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European Monetary Union: Issues in Supervision

After giving a short introduction to the European Monetary Union, different aspects are concerned.

The objectives of the growing cross border banking and therefore a banking transfer system for the whole EU, called TARGET is shown. A look on the supervision and its unification aspects follows. The separation of central banking and supervision in the EMU is discussed. The impact of the EMU and its related tasks and impacts on business are critical viewed. For closing the observation, it will be announced what should be done , with regard to supervision, to form one financial system.

Cross border banking and TARGET:

Separation of central banking and supervision:

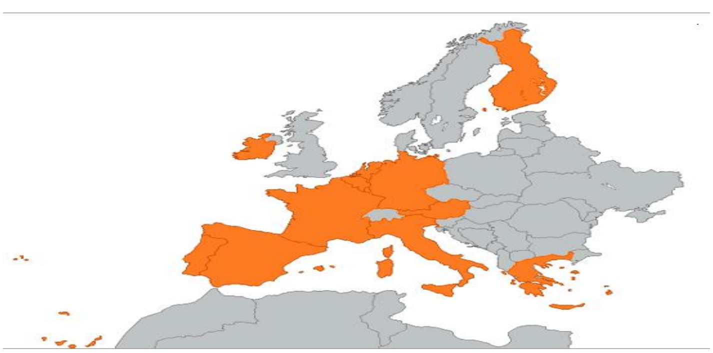
Impacts on business:

INTRODUCTION

Participating countries in the European Monetary Union:

12 Member States of the European Union are participating in the common currency. They are:

Belgium, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, The Netherlands, Austria, Portugal and Finland.



Denmark, Sweden and the United Kingdom are members of the European Union but are not currently participating in the single currency. Denmark is a member of the Exchange Rate Mechanism II (ERM II), which means that the Danish krone is linked to the euro, although the exchange rate is not fixed.

How did the euro evolve?

Our new single currency originates in the Treaties. All the Treaties were prepared and signed by members of the European Council, which comprises the Heads of State or Government of each of the Member States of the European Union (EU), and then ratified by each country according to national legislative procedures. The elected governments of Member States together created and developed the euro. In Madrid in December 1995, the European Council adopted the name euro. The European Central Bank (ECB) was established on 1 June 1998. It is based in Frankfurt am Main, Germany, and aims to maintain price stability and to conduct a single monetary policy across the euro area.

The European System of Central Banks:

The national central banks (NCBs) of the European Union, along with the European Central Bank (ECB), make up the European System of Central Banks (ESCB). The NCBs of Member States not participating in the euro area, Denmark, Sweden and the United Kingdom, have a special status which allows them to conduct their own national monetary policies, but not to take part in deciding and implementing monetary policy for the euro area.

The Eurosystem:

The national central banks of the euro area together with the ECB are known as the Eurosystem. The Eurosystem's primary objective is the maintenance of price stability. It meets its objectives through:

- Deciding and implementing monetary policy.
- Conducting foreign exchange operations.
- Operating payment systems.

The NCBs of the participating Member States played a key role in the smooth transition to the euro. Their responsibilities have included:

- Introducing the euro in their respective countries.
- Managing the changeover from national currencies to the euro.
- Creating the necessary systems to effectively circulate the euro banknotes and coins.
- Withdrawing national currencies.
- Providing advice about and promoting the use of the euro.

What is TARGET?

Distinctive features of the system and how it works

TARGET, which stands for the Trans−European Automated Real−time Gross settlement Express Transfer system, is the real−time gross settlement system for the euro.

TARGET consists of fifteen national real−time gross settlement (RTGS) systems and the ECB payment mechanism (EPM), which are interlinked so as to provide a uniform platform for the processing of cross−border payments. TARGET is more than simply a payment infrastructure; it try to offer a premium payment service which overcomes national borders between payment systems in the EU.

TARGET is very easy to use. To initiate a cross−border payment via TARGET, participants simply send their payment orders to the euro RTGS system in which they participate using the domestic message format with which they are familiar. TARGET takes care of the rest. The beneficiary participant will receive the payment message in its domestic message format.

Why TARGET has been developed

TARGET has been developed to achieve three main objectives:

− To provide a safe and reliable mechanism for the settlement of cross−border payments on an RTGS basis;

− To increase the efficiency of intra−EU cross−border payments; and, most importantly,

- To serve the needs of the ESCB's monetary policy.

Which payments can be made and who can use TARGET?

It is possible to make credit transfers to almost all EU credit institutions via TARGET without any limitation on value. With special emphasis on large−value payments related to money market and foreign exchange operations TARGET contributes to reducing systemic risk.

What are the advantages of using TARGET?

Flexible liquidity management

Liquidity in TARGET is widely available and the turnover of funds can be high. This will facilitate liquidity management compared with net settlement systems, where liquidity is trapped until end−of−day settlement.

Risk reduction

TARGET provides a firm foundation for the management of payment system risks. It gives participants the possibility of settling payments in central bank money with immediate finality, thus eliminating the settlement risk between participants which is inherent in other payment mechanisms.

Real−time operation

The high speed at which cross−border payments in TARGET is processed and facilitates and improve cash management. Moreover, this enable participants to increase their turnover of funds.

For cross−border TARGET payments, under normal circumstances, the average time between the debiting of the account of the sending participant and the crediting of the account of the beneficiary participant will be a couple of minutes, if not only a few seconds.

Operating times to suit everyone

To meet the needs of its customers and those of financial markets in general, TARGET have long operating hours, common to all EU countries. The system is available from 7 a.m. to 6 p.m. Frankfurt time.

The long TARGET operating hours helps to reduce foreign exchange settlement risk substantially. The TARGET business day will overlap with the Fedwire system in the United States completely and with the Bank of Japan Payment System during the first operating hours in the morning.

The possibility of reaching almost any EU credit institution

It is possible to reach almost all credit institutions established in the EU via TARGET and, hence, all their account holders.

Full end−to−end transmission of information in TARGET payment messages

No payment−related information is lost in TARGET. The payment instruction, if provided in accordance with the standards, always is forwarded in its entirety to the beneficiary participant.

The cost of making a payment

TARGET results in cost savings for the following reasons:

- Incoming funds is available for immediate re−use;

- It is possible to reconcile accounts on an intraday basis;
- Immediate reaction is possible should any problem arise with regard to
- the transfer of a payment
- The need to split liquidity between several payment systems during the day can be avoided.

This second part of the paper deals with a look on the separation of central banking and supervision in the European Monetary Union (EMU).

Separation of central banking and supervision in the EMU

First a distinction has to be made between the different institutions involved. The eleven members of the EMU replaced their currency 1999 and on 1st January 2002 the money was replaced against the Euro. With this not only a high degree of economic integration and interaction came up, also a single institutional and legal framework for a single monetary policy was announced. This single monetary policy is formulated by an institution called Eurosystem. It includes the ECB and the eleven National Banks (NCB).

Before the treaty of Maastricht, in every European country the NCB was responsible for the monetary policy. They also did the supervision. So you got monetary policy and supervision both from one institution. Today the Eurosystem puts up the monetary policy. The supervision regulations are different in every EMU member state. The monetary policy and the supervision now comes from two different sides, the Eurosystem on the one side and the different NCB`s on the other. Interest conflicts among the goals of these two different types of institutions can evolve, as shown later in an example. This is the main problem in creating a single financial system, the EMU.

The NCBs are forced to work together with the Eurosystem, laid down in the treaty establishing the European Community TITLE VII (ex Title VI) ECONOMIC AND MONETARY POLICY Chapter 2: Monetary policy Article 105 (ex Article 105): 5. The ESCB (ECB and NCB of the 15 EU members) shall 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.

Every country of the EMU has an interest in maintaining its own banking system stability. Decisions relating to this issue can stand in contrast to the monetary policy of the EMU. A typical example to clarify this conflict could be:

If the regulations in supervision are not strong enough there is the possibility that a bank does give loans for projects which are too risky and there is a significant chance that the money could be lost. In case that the bank loses an enormous amount of money in bad loans the bank could get insolvent because there is not enough equity to cover the risk. This can cause a crisis in the banking sector, because trust is a most important factor for bank customers. If one bank gets insolvent, the customers do not get their money back and they might loose trust in the bank system in that country in general. Most people then try to get their money out of their banks as fast as possible and a banking crises arises. At the point where one bank may become insolvent, the NCB wants to intervene and this stabilization of the banking sector may be in contrast to the monetary policy of the Eurosystem. The risk of Moral Hazard comes up where the NCB pulls out money to the insolvent bank, not taking into account that the Eurosystem wants to keep the supply of money to the banks short because of inflation risks. The problem that monetary policy and supervision are in two different institutions becomes visible. Article 105 covers this problem and tries to establish a more uniform system for banking supervision.

The goal is to have a standard in banking supervision in all countries of the EMU. The Banking Supervision Committee of the ESCB is the present forum for this form of co−operation.

The present situation is fine, but further co−operation is needed because the economies grow together and more cross border banking is done. Additionally the number of financial conglomerates grows, which also provide the costumers more and more with banking services.

In the long run every bank and financial conglomerate in the whole EMU region needs to be integrated to guarantee a uniform supervision and therefore financial and economic stability.

The means of improving the multilateral co−operation will be further supplied on a lower organizational level by the Groupe de Contact, a group of EU banking supervisory authorities. This proves that the EMU undertakes ongoing efforts in solving economic integration key issues.

IMPACT ON BUSINESS

How will the introduction of the euro affect companies' marketing strategies?

Naturally, the much improved price transparency across national markets in the euro area will encourage companies to reduce or remove any differences in the prices of their goods and services, except those that can be justified by specifically local circumstances.

Thus, prices of some goods and services in certain markets can be expected to fall. Pricing will be a very important issue for companies in mass consumer goods markets whose products are priced to sell at so−called sensitive or psychological points such as belgian Franc149 or French franc 49.

These do not convert into equivalent price points in euro, which means that some companies will repackage products or change their weights in order to preserve their profit margins.

All companies in countries which trade in the euro area will have to similarly review their marketing strategies.

Small and medium−sized enterprises:

Economic and Monetary Union will bring small and medium−sized enterprises more choice and business opportunities. Many will be made stronger and more competitive by :

- the disappearance of exchange rate risk in most of the European Union largest markets. In the past, these smaller companies have not had the same access as larger companies to financial instruments to hedge against currency movements.

- increased competition in the banking industry and lower interest rates. These should enable small and medium− sized enterprises to finance their operations at a much more favourable cost than they used to do it.

They are going to think like in a domestic market.

Small and medium−sized enterprises will have the possibility of selling their products and services across bigger areas (economies of scale) to more potential customers.In other words, difficult exporting turns into a easier domestic business exercise.

In the process, Small and medium−sized firms will be encouraged to incorporate innovation and new technical solutions into their business strategies, to the benefit of all the European economy.

Large enterprises:

The impact on bigs enterprises will be different. Large companies operating across Europe will enjoy a reduction in many of their costs, notably in the areas of treasury management, foreign exchange transactions and through the elimination of much of today's foreign exchange risk. But the impact of the euro in these enterprises will be bigger here ,and will affect employment policies, pricing and marketing and decisions on the location of production and distribution centers.

Competition in some sectors will undoubtedly be stronger and with much greater price transparency, the cost to consumers of several goods in several markets may even be expected to fall.

CONCLUSION:

We have looked at the euro area as one that has a central bank which does not carry out banking supervision. This would be normal, because in many countries banking supervision is not a task of the central bank. What is unique is that the areas of jurisdiction of monetary policy and of banking supervision do not coincide.

This situation requires, first of all, the establishment of smooth co−operation between the Eurosystem and the national banking supervisors, as is the case at the national level where the two functions are separated.

The most important reason for this is, of course, the scenario where the provision of liquidity from the central bank has to be made in a situation that is generated by problems of interest to the supervisor. But beyond that, we do not know any country in which the central bank is not very closely interested in the state of health of the banking system, irrespective of its supervisory responsibilities.

We should move as rapidly as possible to a model in which the present division of the geographical and functional jurisdiction between monetary policy and banking supervision plays no significant role.

The system of national supervisors needs to operate as effectively as a single authority when needed. While the causes of banking problems are often local or national, the propagation of problems may be total. The banking industry is much more of a system than other financial institutions.

At the moment we are far from having a common supervisory system. But since the euro has been launched, we have to wait for until need will be set in place.

There is no expectation, that the division of responsibility in the euro area between the central bank and the banking supervisory functions should be abandoned. The Treaty has a provision that permits the assignment of supervisory tasks to the European Central Bank, that we consider it´s very important, and that will allow a kind of euro area collective supervisor that can act effectively as if there was only one supervisor. This is desirable in the first instance to render the supervisory action more effective against the background of current and future challenges and, second, to assist the Eurosystem in the performance of its basic tasks.

To conclude, the view for the euro area appears to be favourable for an upswing in economic growth accompanied by price stability. With the appropriate policies in place, the impulse of growth might eventually turn out to be even stronger than currently expected.

Against this background, the Governing Council of the ECB stay both confident and vigilant.

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