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Monetary and Exchange Rate Policy
Part 2

Introduction into Economic System of the EU

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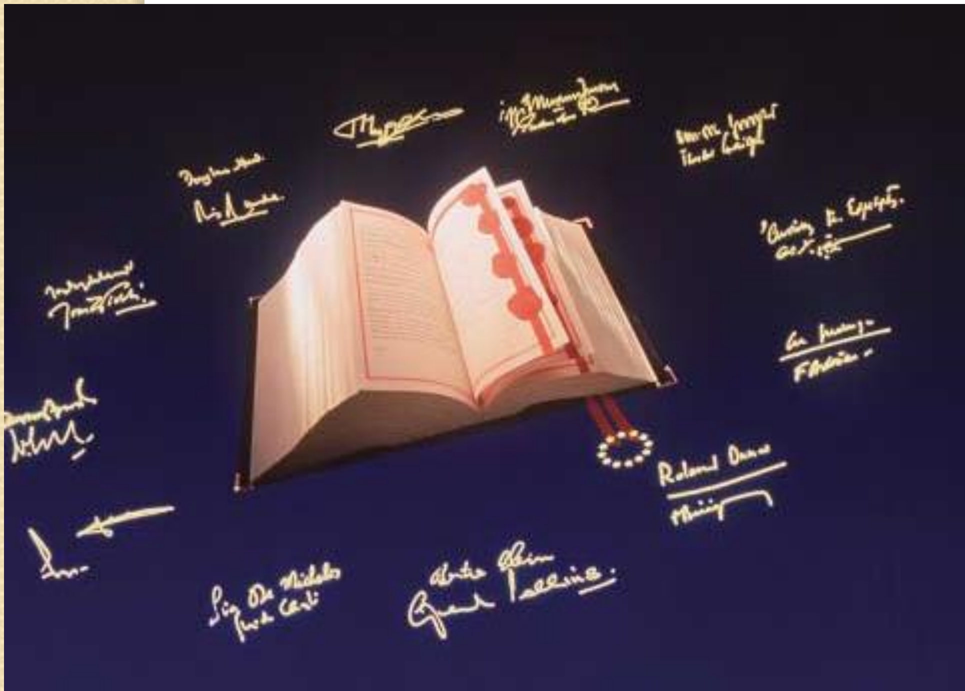
R.Baldwin and C.Wyplosz: The Economics of European Integration, Ch.16 and 17

Monday, December 1tst 2014
18:00 – 20:25



The Maastricht Treaty and the Euro zone

The Maastricht treaty (1992)

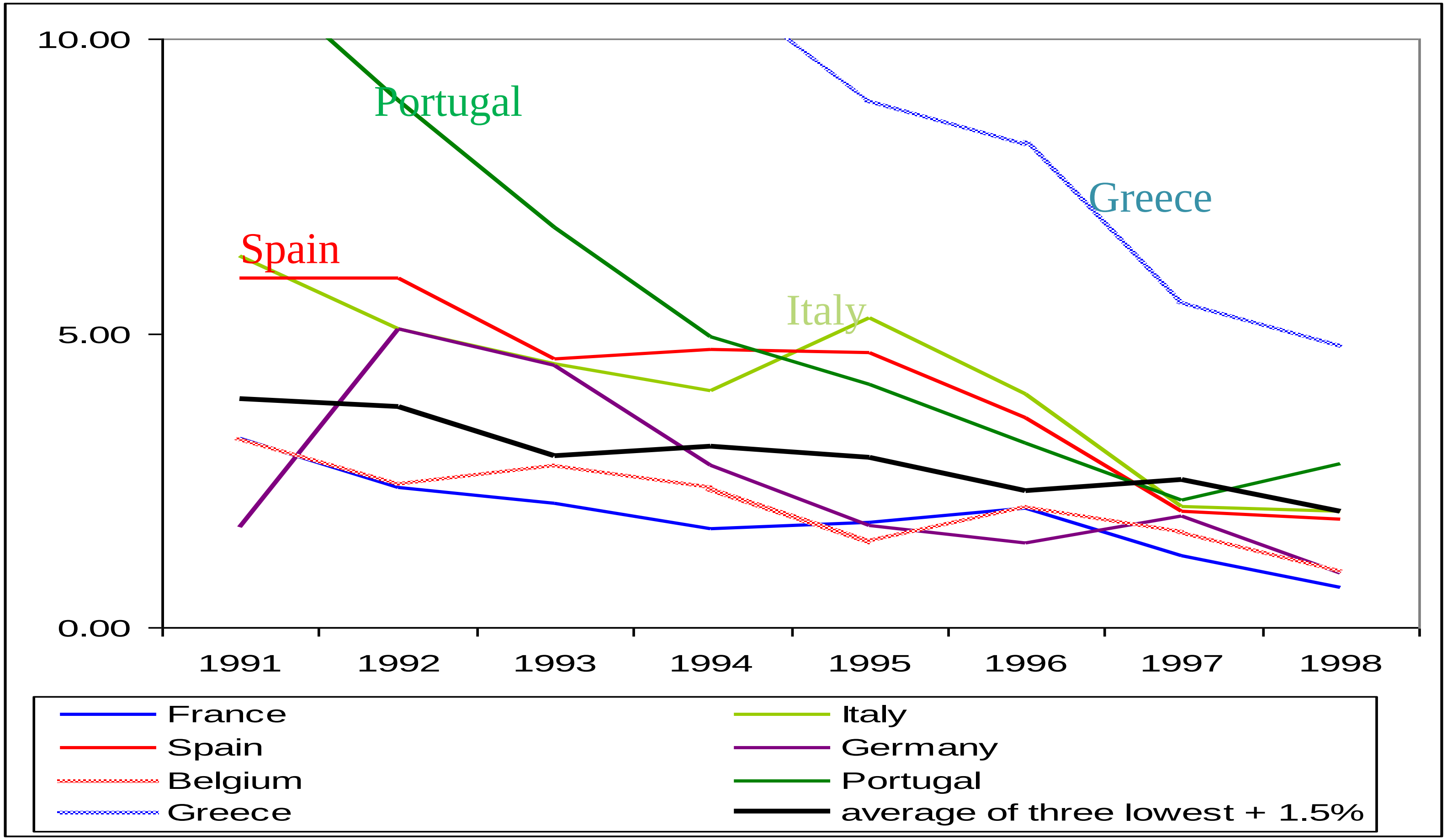
- A firm commitment to launch the single currency by January 1999 at the latest
- A list of five criteria for admission to the monetary union
- A precise specification of central banking institutions
- Additional conditions mentioned (e.g. the excessive deficit procedure)

The Maastricht convergence criteria

1. Inflation
   - Not to exceed by more than 1.5% the average of the three lowest rates among EU countries
2. Long-term interest rate
   - Not to exceed by more than 2% the average interest rate in the three lowest inflation countries
3. ERM membership
   - At least two years in ERM without being forced to devalue
4. Budget deficit
   - Deficit less than 3% of GDP
5. Public debt
   - Debt less than 60% of GDP

The convergence criteria: 1.inflation

- Straightforward fear of allowing in shameless inflation-prone countries



The convergence criteria: 2.long-term interest rate

- A little bit too easy to bring inflation down in 1997 – artificially or not – and then let go again
- Long interest rates incorporate bond markets expectations of long term inflation
- So criterion requires convincing markets
- Problem: self-fulfilling prophecy
  - If markets believe in admission to euro area, they expect low inflation and long term interest rate is low, which fulfils the admission criterion

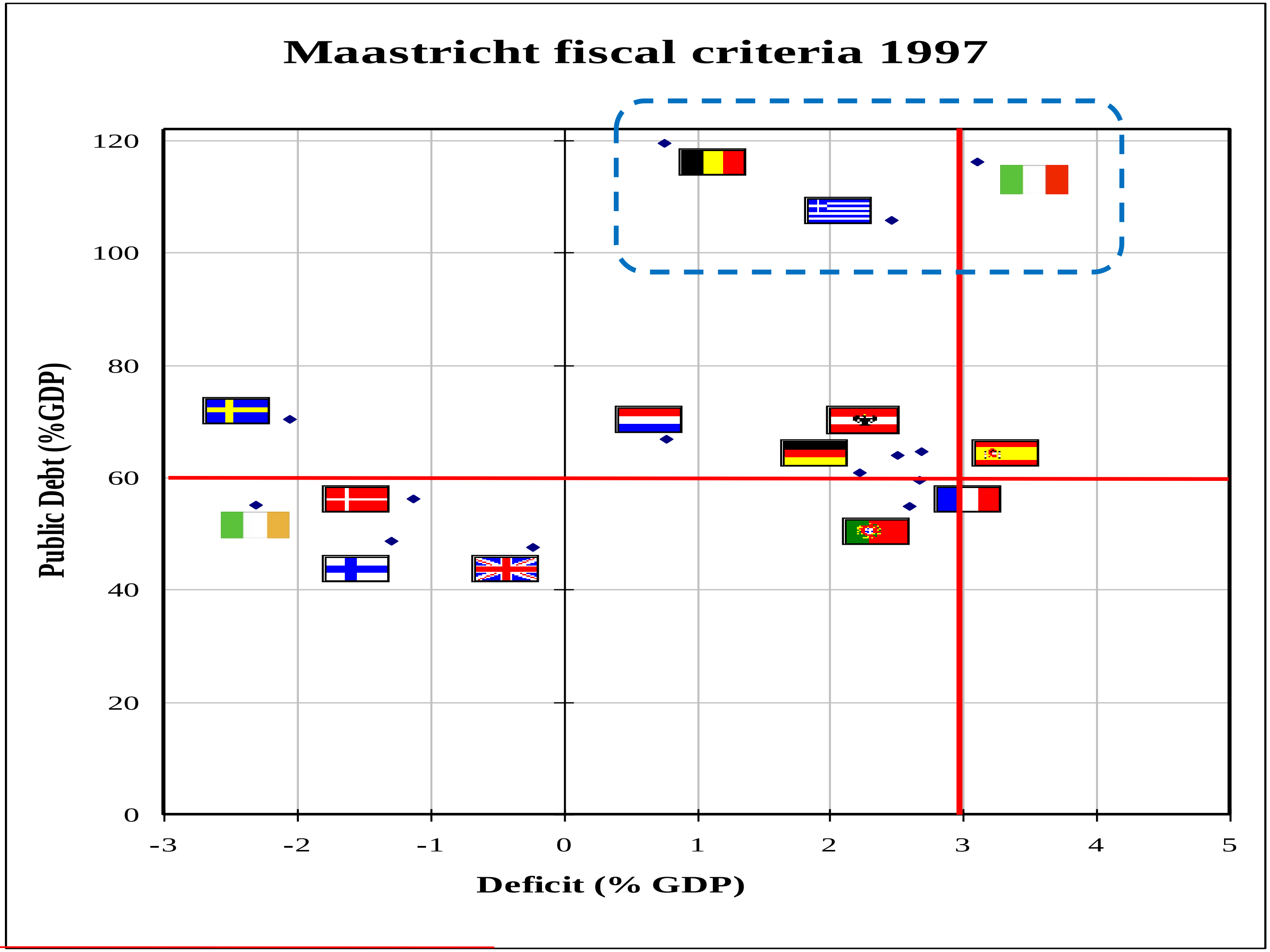
The convergence criteria: 3.ERM membership

- Same logic as the long-term interest rate: need to convince the exchange markets
- Same aspect of self-fulfilling prophecy

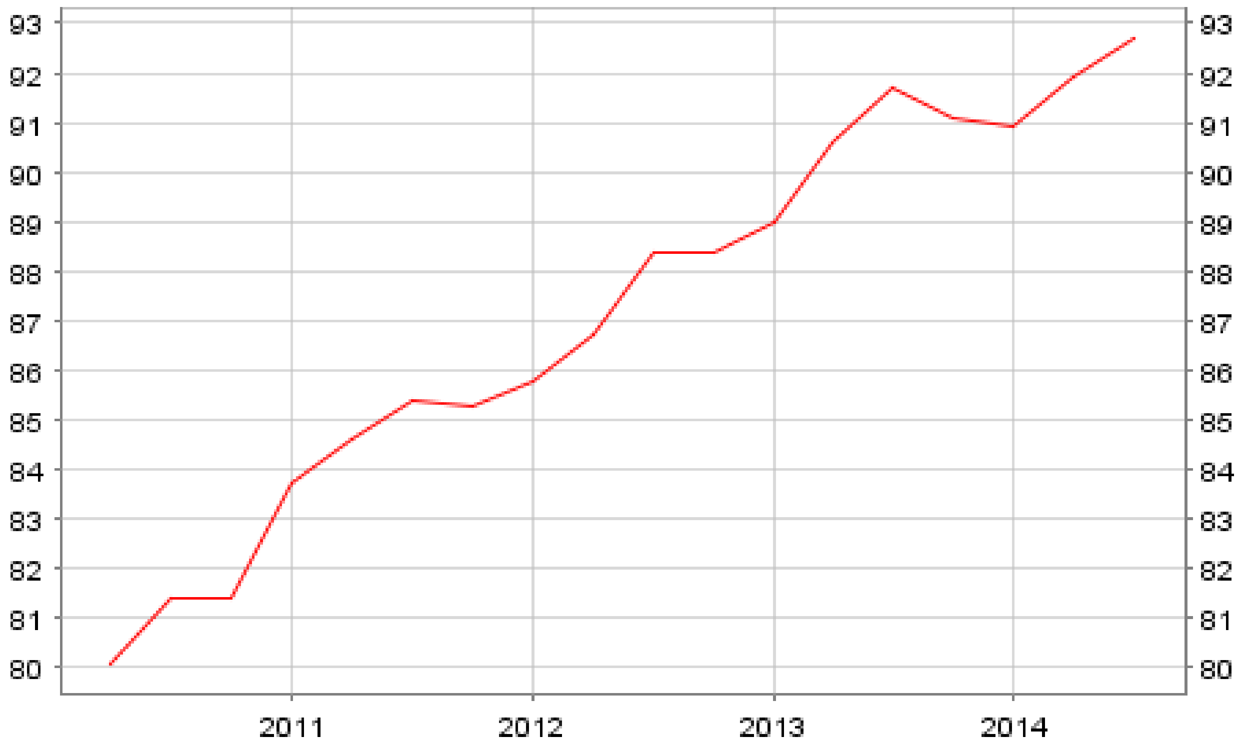
The convergence criteria: 4./5.budget deficit and debt

- Historically, all big inflation episodes born out of runaway public deficits and debts
- Hence requirement that house is to be put in order before admission
- How are the ceilings chosen?
  - Deficit: the German golden rule
  - Debt: the 1991 EU average

The debt and deficit criteria in 1997



The government debt by Euro area



The Monetary System

The system


EUROPEAN SYSTEM OF CENTRAL BANKS (ESCB)
General Council
European Central Bank (ECB)
Governing Council
Executive Board
EUROSYSTEM
Nationale Bank van België/ Banque Nationale de Belgique
Deutsche Bundesbank
Bank of Greece
Banco de España
Banque de France
Central Bank & Financial Services Authority of Ireland
Banca d'Italia
Banque centrale du Luxembourg
De Nederlandsche Bank
Oesterreichische Nationalbank
Banco de Portugal
Suomen Pankki – Finlands Bank
Česká národní banka
Danmarks Nationalbank
Eesti Pank
Central Bank of Cyprus
Latvijas Banka
Lietuvos bankas
Magyar Nemzeti Bank
Central Bank of Malta
Narodowy Bank Polski
Banka Slovenije
Národná banka Slovenska
Sveriges Riksbank
Bank of England

How does the Eurosystem operates?

- Objectives
  - What it is trying to achieve?
- Instruments
  - What are the means available?
- Strategy
  - How is the system formulating its actions?

Objectives

- The Maastricht Treaty's Art.105
- "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 Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2."
- In clear:
  - ***Fighting inflation is the absolute priority***
  - ***Supporting growth and employment comes next***

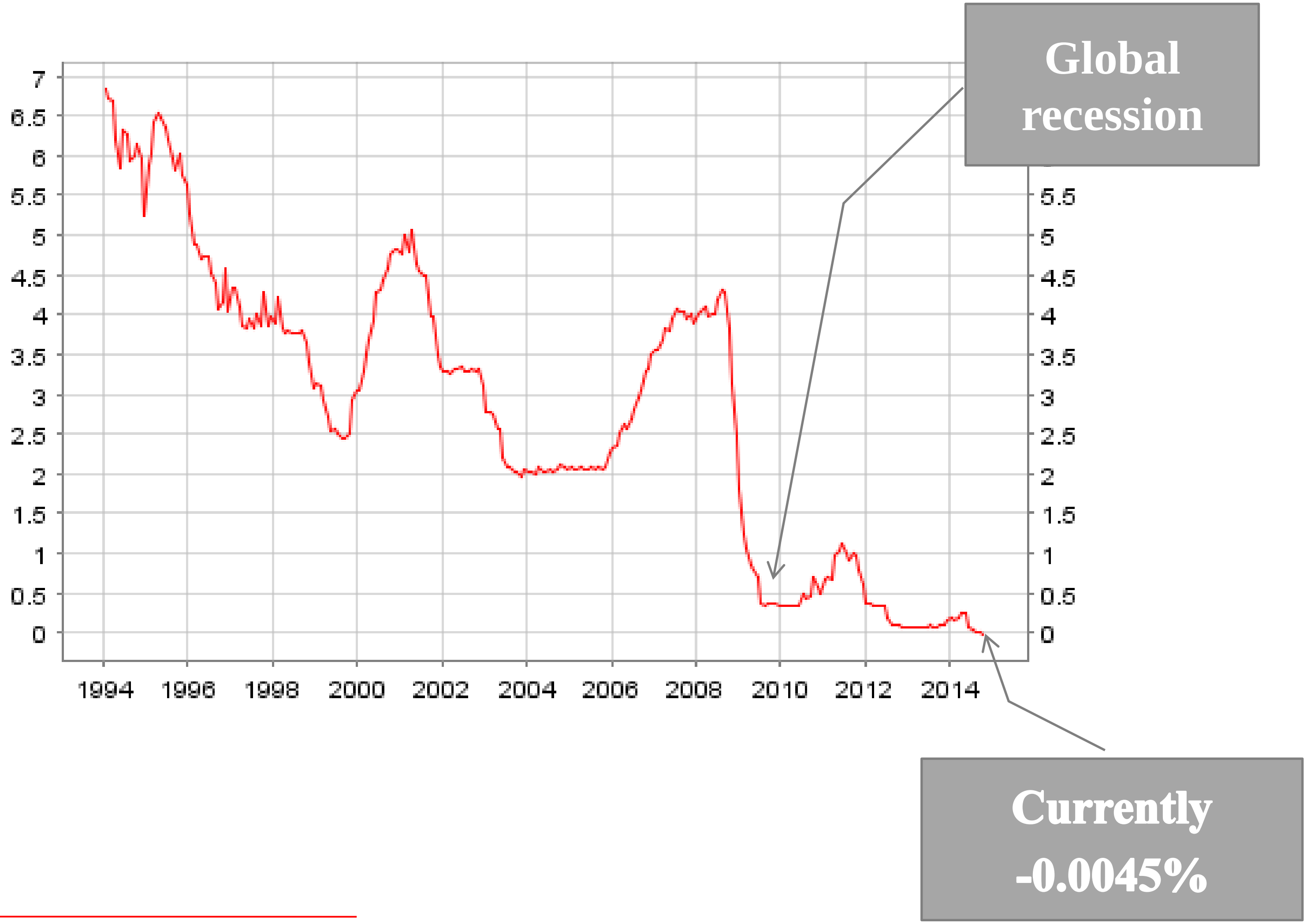
Objectives *continued*

- Making the inflation objective operational: does the Eurosystem have a target?
- No, it has a definition of price stability:
- "Price stability is defined as a 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."
- “The Governing Council agreed that in the pursuit of price stability it will aim to maintain inflation rates close to 2% over the medium term.”
- Leaves room for interpretation:
  - Where below 2%
  - What is the medium term?

Instruments

- The channels of monetary policy are:
  - Longer run interest rates
  - Credit
  - Asset prices
  - Exchange rate
- These are all beyond central bank control
- Instead it can control the very short term interest rate: European Over Night Index Average (EONIA)
- EONIA affects the channels through market expectations

EONIA



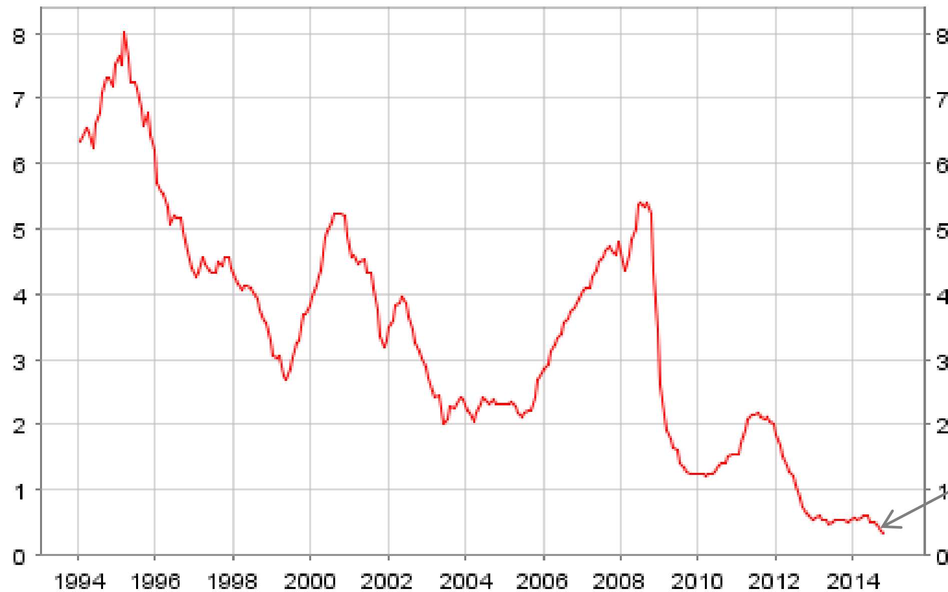
7
6.5
6
5.5
5
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
Global recession
Currently -0.0045%

Instruments continued

- The Eurosystem controls EONIA by establishing a ceiling, a floor and steering the market in-between
- The floor: the rate at which the Eurosystem accepts deposits (the deposit facility)
  - Currently -0.20% (!?)
- The ceiling: the rate at which the Eurosystem stands ready to lend to banks (the marginal lending facility)
  - Currently 0.30%
- In-between: weekly auctions (main refinancing facility)
  - Currently 0.05%.

EURIBOR

- The Euro Interbank Offered Rate (or Euribor) is a daily reference rate based on the averaged interest rates at which banks offer to lend unsecured funds to other banks in the euro wholesale money market (or interbank market).



Euribor 12 months

Currently 0.33%

The two-pillar strategy

- The monthly Eurosystem’s interest rate decisions (every month) rests on two pillars:
- Economic analysis
  - Broad review of economic conditions
    - Growth, employment, exchange rates
    - Anti-cyclical policy
- Monetary analysis
  - Evolution of monetary aggregates (M3, etc.)

Comparison with other strategies

- The US Fed
  - Legally required to achieve both price stability and a high level of employment
  - Does not articulate an explicit strategy
- Inflation-targeting central banks (Czech Republic, Poland, Sweden, UK, etc.)
  - Announce a target (e.g. 2.5% in the UK), a margin (e.g. ±1%) and a horizon (2-3 years)
  - Compare inflation forecast and target, and act accordingly

Independence and accountability

- Conventional wisdom is that central banks ought to be independent
  - Governments tend not to resist to the “printing press” temptation
  - The Bundesbank has set an example
- But misbehaving governments are eventually punished by voters
- What about central banks? Independence removes them from such pressure
- A democratic deficit?

The Eurosystem weak accountability

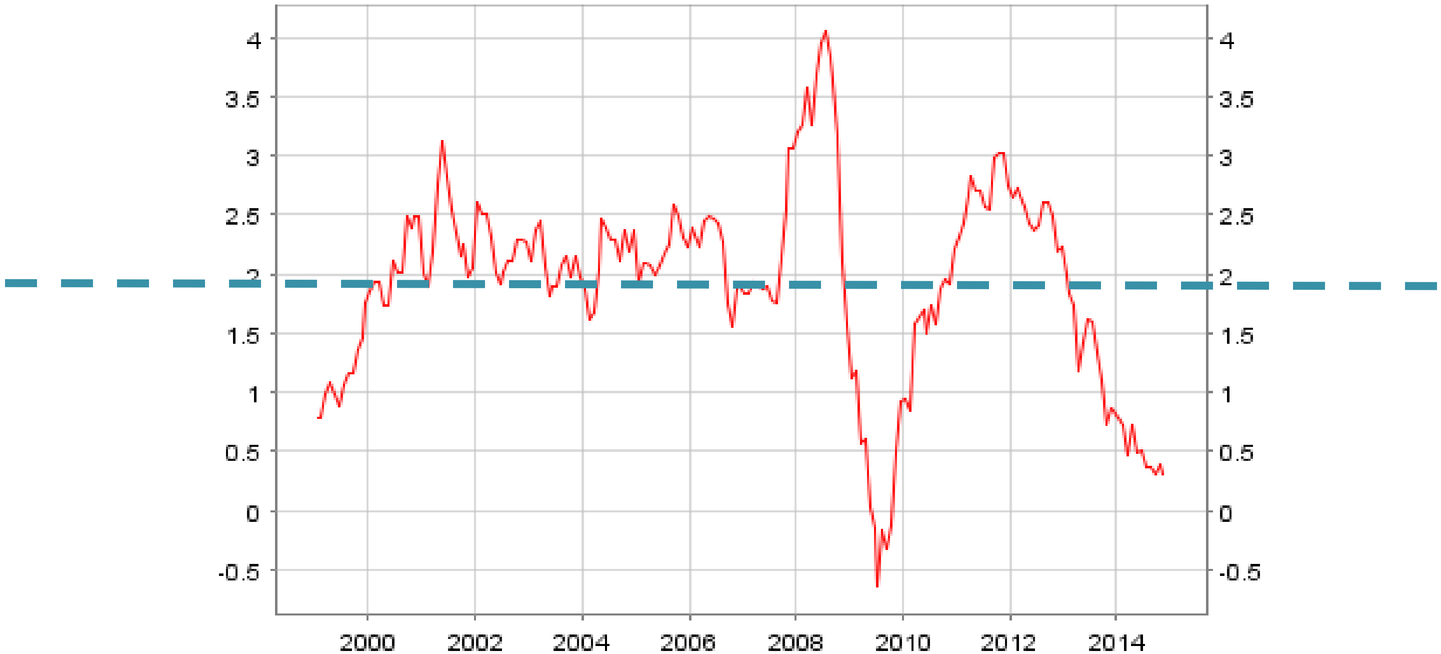
- The Eurosystem must report to the EU Parliament
- The Eurosystem's President must appear before the EU Parliament when requested, and does so every quarter
- But the EU Parliament cannot change the Eurosystem's independence and has limited public visibility

The record so far

- A difficult period
  - An oil shock in 2000
  - A worldwide slowdown
  - September 11
  - The stock market crash in 2002
  - Afghanistan, Iraq
  - Global credit crunch and recession 2008
  - Greek crisis in 2010
  - Crisis in the Euro zone 2011

Inflation: not missing the objective in the long-run

- Average inflation rate (HICP) in period 1999-2014 was 1.93%



- Average inflation rate in period 2008-14 was even lower 1.76%.

The euro: too weak first, then too strong?

- USA Dollar/EUR rates

ECB monetary policy

- ECB terns recently to an expansionary policy,
- M3 monetary aggregate growth rates.

Expansionary policy