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A National Central Bank within a Federal System¹

*Philippe Bonzom
Christian Barontini
Banque de France*

“Sovereignty withers when it is imprisoned in its structures of the past. In order for it to live on, it must be transferred, as the scope of activity expands in a greater space. It can then unite with other sovereignties that are evolving in the same direction. None of them are lost in this transfer; rather, all are strengthened.”

Jean Monnet

In his *Mémoires*, published in 1976, Jean Monnet, one of Europe’s “fathers”, had this luminous explanation of the *raison d’être* and of the modalities of regional integration in general, and of the *de facto* federal construction of Europe in particular. His statement applied primarily to the sovereignty of the national State, faced with all sorts of economic, social and political effects/externalities of globalization. But it can also be applied to monetary policy and central banks, especially when the scope of financial activity (capital movements) expands to a greater, regional area. In Europe, national central banks (NCBs) of the euro area have thus been led to unite. Together with the ECB, they form the Eurosystem, to which one can apply many of the ideas associated, in political sciences and philosophy, with the concept of “federalism”. Indeed, the ECB/Eurosystem is one of the four federal institutions of the European Union.² What is more, the ECB/Eurosystem is built according to a federal framework, with a centre (the ECB) and 12 other member institutions (the NCBs).

¹ The views expressed in this article are those of the authors and do not necessarily represent the positions of the Banque de France. The authors would like to thank their Banque de France colleagues, in particular, Emmanuelle Politronacci and Cécilia Lemonnier for their contribution on linguistic issues, and Anne-Marie Moulin and Romain Bardy on legal aspects.

² Together with the European Parliament, the Court of Justice and the Commission.

Hence, it is no wonder that the traditional debates about federalism have touched upon the Eurosystem. On the one hand, the jury is out, in academic circles, about the optimal level of centralization or decentralization or about the relevance or irrelevance of an *à la FED* evolution (whatever that means exactly). On the other hand, the Eurosystem emphasizes its team spirit and the good functioning of its decentralized set-up.

This debate needs not be over-dramatized. First, because social sciences point to the unavoidable (and potentially creative) “tension” between a centre and its periphery in any federal – indeed, in any human – organization. Second, because the Eurosystem seems to have found an apparent (even though certainly dynamic) equilibrium. To illustrate these ideas, we would like to point to the various reasons for the decentralized set-up of the Eurosystem (1) and to the working of this decentralized set-up, especially at the NCB level (2).

1. Reasons for the Decentralized Set-Up

We have selected six main reasons that played a key role in the choice of a decentralized set-up.

1.1 Compliance with the Treaty and the Statutes

The official acronym of the system is “ESCB” which stands for “European System of Central Banks”³. The choice of the plural form for “Central Banks” was a very conscious one. The Treaty drafters wanted to take into account, *inter alia*, the historical background rooted in institutions bearing the very names of the various countries of the European Union (Oesterreichische Nationalbank, Deutsche Bundesbank, Banque Nationale de Belgique, Banque de France...). Before them, the Delors Report had explicitly proposed “a federative statute, since this would correspond best to the political diversity of the Community”⁴.

A second, somewhat related aspect stemming from the Treaty is the status of the Governing Council as the supreme decision-making body of the ECB/Eurosystem: this is the body in which all euro area NCBs Governors participate. They do not represent their NCB; rather, they sit on the Council in their personal capacity (very much like the Board members, for that matter, who do not

³ The ESCB gathers all EU central banks. The term “Eurosystem” has been chosen to identify specifically the grouping of the central banks of the euro area.

⁴ The Werner Report (1970) was less explicit than the Delors Report in its description of the future institutional set-up for EMU in general and monetary policy in particular. In this later regard, it just mentioned the need for a central body “comparable to the U.S. Federal Reserve Board.”

represent the ECB in the Council). But, part of their personal capacity certainly derives from them running (and having been chosen to run) an NCB.

Finally, and quite consistently with the above, Article 12.1 of the Statute provides that “to the extent deemed possible and appropriate (...), the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB.” In the same vein, most provisions of the Statute dealing with the various specific functions of the monetary authorities allocate them either to the ESCB/Eurosystem or to “the ECB and the NCBs”.

There is thus, both in the words of the Treaty and in the spirit in which it was drafted, a solid foundation for a decentralized set-up.

1.2 NCB’s Experience as an Asset for the System

The choice of this kind of decentralized set-up also underlines the wish to make the system benefit from the NCBs’ experience and credibility.

The fact that the NCBs’ historical legitimacy has been brought as an asset to the system was clearly illustrated by the evolution of market interest rates in the transition to EMU: they converged not towards the average level of participating currencies but towards the lowest level, achieved by the most credible participating NCBs. In this sense, there is hardly any factual basis for the argument that the ECB would be a “young institution”, “lacking credibility and track record” (some of the worst – but, in this case, unfounded – accusations one can make to a central bank!).

On a more operational basis, it is clear that each NCB brings to the Eurosystem its long standing expertise and knowledge of its national economy, its national financial system, its national political framework, its national currency distribution networks, etc... NCBs are well placed, geographically, to have direct access to and contact with economic agents (including public authorities, banks, companies, consumers/citizens). They bring this expertise to the Eurosystem’s collective analysis and, hopefully, collective wisdom.

1.3 Level Playing Field between National Financial Centers

A key, operational feature of the Eurosystem is that NCBs keep the accounts of commercial banks on their books (see art. 2.1 of the General documentation on Eurosystem monetary policy and instruments, last amended in February 2005).⁵

This feature is not that original since, for instance, within the U.S. Federal Reserve System, the Board in Washington D.C. does not keep commercial banks

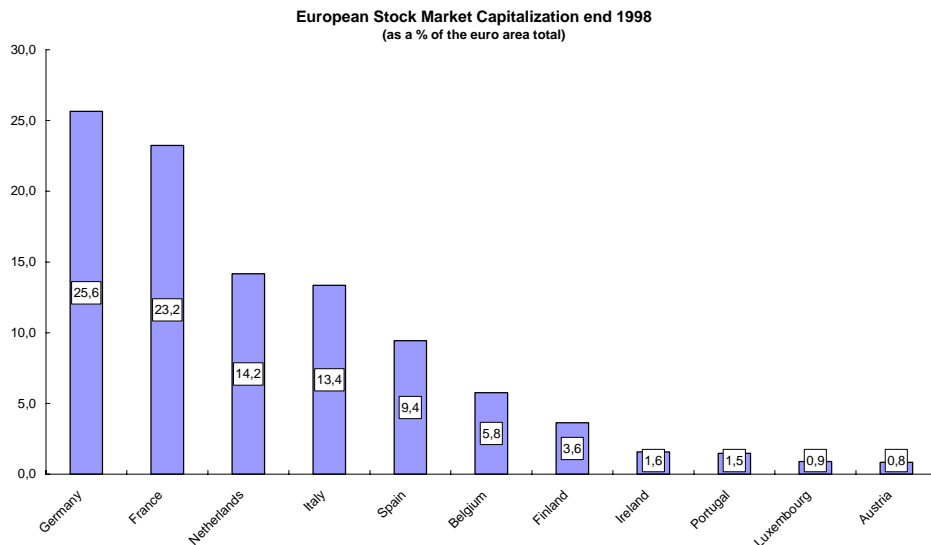
5 “An institution may access the Eurosystem’s standing facilities and open market operations based on standardtenders only through the national central bank of the Member State in which it is established.”

accounts on its books. However, in the European context, this feature has special significance, linked to the structure of European financial markets.

Indeed, if a centralized set-up had been chosen for monetary policy, commercial banks might have been tempted to concentrate some of their key management activities (at least liquidity management) where their central banking counterpart was located. This would have been tantamount to taking an “administrative/political” decision interfering with the normal competition between financial centres.

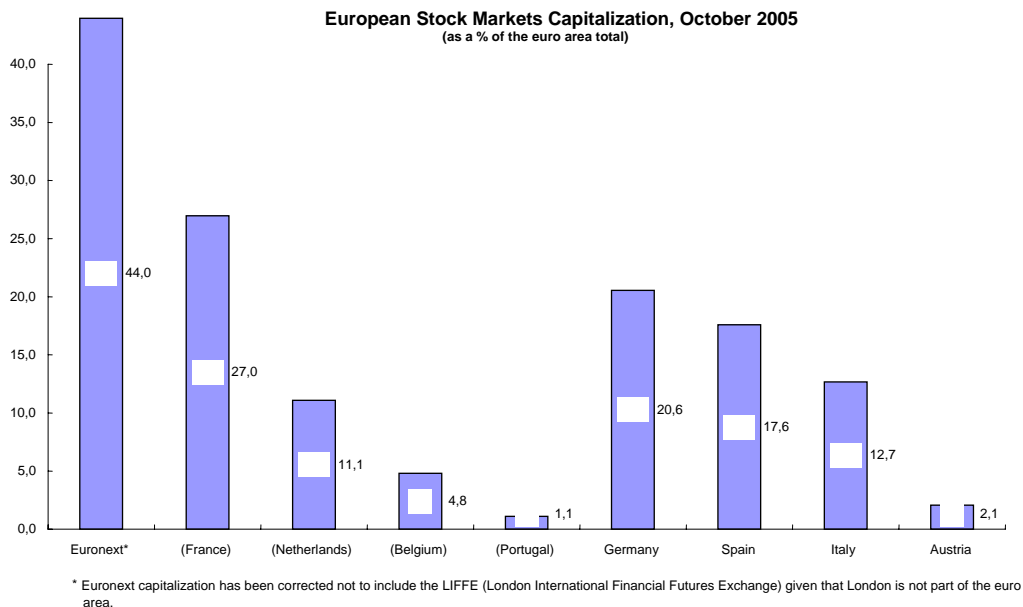
The structure of European financial markets is, in this regard, quite decentralized: this was the case in 1998, when the decision on the organization of the Eurosystem was taken (chart 1); this is still the case, seven years later, even after a degree of consolidation has taken place, with the creation of Euronext (chart 2). This situation is radically different from the one prevailing in the U.S.A. where (1) the Board has its headquarters in a town which is not a financial centre and (2) one financial centre (New York City) overwhelmingly dominates all the others. In the U.S.A., the conduct of monetary operations is delegated to one single member of the U.S. central banking system, namely the Federal Reserve Bank of New York.

Chart 1: Decentralized Structure of the Euro Area Financial Centres in 1998



Source: World-Federation of Exchange, Banque de France calculations.

Chart 2: *Decentralized Structure of the Euro Area Financial Centres in 2005*



Source: *World Federation of Exchange Members, Banque de France calculations.*

It may well be that, over time, the competition between the European financial centres will lead to a higher degree of concentration between them. But, especially in a market economy, one may argue that “administrative/political” decisions on the central bank’s organization should not be a determinant of this phenomenon.⁶

1.4 Multilingual Communication

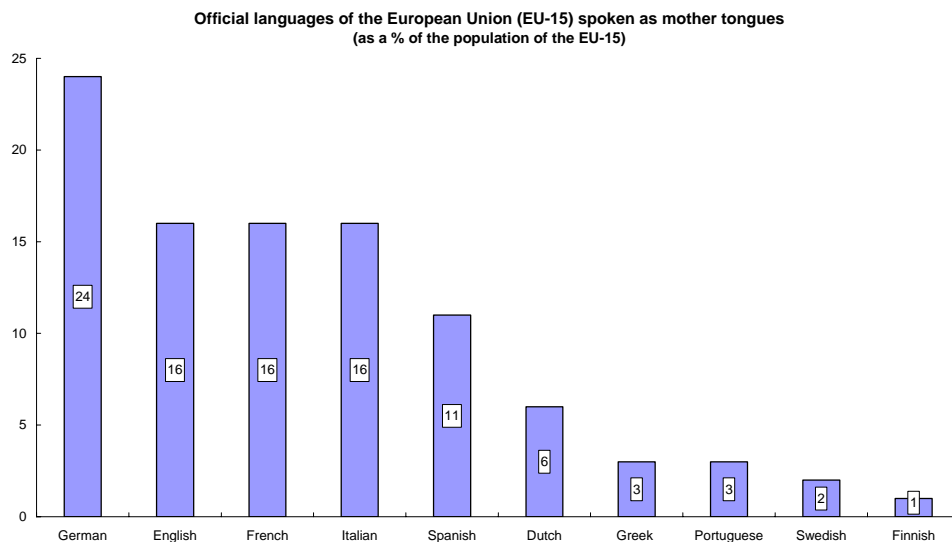
Another, perhaps even more striking difference between the working environments of the ECB/Eurosystem and of the U.S. Federal Reserve System relates to the issue of languages. From a legal and institutional point of view, the EU has 25 Member States and 20 official and working languages (“official and working languages of the institutions of the EU”, as established in Regulation No. 1 of 1958, which has been adapted after each enlargement).⁷ The euro area has 10 of these 20 languages.

⁶ It might be worth recalling, in this respect, that the Statute provides that “the ESCB shall act in accordance with the principle of an open market economy with free competition”.

⁷ As from January 2007, Irish is to become the 21st official language.

From a practical point of view also, no European language is spoken as mother tongue by more than 25% of the EU 15 population (German 24%, French, English and Italian 16% each) and no European language is understood by more than half of the EU 15 population (chart 3). By contrast, in the U.S.A., more than 90% of the population has the same language as its mother tongue or speaks it very well (Census 2000).

Chart 3: Linguistic Diversity in Europe



Source: Eurobarometer 54 Special, Europeans & languages, February 2001.

“Central bankese” is already a rather difficult idiom, in any language. If monetary policy messages cannot be communicated to economic agents/citizens in their own language, the efficiency of monetary policy is at risk. Tougher measures would be needed, to get the same result. The presence of the NCBs and their experience in communicating on monetary policy in their fellow-citizens’ own language, taking into account their constantly evolving cultural patterns, are thus key assets for the central banking system of a multilingual polity like the euro area.

1.5 Independence

It has been argued (Goodfriend, 2000) that the more decentralized a system, the more independent it can be. This may stem from the fact that a decentralized

system is less prone to bend to external pressure.⁸ And, indeed, decision-makers in a decentralized system derive their legitimacy from a variety of backgrounds.

It is thus useful, in order to have an independent monetary policy, to have some members of the ECB Governing Council nominated by European institutions and others by national institutions. Since independence must go hand in hand with accountability, this is reflected in the fact that the ECB is accountable, *inter alia*, to the European Parliament while most NCB Governors are accountable, *inter alia*, to their national parliament.

1.6 Possibilities Offered by New Technologies

Finally, one should stress that the Eurosystem's organizational framework was decided in a context characterized by the advances in new technologies: e-mail, teleconference, visioconference, electronic payment. Having benefited from this progress since its creation, the Eurosystem team, even though geographically spread out over a continent, can fully ensure real-time circulation of information, real-time decision-making and real-time implementation of decisions (including real-time transfers of funds). This was illustrated, for instance, in the immediate aftermath of the September 11, 2001 tragic events. And this is another radical difference with the historical and technological context in which other federal central banking systems were built and first operated.

Conversely, the fact that the implementation of decisions is not geographically concentrated may even help meet the challenges raised by the continuity of operations in times of crises.

2. Working of the Decentralized Set-Up

On this point also, we would like to select a few key areas of the functioning of a central banking system and look at how it works in the case of the Eurosystem.

2.1 Conduct of Monetary Policy

In the early U.S. Fed, Federal Reserve Banks were allowed to implement monetary policy decisions with a relatively high degree of discretion. This contributed to a non optimal monetary strategy which even had some bearing on the making of the 1929 Crisis (Meltzer, 2002). In the Eurosystem's case, everything was designed,

⁸ As the Federal Reserve System puts it, "Congress has carefully insulated the Federal Reserve from day-to-day political pressures so it may act in the best interests of the country. (By devising a system with a Board and 12 District Banks,) Congress wisely spread the policymaking machinery throughout the System (...)", Federal Reserve Bank of Richmond (2003).

from the outset, with this precedent in mind and with a consensus around the fact that no deviation from the single monetary policy stance should be allowed.

Monetary policy decisions are indeed clearly centralized at the level of the ECB's Governing Council. NCBs Governors also bring to the Council analyses prepared by their own staff. As indicated earlier, this can only contribute to enrich the Council's discussions and decisions.

As soon as decisions are taken, they are decentrally implemented in an unambiguous manner: the ECB's Executive Board sends instructions to NCBs on the basis of the Governing Council's decisions (Treaty article 12.1). There is regular ECB monitoring of the compliance of the whole system with these instructions and there are regular and extensive audit missions for the main activities.

Examples of this mode of functioning come easily to everyone's mind as regards the "downstream" conduct of monetary policy: refinancing, interventions on foreign currencies, management of foreign reserves, issuance of banknotes, etc...., after decisions have been taken. One should also bear in mind NCBs' operational role "upstream", before decisions are taken, in particular in the collection of statistics which are indispensable for good decision-making.

Another significant channel for this NCBs' upstream role lies in their participation in the ESCB committees (see section 2.5 below) and in the latter's work which contributes to the decision-making bodies' reflections and, ultimately, to the Governing Council's decisions.

2.2 Communication on Monetary Policy

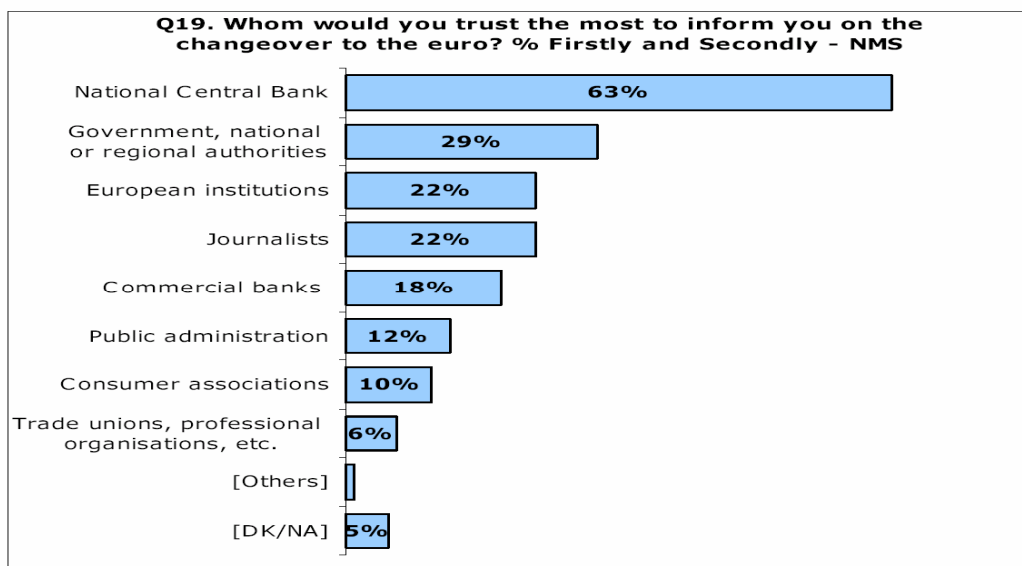
Central banks have to explain their decisions to economic agents through appropriate communication. In this regard also, NCBs contribute, together with the ECB, to the necessary activities through their own speeches, articles, conferences, interviews, auditions and publications but also through their role in translating, in their national language, most ECB publications. The language networks put in place by Banque Nationale de Belgique, Banque Centrale du Luxembourg, Banque de France for the French language, Oesterreichische Nationalbank and Deutsche Bundesbank for the German language, etc... help the ECB, which did not need to build a huge translation service. And this might help get the monetary message out, in terms that are closer to the language actually used in the different countries.

One should also stress that the role of NCBs – which is already very significant in day-to-day communication – is even more crucial in exceptional circumstances. An illustration of this took place on the occasion of the changeover to the euro. At that time, the Eurosystem ran what might have been the first communication campaign at the European continent level, always using the two key principles: central decision (on the concept and the messages), decentralized implementation

(taking into account, inter alia, the idiosyncracies of national mindsets, media consumption habits and advertising markets).

NCBs' role in the System's communication is especially valuable since they seem to enjoy, naturally, a higher degree of recognition than more far-away European institutions. This proximity may be illustrated, for example, by a survey of new Member States' (NMS) citizens regarding their choice of preferred sources of information on their future changeover to the euro (chart 4).

Chart 4: NCBs as Reliable Sources of Information for Citizens



Source: Commission Staff Working Paper, Annex to the first report on the practical preparations for the future enlargement of the euro area, 2004.

2.3 International Activities

Managing an international currency like the euro requires a lot of activity in international fora. NCBs are necessarily present in this activity, in coordination with the ECB, since many of these international fora (e.g. G7, IMF...) are organized according to a "country" mode (which does not prevent those fora from increasingly incorporating regional integration in their reasoning and functioning). Also, many NCBs have, historically, built strong international networks and relationships with central banks and financial communities outside the euro area: Oesterreichische Nationalbank and Deutsche Bundesbank in Eastern Europe, Banco de Espana and Banco de Portugal in Latin America, Banque de France in

Northern and sub-Saharan Africa, Southeastern Europe and South East Asia, for instance.

These complementary networks add to the information gathered by the System and they reinforce the spreading of ECB messages as well as the visibility of the Eurosystem and of its positions.

2.4 Non-Eurosystem Tasks

It should also be noted that, in addition to their ESCB-related tasks, most NCBs perform a very wide array of tasks which have been –and continue to be – assigned to them by their national authorities – most prominently by their national Parliaments. This is an additional recognition of the NCBs professionalism and further illustration of their role in the national institutional landscape.

These non ESCB-related tasks (which, for instance, include banking supervision, financial consumers' affairs, government fiscal agent services) are certainly far from being minor since they account for a significant part of Eurosystem staff. This, by the way, should point to the need for more caution than usually used in some blunt comparisons of staff numbers between central banks in general and between the Eurosystem and the U.S. Federal Reserve System in particular.

But the key point, regarding “federalism”, is that the conduct of those tasks entails no contradiction with Eurosystem tasks and, once again, no deviation from the single monetary policy. Indeed, article 14.4 of the Statute provides for the principle of non-interference of these tasks vis-à-vis ESCB-related ones (and for the means of enforcing this principle).

2.5 Internal Organization of NCBs

Finally, it might be interesting to point to the way in which the working of the decentralized set-up has influenced the internal organization of NCBs. This influence has made NCBs contribution to the Eurosystem more efficient.

First, NCBs' contribution to the System does not stop at their preparing files for their Governor's Governing Council sessions and implementing the Governing Council decisions. NCBs staff directly contribute to Eurosystem decisions through their participation in the 13 ESCB committees, which help to prepare the decisions taken by the Eurosystem. In this sense also, NCBs contribute to the definition of the centrally-decided concepts, messages, and actions. Conversely, participation in these committees contributes – both for NCBs and ECB staff – to the nurturing of a common Eurosystem corporate culture.

Working through these kinds of networks is indeed a very “modern” way of functioning. It also has had structuring effects for NCBs. For instance, the sheer number of experts involved (roughly 110 directly participating, for Banque de

France, in Eurosystem meetings)⁹ has contributed to share international contacts among a higher number of people, in each national central bank, at younger ages and at more medium levels of responsibility, relatively, than in pre-Eurosystem times.

Second, participation in the Eurosystem has led to changes in the structures of the NCBs. We are not pointing here to reductions in the numbers of staff and branches that most central banks have experienced over the last decades: indeed, these reductions are largely independent of the creation of the euro and stem mainly from evolutions in economic activity and in currency distribution networks, which can be witnessed in most of the industrialized world, not just in the euro area. More directly related to the creation of the Eurosystem are reforms of NCBs' decision-making bodies (e.g. the 2002 reform in the Bundesbank board, 1999 refocusing and 2002 reduction in membership of Banque de France's Monetary Policy Council) and in reforms of NCBs services (restructuring of business areas – e.g. at Banque de France – to ensure more optimal contacts with their ECB/Eurosystem counterparts).

3. Conclusion

More generally, the creation of the Eurosystem team has led to a healthy competition and to a permanent benchmarking between the various team players: no member of the team would like to be perceived as a poor performer in the common endeavour. This is another significant advantage of implementing the decentralization principle.

In the end, this principle is very close to the subsidiarity principle which governs the EU officially – and perhaps not coincidentally – since the 1992 Maastricht Treaty (which provided that “the Community shall take action only if and insofar as the objective of the proposed action cannot be sufficiently achieved by the Member States”). Of course, legally speaking, subsidiarity does not apply to monetary policy, which was completely transferred to the Union level by the Maastricht Treaty. However, the Eurosystem experience shows that, in its spirit, subsidiarity applies, with great benefits, in organizational terms (Mersch, 2000; Trichet, 2002). Given the legal caveat, one could also call it the “proximity principle”: as already stated, citizens tend to be distrustful of far away institutions, linked, often unfairly, to the idea of bureaucracy.

In this regard, it might be noted that, in this presentation, we have pointed to several, key differences between the U.S. and European contexts. However, this

⁹ See also the same kind of data for the Oesterreichische Nationalbank in this volume Lindner and Dvorsky, Institutional Changes in the European Integration Process – the Austrian Experience.

above-mentioned distrust of far away institutions is a well-established phenomenon in the United States. And, as evidenced, *inter alia*, by the Constitution ratification process, this feeling has began to grow in Europe –perhaps partly as a natural result of increased Union powers.

In such a context, the decentralized set-up of the Eurosystem certainly might not, in itself, make its policy immune to criticism. But it might contribute to making the Eurosystem more able to “act locally” (in each Member State), “decide regionally” (for the euro area) and “play globally” (in international negotiations) (Sa et al., 2005). In all these three types of actions, NCBs play their role fully. To return to Jean Monnet’s statement, no NCB seems to have been “lost” in the transfer of sovereignty each one has accepted. Rather, they have been strengthened by their participation in the Eurosystem team led by the ECB. In this sense, for the NCBs, the euro was not a revolution but an evolution, not a declining *fin de regime*, but a new *raison d’être*.

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