Sapienza Università di Roma

European Economic Integration
EPOS – Master in Advanced Economics
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The Euro

Class overview

1. Maastricht
2. ECB
3. Instruments
4. First years

- Slides are largely based on Baldwin-Wyplosz’s ones (textbook)

The Maastricht Treaty

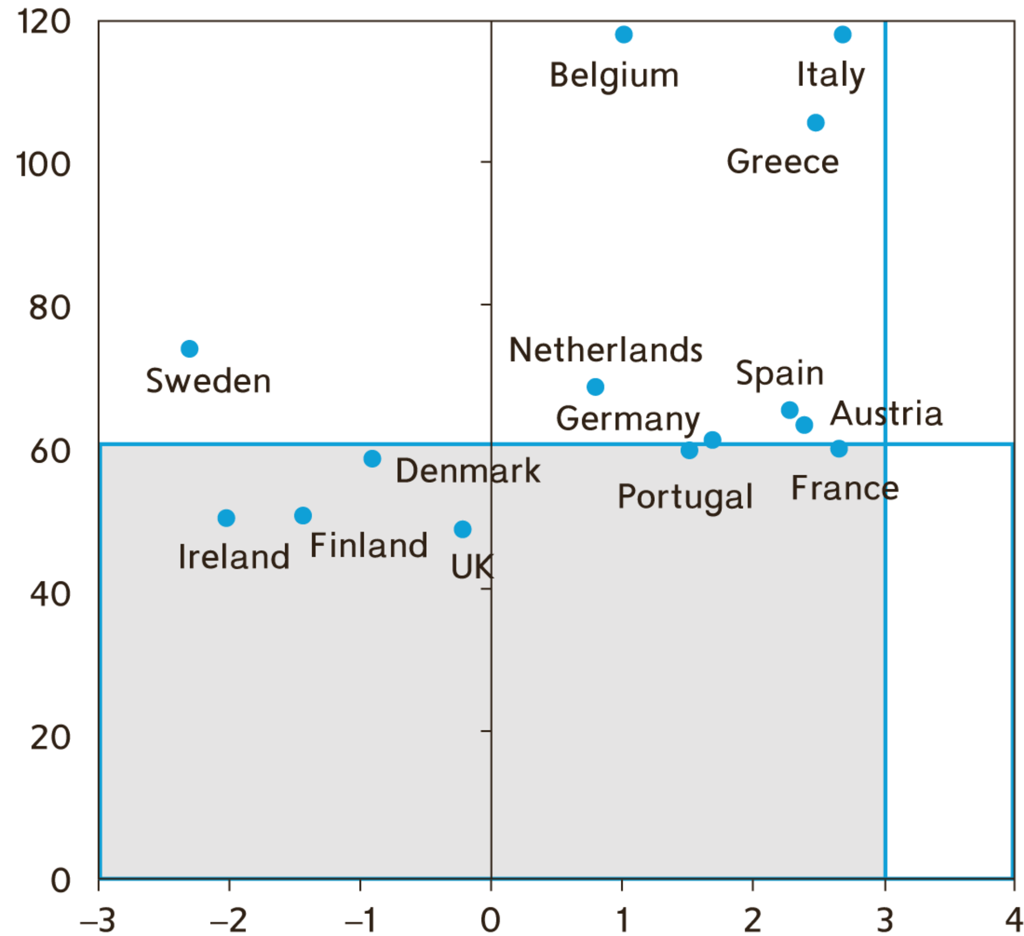
- Monetary union is the outcome of a deal between Germany and the other countries. As part of it, the Maastricht Treaty included:
  - a firm commitment to launch the single currency by January 1999 at the latest;
  - a list of five criteria for admission to the monetary union;
  - a precise specification of central banking institutions;
  - additional conditions mentioned (e.g. the excessive deficit procedure).
- Maastricht Treaty introduced, for the first time, the idea that a major integration move could leave some countries out. It specifies that all countries are expected to join as soon as practical (Denmark and UK were given an exemption; Sweden does not have an exemption but acts as if it did as it is not member of the ERM II).

The Maastricht Treaty: Five entry conditions

- A selection process to certify which countries had adopted a 'culture of price stability' (i.e., German-style low inflation): countries have to fulfill five convergence criteria:

1. **Inflation:** not to exceed by more than 1.5 percentage points the average of the 3 lowest inflation rates among EU countries;
2. **Long-term nominal interest rate:** not to exceed by more than 2 percentage points the average interest rate in the 3 lowest inflation countries (long-term interest rates mostly reflect markets' assessment of long-term inflation);
3. **ERM membership:** at least 2 years in ERM without being forced to devalue;
4. **Budget deficit:** deficit less than 3% of GDP. Historically, all big inflation episodes born out of runaway public deficits and debts!
5. **Public debt:** debt less than 60% of GDP (average of countries).

The Maastricht Treaty: Five entry conditions



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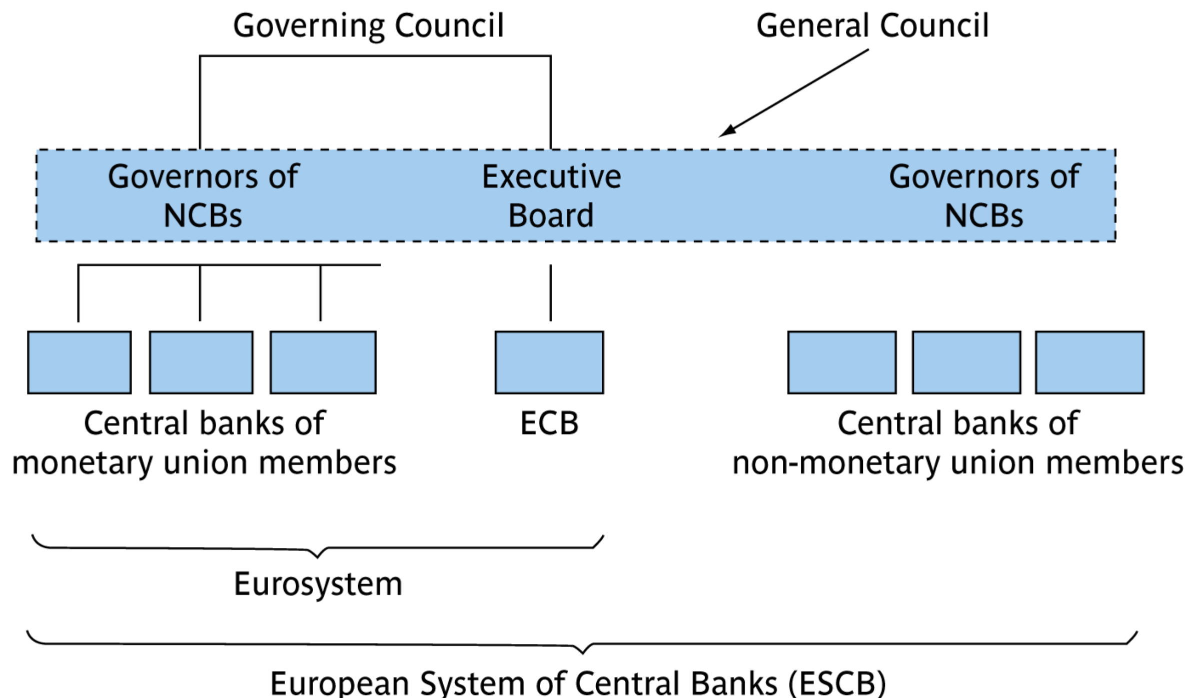
Two-speed Europe

The Eurosystem

- N countries with N National Central Banks (NCBs) and a new central bank at the centre: the European Central Bank (ECB).
- The European System of Central Banks (ESCB): the ECB and all EU NCBs. The Eurosystem: the ECB and the NCBs of euro area member countries.



The rotating voting system (since 2015)

Members of the Executive Board

Six permanent voting rights

21 voting rights in total

First Group

Four rotating voting rights

NCB Governors ranked 1st to 5th

Second Group

Eight rotating voting rights

Half of the total number of NCB Governors

ranked 6th and below

Third Group

Three rotating voting rights

Remaining NCB Governors

Objectives

- "*The primary objective of the ESCB shall be to maintain price stability. Without prejudice to that objective, it shall support the general economic policies in the Union in order to contribute to the achievement of the latter's objectives.*" (Article 282-2)
  - Eurosystem has chosen to interpret it as follows: 'Price stability is defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the Eurozone of below but close to two per cent. Price stability is to be maintained over the medium term.'
  - commonly understood as between 1.5 and 2%;
  - commonly understood to refer to a 2–3 year horizon.

ECB's monetary policy strategy

- Strategy relies on three main elements:
  - **Definition of price stability** as the primary goal: "change in HICP below but close to two per cent"
- and two 'pillars' to identify risks to price stability:
  - First pillar = **'economic analysis'**. It consists of a broad review of recent evolution and likely prospects of economic conditions (e.g., growth, employment, prices, exchange rates, foreign conditions);
  - Second pillar = **'monetary analysis'**. It studies the evolution of monetary aggregates (M3, in particular) and credit.

Independence and accountability

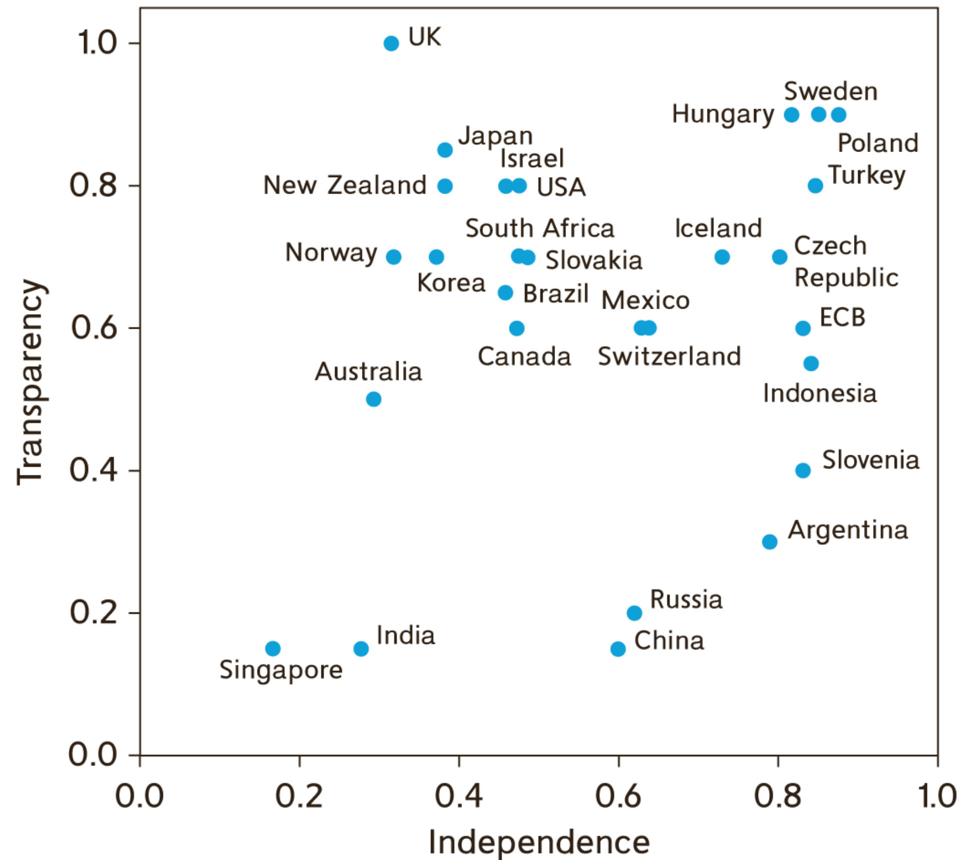
- A central bank must be free to operate without outside interference but delegation to unelected officials needs to be counterbalanced by democratic accountability.
- Eurosystem is characterized by a great degree of independence (probably the world's most independent central bank).
- Eurosystem operates under the control of the European Parliament. Transparency contributes powerfully to accountability.

Transparency

	Public debt	ESCB	Bank of Japan	Bank of England	Bank of Canada	Swedish Riksbank
Interest-rate decision immediately announced	Yes (after 1994)	Yes	Yes	Yes	Yes	Yes
Supporting statement providing some rationale for change	Yes	Yes	Yes	Sometimes	Yes	Yes
Release of minutes	5–8 weeks[a]	No	1 month	13 days	n.a.	2–4 weeks
Official minutes provide full details of:						
Internal debate	Yes	No	Yes	Yes	n.a.	No
Individuals' views	Yes	No	No	Yes	No	No
Verbatim records of MP meetings are kept	No	Yes	No	No	No	Yes
Verbatim records released to the public after:	5 years	n.a.	10 years	n.a.	n.a.	n.a.

Independence and accountability

- Independence and transparency indices:



Instruments

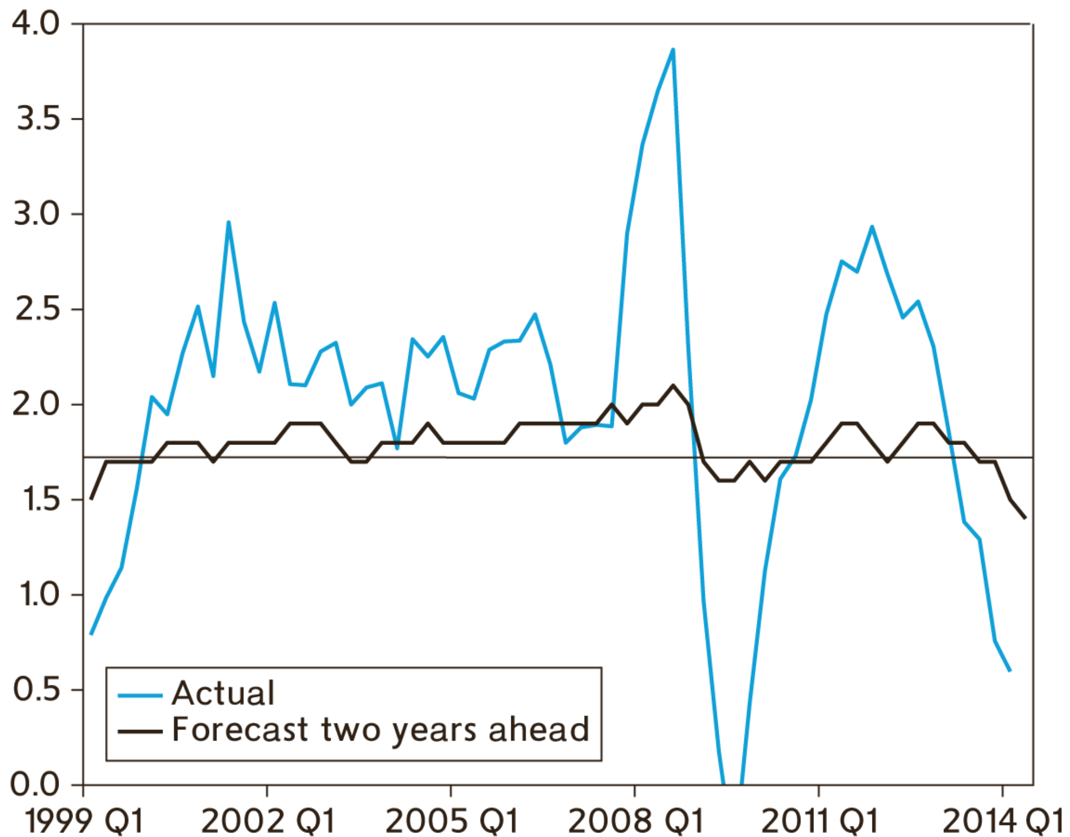
- Eurosystem uses the short-term interest rate: its changes have a knock-on effect on longer-term interest rates (and thus on the cost of credit), on asset prices (and thus on capital costs of firms) and on the exchange rate (and thus on foreign demand for domestic goods and services).
- The Eurosystem focuses on the overnight rate EONIA (European Over Night Index Average, a weighted average of overnight lending transactions in the Eurozone's interbank market):
  - The Eurosystem creates a ceiling and a floor for EONIA by maintaining open lending and deposit facilities at pre-announced interest rates;
  - The Eurosystem conducts, usually weekly, auctions at a rate that it chooses, thus providing liquidity to the banking system and the chosen interest rate serves as a precise guide for EONIA. However, currently 'fixed rate full allotment policy'

Instruments

The first years (until the Great Crisis)

- A difficult period:
  - oil shock in 2000;
  - September 11 in 2001;
  - oil prices to record level and US financial crisis start in mid-2007
- Result: inflation almost always above 2% but close to target (until 2007) and lower than perceived.
- Growth has been generally slow in the Eurozone, prompting criticism of the ECB, including by some member governments.

The first years (until the Great Crisis)



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The first years (until the Great Crisis)

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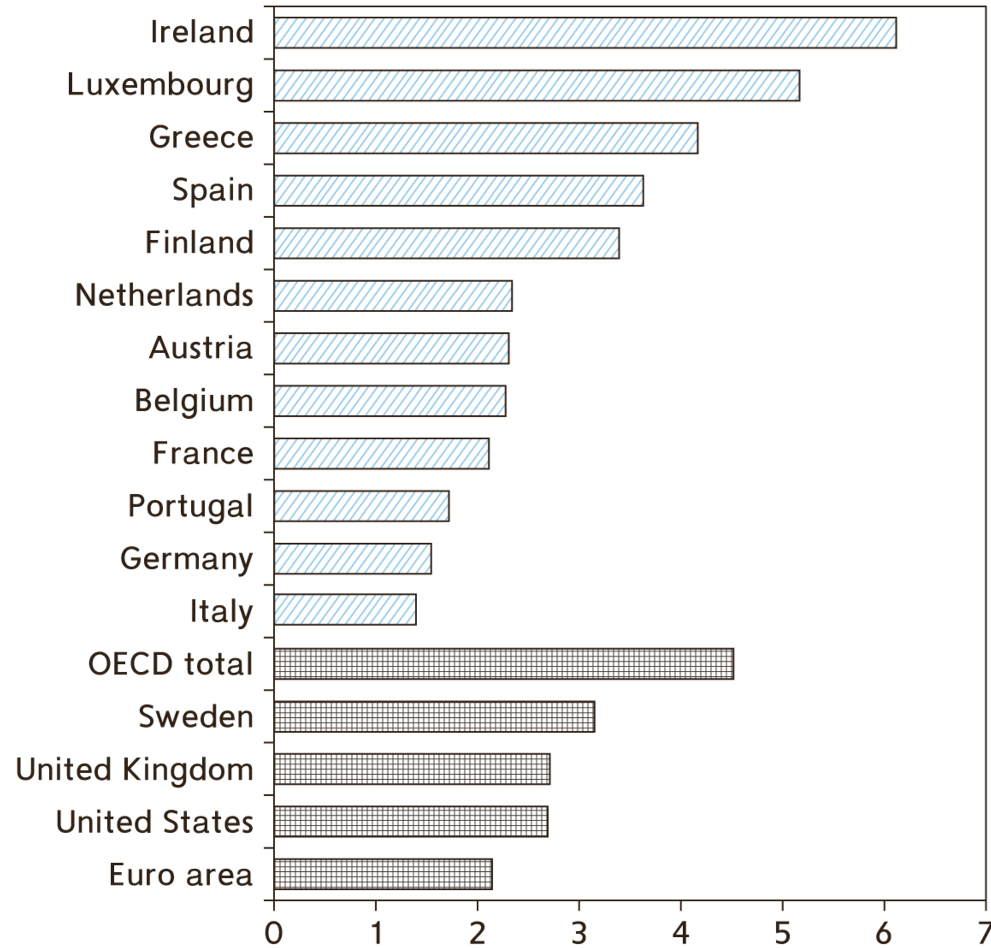
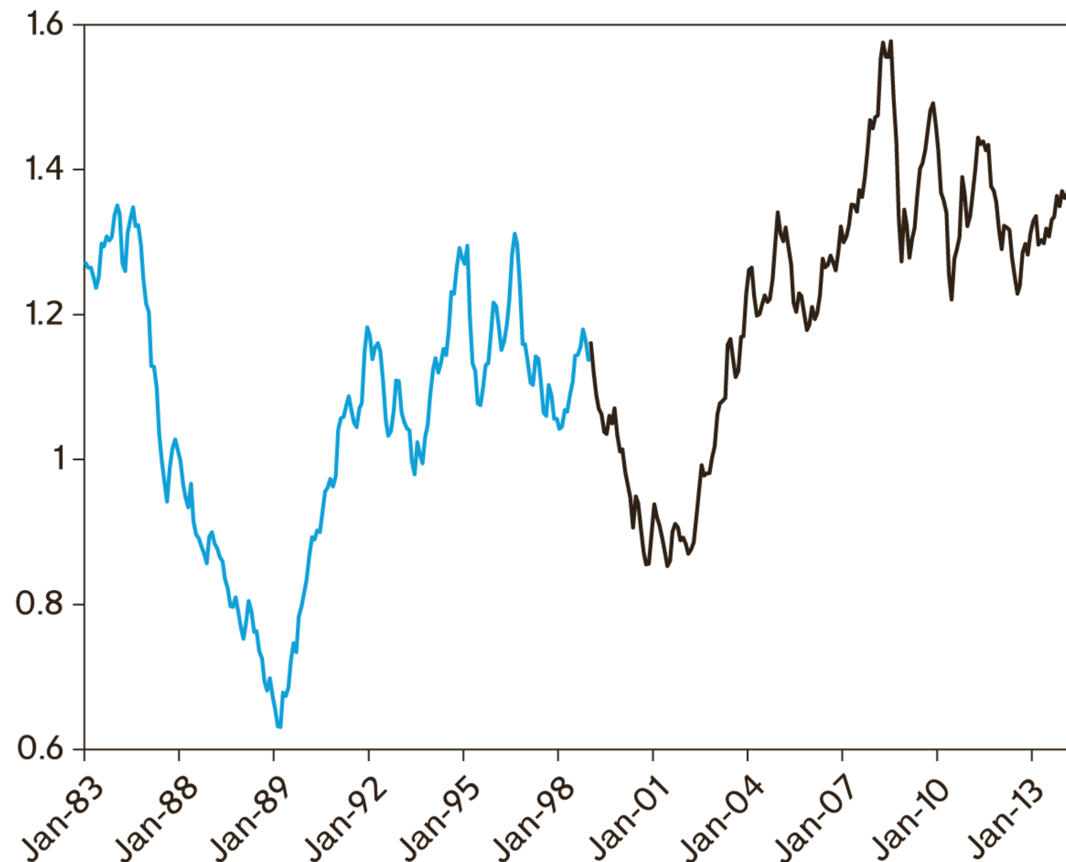
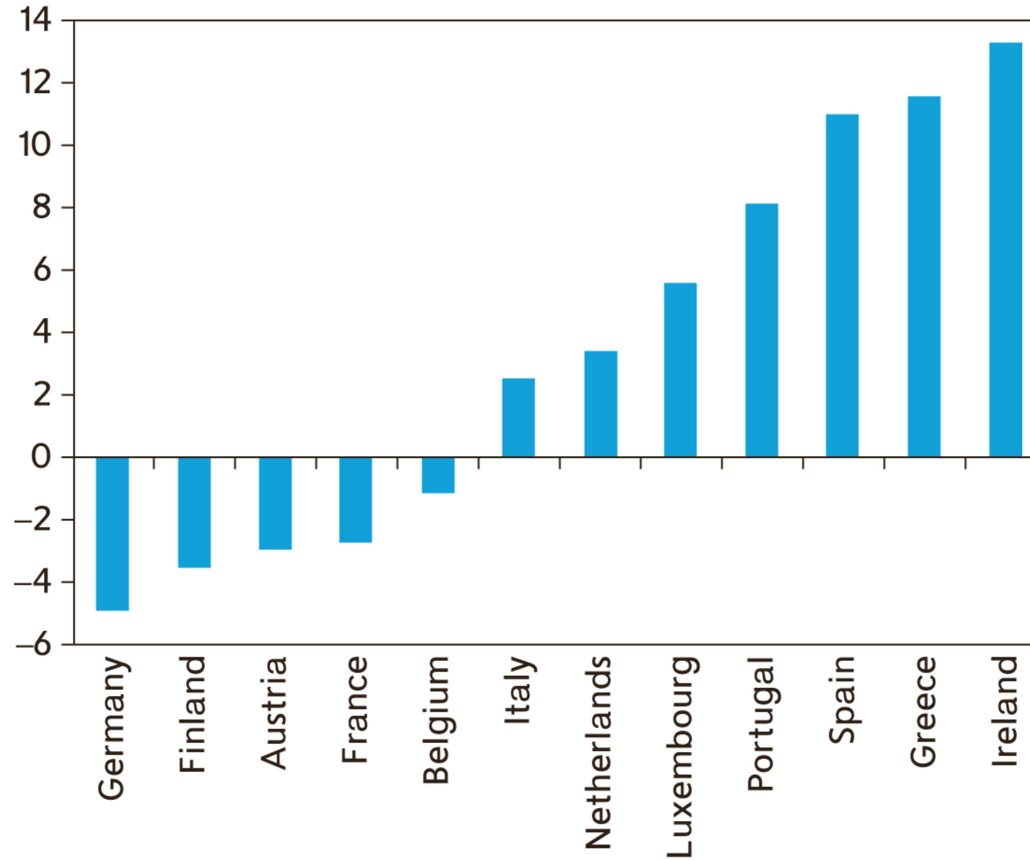


The first years (until the Great Crisis)



The first years (until the Great Crisis)

- Lasting differences in inflation:



The first years (until the Great Crisis)

- Still, large inflation differentials have occurred:
  - lower than average: Germany, France and Finland;
  - higher than average: Ireland, Spain, Portugal, Netherlands and Italy.
- Possible causes:
  - catching up in productivity levels;
  - wrong initial conversion rates;
  - autonomous wage and price setting;
  - policy mistakes, such as fiscal expansion;
  - asymmetric shocks, such as oil price effects.

The first years (until the Great Crisis)

- Diverging current account: