

# **Euro at 20 – Beyond the troublesome teens**

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**Disclaimer:**

My own views, not necessarily those of the EU institutions I work(ed) for.

Presentation based on: “The Single Monetary Policy: 20 years of experience”, Praet, Saint Guilhem and Vidal, forthcoming in the proceedings of the ECB’s 2019 Sintra Forum.

## **First stages of euro's 'life' (rather history!)**

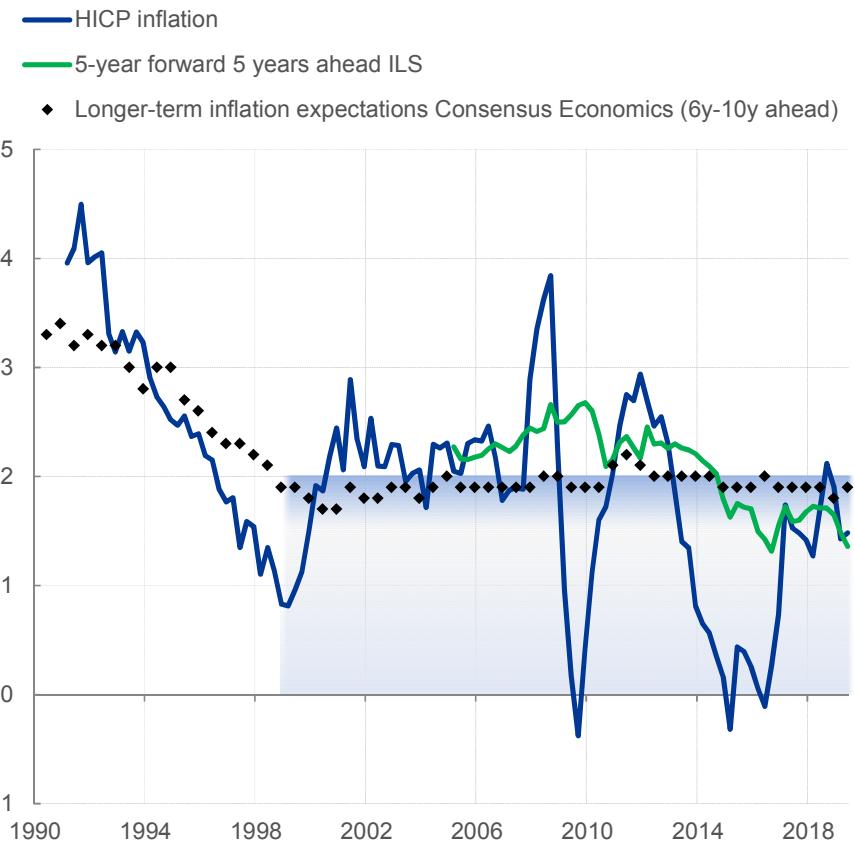
- **Birth:** unprecedented event in monetary history, *sui generis* institutional framework (1 central bank, 19 sovereign Member States)
- **Childhood:** Establishing credibility and anchoring inflation expectations in the aftermath of monetary disorders in Europe
- **Adolescence:** from the Great Moderation to the GFC and the sovereign debt crisis
- **Adulthood:** maintaining credibility in low inflation environment when monetary policy risks reaching its limits in macroeconomic stabilization

# 1. Establishing credibility

## Price stability as the primary objective of monetary policy

- Article 127 of the Treaty: “The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union...”
- Governing Council’s definition of price stability: “year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term”.  
*(October 1998)*
- End of dot com bubble already elicited discussion about lower bound and asymmetry of reaction function. This led to a clarification of the strategy : “below, but close to 2% over the medium term”.  
*(May 2003)*

## Euro area inflation and inflation expectations (percentages per annum)



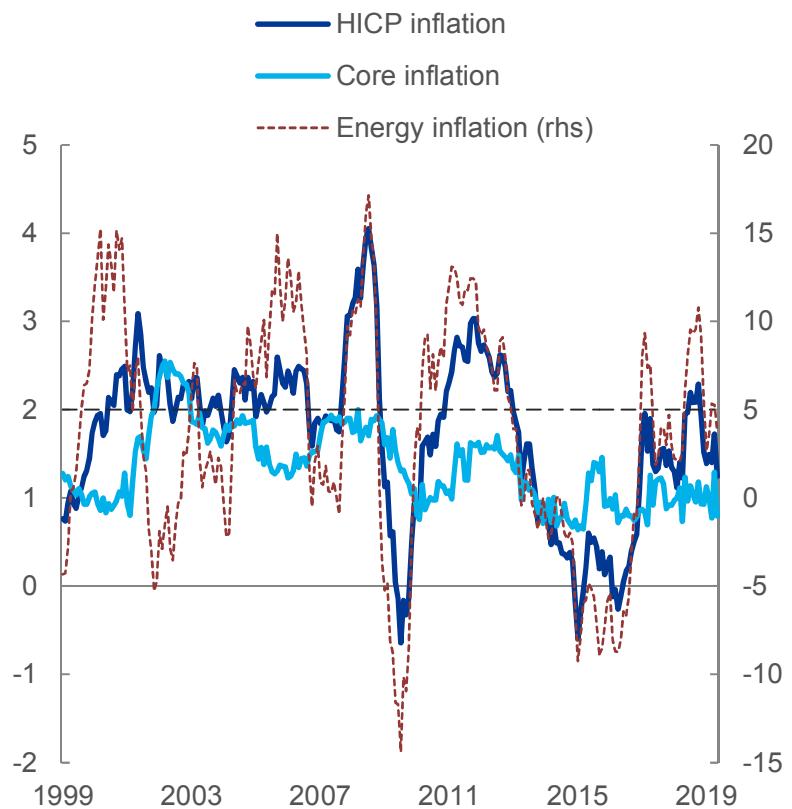
Sources: Bloomberg, Eurostat.  
Latest observation: 2019Q1.

# 1. Establishing credibility

## The pre-crisis years

- The euro was a response to persistent monetary disorders that undermined the Single Market
- Need for newly established ECB to acquire credibility in the context of repeated oil price increases in the run-up to the GFC
- The quantitative definition of price stability has contributed to strong anchoring of inflation expectations
- No signs of second round effects from energy inflation (*Oil prices: from 10\$ in Jan. 1999 to 145\$ in July 2008!*)

## Euro area (year-on-year % change)



Sources: Eurostat, ECB calculations.

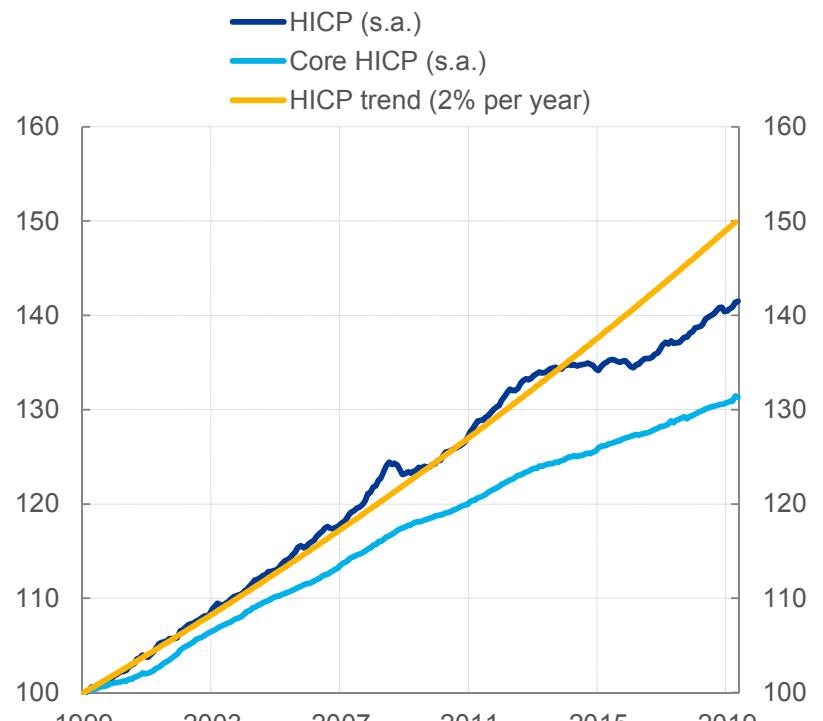
Notes: Core inflation is HICP inflation excluding food and energy.  
Latest observation: May 2019.

# 1. Establishing credibility

## The long view

- Consumer prices evolved broadly in line with a 2% trend until the sovereign debt crisis
- Core consumer prices evolved along a lower trend already well before the crisis
- Downward pressures on both headline and core inflation built up in the aftermath of the sovereign debt crisis

## Euro area HICP (Index, January 1999=100)



Sources: Eurostat, ECB calculations.

Notes: Core HICP is HICP excluding food and energy.

Latest observation: May 2019.

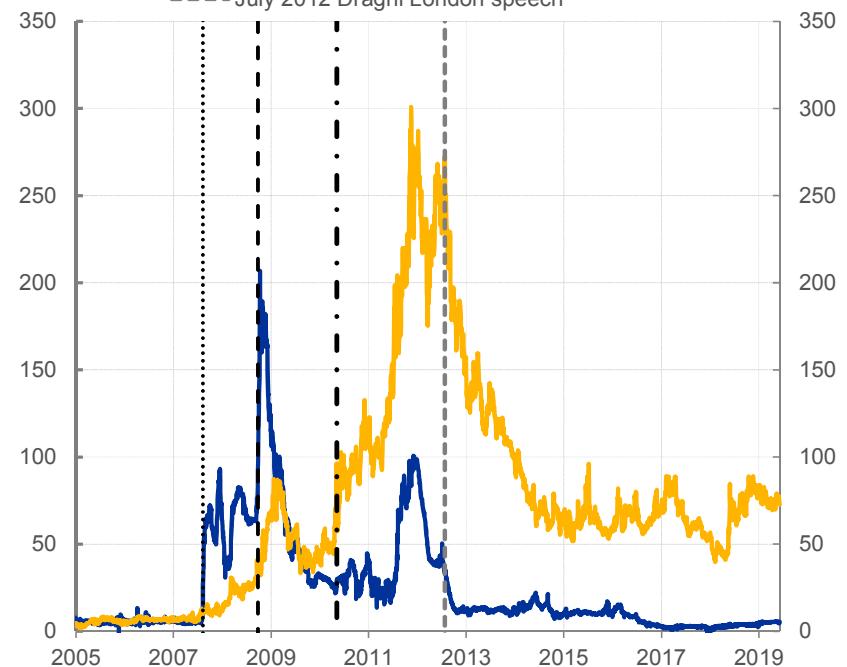
## 2. GFC marked dramatic change in the policy environment

### A dual assessment: policy stance and transmission through the banking system

- **Policy stance:** significant loosening following GFC, but tightening in April-July 2011 amid concerns about second-round effects from energy inflation
- **Transmission:** Generous liquidity provision to banks to prevent disorderly deleveraging (FRFA, VLTROs, ...) and SMP to support monetary policy transmission
- Rising fears of debt restructuring following Deauville

### Euro area money and government bond market spreads (basis points)

— 3-month Euribor-OIS spread  
— Euro area sovereign spread vs 10-y Bund yield  
····· August 2007 turmoil  
- - - Lehman collapse  
- · - May 2010 Greek programme  
- - - July 2012 Draghi London speech



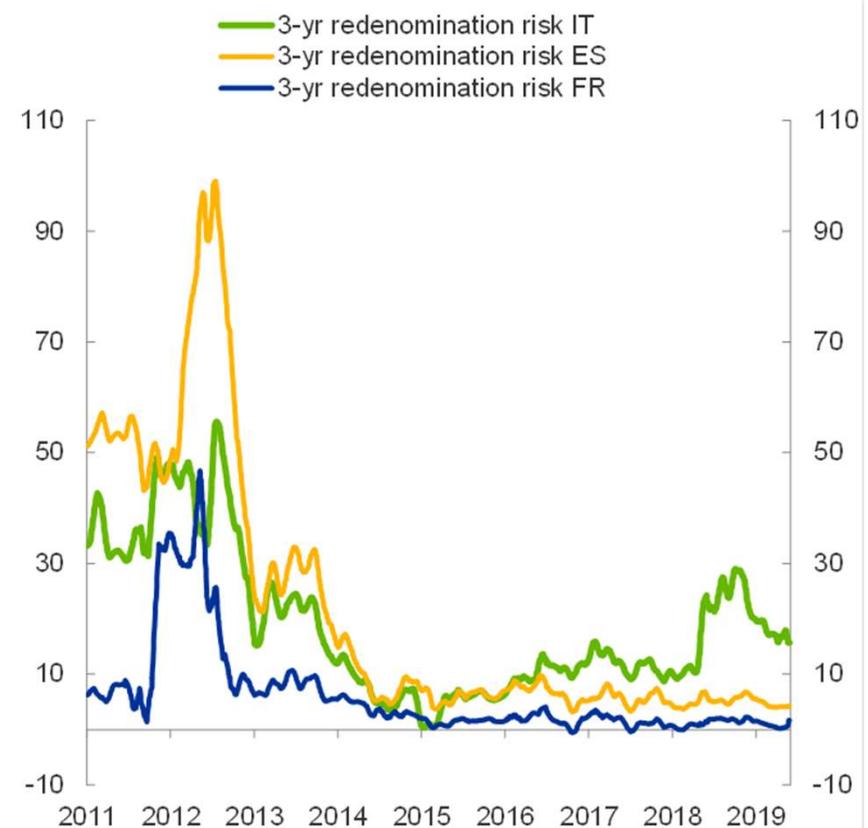
Source: Bloomberg, Eurostat.

Notes: Euribor = Euro Interbank Offered Rate; € OIS = Euro Overnight Index Swap Rate. The euro area's 10-year yield is a GDP-weighted average of euro area member countries' government bond yields.  
Latest observation: 04/06/2019.

## 2. 2012: existential crisis & redenomination fears

- 29 June 2012 euro area summit: “*it is imperative to break the vicious circle between banks and sovereigns.*”
- 26 July 2012 Mario Draghi’s speech: “*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.*”
- 2 August 2012 Introductory statement: “*Risk premia that are related to fears of the reversibility of the euro are unacceptable, and they need to be addressed in a fundamental manner. The euro is irreversible.*”
- 6 September 2012 Introductory Statement: Outright Monetary Transactions (OMT) “*aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy.*”

Redenomination risk in selected euro area countries at 3-yr maturity  
(basis points, 20-day forward moving average)



Sources: Thomson DataStream and De Santis (2018).

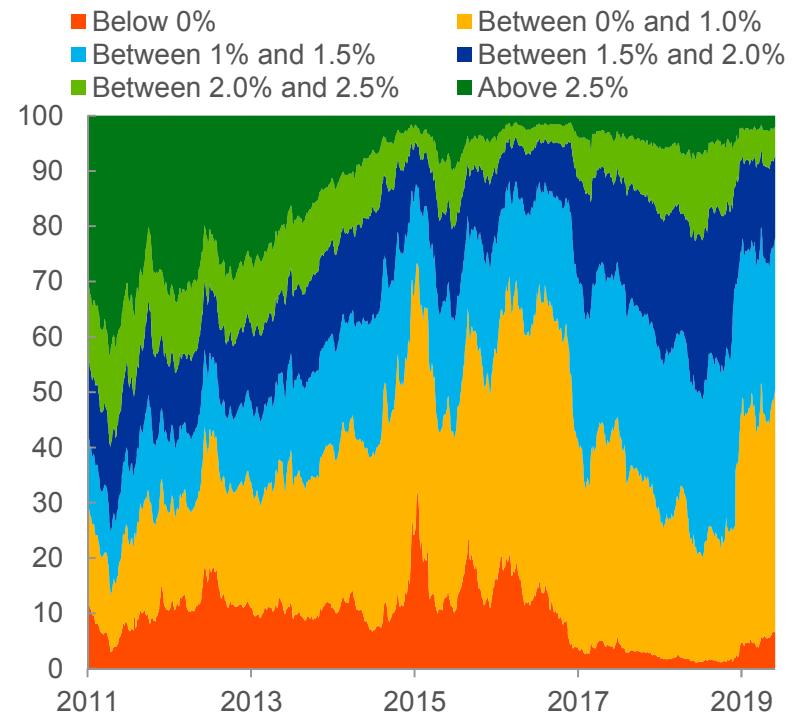
Notes: Redenomination risk is measured as a difference between Quanto CDS for Italy/Spain//France and for Germany. The Quanto CDS is computed as difference between the sovereign CDS quotes in dollars and euros.

Latest observation: 26 May 2019.

## 2. Low inflation recovery with lower bound constraint

- **Rising risks of disanchoring of inflation expectations**
- **Policy response combining a set of mutually reinforcing instruments**
  - **Negative rates and forward guidance on rates**
  - **Asset purchases and forward guidance**
  - **Targeted Long-term Refinancing Operations (TLTROs)**

Option-implied distribution of average inflation over the next 5 years (percentage per annum)



Sources: Bloomberg, Thomson Reuters and ECB calculations.

Notes: Probabilities implied by five-year zero-coupon inflation options, smoothed over five business days. Risk-neutral probabilities may differ significantly from physical, or true, probabilities.

Latest observation: 31 May 2019.

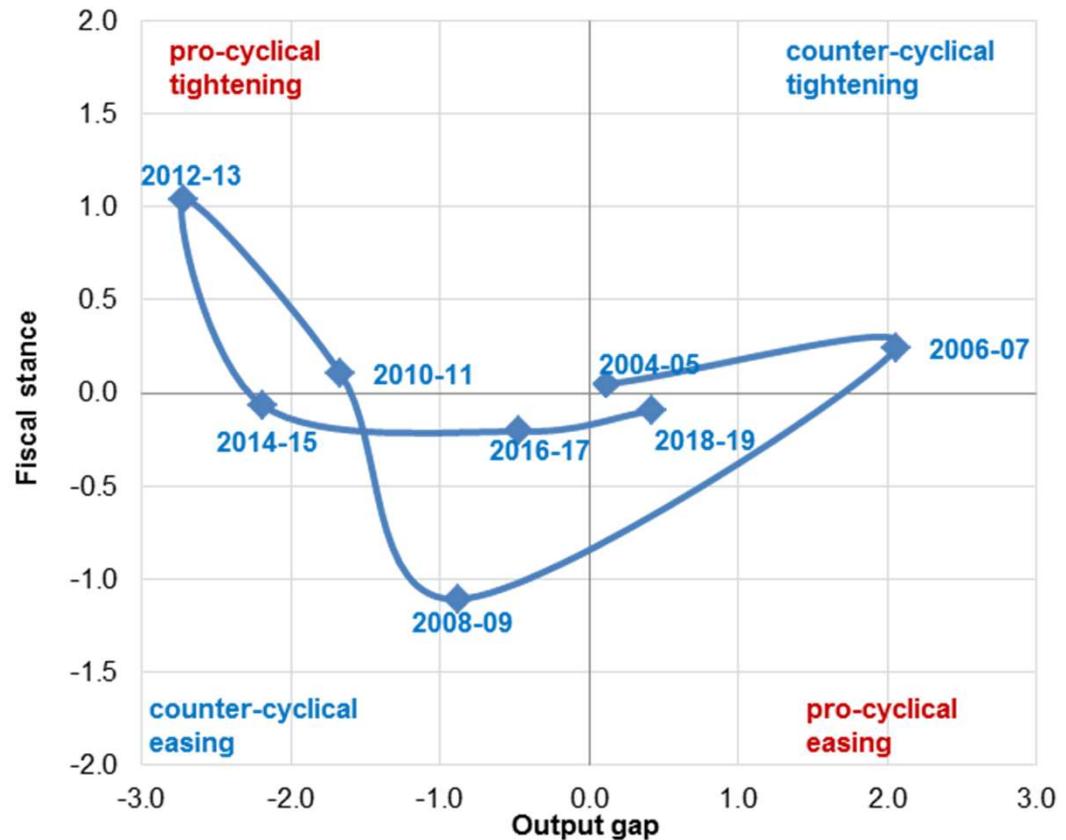
### 3. Macroeconomic stabilisation beyond monetary policy

#### Headwinds to stabilisation policies

##### Fiscal policy in EMU

- National fiscal policies were supposed to cushion country-specific economic shocks in the euro area
- Procyclical fiscal tightening (catch 22 situation) in a number countries resulted in a tight euro area fiscal stance
- This has put an excessive burden on monetary policy for macroeconomic stabilisation

#### Evolution of the fiscal stance and output gap (in % of potential GDP)



Source: Eurostat, ECB calculations.

Notes: The chart shows the standard deviation of CPI inflation and real GDP growth over 1999Q1-2018Q4.

### 3. Macroeconomic stabilisation beyond monetary policy

#### Headwinds to stabilisation policies

##### The incomplete institutional setting of EMU

- **Stabilisation policies need to be supported by strong institutions**
- **Treaty established a sound institutional framework for monetary policy**
- **EMU lacked institutions to ensure financial and fiscal stability (e.g., banking union, macroprudential policy framework, crisis management framework,...)**
- **Crisis opened the road to completing the institutional framework, but EMU is still work in progress (fiscal capacity, euro area safe asset...)**

#### The Five President Report's Table of content

1. The Nature of a Deep, Genuine and Fair Economic and Monetary Union
2. Towards Economic Union - Convergence, Prosperity and Social Cohesion
3. Towards Financial Union - Integrated Finance for an Integrated Economy
4. Towards Fiscal Union - an Integrated Framework for Sound and Integrated Fiscal Policies
5. Democratic Accountability, Legitimacy and Institutional Strengthening

**Annex 1:** Roadmap Towards a Complete Economic and Monetary Union

**Annex 2:** A More Integrated European Semester

**Annex 3:** Advisory European Fiscal Board - Guiding Principles

*Source: The Five President's Report: Completing Europe's Economic and Monetary Union*

## Concluding remarks

- The ECB could act in difficult circumstances, against both upside and downside risks to price stability.
- The asymmetric formulation of the quantitative definition of price stability may lead to misperceptions in a low inflation environment. Clarifying the strategy further could support monetary policy making in an environment characterised by a persistently lower natural rate.
- Need to address the remaining institutional weaknesses of EMU: the role of fiscal policy in macroeconomic stabilisation for the euro area as a whole has to be enhanced.