

THE ENLARGEMENT OF MONETARY UNION AND THE OUTLOOK FOR THE EUROSISTEM

The Eurosystem is made up of the European Central Bank and the national central banks of countries in the euro area. It presently functions in a decentralised manner, which is borne out both in the decision-making process, the way in which monetary policy is set and in banking supervision. As the euro area enlarges to include the new members of the European Union, the functioning of the Eurosystem could move towards greater centralisation and converge, at least in appearance, with that of the US Federal Reserve. Such changes in the working of the Eurosystem could however influence the balance between the major financial markets in the euro area.

■ Decentralised Functioning

The creation of Economic and Monetary Union led to EU members adopting a common monetary policy. It therefore seemed logical that all the governors of the national central banks (NCBs) should participate in policy-making. Decisions on monetary policy are thus taken by the Governing Council of the ECB, which is made up of the six members of the Bank's Executive Board and the twelve Governors of the central banks in the euro area, each member being allowed to vote.

Strong decentralisation characterises the various aspects by which monetary policy in the euro area is implemented, even though the Bank's founding texts do not rule out centralisation. As a result, the ECB, given its statutes, has full operational capacity. However, a decentralised organisation has seemed preferable in as far as it is based on pre-existing inter-bank links at the national level. It was on the basis of these links that TARGET – the Trans-European Automated Real-time Gross settlement Express Transfer – was constructed for large-scale transactions, ensuring fluid movements in central bank money within the euro area, and ensuring, in practice, that short-term interest rates are the same across the area's financial markets. Hence, the twelve national central banks manage this payments system locally,

along with open market operations, whatever their nature. They are also responsible for managing forex reserves. The role of the ECB is to monitor and coordinate such activities, but not to carry them out.

Lastly, regarding banking supervision, the NCBs responsible for this task have full and exclusive powers, though they obviously participate in information and consultation procedures within the Eurosystem. A forum for cooperation between the NCBs, the banking supervisory authorities of the EU and the ECB regularly assesses the ability of banks within the EU to absorb risks¹.

The Eurosystem and the US Federal Reserve System are usually seen as quite close in structural and operational terms. Both institutions are organised federally, with a centre (the Federal Reserve Board in the United States and the ECB in Europe) and federated, peripheral banks (the Regional Reserve Banks and the NCBs). But the Eurosystem is relatively original compared to the centralised functioning of the Fed. It should be remembered that the Federal Open Market Committee (FOMC) includes seven policy-makers from the Washington Board and only five (out of twelve) chairpersons of the regional banks. Only the Chairman of the Federal Reserve Bank of New York is a permanent policy-maker at the Fed: the other eleven chairpersons are all rotating participants. Furthermore, the implementation of

1. ECB (2003), "EU banking sector stability", *Financial Stability Paper*, November.

monetary policy is the sole responsibility of the Federal Reserve Bank of New York. The Federal Reserve Board is responsible for supervising the largest banks and supervision may be exercised locally, but the outline policies for supervision are set by the Board.

The decentralised functioning of the Eurosystem may be explained by bearing in mind that this European institution is the result of a process whereby the national central banks have delegated their authority over monetary policy to a multinational organisation, while at the same time retaining complete freedom in their other missions and in their management. In the United States, the various Federal Reserve Banks² were created at the same time as the Federal Reserve Board, and a certain amount of decentralisation characterised the workings of the Federal System during its early years. The US System was only remodelled in the wake of multiple banking and financial crises between 1913 and 1933, leading to legislation (in 1933-1934) that delegated far greater powers to the Board. Since then, all the activities of the regional Reserve Banks have been placed under the authority of the Board, which has powers of supervision and approves the formers' budgets.

■ Will Enlargement Lead to More Centralisation?

2

Will the European system follow the historical evolution of the United States and become more centralised? This question arises with the process of euro area enlargement, relating to policy-making, the implementation of monetary policy and to banking supervision.

Policy-making

In view of the euro area expanding from 12 to 20 or even 25 members, proposals for reforming the functioning of the Council of governors have set a limit of having 21 voting members, of which six will continue to come from the Executive Board. Rotating participation in the Council will therefore be introduced once EMU membership rises above 15 (see Box). This system would thus converge on US practices. But in the European case, the rotating system does not include the same measure which underpins the logic of the US system, namely the permanent participation in policy-making by the governor(s) representing the major financial centre(s). Whereas the Chairman of the Federal Reserve Bank of New York has a permanent seat and an active vote

on the FOMC, the governors of the euro area's largest central banks will only take part in 4 out of 5 of the Council's votes. Despite the fact that the NCBs participating in the Council far outnumber the members of the ECB Executive Board (15 versus 6), the reform will strengthen policy-making centralisation as only members of the Executive will have permanent voting rights.

The implementation of monetary policy

The staff of the ECB have calculated that a decentralised payments system is more costly than a centralised system. For some future members states, the costs of harmonising the infrastructures of national payment systems could be prohibitive relative to expected benefits, and given the volume of transactions in question. Transactions passing through TARGET are indeed very concentrated: in 2003, 83% of transaction volumes were concentrated in the five largest payment processing platforms (of which Frankfurt accounted for 49.2%), while less than 1.5% of trades occurred via the five smallest platforms. Furthermore, according to the ECB, the participation of the 10 new members would lead to an extremely complicated system, with 26 platforms. Under these conditions, the project of creating a single payment system (TARGET 2), which would allow the management of all payment and settlement systems to be drawn together, could be less costly and more effective in a euro area with 20 or 25 members⁴. Such a single platform structure should be operational as of 2007. It will likely modify the relations between the banking systems and the NCBs.

On entering the euro area, the money markets of the new member states may not be sufficiently liquid, nor provide the technical and legal security for liquidity to be managed in a homogenous manner throughout the area. In this case, banks should be able to obtain central bank money without passing through their NCB. In fact, the commercial banks of the new entrants could be authorised to hold accounts either with a large central bank in the present euro area, or with the ECB. These two options would prevent a multiplication of open market procedures within a euro area of 20 or 26 countries, that could undermine the singleness and uniformity of monetary policy.

In the first case, the implementation of monetary policy could be delegated to certain large central banks, which would then see their operational role within the monetary union increase. They would then become similar to the

2. The Reserve Banks carry out their activities not at the State level, but in "districts" whose boundaries usually cut across existing State boundaries.

3. According to ECB staff, any changes aimed at improving the functioning of the payment system, in order to take into account shifts in the needs of the central banks which are operating in a permanently-changing financial environment (eg: changing software), must be repeated for every payment processing platform. This would clearly increase financial costs.

4. ECB (2004), "Future development in the TARGET system", *Monthly Bulletin*, April.

BOX – THE VOTING RIGHTS WITH AN ENLARGED GOVERNING BOARD

According to the Nice Treaty, the European Council (of heads of government) may, acting unanimously, modify the voting procedures within the Governing Council, at the suggestion of the ECB or the European Commission, and having consulted the European Parliament as well as the Commission (or ECB). This occurred on 3 February 2003, when the European Council adopted the proposal of the ECB relating to voting rights within the Governing Council (of the ECB), once the euro area has more than 15 members. It was then decided to limit the number of votes to 21. The Executive Board will retain all six of its votes, with the euro area states sharing the remaining 15 votes. Two groups (for a euro area of 16 to 21 members) and three groups (for more than 21 members) will then be established according to the size of the Member States and their financial systems. A certain number of votes will be allocated to each of these two or three groups, and voting rights will rotate within each group. For example, the five “large countries” will be allocated four votes: each NCB within the group will therefore be able to vote four out of five times.

This system of rotation should facilitate decision-making, while each NCB will still be able to intervene in the discussions within the Governing Council. Another aim is to give greater influence to those participants who, by their status (the six members of the Executive Board) or because of their economic weight especially relating to the price index (the central banks of the large countries), should more naturally take decisions in response to the overall economic situation of the euro area. This aim has been fulfilled by limiting the total number of votes on the one hand, and by ensuring that the central bank of a large country has the right to vote more often than that of a small country.

Within the existing Eurosystem (with twelve members), the governors of all member central banks have the same voting weight in the Governing Council. Consequently, if three, new (small) countries enter the euro area, the Executive Board and the representatives of the large countries will be in the minority in making policy. The reform, however, stabilises their participation, which would otherwise have fallen progressively as new countries enter the euro area.

	Present situation	Three new members	Start of rotating vote for small countries	Start of rotating vote for large countries	Final structure with two countries groups	Initial structure with three country groups	Euro area= actual EU
Number of euro area members	12	15	16	19	21	22	25
Number of votes	18	21	21	21	21	21	21
Number of large countries	4	4	5	5	5	5	5
Number of small countries	8	11	11	14	16	11	13
Number of “very small” countries							
Weight of each large country	5.6%	4.8%	4.8%	3.8%	3.8%	3.8%	3.8%
Weight of each small country	5.6%	4.8%	4.3%	3.7%	3.3%	3.5%	2.9%
Weight of each “very small” country							
Weight of large countries* + Executive Board	55.6%	47.6%	52.4%	47.6%	47.6%	47.6%	47.6%
Weight of small (and “very small”) countries	44.4%	52.4%	47.6%	52.4%	52.4%	52.4%	52.4%
Weight of large countries* + Executive Board using the existing voting system	55.6%	47.6%	50.0%	44.0%	40.7%	39.3%	35.5%

* Within the present euro area, the large countries include Germany, France, Italy and Spain. In the scenario for 16 or more members, it is assumed that the United Kingdom will join this group.

New York Fed⁵. In the second case, should the implementation of monetary policy of several new members be delegated to the ECB, then it should be provided with enlarged operational capacities. It may be noted that in this case, nothing would prevent commercial banks in Paris or Madrid, for example, from opening accounts with the ECB, as this right will have been accorded to the new member countries. Large commercial banks, which are present in several financial markets, may then judge that direct relations with the “centre” provide for better cash management. The ECB would then become an increasingly active manager of monetary policy. This would modify the operating mode of the Eurosystem, which would become more and more centralised. Its model would then be different to the United States as the “centre” would have both policy-making and operational responsibility.

Banking supervision

In contrast to the United States, banking supervision in Europe is presently very decentralised, though guided by several procedures on consultation and harmonisation. However, enlargement of the euro area risks leading to some pressure for greater centralisation of supervision procedures of the banking system. While the banking systems of the EU’s new members may henceforth be considered as relatively sound⁶, efforts in terms of prudential regulation and banking supervision are still necessary, especially with respect to the Basle Committee directives. The growth of credit held by private agents (74% in 2002 in Hungary, and around 40% in Estonia and Latvia) makes this issue crucial. Furthermore, despite progress being made in consolidating banks’ balance-sheets in recent years, the ratio of non-

5. In this case, it should be noted that their periodic exclusion from decision-making would appear abnormal.

6. ECB (2004), “The acceding countries’ economies on the threshold of European Union”, *Monthly Bulletin*, February.

performing loans to total loans continues to be significantly higher in the new EU members than in euro area on average (3,1% in 2002 – see Table 1). Apart from the greater risk of a banking crisis linked to the future membership of the new members of the euro area, greater financial integration in Europe alone justifies more centralised banking supervision procedures: the notion of financial stability is actually as much European as it is national. In fact, a large majority of banks in Central and Eastern Europe are owned by banks in the euro area (Table 2).

Table 1 – Non-performing loans (as a % of total loans)

	1995	1996	1997	1998	1999	2000	2001	2002
Czech Republic	26.6	21.8	19.9	20.3	21.5	19.3	13.7	9.4
Estonia	2.4	2.0	2.1	4.0	2.9	1.3	1.2	0.8
Hungary			6.6	7.9	4.4	3.1	2.9	4.6
Latvia	19.0	20.0	10.0	6.8	6.8	5.0	3.1	2.1
Lithuania	17.3	32.2	28.3	12.5	11.9	10.8	7.4	5.8
Poland*	23.9	14.7	11.5	11.8	14.5	16.8	20.1	24.6
Slovak Republic	41.3	31.8	33.4	44.3	32.9	26.2	24.3	11.2
Slovenia	9.3	10.1	19.0	9.5	9.3	9.3	10.0	

Note: For Poland, the method of calculating non-performing loans is different, which explains why the level is higher than in other countries.

Source: EBRD (2003), Transition Report.

Table 2 – Number of banks

	1995	1996	1997	1997	1998	1999	2000	2001
Czech Republic	55 (23)	53 (23)	50 (24)	45 (25)	42 (27)	40 (26)	38 (26)	37 (26)
Estonia	19 (5)	15 (4)	12 (4)	6 (3)	7 (3)	7 (4)	7 (4)	7 (4)
Hungary	43 (21)	42 (24)	45 (30)	44 (28)	43 (29)	42 (33)	41 (31)	38 (27)
Latvia	42 (11)	35 (14)	32 (15)	27 (15)	23 (12)	21 (12)	19 (12)	19 (12)
Lithuania	15 (0)	12 (3)	12 (4)	12 (5)	13 (4)	13 (6)	14 (4)	14 (4)
Poland	81 (18)	81(25)	83 (29)	83 (31)	77 (39)	74 (47)	64 (46)	59 (45)
Slovak Republic	33 (18)	29 (14)	29 (13)	27 (11)	25 (11)	23 (14)	19 (13)	18 (15)
Slovenia	39 (6)	36 (4)	34 (4)	30 (3)	31 (5)	28 (6)	24 (5)	22 (6)

Note: The number in brackets is for foreign-owned banks.

Source: EBRD (2003), Transition Report.

Creating a supervisory body for the entire European financial system (insurance companies, investment funds, markets and banks) would be a one possibility, along the lines of the UK's Financial Services Authority⁷. An alternative would be to take into account the importance of the lender-of-last-resort in resolving crises. It may then be advisable for the Eurosystem to take on the prerogatives of banking supervision, just as it has responsibility for monetary policy.

Until now, a broad definition of subsidiarity has held sway concerning the functioning of the ESCB, in as far as implementing monetary policy decisions is concerned. The multinational nature of the euro zone, the existence of several large financial centres and national banking systems with strong links to national central banks have been major factors in determining this structure. If the future enlargement of the euro area leads to a re-examination of this organisation, then the consequences could go beyond the operational aspects of implementing monetary policy, in as far as this risks modifying the balance between the major financial centres of the euro area.

Jean-Pierre Pataat
jppataat@cepii.fr

8. Bank of England (1997), "Memorandum of understanding between HM Treasury, the Bank of England and the FSA", <<http://www.bankofengland.co.uk/legislation/mou.pdf>>.

LA LETTRE DU CEPII © CEPII, PARIS, 2004 EDITORIAL OFFICES Centre d'études prospectives et d'informations internationales, 9, rue Georges-Pitard 75015 Paris. Tél. : 33 (0)1 53 68 55 14 Fax : 33 (0)1 53 68 55 03	PUBLISHER: Lionel Fontagné Director of the CEPII CHIEF EDITORS: Agnès Chevallier Bronka Rzepkowski TRANSLATION: Nicholas Sowels DTP: Laure Boivin DISTRIBUTION: La Documentation française.	SUBSCRIPTION only to the original, French version. (11 issues per year) France 48 € VAT Europe 49.70 €VAT DOM-TOM (NET, econ. air mail) 49 €NET Other countries (NET, econ. air mail) 49.50 €NET Please send your orders to: La Documentation française , 124, rue Henri Barbusse 93308 Aubervilliers Cedex Tél. : 33 (0)1 40.15.70.00	WEB site: www.cepii.fr ISSN 0243-1947 CCP n° 1462 AD 2 nd Quarter 2004 June 2004 Imp. ROBERT-PARIS Imprimé en France <i>The CEPII is entirely responsible for the Lettre du CEPII and its on-line, English translation. The opinions expressed therein are those of the the authors.</i>
--	--	--	--