



EUROPEAN CENTRAL BANK

EUROSYSTEM

Monetary Integration from the European Central Bank Perspective

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Agenda

- 1 History and legal basis of the Economic and Monetary Union
- 2 Institutional set up of the ECB, the Eurosystem and the ESCB
- 3 Role of the ECB in the crisis
- 4 Key lessons for a well functioning monetary union

Three stages to the Economic and Monetary Union (EMU)

1 January 2002
Introduction of euro
banknotes and coins

3 **1 January 1999**
Irrevocable **fixing of conversion rates**,
ECB responsible for monetary policy

2 **1 January 1994**
Establishment of the **European Monetary Institute**,
the ECB's predecessor

1 **1 July 1990**
Abolition of all restrictions
on the movement of capital

Maastricht Treaty (1992) as ‘monetary constitution’

Key elements:

- Binding time table for the introduction of the single currency
- Nominal convergence criteria for adopting the single currency
- Institution to set up central bank/infrastructures (EMI)
- Provisions/design for the ‘steady state’ of EMU

Monetary Union

Monetary policy:

- Centralised at supranational level, focus price stability
- Independent ECB/Eurosystem in charge of monetary policy
- No bail-out clause

Economic Union

Fiscal, economic and financial policies:

- Remain responsibility of member states
- Framework for European policy surveillance, coordination, but few binding provisions

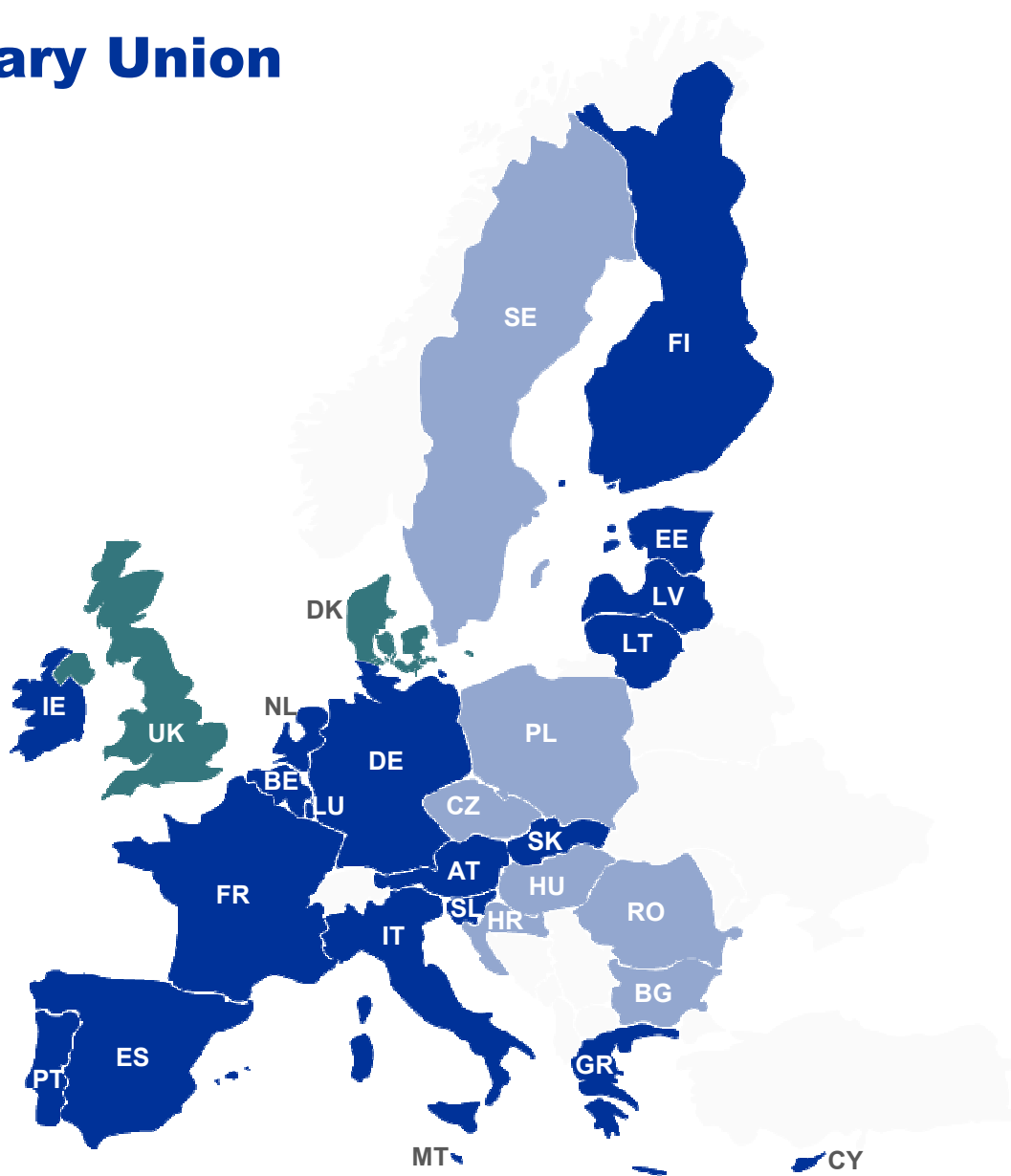
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The ESCB and the Eurosystem, including NCBs

Economic and Monetary Union (EMU)

- EU Member States which have adopted the euro
- EU Member States with a derogation
- EU Member States with a special status



The ECB – objectives and tasks

Objectives of the ECB: *(Art. 127 TFEU)*

- Primary Objective: maintaining price stability
- Secondary Objective: support general economic policies (without prejudice to the objective of price stability)

Tasks of the ECB: *(Art. 127, 128 TFEU and ESCB Statute)*

- Define and implement monetary policies
- Conduct foreign exchange operations
- Hold & manage official reserves of Member States
- Promote smooth operation of payment systems
- Direct and indirect banking supervision

- Exclusive right to authorise issuance of banknotes
- Contribution to financial stability and supervision
- Collection and compilation of statistics
- International and European cooperation

Independence

Article 130 of the Treaty on the Functioning of the European Union:

“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 **ECB**, 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.”

Accountability

- Publications
- Press conferences
- Financial controls
- Hearings
before the European Parliament
- Public speeches & interviews
- Accounts of monetary policy discussions



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Role of the ECB in the crisis – phases of the crisis



The impairments during the crisis

Interest rate channel

Impaired pass through from policy rates to money market rates and other market and bank interest rates

Bank lending channel

Banks' funding difficulties affected loan supply

Balance sheet channel

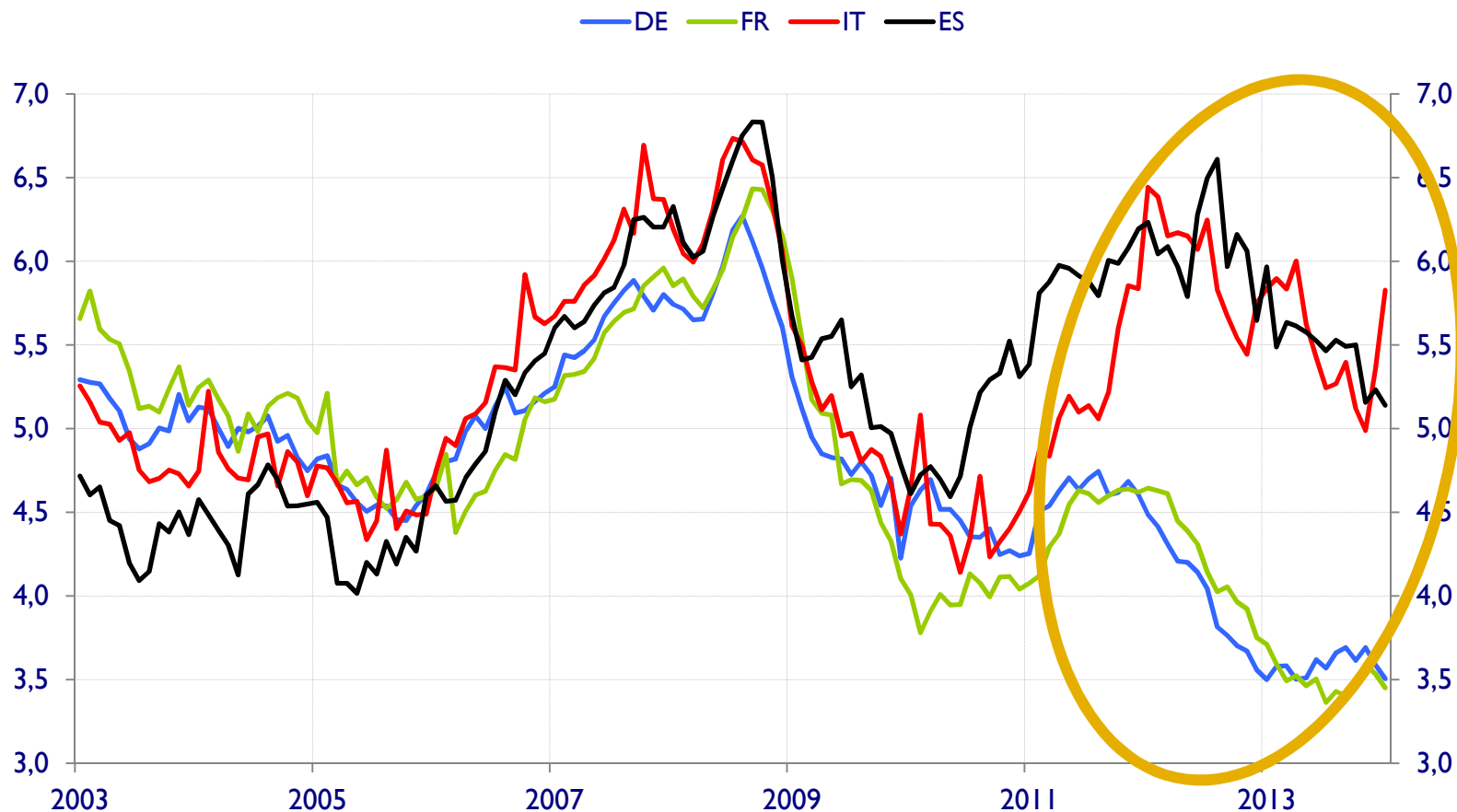
Fall in asset prices affected net worth and capital position of banks' borrowers

Risk taking channel

Unwillingness of financial sector to take on risk

The impact of an impaired transmission mechanism

Bank lending rates to companies (percentage per annum, loans up to EUR 1 million)



Source: MIR database

Latest observation: January 2014.

Note: loans with maturity between 1 and 5 years.

ECB response to the crisis - main elements

Standard measures

Reductions in **key policy rates** counteract downside risks to price stability

Non-standard measures

complement/substitute reductions in key ECB policy rates in the presence of...

...impairments in monetary policy transmission mechanism

...limited room for further loosening (close to lower bound)

....affecting the length and the composition of the central bank balance sheet

Forward guidance to provide an orientation on the future monetary policy stance



Effectiveness of monetary policy

- Fosters a sustainable return of inflation rates towards levels below, but close to 2% over the medium term
- Staved off systemic liquidity risks for financial system, stabilised inflation expectations, eliminated deflation risks
- Improved financing conditions and credit for corporates and households
- Reduced financial fragmentation in the euro area
- Supports increasingly solid and broadening economic recovery and employment

Risks or side effects ?

Inflation?

Deflation risks instead of inflation risks in the wake of the crisis

Financial stability?

Closely monitored; monetary policy not best tool to address potential risks; targeted macroprudential policies better suited to address country or sector-specific risks

Bank profitability?

Not objective of ECB; impact of monetary policy on bank profitability not one-dimensional; structural reasons for low profitability, in particular in Germany

Governments' incentives for structural reforms?

Neither theoretically nor empirically clear link to monetary policy stance; using monetary policy to steer economic or fiscal policies of governments would not be in line with central banks mandates

Distributional effects?

Price stability prevents arbitrary redistribution via inflation/deflation; monetary policy supports job creation/reduces unemployment and thus key poverty risk; no one-dimensional distribution effects

Limits of monetary policy

Monetary policy cannot address the euro area's main economic challenges

—————→ enhance potential growth, productivity, resilience
reduce structural employment

Monetary policy —————→ Price stability

Structural reforms —————→ Business environment, product and labour market flexibility....., country-specific reforms required

Fiscal policies —————→ Growth friendly composition of expenditure/
revenue, public investment, SGP as stability anchor

Further steps towards sharing sovereignty in economic governance, completing EMU, in particular banking union, capital markets union

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Crisis showed the shortcomings of EMU governance

- Failure to enforce rules of **fiscal policy framework** -
 - Insufficient internalisation of EU rules at national level
 - Practice of “non-interference” and weak enforcement by Commission, Eurogroup/EU Council (sanctions never used)
- Lack of a **competitiveness framework**
 - Lack of surveillance of competitiveness and macro imbalances
 - Processes of surveillance and coordination were non-binding
- Failure of **market discipline**
 - Build-up of unsustainable financial imbalances
 - Presumption of rational behaviour
 - Solidarity vs. ‘no bail-out’ clause
- No crisis resolution mechanism to provide **financial support** to EA countries
- Insufficient integration of **financial sector policies**; **unsatisfactory quality of banking supervision**

Key lessons for a well functioning monetary union

The evolution of EMU governance in three phases

Phase 1 (2010-2013)

Acute crisis response



Phase 2 (2012-2015)

Systemic solutions



Phase 3 (2015-2025)

From rules to institutions



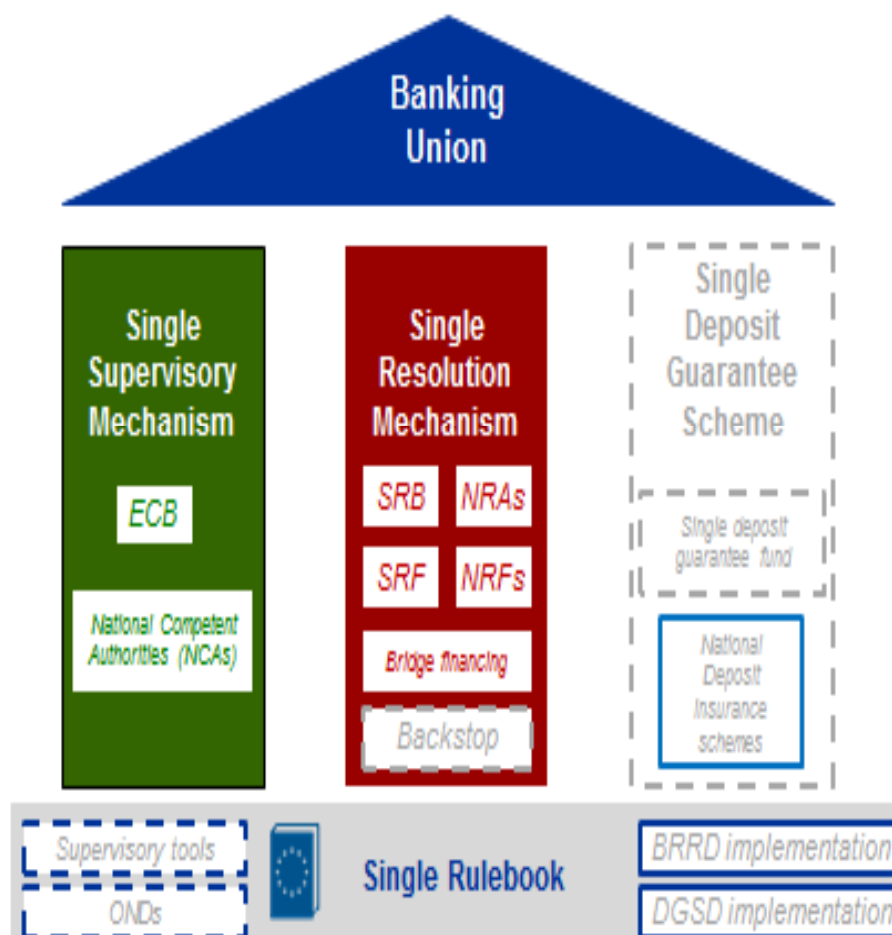
What more is needed?

- **Current situation: centralized monetary policy with decentralized fiscal, structural and financial policies**
- **Solution: Completion of the EMU architecture should ensure a better policy mix in the EA**
 - Five Presidents' Report (2015)
 - **Financial: Banking and Capital Markets Union**
 - **Economic Union**
 - **Fiscal Union**
 - **Commensurate Democratic Accountability & Legitimacy**
 - Latest state of play: Commission White Paper and reflection paper on EMU deepening (May 2017)

Key lessons – Financial Union

Integrated Finance for an Integrated Economy

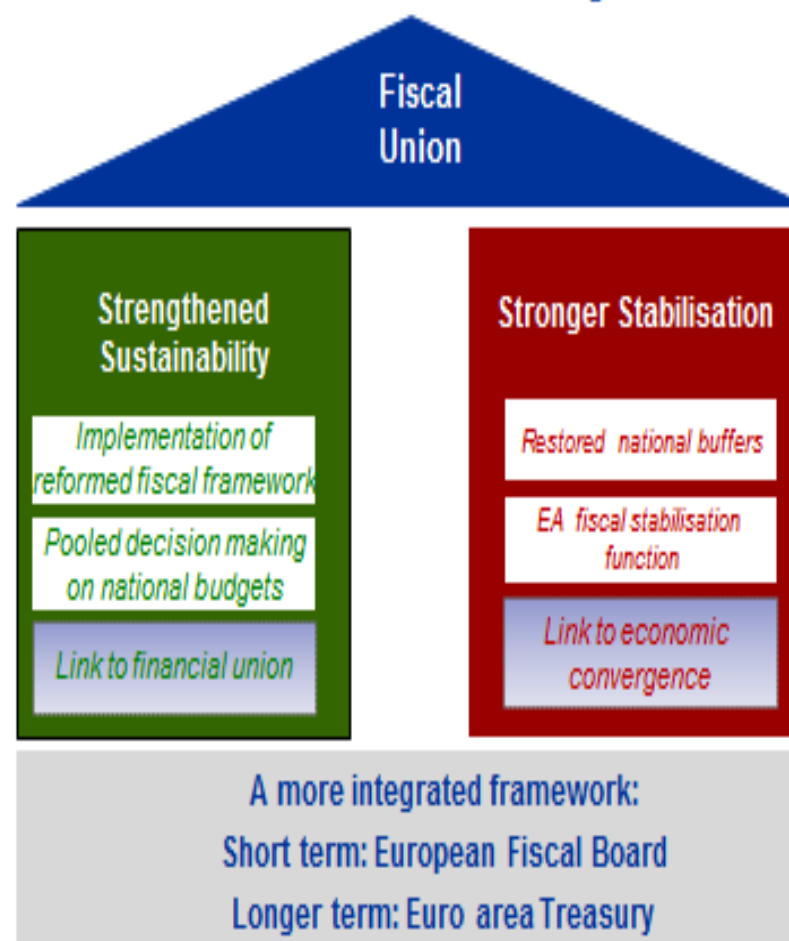
- **Banking Union**
 - ensures level playing field and the singleness of money across the EA, reduce fragmentation;
 - breaks national nexus thereby reducing contagion = helps transmission of monetary policy
- **Capital Markets Union**
 - improves cross-border private risk-sharing and therefore shock absorption capacity;
 - reduces financial fragmentation, unclogs monetary policy transmission channels
- **Financial regulation/legislation**
 - supports the Single Market
- **Macroprudential tools**
 - monetary policy ill-suited to deal with regional and sectoral financial stability risks



Source: ECB staff elaboration

A Framework for Sound and Integrated Fiscal Policies

- **Strengthened sustainability**
 - unsustainable fiscal policies and indebtedness reduce the growth potential of the economy;
 - reduced vulnerability to shocks, which alters the reaction function of the central bank;
 - reduced negative spillovers
- **Stronger stabilisation**
 - supports monetary policy also at the ZLB
 - counteracts hysteresis effects;
 - ensures a more efficient distribution of fiscal efforts;
 - [addresses distributional issues/inequality]
- **How to reconcile sustainability & stabilisation needs in a currency union?**
 - Stronger fiscal rules?
 - How to view the euro area fiscal stance?
 - What kind of euro area fiscal capacity?

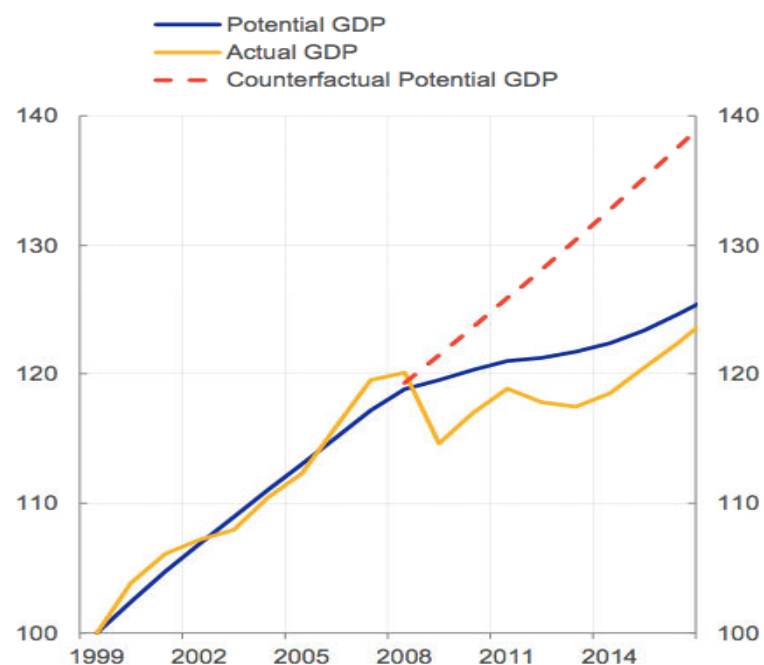


Source: ECB staff elaboration

Convergence, Prosperity and Social Cohesion

- **Raising growth potential, productivity and efficiency of economy**
 - reduces macroeconomic imbalances in the euro area
- **A new convergence process towards similarly resilient economic structures as a basis for fiscal union**
 - develops sound institutional framework and structural conditions to similarly react to exogenous shocks
- **Interdependencies between the Single European Market and currency**
 - supports and integrates further single market, ensuring level playing field and optimizing effects of policy mix and resource allocation

Euro area potential GDP
(index; 1999=100)



Sources: European Commission Spring 2016 forecast, Output Gap Working Group. Note: Counterfactual potential GDP assumes that potential GDP continued to grow at its 2007 growth rate.



Thank you for your attention