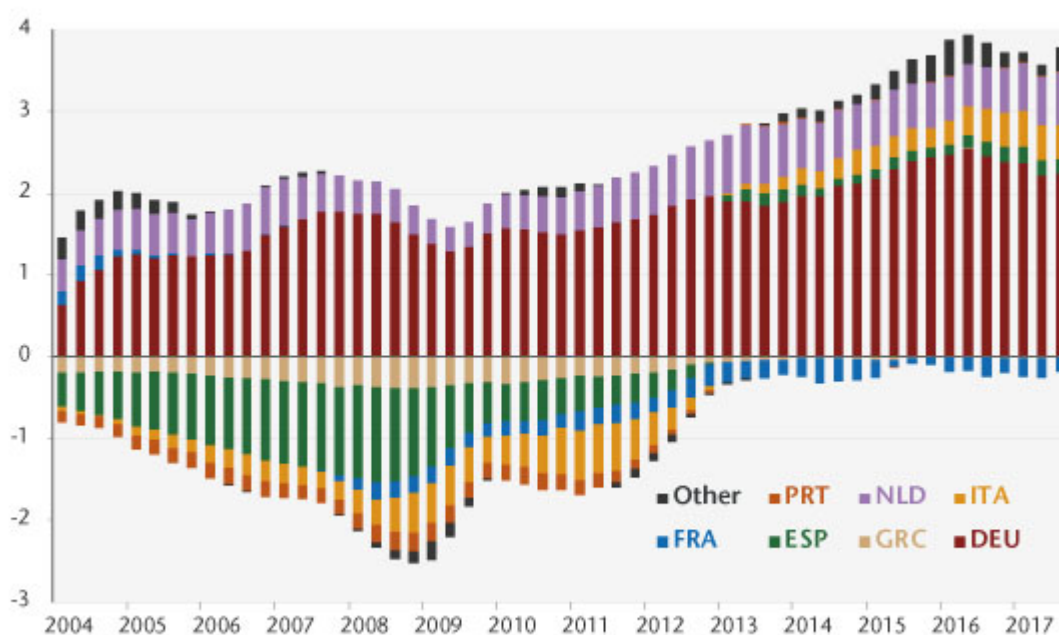


Major adjustments are awaiting the euro zone

By [Bruno Ducoudré](#), [Xavier Timbeau](#) and [Sébastien Villemot](#)

Current account imbalances are at the heart of the process that led to the crisis in the euro zone starting in 2009. The initial years of the euro, up to the crisis of 2007-2008, were a period that saw widening imbalances between the countries of the so-called North (or the core) and those of the South (or the periphery) of Europe, as can be seen in Figure 1.

Figure 1. Current account balances (moving average over four quarters)
in % of GDP of the euro zone



Source: Eurostat.

The trend towards diverging current account balances slowed sharply after 2009, and external deficits disappeared in almost all the euro zone countries. Despite this, there is still a significant gap between the northern and southern countries, so there cannot yet be any talk about reconvergence. Moreover, the fact that the deficits have fallen (Italian and Spanish) but not the surpluses (German and Dutch) has radically changed the ratio of the euro zone to the rest of the world: while the

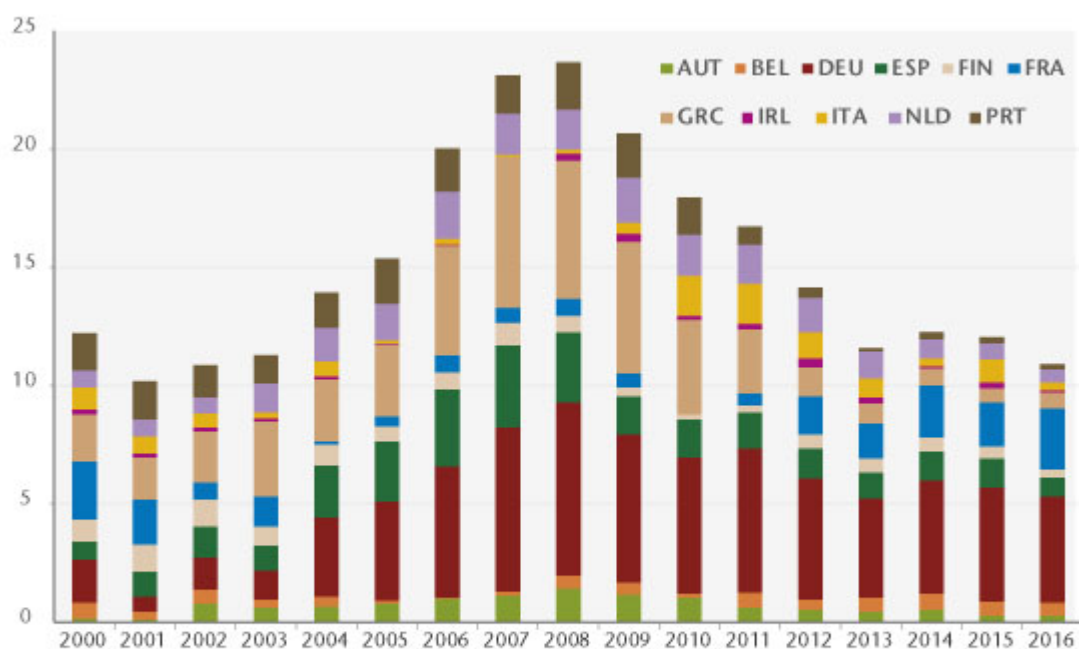
zone's current account was close to balanced between 2001 and 2008, a significant surplus has formed since 2010, reaching 3.3% of GDP in 2016. In other words, the imbalance that was internal to the euro zone has shifted into an external imbalance between the euro zone and the rest of the world, in particular the United States and the United Kingdom. This imbalance is feeding Donald Trump's protectionism and putting pressure on exchange rates. While the nominal exchange rate internal to the euro zone is not an adjustment variable, the exchange rate between the euro and the dollar can adjust.

It seems unlikely that the euro zone can maintain a surplus like this over the long run. Admittedly, the pressures for the appreciation of the euro are now being contained by the [particularly accommodative monetary policy of the European Central Bank](#) (ECB), but when the time comes for the normalization of monetary policies, it is likely that the euro will appreciate significantly. In addition to having a deflationary impact, this could rekindle the crisis in the zone by once again deepening the Southern countries' external deficits due to their loss in competitiveness. This will in turn give new grounds for leaving the euro zone.

[In a recent study \[1\]](#), we seek to quantify the adjustments that remain to be made in order to resolve these various current account imbalances, both within the euro zone and vis-à-vis the rest of the world. To do this, we estimate equilibrium real exchange rates at two levels. First, from the point of view of the euro zone as a whole, with the idea that the adjustment of the real exchange rate will pass through an adjustment of the nominal exchange rate, notably the euro vis-à-vis the dollar: we estimate the long-term target of euro / dollar parity at USD 1.35 per euro. Next, we calculate equilibrium real exchange rates within the euro zone, because while the nominal exchange rate between the member countries does not change because of the monetary union, relative price levels allow adjustments in the real exchange rate. Our

estimates indicate that substantial misalignments remain (see Figure 2), with the average (in absolute terms) misalignment relative to the level of the euro being 11% in 2016. The relative nominal differential between Germany and France comes to 25%.

Figure 2. Indicator of nominal intra-euro zone adjustments with countries' contributions



Note: Figure 2 relates the average (weighted by GDP) of the absolute value of the nominal adjustments. The contribution of each country to this average is shown. The nominal disadjustments correspond to the changes in price of the added value that must be made simultaneously so that all the countries hit their current account target. This figure can be interpreted as a summary measure of the level of the internal disadjustments of the euro zone, with the contribution of each country.
Source: OFCE calculations.

In the current situation, claims by some euro zone countries are not accumulating on others in the zone, but there is accumulation by some euro zone countries on other countries around the world. This time the exchange rate (actual, weighted by accumulated gross assets) can serve as an adjustment variable. The appreciation of the euro would therefore reduce the euro zone's current account surplus and depreciate the value of assets, which are probably accumulated in foreign currency. France however now appears as the last country in the euro zone running a significant deficit. Relative to the zone's other countries, it is France that is contributing most (negatively) to the imbalances with Germany (positively). If the euro appreciates, it is likely that France's situation

would further deteriorate and that we would see a situation where the net internal position accumulates, but this time between France (on the debtor side) and Germany (creditor). This would not be comparable to the situation prior to 2012, since France is a bigger country than Greece or Portugal, and therefore the question of sustainability would be posed in very different terms. On the other hand, reabsorbing this imbalance by an adjustment of prices would require an order of magnitude such that, given the relative price differentials that would likely be needed between France and Germany, it would take several decades to achieve. It is also striking that, all things considered, since 2012, when France undertook a costly reduction in wages through the CICE tax credit and the Responsibility Pact, and Germany introduced a minimum wage and has been experiencing more wage growth in a labour market that is close to full employment, the relative imbalance between France and Germany, expressed in the adjustment of relative prices, has not budged.

Three consequences can be drawn from this analysis:

1. The disequilibrium that has set in today will be difficult to reverse, and any move to speed this up is welcome. Ongoing moderation in rises in nominal wages in France, stimulating the growth of nominal wages in Germany, restoring the share of German added value going to wages, and continuing to boost the minimum wage are all paths that have been mentioned in the various iAGS reports. A reverse social VAT, or at least a reduction in VAT in Germany, would also be a way to reduce Germany's national savings and, together with an increase in German social security contributions, would boost the competitiveness of other countries in the euro zone;
2. The pre-crisis internal imbalance has become an external imbalance in the euro zone, which is leading to pressure for a real appreciation of the euro. The order of

magnitude is significant: it will weigh on the competitiveness of the different countries in the euro zone and will lead to the problems familiar prior to 2012 resurfacing in a different form;

3. The appreciation of the euro caused by the current account surpluses in certain euro zone countries is generating an externality for the euro zone countries. Because their current accounts respond differently to a change in relative prices, Italy and Spain will see their current account balance react the most, while Germany's will react the least. In other words, the appreciation of the euro, relatively, will hit the current accounts of Italy and Spain harder than Germany's and will lead to a situation of internal imbalance much like what existed prior to 2012. This externality together with the reduced sensitivity of Germany's current account to relative prices argues for a reduction in imbalances by boosting Germany's internal demand, i.e. by a reduction in its national savings. The tools to do this could include boosting public investment, lowering direct personal taxes, or raising the minimum wage more quickly relative to productivity and inflation.

[\[1\]](#) Sébastien Villemot, Bruno Ducoudré, Xavier Timbeau: "Taux de change d'équilibre et ampleur des désajustements internes à la zone euro" [Equilibrium exchange rate and scale of internal misalignments in the euro zone], *Revue de l'OFCE*, 156 (2018).

The ECB is still worried

about the weakness of inflation

By [Christophe Blot](#), [Jérôme Creel](#) and [Paul Hubert](#)

The President of the European Central Bank, Mario Draghi, recently [announced](#) that the increase in the ECB's key interest rate would come "well past" the end of the massive purchases of bonds (scheduled for September 2018), mainly issued by the euro zone countries, and at a "measured pace". The increase in the key rate could therefore occur in mid-2019, a few weeks before the transfer of power between Mario Draghi and his successor.

In his quarterly hearing with MEPs, Mario Draghi proved to be cautious about the intensity and sustainability of the economic recovery [\[1\]](#). Listening to him, the euro zone has not necessarily closed its output gap (actual GDP would have remained below its potential) despite the recovery in recent quarters. This is not the time to change the direction of monetary policy at the risk of weakening the recovery. It is also undeniable that the effects of the recovery are only materializing slowly and gradually in wage increases, which partly explains why the euro zone inflation rate remains below its mid-term target.

The ECB President has also been confident that companies are gradually anchoring their price (and wage) expectations on the ECB's inflation target of 2% per year. Mario Draghi also appeared very confident in the effectiveness of monetary policy. He announced that the measures undertaken since 2014 would contribute to a (cumulative) increase of 2 percentage points, respectively in real growth and inflation between 2016 and 2019.

If the ECB's forecast of inflation back to its target in 2019

is contradicted by [Hasenzagl et al. \(2018\)](#), we find these same determinants of European inflation. In a [recent study](#), we also show that the two main determinants of inflation in the euro area are inflation expectations and wage growth. Without anchoring the former on the medium-term target of the ECB and without a second-round effect of monetary policy on wages, inflation will not return to its target in the short term. Structural reforms may have increased potential GDP, as argued by Mario Draghi, but they have so far more certainly weighed on wage and price developments.

[\[1\]](#) Once a quarter, a monetary dialogue is organized between the President of the ECB and the members of the Monetary Affairs Committee of the European Parliament. This dialogue allows the President of the ECB to explain the direction of monetary policy in the euro area and to express his point of view on topics defined upstream. Une fois par trimestre un dialogue monétaire est organisé entre le Président de la BCE et les membres de la Commission des Affaires monétaires du Parlement européen. Ce dialogue permet au Président de la BCE d'expliquer l'orientation de la politique monétaire dans la zone euro et d'exprimer son point de vue sur des sujets définis en amont.

Missing deflation – unique to America?

By [Paul Hubert](#), [Mathilde Le Moigne](#)

Was the way inflation unfolded after the 2007-2009 crisis atypical? According to Paul Krugman: “If inflation [note: in the United States] had responded to the Great Recession and aftermath in the same way it did in previous big slumps, we would be [deep in deflation](#) by now; we aren’t.” Indeed, after 2009, inflation in the United States remained surprisingly stable given actual economic developments. Has this phenomenon, which has been described as “missing deflation”, been observed in the euro zone?

Despite the deepest recession since the 1929 crisis, the inflation rate remained stable at around 1.5% on average between 2008 and 2011 in the United States, and 1% in the euro zone. Does this mean that the Phillips curve, which links inflation to real activity, has lost its empirical validity? In a [note](#) in 2016, Olivier Blanchard recalls on the contrary that [the Phillips curve](#), in its simplest original version, remains a valid instrument for understanding the links between inflation and unemployment, despite this “missing disinflation”. Blanchard notes, however, that the link between the two variables has weakened because inflation is increasingly dependent on expectations of inflation, which are themselves anchored in the US Federal Reserve’s inflation target. In their 2015 [article](#), Coibion [and](#) Gorodnichenko explain the missing deflation in the United States by the fact that inflation expectations tend to be influenced by the most visible price changes, such as changes in the price of a barrel of oil. Since 2015, we have seen a drop in inflation expectations concomitant with the decline in oil prices.

The difficulty in accounting for recent changes in inflation by using the Phillips curve led us in a [recent article](#) to evaluate its potential determinants and to consider whether the euro zone has also experienced a phenomenon of “missing deflation”. Based on a standard Phillips curve, we did not find the conclusions of Coibion and Gorodnichenko when we consider the euro zone as a whole. In other words, real

activity and inflation expectations give a good description of the way inflation is behaving.

This result seems to come, however, from a bias in aggregation between national inflation behaviours in the euro zone. In particular, we find a notable divergence between the countries of northern Europe (Germany, France), which show a general tendency towards *missing inflation*, and the more peripheral countries (Spain, Italy, Greece), which are exhibiting periods of *missing deflation*. This divergence nevertheless shows up from the *beginning* of our sample, that is to say, in the first years when the euro zone was created, and seems to be absorbed from 2006, without undergoing any notable change during the 2008-2009 crisis.

In contrast to what happened in the United States, it seems that the euro zone did not experience missing deflation as a result of the 2008-2009 economic and financial crisis. On the contrary, it seems that divergences in inflation in Europe predate the crisis and tended to be absorbed by the crisis.

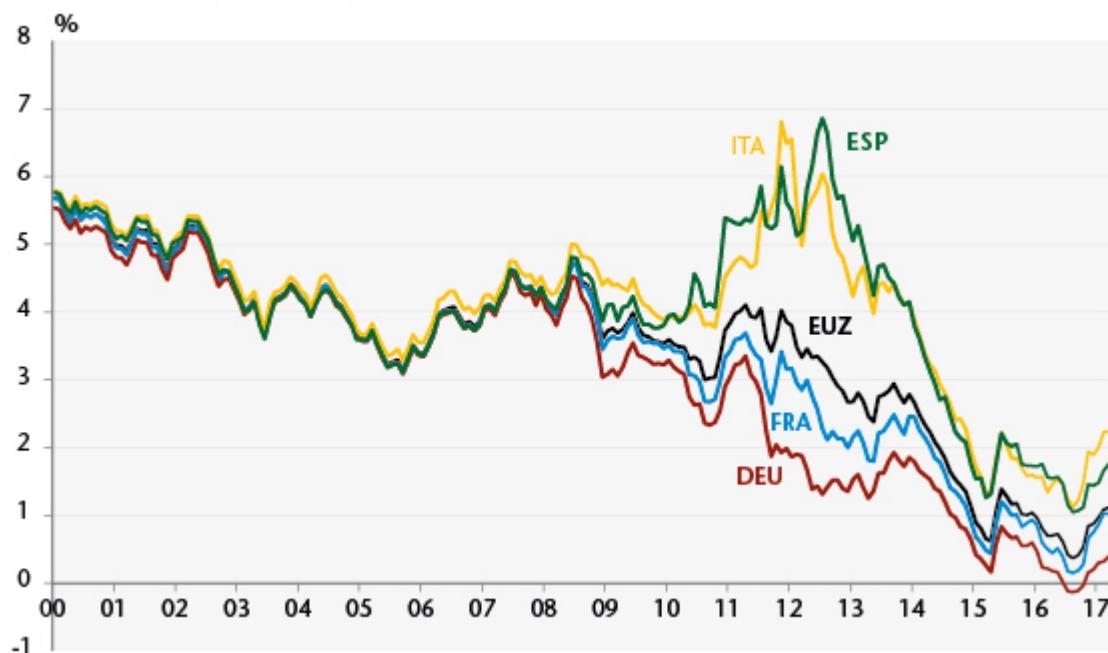
What factors are behind the recent rise in long-term interest rates?

By [Christophe Blot](#), [Jérôme Creel](#), [Paul Hubert](#) and Fabien Labondance

Since the onset of the financial crisis, long-term sovereign interest rates in the euro zone have undergone major

fluctuations and periods of great divergence between the member states, in particular between 2010 and 2013 (Figure 1). Long-term rates began to fall sharply after July 2012 and Mario Draghi's famous "whatever it takes". Despite the [implementation](#) and [expansion](#) of the Public Sector Purchase Programme (PSPP) in 2015, and although long-term sovereign interest rates remain at historically low levels, they have recently risen.

Figure 1: Long-term sovereign interest rates in the euro zone



Source : European Central Bank.

There may be several ways of interpreting this recent rise in long-term sovereign interest rates in the euro zone. Given the current economic and financial situation, it may be that this rise in long-term rates reflects the growth and expectations of [rising future growth](#) in the euro zone. Another factor could be that the euro zone bond markets are following the US markets: European rates could be rising as a result of rising US rates despite the [divergences](#) between the policy directions of the ECB and of the Fed. The impact of the Fed's monetary policy on interest rates in the euro zone would thus be stronger than the impact of the ECB's policy. It might also be possible that the recent rise is not in line with the zone's fundamentals, which would then jeopardize the recovery from

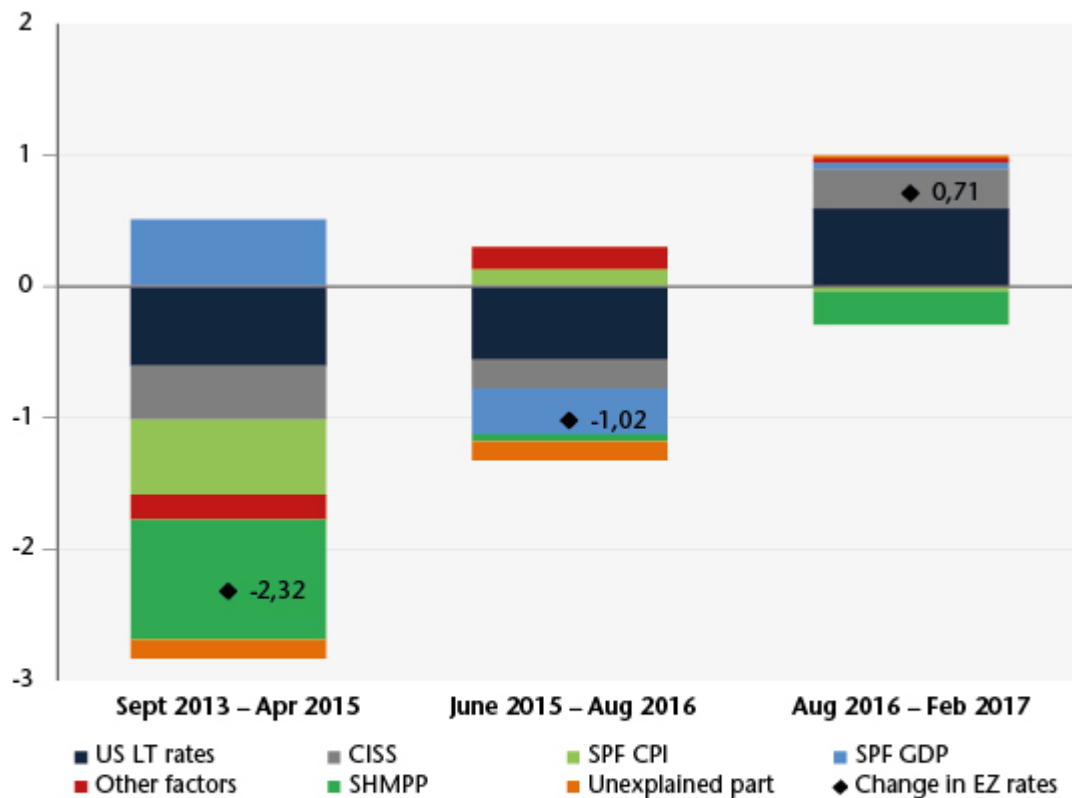
the crisis by making debt reduction more difficult, as public and private debt remains high.

In a recent [study](#), we calculate the contributions of the different determinants of long-term interest rates and highlight the most important ones. Long-term interest rates can respond to private expectations of growth and inflation, to economic fundamentals and to monetary and fiscal policy, both domestic (in the euro zone) and foreign (for example, in the United States). The rates may also react to perceptions of different financial, political and economic risks[\[1\]](#). Figure 2 shows the main factors that are positively and negatively affecting long-term interest rates in the euro zone over three different periods.

Between September 2013 and April 2015, the euro zone's long-term interest rate decreased by 2.3 percentage points. During this period, only expectations of GDP growth had a positive impact on interest rates, while all the other factors pushed rates down. In particular, the US long-term interest rate, inflation expectations, the reduction of sovereign risk and the ECB's unconventional policies all contributed to the decline in euro zone interest rates. Between June 2015 and August 2016, the further decline of about 1 percentage point was due mainly to two factors: the long-term interest rate and the expectations of GDP growth in the United States.

Between August 2016 and February 2017, long-term interest rates rose by 0.7 percentage point. While the ECB's asset purchase programme helped to reduce the interest rate, two factors combined to push it up. The first is the increase in long-term interest rates in the United States following the Fed's tightening of monetary policy. The second factor concerned political tensions in France, Italy and Spain, which led to a perception of political risk and higher sovereign risk. While the first factor may continue to push up interest rates in the euro zone, the second should drive them down given the results of the French presidential elections.

Figure 2: Contributions to changes in long-term sovereign rates in the euro zone



Note: SPF corresponds to the Survey of Professional Forecasters and measures private agent expectations of inflation (CPI – Consumer Price Index) and of GDP (Gross Domestic Product). The CISS (Composite Indicator of Systemic Stress) is an Indicator of stress on the financial markets. The SHMPP (Securities Held for Monetary Policy Purposes), in the Weekly financial statements published by the ECB, measures the amount of purchases of bonds made by the ECB as part of its unconventional policy.

Source: calculation OFCE.

[1] The estimate of the equation for the determination of long-term rates was calculated over the period January 1999 – February 2017 and accounts for 96% of the change in long-term rates over the period. For details on the variables used and the parameters estimated, see the [study](#).

Is missing disinflation a uniquely American phenomenon?

By [Paul Hubert](#), Mathilde Le Moigne

Are the dynamics of inflation after the 2007-2009 crisis atypical? According to Paul Krugman, “If inflation had responded to the Great Recession and aftermath the way it did in previous big slumps, we would be deep in [deflation](#) by now; we aren’t.” In fact, after 2009, inflation in the US has remained surprisingly stable in terms of changes in real activity. This phenomenon has been called “missing disinflation”. Can a phenomenon like this be seen in the euro zone?

Despite the worst recession since the 1929 crisis, the inflation rate has remained stable at around 1.5% on average between 2008 and 2011 in the US and 1% in the euro zone. Does this mean that the Phillips curve, which links inflation to real activity, has lost its empirical validity? In a [note](#) in 2016, Olivier Blanchard argued instead that the [Phillips curve](#), in its simplest original version, is still a valid instrument for understanding the relationship between inflation and unemployment, in spite of this “missing disinflation”.

Blanchard nevertheless noted that the relationship between the two variables has weakened, because inflation increasingly depends on inflation expectations, which are themselves anchored to the inflation target of the US Fed. In an [article](#) in 2015, Coibion and Gorodnichenko explained this missing disinflation in the US by the fact that inflation expectations are influenced by variations in the most visible prices, such as fluctuations in the price of oil. Furthermore, since 2015 inflation expectations have declined concomitantly with oil prices.

The difficulty of accounting for recent trends in inflation through the Phillips curve led us to evaluate its potential determinants in a [recent working paper](#) and to consider whether this “missing disinflation” phenomenon was also present in the euro zone. Based on a standard Phillips curve, we did not come up with the results of Coibion and Gorodnichenko when the euro zone was considered in its entirety. In other words, real activity and inflation expectations do describe changes in inflation.

However, this result appears to come from an aggregation bias between the behaviours of national inflation within the euro zone. In particular, we found a significant divergence between the countries of Northern Europe (Germany, France), which demonstrate a general tendency towards *missing inflation*, and countries on the periphery (Spain, Italy, Greece), which exhibit periods of *missing disinflation*. This divergence nevertheless appears right from the start of our sample, that is to say, in the early years of the creation of the euro zone, and seems to reverse around 2006, without any significant change during the crisis of 2008-2009.

Unlike what happened in the US, it appears that the euro zone has not experienced missing disinflation as a result of the economic and financial crisis of 2008-2009. It seems instead that divergences in inflation in Europe preceded the crisis, and tended to subside with the crisis.

Give Recovery a Chance

By iAGS team, under the direction of [Xavier Timbeau](#)

The ongoing recovery of the Euro Area (EA) economy is too slow to achieve a prompt return to full employment. Despite apparent improvement in the labour market, the crisis is still developing under the covers, with the risk of leaving long-lasting “scars”, or a “scarification” of the social fabric in the EA. Moreover, the EA is lagging behind other developed economies and regardless of a relatively better performance in terms of public debt and current account, the current low rate of private investment is preparing a future of reduced potential growth and damaged competitiveness. So far, the Juncker Plan has not achieved the promised boost to investment. The internal rebalancing of the EA may fuel deflationary pressure if it is not dealt with through faster wage growth in surplus countries. Failure to use fiscal space where it is available will continue to weigh down on internal demand. Monetary policy may not succeed in the future in avoiding a sharp appreciation of the Euro against our trade partners’ currencies. Such an appreciation of the real effective exchange rate of the Euro would lock the EA in a prolonged period of stagnation and low inflation, if not deflation.

A window of opportunity has been opened by monetary policy since 2012. Active demand management aimed at reducing the EA current account combined with internal rebalancing of the EA is needed to avoid a worrying “new normal”. Financial fragmentation has to be limited and compensated by a reduction of sovereign spreads inside the euro area. Active policies against growing inequalities should complement this approach. Public investment and the use of all policy levers to foster a transition toward a zero carbon economy are ways to stimulate demand and respect the golden rules of public finance stability.

For further information, see [iAGS 2016 report](#)

The official introduction of the euro in Lithuania: does it really make no difference?

[Sandrine Levasseur](#)

On 1 January 2015, Lithuania adopted the euro *officially*, becoming the 19th member of the euro zone. The adoption was in reality formal, as the euro was already (very) present in Lithuania. For example at the end of 2014, over 75% of loans to Lithuanian businesses and households were denominated in euros, as were 25% of bank deposits.

The use of the euro alongside Lithuania's national currency, as a currency for loans, a means of savings and for invoicing, is neither an anomaly nor simply an anecdote: this practice concerns or concerned a number of countries in the former communist bloc. "Euroization" [\[1\]](#) is the result of economic and political events that, at one time or another in these countries' histories, have led them to use the euro in addition to their own currency. So given this context, will the official introduction of the euro in Lithuania really not change anything? Not exactly. Lithuania will see some changes, admittedly minor, as will the decision-making bodies of the ECB.

The euroization of loans and deposits: the case of Lithuania, neither anomaly, nor anecdote ...

If we exclude the principalities, islands and States (Andorra,

San Marino, the Vatican, etc.) that have negotiated the adoption of the euro with the European authorities but without joining the European Union together with the countries that have adopted the euro unilaterally (Kosovo and Montenegro), there is in addition a whole set of countries that use the euro alongside their own currency. These countries are mostly from Central and Eastern Europe, the Balkans or the Commonwealth of Independent States (CIS). For example, in 2009, before Estonia and Latvia officially joined the euro zone (in 2011 and 2013, respectively), lending by private agents in the three Baltic states was mainly denominated in the euro, reaching a level of almost 90% in Latvia (Figure 1). Countries such as Croatia, Romania, Bulgaria, Serbia and Macedonia were not far behind, with over 50% of their loans denominated in euros. The figures for deposits in euros are somewhat less striking (Figure 2), but still raise questions as to the attraction that the euro exerted in some countries as a payment or reserve currency or for precautionary savings.

Figure 1. Share of loans to the private sector denominated in euros (emerging Europe, 2009)

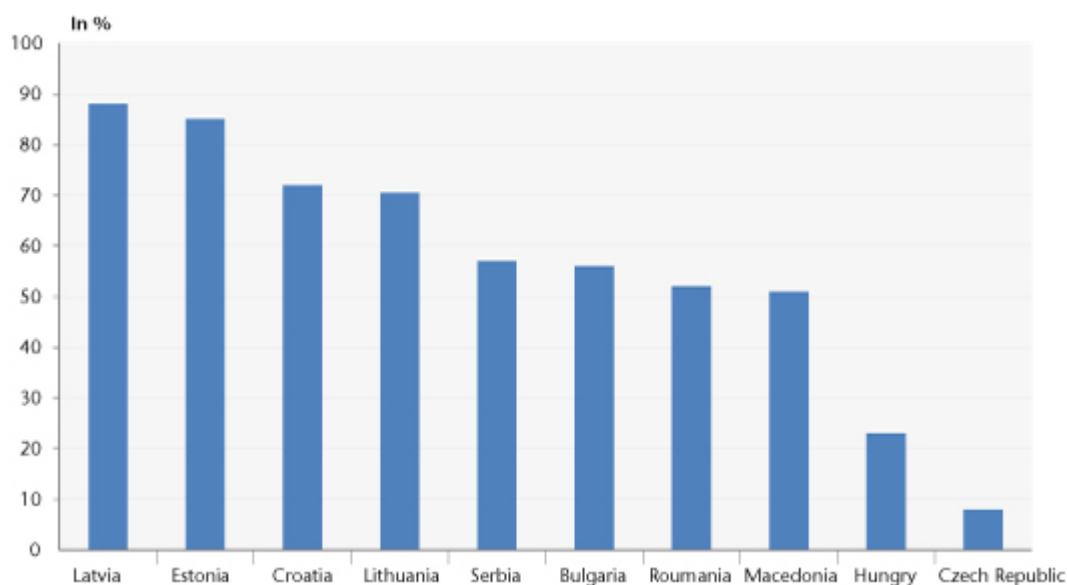
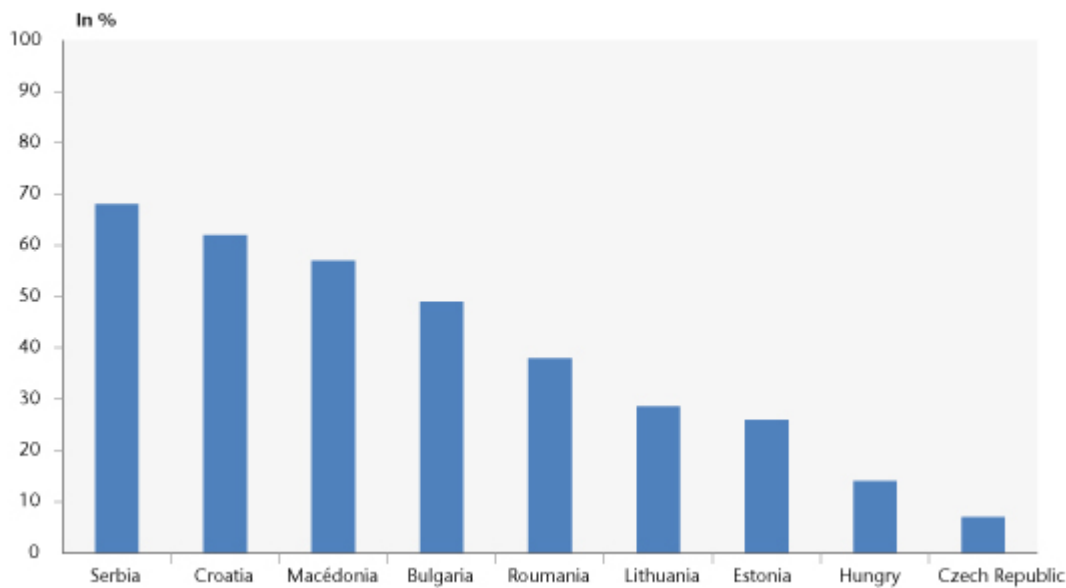


Figure 2. Share of private sector deposits in euros (emerging Europe, 2009)



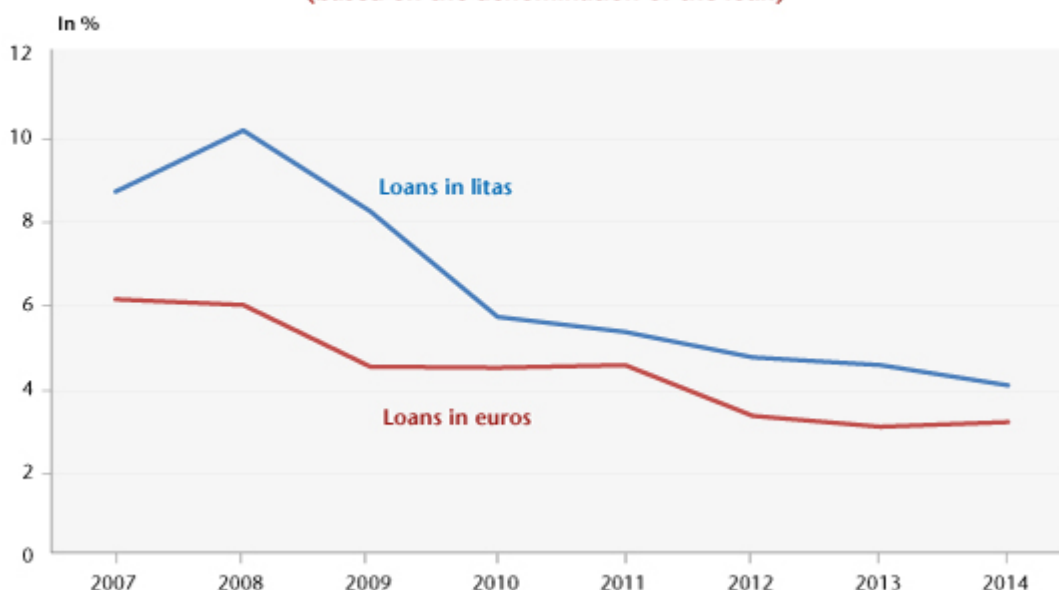
There are a number of reasons why these countries have used the euro in addition to their own currency:

- **The existence of fixed** (or relatively fixed) **exchange rates** against the euro, which protects borrowers against the risk that their euro-denominated debt will grow heavier (since the likelihood of a devaluation / depreciation of the national currency is considered to be low);
- **A lower interest rate on loans denominated in euros** than when the loans are denominated in the national currency;
- **A strong presence of multinational companies (particularly in the banking sector)** that have not only funds in euros but also the “technology” to lend / borrow in euros;
- For loans in euros, **the ex ante existence of bank deposits in euros**, which is itself linked to [multiple factors](#) (e.g. the credibility of the monetary authorities, a strong presence of multinationals, revenue from migration coming from countries in the euro zone) .

These factors have been present to a greater or lesser extent in the different countries. In Lithuania, the existence of a [Currency Board \[2\]](#) vis-à-vis the euro since 2002 has generally

contributed to the economy's "euroization". This system of fixed exchange rates has enjoyed great credibility, prompting the country's businesses and consumers to borrow in euros, particularly since these benefited from very low interest rates (Figure 3). The presence of multinational companies in a number of sectors strengthened the use of the euro as a benchmark currency for different functions (billing, deposits and savings). The importance to Lithuania of banks from the euro zone should nevertheless not be overestimated: [the three largest banks operating in Lithuania are from Sweden and Norway](#). The risk of loans in euros thus involves, beyond the risk associated with the value of the Lithuanian lita, a risk associated with the value of a third currency. ... This risk will obviously not disappear with Lithuania's formal adoption of the euro.

**Figure 3. Interest rates on loans to the private sector
(based on the denomination of the loan)**



What changed on 1 January 2015?

Four changes can be highlighted:

(1) The euro now circulates in Lithuania in the form of notes and coins, whereas previously it existed primarily in the form of bank money (bank deposits and euro-denominated loans); the euro is the legal tender and will be used for all

transactions; and the lita will disappear after dual circulation for a fortnight.

(2) Changes to the price labels for goods will result in additional inflation, due to more frequent rounding off upwards rather than downwards. However, this phenomenon, which has been seen in all countries during the transition (official) to the euro, should have only a [minor impact](#). Experience shows that in general [perceived inflation is higher than actual inflation](#).

(3) Lithuania is adhering *de facto* to the [banking union](#), which can provide benefits in the financial sector (e.g. opportunities for additional collaboration in a common monetary and banking space, existence of an orderly resolution mechanism in case a bank runs into difficulty).

(4) The Governor of Lithuania's Central Bank is now a member of the ECB Governing Council and therefore participates in decision-making on euro zone monetary policy, whereas previously, under its Currency Board system[\[3\]](#), Lithuania's Central Bank had no choice but to "follow" the decisions taken by the ECB in order to maintain parity with the euro. It could be argued that in any case Lithuania will not carry much weight in the ECB's choice of monetary policy due to the size of its economy. Note, however, that Lithuania's entry into the euro zone is bringing changes to the way decisions are made by the ECB Governing Council. The principle of "one country, one vote" that prevailed until now is being abandoned [in accordance with the Treaties](#), due to the entry of a 19th member into the euro zone. Henceforth, the five "major" countries in the euro zone (defined by the weight of their GDP and their financial system) have now four voting rights, while the other fourteen countries have eleven votes. The vote in each group is established according to a [rotation principle](#), which displeases the [Germans](#), but [not just them](#). In practice, however, it is not certain that [this change in the voting system will affect many decisions](#). For example, while the

governor of Germany's central bank now has only [80% of its voting right](#), it still has 100% of its right to speak... Will not voting one month out of five really mean that it loses its power of persuasion?

On 1 January 2015, the official adoption of the euro by Lithuania was thus not at all amount to a Big Bang. However, it is very symbolic for Lithuania, further demonstrating how much it is anchored in both Europe and the euro zone. This shows once again that despite all the turmoil the zone has experienced, it still has its supporters. The most striking result of Lithuania's accession to the euro zone is probably the change in the ECB's system of voting rights: here too the symbolic meaning is heavy, as it sounds the death knell of the principle, "one country, one vote".

For more on the issue of euroization, readers can see:

Sandrine Levasseur (2004), Why not euroization ? *Revue de l'OFCE*, [Special Issue "The New European Union Enlargement"](#), April 2004.

For more on the system of rotating voting rights in the ECB, see:

Silvia Merler (2014), Lithuania changes the ECB's voting system, [Blog of Bruegel](#), 25 July 2014.

[\[1\]](#) Strictly speaking, euroization refers to the adoption of the euro as legal tender by a country without its being given permission by the issuing institution (i.e. the European Central Bank) or the decision-making authorities (i.e. the heads of State of the European Union member countries). Euroization is then said to be [unilateral](#). It differs from the

phenomenon discussed here, where the euro is used in conjunction with the national currency, but only the national currency constitutes [legal tender](#).

[\[2\]](#) A currency board involves a system of fixed exchange rates in which the central bank simply converts foreign exchange inflows and outflows into the local currency at the pre-defined parity. A central bank that adopts this system gives up the tool of autonomous monetary policy: its role is reduced to that of a “cashier”.

[\[3\]](#) See footnote 2.

Dealing with the ECB’s triple mandate

By [Christophe Blot](#), [Jérôme Creel](#), [Paul Hubert](#) and [Fabien Labondance](#)

The financial crisis has sparked debate about the role of the central banks and monetary policy before, during and after the economic crisis. The prevailing consensus on the role of the central banks is eroding. Having price stability as the sole objective is giving way to the conception of a triple mandate that includes inflation, growth and financial stability. This is *de facto* the orientation that is being set for the ECB. We delve into this situation in one of the [articles](#) of the OFCE issue entitled *Reforming Europe* [\[1\]](#), in which we discuss the implementation of these three objectives.

The exclusive pursuit of the goal of price stability is now insufficient to ensure macroeconomic and financial stability.

[\[2\]](#) A new paradigm is emerging in which the central banks need

to simultaneously ensure price stability, growth and financial stability. This has been the orientation of recent institutional changes in the ECB, including its new responsibility for micro-prudential supervision. [\[3\]](#) Furthermore, the conduct of the euro zone's monetary policy shows that the ECB has also remained attentive to trends in growth [\[4\]](#). But if the ECB is indeed pursuing a triple mandate, what then is the proper relationship between these missions?

The crucial need for coordination between the different actors in charge of monetary policy, financial regulation and fiscal policy is lacking in the current architecture. Furthermore, certain practices need to be clarified. The ECB has played the role of lender of last resort (with banks and to a lesser extent States) even though it has not specifically been assigned this role. Finally, in a new framework in which the ECB plays a greater role in determining the euro zone's macroeconomic and financial balance, we believe it is necessary to strengthen the democratic accountability of the Bank. The definition of its objectives in the Maastricht Treaty in fact gives it strong autonomy in interpretation (see in particular the discussion by Christophe Blot, [here](#)). Moreover, while the ECB regularly reports on its work to the European Parliament, the latter does not have any way to direct this [\[5\]](#).

Based on these observations, we discuss several proposals for coordinating the ECB's three objectives more effectively henceforth:

1 – Even without modifying the treaties in force, it is important that the heads of the ECB be more explicit about the different objectives being pursued [\[6\]](#). The declared priority of price stability no longer corresponds to the practice of monetary policy: growth seems to be an essential objective, as is financial stability. More transparency would make monetary policy more credible and certainly more effective in preventing another financial and banking crisis in particular.

The use of exchange rate policy [\[7\]](#) should not be overlooked, as it can play a role in reducing macroeconomic imbalances within the euro zone.

2 – In the absence of such clarification, the ECB's extensive independence needs to be challenged so that it comes up to international standards in this area. Central banks rarely have independence in deciding their objectives: for example, the US Federal Reserve pursues an explicit dual mandate, while the Bank of England's actions target institutionalized inflation. An explicit triple mandate could be imposed on the ECB by the governments, with the heads of the ECB then needing to make effective tradeoffs between these objectives.

3 – The increase in the number of objectives pursued has made it more difficult to deal with tradeoffs between them. This is particularly so given that the ECB has *de facto* embarked on a policy of managing the public debt, which now exposes it to the problem of the sustainability of Europe's public finances. The ECB's mandate should therefore explicitly spell out its role as lender of last resort, a normal task of central banks, which would clarify the need for closer coordination between governments and the ECB.

4 – Rather than calling the ECB's independence completely into question, which would never win unanimity among the Member States, we call for the creation *ex nihilo* of a body to supervise the ECB. This could emanate from the European Parliament, which is responsible for discussing and analyzing the relevance of the monetary policy established with respect to the ECB's expanded objectives: price stability, growth, financial stability and the sustainability of the public finances. The ECB would then not only be invited to report on its policy – as it is already doing to Parliament and through public debate – but it could also see its objectives occasionally redefined. This “supervisory body” could for example propose quantified inflation targets or unemployment targets.

[1] *Reforming Europe*, edited by Christophe Blot, Olivier Rozenberg, Francesco Saraceno and Imola Streho, *Revue de l'OFCE*, no. 134, May 2014. This issue is available in [French](#) and [English](#) and has been the subject of a post on the [OFCE blog](#).

[2] This link is examined in "[Assessing the Link between Price and Financial Stability](#)" (2014), Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Francesco Saraceno, *Document de travail de l'OFCE*, 2014-2.

[3] The implementation of the banking union gives the ECB a role in financial regulation (Decision of the Council of the European Union of 15 October 2013). It is henceforth in charge of banking supervision (particularly credit institutions considered "significant") in the Single supervisory mechanism (SSM). As of autumn 2014, the ECB will be responsible for micro-prudential policy, in close cooperation with national organizations and institutions. See the article by Jean-Paul Pollin, "Beyond the banking union", in *Revue de l'OFCE, Reforming Europe*.

[4] Castro (2011), "[Can central banks' monetary policy be described by a linear \(augmented\) Taylor rule or by a nonlinear rule?](#)", *Journal of Financial Stability* vol.7(4), p. 228-246. This paper uses an estimation of Taylor rules between 1991:1 and 2007:12 to show that the ECB reacted significantly to inflation and to the output gap.

[5] In the United States, the mandate of the Federal Reserve is set by Congress, which then has a right of supervision and can therefore amend the Fed's articles and mandate.

[6] Beyond clarifying objectives in terms of inflation and growth, the central bank's fundamental objective is to ensure confidence in the currency.

[7] This issue is considered in part in a recent OFCE [post](#).

And what if the ECB respected its mandate!

By [Christophe Blot](#)

Article 127 of the Treaty on the Functioning of the European Union (TFEU), *i.e.* former Article 105 of the Maastricht Treaty, states clearly that “the primary objective of the European System of Central Banks ... shall be to maintain price stability”. However, no precise quantification of this goal is given in the Treaty. The European Central Bank has interpreted this by stating that it would target inflation that is below, but close to, 2% over the medium term. Furthermore, Article 127 of the TFEU adds that, “without prejudice to the objective of price stability , the [European System of Central Banks] shall support the general economic policies in the Union, as laid down in Article 3 ...”, which includes in particular the sustainable development of Europe based on balanced economic growth and price stability, full employment and social progress. It is therefore clear that the goal of growth and employment is not abandoned but subordinated to the goal of price stability. Starting from this review of the definition of the ECB’s objectives, what conclusion can we draw on the orientation of monetary policy in the euro zone?

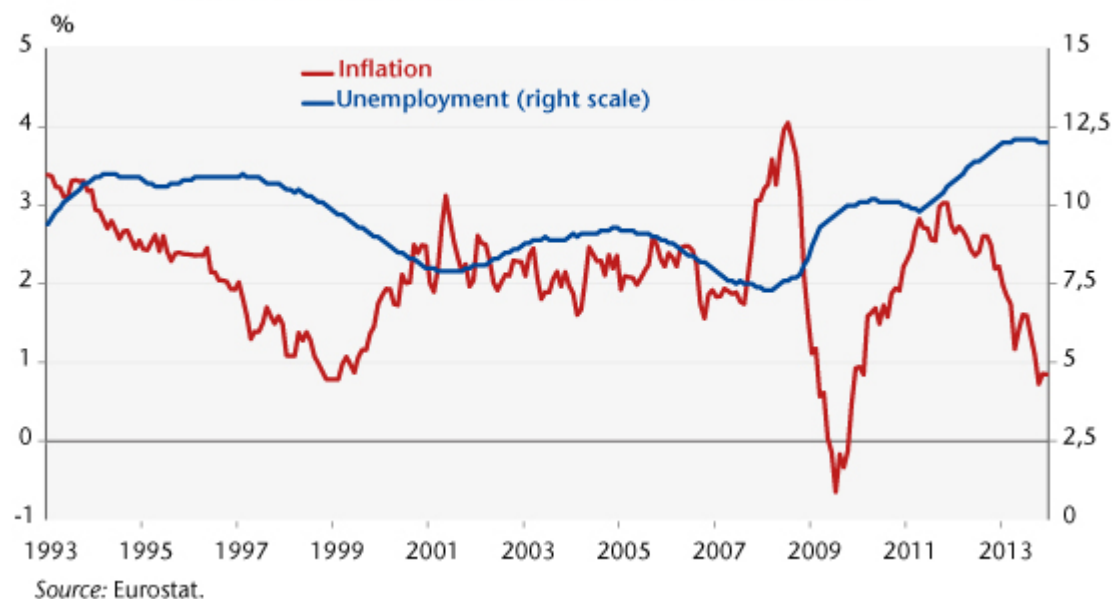
Since the end of 2013, a few signs of economic recovery have appeared in the euro zone. Initial estimates of growth in the fourth quarter of 2013 have confirmed that the recession is ending, with GDP up 0.3%. Nevertheless, the economy is still

in poor health. As proof, simply recall that 12% of the labour force is currently unemployed, which is the highest level since 1993 (see chart). Growth is expected to accelerate in 2014 and 2015. According to the ECB forecasts announced in March 2014, growth will hit 1.2% in 2014 and 1.5% in 2015, a pace that is still insufficient to lead to a rapid or significant reduction in the unemployment rate. In addition, since the end of 2013 inflation has dropped below the threshold of 1% and is coming dangerously close to a point where deflation is a risk. Furthermore, still according to the ECB forecasts, inflation should not exceed 1.0% in 2014, before pushing up to 1.3% in 2015 and 1.5% in 2016. It is in any case far from the mid-term target of 2%. The objective of price stability as defined by the ECB will therefore not be met. At his press conference in March, Mario Draghi announced that the maintenance of the ECB key interest rate [\[1\]](#) at 0.25% and the absence of additional (so-called unconventional) measures could stimulate the euro zone. The status quo was justified by the absence of signs of a more rapid fall in inflation. By taking this stand, the ECB President is indicating that he is satisfied with a situation where inflation remains permanently below the 2% level and where the euro zone is marked by persistent mass unemployment. Are we therefore supposed to reinterpret the definition of price stability invoked by the ECB and accept that the term *below* is more important in the eyes of the members of the ECB Governing Council than the term *close to 2%*? The answer to this question is obviously not neutral, since it would reflect a certain asymmetry in the central bank's reaction to inflation, with the ECB reacting more quickly when inflation exceeds 2% than when it falls below 2%, including over the forecast horizon of its own team. But however its main objective is interpreted, the fact remains that the risk to price stability is not currently a barrier to the implementation of a more expansionary monetary policy. In these conditions, the ECB has all the room it needs to be actively concerned about its other objectives, including first of all growth and unemployment.

So what tools does the ECB have available, knowing that with the benchmark rate at 0.25% it has only very limited manoeuvring room for a downward adjustment? The ECB must therefore use other levers. Communication by the central banks has played an increasing role in the implementation of monetary policy, as this can be used to influence agents' expectations and hence the impact of decisions on inflation and growth. In this respect, the central bank has recently (July 2013) engaged in what is called forward guidance by stating that the key rate will be maintained at a low level for an extended period [\[2\]](#). The ECB could go further by conditioning a hike in the key interest rate on a target unemployment rate, as both the Bank of England and the Federal Reserve have done; this would give added substance to its objectives on employment and growth. In addition, unconventional measures could be used to strengthen the expansionary character of monetary policy. This mainly means measures that alter the size or composition of the central bank's balance sheet, which would supplement the role of the reduction in short-term rates in influencing financing conditions. A recent report by France's Council of Economic Analysis (see [here](#)) points in this direction, and in particular proposes that the ECB should purchase securitized small and medium enterprises' (SME) loans in order to reduce the cost of business financing. The Outright monetary transactions (OMT) programme [\[3\]](#) could have been activated to support the reduction in long-term sovereign rates. The announcement of this measure did indeed contribute to lowering long-term sovereign rates in Spain and Italy, in particular because it sent a signal that the risk of collapse of the euro zone was being averted. Up to now, the ECB has not intervened in the markets to buy government securities. Yet given its unlimited capacity for intervention, doing this would help to reduce long-term rates. Note, however, that the OMT programme is currently being challenged by Germany's Constitutional Court in Karlsruhe, which has questioned the programme's constitutionality, with the case being referred to the

European Court of Justice. A rejection or restriction of the ECB's actions in this matter would be unfortunate. The ECB's scope for intervention does of course need to be clarified. But it is also essential to retain the objectives of price stability and growth. The judges in Germany and at the European Court of Justice would be well advised to keep this in mind.

Figure. Unemployment rate and inflation rate in the euro zone



What monetary policy for the ECB in 2013?

By Paul Hubert

After the monthly meeting of the Board of Governors of the European Central Bank on 7 February 2013, the ECB decided to hold its key interest rate at 0.75%. The analysis of the economic situation by Mario Draghi made during the press conference afterwards pointed to contrasting developments justifying the status quo. In a recent study, we showed that

the inflation forecasts of the ECB can shed new light on future trends in interest rates.

The status quo can be explained by a number of mutually offsetting factors. The banks have started to repay some of the cash obtained through the LTRO facility (140 billion euros out of 489 billion), which reflects an improvement in their financial position, while at the same time lending to non-financial firms is continuing to contract (-1.3% in December 2012) and consumer loans are still at very low levels.

From a macroeconomic viewpoint, the situation in the euro zone is not giving clear signals about future monetary policy: after shrinking by 0.2% in the second quarter of 2012, real GDP in the euro zone fell another 0.1% in the third quarter, while inflation, as measured on an annual basis, decreased from 2.6% in August 2012 to 2% in January 2013 and is expected to drop below the 2% mark in the coming months based on the figures for GDP growth and for current and anticipated oil prices.

Furthermore, the inflation expectations of private agents, as measured by the *Survey of Professional Forecasters*, remain firmly anchored around the ECB's inflation target. In the fourth quarter of 2012, expectations were for 1.9% inflation for the years 2013 and 2014. Given that the target of "below but close to 2%" has now been reached, and with a euro zone in recession and unemployment at record levels, the ECB could give a boost to real activity. However, it anticipates that economic activity should gradually pick up in the second half of 2013, partly due to the accommodative monetary policy being followed today.

Given expectations, and in light of the historically low levels of key interest rates and the lag in the transmission of monetary policy to the real economy [\[1\]](#), a future rate cut seems very unlikely. One final element is sending out mixed messages: the recent rise of the euro – though it is still far

from record levels – could nip in the bud the weak economic recovery that is underway, and could in the eyes of some justify support for export sectors [\[2\]](#).

In a recent [OFCE working paper](#) (No. 2013-04), we discuss how the ECB could use its inflation forecasts to improve the implementation of its monetary policy. We propose a new element to shed light on future developments in interest rates, based on the macroeconomic projections published quarterly by the ECB. In this study on the effects of the publication of the ECB's inflation forecasts on the inflation expectations of private agents, we show that a 1 percentage point reduction in the ECB's inflation projections is associated with a key interest rate cut by the ECB of 1.2 percentage points in the next two quarters. We conclude that the ECB's inflation forecasts are a tool that helps to better understand current monetary policy decisions and to anticipate future decisions.

The latest inflation projections, published in December 2012, were 1.6% and 1.4% for the years 2013 and 2014, respectively.

The publication on March 7th of new projections could provide a further indication of the direction monetary policy is likely to take in 2013.

[\[1\]](#) On average, a change in the key rates is estimated to have an impact on inflation after 12 months and on GDP after 18 months.

[\[2\]](#) Remember, however, that about 64% of trade in the euro zone is conducted with euro zone partners, and thus is independent of fluctuations in exchange rates.