ECB Forum on Central Banking 2019

20 Years of European Economic and Monetary Union

The first 20 years of EMU

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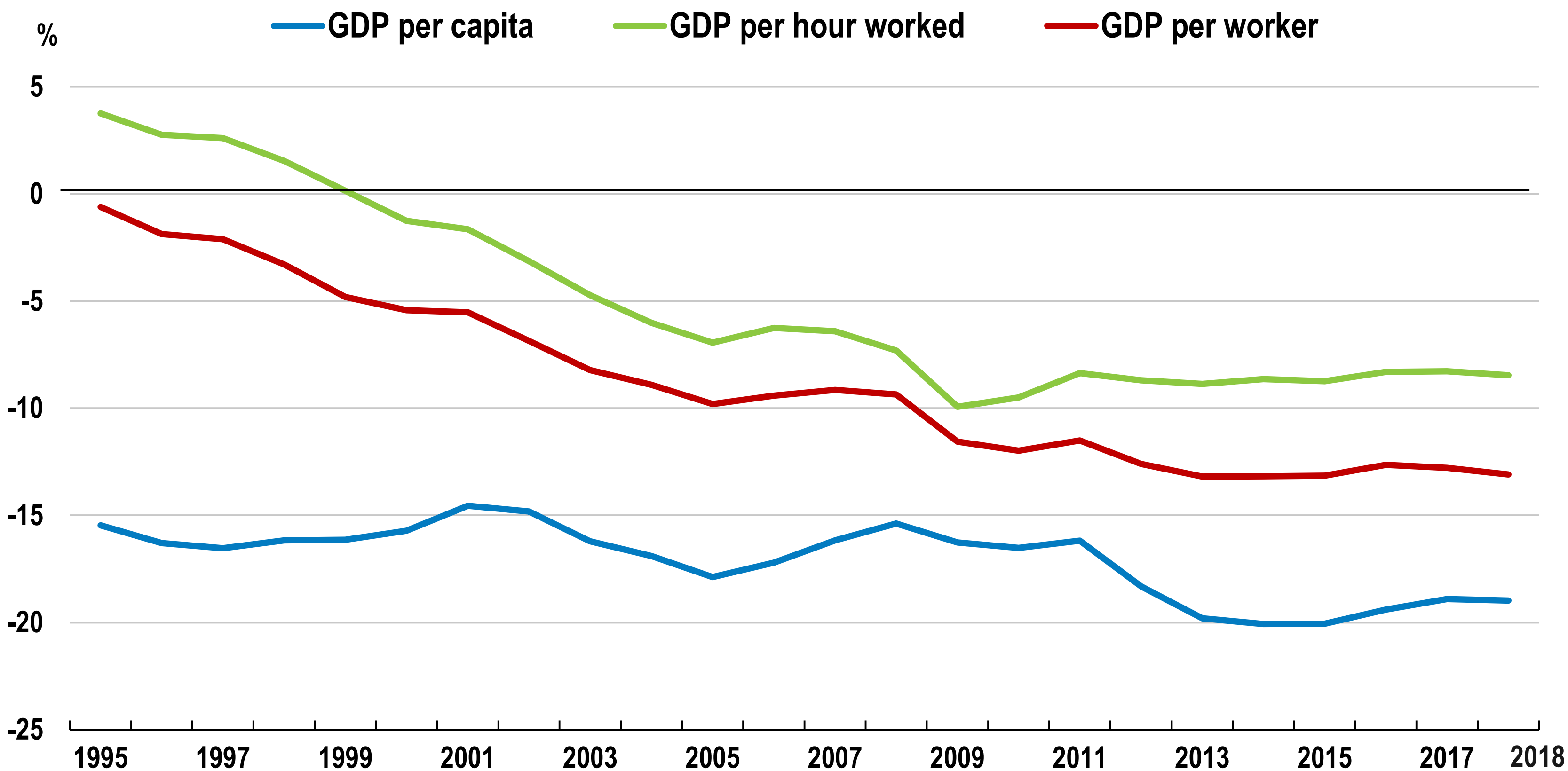
BETTER POLICIES FOR BETTER LIVES

Main messages

- **Euro area growth performance has been poor**, inflation roughly on target, financial outcomes mixed.
- **Possible causes**: structural features, policy mistakes, and architectural deficiencies that largely framed policy choices.
- **To (seek to) apportion responsibilities properly is key**: architectural reforms cannot address policy mistakes, while better policies will fail if the institutional underpinning is the real culprit.
- **Incomplete architecture seems to have played a larger role than policy mistakes** in the first 20 years of the euro.
- **Some policy frameworks may also need to be reviewed.**

Euro area growth performance has been poor: structural, macro or both?

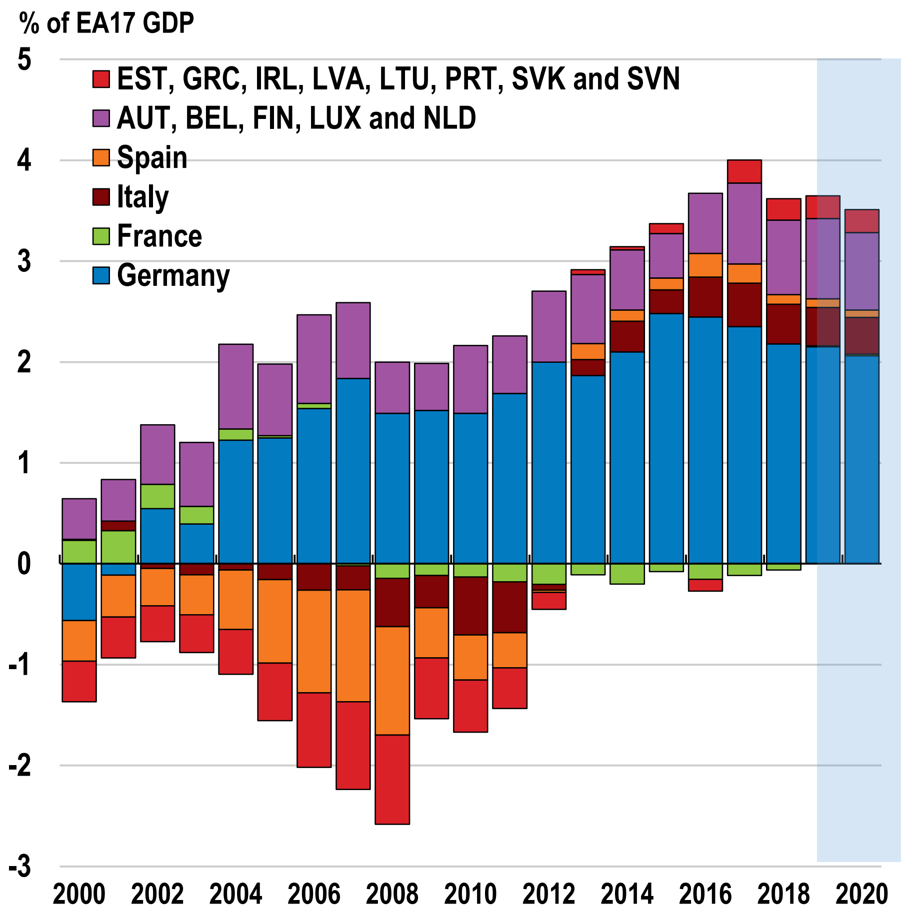
Euro area: Gap to the top 9 non-EA OECD countries



Note: Euro area member countries that are also members of the OECD, except for Estonia and Latvia due to limited data availability (15 countries). The top 9 non-EA OECD countries are Canada, Denmark, Iceland, Japan, Norway, Sweden, Switzerland, the United Kingdom and the United States.
Source: OECD (2019), *OECD Going for Growth Statistics* (database).

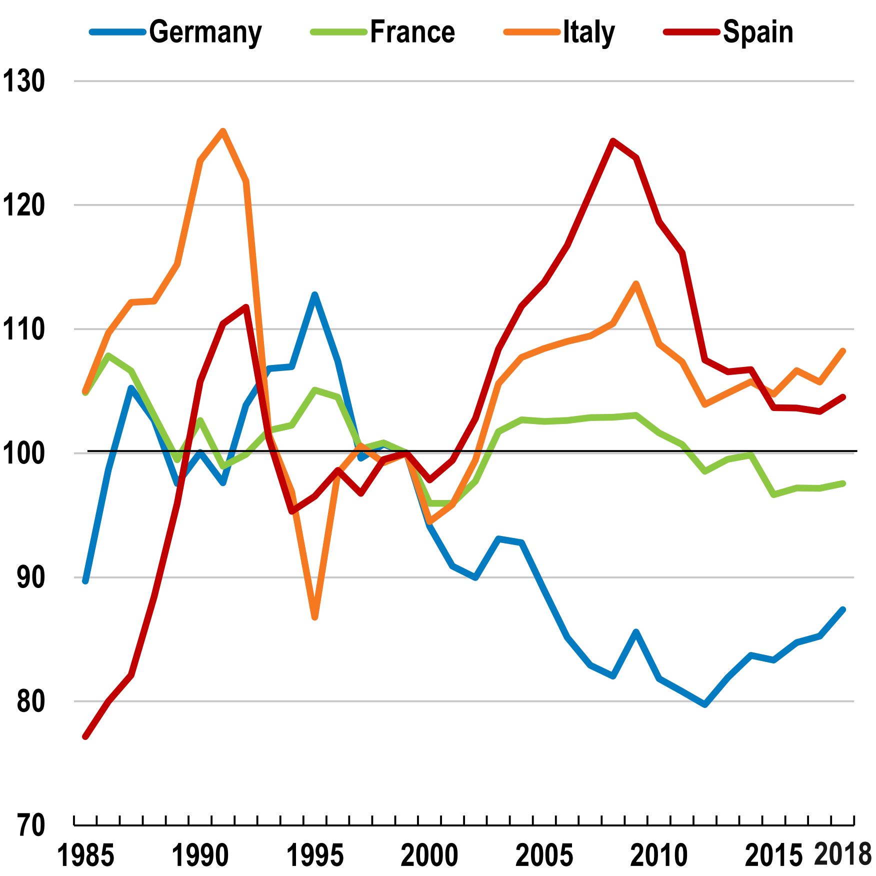
Wage and price adjustments have failed to address structural imbalances

Current account balances



Relative unit labour costs

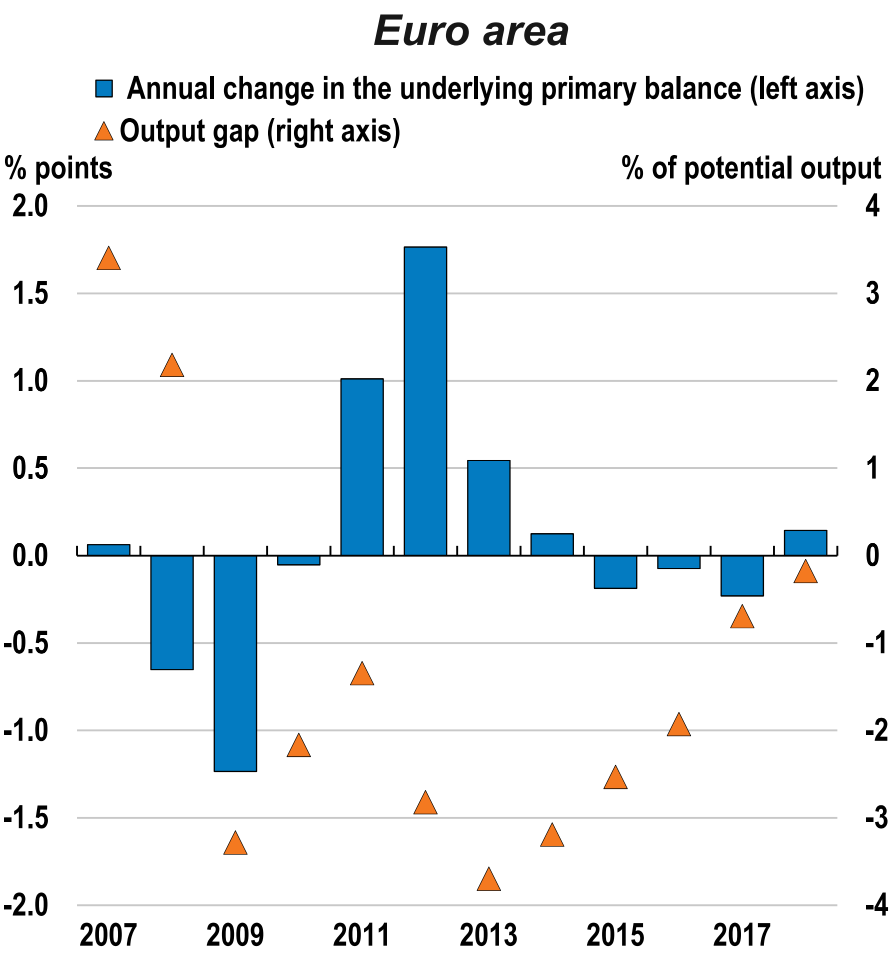
Index 1999 = 100

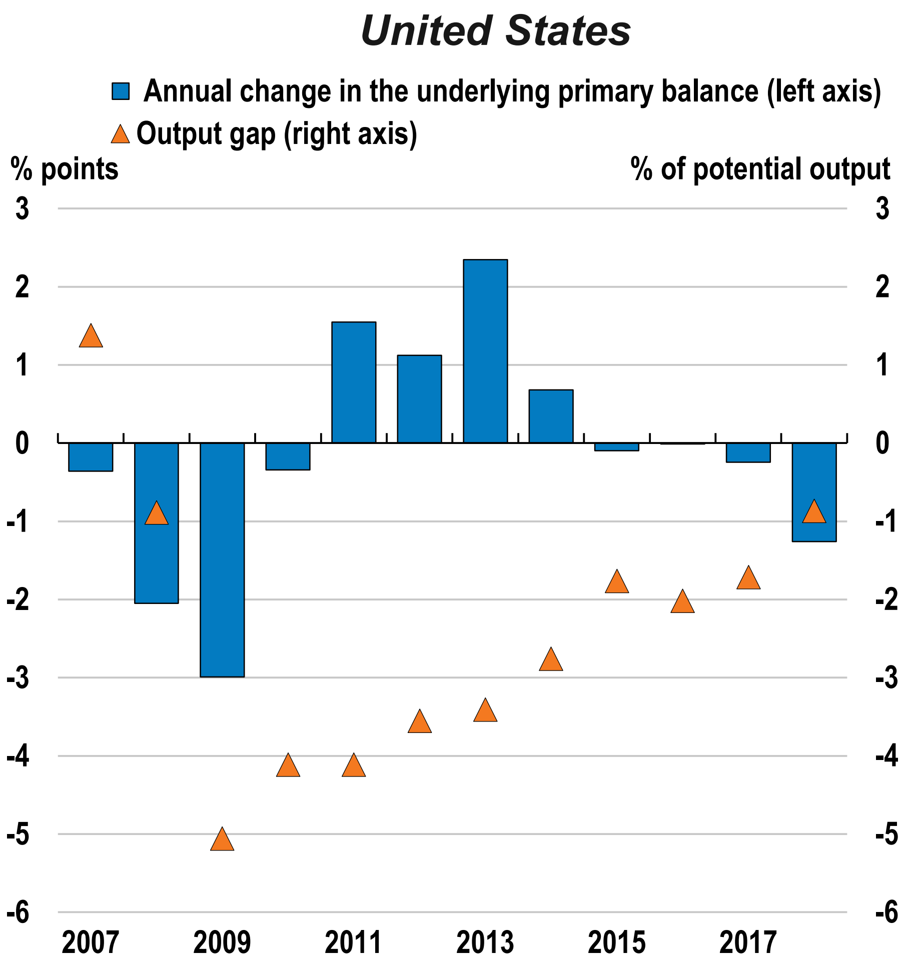


Note: RHS panel: Real effective exchange rate, ULC weights. An increase corresponds to lower competitiveness.
Source: OECD May 2019 Economic Outlook database; and OECD calculations.

Large and pro-cyclical consolidation in the euro area and the United States

Change in the fiscal stance

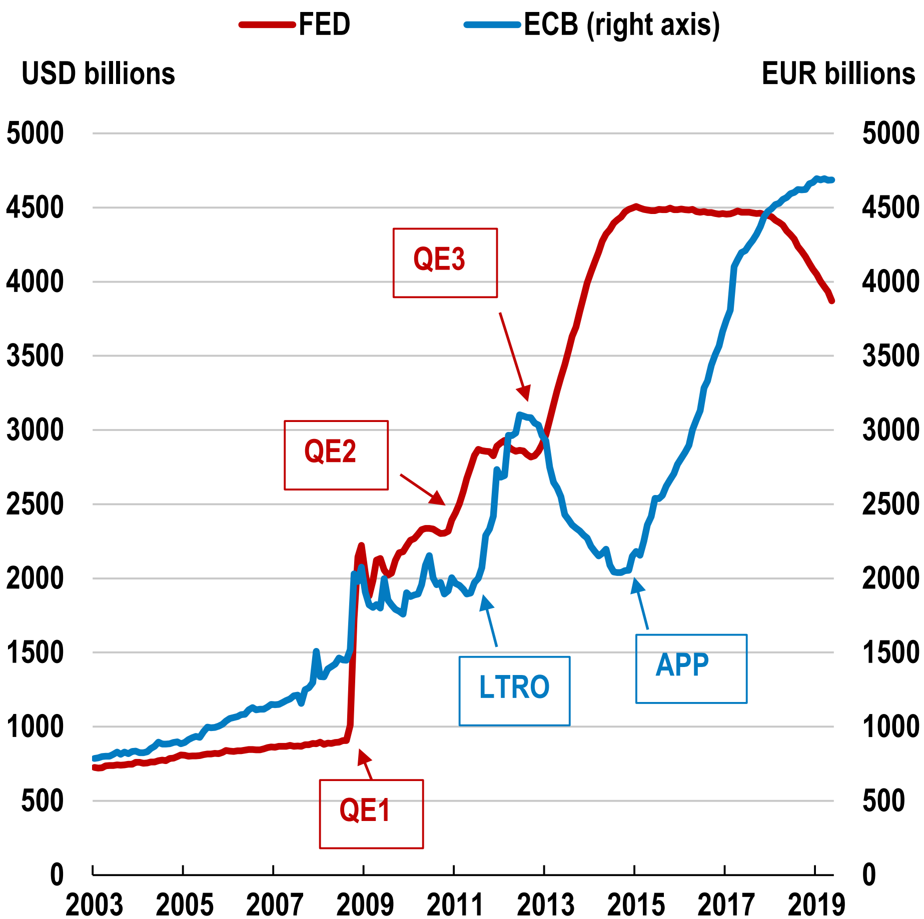




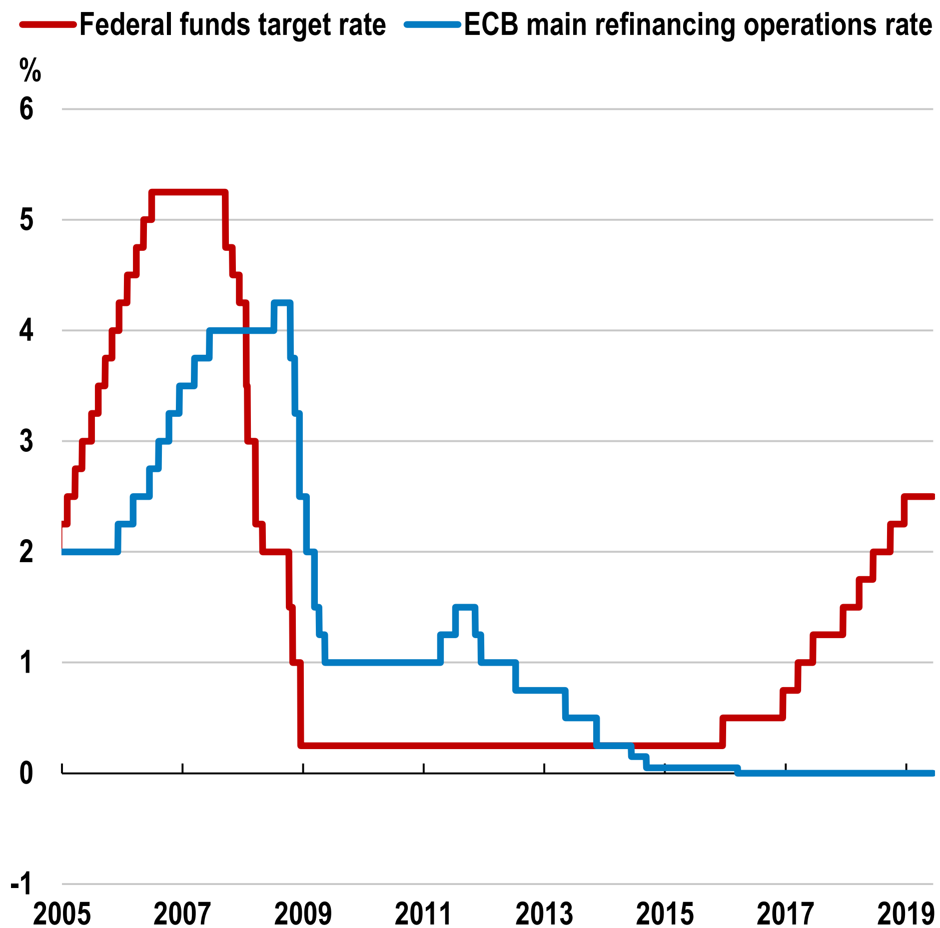
Note: The left chart shows members of the Euro area that are also members of the OECD (17 countries).
Source: OECD May 2019 Economic Outlook database; and OECD calculations.

The ECB followed the Fed with some lag: part policy, part institutional

Total assets



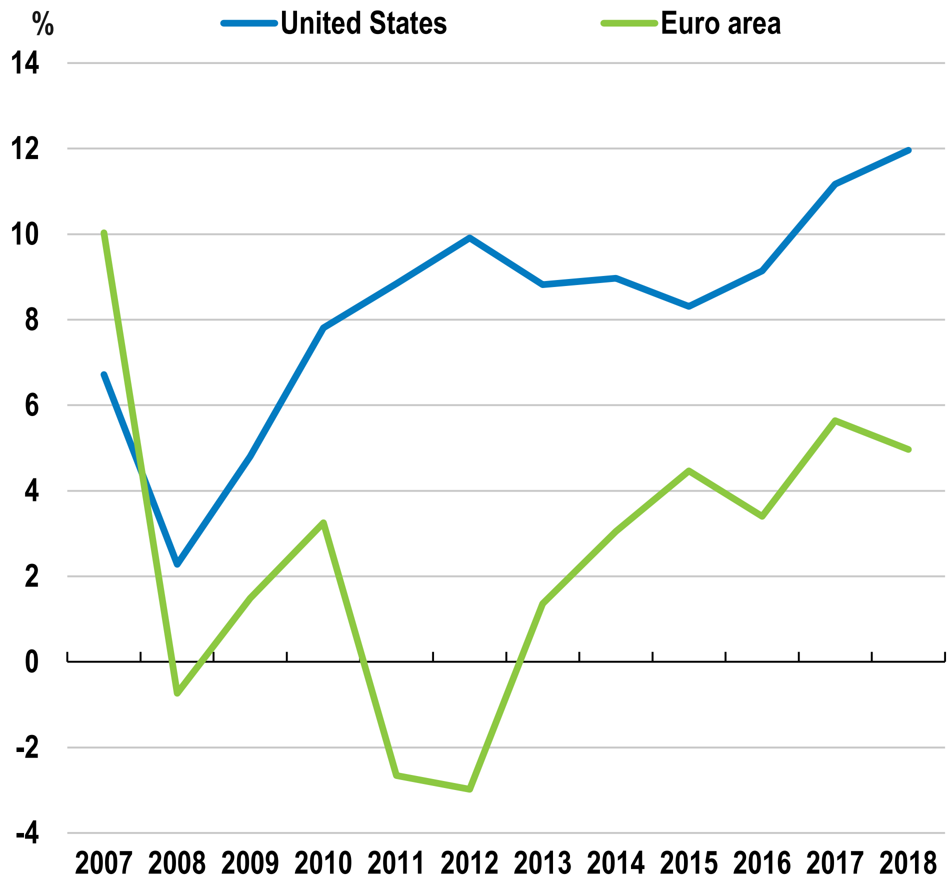
Policy rates



Source: Federal Reserve Board; and European Central Bank.

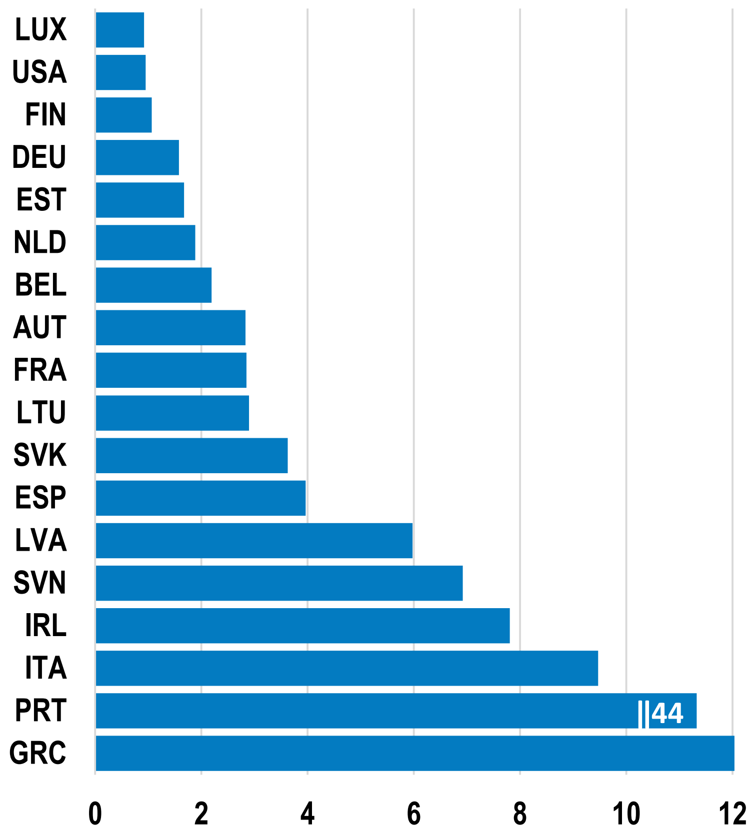
Euro area banks underperform their US peers

Return on equity of banks



Non-performing loans

% of total gross loans, latest available

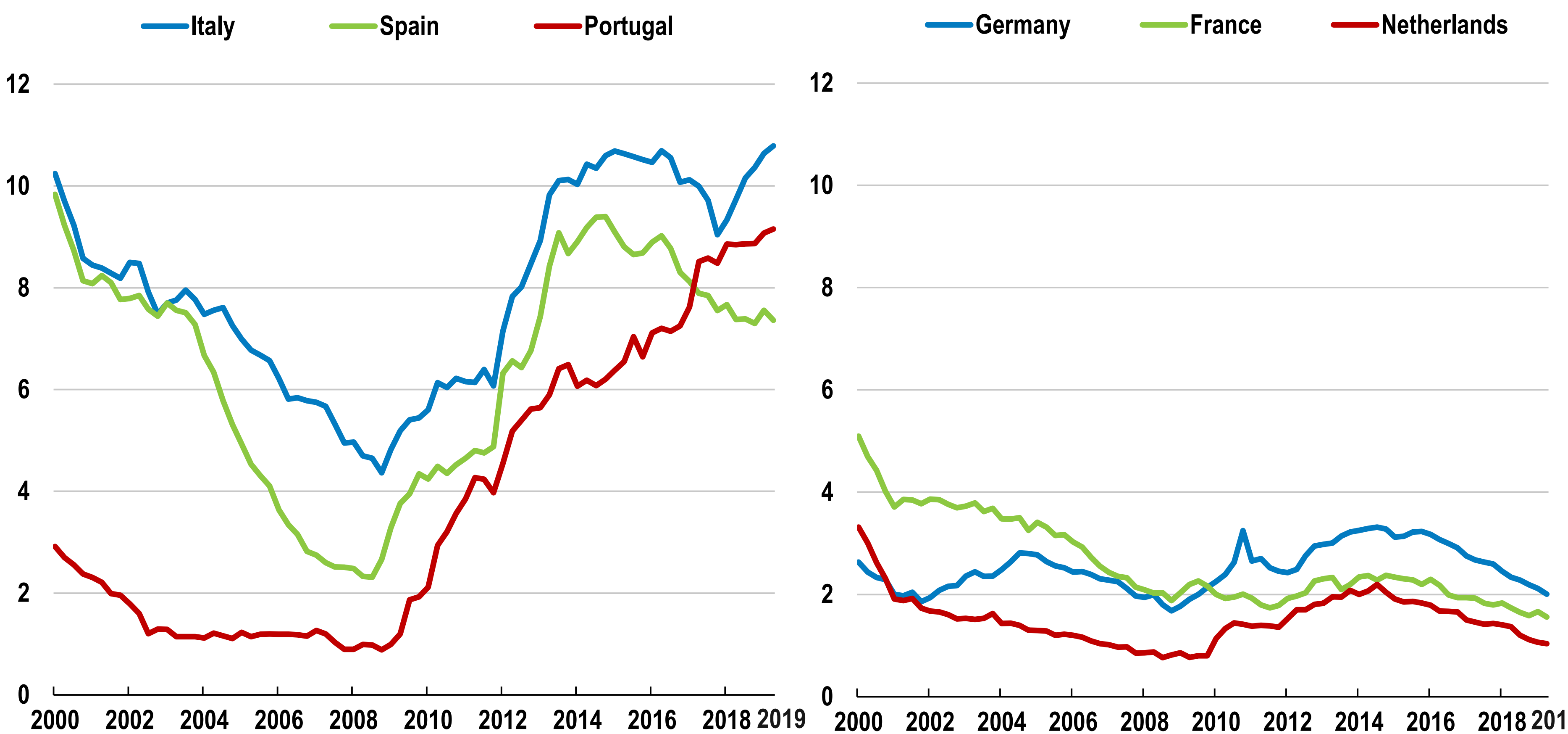


Source: ECB; and Federal Reserve Bank of St. Louis.

The incomplete financial architecture has perpetuated the bank-sovereign nexus

Domestic government debt securities

% of total bank assets



Source: ECB; and OECD calculations.

Conclusion: Institutional framework needs to evolve

Structural: national policies necessary but not sufficient in the face of severe shocks or profound divergence. Single market to be completed.

Macro policy: not counter-cyclical enough, hampered by lack of fiscal stabilisation, which is needed for:

- orchestrating coordination when a crisis or an exogenous shock hits a (weak) euro area economy
- allowing the CB to fulfill a backstop role for sovereign markets

Monetary policy:

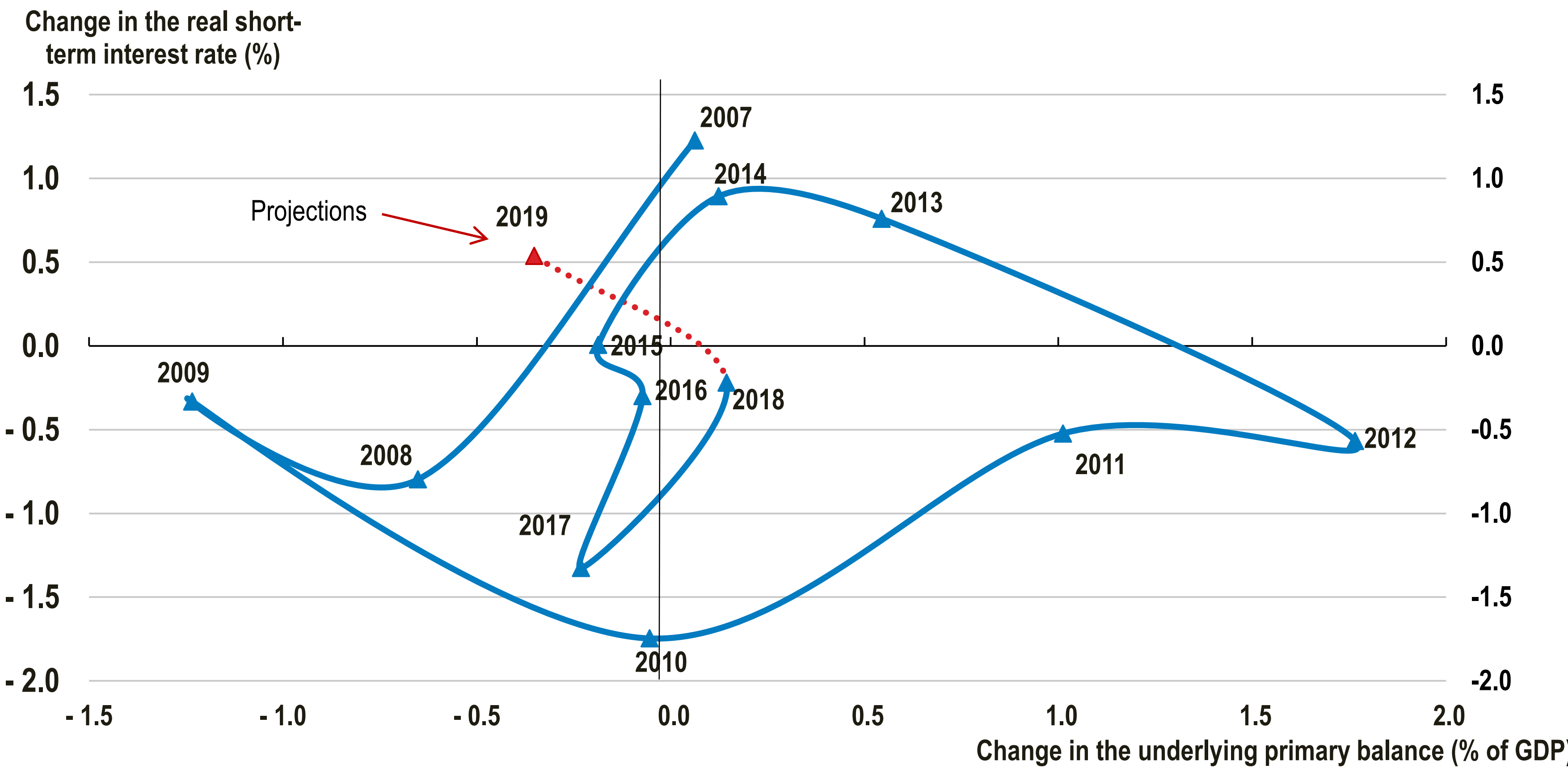
- delays due to innovation & search for (political) consensus
- target (adding employment, symmetry) may explain differences with US: review the framework

Financial policy: too fragmented and too horizontal. Banking union needs to be completed for:

- effective financial risk sharing
- severing the sovereign/bank nexus
- supporting effectiveness of demand and supply policies

The policy mix erred on the pro-cyclical side

Policy mix in the euro area



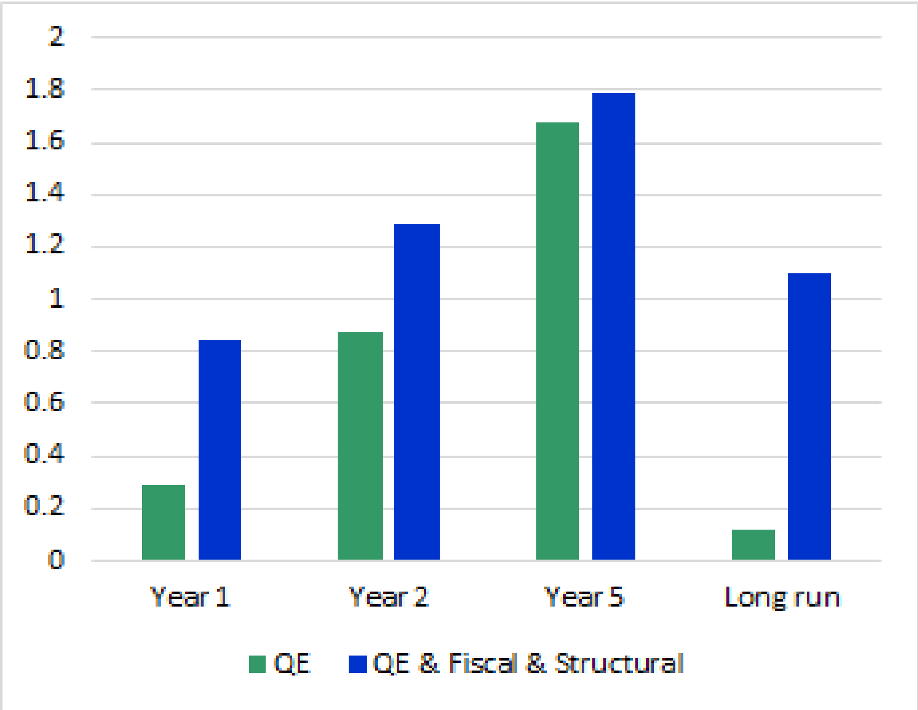
Note: In the absence of a consensus on the level of the natural interest rate, changes in real interest rates are used as a (rough) proxy of changes in the monetary stance (a more accurate measure would be changes in the gap between market and natural interest rates).

Source: ECB (2018), “Financial Market Data: Official Interest Rates”, Statistical Data Warehouse, European Central Bank; and OECD May 2019 Economic Outlook database.

A mix of monetary, fiscal and structural could have better supported GDP with limit effects on debt

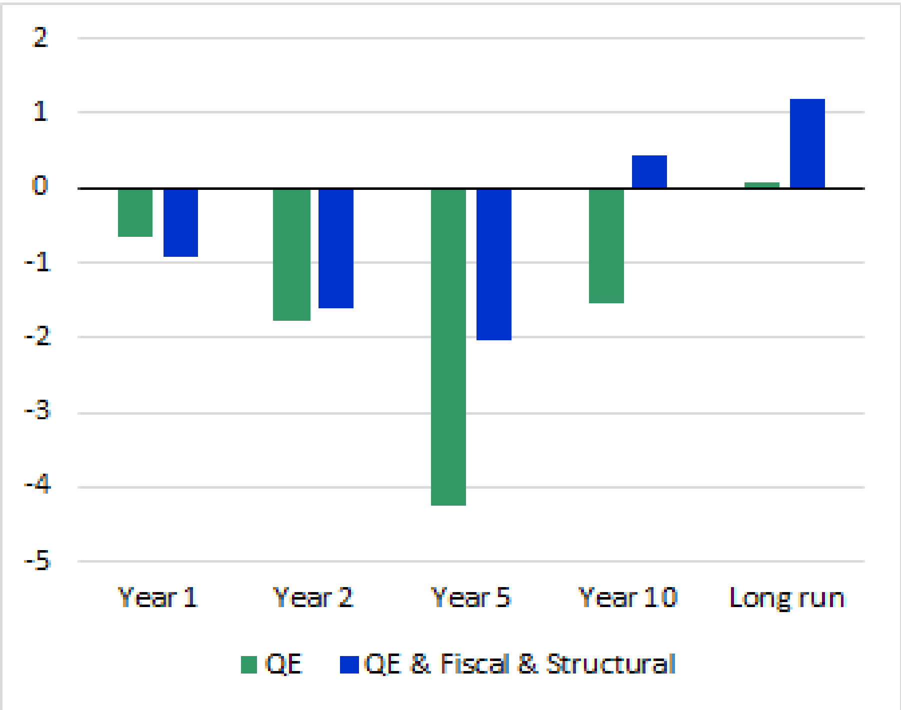
Real GDP, euro area

% difference from baseline



Government debt to GDP, euro area

Absolute difference from baseline, % of GDP

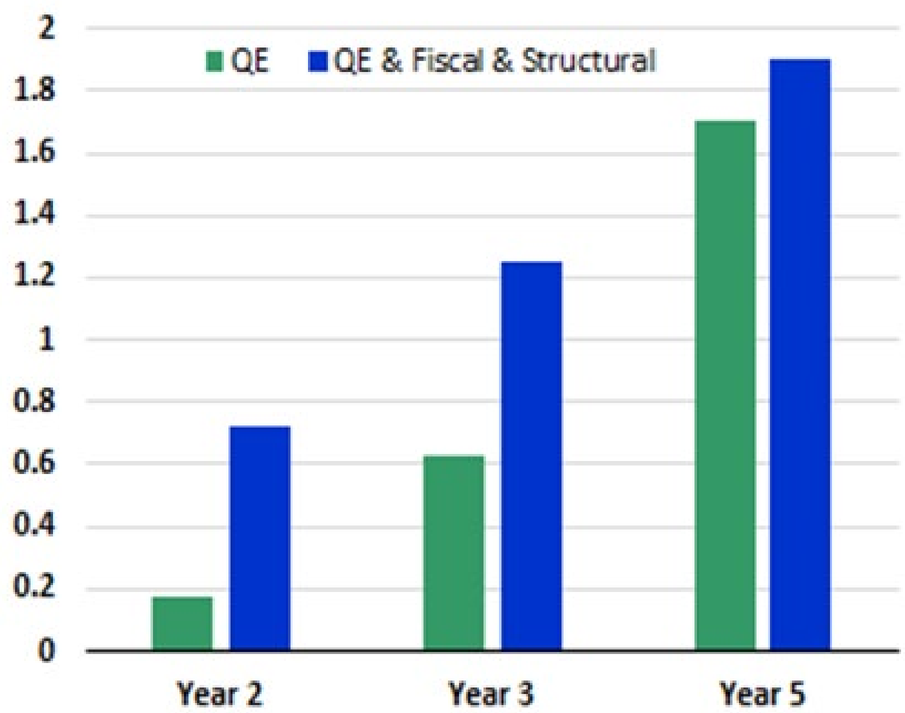


Note: Estimates are simulations using the NiGEM global macro-econometric model. "QE" scenario features: a gradual 5-year reduction in the term premium of 100bps, gradually phased out thereafter; fixed policy interest rates for 5 years; a nominal GDP target shifted up by 1%. "QE & fiscal & structural" scenario features: a gradual 5-year reduction in the term premium of 50 bps, gradually phased out thereafter; fixed policy interest rates for 5 years; a nominal GDP target shifted up by 1%; in countries with fiscal space (Austria, Germany, Baltic countries, the Netherlands and the Slovak Rep.) a debt-financed 0.75% of GDP rise in government investment for 5 years ; in other EA countries, 0.75% of GDP rise in government investment with no shift in budget target; the level of TFP is gradually raised by 1% by the fifth year in all countries.

Such a mix would have supported inflation in the short to medium term but with a smaller impact on asset prices

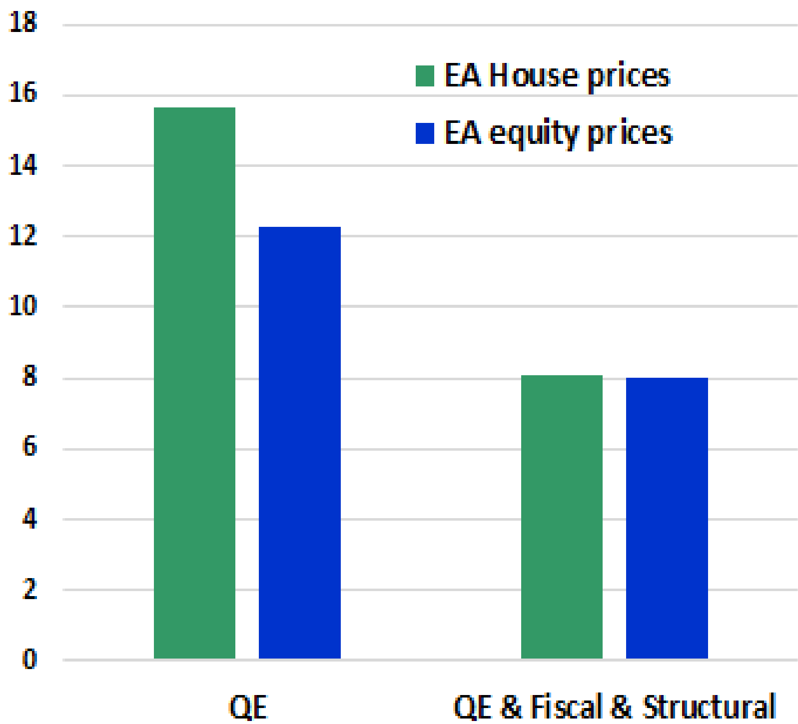
Consumer price level, euro area

% difference from baseline



Asset prices after five years

% difference from baseline

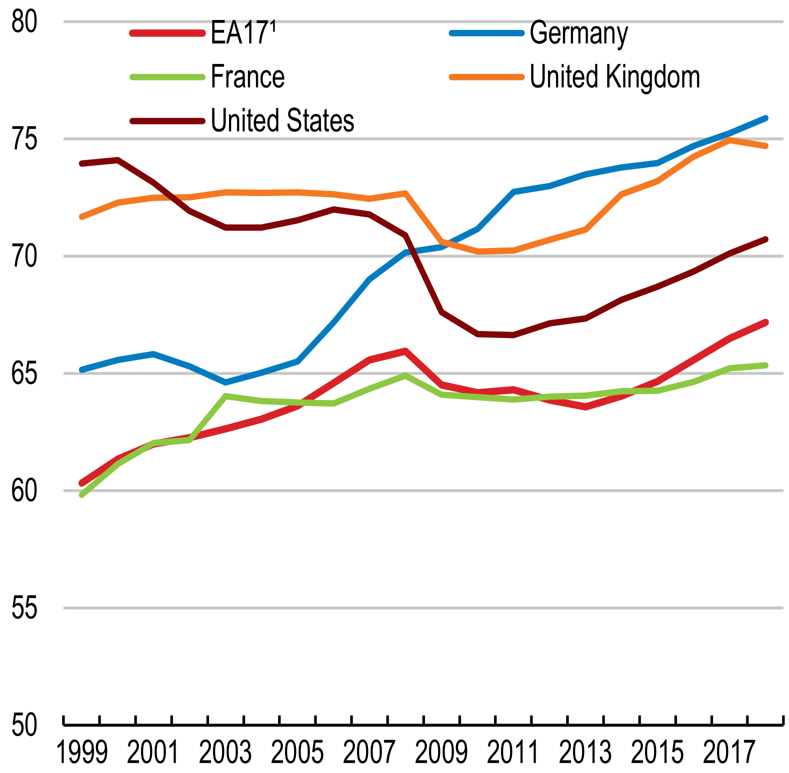


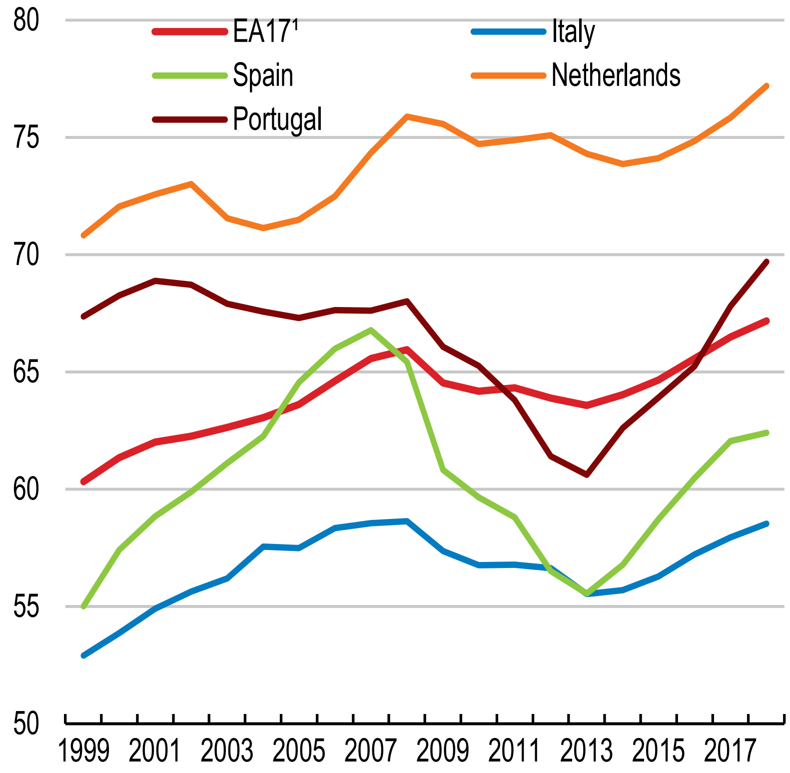
Note: Estimates are simulations using the NiGEM global macro-econometric model. House prices and equity prices for EA are PPP weighted average for Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain.

Employment developments

Employment rates in selected countries

% of the population aged 15-64 years old

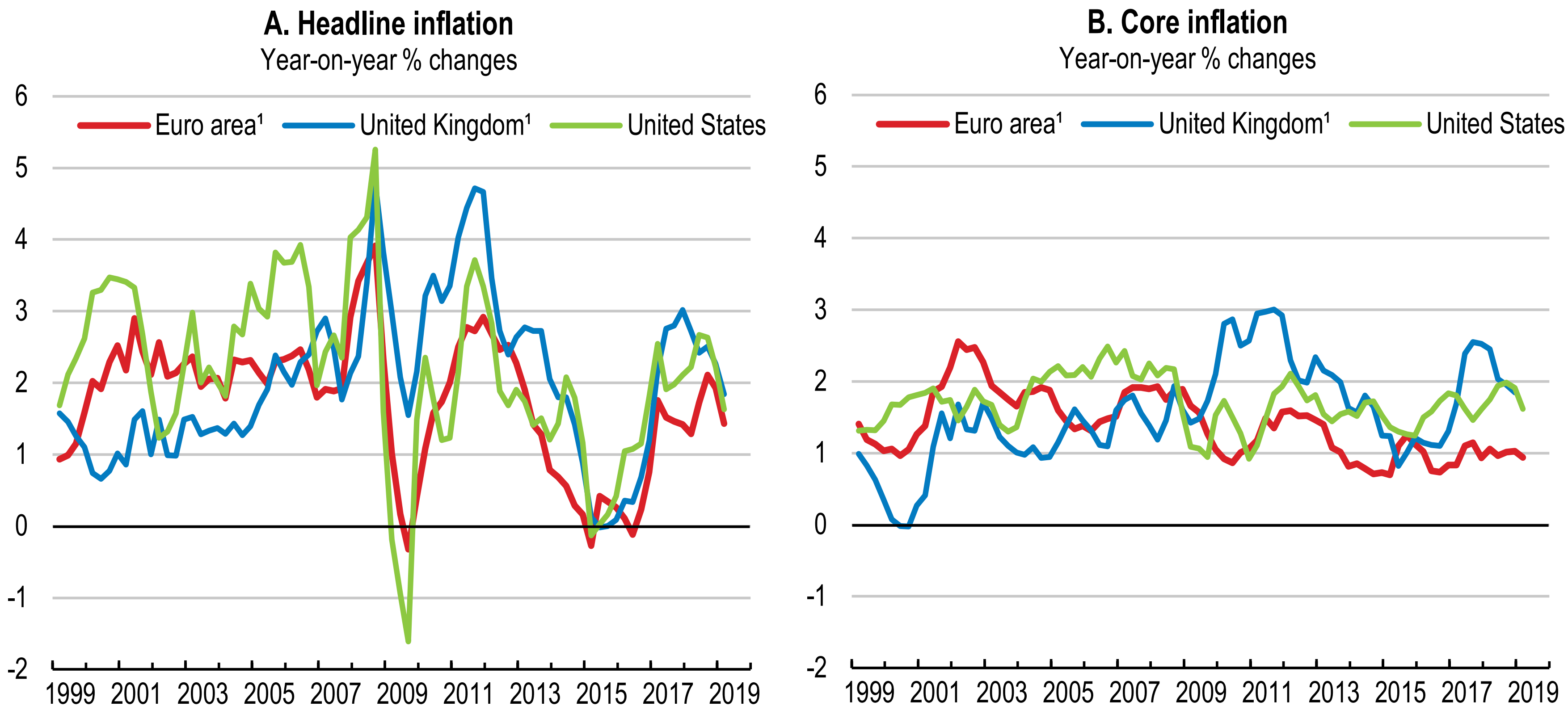




1. Euro area member countries that are also members of the OECD (17 countries).

Source: OECD (2019), OECD Labour Force Statistics (database).

Inflation developments



1. Harmonised indices.

Source: OECD May 2019 Economic Outlook database.