Launch of the Euro
Corsetti & Pesenti

Launch of the Euro
Dec. 31, 1998, based on ECU and bilateral parities as announced May 1998
TARGET payments system for large transfers (Trans-Europe Real-time Gross Settlement Express Transfer)
ECB, established June 1998, coordinated monetary policy in advance of euro
Continuity with Bundesbank policy strategy

The Strategy of Monetary Policy
HICP price increase of < 2% over medium term
Two “pillars” for monitoring inflation:
- 4.5% “reference” growth rate of M3
- Economic factors influencing price inflation
- Dual targeting of money and inflation raises questions
Reports and analysis to Press and EP monthly
- No forecast of inflation
- No minutes of meetings

Implementation of the Strategy
Focus on Price Stability at expense of output?
- April 1999 interest rate cut as evidence against
- Lack of concern over external value of euro
Bias in favor of weaker countries?
- In response to fiscal constraints from SGP
- National Central Bank representatives on Monetary Policy Committee
Role of monetary aggregates in “Two Pillar” Strategy
- Depends on stability of euro money demand
- Continuity with Bundesbank policy rules
Accountability vs. Secrecy in voting and minutes
Instruments of Monetary Policy

- Open Market Operations
  - NCB repo purchases/sales via auction at fixed (refi) rate, switched to variable rate in mid-2000
  - Volume averaging € 3 trillion per year
  - Problems in forecasting impact of national Treasury operations on bank liquidity
- Deposit and Lending Facilities
- Excess Reserves remunerated at refi rate

Deposit and Lending Facilities

Euro Interest Rates

TARGET (Trans-Europe Real Gross Settlement Express Transfer) System

- for large inter-country payments
- Competes with private systems in France, Germany, etc.
- Domestic volume exceeds cross-border volume
- Interbank market for overnight reserves

Liquidity Management

Source: ECB Monthly Report, October 1999

Target System Volume

Source: ECB Monthly Report, November 1992
Bond Market, Public Debt, & Equities

- Rapid growth of corporate bond market, especially on issuing side
- Shift from bank financing via bonds to direct corporate borrowing
- Government bonds reflect credit quality of different governments, relative to SGP goals
- European equity markets boomed in 2000, slumped in 2001-2002
  - Need for Euro company law, common prospectus
  - Lamfalussy Committee Report

Debt Securities Market

- Net issuance of debt securities as a percentage of various GDPs

Euro-bonds

- Bank-dominated vs. market-oriented finance (German vs. Anglo-Saxon model)
- Within country consolidation – “national champions”
  - Reduced competition in segmented national markets
  - National supervision of banks may lack rigor
- Future development of Eurozone-wide banks
- Mergers up from 300/yr in 1980s to 400-800/yr 86-92.
German vs. Anglo-Saxon Financial Markets

Bank credit and stock market in OECD countries (% of GDP)

- Stock Market
- Bank Credit

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<tr>
<th>Country</th>
<th>Stock Market</th>
<th>Bank Credit</th>
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Exchange Rate of the Euro

- Euro weakness since 1999 introduction a surprise
- Business cycle differences the main reason
- Increased supply of euro assets > increased demand, especially given strong US stock market
- Discussion of “target zone” for S/€ rejected in 1999

Impact of Business Cycle on Euro

Figure 3: Revisions to 1995 GDP Growth Forecasts and the S/Euro Exchange Rate

Euro Exchange Rate

Daily Exchange Rates: U.S. Dollars per Euro

Source: Business Economics, European Central Bank
Asymmetries in the Eurozone

- Disparities in Growth Trends – Periphery vs. Core
- Synchronization of cycles
- Endogenous currency union optimality
- Asymmetries in transmission of monetary policy
  - Reliance on consumer credit
  - Importance of variable rate mortgages
  - Role of bank credit vs. credit market
- Inflation disparities due to catch-up of faster-growing laggards
- Price level disparities due to market segmentation

EU Growth & Cycles

- Correlation of Shocks vs. Trade Shares

Correlation of income shocks

- Optimal Currency Area
- US States
- Monetary independence
- Belgium, Netherlands
- EU member countries
- Japan
- US, EU

Extent of trade among members

The Stability & Growth Pact

- To enforce Maastrict Criteria on members:
  - Target Budget Balance, to allow deficits in recessions
  - Convergence Programs required, with monitoring
  - Excess Deficit > 3% of GDP only if “unusual event” or “serious downturn” (-2% of GDP or “further supporting evidence”)
  - Action Plan to remove deficit required
  - Sanctions after 10 months of non-compliance, sooner if deliberate
  - Non-interest-bearing deposit [0.2% of GDP + 10% of excess deficit, up to 0.5% of GDP], converts to fine after 2 years of non-compliance

EU Growth & Cycles chart

Graph showing real GDP growth in Eurozone countries
## Euro Zone Fiscal Deficits

Source: European Commission Forecasts, Autumn 2002

<table>
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<tr>
<th>Euro Area Countries</th>
<th>Deficit or Surplus</th>
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Source: European Commission Forecasts, Autumn 2002