COLLECTION OF THESIS to

László Vigh

The independence in the case of the European Central Bank
Theoretical background, conception making and practice

directed Ph.D. work

Theme leader:

Dr. Hajna Istvánffy
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Budapest, 2007
Department of World Economy

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The boundary of the examined field

The European Central Bank devised as the epitome of an independent monetary authority. It is endowed with autonomy from the day-to-day political process and is given wide-ranging competences to pursue its tasks with the overriding goal of maintaining price stability.

The creation of a central banking system for the European Union is taking place at a time when the concept of independence for the guardian of the currency is gaining acceptance globally, both in academic circles and among politicians. The function of the issuer of money, charged with the objective of keeping it stable, is seen as one which is best served by a separate institution whose independence is limited only by the need of democratic legitimacy through reporting and consultations with the political bodies, and by a precise formulation of its tasks so that the bounds of the public functions which are set aside from the normal political process are well-defined.

The issue of central bank independence has been discussed extensively. This argues that there is a positive correlation between the measure in which central banks are free from political influence and their success in stabilizing the internal value of the currency. The correlation between independence and low inflation has been empirically tested.

The level of inflation has been relatively low in the jurisdiction which have traditionally been champions of central bank independence, such as Germany, the Netherlands.

There have been numerous studies which classify central banks according to perceived autonomy in setting, and implementing, monetary policy. Central bankers themselves have regularly put forward arguments in favour of the independence of their institutions.

Independence of the central bank from government influence in deciding monetary policy and implementing it is not considered sufficient for good inflation results. A clear mandate to seek stable prices helps the monetary authority to focus on its primary goal. However, even when ancillary objectives are entrusted to it, the central bank – in
climate favourable to a strong central bank – may still be successful in combating inflation.

Previously, the respect of fixed rules by which the government was to abide in its money creation activities may have been considered sufficient for the maintenance of the value of money in a fixed-rule environment, the actual degree of independence of the central bank may not be decisive: the rules affecting price stability should ensure the desired result. For instance, the gold standard performed this function leading, as it did, to fixed relationships between the currencies and leaving central banks with very little leeway in the conduct of their ‘policies’ which, after all, were largely determined by the agreed link of the currency to gold.

Nowadays, the safeguards of institutional features insulating the central bank from direct government influence, and the enactment of a single, strict objective of price stability to be pursued, are considered optimal for the desired result: stable price conditions over time. The central bank itself should set the rules of the monetary game, within the confines of its charter and the statutory limits on encroachments, by the government, upon its independence, whether in respect of policy-making or in respect of operations and activities.

The degree of distance from the government, or from parliament, may differ and lead to distinct concepts being used, such as ‘autonomy’ instead of ‘independence’, or ‘independence within the government’ rather than ‘independence from the government’. The former term indicates that the central bank’s guardianship of the currency is a public function exercised by an independent body of the government. Whatever the terms used to describe the central bank’s distance from day-to-day politics, it is clear that it is ‘government’s management of money’ which is at issue. The central bank performs a governmental function which is exercised independently of the other organ of the executive and legislative branches. As to judicial control, the central bank’s activities should, naturally, be subject to the scrutiny of the judiciary.

The independence of the central bank has been likened to that of the judicial branch. I for one would not favour the view that the central bank constitutes a separate branch of government, apart from the executive, legislative and judicial branches. In my opinion
the function of maintaining the value of the currency is fulfilled by a separate “institution” which can be said to form part of the execution of monetary policy, and the exercise of other executive functions. Yet, it may also be entrusted with legislative functions, in the areas for which the legislature, or the constitution, has delegated powers to the monetary and banking supervisory authorities. Thus, it also has traits of this ranch of government.

Independence is often measured in terms of certain constituent elements. The description of these elements varies from one author to the next. Usually, the elements are grouped into classes, such as political – concerning the appointment of central bank board members and the objective the central bank is to pursue; versus functional – concerning the use of monetary policy instruments and the financial autonomy of the central bank; elements. Other distinctions used are between organic or personal elements – concerning appointment, terms of office and compatibility of the function of central banker with other functions; on one hand, and functional or operational elements – concerning the autonomy in selecting monetary policy instruments and the financial autonomy of the central bank; on the other.

The institutional independence concerns the legal autonomy of the monetary authority, being an institution separate from the other bodies of government. An independent central bank should be a separate legal entity. Apart from legal personality, the freedom from instructions from the government, or from any other body is also considered an element of independence which ranks as ‘institutional’. Naturally, the separation from other state organs cannot be absolute. There will be contacts with those responsible for economic policy, if only to arrive at mutual information and consultation between the central bank and the government, while accountability mechanisms ensure a measure of democratic legitimacy. Additionally, judicial scrutiny is inherent in a democracy under the rule of law.

Personal independence concerns the appointment of the members of the decision-making bodies of the central bank. The method of their appointment and the tenure of office should enable them to oversee the implementation of the central bank’s tasks without outside interference. Although the members of the decision-making bodies of
a central bank are usually appointed by the organs of the state, the safeguards surrounding their office should prevent the exercise of political influence upon their performance. Likewise, where they are appointed by private shareholders, the latter’s influence should not interfere with their autonomous decision-making in respect of monetary policy, which is a function exercised in the public interest and not in pursuit of particular private interests.

The renewal of the mandate of the members of the decision-making bodies of the central bank also comes within the sphere of personal autonomy. There are arguments for restricting the appointments to a single term since that would free the incumbent from political considerations concerning a renewal of his or her term of office. Nevertheless, central banks with governors or other members of management whose terms of office are renewable may have an autonomous status and a staunchly independent tradition. Finally, the holders of offices at the central bank may not be dismissed for reasons related to their policy decisions. In an independent central bank, dismissal is only possible on the grounds of serious matter unrelated to the policy of the central bank and is surrounded by adequate safeguards. Further elements of personal independence may be discerned, concerning the salary of the board members, the incompatibilities of central bank board tenure with other occupations, whether gainful or not, and the incompatibility of functions assumed posterior to the membership of the central bank board.

The functional independence refers to the autonomous decision-making in respect of the instruments which the central bank employs to achieve its objective. Although the government may set the limits to the deployment of monetary policy instruments, activating these instruments is the sole prerogative of the independent central bank. Likewise, decisions on interest rates and on transactions in the money and foreign exchange markets should be taken by the central bank without recourse to other bodies, if it is to be considered a fully-fledged independent monetary authority. Of course, the degree of freedom in the area of exchange rate regulation may vary, with some central banks deciding on the rate of exchange and others only free to regulate foreign exchange matters within the confines of decisions at the political level.
Financial independence is the autonomy of the central bank in terms of the funding of its activities and the exercise of its powers come into play.

The finances of an independent central bank do not come under the budget authority of parliament nor are they subject to approval by the minister of finance. His influence on the distribution of the central bank’s profit is circumscribed by law in a transparent way. The authority of state organs to verify the accounts of the central bank may not lead to an influence on its policies. Thus, the function of a state audit body is limited to the scrutiny of the central bank’s efficiency, if it applies at all.

The experiences of periods of high inflation in the 1960s and 1970s engendered a climate favourable for the creation of independent central banks, underpinned by the theoretical arguments for central bank independence, may have played a major role in the granting of independence to the ECB, and in requiring independence for the national central banks. The world-wide trend towards greater autonomy for central banks, underpinned by the theoretical arguments for central bank independence, may have played a major role in the granting of independence to the ECB, and in requiring independence for the national central banks. The requirements of obtaining German approval for the monetary union projects ha been another important element. The Bundesbank will see its role diminish from that of the principal central bank in Europe to that of one of the constituent element of the ESCB. The independence tradition of the Bundesbank has served Germany well. The Deutschmark is only given up for a single currency which is likewise protected by an independent guardian of its stability.

The ECB, and even the ESCBs a system, has been largely modelled on the Bundesbank. It was considered particularly necessary in the Community context to enshrine a far-reaching measure of central bank independence in the majority of member states. Also, as the Committee of Governors noted in its introductory report on the Draft Statue of the ESCB. In the process leading up to the conclusion of the Treaty on European Union, the notion of an independent central banking system was never seriously questioned. In the Delors Committee Report it was stated as one of the principles on which the ESCB was to be based. In memoranda previously issued, which paved the way for the preparations for the EMU, the independence of the
common monetary institution was also stressed as an indispensable factor. If it were not the conviction of the necessity of independence for every central banking institution, the prospect of central bank operating in a federative context such as the Community led to the acceptance of the idea of an autonomous European monetary authority. Although the precise formulation of this independence was not yet ‘common ground’, the constant reference to independence makes clear that an autonomous “institution” was envisaged.

The ESCB have to perform its tasks in full independence: no political influence on its decision-making bodies is permitted. This prohibition against the giving of instructions by the political authorities at the EC or the natural level, and against seeking or taking such instructions, is to ensure that the European Central Bank, whose decision-making bodies govern the ESCB, focus on its primary objective (price stability) and will not be prone to give in to short-term considerations of a political nature.

The provision on central bank independence works in two ways: it impresses upon the entities composing the System and on the members of its decision-making bodies not seek or take any instructions from any body and it enjoins the Community institutions and bodies and member states’ governments to refrain from seeking to influence the members of the System’s decision-making bodies.

This autonomy is also protected by the procedures for appointment and dismissal, by the independent exercise of the powers conferred upon the System, by the financial provisions governing it and by the separate legal personality of the twenty-eight constituent parts of the System. As the Committee of Governors pointed out: Article 7 firmly establishes the principle of independence, other provisions give it practical effect.

As was indicated above, the personal aspect of independence relates to the safeguards in the procedures for appointment of persons to the central bank’s decision-making bodies, their security of tenure and the possibility for the central bank to employ its own staff, separate from the civil service of the Community and the states.
The appointment of the Executive Board is regulated at Community level and embodies several safeguards for the ECB’s independence. The first such safeguard lies in the circle of persons who can be appointed. They are to be ‘of recognized standing and professional experience in monetary or banking matters’. This rules of the appointment of persons who are chosen solely or primarily for their political affiliations. The required competence in the field of central bank operation supports the exercise of wise judgement in the fulfilment of the task of Executive Board member.

Security of tenure of office is furthermore given in the ESCB Statue to the national central bank governors: they should be appointed for terms of at least five years and may apparently by reappointed. There is no role for the ECB in their appointment, which remains a national affair. The governors may be dismissed only for the same strict reasons of health or misconduct which apply to Executive Board members.

A dismissal of a national central bank governor may be brought before the Court of Justice by her- or himself or by the ECB’s Governing Council. A direct appeal to the European Court against a national decision is a novelty which crept into Community law through the backdoor route of MU provisions. There is no rule, in the ESCB Statue, on the incompatibilities of the office of governor of an national central bank with other functions. An exclusivity clause does apply to the other members of the Governing Council. Incompatibility rules for members of the decision-making bodies of the national central banks may be enshrined in national statues. A harmonization of these norms would seem required for the Governing Council to meet, as a body, the same standards of independence, integrity and discretion. Should national laws on this point diverge, a rule on incompatibility may be issued by the Governing Council. It may lay down incompatibility provisions in a guideline or instruction adopted in accordance with Article 14.3 of the ESCB Statue.

Functional, or operational, independence has to do with the attribution of decision-making powers to the central bank or to the political authorities. It will become clear that the powers conferred upon the ESCB give it a large measure of functional independence, circumscribed only – in a few instances – by the necessity of working
in the basis of additional legislation to be adopted by the political institutions and by the influence of the Ecofin Council in the area of exchange rate policy. Here, it may sufficed to note that, in the view of the Committee of Governors, the exercise of central bank functions was considered a competence completely to be decided by the ESCB itself, while the IGC added the intervention of the political authorities in establishing certain thresholds or laying down specifics of the rules applying to the central bank’s instruments.

The base of the financial independence is that the ESCB’s finances are not included in the Community budget. The System derives its income from the investment of the official reserves and from the interest charges on advances and, possibly, the imposition of non-remunerated minimum reserves. The seignorage on the issue of bank notes accrues to the System.

When discussing the elements of ECB independence the immutability of its character is relevant. Where, in other jurisdictions, the legislature may amend the central bank Act should it consider the monetary authority to behave too independently or to ignore unduly the wishes of the electorate, there is no room for similar redress at the European level. It should be remembered that the ESCB Statute and the EMU provisions of the EU Treaty can only be amended by a full-fledged Treaty amendment procedure, involving the convention of an Intergovernmental Conference and the ratification of its results by the parliaments of all member states. The ECB is to be consulted on any amendments of the monetary provisions. As is noted in legal writing this makes the safeguards for the ECB’s independence stronger than those for any other central bank.

The enlargement of the euro area will lead to an increase in the number of members of the Governing Council of the European Central Bank. To maintain the Governing Council’s capacity for efficient and timely decision making in an enlarged euro area, irrespective of the number of member states that adopt the euro, a protocol annexed to the Treaty on European Union for a recommendation from the ECB on voting
arrangements. The ECB is proposing a rotation system which is designed to ensure genuine efficiency in decision-making within the Governing Council and assign voting rights among the governors in an equitable, efficient and acceptable way. The design of the rotation system has been guided by five fundamental principles: one member one vote, is the core principle of the ECB decision-making. It should be retained for members having a voting right. However, rotation system would necessarily imply that there would no longer be permanent voting rights for all the members of the Governing Council.

Price stability as the primary objective

The ESCB is entrusted with one overriding objective: to maintain price stability. This goal is its single most important objective, the reason for which the System is created. It is with a view to this that the central banks of the European Community are to be endowed with a large measure of independence: it is with the ultimate objective of maintaining price stability that the ESCB be put on a separate footing from the political organs of the Community.

The maintenance of price stability as the objective of the ESCB implies that its first task to foster a climate of zero, or very low inflation. The wording has been chosen so as to reflect the absence of inflation from the outset: the Maastricht criteria for entering Stage 3 of EMU imply that the System started operating in a low-inflation climate. Should the ESCB ever have to work in high-inflation circumstances, it should seek to re-establish price stability, and then to maintain it. Also, the word ‘maintenance’ denotes the authority involved in the System’s primary objective, similarly to the maintenance of law order entrusted to law-enforcement and judicial organs.

There is no definition of what constitutes ‘price stability’. The term used denotes internal price stability (the volume of goods and services which can be obtained for one euro), as opposed to the external purchasing power (the strength of the currency in terms of third currencies). It is clear that the ECB is to strive for the former: it is internal price stability which is should maintain. Here, the Treaty and the Statue are
unequivocal. The objective is not ‘safeguarding the currency’ nor the stability in terms of third currencies.

With the ECB free to translate the objective into monetary targets, the question arises where the limits of the right of auto-interpretation lie. They set by the legal constrains upon the activities of the European monetary authority.

The ultimate and overriding objective of price stability is to guide the ESCB in all circumstances. Without detracting from this objective, the System is to support the general economic policies in the Community.

It may be noted that the policies in the Community are to be supported. This way of phrasing the secondary objectives of the ESCB was chosen because the Community, under Economic and Monetary Union, not have a single economic policy which the ESCB is to support, but a set of mutually coordinated and consistent policies.

Legally speaking, the absence of a single economic policy for the Community may give the ESCB more freedom of action, as it is under no constraint to support a specific policy. Economically speaking, the absence of stricter policy coordination may make the task of the ESCB to maintain price stability more difficult to perform, since the impact of the ESCB to maintain price stability more difficult to perform, since the impact of its monetary policy decisions may vary from state to state, being more effective in member states whose fiscal policies re in line with anti-inflation goals and going against the trend in other states whose policies may be at odds with the Community’s strategy for the pursuit of the proper economic policy. It is in this context that calls for an economic government of Europe, and for stricter coordination of fiscal policies, is particularly relevant.

The support which the ESCB is to provide is to the general economic policies in the Community. This means that the ESCB’s actions can be measured not in terms of support of a specific course of action conducted by member states r by the Community, but rather by the support of underlying trends in economic policy. For instance, an anti-cyclical policy can be offset partially by monetary policy stances. Should the maintenance of price stability leave open options between measures which would not be counter to such an anti-cyclical trend and those that would tend to undermine that policy, the former course of action would have to be preferred.
In the context of ESCB’s obligation to support the economic policies in the EC, it should be noted the Community itself may decide to take economic policy measures. The competence to go beyond mere coordination and embedment of national policies within an EC framework, is laid down in Article 103 A (1) U treaty. This provision requires unanimity among member states represented in the Ecofin Council to act upon a Commission proposal. Thus, the ESCB may be required to support such EC-wide measures which the Ecofin Council may adopt for the Community as a whole. Since these measures apply to the Community in its entirety, the ECB, serving as it does price stability in the euro area, may be faced with divergent policy environments. The members of the monetary union may follow a different course of action than their fellow member states outside. The prescription of economic policies for the Community as a whole may be more difficult than for the currency union members who, by virtue of having a common currency, are more inclined to follow similar policies, consistent with the single currency. With further expansion of the Community, the number of member states, and their nature, may become so varied that finding a common framework for their economic policies may result in generalities and meagre constrains. Formally, the ECB would be bound to serve these general economic policies, while it is the – supposedly – stricter set of policies in the euro zone which are relevant for the Community monetary authority. The monetary split-up between single-currency and other states may thus make support by the ESCB of Community-wide economic policies more difficult to achieve.

Conclusions concerning independence and accountability

The provisions on independence and accountability provide a balanced system of distance from the political authorities while assuring a sound measure of consultation and reporting. The latter allows the ECB to present its case and to be called to account for the way it performs its functions. It needs to be recognized that the independence has been written is stone, a feature which may be considered at variance with the imperatives of democracy. Nevertheless,
enshrining the independence of the monetary authority in primary community law provides Europe with the best vantage point from which to engage in the enterprise of managing a single currency and maintaining price stability. A different institutional set-up would not only have been unacceptable politically. Also, it might not have provided a sound basis for convincing the financial markets and the public of the security of the new money.

Furthermore, the seemingly bare provisions on accountability may be stretched to their limits by a combination of the ECB endeavouring to be transparent and give account mandate political bodies, notably the European Parliament, monitoring closely, with interest and insight, the conduct of central banking activities. Naturally, this way of debating monetary policy and other ESCB activities requires a consensus on the proper arrangements for the security of the currency. At the political level, this consensus seems present. Whether it will be prevalent among the public remains to be seen. The ECB would be wise to seek an active debate and to foster understanding for its overriding objective of price stability. Thus ‘accountable independence’ can be achieved.

With these considerations in mind, there is no need, in my view, to advocate amendments to the provisions on the democratic legitimation of the ECB. This independence is, as we have seen, circumscribed through the political involvement in the appointment of the members of the Executive Board and, in most cases, of the NCB Governors, by the absence of prescribed very long terms of office, at least for the majority of the members of the Governing Council, by the presence, during debate and voting, of representatives from two political institutions at meetings of the Governing Council, through the accountability before the European Parliament, as well as through informal and formal contacts with the national Governments. The present arrangements should be made to work first. Further inroads into the ECB’s independence are not required, at least not before the ECB has had a chance of grooving itself capable of performing its main objective of maintaining price stability, and of adequately accounting for its performance on this score.

Any amendment to the ECB’s independence, apart from requiring the consent of each Member State in the Treaty revision procedure of Article N of the Treaty on European
Union, should be based on an assessment that Europe’s monetary authority goes against the best interests of the Community, interest which include the safety and soundness of its single currency.

On one point, the democratic legitimacy of monetary union may be enhanced right away. It does not directly concern the scope of action of the central bank but is of indirect influence thereon. The limited involvement of the European Parliament in the adoption of the necessary secondary legislation is not, to my mind, proper from the viewpoint of democracy. Restricting the role of the representatives of the people to mere consultation is not acceptable for any major piece of legislation. The argument that technical matters are concerned is not convincing: after all, the imposition of reporting and reserve requirements impinges upon the freedom to undertake business activities. The class of persons who are subject to these limitations of the exercise of economic rights is to be decided by the legislature.

Finally, the wording of the principle of independence in Article 07 EU Treaty and Article 7 SCB Statue leaves something to be desired. As discussed above, its far reaching prohibition against seeking to influence the monetary authority, if taken linearly, clearly goes too far. The European Parliament, the Commission and the Ecofin Council should be free to hold consultations with the NCBs in a climate of mutual trust and open discussion. Nevertheless, I see no need for an amendment, although a less complicated way of formulating the independence principle might better have been adopted.

Again as discussed before, it will be difficult to ascertain where exactly consultation and discussion become ‘influence’ in the sense of Article 107 EU Treaty. Any conduct which goes beyond discussion and consultation, for instance the exercise of pressure by political action and also the organization of a public front against the ECB, is prohibited. It will be for the ECB to watch over its independence and ultimately, for the European Court of Justice to guarantee it. Based on the provision alone, a fine balance between independence and political influence seems to have been struck.

The objectives and tasks of the European Central Bank as a matter of fact restricted. In the question of the primary aim the expert of the bank has free hands, but in the case of
the other tasks the bankers have just a minimum opportunity. Certainly they have a bunch of facilities to provide their complex assignment, in such environment, where the member states economy policy can be opposite. The challenge is significant, because there is only one part in the Union’s economy what is single, and that is the monetary policy. This is carried out by the European Central Bank, without any member states effect for the interests of Europe.
The central banks have unnumbered tasks, start with the formulating and control of monetary policy until the care f the financial institutions. In the case of the European Union these tasks partly became dimplier, because the ECB works not as a national central bank, other hand specially complex, while it has to provide a single monetary policy in more independent economy policy.

When the Economic and Monetary Union was born the coordination of the member states – in today view – seemed to be simple, because of two reasons. On the one hand there was a historical situation, that the government of the founder eleven countries was ready to feel the measures of the European Central Bank as the part of national interests, so they supported the execution of them. On the other hand the economic convergence of the founder states was realized not just on “Maastricht” level, but the real convergence was also considered single. When the EMU was enlarged in 2001, not happened changes in this area, since the economic performance of Greece not so differed from the Portuguese.

In the time spent since 1999 both basis changed. In spite of the monetary union the economic leader governments of the member states are front of problems (unemployment, stagnate), so in many cases instead of execution of structural changes it is modest to put the responsibility to the ECB. Considering the elections, especially convincing the inhabitants adequate to critical the ECB, and to lay the problems at the EU door. That was really characteristic, when Oscar Lafontaine pressed the ECB to moderate the interest rates to stimulate “the core countries”, firstly Germany’s economy, and herby to decrease the unemployment rates. So during a really short time the “loftiness” of the European Central Bank disappeared the politicians. This feature can be back in very long time (if it ever happened), so the ECB in the future not has the chance to calculate with this property.

The other basic (the convergence of the member economies) transforms with significant, and for the ECB definite size in a short time. In 2007 enlarged the EMU with Slovenia. This state economic performance is near to the least developed “old” EMU members. During 2006 came to the surface the joining of Lithuania - who in the
moment of the writing of the conclusions – what is more a reality, than a year ago, besides together with Estonia, probably very quickly followed by Latvia. (Malta and Cyprus from this point of view similar as Slovenia, as a potential 2008 enterer.) Namely the participation of the Baltic states in the Monetary Union the overture on was to a new situation. It is clear in the case of these states the real convergence will be realized nor in middle term. The figure 1. shows how changed and in tendencies will change the GDP of the derogated countries. That is evident for the countries in the developing period the target of the monetary policy would to be other than in a developed slowly growing state. In the ECB point of view certainly clear, the maintenance of low inflation economy is the most important aim, but it is not so unambiguous for the Easter-European countries. No matter how much economically true, just for countries, who are thorough grounding in worth to be in the EMU, the home affairs tight the governments and put to the background these arguments. So there are two opportunities for the leader of the European Central Bank in the following years.

Figure 1. Changes in GDP/capita in countries with derogation between 1997-2008.

They “get involved in flood” and sometimes helps the Eastern-European EMU members into with some measurements, this was relieve the needs of the region, but the same way produce disadvantages effects in the core EU members. Last can be solved (maybe with painful) arrangements. Or it definitely keep up this day’s monetary policy principles, this way put on the breaks the close ups for the new EMU members, but make it clear “it is has to be grown up” to participate in the Economic and Monetary Union. Just for the developed countries have the possibility to profit from the advantages and the reduce of the disadvantages of the EMU. (Strictly speaking for this possibility lights the more difficult situation in Portugal.) I have to add, on the continent - taking into consideration the potential EU members – there are more developing stets, than developed, so the numerically their will be in majority those countries, who will use the different methods of pressing, to form the monetary policy for their interests. This opportunity include that the conception of the independence formed by the founder states can be call in question.

Because of all these imaginable tendencies the European Ventral Bank has to prepare for the attack of its independence. It has to create strategy for the present EMU states to not doubt the autonomy and the shaping practice consider disputable. On the other hand it has to deliberate in the future EMU-members, the benefits of the existing independence and there is no possibility to influence the functioning.
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