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## Article

# The price stability oriented monetary policy of the European Central Bank

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## **The price stability oriented monetary policy of the European Central Bank**

### **Abstract**

*The aim of this paper is to present the price stability oriented monetary policy of the European Central Bank. The European Central Bank began activities in 1998 and the primary objective of the European System of Central Banks is to maintain price stability and the ESCB should also support the general economic policies in the Community. Monetary policy is a special tool that national governments and central banks uses to influence on its economy, especially to control the supply of money and to influence on the level of economic indicators. This paper investigates the assumed objective of the European System of Central Banks which is to maintain price stability. What is more, we would like to present the monetary policy strategy of the European Central Bank and analysis of the Harmonized Index of Consumer Prices.*

### **1. Introduction**

The European Union is an international organization of twenty seven member states, which create an economic and political union. The European Union has developed a single market based on the free movement: of people, goods, services and capital. The official objective of the European Union which was announced in 1969 was the creation of a common currency. The economic

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and monetary union was founded by the UE in three steps. The final stage began on 1 January 1999 and the European Central Bank started to function and managed the monetary policy in the European Union. The European Central Bank was the final institution of economic and currency union and it cooperate with national central banks. The primary objective of the European System of Central Banks is to maintain price stability and the ESCB should also support the general economic policies in the Community.

## 2. From the Dellors Report to the European Central Bank

The Dellors Report proposed solutions to achieved economic and monetary union in three steps. The first stage of the realization of economic and monetary union began on 1 July 1990 and on this date all restrictions on the movement of capital between Member States were abolished. The second step was established the European Monetary Institute on 1 January 1994 which the main purpose was to strengthen cooperation and coordination between national central banks and made the preparations for the European System of Central Banks and common currency, euro. On May 1998 the Council of the European Union decided that Member States had fulfilled the conditions for the participation in the third stage of EMU and then adopted the single currency on 1 January 1999. The third final step began on 1 January 1999 and the European Central Bank took the responsibility of a single monetary policy in the eurozone. Establishment of the European Central Bank and European System of Central Banks was the most important step to create economic and currency union in Europe (ecb.europa.eu, 20.03.2010).

**Table 1. Stages of European Monetary Union**

<p><b>The first stage</b> (1990-1993)</p>	<ul style="list-style-type: none"> <li>• the movement of capital between Member States were abolished</li> <li>• enlargement cooperation between central banks and economic policy coordination</li> <li>• acceptance the terms of participation in a currency union</li> </ul>
<p><b>The second stage</b> (01.01.1994-31.12.2008)</p>	<ul style="list-style-type: none"> <li>• The European Monetary Institute was established</li> <li>• strengthening of economic convergence</li> <li>• the Stability and Growth Pact</li> <li>• Preparation for fixing the conversion rates</li> </ul>
<p><b>The third stage</b> (01.01.1999-31.12.2001)</p>	<ul style="list-style-type: none"> <li>• the adoption the common currency (euro)</li> <li>• monetary and exchange rates policy keep in euro</li> <li>• central banks in Member States of the euro zone became part of the Eurosystem</li> </ul>

Source: ours own study based on ecb.europa.eu.

### 3. The European Central Bank, European Systems of Central Banks

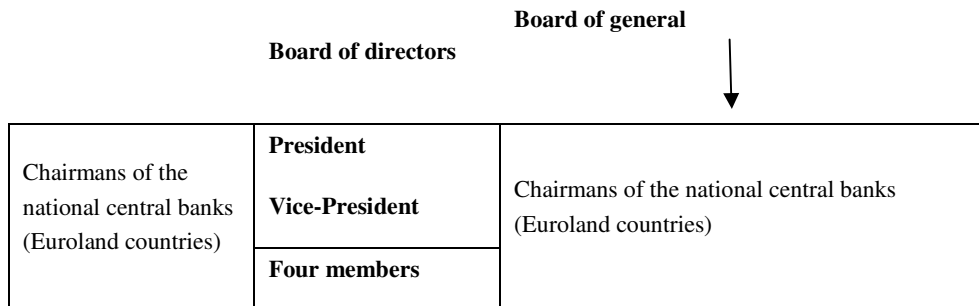
The European Central Bank began activities in 1998 on the basis of the European Monetary Institute. The most important tasks for the EMI was preparation organizational and legal solutions to conduct common currency and to lead general monetary policy in the Euroland. It is considered that good and efficient ECB functioning is dependent on the good preparations which had executed by the European Monetary Institute (Gawlikowska et al; 2004; s. 273).

The European Systems of Central Banks, which is composed of the European Central Bank and national central banks, was the final institutions of the economic and monetary union. In the central part of the whole ESBC is the ECB, which has a juridical personality in each member countries. Organization framework of the European Central Bank Systems is based on the solution which was introduced into German Federal Bank and Federal Reserved Bank in the USA (Baka; 1998; s. 123).

The primary objective of the European System of Central Banks is to maintain price stability and the ESCB should also support the general economic policies in the Community. Monetary policy is a special tool that national governments and central banks uses to influence on its economy, especially to control the supply of money and to influence on the level of economic indicators. The main objective is a macroeconomic stability (low unemployment rate, GDP growth, low inflation and balance of payments). According to the Maastricht Treaty ESBC tasks are carried out through the Eurosystem are:

- *the definition and implementation of the monetary policy of the euro area,*
- *the conduct of foreign exchange operations,*
- *the holding and management of the official foreign reserves of the Member States,*
- *the promotion of the smooth operation of payment systems.*

The most important characteristic of the ESBC is an autonomy which guarantee the primary objective (to maintain price stability). The European System of Central Banks is managed by the organs of decision-making process, like the Governing Council and Executive Board. The Governing Council composed of Executive Board members and the governor of national central banks. The Governing Council is responsible for the monetary policy of the Community and it has got the right to issue banknotes. The Governing Council meet 10 times in a year. The next decision making body is Executive Board which is created by six participants: president, vice president and four participants. Executive Board tasks are carried out by implementation monetary policy (which is created by the Governing Council) (Kołodziejczyk; 2000; s. 85-87).

**Tabela 2. Decision-making bodies of the European Central Bank**

Source: Wierzba R., 2003, p. 50 Europejski Bank Centralny, Biblioteka Bankowca, Warszawa 2004.

#### 4. Targets, instruments and channels of monetary policy

According to the Statue of the European System of Central Banks: „the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community” (art.2). This resolution is based on (Borowiec; 2001, s. 144):

- in the long run thanks to the price stability is possible to achieve another aim, like growth economic development and employment without impair the primary objective,
- monetary policy is the best instruments to achieve price stability because inflation has a monetary character,
- monetary policy will be the most effective if it will be created by the independent European Central Bank.

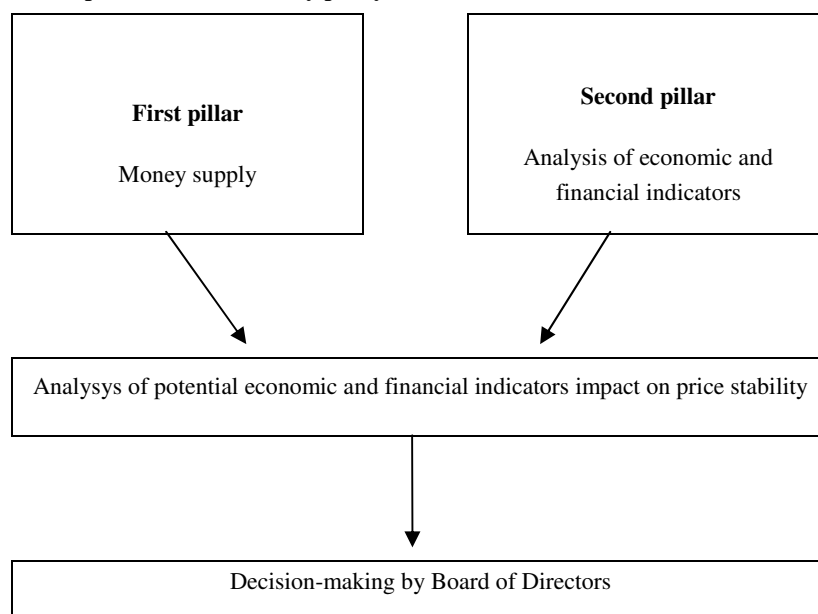
Connection between price stability and real production and development has close connection. The Governing Council defined price stability as a year-on-year increase of the Harmonized Index of Consumer Prices for the euro area. The HICP is a entire measure for inflation because it focuses on the general public on consumer goods. The monetary policy of the European Central Bank based on two pillars which were introduced by the ECB in 2004.

The main elements of the monetary policy strategy was established in October 1998. Monetary policy strategy components are:

- Definition of price stability.
- Two pillars which indicates conditions in the economy and they are tools to conduct decision in the monetary policy.

This primary objective is also in place in each country of the Community, which should have take care of price stability and preservation of the value of the currency. Price stability is interpreted by the ECB as an inflation stabilization. European Union countries which are in the euro area have to accept the ECB interpretation of price stability for the long run. European Union countries which wants to join the euro area in the future should also satisfy convergence criteria.

**Table 3. Two pillars of the monetary policy of the ECB**



Source: Gawlikowska-Hueckel K., Zielińska- Głębocka A., p. 278.

The First pillar has a distinguished meaning for money and the particular role was directed broad monetary aggregate (M3). This aggregate was recognized by the ECB to be a good indicator of inflation. The second pillar is based on a wide range of economic indicators as follow as: producer prices, the real GDP and its components, business and consumers indicators, employment or unemployment rate, exchange rates and any other financial indicators (De Haan et al; 2005, s. 11-14).

The European Central Bank thanks to its independence has right to informal choice of the monetary policy instruments which should be based on:

- methods applied by the ECB have to be compatible with principles of market economy,
- instruments of the monetary policy should put into effect price stability.

The instruments of monetary policy used by the ECB are based on the classical monetary instruments which are applied in the market economy countries. The commonly used instruments are

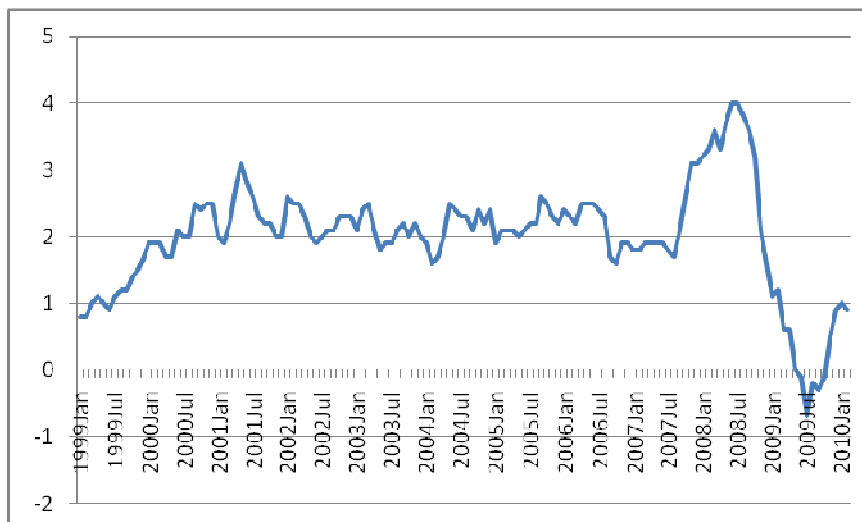
([cenbank.org/OUT/EduSeries/Series9.pdf](http://cenbank.org/OUT/EduSeries/Series9.pdf), 20.03.1010):

- Open Market Operations, the ECB buys or sells securities to the banking and non-banking public. The main purpose of the open market operations is to achieve optimal liquidity for money market.
- Reserve Requirement, the ECB requires deposit money banks to hold a fraction of their deposit liabilities as vault cash and deposits with it.
- Lending by the ECB, the European Central Bank provide credit to deposit money banks.
- Interest rate, the ECB lends deposit money banks at a most favourable rate of interest.
- Exchange Rate, the ECB thanks to selling or buying foreign exchange ensures that the exchange rate is at levels that do not affect domestic money supply in undesired direction.

## **5. Analysis of the HICP in eurozone**

The data used in this paper and connected with inflation come from ECB website. It should be treat as a monthly data, neither seasonally nor working day adjusted.

The analysis of the inflation can be researched from 1999 the common European currency was introduces to world financial markets as an accounting currency, replacing the former ECU at ratio of 1:1. Since January 1999 to February 2010 the average inflation amounted to 1,997. In the first phase of researching (from January 1999 to March 2000) the value of HICP rose up (from 0,8 to 3,1). Then the decrease could be observed and the value was starting to level off between 1,9-2,5. Eventually the present financial crisis caused the inflation increase. The highest level of HICP quotient (3,1;4) was reached between January and October 2008. The increase of prices started reducing from November 2008. HICP was falling and in May 2009 it amounted to 0, and for next five months was being below zero. It has been above zero since November 2009.

**Table 4. HICP in eurozone (1991-1998)**

Source: EBC.

The analysis of the inflation in the individual countries would be quite interesting. The lowest level of the inflation could be observed in Germany (1,54), France (1,75) and Austria (1,75) and the highest in Spain (2,87), Greece (3,12), Slovenia (5,01), Slovakia (5,65). In these two countries, which were mentioned at the end of list, the highest level of the inflation was reached during being apart from Monetary Union. Among the rest of the countries with the highest inflation we can observe at all PIGS country (PIGS is acronym refer to the economies of Portugal, Italy, Greece, and Spain) (Andrade, 2009, s. 2).



**Table 5. HICP by country (1991-1998)**

<b>Germany</b>	1,539552
<b>France</b>	1,749254
<b>Austria</b>	1,752985
<b>Finland</b>	1,776119
<b>Belgium</b>	2,019403
<b>Netherlands</b>	2,233582
<b>Italy</b>	2,249254
<b>Malta</b>	2,477612
<b>Cyprus</b>	2,511194
<b>Portugal</b>	2,526866
<b>Luxembourg</b>	2,597015
<b>Ireland</b>	2,819403
<b>Spain</b>	2,873134
<b>Greece</b>	3,118657
<b>Slovenia</b>	5,007463
<b>Slovakia</b>	5,652239

Source: EBC.

It is easy to noticed that from the establishing Euro Zone the definite decrease of inflation in comparison to dates from the end of the last century. The average inflation in the period of time from January 1991 to December 1998 amounted to 2,62 and was definitely higher than the data points in 1999-2010. The particulars data are included in the fallowing tables.

**Table 6. HICP in eurozone (1991-1998)**

Date	HICP	Date	HICP	Date	HICP	Date	HICP
1998Dec	0,8	1996Dec	1,9	1994Dec	2,6	1992Dec	3,2
1998Nov	0,8	1996Nov	1,9	1994Nov	2,5	1992Nov	3,1
1998Oct	0,9	1996Oct	2	1994Oct	2,6	1992Oct	3,2
1998Sep	1	1996Sep	2	1994Sep	2,7	1992Sep	3,3
1998Aug	1,1	1996Aug	2	1994Aug	2,7	1992Aug	3,3
1998Jul	1,3	1996Jul	2,1	1994Jul	2,6	1992Jul	3,3
1998Jun	1,4	1996Jun	2,1	1994Jun	2,7	1992Jun	3,9
1998May	1,3	1996May	2,5	1994May	2,8	1992May	4
1998Apr	1,4	1996Apr	2,4	1994Apr	2,7	1992Apr	4,2
1998Mar	1,1	1996Mar	2,4	1994Mar	2,8	1992Mar	4,3
1998Feb	1,1	1996Feb	2,4	1994Feb	2,9	1992Feb	3,8
1998Jan	1,1	1996Jan	2,4	1994Jan	2,9	1992Jan	3,9
1997Dec	1,5	1995Dec	2,4	1993Dec	3,2	1991Dec	4,1
1997Nov	1,6	1995Nov	2,4	1993Nov	3,2	1991Nov	4,1
1997Oct	1,5	1995Oct	2,4	1993Oct	3,3	1991Oct	3,7
1997Sep	1,6	1995Sep	2,4	1993Sep	3,3	1991Sep	3,9
1997Aug	1,7	1995Aug	2,3	1993Aug	3,3	1991Aug	4,5
1997Jul	1,5	1995Jul	2,4	1993Jul	3,3	1991Jul	5
1997Jun	1,4	1995Jun	2,6	1993Jun	3,1	1991Jun	4,3
1997May	1,4	1995May	2,4	1993May	3,1	1991May	4,1
1997Apr	1,3	1995Apr	2,6	1993Apr	3,2	1991Apr	3,8
1997Mar	1,6	1995Mar	2,5	1993Mar	3,2	1991Mar	3,9
1997Feb	1,8	1995Feb	2,4	1993Feb	3,4	1991Feb	4,1
1997Jan	2	1995Jan	2,4	1993Jan	3,4	1991Jan	3,9

Source: EBC.

Establishing of the Euro Zone caused the fall of the inflation because of 4 reasons at least. Firstly the members tried to fulfil the convergence criteria what had influence on decrease of the level the inflation (Wypłoz 2006, s. 211) as well as falling the inflation expectation (Angeloni 2006, s. 30). Secondly the lack of the nominal rate of change variability caused that the changes linked with depreciation and appreciation don't correspond with the level of the prices in the whole country (NBP 2009, s. 19) Thirdly in the countries of Euro Zone the international effectiveness and transparency of the markets increase (the European Commission) At least the monetary policy was led by ECB what had positive influence on process of shaping the inflation expectation (NBP 2009, s. 20).

## 6. Conclusion

The European Central Bank is an European institution which is responsible for the monetary policy of the European Union. It is one of the world's most important central banks. The main objective of the ECB is to maintain price stability in the Eurozone and it has a right to authorise the issuance of euro banknotes. The European Central Bank is also responsible for maintaining a stable financial system and monitoring the banking sector. According to our analysis inflation indicators in the European Union countries decreased from the beginning of the establishing the Euro zone. The average inflation rate from 1999 to 2010 was lower than the average inflation rate between 1991 to 1998. The monetary policy strategy conducted by the European Central Bank has got a positive impact on the inflation rate in the eurozone countries but now the ECB should also support the economy market in the EU because of the world economy crisis.

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## Streszczenie

### **POLITYKA EUROPEJSKIEGO BANKU CENTRALNEGO W KONTEKŚCIE STABILIZACJI CEN**

*Celem niniejszego artykułu jest przedstawienie polityki pieniężnej EBC w kontekście stabilizacji cen. EBC rozpoczął swoją działalność w roku 1998 i od tego czasu wraz z Europejskim Systemem Banków Centralnych odgrywa istotną rolę w prowadzeniu polityki pieniężnej Unii Europejskiej. Polityka ta jest specjalnym narzędziem stosowaną przez bank centralny oraz rządy narodowe w celu oddziaływania na gospodarkę. Jednym z działań jest oczywiście wpływ na podaż pieniądza i innych istotnych wskaźników. W niniejszym artykule autorzy starają się dokonać analizy polityki pieniężnej prowadzonej przez EBC ze szczególnym uwzględnieniem HICP.*