The second decade of the euro: old challenges in new clothes

By Ricardo Reis[1]

Abstract

Ten years ago, the first decade of the euro was judged a success on account of the stability of inflation, the widespread global use of the currency, and the ECB's independence from fiscal pressures and national governments. Using the same three criteria, this essay evaluates the second decade. On the positive side, (i) inflation is still close to target, (ii) the euro remains the second most used global currency, and (iii) the ECB resisted attempts at fiscal dominance during challenging times. On the negative side, (i) the need for relative price adjustments within the currency union can put downward pressure on inflation, (ii) the euro is unlikely to grow further without a euro-wide safe asset, and (iii) the independence of the ECB in its lender of last resort functions is neither clear nor necessarily desirable.

1 Introduction

Evaluating twenty years of the euro over fewer than ten pages is not an easy task. One place to start is with the evaluation provided by the ECB president, Jean-Claude Trichet, ten years ago when the euro was ten years old. Trichet (2009) concluded that: "The euro is a historic achievement. Its first ten years have been a success." More important than his verdict are the three criteria he used to evaluate success. The first was *stability*, understood as the ability to keep inflation and expected inflation near the ECB's target. The second was the *role of the euro*, namely in promoting and helping to complete the single European market. The third was *institutional independence*, in which he highlighted the ability of the ECB to solely focus on its target of price stability, independently of national governments and fiscal concerns. A few months earlier, the vice-president of the ECB added an elaboration to the role of the euro, namely its global dimension as a currency that is widely used by financial markets and in invoicing exports. Papademos (2009) concluded: "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."

In this essay, I will stick to the narrow mandate of assessing the euro at twenty according to these three criteria: stability, its role, and its independence. The focus

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will be on the last ten years, from 2009 to 2019. The decade started with a financial crisis in 2008-10. It was quickly followed by a sovereign debt crisis in the European periphery in 2010-12. The last few years, since about 2015, have seen a sluggish recovery and low inflation. All combined, interesting times for a currency in its infancy.[2]

2 Stability: the value of one euro

The chapter in the Founding Treaty that deals with monetary policy starts with a clear statement (article 127): "The primary objective of the European System of Central Banks shall be to maintain price stability." In October of 1998, the governing council of the ECB stated that its interpretation of price stability was: "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." In May 2003, this was clarified as "below, but close to 2% over the medium term," and just yesterday President Draghi clarified further that "our policy aim was fully symmetric, and it was symmetric around the level that we had established in 2003: below, but close to, 2%. It is achieving this aim over the medium term that steers our policy decisions."

The precise symmetry of the target, or its numerical value, is up to interpretation that may change over time. Common to all of these official statements are the references to 2%, and to the medium term. Unlike other inflation-targeting central banks, the ECB has always been committed to what today might be called average inflation targeting, which in the academic literature goes under the name of price-level targeting. Chart 1 therefore evaluates the stability of the euro using this yardstick, represented by a yellow curve that rises at 2% per year.

The first decade of the euro was indeed a success: inflation in January of 2009 was almost exactly where the 2% medium-run target says it should be. The following five years are equally accurate. However, since January of 2014 a persistent gap has emerged.

At first, one could dismiss this deviation. It amounted to inflation in each of the last five years being a few decimal points below 2%. When the Treaty put an emphasis on price stability, the signatories had in mind double-digit, or perhaps even negative, inflation. That a few decimals could be discussed in the media as being concerning would from their perspective be seen as a mark of success. Moreover, anyone who has worked with price indices is well aware of the measurement errors in inflation estimates that make you suspicious when too much is made of decimal changes.

Yet, here the medium-run emphasis bites. It forces us to look not at annual inflation but at the yellow versus the blue line, where decimal deviations in the same direction accumulate year after year. The deviation from target today is large and significant. The price stability of the euro is just about starting to be in danger.

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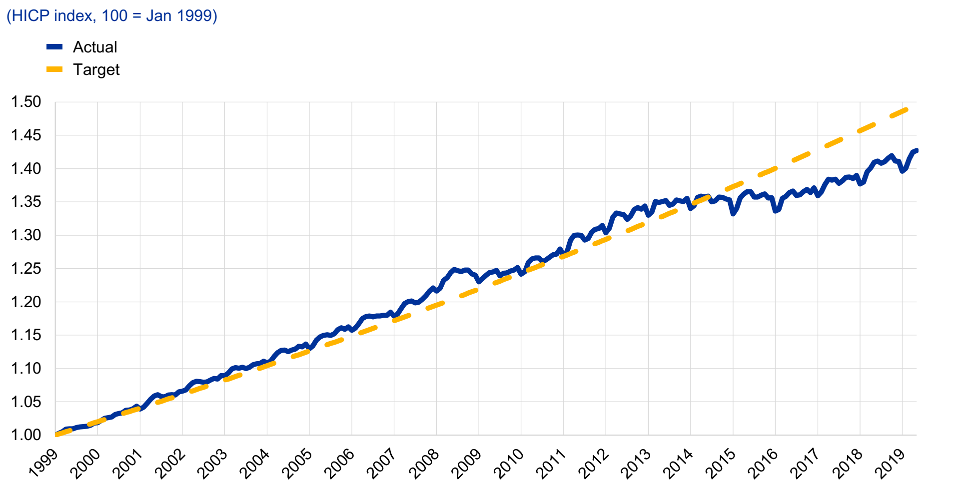
2 For a comprehensive assessment of the first twenty years of the ECB, see Hartmann and Smets (2019).

Chart 1

Inflation in the eurozone: actual versus target



Sources: ECB statistical warehouse.
Notes: The target grows at 2% per year.

In his speech at this conference, Mario Draghi noted that in order to average below, but close to, 2% then inflation has to exceed 2% sometimes. In his dinner speech, Olivier Blanchard reminded us that the fundamental challenge of any currency union is the adjustment of relative prices. To correct current account imbalances within the Eurozone, inflation in surplus regions must be higher than 2%; otherwise it will either be negative in deficit regions, or it will lead to output gaps (or both). I will offer a third perspective, different but complementary to these two.

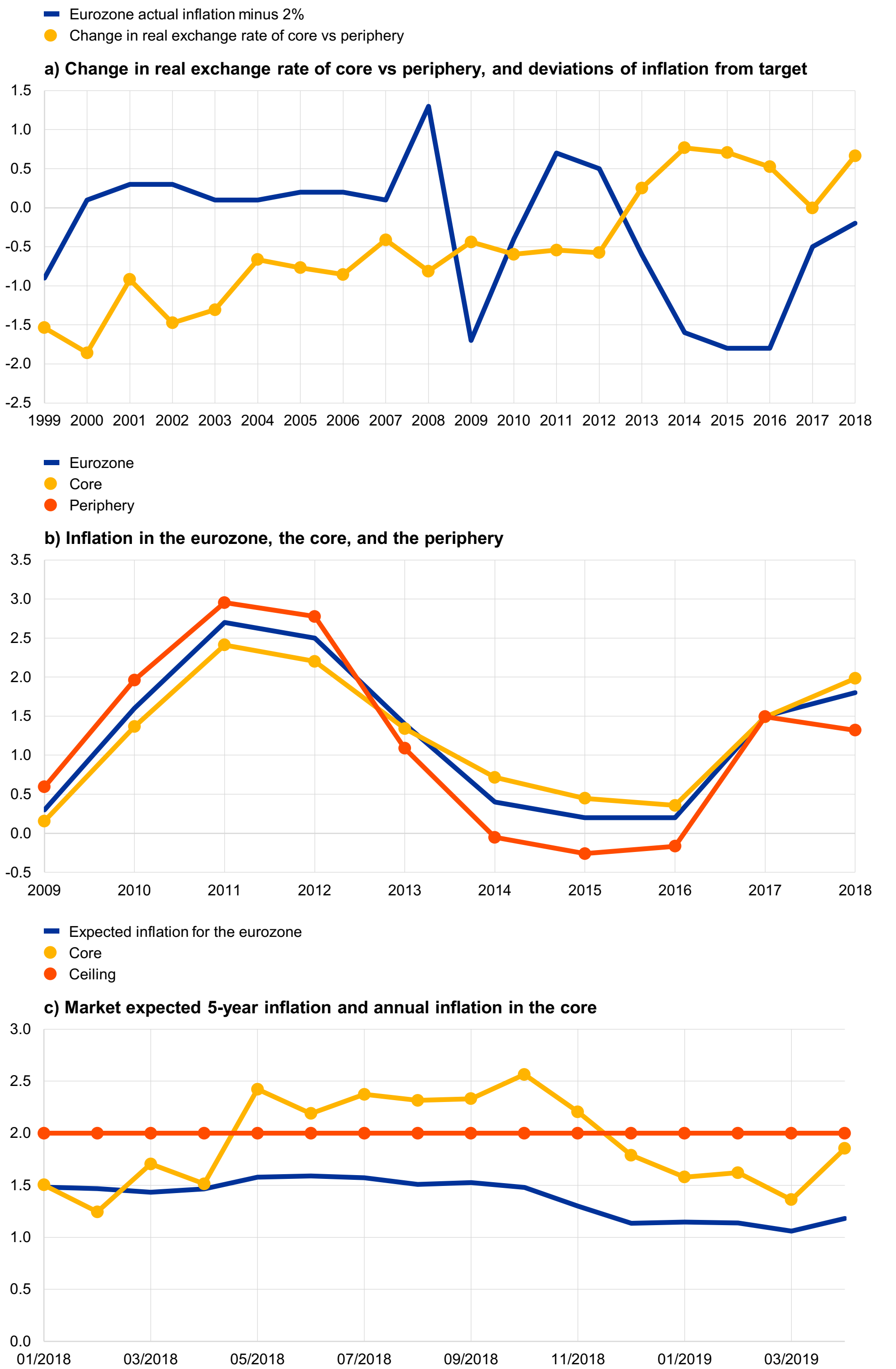
Think of the eurozone as two regions, call them *c* and *p*. Inflation in the eurozone is an average of inflation in each region. The ECB's mandate states that eurozone inflation must be equal to or below 2%. But consider also a further objective, that inflation in region *c* cannot exceed 2% as well, on account of a special aversion of its citizens to higher inflation and their national interpretation of the Treaty. Two scenarios are then possible.

In the first scenario, the real exchange rate between regions *c* and *p* depreciates, for whatever reason. By definition of the real exchange rate, inflation in region *c* will be below inflation in region *p*. The two objectives can be satisfied with eurozone inflation at 2% or near it. In the second scenario, the real exchange rate appreciates. Since inflation in region *c* must be at most 2%, and appreciation means inflation in *c* is above inflation in region *p*, it inexorably follows that eurozone inflation will be persistently below its 2% target.

Chart 2

Inflation in the eurozone: regions and real exchange rates

(a and b: %, year; c:%, month)



Sources: ECB statistical warehouse, Datastream.

The top panel of chart 2 plots the deviation of eurozone inflation from 2% as well as the real exchange rate within the eurozone between the *c* and *p* regions. They stand for countries at the core—France and Germany, accounting for approximately one half of the eurozone’s consumption—and countries in the periphery—Greece, Ireland, Italy, Portugal and Spain, which weight about one third of the eurozone’s price index. It is noticeable that it was precisely in 2013 that a persistent appreciation in the core relative to the periphery started taking place. At that date, there was a shift from the first to the second scenario described above. At that date as well, eurozone inflation became significantly below 2%.

The middle panel of chart 2 decomposes the real exchange rate into the inflation rates in the two regions. While in the first fifteen years of the euro, inflation in the periphery tended to exceed that in the core, the roles reversed in the last five years. In the first fifteen years, targeting “below, but close to, 2%” led to almost exactly 2% inflation; in the last five years, it has meant inflation persistently hovering around 1.5%. Having 2% inflation in the eurozone would have required inflation in France and Germany to be well above 2%.

The bottom panel of the chart insists further by plotting annual inflation at the monthly frequency during the last twelve months in the core region. Also in the chart is expected inflation in the eurozone 5-years out, extracted from inflation swap contracts. During the last year, inflation in the core was temporarily slightly above 2%. Consistent with the account above, this positive deviation has led to expected inflation for the eurozone becoming permanently well below 2%.

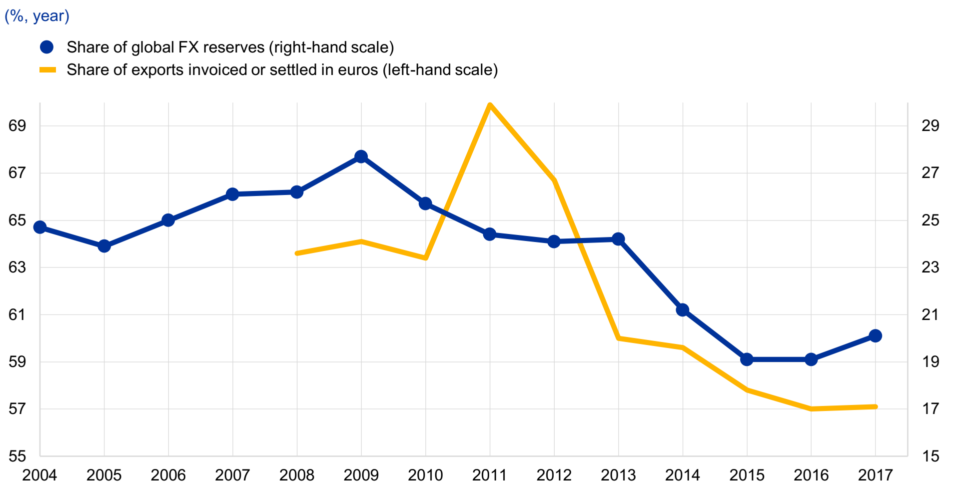
3 Role of the euro: its global use

During the second decade, four more countries joined the eurozone: Slovakia, Estonia, Latvia, and Lithuania. No country has ever left the euro. This was not a small feat. At the height of the eurozone sovereign debt crisis, betting markets and some commentators at times put the probability that one country would leave the euro at above 50%. The ECB won the battle for the integrity of the eurozone.

From another perspective, the last decade was not so positive. The use of the euro in invoices for exports outside the eurozone fell during this decade; see chart 3. Likewise, the weight of the euro in official holdings of currency reserves around the world fell as well. The Papademos verdict in the introduction is still accurate: the euro is, by far, the second world currency. But during its second decade, the euro lost ground to the dollar and has seen the renminbi steadily rise.

Chart 3

The international use of the Euro in invoicing and reserves



Sources: ECB (2018) "The international role of the euro" statistical appendix.

Moving from outcomes to policies, the evaluation is gloomier. During the financial crisis, the Federal Reserve created US dollar swap lines with the ECB, among other central banks. With European financial institutions holding significant investments in dollars, these swap lines provided a lender of last resort that kept investment in dollar-denominated securities steady.[3] This liquidity policy sustained the dominant role of the US dollar in the world. In a few countries in Eastern Europe, the financial system was likewise reliant on euro funding, and its banks held euro-denominated investments. Unlike the Fed, the ECB was reluctant to extend euro swap lines to these countries.

Presently, the prospect of Brexit looms large. The euro's global role requires a financial centre that deals in euros. By reaping economies of scale, it allows for lower transaction costs in financial deals that involve the euro. If London loses that role, and if it is replaced by a dispersed set of European cities, trading in euros may become more expensive, no matter what the ECB does.

Looking forward, the euro cannot grow in its use as a currency worldwide without there being a euro-wide safe asset. With a limited supply of safe assets in euros that provide a positive yield, it is costly for other countries to hold more foreign reserves in euros. Exporters outside of the eurozone are unable to hedge currency fluctuations, so it is risky for them to invoice their exports in euros. The capital market union cannot be complete since abundant safe assets are crucial to provide collateral for operations and to prevent periodic flights to safety from causing sudden stops at the national level. There are many arguments for why a euro-wide safe asset is important, no matter what form this asset may take, for the sake of the internal stability of the eurozone and to prevent a repeat of what happened in 2010-

[3] Bahaj and Reis (2018) discuss the role of the swap lines, highlight the mechanism through which they work, and empirically test their effectiveness.

12. But even leaving crises aside, the global role of the euro is severely hampered by the absence of a euro-wide safe asset.

4 Independence: EMU and fiscal policy

The unique challenge facing the ECB is that it is a single monetary authority facing many fragmented fiscal authorities. Article 130 of the Founding Treaty provided direction to this monetary-fiscal interaction by stating: "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." (My emphasis added.) The ECB is independent from the fiscal authorities, and a strict reading of the Treaty suggests that the scope for coordinating policies with governments is very limited.

During its first decade, the ECB succeeded at upholding this independence. There was barely any public pressure from fiscal authorities for monetary policy to generate more seigniorage revenues or to rebate more net income to the national Treasuries. The ECB was committed to its inflation target and it never flinched at any suggestion that it might be best to inflate away some of the growing public debt.

Both forms of potential fiscal dominance became more attractive during the second decade. The sovereign debt crisis of 2010-12 and the political deadlocks around it led to calls for the ECB to actively redistribute resources across countries. The painful slow recovery in many European countries, which are saddled with high public debt, made it tempting to use the ECB's ability to generate resources in order to relax austerity. In spite of these, the ECB retained its independence from fiscal authorities.[4]

At the same time, the financial crisis brought liquidity policies to the forefront of what a central bank does. The theory and best practice of lender of last resort to both individual banks and financial systems as a whole relies on two stages. First, the central bank should lend to illiquid but solvent institutions. Sometimes, it is inevitable that the illiquid evolve into becoming insolvent. At that time, taxpayer money is at stake so that any further action has clear fiscal consequences. The central bank should call the Treasury and let it decide whether to set up a bailout with public funds or not.

In a deep financial crisis, and when lending of last resort happens, the strict separation of monetary and fiscal policy is neither possible nor desirable. In many states of the world, the illiquid remain solvent, and the central bank can neither seek nor take instructions from governments, but in some states of the world, this separation is not tenable.

[4] Reis (2013) discuss the fiscal challenges facing the ECB, and Reis (2019) surveys the different fiscal linkages and potential forms of fiscal dominance of central banks.

In these, hopefully rare, cases who can the ECB call? In the last decade, the ECB answered this question in different ways according to the circumstances. When it came to isolated and small national banks in Cyprus, Portugal or Spain, the ECB withdrew (or threatened to withdraw) access to its liquidity operations from illiquid and likely insolvent banks. This forced the national Treasuries to either undertake a resolution of these banks or to sell them to other banks. National fiscal authorities shouldered the burden of the losses associated with these outcomes.

In response to the systemic crisis that spread through the whole financial system of the periphery countries, the ECB instead called and worked with the European Commission and with the International Monetary Fund. It joined them in a troika that imposed and supervised a mix of reforms in the banking sector with fiscal measures and structural adjustment policies.

Finally, by purchasing large amounts of national sovereign bonds, the ECB made it possible for one country in the eurozone to default at the expense of others. These redistributions could happen because the losses by the ECB would be shared among all through lower dividends from the central bank. To limit this potential redistribution, the ECB introduced rules dictating that most of the purchases of the national sovereign bonds would be made by the corresponding national central bank so any potential losses would stay within the country. This prevents direct risk sharing from quantitative easing arising in the state of the world where there is sovereign default.

In light of the price stability mandate, these three complementary approaches were successful. Fiscal dominance, in the sense of the central bank being forced to sacrifice inflation control, was avoided. Whether these policies were the best from the perspective of social welfare in the eurozone is more debatable, but it is also a discussion best left for another day. Moving forward though, none of these approaches bind the ECB for the future, nor do they establish a framework or set of rules for future relations. The question of who the ECB will call remains.

The absence of a clear relation between monetary and fiscal authorities can directly cause problems. For instance, it would be reasonable for the ECB to be too conservative in its liquidity policies knowing that it will not be able to transition out of them if the illiquid turn out to be insolvent. It may refuse to be a lender of last resort in a wider set of circumstances or earlier than if it had a clear fiscal counterpart. Yet, this may well be inefficient because the ECB might not internalise the large fiscal costs that arise when a failing bank is excluded from the ECB's liquidity facilities.

From the opposite direction, perhaps the ECB will keep on providing liquidity beyond the point where it should. When a large financial institution that operates in many regions of the eurozone becomes insolvent, different national Treasuries will have an incentive to play games of chicken with each other where the first to blink pays the fiscal costs. During the war of attrition when resolution is delayed, the ECB may be stuck in the middle supporting an insolvent institution.

A related issue is that much of macroprudential policy in the eurozone is conducted at the national level. In spite of the single supervisory mechanism, many of the actual tools of macroprudential regulation are decided by national authorities, often in institutions that depend on the Treasury. Yet, when a macro systemic crisis arises, the central bank is invariably the first respondent. It is inevitable that the central bank will have to interact with the macroprudential authorities even if they are branches of the government. The line that separates having interactions from taking or giving instructions is thin.

In short, I have tried to make three points. First, that all lender of last resort operations are ultimately fiscal. Theory shows this, and the history of major central banks as well as the IMF confirms it. During the 2007-09 financial crisis, decisions in the United States about Bear Sterns or Lehman Brothers were ultimately made by the Treasury in coordination with the Federal Reserve. Decisions made by the IMF on international lending of last resort always involve taking and giving instructions to fiscal stakeholders, including those in the board of the IMF, and those in the countries seeking assistance.

Second, that because the ECB is the lender of last resort in the eurozone but there are fragmented fiscal bodies, it is possible that a lack of coordination between them could lead to inferior outcomes. I discussed the actions taken in the last decade, noting that they preserved price stability, respecting the mandate of the ECB. Whether they were the best for social welfare is less clear.

Third, that one has to think hard about how to formulate the independence of the ECB from the fiscal authorities when it comes to these policies. Article 130 can be interpreted too strictly. Lender of last resort policies always require some coordination with fiscal authorities. Clarified rules, or a better statement of institutions in this regard, are a missing part of the Euro's architecture that may soon become relevant.[5]

5 Conclusion

Was the second decade as successful as Jean-Claude Trichet and Lucas Papademos judged the first decade of the euro to have been? In some ways, it is defensible to conclude that the second decade was actually *more* successful than the first. The challenges were arguably larger and yet, inflation remains under control, the euro is still the second largest global currency, and the independence of the ECB is preserved while preventing a financial collapse and providing ample liquidity.

At the same time, these outcomes leave the ECB with some important questions unanswered as it enters its third decade. How does it interpret and define its inflation target in light of the need for relative price adjustments between different regions in the currency union? How can it promote the global role of the euro if the political bodies continue to fail to deliver a euro-wide safe asset that completes the

[5] Reichlin (2019) in the context of the Eurozone, and Goodhart (1999) more generally, provide alternative discussions of the challenge behind liquidity policies and the lender of last resort.

architecture of the capital market union? How can we re-think and re-state the independence of the central bank as a lender of last resort in its relations with the fiscal authority and with macroprudential regulators?

The crisis should hopefully have taught European policymakers that failures in the architecture of the eurozone that leave questions unanswered sooner or later get exposed in a crisis. The same will surely happen when the next crisis comes about. Whether the third decade of the euro will be a success depends on the answers that are given to these three difficult questions.

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