

# The euro's second decade: old challenges in new clothes

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# On occasion of the first 10 years

*“The euro is a historic achievement. Its first ten years have been a success.”*

**Stability:** inflation and expectations

**Role:** single European market

**Institutions:** focus on price stability and independence.



*Jean-Claude Trichet,  
Speech Osnabruck,  
12/02/2009*

# On occasion of the first 10 years

*“The euro has been a resounding success: it has established itself as a stable and credible currency, which has become the second most important currency in the world after the US dollar.”*

**Role:** importance in world.

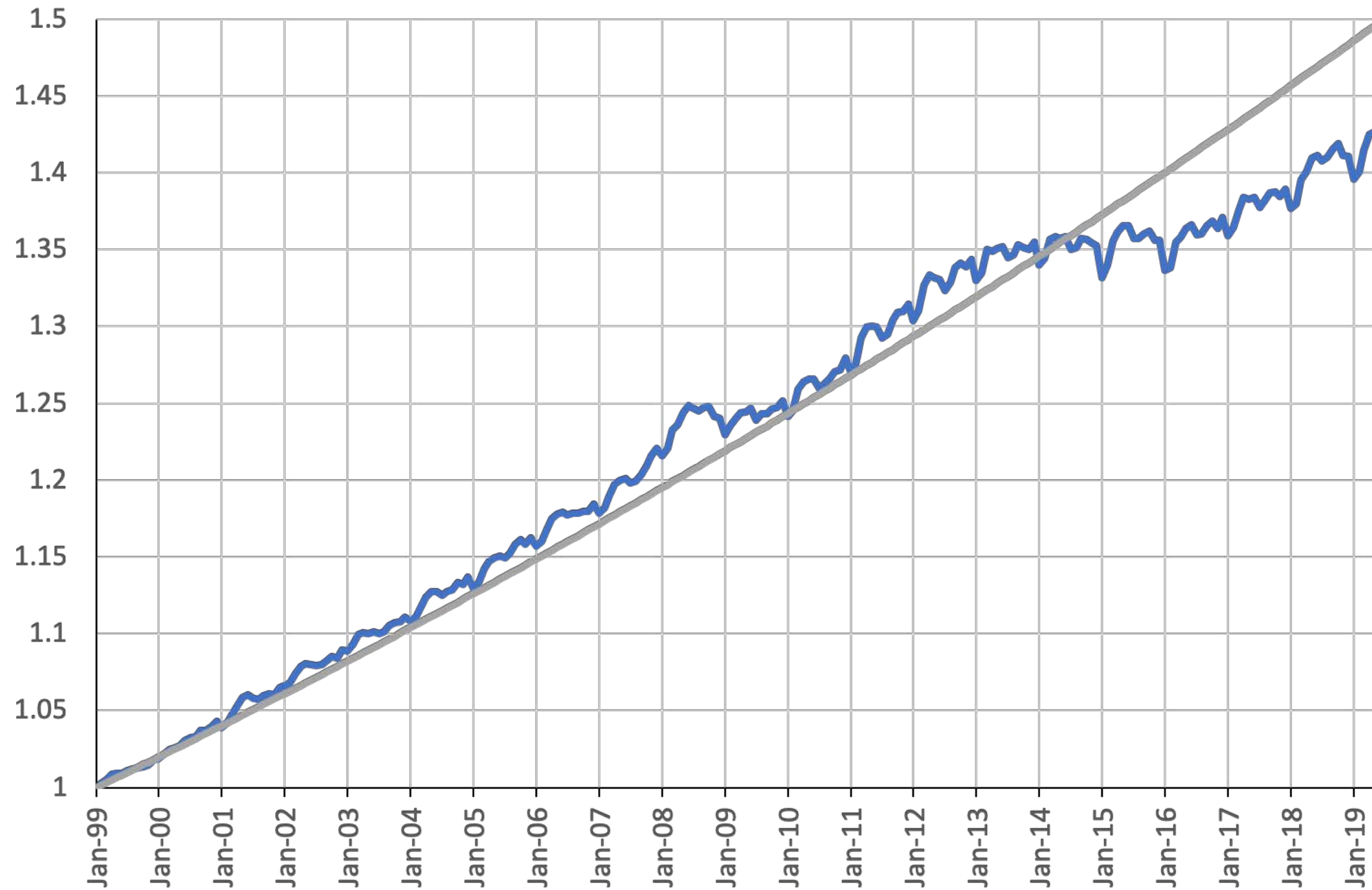


*Lucas Papademos,  
The Euro at 10 –  
Lessons and Challenges,  
13/11/2008*

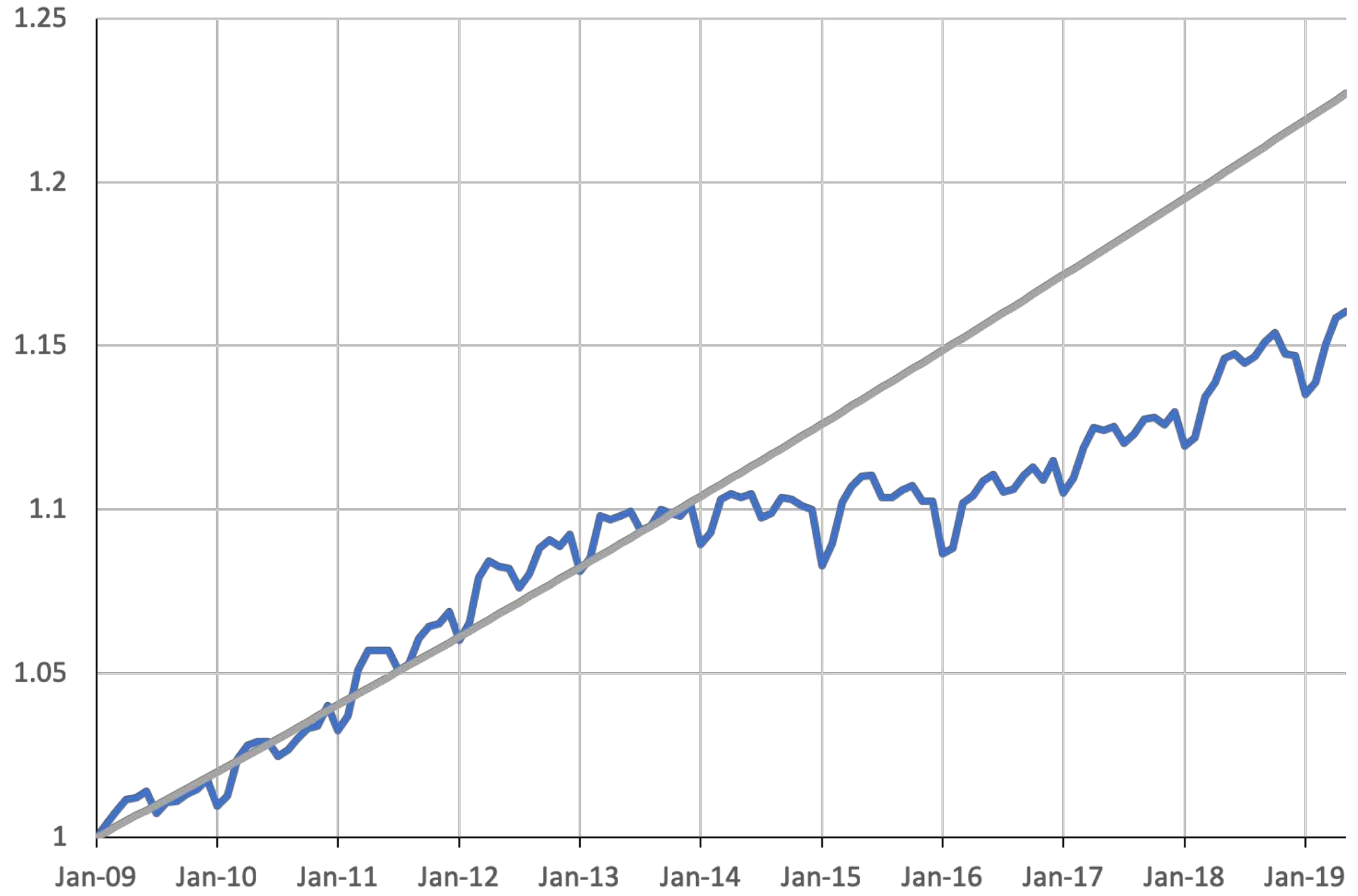
First criteria: stability.

The value of the euro

# Actual inflation: overall



# Actual inflation: second decade



# Challenge of a currency area

With two regions:

$$\pi^{EZ} = \omega\pi^c + (1 - \omega)\pi^p$$

- 1) ECB rule:  $\pi^{EZ} \leq 2$
- 2) Region c preferences:  $\pi^c \leq 2$

Scenario A:  $\Delta RER = \pi^c - \pi^p < 0$

Can have 2% inflation in EZ, and satisfy region c

# Challenge of a currency area

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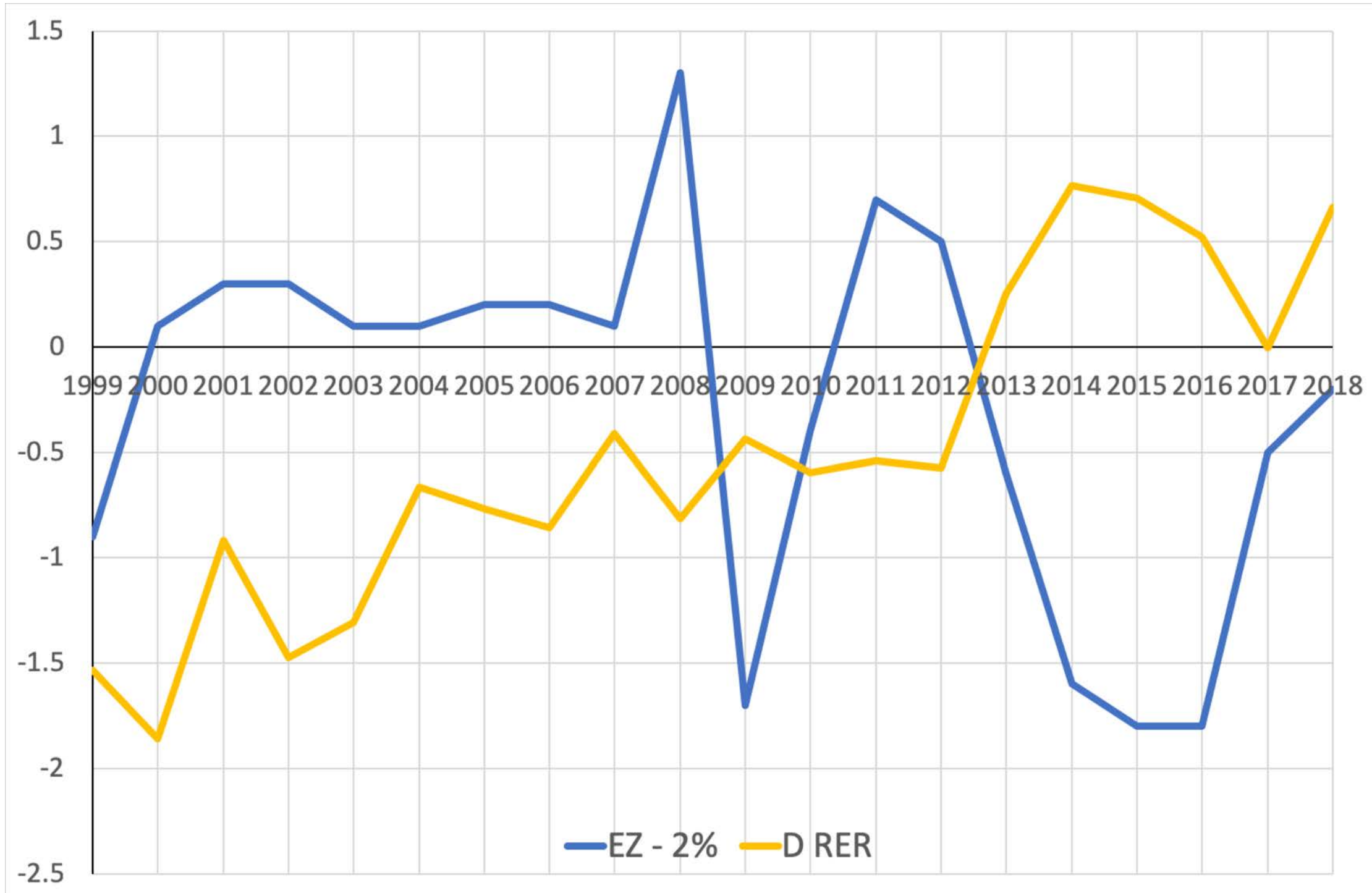
- 1) ECB rule:  $\pi^{EZ} \leq 2$
- 2) Region c preferences:  $\pi^c \leq 2$

Scenario B:  $\Delta RER = \pi^c - \pi^p > 0$

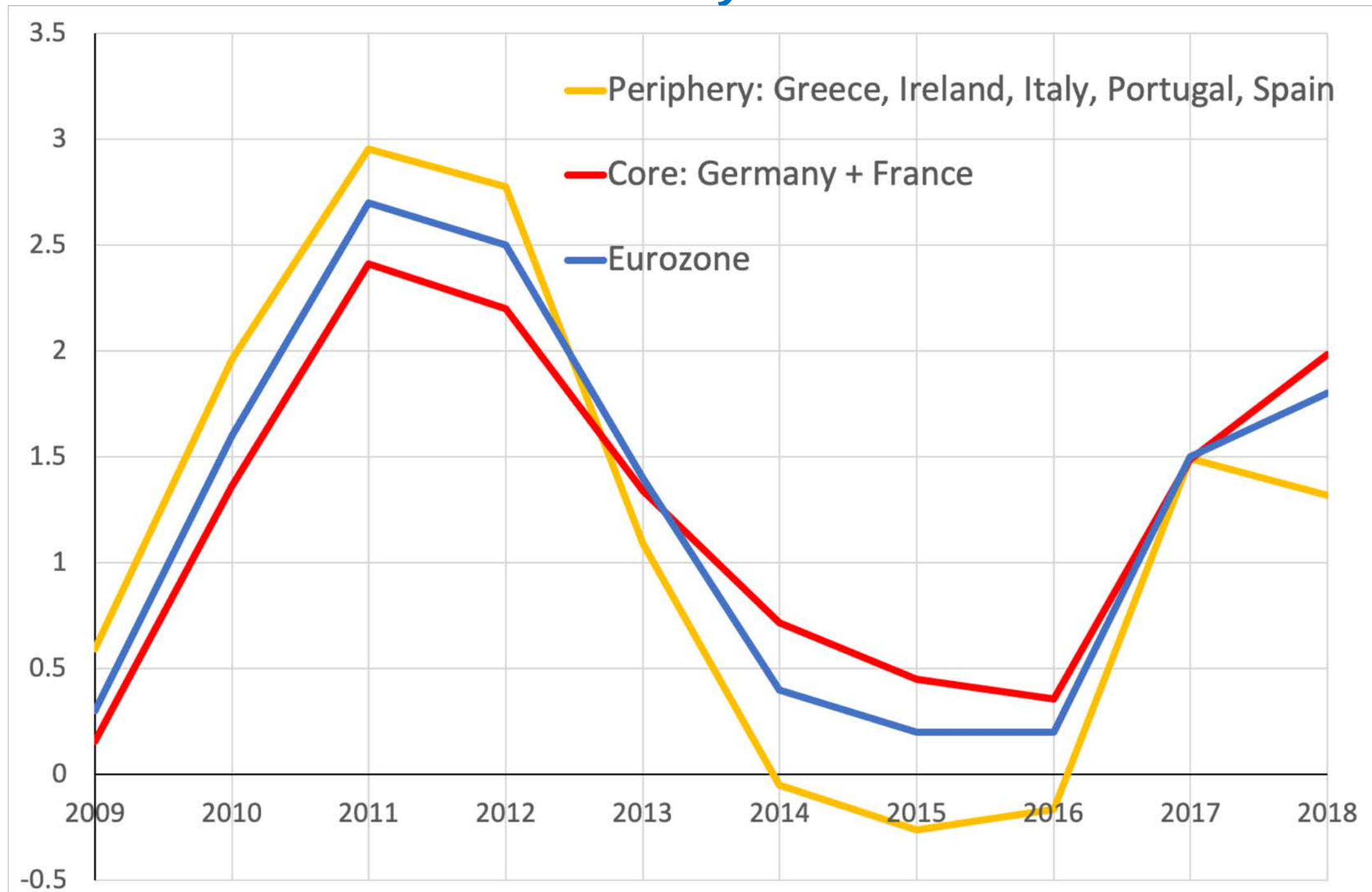
To satisfy 2), must have 1) as strict inequality



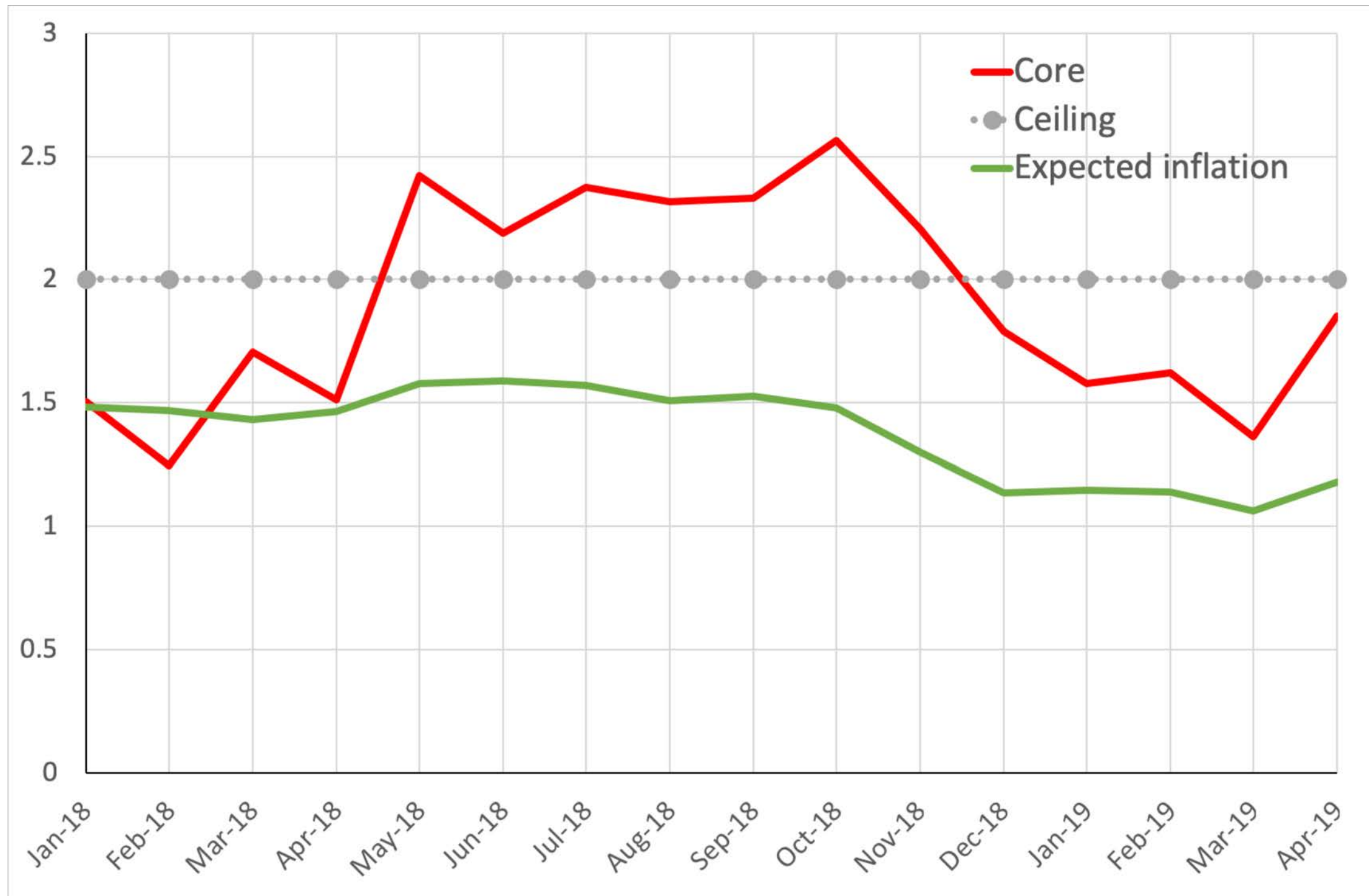
# EZ inflation – 2% vs $\Delta$ RER intra-euro



# Second decade: adjustment reversed



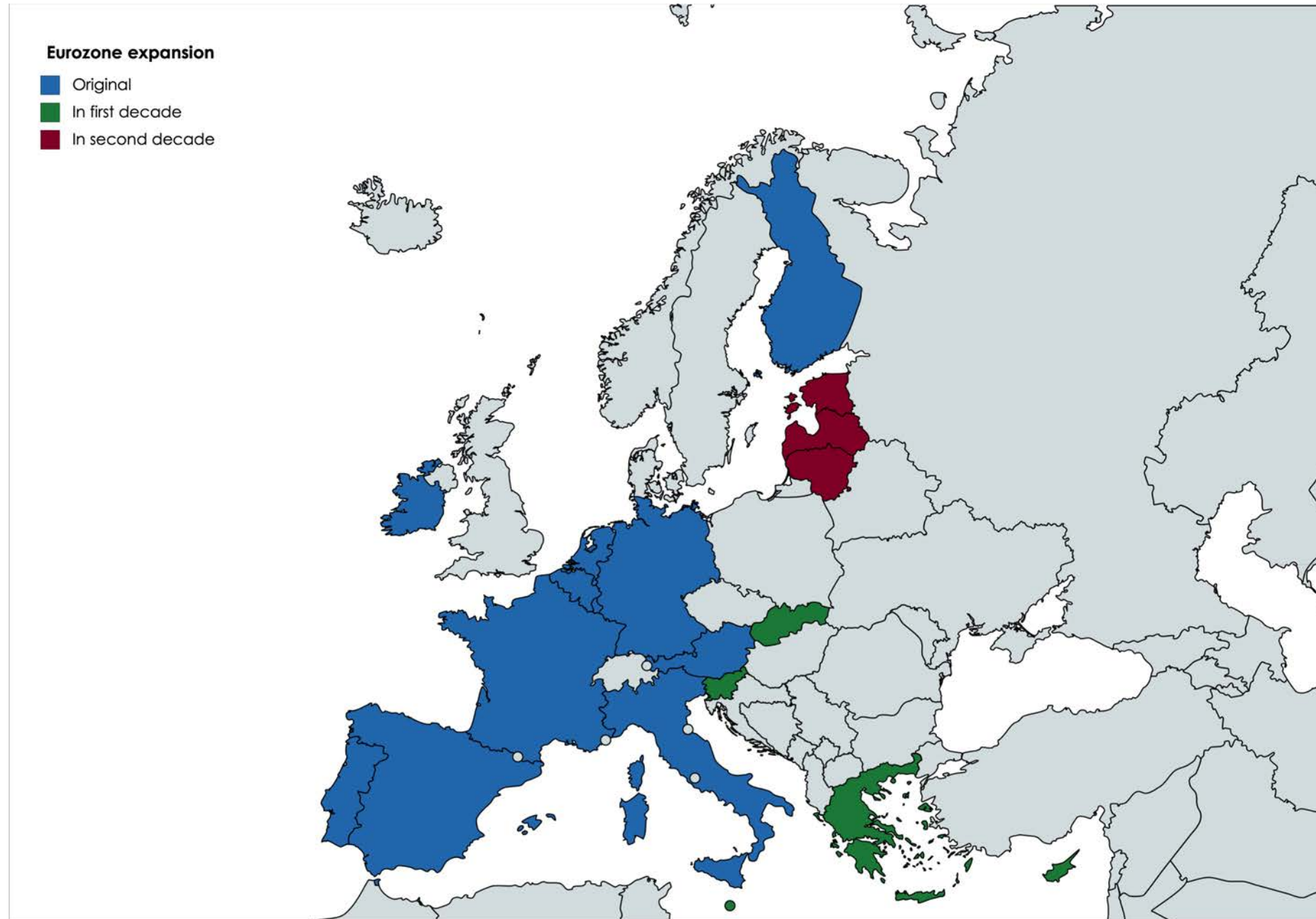
# Recent tick-down? Inflation rose in c



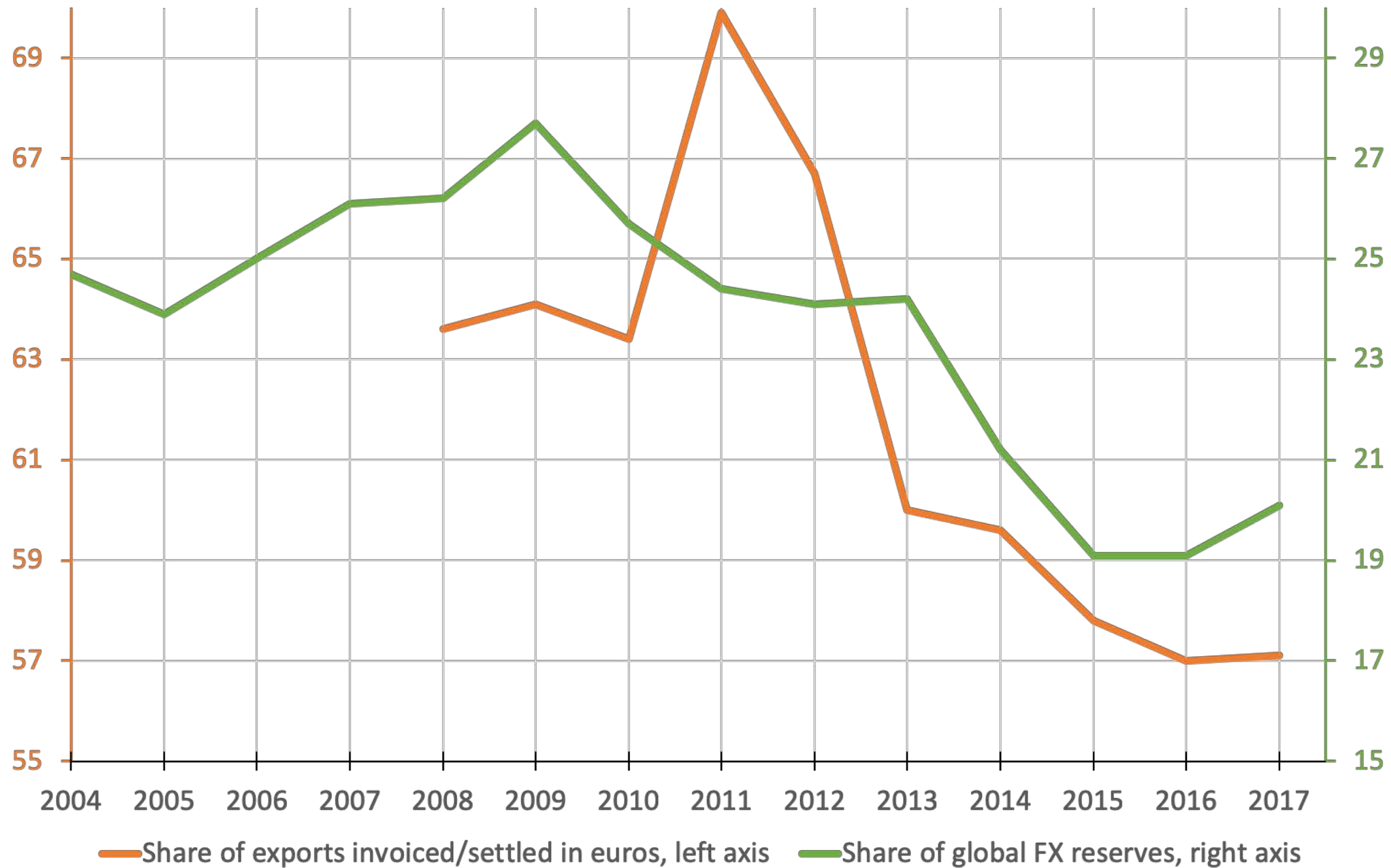
Second criteria: role

The global use of the euro

# Eurozone kept growing



# Fell in invoicing and reserves



# Euro's second decade

1. Liquidity provision: ECB euro swap lines ✓
2. Euro markets financial center: Brexit ?
3. Eurowide safe asset: SBBS still on hold ✗

Third criteria: independence

The EMU and fiscal policy



# Fundamental challenge of EMU

Single monetary policy facing fragmented fiscal policy.

First decade avoided fiscal dominance on the:

- (i) creation of seigniorage
- (ii) unexpected inflating debt

Success

## Article 130 of Founding Treaty:

*When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body.*

# Abandoned one separation principle

ECB had a monetary / liquidity separation principle

- 1) **Monetary policy:** set interest rates, focus on price stability.
- 2) **Liquidity management:** manage refinancing operations, liquidity facilities, size of the balance sheet. Focus on money markets and financial stability.

Abandoned with crisis, rightly so, price stability mandate

# Lender of last resort theory

Theory and best practice of LOLR and liquidity policies to individual banks, and to overall financial systems:

- Start by lending to illiquid but solvent.
- Sometimes, the illiquid become insolvent.
- At that point, call the Treasury.

*LOLR and liquidity has fiscal dimensions once serious crisis.  
Price stability requires ruling out other fiscal dominances.*

# Who can the ECB call?

Who did the ECB call?

- For individual banks: forced resolution on national Treasuries
- During systemic crisis: called IMF and EC (ESM), the troika.
- Separated from risk sharing: ESCBs holding national risk

In light of price stability mandate, fiscal dominance was successfully prevented.

*In light of overall welfare? Less clear*

# Euro's second decade questions

1. Cut out LOLR too early? Do not internalize fiscal costs to national Treasuries.
2. Stay in LOLR until too late? As fiscal authorities of each country play chicken games.
3. Macroprudential policy is national. But if (or when) goes wrong, central bank is always first respondent

Conclusion

# Was second decade successful?

**More successful than first. Bigger challenges and yet:**

- inflation under control;
- euro still second largest global currency;
- liquidity provided, independence preserved, collapse averted

**But leaves questions for the future:**

- define target in light of regional price adjustments;
- invest in architecture for euro to grow;
- rethink and restate independence from fiscal in the context of macro-prudential policies and LOLR activities.