



The Single Monetary Policy and its Decentralised Implementation: An assessment

Daniel Gros

Summary

The statutes of the European Central Bank (ECB) stipulate that it should have recourse to national central banks (NCBs) to carry out monetary policy operations. Such a structure would not be a problem if these operations were all identical across member states and if the resulting profits and losses were shared. But this is not the case today. In this sense, the euro area no longer has a 'single' monetary policy.

There is little one can do about this situation, except to wait until the government purchase programme ends and is then reversed.

However, two steps could be undertaken already now: i) the granting of emergency liquidity assistance should be shifted to the ECB, and ii) the NCBs should be forbidden to undertake any financial operation that is not a direct consequence of their execution of the ECB's monetary policy decisions. The existing stocks of assets (and liabilities), the so-called ANFA (Agreement on Net Financial Assets) holdings, which are not related to monetary policy, should be transferred to either national finance ministries or national special purpose vehicles.

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Executive Summary

Formally speaking, the single monetary policy is not ‘implemented’ in a decentralised way, but is only ‘executed’ operationally by national central banks (NCBs). The statutes of the European Central Bank (ECB) assign the formulation of the policy to the Governing Council and the implementation to the Executive Board of the ECB. The role of NCBs is limited to carrying out operations, but only to the extent possible and appropriate.

The statutes are thus clear: the NCBs should act simply as the agents of the ECB and refrain from exercising any discretion in ‘carrying out operations’, with all profits and losses equally shared.

This is the way the Eurosystem worked until the crisis erupted. Given that the main policy instruments involved operations with banks (as opposed to open market operations), it seemed natural that essentially all operations were carried out by the NCBs.

With the euro crisis, financial markets fractured along national lines and tensions arose among NCBs about the eligibility criteria of collateral for refinancing purposes. In 2011 it was decided that NCBs could, under certain conditions, accept collateral of lower quality, but that these transactions would be taken at their own risk. Although that exemption from the general ECB rules was only temporary and no losses were recorded, it represents the first time NCBs acquired a considerable margin of discretion in their execution of the common policy.

The real ‘decentralisation’ came with the Public Sector Purchase Programme (PSPP) under which 80% of the purchases are implemented by the NCBs, which are supposed to buy only their own government’s bonds. The NCBs are only assigned the amount of bonds to buy. The maturity spectrum and all other aspects are left to their discretion. Moreover, there is no loss (or profit) sharing for these operations. Over time the assets bought under the PSPP have come to dominate the balance sheet of the Eurosystem, which no longer can be regarded as unified. This means that there is no longer a ‘single’ monetary policy.

There is little one can do about this situation, but to wait until the government purchase programme ends and is then reversed.

Nevertheless, two steps could be undertaken already now.

The granting of Emergency Liquidity Assistance (ELA) should be shifted to the ECB.

NCBs should be forbidden to undertake any financial operation that is not a direct consequence of their execution of the ECB’s monetary policy decisions. The existing stocks of assets (and liabilities), the so-called ANFA (Agreement on Net Financial Assets) holdings, which are not related to monetary policy, should be transferred to either national finance ministries or national special purpose vehicles (SPVs).

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1. Introduction

Since the creation of the Economic and Monetary Union (EMU), one principle specific to the Eurosystem is the centralisation of monetary policy decisions and the decentralisation of the actual implementation of monetary policy operations. With the eruption of the crisis and introduction of non-standard monetary policy instruments, the Eurosystem's operational framework has undergone large changes. The sharing of responsibilities between the European Central Bank (ECB) and the national central banks (NCBs) has become more complex and the NCBs seem to have increased their discretion. In that context, the decentralised model might contradict the preservation of simplicity and that of 'single monetary policy'.

The next section recalls the legal framework of the monetary policy setting under EMU and compares it to the US Federal Reserve system. Section 3 looks into the specific role of the ECB, as central entity, and the role of NCBs and how these have evolved after the crisis. This section also looks into the operational costs and how they differ across countries. Section 4 draws conclusions.

2. The legal framework of a decentralised structure

The statutes of the ECB, which are incorporated as Annex in the Treaty on the Functioning of the European Union (TFEU) do not mandate a decentralisation of the implementation of the euro area's monetary policy.

Article 12

Responsibilities of the decision-making bodies

12.1. The Governing Council shall adopt the guidelines and take the decisions necessary to ensure the performance of the tasks entrusted to the ESCB under this Treaty and this Statute. The Governing Council shall formulate the monetary policy of the Community including, as appropriate, decisions relating to intermediate monetary objectives, key interest rates and the supply of reserves in the ESCB, and shall establish the necessary guidelines for their implementation.

The Executive Board shall implement monetary policy

To the extent deemed possible and appropriate and without prejudice to the provisions of this Article, the ECB shall have recourse to the national central banks to carry out operations which form part of the tasks of the ESCB.

The first paragraph of Art. 12 says that the Governing Council of the ECB shall “formulate the monetary policy”. The second paragraph then stipulates: “The Executive Board shall implement monetary policy”. This seems to mandate a centralisation of both decision-making and implementation. What is meant by decentralised implementation of monetary policy is that the Executive Board should translate the broad decisions of the Governing Council into operational instructions (the equivalent of ‘Implementing Acts’ at the Community level), which are then transmitted to the ECB itself or the NCBs.

Decentralisation is mandated only in the third paragraph of Art. 12.1, which says that: “To the extent deemed possible and appropriate [...], the ECB shall have recourse to the national central banks to carry out operations”. The overall intent of the Treaty thus seems to be that national central banks should be used to ‘carry out operations’, but there is no hint that they should have any leeway or margin of discretion in doing this.

The injunction to let NCBs carry out the operations in the third paragraph of Art. 12.1 is understandable given that, at the time the euro was introduced, the *modus operandi* of monetary policy in the euro area was lending to commercial banks against good collateral. For many banks, especially the smaller ones, being able to continue to deal with their usual counterparts at home was important in reducing transaction costs and the uncertainty over how the new regime would work. Language might also have played a role. Moreover, one has to keep in mind that during the first three years of the euro national currencies continued to exist (at least in the form of cash).

But the third paragraph of Art. 12.1 does not say that the national central banks should carry out all operations. The Treaty definitely does not mandate that monetary policy would be implemented only through NCBs. The other institution that can carry out monetary policy operations is the ECB, which has its own distinct legal personality and can undertake all financial operations, just like any national central bank.

The ECB played, admittedly, a minor role at the beginning, mostly related to exchange rate operations. As part of the foreign exchange reserves of Member States were pooled in the ECB, foreign exchange market interventions were centralised.

2.1. The example of the United States

A parallel with the US Federal Reserve system and its decentralised structure is instructive. US monetary policy is implemented today by only one of the constituent regional Reserve Banks, the New York Fed. But this was not the intention at the start.

For a long time, banking was considered a prerogative of the states, which explains why the Federal Reserve was founded only in 1913, 130 years after the founding of the US. The resistance to federal action in this area was overcome only because the absence of a national central bank and national policymaking was finally perceived as being one of the root causes of the higher frequency of financial crisis in the US.

The act that created the Federal Reserve System in 1913, foresaw the formation of 12 districts (formally 8-12), which were supposed to represent different regional economic and banking interests. Each of the 12 Reserve Banks was intended to operate independently from the other Reserve Banks. The Federal Reserve thus did not grow out of an agglomeration of 'state' banks, which had existed in the 19th century. Instead, the districts were created when the Fed came into existence. As the nation's economy became more integrated, the effective conduct of monetary policy began to require increased collaboration and coordination throughout the System. This led to the revisions to the Federal Reserve Act in 1933 and 1935 that created the Federal Open Market Committee (FOMC).

Individual regional Reserve Bank Districts encompass the territory of several states and the borders between the districts do not always run along state lines. Rather districts' boundaries are based on economic considerations. A conscious attempt had been made to avoid a confluence of state-specific political (and business) interests and the components of the Federal Reserve System. This was done despite the fact that, at the time, banking supervision and deposit insurance (where it existed at all) were still the organised along state lines. The individual Federal Reserve District banks thus represented regional business interests (agrarian, versus industrial, for example) rather than formal regional political structures. This was natural at a time when government's influence on banking in general was minimal. The link between state chartered banks and the state level development banks which had existed in the 1830s and 1840s had been abolished under the national banking act passed in the midst of the Civil War (1863), a time when the sovereignty of the was being denied by the (ultimately) victorious North.

The Federal Reserve also relied (and still does so to some extent) on the implementation of its policy by the District Banks, which initially were even able to set different discount rates. From the beginning the New York Fed had a special position as the only District bank with important foreign links. Today it remains the only one conducting foreign exchange operations.

Over time, the entire execution of Federal Reserve policy has been devolved to the 'Desk' at the New York Federal Reserve, which is thus now the only District involved in the implementation of monetary policy in the US. The reason is of course that the financial centre has moved to New York. But the entire NY reserve District would have a share of only about 10% of the Federal Reserve System, if the capital key analogous to the ones of the ECB would be applied. One of the reasons why such a system does not create political frictions is that the governing structure of the New York Fed (whose district encompasses New York State, the 12 northern counties of New Jersey, Fairfield County in Connecticut, Puerto Rico and the US Virgin Islands) has no link at all with the administration or any other body of the state of New York.¹

¹ See Federal Reserve Bank of New York (2016).

3. Decentralised operational implementation versus decentralisation of profit and losses

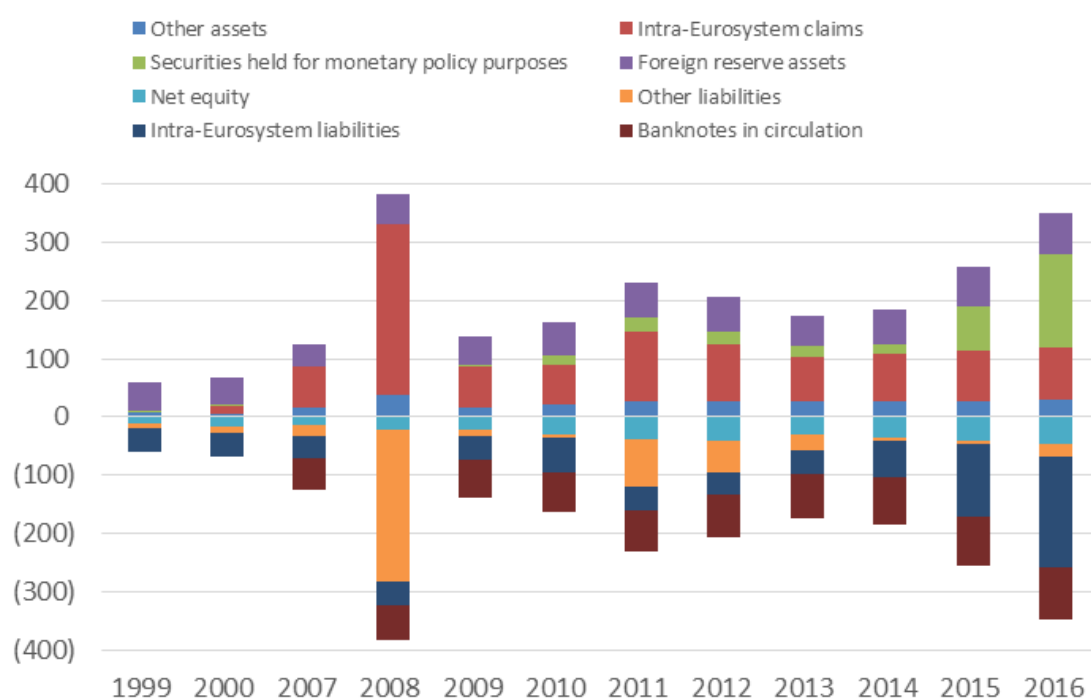
3.1 The role of the ECB

At the beginning of EMU, the ECB did not take an active part in the operational implementation of its policy, and its balance sheet was very small: only around €60 billion in 1999-2000, as shown in Figure 1 below. The balance sheet of the ECB started to increase when it was assigned notionally 8% of the total euro bank notes in circulation. However, this did not mean that the ECB was actively involved in carrying out (its own) policy.

The ECB found itself suddenly involved in an important way in monetary policy operations mainly in 2008, when it became the counterpart of the USD liquidity provided via a SWAP line from the Federal Reserve. In that context, the dollar liquidity was centrally acquired and simply transferred to national central banks, which then offered it to 'their' banks. For this reason, as shown in Figure 1, in 2008 the balance sheet of the ECB suddenly exhibits two large items: intra-euro area claims and 'other liabilities'. However, the need for USD liquidity arose only for a few months in 2008, and when trans-Atlantic money markets resumed operations, this role quickly came to an end for the ECB.

It was few years later, in 2010 that the ECB started to undertake operations in a sustained way only when the asset buying began, under the Securities Markets Programme (SMP).

Figure 1. Evolution of the ECB's balance sheet, 1999-2016



Data source: ECB.

3.2 The role of the national central banks

During the first decade of EMU, NCBs operated basically as local 'access terminals' for the Eurosystem's tender operations. All they could do was to publish the conditions for the tenders fixed in Frankfurt and then check the bids coming in from banks.

Moreover, with risk premia low in general and an integrated money market, different NCBs did not face strong incentives to somehow favour their own national financial institutions.

With the onset of the financial crisis, however, incentives changed. Different NCBs had very different views (and incentives) regarding the criteria of eligibility of assets or prudential haircuts on lowly-rated national debt used as collateral for monetary policy operations.

The policy remained unified, but the rapid deterioration of ratings forced the ECB to lower its threshold for eligibility of collateral several times; it later changed to a sliding scale of gradually increasing haircuts, depending on the ratings. All these decisions were highly controversial internally, but the policy remained unified.²

When in 2010 financial markets became increasingly unsettled by the prospect of Greece losing market access (and governments hesitated to create a 'bail-out' mechanism), the Governing Council decided that a direct intervention in the market was necessary. Buying bonds of some governments in financial difficulties (and one close to default), as under the Securities Market Programme (SMP), was of course also controversial. But the SMP, which involved the ECB in operations, was executed by all NCBs and under full risk (and profit) sharing.

The relatively small, covered bond-buying programmes, which started around the same time, also maintained the full loss-sharing, but they constituted a first, small departure from a unified policy, since the importance of covered bonds varied significantly across member countries.

The first real departure from full loss-sharing and equal rules came in 2011, when market segmentation increased and the ECB felt compelled to change its policy instruments: "The NCBs are allowed, as a temporary solution, to accept as collateral for Eurosystem credit operations additional performing credit claims that satisfy specific eligibility criteria. The responsibility entailed in the acceptance of such credit claims will be borne by the NCB authorising their use."³

² The first leg of the crisis also brought the first (and I believe only) test of the risk-sharing mechanism when the Eurosystem made losses on lending to euro area subsidiaries of the main Icelandic banks. These losses arose because the banks suddenly became insolvent and the collateral had been basically claims drawn on each other (so-called 'love letters', which became worthless when all three of them became insolvent within a very short period of time. The ECB operations with Irish banks had been booked mainly through Luxembourg and the Bundesbank given that the subsidiaries in question had been located there. The ECB has never published a full account of this episode.

³ See https://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html

3.3 The end of the single monetary policy?

Two kinds of operations carried out by NCBs in the eurozone acquired large importance after the crisis and marked a substantial change in the meaning of decentralised implementation of monetary policy: the emergency liquidity assistance (ELA) and the purchases under the Public Sector Purchase Programme (PSPP).

Concerning the ELA, Art. 14 of the Statutes of the ESCB states:

14.3. The national central banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the ECB. The Governing Council shall take the necessary steps to ensure compliance with the guidelines and instructions of the ECB, and shall require that any necessary information be given to it.

14.4. National central banks may perform functions other than those specified in this Statute unless the Governing Council finds, by a majority of two thirds of the votes cast, that these interfere with the objectives and tasks of the ESCB. Such functions shall be performed on the responsibility and liability of national central banks and shall not be regarded as being part of the functions of the ESCB.

It is difficult to say whether ELA operations are part of the 'single' monetary policy. In principle they should not be considered part of monetary policy as their purpose is to provide 'emergency liquidity assistance' to banks that are solvent, but experience temporary liquidity problems. It is provided by the national central banks under their own discretion, subject to a veto by the Governing Council, needing a two-thirds majority, and at their own risk.

The massive continuous recourse to ELA, by a small number of NCBs (including at first the Bundesbank with very large amounts, but only temporarily) created de facto different policies, or at least very different situations, in different countries. In Greece, ELA has amounted to over 30% of GDP and has persisted for years now. It is difficult to consider it as an emergency measure to address a liquidity problem.

The most important breach in the principle that NCBs should only be carrying out operations without any margin of discretion came with the PSPP. Under this programme, 80% of the total purchases are carried out by NCBs and they buy only marketable debt instruments issued by their central government. NCBs are given only the euro amount they should spend per month. The type of bonds, including the duration or maturity, is left to their discretion. This is an important margin of discretion, which impacts the effectiveness of quantitative easing (QE). Indeed, prevalent economic theory suggests that the effectiveness of QE depends on the amount or the duration that the central bank takes off the market. Purchases of very long-term debt securities will have a larger impact on the maturity structure of the remaining debt on the market than purchases of shorter maturities.

Moreover, such structure implies that there is no loss (and one assumes profit) sharing for these purchases of national bonds. As a consequence, the balance sheet of the Eurosystem is no longer unified.

Over time, the PSPP has come to dominate the balance sheet of the Eurosystem. At present about one-half of the balance sheet of the Eurosystem (which is about €3,660 billion) is the result of operations that the individual central banks (see Table 1) have executed with a wide margin of discretion and for which the profits and losses will accrue only to them.

Table 1. Breakdown of debt securities under the PSPP (€ billion)

as of 31 August 2017	Monthly net purchases*	Cumulative monthly net purchases*
Austria	1,223	46,310
Belgium	1,544	58,299
Cyprus	0	215
Germany	9,803	413,868
Estonia	0	65
Spain	5,086	206,189
Finland	528	26,661
France	9,270	334,568
Ireland	488	22,873
Italy	7,657	291,366
Lithuania	4	2,683
Luxembourg	47	2,188
Latvia	25	1,633
Malta	27	994
Netherlands	2,174	92,680
Portugal	414	29,076
Slovenia	141	6,094
Slovakia	60	10,045
Supranationals	4,347	187,531
Total	42,839	1,733,338

Data source: ECB.

There is another set of operations performed by NCBs that represent an issue for the principle of the unified monetary policy, and they are essentially a legacy of the pre-EMU setting. NCBs were allowed to carry over from the pre-EMU times the holdings of assets they had. Operations linked to such assets, the so-called ANFA holdings, have a peculiar nature and are difficult to be analysed through the balance sheet of the Eurosystem. This greatly reduces the transparency of the balance sheet. A 'clean' balance sheet is a key feature for a central bank, as the liabilities of a central bank are regarded as 'high-powered money'.

3.4 Operational considerations

One of the practical considerations behind the operational decentralisation of the implementation of monetary policy was that national central banks had the staff necessary to carry out the tenders and repos through which the euro area's monetary policy was implemented.

Table 2 below shows the staff numbers of the major NCBs in the Eurosystem and two other major world central banks. The first column of number shows that at the start of EMU, the ECB had only 700 staff, twenty times fewer than either the Bundesbank or the Banque de France. The five largest Eurosystem NCBs had a total staff of over 40,000, roughly double that of the Federal Reserve. Over the next decade, the headcount of the ECB doubled to almost 1,600, whereas that of the NCBs fell by about one-quarter. However, the ECB remained tiny compared to any individual national central bank of the larger Member States. By last year the staff of the ECB had doubled again, but this is due mostly to the needs of the Single Supervisory Mechanism. The ECB would probably still not be able to carry out the monetary policy of the euro area on its own.

Table 2. Number of employees at selected national central banks

	1999	2009	2016
DE Deutsche Bundesbank	15,240	10,575	11,222
ES Banco de España	3,148	2,727	2,990
FR Banque de France	15,581	12,746	11,690
IT Banca d'Italia	8,802	7,639	6,921
NL De Nederlandsche Bank	1,632	1,513	1,703
Sum of major eurosystem NCBs	42,700	33,700	32,800
EU European Central Bank	732	1,563	3,171
UK Bank of England	2,810	1,816	3,983
US Federal Reserve Banks	23,288	17,398	19,023

Notes: Different institutions provide different measures of their personnel: headcount, full time equivalent and some are average for the year whereas others refer to year end.

Source: Own compilation based on central banks' annual reports.

It is difficult to determine whether the carrying out the monetary policy operations in a decentralised manner is operationally efficient. Total employment in the Eurosystem and the associated costs are still much higher than for the Federal Reserve. As an aside we note that the staff costs differ widely across NCBs.

Table 3 below shows the cost per headcount at different major national central banks within the euro area. It is apparent that even across countries with similar income per capita, the average employee can cost twice as much as in others. When comparing the average wage of central banks' staff to the average compensation of employees in the country, the ratio is quite different across countries.

Table 3. Staff costs at selected central banks (thousands of euro)

	1999	2009	2016	
	Average annual cost per person			CB average wage relative to national average wage (2016)
Buba	56.6	80.9	100.1	1.17
BdE	54.1	84.7	80.7	1.68
BdF	82.0	108.8	121.6	1.26
BdI	103.8	171.5	202.7	2.25
DNB	54.5	87.8	119.8	1.45

Data sources: National central banks and Ameco.

4. Conclusions

A certain degree of 'disintegration' of the single monetary policy was unavoidable when the Eurosystem encountered a systemic crisis due to the fracturing of the financial markets along national lines – a crisis for which the system was not prepared.

With the (partial) Banking Union and the gradual disappearance of risk premia, one should return as quickly as possible to the single monetary policy, i.e. all operations subject to full loss (and profit) sharing. But this has de facto been rendered impossible by the huge amounts of national government bonds that now sit on the balance sheets of the NCBs.

What could be done is to at least clarify the role of the national central banks in the Eurosystem: their role is to carry out the common monetary policy. They should stop undertaking any other financial operations. This means that all the 'dead wood' (Bini Smaghi and Gros, 2000) on the balance sheets of the national central banks, carried over from the pre-EMU times, should be transferred to other institutions, perhaps national wealth funds. The choice of how this is done could be left to the Member States, but they, or rather the NCBs should be given a clear deadline by which time all assets and liabilities that do not relate to the execution of the common monetary policy would disappear from their balance sheets. In principle, this could be achieved under Art. 14 of the statutes of the ECB by a decision of the ECB itself. But it is unlikely that the NCBs will themselves be willing to give up these other tasks, which provide them with

substantial revenue and activities. A change may be required to amend Art. 14 to clarify that NCBs could only in exceptional circumstances and only temporarily undertake financial operations that are not directly part of their execution of the common monetary policy.

A second conclusion is that responsibility for ELA should be shifted to the ECB (as the central legal entity of the Eurosystem). With the SSM now in charge of supervision, the ECB should have all the required information needed to judge whether a bank is insolvent or not and thus merits liquidity assistance.

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