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The euro at 25 and what's next for the ECB?

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The euro at 25 and what's next for the ECB?

Abstract

The euro has proved to be remarkably resilient and is popular with the EU's citizens. This paper reviews the reasons for this and argues that the euro project is more resilient now due to several institutional changes. It also discusses how the ECB's monetary policy has evolved over time, its policy stance in recent years and some of the ways in which it may need to change in the future.

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ABOUT THE EDITOR
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CONTENTS

LIST OF ABBREVIATIONS

APP	Asset purchase programme
BRRD	Bank recovery and resolution directive
ECB	European Central Bank
ESRB	European Systemic Risk Board
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
EU	European Union
GDP	Gross domestic product
HICP	Harmonised index of consumer prices
MIP	Macroeconomic Imbalance Procedure
QE	Quantitative easing
OMT	Outright monetary transactions
SGP	Stability and Growth Pact
TLTRO	Targeted longer-term refinancing operations
TPI	Transmission protection instrument

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EXECUTIVE SUMMARY

- **The euro has proved to be remarkably resilient and is popular with the EU's citizens**. This paper reviews the reasons for this and argue that the euro project is more resilient now due to several institutional changes.
- **It also reviews how the European Central Bank (ECB)'s monetary policy has evolved over time**. It discusses the ECB's policy stance in recent years and some of the ways in which it may need to change in the future.
- **Prior to its existence, many economists had doubts about the euro project**. US-based economists, in particular, tended to be more sceptical about the economic case for a single currency across many different European countries.
- **Many of the weaknesses in the euro project that were claimed by its critics turned out have some truth to them**. The euro crisis exposed the limits of a common monetary policy and the absence of a shared fiscal policy. In addition, some other largely unpredicted crises also occurred during the 2010-13 period.
- **Despite many thinking the euro could end during the early 2010s, it has survived**. Indeed, surveys show the euro is now more popular than ever with the EU's citizens.
- **Having survived the crisis, there are various reasons why the euro is more resilient than ever.** These include enhanced macroeconomic monitoring and macro-prudential policies, improved banking regulation and supervision and the introduction of the Bank Recovery and Resolution Directive (BRRD).
- **The ECB's monetary policy strategy has been transformed over the past 25 years.** Its definition of price stability has been improved and new programmes have given the ECB a much larger toolkit of policies to deal with negative shocks than it had in 1999.
- **There has been some criticism of the ECB because of the recent high inflation.** This criticism is largely unfair with the principal impetus to inflation being supply shocks that were out of the ECB's control. The ECB's strong response to the COVID-19 pandemic was required and their short delay in raising interest rates in 2022 relative to the Federal Reserve and other central banks was understandable and had little impact on inflation.
- **The ECB will have to consider a number of operational issues in the future.** This paper recommends substantially reducing the Eurosystem's sovereign bond holdings, while maintaining the fixed-rate full allotment approach to providing liquidity and introducing a tiering system for paying interest on deposits.
- **The ECB is devoting a lot of resources to its plan to introduce a digital euro over the next few years.** I am not convinced there is a need for this project.
- **The ECB has become more active and vocal in relation to the issue of climate change.** While these actions can be justified based on the secondary objectives of the Eurosystem to support the EU's policies as set out Article 3 of the Treaty on the European Union, the ECB should be cautious when playing a role supporting these secondary objectives, only intervening when there are clear market failures that call for the specific use of its powers.

1. INTRODUCTION

With the current European Parliament term ending soon and the euro reaching 25 years of age, it is a good moment to assess the euro's progress and consider the future challenges for the ECB.

In the first part of this paper, I discuss the popularity and resilience of the euro. The single currency has survived and expanded over the past 25 years despite scepticism among many economists prior to 1999 as to whether it would. And, indeed, this survival occurred despite some of the gloomier predictions turning out to have some truth to them and despite some other largely unpredicted crises also occurring. I briefly discuss the factors underlying this resilience and the institutional changes that have made the euro a more robust project today than 25 years ago.

In the second part of the paper, I provide a brief discussion of how the ECB's monetary policy framework has evolved since the early days of the euro and also an assessment of its more recent policies.

In the third part, I look forward, discussing areas where the ECB may have to adjust its policies as well as new issues that it is going to face. I rely largely on the positions I have taken on these issues in the briefing papers I have provided in recent years, providing references for those that wish to read in more detail on these points.

2. THE SURVIVAL OF THE EURO

Despite scepticism on behalf of many economists at its birth, the euro has survived for 25 years. And not just survived. It is popular with Europe's citizens and joining it has been seen as having a positive impact, with membership growing from the 11 original countries to 20 today. In this section, I will first discuss the euro's survival and popularity and then discuss some changes that have acted to improve the resilience of the euro project.

2.1. Resilience and popularity

Prior to its existence, the euro project was not universally popular among economists. As discussed in Jonung and Drea (2010) and Whelan (2013), opinions among economists about the euro in the 1990s were sharply divided. US-based economists, in particular, tended to be more sceptical about the economic case for a single currency across many different European countries. They pointed to the big differences in the structures of the Member States' economies, the absence of centralised automatic fiscal stabilisers and the limited integration of the members' labour markets.

Indeed, the flaws in the euro project highlighted prior to its existence did cause problems during the so-called euro crisis of 2010 to 2012. When hit with large asymmetric shocks, the absence of a central fiscal policy exacerbated the austerity that was implemented in the countries most negatively affected. Also, some of the euro area's difficulties during this period—such as asset price bubbles and crashes and various banking crises—were not widely predicted even by its 1990s sceptics.

As highlighted in a 2021 paper by the ECB's Chief Economist, Philip Lane, that the euro survived a sovereign debt default of one of its members, years of painful fiscal austerity in many countries, multiple banking meltdowns and the need to set up a bailout fund and co-ordinate adjustment programmes for Member States with the IMF, showed that the euro was far more resilient than people thought it would be.

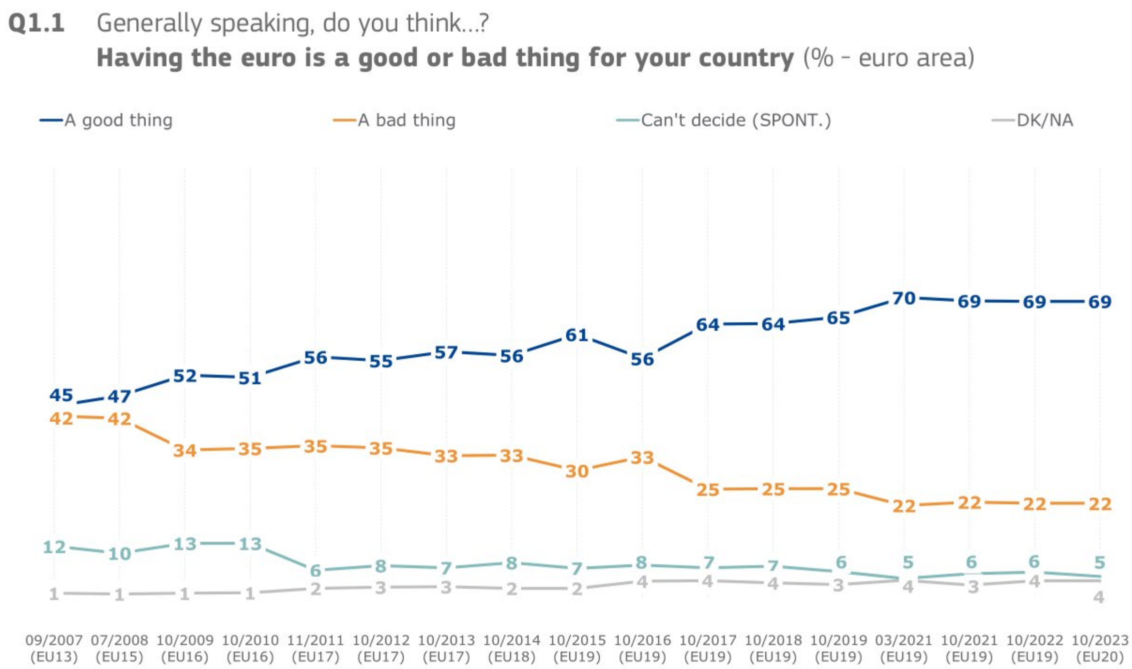
In fact, the common currency has been more popular than ever in recent years. The European Commission's Eurobarometer survey has a regular question asking the public whether they think having the euro is a good or bad thing for their country. In 2007, prior to the global financial crisis or the euro crisis, opinion was almost evenly split. Today, about 70% of EU citizens say having the euro is (or would be) a good thing for their country (Figure 1).

As I discussed in a previous paper reviewing the history of the euro, (Whelan, 2019), one can point to two sets of factors underlying public support for euro membership. There are positive factors relating to the economic successes associated with the euro and there are negative factors related to the fear of what would happen to a country that left the euro.

The positive factors include the convenience savings to consumers and firms from not having to pay currency exchange fees when buying from other European countries. Perhaps more important has been the ECB's ability to deliver on its price stability mandate.

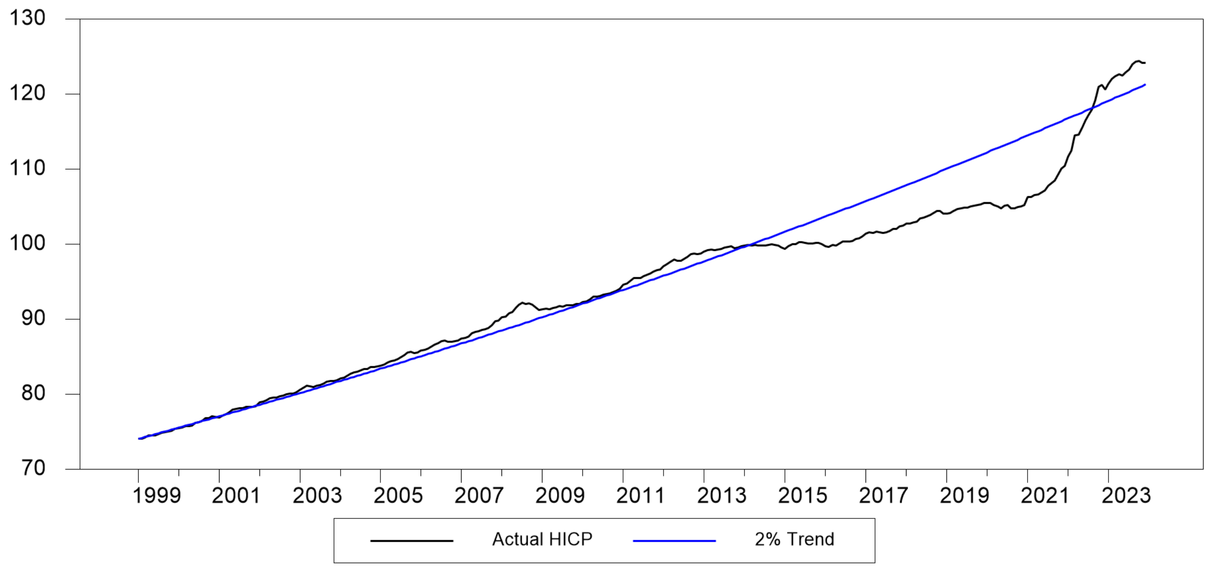
Despite the recent period of high inflation, the average annualised Harmonised Index of Consumer Prices (HICP) inflation rate in the euro area since January 1999 has been 2.1%, which is remarkably close to its 2% target. Currently, the level of the HICP is about 2% above the level consistent with a 2% annualised trend since January 1999 (Figure 2) but this follows a period during which the index fell below this trend. The ECB is not a "price level targeting" central bank but both the period prior to COVID-19 and more recent years saw it actively pursue policies aimed at returning inflation to its target, first from below and now from above. The result has been a remarkable long-run stability of the price level, which is the ECB's mandated primary objective.

Figure 1: Answers to the question: "What do you think? Having the euro is a good or bad thing for your country …"



Source: European Commission, Eurobarometer survey.

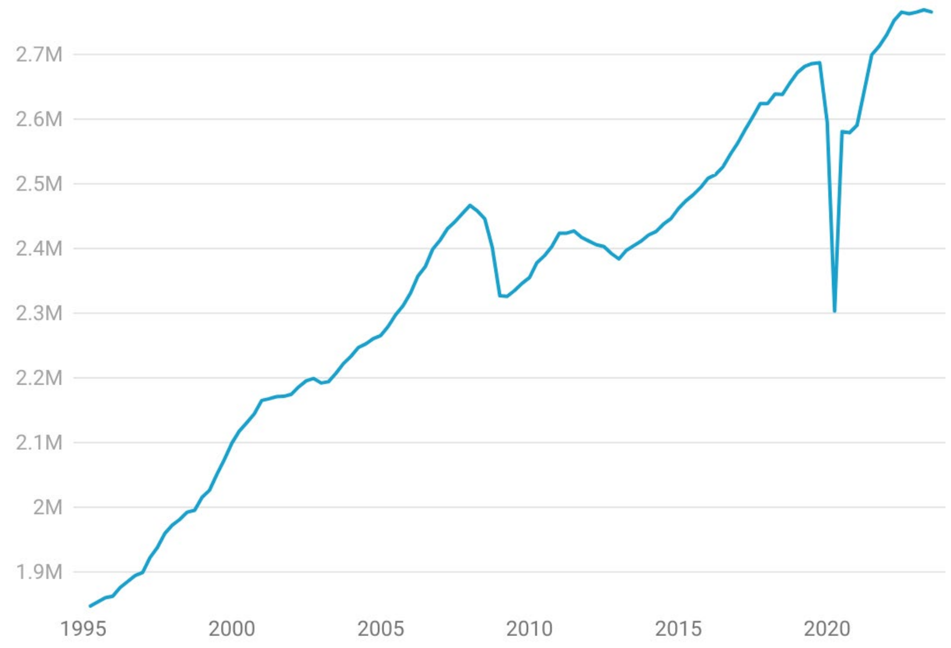
Figure 2: The Harmonised Index of Consumer Prices compared with a 2% trend since January 1999, (index 2015 = 100)



Source: Author's calculations based on data from Eurostat.

Not every aspect of the euro area's economy has been a success. Growth slumped for years after the global financial crisis and has not recovered much. From the beginning of the euro to the onset of the global crisis in 2008Q1, euro area real GDP grew at an annualised rate of 2.2%. In the period from 2008Q1 to 2019Q4, prior to the COVID-19 pandemic, this growth rate dropped to 0.7% (Figure 3). The current low unemployment rate suggests the economy has now fully recovered from the pandemic but the annualised growth rate from 2019Q4 to 2023Q3 was only 0.9%. This disappointing growth performance is not the fault of the euro or the ECB but rather the result of long-running structural supply factors such as low total factor productivity and an ageing population.[1] It shows, however, that price stability is not a sufficient requirement for good macroeconomic performance.

Figure 3: Real GDP in the euro area (millions of chained 2010 euros, quarterly, seasonally adjusted)



Source: Author's calculations based on data from Eurostat.

The other set of factors related to the popularity of the euro are perhaps more negative: People fear what would happen if their country left the euro. This is probably a rational fear because the process of leaving the euro would likely trigger a major short-term crisis. To quote from a previous paper I wrote on this topic (Whelan, 2019):

"*It will be hard for any country to leave without a democratic process in which there is a referendum or vote in parliament authorising this decision. There would likely be a period of enormous capital outflows as investors anticipate their assets being redenominated into a new currency that could trade at a lower value than the euro. This could result in the imposition of capital controls until the decision to leave had been executed. A new currency would then end up, whether pegged to the euro or floated, most likely trading at a substantial discount to the euro. This large devaluation would probably lead to a surge in inflation …*

Once a country has left, there could also be substantial legal problems centring around contracts with payment amounts denominated in euros. The government of the departing country could pass laws declaring all domestic contracts that previously mentioned euros should now be interpreted as meaning the new currency but this would be challenged in international courts. Disruptive legal disputes would likely rumble on for years after a euro exit causing persistent damage to the economy. The departing country's status within the EU could also come into question."

Perhaps counter-intuitively, despite the austerity and chaos that many attributed to euro membership during the euro crisis period, the public may have developed a greater understanding during this period of the risks associated with leaving the single currency. Figure 1 shows that the fraction of those

[1] See McQuinn and Whelan (2018) for a discussion of these structural issues and the impact potential structural reforms may have on the growth rate of the euro area.

who believe single currency membership was good for their country rose during the worst years of the crisis and continued to increase afterwards. This has helped to take the steam out of political support for leaving the euro. While there has been a rise in support for "populist" parties in recent years, these parties have generally backed off their previous positions in favour of leaving the euro because of the unpopularity of this policy with the public. It's hard to be populist with unpopular policies.

2.2. Institutional change and resilience

Those who predicted the euro would not last long under-estimated the appeal of a common currency to European citizens. But even those who were enthusiastic about the euro would have doubted its capacity to survive if you had told them in the 1990s that there would be a multi-year multi-country rolling crisis involving setting up a euro area bailout fund using commonly-issued debt, multiple IMF adjustment programmes, capital controls, haircuts on bank deposits in one euro area member state and sovereign default in another.

However, having come through the crisis, there are several reasons why the euro project is more resilient today than it was at the time of its founding.

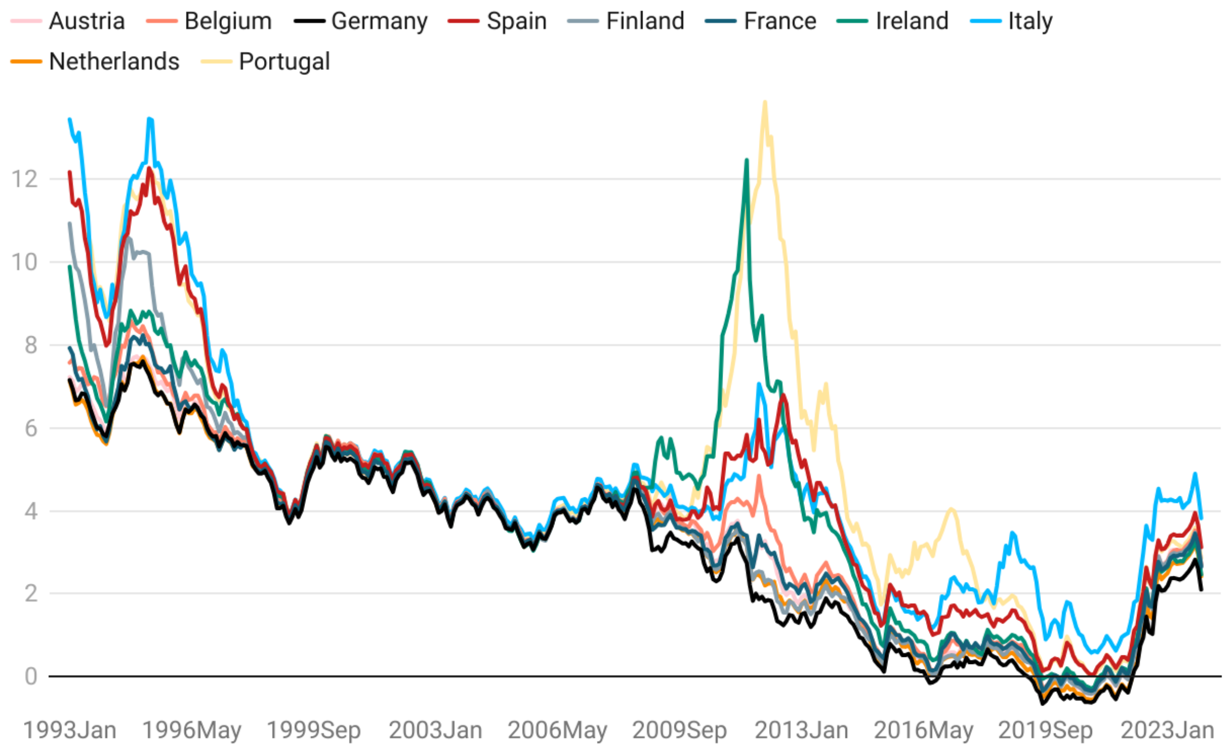
Better understanding from financial markets: One factor that differentiates the current version of the euro area from its early days is that financial markets have a better understanding of the risk associated with lending to euro area governments. In the 1990s, financial markets had not seen a sovereign debt default in Europe in the post-war period but were well attuned to the risks associated with regular currency devaluations.

As the prospect of these devaluations receded in the run-up to the introduction of the euro and then (apparently) disappeared altogether in 1999, yields on sovereign debt across all Member States—which had previously differed substantially—converged within a narrow band and remained this way until 2009. These declining yields were passed on to private sector borrowing rates. Capital flowed into euro area states that had previously had much higher interest rates and this encouraged households and firms to borrow more and, in some cases, led to unsustainable house price and construction bubbles.

Figure 4 shows the long-term sovereign bond rates of a selected group of euro area Member States. Despite substantial variations across euro area Member States in their underlying fiscal positions, financial markets barely priced default risk into sovereign debt yields during the early years of the euro. Greece's fiscal problems and ultimate default in 2012 led to a rapid reassessment of sovereign risk and the peak of the euro crisis saw a huge dispersion in yields driven by expectations of potential default and the possibility of countries leaving the euro.

In recent years, there is a greater understanding that sovereign default is something that can happen within the euro. This more realistic assessment of risk means governments are more exposed to market discipline than prior to 2008 and this may contribute to greater fiscal stability. The experience of bond investors in banks who made bad investments in the early years of the euro has likely also contributed to a more sober assessment of risks in private sector debt markets in more recent years.

Figure 4: Long-term sovereign bond yields (approximately 10 years rates) for selected euro area countries, in %



Source: Author's calculations based on data from the ECB's Data Portal.

Better understanding of non-fiscal imbalances: The initial design of Economic and Monetary Union (EMU) placed a great focus on avoiding fiscal imbalances via the Stability and Growth Pact (SGP). However, little attention was paid to non-fiscal imbalances. In the years prior to 2007, countries like Ireland and Spain had unsustainable house price bubbles driven by huge increases in the supply of credit and this led to a skewing of their economies towards construction activities. However, the revenues generated from these bubbles meant the fiscal positions of these countries looked good and the SGP process did not flag the potential for instability. Fiscal problems only emerged when the bubble-related revenue collapsed when house prices plummeted and construction activity almost came to a halt.

Today, there is a better understanding of the need for a broader assessment of potential imbalances. This can be seen in the Macroeconomic Imbalance Procedure (MIP) now undertaken by the European Commission, which monitors house prices, credit growth, current account deficits and other wider indicators of economic health. It can also be seen in the work of the European Systemic Risk Board (ESRB) and in the policies of various national macro-prudential bodies. For example, in Ireland there are now tight restrictions on loan-to-value and loan-to-income ratios for residential mortgages.

Better banking regulation, supervision and (BRRD): Banking systems were a major source of instability in the first 15 years of the euro. With their loans now denominated in euro, banks in "peripheral" countries were seen as less risky by international investors. Many of these banks expanded rapidly via attracting international depositors and borrowing in the bond market. In some cases, banks in "core" euro area economies expanded their activities into these countries, setting up subsidiaries. This huge expansion in credit went into banking sectors that were often poorly supervised (most notably in Ireland) and that became highly exposed to risk in commercial and residential property markets.

When the "bubble" economies contracted with the onset of the global financial crisis, there was a sharp reversal of these capital flows, what Baldwin et al (2015) termed a sudden stop. Money instead flowed back to the core from the periphery. And as property values collapsed, many banks were revealed to have solvency problems. The source of funds for restoring appropriate capital levels generally fell upon Member States, which became one part of the "doom loop" between banks and sovereigns, with the other part being the risk to banks of losses due to their sovereign bond holdings potentially being restructured.

The Basel 3 regulations introduced from 2010 onwards have improved the resilience of the banking sector both due to higher capital requirements and due to liquidity regulations, such as the liquidity coverage ratio and the net stable funding requirement, which make banks less vulnerable to runs. The decision in 2013 to make the ECB the single supervisor of the euro area's banks meant that these regulations are now enforced by a common high level of supervision and the credibility of the euro area's banking sector has been improved by the regular publication of stress test results.

These factors make damaging bank failures less likely but also important is that when banks do fail, the introduction of the 2015 BRRD means there are now a common set of procedures to resolve failing banks while maintaining financial stability and protecting the taxpayer as much as possible. Hopefully, events such as the enormously costly state bailout of Anglo Irish Bank will not occur again (Whelan, 2012).

Bailout funds and an ECB backstop: The euro crisis exposed how sovereign debt crises can occur in a self-fulfilling manner. Markets begin to speculate that a country might default and this leads to a higher cost of borrowing. The higher borrowing costs then exacerbates the market's belief that the debt is unsustainable and the result is a "buyer's strike" in which the government cannot roll over its debt, thus leading to a default.

Two major developments have weakened the chances of these events affecting euro area Member States. First, the creation of the European Stability Mechanism (ESM) has provided "breathing room" for Member States that have lost access to market funds to implement fiscal adjustment programmes and regain the trust of markets without requiring a default. Second, the policies that followed Mario Draghi's famous "whatever it takes" speech in 2012, first Outright Monetary Transactions (OMT) and the more recent proposed Transmission Protection Instrument (TPI) have shown that the ECB is willing to use its money creation powers to intervene in the bond market to prevent disorderly defaults.

Experience of sovereign default: Another positive element is the euro area has experienced a sovereign default of one its members and we know now that its impact on wider financial stability was minimal. Some European leaders and the leadership of Trichet's ECB spent years warning that any sovereign default in the euro area would have disastrous consequences. An inability to accept such a default drove some of the worst aspects of policy making during the euro crisis. Hopefully, the Greek experience can show us that, while best avoided, sovereign defaults can occur within the euro while protecting financial stability and without requiring the member state to leave the single currency.

3. THE ECB'S MONETARY POLICY

Here I will briefly discuss issues related to the ECB's monetary policy over the past 25 years, first describing the evolution of its monetary policy strategy and then assessing its monetary policy stance in recent years.

3.1. Monetary policy strategy

Like many pan-European institutions, the ECB has a reputation for being relatively conservative and sometimes slow to act and, at times, this reputation has been deserved. However, it is also the case that the ECB has radically revamped its monetary policy strategy over the past 25 years, implementing many improvements and innovations.

In relation to perhaps the most important part of its strategy, the definition of price stability, the ECB began in 1999 by defining price stability as inflation below 2%. This meant that deflation could be considered consistent with price stability and implied more uncertainty than was desirable as to where the price level was likely go in the future. The 2003 strategy review changed this definition to the mysterious "close to but below 2%" without ever defining what "close to" meant. Finally, in 2021, the ECB announced its price stability goal was a simple symmetric 2% inflation medium-term inflation target. This process took longer than it should have but the result has been a victory for common sense.

Another aspect of the ECB's monetary policy strategy that evolved in the correct direction has been the role of the money supply. The ECB's original monetary policy strategy included "*a prominent role for money, as signalled by the announcement of a reference value for the growth of a broad monetary aggregate*." The reference value was initially set as a 4.5% growth rate for M3 and was used to produce a "monetary overhang" measure: the difference between actual M3 growth and the reference value, with higher numbers supposedly representing higher risks for medium term inflation.[2]

This approach was always a bit odd. After the various experiments with monetarism in the 1980s, very few major central banks in the late 1990s were using money supply targets as a key part of their strategies. Bernanke and Mihov (1997) showed that while the Deutsche Bundesbank officially claimed to have money supply targets, it acted as an inflation "targeter" rather than a money supply "targeter".

Sure enough, the prominent role for money was not helpful. M3 growth was very high during the euro's first few years and the "monetary overhang" measure got bigger and bigger while inflation remained low. The 2003 strategy review dropped the reference value from the ECB's strategy.[3] The more recent 2021 review further downgraded the role of money, so those watching the press conference no longer had to hear the ECB President talk about "cross checking" the economic and the monetary analysis. These have been positive developments and show the organisation has been willing to drop elements of its strategy that were important to some its "founding fathers".

The ECB has also transformed its approach to monetary policy operations. Its original approach to monetary policy involved supplying a fixed amount of liquidity to the banking system in the form of one-week loans and having banks bid for the right to borrow this money. As many banks began to experience funding pressures during the global financial crisis in 2008, this was replaced by a fixed rate full allotment approach. The terms of monetary policy operations were then extended, first to 3 months and in later years to as long as 3 years.

[2] M3 is a "broad" monetary aggregate that includes currency, deposits with an agreed maturity of up to two years, deposits redeemable at notice of up to three months and repurchase agreements, money market fund shares/units and debt securities up to two years.
[3] See Constancio (2018) for a review of the early years of the ECB's monetary policy.

The ECB was criticised by many (including me in various briefing papers) during both the euro crisis and the subsequent period in which inflation was below target, for being slow to act. But, in the end, the ECB introduced many new innovations. The announcement of OMT that followed Mario Draghi's "whatever it takes" speech had a transformational effect in stabilising sovereign debt markets, as financial markets realised the ECB was willing to use its enormously powerful balance sheet to maintain order in sovereign debt markets.

The ECB was the last of the major central banks to implement Quantitative Easing (QE) but when they did, their Asset Purchase Programme was substantial and likely had a significant effect on financing conditions. The ECB also introduced other innovative programmes such as the negative deposit rate and targeted long-term refinancing operations aimed at encouraging banks to lend to businesses and households. The monetary policy response to the pandemic was swift and significant, responding to the crisis with a huge programme of asset purchases and liquidity supports for the banking sector.

The 2021 strategy review confirmed that "*when the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched*" so these measures will remain part of the ECB's strategy playbook. This means the ECB should be better placed to cope with any new large negative shocks than it was in the past.

3.2. Monetary policy stance in recent years

As illustrated in Figure 2, the ECB has done a good job over the past 25 years in keeping inflation close to a 2% average rate. However, with price stability as its primary objective, the recent period of high inflation has inevitably raised questions about whether this represents a failure on the part of the ECB. In particular, questions have been raised about whether the ECB applied too much stimulus to the euro area economy during the COVID-19pandemic period and then failed to act quickly enough to cut off rising inflation in 2022.

While every central bank will need to learn from the events of recent years, I think the ECB can largely be absolved from blame for the recent high inflation. In relation to its actions during the pandemic, even if expansionary monetary policy of that period contributed to the subsequent rise in inflation, that does not mean these policies were a mistake. The pandemic was a very special time in history and multiple different outcomes could have happened. As it was, the sharp fiscal and monetary policy interventions around the world and the incredible speed with which a vaccine was made available meant that the global economy avoided the more catastrophic scenarios that many thought were possible in early 2020. But there was little doubt that central bank interventions were needed and were helpful.

In terms of the more recent period, ECB President Lagarde has suggested that the ECB was too slow to act in 2022. In an interview with the Financial Times last October, she said "*But what I regret personally is to have felt bound by our forward guidance. I should have been bolder*."[4] With price stability being the ECB's primary objective, perhaps President Lagarde thinks some public contrition was appropriate, but I think it would be a mistake to attribute much of the recent high inflation to the ECB's failure to raise interest rates quicker than it did.

[4] FT Interview: Christine Lagarde: "I should have been bolder": https://www.ft.com/content/c916c994-492c-4639-84ae-4a6dc2cb7426.

A few reasons for this. First, the forces driving inflation since 2021 have largely been global in nature. Figure 5 shows consumer price inflation for selected countries around the world. From this one can see that there was a simultaneous rise in inflation all around the world after the pandemic. It would clearly be a mistake to view each of these as separate events caused by monetary policy mistakes of the various central banks in each country.

Second, the ECB's policy response has not been particularly different to the other major central banks. Figure 6 shows the policy rates for various central banks (for the ECB it shows the Main Refinancing Operation rate). The chart also shows the ECB started raising rates a few months later than some other central banks—in July 2022 compared with March 2022 for the Federal Reserve for example—but then adjusted rates by about the same amount as all the other major central banks.

This slightly delayed response was understandable. President Lagarde appears to feel the ECB was hampered by previous forward guidance that rate increases would be delayed but the circumstance in the euro area in early 2022 were a little different from in the US, for example. In January 2023, the month before the Russian invasion of Ukraine, inflation in the US was 7.5% and core inflation was 6.1% indicating the inflation problem was not simply restricted to food and energy. In contrast, euro area inflation in January was 5.1% and core inflation was 2.3%. Prior to the start of war in Ukraine, it was legitimate to view the burst of inflation that was occurring as a temporary shock due to global supply conditions.

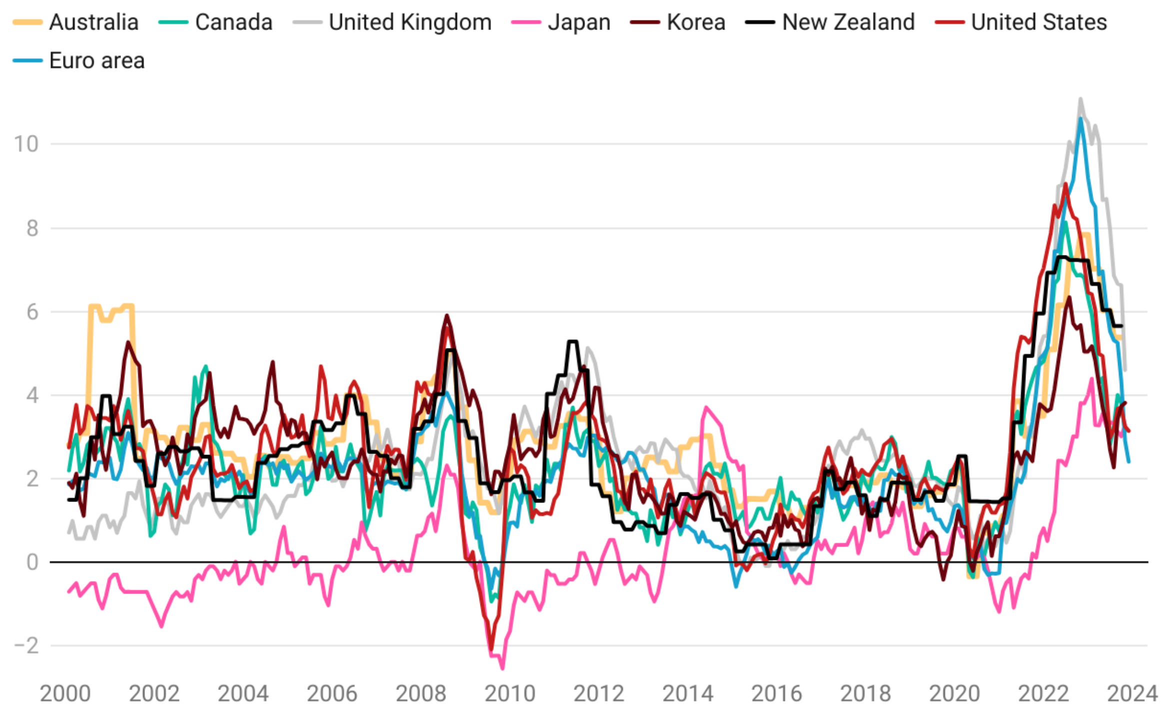
Once the war began, it quickly became clear that the ECB was going to raise interest rates and by late spring, longer term interest rates already reflected the expected tightening that then began in July. This meant that financing conditions began to tighten prior to policy rates being increased. We don't know as much as we would like about how exactly monetary policy affects inflation but I am fairly confident that the ECB's decision to begin raising interest rates in July 2022 rather than March has played a negligible role in the high inflation of the past two years.

Third, as I discussed in my previous briefing paper Whelan (2023c), it is increasingly clear that the supply shocks associated with the war in Ukraine were the key factors driving the surge in euro area inflation in 2022. The impact of these shocks on the inflation rate (though not the price level) is now receding and inflation is moving back to target. Headline year-over-year euro area HICP inflation was 2.9% in December but this was boosted by "base effects" such as energy price rebates that affected the December 2022 index. Figure 7 shows that the seasonally adjusted HICP was flat over the final months, suggesting an end to the period of above-target inflation is within sight.

Core HICP inflation, which excludes food and energy prices, was still 4% in December 2023. However, I argued in Whelan (2023c) that these core measures have been boosted by secondary effects of food and energy prices and that, having been slower to increase, core inflation measures would now also be slower to decline. Research by ECB staff, Marta Banbura, Elena Bobeica and Catalina Martínez Hernández (2023) confirms the significant role supply shocks have played in driving measures of "underlying inflation" and the need to be careful when projecting underlying inflation based on just excluding certain items from the price index.[5]

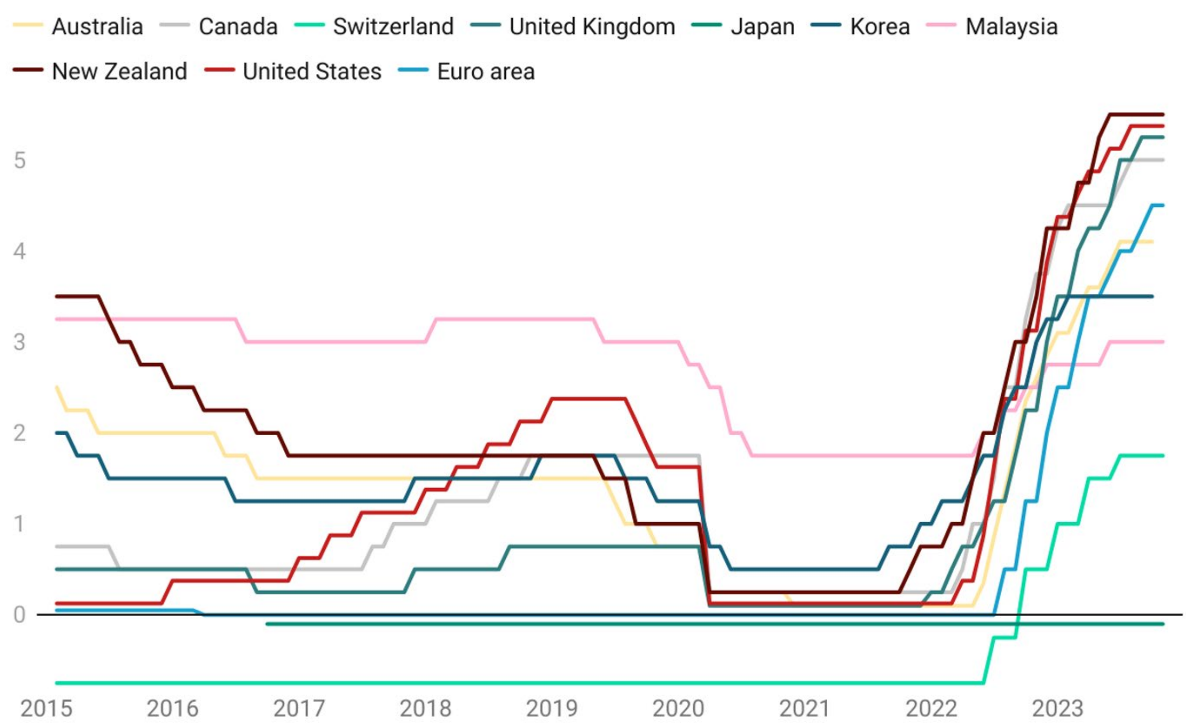
[5] These results were discussed in the August ECB Economic Bulletin https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202305_05~84e89bcb5d.en.html

Figure 5: Consumer price inflation rates for selected countries, in %



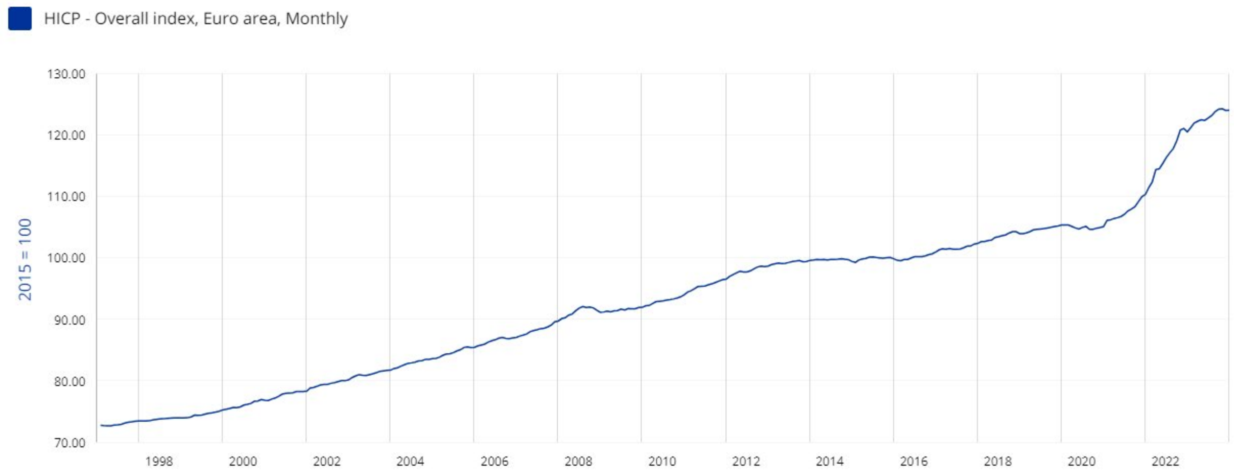
Source: Author's calculations based on data from the Bank for International Settlements.

Figure 6: Monetary policy rates for selected countries, in %



Source: Author's calculations based on data from the Bank for International Settlements.

Figure 7: The seasonally adjusted Harmonised Index of Consumer Prices, index (2015 = 100)



Source: ECB Data Portal.

4. FUTURE CHALLENGES

Finally, I will discuss a few issues that the ECB will have to consider in the coming years.

Sovereign Debt Holdings: I have written a number of articles both through these briefing papers and in journals (Whelan, 2022) about the legal and economic issues relating to the Eurosystem's significant accumulation of sovereign bond holdings. I believe there is a strong argument for the Eurosystem to effect a significant reduction in these bond holdings, perhaps including beginning to sell them directly to the market rather than simply not replacing maturing bonds.

While these bonds have been acquired via secondary market purchases, which are not ruled out by the Treaty, it is not true that the Eurosystem can simply hold as much of the debt of the Member States as it likes. As I wrote in Whelan (2022): "*The European Court of Justice's approach to assessing this issue, illustrated in the 2018 Weiss judgment, was that the programme needs to be assessed against the underlying intent of the monetary financing article in the Treaty rather than its specific wording.*[6] *The Court argued that the aim of the article was to encourage Member States to follow a sound budgetary policy and any actions by the ECB that undermined this aim would be illegal.*

The Weiss judgement ruled that the ECB's actions in introducing the Asset Purchase Programme (APP) were lawful but pointed to several reassurances provided by the ECB in arriving at this decision. The judgement approvingly cited the ECB's requirement that bonds could only be purchased if they had a sufficiently high credit rating as encouraging governments to maintain sound budgetary policies. The Court also stressed the ECB's commitment to limit the fraction of debt that it could purchase from each issuer maintained a primary role for financial markets in setting financing terms for sovereign debt funding.

Since this judgement, the ECB has had another major round of sovereign bond purchases, weakened its requirements on credit ratings and has argued that its issuer limits were a self-imposed requirement that it can choose not to follow. In my opinion, unless the ECB sets a path to firmly reduce its sovereign bond holdings, it runs the risk that future cases against it could rule that the ECB's actions violate Article 123."

There are other good reasons for the Eurosystem to reduce its holdings of sovereign bonds. In Whelan (2020) I pointed out that ""*it may be necessary for the ECB to have sufficient "firepower" available should it ever decide to implement the new Transmission Protection Instrument (TPI). One interpretation of the Weiss judgement is that it places an effective upper limit of just below 50% on Eurosystem ownership of sovereign debt. The higher the Eurosystem's bond holdings are at the time it implements a TPI intervention, the more likely it is that this 50% limit binds as a limit on the size of its potential intervention. And the more markets see the ECB as having a small rather than a big bazooka, the less likely the TPI intervention will be to succeed."*

Balance Sheet Size and Liquidity Provisions: The reduction in sovereign bond holdings is likely to see a substantial decline in the size of the Eurosystem's balance sheet in the coming years. This will involve a reduction in the currently huge level of deposits held by commercial banks "on reserve" with the national central banks. The ECB is currently undertaking a review of its operational framework for monetary policy with an aim to publish the outcome by mid-2024. Some economists such as Angeloni (2023) and Borio (2023) argue that the ECB should return to its pre-2008 procedures. In other words, the ECB should keep a much smaller balance sheet and keep the supply of commercial bank reserve balances very tight. However, in Whelan (2023b), I argued that rather than target a specific balance sheet size, the ECB should keep the "full allotment" approach to its refinancing operations. This

[6] Materials on the Gauweiler case are available at https://curia.europa.eu/juris/liste.jsf?num=C-62/14 and on the *Weiss* case at https://curia.europa.eu/juris/liste.jsf?language=en&num=C-493/17

approach will allow the ECB to gradually reduce the size of its balance sheet without having to worry about the instabilities that would emerge from occasional shortages of reserve balances since, ultimately, the size of the supply of bank reserves would be set by demand from commercial banks.

Interest on Reserves and Tiering: The demand from commercial banks around the world for reserve balances at central banks has clearly risen significantly since the global financial crisis. This reflects both precautionary demand and the use of reserve balances to satisfy the Basel 3 liquidity regulations such as the Liquidity Coverage Ratio. Because the Eurosystem pays interest on reserve balances, this large supply of reserves has fiscal implications now the deposit facility rate is positive. Indeed, many of the national central banks in the Eurosystem seem likely to incur losses in the coming years because interest payments on reserve balances will exceed the interest income they will earn on loans to banks and on the fixed-rate low-yielding securities they purchased via their asset purchase programmes.

As I discussed in Whelan (2023a, 2023b), I do not believe it is necessary for the Eurosystem to pay interest on all reserve balances. As I wrote in Whelan (2023a): "*During the period when the ECB had a negative deposit rate, it introduced a tiering system so that banks did not have to pay interest to their national central banks on all of their reserves but instead paid them on reserve holdings above a specific level. Following on from the Bank of Japan's experience with this approach, the ECB knew that the interest rate paid (or charged) on the marginal deposit would influence market rates even if other deposits had an interest rate of zero. The same logic applies when the deposit rate is positive and, to my knowledge, no ECB official has explained why a tiering approach was appropriate when interest rates were negative but is now not appropriate when interest rates are positive*."

The ECB should consider re-introducing the two-tier system of reserves that it employed when the deposit facility rate was negative but in this case to compensate the first tier of reserves at a lower rate (not necessarily zero) than the second tier.[7] This approach would maintain control of market interest rates while reducing the fiscal cost due to the banking system's desire to hold a large stock of reserves.

Digital Euro: The ECB has put a lot of time and effort into preparing for the introduction of a digital euro. This would be an electronic equivalent of cash that people would keep in accounts with their national central bank, though a cap would be placed on the size of these accounts. According to the ECB, the purpose of this cap would be to "*prevent excessive outflows of deposits from banks, preserving financial stability*."[8] A cap of about €3,000 per account has occasionally been mentioned.

I have read the discussions of the ECB and many other central banks about central bank digital currencies such as the digital euro and I am still unsure whether they are worth bothering with. In the case of the ECB, Article 3 of the ECB's legal protocol sets one of its basic tasks as being "to promote the smooth operation of payment systems" so one could possibly justify the digital euro on this basis. It is unclear, however, what the problem is that the digital euro is a solution to.

Last year, the Financial Times quoted former senior ECB official Ignazio Angeloni on this topic: "*What is the compelling reason for making this reform? This is the big unanswered question. I don't see any big failures in the market that require the public sector to step in and provide a digital euro.*"[9] I agree with this assessment. Until the economic case for the digital euro is somehow made clearer, I think this is a project that should remain at the planning stage.

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[7] Paul de Grauwe has made similar arguments. Here is a video of a recent presentation he gave on this topic at the Deutsche Bundesbank. https://www.bundesbank.de/de/service/termine/professor-paul-de-grauwe-zu-gast-in-der-bundesbank-913964

[8] https://www.ecb.europa.eu/paym/digital_euro/how-it-works/html/index.en.html

[9] https://www.ft.com/content/7c892d3b-c646-4247-9504-5f755e486101

Climate change and secondary objectives: Since Christine Lagarde became ECB President, there has been a greater focus at the ECB on how the Eurosystem can contribute to the fight against climate change. Some high-profile economists such as John Cochrane (2020) have argued that central banks such as the ECB are making mistakes by introducing policies related to climate change and should instead focus only on their primary mandate of price stability.

While these criticisms are understandable, the ECB's actions on climate change can actually be seen as perfectly consistent with its legal mandate. While Article 2 of the ECB legal protocol clearly spells out price stability as the Eurosystem's primary objective, it also states that "*Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union*."

In addition, Article 3 sets out a wide range of goals including "*a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment*" and contributing to "*peace, security, the sustainable development of the Earth*." If the EU has a policy commitment to contain climate change and there are actions the ECB can take to assist with this which do not endanger price stability, one could argue that it is legally obligated to act.

The real counterargument is perhaps subtler. What is there to prevent a future ECB President encouraging a range of actions aimed at promoting full employment or "social progress"? Ultimately, I think the textbook approach to thinking about government intervention in the economy applies here. If there is a clear market failure for which the ECB's policy tools are the right ones to correct the failure, then the ECB should get involved. Otherwise, it should let the other parts of government act. To give an example, one could imagine the ECB making targeted low-cost loans to banks conditional on them being used it to provide cheap funding for climate-related investments by businesses and households. However, this would just be using the Eurosystem's money creation powers to have the same impact as a subsidy provided by the state. In this case, it would be more transparent (and more in keeping with the desirability of central bank independence from politics) for the funding to come from central government rather than indirectly from the central bank.

Unknown Unknowns: There will, of course, be other issues and challenges. The world of central banking is never boring and the most interesting challenges often turn out to be the ones we did not anticipate. 25 years ago, people did not imagine we would see multiple recessions driven by collapsing asset price bubbles or a recession due to a global pandemic. Today there are some obvious risk factors for the global economy such as the risk that deglobalisation or geopolitical tensions but it may well be the things we did not imagine that cause the most difficulty. I don't know if I will be writing more Monetary Dialogue papers but I hope to enjoy observing and commenting on the euro for many years to come.

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The euro has proved to be remarkably resilient and is popular with the EU's citizens. This paper reviews the reasons for this and argues that the euro project is more resilient now due to several institutional changes. It also discusses how the ECB's monetary policy has evolved over time, its policy stance in recent years and some of the ways in which it may need to change in the future.

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