

# The euro is 20 – time to grow up

By [Jérôme Creel](#) and [Francesco Saraceno](#) [1]

At age twenty, the euro has gone through a difficult adolescence. The [success of the euro](#) has not been aided by a series of problems: growing divergences; austerity policies with their real costs; the refusal in the centre to adopt expansionary policies to accompany austerity in the periphery countries, which would have minimized austerity's negative impact, while supporting activity in the euro zone as a whole; and finally, the belated recognition of the need for intervention through a quantitative easing monetary policy that was adopted much later in Europe than in other major countries; and a fiscal stimulus, the Juncker plan, that was too little, too late.

Furthermore, the problems facing the euro zone go beyond managing the crisis. The euro zone has been growing more slowly than the United States since at least 1992, the year the Maastricht Treaty was adopted. This is due in particular to the inertia of economic policy, which has its roots in the euro's institutional framework: a very limited and restrictive mandate for the European Central Bank, along with fiscal rules in the Stability and Growth Pact, and then in the 2012 Fiscal Compact, which leave insufficient room for stimulus policies. In fact, Europe's institutions and the policies adopted before and during the crisis are loaded down with the consensus that emerged in the late 1980s in macroeconomics which, under the assumption of efficient markets, advocated a "by the rules" economic policy that had a necessarily limited role. The management of the crisis, with its fiscal stimulus packages and increased central bank activism, posed a [real challenge to this consensus](#), to such an extent that the economists who were supporting it are now questioning the direction that the

discipline should take. Unfortunately, this questioning has only marginally and belatedly affected Europe's decision-makers.

On the contrary, we continue to hear a discourse that is meant to be reassuring, i.e. while it is true that, following the combination of austerity policies and structural reforms, some countries, such as Greece and Italy, have not even regained their pre-2008 level of GDP, this bitter potion was needed to ensure that they emerge from the crisis more competitive. This discourse is not convincing. [Recent literature](#) shows that deep recessions have a negative impact on potential income, with the conclusion that austerity in a period of crisis can have long-term negative effects. A glance at the World Economic Forum competitiveness index, as imperfect as it is, nevertheless shows that none of the countries that enacted austerity and reforms during the crisis saw its ranking improve. The conditional austerity imposed on the countries of the periphery was doubly harmful, in both the long and short terms.

In sum, a look at the policies carried out in the euro zone leads to an irrevocable judgment on the euro and on European integration. Has the time come to concede that the Exiters and populists are right? Should we prepare to manage European disintegration so as to minimize the damage?

There are several reasons why we don't accept this. First, we do not have a counterfactual analysis. While it is true that the policies implemented during the crisis have been calamitous, how certain can we be that Greece or Italy would have done better outside the euro zone? And can we say unhesitatingly that these countries would not have pursued free market policies anyway? Are we sure, in short, that Europe's leaders would have all adopted pragmatic economic policies if the euro had not existed? Second, as the result of two years of Brexit negotiations shows, the process of disintegration is anything but a stroll in the park. A

country's departure from the euro zone would not be merely a Brexit, with the attendant uncertainties about commercial, financial and fiscal relations between a 27 member zone and a departing country, but rather a major shock to all the European Union members. It is difficult to imagine the exit of one or two euro zone countries without the complete breakup of the zone; we would then witness an intra-European trade war and a race for a competitive devaluation that would leave every country a loser, to the benefit of the rest of the world. The costs of this kind of economic disorganization and the multiplication of uncoordinated policies would also hamper the development of a [socially and environmentally sustainable European policy](#), as the European Union is the only level commensurate with a credible and ambitious policy in this domain.

To say that abandoning the euro would be complicated and/or costly, is not, however, a solid argument in its favour. There is a stronger argument, one based on the rejection of the equation "euro = neoliberal policies". Admittedly, the policies pursued so far all fall within a neoliberal doctrinal framework. And the institutions for the European Union's economic governance are also of course designed to be consistent with this doctrinal framework. But the past does not constrain the present, nor the future. Even within the current institutional framework, different policies are possible, as shown by the (belated) activism of the ECB, as well as the exploitation of the flexibility of the Stability and Growth Pact. Moreover, institutions are not immutable. In 2012, six months sufficed to introduce a new fiscal treaty. It headed in the wrong direction, but its approval is proof that reform is possible. We have worked, and we are not alone, on two possible paths for reform, a [dual mandate](#) for the ECB, and a [golden rule for public finances](#). But other possibilities could be mentioned, such as a [European unemployment insurance](#), a [European budget](#) for managing the business cycle, or modification of the European fiscal rules. On this last point,

the proposals are proliferating, including for a rule on expenditures by [fourteen Franco-German economists](#), or the [replacement of the 3% rule by a coordination mechanism](#) between the euro zone members. Reasonable proposals are not lacking. What is lacking is the political will to implement them, as is shown by the slowness and low ambitions (especially about the euro zone budget) of the decisions taken at the [euro zone summit on 14 December 2018](#).

The various reforms that we have just mentioned, and there are others, indicate that a change of course is possible. While some policymakers in Europe have shown stubborn persistence, almost tantamount to bad faith, we remain convinced that neither European integration nor the euro is inevitably linked to the policies pursued so far.

[\[1\]](#) This post is an updated and revised version of the article “Le maintien de l’euro n’est pas synonyme de politiques néolibérales” [Maintaining the euro is not synonymous with neoliberal policy], which appeared in *Le Monde* on 8 April 2017.

---

## **Non-performing loans – A danger for the Banking Union?**

By [Céline Antonin](#), [Sandrine Levasseur](#) and [Vincent Touzé](#)

The establishment of the third pillar of the Banking Union, namely the creation of a European deposit insurance scheme,

has been blocked up to now. Some countries – like Germany and the Netherlands – are arguing that the risk of bank default is still too heterogeneous in the euro zone to allow deposit guarantees to be pooled.

Our article, [L'Union bancaire face au défi des prêts non 'performants'](#) ["The Challenge of Non-performing Loans for the Banking Union"], focuses on how to solve the "problem" of non-performing loans (NPLs) in a way that can break this deadlock and finally complete the Banking Union. This is a crucial step in order to restore confidence and allow the emergence of an integrated banking market.

Our review of the current situation shows that:

1. The level of NPLs is still worrying in some countries. The situation is alarming in Cyprus and Greece, where unprovisioned NPLs represent more than 20% of GDP, whereas the situation is "merely" worrying for Slovenia, Ireland, Italy and Portugal, where unprovisioned NPLs are between 5% and 8% of GDP;
2. In total, at end 2017, the amount of unprovisioned NPLs for the euro area came to 395 billion euros, which is equivalent to 3.5% of euro area GDP. On this scale, the "problem" of non-provisioned NPLs thus seems more modest.

Looking beyond private solutions such as debt forgiveness, provisioning, securitization and the creation of bad banks, our conclusion is that it is the public authorities at the European level who ultimately have the most effective means of action. They have multiple levers at their disposal, including the definition of the relevant regulatory and institutional framework; supervision by the ECB, which could be extended to more banks; and not least monetary and fiscal policies at the euro zone level, which could be mobilized to buy up doubtful debt or enter the capital of banks experiencing financial distress.

---

# What role for central bank balance sheets in the conduct of monetary policy?

By [Christophe Blot](#), [Jérôme Creel](#) and [Paul Hubert](#)

By adjusting the size and composition of their balance sheets, the central banks have profoundly changed their monetary policy strategy. Although the implementation of these measures was initially envisaged for a period of crisis, questions are now arising about the use of the balance sheet as an instrument of monetary policy outside periods of crisis.

The central banks' securities purchase policy has resulted in significantly expanding the size of their balance sheets. In September 2017, the balance sheets of the Federal Reserve and the European Central Bank amounted, respectively, to nearly 4,500 billion dollars (23.3% of US GDP) and 4,300 billion euros (38.5% of euro zone GDP), while in June 2007 they were 870 billion dollars (or 6.0% of GDP) and 1,190 billion euros (12.7% of GDP). The end of the financial crisis and the economic crisis calls for a gradual tightening of monetary policy, which is already underway in the United States and forthcoming in the euro zone. The Federal Reserve, for instance, has raised the key interest rate five times since December 2015, and in October 2017 it began to reduce the size of its balance sheet. However, no precise indication has been given as to the size of the bank's balance sheet once the

process of normalization has been completed. Beyond simply size, there is also the question of the role that these balance sheet policies will play in the conduct of monetary policy in the future.

Initially, the measures taken during the crisis had to be exceptional and temporary. The aim was to satisfy a need for substantial liquidity and to act directly on the prices of certain assets or on the long end of the yield curve at a time when the standard monetary policy instrument – short-term interest rates – was constrained by the zero lower bound (ZLB). The use of these measures over a prolonged period – the last ten years – suggests, however, that the central banks could continue to use their balance sheets as a tool of monetary policy and financial stability, including in so-called “normal” periods, that is to say, even when there is enough maneuvering room to lower the key rate. Not only have these unconventional measures demonstrated some effectiveness, but their transmission mechanisms do not seem to be specific to periods of crisis. Their use could thus both enhance the effectiveness of monetary policy and improve the central banks’ ability to achieve their macroeconomic and financial stability objectives. We develop these arguments in a [recent publication](#) that we summarize here.

In an article presented at the 2016 Jackson Hole conference, [Greenwood, Hanson and Stein](#) suggested that the central banks could use their balance sheets to provide liquidity to meet a growing need in the financial system for liquid, risk-free assets. The extra reserves thus issued would increase the stock of safe assets that could be drawn on by commercial banks, enhancing financial stability. The central banks could also intervene more regularly in the markets to influence the price of certain assets or risk premiums or term premiums. What is involved here is not necessarily a matter of increasing or reducing the size of the balance sheet, but of modulating its composition in order to correct any distortions

or to strengthen the transmission of monetary policy by intervening in all segments of the rate curve. During the sovereign debt crisis, the ECB launched a [Securities Market Programme](#) (SMP) aimed at reducing the risk premiums on the yields of several countries (Greece, Portugal, Ireland, Spain and Italy) and at improving the transmission of the common monetary policy to these countries. In 2005, the Chairman of the Federal Reserve encountered an [enigma](#) on the bond markets when noting that long-term rates did not seem to be responding to the ongoing tightening of US monetary policy. The use of targeted purchases of securities with longer maturities would no doubt have improved the transmission of the monetary policy, as was being sought at that time by the Federal Reserve.

In practice, the implementation of a strategy like this in “normal” times raises several issues. First, if the balance sheet policy complements the interest rate policy, the central banks will have to accompany their decisions with the appropriate communications, specifying both the overall direction of monetary policy and the reasons justifying the use and the goal of such a policy. It seems that they managed to do this during the crisis, even as the number of programmes proliferated; there is therefore no reason to think that suddenly communications like this would become more difficult to implement in a “normal” period. Furthermore, using the balance sheet as a monetary policy instrument more frequently would result in holding more, and potentially riskier, assets. In these circumstances, there would be a trade-off between the efficacy that could be expected from monetary policy and the risks being taken by the central bank. It should also be noted that using the balance sheet does not necessarily mean that its size would be constantly growing. Central banks could just as easily choose to sell certain assets whose price was deemed to be too high. However, in order to be able to effectively modulate the composition of the central bank’s assets, its balance sheet must be large enough to facilitate its portfolio



operations.

It should be recognized that economists have not yet fully analyzed the potential effects of balance sheet policies on macroeconomic and financial stability. But the remaining uncertainty should not prevent the central banks from making use of balance sheet policies, as only experience can lead to a comprehensive assessment of the power of balance sheet policies. The history of the central banks is a reminder that the objectives and instruments used by central banks have changed steadily [\[1\]](#). A new paradigm shift thus seems possible. If balance sheet policies are able to enhance the effectiveness of monetary policy and improve financial stability, central banks should seriously consider their use.

For more, see: Christophe Blot, Jérôme Creel, Paul Hubert, [“What should the ECB ‘new normal’ look like?”](#), *OFCE policy brief* 29, 20 December.

[\[1\]](#) See [Goodhart](#) (2010).

---

# The redistributive effects of the ECB's QE programme

By Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Xavier Ragot

Rising inequality in income and wealth has become a key issue in discussions of economic policy, and the topic has inserted itself into evaluations of the impact of monetary policy in the US and Japan, the precursors of today's massive

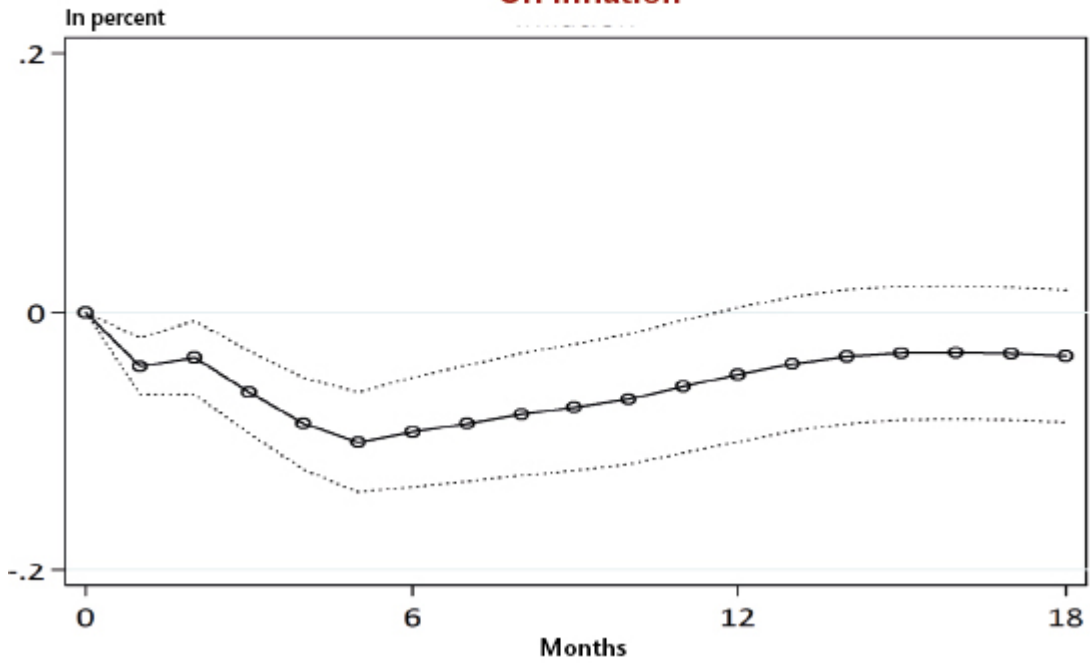
quantitative easing programmes (QE). The question is thus posed as to whether the ECB's QE policy has had or will have redistributive effects.

In a paper prepared for the European Parliament, [Blot et al. \(2015\)](#) point out that the empirical literature gives rise to two contradictory conclusions. In the US, the Fed's base rate cuts tend to reduce inequality. Conversely, in Japan an expansionary QE type policy tends to increase inequality. So what's the situation in Europe?

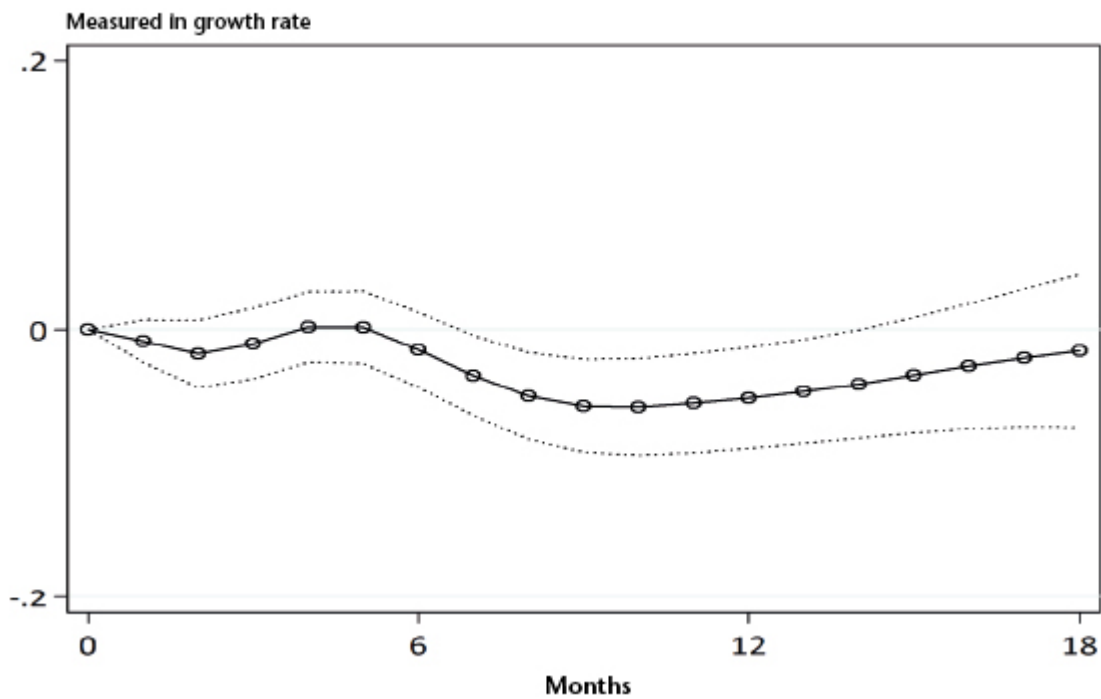
Based on macroeconomic data aggregated for the euro zone as a whole, Blot et al. (2015) show that while European monetary policy, conventional and unconventional, have indeed had an impact on the unemployment rate, the number of hours worked and the rate of inflation (see graphs), this was limited. This result suggests that the ECB's expansionary monetary policy has tended to reduce inequality, but not by much. So when the ECB finally decides to wind up its expansionary policy, we can expect a slight increase in inequalities to follow. Because of this effect, though small, Blot et al. (2015) suggest that the ECB should be held accountable not just for price stability or economic growth, but also for the impact of its policies in terms of inequality and the mechanisms needed to take this into account.

Figures. The impact of a restrictive monetary policy shock (0.2 percentage point hike in the implicit interest rate) in the euro zone...

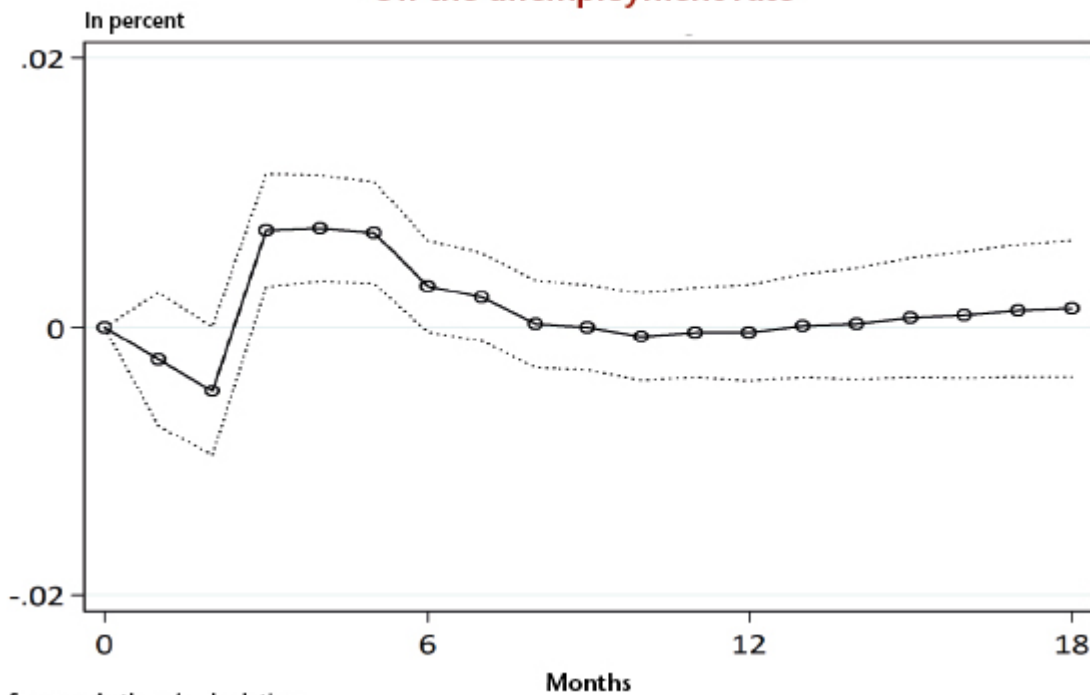
**On inflation**



**On hours worked**



## On the unemployment rate



# Why a negative interest rate?

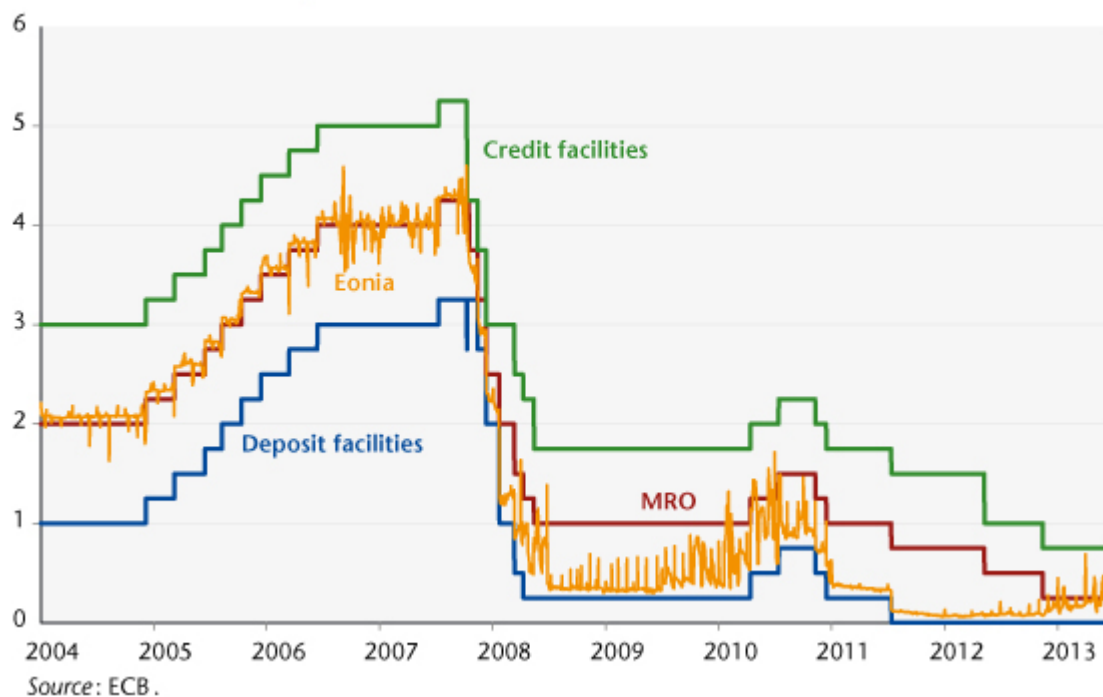
[Christophe Blot](#) and [Fabien Labondance](#)

As expected, on 5 June 2014 the European Central Bank (ECB) unleashed an arsenal of new unconventional measures. The aim is to curb deflationary tendencies in the euro zone. Among the measures announced, the ECB decided in particular to apply a negative interest rate to deposit facilities. This unprecedented step deserves an explanation.

Note that since July 2012, the rate on deposit facilities has been 0%. It now falls to -0.10%, meaning that a bank depositing cash at the ECB will have its deposit reduced by that rate. Before considering the repercussions of this measure, it is worth clarifying the role of deposit facilities. The ECB's activity is based on loans to credit institutions in the euro zone through the channel of main

refinancing operations (MRO) or long-term refinancing operations (LTRO). Prior to the crisis, these operations were conducted at variable rates based on an auction mechanism, but since October 2008 they have been conducted at fixed rates. The refinancing operation rates must allow the ECB to influence the rate charged by credit institutions for interbank loans (Euro OverNight Index Average rates, or Eonia) and, through this channel, the entire range of bank rates and market rates. To ensure the Eonia is not too volatile, the ECB provides the banks with two facilities: credit facilities, enabling them to borrow from the ECB for a period of 24 hours, and deposit facilities, enabling them to make cash deposits with the ECB for a period of 24 hours. In case of a liquidity crisis, the banks thus have a guarantee of being able to lend or borrow via the ECB, at a higher for credit facilities or a lower rate for deposit facilities. These rates can then be used to regulate fluctuations in the Eonia, as shown in Figure 1.

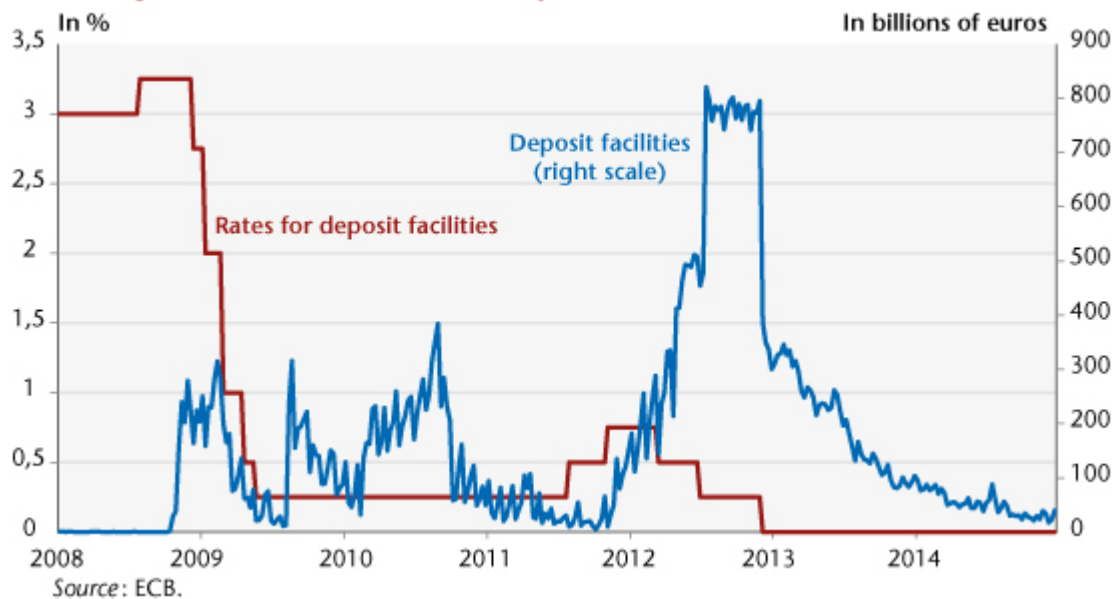
**Figure 1. Main ECB rates and EONIA rate**



In practice, until the collapse of Lehman Brothers in

September 2008, banks made little use of deposit facilities, indicating that the interbank market was functioning normally. The situation has radically changed since then, and the amount of deposits left with the ECB has fluctuated to a greater or lesser extent, depending on concerns over the sovereign bond crisis (Figure 2). The height of the crisis in spring 2012 coincided with a peak in the amounts deposited by the banks, which had excess liquidity. Over a period of three months, around 800 billion euros (equivalent to just under 10% of euro zone GDP), paid at 0.25%, were deposited by Europe's banks. In the context of fear of a euro zone collapse and uncertainty about the financial situation of financial and non-financial agents, the banks have been depositing poorly compensated sums with the ECB. They chose to do this rather than to exchange the excess liquidity in the money market or support activity by lending to companies or buying shares. It was not until Mario Draghi's statement in July 2012 that the ECB would do "whatever it takes" to support the euro zone that confidence returned and these sums fell. It was also then that the rate went down to 0%, further reducing the incentive to use the deposit facilities. The level of deposits fell by half, from 795.2 billion euros to 386.8 billion. Since then, they have declined gradually, but are still high, especially given that they receive no interest. In the last week of May 2014, there were still 40 billion euros in deposits (Figure 2).

**Figure 2. Rates and levels of deposit facilities with the ECB**



This situation prompted the ECB to set a negative rate in order to encourage commercial banks to reallocate this money. We can be sure that once the negative rate applies, the level of deposits will quickly drop to zero. Even so, this will mean an impulse of only 40 billion euros, and further action will be needed to support the real economy. On its own, this step by the ECB has certainly not convinced the markets that it has dealt with the situation.

The ECB has thus once again demonstrated its proactive approach to curbing the risks facing the euro area. Its reaction can be compared to the response of Europe's other institutions, which have struggled to fully take on board the depth of the crisis. Looking outside the euro zone, it is noteworthy that the US Federal Reserve and the Bank of England moved with greater speed, even though the risk of deflation was lower in the United States and the United Kingdom. This active approach is perhaps no stranger to the renewed growth seen in these countries. The ECB's action is therefore welcome. Now we need to hope that it will stave off the risk of deflation hanging over the euro zone, a risk that could have been avoided if the euro zone's governments had not

generally adopted austerity policies, and if the ECB had taken less of a wait-and-see attitude.