

CENTRAL BANKING IN THE EUROPEAN UNION

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A brief history of central banking

In the system of a society's government a key role is played by central banking. Since the 17th century, which can be considered the period when central banking emerged, we have been witness to the creation of a variety of institutional arrangements.

state, only later becoming issuing banks, to which were progressively added a series of further functions.

Besides institutional and functional characteristics, central banks also differed in terms of their operating framework, meaning that there were differences in the use of direct and indirect monetary policy instruments. The latter, of course, resulted from the characteristics of the

monetary circulation and from the need to solve, at a given moment, a problem in monetary development. In this regard therefore neither were the constructions of monetary objectives always identical, even if in the broader sense it is possible to find certain common elements.

As regards the legal standing and subsequently financial aspects of central banks, we can in this case speak of public institutions, companies

Table 1: Overview of central banks operating in Slovakia's territory

Central bank's name	Establishment
Privileged Austrian national bank	1 June 1816 The first branch in Slovakia – Košice in 1854
Austrian-Hungarian Bank	1878 The first branch in Slovakia – Bratislava in 1879
Banking Authority of the Ministry of Finance	6 March 1919 Origin of Czechoslovak currency – 25 January 1919
The National Bank of Czechoslovakia	1. april 1926
The Slovak National Bank	1939 Declaration of Slovak autonomy – 6 October 1938
The National Bank of Czechoslovakia	26. november 1945 The Slovak National Bank became a part of the National Bank of Czechoslovakia Single currency – Czechoslovak koruna – 1 November 1945
The State Bank of Czechoslovakia	Act No 31/1950 9 March 1950 Monetary reform in Czechoslovakia – 1953
The National Bank of Slovakia	Act No 566/1992 Coll. on the NBS as later amended, in particular amendments No 149/2001 Coll. and No 602/2003 Coll. on the NBS

By a variety of institutional arrangements we mean the differential coverage of monetary policy by entities – in history we can find examples formed for central banks created at the national and regional level; we can likewise find various central banking systems – from simple homogenous systems (one institution forming the central bank, e.g. the NBS) through to structured systems (for example the Federal Reserve System in the USA).

Besides the different institutional arrangement, we can see also a differentiated approach among central banks in carrying out their individual functions. Monetary authorities began to be considered as central banks only following the incorporation of an issuing function into their activities. This was not always however the primary function these institutions oversaw. From the historical aspect, the first "future" central banks at first performed the function of a bank to the

es formed from share capital (shareholder structure is differentiated), as well as of specific subjects, where in certain activities the central bank has the status of a body of general government, and in other activities (for example in the acquisition and administration of own assets) has the status of a business.

Despite these differences, it may be claimed that monetary authorities always featured as sophisticated institutions, recognised by the public. From both the aspect of aims fulfilled, as well as functions entrusted to them, central banks were, alongside governments, the most important entities in any country.

Current state of central banking in EMU

The establishment of the Economic and Monetary Union has stimulated processes of change in central



banking. Since 1 January 1999 two systems have operated within it, and in which the European Central Bank (ECB)¹ has a key standing. The first system is the European System of Central Banks, comprising the European Central Bank and the national central banks of the member states of the European Union², and the second system is the Eurosystem, comprising the ECB and national central banks of the member states of the Economic and Monetary Union (the EMU 12 member states).

With regard to the historical examples of the formation of monetary authorities at the national, or regional principle, we can to a certain degree draw a parallel also in the framework of the united Europe, on the other hand, central banking in the European Union has specific features.

A historical parallel may partially be considered to be the transfer in competences in directing monetary policy to the European Central Bank, where the difference may be deemed the fact that the responsibility for monetary policy lies not solely with the European Central Bank, but rather with the Eurosystem as a whole. The European Central Bank on its own is, at the same time, a special institution. Its exceptional nature is underlined by the fact that it is not derived from a national principle (it is not the central bank of any one country which performs functions also for other countries), but is a supranational institution.

The standing of the European Central Bank was legally codified back in the Treaty Establishing the European Community, in the part the Statute of the ESCB and ECB. This statute is also a part of the European Constitution, which at present is in the process of ratification by the EU member states. The subscribed capital of the European Central Bank is formed by shares of the individual national central banks of the EU member states, i.e. not only of the EMU national

central banks. This may also be considered a specific feature, since it is an historic first in the construction of subscribed capital.

Following the EU's enlargement in May 2004 by 10 new members its subscribed capital totals EUR 5,564,669,247.19 (Table 2)³.

The subscribed capital however is not fully paid up. The national banks in the Eurosystem have had to fully pay up their share, whereas non-members of the Eurosystem (the central banks of Britain, Sweden, Denmark and the 10 countries of central and eastern Europe) have had to pay up only 7% of the set share. Thus, of the total amount of EUR 5,564,669,247.19, EMU member central banks have paid up EUR 3,978,226,562.17 and non-members EUR 111,050,987.95, thus the total paid-up capital of the ECB represents EUR 4,089,277,550.12.

The largest shareholders from the aspect of the total amount of subscribed capital are the Deutsche Bundesbank, Banque de France and Bank of England (in total 50.3898%), of EMU members they are Deutsche Bundesbank, Banque de France and Banca d'Italia (in total 49.0592%). Of the new EU member states the largest shareholders are Narodowy Bank Polski, Česká národní banka and Magyar Nemzeti Bank (in total 7.9848%).

A further specific feature of the European Central Bank is its independence. The European Central Bank has institutional, financial, functional and staffing independence (see diagram 1)⁴. These forms of independence are today also the standard for central banks in the united Europe. Independence allows a central bank autonomy in its decision-making on the aims and procedures in monetary policy in the eurozone.

The main aim of monetary policy in the eurozone in this context is to ensure price stability, which in quantitative terms is set as the upper limit for growth of the harmonised index of consumer prices – HICP⁵ on an annual basis, and this of up to 2%, where the ECB takes this parameter to be a medium-term target. The monetary policy strategy of the ECB is a certain mix of the theoretically defined monetaristic transmission mechanism and inflation targeting. The first, basic pillar of the Eurosystem's monetary policy strategy is

¹ ECB was established in June 1998, but it began to fulfil the functions of a central bank only on 1 January 1999.

² In the period from 1 January 1999 to 1 May 2004 it was 15 national central banks, following the EU's enlargement to 25 members ESCB is formed, besides the ECB, by 25 national central banks.

³ Contributions of individual national central banks of member states to the ECB's subscribed capital were set according to the key, decided on by the Managing Council on 3 December 1998. The share of a national central bank in the ECB's capital represents a weighted share equalling the sum of two indicators, with a weighting of 50% each: 1. share of the given state to the Community population in the penultimate year, which preceded the establishment of the Eurosystem, and 2. share of this members state to the GDP at Community market prices for 5 years preceding the penultimate year prior to the establishment of the Eurosystem. Percentages are rounded up for the next multiple of 0.05%. The level of the subscribed capital was to be adjusted every 5 years. Following the EU's enlargement by 10 new countries and also by ESCB, the ECB adopted a new key for subscribing the subscribed capital in its decision of 22 April 2004 – for more details see table 2.

⁴ For more information see: Kotlebová, J.: Medzinárodné finančné centrá. IURA Edition Bratislava 2004, Chapter 3 Európska integrácia v Európe.

⁵ Note: HICP – the basic components of this index are prices of goods – in the division into processed and non-processed, further industrial goods and energy, and the second component of this index are prices of services. For example in 2001 the prices of goods represented 61.9% of the index, whereas prices of services only 38.1%.

Table 2: Subscribed capital of the European Central Bank

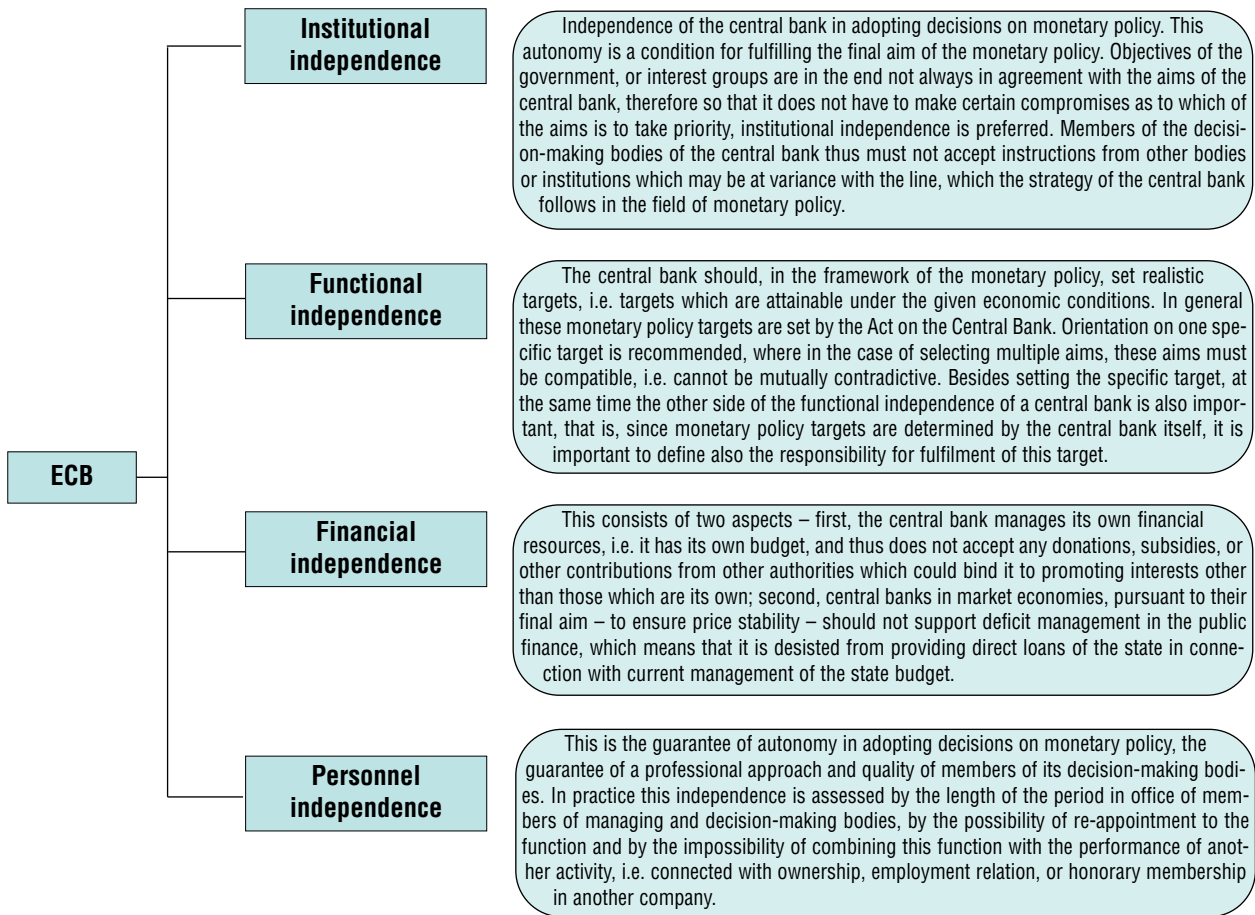
National central bank	Share in the subscribed capital			
	ECB Decision of 3 Dec. 1998	ECB Decision of 22 April 2004		Paid-up capital as at 1 May 2004
	%	%	EUR	EUR
Banque Nationale de Belgique	2.8658	2.5502	141 910 195.14	141 910 195.14
Deutsche Bundesbank	24.4935	21.1364	1 176 170 750.76	1 176 170 750.76
Bank of Greece	2.0564	1.8974	105 584 034.30	105 584 034.30
Banco de España	8.8935	7.7758	432 533 093.09	432 533 093.09
Banque de France	16.8337	14.8712	827 533 093.09	827 533 093.09
Central Bank and Financial Services Authority of Ireland	0.8496	0.9219	51 300 685.79	51 300 685.79
Banca d'Italia	14.8950	13.0516	726 278 371.47	726 278 371.47
Banque centrale du Luxembourg	0.1492	0.1568	8 725 401.38	8 725 401.38
De Nederlandsche Bank	4.2780	3.9955	222 336 359.77	222 336 359.77
Oesterreichische Nationalbank	2.3594	2.0800	115 745 120.34	115 745 120.34
Banco de Portugal	1.9232	1.7653	98 233 106.22	98 233 106.22
Suomen Pankki	1.3970	1.2887	71 711 892.59	71 711 892.59
Total for EMU members	80.9943	71.4908	3 978 226 562.17	3 978 226 562.17
Česká národní banka	-	1.4584	81 155 136.30	5 680 859.54
Sveriges Riksbank	2.6537	2.4133	134 292 162.94	9 400 451.41
Danmarks Nationalbank	1.6709	1.5663	87 159 414.42	6 101 159.01
Eesti Pank	-	0.1784	9 927 369.94	694 915.80
Central Bank of Cyprus	-	0.1300	7 234 070.02	506 384.90
Latvijas Banka	-	0.2978	16 571 585.02	1 160 010.95
Lietuvos bankas	-	0.4425	24 623 661.42	1 723 656.30
Magyar Nemzeti Bank	-	1.3884	77 259 867.83	5 408 190.75
Bank Centrali ta' Malta/Central Bank of Malta	-	0.0647	3 600 341	252 023.87
Narodowy Bank Polski	-	5.1380	285 912 705.92	20 013 889.41
Banka Slovenije	-	0.3345	18 613 818.63	1 302 967.30
Národná banka Slovenska	-	0.7147	39 770 691.11	2 783 948.38
Bank of England	14.6811	14.3822	800 321 860.47	56 022 530.23
Total for EMU non-members	19.0057	28.5092	1 586 442 685.02	111 050 987.95
TOTAL	100	100	5 564 669 247.19	4 089 277 550.12

the analysis of the development of the M3 money aggregate in relation to a reference value. The second pillar is the analysis of the development of a broad set of economic and financial indicators. The combination of the two pillars of the Eurosystem ensures that monetary, financial and economic development is carefully and thoroughly monitored. This thorough analysis enables the ECB to set interest rates at a level best serving to maintain price stability.

Three bodies operate within the ECB, these being the Governing Council, Executive Board of the ECB and General Council. The supreme body is the Governing Council (composed of members of the Executive Board of the ECB and of the governors of the national central banks of eurozone states), the key role of which is to formulate monetary policy. The Executive Board of the ECB (composed of the president of the ECB, its vice-president and four other members) has the task of implementing monetary

policy and to this end gives instructions to the national central banks of the Eurosystem. The Governing Council of the ECB (composed of the president of the ECB, its vice-president and the governors of the national central banks of all EU member states) is involved in the advisory and coordination activity of the ECB. In connection to the enlargement of the EU, from 1 March 2004 new Rules of Procedure have been in force at the ECB. These Rules define also the relations between the Governing Council and the General Council of the ECB, as well as relations between the Executive Board and the General Council of the ECB. The General Council of the ECB has for example, pursuant to these Rules, the right to comment on proposals prior to their approval by the Governing Council, where these proposals concern Article 4 and 25.1 of the Statute of the ESCB and ECB, to comment on recommendations in the field of statistics in accordance with Article 42 of the Statute

Diagram 1: Independence of the European Central Bank



of the ESCB and ECB, on the Annual Report, on standardisation rules in accounting and reporting, staffing conditions at the ECB, as well as the conditions for the transition of countries with a derogation over to irrevocable fixed exchange rates. In relation to the Executive Board the General Council of the ECB has the right to comment upon draft legal norms in the case of which this is explicitly required by the Statute of the ESCB and ECB.

In the European Constitution, the part concerning the Statute of the ESCB and ECB already contains paragraphs concerning changes to the voting system in the Governing Council of the ECB following the entry of further countries into EMU. This new voting system is constructed on the principle of the future 27 members of the eurozo-

ne, where 6 members of the Executive Board of the ECB will have a permanent vote (6 votes) and 15 votes will rotate depending on the group into which the respective national central bank (represented by its governor) is included according to the given country's share in the GDP of the member states without derogation, at market prices and according to the given country's share in the aggregated balance of the monetary financial institutions of member states

Diagram 2

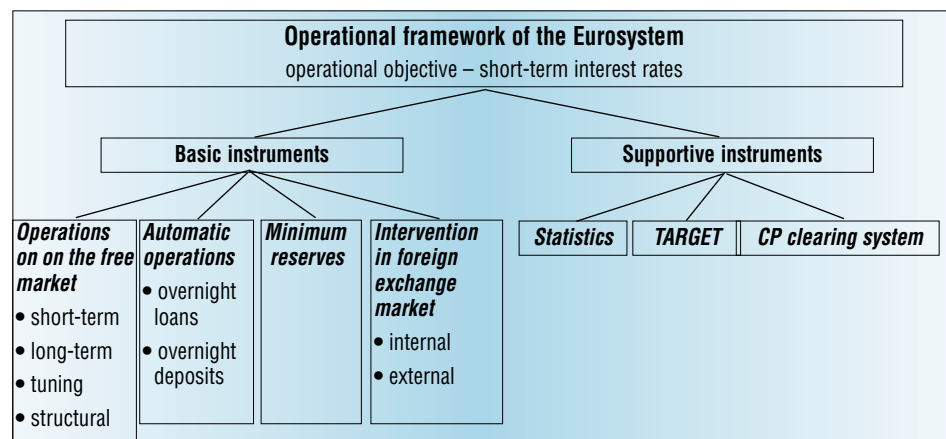
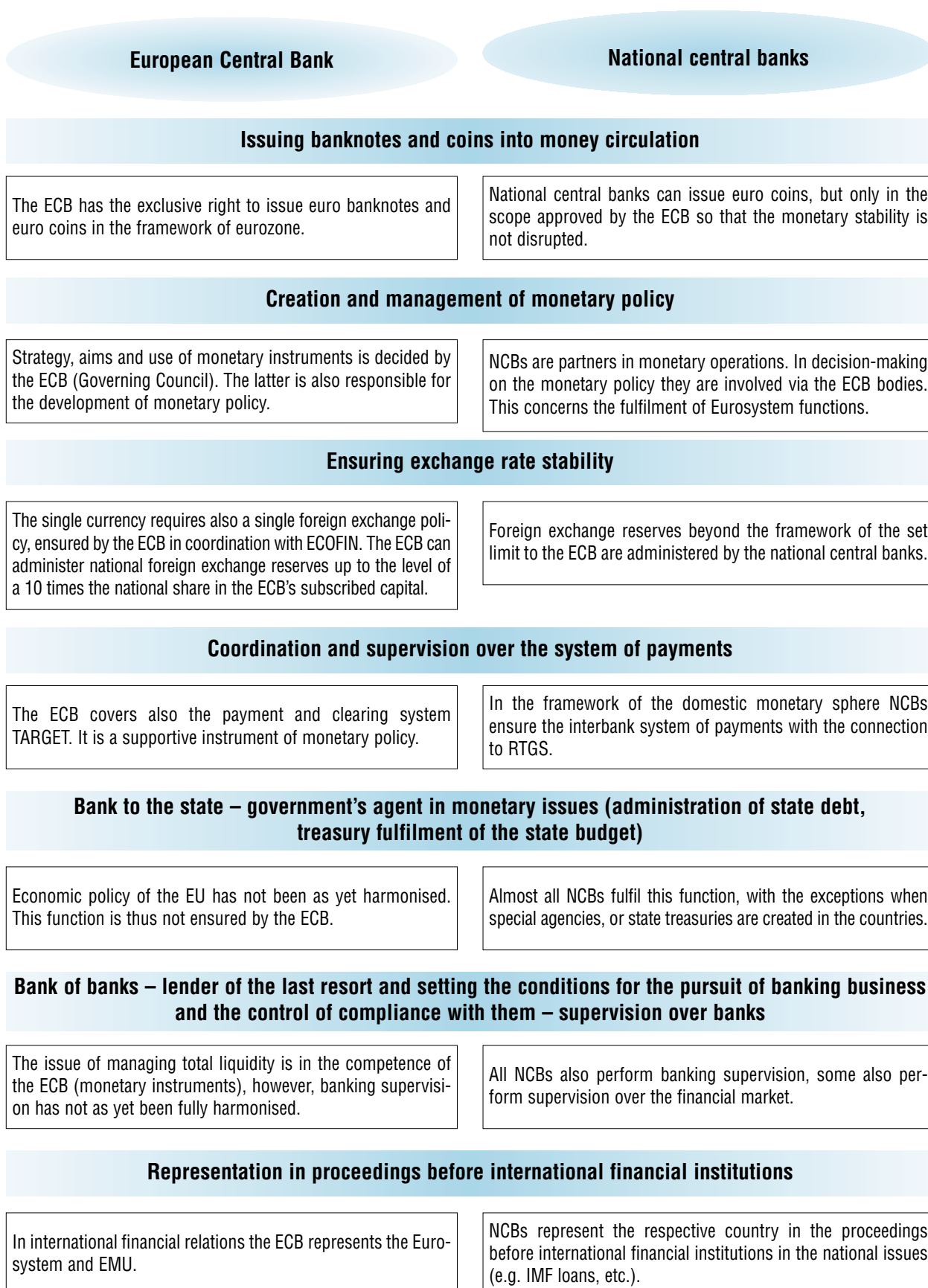


Diagram 3: Functions of the central banks in the Eurosystem





without derogation.⁶ The first share has a 5/6 weighting in the total evaluation, and the second share a 1/6 weighting. Provided the number of governors in the Governing Council ranges from 15 to 22, two groups will be compiled. The first group will comprise 5 governors with the best shares (as defined above) and the second group will comprise the remaining governors. The first group will have a weighting of 4 votes and the second group 11 votes. Once the number of governors exceeds 22, these governors shall be divided into three groups, where the first group shall comprise 5 governors with a total number of 4 votes, the second group will comprise half the remaining governors with a total number of 8 votes and the third group will comprise the rest of governors, with a total number of 3 votes, still divided according to the mentioned two criteria (shares). Once the number of eurozone members reached 27, the first group will be engaged in the voting with 80% frequency, the second 57% and the last 38%. Within the individual groups governors will over time have always an equal share in the voting, on the principle of rotation. In the voting, a decision is made on the basis of a two-thirds majority.

Thus, in the long run only EMU members will decide on the manner of realising the ECB's monetary policy. Monetary instruments are available to the European Central Bank in its execution of monetary policy. These are of an indirect nature, i.e. market instruments (see Diagram 2). The predominance given to the use of indirect instruments in monetary policy may be considered a common feature of central banking around the world. Operations on the free market in the Eurosystem may take the form of direct transactions, repo trades, the collection of term deposits, bond issues and exchange rate swaps.

The main refinancing operations are used most, with a frequency and maturity of one week.

Changes in central banking in the changeover from the EU to EMU

The main functions of central banks operating in the new era are around the world generally considered to be:

- the issuing of bank notes and coins into national money circulation,

- the creation and management of monetary policy,
- ensuring exchange rate stability of the domestic currency,
- coordination and supervision over the system of payments,
- the bank to the state – the government's agent in monetary issues (administering the state debt, treasury performance of the state budget),
- the bank of banks – a lender of last resort and setting the conditions for the pursuit of banking business and the control of compliance with them – inspection of and supervision over banks,
- representing the country in proceedings before international financial institutions.

The establishment of EMU brought about a transformation of national banks' functions. Today we talk of Eurosystem and non-Eurosystem functions. Since the preponderance of competences and responsibilities lies with the European Central Bank in the Eurosystem, Eurosystem functions of the national central banks essentially mean the support and unified procedure in realising ECB objectives in accordance with declared monetary policy aims in the eurozone. National central banks in EMU enter into a relationship with the ECB as partners in monetary operations, though decision making on the orientation of monetary policy, and thus also changes in monetary instruments, lies wholly within the powers of the ECB. Non-Eurosystem functions are then other central bank functions ensured by these banks in relation to the national economy (see diagram 3).

As regards central banks in the EU which are not Eurosystem members, these until entering EMU perform an autonomous monetary policy. Their representatives' participation on the Governing Council of the ECB and on ECB committees enables them to coordinate procedures and gain experience of the single monetary policy. However, until entering EMU these national central banks have discretion as to in what operative framework they will realise this monetary policy. Thus, the derogation principle also applies to the field of monetary policy. With regard to the objective of entering also EMU these national central banks will endeavour to harmonise also the strategic and operative framework of monetary policy.

As regards changes in the system of exchange rates applicable in EMU – with the fact that the EU has expanded to 25 states, the first step on the road to EMU is to enter the ERM II exchange rate system, which in essence means the fixing of the national currency's exchange rate to EUR and maintaining its fluctuation band within $\pm 15\%$ without currency devaluation for a period of two years. Of the old non-EMU member states only Denmark is presently participa-

⁶ Recommendation, under Article 10.6 of the Statute of the European System of Central Banks and of the European Central Bank, for a Council Decision on an amendment to Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank (ECB/2003/1) (2003/C 29/07) (Submitted by the European Central Bank on 3 February 2003).



ting, using the narrower band of $\pm 2.25\%$; of the new EU member states Estonia, Slovenia and Lithuania joined the ERM II system in June 2004, in the broader band.

The transition to EMU means a certain curtailing of the functions previously performed by central banks. All central banks perform also other tasks, such as gathering statistics and research in the field of monetary policy. Some also maintain a register of credit or securities. In each case the transition to the Eurosystem presents the question of whether it will mean a loss of national sovereignty in the field of monetary policy, and whether it will be reflected also in a reduction of the professional personnel who will perform these functions in the future.

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