An Alternative for the European Money Market

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This paper concerns an alternative of monetary policy operational framework for the newly created European Central Bank (ECB). Composed of 12 central banks (many of them with an outstanding prestige) it must create the new quality as the emerging single central bank of the large monetary union.

The most important question the Eurosystem should answer is what should be the targeted structure of the European money market? To detain its *insider* bank-based structure or to change it into market-based *outsider* structure? For an answer to such a question we should remember that the Eurosystem issues the currency that might challenge the dollar in the future what may increase a demand for the euro. In the wake of coming enlargement the Bank of England might play in such a market the special role.

The first part concerns the most important feature of a central bank, which even such a particular central bank as the ECB should remember and to take into consideration while analysing the efficiency of its monetary operations. The second part concerns the comparisons with the Federal Reserve System and the third part concerns the prospective enlargement of the euro's zone.

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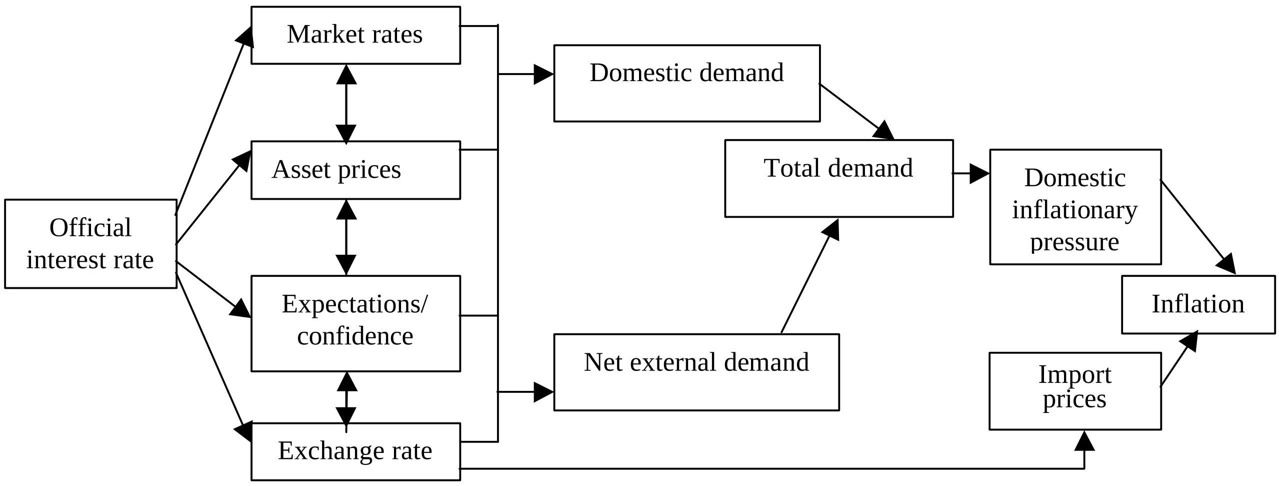
The main feature of central banking

A central bank derives the power to determine specific interest rates from the fact that it is monopoly supplier of 'high-powered' money, which is also known as 'base money'[1]. This principle and as well operating procedures are common for many central banks, however institutional details differ slightly from country to country. The key point is how a central bank chooses the price at which it will lend this high-powered money to private sector institutions. A modern central bank lends predominantly through sale and repurchase agreement (repo) at the described maturity (usually two-week). Such a rate (known also as a repo rate) is often described as official interest rate of such a central bank.

The most important question concerning the efficiency of monetary policy is to explain how and to what degrees the official interest rate, their level and changes affect market interest rates (credit rates and bank deposit rates). If rates are set too low this may encourage the emergence of inflationary pressures so that inflation might be persistently above target. If rates are set too high there is likely to be an unnecessary loss of output, increase of unemployment, and inflation might be persistently below target. These policy actions and announcements affect expectations about the future course of economy and the confidence at which these expectations are held and as well the asset prices including the exchange

[1] described also as a monetary base M0 which consists notes and coins issued plus banker's deposits at a central bank,

rate. This is often explained by the transmission mechanism of monetary policy, which might be illustrated below[2]:



But does this mechanism work in the same or similar manner everywhere? We know three main channels of transmission changes of short-term interest rates to the economy: the textbook channel (based on IS-LM schedule), the broad credit channel and the bank credit channel.

In exercising the power mentioned above the European Central Bank (ECB) does not considerably differ form other central banks. Its operations, procedures or technical aspects are done in nearly the same way as e.g. in the Federal Reserve System or in the Bank of England. Some authors even compare the EONIA (euro overnight index average) to the American federal funds rate and even find both quantities equivalent in respect to volatility[3]. This comparison (as well as many others) might be described as good and illuminating. The American Federal Reserve System and its experience could serve as a kind of prototype for the Eurosystem but this requires some further comments and explanations concerning differences between them.

Affinities, differences and some hopes

Both central banks have apparently the same organisational structure. The Fed is composed of 12 member banks and the Eurosystem is composed of 12 member banks. The Fed is an established part of the American financial system functioning since 1913. Its federal open market committee (FOMC) makes the Fed’s biggest policy decisions. These decisions are implemented by the most

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[2] this figure comes from “The Transmission Mechanism....”, p. 3,

[3] e.g. *Nyborg, Bindseil and Strebulayev* (2002), p. 8,

powerful of the Reserve Banks - the Federal Reserve Bank of New York, which carries out open market operations and intervention in the foreign exchange markets for the whole system.

Do we have something that might be called an integrated European financial system? Or maybe the Eurosystem is a harbinger of that? The Fed is a central bank of one country. The Eurosystem is the first single central bank of the large currency area (also the first in such a version) existing only for three years and composed of 12 independent countries. The Eurosystem has also its common decisive body but some important decisions about monetary operations are made and implemented by each member central bank according to the rules set out in its statute.

The Fed uses chiefly one powerful financial instrument - the Treasury bill for its open market operations. The Eurosystem could only establish very complicated two-tier asset system from which such a uniform instrument may emerge in the future.

In the federal funds market (FFM) there are selling and buying banks. So we have lenders (sellers) and borrowers (buyers). The lenders are likely to be liability-driven banks and the borrowers are typically asset-driven banks. In the European market there are buying banks and only one seller (the Eurosystem).

The American FFM derives from the US reserve requirement. The comparison made in the above mentioned research shows that American required reserves consist only 15% of their European equivalent explaining that this might occur mainly due to circumventing the reserve requirement by shrinking the reserve base.[4] It should be born in mind that the United States (and the UK) have market-based or *outsider* system that relies on active stock markets trading existing debt and available for launching new debt. The vast majority of the EU countries have an *insider* system, in which financial markets play still small roles and companies there even long term-debt receive from banks. So under European bank-based *insider* system the reserve base must be much higher than under market-based *outsider* system[5].

But the most important difference is in decisions concerning interest rate levels. The Eurosystem sets its basic interest rate concerning main refinancing operations (MRO) in the middle of the corridor set by two standing facilities (deposit and marginal lending facility) which are also set up by the Eurosystem. The interbank overnight rate should always correspond to the marginal value of reserves at the end of the reserve maintenance period.[6]

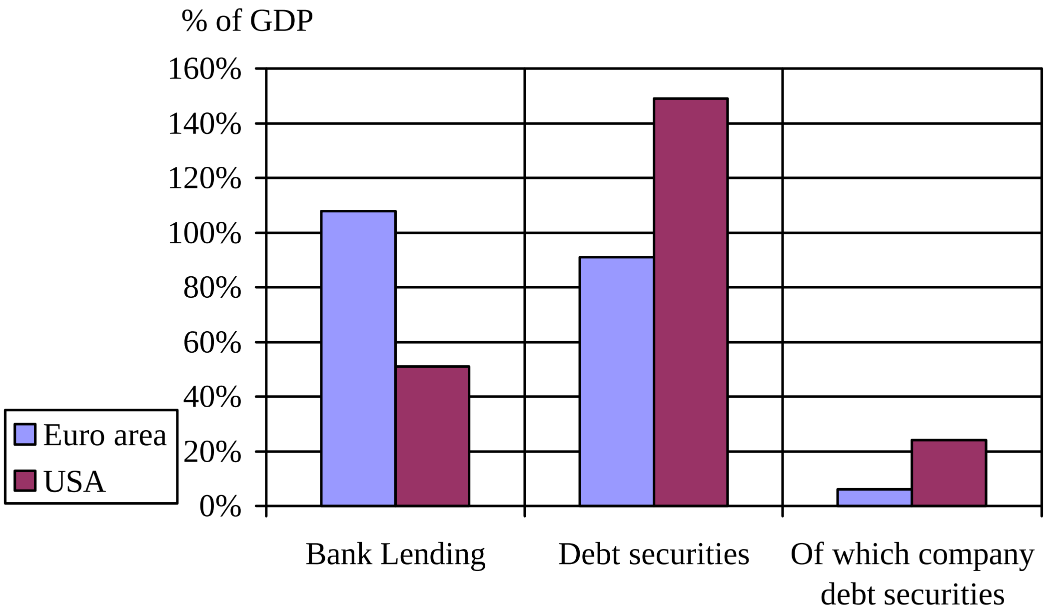
The Fed's decisive procedure is much more market oriented. The federal funds rate is fully set by market forces (demand and supply) and the Fed's FOMC stipulates only the target range for its level. This target is met by appropriate open

[4] *ibid*., p.3,

[5] this distinction comes from *Begg, Fisher and Dornbush*, (1997), box 7-1, p.95.

[6] according to *Nyborg, Bindseil and Strebulayev*,(2002), it is weighted average of both standing facilities rates whereby the weights correspond to the likelihood of being long and short, (p.4),

CHART1: DEBT OUTSTANDING IN THE EURO AREA AND USA



market operations, which by changes in the demand and supply of money try to change the respective level of the federal funds rate in the direction closer to the target range. The Fed sets up also the discount rate but the discount window credit makes up relatively small portion of the total domestic financial assets held by the Fed. Despite of that the existence of the discount window credit facility is an important part of the monetary policy implementation framework. It may moderate the upward movements of the federal funds rate in the event of shortage of Fed balances. Such a procedure is possible thanks to highly developed nature of financial markets in the United States. In such financial markets potential lenders and borrowers find the most satisfactory terms and interest rates. Such a market making process allocates savings to the uses offering the highest return and searches out the interest rates that bring supplies and demands into balance.

The above mentioned differences may be illustrated by the corresponding data. At the end of 2001 bank lending in the euro area amounted to 108% of GDP and was significantly greater from that of USA where it reached only 51% of GDP. But the value of debt securities outstanding in the euro area (91% of GDP) is considerably smaller than in USA (149% of GDP). The difference is even greater (four times) in the portion concerning debt securities issued by companies in euro area (6% of GDP) and in USA (24% of GDP). The above mentioned data are demonstrated in the chart 1.[7]

Taking into consideration the above mentioned circumstances and data the Eurosystem should answer the following question: what is the required target of the European financial system, to detain its *insider* bank-based structure or to change it into market-based *outsider* structure? If the answer is to maintain the present structure the present strategy of the Eurosystem does not require

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[7] "Practical Issues.....",(2002), p. 12,

considerable changes. It requires of course the continuous improvement of organisation and monetary policy instruments. But the second option requires changes. If the Eurosystem decides to reach the market-based *outsider* structure its strategy requires considerable changes. Under the bank-based *insider* system the money market is far less significant as the monetary authority (a central bank) takes the basic decisions concerning the level of interest rates[8]. Here the level of interest rates does not have a need to reflect fully the market forces and the monetary authority wants to create itself the required tendencies of interest rates levels. Under market-based *outsider* system the monetary authority tries to establish the effective money market and gives up its power to market forces. To influence the level of interest rates the monetary authority confines its activities to increasing or decreasing the demand and supply of money using for that purpose its monetary base (M0). In the present European reality this alternative requires scrupulous consideration of the coming enlargement of the euro's zone.

The consequences of eventual enlargement of the euro's zone

The coming enlargement of the euro's zone is usually matched with the present accession countries willing to join the European Union in 2004. Most of them are post-communist countries of the Central Europe. It is hardly possible that the all above-mentioned countries will join the euro's area en bloc at one point of time. The most probably there will be several (or even more) years in which new entrants will be admitted. All these enlargements will have importance for the monetary policy framework. But the Eurosystem is expecting another enlargement that might have much more important for their monetary policy consequences, the potential enlargements with the three present members of the EU not yet participating in the EMU i.e. the United Kingdom, Denmark and Sweden.

All the three above-mentioned countries will become important parts of the euro's area but one of them might appear that of particularly great importance. This is the United Kingdom with the Bank of England, which with the British commercial banking and the City of London makes one of the world's three financial capitals.

Historically, the City of London developed as a world's important financial center because of international role of sterling and until now generates huge exports of financial services. For a long time its role depended on making markets and providing financial services in foreign currencies. Foreign owned and internationally oriented monetary institutions of the City find their business very competitive to do there.

Today the euro makes a significant contribution to the City firms' international business, which consider it as an integral part of their international activities. This is due to the fact that the euro is today the second most widely

[8] it does not matter whether this decision is made directly (setting up the appropriate rate) or indirectly (e.g. through the auction bidding) as here the monetary authority sets up the minimum bid rate,

used currency internationally[9] and as well due to the recent development of the euro market in Europe. The City market firms have actively participated in the development of the euro market by providing deep, liquid and innovative markets in London.

The level of financial services in the City has not just been only a function of its activities in the euro markets, or competition between London and other European financial centers. It has rather been a function of the City's global competitiveness mainly in comparison to New York and of the high technology used on both financial centers. The euro market remains today globally competitive thanks to substantial contribution of the City which by providing efficient wholesale financial services across Europe helped to stimulate financial activity in Frankfurt and Paris.

Supported by two pan-European settlement system (TARGET and EURO I) the unsecured euro inter-bank deposit markets are fully integrated and far more liquid than the legacy markets. This may be observed in identical short-term euro interest rates across Europe, a large increase in the number of transactions in EURIBOR (futures) and in EONIA (swaps), narrower dealing spreads in the money and foreign exchange markets, declining foreign exchange turnover among European countries and increasing volume of transactions by large banks across borders.

But trading in secured euro money markets is not yet fully integrated. Though euro-area government bonds are being increasingly traded on pan-European basis and significant increase of cross-border repo turnover takes place it is still not easy and quick to deliver collateral across borders (as it is within borders).

All the facts mentioned above designate the Bank of England for special role in the Eurosystem under assumption that the United Kingdom joins the euro's area. This special role might be the similar as the role of the Federal Reserve Bank of New York in the Federal Reserve System. It is not necessary for the Bank of England to be a copycat version the New York Fed as there is no need for the Eurosystem to be a copycat version of the Federal Reserve System. But the Bank of England might play a vital role in transition of European financial system from the present *insider* bank-based structure to the targeted *outsider* market-based structure.

But the strongest argument for the special role of the Bank of England in the Eurosystem lies in the procedure of choosing its official repo rate. Arbitrage between short-term sterling markets keeps their interest rates highly adjusted for the market conditions and each change of the repo rate is quickly reflected across the spectrum of markets. If the United Kingdom joined EMU a number of changes would be required in the Bank of England's monetary policy operations. So the question might be asked: which changes would be more appropriate? Those adapting the Eurosystem for more market oriented strategy, which could be

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[9] according to IMF's estimates cited in "Practical issues..." p. 8, around 13% of official international foreign exchange reserves of IMF countries was denominated in euro at the end of 2001, while in dollar 68%,

borrowed from the Bank of England, or those adapting the Bank of England to the present operational framework of the Eurosystem but without giving up its advanced market oriented strategy?

In the wake of the coming enlargement the Bank of England with the British clearing banks and the City of London will not probably differ in its status from post-communist central banks making the dirty financial markets with the Polish, Hungarian or Czech pocket banks.

Some distinguished economists like Buiter and Issing have openly used the charming Lewis Carroll's classic stories in their essays concerning ECB.[10] If we continue to call the Bank of England flexible and wise old lady at any rate we cannot identify the Central Eastern European (CEE) Central Banks with Alice (flexible and self-possessed young lady). But we may find the appropriate character for them. This could be Lady Muck, which reminds rather The Queen of Hearts, the Hatter or the March Hare. Their scenery reminds The Queen's croquet-ground with painted roses and leaves or the tulip-roots cooked instead of onions. Their monetary policies remind the croquet played with hedgehogs stricken by flamingos instead of balls and mallets.

Through the rooking-glass and what some economists and politicians do not want to find there

Countries wishing to become members of the EU are expected not just to subscribe to the principles of democracy, the rule of law and market economy but actually to put them into practice in daily life[11]. Proof of the existence of a functioning market economy requires minimum level of economic competitiveness necessary in order to withstand the competitive pressures and market forces at play within the Union. In applying for membership, the candidate countries accepted the objectives of the Treaty on European Union, including political, economic and monetary union. Although unable to join the euro immediately on accession, the candidate countries will have to adopt the *acquis communautaire* of Stage 2 of EMU. This implies central bank independence, coordination of economic policies, and adherence to the relevant provisions of the stability and growth pact. New Member States must forego central bank financing of public sector deficits, and complete the liberalization of capital movements. Finally, they must participate in an exchange rate mechanism and avoid exchange rate fluctuations.

This assumes that financial authorities in the post-communist CEE countries understand the above mentioned rules so as they are understood in the countries of

[10] see *Buiter*, (1999) and *Issing*, (1999); I think the time is up to establish the Lewis Carroll's classics as a compulsory literature for economists as Buiter and Issing are not the first to do it; you may find them also in *Begg, Fisher and Dornbush*, (1997); this concerns *Alice's Adventurers in Wonderland*, *Through the Looking-Glass and What Alice Found There*, and *The Hunting of the Snark; An Agony in Eight Fits*, or as well *The Tangled Tale*,

[11] according to: http://europa.eu.int/comm/enlargement/pas/phare/wip/copenhagen.htm of 9 Feb. 2000,

the European Union and the institutions of the countries referred (many of them have not yet appeared) should only be adapted to European standards. Everything indicates that the financial and banking sectors of these countries require greater and deeper changes than their admirers might wish. It is worth to remember that Greece and Sweden, the two countries that have not complied with Maastricht convergence criteria in 1999, have been far better known for a long time from economic and financial side. Greece joined EEC in 1981 and since 1984 has cooperated with European Monetary System. Sweden however joined the EU only in 1995 but as early as in the seventies joined the European Exchange Rate Arrangement (the “snake”) so their experience and knowledge of their performance by the other European countries cannot be compared with those of post-communist prospective members.

For all prospective members of the European Union, the European Commission’s opinions concluded that it was still premature to judge when they will be ready to adopt the euro. Nobody is able to predict whether the post-communist countries will be able to do it in this decade or even at any time. Earlier access i.e. better performance than Greece and Sweden is rather implausible. So the important question arises how long the new enlarged European Union can afford to wait for that transition.

Many publications indicate that CEE accession countries have attained substantial progress in their transition to market economy. Their private sector’s output share exceeds 60 per cent of GDP. Inflation has been substantially reduced and becomes to make one-digit rate. Foreign indebtedness has substantially decreased. But is this enough? Everybody should remember that the combined GDP of all accession countries accounts only around 5%[12] of GDP of that of the present EU.

Nominal and real convergence

For further consideration it will be helpful to distinguish between nominal and real convergence. Nominal convergence means fulfillment of Maastricht criteria two of which are fiscal, two are monetary and one concerning foreign exchange performance. It will not be easy for any CEE country to fulfil all five Maastricht criteria at the earliest possible date i.e. two years after accession and the most probably none of CEE countries will join the euro’s area at the earliest possible date. Presumably not all CEE countries will join the ERM II immediately on accession.

Buiter and Grafe argue that “any credible foreign exchange regime prior to EMU membership would risk running afoul of the inflation criterion for the EMU membership because of the Balassa-Samuelson effect”.[13] The Balassa-Samuelson effect is very often raised as a device explaining impossibility to meet inflation

[12] such a share has been quoted in *Noyer*, (2001), that of 12 November,

[13] *Buiter and Grafe*, (2002), in abstract,

criterion (it means potential inflationary pressure arising from higher productivity growth in catching-up CEE economies). But it is not quite obvious whether the Balassa-Samuelson model may be applied when prices are not fully created by the market forces (e.g. interest rates)[14]. Everything indicates that fulfilling of all Maastricht convergence criteria by any CEE country is hardly possible at one point of time. Meeting monetary criteria might push up fiscal criteria. Moreover such a fulfilling at any price might cause even recession in the countries referred.

But much more important is real convergence, which means that CEE economies will really catch up towards structures prevailing in the EU. That they will be transformed in fully-fledged market economies being able to cope with competitive pressures and provide the conditions for sustainable and non-inflationary growth. This requires much more than meeting the above mentioned criteria. The process of real convergence among new entrants and the present European Union incumbents might take some more time than many advocates of quick enlargement assume. Nobody is able today to predict how long it will last. So no wonder that various proposals appear. On one side are those who propose to enlarge euro area immediately on accession and on the other side are those, who submit warnings against premature adoption of euro and propose to extend somewhat the transition period in order to adjust CEE economies in terms of nominal and real convergence. Already mentioned Buiter and Grafe support the first option. Representatives of the European Central Bank and European Banking Federation support the second option. Let us name for working purposes the first option as a premature adoption of euro and the second one as a suitable adoption of euro.

The first option that of premature adoption of euro assumes so great progress in some CEE economies that its advocates despite of many unfavorable data and circumstances are delighted in them. The two-year requirement of joining ERM II they describe as pointless and costly so they propose a derogation or waiver of the exchange rate criterion. They propose also a derogation of inflation criterion arguing that because of Balassa-Samuelson effect CEE economies are not disposed to fulfill this criterion.[15]

Such an attitude is not only in conflict with European Treaties[16]. Instead of quicker convergence process it might cause serious and real divergence that may result in further backwardness of standards of living of new entrants and creation of economic discrepancies between them and the core EU countries (present members). This in consequence could make new entrants somewhat alike to the present members of the EU and could make the latter group somewhat alike to the

[14] the problem of dirty market forces in CEE economies is discussed in *Rutkowski*, (2002),

[15] the similar views are represented by *Orlowski*, (2001), and also by the majority of representatives of central banks from CEE countries,

[16] it should be borne in mind that this diagnosis concerns the present legislature of the EU which may be changed after accession by the new enlarged EU; there is also a possibility of precedent; if one country by any chance joins the euro's area with any kind of waiver this will probably be adopted by the functioning legislature,

present accession countries. Of course neither the incumbents nor the accession countries should be interested in such results.[17]

The second option, that of suitable adoption of euro, expressed by the representatives of the ECB, recommends somewhat like transition period before adopting euro. First: it is not necessary for CEE accession country to join ERM II immediately after accession and second: it is not necessary to limit this membership in ERM II only to two years. A longer membership in ERM II might for some CEE countries be helpful and desirable. So the membership in the euro's area requires time and flexibility, and that it is not wise to speed up that process. It should be in the interest of the accession countries to make use of the higher degree of flexibility available prior to adoption of the euro and to effect structural reforms aiming at achievement a desirable level of real convergence. A thorough discussion should be started on the future organization of the ECB and this debate should be finished before enlargement of the EU starts.[18]

So the conclusion may be drawn that the suitable adoption of euro by new CEE entrants should be delayed in time.

Central banking

All countries that have emerged from the soviet-type economics usually operated in the absence of economic legality. They have already had central banks but the communist authorities had created all them. All they were subordinated to communist governments and fulfilled so called the credit plan. In the beginning of nineties all they started to become independent but this independence has became peculiar. It was limited only to removing the government's supervision but the majority of their activities and legal rules have been remaining unchanged for a long time. Today we may observe overtaking of CEE central banks by party leaders that lost recent elections and they use the argument of independence for defending their strongholds of cronies. They use banking supervision for persecution of criticism and try to involve some gullible officials of the EU to defend there allegedly endangered independence making impossible any necessary central banking reforms. So they have had no responsibility, no external control (audit), all central bank money at their disposal and independence equal absolute discretion or freedom. Such central banks have been at a loss to achieve any pre-determined inflation's goal regarding stabilization policy as their instruments and indicators used were inconsistent with targets pre-determined. Sometimes these central banks were close to some disinflation goals but costs of their operations quite often proved to be much higher than expected and acceptable.

In all these central banks' monetary policies the transmission mechanism has not yet started to work properly or even has not yet started at all. The only

[17] the potential pitfalls and dangers arising from premature adoption of the euro are developed by *Wagner*, (2001), and by *Begg,* and others, (2001),

[18] such a view has been expressed by European Banking Federation (FBE) in *FBE Letter* from February 2002,

instrument - exorbitant interest rates backed by high obligatory reserve ratios - sometimes induced the converse effects than intended. This defected transmission mechanism is additionally distorted by unsound commercial banks that are at a loss to control their balance sheets and often fail to respond to changes in reserve money or interest rates.

The traditional power of the lender of last resort has hardly been performed by these central banks. Rediscounting the bills of exchange and lombard operations are in their offer but their amount rarely exceeds 1% of the whole assets. They offer large amount of central bank bills for commercial banks, which cannot find enough demand for credit at so extremely high interest rates. It is true that they do it in a market manner but is it correct to name them open market operations? Their money markets are still at the embryonic stage so the differences between open and inter-bank money markets are so weak that there is no reason to distinct they. Moreover in this situation the central bank is the last and often the only resort to pay so high interest for commercial banks and such a central bank becomes something like borrower-of-last-resort authority.

Until now no comprehensive audit has been carried out since the creation of these banks by the communist authorities. Any attempt to organize such an audit during the last decade has been dismissed as a step to interfere their independence. They have very strange accounting standards, which are entirely different from those known across the Europe. It is worth to remind that solely their chairmen have always submitted the accounting standards for the central banks of these countries.[19] And this has been also explained as a consequence of their independence.

Finally in all these countries the central bank staff consists unscrupulous and unregulated professionals which are easily tempted and often looking there high lucrative rewards, assuming that their stay in the central bank will not be too long. Among workers and the management of the referred central banks the number of those who have ever learned finance and banking may be usually counted on one hand.

But some of these countries already had in the past reliable central banks. They were created and incorporated after the First World War. These central banks were encouraged to centralize the payments function, to manage exchange rates in order to keep control of the money supply and achieve monetary stability. One could argue that the interwar experience of these central banks might prove relevant to credible institution building. Until now none of these countries has referred to its splendid tradition[20].

Their commercial banking comes from the carve-up of the monobanking system and a plethora of small so-called “pocket” banks flouting the prudential standards of developed countries and remaining in the face of systemic collapse.

[19] the best example is Poland where the accounting standards for the National Bank of Poland have been submitted solely by the chairman of the NBP and since 1998 they should be only approved by the monetary policy council of the NBP,

[20] The case of Czech Republic, Hungary and Poland is examined by *De Cecco*, (1994),

The large portfolio of bad loans, relatively small share of loans to non-banking sector and large amount of central bank remuneration for payment of interest for depositors are the main features of this new born sector.

Foreign exchange rate policy

Masson[21] recommended three exchange rate options for these countries: a currency board arrangement (CBA); a band around an adjustable central parity (i.e. ERM II); and a more flexible exchange rate (crawling band or managed float), augmented by another anchor for monetary policy. This is not the first proposal to establish currency board with the euro for Central and Eastern Europe as the most appropriate mechanism to start the way to convergence. Mundell[22] describes this arrangement as the best approach to convergence and concludes, "if a country cannot do a currency board, it cannot do monetary union!" Dornbush and Giavazzi[23], despite of quoting a bunch of objections, recognize the currency board to euro as a springboard to implement the wider political agenda and a mechanism to assert the fundamental ambition to be part of European Community.

Both kinds of adjustable pegs mentioned above may be highly efficient and attractive for liberal authorities of the countries referred. Such a rate demonstrates the cardinal principle underlying the market economy while market forces determine it. The authorities of these countries rarely realize that efficient operation of any kind of floating exchange rate arrangement requires efficiently operating financial markets. That without the developed financial market any effective intervention of the central bank is impossible although these banks often explain execution of all its foreign exchange deals, even those bought and sold on behalf of its own customers, as intervention bargains. Without the financial markets any predictor of future exchange rate is highly uncertain. Without financial market any alleged floating defended e.g. by exorbitant interest rates becomes inefficient dirty floating.[24] We may add some other arguments like vulnerability to destabilizing speculation, possibility of real appreciation not justified by productivity growth and other dangers but one of them is particularly important and quite rarely quoted - the lack of transparency. When the Norwegian government introduced basket of currencies everybody could know even the kind of mean used to weight its basket[25]. When the CEE country informs that is uses crawling peg based on the basket of currencies with given only percentage values of the basket currencies it is not possible to predict anything and often even to understand its performance.

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[21] *Masson*, (1999),

[22] *Mundell, R. A.* (1999), p. 19,

[23] *Dornbush, R., Giavazzi, F.*, (1999), p.4

[24] this notion comes from *Wagner*, (2001), p. 12,

[25] the problems connected with management of the currency basket are described in *S. Takagi*, "Pegging to a Currency Basket" in *Finance & Development*, 1986, Vol. 23, No 3, pp. 41- 44,

Other misfits

The Central and Eastern Europe region is often mentioned as a significant source of different criminal proceeds. Money laundering operations originating from Russia have created the new phenomenon. Capital flights from Eastern Europe and Russia have helped in recent years to create an environment in which the movement of criminal funds from out of the region has become difficult to detect.

The most common predicate offence for money laundering among these countries is fraud (i.e., the looting of government holdings or financial institutions). Money laundering methods involve the use of legitimate financial agencies (local pocket banks acquired for money laundering purposes) to move funds in and out of these countries. Bank loans are widely used to legitimize funds embezzled from hastily privatized state-owned enterprises to the accounts of companies registered in offshore locations with no possibility to determine beneficial owners and account relationships. The wide variety of methods is used to effect money laundering. Temporary bank accounts (where cash proceeds of crime are deposited and then quickly withdrawn), alternative remittance systems, purchase of luxury goods, large number of bureaux de change (which recently are increasingly found in laundering operations) and other methods. Recently a good reputation created under false pretences has become particularly popular when old communist party officials become reputable and resourceful businessmen[26].

All this malpractice is hardly detected by respective banking supervision units. As the main cause of that the loopholes in financial and banking regulations may be indicated. There is no definition of credit institution and definitions of banks usually are imprecise so they may carry out different businesses. Assessing of the backgrounds of managers and beneficial owners of financial and banking institutions is very difficult and often impossible. Their customer identification requirements are still inadequate. Secrecy provisions regarding financial and banking institutions and particularly those concerning central banks are excessive and often overused. There is also some concern about suspected collusion between such businesses, politicians and organized crime. In June 2001, the Financial Action Task Force amended its black list of non-cooperative countries in the fight against money laundering to include Hungary.

One may argue that this is the task for their judicial systems but the extent to which such illicit practices affect their economic and financial data and how far their official institutions are involved in them is also of great, and often of vital importance.

[26] according to FATF Report on Money Laundering Typologies 1999-2000 of 3 Feb. 2000, points 85-87 and annex,

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In order to enlarge successfully the euro's area with the post-communist CEE countries of Europe the Eurosystem should be aware of misfits and misconduct taking place there coincided with their intended sneaking into the EMU by so called unilateral euroization. Their scarce central banking experience combined with high degree of political envelopment of their central banks, incipient, shallow and volatile financial markets and trend to the most flexible exchange rate mechanisms expose these countries to acute currency crisis and high risk premiums. This potential enlargement might have a considerable influence on monetary operations of the Eurosystem. The accession countries will require standing behind them as lender of last resort. In this area the recent Fed's experience is less relevant. More relevance might be find in the early stage of the German Federal Bank.

In order to enlarge the euro's area with the Great Britain and the Bank of England with all its differences in doing monetary policy the experience of the Fed looks more applicable. What the Eurosystem should borrow first from the Fed? This is the idea of the Beige Book - the issue prepared at the Federal Reserve Bank of New York which summarizes comments received from businesses in twelve districts and contacts outside the Federal Reserve and is not a commentary on the views of Federal Reserve officials[27]. The eventual European Beige Book setting out the economic conditions in the member European countries might become an important complement of conclusions and findings made on the base of the above mentioned research I hope being continued in the future. And it will probably allow working out the rules, which the financial markets understand better.

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[27] according to http://www.federalreserve.gov/FOMC/BeigeBook/2002/20020731/Default.htm

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