20 Years of European Monetary Union …

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Successes in the past 20 years

- Initial convergence, inclusion of Eastern & Central European Countries, …
- Price stability like for the DM, low inflation <2%
  - but regional inflation divergence in first 10 years
- Progress on banking union
- …
- But challenges

Challenge 1 – hidden before the Euro crisis

- Hidden difference in economic philosophies break open / “Rhine divide”

“France”

1. Discretion

   but commitment: no default/exit

2. Solidarity
3. Liquidity

   spillovers ➡ bailout

4. Keynesian stimulus

More recent

- *Euro-area budget*

“Germany”

1. Rules

   debt restructuring

2. Liability principle (moral hazard)
3. Solvency

   ➡ bail-in

4. Austerity/reform

- *Risk reduction*

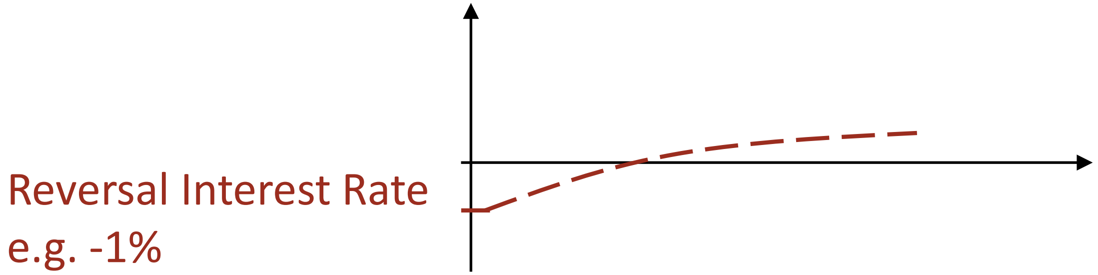
Brunnermeier

Challenge 2: Limited Monetary Policy Space

- Reversal Interest Rate:
  How low/negative can central banks go?

Brunnermeier & Koby (2017)

- Interest rate cut affects profitability of financial sector
  1. Positively: New Keynesian demand effects
     Capital gains on long-dated assets
  2. Negatively: Net Interest Income (NII) – interest margins are squeezed



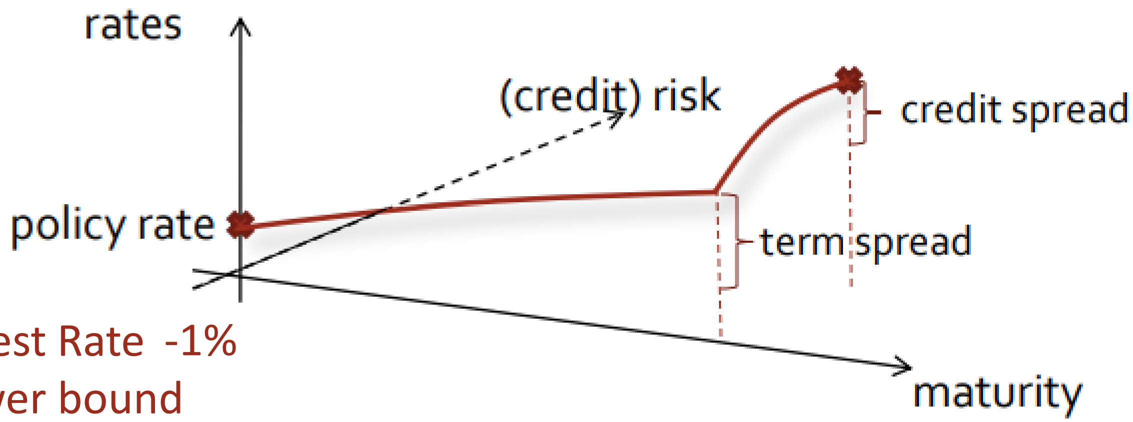
- For how long?
  "Creeping up effect"
  - Positive Capital gains effect dies out as bond mature

Effectiveness

Not specific to Euro area!

Way out 2: Shift from interest rate to risk premia

- Risk free rate



- Spreads
  - Term spread
  - Credit spread

Reversal Interest Rate -1%
= effective lower bound

contain
  - Expected loss +
  - Risk premium = price of risk * (exogenous risk + endogenous risk)

amplifications, spirals, run, …

"The I Theory of Money"

Safe Asset
(symmetrically supplied)

Way out 2: Safe Asset

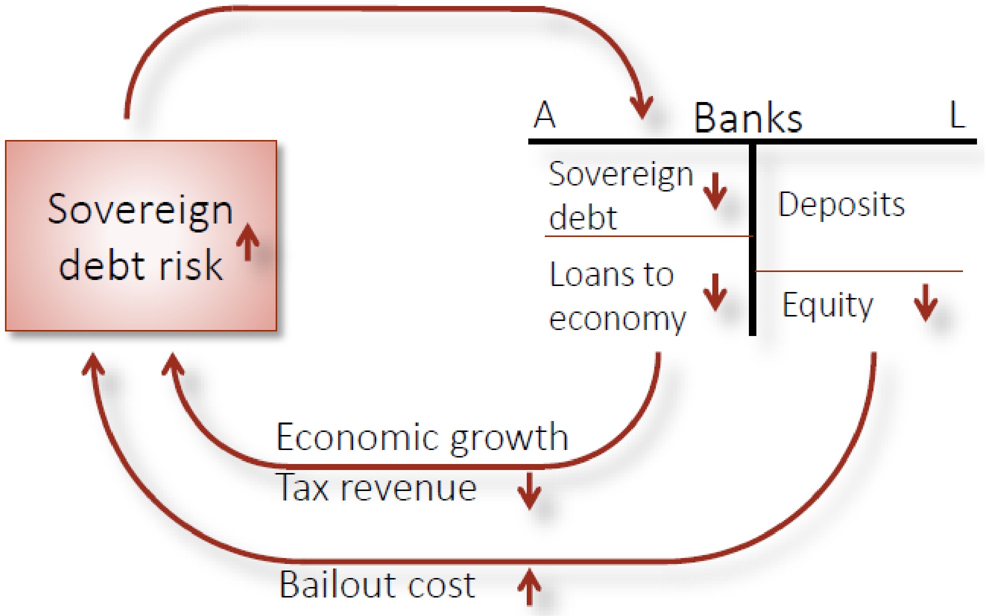
- Flight-to-safety leads to Risk-on Risk-off switches

1. cross-border capital flows
   - If safe asset asymmetrically supplied

     (not a scarcity problem)

2. doom loop/diabolic loop

   if national gov. bonds held by banks



- Causes: Destabilizing endogenous risk + extra risk premia

Challenge 3: Single MoPo Tool & Heterogeneity

- Euro area fiscal budget   not consistent with different philosophies
- MoPo   limited space

- Tensions between:
  - Monetary policy (interest rate and)   on accelerator
  - Prudential policy   brakes are on!

- Heterogeneity
  - National, but euro-wide coordination

Way out 3: MacroPru as Macro-Management Tool

- Use macro-prudential policy, esp. countercyclical buffer (Basel III)
  - Not only for financial stability,

1. … but to manage/stimulate economy

2. Coordinate in order to optimize a suboptimal currency area
   (see my paper during Papademos ECB Symposium 2010)
   - Manage risk premia (price of risk and endogenous risk)

Conclusion

- Early successes + resilience via creativity + Progress on Banking Union

- Tensions: Different schools of thoughts "Rhine Divide"

- Challenge: Limited policy space due to creeping up Reversal Interest Rate
  - creativity
  - ➡ focus on risk premia + reduction of endogenous risk
  - ➡

- Challenge: MoPo accelerator, MacroPru brakes
  - MacroPru as a Macro/stimulus tool (not only fin stability)
  - ➡ optimize Suboptimal currency area
  - ➡ safe asset to reduce endogenous risk (amplification)
  - ➡