European Parliament

**DG INTERNAL POLICIES OF THE UNION**
- Directorate A -
ECONOMIC AND SCIENTIFIC POLICY
POLICY DEPARTMENT

**Monetary Dialogue – 2 December 2019**

# Executive summaries of the papers prepared by the Monetary Expert Panel

*(also available at http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html)*

## 1. TASK AHEAD: REVIEW OF THE ECB'S MONETARY POLICY STRATEGY

Background

The last official comprehensive review of the ECB's monetary policy strategy was carried out in 2003. Macroeconomic conditions, but also the understanding of underlying factors and their responsiveness to monetary policy, have changed substantially since then. Today, the ECB finds itself in a situation where, despite the continuing use of non-standard policy measures and abundance of liquidity injected in the financial system, inflation in the euro area remains persistently below the target and growth is sluggish. Is it time for a new official review of the ECB's monetary policy strategy that would take stock of these developments and challenges ahead (short-term but also longer-term structural ones such as demographic, technological and climate change-related)? The incoming ECB President, Ms Christine Lagarde, signalled in her appointment hearing in ECON on 4 September, that she would be open to a review. What would be the desirable scope and format of the review? What are the preliminary recommendations and policy options that could be considered?

Papers:

**"Thoughts on a Review of the ECB's Monetary Policy Strategy"** by Christophe BLOT, Jérôme CREEL and Paul HUBERT (OFCE)

- While the ECB monetary strategy has certainly evolved over time, no comprehensive review by the ECB itself has been carried out since 2003. However, monetary policy strategy has evolved since the global financial crisis, knowledge on monetary economics has improved and structural changes of the economies have occurred. A comprehensive review is therefore needed.
- The previous review took place during the so-called "Great Moderation" whereas now economists fear "secular stagnation". A lower natural rate of interest environment would call for a reflection on how monetary policy should be implemented.
- Academic knowledge about monetary policy has accumulated. The strategy should evolve in line with the science on the transmission of monetary policy, communication policies, the signalling of monetary policy, the design and the decision-making process and the model that best helps to understand the functioning of the economy.

- The preceding review of the ECB monetary policy happened in a period where social media were not that present and the next review should investigate all the ins and outs of these new communication standards.
- If the mandate is unchanged, the Governing Council may change the definition of the inflation target. What should be the level of the target, should it be a symmetric target or not? Beyond the reference value, there is a need to discuss the strategy: would a price-level targeting or an average inflation targeting be more appropriate?
- The ECB may also revise its monetary policy strategy to account for the effects of globalisation. The ECB should better target what it can control.
- The review should investigate whether the heterogeneity of country inflation rates matters for promoting price stability for the euro area (EA) as a whole and regarding the need to contribute to fostering convergence in the EA.
- Is the current two-pillar strategy still relevant? The ECB may think about the horizon over which the balance of risk is assessed and separate short-term prospects for inflation and long-term risks for inflation.
- It would be useful to complement the strategy with guidelines regarding the use of what were called "non-standard measures". Should the ECB resort to those measures not only in exceptional periods but also in normal times?
- Do we need a radical change in the ECB mandate? Reviewing the monetary policy strategy against the alternative of a dual mandate and even a triple mandate (encompassing financial stability) would provide a comprehensive review of monetary policy as it would account for its effect on real activity and financial stability. The review of the ECB monetary policy strategy should also investigate the role that this public institution wants and needs to play in fighting climate change.

**"The Two-pillar Strategy of the ECB: Ready for a Review"** by Daniel GROS and Angela CAPOLONGO (CEPS)

The persistence of low inflation despite massive doses of unconventional policy by the ECB suggests that a fundamental review of its strategy is warranted. All aspects of monetary policy strategy, including the definition of price stability, the instruments of monetary policy and communications should be up for review. This contribution cannot deal with all these aspects. It concentrates on two sub-issues: the organisation of the review and the presentation of the strategy in ECB communications.

Within this limited scope, our recommendations about the review of monetary policy of the ECB are the following:

- The ECB still follows officially a 'two pillar' strategy. But, *de facto* the pillars have been abandoned since the financial crisis. Over the last decade, the two pillars have been used in a formal way to justify monetary policy decisions. In reality, one finds little trace of the essential elements of the monetary pillar in the speeches of members of the Governing Council.
- We could not find a single instance in which the ECB admitted that the two pillars, i.e. the economic and the monetary analysis gave different signals. This not credible. In reality there have been important instances when taking into account the different signals from the two pillars could have led to different decisions.

- The economic pillar has become an *ad hoc* application of basic relationships between interest rates, demand and prices all of which have become rather tenuous or at least contested over the last years. A fundamental appraisal of the current working of these economic mechanisms is thus overdue. (But, this will take considerable resources and thus cannot be achieved in this limited contribution).
- The review should be conducted as much as possible by outside experts. The 2003 review was conducted by the Governing Council itself and resulted merely in a confirmation of the existing (two pillar) strategy.
- Elements of the 'Fed Listens' framework might be useful for the review of the ECB's strategy. But, one key element, namely events involving the local public organised by the individual District Federal Reserve Banks might be difficult to replicate. Great care should be taken to ensure that events organised by national central banks do not degenerate into platforms for national points of views. There is no need to institutionalise the review.

**"Priorities for Review of the ECB's Monetary Policy Strategy"** by Jérémie COHEN-SETTON, Christopher G. COLLINS and Joseph E. GAGNON (Peterson Institute for International Economics)

- Lower neutral rates of interest have eroded the monetary policy space to fight the next recession for central banks around the world. Against this backdrop, several of them are reviewing their strategy and framework to see if they can be improved.
- In the euro area, the typical process of interest rate normalisation that takes place during a recovery has not even started, so the ECB has even less scope than other central banks to cut policy rates.
- The ECB is, however, well placed to improve its strategy and framework, especially given the high degree of discretion that it enjoys compared to other central banks when it comes to introducing new policy instruments.
- The paper recommends that the ECB start a broad review of its strategy along the lines of those happening in Canada and Sweden. In particular, the ECB should not follow the Federal Reserve in its decision to exclude a redefinition of its inflation objective from the review.
- The paper views (1) the redefinition of the price stability objective and (2) establishing contingency plans for using new instruments as the two most urgent elements on which the review should focus.
- The ECB should redefine price stability as a year-on-year increase in the Harmonised Index of Consumer Prices for the euro area close to 3%. By providing a higher starting point for bond yields across the yield curve, a higher inflation target could provide a total increase in policy scope that is equivalent to a 300 basis points cut in the policy rate.
- The ECB should not only detail how the parameters governing the use of its current instruments could be modified to provide more stimulus but also explore adding new instruments to its toolkit such as equity purchases and outright cash transfers to households.

**"The Urgent Need for a Review of the ECB's Monetary Policy Strategy: Towards an Institutional Review"** by Christopher A. HARTWELL (CASE)

- Sixteen years is a long time. In the period since the European Central Bank (ECB) underwent its last monetary policy review, Europe has been through a global financial crisis, a sovereign debt crisis, a decade of unconventional monetary policy, the rise of populism, and continued anaemic growth.
- A review of the ECB's monetary policy is thus long overdue.
- However, this briefing paper proposes a slightly different review than was undertaken in 2003, namely an *institutional review*.
- The purpose of an institutional review would be to combine a process management approach with a political economy analysis, starting from first principles to examine what the ECB wants to do, how it relates to other EU organs, how it should do it, and how it has performed in undertaking these interventions in the past.
- The review would be structured into two main components. The first is a backward-looking (ex post) assessment of the ECB's mandate, its tools, its placement within the European economic system, and a rigorous analysis of how the ECB performed as measured against economic metrics of success.
- The institutional review should not shy away from hard questions about the desirability of the ECB's independence, alternate mechanisms for achieving the goals elucidated in the Treaty on European Union, or on the reality of the ECB as a political (as well as monetary) institution. But the review should remain focused on the question of mandate.
- The second portion of the review will be forward-looking (*ex-ante*), attempting to grapple with the future challenges that the euro area economy will face. These challenges are legion, and include continued demographic decline, over-regulation, the possible (spatially differentiated) effects of climate change, and continued innovation in the financial sector.
- However, the possible future issues that the ECB will face are uniformly structural and not monetary, and thus the ECB should retain flexibility to deal with them while remaining focused on its core mandates (as decided in the earlier part of the review).
- The modalities of the review are less pressing than asking the right questions, which is the reason why this paper focuses more on these questions and their sequencing. I recommend that the review is institutionalized, but on a not-too-frequent basis. More important is to make recourse to first principles so that the review can be a useful exercise for the entirety of the euro area going forward.

**"Recommendations for the ECB's Monetary Policy Strategy Review"** by Karl WHELAN (University College Dublin)

- A review into monetary policy strategy, tools, and communications is underway at the Federal Reserve. The ECB's new President has signalled support for a review of this sort for the Eurosystem.
- This paper considers five areas where a review of ECB monetary policy strategy could focus and makes recommendations in relation to each area. The five areas are price stability, the monetary pillar, liquidity provision, balance sheet risk and communications.

- The paper recommends that the ECB adopt a 2 percent average inflation rate over a relatively long period as its inflation target.
- The ECB should also consider clarifying its approach to the swings in volatile components of the consumer price indices, such as food and energy.
- The ECB should remove the monetary pillar from its official monetary policy strategy. There is no good statistical evidence that measures of the money supply are useful in forecasting inflation and the focus on monetary analysis and "cross checking" waste valuable time in Governing Council press conferences on unimportant issues.
- The ECB should announce that it will permanently adopt the fixed rate full allotment approach to the provision of liquidity to banks.
- The provision of Emergency Liquidity Assistance (ELA) should also be reformed with assistance being instigated and decided on solely at Governing Council level and profits and losses from these operations being shared across the Eurosystem.
- A review of monetary policy strategy should clarify the ECB's policy on how much risk it is willing to take on its balance sheet. If it is not willing to raise its current self-imposed issuer limits for sovereign bond purchases, the ECB will need to consider whether it wishes to prioritise the Asset Purchase Programme or maintaining sufficient room for an effective Outright Monetary Transactions (OMT) tool.
- ECB should consider adopting the FOMC's approach to forecasting future economic data and policy. Specifically, they should consider having each Governing Council member provide forecasts for inflation, output and the ECB's policy rates for the next few years and also for the longer run.
- The ECB should devote more effort to communicating the broadness of its mandate. The ECB is required by the EU Treaties to support high levels of employment and other policy goals such as a high-quality environment, provided actions it takes in support of these goals do not endanger price stability. In the current environment, with inflation falling short of the ECB's target levels, there is room for new and innovative ECB policies to support the EU's policy goals.

## 2. THE FUTURE OF MONEY

Background

Most developed economies are rapidly moving towards becoming cashless societies as less and less payments are made using banknotes and coins. In parallel with this trend, cryptocurrencies such as Bitcoin, Ethereum or Ripple have gained prominence in recent years but, despite their stellar increase in market capitalisation, they remain largely irrelevant in overall size and mainly used for speculative purposes. Their success was hindered in part due to their extreme volatility, thus failing to fulfil one of the basic functions of money as a store of value. This has led, more recently, to the emergence of stablecoins, which have also thus far failed to reach a 'critical mass' in terms of adoption. The game-changer was the announcement of Facebook of its plans to launch Libra. Despite the fact that this project is seemingly losing steam due to the severe backlash from lawmakers, regulators and central banks worldwide, the notion of global tech companies pursuing such initiatives in the future should not be ruled out. Partly due to this development, major central banks are contemplating to issue central bank digital currencies (CBDCs). What are the perceived societal benefits and costs of these trends? Should central banks issue CBDCs? What are the implications for the global monetary and financial system and, more generally, the role of central banks?

Papers:

**"The Impact of Digitalisation on the Monetary System"** by Salomon FIEDLER, Klaus-Jürgen GERN and Ulrich STOLZENBURG (Kiel Institute for the World Economy)

- Digital money can take different forms representing inside or outside money, account-based or token money, and may be an independent currency or part of a traditional currency domain.
- Currency competition has been limited historically due to strong network externalities in the usage of money. By unbundling the properties of money, digitalisation substantially raises the potential for currency competition. Re-bundling of digital money along large social or commercial platforms works in the opposite direction.
- The decline in the relative importance of cash in most economies is mainly driven by the convenience and efficiency gains offered by electronic payment methods in combination with mobile devices. In the transition to a cashless society, a major social challenge is to prevent parts of the population from being left behind.
- Introduction of digital currency has the potential to be welfare enhancing by exploiting the potential of linkages and exchange in a network's ecosystem and by providing users with the possibility of direct, peer-to-peer transfers of money. However, a plethora of legal and regulatory challenges will have to be addressed before the launch of stablecoins with global scale and scope. Different regulatory regimes in different countries may ultimately lead to an increasingly fragmented international financial system. A serious concern is the possibility that the association of a widely used electronic currency with a large social or commercial electronic platform will reinforce monopolistic tendencies already inherent in network industries.
- A digital currency issued by a central bank (CBDC) can be disruptive for the fractional reserve system, because money users would have the option to hold direct claims against the central bank. Commercial banks would increasingly have to replace deposits with more reliable sources of funding.

- There are plenty of reasons why central banks may actually decide to launch a CBDC, independently or jointly: Installation of a backup payment system, higher revenue, financial inclusion, efficiency of the payment system, traceability of illegal transactions, surveillance, upholding the public monopoly of money while satisfying the need for digital money, and countering competition from private currencies as well as from foreign CBDCs.
- It is unclear if and when a major central bank will actually introduce a CBDC of global relevance. Intuition suggests that CBDCs will be a realised at some point in time, and that today's leading currencies will rather not be the frontrunners of such a move.
- The implications of digital money for monetary policy are not straightforward. If digitalisation means the replacement of cash with central bank derived digital money, then the central bank's ability to produce inflation will increase because the effective lower bound on interest rates will loosen. However, if digitalisation raises the possibility of the introduction of (private or foreign) competing currencies, the ability of central banks to inflate their currencies would be constrained by the threat of people switching to these competing currencies.
- The welfare implications from digital currencies thus depend on the optimal rate of inflation. If the optimal inflation rate is high, then constraints on the central bank's ability to increase inflation could pose a problem. If, however, optimal inflation is low, then the reverse is true.
- There is considerable disagreement on the optimal rate of inflation. The choice of the targets of around 2 percent used by many central banks today are to a considerable degree arbitrary.

**"Virtual Money: How Much do Cryptocurrencies Alter the Fundamental Functions of Money?"** by Eddie GERBA (London School of Economics and Political Science) and Margarita RUBIO (University of Nottingham)

- It is widely agreed that the functions of money can be divided into three layers (primary, secondary, and tertiary), where each layer reflects the descending degree of direct functionality but increasing degree of generality and transcendence that money plays. The primary functions relate to it as a medium of exchange and measure of economic value. The secondary functions reflect its store of value, and standard for payments. The tertiary layer reflects its' contingent functions such as basis of credit, liquidity to wealth, distribution of income, and measurement and maximization of utility.
- The preference for money, in particular fiat currency has increased since the 00's in both the Euro Area and the US, not decreased as one may expect by the emergence of cryptocurrency. This coincides with the launch of the Euro in January 2002, which hints that the issuance of the new currency increased the demand for it and the share of it in broad money.
- By end of 2019, market capitalisation of cryptocurrencies is just under EUR 1 trillion, and of similar magnitude to total currency in circulation in the third quarter of 2019 (at EUR 1.2 trillion). While the growth in total market capitalisation has somewhat slowed down since the latest peak in 2018, in not so distant future, the activity in this market will surpass the size of the traditional Euro currency market, which shows its rapid growing importance.
- In 2018, Bitcoin amounted to almost 46% of the market.
- Volatility is another important driver of the price. Given the absence of the underlying sovereign guarantee (which in case of fiat currency comes through the central bank), it is prone to larger speculative activity. This implies that the introduction of a reserve guarantee would also reduce the volatility. Moreover, a regulatory system aimed at safeguarding the currency

and preventing it from speculative attacks and Ponzi games would increase its reliability and effectiveness as a monetary alternative. Considering the cross-border nature and usage of cryptocurrency, the regulatory architecture would require an international coordination in the compliance as well as supervisory tasks, as advocated by the International Monetary Fund and Bank of England.

- Several benefits of the blockchain technology have been proposed in the literature. Amongst the most prominent is the decentralised nature makes it less prone to corruption and manipulation. Another important benefit is that the blockchain transactions are less expensive and quicker than those of the normal fiat currency transactions. There are recent developments in blockchain which indicate that it can play a very significant role in the future payment systems. One of the last documented large benefits of blockchain is that payments are validated 24/7.
- Bitcoin and other digital currencies may change the function of money. The limited evidence we can collect so far may suggest that digital currencies are primarily viewed as stores of value and are not typically used as medium of exchange. At present, there is little evidence of digital currencies being used as units of account. Thus, digital currencies do not really function as money in the economy and imply some risks if they were to be overall used in the long run. Therefore, it is not likely that digital currencies, in their current form, replace the traditional form of money in any economy.
- From a macroeconomic point of view, cryptocurrencies could pose a risk to monetary and financial stability. From a microeconomic perspective, they imply a risk to investors, who could lose all their money. However, nowadays, the small size of digital currency schemes makes it unlikely to pose real risks to financial stability. Risks to monetary stability could, in theory, emerge if a digital currency were to achieve widespread usage, but this is extremely unlikely.
- Private digital instruments possess the following two advantages: First, they introduce the fintech technology to reduce the costs of transacting across different fiat currencies. Second, in countries with underdeveloped financial systems in which many consumers are excluded from the financial system, private digital currencies are potentially contributing to financial inclusion.
- The demand for a stable asset, which uses the DLT has opened the debate about the possibility of issuing a central bank digital currency. Central banks can take advantage of digital currency technology and still make use of monetary policy in its usual way. Digital currencies could be directly converted into cash and notes. However, this may also pose problems, questioning the role of banks in financing economic activity.
- Stablecoins may be seen as an intermediate solution between privately issued cryptocurrencies and central bank digital currency. In view of the volatility of cryptoassets and given the remaining questions surrounding CBDCs, stablecoins have come to the fore as a potential third type of asset that aspires to bring stability to the volatile market for cryptoassets. Nevertheless, stablecoins are still in their infancy, and therefore not a sufficiently secure investment vehicle. Maybe, with time and the refinement of the different models in the future, they could end up replacing the traditional digital currencies like Bitcoin or Ripple.

**"Public or Private? The Future of Money"** by Chi Hyun KIM and Alexander KRIWOLUZKY (DIW Berlin)

- In 2009, an anonymous programmer introduced Bitcoin, a cryptocurrency that is fully decentralised and usable without the need for intermediaries. Despite its technological advances and global reach, high price volatility makes Bitcoin unattractive as a mean of payment. 10 years later, a new generation of cryptocurrencies – stablecoins – has caught the attention of crypto market, becoming potential competition for central bank money. The ultimate wake-up call for monetary- and regulatory authorities was the June 2019 announcement by Facebook that it would issue its own stablecoin, Libra.

- Stablecoins of large tech firms have distinct advantages over alternative digital forms of money *and* traditional fiat money. First, compared to the first generation of cryptocurrencies, such as Bitcoin, stablecoin issuers guarantee the price stability of their coins by backing them with safe assets (or a basket of assets). Second, compared to central bank fiat money, stablecoin issuers provide their users a platform where they can easily access their coins, where regional borders do not play a role.
- Nevertheless, the global spread of such stablecoins can bring risks to international financial systems and challenge the monetary authority of central banks. Unfortunately, there is not a global legal system that provides a sound regulatory framework for stablecoin issuers. This can lead to an abuse of private user data and a lack in transparency in their risk management.
- If private digital currency substitutes for fiat money, the efficacy of monetary policy could also be in danger. First, a decrease of central bank reserves in households and businesses' balance sheets can weaken the interest rate channel of the monetary policy transmission mechanism. Second, central banks may lose seigniorage revenue. Third, stablecoins may lead to a high interdependency between domestic monetary policies.
- How should monetary- and regulatory authorities react to the rise of private stablecoins? One option for central banks is to issue central bank digital currency (CBDC). However, this option can be very costly as it requires complex management of customers, which can jeopardise the hard-earned trust of the public regarding the ability of central banks to maintain price stability, their primary mandate. Therefore, we suggest that public-private-cooperation can be an answer. Central banks should cooperate with stablecoin providers by providing them access to central bank reserves, a concept that is known as synthetic central bank digital currency (sCBDC).

**"The Next Generation of Digital Currencies: In Search of Stability"** by Grégory CLAEYS and Maria DEMERTZIS (Bruegel)

- Four major developments in the last decade have challenged the *status quo* and have re-opened the debate on the forms that money will take in the future: 1) use of cash as a medium of exchange has declined; 2) distributed ledger technology (DLT) has led to the emergence of thousands of digital cryptocurrencies; 3) some global tech giants are planning to provide private digital currencies to their billions of users in the form of stablecoins; and 4) in turn, public authorities are thinking about providing their own digital currencies to the general public.
- These developments raise crucial questions about their potential implications for financial stability, the transmission of monetary policy and the future of financial intermediation. This paper focuses in particular on the consequences that the rise of stablecoins and central bank digital currencies could have.
- Stablecoins, such as Facebook's Libra, differ from earlier generations of cryptocurrencies in three fundamental ways. First, they would immediately start with large networks of users and global accessibility, two pivotal features for the critical uptake of a new currency. Second, given

the current limitations of DLT, including in terms of energy efficiency, new stablecoins would rely on (more) centralised systems to validate transactions. Third, stablecoins would focus particularly on reducing the volatility in the value of the new currency.

- These new features of stablecoins attempt to correct some of the critical deficiencies identified in first-generation cryptocurrencies, which meant they did not acquire the main functions of money. However, new stablecoins raise other questions and potentially create new problems. One issue could arise from the more centralised (permissioned) validation system, which could lead to collusion problems. Another issue could arise from the reserve system that is supposed to ensure the stability of stablecoins, such as Libra, which could be incompatible with the profit maximisation behaviour of a private issuer.
- Facebook's Libra plan has been a wake-up call to central banks and governments which, afraid of losing their monetary sovereignty, have renewed their interest in central bank digital currencies (CBDCs) as a potential solution. CBDCs could make private digital currencies less attractive and slow down their adoption.
- But there are other good reasons to give the general public access to central bank liabilities. One important reason to provide CBDCs to citizens is that if cash disappears, citizens will lose direct access to sovereign money. Another benefit of the introduction of CBDCs is that monetary policy could be strengthened by transmitting it directly to the general public.
- However, the introduction of CBDCs could also be very disruptive and create new risks. In particular, CBDCs could have some major consequences for financial intermediation. These risks would have to be carefully considered and evaluated by policymakers before any decisions are taken.
- If CBDCs are introduced, central banks would have to carefully calibrate their properties to minimise these risks. But, eventually, if these risks – and in particular the risk of structural financial disintermediation – do materialise, central banks would have various instruments to counter them.