

THE FUTURE ROLE OF EESTI PANK AS A MEMBER OF THE EURO AREA

If Estonia adopts the euro, Eesti Pank will become a **fully-fledged member¹ of the European System of Central Banks (ESCB)**. This will entail significant changes in those functions of Eesti Pank that fall under the competence of the European Central Bank (ECB) and the ESCB in accordance with the founding treaties of the European Union. A number of the central bank's key responsibilities, such as maintaining financial stability, will still be outside the competence of the ESCB, although they will involve close trans-European cooperation.² The changes caused by joining the euro area will be minimal in these areas. The functions that are not directly connected to EU membership will be virtually the same: monitoring and analysis of the Estonian economy, compilation of economic forecasts, management of official foreign reserves³, organisation of financial supervision, international cooperation outside the European Union, with the IMF and the BIS among others, and other similar tasks.

The ESCB consists of the European Central Bank and the central banks of the EU Member States, which are all independent institutions. All the central banks of EU Member States are part-owners of the European Central Bank and make contributions to its fixed capital and reserves. The amount of each Member State's contribution depends on its GDP and population.

The ESCB's **primary objective is to maintain price stability** and help the European Union achieve its broader economic policy goals while ensuring price stability.

The ESCB has the following key functions:

- development and implementation of the single monetary policy of the Eurosystem;

- execution of foreign currency operations;
- management of the foreign reserves of the euro area Member States;
- operation and supervision of payment and settlement systems.

In addition, the ESCB provides assistance to financial supervision institutions and helps guarantee financial stability in the European Union. The ESCB also arranges the collection of the statistical data that it needs to fulfil its responsibilities.

In conclusion, becoming a member of the euro area entails big changes in monetary policy and in the economic analysis, reserve management and foreign currency operations, statistics, cash, and payment and settlement systems of the euro area.

Monetary policy and economic analysis

The monetary policy of the euro area follows the principle of **centralised decision-making and decentralised implementation**. All monetary policy issues, enforcement of regulations and decision-making fall under the competence of the **Governing Council of the ECB⁴**. The ECB Governing Council works with the central banks of the Member States to design the monetary policy framework and set monetary policy goals. The work is done in numerous ESCB committees and task forces, where all important issues are discussed before any decisions are made. The ECB Executive Board is responsible for implementing the decisions of the ECB Governing Council through national central banks.

The primary monetary policy measures used by the ESCB are the regular **repo auctions** to give

¹ Eesti Pank currently participates in the ESCB as a member with derogation.

² The ESCB has only a limited role in guaranteeing financial stability, as it primarily provides information about events taking place in various countries. Financial sector regulations are in the competence of other EU institutions and EU Member States.

³ Not to be confused with the central bank's reserves (see "Reserve management and foreign currency operations", pp 25).

⁴ The ECB Governing Council consists of the members of the ECB Executive Board and the governors of the national central banks of the euro area. If Estonia adopts the euro, the Governor of Eesti Pank will become a member of the ECB Governing Council.

short-term loans to commercial banks and the **system of reserve requirements**. The ECB and the ESCB committees draft the materials which the ECB Governing Council then uses to set the specific inflation goal and the monetary policy interest rates that are needed for that goal to be achieved. The current priority of monetary policy is to maintain the inflation rate close to but below 2% in the medium term. The most important monetary policy interest rate is the interest rate applied to the ESCB's main refinancing operations, which stood at 1.00% before 1 January 2010.

Implementation of daily monetary policy is shared between the ECB and the national central banks. For instance, the reserve requirement and the level of regular refinancing operations, which give the total of short-term loans granted to commercial banks in the Eurosystem, are decided by the ECB, while monetary policy transactions are intermediated by the national central banks. The required reserves of commercial banks are held with the national central banks. Lending to commercial banks also takes place via the Eurosystem's central banks, meaning the partner of a commercial bank in a refinancing operation through a loan contract is generally a national central bank, not the ECB.

The ESCB could not achieve its primary monetary policy objective without monitoring, analysing and forecasting economic developments. The ECB Governing Council makes its interest rate decisions on the basis of comprehensive analyses of the euro area economy and the money supply. The analytical work is divided into two major areas. In the first

of these, both the ECB and the national central banks of the euro area carry out general monitoring of the euro area economy by analysing total demand, the interest rate levels and liquidity of financial markets, the capital and labour markets, changes in the euro exchange rate, and global economic developments. Fiscal policy is an essential part of the euro area economies. Economic analyses result in short- and medium-term assessments of inflation developments. The second focus is on the aggregate indicators of money supply and credit and their long-term impact on inflation.

All this takes place in close cooperation between the ECB and the national central banks. This requires extensive homework from the national central banks to present their standpoints and participate in the discussions, and this in turn sets high standards for the working methods and staff of the central banks.

Reserve management and foreign currency operations

The management of foreign reserves in the ESCB is divided into two parts. Each central bank of the euro area makes a **contribution to the fixed capital and foreign reserves of the ECB**. If needed, these reserves are used for currency market interventions, which are performed exclusively by the ECB, by all the central banks of the euro area or by a combination of participants. The ECB does not invest its reserves; instead, these are managed by the central banks of the Member States. To this end, the ECB's reserves are distributed among national central banks according to the capital key⁵. The income from

⁵ Under Article 29 of the Protocol on the Statutes of the European System of Central Banks and of the European Central Bank, the shares of the national central banks are weighted according to the shares of the Member States in the total population and the gross domestic product of the European Union (EU), in equal measure, as notified to the ECB by the European Commission. The weightings are adjusted every five years or whenever a country joins the EU. Accordingly, on 1 January 2009 the ECB's capital key was adjusted for the five-yearly update, on the basis of data provided by the European Commission. On 1 January 2009, the total of the subscribed capital of the ECB was EUR 5,760,652,402.58. Estonia's contribution was 0.1790%. The 11 non-euro area Member States are required to pay a minimal percentage of their subscribed capital (currently 7%), as a contribution to the operational costs of the ECB. See also http://www.ecb.int/press/pr/date/2009/html/pr090101_1.en.html.

investment belongs to the ECB and the Member States participate in distributing the profit and increasing the capital of the ECB, if needed.

In addition to the reserves of the ECB, every central bank that is a member of the ESCB independently manages its own national foreign reserves. No common rules have been laid down to regulate the management of the reserves of the Member States. The function of these reserves in the Eurosystem is to guarantee that an additional contribution can be made to the ECB's reserves if needed. However, central bank reserves also have a broader role. The central banks of the Member States, including Eesti Pank, are independent legal entities with their own assets and liabilities, which is why they need sufficient capital buffers to cover extraordinary losses. Eesti Pank also needs a sufficient capital buffer to fulfil those of its tasks that are not directly related to the implementation of the Eurosystem's monetary policy.

Cash and payment and settlement systems

The regulations pertaining to the circulation of cash are laid down by the ECB Governing Council after consultation with the national central banks. The daily management of cash circulation is the responsibility of the Eurosystem's central banks and euro cash is launched into circulation through commercial banks by national central banks, not the ECB. This means that the euro cash in circulation is also a liability of national central banks, not the ECB, and is recorded on their balance sheets.

A key task of the ESCB is to foster the smooth operation of payment and settlement systems. The central banks of the ESCB fulfil this responsibility in two ways, as managers of the payment

and settlement systems and as policy developers with oversight.

For Eesti Pank as a manager of payment and settlement systems, joining the euro area will not entail any changes.

Eesti Pank has two main obligations as a member of the ESCB in developing the policies for payment and settlement systems. First, Eesti Pank will be participating in the ESCB by shaping the policy of payment and settlement systems, which mainly means setting the ESCB standards and guidelines and writing the legislation of the European Central Bank. Second, Eesti Pank is and will be responsible for the oversight of payment and settlement systems by assessing the systems' compliance with the standards.

Statistics

The ESCB needs detailed information about the euro area economy and financial system in order to fulfil its key functions. The division of responsibilities between the ECB and the national central banks regarding the collection, processing, analysis and publication of data and the methodology for this is similar to the division in monetary policy. The ECB Governing Council approves the standardised statistics requirements and the due dates for the submission of the statistics that are needed for the work of the ESCB, having first consulted with the national central banks. The central banks are responsible for the daily collection and processing of statistics.

If Estonia joins the euro area, Eesti Pank's responsibilities in statistics will grow, since in the single currency system the euro area central banks are required to present more detailed statistics than are the non-euro area central banks.

Assets and liabilities of the central bank after the changeover

Similar to other national central banks of the euro area, Eesti Pank will still remain an independent and autonomous central bank with its own assets and liabilities after the adoption of the euro. Joining the Eurosystem will not lead to any excess assets or reserves on the balance sheet of Eesti Pank. However, the balance sheet total will decrease slightly, primarily as a consequence of a change in the reserve requirement for commercial banks.

Only two technical changes will occur on the liabilities side of the balance sheet of Eesti Pank. First, the issuance of cash, which is reflected on the balance sheet as a central bank liability, will be recorded not in kroons but in euros, meaning that the currency will change. The value of liabilities will not change, since technically the entry of the issuance of cash on the balance sheet will be an estimate of Estonia's share of the total amount of cash put into circulation in the whole region. As kroons are now, in the future the euro bank notes circulating in Estonia will remain a liability of Eesti Pank and have to be fully backed by the assets of Eesti Pank.

Second, the reserve requirement for Estonian banks will fall after the adoption of the euro, from the current 15% to 2%⁶. As a result, commercial banks will be depositing less money on their accounts in Eesti Pank.

On the side of assets, two changes will occur after a changeover to the euro. First, Eesti Pank's share in the ECB will increase and some of the reserves will be transferred. Second, since commercial banks will withdraw some, but not all, of their account money from Eesti Pank once the

reserve requirement falls, Eesti Pank's external assets will also shrink.

After the changeover, the **structure of Eesti Pank's assets will start to change gradually**. In the currency board system the issue of kroons must be backed by external assets alone, whereas euro issues may be covered by domestic and external assets, with claims against the European Union and its Member States and also other countries, in accordance with the common requirements of the ESCB. Currently, the reserves backing the kroon consist of the government bonds of major industrial countries in the USA and euro area, but in the euro area the reserves backing the euro may also consist of other financial assets, such as loans granted to commercial banks.

⁶ The actual decrease in the reserves deposited in the central bank will be smaller, since banks will be allowed to fulfil about half of their reserve requirement with high-quality liquid external assets.