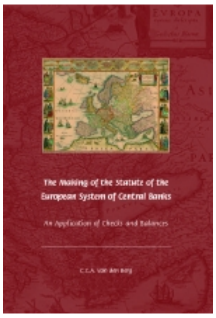
The Making Of The Statute Of The European System Of Central Banks



May, 2018: The complete book – updated version – will be online soon.

Do you find it difficult to understand why the European Central Bank is restricted in its assistance to EU countries which have difficulty borrowing from financial markets? And do you find it interesting to learn what the tools are of the ECB, compared to the Federal Reserve System, and why the monetary part of the Economic and Monetary Union is so much more successful than its economic leg? These questions are answered in the book *The Making of the Statute of the European System of Central Banks*, which first appeared as a dissertation in 2004. It describes the economic, political and legal discussions behind every article of the statute of the ESCB, which rules its behaviour and which restrict the options for politicians to intervene in the policy of the ECB. After you have read this, you will find it much easier to understand and predict the behaviour of important actors, like the decision-making body of the ECB and politicians, and the tensions between them.

Checks and balances
The phrase '*checks and balances*' is most known for its use as a description of the American system of government. The essential feature is that the departments (branches) of government are not just separate from each other (i.e. having their own functional jurisdiction and the absence of personal unions), but also exert limited control over each other, to the extent necessary for preventing departments (branches) from assuming authority in areas for which other branches are responsible. This philosophy was based on the experience that especially the legislature if left to itself could expand its powers in the field of the executive and in extreme cases even taking on judicial powers.

Such an extreme case had been the Long Parliament, which governed England for a period of twenty years (1640-1660) following the Civil War by appointing a host of committees dealing with all the affairs of state, confiscating property, summoning people before them, and dealing with them in a summary fashion. A similar, though less extreme development took place in the early years of the United States (1776-1787), when the States established constitutions based on the concept of the separation of powers, but where in fact the State legislatures soon meddled in every type of government business, including those normally reserved to the judiciary. This explains why the Constitution of the United States of 1787 is based on a combination of the ideas of the separation of powers and checks and balances. Checks and balances presuppose one is able to distinguish several functional powers, which can be separated without creating deadlock. These checks can take different forms. Examples (taken from the American Constitution) are: the president has a veto power over Congressional legislation (though he can be overruled), Congress has the power of impeachment, the president nominates (e.g. Judges of the Supreme Court, Ambassadors, important officials) but needs the assent of the Senate, the Supreme Court may invalidate legislation. Some define the bicameral character of Congress, consisting of a House of Representatives and a Senate, as another (internal) check and balance, as both chambers have to agree with legislation.

In the framework of the European Communities, the functional separation of powers is less clear: e.g. the Commission is both legislator and executive, the Council of Ministers has legislative power, but its members are, back home, part of the executive branch. On the other hand, the European system is characterized by many control mechanisms: Community legislation requires input or approval from two (sometimes three) 'branches' (the Commission, the Council of Ministers, the European Parliament – sometimes advice, sometimes approval), the appointment of the Commission members by the Heads of State is subject by the European Parliament,26 the Commission can be dismissed by the European Parliament, the legality of decisions by the Council of Ministers is subject to review by the Court of Justice.

Separation of powers does not only exist between the branches, but also within branches. Again, this is the case in the United States, where I refer especially to the establishment by Congress of independent regulatory commissions, like the Interstate Commerce Commission (1887) and the Securities and Exchange

Commission (1934). The increased role of government in modern society and the increased complexity of this role in general have led to a reduced role of the legislative branch and – in the European context – an increased role of the government as regulator, while the implementation (i.e. decisions to be taken in individual cases) is also in the hands of the government (civil service). This could create two temptations: first, the temptation to change regulation ad hoc, at short notice and in an opportunistic way, with the argument that he who sets the rules, can at least also change them; second, and in fact going one step further, the temptation to dispense with regulation altogether. This could lead to arbitrariness, abuse of regulatory power for political reasons and unequal treatment and could constitute in itself a very valid reason to set these regulatory tasks at a distance of the Minister by creating *independent* bodies for applying the rules to individual cases. The case of a central bank is related to this, in the sense that a government could, under circumstances, be tempted to intervene in central bank's monetary policy decision-making. However, this would affect the credibility of the central bank's monetary policy, and therefore its effectiveness. Thus, there are good reasons to grant the central bank independence, i.e. independence from the executive and the legislator. In the case of the ECB the independence is directed to the European governmental branches. Another threat to the effectiveness of the ESCB could come not so much from a direct instruction (or political pressure), but from uncontrolled fiscal behaviour. Monetary Union makes free rider behaviour more likely, as neither ballooning current account deficits nor exchange rate pressures can exert discipline anymore once the national currency has been replaced by a single currency.

Indeed, a major threat to price stability (the ESCB's primary objective) could come from derailed *national* budgetary positions (which are more relevant than the small budget of the European Commission), for which reason the 3 per cent of GDP limit for national government deficits can be seen as an important check, *in casu* on the behaviour of national governments. This risk emanating from the fiscal side was already clearly described by the Delors Committee, and this led to the rule for a limit on the deficit and the debt. Failing budgetary policies together with high unemployment will make the ECB vulnerable: inflation which is too high in some countries (eating away purchasing power) and too low in other countries (deflationary) will lead to attacks on its monetary policy and, in the end, on its independence. This is why the ECB has every reason to be openly critical on any deviations from agreed budgetary rules, which rules are part of its constitutional checks and balances. We will make some critical remarks on the economic part of EMU in chapter 12, seen from the perspective of checks and balances. *(pp. 15-18)*

The 'E' of EMU

We noted earlier that the effectiveness of the system is not completely ensured, because there are external risk factors. Even at the time of the Delors Report the governors were aware of these risks. Large parts of the meetings of the Delors Committee were devoted to describing the conditions for economic policy that need to be fulfilled in order to have successful monetary integration. The Delors Report made clear that binding fiscal rules would be indispensable (see Delors Report, par. 25, 30 and 33). We could say that the introduction of national budgetary rules was felt to be a quid pro quo for the surrender of monetary sovereignty. This demand was understandable in view of the very high fiscal deficits then prevailing in some EC countries. Debts were very high too, and due to short maturities debt servicing costs were affected rapidly by changes in interest rates. Budgetary rules were new to most EC countries, only Germany knew the so-called golden financing rule – which allows borrowing only for investment purposes (this rule existed at federal level (Art. 115 Basic Law (version 1969), with a conjunctural escape clause) and at the regional level (Delors Report, p. 104)). Therefore, the recent failure of some Member States to live up to the Treaty provisions regarding the limitation of the deficit (and of the Ecofin to enforce it) is a breach of the checks and balances underlying EMU, and in fact a breach of the conditions of the stability-oriented countries for surrendering their monetary sovereignty.

This breach brings to the fore that the 'excessive deficit procedure' (EDP) – laid down in Art. 104C-EC and clarified in the Stability and Growth Pact – contains a fundamental flaw. The flaw is that in the EDP Ecofin is both legislator, executive and judge. This is in flagrant contradiction to the doctrine of separation of powers; any regime based on such a construction is bound to derail. In the United States discretionary powers are sometimes given to an independent governmental agency or regulatory commission, consisting of non-reappointable board members. This could be copied here, with such a body working on the basis of an authoritative interpretation of the EDP, e.g. taking over from the Ecofin the power to decide on the existence of an excessive deficit and on the imposition of sanctions, based on evidence by the Commission and possibly the Ecofin. (It would seem that at present the Commission cannot fulfil such a function, as in the end the Commission is not only a technocratic, but also a political body, also because it handles so many other politically sensitive dossiers at the same time.) In any case, one should extend a formal role to the European Parliament extending beyond consultation, in all cases where the Ecofin wants to amend the interpretation of the fiscal rules contained in the Treaty (or when it wants to amend the Pact). This would end the Ecofin being the only legislator in its own case. Such a solution would achieve a better balance between the Economic and the Monetary part of EMU.

Apart from the procedures one could also consider to improve the rule itself. More emphasis on structural deficits (i.e. corrected for the position in the business cycle) is imagineable, but these lend themselves less well for triggering sanctions, as the exact level of the structural deficit can only be determined with a considerable lag. One could however put more emphasis on monitoring the structural deficit over the whole business cycle, because the seed for excessive deficits is usually sown in the period of economic upswings. In this respect one could give a strong role to the new autonomous body just referred to. However, because doing away with annual targets increases the risk of misjudgements, one should only apply such a rule to countries with a low debt ratio. As long as the debt to GDP ratio is at low levels, one could even consider allowing countries to opt for certain alternative rules, like a balanced current budget over the cycle, which allows borrowing for certain well-defined investment expenditures. But in all cases an independent body remains indispensable to take impartial decisions, including on sanctions. Finally, it is to be expected that tax reductions in a situation where a country is running a deficit close to the three percent of GDP ceiling will become increasingly less effective as an electoral tool to stimulate growth, as in those circumstances consumers will increasingly be aware of the need for the country to raise taxes (or to reduce expenditures) in order to respect the Treaty. *(pp. 486-488)*

Comparing the Fed and the ESCB

In the U.S. central bankers would stress the Fed is part of the government, denying such would trigger the wrath of Congress. In Europe central bankers would stress their independence of the government, that is both of the executive and the legislative branch. The difference is due to the fact that the US has a unique constitutional relationship between parliament and central bank: the Constitution gives Congress, not the Executive, the power to coin money and regulating its value. Congress has delegated these functions to a governmental agency (the Fed) protected as much as possible from party politics, which had led to the discontinuation of both the First and the Second Bank of the United States. In Europe circulation banks had usually received their charter from the sovereign [or the government], even though in many cases circulation banks were partly owned by private stockholders. However, policy was not by the private sector stock holders, but by the government. Many of these governments abused their monopoly, leading to inflationary outbursts (quite often related to war efforts).

So, whereas the drafters of the FRA positioned the central bank outside the reach of partisan politics by delegating monetary powers to an autonomous governmental agency, the drafters of the ESCB Statute were more focussed on safeguarding the autonomy of the central banks vis-à-vis the government. For instance, it is striking that the Statute explicitly forbids the government to instruct or influence the ECB's decision-making bodies, whereas in the US this was never considered necessary, because the Fed is not under government instruction, nor of Congress nor of the Administration. Nonetheless, the Fed values a good relationship with the Administration. During his (re)confirmation hearings in 1992 Greenspan explained he had monthly meetings with the Council of Economic Advisors and with the Treasury. Occasionally he would meet the president. It seems that the regular luncheons between the Fed chairman and the Secretary of the Treasury are more conducive to a good understanding and relationship than meetings between the Fed chairman and the president, because the president usually 'wants something' when he meets the chairman of the Fed. *(pp. 95)*

7.2 GENESIS OF SELECTED ARTICLES (CLUSTER II)
Article 3.3:
Article 3.3-ESCB (non-basic task of the ESCB)

"In accordance with Article 105(5) of this Treaty, the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system." [….]

At the end of the eighties central banks felt increasingly responsible for safeguarding the stability of the **financial system** as a whole. The stock market crash in October 1987 had shown how quickly disturbances could spread among financial markets. The speed with which disturbances could spread among markets had increased considerably during the eighties due to IT developments and increased interlinkages between different financial market segments, which in themselves could also mitigate shocks by spreading the effects over more participants (increasing the absorption capacity), but under circumstances could also trigger avalanches. These developments created new kinds of responsibilities relating to prevention of system crises and the management of such crises when they occur, for instance by injecting liquidity to prevent gridlocks in the payment systems. The explicit mentioning in the ESCB Statute of some responsibility for the stability of the financial system was new, as evidenced by the fact that at that time no central bank act contained such a task, most of them focussing in this respect on guarding the solvency of individual institutions. An exception was the Banque de France law which stipulated that "*elle veille au bon fonctionnement du system bancaire.*"

Some central banks stressed the importance of having under the same roof knowledge of the financial markets, payment systems and financial institutions. However, the **Bundesbank** would oppose bringing supervisory responsibilities into the European central bank. It supported the German model, where the central bank is closely involved in supervision, but does not bear formal responsibility for supervisory policy. In the view of the Bundesbank combining monetary and prudential responsibilities can create a conflict of interest within the central bank, e.g. when raising interest rates would jeopardize the health of some banks. This would reduce the central bank's ability to achieve price stability. Furthermore, decisions like closing of a bank were viewed as the responsibility of the government, since the central bank's reputation could be tarnished, if one or more banks fail while it is responsible. To the extent that the government would retain ultimate responsibility for supervision, the central bank would run the risk of receiving instructions from the government, thus losing its independence. Nonetheless, because of its closeness and expertise with the banking sector, the Bundesbank always considered it had a legitimate interest in being closely **involved** in analysing the prudential reporting by the banks and in the design of general regulations in the field of banking supervision. This thinking was reflected in the paper submitted by Pöhl in September 1988 to the Delors Committee: 'The European central bank should be given the right to take part in the establishment of general regulations in the field of *banking supervision*. Moreover, owing to its expertise, deriving in particular from its business relations with credit institutions, the central bank should be closely involved in day-to-day banking supervisory activities.' An important aspect in this context is the *lender of last resort function* of a central bank, which is aimed at helping solvent banks by supplying liquidity where the market temporarily is unwilling or unable to.

In most countries this function is not listed explicitly in the central bank statute to prevent moral hazard among commercial banks and to prevent political pressure on the central bank for bailing out possibly insolvent banks. The border line between solvent and insolvent is sometimes thin. For an overview of the possibilities for the ECB to provide LOLR assistance, see Van den Berg and Van Oorschot (2000), 10 who conclude that the ESCB has at its disposal adequate instruments to inject at very short notice liquidity through its NCBs in the financial system ('quick tenders' have proven their value in the aftermath of the September 11 events in 2001)11. Emergency liquidity assistance (ELA) to an *individual* institution could either be defined as a system function ('bilateral transactions') or a non-system ('Article 14.4') function. In both cases decision-making can be quick, though in the first case the execution of ad hoc 'bilateral transactions' needs the approval of the Governing Council, just as the acceptance of non-listed collateral. One could very well conceive of **delegation** of the authority to approve non-listed collateral in individual emergency cases, to the Executive Board in order to ensure expediency. At the same time it is difficult to imagine the Governing Council being cut out completely from such decisions. In case ELA is defined as a non-system function, the Executive Board should be notified, because it has to be able – if desired – to consult the Governing Council on whether it wants to raise objections under Art. 14.4-ESCB. *(pp. 273-275)*

8.2.1 Short reviews (with emphasis on checks and balances)
Supervision (Article 3.3- and 25-ESCB):
Discussion on this article on prudential supervision and financial stability was complicated because the existing national arrangements differed. Some central banks were responsible for supervision; others (in fact most of them) were only 'involved' through cooperation with or membership of their governor of a separate supervisory body. In practical terms, though, all central banks, except the Danish, were actively involved in the supervisory process. Financial stability,

i.e. the stability of the financial system, was increasingly seen as an area calling for active central bank involvement, though this had as yet not been reflected in the mandates of the NCBs.

The reluctance of the German central bank to be made responsible for supervision combined with the reluctance of other NCBs/countries to share their supervisory responsibilities, which had always been a closely guarded functional area, with other countries/central banks. This reluctance was also felt vis-à-vis the ECB, which was a new potentially powerful institution, which might start encroaching on the supervisors' territory. In retrospect, there was no willingness to make optimal use of the opportunity to create synergy in the field of supervision; the national roles could adequately have been safeguarded by explicitly putting down on paper the (minimum) involvement of NCBs in supervision, e.g. in the area of on-site inspections. However, what happened was that the NCBs, and also the Finance Ministries, seeing the ECB as a potential supervisory competitor, marginalised the supervisory role of the System and the ECB, though a potential role was not excluded.

This brings us to the following general observation leading to two suggestions for improvement. Protecting financial stability in the euro area requires an effective network of cooperation and information sharing between national supervisory authorities. What is true at the national level, i.e. that there is potential synergy between being monetary authority and being involved in supervisory tasks, is also true at the European level. At the same time, the problems Germany had (and has) with a possible conflict of interest between monetary and supervision at the European level should be coped with. This could be achieved by copying the German-style involvement of the ECB in supervision, through a Treaty article explicitly obliging central banks and supervisors to inform the ECB of relevant developments (first improvement) and by making the ECB for instance co-supervisor for large foreign banks or large bank holdings (second improvement).2 The tasks of the ECB need to be spelt out quite clearly. The requirement to inform and be informed would also allow the ECB to make most of its role as contributor to financial stability. The ECB is uniquely placed to oversee financial stability issues on a daily basis for two reasons: it has a European scope and it has daily contacts with the financial markets. This makes a difference with other supervisors: *national* supervisors only have a national scope and *European* regulatory bodies only meet infrequently. The institutional balance between the

NCBs and the ECB, if considered important in this respect, would not be disturbed, because the ECB would only be cosupervising with the relevant national supervisors (i.e. the ECB would not substitute for supervision by national supervisors), but at the same time it would enable the system to acquit itself more effectively of one of its tasks. The appointment as co-supervisor could be enacted through activation of Art. 25.2, which could possibly be confined to specific supervisory issues. The Executive Board would be informed on a continuous basis and the Governing Council would be informed regularly, or when deemed necessary, while regular reporting should also take place in relevant European fora. *(pp. 359)*

Articles 17-24 (Chapter IV):
Chapter IV: Monetary Functions and Operations **1**
[….]
Article 18 allows the ECB and the NCBs to conduct all the typical central bank transactions with other parties. A distinction is made between open-market (either outright or under repurchase agreements) operations and lending activities. Lending has to be based on 'adequate collateral'. The *IGC* decided in favour of a collateral requirement, after the *Committee of Governors* had been unable to agree on this issue, most of the governors valuing flexibility in case of emergencies, while some were less lenient (wishing to protect the System against credit risk). The decision also implies NCBs cannot be 'forced' into lending of whatever kind without adequate security. For domestic monetary policy operations 'eligible' collateral has been defined in a limitative sense in the *General Documentation*. This also means that a central bank when extending emergency liquidity assistance (ELA) to one or more individual institutions does not need the approval of its shareholder (usual the Minister of Finance), because their lending to the institution(s) with liquidity problems does not put the NCB's capital at risk.

Art. 18.2 requires the ECB to publish its main rules of the game: 'The ECB shall establish general principles for open market and credit operations carried out by itself or the NCB[….]' This led to the publication of the *General Documentation on the ESCB's monetary instruments and operations*, which was prepared by the EMI and approved by the Governing Council in 1998. This General Documentation provides that reverse transactions19 are the main instrument to provide liquidity to the banking system. These regular open-market refinancing transactions are conducted using system-wide tender procedures. Subscriptions are collected through the NCBs, the allotment decision is made at the ECB (Executive Board) and the liquidity is provided to the banks by the NCBs. The interest rate is decided by the Governing Council at their two-weekly meetings, one of which (*viz.* the first meeting of the month) is devoted to monetary policy, though the other meeting can also be used to change interest rates. All transactions are executed in a *decentralized* manner, the only possible exception being bilateral fine-tuning reverse transactions, which under exceptional circumstances (to be decided by the Governing Council) may be engaged upon by the **ECB** – in which case the ECB contacts a counterparty for the purpose of engaging in a transaction, the settlement of which would still take place through the books of an NCB. NCBs offer two standing facilities, which are permanently available for eligible counterparties, *viz*. a deposit facility and a marginal lending facility, at rates respectively below and over the main refinancing operations (MROs) rate). These rates constitute a corridor for the short-term interest rates. Only strong expectations of imminent changes in the rates for refinancing operations (refi-rates) could lead interest rates to move outside this corridor. *(p. 347)*

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