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## MONETARY UNION IN PRACTICE: Lessons from European Monetary Union\*

Sheriffdeen A. Tella, Ph.D

*Financial integration is harder to achieve than economic integration. The currency of a country, like its flag, is the most important symbol of its separate identity ... so few African countries will lightly part with their separate units of currencies into a nebulous inefficient central institution in the name of financial integration .... But like Ecclesiastes, if we stand singly we risk the pain of death, together in our weaknesses Africa will constitute a sleeping giant that may and should wake up in the future. (Is that future here?)*

(Aluko, 1992)

### L. INTRODUCTION

Monetary integration is the heart of economic integration. While intra-regional trade usually forms the primary focus of economic integration, the imperatives of monetary integration, which involves harmonising monetary and fiscal policies, as well as integration of the money and capital markets of the integrating partners, is never overlooked. The *raison d'être* for such harmonisation is underscored by the fact that regional stability founded on sound economic framework and payments system, which monetary integration entails, tend to withstand disruptive external shocks and the consequent grave implications of one or two members abandoning the integration arrangement.

Full economic integration process that relegates monetary cooperation to the background while establishing a custom union, as the first step, is bound to face problem of foot-dragging when it finally decides to return to the realm of monetary integration (Delors Report, 1989). It is noteworthy that African countries are aware of the importance of economic integration generally and the particular need to harmonise their macroeconomic policies, which principally involve synchronisation of monetary and fiscal policies as well as promote efficient money and capital markets. Thus, monetary integration or monetary union has been an integral part of the Treaties of most of the Regional Economic

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Communities (RECs) in Africa. Chapter VI of the Treaty establishing the Economic Community of West African States (ECOWAS) is devoted to the issue of money finance and payments systems. In this regard, Article 44, paragraphs 1 and 2 of the Treaty state *inter alia*:

Monetary cooperation will entail that member States shall, within a time-table to be determined by the Assembly, harmonise their monetary, financial and payments policies, in order to boost intra-community trade in goods and services, to further the objectives of the community and to enhance monetary and financial cooperation among Member States.<sup>1</sup>

Conducive economic environment, which includes developed financial market, is a necessary condition for achieving the objectives of monetary integration. Without such market standard, the payments system would be cumbersome, the foreign exchange market under flexible exchange regime would be highly distorted and more importantly, the use of monetary policy will be highly ineffective.

It is within this context that this paper sets out to discuss the nature of the environment and the actual practice of monetary integration in the European Monetary Union, which is regarded as the most successful among its peers in the world. The outcome of this paper should be able to provide readers and listeners with the elements that bring about this success story. The paper is divided into five sections including this introduction. Section 2 explains the definition, criteria and forms of monetary integration while Section 3 contains the core of the paper which describes the practice of monetary integration in the European Union (EU). Section 4 is the final section and contains summary and concluding remarks.

## **2.1. Definition, Forms and Criteria for Monetary Integration**

The need to understand the definitions and criteria for successful monetary integration efforts is germane for meaningful discussion of monetary union. Monetary

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<sup>1</sup> This is also stated in Chapter VII of the Abuja Treaty establishing the African Economic Community.

union is defined by Max Corden (1972)<sup>2</sup> as involving two components viz. “exchange rate union, that is, an area within which exchange rates bear a permanently fixed relationship to each other...” and “convertibility – the permanent absence of all exchange controls, whether for current or capital transactions within an area”. Allen (1976)<sup>3</sup> defines a monetary union with the following characteristics: (i) a single money, or several currencies fully convertible at immutably fixed exchange rate; (ii) an arrangement whereby monetary policy is determined at the union level, allowing no national autonomy in monetary policy; and (iii) a single exchange rate policy with a common pool of external reserves of members.

Masson and Pattillo (2001a) posit that “a monetary union is a zone where a single monetary policy prevails and inside which a single currency or currencies which are perfect substitutes circulate freely”. Based on the definitions and criteria above, Chipeta and Mkandawire (1994) expatiate on the characteristics of monetary union as:

- i. Use of a common currency, or if there exists several currencies, the existence of a permanently and rigidly fixed exchange rate relationship between the currencies.
- ii. A common monetary and fiscal policy to ensure control over the creation of high-powered money and the expansion of government debts.
- iii. A central management of the common pool of foreign exchange reserves, external debts and exchange rate policy.
- iv. The existence of a regional monetary authority or central bank which should be the sole issuer of the economy wide currency, in the case of a full currency union.
- v. Harmonisation of domestic credit which can be achieved by the imposition of credit ceiling at the central monetary authority. The national monetary authorities retain the allocation and distribution of domestic credit between sectors.
- vi. A common development bank to finance regional and national projects that will assist in the integration processes and reduce economic disparities between the member countries.

Five forms of monetary integration can be identified in literature. These are limited currency convertibility, parallel currency union, partial monetary union, single currency union and full economic and monetary union.<sup>4</sup>

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<sup>2</sup> Cited by Masson and Pattillo (2001a)

<sup>3</sup> Cited by Masson and Pattillo (2001a)

Under the *limited currency convertibility*, all exchange restrictions involving the use of the sub-regional currencies are removed. The countries involved agree to harmonise their exchange rates and adopt a policy of uniform variation of these rates with the rest of the world. The unrestricted exchange and use of the members' currencies make it essential to have a clearing house through which transactions are channelled.

The *parallel currency union* situation allows for the circulation of a common currency along side national currencies, which have defined and fixed relationship with the common currency. This is also referred to as *mutual currency management arrangement* (Crockett, 1991). This was the former system by the European Union under the European Monetary System (EMS) and the current system in the Common Monetary Area (CMA) in Southern Africa.

In the *partial monetary union*, the participating countries agree to implement the same exchange rate regime (fixed or floating) and establish a fixed exchange rate between their currencies and the regional rate. The *single currency model* involves the creation of a monetary zone with a single currency; a common pool of external reserve and the management of monetary, fiscal and other financial policies are unified. However, each member retains its central bank. This is the present model in the European Union (EU) and is closest to *full economic and monetary union* where a single central bank is established to provide central banking services to all members. In this case, the common central bank not only produces the region-wide currency but monetary policy is also centrally arranged, based on some laid down criteria. Although members have the freedom to determine their fiscal policy operations, the central arrangements have implicit influence on the domestic fiscal policy. For instance, budget deficit could be fixed as a percentage of the reserve. The common example exist in the CFA zones (CEMAC and UEMOA).

For any form of monetary union to succeed however, some criteria have to be satisfied. It is important to discuss these criteria since the satisfaction of most of them had contributed to the success of the EU.

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<sup>4</sup> (for details see Crockett, 1991; Taylor, 1994; Chipeta and Mkandawire, 1994; Soyibo, 1998).

Mundell (1961) posited that the *degree of factor mobility* within a currency union is of utmost importance. In this connection, movement of labour and capital goods across borders is not restricted such that it is easy for factors to move to areas where they can earn maximum remuneration for the services rendered. Also within this scope, restriction on repatriation of income of non-national is eliminated. An essential requirement here is the presence of at least, *an internally convertible currency* within the union.

McKinnon (1963) opined that *openness and regional interdependence* are important elements in monetary union. High intra-regional trade, for example, will bring about greater benefit from the reduction in transaction cost associated with the use of a common currency. However, large changes in the nominal exchange rate, e.g. large depreciation occasioned from outside the area may generate disruptive movements in the cost of living across country. This is why Frankel and Goldstein (1991) suggested that there should be a *diversified production base* in the region. They contended that the more diversified an economy's production structure, the less likely it is that a demand or supply shock to an industry (or an economy) will cause an economy-wide disruption.

There must be *a mix of macroeconomic policies* to counter any country-specific real shocks and stabilise the economy before economy-wide disruption occurs (Frankel and Goldstein, 1991). Masson and Pattillo (2001b) contended that asymmetry of shocks could be less of a problem if there is substantial labour mobility or if there exists a system of fiscal transfer across the region. Another important criterion is the existence of *a developed capital market*. An integrated economy-wide capital market that is free from geographical restrictions of any kind and aids capital movements is imperative in a currency zone (Dadzie, 1990).

The above set of criteria assumes the existence of a capitalist state where the market mechanism works. Hence, the existence of a large private sector operating on free, deregulated and competitive environment is taken for granted. While developed countries like those within the European Union enjoy these operating elements, many developing countries, including ECOWAS members, are just transiting to market economies and the dismantling of tough regulations on the activities of the private sector has not been completed. Thus, the absence of *a vibrant private sector* could constitute a big problem in the achievement of an

ideal monetary zone. This is because efficient banking and other financial businesses, as well as trading, manufacturing, et cetera are within the purview of well-organised private sector. Albeit, there should also exist availability of *highly skilled manpower* that can run these businesses efficiently.

## 2.2 Benefits and Cost of Monetary Integration

All ventures have gains and losses, and this includes monetary integration exercise. It is therefore desirable to create time to understand the benefits and costs, in order to maximise the benefits and minimise the costs. These costs and benefits go beyond economic alone but are also social and political. Jones (2000) succinctly highlights some of the benefits thus<sup>5</sup>:

- i. The common pool of foreign exchange reserves provide reservoir for payments for the transactions undertaken in intra-REC thus reducing cost of transactions within the REC.
- ii. There will be a reduction in the cost of financial management and the elimination of speculative capital flow, thus relieving the national authorities of the frustration in monetary control. The integration will allow the spreading of the overhead cost of financial transactions widely.
- iii. Stability of the exchange rate and convertibility of the domestic currencies enhance trade and optimal use of capital, as it is moved to where it will give highest reward.
- iv. The resulting integration of the capital market will enhance capital flow into the region. Both foreign direct investments and portfolio investments will be encouraged and this will have further positive effects on the budding stock exchange markets.
- v. The membership of a monetary union may help make the shocks hitting member countries more symmetric and also expand intra-union trade. This is particularly true if there is substantial labour mobility or if there is a system of fiscal transfer across the region.

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<sup>5</sup> See also Frankel and Rose, (1998); Masson and Pattillo (2001a).

The major losses include:

- i. Loss of autonomy of action in some areas of policy formulation. The cost of a monetary union derives from the fact that when the country surrenders its national currency, it invariably relinquishes an important instrument of economic policy. The country will not be able to change the price of its currency at will nor determine its money supply.
- ii. Although the country can formulate and implement its fiscal policy, there is always a link between monetary and fiscal policy. In the case of fiscal expansion to generate employment for instance, the government will have to rely only on fiscal tool like reducing taxes alone, whereas this could have been complemented with the use of interest rate and other monetary tools. Important ingenuity will thus be required to carry on with “one-leg” independent policy.
- iii. Problems of uneven development could occur if capital flows mainly to the more developed countries, unless the fiscal compensation system is well developed to reduce the stress. This is why a development finance institution must exist to use the surplus in the economy-wide reserve for development assistance for less developed members.

The foregoing sets of information necessarily provide the bedrock into the discussion that will be undertaken in the succeeding section which is the kernel of this paper.

### **3.0 Monetary Union in Practice: The European Monetary Union**

The core institution of the European Monetary Union is the European System of Central Banks (ESCB) which comprises of the European Central Bank (ECB) and the central banks of the Member States. This is in accordance with Article 8 of the Treaty establishing the European Community. Thus monetary union practices should focus on this institution and this is the accepted format for this paper, albeit we consider a brief discussion on the European Union or Community as imperative before detailed exposition of the ESCB.



### 3.1. The European Union

The European Common Market transformed into European Union in 1999 and currently comprises of Austria, Belgium<sup>6</sup>, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain as members. Although Denmark, Sweden and the United Kingdom have always been and remain members of the Union, they have not fully agreed with the tenets of the Union with respect to monetary union.

At the formation of the Union in 1999, the member countries accounted for 15.5 per cent of world GDP and 32 per cent of world exports (IMF, 1999). From Table I, it is clear that the group maintained the highest intra-regional trade amongst the existing trading blocs in both the developed and developing countries. The intra-REC trade accounted for 60.8% in 1980 and peaked at 65.9% in 1990 before declining to 55.5% in 1997. As at 1999, the intra-regional trade was 62.6 per cent.

**Table 3.1: Intra-Regional Trade (1970 – 1999)**  
(percentage of Total Export)

Regional Groupings	1970	1980	1985	1990	1995	1996	1997	1998	1999
ASEAN	22.9	18.7	19.8	19.8	25.4	25.4	25.0	21.7	22.2
COMESA	9.1	6.1	4.7	6.6	7.8	8.0	7.9	8.6	7.5
ECOWAS	2.9	10.1	5.2	7.8	9.8	9.4	9.7	11.8	12.2
E.U	59.5	60.8	59.2	65.9	62.4	61.4	55.5	57.0	62.6
MERCOSUR	9.4	11.6	5.5	8.9	20.3	22.7	24.8	25.0	20.5
NAFTA	36.0	33.6	43.9	41.4	46.2	47.6	49.1	51.7	54.6
SADC	8.0	2.0	3.8	4.8	8.7	9.4	10.4	10.2	9.3
UDEAC	4.9	1.6	1.9	2.3	2.2	2.3	2.1	2.3	1.6
UEMOA	6.5	9.6	8.7	12.9	10.0	9.8	11.8	11.6	12.7

Source: World Bank: World Development Indicators, 2001. Pp. 333

<sup>6</sup> There existed Belgium-Luxembourg Economic Union (BLEU) since 1922, whereby each country issued its own currency but exchangeable at par. Albeit, only the Belgian currency is acceptable in both countries and the National Bank of Belgium controls monetary creation, with an input into the decisions by Luxembourg. The membership of both countries in the European Union and the adoption of euro as the economy-wide currency have superseded the operations of the BLEU.

The EU has had a long gestation period since the creation of the customs union in 1957 and the transmutation into a single market for goods and services in 1986. The Union consists of industrialised countries with high per capita incomes, diversified economies and relatively low inflation rates. The Werner Report of 1970 recommended the establishment of a monetary union among the then European Community members by 1980. The European Monetary System (EMS) was formed as a monetary arm in 1979. This enhanced exchange rate cooperation among members, creating margins of fluctuation around fixed but adjustable central parities, and credit facilities for intervention. The Delors Report of 1989 enhanced the regional integration efforts and led to the signing of the Maastricht Treaty on European Union in February 1992.

The absence of capital account restrictions and uncertainty about ratification of the Treaty in the early period of 1990s led to speculative attacks against a number of the EMS currencies in the September 1992-July 1993 period. The pound sterling and Italian lira were withdrawn from the exchange rate mechanism and several devaluations of other central parities occurred. In fact, the band of fluctuation around the EMS currency widened to plus or minus 15% at the beginning of August 1993. In spite of the advanced level of development of the EU members, the Treaty mandated a long transition period for the countries to prepare and prove that they have converged to low fiscal deficits, low rates of inflation and stable exchange rates before full membership of the Union <sup>7</sup>(Masson and Pattillo, 2001a).

The European Union is presently characterised by the use of a single currency – euro – which had been in circulation since January 1999 and co-existed with national currencies before eventually replacing them on January 1, 2002. The EU has a comprehensive structure to support the desired objectives of regional integration. The institutional supports are provided by the common market, European Court of Justice, European Coal and Steel Community, Single European Act, Common Agricultural Policy, and extensive policy harmonisation in many other areas (Masson and Pattillo, 2001a). Let us now turn to the relevant institutional arrangement for successful monetary integration.

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<sup>7</sup> These are the elements of the convergence criteria which are a set of economic conditions which have to be met by EU members before they can participate in the euro area. These criteria, often referred to as Maastricht criteria relates to achievement of low inflation, sound public finances, stable exchange rate and low and stable interest rates.

## 3.2 The European System of Central Banks<sup>8</sup>

### 3.2.1 Objectives and Tasks

We stated in the preceding section that the core institution for implementation of the programmes of monetary integration is the European System of Central Banks (ESCB). The power to achieve the Community objective of monetary integration is vested in the European System of Central Bank (ESCB). The functions and powers of the ESCB are clearly stated under Title VI of the Treaty relating to Economic and Monetary Policy. These are elaborated upon later in this section.

It was explained in Section 2 that the European Union adopted the single currency model of monetary integration. This implies that each member country has its central bank but there also exist a common central bank - the European Central Bank (ECB) which sets the monetary policy and has the exclusive right to authorise the issue of bank notes within the Community. The ESCB is composed of the European Central Bank (ECB) and the National Central Banks (NCBs) of all the 15 EU Member States. The *Eurosystem* is the term used to refer to the ECB and the NCBs of the Member States which have adopted the use of euro as the common currency. The NCBs members which do not participate in the euro area are however, members of the ESCB with a special status. They are allowed to conduct their respective national monetary policies but do not take part in the decision making with regards to the single monetary policy for the euro area and the implementation of such decisions. We will first focus on the activities of the ESCB before dovetailing to the ECB.

The primary objective of the monetary policy of ESCB is to maintain price stability through setting of targets for monetary aggregate (M3) and inflation across the membership of the Community. It is therefore expected to support the general economic policies in the Community with a view to contributing to the achievement of the overall objectives of the Community. The ESCB is equally expected to act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources (ECB Compendium, 2002).

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<sup>8</sup> The whole of this section benefits greatly from ECB compendium 2002 downloaded from the internet at [www.europeanunion](http://www.europeanunion).

The Basic tasks to be carried out through the ESCB, in accordance with Article 105 (2) of the Treaty are:

- to define and implement the monetary policy of the community;
- to conduct foreign exchange operations consistent with the provisions of Article 111 of the Treaty;
- to hold and manage the official foreign reserves of the Member States;
- to promote the smooth operation of payment systems.

(Article 102: 1 & 2 of ESCB)

Based on these objectives and tasks, the ESCB performs a number of functions that should bring into fruition the expectation of a successful monetary integration in the Community. These functions can be categorised into:

- Intervention/Advisory
- Information Gathering and Dissemination
- International Cooperation.

- i. Intervention/Advisory Functions: The ECB as the main monetary institution, shall be consulted by the respective Community Organ or Member States on any proposed Community act or national legislative provision in its field of competence. It can on the other hand submit opinions to the appropriate Community Institutions or bodies or to national authorities on matters in its field of competence.

In fact, ESCB is mandated by law to 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.

- ii. Information Gathering and Dissemination: The ECB, with the assistance of the National Central Banks, collect necessary and relevant statistical information from both competent and appropriate national authorities, and from economic agents. In this wise, the ESCB has to cooperate and work in conjunction with the Community's institutions or bodies, relevant authorities of Member States or third countries and with international organisations.

The collected information are processed for distribution and application under the guidance of the ECB which is empowered by law to harmonise, where necessary, the rules and practices governing collection, compilation and distribution of statistics in the areas within its fields of competence.

- iii. International Cooperation: Anchored on the tasks entrusted to the ESCB, the ECB shall decide how the ESCB shall be represented in the field of international cooperation. Thus, subject to the approval of ECB, the National Central Banks may participate in International Monetary Institutions.

### 3.2.2 Organisation of the ESCB

Article 108 of the Treaty establishing the ESCB gives express approval to its independence from influence by individual or group of countries. The Article states *inter alia*

When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and this Statute, neither the ECB, nor a National Central Bank, nor any member of their decision-making bodies shall seek or take instructions from Community Institutions or bodies, from any government of a Member State or from any other body.

The Community Institutions and bodies as well as the governments of the Member States have accepted to respect this principle and not to seek to influence the members of the decision-making bodies of the ECB or of the National Central Banks in the performance of their tasks. The process of decision-making in the Eurosystem is centralised through the decision-making bodies of the ECB which comprise of the Governing Council and the Executive Board. As long as there are Member States that have not yet adopted the euro, a third decision-making body, the General Council, also exist. The pivotal role of the ECB requires that we give the Bank some level of special attention.

### ***The European Central Bank (ECB)***

The ECB has legal personality and enjoys in each of the Member States the most extensive legal capacity accorded to a legal person under its laws. In this wise, it may, in particular, acquire or dispose of movable and immovable property and may be a party to legal proceedings (Article 107(2)). The Bank shall ensure that the tasks conferred upon the ESCB are implemented either by its own activities or through the National Central Banks.

The ECB's capital amounts to EUR 5 billion. The NCBs are the sole subscribers to and holders of the capital of the ECB. The subscription of capital is based on a key

established on the basis of the EU Member States' respective shares in the GDP and population of the Community. It presently has a paid up capital of just over EUR 4 billion. The euro area NCBs have paid up their respective subscription to the ECB's capital in full while the NCBs of the non-participating countries have paid up 5% of their respective subscriptions as contribution to the operational costs of the ECB. When Greece entered the third state of EMU on 1<sup>st</sup> January 2001, the Bank of Greece paid up the remaining 95% of its subscription of the ECB's capital.

In addition, the foreign reserve assets with ECB as provided by the Member States participating in the eurosystem amount to an equivalent of about EUR 40 billion. The contributions of each NCB were fixed in proportion to its share in the ECB's subscribed capital, while in return, each NCB was credited by the ECB with a claim in euro equivalent to its contribution. Fifteen per cent of such contributions were made in gold and the remaining 85% in US dollars and Japanese yen.

As part of its independence, the ECB has its own budget and separate from that of the European Community. This keeps the administration of the ECB independent of the financial interests of the Community. The responsibilities of the ECB include drawing up and publishing quarterly reports on the activities of the ESCB which are made available to interested parties free of charge. Also, it shall address an annual report on the activities of the ESCB and on monetary policy of both the previous and the current year to the European Parliament, the Council and the Commission, as well as to the European Council.

### *The Governing Council*

This comprises of all the members of the Executive Board and the Governors of the National Central Banks of the Member States without a derogation, i.e. those countries which have adopted the euro. Only members of the Governing Council present in person shall have the right to vote. However, by way of derogation from this rule, the Governing Council may adopt Rules of Procedure, as part of its powers, to allow members to cast their votes by means of teleconferencing. Each member has one vote and action is taken based on simple majority, though the President has a casting vote in the event of a tie.

A quorum of two thirds of the members is necessary for voting to take place. However, if the quorum is not met, the President may convene an extraordinary meeting at



which decisions may be taken without regards to the quorum. The proceedings of the meetings shall be confidential, albeit, the Council may decide to make the outcome of its deliberation public.

The responsibilities of the Council are:

- i. to adopt the guidelines and take the decisions necessary to ensure the performance of the task entrusted to the Eurosystem;
- ii. to formulate the monetary policy of the euro area, including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the Eurosystem, and
- iii. to establish the necessary guidelines for their implementation.

### ***The Executive Board***

Membership of this Board comprises of the President, the Vice President and four other members, all chosen from among persons of recognised standing and professional experience in monetary or banking matters. The President chairs the meetings of the Governing Council except in his absence where the Vice-President takes over. He or his nominee normally represents the ECB externally. Only nationals of the Member States may be members of the Executive Board. They are appointed by common accord of the governments of the Member States at the level of Heads of State or Government, on a recommendation from the EU Council after it has consulted the European Parliament and the Governing Council of the ECB (i.e. the Council of the European Monetary Institute (EMI) for the first appointment).

The members are appointed on full time basis. Thus, no member of the Board can engage in any occupation whether gainful or not, except an exemption is granted by the Governing Council. Their term is normally for eight years and is not renewable. If a member can no longer fulfil the conditions required for the performance of his duties or if he has been found guilty of serious misconduct, the Court of Justice may, on application by the Governing Council or the Executive Board, compulsorily retire him and the vacancy filled by the appointment of a new member in accordance with laid down procedure.

The main responsibilities of the Board are:

- i. to implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council of the ECB and, in doing so, to give the necessary instructions to the NCBs; and
- ii. to execute those powers which have been delegated to it by the Governing Council of the ECB.

### ***The General Council***

This comprises of the President, the Vice-President and the governors of the NCBs of all the 15 Member States. The General Council performs the tasks which the ECB took over from the EMI and which, owing to the derogation of one or more Member States, still have to be performed in State Three of Economic and Monetary Union (EMU). In addition to this, the General Council contributes to:

- i. the ECB's advisory functions;
- ii. the collection of statistical information;
- iii. preparation of the ECB's annual reports;
- iv. the establishment of the necessary rules for standardising the accounting and reporting of operations undertaken by the NCBs;
- v. the taking of measures relating to the establishment of the key for the ECB's capital subscription other than those already laid down in the Treaty;
- vi. the laying-down of the conditions of employment of the members of staff of the ECB; and
- vii. the necessary preparations for irrevocably fixing the exchange rates of the currencies of the Member States with a derogation against euro.

### ***The National Central Banks***

The National Central Banks are an integral part of the ESCB and are expected to act in accordance with the guidelines and instructions of the ECB. Thus, the Governing Council has been mandated to take necessary steps to ensure compliance with the guidelines and instructions of the ECB, and can seek and obtain any necessary information from the banks. Actually, Article 109 of the Treaty setting up the ESCB provided that each Member State should ensure, at the latest at the date of the establishment of the ESCB, that its national



legislation, including the statutes of its National Central Bank be compatible with the Treaty and the Statute of the ESCB. Such national statute should provide that the term of office of a Governor of a National Central Bank cannot be less than five years. However, a Governor may be removed if he no longer fulfils the conditions required for the performance of his duties or is guilty of serious misconduct. A decision to that effect may be referred to the Court of Justice by the Governor concerned or the Governing Council on ground of infringement of the Treaty or of any rule of law relating to its application.

### **3.2.3 Monetary Functions and Operations of the ESCB**

In accordance with Article 106 (10) of the Treaty, the Governing Council has the exclusive right to authorise the issue of bank notes within the Eurosystem. In this connection, the ECB and the National Central Banks may issue such notes which shall be the only legal tender within the Community. Albeit, the ECB must respect, as much as possible, existing practices regarding the issue and design of banknotes. In order to conduct their operations, the ECB and the National Banks may open account for credit institutions, public entities and other market participants and accept assets, including book entry securities, as collateral.

The specific way in which the ECB pursues its primary objective of maintaining price stability is laid down in monetary policy strategy which rests on two pillars viz a prominent role for money and a broad based assessment. The Governing Council chose a monetary strategy which ensures as much continuity as possible with the strategies pursued by the National Central Banks prior to the advancement into Monetary Union, even though the launching of the euro presented a completely new situation.

Under the first strategy which gives money prominent role, the Council announces a reference value for the growth of the money supply in a broad sense (M3), with inflation being defined in terms of too much money chasing a limited amount of goods and services. The monetary aggregate, M3, measures the amount of cash in circulation, short-term deposits in credit institutions (and other financial institutions) and other short-term interest-bearing securities issued by these institutions. The reference value for the annual growth rate of M3, since 1999 is 4.5%, and is intended to help the Governing Council to analyse and present information contained in the monetary aggregates in a manner that provides a coherent and credible guide to its monetary policy.

The second strategy is the broadly based assessment of the outlook for future price developments and the risk to price stability in the euro area. The assessment uses such indicators as wages, the exchange rate, long-term interest rates, various measures of economic activities, fiscal policy indicators, price and cost indices, and business and consumer surveys. These kinds of indicators provide information on future price developments.

The combination of the two pillars allows that monetary, financial and economic developments are closely monitored and analysed. This also allows the ECB to set its interest rates at a level that best serves the maintenance of price stability and thus indirectly safeguarding the domestic and external purchasing power of the euro. The monetary policy is formulated by the Governing Council of the ECB, though its implementation is decentralised with most of the operations being carried out by the National Central Banks.

### *The Monetary Policy Instruments*

To achieve the basic objective of monetary policy requires that appropriate monetary instruments be used. The purpose of the instruments used in the Eurosystem is to influence market interest rates, manage liquidity situation in the banking system and signal the general direction of monetary policy.

The major instruments are refinancing operations, fine-tuning operations, imposition of minimum reserve requirements. The *main refinancing operations* are used to provide the banking system with sufficient liquidity and to signal the general stance of monetary policy. They are conducted once a week and have a maturity of two weeks. The *longer-term refinancing operations* also exist and are equally liquidity providing transactions. These are conducted monthly and have a maturity of three months.

The *fine-tuning operations* are executed on an ad hoc basis, with the aims of managing the liquidity situation in the market and steering interest rates. The specific goal is to smoothen the effects on interest rates of unexpected liquidity fluctuations in the market. In order to stabilise demand for central bank money, the imposition of **minimum reserve requirements** on credit institutions becomes the main instrument. In this situation, each credit institution must keep a certain percentage of its own customer deposits in a deposit account with the Eurosystem. This invariably stabilises money market interest rates.

There also exist *marginal lending facility* and *deposit facility* which aim to provide and absorb overnight liquidity. The interest rates on these standing facilities form a corridor for movement of overnight market interest rates.

The backbone of the single money market of the euro area is the system for payment transfers known as Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET). The TARGET links together, the 15 national payment systems i.e. one in each of the Member States of EU and the ECB payment mechanism. It is thus possible to transfer large amounts of money between bank accounts from one end of the European Union to the other within minutes or seconds. Because of its safety and efficiency, TARGET is now by far the most important payment system in Europe and one of the largest three systems in the world (ECB Compendium, 2002).

The legal provision for the monetary functions and operations of the ESCB are provided in Chapters IV – VI of the Statute establishing the body. Within the provision, the ECB alone or in conjunction with the National Central Banks are given the powers to, among others:

- i. operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claim and marketable instruments, whether in Community or in non-Community currencies, as well as precious metals;
- ii. conduct operations with credit institutions and other market participants, with lending being based on adequate collateral;
- iii. establish general principle for open market and credit operations carried out by ECB or the National Central Banks, including announcement of conditions under which they stand ready to enter into such transactions;
- iv. define the basis for minimum reserves and the maximum permissible ratios between those reserves and their basis, as well as the appropriate sanctions in cases of non-compliance;
- v. provide facilities and make regulations to ensure efficient and sound clearing and payment systems within the community and with other countries; and

- vi. establish relations and do business with central banks and financial institutions in other countries and, where appropriate, with international organisations.

The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system. Since the operations of the ECB like any other central bank must result in profits or losses, it becomes imperative to understand the legal provision. Article 33 of its Statute states that:

- 1a. an amount to be determined by the Governing Council, which may not exceed 20% of the net profit, shall be transferred to the general reserve fund subject to a limit equal to 100% of the capital;
- 1b. the remaining net profit shall be distributed to the shareholders of the ECB in proportion to their paid-up shares.
- 2. In the event of a loss incurred by the ECB, the shortfall may be offset against the general reserve fund of the ECB and, if necessary, following a decision by the Governing Council, against the monetary income of the relevant financial year in proportion and up to the amount allocated to the National Central Banks in terms of their paid up shares in the capital of the ECB.

#### **4. Concluding Remarks**

We have in the last couple of pages discuss various aspects of organisation and operation of the European Monetary Union. We equally explained that the environment under which the Union operates is clearly defined in its Treaty as free market or capitalist state. Although this does not imply absence of institutional intervention in the market, this is kept to barest minimum. More importantly, there is some level of relationship between the various organs of the Monetary Union but the independence of decision making and implementation, particularly for the European System of Central Banks, is mutually agreed and adhered to by Member States, irrespective of their economic strength and weaknesses.

This independence to a large extent remove incidence of mutual suspicion. In addition, Member States join the Union at their conveniences and are subject to meeting the criteria set for entry.

An important observation which cannot be ignored is the fact that European Community is multi-lingual yet this has not resulted in overarching problem but rather become strength in diversity.<sup>9</sup> In synopsis, a number of lessons can be drawn from the foregoing and this include:

- i. the long gestation period and stages for the establishment of the monetary union;
- ii. the non-coercion of members into joining the Union at the same time;
- iii. the definition of operating environment i.e. capitalist environment where free market reigns and freedom of operation is given to the monetary institution and organisational structures to operate the monetary policy;
- iv. the provision of defined extensive legal framework to back up activities of the ESCB and other organs of the Community and upholding of or respect for these provisions by both the direct operators and Member States;
- v. adoption of an appropriate definition of money with focused monetary policy objective (price stability) and limited number of monetary instruments which can be easily manipulated to achieve the desired goal;
- vi. the existence of well developed financial markets and diversified economy but with mutually agreed high level of intra regional trade;
- vii. provision of acceptable profit and loss sharing; and
- viii. the use of language diversity as strength by pushing such problem to the background and adopting the universal language of business - liquidity.

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<sup>9</sup> See Tella, Sheriffdeen and Bolaji Adesoye, 1998.

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