The euro 20 years on

The fundamental principles:
a reality check

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Outline

- The fundamental principles
- Reality check
- Lessons

The fundamental principles

- The euro: a response to monetary disorders jeopardising the single market.
- Convergence of views on the design of central banks.
- The best contribution of monetary policy to welfare is to ensure price stability.
- Monetary policy role in stabilisation policy can only work if inflation expectations are solidly anchored. When the CB reaction function is fully internalised the economy is virtually on ‘automatic pilot’.

The fundamental principles

- Instrument independence is key for the CB to fulfill its mandate.
- The EMU legal framework provides broad discretion but conditional .
- The chosen instruments must be ‘suitable, necessary and proportionate’.
- The ‘no monetary finance/ no privileged access’ rules are reflected in several policy decisions and in market expectations.

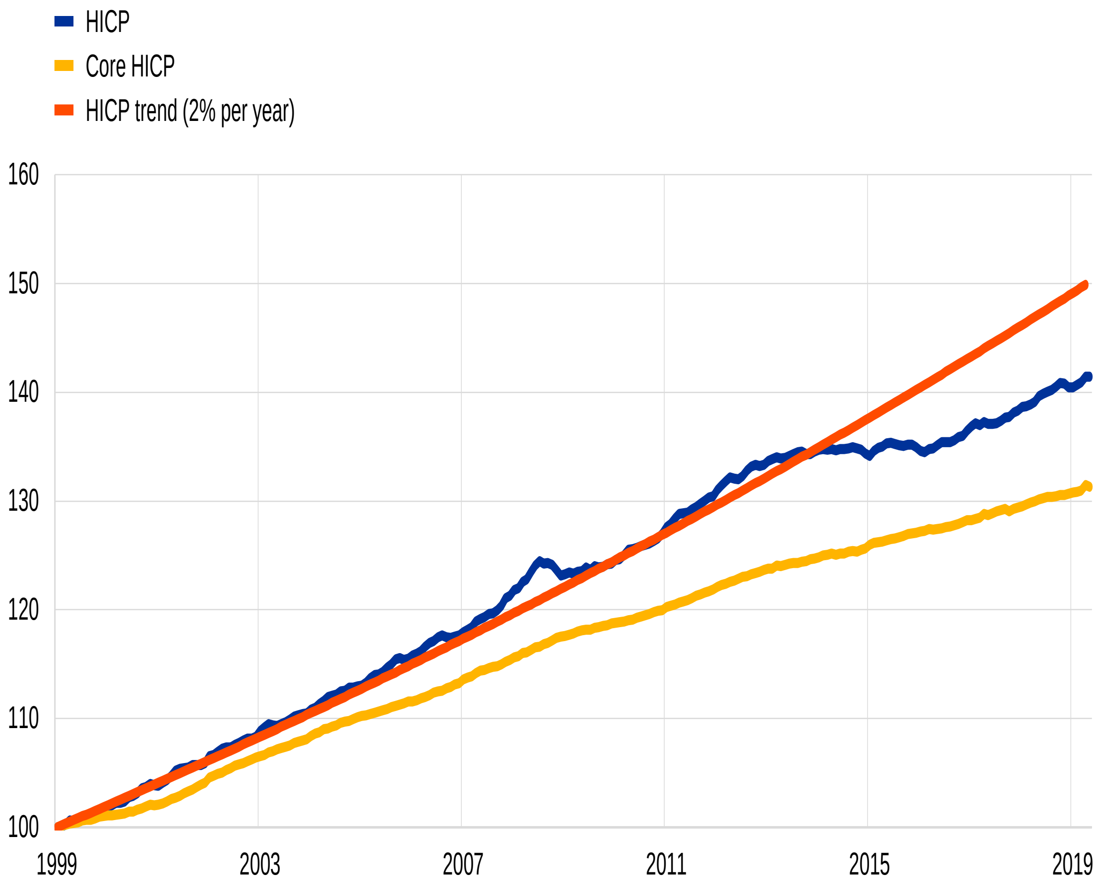
The fundamental principles

- Little role for fiscal policy in stabilisation policy for the EA as a whole (monetary dominance) but important role for national fiscal policies when asymmetrical shocks.
- The ‘no exit/ no monetary finance/ no privileged access’ rules seen as high power incentives to internalise the single currency framework.
- Complemented by SGP + surveillance of imbalances.
- Confidence in the role of private sector risk-sharing and market discipline.

The reality check: first decade

- Building credibility in a MU composed of countries with very different inflation histories…
- …in a context of one-sided supply shocks (oil prices increased more than tenfold in the first 10 years).
- HICP evolved broadly in line with a 2% trend until 2014…
- …but the EA entered the GFC crisis with a weak Core inflation.

The reality check



The fundamental principles tested

- *The euro: a response to monetary disorders* **# euro sov debt/banking crisis**
- *Convergence of views on design of central banks* **# Diverging views when interest rates at the 'lower bound'.**
- *The best contribution of monetary policy to welfare is to ensure price stability* **# price stability is not enough.**
- *When the CB reaction function is fully internalised the economy is virtually on 'automatic pilot*' **# what if 'lower bound', geopolitical uncertainty…?**
- *Broad discretion on monetary policy instruments, but conditional* **# destabilising market dynamics can occur in the absence of a strong institutional framework.**

The fundamental principles tested

- *Little role for fiscal policy in stabilisation policy for the EA but important role for national policies when asymmetrical shocks*. **# procyclical fiscal stance for the EA as a whole.**
- *The 'no exit/ no monetary finance/ no privileged access' rules seen as high power incentives.* **# stretched public finances and build-up of imbalances. Lack of relative price adjustments across countries (real exchange rate).**
- *SGP + surveillance of imbalances* **# stretched public finances and build-up of imbalances.**
- *Private sector risk-sharing and market discipline* **# private sector risk-amplification.**

The lessons

- Institutional and structural reforms occur, but most often as a reaction to severe stress.
- The ‘Europe will be forged in crises’ approach is costly and risky.
- Different visions are by themselves a source of uncertainty, at a time when the economic and geopolitical environment requires clarity and urgent action.
- Broad agreement on the overall direction of institutional reforms, but still deep divisions on how, at what speed, what sequence, what prior conditions, etc

The lessons

- Completing the BU/CMU is a priority. The financial system has been strenghtened, but its capacity to smoothing shocks is still questionable.
- A positive narrative for the financial sector is needed, based on concrete action and an ambitious timetable so as to influence strategic decisions.
- In parallel this requires reinforcing the Macroprudential framework.
- Stabilisation policy needs to be better articulated between monetary and fiscal policy, while preserving the independence of the central bank.
- Over time, a european fiscal capacity needs to be developped, with an accent on automatic stabilisers.
- Difficult questions on how to deal with real convergence. What role for the BICC (Budgetary instrument for convergence and competitiveness)?