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Central Bank of Ireland
Eurosystem

Macro-Financial Stability and the Euro

Philip R. Lane, Euro At 20 Conference

Two Lessons from Twenty Years of the Euro

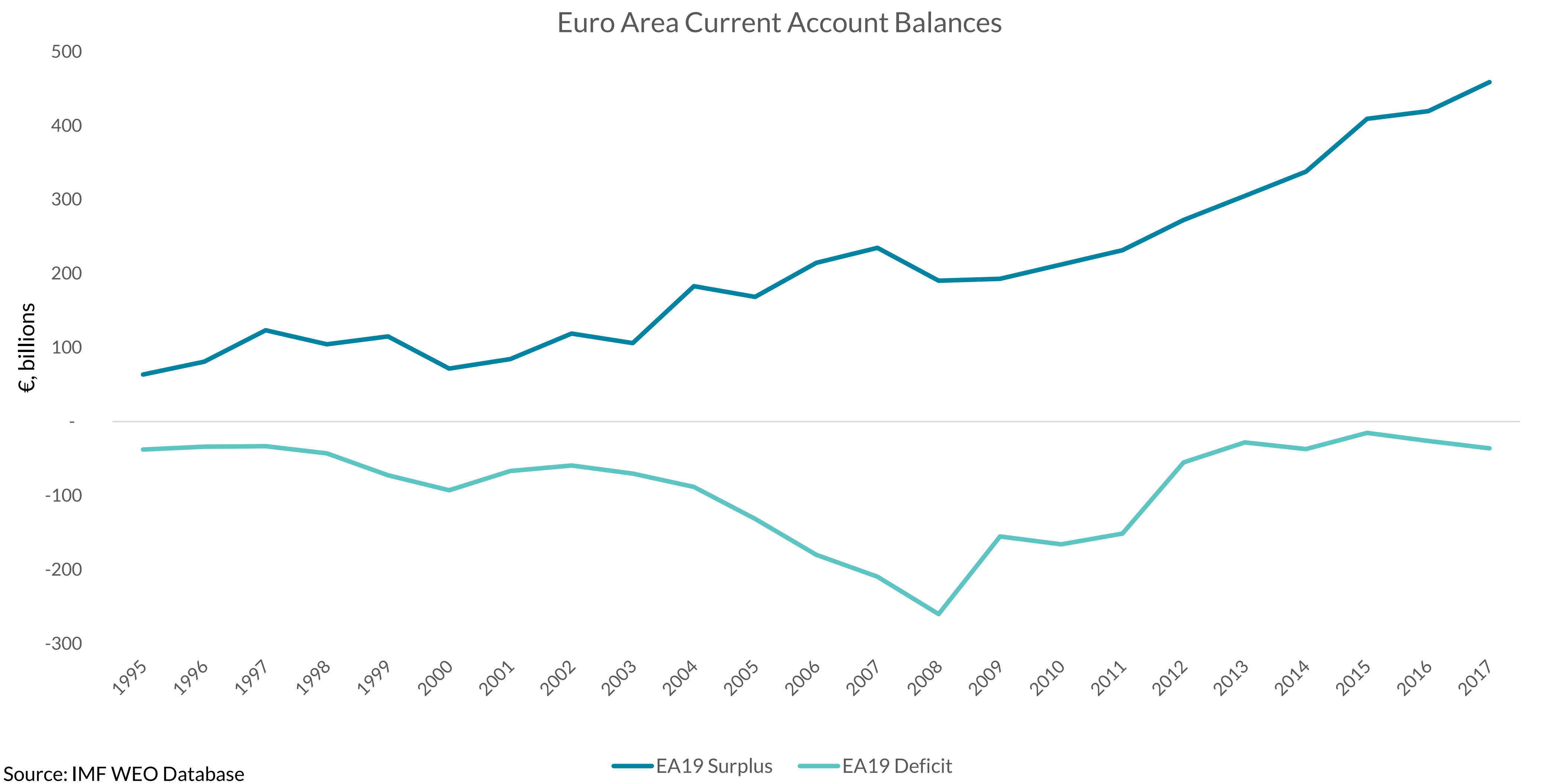
- Avoid accumulation of excessive imbalances: pre-emptive use of fiscal and macroprudential policy tools
- Improve crisis management toolkit
- Focus on these topics
- Do not cover: ECB monetary policy; cross-border integration; political economy; income convergence

Outline

- Asymmetric Patterns during 1999-2008
- Counterfactuals?
- Crisis Dynamics during 2007-2012
- Reform Agenda
- Conclusions

Asymmetries During 1999-2007

- Differential exposures to global and technological forces
- Differential exposures to extra-EA shocks
- Differential initial conditions
- Differential domestic policy responses
- Focus on external imbalances



Source: IMF WEO Database

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Analytical Issues

- Entry phase (1999-2001) : Blanchard-Giavazzi interpretation
- Expansion during 2003-2008:
  - Global credit boom
  - Increased procyclicality (Lane and Pels 2012); Exceeded fundamentals-based norms (Lane and Milesi-Ferretti 2012, 2015); Deterioration in fundamentals (Giavazzi and Spaventa 2011, Benigno and Fornaro 2014)
  - "Sudden stop" risk versus soft landing scenarios

External Adjustment During the Crisis

- Severe drops in output and consumption
- Cross-country incidence of crisis strongly correlated with excessive initial imbalances (Lane and Milesi-Ferretti 2011, 2012, 2015)
- But: no differential “euro” impact compared to wider sample
- No differential real exchange rate pattern compared to wider sample
- Role of exchange rates in adjustment (Mussa 1990, Engel 2011, Berka et al 2017, Lane and Stracca 2018)

Counterfactual Scenarios

- More pro-active counter-cyclical use of national macroprudential and fiscal policies: Martin-Philippon (2017)
- “No monetary union” alternative benchmark: national Taylor rules?

Figure 2: Household Debt - Ireland

Macroprudential + Fiscal Counterfactual Scenario

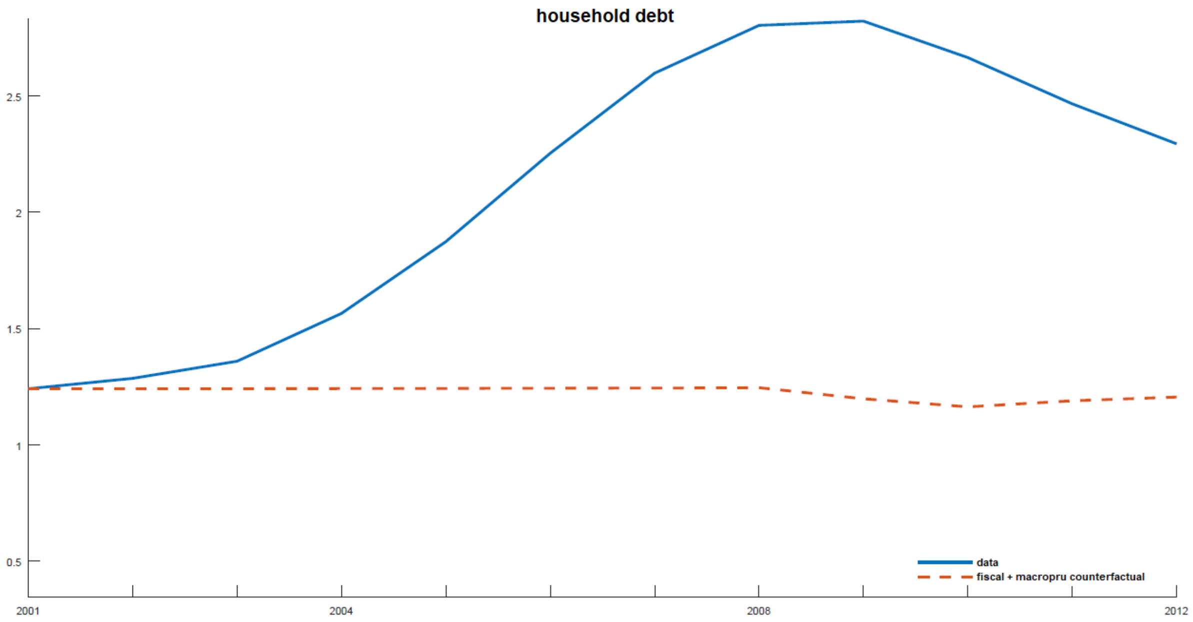

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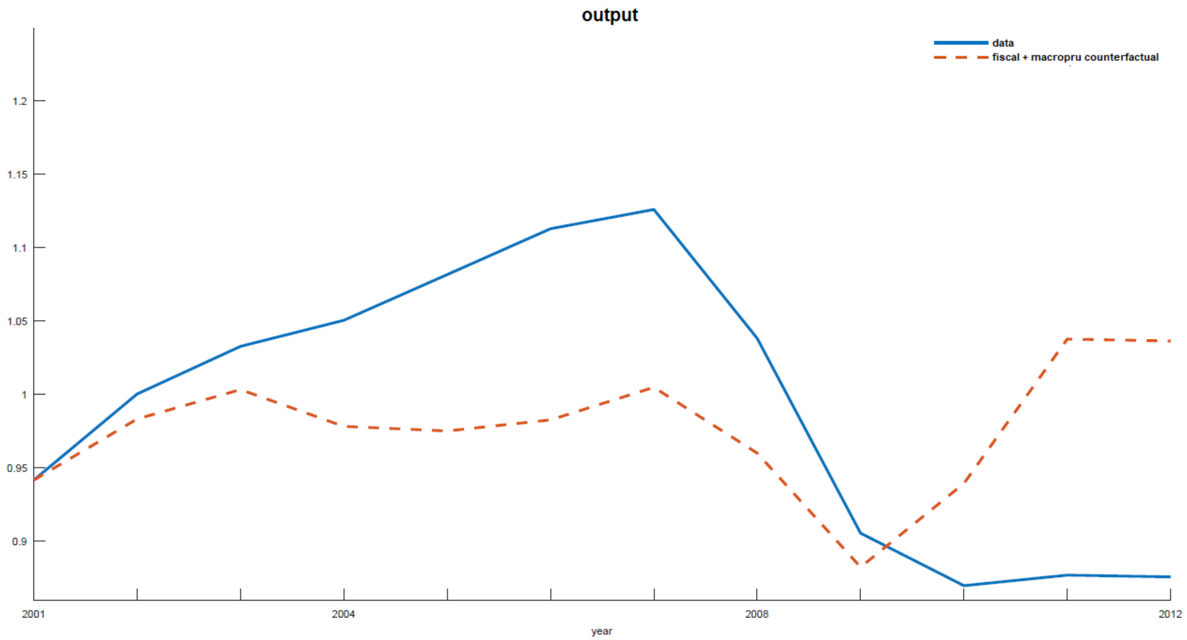
Figure 3. Output - Ireland

Figure 3b: Macroprudential + Fiscal Counterfactual Scenario



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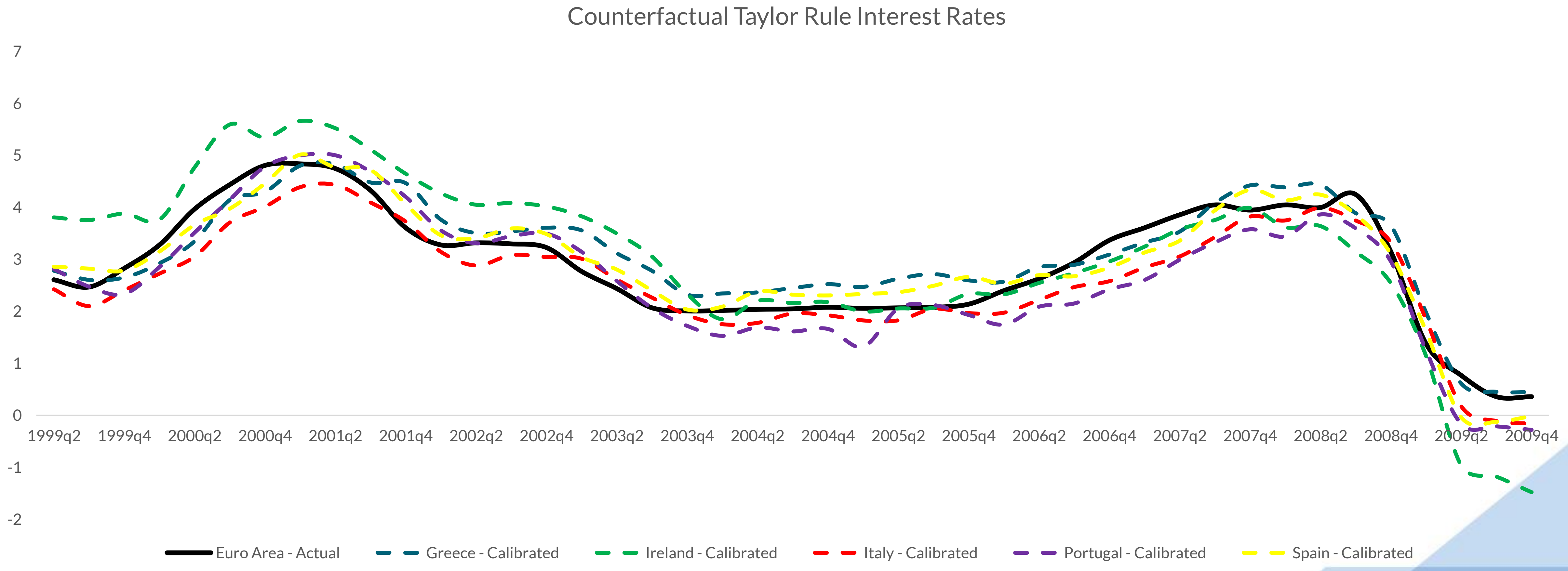
National Interest Rates: Taylor Rules



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The Euro and the Crises of 2007-2012

- Global Financial Crisis of 2007-2009: buffering role of eurosystem liquidity
- Doom Loop Crisis of 2010-2012: exposed institutional flaws in institutional framework (sovereign-banking linkages; role of ECB in forestalling redenomination speculation)

Institutional Design of European Monetary Union

- Institutional framework for national fiscal policies: precondition for ESM, banking union and OMT
- ESM: rollover risk in a monetary union
- Banking Union: eliminate fragmentation; stabilising for cyclical shocks; mitigates doom loop dynamics; Capital Markets Union: debt markets; equity markets (relation to product market integration)
- Improved macroprudential toolkit

Fiscal Union?

- ECB, ESM, European Commission: existing fiscal linkages
- Central Fiscal Capacity (CFC) for macroeconomic stabilisation
  - Shocks versus Policy Errors?
  - Temporary shocks: national fiscal policies; Permanent shocks: cross-country insurance; Private equilibrium insufficient: macroeconomic factors (Farhi and Werning 2017)
  - Non-Linear Scheme; "Usage Premiums"

Debt Issuance

- SBBS
- Ring-Fenced, Limited-Purpose Entities: ESM; CFC ?
- Eurobonds
- Hybrid Schemes (Leandro and Zettelmeyer 2018)
- Implications for national sovereign bond markets

Wage Negotiations

- Revisit potential of national component in wage determination (Blanchard 2018)
- Tricky to organise but potential gains
- Lane (2010): two-part wage contracts (Irish public sector pay process)

Conclusions

- Convergence in diagnosis: but research agenda still very open
- Euro Area: unique construct
- Future evolution of institutional design: political backing required for cross-border risk sharing
- Implementation challenge: making effective use of enhanced policy toolkit