IMPORTANCE OF BUDGETING THE EUROPEAN CENTRAL BANK FOR STABILITY OF FINANCIAL MARKETS

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Abstract: The subject of our research is processes and relationships that led to establishment of the European Union and European Monetary Union and functioning of one of the most important institutions of the Union, the European Central Bank. In the same way, we will present the policy, planning and control of finances of the bank responsible for the stability of the European monetary market which, as such, has a direct impact on financial flows of the member states and other European states, such as Serbia among others. The budget of the European Central Bank is of great importance for the society for being the institution that is most directly responsible for the stability of the monetary market and value of the European currency.

Keywords: budgeting, the European Central Bank, incomes and expenses

1.  INTRODUCTION

Incomes and expenses of the bank affect its work and are thus the indicator of the strength and stability of the bank. The analysis of the work of the European Central Bank will give us a clearer picture of the institution which, within the framework of the European Union, has a wide range of powers, such as management of foreign exchange reserves of the member states, improvement of payment operations, supervision over the operation of banks and other financial institutions. The scientific goal of this verified research is the scientific description of facts by which we primarily want to find the answers to the following questions: How was the Central Bank established? How does the Bank make money? How does the Bank spend money? How does the Bank manage its incomes and expenses? The social goal of this research is the clarification of the financial plan and strength of the institution whose functions are of crucial importance for the population of the Union and also the population of other European countries that have tied their currency to the euro.

2.  EUROPEAN MONETARY UNION - EMU

History of monetary unions is long and diverse, and European Monetary Union is different for being the first monetary union seen from the perspective of history, where the sovereign states agreed on withdrawing national currencies from use and introducing a new and a single currency – Euro.

Each monetary union entails a few things – establishment of fixed exchange rate among currencies of the member states and integration of capital markets, the single currency, the single central bank and the single credit-monetary policy. Monetary union does set as a mandatory condition the introduction of the single currency, because the exchange rates of member states are mutually fixed, and they have a floating exchange rate against other currencies. The existence of the single currency means the
reduction of transaction costs – the loss of costs of mutual exchange of currencies of member states and reduction of costs of maintenance of several currencies. However, the introduction of the single currency in the monetary union is a kind of guarantee that a state will remain in the Union. Specifically, the cost of leaving the Union is much higher in case of a single currency. The establishment of the EMU was the most complicated step in the European integrations as it entailed a series of decisions to be reached and implemented.

The first important step in the process of the European monetary integration was the introduction of the European Monetary System (EMS) on 13 March 1979, which was the outcome of compromises. Some member states expressed a fear that stability of their currencies in the light of other inflationary currencies would be more difficult as their currencies would be more expensive than inflationary currencies, which would raise the costs of export. These states are Austria, Belgium, Holland, Luxemburg and Germany. On the other hand, states with inflationary currencies did not have a problem with export but with import, which was getting expensive. These states are Italy, Portugal and Spain. [1]

The result of the establishment of the EMS was soon apparent: inflation fell from 12% to about 4% in the period from 1980 to 1992. When established exchange rates were in danger of being lost, central banks intervened by exchanging the quantity of money in circulation, changing the exchange rates and controlling the capital investments.

However, the EMS fell apart in 1992 because some currencies (lira, pound, peseta and escudos) exceeded the allowed fluctuations. At the time, the process of introduction of the single currency was underway. The process needed to be carried out in three phase:

The first was planned for July 1990, with an aim of liberalisation of capital flows,
The second was planned for January 1994, with an to prepare for the fulfilment of the envisaged conditions and establishment of institutional framework,
The third was planned for 1997 and 1999, with an aim to introduce the single currency.

After the dissolution of EMS in 1992, member states of the EU continued negotiations about the further monetary integration. New system provided for the system of central banks of countries able to fulfil the given conditions, and those that wanted to join the single currency. The system was headed by the European Monetary Institution, which was later inherited by the European Central Bank (ECB).

European Central Bank (ECB) has had this name since 1 June 1998, and emerged from EMI (European Monetary Institute) and ESCB (European System of Central Banks). It is managed by the committee of six members, including the President and Vice-President. All members are appointed for eight years and have no right to re-election. The members are elected by the European Council. The basic goal of the ECB is to preserve price stability and helping the economic policies of member states of the euro zone.

European Monetary Union is based on:

- harmonization of monetary policies of member states,
- single reserves,
- single central bank.

All the mechanisms of management of exchange rates, foreign currency reserves and monetary flows transfer from central banks of member states to the ECB seated in Frankfurt.

Central Bank and banks of member states are forbidden to cover deficits or approve loans to institutions, agencies or bodies of the Union, and to take debt instruments directly from them. [2]
To join the European Monetary Union, member states had to fulfil the necessary conditions called “convergence criteria” or conditions of the “stability pact”. They include the following:

- **PRICE STABILITY** – inflation shall be no more than 1.5 % higher than the average inflation rates of three countries with the lowest inflation.
- **ANNUAL BUDGET DEFICIT** – shall be no more than 3% of gross domestic product of the country.
- **TOTAL PUBLIC DEBT** – shall be no more than 60% of gross domestic product of the country.
- **LONG-TERM INTEREST RATE** – shall be no more than 2% higher than the average of the interest rates in three member states with the lowest interest rates.

The following evaluation, which was supposed to be done, referred to how many countries would be able to meet the required criteria. It was thought that there was no sense to introduce the common currency in less than seven countries. In order to ensure that number, the criteria needed to be somehow corrected (weakened). But basically, they had to be mechanical and arbitrary. [3]

Even though the convergence criteria were very precise, some states joined the EMU although they did not strictly meet them. In the period from 1996 to 1998, only one EU country met all four criteria all the time (Luxemburg), while a few countries were close to meet them (Austria, Belgium, France, Holland, Germany, Ireland). However, the fact that these countries were close to meet the convergence criteria does not mean that they managed to meet them. [4]

The Commission was generous in the establishment of the Monetary Union, because it did not pay attention to what might be called the quality of procedure, which some countries used for the reduction of public debt. It is known that some countries used single methods for the reduction of public debt in order not to affect the mechanism that creates public debt, which was not simple, given the political circumstances in those countries. For instances, those are: sale of state assets (in Germany – sale of Telekom, in France – operations with pension bonds of Telekom). In Italy, at one moment “euro tax” was introduced in order to cover public debt from collected funds. [5] Debt of Italian state railways was not included in public debt either. [6]

### 3. EUROPEAN CENTRAL BANK

European Central Bank (ECB) was established on 1 January 1999, when it started operating. Based on Maastricht Treaty, the European Central Bank and national central banks of the countries in the euro zone established the European System of Central Banks (ESCB). ESCB is the pillar of the monetary authorities and monetary policy of the European Union, which determines the frameworks of monetary aggregates, defines and conducts the monetary policy. Also, it uses the instruments of monetary policy, including interest rates policy.

The basic tasks of the European Central Bank are: managing the foreign currency reserves of the member states, improvement of payment operations, supervision over the operation of banks and other financial institutions.

ECB is a legal entity and has the widest legal powers in each member state, which are recognized by the national law to legal entities.
ECB capital paid by member states of the European System of Central Banks amounts to 5 billion Euros. The manner in which the participation in the founding capital was defined was based on the participation of member states in the Gross Domestic Product (GDP) and EU population. Each member state participates also in the formation of foreign currency reserves of the European Central Bank, up to total amount of 50 billion Euros. [7]

4. BUDGETING OF THE EUROPEAN CENTRAL BANK [8]

Activities and the budget of the European Central Bank (ECB) were described in detail in the relevant chapters of the annual report.

ECB decision-making bodies are Governing Council and the Executive Board and the Budget Committee for the budget issues. Budget Committee is a body responsible for the budget issues and it is formed by the Governing Council. It consists of the representatives of the European central banks. The Budget Committee discusses the issues of the budget of the European Central Bank and provides its opinion about the budget before it is adopted. It also controls the implementation of the budget policy of the bank and submits its report on it to the Governing Council.

Members of the Executive Board are appointed from among the persons of recognized standing and professional experience in monetary or banking matters by common accord of the governments of the Member States at the level of Heads of State or Government, on a recommendation from the Council of Europe, after it has consulted the European Parliament and the Governing Council.

Budget Committee (BUCOM) consists of experts from the ECB and central banks of the EU Member States and it crucially contributes to the process of the ECB finance management. BUCOM supports the Governing Council by providing a detailed evaluation of the ECB draft annual budgets and proposal and requests for additional budget funds provided by the Executive Board before submitting to the Governing Council for approval. Spending above the agreed budget is regularly monitored by the Executive Board, taking into account the internal controlling functions of the ECB, and the Governing Council by the assistance of BUCOM.

ECB annual accounts are compiled by the Executive Board, in accordance with the principles established by the Governing Council. The accounts are approved by the Governing Council.

Budget Committee is a body that deals with the budget issues and is formed by the Governing Council. Certain principles, primarily the following, are applied when forming the Budget Committee [9]:

- principle of budget unity which requires that all incomes and expenses shall be presented in a single budget.
- principle of full-disclosure or universality which means that all incomes and expenses are presented in the budget.
- principle of accuracy and realism.
- principle of balanced budget, which means that expenses in the budget are in balance with incomes presented in the budget.
- principle of specialisation that sets an imperative that incomes and expenses in the budget shall be presented based on a particular specification that shall provide that approved budget funds are spent:
  1) in defined amount
  2) for defined purpose
  3) within defined period.
principle of duration or periodicity and annuality, which means that budget is adopted for the period of one year.
- principle of clarity, which means the unique grouping of all incomes based on their sources and all expenses based on their purpose.
- principle of transparency, which means that the budget shall be exposed to the public through a broad range of mass media.

When basic elements for the elaboration of the budget are prepared, the volume of incomes is estimated, which is the framework for the planning of expenses. In order to determine total volume of expenses, general balance expenses is prepared with the basic structure that is compared with the expense structure from the previous year.

Budget execution consists of collection of incomes on one hand, and financing of project expenses on the other. A special and very important part of the budget procedure is surely the budget control. Budget Committee controls the implementation of the budget policy of the bank and submits its report to the Governing Council. Budget control particularly refers to the budget execution phase. The control is diverse, and it is conducted in all phases of the budget procedure and includes all persons who manipulate the funds in the execution of the budget.

5. INCOMES OF EUROPEAN CENTRAL BANK

The basic tasks of European Central Bank can be presented as follows:

- maintenance of the price stability and the single currency – euro,
- creation and implementation of monetary-credit policy of the European Union,
- taking care of foreign reserves of member states,
- management of internal and external payment operations.

In order to perform the assigned and set tasks, the ECB has costs that must be covered from its own incomes. In addition, it can open accounts in credit institutions, public organizations and other agents in the market and it receives assets, including the booking state of securities booked as collaterals.

In order to increase the incomes and provide funds for the realization of proclaimed goals and tasks, the ECB can:

- intervene in financial markets by direct purchase and sale (urgently or on set date) or, in accordance with the agreement on subsequent repurchase, by approving or taking by loan the receivables and suing instruments, either in communitarian currency or the currency of non-state member, and precious metals;
- carry out credit operations with credit instructions and other participants in the market with appropriate collateral;

In operations with foreign countries, the ECB can:

- establish relationships with central banks and financial institutions of third countries and, in case of a need, with international organizations;
- purchase and sell, urgently and on set date, all categories of foreign exchange assets and precious metals. The term “foreign currency assets” implies securities and all other assets expressed in the currency of any country or in calculation units, regardless of the category;
take care or manage the above stated assets;
conduct all kinds of banking operations with third countries and international organizations, including the operations of approval and loan taking.

In addition to the basic tasks, the ECB may conclude transactions for their administrative needs or the needs of their staff.

The main incomes of banks are incomes received through interest rates, fees, commissions and other results of operation, such as dividend for instance. Any kind of income is published separately and per segments, if necessary.

The incomes of the European Central Bank can be divided into several categories:

- interest on current accounts
- incomes from deposits in the cash market
- agreement on reverse repurchase
- income from securities
- interest income from foreign currency termed and swap transactions
- interest income from foreign reserves funds.

Other incomes of the European Central Bank may include:

- penalties imposed by credit institutions for incompliance with the minimal requests for reserves
- incomes from fees and commission payable in current accounts
- incomes from stock share and participation interests
- other various incomes during the whole year mainly generated from the transfer of unused administrative reserves in the profit and loss account.

Transfer of the ECB net profit is performed in the following order:

- the amount determined by the Governing Council, which shall not exceed 20% of net profit, is transferred to the General Reserves Fund limited to 100% of capital;
- the remaining part of net profit is divided to owners of the ECB shares in proportion to subscribed shares.

If the ECB produces loss, it is covered by funds of the General Reserves Fund and, if necessary, based on the decision of the Governing Council, from the monetary income achieved in the same fiscal year in proportion and the amount approved to national central banks.

6. EXPENSES OF THE EUROPEAN CENTRAL BANK

The main expenses of the Bank are the expenses made through interests, fees, commission and losses from the sale of HOV and losses on placements and advance payments, losses on impairment of investments and general administrative expense. [10]

- expenses for employees
- administrative costs
- costs of manufacture of banknotes.
7. CLAIMS OF THE EUROPEAN CENTRAL BANK

Portfolio of the ECB foreign reserves consists of funds of foreign reserves transferred from banks of the member states in accordance with the conditions of the Article of Associations of the European System of Central Banks and European Central Bank, and income achieved from them. It serves to finance the activities in the foreign currency market.

Portfolio of the ECB funds reflects the investment of its paid capital, copy of commission from foreign currencies, risk of interest rate and price of gold, funds and incomes of general reserves collected on the portfolio in the past. Its purpose is to provide income to the ECB to contribute to coverage of its operative costs.

Claims and debts denominated in foreign currency are converted into euro at the exchange rate prevailing on the date of the final account. Income and costs are converted at the exchange rate prevailing on the booking date. Revalorization of foreign currency claims and debts, including balance and off-balance instruments, is conducted based on the relationship of the currency to currency.

Revalorization of the market price for claims and debts denominated in foreign currency is treated separately from the revalorization of the exchange rate. Gold is valued based on the market price prevailing at the end of the year. Differences of prices and revalorization of the currency for gold are not separated. Instead, one valuation of gold is calculated based on the price in Euros for fine ounce of gold. All securities eligible to trade and similar claims are valued at mid market prices prevailing on the date of the final calculation based on securities by securities.

Incomes and costs are approved for the period in which they are earned or made. Realized incomes and losses resulting from the sale of foreign currency, gold and securities are transferred to the profit and loss account. Such incomes and losses are calculated in relation to average price of the relevant assets.

Fixed assets, with exception of the land, are measured by depreciation costs. Land is valued by the price. Depreciation is calculated linearly, starting from the quarter after the acquisition and continuing during the expected economic life cycle of the fixed asset, in the following way:

Period of depreciation for capitalized buildings and renewed consumption that refers to the existing ECB premises has been reduced to ensure that these funds are fully written off before the ECB moves to its new premises.

Balances with banks and investments in securities, external loans and other external funds and claims of residents of euro zone denominated in foreign currency consist of balances with banks and loans denominated in foreign currency and investments in US dollars and Japanese yen. The fall of the value over the past two years in these positions has been primarily caused by bringing down the price of US dollar and, to a lesser extent, Japanese yen against euro.

8. CONCLUDING REMARKS

The research we have conducted in this paper shows how the budget is important in the work of one institution, especially the European Central Bank, which is directly responsible for the stability of the European currency and integration of the single market. Therefore, the subject of analysis in this study was the analysis of the balance sheet, profit and loss statement and balance of cash flows, analysis of functions and business reporting of the institution.
Budget of any institution is the basic document for planning of incomes and expenses and uninterrupted performance of planned activities. ECB Budget as such is applicable for financing of activities conducted by the bank in order to provide funds to cover all those costs envisaged within it, with an aim to:

- establish the single market, economic and monetary union;
- harmonious and balanced development of economic activity without inflation;
- high level of use of economic performances;
- increase of life standard;
- solidarity among member states.

Budget of the European Central Bank provides for obtaining funds for financing the work of the bank and its bodies and performance of tasks arising from the main goals. Budget of the bank is based on its sources of income. The largest part of budget expenses is directed at costs of salaries and administrative fees. ECB budget applies budget principles, respects the described budget procedure of elaboration, adoption, implementation and control of the budget.

Long-term advantages of functioning of monetary union will be best seen in case of existence of a stable single currency. Therefore, we should expect that member states will behave in accordance with this goal, that is – to refrain from behaviour that can undermine this stability.

European Central Bank showed the real value and significance only at the end of 2007, after the collapse of mortgage market in the USA, when it began rescuing the whole financial sector by its investments.

Specifically, on 9 August 2007, shares on New York Stock Exchange significantly fell which, according to the law of communicating vessels, resulted in the fall of shares on the most of world stock exchanges. The real cause of the fall of shares was the collapse of mortgage market, that is – the confession of the banks on not being able to collect mortgage loans from indebted USA citizens.

In the USA, the number of citizens who are not able to repay so-called highly risky loans which they took to buy real estate increases from month to month. Financial systems around the world feel the consequences because banks outside the USA which invested in the American market of housing loans are experiencing loss now when the part of those loans are not repaid.

Only two days after 9 August 2007, the European Central Bank put 156 billion Euros in the market in order to stabilize financial markets. It was the largest amount put in the market in the history of that bank, even more than 69 billion Euros paid after terrorist attacks at the USA on 11 September 2001. Afterwards, it continued with interventions in order to preserve the stability of the market.

In order to avoid the problems in the American banking system grow into a global financial crisis, the European Central Bank intervened and thus justified its existence after a little more than a decade since its establishment and showed the importance of the existence of such institution that will contribute to financial stability of not only member states but also the whole world financial system, by working on the achievement of its own goals.
9. LITERATURE