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

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Executive summaries of the papers prepared by the Monetary Expert Panel[1]

1. THE ECB'S MANDATE: PERSPECTIVES ON GENERAL ECONOMIC POLICIES

Background

The ECB has a clear primary objective to maintain price stability. The Treaty is less clear on how the ECB is required to fulfil its so-called secondary objective of "supporting general economic policies of the Union". Just as the ECB was about to start its monetary policy strategy review which also provided an opportunity to clarify these elements of the mandate, the COVID-19 crisis brought the toughest test yet for its ability to deliver on the objectives. In addition, the German constitutional court delivered a judgement on the ECB's public sector purchase programme (PSPP) which might bring further legal and economic consequences.

Papers

The ECB Mandate: Perspectives on Sustainability and Solidarity by Rosa LASTRA (Queen Mary University London) and Kern ALEXANDER (University of Zurich)

- **As part of its monetary policy strategy review**, the European Central Bank (ECB) is reassessing how its monetary policy tools to achieve its primary objective of price stability should take account of "other considerations, such as financial stability, employment, environmental sustainability" in accordance with Article 127 TFEU and Article 3 TEU.
- **This paper considers the ECB's legal mandate and whether it is adequate to manage the economic and financial risks associated with unsustainable activity**, including climate change, financial crises and pandemics like COVID-19. It argues that the potential consequences of these risks – for the economy and for the financial sector in particular – fall squarely within the ECB's mandate to support the economic policies in the EU and that they interact with the primary objective of price stability.
- **Regarding monetary stability, we recommend that the ECB focus on low and stable inflation as a priority, but also support a sustainable growth rate that is defined as such over the long-term**. The ECB should support national governments in considering how monetary measures can be used to help provide credit to support climate adaptation and mitigation strategies and to address the economic damage caused by the COVID-19 crisis, in line

[1] also available at http://www.europarl.europa.eu/committees/en/econ/monetary-dialogue.html

with the principle of solidarity, but within the confines of the Article 123 (1) Court of Justice of the European Union (CJEU) jurisprudence.

- **Financial stability considerations suggest that central banks should go further than this, to positively promote a transition to a sustainable and hence lower carbon economy, as part of their primary objectives**. The full recognition of the ECB's secondary objectives, to support the EU's wider economic policies, can be invoked as necessary, including deciding what tools can be used to stabilise the banking sector in response to the COVID-19 crisis.
- **The ECB's role as a bank supervisor will be important for ensuring that authorised firms are identifying and managing environmental and social risks**. For instance, the ECB can help banks build stress tests based on forward scenarios that will help the industry judge what its capital and liquidity requirements should be in the face of future threats to stability caused by environmental or social phenomena.
- **The paper concludes, however, that EU institutions and Member State fiscal authorities have the primary role to play managing economic policy to address these risks because of their control over taxation, expenditure, legislation and regulation**. **Nevertheless, the ECB must take environmental, social and economic sustainability into account to the extent that these secondary objectives impact upon the primary price stability mandate.** The ECB can facilitate a growing role for EU institutions and Member States to fill the governance gap in fiscal policy at the EU level by providing more economic backing to address environmental and social sustainability risks, particularly regarding the urgent need to adopt substantial measures to address the COVID-19 crisis.

The ECB's Mandate and Legal Constraints by Karl WHELAN (University College Dublin)

- **This paper considers how the ECB can implement its mandate in the current crisis conditions and the legal constraints that exist on its actions**.
- **Price stability is the Eurosystem's primary objective**. However, **the Eurosystem is also legally obligated to support economic policies of the Union**, provided this support does not prejudice its primary objective.
- **In recent years, the ECB has fallen short of meeting its self-defined price stability target of inflation being close to but below 2 percent**. And the current state of the euro area economy means the threat to meeting its primary objective of price stability stems from the possibility of a long period of below-target inflation.
- **The evidence on the behaviour of inflation over the past 25 years also gives the ECB room to pursue policies that previously would have been considered illegal**. Economists have less certainty now than they did when the ECB was founded about exactly which factors determine inflation. Evidence suggests that neither low unemployment rates nor rapid expansion of the monetary base necessarily lead to high inflation.
- **This means there are many new actions the ECB could take to both meet its primary and secondary objectives.** Actions that support the economic policies of the Union and stimulate the economy can move inflation back to its target level and help the ECB meet its primary objective. Tools to constrain inflation during a recovery are also available.

- **The ECB, however, will be constrained by the ECJ's interpretation of the monetary financing clause.** Actions that could be considered legal via a literal reading of the EU Treaties are likely to be ruled illegal due to ECJ's interpretation of Article 123 of the Treaty on the Functioning of the European Union (TFEU).
- **The ECB's ability to meet its primary objective is also threatened by the recent German constitutional court judgement** which is flawed in both its legal and economic analysis.
- **The German constitutional court's distinction between monetary and economic policies is unjustified**. Its position on the proportionality of the PSPP programme has little legal justification and the economic analysis underlying its decision is also highly flawed.
- **The ECB does not have to respond to the German constitutional court but it should be relatively easy to provide a convincing explanation** that the PSPP represents a proportionate response to economic conditions, thus allowing the continuation of a shared monetary policy across all euro area Member States.

The Dimensions of Responsibility: Perspectives on the ECB's Monetary Policy Mandate by Joseph E. GAGNON, Jacob F. KIRKEGAARD, David W. WILCOX, Christopher G. COLLINS (Peterson Institute for International Economics)

- **This paper provides a normative analysis of how the ECB's mandate should be defined**. Particular emphasis is given to the central bank's core monetary policy mandate of macroeconomic stabilisation, and whether that mandate should be limited to inflation or price stability, or should also recognise a role for promoting maximum employment. If "yes" is the answer to the latter question, the paper examines whether inflation or price stability should take priority, or whether output stabilisation should be on an equal footing. The paper also examines the extent to which a central bank's mandate should include responsibility for financial stability and possibly addressing climate change and inequality concerns.
- **A strong theoretical and empirical case exists for a dual mandate for central banks comprising goals for both inflation or price and output stabilisation**. Focusing exclusively on price stabilisation at a time of demographic decline risks lulling a central bank into acting too timidly against negative deviations in output, and tolerating persistent undershooting of the price stability target.
- **Maintaining financial stability, including the role of lender-of-last-resort, is a crucial function of efficient modern central banking**. This function is, however, best carried out via thorough and tireless financial sector supervision, and through aggressive utilisation of macroprudential regulatory tools. Financial stability should not be a first-order concern for monetary policy, due to the high costs of countering rapidly rising asset prices though higher interest rates.
- **Central banks are not well equipped to directly address climate change concerns, a task best left to governments though the legislative tools at their disposal, including the introduction of comprehensive carbon pricing.** Central banks must, however, be vigilant against the impacts of climate change on their price stability, output and financial stability responsibilities. Independent central banks, such as the ECB, may at their own initiative seek guidance from relevant democratically elected bodies regarding the extent to which climate change should be an explicit criterion in the implementation of the central bank's regular

monetary decisions. This may be particularly relevant for central banks' design of sound asset purchase programs.

- **Central banks can contribute importantly to combatting inequality by pursuing price and output stability, thereby mitigating economic contractions that invariably affect marginalised groups more than society's affluent layers**. As an empirical matter, this general perspective appears valid even when central banks exercise their more recently developed policy tools, including large scale asset purchases. The positive effects on inequality from stronger job creation arising from such purchases more than offset the benefit derived by the holders of appreciating assets. As with climate change, central banks may adopt inequality concerns as a design parameter, seeking explicitly to reduce any negative effect on inequality in the implementation of its monetary policy decisions.

Setting New Priorities for the ECB's Mandate by Christophe BLOT, Jérôme CREEL, Emmanuelle FAURE and Paul HUBERT (Sciences Po – OFCE)

- **In a statement announcing the review of its monetary policy strategy, the European Central Bank (ECB) stated that it will, in addition to price stability, also take into account how "other considerations, such as financial stability, employment and environmental sustainability, can be relevant in pursuing the ECB's mandate"**. The key question is which precise objectives shall be taken into account and how the ECB might reach them, keeping in mind that some trade-offs *vis-à-vis* the primary objective may arise.
- **We choose relevant indicators of these secondary objectives and compute their respective correlation coefficient with the inflation rate in the euro area**; hence, we illustrate the statistical interactions between these objectives and the primary objective of the ECB.
- **When objectives are complementary, the ECB can achieve other objectives while still maintaining price stability**. This may be the case, for instance, with heterogeneity of inflation rates. When there is no relationship, achieving price stability does not help in fulfilling the other objective as highlighted, for instance, for financial stability, financial integration, technological progress, climate change and inequality. Challenges are more complex when objectives are substitutable. In this case, trade-offs may arise.
- **Keeping the current mandate is inevitably the baseline case to be considered but it may not enable the ECB to achieve macroeconomic and financial stability**. This suggests the need to broaden the mandate of the ECB to integrate full employment and financial stability because these objectives, socially important, are closely connected with monetary policy. Yet, it must be acknowledged that this would entail a change in the Treaty, which remains a difficult task.
- **We do not recommend assigning the ECB with tasks it cannot be held accountable for and which are highly political**. This is notably the case with climate change or inequality. It would be hazardous to set in stone in the Treaty an objective relating, for instance, to a desired level of greenhouse gas emissions and to leave the ECB to be accountable for achieving it.
- **The global financial crisis highlighted the institutional flaws of the Economic and Monetary Union (EMU)**. Price stability may not be enough to prevent external imbalances. The ECB might consider changing its definition of the price stability target to avoid discrepancies between national inflation rates. This change does not require to modify the Treaty as the ECB has discretion to specify its target.

- **Adopting new objectives for monetary policy may require additional instruments**. In any case, higher transparency is needed if the ECB implements supposedly conflicting policies as regards the primary and secondary objectives.
- **The COVID-19 crisis has shown that shared identification of shocks is crucial to remove the risk of inappropriate policies (monetary contraction and/or permanent fiscal expansion after a negative supply shock)**. Coordinated monetary and fiscal policies help to bolster their respective effects and to achieve their objectives.
- **Even if climate change does not enter the mandate, monetary policy may yet contribute to the transition to a low-carbon economy through the purchase of assets such as green bonds, as long as quantitative easing (QE) programmes are still activated**. But the question whether to issue those bonds is foremost a policy decision taken by governments.

The ECB in the COVID-19 Crisis: Whatever it Takes, Within its Mandate by Grégory CLAEYS (Bruegel)

- **Central banks have taken a number of drastic steps to keep their economies afloat during the COVID-19 lockdowns**. In the euro area, the European Central Bank (ECB) has eased significantly the conditions of its refinancing operations and has announced a new asset purchase programme to ensure that its monetary policy continues to be well transmitted to all countries of the monetary union. This response has triggered fears of a significant increase in inflation, and concerns about whether the ECB measures are compatible with its price stability mandate and with the limits set by the EU Treaties.
- **We believe that accelerating inflation is not an immediate threat, as the euro area will experience in 2020 its deepest recession ever recorded**. Initially, the pandemic took the form of a supply shock, but second-round effects have now generated a massive aggregate demand shock. The overall impact on prices will depend on which of these two shocks dominates. At this stage, it seems that the fall in demand is going to be greater than the fall in productive capacity. Combined with the direct effect of the substantial fall in oil prices, this means that deflationary forces are likely to dominate and bring headline inflation into negative territory in the near future.
- **With deflation risks mounting, and inflation expectations drifting downwards, an expansionary monetary policy is clearly warranted today for the ECB to fulfil its price stability mandate**. Moreover, given the severity of the shock, there is currently no trade-off between the ECB's primary mandate and its secondary macroeconomic objectives, which all point in the same direction.
- **We also believe that the new measures implemented by the ECB respect the legal boundaries** set by the EU Treaties and the criteria set by the EU Court of Justice in its rulings on previous ECB asset purchase programmes.
- **However, the legal situation has been complicated by the 5 May 2020 ruling of the German Constitutional Court (GCC) on the ECB Public Sector Purchase Programme, which was launched in 2015**. The ECB is not under the jurisdiction of the GCC, and should not comply directly in order to avoid setting a dangerous precedent. The legal situation is currently unfolding and it is difficult to predict how it will be resolved, but from an economic perspective, if the ECB were to abide by the more stringent rules dictated by the GCC in the future, it would make it more difficult for the ECB to fulfil both its primary mandate and secondary objectives.

- **In the long-run, there are some fears that the current increase in the money supply will at some point lead to too much credit and inflation**. However, in modern economies central bank reserves play a marginal, if any, role in credit creation. A high level of liquidity should not prevent the ECB from influencing credit creation or from tightening its policy if needed, as long as the ECB retains control over short-term interest rates and is able to influence the benchmark risk-free yield curve.
- **Our analysis suggests that the ECB's current actions and the increase in the size of its balance sheet, even if it were to prove permanent, do not restrict significantly its ability to increase rates to fulfil its price-stability mandate in the future**. The ECB would have enough tools at its disposal to counter a surge in inflation if it were to happen.
- **Moving away from the current crisis, we conclude by discussing how the ECB should deal with trade-offs between different objectives when they arise**. While the ordering is clear between its primary price stability mandate and its secondary objectives, the secondary goals are not ranked by priority. Sometimes, the solution to achieve multiple objectives at the same time is simply to use multiple tools, but when this is not possible what should the ECB do? Dealing with difficult trade-offs is essentially a political task and should, as much as possible, be taken out of the hands of unelected policymakers. That is why, in these particular cases, the ECB should welcome some clear guidance from the European Parliament and EU Council on which secondary objectives are the most relevant for the EU in a particular situation.

2. INTERNATIONAL ROLE OF THE EURO: A MONETARY POLICY VIEW

Background

At the intersection between international economics and geopolitics, propositions and predictions on how the euro could challenge the global dominance of the US dollar have been circulating since the inception of the common currency. After an initial period of expansion, since 2006 the euro's international role has largely diminished or stagnated. Developments such as the resurgence of trade protectionism and, more recently, the COVID-19 crisis bring about a number of risks and opportunities for the euro at the global stage.

Papers

The International Role of the Euro: State of Play and Economic Significance by Joscha BECKMANN, Salomon FIEDLER, Klaus-Jürgen GERN, Josefin MEYER (Kiel Institute for the World Economy)

- **20 years after its introduction, the role of the euro as an international currency remains under debate.** While the euro has become and remains to be the second most important currency in the international financial system, by most measures it continues to lag the US dollar by a wide margin.
- **Following a rise in importance in the first decade since its inception, the euro experienced a setback between 2008 and 2014 in the wake of the global financial crisis and the European sovereign debt crisis.** These developments suggest that the euro's international use is highly dependent on the stability of the euro financial markets and the credibility of the euro area institutions.
- **International currency status is not necessarily a binary variable but can be a matter of degree.** A currency can be of different international importance to private and public users along different roles and functions – a currency does not have to be equally important as an international medium of exchange, unit of account, and store of value, respectively.
- **High demand for a currency as an international store of value will reduce external financing costs for the issuer.** On the flipside, there is a concern that this results in currency overvaluation reducing the international price competitiveness of domestic firms. Overall, however, domestic agents are set to benefit, although the size of the "exorbitant privilege" may be relatively small in the current low interest rate environment.
- **The effects of international currency status on the effectiveness of monetary policy are ambiguous.** On the one hand, an increased international transmission with positive spillbacks to the domestic economy and a reduced exposure of domestic prices to exchange rate shocks make it easier for a central bank to hit its target for inflation or economic activity. On the other hand, lower effects of monetary policy on import prices as well as blurred signals from monetary aggregates can also complicate matters.
- **Being the issuer of an international currency can change one's relationship with the rest of the world.** On the one hand, it can enable the issuer to achieve non-monetary side objectives because foreign agents may be forced to follow domestic financial regulations. On the other

hand, international pressure on the issuer may arise to deviate from own policy preferences in order to accommodate foreign needs (e.g. provide financial support in times of economic trouble abroad).

- **Strengthening the international role of the euro can be pursued along different lines.** The euro's international attractiveness could rise as a natural outcome of improved, more consistent institutional arrangements in the euro area leading to credible and sound economic and fiscal policies. Policy could also try targeting individual markets, such as emerging economy debt markets or energy markets, with interventions in order to increase the international use of the euro.

The Euro and the Geopolitics of Post-COVID-19 by Corrado MACCHIARELLI (London School of Economics and National Institute of Economic and Social Research)

- **Propping up the international role of the euro has long been discussed in both academic and policy circles**. This is an issue now at the core of the European policy debate as voiced recently by both the European Commission and the European Central Bank (ECB). At the centre stage of an internationally relevant and stable euro must be an independent central bank superseding strong economic and financial fundamentals and strong political governance.
- **Despite having a large economy, the euro area has not deep enough and integrated financial markets, particularly in some segments**. It does have, however, differently from China, more widespread confidence in its currency.
- **The classic three functions of money in an economy, i.e. store of value, medium of exchange and unit of account, can be understood at the international level as well**. Looking at the euro's use in denominating bond and loan contracts, its use in denominating international trade, the volume in foreign exchange trading and the euro share of central banks' reserves, the evidence does support the idea that the euro has made progress along those dimensions. Still, the euro and the USD have witnessed a relative decline in their role as foreign reserve currencies since the global financial crisis.
- **There are still specific factors which are likely to hinder the growth of the euro as a global currency**. The main problems are embodied not only in the need to enhance the euro's global geopolitical outreach (foreign policy and defence), but also in strengthening internal fiscal policies and cohesion.
- **The COVID-19 shock has revealed yet again the limits of the euro area fiscal and policy response, which has been synchronised in the response to the pandemic but largely uncoordinated**. Thus, there is a risk that the relative decline of the euro as a foreign reserve currency, observed since 2009, may accelerate with or after the COVID-19 shock.
- **To convince markets above all, the euro's role as an anchor currency will have to be pursued with the longer-term goal of achieving fiscal and political breadth**. For instance, the recent German Constitutional Court's ruling against the proportionality of the public sector purchase programme (PSPP) goes in the opposite direction and echoes a still strong North-South divide.
- **If left unaddressed, the lack of a credible European long-term response to the pandemic risks vanishing not only any attempts at internationalising the euro further but even**

jeopardising the European project as a whole. International investors, on the margin, might prefer to avoid a currency whose values or even whose mere existence may be often at stake.

- **The hope is now that politics at the higher echelons of EU leaders' level would support the ECB President Lagarde's announcement that it is the time for Europe's Schuman moment towards greater solidarity**. If not, other countries such as China, Russia and Turkey will seek to capitalise on the increasing fragmentation of the global order, including in the European immediate neighbourhood such as in the Western Balkans region.

Can the Euro Dethrone the US Dollar as the Dominant Global Currency? Not so Soon, if Ever

by Marek DABROWSKI (CASE)

- **Before the introduction of the euro (EUR) in 1999, there were expectations that it would play an important global role and become a serious competitor to the US dollar (USD)**. This happened only in part. The EUR is a strong regional currency in the European Union (EU) and its neighbourhood and the second global currency, far behind the USD. Despite several economic and political shocks, the USD has managed to sustain its leadership position since WWII.
- **Historically, after initial moderate gains in the early 2000s, the global position of the EUR began to weaken in 2006, according to most available metrics**. By the end of the 2010s, the EUR had a similar international weight as at its inception.
- **The international role of the EUR is uneven across different segments of the financial market and its various functions**. It is more important in the international payment system, the deposit market and in creating the international reserves of central banks. It is less important in the debt securities market and other segments of the stock market.
- **The demand for international currencies is determined largely by private sector preferences**. The political or geopolitical preferences of governments and international institutions may correct them only marginally. In turn, private sector preferences depend on the size, depth and sophistication of the financial market for a given currency, its legal and institutional infrastructure and the perception of currency's long-term stability (economic and political). Network externalities and incumbent power also play a very important role because changing the dominant currency is a costly and lengthy process for market participants.
- **Since 2018, the European Commission has declared its desire to increase the international role of the EUR, partly as a reaction to the protectionist and unilateral measures of the Trump administration in the United States**. The European Central Bank (ECB), which was rather sceptical of promoting a broader use of the EUR outside the euro area (EA), also changed its attitude towards more proactive. However, EU governing bodies must draw lessons from the history of the international monetary system, which tells us that changes in the global monetary standard and dominant currency are rare, happen only as a result of extraordinary shocks like world wars or global economic crises and take several decades to be completed.
- **Realistically, a plan to increase the international role of the EUR cannot expect to challenge the dominant role of the USD but would only allow for a limited increase in the share of the EUR in official reserve assets and trade and financial transactions.** However, even such a moderate goal would take several years to be accomplished and would require several reforms within the EA and EU – specifically, completing the Banking Union and Capital Market Union to deepen and fully integrate the financial market in Europe.

Global Currencies During a Crisis: Swap Line Use Reveals the Crucial Ones by Daniel GROS, Angela CAPOLONGO (CEPS)

- **Before the present crisis broke out earlier this year, the EU institutions, and in particular the Commission pushed the idea that the euro should have a stronger global role**.
- **This was based on political and economic grounds**. We discuss here only one specific aspect, namely currency swap lines.
- **One element which attracted attention was the observation that during the financial crisis of 2008-2009 the US Federal Reserve granted swap lines to a number of other central banks**. The purpose was to enable these partners to furnish their respective banking systems with dollar liquidity. These lines were heavily used (albeit only for a short time) and probably greatly attenuated the short-term dollar shortage, which had developed outside the US in 2008-2009 when US money markets temporarily ceased to function normally.
- **This episode seemed to show that providing other central banks with liquidity is one attribute of a global reserve currency.** We therefore consider the idea that the international use of the euro could be enhanced if the ECB establishes more swap lines by itself.
- **The ECB is part of a restricted network of major central banks which have unlimited swap lines among themselves** and it has over the last years also agreed to provide some other smaller central banks with swap lines in euro.
- **During the present crisis, the swap lines of the Federal Reserve have again been used extensively**. However, this has apparently not been the case for the (modest) swap lines the ECB has agreed to with some other national central banks in Europe (e.g. Denmark, Switzerland and the UK). There are also no reports of significant shortages of euro liquidity in other parts of the global financial system.
- **The basic conclusion is that the ECB establishing swap lines with as many other central banks as possible is not enough to foster the international role of the euro**. These lines will only be used if there is a real need. The current crisis has shown once again that the dollar remains the dominant reserve currency.
- **The same observation applies to another potential competitor to the USD, namely the renminbi**. The PBOC has also established an extensive network of currency swaps, but it seems that these have not been needed.
- **The broad conclusion is simple: establishing swap lines is in the self-interest of the home country of a currency that is already widely used internationally**. However, on their own, they should not be expected to contribute significantly to fostering the international use of the euro.