payments. Moreover, they undertake foreign reserve management operations on their own account and as agents for the ECB.

In addition, the NCBs are largely responsible for collecting national statistical data and for issuing and handling euro banknotes in their respective countries. The NCBs also perform functions outside the scope of the Statute, unless the Governing Council deems them to be incompatible with the objectives and tasks of the Eurosystem.

Under national laws, the NCBs can be assigned other functions that are not related to monetary policy functions: some NCBs are involved in banking supervision and/or act as the government's principal banker.

## 2.6 DECISION-MAKING BODIES OF THE ECB

### Governing Council meets every second Thursday

The Governing Council of the ECB comprises the members of the Executive Board of the ECB and the governors of the NCBs of the euro area countries. The Statute of the ESCB states that the Governing Council of the ECB must meet at least ten times a year. The dates of its meetings are decided by the Governing Council itself on the basis of a proposal from the Executive Board. Unless at least three governors object, meetings may also be held by

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teleconference. The Governing Council currently meets twice a month, usually on the first and third Thursday of each month. Monetary policy issues are normally discussed at the first meeting of the month only.

The President of the **EU Council** and a member of the **European Commission** may attend the meetings, although only the members of the **Governing Council** have the right to vote. Each member of the Governing Council has one vote and, except for decisions on the ECB's financial matters, the Governing Council takes its decisions by a simple majority. In the event of a tie, the President has the casting vote. As regards financial matters – for example, the subscription to the ECB's capital, the transfer of foreign exchange reserves, or the distribution of monetary income – the votes are weighted according to the NCBs' shares in the subscribed capital of the ECB.

The Treaty on European Union and the Statute of the ESCB and the ECB empower the Governing Council to take the most strategically significant decisions for the **Eurosystem**.

The main responsibilities of the Governing Council are:

- to formulate the monetary policy of the euro area; i.e. to take decisions on the level of the key ECB interest rates;
- to adopt the guidelines and take the decisions necessary to ensure the performance of the Eurosystem's tasks.

When taking decisions on monetary policy and other tasks of the Eurosystem, the Governing Council takes into account the developments in the euro area as a whole.

**Focus on the euro area**

The **Executive Board** comprises the President and the Vice-President of the ECB and four other members. They are appointed from among persons of recognised standing and professional experience in monetary and banking matters by common accord of the governments of the euro area at the level

**Executive Board meets every Tuesday**

# STRUCTURE AND TASKS



of the Heads of State or Government, on a recommendation from the **EU Council** <sup>1</sup> after it has consulted the **European Parliament** <sup>2</sup> and the Governing Council of the ECB. The Executive Board normally meets every Tuesday.

The President of the ECB or, in his absence, the Vice-President, chairs the meetings of the Governing Council, the Executive Board and the General Council of the ECB. The President is invited to the meetings of the **Eurogroup** <sup>3</sup>, the informal group of the euro area economics and finance ministers, and he may participate in EU Council meetings on topics relating to the objectives and tasks of the Eurosystem.

The main responsibilities of the Executive Board are:

- to prepare the meetings of the Governing Council;
- to implement monetary policy in the euro area in accordance with the guidelines and decisions laid down by the Governing Council and, in so doing, to give instructions to the NCBs;
- to manage the day-to-day business of the ECB;
- to exercise certain powers, including regulatory powers, delegated to it by the Governing Council.

**General Council meets four times every year**

The General Council comprises the President and the Vice-President of the ECB and the governors of the national central banks of all EU Member States. The other members of the Executive Board, the President of the EU Council and a member of the **European Commission** <sup>4</sup> may attend the meetings of the General Council but they do not have the right to vote. Meetings of the General Council may be convened whenever the President deems it necessary or at the request of at least three of its members. The General Council usually meets in Frankfurt once every three months.

The General Council has no responsibility for monetary policy decisions in the euro area. It has taken over tasks from the EMI which the ECB has to perform in Stage Three of EMU as long as some EU Member States have not adopted the euro. This implies that it is responsible primarily for reporting




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<sup>1</sup> see Glossary



on the progress made towards convergence by EU Member States which have not yet adopted the euro, and for giving advice on the preparations necessary for adopting the euro as their currency. It contributes to the advisory functions of the ESCB and helps to collect statistical information.

## 2.7 ESCB COMMITTEES

The decision-making bodies of the ECB are supported by ESCB Committees. These Committees are also important for intra-ESCB cooperation. They consist of members from the ECB and the national central banks (NCBs) of the **Eurosystem** , as well as from other competent bodies, such as national supervisory authorities in the case of the Banking Supervision Committee. The NCBs of the non-euro area countries have each appointed experts to take part in ESCB Committee meetings whenever a Committee is dealing with matters which fall within the field of competence of the General Council. The mandates of the Committees are laid down by the **Governing Council** , to which the Committees report via the **Executive Board** .

Expert committees support decision-making bodies

At present, the Committees are as follows: the Accounting and Monetary Income Committee, the Banking Supervision Committee, the Banknote Committee, the Eurosystem/ESCB Communications Committee, the Information Technology Committee, the Internal Auditors Committee, the International Relations Committee, the Legal Committee, the Market Operations Committee, the Monetary Policy Committee, the Payment and Settlement Systems Committee and the Statistics Committee.

In 1998 the Governing Council also established a Budget Committee, composed of members coming from the ECB and the Eurosystem NCBs. The Budget Committee assists the Governing Council in matters related to the ECB's budget.

Finally, in 2005 a Human Resources Conference was established, consisting of members from the ESCB. This Conference aims to further promote the cooperation and team spirit among Eurosystem/ESCB central banks in the field of human resources management.

# MONETARY POLICY



## 3.1 PRICE STABILITY

The primary objective of the **Eurosystem** is to maintain **price stability**. Without prejudice to the objective of price stability, the Eurosystem shall support the general economic policies of the European Community.

### Price stability is the top priority

Article 2 of the **Treaty** on European Union states that the European Union aims to promote “economic and social progress and a high level of employment and to achieve balanced and sustainable development”. The Eurosystem contributes to these objectives by maintaining price stability. In addition, in the pursuit of price stability, it takes these objectives into account. Should there be any conflict between the objectives, the maintenance of price stability must always be given priority by the ECB.

The Eurosystem acts in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

## 3.2 MONETARY POLICY STRATEGY OF THE ECB

The ECB must influence conditions in the money market, and thereby the level of short-term interest rates, in order to achieve price stability.

The ECB has adopted a strategy to ensure that a consistent and systematic approach is applied to monetary policy decisions. Consistency helps to stabilise **inflation** expectations and enhance the credibility of the ECB.

A main element of the ECB **Governing Council's** monetary policy strategy is its quantitative definition of **price stability**: “a year-on-year increase in the **Harmonised Index of Consumer Prices (HICP)** for the euro area of below 2%”. Price stability must be maintained over the medium term, which reflects the need for monetary policy to be forward-looking. In the pursuit of price stability, the ECB aims to maintain inflation rates below but close to

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2% over the medium term. This underlines its commitment to provide a sufficient safety margin to guard against the risks of **deflation** ☐.

Monetary policy needs to be forward-looking since there are significant lags in the **transmission mechanism** ☐ (see next section). In addition, monetary policy should anchor inflation expectations and help to reduce volatility in economic developments.

### Forward-looking monetary policy

In addition to the definition of price stability, the monetary policy strategy consists of a comprehensive assessment of the risks to price stability consisting of an economic analysis and a monetary analysis. Every decision on monetary policy is preceded by a thorough cross-checking of the information coming from the two analyses.

## 3.3 MONETARY POLICY INSTRUMENTS

The transmission mechanism of monetary policy starts with the central bank's management of liquidity and steering of short-term interest rates.

The money market, as part of the financial market, plays a crucial role in the transmission of monetary policy decisions, since it is the first market to be affected by changes in monetary policy. A deep and integrated money market is essential for an efficient monetary policy, since it ensures an even distribution of central bank liquidity and a homogeneous level of short-term interest rates throughout the single currency area. This precondition was met almost immediately from the start of Stage Three of EMU when the national money markets were successfully integrated into an efficient euro area money market.


### Money market is the first to be affected

To steer short-term interest rates, the Eurosystem has at its disposal a set of monetary policy instruments, namely open market operations, standing facilities and reserve requirements.

# MONETARY POLICY






Open market operations can be divided into:



- **main refinancing operations** ; these are regular liquidity-providing transactions with a frequency and maturity of one week;
- longer-term refinancing operations; these are liquidity-providing transactions with a monthly frequency and a maturity of three months;
- fine-tuning operations; these can be executed on an ad hoc basis to manage the liquidity situation in the market and to steer interest rates. In particular, they aim to smooth the effects on interest rates of unexpected liquidity imbalances; and
- structural operations can be carried out by the Eurosystem through reverse transactions, outright transactions and issuance of debt certificates.

## Standing facilities

The Eurosystem also offers two standing facilities, which set boundaries for overnight market interest rates by providing and absorbing liquidity:

- the marginal lending facility, which allows **credit institutions**  to obtain overnight liquidity from the national central banks against eligible assets; and
- the **deposit facility** , which can be used by **credit institutions**  to make overnight deposits with the national central banks in the Eurosystem.

## Minimum reserve requirements

Finally, the Eurosystem requires **credit institutions**  to hold minimum reserves in accounts with the national central banks. Each **credit institution**  must keep a certain percentage of some of its own customer deposits (as well as of some other bank liabilities) in a deposit account with the relevant national central bank on average over a reserve maintenance period of around one month. The Eurosystem pays a short-term interest rate on these accounts. The purpose of the minimum reserve system is to stabilise money market interest rates and create (or enlarge) a structural liquidity deficit in the banking system.

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 see Glossary



### 3.4 COMMUNICATION

Efficient external communication is an essential part of a central bank's job. Communication contributes to the effectiveness and credibility of monetary policy. In order to increase the public's understanding of monetary policy and other central bank activities, the ECB must be open and transparent. This is the main guiding principle for the Eurosystem in its external communication, which involves close cooperation between the ECB and the NCBs.

To make its communication effective, the ECB and the NCBs use many different tools. The most important are:

- regular press conferences after the first Governing Council meeting in each month;
- publication of a Monthly Bulletin containing a detailed description of economic developments in the euro area and articles on topics relevant to the ECB's activities;
- public hearings of the ECB's President and other members of the ECB's **Executive Board** in the **European Parliament**;
- speeches and interviews given by members of the ECB's decision-making bodies;
- press releases explaining the decisions and views of the Governing Council;
- the websites of the ECB and the NCBs, which give access to all published material, including a very large collection of statistical data;
- working papers;
- occasional papers.

# MONETARY POLICY




## 3.5 MONETARY AND FINANCIAL STATISTICS

The ECB compiles and publishes financial and monetary statistics in close cooperation with the NCBs. This statistical information supports the monetary policy of the euro area and the decision-making of the ECB.

### ECB compiles aggregates for the euro area

The NCBs (and, in some cases, other national authorities) collect data from financial institutions and other sources in their respective countries and calculate aggregates at the national level, which they send to the ECB. The ECB then compiles the aggregates for the euro area.

The legal basis for the development, collection, compilation and dissemination of statistics by the ECB is laid down in the Statute of the European System of Central Banks and of the **European Central Bank**  annexed to the Treaty. While ensuring that its statistical requirements are met, the ECB seeks to minimise the burden which statistical reporting places on financial institutions and other reporting agents.





Responsibility for statistics at the European level is shared between the ECB and the **European Commission**  (through Eurostat, the Statistical Office of the European Communities). The ECB is primarily or jointly responsible for euro area monetary, financial institutions and financial markets statistics, external statistics (including the balance of payments), financial accounts and the development of quarterly non-financial accounts for institutional sectors (households, corporations and government). Responsibility for the statistical infrastructure (including seasonal adjustment, the design of a quality framework and data transmission standards) at the European level is also shared between both institutions. Wherever possible, ESCB statistics conform to international standards.

# THE TARGET SYSTEM



Real-time gross settlement  
in euro

## 4 THE TARGET SYSTEM

**TARGET (Trans-European Automated Real-time Gross settlement Express Transfer)** is the RTGS system for the euro, provided by the **Eurosystem**. It is used for the settlement of central bank operations, large-value euro interbank transfers as well as other euro payments. It provides real-time processing, settlement in central bank money and immediate finality. It consists of national real-time gross settlement (RTGS) systems and the ECB payment mechanism (EPM), which are interconnected. TARGET is the RTGS system for the euro and has been in operation since the start of EMU in January 1999, and has a daily turnover of some €1,700 billion.

The system was developed:

- to provide a safe and reliable mechanism for the settlement of euro payments on an RTGS basis;
- to increase the efficiency of cross-border payments in euro; and, most importantly,
- to serve the needs of the monetary policy of the ECB and to promote the integration of the euro money market.

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TARGET is available for all transactions in euro between and within the euro area countries as well as several other EU Member States. It processes both interbank and customer payments. There is no upper or lower value limit for TARGET payments. EU Member States which have not yet adopted the euro have the possibility, but no obligation, to connect to TARGET. Under certain conditions, the system is also open to the banks of the EU Member States which have not yet adopted the euro.

The Eurosystem is currently building the next generation of TARGET, TARGET2. The new system is expected to go live in 2007 and will achieve even higher levels of safety and efficiency through a harmonised and centralised technical infrastructure. In TARGET2, all participating banks will be offered the same high-quality services, functionality and interfaces, as well as a single price structure.

# EURO BANKNOTES AND COINS



## 5.1 BANKNOTES

Euro banknotes were put into circulation on 1 January 2002. There are seven denominations, each with a different size: €5, €10, €20, €50, €100, €200 and €500.

The banknotes depict the architectural styles of seven periods in Europe's cultural history – classical, Romanesque, Gothic, Renaissance, baroque and rococo, the age of iron and glass architecture, and modern twentieth century architecture – and show three main architectural elements: windows, gateways and bridges. None of the designs depicts actual buildings or monuments.

The windows and gateways on the front of each banknote symbolise the spirit of openness and cooperation in Europe. The reverse of each banknote features a bridge. These bridges are used as a metaphor for communication between the nations of Europe and between Europe and the rest of the world.

A number of security features have been incorporated into the banknote designs to protect them against counterfeiting and enable people to recognise genuine banknotes. Special design features have also been included to help blind and partially sighted people.

Strict quality controls ensure that all banknotes produced are identical in quality and appearance. The banknotes do not have individual national designs.



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## 5.2 COINS

One euro is divided into 100 cent. There are eight euro coins: 1, 2, 5, 10, 20 and 50 cent, €1 and €2. The designs on one side of the coins are common to all the countries of the euro area, while the other side reflects national identities. Of course, all euro coins can be used in all euro area countries, irrespective of their national side.

The eight euro coins vary in size, weight, material, colour and thickness. Some additional innovative features have also been included to help users, particularly blind and partially sighted people, to recognise the different denominations. For instance, each consecutive coin in the series has a different edge. A detailed quality management system ensures that all euro coins are interchangeable throughout the euro area and conform to the standards necessary for their use in vending machines.

Particular care has been taken in the production of the higher-value euro coins (€1 and €2) to protect them against counterfeiting. Their sophisticated two-colour design makes them difficult to counterfeit, as does the lettering around the edge of the €2 coin.



# BANKING SUPERVISION



## 6. BANKING SUPERVISION

The direct responsibility for banking supervision and financial stability remains with the competent authorities in each EU Member State, but the **Treaty** <sup>1</sup> has assigned to the ESCB the task of “contributing to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of **credit institutions** <sup>2</sup> and the stability of the financial system”.

This task is mainly carried out in three ways.

### Monitoring financial stability

First, the ESCB monitors and assesses the financial stability at the euro area/EU level. This activity complements and supports the corresponding activity at the national level, carried out by the national central banks and supervisory authorities in order to maintain financial stability in their respective country.

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<sup>1</sup> see Glossary

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Second, the ESCB gives advice on the design and review of regulatory and supervisory requirements for financial institutions. Much of this advice is provided through the ECB's participation in the relevant international and European regulatory and supervisory bodies, such as the Basel Committee on Banking Supervision, the European Banking Committee and the Committee of European Banking Supervisors.

Third, the ECB promotes cooperation between central banks and supervisory authorities on issues of common interest (e.g. payment system oversight, financial crisis management).

These activities are carried out with the assistance of the Banking Supervision Committee (one of the ESCB committees mentioned in section 2.7), which brings together experts from the EU central banks and supervisory authorities.

# GLOSSARY

**Base money:** sometimes also called “high-powered money” or the “monetary base”. It comprises banknotes and coins outside central bank vaults plus credit institutions’ deposits with the central bank system.

**Bond market:** companies and governments issue bonds to raise capital for their investments. Bonds are interest-bearing securities either with a fixed interest rate or with a floating rate and with a maturity of at least one year (from the time of issuance). Fixed-interest rate bonds make up the largest share of the bond market.

**Central bank:** an institution which – by way of a legal act – has been given responsibility for conducting the monetary policy for a specific area.

**Convergence criteria:** four criteria must be met by each EU Member State before it can adopt the euro: a stable price level, sound public finances (a limited deficit against GDP and a limited level of debt against GDP), a stable exchange rate and low and stable long-term interest rates.

**Copenhagen criteria (accession criteria):** countries wanting to join the EU must fulfil several criteria: political criteria (stable institutions guaranteeing democracy, the rule of law, human rights and respect for minorities), economic criteria (a functioning market economy), and incorporation of the *acquis communautaire* (the EU’s body of law). They were set by the Copenhagen European Council in June 1993 and confirmed by the Madrid European Council in December 1995.

**Court of Justice of the European Communities (CJEC):** this institution ensures that the law is observed in the interpretation and application of the Treaties and of the legal acts laid down by the European institutions.

**Credit institution:** Banks and savings banks are the commonest types of credit institutions. According to Article 1(1) of Directive 2000/12/EC, a credit institution is “(i) an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account; or (ii) an undertaking or any other legal person, other than those under (i), which issues means of payment in the form of electronic money. “Electronic money” shall mean monetary value, as represented by a claim on the issuer, which is: (a) stored on an electronic device; (b) issued on receipt of funds of an amount not lower in value than the monetary value issued; and (c) accepted as a means of payment by undertakings other than the issuer.

**Deflation:** a process in which the general price level falls continuously over a sustained period of time.

**Delors Committee:** In June 1988 the European Council mandated a committee chaired by Jacques Delors, the then President of the European Commission, to study and propose concrete stages leading to economic and monetary union. The committee was composed of the governors of the then European Community (EC) national central banks; Alexandre Lamfalussy, the then General Manager of the Bank for International Settlements (BIS); Niels Thygesen, professor of economics, Denmark; and Miguel Boyer, the then President of the Banco Exterior de España. The resulting Delors Report proposed that economic and monetary union should be achieved in three stages.

**Deposit facility:** a standing facility of the Eurosystem which counterparties may use to make overnight deposits, remunerated at a pre-specified interest rate, at an NCB.

**Derogation:** According to Article 122 of the EC Treaty, Member States with a derogation are the ones which are preparing to adopt, but have not yet adopted, the euro. This status refers to 11 Member States (Sweden and the new Member States): rights and obligations relating to the introduction of the euro as a single currency are not applicable to them. The case of Denmark and the United Kingdom is different: they have an exemption from participating in the third stage of Economic and Monetary Union.

**ECOFIN:** see EU Council

**Economic and Monetary Union (EMU):** the process which leads EU Member States to harmonise their economic and monetary policies and to create a single currency. The Maastricht Treaty provided for EMU to be achieved in three stages: in the first stage (1 July 1990 to 31 December 1993), Member States established the free movement of capital between their respective territories, with closer coordination of economic policies and closer cooperation between central banks; the second stage (1 January 1994 to 31 December 1998) started with the creation of the European Monetary Institute, and was dedicated to technical preparations for the creation of the single currency, the avoidance of excessive deficits, and enhanced convergence of the economic and monetary policies of the Member States (to ensure stability of prices and sound public finances); and the third stage (from 1 January 1999) began with the irrevocable fixing of exchange rates, the transfer of monetary policy competence to the ECB and the introduction of the euro as the single currency.

**ERM II:** see Exchange Rate Mechanism II.

**Equity market:** the market for shares in companies listed on a stock exchange. Equities are normally considered more risky investments than bonds, since the holders of equities are entitled to receive a dividend from the issuing companies, while bond holders are entitled to an interest payment independent of the companies’ profits.

**EU Council (Council of Ministers):** an institution of the European Community made up of representatives of the governments of the Member States, normally the ministers responsible for the matters under consideration (therefore often referred to as the Council of Ministers). The EU Council meeting in the composition of the ministers of economy and finance is often referred to as the ECOFIN Council. In addition, for decisions of particular importance, the EU Council meets in the composition of the Heads of State or Government. This should not be confused with the European Council, which also brings together the Heads of State or Government but which provides the Union with the necessary impetus for its development and defines the general political guidelines.

**Eurogroup:** an informal gathering of the ministers of economics and finance of the euro area member countries. The ministers discuss issues connected with their shared responsibilities in respect of the single currency. The European Commission and the ECB are invited to take part in the meetings. The Eurogroup usually meets immediately before an ECOFIN meeting.

**European Central Bank (ECB):** established on 1 June 1998 and based in Frankfurt am Main, the ECB, together with the national central banks of the euro area, defines and implements the monetary policy of the countries participating in the euro area.

**European Coal and Steel Community (ECSC):** One of the European Communities, the ECSC was created in 1951 in Paris, and established a common market for coal and steel between the six founder Member States (Belgium, France, Germany, Italy, Luxembourg and the Netherlands).

**European Commission:** One of the five European institutions, the European Commission was created in 1967 for the three European Communities. It drafts proposals for new European laws, which it presents to the European Parliament and the Council. The Commission makes sure that EU decisions are properly implemented and supervises the way EU funds are spent. It also monitors compliance with the



European treaties and Community law. As the guardian of the Treaties, it ensures, together with the Court of Justice of the European Communities, that the legislation applying to all EU Member States is properly implemented. At the moment, the Commission consists of a president and 24 commissioners. Its departments, called Directorates General, are responsible for the implementation of common policies and general administration in a specific area. It represents the general interest of the EU and is independent of the Member States. The Commission is appointed for a five-year term, but it can be dismissed by Parliament.

**European Council:** provides the European Union with the necessary impetus for its development and defines the general political guidelines thereof. It brings together the Heads of State or Government of the Member States and the President of the European Commission (see also EU Council).

**European Economic Community (EEC):** established in 1957 by the Treaty of Rome, the EEC was a step towards economic integration, i.e. the free movement of persons, goods, capital and services between EU Member States.

**European Monetary Institute (EMI):** a European body responsible for preparing the final stage of Economic and Monetary Union. It was created on 1 January 1994 and was replaced by the ECB on 1 June 1998.

**European Monetary System (EMS):** before the euro was introduced a number of currencies of EU Member States were linked together in the EMS, which existed from 1979 until 1999. It had three main components: the ECU, which was a basket of the currencies of the Member States; the exchange-rate and intervention mechanisms, which gave each currency a central exchange rate linked to the ECU (bilateral exchange rate), and the credit mechanisms, which allowed central banks to intervene if bilateral exchange rates exceeded a threshold. On 1 January 1999 the EMS was replaced by the Exchange Rate Mechanism II.

**European Parliament:** This European institution consists of 732 directly elected representatives of the citizens of the EU Member States. Although it mainly has consultative powers, it also shares budgetary powers with the EU Council in voting on the annual budget. It is also associated with the EU Council in the making of European laws and controls the European Commission.

**European System of Central Banks (ESCB):** consists of the European Central Bank and the national central banks of all EU Member States.

**Eurosystem:** comprises the European Central Bank and the national central banks of the euro area member countries. It defines and implements the monetary policy of the euro area.

**Exchange Rate Mechanism II (ERM II):** the framework for exchange rate policy cooperation between the euro area countries and those outside the euro area. Membership of the mechanism is voluntary. Nevertheless, Member States with a derogation are expected to join the mechanism, thereby establishing a central parity of their currency against the euro and a fluctuation band around the central parity. The standard fluctuation band is  $\pm 15\%$ . In the case of countries with a very high level of convergence with the euro area, a narrower band can be agreed on at the request of the non-euro area Member State concerned.

**Executive Board:** one of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and four other members appointed by common accord by the Heads of State or Government of the countries that have adopted the euro.

**Financial intermediary:** a company or an institution which serves as an interface between borrowers and lenders, for example, by collecting deposits from the public and making loans to households and businesses.

**Foreign exchange operations:** the buying or selling of foreign exchange. In the context of the Eurosystem, this means buying or selling other currencies against the euro.

**General Council:** one of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and the governors of the national central banks of all EU Member States.

**Governing Council:** the supreme decision-making body of the ECB. It comprises the six members of the ECB's Executive Board and the governors of the national central banks of the EU Member States which have adopted the euro.

**Gross Domestic Product (GDP):** a measure of economic activity. GDP represents the value of all the goods and services produced by an economy over a specified period.

**Harmonised Index of Consumer Prices (HICP):** the measure of prices used by the Governing Council to assess price stability in the euro area. It is calculated and published by Eurostat, the Statistical Office of the European Communities.

**Inflation:** a persistent increase in the general price level, leading to a persistent fall in the purchasing power of money. It is usually expressed as an annual percentage change in a consumer price index such as the HICP.

**Interbank money market:** the market for short-term loans between banks. The term usually describes the trading of funds with a maturity of between one day (overnight or even less than one day) and one year.

**Interest-bearing claim:** a financial asset which entitles its owner to receive interest payments from the debtor who issued it.

**Longer-term interest rates:** interest rates or yields on interest-bearing financial assets with a relatively long time to maturity. Often the yields on government bonds with 10 years to maturity are used as a benchmark for longer-term interest rates.

**Main refinancing operations:** regular open market operations executed by the Eurosystem in order to provide the banking system with the appropriate amount of liquidity. They take the form of weekly auctions in which the banks can bid for liquidity.

**Marginal lending facility:** a standing facility of the Eurosystem which counterparties may use to receive overnight credit from an NCB at a pre-specified interest rate against eligible assets.

**Minimum bid rate:** the minimum bid rate in the main refinancing operations. It is determined by the Governing Council, normally at the first meeting of each month.

**Minimum reserve requirement:** the obligation for credit institutions to keep a deposit with the central bank. The minimum reserve requirement for an individual institution is calculated as a percentage of the money deposited by the (non-bank) customers of this institution.

**Monetary aggregate (e.g. M1, M2, M3):** banknotes and coins plus certain liabilities of financial institutions (deposits and short-term securities) that have a high degree of liquidity and are held by non-banks resident in the euro area. M1 is a subset of M2 which is a subset of M3.

# GLOSSARY

**Price stability:** primary objective of the Eurosystem. The Governing Council defined price stability as a year-on-year increase in consumer prices (measured by HICP) for the euro area of below 2%. In the pursuit of price stability the Governing Council aims to maintain inflation rates below but close to 2% over the medium term.

**Purchasing power parities (PPPs):** Purchasing power parities (PPPs) are the rates of currency conversion that equalise the purchasing power of different currencies by eliminating the differences in price levels between countries. In their simplest form, PPPs show the ratio of the prices in national currencies of the same good or service in different countries.

**Standing facility:** a central bank facility available to credit institutions on their own initiative. The Eurosystem offers two standing facilities, the marginal lending facility and the deposit facility.

**TARGET (Trans-European Automated Real-time Gross settlement Express Transfer system):** A payment system consisting of 15 national real-time gross settlement (RTGS) systems and the ECB payment mechanism (EPM). RTGS systems enable payments to be processed on an order-by-order basis in real time. TARGET is unique in its coverage, with almost 1,100 direct participants and more than 48,000 banks – including branches and subsidiaries – accessible through the system.

**Transmission mechanism:** the process in which changes in interest rates through various channels influence the behaviour of economic agents, economic activity and ultimately the general price level.

**Treaty:** refers to the Treaty establishing the European Community. The original Treaty was signed in Rome on 25 March 1957 and entered into force on 1 January 1958. It established the European Economic Community (EEC), which is now the European Community (EC), and is often referred to as the "Treaty of Rome". The Treaty on European Union (which is often referred to as the "Maastricht Treaty") was signed on 7 February 1992 and entered into force on 1 November 1993. The Treaty on European Union amended the Treaty establishing the European Community and established the European Union. The "Treaty of Amsterdam", which was signed in Amsterdam on 2 October 1997 and entered into force on 1 May 1999, and most recently the "Treaty of Nice", which was signed on 26 February 2001 and entered into force on 1 February 2003, amended both the Treaty establishing the European Community and the Treaty on European Union.

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