

Zentrum für Europäische Integrationsforschung
Center for European Integration Studies
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**Innovations of the
European Central Bank in
the Context of Financial
and Monetary Integration
A Chinese Assessment**

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Innovations of the European Central Bank in the Context of Financial and Monetary Integration

A Chinese Assessment

On November 4, 2014, the European Banking Single Supervisory Mechanism (SSM) was officially launched. As the center of this mechanism, the European Central Bank (ECB) will work with the national competent authorities (NCAs) of the Member states to undertake the regulatory functions of the banking sector in the Eurozone to ensure the stability of the financial markets.¹ Two months later, on January 22, 2015, the ECB announced the introduction of the expanded asset purchase program. This so-called “European Quantitative Easing” made the ECB again the focus of discussion.² Compared to when it was first established in 1998, today’s ECB has undergone obvious changes in its decision-making mechanisms, policy means and functional competence.³ Given the key role played by the ECB in the Economic and Monetary Union (EMU), the reasons, specific performance and impact of the related changes are definitely worth exploring. These changes have naturally had a close association with the integration process in the European monetary and financial system since the establishment of the Eurozone.

- 1 European Central Bank (ECB). Online at : www.ecb.europa.eu/ssm/html/index. Last access on 29.11.2014.
- 2 ECB, “Press Release”, 22.01.2015. Online at: www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html. Last access on 28.1.2015.
- 3 ECB. Online at: www.ecb.europa.eu/press/pressconf/1998/html/is980609.en.html. Last access on 29.11.2014.

1. Integration process of the European financial and monetary system

Financial and monetary integration in Europe is manifested in both horizontal and vertical aspects. That is to say, the EU and the Eurozone have established increasingly closer ties during their continuous geographical expansion.

a) Horizontal integration

On February 7, 1992, the Maastricht Treaty was signed, establishing the EMU in three stages on the basis of the Delors Report; it planned to start the third stage on January 1, 1999⁴ – that is the introduction of a common currency: the euro. In principle, in line with the four convergence criteria, the EU Member States are obliged to join the monetary union.⁵ These criteria include a low rate of inflation, sound public finances,⁶ a stable exchange rate relationship, the convergence of nominal interest rates to currencies with a low level of inflation and so on.⁷ In the first batch, a total of 11 countries joined the Eurozone.⁸ For EU Member States that did not

4 The premise is that the resolution on the launch date of the third stage was not yet reached at the end of 1997; see Maastricht Treaty, Article 109j (4).

5 Respectively, in accordance with the protocol on certain provisions related to Denmark and the United Kingdom of Great Britain and Northern Ireland – or the so-called opt-out clause – both were exempted from the obligation of automatically entering the third stage. In addition, although Sweden did not sign an official opt-out clause, it delinked the introduction of the euro with its domestic referendum, which, to some extent, exempted the country from the obligations of entering the Eurozone. Given the fact that the year in which Sweden joined the European Union (1995) was prior to the year in which the Eurozone was established (1999), the EU Commission adopted an attitude of tolerance and restraint; however, to maintain the constraints of the Treaty of Maastricht, the EU Commission demanded that Member States that had joined the European Union after 1999 must fulfil this obligation. Details online at: www.ec.europa.eu/economy_finance/euro/adoption/who_can_join/index-en.html. Last access on 29.11.2014.

6 Including the two indexes of government deficit and public debt this is why some documents give five convergence criteria; see Maastricht Treaty, Article 109j (1).

7 Treaty on European Union (92/C 191/01), Official Journal of the European Communities, 29.7.1992: 20.

8 Council Decision (3 May 1998) in accordance with Art. 109j (4) of the treaty (98/317/EC), Off. Journal of the European Communities, 11.5.1998, L139: 30-35.

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meet the conditions,⁹ the European Commission and the ECB submit reports on economic convergence at least every two years (or at the request of a Member State with derogation) to the European Council to assess whether they are eligible to join the Eurozone. If the Member States with derogation have been in the European Exchange Rate Mechanism II (ERM II)¹⁰ for two years and meet the above convergence criteria, they should introduce the euro.¹¹ With the EU's eastward expansion, the Eurozone is also expanding. Currently, the number of EU Member States has reached 28. With the official introduction of the euro in Lithuania on January 1, 2015, a total of 19 EU Member States have joined the monetary union taking the euro as their official currency. Another seven EU Member States will also fulfil their obligations of joining the Eurozone when conditions are satisfied.¹²

b) Vertical integration

In 1999, in line with the launch of the euro, the European Commission issued the Financial Services Action Plan (FSAP), which was intended to promote the full integration of the financial sector and capital markets.¹³ The core of this program is the Markets in Financial Instruments Directive (MiFID), which was designed to promote the cross-border activities of investors within the EU.¹⁴ The financial systems of EU countries (with the exception of the United Kingdom) are bank-oriented; the banks are also regarded as key players in the financial system, as they serve the function

9 Member state with derogation.

10 Sweden adopted a method without applying to join this mechanism; so it has no need to respond to the pressure of fulfilling the obligations of joining the Eurozone.

11 TFEU, Art. 140 (Maastricht Treaty, Art. 109 j).

12 With the exception of the United Kingdom and Denmark, the remaining seven Member States that have not introduced the euro have been seeking to enter the European exchange rate mechanism in order to introduce the euro; however, from 1 Jan. 1999 to now, Denmark has been a Member State of the European exchange rate mechanism. For details, see Keynote Speech by Mario Draghi on 25.9.2014. Online at: www.ecb.europa.eu/press/key/date/2014/html/sp140925_1.en.html. Last access on 29.11.2014.

13 See European Commission (EC). Online at: ec.europa.eu/internal_market/finances/actionplan/index_en.htm#transposition. Last access on 29.11.2014.

14 Directive 2004/39/EC, OJ L 145, 30.4.2004: 1-44.

of providing liquidity for individuals, enterprises and other financial institutions.¹⁵ Therefore, the vertical deepening of European financial and monetary integration is mainly reflected in the integration of the financial system dominated by the banking sector.

1. Price-based indicators: According to the law of one price, the convergence of the price of financial assets or return (i.e. interest rates) may reflect the deepening of its integration. Before the outbreak of the European debt crisis, the EU wholesale banking business, such as inter-bank lending, investment banking, government bonds and various financial derivatives markets, had reached a high degree of integration. The yields on the money market and government bonds (especially in the Eurozone countries) almost entirely converged; corporate bond yields were basically immune from the environment of their respective nations but were more affected by various types of common factors. Although the integration process of the retail banking business is relatively slow due to various factors,¹⁶ there was quite an obvious trend of increasingly smaller interest rate differences.¹⁷

2. Quantity-based indicators: The integration of the financial sector also means more frequent cross-border business activities of different types for financial institutions. From 2000 to 2007, the cross-border penetration index¹⁸ of the EU banking sector increased from 14% to 21%.¹⁹ The

15 Kleimeier, S./Sander H., *Integrating Europe's Retail Banking Market: Where Do We Stand?* Research Report in Finance and Banking, Centre for European Policy Studies, Brussels, 2007: 5-6.

16 The factors restricting the convergence of interest rates in retail banking mainly include banking clients' trust in local banks, information asymmetry, transportation costs and barriers to integration.

17 Commission of the European Communities, *European Financial Integration Report 2007*, Commission Staff Working Document, SEC (2007), 1696, Brussels, 10.12.2007: 8-9.

18 This is the proportion of other EU Member States' banking assets in an EU member state's total banking assets.

19 Schoenmaker, D., *Post-Crisis Reversal in Banking and Insurance Integration. An Empirical Survey*, European Commission Economic Papers 496, April 2013: 12-14; de Haan, J. D./Oosterloo, S./Schoenmaker, D., *European Financial Markets and Institutions*, Cambridge, 2009: 220.

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weighted average of the cross-border business of the top 30 banks²⁰ in the rest of the EU increased from 20% in 2000 to 23% in 2007.²¹ Meanwhile, on the one hand, the introduction of the euro and the implementation of the financial integration measures intensified competition among banks, and banks (and the financial trading market) sought to enhance competitiveness through mergers and acquisitions; on the other hand, conditions for cross-border mergers and the acquisition of banks (and the financial trading market) were created, and as a result cross-border mergers and acquisitions in the EU grew exponentially.²²

c) Summary

Since the start of the European Monetary Union, following the EU's eastward expansion and the maturation of the conditions of non-Eurozone Member States, the Eurozone has continued to expand. At the same time, the European financial sector is also increasingly integrated thanks to a series of measures: The price of capital and its rate of return between EU/Eurozone Member States converged, and cross-border financial business in the region was increasingly frequent. The internal relationship of the financial system is closer, and the influence between the financial institutes continued to be enhanced, thereby showing a higher level of integration.²³ Such changes in the external environment will naturally have a far-reaching influence on the operation of the European Central Bank's relevant mechanisms.

20 In 2007, the total assets of these 30 banks accounted for about 63.61% of the EU's total banking assets.

21 Schoenmaker, D./Peek, T., "The State of the Banking Sector in Europe", in: *OECD Economics Department Working Papers*, No.1102, ECO/WKP (2013), 94, 2014:17.

22 Ref. Haan, J. D./Oosterloo, S./Schoenmaker, D., *European Financial Markets and Institutions*, Cambridge, 2009: 227 (for a detailed analysis and data related to the deepening vertical integration of internal finance in the European Union/Eurozone).

23 Council of the European Union, "Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions", 2012/0242(CNS), Brussels, 14.12.2012. Online at: register.consilium.europa.eu/pdf/en/12/st17/st17812.en12.pdf. Last access on 30.11.2014.

II. Changes to the ECB's decision-making mechanisms in the context of integration

a) ECB decision-making system

The ECB's decision-making mechanism is divided into three levels: the Executive Board, the Governing Council and the General Council. The Executive Board is responsible for the daily operations of the ECB, including the preparatory meeting of the Governing Council, the implementation of the Governing Council's monetary policy guidelines and relevant decisions, and the delivery of necessary instructions to other central banks; meanwhile, it can exercise the corresponding powers authorized by the Governing Council.

The Executive Board shall consist of a president, a vice president and four professionals. To ensure that the institution takes the overall interests of the Eurozone as the fundamental starting point, its members must obtain a qualified majority from the European Council before they are appointed.²⁴ Meanwhile, the term of the Executive Board members is defined as eight years and is non-renewable, and the first members have staggered outgoing times so as to maintain the continuity and stability of the monetary policy.²⁵ The Governing Council is the highest decision-making body of the ECB, and it is responsible for formulating the Eurozone's monetary policy and passing necessary guidelines for the fulfilment of the responsibilities of the ECB and the Eurosystem. The Governing Council consists of all members of the Executive Board and the governors of all Member States' central banks in the Eurozone.²⁶ The president of the European Central Bank serves as the chairman and voting generally follows the "one member, one

24 Treaty on the Functioning of the European Union (TFEU), Art. 283 (Maastricht Treaty, Art. 109 a).

25 Since the establishment of the European Central Bank, Germany, France, Italy and Spain have had always a seat on the Executive Board; in 2012, Luxembourg's Yves Mersch replaced Spain's José Manuel González-Páramo as the member of the Executive Board, breaking this tradition.

26 TFEU, Art. 283 explicitly stipulates that the Governing Council is composed of members of the ECB Executive Board and Central Bank governors of Eurozone Member States. See Nice Treaty, Art. 112 and Maastricht Treaty Art. 109 a.

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vote” and “simple majority” principles;²⁷ on some specific issues (such as subscribed capital, foreign exchange reserves and proceeds from the ECB), it follows the principle of the qualified majority, and the members of the Executive Board have no right to vote.²⁸

Given that not all EU countries have joined the Eurozone, the General Council was established; it is composed of the European Central Bank’s president and vice presidents and the governors of all EU Member States’ central banks. Its function is similar to that of the European Monetary Institute (EMI), and it is responsible for coordination and cooperation between the various central banks and monetary policies in the EU during the transition period.²⁹

b) Impact of the integration process on decision-making mechanisms

As the central bank of the Eurozone, ECB monetary policy shall take the overall interest of the Eurozone as its fundamental starting point. Therefore, it is necessary to avoid the domination of monetary policy by Member States that have advantages in terms of numbers, but have a small volume of the economy and population, as this will result in a lack of representation in the area of monetary policy. However, the continuous expansion of the monetary union in geographical terms leads to a corresponding expansion of the Governing Board. Under the “one member, one vote” and “simple majority” principles, the issue of how to ensure the representativeness of its monetary policy undoubtedly becomes enormously challenging.

At the same time, the bloated size of the Governing Council will also greatly reduce the efficiency of decision-making regarding monetary policies. These problems have caused concern in the EU from as early on as before the 10 countries in Eastern Europe joined the EU. On 4

27 In case of an equal number of votes, the ECB governor’s vote plays a decisive role.

28 That is, events involved in Art. 28, 29, 30, 32, 33 and 51 in the Protocol on the Statute of the European System of Central Banks and the European Central Bank (hereinafter referred to as Statute or Statue), see Art. 10.3, Statute.

29 See ECB. Online at: www.ecb.europa.eu/ecb/orga/decisions/genc/html/index.en.html. Last access on 29.11.2014.

December, 2000, the Council of the European Union suggested that the European Central Bank modify the Governing Council's voting rules.³⁰ The Treaty of Nice, which was signed later, provided both a legal basis for the revision of the rules³¹ and set the red line: The composition and competence of the ECB Governing Council cannot be changed.³²

The core of the reform was to ensure that voting results reflect the Eurozone's economic fundamentals while ensuring an effective and efficient decision-making process. Because the Executive Board is regarded as the spokesperson of the Eurozone's overall interests, its voting rights in the Governing Council should always be retained,³³ while adjustment of the voting rights of the Member State central bank governors naturally becomes the focus of the new rules. The ECB's possible decision making mechanisms include the rotation of the Federal Open Market Committee (FOMC); the representation of the International Monetary Fund (IMF), or giving Member States' central bank governors different voting weight in accordance with specific criteria; and other mechanisms. However, the ECB regards "one member, one vote" as an unshakable core constitutional principle of its monetary policy;³⁴ therefore, giving members of the Governing Council different voting weights is naturally inconsistent with this principle and cannot be considered.

The rotation system and the representation system have pros and cons, as the rotation system cannot take into account the vast differences in volume between different economies in the Eurozone, while the representation system leads to the loss the independence of monetary policy of some Member States (especially small ones). Therefore, taking into account the special circumstances of the Eurozone, the ECB drew on the merits of these

30 Opinion of the European Central Bank (ECB) of 5.12.2000, *Official Journal of the European Communities*, C362, 2000: 13. Online at: www.ecb.europa.eu/ecb/legal/pdf/c_36220001216en00130014_d.pdf. Last access on 30.11.2014.

31 Statute, Art. 10.6.

32 Treaty of Nice, Art. 5; Belke, A./Kruwinnus, D., "Erweiterung der EU und Reform des EZB-Rats", in: Europäische Zentralbank Wirtschaftsdienst, H. 5, 2003: 325.

33 Ref. Aksoy, Y./De Grauwe, P./Dewachter, H., "Do Asymmetries Matter for European Monetary Policy?", in: *European Economic Review*, Vol. 46, 2002: 443-469.

34 ECB, op. cit., 14.

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two existing mechanisms and creatively introduced the rotation system called “minimal representation mode”.³⁵

According to the amended Articles of the *Statute* adopted by the ECB on March 21, 2013, when the number of Eurozone Member States is over 15, the new voting mechanism³⁶ should be introduced into the Governing Council. The new mechanism ranks the Member States according to specific criteria³⁷ and divides them into two groups. The central bank governors of the top five Member States fall into one group and have four voting rights, and the central bank governors of the remaining Member States are in the other group and share the remaining 11 voting seats (this is similar to the representation mechanism). The voting rights are rotated monthly in each group. When the number of Member States reaches 22, they should be divided into three groups. The central bank governors of the top five Member States still hold four voting rights, and the central bank governors of half of the Member States are categorized into the second group, which holds eight voting rights. The remaining central bank governors have three voting seats. After the introduction of the new voting rules, the central bank governors of the Member States receive a total of 15 voting seats, and the members of the Executive Board still hold six voting rights.³⁸ The new voting mechanism not only ensures that the monetary policy reflects the overall interests of the Eurozone but also fully guarantees different Member States the right to express their pursuit of monetary policies. Therefore, it is undoubtedly an enormous institutional innovation in the area of international financial cooperation.

35 ECB, “Empfehlung gemäß Art. 10.6 der Satzung des Europäischen Systems der Zentralbanken und der Europäischen Zentralbank für einen Beschluss des Rates über eine Änderung des Art. 10.2 der Satzung des Europäischen Systems der Zentralbanken und der Europäischen Zentralbank”, *Amtsblatt der Europäischen Union*, C29, 7.2. 2003: 6-11.

36 In accordance with Statute 10.6, the ECB Governing Council is entitled to postpone the introduction of the voting mechanism.

37 GDP at market prices accounted for 5/6, while the assets of monetary financial institutions accounted for 1/6 of the total on the balance sheet.

38 Statute, 10.2.

On December 8, 2008, the ECB announced the postponement of the start of the new voting procedure, according to which, before the number of Member States reaches 19, the members will continue to vote in keeping with the previous rules.³⁹ On January 1, 2015, simultaneously with Lithuania's accession to the Eurozone, the new Governing Council officially started its new voting rules, resolving the plight of the decision-making mechanism that resulted from the increase in the number of Member States in the Eurozone.

III. Changes in the ECB's monetary policy strategy and instruments in the context of integration

a) ECB monetary policy strategy and tools

On October 13, 1998, the ECB Governing Council reached a consensus on the ECB's stability-oriented monetary policy strategy – that is, ensuring price stability based on the two pillars of “economic analysis” and “monetary analysis”. This is to ensure that the Harmonized Index of Consumer Prices (HICP) in the Eurozone has an annual average growth rate of no more than (but close to) 2% over the medium term.⁴⁰ The connotation of this strategy was, once again, reiterated and emphasized on May 8, 2003 at the Governing Council.⁴¹ Interest rates are the cornerstone of the ECB's implementation of its monetary policy strategy and the core issue discussed by the Governing Council. For this reason, the ECB mainly adopts strategies such as the movement of interest rates, regulation of market liquidity and release of monetary policies, in order to realize its monetary policy strategy. Its major tools include the following:

1. Standing facilities: That is, the ECB provides overnight lending services to financial institutions in the Eurozone through the central banks

39 ECB, “Decisions of the European Central Bank of 18 December 2008 to Postpone the Start of the Rotation System in the Governing Council of the European Central Bank”, ECB/2008/29, *Official Journal of the European Union*, 7.1.2009, L3/4-5.

40 ECB, “Press Release” on 13.10.1998. Online at: www.ecb.europa.eu/press/pr/date/1998/html/pr981013_1.en.html. Last access on 30.11.2014.

41 Ibid.

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of the Member States in order to signal the monetary policy direction and affect the overnight market interest rates. Specifically, the financial institutions that meet the conditions on the one hand can use their qualified assets as collateral to obtain overnight liquidity through the marginal lending facility, and on the other hand, they can deposit excess positions into the ECB every day through the deposit facility. The interest rates set by these two facilities of the ECB usually serve as the upper and lower limits of the overnight market interest rates.

2. Open market operations are different from the traditional bonds traded in the open market (such as those issued by the Federal Reserve), and the ECB's open market operations are more repurchase agreements, trade-off transactions, issuance of debt obligations, currency swaps, retention of time deposits and so on. They regulate market liquidity through standard tender, quick tender or direct bilateral trade, including main refinancing operations (MROs), longer-term refinancing operations (LTROs), fine-tuning operations and structural operations. Among them, the most critical tool is MROs – that is, the reverse repo operations implemented by the central banks of different Member States every week through standard tendering procedures – and they have a period of one week (two weeks before March 2004) in which to provide extensive liquidity to the financial market. The facility's lowest tender rate is between the interest rates of the marginal lending facility and the deposit facility and forms the key interest rates of the Eurozone together with the latter two. It is a barometer of the Eurozone's monetary policy.

3. The minimum reserves or required reserves system⁴² serves to stabilize the money market interest rates and create or increase structural liquidity shortage to make the liquidity facility better serve the interest rate target.⁴³

42 The interests are calculated as per the interest rate of the main refinancing operations.

43 ECB. Online at: www.ecb.europa.eu/mopo/html/index.en.html. Last access on 2.12.2014; Statute, Chapter IV; also see Ruckriegel, K./Seitz, F., *Zwei Währungsgebiete – Zwei Geldpolitiken. Ein Vergleich des Eurosystems mit dem Federal Reserve System*, Frankfurt am Main: Bankakademie Verlag, 2002: 30–36.

b) Impact of the integration process on monetary policy strategy and tools

Along with the continuous deepening of economic integration in the Eurozone, monetary policy strategy with interest rates at the core gradually loses the ability to ensure that the ECB will fulfil its monetary policy tasks, and the failure of the monetary policy transmission mechanism gradually emerges. However, turbulence in the Eurozone's financial market and the huge differences in the macroeconomic structures of different Member States are the primary factors leading to this problem.

1. Factors for stable financial markets

The introduction of the euro is inseparable from strong political will,⁴⁴ but the Eurozone does not meet the Optimum Currency Area (OCA) requirements, as from an economic point of view it does not have the required conditions for the establishment of a monetary union.⁴⁵ This is because, on the one hand, the macroeconomic conditions and economic structures of different countries vary a great deal, and on the other hand, after the introduction of a common currency, the Member States lose control over exchange rate policy, which is an important tool for adjusting competitiveness. An appropriate alternative facility (such as a unified fiscal policy, the fully free labor market or flexible wage, price policies, etc.) has not been established; therefore, the entire Eurozone faces huge risks of macroeconomic imbalances.⁴⁶ Before the outbreak of the global financial crisis in 2008, this risk was mainly represented by serious imbalances of intra-regional international payments⁴⁷ caused by the differentiation of

44 Grosser, D., *Das Wagnis der Währungs-, Wirtschafts- und Sozialunion. Politische Zwänge im Konflikt mit ökonomischen Regeln. Geschichte der Deutschen Einheit*, München: Deutsche Verlags-Anstalt (DVA), 1998.

45 See Krugman, P./Obstfeld, M., *International Economics: Theory and Policy*, Cambridge: Addison Wesley Longman, 1997: 631-634.

46 Eichengreen, B., "Is Europe an Optimum Currency Area?", in: *NBER Working Papers*, No. 3579, January 1991: 1-3.

47 Prior to the introduction of the euro, Eurozone's major economies had stable balance of payments, and the vast majority of them enjoyed a surplus. After the introduction of the euro, Germany, Austria, the Netherlands and other countries continued to see a surge of surplus in the international balance of payments, while France, Italy and Spain began to see a decline in surplus. Before the outbreak of the

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competitiveness.⁴⁸ After the financial crisis, the impact on countries was very asymmetrical and imbalance intensified, spreading to all areas of economic growth, consumption, employment, public finance and financial markets, and ultimately evolving into a vicious cycle of banking crisis and the sovereign debt crisis.⁴⁹

With the credit crunch and liquidity shock, major Member States have been facing the risk of economic recession.⁵⁰ In order to relieve inflationary pressure, apart from through conventional interest rate policy,⁵¹ the ECB adopted various so-called ‘nonstandard’ measures that aimed to improve financing conditions and liquidity in the real economy and in private consumption.⁵² These non-standard measures included two rounds of euro-denominated covered bonds purchase programmes (CBPR) in May 2009 and November 2011 set at €60 billion and €40 billion, respectively,⁵³ two rounds of fixed-rate tender-based longer term refinancing operations (LTROs) in December 2011 and February 2012 with a maturity of 36 months to support bank lending and money market activity,⁵⁴ the Securities

European debt crisis, these three countries’ international balance of payments had been in deficit for many years; see Eurostat.

- 48 After the introduction of the euro, unit labour cost-based real effective exchange rates differentiated a great deal. For instance, in 1998-2006, Germany’s unit labor cost decreased by about 30%, compared to Portugal. For the study of the economic differentiation of Eurozone countries after the introduction of the euro, please refer to De Grauwe, P., “The Challenge of Enlargement of the Eurozone”, in: *SUERF Annual Lecture 2007: the Austrian National Bank*, June 22, 2007: 10.
- 49 De Grauwe, P., “The Governance of a Fragile Eurozone”, in: *Australian Economic Review*, Vol. 45, September 2012: 255–268.
- 50 See related data on the ECB. Online at: www.ecb.int/press/pr/stats/md/html/index.en.html. Last access on 2.12.2014.
- 51 The ECB’s interest rate decreased for seven consecutive months from October 2008 to May 2009. The benchmark interest rate was lowered from 4.25% to 1%. The figure declined to 0.75% on 11 July 2012. Refer to ECB data. Online at: www.ecb.int/stats/monetary/rates/html/index.en.html.
- 52 ECB, Monthly Bulletin, June 2009: 9-10.
- 53 ECB, “Press Release” on 30 June, 2010. Online at: www.ecb.int/press/pr/date/2010/html/pr100630.en.html; ECB, “Press Release” on 3 November, 2011. Online at: www.ecb.int/press/pr/date/2011/html/pr111103_1.en.html. Last access on 2.12.2014.
- 54 ECB, “Press Release” on 7 May, 2009. Online at: www.ecb.europa.eu/press/pr/date/2009/html/pr090507_2.en.html. Last access on 2.12.2014.

Market Programme (SMP)⁵⁵ and two LTROs with a maturity of 36 months.⁵⁶ The ECB hoped to provide the market with low-interest liquidity through these nonstandard monetary policy tools.

However, the EU/Eurozone's specific legal framework and its economic governance model, make it lack a universally recognized lender of last resort (LLR) mechanism. The emergence of these measures changed neither this reality nor the outside world's cognition of it.⁵⁷ In this case, although the key interest rate was very low, market fear still lingered. The interbank market was still intense, and the bond market was seriously distorted. The difficulty and cost of financing kept increasing, the crisis intensified and the liquidity crisis was growing.⁵⁸ Faced with this reality, in addition to the interest rate,⁵⁹ the ECB gradually began to focus on a smooth monetary policy transmission mechanism. From as early as the introduction of the SMP, the ECB said that the starting point of its policy was the "severe tensions in certain market segments which are hampering the transmission mechanism of the monetary policy and thereby the effective conduct of monetary policy oriented towards price stability in the medium term".⁶⁰ Ultimately, on September 6, 2012, the ECB introduced a new non-standard measure: outright monetary transactions (OMTs). Under this scheme, if a troubled country meets the conditions to apply for the

55 ECB, "Press Release" on 10 May, 2010. Online at: www.ecb.int/press/pr/date/2010/html/pr100510.en.html, Last access on 3.12.2014.

56 ECB, "Press Release" on 8 December, 2012. Online at: www.ecb.int/press/pr/date/2011/html/pr111208_1.en.html. Last access on 3.12.2014.

57 Most of these "non-standard measures" were implemented on a predetermined or limited basis; see M. Draghi's speech at the European Parliament's Economic and Monetary Affairs Committee, 25.4.2012. Online at: www.ecb.int/press/key/date/2012/html/sp120425.en.html. Last access on 3.12.2014.

58 For related data, such as the yield of 10-year treasury bonds, please refer to the ECB's official website.

59 From October 2008 to May 2009 the ECB reduced the key interest rate seven times, reducing the interest rate of the refinancing operation from 3.75% to 1.00%. Online at: www.ecb.int/stats/monetary/rates/html/index.en.html. Last access on 2.12.2014; on December 8, 2011, it reduced the deposit reserve ratio from 2% to 1%. Online at: www.ecb.int/press/pr/date/2011/html/pr111208_1.en.html. Last access on 4.12.2014.

60 ECB, "Press Release" on 10 May, 2010. Online at: www.ecb.int/press/pr/date/2010/html/pr100510.en.html. Last access on 3.12.2014.

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bond purchase on the primary market of the “European Financial Stability Facility” (EFSF)/European Stability Mechanism (ESM), the ECB can purchase its 1-3Y bonds with an unlimited amount on the secondary market. The ECB leadership made it clear that the move was designed to correct serious distortions in the public bond market due to unwarranted panic in order to maintain the singleness and the transmission mechanism of monetary policy and to avoid the devastating effects of price stability in the Eurozone.⁶¹ With the introduction of OMTs, the ECB and the “ESM” began to creatively play the role of LLR in the Eurozone.⁶² As a result, the international financial markets’ confidence in the euro improved significantly, and the short-term risk of the Eurozone’s collapse due to the liquidity crunch faded quickly.

2. Factors for different macroeconomic conditions

Member States of the Eurozone have different macroeconomic structures and development levels, and their transmission mechanisms of monetary policy vary a great deal. How a uniform interest rate policy which takes into account such differences is a huge challenge that the ECB faces.⁶³ With the introduction of OMTs, the risk of monetary policy transmission mechanism failures in the Eurozone, due to financial market turmoil gradually faded away. However, the problem of monetary policy failure resulting from the different monetary policy transmission mechanisms of the Member States became increasingly obvious. Since the end of 2012, the ECB has kept lowering key interest rates,⁶⁴ but the structural imbalances within the Eurozone have led to the very different effects of loose monetary policies on different countries: On the one hand, the monetary financial

61 ECB Introductory Statement to the Press Conference, 6.9.2012.

62 For related research, please refer to Hu, K., “The Institutional Innovation of the Lender of Last Resort Facility in the Europe”, in: *Journal of European Integration*, Vol. 7, 2014: 2-15.

63 For example, Gros, D./Hefeker, C., “One Size Must Fit All: National Divergences in a Monetary Union”, in: *German Economic Review*, Vol. 3, 2002: 247-262.

64 On 11 June, 2014, the interest rate of the deposit mechanism was lowered to -0.1%, and on 10 September, it was again lowered to -0.2%, see ECB. Online at: www.ecb.europa.eu/stats/monetary/rates/html/index.en.html. Last access on 28.1.2015.

institutions (MFIs) in key countries⁶⁵ basically kept a stable stream of loans to the private sector, and the inflation rate was maintained at a certain level for a longer period; on the other hand, in the crisis countries,⁶⁶ due to weak economic performances and a lack of confidence, low interest rates did not result in the flow of capital into the real economy, but resulted in the circulation of the liquidity within the banking sector, which then exacerbated the economic downturn, and the inflation rate continued to decline, eventually dragging down the entire Eurozone.⁶⁷ Thus, despite the low interest rates, the balance of loans to the private sector from the MFIs in the Eurozone continued to shrink. The declining inflation rate trend continued after a short-term rise in mid-2013, and in December 2014, it fell into a technical deflation (-0.2%). Different countries within the Eurozone have different monetary policy transmission mechanisms, thereby a uniform interest rate policy is unable to ensure that the ECB can fulfil the primary objective of monetary policy – maintaining price stability.⁶⁸

Faced with this dilemma, on January 22, 2015, the ECB announced the introduction of the expanded asset purchase program, deciding to purchase 60 billion euros' worth of government and private bonds on the secondary market every month to promote the development of the real economy and bring the mid-term inflation rate back to a target level close to 2% during the period from March 2015 to September 2016, as expected. According to the program, the purchase by the ECB accounts for 8% of the total number of bonds under the program, and the remaining amount is allocated to the central banks of different countries according to the proportion of their investments in the ECB's core capital. With the exception of the bonds issued by European institutions, which account for 12% of the total size of the program, the central banks of different countries can purchase the bonds issued by their respective governments and institutions within the set amount, but they have to assume the risks themselves.⁶⁹ In the framework

65 These include Germany, Finland, Austria, Luxembourg and other countries.

66 These include Greece, Portugal, Ireland, Spain, Italy and other countries.

67 ECB, "Financial Stability Review", November 2014: 67, 134.

68 See Eurostat Database.

69 ECB, "Press Release" on 22 January, 2015. Online at: www.ecb.europa.eu/press/pr/date/2015/html/pr150122_1.en.html. Last access on 28.1.2015.

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of this program, on the one hand, the ECB controls all the technical details and coordinates purchase actions to ensure that the singleness of the Eurozone's monetary policy is not compromised,⁷⁰ and on the other hand, the central banks of different countries have been given permission to purchase debts independently so as to flexibly respond to the unique monetary policy environment of their own countries and, as far as possible, eliminate the monetary imbalances resulting from the monetary policy transmission mechanism.

Possible moral hazard may, therefore, be avoided as much as possible through the principle of assuming risk by oneself. Therefore, this program is not as simple as a European-style quantitative easing which aims to inject more liquidity and increase market confidence; it is more a bold and innovative attempt by the ECB in response to the dilemma of differentiation between the transmission mechanisms of monetary policy. This series of policy practices greatly enriched the ECB's monetary policy instruments and, simultaneously, made the transmission mechanism of monetary policy a new cornerstone of monetary policy strategy, equally as important as interest rates.⁷¹

IV. Changes in the ECB's functions and authority in the context of integration

a) The ECB's functions and authority

After the establishment of the monetary union, the ECB and the central banks of all the EU Member States together constituted the European System of Central Banks (ESCB), to exercise the exclusive competence of European monetary policy. The system is led by the ECB decision-making bodies (i.e. the Executive Board and the Governing Council), whose primary objective is to ensure the stability of prices. Only under the

70 Draghi, see ECB. Online at: www.ecb.europa.eu/press/pressconf/2015/html/is150122.de.html. Last access on 28.1.2015.

71 ECB. Online at: www.ecb.europa.eu/mopo/html/index.en.html. Last access on 4.12.2014.

premise of not affecting this objective can they support the EU's overall economic policy.⁷² This is because not all EU countries are Member States of the Eurozone; the ECB and the central banks of the Eurozone Member States alone compose the Eurosystem, which is responsible for monetary policy matters in the Eurozone. Throughout the ESCB, the ECB is the core and has legal status, and its independence and price stability-oriented monetary policy are guaranteed by law.⁷³

b) Impact of integration on functions and authority

The reason why the international financial crisis in 2008 first had a huge impact on the European financial markets and triggered a banking crisis and the sovereign debt crisis, was inextricably linked with the plight of European banking supervision in the context of deepening financial integration. To reduce resistance to financial integration, the EU follows the principle of “home country control combined with minimum standards and mutual recognition”⁷⁴ and basically does not touch the existing bank regulatory systems. This strategy not only effectively promoted the deepening of European financial integration but also led to distinct features of the EU banking supervision system. That is, the Member States conduct regulation in their own way, and the models, rules and practices of different countries vary a great deal.⁷⁵ With the deepening of the financial integration process, there is a growing correlation between the EU's credit institutions, and the EU's banking regulatory system which is gradually being seriously challenged by a trilemma – namely; that the stability of the financial system, the integration of the financial system and Member State

72 Maastricht Treaty, Art. 4, 105 (1), 106.

73 Treaty on European Union (TEU), Art. 13, TFEU, Art. 130 and 282, Statute, Art. 7, 8, 9; also see ECB. Online at: www.ecb.europa.eu/ecb/orga/escb/html/mission_eurosys.en.html. Last access on 4.12.2014.

74 Commission of the European Communities, *Completing the Internal Market: White Paper from the Commission to the European Council* (Milan, 28-29 June 1985), COM (85) 310, Brussels, June 1985: 29-30.

75 De Haan, J./Oosterloo, S./Schoenmaker, D., *European Financial Markets and Institutions*, Cambridge, 2009: 304.; Schoenmaker, D./Wierds, P., “Financial Supervision: Which Model for Europe?”, in: *FMG Special Paper 143*, London: London School of Economics, 2002: 6.

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responsibility for financial supervision cannot all be achieved. This means that in the context of the highly integrated EU banking sector, the EU banking supervision system that follows the “home country control” principle cannot effectively protect the stability of the European financial market.⁷⁶ The crisis has sounded the alarm for this. Promoting financial integration is the EU’s established objective, and a high degree of integration has become a reality; therefore, the EU needed to choose between retaining the banking regulatory authority of Member States and maintaining stability in financial markets. Eventually, in the crisis, the EU’s banking regulatory concept and mode took on a fundamental change from “home country control” to “prudential supervision”, under which Member States handed over banking regulation authority to the EU to ensure the stability of the financial system.⁷⁷ In this context, the EU summit in June 2012 proposed the establishment of an SSM to ensure the safety of credit institutions and the stability of the financial market.⁷⁸ According to this resolution, in September that year, the EC submitted a proposal to the Council of the European Union. It proposed giving the ECB the single supervisory authority in accordance with Article 25 of the Statute and paragraph 6, Article 127 of the Treaty on the Functioning of the European Union (TFEU):

After consulting the European Parliament and the European Central Bank, the European Council may pass regulations in a consistent manner and according to a special legislative procedure to give the European Central Bank the specific task of prudent regulatory policy of credit institutions and other financial institutions except insurance.

After repeated discussions and revisions, this proposal was finally passed on October 15, 2013. It marked the introduction of the SSM, which kicked off officially on November 4, 2014 after one year of preparation and

76 Schoenmaker, D., “Central Banks and Financial Authorities in Europe: What Prospects?”, in: Masciandaro, D. (ed.), *The Handbook of Central Banking and Financial Authorities in Europe*, Cheltenham: Edward Elgar, 2005: 398-456.

77 Hu, K./ Liu, D., “Transformation and Innovation in the EU’s Bank Regulation and Supervision System in the European Debt Crisis Context”, in: *Global Review*, Summer 2014: 85-109.

78 Euro Area Summit Statement on 29 June 2012. Online at: consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf. Last access on 4.12.2014.

testing.⁷⁹ The new mechanism is composed of the ECB and the regulatory agencies of the countries involved, and it covers all the banks in the Eurozone, amounting to about 4,700. It implements prudential supervisory authority in accordance with a single rulebook developed by the European Banking Authority (EBA) to maintain the stability of the financial system in the Eurozone.⁸⁰ The ECB is the core of this mechanism. The Joint Supervisory Teams (JSTs)⁸¹ are responsible for the outright supervision of 123 “significant”⁸² credit institutions, whose total assets account for 82% of the entire Eurozone’s banking assets. The supervisory mission of the remaining 3,500 “less significant” banks is subject to ECB’s regulatory standards, which are implemented by the regulatory agencies in the different countries; however, the ECB has the final say.⁸³ This new mechanism fully shows the spirit of innovation of Europe based on its special political structure:

For the systemically important large credit institutions that may cause financial fluctuation, the new banking supervision system adopts the functional mode (that is the European Central Bank taking charge of macro and micro prudential supervision and the member countries of business conduct supervision) so as to rapidly and effectively maintain financial market stability; for small and medium-sized credit institutions, the integration mode is adopted (that is the European Central Bank taking charge of macro prudential supervision and the member countries of micro prudential supervision and business conduct supervision) so as to more flexibly guarantee the safety of credit institutions and maintain banks’ customers’ interests. This is no doubt huge innovation in the financial supervision mode itself.⁸⁴

79 ECB, op. cit. Online at: www.ecb.europa.eu/ssm/html/index.en.html. Last access on 4.11.2014.

80 Council Regulation (EU) No. 1024/2013 of 15 October 2013, Official Journal of the European Union, L287, 29.10.2013, Article 7.

81 ECB, “Leitfaden zur Bankenaufsicht”, 11/2014: 12. Online at: www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.de.pdf. Last access on 4.12.2014.

82 See ECB, “The List of Significant Supervised Entities and the List of Less Significant Institutions”, September 2014. Online at: www.ecb.europa.eu/pub/pdf/other/ssm-listofsupervisedentities1409en.pdf. Last access on 4.12.2014.

83 The issuance, cancellation and transfer of all banks’ licenses are the direct responsibility of the ECB; please also refer to the official website of the SSM. Online at: www.bankingsupervision.europa.eu/press/pr/date/2014/html/sr141104.de.html. Last access on 4.12.2014.

84 Hu, K./Liu, D., “Transformation and Innovation in the EU’s Bank Regulation and Supervision System in the European Debt Crisis Context”, in: *Global Review*, Summer 2014: 107.

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In addition to certain legal bases, the reasons that the ECB has become the core of this mechanism also include its sufficient technical means⁸⁵ to perform these supervisory functions; through its Banking Supervision Committee (BSC), it has accumulated a wealth of experience and expertise in banking supervision and maintaining financial market stability, and moreover, it is the observer of the Basel Committee on Banking Supervision (BCBS).⁸⁶

To avoid conflict between banking regulatory functions and monetary policy functions and ensure their independence, the ECB established within itself a supervisory board. Consisting of a president, a vice president (ECB Executive Board member), four ECB representatives and one representative from each participating country's supervisory body, its voting follows a simple majority system. Under circumstances in which there is an equal number of votes, the president has the right to decide. Meanwhile, the supervisory board's decision is submitted to the Governing Council for approval, and the procedure follows the "non-objection" principle; at the same time, the ECB has also established the Administrative Board of Review, which consists of five independent persons who oversee the exercising of its functions.⁸⁷

85 For example, monetary policy-based information collection and adequate liquidity are used for crisis management.

86 ECB, "The Role of Central Banks in Prudential Supervision". Online at: www.ecb.int/pub/pdf/other/prudentialsupcbrole_en.pdf. Last access on 25.3.2013.

87 ECB, "Leitfaden zur Bankenaufsicht", November 2014: 14. Online at: www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.de.pdf. Last access on 4.12.2014.

V. Review and Outlook

In the 15 years since the introduction of the euro, the integration process within the European Economic and Monetary Union has seen rapid development in terms of both breadth and depth. Exclusively responsible for the monetary policy of the Eurozone, the European Central Bank has continued to adjust to cope with the challenges brought about by changes resulting from various innovations.

First, the EU and the Eurozone continue to expand, making the original decision-making mechanism unable to ensure representative monetary policy at the Eurozone level. To this end, on the basis of the traditional “rotation system” and “representation system”, and factoring in the local features, the ECB creatively introduced the so-called “minimal representation model”, which not only ensures the fairness and independence of decision-making by all members of the Governing Council but also helps monetary policy reflect the needs of the regional economy as a whole.

Second, the Eurozone, as a “non-optimal currency area”, faces huge risks of imbalances everywhere, which triggered the banking crisis and the sovereign debt crisis under the impact of the international financial crisis. The Eurozone’s monetary policy transmission mechanism was distorted by the crisis, and the ECB’s interest rate-oriented monetary policy tradition frequently failed, prompting the ECB to introduce all sorts of non-standard monetary policy tools and eventually treating the transmission mechanism of monetary policy as the strategic fulcrum of monetary policy, equally as important as interest rates.

Again, under the impact of the international financial crisis, the Eurozone’s banking supervision system was seriously challenged by the “trilemma”, and the highly integrated European financial market quickly fell into turmoil, triggering the banking crisis and the sovereign debt crisis.

Ultimately, the Eurozone Member States gave up the “home country control” principle of banking regulation, handing over the regulatory authority of banking to the ECB and introduced the structure-subtle SSM to

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ensure stability of the financial system. Since then, as the core of the ECB/Eurosystem, the ECB, while fulfilling the functions of the exclusive monetary policy, its authority has also extended to the field of financial regulation. Hence, it has become the core of the SSM. Every change in the ECB reflects the European spirit of innovation.

However, in light of the economic and social imbalances and huge differences in macroeconomic conditions within the Eurozone, can measures taking into account the different monetary policy transmission mechanisms of its Member States work? At the same time, can the carefully designed SSM framework really ensure mutual independence of monetary policy and banking supervision functions? We must wait and see.

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