HIGHER SCHOOL OF INSURANCE AND FINANCE - SOFIA

DOCTORAL DISSERTATION

ON THE SUBJECT

THE INFLUENCE OF THE EUROPEAN CENTRAL BANK ON THE MONETARY POLICIES OF THE MEMBER STATES OF THE EUROPEAN UNION AND THE REPUBLIC OF BULGARIA AND THE REPUBLIC OF NORTHERN MACEDONIA

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ABSTRACT

The main goal of the European Central Bank (ECB) is price stability. This means that prices should not rise too much (inflation), rise too slowly, or even fall too low (deflation). To achieve this, the ECB is taking steps. This is what we call monetary policy. The ECB does not have a direct impact on rising and falling prices, but it does have the tools to indirectly impact inflation, namely monetary instruments. There is a difference between conventional monetary instruments - such as political interest rates - and unconventional instruments - such as buying programs. The ECB pursues an adjustable monetary policy - also known as quantitative easing - as it seeks to stimulate the economy by providing low interest rates for households, businesses and governments. It does so, for example, during a recession such as the current coronavirus crisis. For this, the ECB relies on its interest rate instrument and procurement programs. The ECB announced its new monetary strategy on July 8, 2021. The Governing Council believes that price stability is best maintained if you are aiming for a 2% inflation target in the medium term. This target is symmetrical, which means that the negative and positive deviations of inflation from the target are equally undesirable. The ECB is taking action against the eurozone and all its central banks.

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INTRODUCTION

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1. SOCIAL JUSTICE FOR STUDYING THE TOPIC

The European Central Bank (ECB) is the main component of the Eurosystem and the European System of Central Banks (ESCB), as well as one of the seven institutions of the European Union. It is one of the most important central banks in the world.

The ECB creates the monetary policy for the euro area and the European Union, manages the foreign reserves of the EU member states, engages in foreign exchange operations and defines the average monetary targets and the basic interest rate of the EU. The Executive Board of the ECB implements the policies and decisions of the Governing Council and may direct national central banks in doing so. The ECB has the exclusive right to authorize the issuance of euro banknotes. Member States may issue euro coins, but the volume must be approved in advance by the ECB. The Bank also manages the TARGET2 payment system.

The ECB was established by the Amsterdam Treaty in May 1999 to guarantee and maintain price stability. On 1 December 2009, the Lisbon Treaty entered into force and the bank gained official status as an EU institution. When the ECB was created, it covered an eleven-member eurozone. The ECB is directly regulated by European Union law. Its capital, worth 11 billion euros, is owned by all 27 central banks of the EU member states as shareholders. The shares in the ECB are non-transferable and cannot be used as collateral.

The European System of Central Banks (ESCB) consists of the ECB and the national central banks of all EU member states. The primary goal of the ESCB is to maintain price stability. In order to achieve this primary goal, the ECB bases its decisions on an integrated analytical framework and implements both standard and non-standard monetary policy measures. The main instruments of the ECB's standard monetary policy are open market operations, fixed capacity and the maintenance of minimum reserves. In response to the global financial crisis, the ECB has also changed its communication strategy by providing guidance on the future path of the ECB interest rate policy conditioned by the prospect of price stability and has taken a number of non-standard monetary policy measures. These include the purchase of assets and government bonds on the secondary market in order to maintain price stability and the effectiveness of the monetary policy transmission mechanism.

From July 2021, price stability is defined as the inflation rate (year-on-year increase of the Harmonized Consumer Price Index for the euro area by 2% in the medium term. The target is symmetrical, which means that both negative and positive deviations from this target are This may mean a transitional period in which inflation is moderately above the 2% target.

In July 2021, the existing two-pillar strategy was revised to become an "integrated analytical framework" consisting of (1) economic analysis and (2) monetary and financial analysis. Economic analysis focuses on real and nominal economic trends. Monetary and financial analysis examines monetary and financial indicators, allowing focus on the mechanism of monetary transmission and the implications of financial imbalances and monetary factors on medium-term price stability.

The 2020-2021 Strategy Review recognizes that climate change has implications for price stability and has led to a commitment to address, within the ECB's mandate, the implications of climate change and the carbon transition for monetary policy and central banking. The ECB has adopted a Climate Action Plan, which aims to incorporate climate factors into monetary policy assessments, expand climate change analytical capacity, adjust the design of the monetary policy operating framework, and implement activities in the field of monetary policy. disclosure of environmental sustainability. and reporting.

The ECB prepares and publishes reports on the activities of the ESCB at least quarterly. The ESCB consolidated financial statements are published weekly. From the outset, the ECB Monthly Bulletin provides an in-depth analysis of the economic situation and price growth prospects. The ECB submits an annual report on the activities and monetary policy of the ESCB for the previous and current year to the European Parliament.

The ECB is accountable to the European Parliament and members of the ECB Executive Board appear before it regularly.

2. SUBJECT OF RESEARCH

The main objective is not focused on the monetary policy pursued by the European Central Bank, the responsibility, role and tasks of the bank itself.

The content of the paper is conceived in a way that will first present a complete picture of the role of the European Central Bank in the creation of EU monetary policy and its implementation.

The role of the ECB in shaping the monetary policy of EU member states outside the Eurozone, such as Bulgaria, and candidate countries for EU membership, such as Macedonia, is also the subject of the paper. Then, an overview of the institutional framework for the introduction of the single monetary policy in the EU will be given.

A special part of the paper will be dedicated to the monetary policy strategy of the European Central Bank (ECB), ie the general principles and main elements, a risk analysis for price stability and an overview of the ECB monetary policy strategy.

Also, the focus of this is the implementation of the strategy, the liquidity of the Central Bank and the liquidity needs of the banking system.

3. PURPOSE OF THE RESEARCH

The European Union (EU) is a supranational and intergovernmental community of 27 democracies. The European Central Bank (ECB), based in Frankfurt, is the central bank of the Eurozone and is responsible for the monetary policy of the European Union member states that use the euro as their currency.

The European Central Bank is responsible for managing the euro and the EU monetary policy. The tasks of the European Central Bank are defined by the Treaty establishing the European Community. The primary objective of the Bank is to maintain price stability and to support the main economic policies of the Community.

The purpose of the study is to confirm the significance and role of the Bank's core tasks which are:

- defining and implementing monetary policy in the euro area;
- maintenance and management of the foreign exchange reserves of the euro area countries and
- promotion of the functioning of payment systems.

4. HYPOTHESIS

Basic (general) hypothesis:

The paper starts from the assumption that "without a good monetary policy free financial flows in conditions of globalization there is no successful economic development."

First special hypothesis:

What are the main issues related to the monetary policy making of the Eurozone member states, the EU member states outside the Eurozone and the candidate countries for EU membership.

Second special hypothesis:

Ensuring an appropriate monetary policy to support the development financial and price stability of EU member states and candidate countries

Third special hypothesis:

A stable economic system enables countries, their governments and institutions to plan and direct economic development activities in terms of their expansion and strengthening across countries around the world in order to achieve the highest possible level of price stability.

Auxiliary hypothesis:

What are the new strategies for proper economic development in a pandemic KOVID 19.

5. RESEARCH METHODS

The preparation of the doctoral dissertation is based on data provided by international literature which allows to see the theoretical foundations for the formation and formation of the European Union, and within that of the European Central Bank. , articles and papers by several authors.

In the part of the monetary policy strategy of the European Central Bank (ECB) and the implementation of the policy itself, data available via the Internet are used.

For the purpose of successful processing and elaboration of the topic of the doctoral dissertation that requires a multidimensional approach, a number of research methods are used, which are:

- ***historical*** - applying this method historically determines the beginnings of the creation of the EU and the ECB, its growth and development and impact on the economy in EU countries;
- ***content analysis*** - using this method, the results of the economic functioning of the ECB are analyzed
- ***comparative method*** (comparative) - the application of this provides a comparative view of the experiences, methodology and differences of the impact of the ECB monetary policy on the economic of the EU member states;
- ***statistical method*** - by applying this method, the effectiveness of the monetary policy measures implemented by the EU is processed.

- ***synthesis*** - with the help of this method the data obtained with the help of the previous methods are combined.

6. TIME FRAMEWORK OF THE RESEARCH

Due to the nature of the material covered in the doctoral dissertation, the time matter is researched in the period from the establishment of the ECB to 2021 to determine how the impact of the monetary policy created and implemented by the ECB has developed.

7. INFORMATION BASE OF THE DOCTORAL DISSERTATION

The information base during the preparation of the dissertation was based on the materials from the statistical yearbooks, statistical bulletins, Materials from the Internet, materials from the European Central Bank, from the National Banks of the Republic of Bulgaria and the Republic of Northern Macedonia.

8. DEGREE OF PROBLEM DEVELOPMENT

There are numerous studies in the literature on the role of the ECB in shaping and implementing EU monetary policy. In recent years, a number of theoretical and practical aspects of the characteristics of monetary policy have been considered, which fully elaborate on the various effects of monetary policy on the economic, political, social and cultural behavior of individual EU Member States and candidate countries.

PART ONE: INSTITUTIONAL FRAMEWORK FOR IMPLEMENTATION OF A SINGLE MONETARY POLICY IN THE EU AND THE EUROSYSTEM

1.1. General framework of the European Union monetary policy

Since 1 January 1999, the European Central Bank (ECB) has played an active role in establishing and implementing the Eurosystem's monetary policy:[1]

- The primary goal of monetary policy is to maintain price stability in the euro area. The Eurosystem, consisting of the ECB and the National Central Banks (NCBs) of the countries that have adopted the euro, defines and implements the monetary policy for the euro area according to this goal.

Eurosystem: ECB + central banks of the euro area countries	**Eurosystem: ECB + central banks of the countries in the euro area.**

- The Maastricht Treaty established the completion of the Economic and Monetary Union (EMU) as a formal goal and set a number of convergence criteria. The EMU monetary policy is guided by the Eurosystem consisting of the ECB and the NCB of the EU member states whose currency is the euro.
- Following the Maastricht Treaty, the central banks of the 15 member states of the European Union and the newly created European Central Bank (ECB) became members of a supranational institution: the European System of Central Banks (ESCB).

ECSC: ECB + central banks of 27 EU countries	**ESCB: ECB + central banks of the 27 EU countries. ESCB: ECB + central banks of the 27 EU countries.**

[1] General framework for European monetary policy | nbb.be, (2021), https://www.nbb.be › general., p. 1

Monetary policy concerns the decisions taken by a central bank, within its mandate, to influence the cost of borrowing and the amount of money in the economy:[2]

- In the euro area, the most important decision of the European Central Bank (ECB) is usually to set the key interest rates. If necessary, the ECB may decide to use other instruments.
- Monetary policy is used to influence changes in the prices of the goods and services which are consume.
- The ECB's primary objective is to maintain price stability in the euro area. This means making sure prices do not increase a lot or have large fluctuations, i.e. ensuring that inflation is low and stable.
- The ECB sets monetary policy aiming for 2% inflation over the medium term.

The European System of Central Banks (ESCB) comprises the ECB and the national central banks of all the EU Member States. The primary objective of the ESCB is to maintain price stability. In order to achieve this primary objective, the Governing Council of the ECB bases its decisions on an integrated analytical framework and implements both standard and non-standard monetary policy measures:[3]

- The main instruments of ECB standard monetary policy are:
  - ✓ open market operations,
  - ✓ standing facilities and
  - ✓ holding of minimum reserves.
- As a response to the global financial crisis, the ECB has also changed its communication strategy by providing forward guidance on the future path of the ECB's interest rate policy conditional on the outlook for price stability and has taken a number of non-standard monetary policy measures. These include the purchases of assets and sovereign bonds on the secondary market, with the aim of

[2] What is monetary policy and what is it used for? (2022), https://www.bportugal.pt › w.
[3] European monetary policy | Fact Sheets on the European Union, (2022), https://www.europarl.europa.eu › factsheets › sheet › eu.

safeguarding price stability and the effectiveness of the monetary policy transmission mechanism.

The primary objective of the ECB's monetary policy is to maintain price stability. This mean that inflation – the rate at which the prices for goods and services change over time – remains low, stable and predictable. To succeed, ECB seek to anchor inflation expectations and influence of the economy making sure the conditions are just righ:[4]

- The primary monetary policy instrument is the setting of ECB policy rates, which influence financing conditions and economic developments, thereby contributing to keeping inflation at the ECB's target level.
- Interest rates are the primary instrument that ECB use for monetary policy. In recent years ECB have added new instruments toolbox in response to big changes and large shocks in the economy that have made its task of maintaining price stability more challenging.
- ECB monetary policy framework strives to ensure the participation of a broad range of eligible counterparties. In the case of standing facilities and tender open market operations, only credit institutions that are subject to minimum reserves and fulfil all the necessary eligibility criteria are eligible to participate. For outright transactions, there are no a priori restrictions on the range of counterparties.

The ECB has no direct influence on rising and falling prices, but it can use its monetary policy to exert indirect influence on inflation. Important tools are the key interest rates, which are the rates at which banks borrow money from the ECB or deposit money with the ECB. There are also other tools which the ECB can use to influence inflation. If inflation is above or below 2% for too long in the medium term, the ECB can adjust the key interest rates:[5]

- *Too high:* If inflation is persistently too high, the ECB can raise interest rates. It will do so if it wants to depress inflation to achieve price stability. The idea is

[4] Introduction - European Central Bank, (2022), https://www.ecb.europa.eu › i.
[5] ECB monetary policy - De Nederlandsche Bank, @022https://www.dnb.nl › the-euro-and-europe › the-ecb-s-mo.

that if interest rates are high, people will borrow and spend less, firms will invest less and inflation will fall.

- *Too low:* If inflation is persistently too low, interest rates can only become negative to a limited extent. Deeply negative interest rates will damage the economy, for example because they put pressure on the financial positions of banks and pension funds. So if key interest rates are already low, the ECB cannot lower them much further. It must then use other monetary instruments to pursue an accommodative monetary policy.

The definition of price stability is based on the following elements:[6]

- The key measure of price developments in the euro area is the Harmonised Index of Consumer Prices (HICP), which is released by Eurostat and is harmonised across the euro area countries, in order to ensure that price developments are measured on a comparable basis. The HICP is the best measure of the average change over time in the prices paid by households for a representative basket of consumer goods and services in the euro area.
- The definition refers to the inflation rate in the euro area as a whole and, accordingly, single monetary policy decisions are made from a euro area-wide perspective. Moreover, in a monetary union, monetary policy can steer the average level of money market interest rate in the area as a whole rather than in individual member countries. This is so because there is a common currency (euro), and thus monetary policy rates are also common for all member states of the euro area.
- Price stability has a medium-term orientation, focusing on the inflation rate over considering the inflation rate over time rather than focusing on short-term peaks and troughsthat are typically due to exogenous and short-lived factors.
- Without prejudice to the primary objective of price stability, the Eurosystem's monetary policy supports the general economic policies of Member States with a

[6] Monetary policy mission, (2022), https://www.bankofgreece.gr ›

view to contributing to the achievement of their objectives. These include inter alia full employment and balanced economic growth.

- ✓ Price stability is important because it preserves the euro's purchasing power.
- ✓ A persistent, broadly-based increase in the prices of consumer goods and services over a protracted period (inflation) leads to a decline in purchasing power.
- ✓ The central bank has the exclusive privilege of issuing currency, i.e. is the monopoly supplier of the monetary base, therefore it is able to influence the cost and availability of money.
- ✓ Commercial banks obtain liquidity from the central bank and use it e.g. to extend loans to enterprises and households, as well as to other banks.

1.1.1. Monetary policy decision making

The conduct of the Eurosystem monetary policy is based on two principles:

- ✓ Decisions are made centrally by the Governing Council of the ECB,
- ✓ Decisions are implemented on a decentralized basis by the national central banks.

The ECB has three decision-making bodies:[7]

- ➢ ***Governing Council*** - The Governing Council is the main decision-making body of the ECB. It consists of six members of the Executive Board of the ECB, plus the governors of the national central banks of the 19 euro area countries. The Governing Council assesses economic, monetary and financial developments and makes its monetary policy decisions every six weeks. At other meetings, the Council discusses mainly issues related to other tasks and responsibilities of the ECB and the Eurosystem. To ensure that monetary policy and other tasks of the ECB are separated from

[7] General framework for European monetary policy - Monetary policy decision-making| nbb.be, 2022), https://www.nbb.be › general.

- ***ECB Executive Board*** - The Executive Board of the ECB consists of the President of the ECB, the Vice-President and four other members. All members are appointed by the European Council, acting by a qualified majority. The Executive Board of the ECB is responsible for the day-to-day management of the ECB and prepares the meetings of the Governing Council. He is responsible for implementing the monetary policy decisions made by the Governing Council and for that purpose gives the necessary instructions to the national central banks of the euro area.

- ***General Council*** - The General Council consists of the President and Vice-President of the ECB plus the Governors of the National Central Banks (NCBs) of the 28 EU Member States. As a rule, it meets four times a year and will continue to exist as long as there are EU member states that have not yet introduced the euro. It deals with topics related to both the monetary union and other EU member states.

The Governing Council formulates monetary policy in the euro area free from political interference and is required to represent the interests of the euro area as a whole. As members of the Governing Council, Governors of NCBs play a crucial role in decisions relating to monetary policy for the euro area:[8]

- Responsibilities the Governing Council are:
  - ✓ to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ECB and the Eurosystem;
  - ✓ to formulate monetary policy for the euro area. This includes decisions relating to monetary objectives, key interest rates, the supply of reserves in the Eurosystem, and the establishment of guidelines for the implementation of those decisions.
  - ✓ in the context of the ECB's responsibilities related to banking supervision, to adopt decisions relating to the general framework under which supervisory

[8] Governing Council decisions - European Central Bank, (2022), https://www.ecb.europa.eu › press › html › index.en.html.

decisions are taken, and to adopt the complete draft decisions proposed by the Supervisory Board under the non-objection procedure.

- The Governing Council assesses economic and monetary developments and takes its monetary policy decisions every six weeks. At the other meetings, the Council discusses mainly issues related to other tasks and responsibilities of the ECB and the Eurosystem. To ensure the separation of the ECB's monetary policy and other tasks from its supervisory responsibilities, separate meetings of the Governing Council are held.

1.1.2. Implementation of monetary policy

Traditionally, the implementation of monetary policy by the Eurosystem aims to guide short-term market interest rates by using key ECB interest rates as anchor points. The implementation of monetary policy focuses on the primary goal of maintaining price stability in the euro area.

The Eurosystem is in a way a "bank of the bank" in the Eurozone, as credit institutions in the Eurozone need to borrow liquidity from the Eurosystem to meet the demand for banknotes and to form (required) reserves with the national central banks.

Traditionally, the Governing Council has guided the monetary policy of the Eurosystem by setting interest rates on secured liquidity (ECB policy rates). They also affect a number of other long-term rates, such as those applied by credit institutions to their clients, and - more indirectly - exchange rates. These financial variables in turn affect the demand for goods and services in the economy and the level of prices and wages.

Since the global financial crisis, given the constraints on managing short-term interest rates, the monetary policy pursued by the Governing Council has been used to influence time premiums and, more directly, long-term interest rates. This is achieved through other instruments, not just key interest rates.

The decisions of the Governing Council are intended to maintain price stability for the euro area as a whole. Its mode of action is countercyclical. Usually, if inflation is too low in relation to the target, monetary policy measures are primarily aimed at easing the conditions for financing the economy (interest rates are reduced) in order to stimulate the economy and, through the impact of the impact, to encourage price dynamics. Conversely, if inflation gets out of control, monetary policy measures are used to tighten financing conditions (interest rates rise) in order to limit activity growth and maintain the associated inflationary pressures.

In order to achieve its primary objective of maintaining price stability for the euro area as a whole, the Eurosystem uses a set of monetary policy instruments and procedures. These provide the operational framework for the implementation of monetary policy decisions in practice:[9]

- The monetary policy instruments are:
  - ✓ open market operations, aiming to steer interest rates, regulate the money supply in the financial market and signal the monetary policy stance;
  - ✓ standing facilities, aiming to provide and absorb overnight liquidity;
  - ✓ minimum reserve requirements (the minimum amount of reserves a commercial bank must hold with their central bank),
- The Eurosystem open market operations are executed through tender procedures and may either involve tenders or be bilateral procedures, where the central bank deals directly with only one or a few counterparties.
- Counterparties to the Eurosystem’s monetary policy operations must fulfil the following criteria to participate in these operations:
  - ✓ meet the minimum reserve requirements;
  - ✓ be supervised by competent authorities according to Directive 2013/36/EU on prudential supervision of credit institutions and investment firms (see summary) and Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (see summary);

[9] Implementation of the Eurosystem monetary policy framework, (2022), https://eur-lex.europa.eu › im.

- ✓ be financially sound;
- ✓ satisfy all the contractual requirements specified by the European Central Bank (ECB) or the national central bank.

1.1.3. Monetary policy strategy

The Maastricht Treaty stipulates that the primary objective of monetary policy pursued by the Governing Council of the ECB is to maintain price stability. The Board of Directors has defined a strategy that contains a quantified definition of price stability:[10]

❖ ***The primary goal of monetary policy*** - the Maastricht Treaty gives the Eurosystem responsibility for maintaining price stability in the euro area. The signatory states are convinced that a monetary policy that protects the intrinsic value of the currency is the best way to encourage the improvement of economic prospects and the increase of living standards. In the past, deflation and inflation have proven to be harmful: they destroy the information contained in the pricing system, have an unprecedented effect on the value of contracts and savings, generate increased uncertainty and therefore hinder the efficient allocation of resources, investment and growth.

❖ ***Definition of price stability*** - The Governing Council of the ECB publishes a quantitative definition of price stability in order to provide a stable reference point for price expectations and to make it easier for the public to evaluate its actions. The gradual increase of the consumer price index is considered as an indicator that prices are stable in general, because the index is affected by "measurement errors" mainly due to changes in spending patterns and improved quality of goods and services. The Eurosystem can not be blamed for short-term shocks, such as the rise in prices resulting from rising commodity prices in the international market, but can be blamed for the price trend. Because its policy is medium-term, it can also respond gradually and cautiously to certain unexpected forms of economic disruption.

❖ ***Integrated analytical framework*** - The Eurosystem does not have direct control over prices, which are influenced only after a long process through the operation of

[10] General framework for European monetary policy | nbb.be, (2021), https://www.nbb.be › general., p. 3-4

monetary policy instruments. Therefore, the Eurosystem should not react to the observed changes in the consumer price index, but should predict predictable developments that may jeopardize price stability in the future. Such an action is based on a detailed analysis of all available information, using an integrated analytical framework containing various analyzes.

- Economic analysis and
- Monetary and financial analysis.

  - ✓ *The economic analy*sis refers to the real and nominal economic movements. It focuses on the analysis of short-term variations in economic growth, employment and inflation, the assessment of the factors behind shocks affecting the euro area economy, the projections produced by the Eurosystem and the ECB staff on the main medium-term macroeconomic variables and the overall economic growth risk assessment. and price stability. Emphasis is placed on the regular analysis of structural trends and their implications for inflation, potential output and real equilibrium interest rates, the role and importance of heterogeneities and nonlinearities, and the use of new available granular data, including research as expected. for consumer expectations.
  - ✓ *Monetary and financial analysis* plays a key role in examining monetary and financial indicators, with an emphasis on the functioning of the monetary policy transmission mechanism, in particular through loans, bank loans, risk taking and asset prices. These estimates facilitate the identification of any changes in transmission (related, for example, to structural factors such as increased non-bank financial intermediation) or transmission barriers due to, for example, market fragmentation or tensions. Monetary and financial analysis also allows for a more systematic assessment of the long-term accumulation of vulnerabilities and financial imbalances and their potential implications for residual operating and inflation risks. In addition, it assesses the extent to which

macroprudential measures reduce all risks to financial stability that are relevant from a monetary policy perspective. Thus, monetary and financial analysis recognizes that financial stability is a prerequisite for price stability. The integrated analytical framework aims to take into account the information obtained from monetary and credit aggregates. The inclusion of that information and other variables used to assess the functioning of monetary and financial transfers reflects the relevance of those indicators to assess the accumulation of vulnerabilities and risks to price stability. Additionally, a detailed assessment of the interaction between monetary policy and financial stability is planned to take place at regular intervals as part of the monetary and financial analysis, and is examined at the meetings of the Governing Council for monetary policy based on Financial Stability.

❖ Other monetary policy objectives - The Eurosystem supports the general economic policies of the Union in order to contribute to the achievement of objectives such as growth, employment, economic and social cohesion and improvements in environmental quality. The restriction expressed by the words "without prejudice" unequivocally states the basic goal set for the Eurosystem. Creating a stable environment is the best way to promote growth and employment, although those goals require other economic policy measures. In addition, it often happens that the intervention necessary to preserve price stability is useful for other purposes, such as stabilization of economic activity and the financial sector. Thus, price stability risks are often associated with cyclical fluctuations: if those risks tend to decrease, given the decline in activity, the Eurosystem will lower interest rates, which will boost demand. Because the eurozone is a significant economy in which foreign trade is only about 15%. Of the total demand for goods and services, the euro exchange rate does not play a significant role in the Eurosystem's monetary policy strategy, but enters the second "pillar" of that strategy. The economic analysis, however, takes into account the effects of exchange rate fluctuations on domestic prices.

The monetary policy strategy of the ECB is both guided and bound by its mandate conferred by the Treaty on European Union and the Treaty on the Functioning of the European Union:[11]

- The primary objective of the ECB is to maintain price stability in the euro area. These include:
  - ✓ balanced economic growth,
  - ✓ a highly competitive social market economy aiming at full employment and social progress, and
  - ✓ a high level of protection and improvement of the quality of the environment.
- The new monetary policy strategy incorporates two innovations that warranted an update to our forward guidance on interest rates:
  - ✓ first, the redefinition of price stability objective as a symmetric two per cent inflation target over the medium term; and,
  - ✓ second, a conditional commitment to take into account the implications of the effective lower bound when conducting policy in an environment of structurally-low nominal interest rates.
- The two per cent inflation target is intended to provide a sufficient safety margin to protect the effectiveness of monetary policy in responding to disinflationary shocks.
- The conditional commitment to take into account the implications of the effective lower bound when conducting policy in an environment of structurally-low nominal interest rates reflects the asymmetric nature of the constraint imposed by the effective lower bound. While central banks can technically raise nominal interest rates without limits, there is only limited space to lower rates into negative territory, owing to the lower bound on cash.

[11] Lane, R. P., (2021), The new monetary policy strategy: implications for rate forward guidance, https://www.ecb.europa.eu ›

1.2. EUROSYSTEM MONETARY POLICY INSTRUMENTS

Maintaining price stability is the primary objective of monetary policy. In order to achieve that its primary objective, the Eurosystem uses a set of monetary policy instruments and procedures in which the national central banks perform a key role:[12]

- In accordance with the principle of an open market economy which encourages free competition and an efficient allocation of resources, the Eurosystem operates mainly via transactions with euro area credit institutions. It does not apply any regulations such as exchange controls or credit restrictions.

- The reserve requirements are the only regulatory instrument. The reserves all bear interest, which means that interest is payable on (the main refinancing operationsrate for the required reserves and on the deposit facility rate for excess reserves,) and no credit is granted on preferential terms, so that the monetary policy operating framework does not offer any scope for implicit taxation or subsidies.

To achieve its primary goal, the Eurosystem uses a set of monetary policy instruments and procedures. This set of instruments forms the operational framework for the implementation of the single monetary policy:[13]

- The operational framework of the Eurosystem consists of the following set of instruments
  - ✓ Open market operations,
  - ✓ Standing facilities,
  - ✓ Minimum required reserve for credit institutions,

- In addition, since 2009 the European Central Bank - ECB has implemented several non-standard monetary policy measures to complement the regular operation of the Eurosystem:

[12] Monetary policy instruments - | nbb.be, https://www.nbb.be › monetary-policy › monetary-policy.
[13] Monetary policy instruments - European Central Bank, (2021), https://www.ecb.europa.eu › i., p. 1-5

- ✓ Asset purchase programmes (APP),
- ✓ Pandemic Emergency Purchase Program (PEPP).

1.2.1. Open market operations

Open market operations play an important role in steering interest rates, managing the liquidity situation in the market and signalling the monetary policy stance:[14]

- Five types of financial instrument are available to the Eurosystem for its open market operations. The most important instrument is the reverse transaction, which may be conducted in the form of a repurchase agreement or as a collateralised loan. The Eurosystem may also make use of outright transactions, issuance of debt certificates, foreign exchange swaps and collection of fixed-term deposits.
- Open market operations are initiated by the ECB, which decides on the instrument and the terms and conditions. It is possible to execute open market operations on the basis of standard tenders, quick tenders or bilateral procedures.
- Open market operations may differ in terms of aim, regularity and procedure.
  - ✓ Main refinancing operations are regular liquidity-providing reverse transactions conducted by the Eurosystem, with a frequency and maturity ofone week. They are executed in a decentralised manner by the national central banks on the basis of standard tenders and according to an indicative calendar published on the ECB's website. The main refinancing operations play a pivotal role in fulfilling the aims of the Eurosystem's open market operations and normally provide the bulk of refinancing to the financial sector.
  - ✓ Longer-term refinancing operations are liquidity-providing reverse transactions with a longer maturity than the main refinancing operations.

[14] Monetary policy instruments - Open market operations -| nbb.be, (2022), (2022), https://www.nbb.be › monetary-policy › monetary-policy.

- Regular longer-term refinancing operations have a maturity of three months and are conducted each month by the Eurosystem on the basis of standard tenders in accordance with the indicative calendar on the ECB's website.
- The Eurosystem may also conduct non-regular longer-term operations, with a maturity of more than three months. Longer-term open market operations differ from the traditional provision of liquidity in their longer maturity and generally also in the larger volumes granted and/or more attractive rates. Some of these operations are specifically intended as a substitute for short- and medium-term operations of financial players on the financial markets if those markets are paralysed, e.g. because of suddenly escalating risk aversion. The Eurosystem thus acts as an intermediary between the commercial banks. Other operations aim to provide liquidity for the commercial banks so that monetary easing is properly reflected in the credit terms that they apply to businesses and households.

✓ Apart from the regular longer-term open market operations there are also the following operations:

- the three-year longer-termrefinancing operations,
- the targeted longer-term refinancing operations, and
- the pandemic emergency longer-term refinancing operations.

✓ Fine-tuning operations can be executed on an ad hoc basis to manage the liquidity situation in the market and to steer interest rates. In particular, they are aimed at smoothing the effects on interest rates caused by unexpected liquidity fluctuations. Fine-tuning operations are primarily executed as reverse transactions, but may also take the form of foreign exchange swaps or the collection of fixed-term deposits. The instruments and procedures applied in the conduct of fine-tuning operations are adapted to the types of transaction and the associated specific objectives pursued in performing the operations. Fine-tuning operations are normally executed by the Eurosystem through quick tenders or bilateral procedures. The Eurosystem may select a limited number of counterparties to participate in fine-tuning operations.

- ✓ Structural operations can be carried out by the Eurosystem through reverse transactions, outright transactions, and the issuance of debt certificates. These operations are executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector (on a regular or non-regular basis). Structural operations in the form of reverse transactions and the issuance of debt instruments are carried out by the Eurosystem through standard tenders. Structural operations in the form of outright transactions are normally executed through bilateral procedures.

Eurosystem's regular open market operations consist of one-week euro refinancing operations (main refinancing operations, or MROs), as well as three-month euro liquidity operations (longer-term refinancing operations) (longer-term refinancing operations, or LTROs).

- ✓ The main operations to provide liquidity are to manage short-term interest rates, to manage the liquidity situation and to signal the position of the monetary policy in the euro area.
- ✓ Long-term refinancing operations provide additional, longer-term refinancing of the financial sector.

1.2.2. Permanent capacities

Standing facilities aim to provide and absorb overnight liquidity, signal the general monetary policy stance and constrain overnight market interest rates. Two standing facilities, which are administered in a decentralised manner by the NCBs, are available to eligible counterparties on their own initiative:[15]

- Marginal lending facility - Counterparties can use the marginal lending facility to obtain overnight liquidity from the NCBs against eligible assets. The interest rate on the marginal lending facility usually provides a ceiling for the overnight market interest rate.
- Deposit facility - Counterparties can use the deposit facility to make overnight deposits with the NCBs. The interest rate on the deposit facility usually provides a floor for the overnight market interest rate.
- The Eurosystem offers credit institutions two permanent benefits:
    - ✓ Marginal credit capacity in order to obtain overnight liquidity from the central bank, as opposed to showing sufficiently acceptable assets;
    - ✓ Securing deposits for overnight deposits with the central bank.
- Both facilities are available to eligible contracting parties on their own initiative, provided they meet certain operational access requirements. The time limit for requesting access to the existing facilities is half an hour after the closing of TARGET2, except for the last working day of the reserve maintenance period, when the time limit is one hour. Permanent facilities are administered in a decentralized manner by the national central banks. The conditions and rules for the use of permanent facilities are identical throughout the euro area. Marginal interest rates on loans and deposits usually provide a ceiling and floor for the overnight market interest rate.

1.2.3. Minimum required reserve

Minimum reserves are an integral part of the operational framework of monetary policy in the euro area:[16]

[15] Monetary policy instruments - Standing facilities -| nbb.be, (2022), (2022), https://www.nbb.be › monetary-policy › monetary-policy.

- The intention of the minimum reserve system is to pursue the aims of stabilising money market interest rates, creating (or enlarging) a structural liquidity shortage and possibly contributing to the control of monetary expansion.

- The reserve requirement of each institution is determined in relation to elements of its balance sheet. In order to pursue the aim of stabilising interest rates, the Eurosystem's minimum reserve system enables institutions to make use of averaging provisions. This implies that compliance with the reserve requirement is determined on the basis of the institutions' average daily reserve holdings over a maintenance period of about six weeks. The reserve maintenance periods start on the settlement day of the main refinancing operation (MRO) following the Governing Council meeting at which the assessment of the monetary policy stance is pre-scheduled. The required reserve holdings are remunerated at a level corresponding to the average interest rate over the maintenance period of the main refinancing operations of the Eurosystem.

- The ECB requires credit institutions established in the euro area to keep deposit accounts with their national central bank. These are called "minimum" or "required" reserves. Minimum required reserves (reserve coefficients, standardized deductions and lump sum allowance) are calculated on the basis of a list of institutions subject to the minimum required reserve of the Eurosystem (monthly data).

1.2.4. Asset Purchasing Programs (APP)

A central bank’s large-scale asset purchases are intended to bring down risk premiums and/or term premiums. In practice, this means that the purchases exert downward pressure on long-term interest rates, even if short-term rates have reached their lower bound. Via this effect on long-term interest rates, monetary policy continues to exert very direct influence over the investment and consumption expenditure of firms,

[16] Monetary policy instruments - Minimum reserves -| nbb.be, (2022), (2022), https://www.nbb.be › monetary-policy › monetary-policy.

households and government, as decisions on consuming or investing in durable goods generally concern the medium or long term:[17]

- Full reinvestment of the principal payments from securities purchased under the APP which have reached maturity, is continue, and for an extended period of time past the moment the Governing Council starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

- The ECB asset purchase program is part of a package of non-standard monetary policy measures, which also includes targeted long-term refinancing operations. The program consists of::

  - ✓ corporate sector purchase programme (CSPP),
  - ✓ public sector purchase programme (PSPP),
  - ✓ asset-backed securities purchase programme (ABSPP),
  - ✓ covered bond purchase programme (CBPP).

1.2.5. Pandemic Emergency Purchase Program (PEPP)

The existing asset purchase programmes are complemented by a new, temporary programme for the purchase of private and public sector securities, namely the Pandemic Emergency Purchase Programme (PEPP). The PEPP is intended to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area arising from the outbreak and rapidly increasing spread of the coronavirus:[18]

- The ECB's Pandemic Emergency Procurement Program is a non-standard monetary policy measure initiated in March 2020 to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area caused by the outbreak of coronavirus (COVID-19).

[17] Monetary policy instruments - Asset purchase programmes -| nbb.be, (2022), (2022), https://www.nbb.be › monetary-policy › monetary-policy.
[18] Monetary policy instruments - Pandemic Emergency Purchase Programme (PEPP) -| nbb.be, (2022), (2022), https://www.nbb.be › monetary-policy › monetary-policy.

- PEPP is a temporary program for the purchase of securities from the private and public sectors. All categories of eligible assets under the existing Acquisition Program (APP) are also eligible under the PEPP, and the waiver of eligibility is approved for securities issued by the Greek government.
- Additionally, the eligibility of nonfinancial commercial documents under the corporate sector acquisition program has been extended to include securities with a maturity of at least 28 days. For the purchase of public sector securities under PEPP, benchmark distribution across jurisdictions is the capital key of the Eurosystem of national central banks. At the same time, procurements are made in a flexible manner based on market conditions and in order to prevent the tightening of financing conditions that is not in line with countering the downward impact of the pandemic on the projected inflation path. Purchasing flexibility over time, across asset classes and between jurisdictions continues to support the smooth transmission of monetary policy.
- The Governing Council shall discontinue the purchase of net assets under PEPP after assessing that the COVID-19 crisis phase is over, but in any case not before the end of March 2022, at least until the end of 2023. In any case, the future transfer of the PEPP portfolio is managed to avoid interference in the appropriate monetary position.

1.3. EUROSYSTEM MONOPOLY SUPPLIER ON MONEY BASIS

Euro banknotes and coins are money but so is the balance on a bank account.Modern economies, including the euro area, are based on money:[19]

- Money, whatever its form, has three different functions:
  - ✓ Money is a medium of exchange – a means of payment with a value that everyone trusts.
  - ✓ Money is also a unit of account allowing goods and services to be priced.

[19] What is money? - European Central Bank, (2017), https://www.ecb.europa.eu › html › what_is_money.en.html.

- ✓ Money is a storing of value.

- The ECB acts as a bank for the commercial banks and this is also how it influences the flow of money and credit in the economy to achieve stable prices. Commercial banks, in turn, can borrow money, i.e. central bank reserves, from the ECB, usually to cover very short-term liquidity needs. The ECB's main tool for controlling the quantity of "outside" money, and hence the demand for central bank reserves by commercial banks, is setting very short-term interest rates – the "cost of money".

- Commercial banks can also create so-called "inside" money, i.e. bank deposits – this happens every time they issue a new loan. The difference between outside and inside money is that the former is an asset for the economy as a whole, but it is nobody's liability. Inside money, on the other hand, is named this way because it is backed by private credit: if all the claims held by banks on private debtors were to be settled, the inside money created would be reversed to zero. So, it is one form of currency that is created – and can be reversed – within the private economy.

- In practice, only the national central banks physically issue euro banknotes. "Money-printing" is the colloquial term for the ECB's asset purchase programme, a form of "quantitative easing". By purchasing assets in the financial market, the ECB creates additional central bank reserves that can help reduce – through a variety of channels – the interest rates faced by households and firms with a view to supporting the economy and, ultimately, to keep the value of money stable when the room to cut those interest rates directly controlled by the ECB is limited. In this process, the ECB does not actually print banknotes to pay for the assets but creates money electronically, which is credited to the seller or intermediary, e.g. a commercial bank. The seller can then use the additional liquidity to buy other assets or, in case of a commercial bank, extend credit to the real economy. The purchases contribute to improving monetary and financial conditions, making it cheaper for businesses and households to borrow so they can invest and spend more.

The central bank is the sole issuer of banknotes and bank reserves. That means it is the monopoly supplier of the monetary base. By virtue of this monopoly, it can set the conditions at which banks borrow from the central bank. Therefore it can also influence the conditions at which banks trade with each other in the money market:[20]

- In the short run, a change in money market interest rates induced by the central bank sets in motion a number of mechanisms and actions by economic agents. Ultimately the change will influence developments in economic variables such as output or prices. This process – also known as the monetary policy transmission mechanism – is highly complex. While its broad features are understood, there is no consensus on its detailed functioning.
- Long-run neutrality of money - It is widely agreed that in the long run – after all adjustments in the economy have worked through – a change in the quantity of money in the economy will be reflected in a change in the general level of prices. But it will not induce permanent changes in real variables such as real output or unemployment. This general principle, referred to as "the long-run neutrality of money", underlies all standard macroeconomic thinking. Real income or the level of employment are, in the long term, essentially determined by real factors, such as technology, population growth or the preferences of economic agents.
- Inflation – a monetary phenomenon. In the long run a central bank can only contribute to raising the growth potential of the economy by maintaining an environment of stable prices. It cannot enhance economic growth by expanding the money supply or keeping short-term interest rates at a level inconsistent with price stability. It can only influence the general level of prices. Ultimately, inflation is a monetary phenomenon. Prolonged periods of high inflation are typically associated with high monetary growth. While other factors (such as variations in aggregate demand, technological changes or commodity price

[20] Scope of monetary policy - European Central Bank, (2022), https://www.ecb.europa.eu › i..

shocks) can influence price developments over shorter horizons, over time their effects can be offset by a change in monetary policy.

The Eurosystem is the sole issuer of banknotes and bank reserves in the euro area:[21]

- This makes it a monopoly supplier of the monetary base consisting of currency (banknotes and coins) in circulation, the reserves held by the Eurosystem contracting parties and the recourse of credit institutions to the Eurosystem deposit capacity
    - ✓ These items are liabilities in the balance sheet of the Eurosystem. Reserves can be further subdivided into required and surplus reserves.
    - ✓ In the Eurosystem minimum reserve system, contracting parties are required to hold reserves with national central banks (NCBs). In addition, credit institutions typically store only a small amount of voluntary surplus reserves in the Eurosystem.
- Based on its monopoly, the central bank can manage the money market liquidity situation and influence money market interest rates.
- In addition to managing interest rates through liquidity management, the central bank can also signal its position on monetary policy in the money market. This is usually done by changing the conditions under which the central bank is willing to enter into transactions with credit institutions.
- In its operations, the European Central Bank also aims to ensure the proper functioning of the money market and to help credit institutions meet their liquidity needs in a seamless manner. This is achieved by providing and regularly refinancing the credit institutions and the funds that enable them to cope with the balances at the end of the day and to amortize the transient fluctuations of the liquidity.

[21] Monetary policy instruments, (2021), https://www.ecb.europa.eu › i, p. 2 - 3

- The operational framework of the Eurosystem is based on the principles set out in the Treaty on the Functioning of the European Union. Article 127 of that Agreement states that in achieving its objectives, the Eurosystem will act in accordance with the principle of an open market economy with free competition, favoring the efficient allocation of resources. .
- In addition to the principles set out in the Treaty on the Functioning of the European Union, the operational framework follows several guiding principles:
  - ✓ *Operational efficiency* - The most important principle is operational efficiency. It can be defined as the capacity of the operating framework to enable monetary policy decisions to feed short-term money market rates as accurately and quickly as possible. They, in turn, through the mechanism of transmission of monetary policy, affect the level of prices.
  - ✓ *Equal treatment and compliance* - Another principle is that credit institutions must be treated equally regardless of their size and location in the euro area. The harmonization of rules and procedures helps to ensure equal treatment by trying to provide identical conditions for all credit institutions in the euro area in transactions with the Eurosystem.
  - ✓ *Decentralized implementation* - One Eurosystem-specific principle is the decentralized implementation of monetary policy. The ECB coordinates operations and the National Central Banks (NCBs) carry out transactions.
  - ✓ *Simplicity, transparency, continuity, security and economy* - Simplicity and transparency ensure a proper understanding of the intentions behind monetary policy operations. The principle of continuity aims to avoid major changes in instruments and procedures so that central banks and their contracting parties can benefit from the experience of participating in monetary policy operations. The principle of security requires that the financial and operational risks of the Eurosystem be kept to a minimum. Cost-effectiveness means maintaining a low level of operating costs for both

the Eurosystem and its contracting parties arising from the operational framework..

The ECB is responsible for overseeing the activities of the NCB and promoting the further harmonization of cash services in the euro area, while the NCBs are responsible for the operation of their national cash distribution systems. NCBs put banknotes and coins into circulation through the banking system. The ECB cannot carry out these operations because it does not have the appropriate technical departments (distribution units, banknote processing units, vaults, etc.).[22]

The Eurosystem is the sole issuer of banknotes and sets the reserve requirements for the commercial banks, which means that it is the monopoly supplier of the monetary base:[23]

- The monetary base consists of:
  - ✓ currency in circulation in the form of banknotes and coins;
  - ✓ the reserves held with the Eurosystem by counterparties; and
  - ✓ the money held by credit institutions in the deposit facility.
- The components of the monetary base are recorded as a liability on the balance sheet of the Eurosystem. Reserves can be broken down further into mandatory reserves and excess reserves. In the Eurosystem's minimum reserve system, credit institutions have to hold reserves as deposits and loan collaterals on accounts at the national central banks. The reserve requirement is currently 1% for liabilities with maturity of up to two years. Beyond that, credit institutions usually hold only small amounts on their accounts at central banks, as those amounts do not earn income with the Eurosystem.
- This means that the Eurosystem as the monopoly supplier of the monetary base can manage liquidity in the money market and steer the money market interest rates.

[22] Banknotes - European Central Bank, 2021, https://www.ecb.europa.eu › i., p. 1
[23] Operational framework - monetary policy - Eesti Pank, (2022), https://www.eestipank.ee › op.

1.3.1. Issuance and circulation with the euro

The ECB and the central banks of the eurozone countries have the legal right to issue euro banknotes. In practice, only national central banks physically issue and withdraw euro banknotes (as well as coins). The ECB has no cash register and does not handle cash in any way. As for the euro coins, the legal issuers are the eurozone countries. The European Commission coordinates all coin issues at the euro area level:[24]

- The ECB oversees the activities of the NCB and initiates further harmonization of cash services in the euro area, while the NCBs ensure the proper functioning of their national cash distribution systems. They issue banknotes and coins through the banking system and, to a lesser extent, through retail. The ECB can not perform these operations because it has neither the functions nor the capacities, ie. distribution units, banknote processing units, vaults, etc.

- After the introduction of the euro, the number of banknotes in circulation is constantly increasing. Low and medium value banknotes are most often used for everyday payments. Higher denominations are mainly used as a storehouse of value and for expensive purchases.

Since 2002, euro banknotes have been produced jointly by the national central banks (NCBs) of the euro area. Each NCB is responsible and bears the costs of a part of the total annual production in one or more denominations:[25]

- The annual production of euro banknotes should be sufficient to meet expected increases in demand, such as seasonal peaks, and to replace unsuitable banknotes. It must also be able to handle unexpected surges in demand.

- Output volumes for the following years are calculated on the basis of forecasts provided by the NCBs and the central forecast produced by the ECB, thus combining national expertise with a Eurozone-wide perspective. The calculated figures have to be approved by the Governing Council of the ECB.

[24] Issuance and circulation - European Central Bank, (2021), https://www.ecb.europa.eu › i,
[25] Banknotes and coins production - European Central Bank, (2022), https://www.ecb.europa.eu › i.

- The responsibility for minting euro coins rests with the national governments of the eurozone countries. However, the total value of the coins to be put into circulation each year has to be approved by the Governing Council of the ECB.

1.3.2. Circulation of the euro in the euro area

Euro banknotes (and coins) circulate widely in the euro area, mainly due to tourism, business travel and cross-border shopping. To a much more limited extent, national banknotes, before the introduction of the euro, were also "moved" across borders and then had to be "repatriated", mainly through the commercial banking system, to the central bank that issued them. Such yields are not necessary with the euro. However, because large quantities of euro banknotes do not remain in the country where they were issued, but are carried to other euro countries and spent there, central banks must redistribute them to avoid a shortage of banknotes in one country and a surplus in another. These mass transfers are centrally coordinated and funded by the ECB.[26]

Euro banknotes and coins are legal tender in the euro area which, as of 1 January 2011, comprised 19 of the 28 EU member states: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain:[27]

- Both the European Central Bank (ECB) and the euro-area National Central Banks (NCBs) are legally authorized to issue euro notes. In practice, however, only the NCBs actually issue and withdraw euro notes. The ECB does not have a cash handling division and is not involved in any cash transactions.
- Individual NCBs are required to handle all the euro notes present in their respective national systems, regardless of the country that issued them. Under the principle of the decentralized performance of Eurosystem operations, NCBs are responsible for the issuance, destruction and replacement of worn notes.

[26] Issuance and circulation - European Central Bank, (2021), https://www.ecb.europa.eu › i,
[27] Euro issuance - Bank of Italy - Banca d'Italia, (2022), https://www.bancaditalia.it › e.

- The issuance of euro coins, unlike banknotes, is the responsibility of the Member States participating in the Eurosystem, coordinated by the European Commission.
- Euro coins are minted in Italy by the State Printing Works and Mint on behalf of the Ministry of Economy and Finance.
- The ECB and the Eurosystem NCBs pursue the objective of ensuring the integrity and good state of the notes in circulation, so as to maintain the public's confidence in euro banknotes.

1.3.3. Circulation of the euro outside the euro area

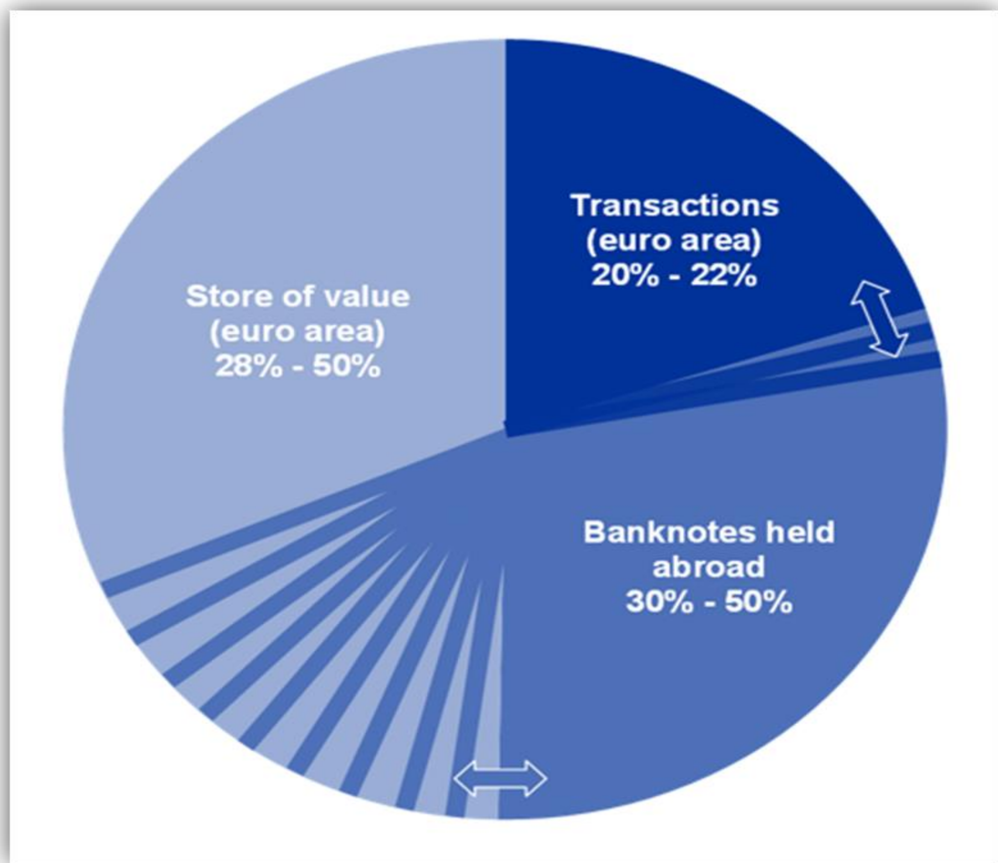
Introduced in 1999, the euro has gradually become the single currency of 19 of the European Union’s 27 Member States, which together make up the euro area. Within the Eurosystem, more than 300 million citizens use the euro on a daily basis to make or receive payments in exchange for goods and services, to save or to make investments. But the use of the euro is not just limited to the euro area – it also extends beyond the region’s borders:[28]

- The euro can be used as a reserve currency (as part of a country’s foreign exchange reserves), for saving purposes (hoarding of euro banknotes, particularly in periods of tension), for trade (for exports and imports), or as a currency peg.
- Demand for euro banknotes has risen sharply, especially in non-EU countries in Eastern Europe, when the financial crisis erupted in 2008 and national currencies depreciated against the euro. These euro banknotes remain in circulation, suggesting that they are kept by non-euro area residents.
- The European Central Bank estimates that between 30% and 50% of euro banknotes (by value) are held outside the euro area, especially in neighbouring countries. At end-December 2020, at least EUR 167 billion worth of banknotes were estimated to be in circulation outside the euro area near to 12% of the value of euro banknotes in issuance.

[28] International role of the euro | Banque de France, (2021), https://www.banque-france.fr › analysing-and-anticipating.

Figure 1

Circulation of the euro



Source: International role of the euro | Banque de France, (2021), https://www.banque-france.fr › analysing-and-anticipating.

- The COVID-19 pandemic had a strong impact on foreign demand for euro cash outside the euro area. Net outflows of banknotes decreased by an unprecedented 2%. Exports of euro banknotes to regions outside the euro area halved in 2020, while imports fell by around 40% due to travel restrictions.
- The main international uses of the euro are:
  - ✓ A reserve currency – At the end of 2019, 20.6% of international foreign exchange reserves were held in euro, or a total of USD 11,076 billion. Despite rising international trade tensions and a protracted slowdown in

global growth, the euro remains the second most important currency in the international monetary system, behind the US dollar.

- ✓ Ahoarding currency outside the euro area – Non-residents use euro banknotes, particularly the higher denominations, as a store of value. In times of economic or political stress, they even use them to hoard cash as a last resort, helping to safeguard financial stability.
- ✓ A trading currency – In 2020, the euro is used as the invoicing currency in 59.7% of the euro area’s exports and 51.3% of its imports.
- ✓ A currency peg – Some foreign countries use the stability of the euro's monetary system to strengthen their domestic economy by pegging their currencies to the euro. In general, these are European Union Member States that do not belong to the euro area but with which the euro area maintains economic and monetary relations. Other countries such as Andorra, Monaco, San Marino and the Vatican City, use the euro as an official currency by virtue of specific monetary agreements with the euro area.

1.3.4. The cash cycle of the euro

National Central Banks (NCBs) are responsible for issuing banknotes and for maintaining confidence in the currency. The production of banknotes is performed by NCBs or by specialized manufacturers on behalf of NCBs. The transportation of cash between retailers, commercial cash centres and NCBs, as well as internal cash management processes, are widely outsourced to professional cashhandling companies:[29]

- ➢ Euro area NCBs check the authenticity and condition of banknotes, withdrawing unfit notes from circulation. The Eurosystem also make efforts to help banknote equipment manufacturers to ensure that their machines meet the ECB’s standards for checking banknotes for authenticity and condition prior to recirculation.

[29] European Payments Council, (2020), Understanding the cash cycle for banknotes: a high-level description ofthe generic model and some observations, https://www.europeanpaymentscouncil.eu ›

- Credit institutions and other professional cash handlers check banknotes for authenticity and condition using such machines. This fitness checking is a requirement before banknotes can be put back in circulation, and a minimum number of banknotes need to be sent back to the NCBs for more in-depth fitness checking, that only NCBs can perform.

Euro banknotes and coins are legal tender in the euro area, and cash is the only form of public money to which everyone can have direct access. The ECB and the national central banks – also known as the Eurosystem – have a fundamental responsibility, together with the banking sector, to ensure the smooth supply of cash and facilitate the use of cash in payments by people and businesses:[30]

- The national central banks offer free-of-charge cash services throughout their countries and they also work to make the cash cycle as cost efficient as possible.Between 30% and 50% of euro banknotes circulate outside the euro area.

- Most people in the euro area still prefer to use cash for retail payments. Ensuring that cash is accepted everywhere is therefore a vital part of the payment system and is also in line with its status as legal tender. It allows consumers the freedom to choose how to pay and means that people who do not have access to electronic payments are not disadvantaged.

- Retailers, traders and other private businesses cannot refuse cash payments, unless the two parties have previously agreed on other means of payment. Generally, public authorities and service providers must also accept cash, unless otherwise stipulated by law.

The economy requires a certain amount of available cash to function. Cash is the dominant means of payment within the euro area, as the clear majority of daily payments are made using banknotes or coins. Cash is also essential for the inclusion of socially

[30] The Eurosystem cash strategy - European Central Bank, (2022), https://www.ecb.europa.eu › i.

vulnerable citizens, such as the elderly or lower-income groups. Cash offers other important functions and benefits:[31]

- It ensures freedom and autonomy. Banknotes and coins are the only form of money that people can keep without involving a third party. People don't need access to equipment, the internet or electricity to pay with cash.
- It's legal tender. Creditors, such as shops and restaurants, cannot refuse cash, unless both they and the customer have agreed on another means of payment in advance.
- It ensures privacy. Cash transactions respect fundamental right to have privacy, data and identity protected in financial matters.
- Cash is inclusive. Cash provides payment and savings options for people with limited or no access to digital money, making it crucial for the inclusion of socially vulnerable citizens such as the elderly or lower-income groups.
- Cash helps keep track of expenses. Cash allows to keep closer control of spending, for example by preventing y from overspending.
- Cash is fast. Banknotes and coins settle a payment instantly.
- It's secure. Cash has proven to be secure in terms of cybercrime, fraud and counterfeiting. And, as it's central bank money, it doesn't entail financial risks for either the payer or the payee.
- Cash is a store of value. Cash is more than just a payment instrument. It allows people to hold money for saving purposes without default risk. It is useful for small person-to-person gifts and payments.

Banknotes follow a specific path through the economy. Commercial banks order them from central banks and then issue them. People spend their money in shops, markets and other places, and banknotes in turn are deposited by retailers and others in their banks. Banks and other cash handlers then either send them back to their central bank, or recycle

[31] The role of cash, (2022), The Eurosystem cash strategy - European Central Bank, https://www.ecb.europa.eu › i.

the banknotes after checking that they are genuine and "fit" for circulation. When we think of money, we generally mean cash in our wallet, bank account balance or payments made. What does money do in the economy, and what does money mean for central banks:[32]

❖ Money serves three different functions in the economy::

- ➢ they are a medium of exchange with a value that everyone trusts,
- ➢ they are a unit of account that allows prices to be set for goods and services, and

➢ it is a repository of value that can be saved for later use..

❖ The most basic and intuitive form of money is cash - banknotes and coins - The nature of cash evolves over time. In the early days, it was usually in the form of commodity money - an item made from something that had its own market value, such as coins made of gold. Later, commodity money was replaced by representative money, such as banknotes, which could be exchanged for a fixed amount of gold or silver. Modern economies, including the eurozone, are based on formal money. This is money that has been declared a legal tender and issued by a central bank. Instead of relying on a substance or commodity, such as gold, to secure its core value, formal money is widely accepted because people trust the central bank to keep the value of money stable over time.

❖ The legal tender for the euro area is the euro. More than 342 million people use it as the single currency in the 19 EU member states that make up the eurozone. This makes the euro a tangible symbol of European integration. Legally, euro banknotes are issued by the Eurosystem, which consists of the European Central Bank (ECB) and the national central banks of the eurozone countries. In practice, however, only national central banks actually issue euro banknotes and withdraw them from circulation.

❖ After their issuance, the banknotes are put into circulation by being delivered over the counter by the banks or by cash. Unless they are stored as value storage, they are used for payments, returned to banks and recycled until they become unusable (damaged or

[32] Cash - Euro area statistics, (2021), https://www.euro-area-statistics.org ›, p. 1

worn out), at which point they are withdrawn from circulation by the national central banks.

PART TWO: THE ROLE OF THE EUROPEAN ECONOMIC AND MONETARY UNION AND THE EUROPEAN CENTRAL BANK IN THE EU MONETARY POLICY

2.1. FORMATION OF THE EU ECONOMIC AND MONETARY UNION

The European Monetary Union is in fact only one part of a grand vision of an integrated Europe. The Formation of the European Monetary Union has been a long process of an immense historical significance. Signing the Paris and Rome conventions, European leaders have founded the European Union's legal basis:[33]

- One of the most significant achievement is the establishment of common market, including free movement of people, goods, and capital.
- The European Monetary Union implies changes within the system of different national currencies into the single European currency (the euro), with separated National Central Banks, and with separated National
- Monetary policies altogether with a single European system of Central Banks, and single European Monetary policy. The adoption of the single currency is one of the most courageous attempts ever done, so that big and diverse group of sovereign states could earn a variety of profit using the single currency.
- The EMU contributes both symbolically and practically to the formation of a single, democratic Europe, where national differences are constructively agreed, and within them exist the free movement of people, commodity and investments. The EMU is a developmental method of coexistent monetary arrangement without contradictions in Europe. It implies common monetary policy, common currency, euro and coordination between economic and financial policy. Being an EMU member is of an immense significance for each member state. The following advantages are the most important:
  - ✓ transaction cost reduction,

[33] Stanković, M., (2022), The Advantages of Being a Member of the European Monetary Union, http://www.vps.ns.ac.rs ›

- ✓ euro as the single currency,
- ✓ reduction of exchange rate fluctuation risk,
- ✓ single market,
- ✓ bigger price transparency,
- ✓ prevention of competitive devaluation and speculation.

The Economic and Monetary Union is a step that the EU took to further integrate the economic markets of the member states. The EMU countries coordinate their economic and fiscal policymaking initiatives and share a common monetary policy with a common currency – the euro:[34]

- ➢ The European Economic and Monetary Union (EMU) integrates the economies of the 19 European Union (EU) member states through a group of economic and monetary policies.
  - ✓ The fiscal policies are coordinated mainly through government deficit and debt limitations under the Stability and Growth Pact (SGP). According to the SGP, government deficits must be limited to below 3% of GDP, and government debts must be less than 60% of GDP.
  - ✓ The monetary policy and euro are managed by the European Central Bank (ECB) and national central banks, with a medium-term inflation target of close to but below 2% across the eurozone. The 2% inflation rate is considered to be optimal for economic growth and employment rate.
  - ✓ The monetary policy decision-making is independent of outside influence. The countries that are members of the EU but not within the eurozone coordinate their monetary policy with the ECB.

[34] European Economic and Monetary Union (EMU), (2021), https://corporatefinanceinstitute.com › economics › europ.

Figure 2

The main elements of EMU

Source: Introduction to EMU and the euro, EMU, the Euro, and the Current Economic Situation in the Euro Area, (2022), https://europe.unc.edu › uploads › sites ›

- There are seven major actors responsible for the economic governance in the EMU:

  1. The European Council is responsible for setting the policy orientations.
  2. The Council of the EU (a.k.a. the Council) negotiates and adopts EU laws, as well as coordinates policies together with the European Parliament.

3. The Eurogroup coordinates the policy of currency and the common interest across the eurozone member states.

4. The Member States set their own budgets and structure policies while following the coordinated deficit and debt limits.

5. The European Commission is responsible for performance and compliance monitoring.

6. The ECB is the central supervisor of the financial institutions within the eurozone. As mentioned above, it sets the monetary policy with the primary objective of price stability.

7. The European Parliament formulate legislation and establish budgets together with the Council. It is also responsible for the democratic scrutiny of all EU institutions.

8. Under the monetary and fiscal policies coordinated, adopted, and monitored by the institutions, the EMU facilitates the member states with economic stability and a more effective single market.

The decision to establish the Economic and Monetary Union (EMU) was taken by the European Council in the Dutch city of Maastricht in December 1991, and was later incorporated into the Treaty on European Union (Maastricht Treaty). Economic and Monetary Union takes the EU one step further in its process of economic integration. The European Union offers opportunities for economic stability, higher growth and more employment. In practical terms, EMU means:[35]

- Coordination of economic policy-making between EU member states
- Coordination of fiscal policies, in particular by limiting government debt and deficit,
- Independent monetary policy pursued by the European Central Bank (ECB),

[35] What is the Economic and Monetary Union? (EMU), (2021), https://ec.europa.eu › info › business-economy-euro › wh, p. 1

- Unique rules and supervision of financial institutions in the euro area,
- The single currency and the eurozone.

2.1.1. History of Economic and Monetary Union

The Economic and Monetary Union (EMU) is the result of progressive economic integration into the EU. It is an expansion of the EU's single market, with common product regulations and the free movement of goods, capital, labor and services. A common currency, the euro, has been introduced in the eurozone and currently covers 19 EU member states. All EU member states - with the exception of Denmark - must adopt the euro once they meet the convergence criteria. A single monetary policy is set by the Eurosystem (composed of the Executive Board of the European Central Bank and the governors of the euro area central banks) and is complemented by fiscal rules and varying degrees of economic policy coordination. There is no central economic government within the EMU. Instead, responsibility is shared between member states and various EU institutions.[36]

❖ EMU is a result of step-by-step economic integration and is therefore not an end in itself. EMU is designed to support sustainable economic growth and high levels of employment through appropriate economic and monetary policy-making. This consists of three main fields:

- implementation of monetary policy that pursues the main goal - price stability;
- avoiding possible negative spillover effects due to unsustainable government finances, preventing the emergence of macroeconomic imbalances in the Member States and coordinating to some extent the economic policies of the Member States;
- ensuring the smooth functioning of the single market.

[36] History of economic and monetary union | Fact Sheets on the European \Union, (2021), https://www.europarl.europa.eu › factsheets › sheet › hi.

❖ The euro is now part of everyday life in the 19 member states of the European Union. Other member states are expected to adopt it in the future. The single currency has a number of advantages, including reducing the cost of financial transactions, facilitating travel, and strengthening Europe's role internationally. It helps maintain a single market.

❖ At the 1969 Hague Summit, EU heads of state or government defined a new goal of European integration: economic and monetary union (EMU). The ultimate goal of EMU is to achieve:

- ull liberalization of capital movements,
- full convertibility of Member States' currencies and
- irrevocable fixation of exchange rates.

❖ In December 1989, the Strasbourg European Council convened an intergovernmental conference to identify which amendments to the Treaty were needed to achieve EMU. The agreement envisages the introduction of EMU in three phases:

- Phase 1: establishment of free movement of capital between Member States;
- Phase 2: Convergence of Member States 'economic policies and strengthening cooperation between Member States' national central banks. Monetary policy coordination has been institutionalized with the establishment of the European Monetary Institute (EMI), which has the task of strengthening cooperation between national central banks and carrying out the necessary preparations for the introduction of the single currency.
- Phase 3: implementation of a common monetary policy under the auspices of the Eurosystem and gradual introduction of euro banknotes and coins in all euro area member states.

❖ As a result of the European debt crisis, which emerged in 2009-2010, activities have been undertaken to strengthen the EMU, including by improving its governance framework by establishing a permanent support mechanism for Member States in distress, provided the mechanism should be based on an intergovernmental agreement, not to jeopardize the stability of the eurozone as a whole and financial support is linked to strict conditionality. This led to the establishment of the European Stability Mechanism (ESM). An instrument for full monetary transactions has been developed that allows the ECB to buy sovereign bonds of a member state in distress, provided the country signs a memorandum of understanding with the ESM. To avoid a recurrence of the sovereign debt crisis, EMU secondary legislation has been upgraded. The European Semester was established, which strengthened the Stability and Growth Pact, introduced the Macroeconomic Imbalance Procedure, and sought to further strengthen economic policy coordination.

❖ In 2015, the Presidents of the European Commission, the European Council, the Eurogroup, the ECB and the European Parliament published a report on the completion of the European Economic and Monetary Union. A reform plan is outlined aimed at achieving real economic, financial, fiscal and political union in three phases.

❖ The economic crisis caused by SOVID-19 has put significant pressure on public finances. In March 2020, the Council activated a general clause to give Member States a limited period of time in which they could increase their public debt beyond the limits of fiscal rules. The ECB is launching an emergency procurement program to combat the pandemic, which involves acquiring large amounts of government debt in secondary markets.

❖ In the autumn of 2021, in light of the faster-than-expected economic recovery and the unexpectedly rapid rise in inflation (albeit perhaps only for a limited time), the discussion gained momentum in the Eurosystem regarding a possible cautious reduction in quantitative easing as of 2022, and possible increases in interest rates in the medium term.

2.1.2. Way of functioning of the European Monetary Union

Economic and Monetary Union (EMU) is not an end in itself. It is a means of ensuring stability and stronger, more sustainable and inclusive growth across the euro area and the EU as a whole to improve the lives of EU citizens.[37]

2.1.2.1. Economic activities included in EMU

The operation and management of the Economic and Monetary Union (EMU) are designed to support sustainable economic growth and high employment through economic and monetary policy. This includes four main economic activities:

- implementation of an effective monetary policy for the euro area in order to stabilize prices,
- coordination of economic and fiscal policies in EU countries,
- ensuring the smooth functioning of the single market,
- supervision and monitoring of financial institutions.

Monetary policy involves influencing interest rates and exchange rates to benefit a country's economy. This is done by the central bank that controls the money supply in the economy. However, if each EU country had its own monetary policy, then:

- ✓ a single market would be much less efficient,
- ✓ trade may be disrupted,
- ✓ the benefits would be smaller,

For this reason, within the EMU, monetary policy is closely coordinated, and in the euro area it is centralized and independent.

[37] How the Economic and Monetary Union works, (2021), https://ec.europa.eu › info › business-economy-euro › ho.

Economic and Monetary Union (EMU) is a key stage towards compete integration, and involves a single economic market, a common trade policy, a single currency and a common monetary policy:[38]

- *Economic integration* - Economic and Monetary Union (EMU) is an important stage in the process of economic integration:
  - ✓ There are several stages in the process of economic integration, from a very loose association of countries in a preferential trade area, to complete economic integration, where the economies of member countries are completely integrated.
  - ✓ A regional trading bloc is a group of countries within a geographical region that protect themselves from imports from non-members in other geographical regions, and who look to trade more freely with each other. Regional trading blocs increasingly shape the pattern of world trade – a phenomenon often referred to as regionalism.
  - ✓ Preferential Trade Areas (PTAs) exist when countries within a geographical region agree to reduce or eliminate tariff barriers on selected goods imported from other members of the area. This is often the first small step towards the creation of a trading bloc. Agreements may be made between two countries (bi-lateral), or several countries (multi-lateral).
- *The euro-system* - The euro-system has two elements – the European Central Bank (ECB), which is responsible for all monetary policy in the eurozone (euro area), and the National Central Banks (CBs) of the 19 member countries. Other European countries are free to join the euro area if they meet the criteria laid down in various treaties. The two most important criteria for entry are that the applicant country has demonstrated price stability, and that its public finances are well managed.

[38] Monetary Union - Economics Online, (2020), https://www.economicsonline.co.uk ›

- *Co-ordination of macro-economic policies* - Co-ordination of policy was designed to enable the original 12 economies of the euro-area to converge. A key feature of this was the Stability Pact, which involved members agreeing to keep their economies stable, and keeping their budget deficits under control. The agreed limit for a deficit was that it must be no more than 3% of GDP. This restriction was designed to prevent any unnecessary fiscal stimulus which might de-stabilise the economy, even in the face of high unemployment. However, several countries, including Germany, France, and most notably, Greece, have broken this rule, and this has cast serious doubts about the ability of the euro area to maintain this rule.

2.1.2.2. The role of national governments

Monetary and fiscal policy are two important tools to keep the economy healthy. Both influence the economy, but in different ways. Monetary policy is about keeping the prices of the goods and services we buy stable. It is the central bank's job to make sure that inflation – the rate at which the overall prices for goods and services change over time – remains low, stable and predictable. Fiscal policy refers to the economic decisions that governments take. Governments can decide to spend money to provide public services, support the economy and reduce inequalities. They can collect this money via taxes or by borrowing from financial markets:[39]

- Monetary and fiscal policy work in different ways. But they interact with each other too since price stability and a balanced economy are two sides of the same coin. The way monetary and fiscal policy interact with each other matters for the health of the economy. Monetary and fiscal policy need to work hand in hand for an economy to run smoothly. That is not always easy – especially as they work independently of one another in the euro area. The ECB runs a single monetary policy for the 19 countries of the euro area. But the national government of each of those countries runs its own fiscal policy.

- National governments control other areas of economic policy. They include:

[39] Fiscal and monetary policy in a monetary union, (2022), https://www.ecb.europa.eu ›

- ✓ fiscal policy related to government budgets,
- ✓ tax policies that determine how revenue increases,
- ✓ structural policies that determine pension systems, labor market and capital market regulations.

➢ EMU brings greater economic integration, especially in the euro area. As a consequence, the creation of economic policy becomes a matter of common concern for all EU countries. To ensure the smooth functioning of the EU economy as a whole, it is important that all countries coordinate their economic and fiscal policies with the common goal of stability and growth.

The European Union uses different instruments to coordinate and supervise the economic and fiscal policies of the Member States. The aim is to combat and correct trends weakening economic growth in the Member States and to enhance economic stability in the EU as a whole. The focus in the coordination is on policy areas where impacts might be felt across the Union. The EU has established particularly strict procedures for fiscal policy, Governments use fiscal policy to manage general government revenue and expenditure and thus also the national economy as a whole:[40]

➢ There are many reasons for agreeing on common rules. It is important to ensure that the Member States adhere to a rules-based fiscal policy because in a highly integrated union, a budgetary crisis in one country may also cause difficulties for other Member States. The coordination of monetary and fiscal policy, which became more complicated with the establishment of the Economic and Monetary Union, also made it important to establish common rules. In addition to ensuring that the rules are observed, fiscal policy supervision also provides a framework for an exchange of views between the Member States, which may also promote stable economic growth.

➢ The purpose of the preventive arm is to enhance the supervision and coordination of economic policy so that the Member States would not accumulate excessive

[40] Fiscal policy rules in the Economic and Monetary Union, (2022), https://www.vtv.fi › fiscal-pol.

budget deficits or debts. The corrective arm also aims to prevent excessive general government debts and deficits and to speed up the corrective process if problems arise.

- The three-per-cent limit to the deficit in general government finances and a limit of 60% to the public debt to GDP ratio, which are laid down in Treaty establishing the European Union, are the key indicators set out in the corrective arm of the Stability and Growth Pact. Deficit and debt levels are monitored on the basis of statistics and forecasts. However, exceeding the reference values does not necessarily mean that a Member State is in breach of the rules as the situation is evaluated on a comprehensive basis and consideration is also given to such matters as the excess being only temporary. This means that assessing compliance with the criteria is not always a straightforward matter.

2.1.2.3. Single currency to support the single market

In addition to the benefits of economic stability, EMUs and the single currency also support a more effective single market that benefits people and businesses. If national economic policies discourage the free movement of goods, services, capital and labor, then these benefits, including jobs and growth, would be diminished. Therefore, the creation of economic policy in EU countries acts to support the single market.

The only banking system is a mirror image of a single currency. Because bank deposits make up the vast majority of money, a currency can only be truly unique if the confidence in the security of bank deposits is the same in which country the bank operates.

This is also crucial to addressing the negative feedback from sovereign banks that has been one of the main causes of the recent global economic crisis.

2.1.2.4. Monetary policy

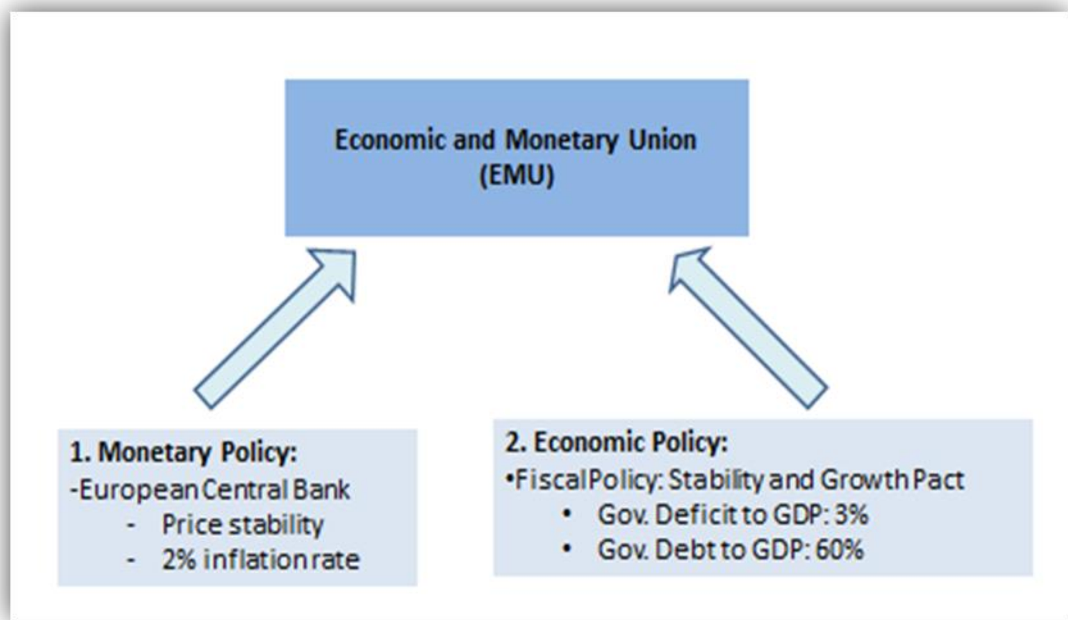
Unlike many other areas of policy in the EU, monetary policy is completely centralised. The EU Treaties stipulate that it is determined and implemented by the European Central Bank (ECB), with the primary objective being price stability. According to the Central Bank's interpretation of this term, price stability is achieved when annual inflation is just under two per cent:[41]

- Monetary policy for the euro area is managed through the European Central Bank (ECB) and the national central banks of the euro area countries, which together make up the Eurosystem. Decisions on monetary policy in the euro area can only be made by the Governing Council of the ECB, composed of the governors of the national central banks of the euro area countries and members of the Executive Board of the ECB.
- These decisions are made free from external influences. EU countries outside the euro area coordinate their monetary policy with the ECB within the European system of central banks.
- The agreement sets out the ECB's mission to ensure price stability in the eurozone. The ECB aims to keep price inflation in the eurozone below, but close to 2% in the medium term. This 2% inflation target is considered optimal for promoting growth and employment.
- The main instrument of monetary policy is the key interest rate (main refinancing rate). According to prevailing economic theory, interest rates are to be raised in times of good economic growth and high inflation in order to dampen business investment and thus avoid an "overheating" of the economy. In a weak economy, the opposite should occur.
- Monetary policy further includes the provision of liquidity to the financial sector. Normally, banks require only a small number of loans from the Central Bank, since they manage savings deposits and lend each other money in the interbank market.

[41] Ederer, S., (2022), The EU's Monetary Policy - The European Illusion, https://the-european-illusion.eu ›

Figure 3

Monetary Policy of the Economic Monetary Union - EMU



Source: Lorca-Susino, M., (2020), EMU Economic and Monetary Union (EMU) 1. Monetary Policy, https://miamieuc.fiu.edu › resources › euro-past

The objective of the European Central Bank (ECB) is price stability – an inflation rate of 2%. It seeks to realise this with its monetary policy, and this includes setting interest rates. In doing so, the central bank takes into account economic developments:[42]

- Inflation that is too low is just as undesirable as inflation that is too high. But inflation may temporarily be slightly above or below 2%. For example, in the case of economic shocks. So temporary deviations from the inflation target are not a problem. In monitoring price developments the ECB looks at the medium term. This provides more flexibility in terms of its policy.
- The ECB has no direct influence on rising and falling prices, but it can use its monetary policy to exert indirect influence on inflation. To support its monetary policy, the ECB has well tools. Important tools are the key interest rates, which are the rates at which banks borrow money from the ECB or deposit money with the ECB. There are also other tools which the ECB can use to influence inflation.

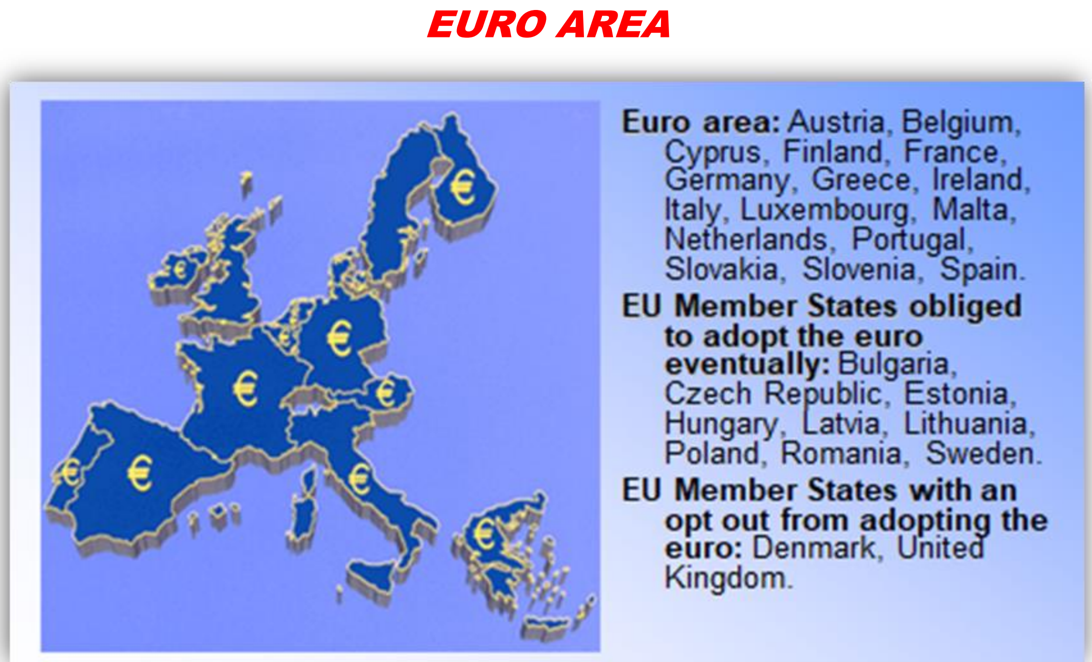
[42] ECB monetary policy - De Nederlandsche Bank, (2022), https://www.dnb.nl › DNB.nl › The euro and Europe.

Over the past few years, the ECB has added new tools to its toolbox to maintain price stability in response to the huge changes that the economy has been undergoing, such as the special purchase programmes.

2.1.3. Eurozone

The eurozone, officially known as the euro area, is a geographic and economic region that consists of all the European Union countries that have fully incorporated the euro as their national currency. As of 2022, the eurozone consists of 19 countries in the European Union (EU): Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain. Approximately 340 million people live in the eurozone area:[43]

Figure 4



Source: Introduction to EMU and the euro, EMU, the Euro, and the Current Economic Situation in the Euro Area, (2022), https://europe.unc.edu › uploads › sites ›

[43] Kenton, W., (2022), European Economic and Monetary Union (EMU) - Eurozone - Investopedia, (2022)https://www.investopedia.com ›

- The eurozone is one of the largest economic regions in the world and its currency, the euro, is considered one of the most liquid when compared to others. This region's currency continues to develop over time and is taking a more prominent position in the reserves of many central banks. It is often used as an example when studying trilemmas, an economic theory that postulates that nations have three options when making decisions regarding their international monetary policies.
- In 1992, the countries making up the European Community (EC) signed the Maastricht Treaty, thereby creating the EU. Regarding economic policy, the Maastricht Treaty aimed to create a common economic and monetary union, with a central banking system—the European Central Bank (ECB)—and a common currency (the euro).In order to do this, the treaty called for the free movement of capital between the member states, which then graduated into increased cooperation between national central banks and the increased alignment of economic policy among member states. The final step was the introduction of the euro itself, along with the implementation of a singular monetary policy coming from the ECB.
- In order to join the eurozone and use the euro as their currency, EU nations must meet certain criteria consisting of four macroeconomic indicators that focus on:
  - ✓ price stability,
  - ✓ sound and sustainable public finances,
  - ✓ the durability of convergence, and
  - ✓ exchange rate stability.
- For an EU nation to demonstrate price stability, it must demonstrate sustainable price performance and average inflation no more than 1.5 percent above the rate of the three best-performing member states. To demonstrate sound public finances, the government must run a budget deficit no greater than 3% of GDP and hold public debt no greater than 60% of GDP.

- A nation's durability of convergence is assessed through its long-term interest rates, which cannot be more than 2 percent above the rate in the three member states with the most stable prices. Lastly, the nation must demonstrate exchange rate stability by participating in the Exchange Rate Mechanism (ERM) II for at least two years "without severe tensions" and without devaluing against the euro.

All European Union countries that adopted the euro as their national currency form a geographical and economic region known as the Eurozone. The Eurozone forms one of the largest economic regions in the world. Nineteen of the 28 countries in Europe use the euro as their national currency and, thus, it is a common national currency for a group of countries together known as the Eurozone:[44]

- The Eurosystem is the monetary authority of the Eurozone. The European Central Bank (ECB) exercises the sole power to set the monetary policy for the Eurozone countries. The ECB is headed by a president and a board, comprising the heads of the central banks of the participating nations. One of the primary tasks of the ECB is to keep the inflation in Eurozone countries under control. Local monetary situations in the individual countries can differ from the stance of the ECB, but members are prohibited from implementing individual monetary policies.
- The ECB and the central banks of the EU states in the Eurozone together decide the monetary policy of the union. The ECB exercises the sole authority to decide the printing and minting of euro notes and coins. It also decides the interest rate for the Eurozone.
- The usefulness of the euro increases due to its wider use across the member countries. The instability and uncertainty of nominal exchange rates are much lower as a result of the single currency use. Thus, the costs of transaction and hedging are low. There is an increase in trade and commerce in the intra-eurozone countries without any reported diversion of trade. Financial integration across the nations are deeper. With the declining cost of equity capital and bond

[44] Learn About Macroeconomic Benefits of the Eurozone, (2019), https://corporatefinanceinstitute.com ›

financing, financial integration may witness a boost. Greater price transparency encourages lesser market segmentation and discourages price discrimination.

- The ECB's credibly brought down inflation in its member countries. Even during the fiscal crisis, following the launch of the euro, expectations of inflation were lower. The decline in interest rates translated into supporting growth and investment and lowering of public debt servicing. Stable prices are contributing to overall macroeconomic stability. The Eurozone is almost resilient to shocks and external developments. However, the initial cost of adopting a new currency for all member nations, and the legal, administrative costs and changes, imposed a huge cost.
- As member countries could no longer exercise direct control over monetary policy or exchange rates, it was implicit that Eurozone members with wage rigidities and higher nominal prices would initially face frictional unemployment. It was expected to lead to short-term fluctuations in output and unemployment in those countries where the product and labor markets are less flexible.
- Real exchange rates changed after the launch of the euro and the burden of adjusting fell more on the deficit countries because they were not able to devalue.
- There was a consolidation of economic governance as the financial integration deepened and the circulation of the currency widened. Time played an important role in shaping the fiscal fate of the Eurozone.
- Despite using a single currency, the Eurozone is a heterogeneous mix of economies. For overall success, differences in institutions, financial structures, and legal systems must be eliminated. The massive concentration of power at the top with the decision-making authority poses a threat to the individual liberty of the member nations. However, it cannot be denied that the use of a common currency facilitates the exchange, specialization, and integration of national markets into a wider market. It also significantly reduces the costs of transaction induced by currency risk and increases benefits from international trade.

The euro is created to promote growth, stability, and economic integration in Europe. Originally, the euro was an overarching currency used for exchange between countries within the union. Given the enormous influence of the euro on the global economy, it is useful to look closely at his advantages and disadvantages:[45]

- Advantages of the Euro are:
  - *Promoting Trade* - The main benefits of the euro are related to increased trade. Travel was made easier by removing the need for exchanging money. More importantly, the currency risks were eliminated from European trade. With the euro, European businesses can easily lock in the best prices from suppliers in other eurozone countries. That makes prices transparent and increases the competition between firms in countries using the euro. Labor and goods can flow more easily across borders to where they are needed.
  - *Encouraging Investment* - The euro also supports cross-border investments within the eurozone. Investors in countries using foreign currencies face significant foreign exchange risk, which can lead to an inefficient allocation of capital. Although stocks also have exchange rate risks, the impact on bonds is far greater because of their lower volatility. The prices of most debt instruments are so stable that exchange rates influence returns far more than interest rates or credit quality. As a result, foreign currency bonds have a poor risk-return profile for most investors.
  - *Mutual Support* - In theory, the euro should help countries that adopt it to support each other during a crisis. The currencies of countries with larger economies tend to be more stable because they can spread risk more effectively.
- Disadventages of euro:
  - *Rigid Monetary Policy* - By far, the largest drawback of the euro is a single monetary policy that often does not fit local economic conditions. It is

[45] Beattie, A., (2021), Pros and Cons of the Euro - Investopediahttps://www.investopedia.com › euro-introduction-debut,

common for parts of the EU to be prospering, with high growth and low unemployment. In contrast, others suffer from prolonged economic downturns and high unemployment.

- ✓ The high growth country ought to have high *interest rates* to prevent inflation, overheating, and an eventual economic crash. The low growth country should lower interest rates to stimulate borrowing. In theory, countries with high unemployment do not need to worry much about inflation because of the availability of the unemployed to produce more goods. Unfortunately, interest rates cannot be simultaneously raised in the high growth country and lowered in the low growth country when they have a single currency like the euro.

2.2. THE ROLE OF THE EUROPEAN CENTRAL BANK

Role of European Central Bank (ECB) is to manage the euro, keep prices stable and conduct EU economic and monetary policy. The European Central Bank (ECB) manages the euro and frames and implements EU economic & monetary policy:[46]

- ➢ ***Main aim*** of ECB is to keep prices stable, thereby supporting economic growth and job creation. What does the ECB do:
  - ✓ sets the interest rates at which it lends to commercial banks in the eurozone (also known as the euro area), thus controlling money supply and inflation
  - ✓ manages the eurozone's foreign currency reserves and the buying or selling of currencies to balance exchange rates
  - ✓ ensures that financial markets & institutions are well supervised by national authorities, and that payment systems work well
  - ✓ ensures the safety and soundness of the European banking system
  - ✓ authorises production of euro banknotes by eurozone countries

[46] European Central Bank (ECB), (2022), https://european-union.europa.eu › ecb_en.

- ✓ monitors price trends and assesses risks to price stability.

- ➢ ***The mission of the ECB:***

  - ✓ The European Central Bank and the national central banks together make up the Eurosystem, the central banking system of the Eurozone. The main objective of the Eurosystem is to maintain price stability: to protect the value of the euro.

  - ✓ The European Central Bank is responsible for the prudential supervision of credit institutions located in the euro area and non-euro area member states, within the framework of the Single Supervisory Mechanism, which also includes national competent authorities. It thereby contributes to the safety and stability of the banking system and the stability of the financial system within the EU and each participating member state.

The European Central Bank (ECB) is one of the seven EU institutions and the central bank for the entire eurozone. It is one of the most important central banks in the world, supervising over 120 central and commercial banks in the member states. The ECB works with central banks in each EU member state to formulate monetary policy and help maintain stable prices and strengthen the euro.[47]

2.2.1. History of the European Central Bank

The European Central Bank (ECB) was established in June 1998, following the Amsterdam Treaty, which amended the Treaty on European Union. The Bank inherited the European Monetary Institute (EMI), which was set up in the second phase of the Economic and Monetary Union (EMU) to deal with the transitional issues of adopting the euro as the European Union's common currency.

The ECB first exercised its full powers on 1 January 1991 after the introduction of the euro as the official currency of the euro area. During that time, the national central banks of the 11 EU member states shifted their function to the ECB's monetary policy.

[47] European Central Bank (ECB) - Corporate Finance Institute, (2021), https://corporatefinanceinstitute.com › Resources,

Other EU countries later joined, with Greece, Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia and Lithuania joining the EU between 2001 and 2015. The expansion broadened the bank's reach and marked a turning point in the complex EU integration process.

The European Central Bank is the central banking body of the euro area, consisting of 19 European Union (EU) member states that have adopted the euro as their common currency. The main task of the European Central Bank (ECB) is to conduct monetary policy in the region by managing the euro supply and maintaining price stability. The ECB is responsible for overseeing lending institutions in the Eurosystem and in non-euro area Member States. The ECB is overseen by a governing body of six members of the executive board, one of whom is the president and 19 governors of the national central banks of the euro area. The members of the Executive Board are appointed by the European Council.[48]

2.2.2. Organizational structure of the ECB

There are four decision-making bodies of the ECB that have a mandate to achieve the goals of the institution. These bodies include: [49]

- Board of Directors,
- Executive Board,
- General advice.

Also, there is a Supervisory Board as a body.

2.2.2.1. Governing Council

Governing Council is the main decision-making body. The Governing Council consists of six members of the Executive Board and governors of the national central banks of the euro area. Responsibilities of the Governing Council are:

- to adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ECB and the Eurosystem;

[48] European Central Bank | bank, Europe | Britannica, (2021), https://www.britannica.com ›,
[49] European Central Bank (ECB), (2022), https://european-union.europa.eu › ecb_en.

- to formulate monetary policy for the euro area. This includes decisions relating to monetary objectives, key interest rates, the supply of reserves in the Eurosystem, and the establishment of guidelines for the implementation of those decisions.
- in the context of the ECB's responsibilities related to banking supervision, to adopt decisions relating to the general framework under which supervisory decisions are taken, and to adopt the complete draft decisions proposed by the Supervisory Board under the non-objection procedure.
- The Governing Council usually meets twice a month at the ECB's premises in Frankfurt am Main, Germany:
  - ✓ The Governing Council assesses economic and monetary developments and takes its monetary policy decisions every six weeks. At the other meetings, the Council discusses mainly issues related to other tasks and responsibilities of the ECB and the Eurosystem. To ensure the separation of the ECB's monetary policy and other tasks from its supervisory responsibilities, separate meetings of the Governing Council are held.
  - ✓ The monetary policy decision is explained in detail at a press conference held every six weeks. The President, assisted by the Vice-President, chairs the press conference.
  - ✓ In addition, the ECB publishes regular accounts of the Governing Council's monetary policy meetings before the date of the next one.
- One of the primary functions of this body is to formulate monetary policy for the euro area. In that regard, they make decisions about:
  - ✓ monetary objectives,
  - ✓ interest rates and
  - ✓ the supply of reserves in the Eurosystem.
- Every six weeks, the President and Vice-President of the ECB must chair a press conference to explain in detail their monetary policy decisions. The Governing

Council shall also take the necessary decisions to ensure the performance of the functions of the ECB and the Eurosystem.

- The rotation system concerns the allocation of voting rights to the members of the European Central Bank's Governing Council. It helps maintain the Governing Council's ability to take action even as the number of euro area countries gradually increases and with them, the number of members of the Governing Council.
- Euro area countries are divided into groups according to the size of their economies and their financial sectors. To determine which national central bank Governor belongs to which group, a ranking was established. The Governors from countries ranked first to fifth – currently, Germany, France, Italy, Spain and the Netherlands – share four voting rights. All others (14 since Lithuania joined on 1 January 2015) share 11 voting rights. The Governors take turns using the rights on a monthly rotation.

2.2.2.2. Executive Board

Executive Board handles the day-to-day running of the ECB. The Executive Board consists of the President, the Vice-President and four other Executive Members appointed for 8-year terms by the leaders of the eurozone countries..

- All Executive Board members are appointed for an eight-year term that cannot be renewed. As an exception, the members appointed to the first Board in 1998 received terms of varying lengths so that not all members would need to be replaced in the same year.
- Responsibilities
  - ✓ to prepare Governing Council meetings;
  - ✓ to implement monetary policy for the euro area in accordance with the guidelines specified and decisions taken by the Governing Council. In so doing, it gives the necessary instructions to the euro area NCBs;

- ✓ to manage the day-to-day business of the ECB;
- ✓ to exercise certain powers delegated to it by the Governing Council. These include some of a regulatory nature.

2.2.2.3. General advice

General Council has more of an advisory & coordination role. The General Council comprises the President and the Vice-President of the ECB and the governors of the national central banks (NCBs) of the EU Member States. In other words, the General Council includes representatives of all euro area countries and all non-euro area countries in the EU. The other members of the ECB's Executive Board, the President of the EU Council and one member of the European Commission may attend the meetings of the General Council but do not have the right to vote. Responsibilities:

- ➢ The General Council can be regarded as a transitional body. It carries out the tasks taken over from the European Monetary Institute which the ECB is required to perform in Stage Three of Economic and Monetary Union on account of the fact that not all EU Member States have adopted the euro yet.
- ➢ The General Council also contributes to:
  - ✓ the ECB's advisory functions;
  - ✓ the collection of statistical information;
  - ✓ the preparation of the ECB's annual report;
  - ✓ the establishment of the necessary rules for standardising the accounting and reporting of operations undertaken by the NCBs;
  - ✓ the taking of measures relating to the establishment of the key for the ECB's capital subscription other than those laid down in the Treaty;
  - ✓ the laying-down of the conditions of employment of the members of staff of the ECB; and

- ✓ the necessary preparations for irrevocably fixing the exchange rates of the currencies of the "EU Member States with a derogation" against the euro.

- ➢ In accordance with the Statute of the European System of Central Banks and of the European Central Bank, the General Council will be dissolved once all EU Member States have introduced the single currency.

- ➢ As a transitional body, the General Council has the task of fixing the exchange rates of the currencies of the countries that adopt the euro. The Council also contributes to the preparation of the ECB's annual report, the setting of employment conditions for European Central Bank staff and the collection of data.

2.2.2.4. Supervisory Board

The Supervisory Board meets every three weeks to discuss, plan and carry out the ECB’s supervisory tasks. It proposes draft decisions to the Governing Council under the non-objection procedure.

- ➢ Composition:
  - ✓ Chair (appointed for a non-renewable term of five years),
  - ✓ Vice-Chair (chosen from among the members of the ECB's Executive Board)
  - ✓ four ECB representatives
  - ✓ representatives of national supervisors

- ➢ If the national supervisory authority designated by a Member State is not a national central bank (NCB), the representative of the competent authority can be accompanied by a representative from their NCB. In such cases, the representatives are together considered as one member for the purposes of the voting procedure..

- ➢ There is a Steering Committee that supports the activities of the board, including the organization of board meetings. The members of the Management Board consist of the Chairman and Vice-Chairman of the Supervisory Board, one representative of the ECB and five representatives of the national supervisors.

2.2.2.5. Guiding principles for external communication

The members of the Governing Council, the Executive Board and the Supervisory Board (hereinafter the ‘members of high-level European Central Bank (ECB) bodies’) are subject to and act in accordance with the existing rules, as defined in particular in the Statute of the European System of Central Banks and of the ECB and in the Code of Conduct of high-level ECB Officials:[50]

- ➢ The members of high-level ECB bodies attach great importance to clear, effective and timely communication of the ECB’s strategy and policy decisions as well as issues related to their implementation.
  - ✓ The communication policy of the ECB is an essential part of its accountability and good governance obligations as an independent monetary and supervisory authority.
  - ✓ Regular contacts and interaction with members of the public, private sector, academia, interest groups, representative associations and civil society provide relevant input and information that help to understand the dynamics of the economy, the financial markets and the banking sector, and the broader societal context.
  - ✓ Two-way communication is based on open, transparent and regular dialogues and debates between the members of high-level bodies and the public as well as specialised audiences.
- ➢ Guided by the values of integrity and transparency, members of high-level ECB bodies and alternates hereby confirm their adherence to the following principles when interacting with private sector, academia, interest groups, representative associations and civil society representatives:

[50] European Central Bank (ECB) - Guiding principles for speaking engagements - https://european-union.europa.eu › ecb_en.

- ✓ First, the members of high-level ECB bodies and alternates safeguard confidential information in accordance with their obligations and apply utmost prudence in selecting speaking engagements at external events to avoid any appearance that potentially market-sensitive information may not be available to the widest possible public audience at the same time.
- ✓ Second, when considering invitations to speak at non-public events or to accept bilateral meetings, e.g. with bankers, industry representatives, or with special interest and advocacy groups, the members of high-level ECB bodies and alternates ensure that no market-sensitive information is divulged.
- ✓ Third, to enhance transparency and accountability, the members of high-level ECB bodies shall, as a general rule, include information on their meetings with external parties in their published meeting calendars, to the extent such information relates to their role as members of high-level ECB bodies.
- ✓ Fourth, the members of the Governing Council and of the Executive Board, and their alternates, re-affirm their adherence to the quiet period principle, whereby speeches and public remarks, given in the seven days prior to each scheduled monetary policy meeting of the Governing Council, should not be such as to influence expectations about forthcoming monetary policy decisions.

2.2.3. Functions of the European Central Bank

The European Central Bank is the central bank of the European countries, which has the single aim of maintaining the price stability of the Euro, which is adopted by all the member states. It aims to control inflation by monitoring the monetary policy and controlling the money supply in the market through interest rates.The European Central Bank is managed and monitored by the team of the European central bank. The team members are amongst representatives of the member states as decided and agreed mutually.

The bank functions according to the predefined rules and regulations, and all the decisions are taken on the majority basis after surveying the market situations and conditions.[51]

Figure 6

Finctions of European Central Bank

Извор: Srivastav, K. A., (2022), European Central Bank - Functions, How does it Work?, https://www.wallstreetmojo.com ›

1. The primary function of the ECB is related to its main goal - ***price stability and monetary policy*** formulation.: [52]

❖ This includes:

✓ decision making for monetary purposes,

✓ key interest rates,

✓ the supply of reserves in the euro system and

[51] Srivastav, K. A., (2022), European Central Bank - Functions, How does it Work?, https://www.wallstreetmojo.com ›

[52] Hayes, A., (2020), European Central Bank (ECB) Definition - Investopedia, https://www.investopedia.com › terms › europeancentralb, p. 1

- ✓ establishing guidelines for implementing those decisions.

❖ The ECB is also working on:

- ✓ Defining and implementing monetary policy in the euro area,
- ✓ Conducting foreign exchange operations,
- ✓ Holding and managing the official foreign exchange reserves of each country,
- ✓ Issue banknotes in the euro area,
- ✓ Collects and centralizes statistics from national authorities and economic entities,
- ✓ Audit of credit institutions in the Member States.

❖ Monetary policy decision-making meetings are held every six weeks, and the ECB is transparent about the rationale behind its decisions. A press conference is held after each such meeting, and the minutes of the meeting are published later.

❖ The ECB is also the EU body responsible for banking supervision. In cooperation with the supervisors of the national central banks, the ECB operates as it is called the Single Supervisory Mechanism. The decisions included in this function are mainly aimed at ensuring the security and stability of the European banking system:

- ➢ The European Central Bank does the following:
  - ✓ sets the interest rates at which it lends to commercial banks in the euro area (also known as the euro area), which controls money supply and inflation;
  - ✓ manages eurozone foreign exchange reserves and buys or sells currencies to balance exchange rates,
  - ✓ ensures that financial markets and institutions are well supervised by national authorities and that payment systems function well;
  - ✓ maintains the security and stability of the European banking system,

- ✓ approves the production of euro banknotes by euro area countries
- ✓ monitors price trends and assesses risks to price stability.

❖ The main goal of the ECB is to maintain price stability, ie to protect the value of the euro. Price stability is essential for economic growth and job creation - two of the European Union's goals - and it is the most important contribution that monetary policy can make in this area.

❖ The European Central Bank is responsible for prudent supervision of credit institutions located in the euro area and non-euro area member states, under the Single Supervisory Mechanism, which also covers national authorities. It thus contributes to the security and stability of the banking system and the stability of the financial system within the EU and each participating Member State.

❖ The European Central Bank is committed to the efficient performance of all its tasks. In doing so, it strives for the highest level of integrity, competence, efficiency and responsibility. The ECB respects the division between monetary policy and supervisory tasks. In carrying out its tasks, the ECB is transparent and fully complies with applicable confidentiality requirements.

The ECB defines policies for the euro area. Ensures the various national central banks to carry out decentralized operations in a consistent manner. National central banks are responsible for conducting monetary policy operations in their countries. National Central Banks:[53]

- ✓ execute current transactions,
- ✓ supply currency to commercial banks,
- ✓ manage the foreign exchange reserves operations for the ECB as well as their own foreign reserves and
- ✓ contribute to the proper functioning of financial markets and payment instruments.

[53] What is the role of the European Central Bank? - BNP Paribas, (2015), https://group.bnpparibas › news, p. 1

- ✓ mint coins.
- ✓ depending on the country, they may also perform specific functions that are assigned on a country-by-country basis..

The European Central Bank collects data on the international investment position of the euro area. This database contains information on the inventories of external assets and liabilities of the euro area as a whole by asset class:[54]

- ✓ foreign direct investment,
- ✓ portfolio debt,
- ✓ portfolio capital,
- ✓ financial derivatives and
- ✓ other investments.

The geographical division is limited to a few countries outside the euro area (Brazil, Canada, China, Denmark, Hong Kong, India, Japan, Russia, Sweden, Switzerland, the United Kingdom and the United States).

2. The ECB's inflation target makes clear that the focus of the ECB's monetary policy is on the euro area as a whole. Therefore, the 2% inflation target is assessed on the basis of inflation developments in the euro area economy:[55]

- ➢ Reasons for inflation target of 2%
  - ✓ An inflation rate of 2% is low enough for the economy to fully reap the benefits of price stability while also underlining the ECB's commitment to the following.
  - ✓ Providing a safety margin against the risk of deflation and making sure monetary policy remains effective when it needs to respond to inflation that is too low. Having a margin against deflation is important because there are limits to how far interest rates can be cut. In a deflationary environment

[54] European Central Bank - an overview | ScienceDirect Topics, (2021), https://www.sciencedirect.com ›, p. 1
[55] Two per cent inflation target - European Central Bank, (2022), https://www.ecb.europa.eu › i.

monetary policy may not be able to sufficiently stimulate the economy by using its interest rate instrument. This makes it more difficult for monetary policy to fight deflation than to fight inflation.

- Providing a sufficient margin to allow for:
  - ✓ a smoother adjustment of macroeconomic imbalances across euro area countries, avoiding inflation in individual countries persistently falling into negative territory;
  - ✓ downward wage rigidities, which risk raising unemployment excessively; and
  - ✓ a positive measurement bias in the price index, which could imply that the true level of inflation is lower than the measured level.
- Avoiding inflation that is too high or too low
  - ✓ We consider negative and positive deviations from our 2% inflation target to be equally undesirable. This target provides a clear anchor for inflation expectations, which is essential for maintaining price stability.
  - ✓ When the economy is operating close to the lower bound on nominal interest rates, it requires especially forceful or persistent monetary policy action to prevent negative deviations from the inflation target from becoming entrenched.

3. Monitoring import export transactions. The euro area economy is relatively open. Its trade openness is noticeably increasedy as a result of growing trade with new EU Membe:[56]

- Trade in goods - Trade in goods accounts for about three-quarters of total euro area external trade. Energy and raw materials together tend to represent a large share of imports from outside the euro area, while exports are more focused on processed goods, in particular machinery and transport equipment. This reflects

[56] External trade - European Central Bank, (2022), https://www.ecb.europa.eu › i.

increasing globalisation, the international division of labour and the scarcity of raw materials in the euro area.

- Trade in services - Trade in services makes up for the remaining quarter of total euro area external trade. The breakdown by service classification type of trade flows for services is rather similar for imports and exports, with other business services accounting for the largest share, followed by transportation and travel services.
- Trading partners - The non-euro area EU Member States and the euro area's top ten trading partners outside the EU together account for about three-quarters of euro area external trade. The United Kingdom, the United States and China are the euro area's three main trading partners, with a continued rise in the importance of emerging market economies. Non-euro area EU Member States also account for a large share of external trade.

4. ECB surveys provide useful information on diverse topics for which no other harmonised statistics exist.The ECB Survey collects information on market participants' expectations about the future evolution of key monetary policy parameters, financial market variables, and the economy. The ECB Survey runs eight times a year. The survey questionnaire aims to gather regular and systematic information on market participants' expectations about the future evolution of monetary policy instruments and initiatives that the ECB. Selection of survey respondents is based on the fulfilment of the following criteria: market relevance, geographic diversity, commitment to regular participation in subsequent rounds of the survey, and whether the institution is active in the field that is being surveyed:[57]

- They include:
  - ✓ household finance and consumption survey (HFCS),
  - ✓ survey on the access to finance of enterprises (SAFE),
  - ✓ bank lending survey (BLS),

[57] ECB surveys, (2022), https://www.ecb.europa.eu › i.

- ✓ survey of monetary analysts (SMA),
- ✓ survey of professional forecasters (SPF),
- ✓ survey on credit terms and conditions in euro-denominated securities financing and over-the-counter derivatives markets (SESFOD),
- ✓ consumer expectations survey (CES),
- ✓ study on the payment attitudes of consumers in the euro area (SPACE),
- ✓ use of cash by companies in the euro area.

➢ These surveys provide important insights into various issues, such as:

- ✓ micro-level information on euro area households' assets and liabilities,
- ✓ financing conditions faced by small and medium-sized enterprises,
- ✓ lending policies of euro area banks,
- ✓ market participants' expectations of the future course of monetary policy,
- ✓ expectations about inflation rates and other macroeconomic variables,
- ✓ trends in the credit terms offered by firms in the securities financing and over-the-counter (OTC) derivatives markets, and insights into the main drivers of these trends,
- ✓ the economic and financial behaviour of households in the euro area.

5. ECB economy's smooth functioning policy is realised by economic reforms in the goods, capital and labour markets which remove barriers to competition and increase market flexibility are essential for the smooth functioning of the Economic and Monetary Union (EMU). Such reforms are key to raising productivity and employment in the euro area, thereby supporting the growth potential of the euro area in the long run. At the same time, such reforms will contribute to lowering price pressures by enhancing competition and fostering innovation. By making the euro area markets more flexible, they also help countries to adapt faster and at lower cost to economic shocks. The case for structural economic reforms is very strong in a monetary union, such as the euro area, since there are no longer national monetary and exchange rate policies to respond to country-specific shocks and to improve competitiveness:[58]

- The economic reform agenda for Europe has been laid down in the so-called Lisbon Strategy for Growth and Jobs. In this context, the EU Heads of State or Government (European Council) launched a wide-ranging and ambitious programme of economic, social and environmental reforms in March 2000 covering policies at both the national and the EU level to enhance the standard of living of European citizens. To achieve this goal, the Lisbon Strategy aimed to transform the European Union into a highly competitive and knowledge-based economy while maintaining a high degree of social cohesion and environmental sustainability.
- As the results obtained in the first five years of implementation were rather mixed, partly due to a lack of clear focus, the Lisbon Strategy was relaunched in March 2005. The European Council streamlined the governance framework and refocused the strategy on ‘growth and jobs’ by identifying four main priority areas:
  - ✓ Promoting knowledge and innovation
  - ✓ Making the EU an attractive area to invest and work in
  - ✓ Fostering growth and employment based on social cohesion
  - ✓ Promoting sustainable development.
- Union’s strategy for creating jobs and promoting growth through economic and social reforms, while respecting environmental limitations is realised under the three headings of smart, sustainable and inclusive growth. The strategy covers policy actions at both national and EU level aimed at enhancing the welfare of European citizens. Under the Strategy, Member States will align their economic policies with redrafted Integrated Guidelines adopted at EU level (see below). They will also design structural reform strategies to overcome country-specific

[58] Economic policy - European Central Bank, (2022), https://www.ecb.europa.eu › i.

growth and employment bottlenecks. At EU level, seven flagship initiatives developed and suggested by the Commission will also support the strategy. One of them is the ‘ Innovation Union ’, which aims to improve the framework conditions and access to finance for research and innovation. Other initiatives focus on areas such as education, competitiveness and raising skill levels. Three flanking policies at EU level are also foreseen:

- ✓ The re-launch of the Single Market,
- ✓ Aligning the EU budget and EIB lending with the Strategy, and
- ✓ A new trade strategy improving global market access for EU companies.

2.3. THE NEW MONETARY POLICY STRATEGY OF THE EUROPEAN CENTRAL BANK

The Governing Council of the European Central Bank (ECB) launched a review of its monetary policy strategy adopted in 1998 and some of its elements clarified in 2003:[59]

- Since 2003 the euro area and the world economy have been undergoing profound structural changes. Slowing productivity growth, an ageing population and the legacy of the financial crisis have driven interest rates down, reducing the scope for the ECB and other central banks to ease monetary policy by conventional instruments in the face of adverse cyclical developments. In addition, inflation and inflation expectations have fallen below the ECB’s price stability target. The threat to environmental sustainability, rapid digitalisation, globalisation and evolving financial structures have further transformed the environment in which monetary policy operates, including the dynamics of inflation.
- The monetary policy strategy review will encompass the formulation of price stability, the monetary policy toolkit and its effectiveness, economic and monetary analyses and the ECB’s communication practices. Other considerations, such as financial stability, globalisation, employment and environmental sustainability, will also be part of the review.

[59] ECB Monetary Policy Strategy Review - Suomen Pankki, (2021), https://www.suomenpankki.fi ›

- The Governing Council of the European Central Bank (ECB) has published its new monetary policy strategy on 8 July 2021:
  - ✓ New strategy adopts symmetric 2% inflation target over medium term,
  - ✓ New monetary policy strategy is result of thorough review launched in January 2020,
  - ✓ Governing Council approves climate change action plan.
- The strategy describes how the ECB will maintain price stability in the euro area and what objectives it sets for its monetary policy. A stable and predictable outlook for prices and hence public confidence in the preservation of purchasing power are key prerequisites for sustainable economic growth and full employment.To a large extent, balanced economic growth, full employment and price stability are mutually consistent objectives.
- According to the new strategy, price stability is best maintained by aiming for a 2% inflation target over the medium term. This target is symmetric, meaning the Governing Council considers negative and positive deviations of inflation from the target as equally undesirable. The 2% inflation target provides a clear anchor for inflation expectations, which is essential for maintaining price stability.
- Long-term structural trends, in particular slower productivity growth and the ageing of the population, have slowed the pace of growth in the economy and driven down equilibrium real interest rates. Due to the proximity of the zero lower bound, this has reduced the scope for the ECB and other central banks to achieve their objectives by exclusively relying on traditional instruments, primarily changes in policy interest rates. Forward guidance, asset purchases and longer-term refinancing operations have helped to partially overcome the constraints induced by the lower bound and will continue to be used as appropriate.
- To maintain the symmetry of its inflation target, the Governing Council recognises the importance of taking into account the implications of the effective

lower bound. When the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched.

- Without prejudice to the price stability objective, in the medium term will be taken into account factors relating to e.g. full employment and financial stability. The setting of a medium-term inflation target will also allow other important objectives, such as full employment, to be emphasised in decision-making, naturally without prejudice price stability.
- Climate change will impact structural and cyclical developments in the economy and the financial system. In strategy is stresses that it is committed to systematically take factors relating to environmental sustaina.

The ECB announced that it is willing to accept a transitory period of moderate inflation overshoot in its efforts to push inflation upwards after a long period of undershooting its target. The results point to the conclusion that the average inflation rate over the business cycle consolidated about one percentage point below the ECB's target rate. A temporary asymmetry of the ECB's monetary strategy seems therefore justified to realign inflation and inflation expectations with the target rate:[60]

- Two key elements of this new strategy are:
  - ✓ The symmetry of the inflation target and
  - ✓ The use of especially forceful or persistent measures when the economy is close to the effective lower bound.

❖ ***The symmetry of the inflation target*** serves as an important counterpoint to the asymmetric threat to price stability induced by the ELB. A central bank can always raise the policy rate in response to an inflationary shock, thereby containing the amount by which inflation overshoots the target. In contrast, the ELB may prevent the central bank from lowering the policy rate sufficiently in response to a large disinflationary shock so

[60] Hennecke, P., (2022), The ECB's New Monetary Policy Strategy - Intereconomics, https://www.intereconomics.eu › year › number ›

that inflation may fall well below target (providing there is no perfect substitute for the policy rate in the toolkit). If agents attach a positive probability to the possibility of a binding ELB, this asymmetry in the ability of central banks to respond to shocks makes it rational for households, firms, and financial market participants to lower their inflation expectations.

- In such a situation, an inflation objective that is unequivocally symmetric signals the central bank's willingness to counteract the ELB-induced disinflationary bias with appropriate measures.
  - ✓ Does the ECB's symmetric inflation target facilitate the achievement of price stability over the medium term in a low-interest-rate environment? To provide a model-based answer, must formalise the ECB's medium-term orientation. One potential formal representation is the model's risky steady state. The risky steady state is the point to which the economy converges when contemporaneous shocks have receded, but people take into account the risk associated with future shocks.
  - ✓ A key disadvantage of such an asymmetric approach is that it may give rise to an inflation bias characterised by a risky steady state of inflation above target. This could happen, for example, when economic fundamentals change and the central bank fails to adjust its asymmetric target accordingly. Such an inflation bias would be inconsistent with the ECB's medium-term price stability objective. A symmetric inflation target is thus more robust than an asymmetric inflation target of either type.

❖ Forceful or persistent monetary policy measures has hav intended to avoid negative deviations from the inflation target becoming entrenched. The Governing Council is not deliberately aiming for inflation overshoots, a notable difference to the average inflation.

- Persistence is a common feature of optimal monetary policy in New Keynesian models. Amonetary policy reaction function that features state-contingent interest-rate smoothing. In most statesmonetary policy responds only modestly, if at all, to the lagged policy rate, but, when the ELB becomes binding, the response coefficient on the lagged policy rate increases temporarily. The central bank adjusts the policy rate only slowly in response to changes in economic conditions. If the policy rate increases more gradually than the speed at which the economy recovers from the previous downturn, inflation will transitorily overshoot its target. The inflation overshoot is a possibility rather than a necessity, and depends on the speed of the economic recovery. Nonetheless, the mere possibility of an overshoot will have a positive effect on inflation expectations during the economic downturn, when the ELB is still binding and inflation is below target.

- While persistence is a feature of the optimal monetary policy response after an ELB episode when the disinflationary shock that has led to a binding ELB starts to recede, forcefulness is a feature of the optimal response when the shock arises and the risk of a binding ELB increases. In this situation, the central bank lowers its policy rate aggressively to keep inflation close to its target. If the central bank instead lowered its policy rate only sluggishly in response to the disinflationary shock, inflation would fall below target even before the ELB became binding, and the downward bias in inflation expectations induced by ELB risk would increase.
- An aggressive reduction in the policy rate when the economy is buffeted by a disinflationary shock and approaches the ELB is one example of an especially forceful policy response. Another, potentially complementary, example is the use of additional policy instruments. This is intended to compensate, at least partially, for the lack of further policy rate reductions.

The new monetary policy strategy of the European Central Bank has been published since it was determined that it is suitable for the purpose, both today and in the future. The new strategy covers all aspects of the ECB's monetary policy within its mandate, which is to maintain price stability.[61]

The ECB's new monetary policy strategy has the following characteristics:[62]

- The new, corrected monetary policy strategy envisages inflation of 2% is clear and unambiguous. The target is symmetrical, which means that both negative and positive deviations of inflation from the target are considered equally undesirable. Commitment to the symmetrical inflation target requires particularly strong or persistent monetary policy measures when interest rates are close to their effective lower limit. This could mean a transition period in which inflation is moderately above the target. The medium-term inflation targeting also allows the ECB to emphasize sustainable growth and full employment in its decision-making. In its monetary policy, the ECB also takes into account environmental sustainability, in line with the new climate action plan.

- The monetary policy strategy of the European Central Bank shows how the ECB maintains price stability in the euro area and what goals it sets for its monetary policy. The strategy also provides a coherent analytical framework for monetary policy decision-making and communication..

- Stable and predictable pricing prospects, and thus public confidence in preserving purchasing power, are key preconditions for sustainable economic growth and high employment. The strategy is based on the premise that, at the level of the economy as a whole, price stability, balanced growth and high employment are mutually consistent goals. Successful monetary policy contributes to ensuring the monetary policy of the central bank to maintain price stability and to promote the welfare of citizens in an optimal way. Targeted monetary policy communication can significantly reduce monetary policy uncertainty and improve citizens 'and market participants'

[61] European Central Bank Strategy Review, (2021), https://www.centralbank.ie ›, p. 1 - 2
[62] ECB revised its monetary policy strategy – what's changed?, (2021), https://www.bofbulletin.fi › ecb-revised-its-monetary-poli. p. 1

understanding of how monetary policy decisions relate to real and expected economic developments.

- One of the main structural factors is demographic change. An aging population has increased savings and demand for liquidity and lowered interest rates. It may also have slowed economic growth, through lower productivity and reduced investment. At the same time, the demand for loans has decreased, and interest rates have a decreasing trend.
- As a result of the global financial crisis and the sovereign debt crisis in the euro area, inflation has also slowed in the euro area. Globalization and digital technologies, in turn, have had an impact on the composition of the production of goods and services, on the labor market, and probably also on inflation in the long run. Demographic factors are deflationary due to the associated contraction of aggregate demand.
- Threats to environmental sustainability have also become a major global and political challenge. Addressing climate change is now also one of the European Union's policy priorities. While governments and parliaments have a primary responsibility to act on climate change, within its mandate, the ECB recognizes the need to include more climate considerations in its monetary policy framework.
- Successful monetary policy requires transparency and accountability. Monetary policy communication - that is, the provision of information on monetary policy decisions to the media, the general public, businesses and financial market participants - plays a key role in transmitting these decisions to the economy. The role and importance of direct information channels and social media has grown at the expense of the traditional press and news channels. This requires a new type of communication policy from central banks that will take into account the target audience and the media.

2.4. THE ROLE OF MONETARY POLICY AND THE BENEFIT OF PRICE STABILITY

Economy works best when there is price stability. That means that economy is need to guard against an inflation rate – the rate at which the overall prices for goods and services change over time – that is either too low or too high. Price increases should be small enough not to create the problems that come with high inflation for people and businesses. But they should be large enough to avoid bad scenarios that may unfold if inflation falls too low. When inflation is low, stable and predictable, it helps people and businesses to better plan their savings, spending and investment. That helps the economy to grow, in turn creating jobs and prosperity:[63]

- Price stability has the following benefits.
  - ✓ Stability allows to avoid the inefficiency costs arising from the presence of nominal rigidities.
  - ✓ Stability reduces the inefficiency costs created by inflation being a tax on money balances.
  - ✓ Stability avoids adverse redistributive effects of inflation. The adverse effect of inflation on income and wealth differs across different cohorts of society, with higher inflation especially detrimental for low-income households with limited investment options.
  - ✓ Stability avoids adverse interactions of inflation with taxation. The presence of inflation creates distortions because taxes are levied in nominal terms and there is no full indexation. For instance, if your nominal income grows in line with inflation but the tax brackets are not updated in line with inflation, you end up paying more taxes even if inflation-adjusted income has not changed. By keeping inflation low and stable this effect is reduced.
  - ✓ Stability reduces unexpected changes in inflation, which create distortions. For example, if there is an unanticipated increase in inflation, the value of

[63] Benefits of price stability - European Central Bank, (2022)https://www.ecb.europa.eu › i.

savings goes down and the value of debt goes down, which transfers wealth from savers to borrowers.

- ✓ Stabilitydecreases the volatility of inflation, which in turn lowers uncertainty and market interest rates and this motivates people to invest.
- ✓ Stability contributes to a more stable financial system.
- ✓ Stability helps to maintain social cohesion and stability. History has shown that episodes of high inflation as well as episodes of deflation, or persistently falling prices, tend to be associated with social unrest.

- ➢ Unstable inflation particularly affects low-income households because they have fewer resources to protect themselves. When prices are stable, everyone is better off: price stability supports economic growth and employment, and allows people to make more reliable plans when taking decisions about borrowing, saving, and expanding businesses.

Frequent changes in individual prices are quite normal in market economies, even if there is price stability as a whole. Changes in supply demand for individual goods or services inevitably lead to changes in their prices:[64]

- ✓ Inflation and deflation are important economic phenomena that have negative consequences for the economy. Basically, inflation is defined as a general, or on a broad basis, an increase in prices of goods and services over a long period of time, which in turn leads to a decline in the value of money, and thus its purchasing power.
- ✓ Deflation is often defined as the opposite of inflation, namely as a situation in which the overall price level falls over a longer period.
- ✓ When there is no inflation or deflation, it can be said that there is price stability if on average prices neither increase nor decrease, but remain stable.

[64] European Central Bank (ECB) - Price Stability: Why is it Important for you?, https://www.ecb.europa.eu › pub › pdf › other. p. 1 - 3

- ✓ Price stability prevents the occurrence of costs and brings important benefits to all citizens. There are several ways in which price stability helps to achieve high levels of economic well-being, e.g. e. in the form of high employment.
- ✓ Price stability makes it easier for people to identify changes in the prices of goods expressed in relation to other goods (ie "relative prices"), because such changes are not hidden by fluctuations in the overall price level. For example, suppose the price of a product increases by 3%. If the general price level is stable, consumers know that the relative price of this product will increase and therefore may decide to buy less than that. However, if there is high and volatile inflation, it is more difficult to find out the relative price..

Price stability means avoiding both prolonged inflation and deflation:[65]

❖ Inflation is an increase in the general level of prices of goods and services in an economy over a long period of time that results in a decline in the value of money and purchasing power.

- ✓ Too fast inflation is negative for many reasons:
  - ✓ complicates the decision-making process in the economy and
  - ✓ slows economic growth.
  - ✓ in addition, inflation reduces the value of savings.

❖ Deflation is the reduction of the general level of prices of goods and services over a longer period of time.

- ✓ Deflation is accompanied by the threat of a slowdown in economic growth, as the general level of prices falls, and thus, people delay consumption, and companies delay investment. An inflation gap may appear which is very difficult to bridge. The real value of non-performing loans is increasing, which means that debtors are facing

[65] Importance of price stability | Eesti Pank, (2021), https://www.eestipank.ee › im, p. 1 -2

difficulties, and credit losses are also a threat to financial institutions. It is often difficult for companies to reduce wages, even if the cost of their production is declining. This causes an increase in unemployment and the number of bankruptcies.

❖ Price stability contributes to achieving high levels of economic activity and employment, improving the transparency of the price mechanism. Under price stability, people can recognize changes in relative prices (ie prices between different goods), without being confused by changes in the overall price level. This allows them to bring:

- ✓ well-informed consumption and investment decisions and allocate resources more efficiently;
- ✓ reduction of the premium for inflation risk in interest rates (ie compensation creditors seek for the risks associated with holding nominal assets). This lowers real interest rates and increases investment incentives;
- ✓ avoiding unproductive activities to protect against the negative impact of inflation or deflation;
- ✓ reducing inflation or deflation disturbances, which may exacerbate the disturbance of the impact on the economic conduct of tax and social security;
- ✓ preventing arbitrary redistribution of wealth and income as a result of unexpected inflation or deflation.

❖ Price stability is an annual increase of the harmonized consumer price index for the euro area below 2%. "Price stability must be maintained in the medium term." The inflation rate below, but close to 2% is low enough to allow the economy to fully benefit from price stability. It also emphasizes the Eurosystem's obligation to guarantee an adequate inflation rate in order to avoid the risk of deflation. This is important to keep the nominal interest rates above zero. In a deflationary environment, monetary policy may not be able to sufficiently stimulate aggregate demand by using its interest rate instrument. This makes it harder to fight monetary policy deflation than it is to fight inflation.

2.4.1. Price stability and monetary balance

The ECB's main task is to keep prices stable. This is the best contribution central banks can make to improving people's individual welfare:[66]

- Stable prices means that prices should not go up (inflation) significantly, and an ongoing period of falling prices (deflation) should also be avoided. Long periods of excessive inflation or deflation have negative effects on the economy. Whereas stable prices help to ensure that the economy is growing, jobs are safe and people can feel confident that the money in pocket will be worth roughly the same tomorrow as it is today.
- If the prices of many items that people buy go up, they lose purchasing power. In other words, the money people have – their income and savings – does not buy as much as it used to. This can lead to a spiral of increasing prices.
- The reason for this is that if everything is becoming more expensive, workers may ask employer for a salary increase. Employer may react by raising the company's prices to fund staff's requested salary increases. If this is happening in many companies, the prices of many items will rise further, and so the spiral continues.
- This makes it more difficult for businesses to plan savings and investments. People may lose confidence in the currency as it is losing value rapidly.
- While falling prices might sound good to as a consumer, an ongoing and widespread fall in prices across the economy that is not due to improvements in production is a problem because it can lead to a spiral of falling prices.
    - ✓ The economy will start slowing down as consumers and businesses cut back on spending and investing. It might also become more difficult to pay off any

[66] Why are stable prices important? - European Central Bank, (2022), https://www.ecb.europa.eu › s.

debts may have, such as mortgage, which will not decrease even though income might.

- ✓ The same goes for public finances. Tax revenues decline as incomes and spending decrease, but government debt will still have to be paid. As a result, public spending on infrastructure and healthcare, for example, might need to be reduced. The negative consequences of deflation are therefore felt by everyone.

Price stability in an economy means that the general price level in does not change much over time. In other words, prices neither increase nor decrease; there is no significant degree of inflation or deflation. The term monetary policy refers to the decisions that the government makes regarding interest rates and the money supply in an economy. Monetary policy can be used to try to keep prices stable. In the EU, the European Central Bank determines monetary policy:[67]

- ➢ The general purpose of monetary policy is to help the economies of EU countries achieve or maintain monetary balance. The economy is in monetary equilibrium when the required amount of money is equal to the amount of money delivered. The level of prices where the money supply is equal to the demand for them is the equilibrium price, which tends to be stable unless some external factor changes the demand or supply. In other words, prices will be stable when people do not have more money or less money than they have
- ➢ The European Central Bank can try to control inflation or deflation by engaging in open market operations. In open market operations, the bank buys or sells government securities on the open market to change the growth rate of the money supply. The change in the money supply affects the general level of prices.

[67] Price Stability in Monetary Policy: Definition & Overview - Study.com, (2021), https://study.com › academy › lesson › price-stability-in-,

- Monetary policy can be used to increase or decrease the money supply. As the money supply decreases, interest rates will increase; and as the money supply increases, so do interest rates. In this way, the ECB can indirectly influence interest rates. However, the ECB also has more direct, albeit less effective, means of influencing interest rates that can also affect price levels.

As inflation rises across the eurozone, the ECB is under pressure to hit back with monetary policy tools, the most important of which is the key interest rate, which affects the cost of loans private banks make to businesses and private households:[68]

- With higher interest rates, investment becomes more expensive, reducing demand in the overall economy, which should reduce pressure on prices. In the current circumstances, where a lack of supply mainly drives prices, the effectiveness of this mechanism is somewhat limited.
- The rise in interest rates should also signal to citizens and companies that the central bank is serious about the fight against inflation, which aims to influence expectations for further inflation.
- The ECB is under increased pressure as higher interest rates can contribute to the economic downturn, which is expected anyway due to the energy crisis.
  - ✓ Multiple Eurozone countries are headed toward a situation where economic activity stagnates or declines, but inflation remains high, posing challenges for central banks and finance ministries.
  - ✓ Increasing interest rates also make it harder for governments to borrow money to support citizens financially or make investments, for example, in energy infrastructure, that could help ease some of the supply issues driving up energy prices.

[68] Packroff, J., (2022), ECB hikes interest rates, insists on price stability mandate, (2022), https://www.euractiv.com › e.

- ✓ In the present state of uncertainty, with the likelihood of recession looming much more on the horizon and the probability of it having increased, everyone has to do their job. And job of ECB is price stability.

2.4.2. Price stability in the Eurosystem

The primary objective of the ECB's monetary policy is to maintain price stability. This means sure that inflation – the rate at which the prices for goods and services change over time – remains low, stable and predictable:[69]

- To help keep prices stable, ECB need to have the right tools available. Interest rates are the primary instrument that ECB use for monetary policy. In recent years ECB have added new instruments to toolbox in response to big changes and large shocks in the economy that have made hers task of maintaining price stability more challenging.
- Objectives include balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment – without prejudice to the objective of price stability.
- ECB 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.
- ECB act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources.

The primary objective of the Eurosystem is to maintain price stability. This is a key provision of the monetary policy chapter of the EC Treaty. By focusing on the ECB monetary policy, it incorporates modern economic thinking into the role, scope and limits

[69] Introduction - European Central Bank, (2022), https://www.ecb.europa.eu › i.

of monetary policy and emphasizes the institutional and organizational set-up of the central bank in the union:[70]

- First, decades of practical experience and a number of economic studies suggest that monetary policy will contribute most to improving economic prospects and raising the living standards of citizens by maintaining price stability in a lasting way.
- Second, maintaining stable prices is the only achievable goal for a single monetary policy over the medium term. In contrast, apart from the positive impact of price stability, monetary policy has no room to have a lasting impact on real variables. The Eurosystem is required to act in accordance with the principle of an open market economy with free competition, favoring an efficient allocation of resources.

2.4.2.1. Defining price stability

Price stability is when there are no major fluctuations in the prices of general consumer goods. While it's important to note that the law of supply and demand will always result in some fluctuations as market dynamics shift, a stable economy sees those fluctuations moving within a normal range:[71]

- One of the most important aspects of a well functioning economy is understanding the value of the money you have. Extreme fluctuations alter the value of money and make it difficult to make purchasing and pricing decisions. These fluctuations can come in two flavors: inflation, where prices go up, and deflation, where prices go down.
- When prices rise dramatically, the purchasing power of the individual goes down. When this happens, consumers become more thrifty. The resulting decline in demand has an impact on what companies can get away with charging and can affect revenue.

[70] Price Stability – Objective of the Eurosystem, (2021), https://www.ecb.europa.eu › educational › shared › img.,
[71] What is price stability & why is it important? [+examples], (2022), https://www.profitwell.com ›

- It may seem as though deflation is good for business, since inflation is bad. This isn't the case. When consumers notice a rapid drop in prices, they'll often hold off on purchases of non-essential items based on theexpectation that prices will go lower. So deflation, too, can cause a drop in demand.

Changes in monetary policy always affect prices with significant time delays, and the magnitude of the potential impact is uncertain. This implies that monetary policy can not offset all the unexpected shocks to the price level in a short period of time. Therefore, some short-term inflation volatility is inevitable. There are three main reasons for publishing a quantitative definition of price stability:

- ✓ By clarifying the objectives of monetary policy, the definition helps to make monetary policy more transparent.
- ✓ The quantitative definition provides a measure against which the public can hold the ECB accountable. As deviations in price movements from price stability can be easily identified by citizens, the ECB must explain how price stability will be restored within an acceptable period of time.
- ✓ The definition provides guidance to the public on shaping expectations for future price developments. Stabilizing long-term inflation expectations in line with price stability facilitates the task of monetary policy and improves its effectiveness.

2.4.2.2. Benefits of price stability

The purpose of price stability refers to the general level of prices in the economy and means avoiding inflation and deflation. Price stability contributes in several ways to achieving high levels of economic activity and employment:

- ✓ Price stability makes it easier for people to recognize changes in relative prices because such changes are not obscured by fluctuations in the overall price level. This allows companies and consumers to make better informed decisions about consumption and investment. This in turn allows the market for more efficient allocation of resources. By helping the market direct resources to where they can be most used productively, price stability increases the productive potential of the economy.

- ✓ If investors can be sure that prices will remain stable in the future, they will not seek an "inflation risk premium" to offset the risks associated with holding nominal assets in the long run. By reducing such risk at the real interest rate, monetary policy can contribute to the allocative efficiency of the capital market, and thus increase investment incentives. This in turn encourages economic prosperity.
- ✓ With reliable price stability, individuals and firms are less likely to divert resources from productive uses to inflation protection. For example, in an environment of high inflation there is an incentive to store real goods because they retain their value better than money or some financial means in such circumstances. However, storing goods is not an effective investment decision, as it hinders economic growth.
- ✓ Tax and social systems can create incentives that disrupt economic behavior. In most cases, these disorders are exacerbated by inflation or deflation. Price stability eliminates the real economic costs that are imposed when inflation exacerbates the impact of taxes and social security systems.
- ✓ Price stability prevents a significant and arbitrary redistribution of wealth and income arising in both inflationary and deflationary environments. Price stability helps maintain social cohesion and stability.

- ➢ Businesses, and the economy in general, benefit when price fluctuations are kept to a minimum:[72]
- ➢ Price transparency - Prices will always change. But with price stability, consumers will be able to recognize when a given good is going up and down in price, and make more informed decisions about their purchases. When everything is moving in price, it becomes harder for consumers to adapt. Clearer pricing

[72] 8What is price stability & why is it important? [+examples], (2022), https://www.profitwell.com ›

developments associated with greater price stability reduces hesitation on the part of the consumer.

- Avoids random wealth redistribution - When prices are changing outside of typical supply and demand forces, there are winners and losers that have little control over their circumstances. An example from earlier, how inflation from the pandemic hurt the construction industry particularly hard, illustrates how revenues can change disproportionately.
- Low risk premia - Another example from above illustrates this example. When the housing market is affected by inflation, it will have an impact on the number of people willing to take a risk on investment. This slowing of investment applies to the business sector as well, resulting in lower economic growth than occurs at more stable prices.
- Reduced unproductive investment activities - The risk premia calculation mentioned above certainly affects how investors behave, and results in them making fewer worthwhile investments. However, attempts to get ahead of inflation or deflation can have the opposite effect. For example, a company might purchase more supplies than they need to avoid paying more later.

2.4.3. Risks for price stability in the ECB monetary policy

To achieve its goal of price stability and improve the transmission of monetary policy, the ECB announces its assessment of the balance of risks to price stability and growth:[73]

- The decline in economic activity puts downward pressure on prices outside the short-term impact of falling commodity prices. This leads to concerns that the euro area may not enter a situation that will lead to a sustainable and wide decline in the aggregate price level, ie. deflation. The European Central Bank (ECB) is responding to developments by rapidly reducing its key

[73] Risks to price stability, the zero lower bound and forward Guidance, (2013), https://www.ecb.europa.eu › scpwps › ecbwp1582, p. 5 - 6

interest rates to historically low levels in order to support aggregate demand and prevent further loss of confidence:

- Forecasts are a central element in the thinking of monetary policy makers regarding the outlook for the economy and the calibration of the monetary policy stance. However, accurate forecasts fail to convey the great uncertainty regarding unforeseen events and happenings over the forecast horizon. Basic forecasts include a wider range of data and cover different models and perspectives.
- The ECB has also implemented a number of non-standard monetary policy measures, including ensuring unlimited liquidity of the banking system, maintaining financial intermediation and maintaining the availability of credit to the private sector.

Risks to financial stability in the euro area have increased amid soaring energy prices, elevated inflation and low economic growth. At the same time, financial conditions have tightened as central banks act to rein in inflation:[74]

- People and firms are already feeling the impact of rising inflation and the slowdown in economic activity.Assessment is that risks to financial stability have increased, while a technical recession in the euro area has become more likely.
- These recent developments are increasing the vulnerability of households, firms and governments that hold more debt. They are also adding to financial market stresses and testing the resilience of investment funds. Moreover, all of these vulnerabilities could unfold simultaneously, potentially reinforcing one another.
- Corporate sector challenges have grown amid higher energy and other input costs, with profits expected to decline as funding costs increase. If the outlook deteriorates further, an increase in the frequency of corporate defaults cannot be excluded, particularly among energy-intensive firms.

[74] ECB Financial Stability Review shows risks increasing as economic and financial conditions worsen, (2022), https://www.ecb.europa.eu ›

- Inflation, as well as soaring gas and electricity bills, is also hitting households, decreasing their purchasing power and potentially reducing their ability to repay loans. Lower-income households that generally spend a greater share of their income on energy and food are particularly affected.

- As firms and households find it increasingly challenging to service their debts, banks could face higher credit losses in the medium term. While the banking sector has recently seen a recovery in profitability as interest rates have risen, there are incipient signs of asset quality deterioration, which may require larger provisions.

- Many governments have been providing fiscal support to firms and households to soften the impact of rising energy prices. However, high levels of government debt following the pandemic, paired with tighter funding conditions, limit the scope for fiscal expansion measures that do not trigger risks to debt sustainability. Support should therefore be temporary and targeted at those most affected.

- Uncertainty around the outlook for inflation and interest rates has heightened the risk of disorderly asset price adjustment in financial markets, notwithstanding recent corrections. Many investment funds remain heavily exposed to further valuation and credit losses. Those with large structural liquidity mismatches and low cash buffers are particularly vulnerable to market dislocations and the outflow of funding. Diminished liquidity in some financial markets could also pose challenges for adjusting portfolios or raising funds. It also raises the risk of unexpectedly large margin calls, which could aggravate adverse market dynamics if funds are forced to sell assets to meet them.

- Overall, the euro area banking system is well placed to withstand many risks, in part because of the regulatory and prudential policy reforms of the past decade. Given the deterioration of the economic and financial outlook, targeted macroprudential policies such as capital buffers can help to further strengthen the resilience of the financial system.

- Persistent vulnerabilities and risks in the non-bank financial sector require close attention from relevant supervisors. Urgent progress on regulatory frameworks is needed to enhance the resilience of the sector, especially to address liquidity mismatches and leverage.

2.4.4. The impact of climate change and climate policy on the ECB's goal of price stabilit

The ECB will incorporate climate change considerations into its new monetary policy strategy. To this end, the ECB has prepared an action plan setting out adjustments to macroeconomic modeling and statistics to gain a better understanding of the impact of climate change on the economy and the financial sector. Furthermore, the ECB will explicitly take into account the climate change risks inherent in its financial market operations, such as the purchase of corporate bonds. The ECB will also identify the risks of climate change to which it is exposed. These measures send an important signal for financial market participants to follow suit.[75]

- Governments have primary responsibility for climate policy. To meet this responsibility, they have at their disposal instruments such as greenhouse gas emission taxes and climate investment schemes. Governments are also increasingly responding to climate change, driven by initiatives such as the European Union Green Agreement. Because of their impact on the economy and financial system, climate change and climate policy are also relevant to the mandate of central banks.

- Climate change and climate policy affect the ECB's goal of price stability because both can affect inflation. Prices for goods and services can fluctuate sharply due to economic shocks resulting from the impact of climate change such as droughts or floods. Governments' climate policies, especially emissions taxes, also generally affect price levels. In a scenario where governments are forced to sharply raise emission taxes, for example because they were initially too slow to

[75] ECB includes climate change in monetary policy strategy, (2021), https://www.dnb.nl ›

respond, prices could rise significantly. Such effects on inflation are uncertain, but central banks must have these risks on their radar, given their mandate for price stability. The ECB is therefore adapting its macroeconomic models and statistics to gain a better understanding of the impact of climate change on the economy and the financial sector..

- Policy adjustments for purchasing assets based on climatic criteria.
  - ✓ The ECB will also take into account the climate change risks inherent in its financial market operations. Fundraising programs are a key tool for monetary policy in this regard. The Action Plan looks at how to adjust the distribution of procurement under the Corporate Sector Procurement Program (CSPP), based on climate criteria. Based on these criteria, the ECB can monitor companies' commitment and compliance with EU legislation in implementing the Paris Agreement.
  - ✓ The amount of bonds the ECB currently buys is still based on the outstanding amount of debt of nonfinancial corporations in the capital market. Because heavy-duty corporations are large and have significant recourse to debt financing, they are also a relatively large component of CSPP. As a result, in macroeconomic terms, CSPP does not contribute to the optimal distribution of capital in the economy.
- Risk control measures:
  - ✓ The action plan also contains specific measures to incorporate climate considerations into ECB risk control measures. Climate change has implications for the value and risk profile of assets held on the central bank's balance sheet. Climate shocks can lead to the write-off of government and corporate bonds in monetary policy portfolios and therefore can affect the balance sheets of central banks. In addition, central banks must take into account climate change and transition risks for collateral provided by the banks to which they lend. Ultimately, the credit quality of that collateral may deteriorate if these risks materialize.

- ✓ Under the action plan, the ECB will identify the climate risks to which it is exposed, primarily for corporate bonds under CSPP and its investment portfolios. In addition, the ECB will make climate-related reporting a prerequisite for financial institutions to participate in monetary operations and to qualify for the purchase and eligibility (as collateral) of assets. The ECB is also examining the possibility of incorporating climate change risks into the collateral framework, for example, by applying hairstyles to the collateral valuation that aligns with these risks. The ECB will also integrate climate risks into its own risk control framework by conducting climate stress tests.

Addressing climate change is a global challenge and a policy priority for the European Union. While governments and parliaments have the primary responsibility to act on climate change, within its mandate, the ECB recognises the need to further incorporate climate considerations into its policy framework:[76]

- ➢ Climate change and the transition towards a more sustainable economy affect the outlook for price stability through their impact on macroeconomic indicators such as inflation, output, employment, interest rates, investment and productivity; financial stability; and the transmission of monetary policy. Moreover, climate change and the carbon transition affect the value and the risk profile of the assets held on the Eurosystem’s balance sheet, potentially leading to an undesirable accumulation of climate-related financial risks.

- ➢ With action plan, the ECB increase its contribution to addressing climate change, in line with its obligations under the EU Treaties. The action plan comprises measures that strengthen and broaden ongoing initiatives by the Eurosystem to better account for climate change considerations with the aim of preparing the ground for changes to the monetary policy implementation framework. The design of these measures will be consistent with the price stability objective and should take into account the implications of climate

[76] The European Central Bank's new monetary policy strategy, Action plan to include climate change considerations in its monetary policy strategy, (2022), https://www.bde.es › GAP › Secciones › SalaPrensa.

change for an efficient allocation of resources. The recently established ECB climate change centre will coordinate the relevant activities within the ECB, in close cooperation with the Eurosystem. These activities will focus on the following areas:

- Macroeconomic modelling and assessment of implications for monetary policy transmission. The ECB will accelerate the development of new models and will conduct theoretical and empirical analyses to monitor the implications of climate change and related policies for the economy, the financial system and the transmission of monetary policy through financial markets and the banking system to households and firms.

PART THREE: ECB POLICY TOWARDS EU MEMBERS OUTSIDE THE EUROZONE AND MONETARY POLICY OF THE REPUBLIC OF BULGARIA

3.1. COUNTRIES OUTSIDE THE EUROZONE

The formation of the European Union (EU) paved the way for a unified financial system with several countries under a single currency - the euro. While most EU member states have agreed to adopt the euro, few are sticking to their inherited currencies.:[77]

- The European Union has 27 member states, of which eight are not in the eurozone - the unified monetary system used by the euro. Denmark is legally exempt from adopting the euro. All other EU countries must join the eurozone once they meet certain criteria. However, countries have the right to delay meeting the eurozone criteria and thus delay their adoption of the euro. EU countries that do not use the euro as their currency are Bulgaria, Croatia, the Czech Republic, Denmark, Hungary, Poland, Romania and Sweden.
- EU member states differ in culture, climate, population and economy. Countries have different financial needs and challenges to address. The single currency imposes a system of central monetary policy applied equally. The problem, however, is that what is good for one eurozone economy can be bad for another. Most EU countries that have avoided the eurozone are doing so in order to maintain economic independence. Here is a look at the issues that many EU countries want to address independently.
- As the European Central Bank (ECB) sets economic and monetary policies for all eurozone countries, there is no independence for an individual country to create policies tailored to its own conditions.
- Every economy has its challenges. Greece, for example, is highly sensitive to changes in interest rates because most of its mortgages have a variable interest rate rather than a fixed one. However, as it is bound by European

[77] Seth, S., (2021), Why These European Countries Don't Use the Euro, https://www.investopedia.com ›, p. 1 - 2

Central Bank regulations, Greece does not have the independence to manage interest rates to benefit its people and its economy the most.

- A country's economy is very sensitive to government bond yields. Again, non-euro countries have an advantage here. They have their own independent central banks that can act as a last resort for the country's debt lender. In the event of an increase in bond yields, these central banks begin to buy bonds and thus increase market liquidity.
- Eurozone countries have the ECB as their central bank, but the ECB does not buy bonds specific to member states in such situations. The result is that countries like Italy have faced major challenges due to rising bond yields.

The euro is the most tangible proof of European integration: around 341 million people use it every day, making it the second most-used currency worldwide. The benefits of the common currency are immediately obvious to anyone travelling abroad or shopping online on websites based in another EU country. Currently, the euro (€) is the official currency of 19 out of 27 EU member countries which together constitute the Eurozone, officially called the euro area:[78]

- These are countries where the euro has still not been adopted but who will join once they have met the necessary conditions. Mostly, it consists of countries of member states which acceded to the Union in 2004, 2007 and 2013, after the euro was launched in 2002:
  - ✓ Bulgaria,
  - ✓ Croatia,
  - ✓ Czechia,
  - ✓ Hungary,
  - ✓ Poland,
  - ✓ Romania,

[78] Countries using the euro - European Union, (2022), https://european-union.europa.eu › institutions-law-budget.

- ✓ Sweden.

- ➢ In order to join the euro area, EU member states are required to fulfil so-called convergence criteria:
  - ✓ These binding economic and legal conditions are agreed in the Maastricht Treaty in 1992 and are also known as 'Maastricht criteria'. All EU Member States, except Denmark and the United Kingdom, are required to adopt the euro and join the euro area, once they are ready to fulfil them.
  - ✓ The Treaty does not specify a particular timetable for joining the euro area, but leaves it to member states to develop their own strategies for meeting the condition for euro adoption.
  - ✓ The European Commission and the European Central Bank jointly decide whether the conditions are met for euro area candidate countries to adopt the euro. After assessing the progress made against the convergence criteria, the two bodies publish their conclusions in respective reports. These are further ratified by the ECOFIN Council in consultation with the Parliament and Heads of State. If favourable, the adoption process can begin.

3.1.1. Inflation control measures

After a long period when inflation in the euro area was too low, it is now far too high. Inflation is being caused by a series of unprecedented shocks, which have led to turning points in the global economy. As a result, price pressures have proven much stronger and more persistent than originally projected:[79]

- ➢ Monetary policymakers must ensure that inflation does not become entrenched and that it returns to target in the medium term:
  - ✓ In monetary policy strategy, the appropriate response to a deviation of inflation from target depends on three factors: the source, size and persistence of that deviation.

[79] Monetary policy in the euro area - European Central Bank, (2022), https://www.ecb.europa.eu ›

- ✓ Typically, when the source of an inflationary shock is stemming mainly from demand, monetary policy will respond proactively to prevent the economy from overheating. And when faced with supply shocks, to the extent that such shocks are seen to have no lasting impact on inflation, central banks will “look through” and extend the medium-term policy horizon if necessary.

- ✓ The euro area is seeing an increase in inflation driven by two unprecedented shocks. These shocks have constrained global supply, but they have also shifted demand and led to a large and persistent inflation response.

- ➢ In the recent past, elastic global supply has meant that shocks to production or energy have dissipated eventually. But the shocks triggered by the pandemic and the war have also created a “new global map” of economic relationships. The economic turning points on this new global map imply that supply constraints are likely to last longer than in the past. And this means, in turn, that it is taking longer for the inflationary effects of those shocks to fade out.

- ➢ If energy prices are durably higher during the transition, it may have an impact on industrial production in Europe, affecting both supply and prices. This is certainly how firms in the euro area see the situation. In a recent ECB survey, at least 80% of respondents expected the ongoing transition to make the raw materials and energy they use more expensive, leading to higher prices for their products.

- ➢ When inflation is high and growth is constrained by inelastic supply, monetary policy cannot remain expansionary and add to inflationary pressures by pushing up demand. It is therefore appropriate to pursue a strategy of monetary policy normalisation. As I explained in a blog post earlier this year.

- ➢ When inflation rises in the economy, an effective response is to raise interest rates. Non-euro area countries can do this through the monetary policy of their independent regulators. Eurozone countries do not always have that option. For example, after the economic crisis, the European Central Bank raised interest rates amid high inflation in Germany. The move helped Germany, but other eurozone countries, such as Italy and Portugal, have suffered from high interest rates.

- The consideration in responding to current inflation is the pace of rate increases:
  - ✓ When inflation is high for a long period of time, an important role for monetary policy is to ensure that inflation expectations remain anchored as the shocks work their way through the economy. If expectations become de-anchored and trigger a wage-price spiral, it can lead to inflation becoming persistent even after the shocks disappear.
  - ✓ Raising interest rates has a mechanical effect on demand and inflation, and thereby on inflation expectations. But when interest rates are starting from unusually low levels, rate hikes are more powerful if they also create signalling effects that influence expectations directly.

3.1.2. Currency devaluation

The euro's value has fallen sharply against the dollar in recent months. In the summer of 2021, one euro still cost $1.20. By mid-July 2022, the European currency was worth just one dollar. This is the lowest exchange rate in 20 years. A weak euro helps European companies that sell their products in the US. But it also has serious disadvantages for the EU in the current economic situation. Above all, it accelerates inflation in the euro area:[80]

- Countries may face economic challenges due to periodic cycles of high inflation, high wages, reduced exports, or reduced industrial production. Such situations can be effectively addressed by devaluing the national currency, which makes exports cheaper and more competitive, and encourages foreign investment. Non-euro area countries can devalue their respective currencies as needed. However, the eurozone can not change the value of the euro on its own - it affects other countries and is controlled by the European Central Bank.

[80] A Weak Euro - What Does it Mean for Europe's Economy?, (2022), https://globaleurope.eu › europes-future › a-weak-euro-w.

- There are three main reasons for the euro's weakness.
  - ✓ First, the euro area's economies are suffering more from the Ukraine war than the US. This is partly because the US has fewer economic ties with Russia than the EU. The US also suffers less from the high prices for fossil fuels than Europe because the US itself is the largest producer of fossil fuels. What the American economy loses in purchasing power in its role as an energy consumer it gains in its role as an energy producer.
  - ✓ Second, the US Federal Reserve has already raised its key interest rate three times this year, causing a rise in interest rates in the US. As a result, capital is flowing into the US to take advantage of these higher interest rates. This means higher demand for dollars and dollar appreciation.
  - ✓ Third, in times of uncertainty, investors look for a "safe haven" for their investments. The US dollar is currently the only global currency and is therefore considered the safe haven.

The euro and the U.S. dollar are exchanging at a 1-to-1 rate for the first time in nearly two decades, when the European currency was in its infancy: [81]

- The euro has been losing ground against the dollar since the start of the year, when it hovered near $1.13, amid an aggressive inflation-fighting campaign by the U.S. Federal Reserve, along with broader global disruptions set off by the Russian invasion of Ukraine. They reached parity on Wednesday morning, according to Bloomberg data.
- The stronger dollar is good news for Americans considering a European vacation or buying goods abroad. It could lower the price of commodities, such as grain, and potentially ease the relentless inflation that has sent household and business expenses surging. But experts say the euro's retreat also hints at the slower pace of global trade, adding to recession worries.

[81] The euro is equal to the dollar. Here's why it matters. - The Washington Post, (2022), https://www.washingtonpost.com › business ›

- Why is the euro falling against the dollar - It’s a mix of factors, chief among them the war in Ukraine:
  - ✓ The conflict upended food supplies and sent energy prices soaring around the world, particularly impacting the European Union, where many countries have relied heavily on Russian fossil fuel imports.
  - ✓ As part of a pressure campaign against its eastern neighbor, the 27-nation European Union moved to wean itself off Russian oil, while Moscow sharply reduced gas flows. That raised costs for Europeans already reeling from the pandemic.
  - ✓ In the United States, the Fed has been aggressively raising interest rates, pushing yields on Treasury bonds higher, and making the greenback more attractive to investors than the euro. America’s central bank has raised rates three times in 2022 and has signaled that it has four more increases planned as part of its strategy to bring inflation under control.
  - ✓ The European Central Bank also is expected to raise rates to bring inflation back to a 2 percent target, but at a slower pace than the United States: It has penciled in a 0.25 percentage point rate hike for July, while the Fed is widely expected go with a 0.75 percentage point, just as it did in June.
  - ✓ The dollar is considered a safe haven, and it has gained strength as investors maneuver an uncertain economic playing field in Europe and elsewhere.
- Shifting global currencies can have a profound effect on businesses that sell their products abroad or rely on foreign raw materials to make them. It also can also can play into the price of commodities, such as grain, that have a straight line to consumers:
  - ✓ European businesses that sell their wares abroad might find the weaker currency makes their exports more appealing, because the buyer’s currency will be more valuable by comparison.

✓ But any gains to exports could be offset by rising inflation in the 19 countries that use the euro, meaning any imported goods or raw materials will become more expensive. The shifting exchange rates could create winners and losers depending on the mix of imports and exports.

3.2. REQUIREMENTS TO JOIN THE EUROZONE

To join the eurozone, EU member states are required to meet so-called "convergence criteria":[82]

❖ The convergence criteria are set to measure progress in countries' readiness to adopt the euro and are defined as a set of macroeconomic indicators that focus on:

- Price stability,
- Solid public finances to ensure that they are sustainable,
- Exchange rate stability, to show that a Member State can manage its economy without resorting to excessive currency fluctuations,
- Long-term interest rates to assess the duration of convergence.

❖ These binding economic and legal conditions were agreed upon in the Maastricht Treaty of 1992 and are also known as the "Maastricht Criteria". All EU member states, except Denmark and the United Kingdom, are obliged to adopt the euro and join the eurozone once they are ready to meet them.

❖ The agreement does not specify a timetable for joining the eurozone, but leaves it to member states to develop their own strategies for meeting the condition for adopting the euro.

❖ The European Commission and the European Central Bank jointly decide whether the conditions for the eurozone candidate countries to accept the euro are met. After assessing the progress made on the convergence criteria, the two bodies shall publish their conclusions in the relevant reports.

[82] Countries using the euro - European Union, (2021), https://european-union.europa.eu ›, p. 1

The convergence criteria ensure that a member state is ready to introduce the euro, and that its joining the euro area is not going to cause economic risks for the member state itself or for the entire euro area.The criteria are set out in Article 140 (1) of the Treaty on the Functioning of the European Union. Article 140 of the Treaty on the Functioning of the European Union (convergence criteria), Protocol (No 13) on the convergence criteria (Treaty on the Functioning of the EU):[83]

- The economic conditions for joining the euro area help to ensure that a country is ready for integration into the monetary regime of the euro area. There are four economic convergence criteria:
  - ✓ Price stability - The inflation rate cannot be higher than 1.5 percentage points above the rate of the three best-performing member states.
  - ✓ 2Sound and sustainable public finances - The country should not be under the excessive deficit procedure. Excessive deficit procedure (European Commission)
  - ✓ Exchange-rate stability - The country has to participate in the Exchange Rate Mechanism (ERM II) for at least two years, without strong deviations from the ERM II central rate and without devaluing its currency's bilateral central rate against the euro in the same period.
  - ✓ Long-term interest rates - The long-term interest rate should not be higher than two percentage points above the rate of the three best-performing member states in terms of price stability.
- Legal convergence - Candidates to join the euro area must also ensure that national legislation is compatible with the Treaty and the Statute of the European System of Central Banks (ESCB) and the European Central Bank (ECB). The Treaty and Statute provide for the independence of central banks.

[83] Conditions for joining the euro area: convergence criteria, (2020), https://www.consilium.europa.eu › policies › convergence.

Table 1

The four convergence criteria

What is measured:	**Price stability**	**Sound and sustainable public finances**	**Durability of convergence**	**Exchange rate stability**
How it is measured:	Harmonised consumer price inflation	Government deficit and debt	Long-term interest rate	Exchange rate developments in ERM II
Convergence criteria:	A price performance that is sustainable and average inflation not more than 1.5 percentage points above the rate of the three best performing Member States	Not under excessive deficit procedure at the time of examination	Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability	Participation in ERM II for at least 2 years without severe tensions, in particular without devaluing against the euro

Source: Convergence criteria for joining - Economy and Finance, (2022), https://economy-finance.ec.europa.eu ›

3.2.1. Characteristics of EU member states outside the Eurozone

The formation of the European Union (EU) paved the way for a unified, multi-country financial system under a single currency—the euro. While most EU member nations agreed to adopt the euro, a few, such as Denmark and Sweden (among others), have decided to stick with their own legacy currencies.EU nations are diverse in culture, climate, population, and economy. Nations have different financial needs and challenges to address. The common currency imposes a system of central monetary policy applied uniformly. The problem, however, is what’s good for the economy of one eurozone nation may be terrible for another. Most EU nations that have avoided the eurozone do so to maintain economic independence. Here's a look at the issues that many EU nations want to address independently.[84]

[84] Seth, S., (2022), Why These European Countries Don't Use the Eurohttps://www.investopedia.com ›

The eight EU member states outside the Eurozone (Bulgaria, Denmark, Croatia, Poland, Romania, Sweden, the Czech Republic and Hungary) are a heterogeneous group of countries that follow very different economic models and are in different stages of economic development:[85]

❖ For example

- ➢ Denmark's gross domestic product (GDP) per capita is seven times that of Bulgaria. There is also a significant gap in the competitiveness of non-euro area countries.
- ➢ According to the 2018 Global Competitiveness Report, Sweden and Denmark are among the most competitive countries in the world. They occupy the ninth and tenth place in the ranking. The other non-euro countries, which are currently plagued by political instability and institutional weaknesses, still base their competitiveness on low wages. The size and importance of their financial sectors for their economies also vary widely within the group.
- ➢ The share of banking sector assets in GDP is three times higher in Denmark than in Poland. Central and Eastern European countries faced enormous challenges during the global financial crisis as their banking sectors were largely owned by foreign banking groups. This meant that national banking authorities were able to carry out their supervisory tasks only to a limited extent.
- ➢ All these differences mean that non-euro countries have completely different priorities when it comes to EU legislation in the field of financial regulation..

❖ The dynamics of economic growth in these non-euro countries are influenced by their different stages of economic development. The less developed among them often achieve higher growth rates due to the effect of maturity. With the exception of Sweden and Denmark, whose economic growth in 2017 was slightly below the eurozone average of

[85] Non-euro Countries in the EU after Brexit, (2019), https://www.swp-berlin.org ›, p. 1

2.4 percent, the economies of those less economically developed EU member states grew much faster.

❖ Individual Euro-out relations to the euro and the euro area are also very different. Most of them pursue independent monetary policies. Denmark has been a member of the Exchange Rate Mechanism 2 (ERM 2) since 1999 and pursues a fixed exchange rate policy against the euro. After Brexit, Denmark will be the only country with a waiver clause in the third phase of the Economic and Monetary Union. All other EU countries are contractually obliged to accept the euro as soon as they meet the convergence criteria.

❖ The Bulgarian lev is pegged to the euro at a fixed rate as part of a currency board arrangement. Romania and Croatia maintain exchange rate regimes with a managed fluctuating exchange rate against the euro. Croatia's relationship with the single currency is very special. The country's economy is largely "euroized". About 75% of assets and 67% of liabilities are denominated in euros.

❖ All countries in the group are open economies interested in deepening the single market. Furthermore, they are all for the eurozone to be open to new members. At the same time, they support the integrity of the eurozone, although they are not prepared to bear the necessary costs of stabilization. The economic diversity of non-euro area countries and their diverse relations with the euro and the euro area make political co-operation between non-euro area member states within the EU difficult. This increases their risk of losing influence in the post-Brexit Union.

Countries member of EU which do not use the euro have this characteristics:[86]

- ***Denmark*** - Denmark signed the Maastricht Treaty, which provides special conditions where it does not have to adopt the euro currency despite being a member state of the European Union (the United Kingdom also had signed this agreement, prior to leaving the EU in January 2020). Denmark uses Danish krone currency (1 DKK = .15 USD).

[86] Smithson, B., (2020), Which European countries don't use the euro currency and why? https://thepointsguy.com › w

- ***Sweden*** - While not a signatory to the Maastricht Treaty, Sweden has retained its Swedish krona currency following a 2003 referendum in Sweden where the public voted not to adopt the euro. Currently, 1 SEK = .11 USD.
- ***Bulgaria, Croatia and Romania*** - These three countries are working through the fulfillment of their various 'nominal euro convergence criteria' as specified by the European Union to join the eurozone. They intend to adopt the euro currency, though this will still be several years away. Until then, these countries retain their existing currencies:
  - ✓ Bulgarian lev (1 BGN = .57 USD)
  - ✓ Croatian kuna (1 HRK = .15 USD)
  - ✓ Romanian leu (1 ROM = .23 USD)
- ***Czech Republic, Hungary, Poland*** - While each of these countries should adopt the euro currency as member states of the European Union once they have fulfilled certain economic obligations, all three say they have no immediate plans to do so. The populations of these three countries overwhelmingly do not wish to adopt the euro currency. So for the time being, these countries retain their existing currencies:
  - ✓ Czech koruna (1 CZK = .04 USD)
  - ✓ Hungarian forint (1 HUF = .003 USD)
  - ✓ Polish zloty (1 PLN = .25 USD)

The European Union has given Croatia the green light to begin using the euro- and join the Schengen zone from next year. The country will join 19 other EU member states that use the currency. It will adopt the currency from 1 January 2023, making Croatia the latest nation to join the eurozone since Lithuania in 2015:[87]

- Croatia will continue to use its own currency, the kuna, until January next year. Currently, one Croatian kuna is worth around €0.13.

[87] As Croatia joins the euro, which 7 EU countries still use theirown currency? https://www.euronews.com ›

- ✓ In order to adopt the euro, a country has to fulfil a set of economic conditions including having a stable exchange rate and low inflation.
- ✓ By adopting the euro, the eastern European nation hopes to gain more financial security and improve the living standards of its citizens.
- ✓ Croatia will also benefit economically from closer financial links with the single currency area’s other members and the European Central Bank.

The Eurozone now covers 26 nations, including 22 EU countries, and almost 420 million citizens. But a handful of EU countries have yet to enjoy the benefits of passport-free travel. This is the case of Bulgaria and Romania, two countries that joined the EU in 2007 and have patiently waited at Schengen's doorstep:[88]

- ➢ Joining Schengen requires, among other things, the application of common rules, proper management of external borders, sharing of security information, and efficient police cooperation. The governments insist that they met the necessary criteria years ago. Last summer, they even joined Schengen's common visa system as read-only participants, despite the checks on their borders.
- ➢ The European Commission and the European Parliament are unequivocally on their side: the executive has repeatedly confirmed the candidates have fulfilled all technical conditions while MEPs have criticised their exclusion as discriminatory.
- ➢ Bulgaria and Romania are so convinced about their readiness that they invited a fact-finding mission of experts to visit their nations and carry an additional evaluation.
- ➢ But one obstacle remains: politics.
    - ✓ The final green light has to come from the Council of the European Union, which gathers ministers from the 27 EU countries. The approval of a new Schengen member has to be rubberstamped by unanimity, which means a single "no" can effectively freeze the whole process.

[88] What's keeping Bulgaria and Romania out of Schengen? (2022), https://www.euronews.com ›

- ✓ In 2011, the double bid was reportedly opposed by France, Germany, Finland, Sweden, the Netherlands and Belgium over concerns related to corruption, organised crime and judicial reforms.
- ✓ In the following years, the question was pushed to the front several times, only to be pushed back. The 2015 migration crisis, which became Schengen's litmus test, further dampened hopes for admission. But the tide began turning after the COVID-19 crisis.
- ✓ A decision on expanding the Schengen Area requires unanimous approval. For Romania and Bulgaria to join the zone in opposition are Austria and Netherlands.

European Union interior ministers have voted to accept Croatia into the 26-nation, border-free Schengen zone, but to reject Romania and Bulgaria:[89]

- ➢ Austria and the Netherlands voted against admitting Romania and Bulgaria, citing concerns that both were soft on illegal migration.
- ➢ As its main reason for keeping Romania and Bulgaria out of Schengen, the government in Vienna cited a rapid increase in the number of migrants entering Austria illegally through the West Balkan route.

3.2.2. Characteristics of the monetary policy of the Republic of Bulgaria

Bulgaria has undergone a significant transformation over the past three decades, moving from a highly centralized, planned economy to an open, market-based, upper-middle-income economy securely anchored in the European Union (EU). In its initial transition to a market economy, the country went through a decade of slow economic restructuring and growth, high indebtedness, and loss of savings:[90]

- ➢ The advancement of structural reforms, starting in the late 1990s, the introduction of a currency board, and expectations of EU accession unleashed a decade of

[89] Thorpe, N., (2022), Schengen: No EU border-free zone for Romania and Bulgaria, https://www.bbc.com › news.
[90] Bulgaria Overview: Development news, research, data, (2022), https://www.worldbank.org ›

exceptionally high economic growth and improved living standards. Yet, some legacy issues from that early period remain and, along with the global economic crisis of 2008 and the pandemic-induced crisis in 2020, have undone some of the gains achieved during the high-growth period.

- The long-term structural challenges facing Bulgaria include negative demographic trends, coupled with institutional and governance weaknesses. Strengthening institutions together with improved efficiency of public service delivery will support private sector expansion unlocking inclusive growth and shared prosperity.
- High rates of inequality of opportunity limit access to key public services, constraining the ability of individuals to escape poverty and thus leading to persistently high-income inequality. Poverty and inequality are reinforced by inadequacies in the targeting, coverage, and generosity of the social security system, limiting its role as a redistributive mechanism.

Bulgaria is not yet a member of the eurozone. However, the left is part of the exchange rate mechanism (ERM II) from July 10, 2020. Bulgaria must participate in the mechanism without serious tensions and without devaluing its central rate against the euro for at least two years before it can qualify for euro acceptance. Being part of the Exchange Rate Mechanism aims to help non-euro area countries prepare to become part of the euro area. This is an important milestone in the adoption of the euro. The left has a central rate of 1.95583 per euro. Bulgaria also pledged to unilaterally extend currency board arrangement under ERM II:[91]

The Bulgaria has followed sound macroeconomic policies in recent years and has weathered the Covid-19 economic crisis relatively well. However, pre-pandemic annual economic growth was only 2 percent on average for the last decade. And although incomes

[91] What is the euro area? | European Commission, (2021), https://ec.europa.eu › info, p. 1

per capita reached 55 percent of the EU average in 2020 (in Purchasing Power Standard Terms), convergence in parts of the country has stalled:[92]

- Four priority areas of collaboration that could help unlock Bulgaria's growth potential:
  - ✓ Upgrading institutions and improving good governance,
  - ✓ Boosting productivity, skills and employability for all,
  - ✓ Strengthening public spending for improved service delivery,
  - ✓ Enhancing the sustainability of the growth model.
- In addition, policies need to address the impact of climate change to help unlock economic growth and limit losses due to natural disasters, including floods and storms, which are estimated to have cost the Bulgarian economy over $2 billion.
- Bulgaria has the potential to rapidly accelerate growth while taking care of vulnerable people and the environment. Success should be measured by the services the government provides to its citizens, including the poorest, the quality of its institutions, and the sustainability of the economy.

3.2.2.1. The role of the National Bank of Bulgaria in creating and implementing monetary policy

The Bulgarian National Bank is an independent institution of the State. It plays a key role in the Bulgarian economy and takes care of maintaining the stability of the Bulgarian currency, and of strengthening and development of the banking and credit system in the country:[93]

- The Bulgaran National Bank's major objective is to maintain price stability by ensuring the stability of the national currency.

[92] Bulgaria, World Bank Frame Partnership Focused on Quality of Economic Growth, (2022), https://www.worldbank.org ›

[93] Bulgarian National Bank (BNB) - Sofia Guide, (20220, http://www.sofia-guide.com ›

- The Bank supports the creation and functioning of efficient payment systems and exerts oversight over these.
- The Bulgarian National Bank is the only issuing institution in Bulgaria and maintains the cash cycle.
- Bulgarian National Bank regulates and supervises the other banks' activities in this country for the purpose of ensuring the stability of the banking system and protecting depositors' interests.
- The Bank carries out research work, compiles, aggregates and analyses statistical data.

❖ The National Bank of the Republic of Bulgaria was established and operates on the basis of the Law on the Bulgarian National Bank.Бугарската народна банка е една од најстарите национални институции која има клучна улога во бугарската економија:

- takes care of maintaining the stability of the Bulgarian currency as well
- to strengthen and develop the country's banking and credit system..

❖ The independence of the BNB is guaranteed by its structural law (BNB) and the Treaty on the Functioning of the European Union. Since 1 January 2007, BNB is a full member of the European System of Central Banks and actively participates in decision-making in the field of banking and finance in the European Union. The Governor of the BNB is a member of the General Council of the European Central Bank.

❖ The main goal of the BNB is to maintain price stability by ensuring the stability of the national currency. The Bank assists in the establishment and operation of efficient payment systems and oversees them. It is the only issuing institute in Bulgaria and maintains cash operations. BNB regulates and supervises the activities of other banks in the country in order to maintain the stability of the banking system and protect the interests of depositors. The Bank conducts research, collects, summarizes and analyzes statistical data.

❖ The Bulgarian National Bank has the exclusive right to issue banknotes and coins. They are legal tender and must be accepted for payment in their full face value without limitation. The Bulgarian National Bank provides printing of banknotes and minting of coins, as well as protection and storage of uncollected banknotes and coins, and protection and destruction of withdrawn funds.

❖ Reliable and effective banking supervision, together with appropriate macroeconomic policies, is crucial to the financial stability of any country. Regulating and supervising the activities of credit institutions in the Republic of Bulgaria is one of the main functions of the BNB, which aims to maintain the stability of the banking system and protect the interests of depositors..

3.2.2.2. The banking system of the Republic of Bulgaria

The Bulgarian National Bank regulates and supervises other banks' activities, carries out research and compiles and analyzes statistical data. BNB is a member of the European System of Central Banks. BNB operates independently of the government and reports directly to Parliament. The Bulgarian currency is pegged to the euro; the fixed exchange rate is 1 EUR = 1.95583 BGN:[94]

- There are 25 commercial banks in Bulgaria; five are branches of foreign banks. Citibank and Bulgarian-American Credit Bank are the only U.S. banks with an office in Bulgaria.
- While credit cards and e-banking are popular, personal checks are largely unknown and unused. The number of POS terminals in the country and the share of the non-cash transactions grew significantly in the past few years.

The Bulgarian banking system is subject to the international regulatory framework - Basel III in the European Union through the introduction of the Regulation and the Capital Requirements Directive. The Capital Requirements Regulation (Regulation 575/2013 / EU on prudential requirements for credit institutions and investment firms and amending Regulation №648 / 2012 / EU) is directly applicable to the Member States, while the Capital Requirements Directive (Directive 2013/36 / EU of the European Parliament and of the Council on the operation of credit institutions and on prudential supervision of credit institutions and investment firms, amending Directive 2002/87 / EC and repealing

[94] Bulgaria - Banking Systems - Privacy Shield, (2022), https://www.privacyshield.gov ›

Directives 2006/48 / EC and 2006/49 / EC) is transposed into national law by the Law on Credit Institutions and its implementing acts, which form the national legal framework governing access rules for credit institutions and investment firms, as well as the applicable supervisory and prudential framework.

The activity of credit institutions is regulated by regulations adopted by the European Parliament and the Council, as well as delegated regulations of the European Commission, which are part of the European legal framework directly applicable to Bulgaria. These regulations are binding and should be fully implemented in all EU countries. The control of their implementation is performed by both the BNB and the official European institutions (EBA, Commission, etc.). Consistent application of the Union's legally binding acts, the establishment of high quality common regulatory and supervisory standards and practices is also ensured through guidelines and recommendations issued by the European Banking Authority.

The Bulgarian National Bank (BNB) is a body for restructuring credit institutions under the Law on Reconstruction and Restructuring of Credit Institutions and Investment Intermediaries (LVPKIIP), which introduces the provisions of Directive 2014/59 / EU into national law. This BNB function covers the entire restructuring planning process based on the collection and analysis of reporting data and other information from banks and third country banks established in Bulgaria, implementation of restructuring instruments and management of the national restructuring financing mechanism. .

As of October 1, 2020, as a result of the establishment of close cooperation with the European Central Bank (ECB) and as a result of the accession to the Single Restructuring Mechanism, the function of restructuring credit institutions is divided between the BNB and the Single Restructuring Board. The sole restructuring board is responsible for the banks that are subject to direct supervision by the ECB, and the BNB restructuring powers include all other credit institutions operating in Bulgaria.

The financial system in Bulgaria is dominated by banks which account for 83% of the total financial sector assets. Other financial institutions such as insurance, leasing, investment funds are rather small and do not have a significant impact on the overall health of the financial system. So, the present analysis will focus on commercial banks:[95]

- Commercial banks in Bulgaria are mostly foreign owned. Domestic ownership in banks comprises only 22% of the total banking sector assets. EU participation in the banking sector assets is 75%.
- The financial depth in Bulgaria is not high relative to peer countries. The loan to GDP ratio as of the end of 2020 stands at 53%. Market concentration is not high in the Bulgarian banking system. The 5 largest banks hold 66% of total banking sector assets and none of these banks have a market share of more than 20%. In July 2020 Bulgaria joined the European Banking Union, which means that The European Central Bank (ECB) now supervises the five largest banks directly. Overall the Herfindahl-Hirschman's index of concentration for the banking sector in Bulgaria as of September 2020 stands at 11% which points to the low level of market concentration.
- Loans account for around 53% of the total banking sector assets in Bulgaria, which is on the lower end compared with other BSTBD member countries and regional peers. Liquid assets account for around 30% of the total assets. Banks fund their assets mostly with deposits that correspond to 90% of the total liabilities and are considered as a more stable source of funding relative to a capital market.
- Banks are well capitalized in Bulgaria. After the global financial crisis of 2008 capitalization of Banks increased in many countries including Bulgaria. As a result, the capital adequacy ratio has been above the required minimum of 8% for many years already and it grew further in 2020. By the end of 2020 CAR reached 22.9%. High capitalization points to the strong shock absorbing capacity of the system.

[95] Overview of the financial sector in Bulgaria, (2021), https://www.bstdb.org › Overview of the fin_secto.

PART FOUR: ECB POLICY TOWARDS COUNTRIES CANDIDATES FOR EU MEMBERSHIP AND MONETARY POLICY OF THE REPUBLIC OF NORTHERN MACEDONIA

4.1. COUNTRIES CANDIDATES FOR EU MEMBERSHIP

Candidate country status is conferred by the European Council on the basis of an opinion from the European Commission, drawn up following an application for membership of the European Union (EU) by the country concerned:[96]

- Candidate country status does not give an automatic a right to join the EU. The Commission scrutinises the application in the light of the accession criteria (Copenhagen criteria), while the accession process starts with the European Council decision to open accession negotiations.
- Depending on their circumstances, a candidate country may be required to institute a reform process to bring their legislation in line with the EU acquis and to strengthen their infrastructure and administration if necessary. The accession process is based on the pre-accession strategy, which provides instruments such as financial aid.
- Accession and membership of the EU depends on the progress made by the candidate country, which is regularly assessed and monitored by the Commission.

Historically, the enlargement policy is often referred to as the most important and most successful foreign policy instrument in the EU literature, both in terms of spreading the transformative power of the EU to its environment and also having a major role in the internal transformation of the EU:[97]

- The enlargement policy of the EU, in parallel with the deepening process of the Union, has taken its present form by being reshaped with each new enlargement wave. In particular, the last enlargement of Central and Eastern European

[96] Candidate country (EU) | Practical Law - Thomson Reuters, (2022), https://uk.practicallaw.thomsonreuters.com›
[97] Enlargement of the European Union - AB Başkanlığı, (2022), https://www.ab.gov.tr › enlar.

countries became a leading step for the enlargement policy to reach its current position and institutionalization of the 'conditionality' principle. Accession conditionality can be briefly defined as the sum of the obligations that the countries applying to become a member of the EU have to undertake before their accession.

- The criteria defined at the Copenhagen European Summit in 1993, known as the 'Copenhagen Criteria', serve as a basic guide for the countries wishing to become a member of the Union. The EU takes the decision to start negotiations with candidate countries only if they fulfill the requirements, which are also known as the Copenhagen "Political" Criteria; including democracy, the rule of law, human rights and the existence of institutions that guarantee minority rights.

Recognized candidates for membership in the European Union are:[98]

- Turkey (applied in 1987),
- Northern Macedonia (applied in 2004),
- Montenegro (applied in 2008),
- Albania (applied in 2009) and
- Serbia (applied in 2009). Everyone has started accession negotiations.
- Kosovo (whose independence is not recognized by the five EU member states) and Bosnia and Herzegovina are recognized as potential candidates for EU membership. Bosnia and Herzegovina has formally applied for membership, while Kosovo has a Stabilization and Association Agreement (SAA) with the EU, which generally precedes the application for membership..

Negotiations are being conducted with each candidate country to determine their ability to implement EU legislation (acquis) and to examine their possible application for transitional periods. In order to conduct accession negotiations, EU legislation and

[98] EU candidate status for Albania and North Macedonia". European Commission. 25 March 2020. Archived from the original on 11 November 2020. Retrieved 25 March 2020., https://en.wikipedia.org › wiki › Potential_enlargement.

standards are divided into 35 chapters that are negotiated one by one. The Directorate-General for the Environment assists countries, in particular, in preparing to comply with the environmental component of Chapter 27.

The basic principle of the negotiations is that the countries should fully transpose and implement the EU legislation by the time of accession. Transitional measures can be awarded essentially for large investment directives, provided that the measures are limited in time and scope and do not distort competition for the EU single market. These are mainly in the areas of waste, water, industrial pollution and air quality. No transition periods have been allocated for horizontal legislation (environmental impact assessment, access to information, etc.) and nature legislation. Transition periods are awarded only on the basis of detailed justification of needs and realistic implementation plans specifying the steps to be taken to ensure full compliance with the target legislation by the end of the transition period.[99]

- ***Albania*** applied for the EU membership in April 2009 and received the candidate status in June 2014. In April 2018, the Commission issued an unconditional recommendation to open accession negotiations. The Council set out the path towards opening accession negotiations in June 2019, depending on progress made in key areas such as the judiciary, fight against corruption and organised crime, intelligence services and public administration. In March 2020 the members of the European Council endorsed the General Affairs Council's decision to open accession negotiations with Albania and in July 2020 the draft negotiating framework were presented to the Member States.
- ***Moldova*** was declared a candidate country in June 2022. Find out more about Moldova's application and EU-Moldova relations.
- ***The Republic of North Macedonia*** was declared a candidate country in December 2005. Since October 2009, the Commission has continuously recommended to open accession negotiations with North Macedonia. In 2015 and 2016, the recommendation was made conditional on the continued

[99] Candidate Countries - Enlargement - Environment - European Commission, (2021), https://ec.europa.eu › environment › enlarg › candidates, p. 1

implementation of the Pržino agreement and substantial progress in the implementation of the 'Urgent Reform Priorities'. In March 2020, the General Affairs Council decided to open accession negotiations with North Macedonia. The decision was endorsed by members of the European Council. In July 2020 the draft negotiating framework was presented to the Member States.

- ***Montenegro*** submitted the application for EU membership in December 2008. The candidate status was granted on 17 December 2010. The opening of accession negotiations took place in June 2012. The accession negotiations for Chapter 27 - Environment were opened on 10 December 2018.
- ***Serbia*** applied for the candidate country status in December 2009. The candidate country status was granted in March 2012. On 21 January 2014, the first Intergovernmental Conference took place, signalling the formal start of Serbia's accession negotiations. The screening exercise for Chapter 27 – Environment took place in 2014 and the screening report has been adopted by the Council in December 2016 without an opening benchmark. The Presidency invited Serbia in December 2016 to submit its negotiating position for Chapter 27, which Serbia did in February 2020.
- ***Turkey*** was declared a candidate country in December 1999. Negotiation talks were opened on 3 October 2005 and Chapter 27 was open for negotiations on 21 December 2009. Technical discussions are on-going in areas such as water, waste, nature protection or horizontal legislation.
- ***Ukraine*** was declared a candidate country in June 2022. Find out more about Ukraine's application and EU-Ukraine relations.

4.2. REPUBLIC OF MACEDONIA CANDIDATE FOR EU MEMBERSHIP

North Macedonia's application for EU membership was submitted on 22 March 2004.[100]

[100] North Macedonia - Consilium.europa.eu, (2022), https://www.consilium.europa.eu › policies › enlargement.

- The Republic of Northern Macedonia was declared a candidate country in December 2005. Since October 2009, the Commission has continuously recommended open accession negotiations with Northern Macedonia. In 2015 and 2016, the recommendation was conditioned by the continuous implementation of the Przino Agreement and significant progress in the implementation of the "Urgent Reform Priorities". In March 2020, the General Affairs Council decided to open accession negotiations with Northern Macedonia. The decision was approved by the members of the European Council. In July 2020, the draft negotiating framework was presented to the Member States.

- Since October 2009, the Commission has continuously recommended open accession negotiations with Northern Macedonia. In 2015 and 2016, the recommendation was conditioned by the continuous implementation of the Przino Agreement and significant progress in the implementation of the "Urgent Reform Priorities". In light of the progress made, the Commission reiterated its unconditional recommendation to open accession negotiations in April 2018. Given the significant progress made and the conditions met unanimously set by the Council in June 2018, the Commission recommended in May 2019 to open accession negotiations with Northern Macedonia.

- The Council adopted conclusions in June 2018 in which it agreed to respond positively to the progress made by North Macedonia, and set out the path towards opening accession negotiations in June 2019. The Council underlined the critical need for North Macedonia to continue making concrete progress on certain key areas, such as the fight against corruption, judicial reform, intelligence and security services reform and public administration reform.

- On 24 March 2020, ministers for European affairs gave their political agreement to the opening of accession negotiations with Albania and North Macedonia. This was formally adopted by written procedure and endorsed by members of the European Council on 26 March 2020.

- Once accession negotiations have been opened, the negotiations take place at an intergovernmental conference (also called an 'accession conferences') between ministers and ambassadors of EU member states and the candidate country. The negotiations look at 35 different policy fields (called chapters). These meetings can be at either ministerial level or at deputy level.
- On 19 July 2022, the EU held its first intergovernmental conference with North Macedonia.
- To review the progress of EU-North Macedonia relations under the stabilisation and association process, representatives from the EU and North Macedonia meet in the EU-Republic of North Macedonia Stabilisation and Association Council.
- As of March 2019, there have been fifteen Stabilisation and Association Council meetings between the EU and North Macedonia. At the latest meeting, participants discussed relations between the EU and North Macedonia and took stock of progress in the pre-accession strategy, with a focus on political and economic criteria and financial cooperation.
- Every year, the Council adopts conclusions on enlargement and the stabilisation and association process, which take stock of progress made in each of the Western Balkans partners and Türkiye on their European path.
- In the latest conclusions, which were adopted in December 2022, the Council welcomed the fact that the first intergovernmental conference was held in July 2022, stating that this was a clear recognition of the progress North Macedonia has achieved on advancing the EU reform agenda and on delivering tangible and sustained results.
- he Council further welcomed the progress made in the area of rule of law but stated that more efforts are needed and called on North Macedonia to further strengthen fundamental rights, media freedom and freedom of expression. Regarding the judiciary, the Council emphasised the need to ensure systematic implementation of the updated action plan on the judicial reform strategy and to

step up the implementation of the human resource strategies for the judiciary and the prosecution.

- The Council also noted that North Macedonia has made limited progress in the area of public administration reform and stated that ensuring respect for the principles of transparency, merit and equitable representation remain essential.

4.2.1. The monetary policy of the ECB towards Macedonia

The monetary policy of the European Central Bank (ECB) has positive transmission effects on the Macedonian economy and in general, on the economies in our region: [101]

❖ It allows:

- The public and private sectors should have unimpeded access to finance through international financial markets.
- It also contributes to a larger space for the implementation of a relaxed monetary policy by the National Bank, and thus to more favorable domestic financing conditions.

❖ At the onset of the crisis, international financial markets quickly tightened their grip, especially on emerging economies, but after the ECB and central banks reacted more strongly to more advanced economies, investor confidence increased, markets stabilized and interest rates fell. Compared to the global financial crisis, given the current faster and bolder reactions of central banks, the tightening of conditions in the financial markets was less, and the stabilization of financial conditions was faster. This was especially important for us and for other countries in the region.

Following the assessment of the request for liquidity support submitted by the National Bank, the European Central Bank (ECB) responded positively to the request by approving a bilateral repo line. Our central bank is enabled to use liquidity assets in the amount of up to EUR 400 million, if necessary, in the form of repo transaction for the period until the middle of next year, or as long as necessary. In doing so, the ECB has

[101] Монетарната политика на ЕЦБ има позитивни преносни ефекти врз македонската економија, (2020), https://www.nbrm.mk › ns-newsarticle-soopstenie-0611., p. 1

shown its readiness to support the National Bank in the face of the crisis caused by the Covid-19 pandemic.[102]

The European Central Bank (ECB) and National Bank of the Republic of North Macedonia have agreed to set up a repo line arrangement to provide euro liquidity to the Republic of North Macedonia's financial institutions through the central bank to address possible euro liquidity needs in the presence of market dysfunctions due to the COVID-19 shock:[103]

- Under a repo line, the ECB provides euro liquidity to a non-euro area central bank in exchange for adequate euro-denominated collateral.
- Under the repo line, the National Bank of the Republic of North Macedonia will be able to borrow up to €400 million from the ECB. The maximum maturity of each drawing will be three months. The repo line will remain in place until the end of June 2021, unless an extension is decided.

The European Central Bank (ECB) said it has decided to extend its euro liquidity lines to the central banks of Albania and North Macedonia by more than nine months, to January 15, 2023:[104]

- In the context of heightened geopolitical tensions triggered by the Russian invasion of Ukraine, the lines are designed to prevent spillover effects in euro area financial markets and economies that might adversely affect the smooth transmission of the ECB's monetary policy, the ECB said in a statement on Monday.
- The original lines, established in 2020 to provide euro liquidity to financial institutions through the central banks during the coronavirus pandemic, will expire at the end of March.

[102] ЕЦБ за првпат овозможи Народната банка да има пристап до девизна ликвидност во евра, (2020), https://www.nbrm.mk › ns-newsarticle-soopstenie-1808., p. 1
[103] ECB and National Bank of the Republic of North Macedonia set up repo line to provide euro liquidity, (2020), https://www.ecb.europa.eu ›
[104] ECB extends euro liquidity lines to Albania, N. Macedonia, (2022), https://seenews.com › news.

- Under the respective repo line agreements, Albania's central bank and North Macedonia's central bank can each borrow up to 400 million euro ($440 million) from the ECB. Under a repo line, a national central bank can borrow euro up to the specified limit in exchange for adequate euro-denominated collateral.
- The ECB added it expects the central banks to comply with the EU sanctions against Russia and that the lines will not be used to circumvent the sanctions.

North Macedonia's central bank said that it had decided to leave its policy rate unchanged at the historically low level of 1.25%, as the current monetary stance supports lending to companies and citizens, providing support for the economy's further recovery:[105]

- The bank concluded that recent developments in Ukraine are significantly changing the global economic context and affecting the domestic economy – meaning an upward risk for inflation and a downward risk for economic growth.
- However, while the effects on inflation are visible, demand is likely to slow due to increased uncertainty and reduced demand from trading partners.
- North Macedonia's gross domestic product (GDP) increased by 4% in 2021 and 2.3% on the year in the fourth quarter alone. Current data indicates continued growth in early 2022, but there are downward risks to the growth projection and the economic outlook for this year due to the situation in Ukraine, the central bank also said.
- The acceleration of average annual inflation to 7.1% in the first two months of the year is a result of the rise of import prices, especially those for energy and food, the statement added.
- North Macedonia plans to borrow a total of €600 million in 2022, the finance ministry said.
- North Macedonia placed a seven-year Eurobond worth €700 million in March 2021. The Eurobond bears an interest rate of 1.625%. The finance ministry is

[105] North Macedonia Central Bank to keep historically low policy rate unchanged, (2022), https://www.euractiv.com › n.

also working on an analysis for a budget revision, said Finance Minister Fatmir Besimi.

- North Macedonia's government projected a budget deficit of 33.5 billion denars in 2022, equivalent to 4.3% of GDP.

4.2.2. The role of the National Bank of the Republic of Northern Macedonia

The National Bank of the Republic of Northern Macedonia is a bank that with flexible, appropriately designed and timely decisions, in a time of rapid change and digital transformation, contributes to a higher standard of living of citizens by creating an environment of sustainable and inclusive economic development: [106]

❖ The mission, vision and organizational values of the National Bank are determined depending on the macroeconomic environment and key challenges:

- ***Mission*** - By fulfilling its mandate and competencies, the National Bank contributes to maintaining price and financial stability for sustainable and inclusive economic development and higher living standards of citizens. Contributes to maintaining a stable, competitive and market-oriented financial system resistant and flexible to rapid changes in the environment, which works in the best interest of consumers and the overall economy.
- ***Vision*** - The vision of the National Bank is to be recognized as an independent, responsible, professional, innovative and transparent institution that enjoys high trust and credibility in the public.
- ***Values*** - The National Bank operates in accordance with the following principles and values:
  - ✓ quality,
  - ✓ integrity,
  - ✓ loyalty,

[106] Народна банка на Република Северна Македонија - Стратегија, (2021), https://www.nbrm.mk.,

- ✓ transparency,
- ✓ leadership,
- ✓ innovation,
- ✓ flexibility,
- ✓ professionalism and
- ✓ team spirit.

❖ The realization of its vision and mission within its mandate and competencies is directed through the following strategic goals:

- ✓ SC1 Improving the infrastructure for conducting monetary policy,
- ✓ SC2 Maintaining and further strengthening the stability and resilience of the banking system,
- ✓ SC3 Supporting the population and the corporate sector by developing reliable, innovative and efficient payment systems,
- ✓ SC4 Improving the investment policy and ensuring optimal return of foreign reserves in accordance with the principles of security and liquidity,
- ✓ SC5 Adaptation to the standards of the European System of Central Banks
- ✓ SC6 Increased transparency and accountability,
- ✓ SC7 Financial education and inclusion,
- ✓ SC8 Increased awareness of climate change and contribution to a green sustainable economy,
- ✓ SC9 Strengthening risk management at the level of the National Bank.

❖ Through the nine strategic goals, the National Bank will continue to be committed to improving the implementation of monetary policy, the stability of the banking system, the smooth functioning of payment systems, the management of foreign reserves, and ultimately to provide conditions for efficient, innovative and reliable financial services. At the same time, as we live in a time of rapid change on the global stage, as a result of the processes of globalization, digitalization, innovation, climate change and the global health pandemic, the National Bank emphasizes these new trends in these areas.

Pursuant to the legal powers, the National Bank establishes, registers and supervises the reliability, stability and efficiency of payment, settlement and clearing systems:[107]

- The National Bank is the user of the payment systems in the country for implementing monetary policy, maintaining financial stability and performing other important functions of a central bank.
- The National Bank is the user of the payment systems abroad for the purposes of managing the foreign exchange reserves and carrying out the payment transaction abroad for the state authorities. In that sense, the National Bank has the following roles in payment systems:
  - ✓ operational role;
  - ✓ supervisory role;
  - ✓ developmental and catalytic role.

Operational role - The operational role of the National Bank covers the following aspects:

- ✓ MIPS Large Payment System Operator - The National Bank fulfills this role by operating and managing the only real-time gross settlement payment system - MIPS.
- ✓ Back-office operations - Back-office operations are internal operations of the National Bank related to the settlement of concluded transactions on the financial markets, and include: processing, confirmation and settlement of transactions, accounting recording and reconciliation of the balance of cash and securities accounts.

[107] Улогата на Народната банка во платните системи - НБРМ, (2022), https://www.nbrm.mk › ulogata_na_nbrm_vo_platnite.

- ✓ Payment transactions abroad in the name and at the expense of the state - Foreign payments are made through foreign currency accounts of the National Bank opened in foreign central and commercial banks with which it has established correspondent relations and with indirect participation in the TARGET2 payment system through central banks from the Eurosystem.

Supervisory role - The supervision of payment systems by the National Bank is a legally defined function. Pursuant to the Law on Payment Transactions, the supervision of payment systems is aimed at achieving the goals related to the reliability and efficiency of payment systems through the process of monitoring existing and planned arrangements, assessing them against the goals and policies. Supervision of payment systems by the National Bank is an integral part of its broader responsibilities for implementing monetary policy and maintaining financial stability.

Developmental and catalytic role - the National Bank performs the development role by improving the regulation for payment systems, participating in the harmonization of the national regulation with the European regulation, the introduction of new standards in the operation of payment systems that are in line with internationally accepted standards, monitoring the development tendencies and creating an environment for their implementation in the Republic of North Macedonia with the aim of readiness in the integration flows of SEPA within the EU.

4.2.3. Position of the monetary policy of the Republic of Northern Macedonia

The position of the Monetary Policy of the Republic of Northern Macedonia is as follows:[108]

4.2.3.1. Monetary policy stance

The National Bank of the Republic of Northern Macedonia is a central bank, whose main goal is to maintain price stability, and it is independent in performing its functions. Thereby, the National Bank supports the economic policy and financial stability of the

[108] Народна банка на Република Северна Македонија - Поставеност на монетарната политкиа, (2021), https://www.nbrm.mk., p. 1

country without jeopardizing the achievement of the basic goal, respecting the principles of the market economy. In accordance with the legally defined functions, the National Bank designs and implements the monetary policy. At the end of the current year, in accordance with the previously established macroeconomic policy framework, the National Bank prepares a Monetary Movement Projection for the next year, which is adopted by the National Bank Council:

- The assessment of the latest macroeconomic indicators and the monetary policy environment does not point to a current need for a change in the base rate, but points to a need for vigilant monitoring.
- The foreign exchange reserves are still in the safe zone, and the achievements in 2021 are slightly better than the expectations according to the latest projections. Collectively for the entire year 2021, foreign exchange reserves grew by 283 million euros, which is slightly more than expected. Regarding the factors that influence the achievements of the foreign exchange reserves, we do not have complete data, but according to the latest available data, the trade deficit and exchange operations correspond to the projections.
- In terms of inflation, the average annual price change for 2021 is within the projection. On average for the entire year 2021, the annual price growth is 3.2%, with a projected growth of 3.1%. However, as in the global framework, in the last period, the annual price growth has accelerated, and the expectations for import prices have been corrected upwards. The price pressures are a consequence of the growth of the prices of primary products and the adjustments related to the specificity of the pandemic, for which the international financial institutions expect a gradual stabilization.
- Regarding the movements in the real economy, in the third quarter of 2021, the gross domestic product recorded a real growth of 3% on an annual basis. These achievements indicate that the domestic economy is still gradually recovering, in conditions of further immunization of the population and without major negative effects from the appearance of the fourth wave of covid-19 in this period. On

average, in the first three quarters of 2021, the economy recorded a real growth of 4.6%, which is close to the expectations of the National Bank from the October projection.

- The recovery of the economy is supported by the solid movements in the monetary sector. According to preliminary data for December 2021, movements in deposits and loans are above the level projected for the last quarter of 2021, in accordance with the October projection.

- In the international financial markets, with investors' concern about the negative consequences of the spread of the "omicron" variant, in December the center of their attention was the withdrawal of the monetary stimulus by the central banks this year. In such conditions, the prices of the safest government bonds issued by the leading economies in the world had a mostly downward trend, that is, their yields recorded an increase, which was also supported by increased inflationary expectations.

4.2.3.2. Monetary policy objectives

Maintaining price stability is the main goal of the National Bank, determined by law. The setting of this goal is in line with the empirically confirmed knowledge that price stability creates the most favorable macroeconomic environment for long-term sustainable economic development. As of 1999, inflation in our country was measured by the retail price index, and since 2000 it has been monitored by the cost of living index. In order to achieve the ultimate goal, the National Bank determines the intermediate goal of the monetary policy. Thus, from April 1992 to September 1995, the National Bank applied the strategy of targeting the M1 money supply, as an intermediate goal of the monetary policy. Starting from October 1995 onwards, the National Bank implements a monetary strategy of targeting the nominal exchange rate of the Denar against the German mark, and from January 2002 against the Euro. Therefore, maintaining the stability of the Denar exchange rate is an intermediate goal of monetary policy. The application of the exchange rate targeting strategy results from:

a) the importance of the exchange rate in a small and open economy;

b) the need for a nominal anchor to maintain credibility; c) the high degree of euroization, and

c) the transparency of the exchange rate policy and the possibility for daily monitoring by the economic entities.

The main goal of monetary policy, as always, during the pandemic, as well as with the new challenges brought by the energy crisis and the war in Ukraine, is the preservation of stability. Although the two crises are of a different nature and require a different reaction and setting of the monetary policy, the ultimate goal is the same - preservation of macroeconomic stability.[109]

4.2.3.3. Interest rate policy and transmission mechanism

In conditions when the monetary policy is aimed at maintaining the stability of the Denar exchange rate, interest rates and money supply are dependent categories, determined by the achievement of the intermediate goal. Through its interest rate policy, the National Bank sends monetary signals to the banks and thus seeks to influence the amount of their active and deposit interest rates. Currently, the basic interest rate of the National Bank is the interest rate realized at the auctions of CB bills.

4.2.3. Implementation of the monetary policy of the National Bank of the Republic of Northern Macedonia

In order to achieve price stability, as a primary goal of monetary policy, the National Bank has various instruments for monetary regulation.:[110]

❖ Having in mind that there is a complex and indirect connection between the instruments and the ultimate goal of the monetary policy with time lag, the National Bank monitors the movement of certain economic variables - operational and intermediate goals. Operational goals are easier to control, but farther from the end goal, while intermediate goals are more difficult to control, but closer to the end goal. By managing the level of

[109] Ангеловска-Бежоска на „Еуромани“, (2022), https://denar.mk › ekonomija › angelovska-bezoska-na-
[110] Народна банка на Република Северна Македонија - Спроведување на монетарната политика, (2021), https://www.nbrm.mk

interest rates, and thus the level of liquid assets in the banking system, as an operational goal, the National Bank seeks to influence the level of the exchange rate, as an intermediate goal of monetary policy.

❖ From the instruments of the National Bank, the most flexible are the open market operations, which, depending on the liquidity situation in the overall banking system, can be conducted through the issuance of securities of the National Bank - auctions of treasury bills, or by buying or selling securities from value on a temporary or definitive basis. A standard instrument is the required reserve through which the National Bank directly affects the money supply and loans. To overcome the short-term liquidity shortage of banks at the end of the day, the National Bank approves available overnight loans. In conditions of short-term excess liquidity, banks can place funds with the National Bank in available deposits overnight and for seven days.

The National Bank, through a series of instruments, started the tightening of the monetary policy, in the direction of anchoring inflationary expectations. Inflationary pressures last longer, are more dispersed, affect Inflationary Expectations and from there the central banks must react. The National Bank optimally regulates the liquidity that is in circulation through the use of several different instruments, and above all through intervention in the foreign exchange market:[111]

- ➢ The National Bank intervenes with the interest rate, but not only the basic interest rate, but also the interest rate on overnight loans, overnight deposits, and seven-day deposits. The National Bank reacts with the mandatory reserve, and takes other measures aimed at gradually tightening the monetary policy.
    - ✓ The National Bank points out that there is a significant difference between the inflation in our country and the average inflation in the EU and the reasons for this are several.

[111] Затегнувањето на монетарната политика, (2022), https://www.dw.com › mk › затегнувањето-на-монета.

- ✓ First, there is a big difference in the degree of openness and import dependence of the European economy and our economy, trade openness in our country is 140% of GDP, and in the EU it is about 70%.
- ✓ The higher the import dependence, the more vulnerable the economy is to external shocks. Import dependence is particularly high among energy producers, but we also use more energy to produce a unit of GDP than the EU.
- ✓ The structure of the consumption basket is also a significant factor, namely, in our country, food and energy account for about 50 percent of the consumption basket, while in the EU it is only 30%, and the shock is exactly in those segments.
- ✓ In addition, the type of measures taken by the policy makers, as well as the degree of competition in the domestic economy, also play a significant role.

- ➢ International financial institutions forecast a slowdown in inflation next year. The International Monetary Fund expects a slowdown in the inflation rate for both the global and our economy.

CONCLUSION

The European Central Bank is the "bank of banks" of the member states of the European Union. The European Central Bank significantly adjusted its regular refinancing operations, which adjustment meant increasing the maturity of loans, allowing banks to access unlimited liquid funds at a basic interest rate with a maturity of up to six months. The European Central Bank currently acts as a surrogate in the market through the allocation of liquidity and the formation of prices on the financial market.

The main goal of the ECB is to maintain price stability in the euro area. To that end, the ECB uses interest rates - and from the crisis and other measures - to influence financing conditions in the economy. By regulating financing conditions, the ECB can influence the overall level of activity in the economy and can ensure that inflation is met.

The European Central Bank uses open market operations as a basic instrument for the implementation of monetary policy and for setting the interest rate, which are the basic issues related to the creation of the monetary policy of the member states of the Eurozone, the member states of the EU outside the Eurozone and the candidate countries. for EU members.

Basic refinancing operations are the dominant form of open market operations in ensuring an appropriate monetary policy to support the development, financial and price stability of EU member states and candidate countries for EU membership.

The European Central Bank conducts open market operations in a decentralized manner, so that they are carried out by individual national central banks to ensure a stable economic system that enables countries, their governments and institutions to plan and direct their economic activities. development in terms of their expansion and strengthening throughout all countries in the world in order to reach the highest possible level of price stability.

The purpose of price stability refers to the general level of prices in the economy. That means avoiding both prolonged inflation and deflation.

Price stability contributes to achieving high levels of economic activity and employment by improving the transparency of the pricing mechanism.

Under price stability, people can recognize changes in relative prices (ie prices between different goods), without being confused by changes in the overall price level. This allows them to make well-informed consumption and investment decisions and to allocate resources more efficiently.

The European Central Bank is the sole issuer of banknotes and bank reserves. This means that it is a monopoly supplier of the monetary base. Based on this monopoly, it can set the conditions under which banks lend to the central bank. Therefore, it can also affect the conditions in which banks trade with each other in the money market.

In the short run, the change in interest rates on the money market, encouraged by the European Central Bank, launches a series of mechanisms and activities of economic entities. Finally, change affects the development of economic variables such as output or prices.

Each monetary policy decision by the Governing Council of ECB is based on an assessment of the monetary policy stance. The assessment of the monetary policy stance determines whether monetary policy is contributing to economic, financial and monetary developments in a way that maintains price stability over the medium term. The appropriate monetary policy stance is delivered by choosing and calibrating the appropriate monetary policy tools, both individually and in combination.

When making monetary policy decisions, the Governing Council systematically assesses the proportionality of its measures. These assessments include an analysis of the benefits and possible side effects of monetary policy measures, their interaction and their balance over time.

The ECB’s main decision-making body, the Governing Council, sets monetary policy for the euro area. The Council consists of six ECB Executive Board members and the Governors of euro area national central banks. They assess economic, monetary and financial developments before taking monetary policy decisions. This happens every six weeks.

After the Governing Council makes monetary policy decisions, it is typically the national central banks which implement them. For example, the national central banks lend money to commercial banks through what we call refinancing operations.

From the aspect of the monetary policy, the Republic of North Macedonia should undertake activities for:

- Full compliance with European legislation, and the National Bank to maintain financial stability, as well as to provide space for significant credit support for citizens and companies.
- The National Bank should be an entirely independent institution, free from interference by other authorities, to be the guarantor of monetary and financial stability.
- The National Bank is fully committed to the application of the code of statistical standards and to improve its capacity for their constant implementation in its operations.

The key criteria to be met by the Republic of North Macedonia should be structured into three groups:

- political criteria – stable institutions that guarantee the rule of law, democracy, human rights, respect and protection of minority groups;
- economic criteria – a functional market economy that can withstand the competitive pressures of the European market;
- sectoral administrative and institutional capacity – ability to undertake the obligations required by European law in all regulated areas.

In the process of negotiations, until the entry into the EU, the National Bank should work on further harmonization of the regulation in several spheres of its activity:

To work towards further harmonization in the field of banking regulation in order to maintain a stable and healthy, but also a more competitive banking system, taking into account adequate consumer protection.

To ensure smooth and safe performance of payment services, but in a more competitive environment with new payment service providers besides banks and greater transparency for the type of services and the price of fees, in accordance with European regulatory requirements and standards.

Regarding the question of the expected effects of joining the EU internal market on macroeconomic stability and the Macedonian economy, integration and the overall reform process of the country should be aimed at meeting European standards, and acting favorably on the growth potential of the economy and its stability.

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