Executive summaries of the papers prepared by the Monetary Expert Panel


Topic 1: Interaction between euro-denominated payment systems and ECB monetary policy: challenges ahead for the single currency

BRUEGEL (Francesco PAPADIA)

The paper analyses the interactions between, on one hand, monetary policy and financial stability responsibilities of the ECB and, on the other hand, Post-Trading-Financial Market Infrastructures. Its basic conclusion is that Payment Systems are critical for monetary policy while Central Counter Parties (CCPs) are critical for financial stability. However, in stressed conditions CCPs can be the source of risks also for monetary policy.

Key points:

- Five types of Financial Market Infrastructures (FMIs) participate to Post-Trading: PS (Payment Systems), CSDs (Central Securities Depositories), SSSs (Securities Settlement Systems), CCPs (Central Counter Parties), and TRs (Trade Repositories).
- Post-Trading includes three sub-functions: Payment System, Clearing and Settlement.
- The ECB has a dominant price stability objective but also financial stability responsibilities, even if they are less forcefully formulated and are shared with other institutions.
- The Payment System is critical for monetary policy and the issuing central bank, specifically the ECB, must maintain full control over it. Such full control is only possible if the Payment System is located in the euro-area.
- Clearing and Settlement are relevant for monetary policy, but do not have the same degree of criticality as the Payment System.
- CCPs (Central Counter Parties) have no direct interaction with monetary policy in normal conditions, but can become relevant for monetary policy in stressed conditions. In these conditions, risks can thus arise for the conduct of ECB monetary policy from the fact that some key CCPs are located outside of the euro-area.
- Clearing and settlement systems, particularly CCPs, are critical for financial stability.
- Locating these systems in the jurisdiction of the relevant central bank is the safest and simplest option for assuring their continued contribution to financial stability, in both normal and crisis conditions.
Particularly tight, and not easy to design and agree, arrangements with the institution responsible for financial stability and monetary policy in the jurisdiction where the CCP is incorporated, specifically the Bank of England for the London Clearing House (LCH), as well as direct intervention rights for the issuing central bank (i.e. the ECB), can approximate the conditions that would prevail if the CCP was located in the jurisdiction of the issuing central bank.

**DIW Berlin, German Institute for Economic Research - Queen Mary University of London (Andromachi GEORGOSOULI)**

This paper examines the evolution of the supervisory framework of third-country CCPs in the EU making special reference to risks associated with the imminent withdrawal of the United Kingdom from the European Union (Brexit). Its key finding is that the proposed reform is in principle in the right direction but there are still challenges ahead and a more comprehensive package of measures will be required to address them.

**Key points:**

- The size and cross-border relevance of euro-denominated clearing services in the UK raise salient financial stability and monetary policy concerns for the euro area.
- The imminent withdrawal of the UK from the European Union has been a catalyst for the current reform of the EU legal framework for the supervision of third-country CCPs.
- Brexit imposes particular risks:
  - a) It will increase transaction costs.
  - b) In the absence of a comprehensive policy to make the euro area an attractive place for the migration of euro-denominated clearing services, it may drive central clearing services overseas.
  - c) If transaction costs are high, it will be very difficult to sustain the currently large volume of euro-denominated clearing transactions. If this happens, attempts to turn the euro into a global reserve currency will be undermined.
  - d) The cross-border oversight of systemic CCPs will become more difficult.
- Brexit risks are real but nevertheless manageable over time for mainly the following reasons:
  - a) Both the EU and the UK will remain committed to international regulatory convergence.
  - b) The UK legal framework and overall supervisory approach will continue to be consistent with EU requirements taking into account the ‘Great Repeal Bill’ currently discussed in the UK Parliament.
  - c) The relocation requirement can be satisfied by opening up subsidiaries in the euro area.
- The proposed EMIR II legal framework regarding the supervision of third-country CCPs is in principle sound. It is more forward looking, risk-based and proportionate compared to EMIR. Furthermore, the introduction of a relocation requirement as a measure of last resort will enhance existing ECB capabilities to monitor systemic CCPs.
- At the same time there are challenges ahead. Specifically:
a) An unintended consequence of the relocation requirement might be to drive euro-denominated clearing to an overseas jurisdiction that has been granted equivalence instead of mainland Europe.

b) The proposed EMIR II framework will continue to evolve around the legal concept of equivalence but equivalence is by its very inception neither resilient over political pressure nor durable enough to provide a reasonably stable mechanism for the long term management of cross-border systemic risks.

c) The enhanced powers of ESMA are likely to stretch the already overstretched boundaries of the Meroni doctrine and, consequently, expose ESMA to legal risk.

- In response to those challenges the following recommendations are made:
  - a) As long as it is desirable to keep the existing high volume of euro-denominated clearing and to attract the relevant business in mainland Europe, a more comprehensive package of measures will be required to turn the euro area into a world-leading hub for capital markets.
  - b) Treaty amendments are recommended to place the mandate and powers of ESMA on a proper constitutional basis.

The Commission should consider changing the existing equivalence framework into a more stable mechanism of cross-border systemic risk management.

**LSE, London School of Economics (Corrado MACCHIARELLI, Mara MONTI)**

The framework for euro-denominated payment systems has undergone significant changes in recent years leading to a concentration of payments performed by Central Counterparty Clearing Houses. As it stands, a large part of euro-denominated transactions, derivatives in particular, are cleared through CCPs located in the UK; which poses challenges to the current supervisory framework because of the UK leaving the EU. Against this background, this note discusses the extent to which the current set-up bears risks, including for the conduct of the ECB monetary policy.

**Key points:**
- With its general responsibility for financial stability, the Eurosystem and regulators have a general interest in the smooth functioning of securities clearing and settlement systems.
- While CCPs have a higher concentration of risk than the single participants of a decentralised market, this concentration contributes to a market’s liquidity by keeping the cost of trade completion as low as possible, reducing risks to its participants.
- As seen during the sovereign debt crisis, however, CCPs can also have a negative impact on a market’s liquidity through margin requirements.
- The fact that the largest clearing houses engaging in euro-denominated transactions are located in the UK was a contested issue even before the UK referendum.
- Once the UK will withdraw from the EU, the European law would require the EU to determine that the UK has an “equivalent” regulatory regime for its clearing and trading platforms. This is the same “equivalence” process that applies to other non-EU members.
- Leaving the European Economic Area (EEA) would mean that the UK would no longer be legally obliged to subscribe to the EMIR framework. Among other things, this implies that derivative
transactions conducted in the UK would no longer have to be reported to the European Securities and Markets Authority (ESMA).

- Failure to find equivalence status would mean European financial firms will face higher capital charges for transactions cleared in the UK.
- The Commission’s proposal makes relocation of large clearing houses as a last resort possibility, to apply only should the EU and the UK authorities fail to come to an agreement on “enhanced supervision” of CCPs based in London.
- Besides this specific consultation regarding the UK’s EU withdrawal, the paper argues that further concentration of the EU clearing is very likely, along the lines of the US experience. In the EU, as well, the existence of economies of scope and of scale will favour the emergence of very large service providers, particularly in the light of the Capital Market Union.
- At the moment, should euro-clearing leave London, there is no euro-area equivalent of a large centralised clearing services provider like LCH Clearnet. One of the main recipients of London’s euro-denominated clearing business could potentially be Eurex in Germany, supervised by the German Bundesbank and ESMA.
- It should be mentioned that, if Europe insists that clearing of euro-denominated products cannot occur in London, this could also rise to questions as to whether euro-clearing can occur anywhere outside of Europe, including in the United States. This could lead to other countries considering whether to adopt similar policies regarding clearing of products in their own currencies.
- Going forward, a joint approach, as is applied currently to EU-based CCPs that operate in the US, could be viable, with the EU and the UK sharing supervisory roles for systematically important extraterritorial CCPs.

**Topic 2: An economic recovery with little signs of inflation acceleration: transitory phenomenon or evidence of a structural change?**

**Daniel GROS (CEPS, Centre for European Policy Studies)**

The huge literature on the causes of the persistent weakness in inflation in the euro area has not identified one single key factor. Moreover, inflation has also been lower than expected in many advanced countries. Low inflation expectations seem to have played an important role in reducing wage demand, both in the US and the euro area; but a residual output gap also contributes.

The concerns about low inflation seem overblown. The HICP (Harmonized Index of Consumer Prices) used to measure inflation in the euro area differs from the indices used in most advanced countries in that it does not account for the cost of owner occupied housing. This omission has a considerable impact on measured inflation and can explain most of the difference between inflation in the US and in the euro area. If the HICP were to incorporate the available estimates of inflation in owner occupied housing, measured inflation would be close to 2 %.

**Key points:**

- Inflation seems under-estimated in the euro area.
- The HICP (Harmonized Index of Consumer Prices) used to measure inflation in the euro area does not account for the cost of owner occupied housing (OOH).
• By contrast the indices used in most advanced countries include owner occupied housing.
• This omission of OOH in the HICP has a considerable impact on measured inflation.
• If the HICP were to incorporate the estimates of inflation in owner occupied housing made available recently by Eurostat, measured core inflation would be close to 2% (and close to the US level).
• On a globally comparable index the ECB would thus have reached, or be very close to reaching, its price stability target. The continuation of non-standard policy measured might thus not be necessary any more.

OFCE, Observatoire Français des Conjonctures Économiques - (Christophe BLOT, Jérôme CREEL, Paul HUBERT)

This paper investigates the determinants of inflation in the euro area since 2000 and shows that the most important determinants are inflation expectations and wage growth. Both indicators have contributed negatively to inflation since 2014 but inflation expectations less so since 2015 whereas the contribution of wage growth has remained negative. The authors suggest that structural reforms may have put a drag on the ability of the ECB to reach its inflation target rapidly

Key points:
• The euro area’s recovery is currently under way. It is accompanied by a decrease in the unemployment rate. The current situation between economic growth and unemployment looks even a bit better than one would expect from their correlation since the adoption of the euro.
• Yet some countries still report a negative output gap, i.e. lower actual GDP than the potential.
• In this context, headline and core inflation rates remain subdued in the euro area. The situation of higher economic activity and low inflation in Europe is not exceptional though.
• Drawing on some empirical estimations, the authors explain the dynamics of inflation since 2000 by different cyclical and structural factors. They also introduce an indicator of both conventional and unconventional monetary policies to assess the direct incidence of ECB’s policies on actual inflation. All these factors explain the bulk of inflation variance since 2000.

Andrew Hughes HALLETT (Copenhagen Business School, Frederiksberg, Denmark)

This paper investigates the possibility that there has been a structural shift in inflation (upward) in the euro area since the recovery in 2014 or 2015. From the perspective of policy, it is important to be sure that any such shifts are significant statistically, sustained or likely to be sustained (durable) over the near future, and are evenly distributed over the member economies so that no one of them is damaged by anti-inflation measures taken to help the others.

The author approaches the problem in two steps: first by examining the circumstantial and informal evidence, and then conducting formal statistical tests for structural changes in euro area inflation in 2015 or 2016. The author finds no evidence of a structural change under the four criteria mentioned. The even distribution of inflation criterion is the closest to being satisfied, but the other three are far from satisfied in any formal sense. There was a brief acceleration in inflation in mid-2016 towards 2%, but it flattened out in 2017 and has been constant at 1.5% ever since. Core inflation was constant at 0.9% throughout.
The question is why has there been no inflation in the recovery and how long is that likely to last? In a third step, the author explains how low growth in real wages and self-reinforcing low productivity growth produces slow output growth and low inflation. This model fits the data pretty well, down to the lack of labour and total factor productivity and to substituting cheaper labour for excess capital stock. It implies a fall in investment spending (also seen in the data) which in turn extends the period for which low productivity-low inflation outcomes apply.

Key points:

The question posed in this paper asks to test whether the uptick in euro area inflation, observed in the slow recovery since the great recession, now constitutes a permanent state of affairs (a “new normal”) and therefore warrants a new policy stance from the ECB on a permanent basis: a degree of monetary tightening to offset the extra inflation to be expected in the future.

It is therefore necessary to establish (test formally) whether this observed increase in the inflation rate is transitory; or whether it constitutes a structural change – that is, be expected to continue indefinitely at the higher rate observed in 2016-17 and ultimately to settle at or above the ECB’s 2% inflation threshold that would normally trigger a change in policy.

Thus, from the perspective of policy, it is important to be sure that any shift in inflation is a) significant statistically, b) likely to be sustained into medium term and prove durable thereafter, and c) be evenly distributed so that the low inflation economies are not unfairly penalised by the measures taken to help those who have caused the inflation.

Circumstantial evidence and informal tests show that there was a brief acceleration in inflation in mid-2016 towards 2%, but it flattened out in early 2017 and the proximity to 2% was lost. Inflation since then has been constant at 1.5%. Moreover core inflation was constant at 0.9% throughout, which demonstrates that inflation itself was mostly generated externally, not by the recovery. It is therefore doubtful if this inflation episode could be classed as a suitable candidate for a policy change.

What accounts for the weak price dynamics so far? It appears that low growth in real wages has led to substantial increases in (mostly) low skilled employment. That then implies slow productivity growth and consequently slow output growth and low inflation.

It turns out that this model fits the data rather closely, down to the lack of labour productivity growth and low total factor productivity. It also implies the advanced economies have been substituting now cheaper labour for the excess capital stocks of the past.

As a result, some of the inefficiencies caused by excessive capital are being worked off which will help the euro area economies in the long term if this process is allowed to continue. It is also true that the euro area is not alone in this situation; the same process has been unfolding in all the advanced economies to a greater or lesser extent (although the euro area is not among the better performers in this regard). This may be cold comfort, but it is some comfort.

Hence, it is unlikely that the subdued inflation and weak wage dynamics are due to excess capacity (or slack) in the euro economy as a whole (as opposed to in the labour market per se). Instead it would require changes in the wage setting process and/or productivity growth to effect a significant change, unless changes appear elsewhere in the economy. This seems improbable because one of the implications of our low inflation, low productivity growth argument is a fall in investment
spending (also seen in recent data). That then extends the period for which low productivity-low inflation outcomes would apply.

**CASE, Centre for Social and Economic Research - (Marek DABROWSKI)**

In the last decade, advanced economies, including the euro area, experienced deflationary pressures caused by the global financial crisis of 2007-2009 and the anti-crisis policies that followed—in particular, the new financial regulations (which led to a deep decline in the money multiplier). However, there are numerous signs in both the real and financial spheres that these pressures are disappearing. The largest advanced economies are growing up to their potential, unemployment is systematically decreasing, the financial sector is more eager to lend, and its clients—to borrow. Rapidly growing asset prices signal the possibility of similar developments in other segments of the economy. In this new macroeconomic environment, central banks should cease unconventional monetary policies and prepare themselves to head off potential inflationary pressures.

**Key points:**

- In the last decade, advanced economies, including the euro area, experienced deflationary pressures caused by the global financial crisis of 2007-2009 and the resulting collapse in financial intermediation which, in turn, led to a deep decline in the money multiplier and the money supply. The anti-crisis policies aimed at avoiding a deflationary spiral similar to that of 1929-1933 (by means of unconventional monetary policies, including quantitative easing) and repeating financial crises in the future (by tightening financial regulation) further pushed the money multiplier down. Other deflationary shocks have come from the decreasing money velocity and the collapse of world commodity prices in 2014-2015. However, these deflationary factors have had either a temporary or one-off character.

- In 2016-2017, economic and monetary conditions started to change: most advanced economies, including the euro area, entered a path of economic growth and have either already closed or are about to close the negative output gap. There are signs of rising inflationary pressures, in particular, on asset markets. The post-crisis deflationary factors are gradually disappearing. Commodity prices have started to increase again. The money multiplier and money velocity are unlikely to continue their decline and may start recovering soon, reflecting greater consumer and investment confidence and faster credit growth.

- The recent growth recovery takes place in a low-inflation environment. This means that low or even moderately negative inflation (for a certain period of time) does not need to be damaging for growth and employment and that a Phillips curve type of interrelation between inflation and unemployment does not necessarily hold in these new circumstances.

- In the new macroeconomic environment, major central banks, including the ECB, must prepare themselves to deal with potential inflationary pressures, which were largely absent in the last decade. They should not continue pushing inflation up to the officially-targeted level of 2%. There is nothing wrong if inflation remains below 2%, so long as the economy is growing and a country’s negative output gap is disappearing. Instead, they must focus their attention to avoid the risk of building new asset bubbles (which may lead to a new round of financial crises if they burst) and overheating their economies.

- Central banks must also intensify their work on departing from unconventional monetary policy measures. It will not be an easy process because of the potential consequences for financial markets (changes in the profile of the yield curve) and governments (pushing up the price of government securities), but this is the reason to start normalisation sooner rather than later.

- As one of the lessons from the post-crisis experience, policy makers should remember the strong impact of changes in financial regulation on the monetary condition, a factor which was not always sufficiently understood in the last decade. Another lesson points to the importance of constructing a broader price
aggregate which, apart from consumer prices, would also include asset prices. This could help avoid the illusion of low inflation in situations where asset markets are evidently overheated.

Kiel Institute for the World Economy (Salomon FIEDLER, Stefan KOOTHS, Ulrich STOLZENBURG)

Inflation has been persistently below the inflation target of the ECB despite the ongoing economic recovery in the euro area. In this paper, the authors analyse whether the relationship between inflation and economic activity in the euro area has changed based on a review of the literature and discuss implications for monetary policy.

Key points:

- There are several obstacles when estimating the strength of the relationship between inflation and economic activity (or economic slack) via the Phillips curve, which explains the wide range of results in the literature.
- Overall, the evidence suggests that the relationship has indeed weakened, that it is currently weak, and that it varies over time.
- Factors behind the weakening of the relationship could be that inflation expectations are better anchored at the inflation targets of central banks and certain aspects of globalisation.
- Inflation has been persistently below target since the Global Financial Crisis. The amount of economic slack in the euro area is currently low and according to recent estimates, the output gap is closed, by and large. Overall, euro area inflation currently seems to be broadly in line with Phillips curve estimates.
- A weak and unstable relationship between inflation and economic activity can hamper the ability of central banks to control inflation, because this relationship describes one of the most important transmission channels of monetary policy. Moreover, it is becoming more difficult to assess the impact of monetary policy measures on inflation.
- A weak Phillips curve relationship also implies that central banks may have to accept inflation deviating from their inflation targets for longer periods of time because larger fluctuations in economic activity may be required to keep inflation on target and it is not obvious that fluctuations in economic activity are less costly in terms of economic welfare than fluctuations in inflation.
- Extended periods of extraordinary monetary policy measures – may be necessitated if the central bank’s control over inflation by ordinary means is reduced – could come with increased undesired side effects. These side effects include risks for financial stability and the misallocation of production factors, which could weigh on productivity and the long-run growth prospects of an economy.
- In consideration of all the challenges central banks have been facing since the Global Financial Crisis, it might be worth starting a discussion whether the current framework of inflation targeting is still optimal.
- The most important determinants of inflation in the euro area are inflation expectations and wage growth. Both indicators have contributed negatively to inflation since 2014 but inflation expectations less so since 2015 whereas the contribution of wage growth has remained constant.
• Drawing on evidence of uneven recovery across euro area Member States, it shall be recommended to keep on pursuing the expansionary stance of monetary policy until the ECB achieves its inflation objective.

• Moreover, the evolution of inflation and its determinants do not meet the conditions that the ECB regarded as genuine progress towards its policy objective. Inflation has not yet happened and is not expected in the medium-run; moreover, without second-round effects on wages, it is not yet possible to expect that once inflation goes back to target, it will be self-sustained.

• The features of the ongoing developments in wage-price inflation suggest a decrease in the nominal anchor. The recent structural reforms may have put a drag on the ability of the ECB to reach its inflation target rapidly.

• The timing of structural reforms is important. They may be helpful at fostering innovation and productivity provided they are implemented after economic growth has been sustained and evenly distributed across the Member states, and after inflation has reached its medium-run objective.