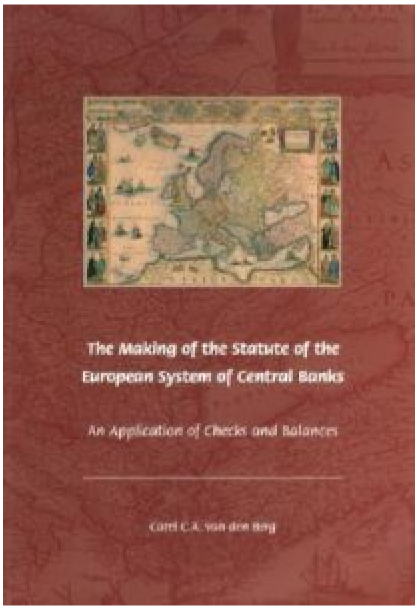
The Making Of The Statute Of The European System Of Central Banks ~ Cluster II - Chapter 6: Introduction To Cluster II



Checks and balances between the ECB and the NCBs (the relations *within* the System)

Chapter 6: Introduction to Cluster II
In this cluster we focus our attention on the issue of checks and balances *within* the System. At an early stage major players expressed their preference for a federally construed central bank system; cf. Werner Report of 1971; Balladur's Memorandum of December 1987; Stoltenberg's reaction to Genscher's memorandum of February 1988; Pöhl's contribution to the Delors Report and the Delors Report itself.

The Werner Report mentions that 'the constitution of the Community system for the central banks could be based on organisms of the type of the Federal Reserve System operating in the United States.' Stoltenberg stressed the need for an 'ausgewogenes Verhältnis von zentralen und föderativen Elementen bei der Willensbildung.' Pöhl advocated a federal structure of the central bank system, which 'would correspond best to the existing state of national sovereignty and would additionally strengthen the independence of the central bank.' The Delors Report (par. 32) favoured '[a] federative structure, since this would correspond best to the political diversity of the Community.'

It is not surprising that the federal character of the new European central bank was relatively undisputed. Apparently, a centralized structure with no regional elements, i.e. consisting only of an ECB, was seen as an unacceptable risk to those Member States with a tradition of independent central banks and price stability. There would be no guarantee that such institution would not be taken over by politically appointed board members, whereas in a federal European central bank system power would at least partially rest with the governors of the NCBs.

The issue of a federative structure raises the question of the relative roles of the centre and the existing NCBs and the division of labour between them. A major element in this respect has been the conviction, especially expressed from the German side, that monetary should be completely centralized, though the decision-making centre should be composed of persons both from the centre and the regions, thus upholding the federal character. This relates in particular to the issue of the relative roles of the Executive Board and the governors in the decision-making process, which is dealt with in cluster III. Monetary policy making being centralized still leaves undecided the division of labour between the centre and the regions in the area of monetary policy operations, the focus of this chapter.

The division of labour in the operational area relates to mundane questions such as who issues and distributes banknotes, to what extent are NCBs free to conduct non-System functions, what would the ECB's balance sheet consist of, would it own foreign reserves and would it be allowed to deal directly with banks – many of these issues relating to the 'standing of the centre'. The division of labour issue played against the following background, best explained by confronting the German and French views as they came to the fore in especially the Committee of Governors meetings during the drafting of the ESCB Statute.

Throughout the negotiations within the Committee of Governors the German governor *Karl-Otto Pöhl* favoured a strong centre. Three arguments played a role. First, Germany had reasons to fear that national governments would try to influence the new central bank system, because not all countries had the same tradition of central bank independence. The best guarantee against outside political pressure would be a clearly visible and independent decision-making centre, which would be more than a token institution. Second, the example of the Bundesbank showed that a system could have a strong centre, while still being regarded as a federally organized system, one important federal element being that the presidents of the Landeszentralbanken each had a vote in the central decision-making body. Third, at occasions Pöhl had really been annoyed by the reluctance of the Landeszentralbankpresidents to vote along with the Direktorium. Pöhl may also have assumed at an early stage that the new central bank would be located in Germany anyhow.

Pöhl's Alternate, Hans *Tietmeyer*, shared Pöhl's inclination for a strong centre. Tietmeyer was especially focussed on ensuring the indivisibility of the system's monetary policy. At an early stage of the discussions Tietmeyer had objected to the recommendation of the central banks' legal experts group to substitute in the draft Statute the word 'System' by 'ECB and/or NCBs' in those cases wherever reference was made to decisions, advisory functions and operations; Tietmeyer preferred to present the system *unisono*. However, the experts' advice prevailed, as they argued that the functions referred to could only be attributed to entities with legal personality, with which the System would not be endowed.[1] Tietmeyer's position was softened, to the extent that NCBs took it for granted that they would only operate under the precise instruction of the centre, though until the end Tietmeyer would keep a preference for the centre (the Executive Board), and not the Governing Council, deciding on the degree of decentralization.

On the other side of the spectrum operated *de Larosière*, the governor of the Banque de France. He referred to the idea of *subsidiarity*, i.e. the idea that competences should be laid at the lowest possible level which still allows for effective policy-making. De Larosière borrowed this idea in order to support his point that the execution of monetary policy should take place at low levels in the organization, i.e. by the NCBs.[2] In fact, his line of reasoning was supported by most, though not all, governors as we will see when dealing with Article 12.1c.

Views of the respective committees

As regards the relative role of the NCBs, the *Delors Committee* had recommended that an ESCB should be based on a federal structure, that the governors of the central banks would be members of the ESCB Council, together with the members of the executive board, and that the NCBs 'would execute operations in accordance with the decisions taken by the ESCB Council.' [3] At an early stage therefore the choice was made for centralized decision-making and decentralized operations.[4] The *Committee of Governors*, when it started drafting the ESCB Statute, while taking this as the starting point, saw the exact degree of division of labour between the ECB and the NCBs as one of the problems it had to solve. In his capacity as chairman of the Committee of Governors Pöhl presented the issue in the following neutral fashion to the informal Ecofin on 8 September 1990: ‘the System must have a strong centralised structure and organization, with monetary policy decisions being placed firmly in the hands of central decision-making bodies. However, this necessary centralization does not mean that there is not some room for a division of labour. NCBs will have their role to play in the application of the common monetary policy. However, the discussion about the scope for decentralization, which will have to be limited in any case, has not yet been concluded; it involves difficult technical issues. [....] there can be no doubt that all operational measures must be implemented strictly in accordance with instructions from the decision-making bodies. To what extent the practical execution of open-market purchases and sales of assets, rediscounting or operations on the foreign exchange market need actually be carried out from the centre or could be left to the NCBs will in good part depend on technical or market considerations which may well change over time. Irrespective of the precise form of the balance-sheet structure of the System, it must be understood that in the field of monetary policy, NCBs can act only as the operational arm of the System. In areas which are not linked to monetary policy operations, the NCBs may still have a responsibility of their own, for instance, in settling payments, performing prudential tasks, assessing risks or carrying out business on behalf of government institutions.’ The governors finished a preliminary draft of the ESCB Statute containing the most important articles on 27 November 1990, though they had not solved the issue of decentralization.

The draft ESCB Statute was sent to the *IGC* before its start in December 1990.[5] In an accompanying letter the governors asked the IGC to decide on two relevant issues in this context, on which they had not been able to agree and which were still left open in the draft Statute: (1) the question of the precise division of decision-making responsibilities between the decision-making bodies (the Executive Board and the ESCB Council) and (2) the question of how strong the bias should be for the System to make use of the NCBs for the execution of its operations.[6] In both cases Germany was standing almost completely alone, supporting independent (and not only delegated) tasks for the Executive Board, placing responsibility for the execution of monetary policy in the hands of the

Executive Board. In doing so, the Executive Board should make use of the NCBs to the extent possible and appropriate. The Germans opposed the alternative, which mentioned that 'to the full extent possible in the judgment of the Council the NCBs shall execute the operations arising out of the System's tasks').

The IGC would decide to give the Executive Board powers of its own, and not only delegated powers[7] and it would take a middle ground on the second issue by placing the decision on the extent to which NCBs should be used in the implementation of monetary policy in the hands of the Governing Council, with a strong, but not the strongest possible, bias towards using NCBs. Formally, this decision is placed in hands of the 'ECB'. However, such a fundamental issue would not seem to fall under 'current business' of the Executive Board, and to the extent that it could be seen as part of the 'implementation' of monetary policy, the Executive Board has to operate 'in accordance with the guidelines and decisions of the Governing Council.'

The purpose of this part of our study is to find which balance between the ECB and the NCBs the founding fathers had in mind, when they drafted the ESCB Statute, and for which reasons. We will also look into the actual division of labour as specified by the Governing Council in 1998, basing themselves inter alia on Art. 12.1, third paragraph, to prepare for the start of the ESCB in 1999. As in Cluster I, we will approach these questions by studying the genesis of the relevant articles of the ESCB Statute.[8]

Different degrees of centralization

We will focus on those articles relating to the internal structure of the ESCB which are relevant for assessing the *balance of power* between the ECB and the NCBs. While it is clear that all elements of the system have to cooperate for the system to be effective and successful, this can be achieved at different degrees of centralization at the operational level. One example of relatively strong centralization would be the *Bundesbank*, where the centre (Board of Directors) is explicitly charged with all open-market operations, foreign exchange transactions and transactions with the Federal government; the Landeszentralbanken conclude transactions with state authorities and credit institutions to the extent they do not fall under the authority of the Board; the Bundesbank has one balance-sheet, because the Landeszentralbanken are branches (administrations) of the Bundesbank. [9] At the other end of the spectrum is the *United States*, where the centre does not have operational capabilities at all. It should be added though that the United States is specific in the sense that all open-market and foreign-exchange operations are conducted by one reserve bank, namely New York. Therefore, it seems that within a federally organized central bank system different degrees of centralization are possible and effective. But even then, within each type of solution there might be an underlying tendency towards more (or less) centralization. We will draw conclusions in this regard with respect to the Federal Reserve in chapter 8.2.4.

Federal Reserve
Because of its relevance for our study we will give in this introduction some background information on the Federal Reserve and its origins, focussing on the division of labour between the centre and the regional Federal Reserve Banks. This will help us better understand the different ways in which the *checks and balances* in a federally organized central bank system can be designed and how such a system might develop. In the United States a federal central bank system was enacted in 1913. The following arguments in favour of a decentralised system had played a role: a general dislike among Congress of any concentration of economic power[10] and the fear that a dominant centre would especially protect the interests of the financial sector which was concentrated in the East, without an eye to the economic needs of the other parts of the country. At the same time there was the traditional reluctance to transfer too much power to the government. During the debate on the FRA there were coinciding forces against a powerful centre: bankers feared a politically run centre, the regions feared a centre dominated by bankers (read New York). Almost everybody had a reason to be against a strong centre.

Indeed, the outcome was a system with a (typically American) federal structure. Or as H. *Parker Willis* (first secretary of the Board) wrote in 1915: “The new act … generally diffuses control instead of centralizing it.” There would not be one central bank for all America, but twelve “district Federal Reserve Banks.” [11] The envisaged system of a limited number of regional local reserve banks would substitute for the existing system of pyramiding required reserves through several levels of banks, with New York, Chicago and St. Louis at the top. That system immobilized reserves and amplified local changes in the demand for currency, e.g. during the crop selling season. [12] The Federal Reserve System allowed banks to borrow from the FRBs against commercial paper collateral, the supply of which would fluctuate elastically with local economic conditions.[13]

The centre (i.e. the Federal Reserve Board) was given regulating powers, e.g. with regard to the rediscounting of eligible paper, and the power to approve or disapprove changes in an FRB's discount rate.

The aim of the creation of the FRS was more to improve the functioning of the American banking system than to be able to control the money supply or the price level.[14] Under the then prevailing gold standard with fixed exchange rates a country's price level was related to the gold stock and the business cycle.[15]

An important development for the Fed was the increasing importance of open market operations for monetary policy, basically as of the early twenties. The Federal Reserve Act had not provided for sharing power in this respect, which initially left the Board in the cold. This changed with the Banking Act of 1935, which while maintaining the federal structure of the system centralized decision-making power on open-market operations in the System's Federal Open Market Committee, in which the Board of Governors was to have a majority of the votes. Thus the balance tipped toward shifting decision-making power to the centre.

We have captured the most important developments in the Fed's history in a separate *appendix* included at the end of this cluster. The main features in terms of division of labour are an important (but not exclusive) role for the Board of Governors in monetary policy decision-making (e.g. co-determining the federal funds rate) and an exclusive role for the FRBs in executing domestic and external monetary policy operations, open market operations and foreign exchange interventions being completely centralized in the FRB of New York and discount windows being operated locally (though since the 1920s they only play a very minor role). The Board is not empowered to hold 'monetary' assets and thus has no balance sheet of its own except for items like its premises.

We have seen that the main purpose of *checks and balances* is to prevent one party or agent coming on top and dominating all others. In the case of the Federal Reserve, the parties to be kept in check were both the commercial bankers and the central government.[16] Therefore, the balance between the FRBs and the Board was designed not so much as a balance between the regions and the centre, but between private and public interests. Nowadays the FRBs are not so much seen as representing private sector interests, but as a factor preventing the concentration of too much power in one body, the Board of Governors. One feature is very typical for the United States, that is the unique dominant role of one of the FRBs, New York. A dominant influence by New York was feared by the regions, which was one of the reasons behind designing a regional system, which worked well in the beginning.[17] Not foreseen was the development of the open market operations (OMOs) into one of the most important monetary policy instruments – this favoured New York which had the only significant financial market in which many types of paper were traded. The FRBs agreed to coordinate their OMOs and to execute them in one spot (in practice: New York). This remained like this, until in 1935 the FOMC became the body deciding on all OMOs. In EMU, the situation is different. There are more market places, all commercial banks hold accounts with their central bank (there is no primary dealer system) and technically (thanks to IT developments) there is no need for one market place, which means the NCBs did not see each other as competitors, in their eyes the future ECB being their only new real competitor.

NOTES

[1] See chapter 4, under Art. 1-ESCB, section II.2. This argument and the fact that he probably wanted his institution to continue to exist as a legal entity can explain why Pöhl referred to the Federal Reserve System, and not so much to the Bundesbank as an example.

[2] In fact, one should have referred to the principle of decentralization, because subsidiarity is a concept applied to the attribution of competences to higher or lower levels of decision-making and not to implementation (cf. R. Smits (1997), p. 112) – see also the box on the principle of subsidiarity at the end of our description of Art. 12.1c.

[3] Delors Report, par. 32.

[4] The ECB though was envisaged to have a balance sheet of its own (Delors Report, par. 32).

[5] In April 1991 the governors completed, and sent to the IGC, the final draft – now also including the article on the distribution of income of the System and the two chapters on general and transitional provisions.

[6] See the square brackets in Art. 12.1 and Art. 14.4 (later transferred to Art. 12.1c) of the governors' draft and the accompanying commentary. The Committee of Governors had failed to agree on one more issue, i.e. the issue whether part of the foreign reserve assets could remain under the full control of national governments (on which the Bank of England took a minority position – see Art. 3.1-draft ESCB Statute). On the other articles the Committee had been unanimous, though the Committee noted in its letter to the IGC that 'the

Governor of the Bank of England has indicated that the authorities of the United Kingdom are unable to accept the case for a single currency and monetary policy', which was a clever formulation keeping the UK governor onboard as to the technical content of the draft Statute.

[7] Art. 12.1, second paragraph.

[8] The articles describing the internal relations of the system were not repeated in the main body of the Treaty, i.e. they only appear in the ESCB Statute.

[9] Legally speaking the Landeszentralbanken (LZBs), which before had acted as central banks within their respective territories, merged with the Bank deutscher Länder (BdL), a joint subsidiary of the LZBs. The BdL had been responsible for banknote issuance and the coordination of policy. After the merger the LZBs lost their legal personality, but kept their name. The Bundesbank Act reserved for the LZBs transactions with their respective state authorities and transactions with banks in their area, other than banks with central functions throughout the Federal territory. (Bundesbank Act 1957, Art. 8(2); Deutsche Bundesbank (1982), *Special Series No. 7*, p. 4-7) This organizational form had been a compromise between a proposal by Schaeffer (Minister of Finance), who promoted a *decentralized* Federal system, thereby basically transferring the rights of the Allied Banking Commission which had *de jure* controlled the predecessor of the Bundesbank (Bank deutscher Länder) to the Federal *government*, and a proposal by Erhard (Minister of Economics), who favoured a *centralized* single tier system, while granting the Bank *autonomy* from the Federal government. For further references to this conflict which delayed the establishment of the Bundesbank (founded in 1957), see Amtenbrink (1999), p. 89-94, and Deutsche Bundesbank (1999), p. 111-115.

[10] On the basis of hearings during 1912 and early 1913 the House Banking and Currency Committee had concluded that there was a vast and growing concentration of control of money and credit in the hands of comparatively few men. (Federal Reserve Bank of Boston (1990), *Historical Beginnings ... The Federal Reserve*, p. 19-21)

[11] Bankers had shown a strong dislike for a framework of government regulation, which they feared would be dominated by political appointees. However, when Wilson selected the candidates for the initial Federal Reserve Board, he did not aim for a Board which would work to break Wall Street's control over the nation's credit, as some had advised him. Instead, he selected men whom he hoped would win the confidence and cooperation of the banking community. The progressive wing of the Democrats were appalled by his choice, and two out

of Wilson's five nominees had to withdraw, because they would not get the Senate's consent. (FRB of Boston (1990), p. 19-26 and 55-58.) (The Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Federal Reserve Board.)

[12] For a short description of the banking system and its problems before 1913, see appendix 1 at the end of cluster II. See also FRB of Boston (1990), p. 13-15 and Moore (1990), p. 4-5.

[13] The so-called *Real Bill doctrine* – see Art. 12.1c, section I.2.

[14] Friedman and Schwartz (1963), p. 195.

[15] Friedman and Schwartz (1963), p. 135-140.

[16] Early plans for establishing a more efficient banking system envisaged the creation of a central institution, the National Reserve Association, with branches all over the country and the power to issue currency and to rediscount the commercial paper of member banks. The institution would be controlled by a board of directors, the overwhelmingly majority of whom would be bankers (Aldrich plan, 1911; Aldrich was an influential conservative senator close to the eastern establishment). This plan was criticized strongly by the progressives. They protested it would not provide for adequate public control of the banking system and that it would enhance the power of the larger banks and the influence of Wall Street. But Wilson had promised financial reform without the creation of a central bank. In the end, the solution was to be a system of privately owned reserve banks, under the supervision of a public body. Also in other respects Wilson increased the public sector character of the system, inter alia by defining the reserve currency as an obligation of the United States.

[17] Opinions diverged on whether the role of New York would be diminished more by opting for many districts or instead by opting for a few, but relatively large districts, because according to some, if there were twelve (small) reserve banks, New York would undoubtedly remain the sole money centre (Warburg (1930), p.108).