



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

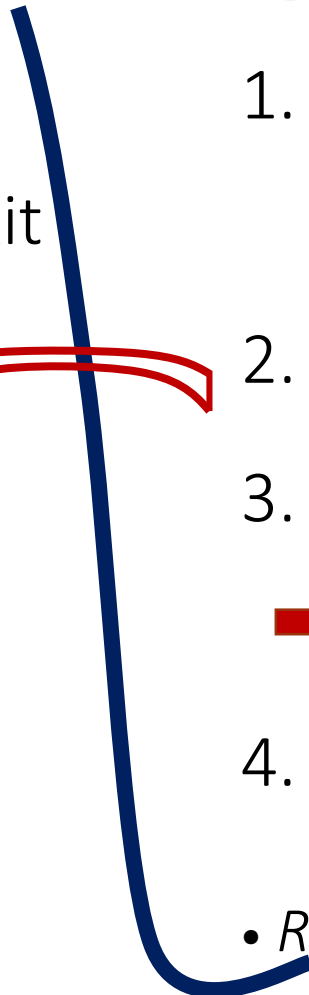
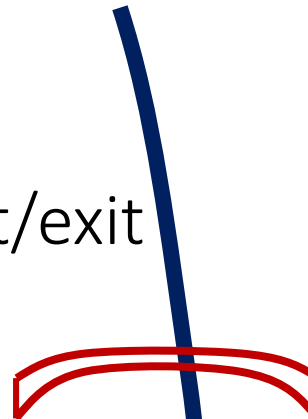
2. Liability principle (moral hazard)

3. Solvency

→ bail-in

4. Austerity/reform

• *Risk reduction*

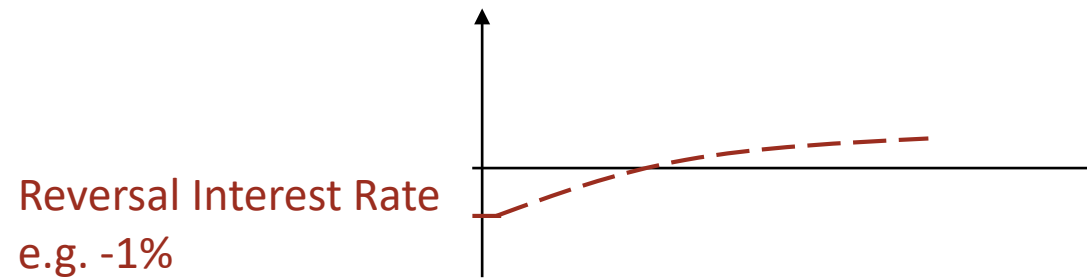


Challenge 2: Limited Monetary Policy Space

- 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”

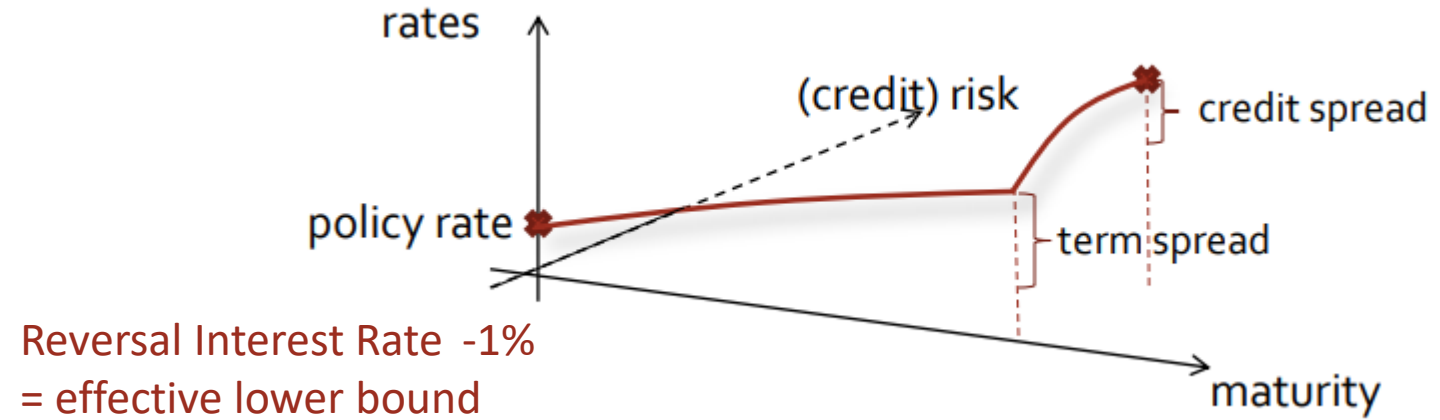
- Positive Capital gains effect dies out as bond mature

Effectiveness

Not specific to Euro area!

Way out 2: Shift from interest rate to risk premia

- Risk free rate
- Spreads
 - Term spread
 - Credit spread



contain

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

amplifications, spirals, run, ...



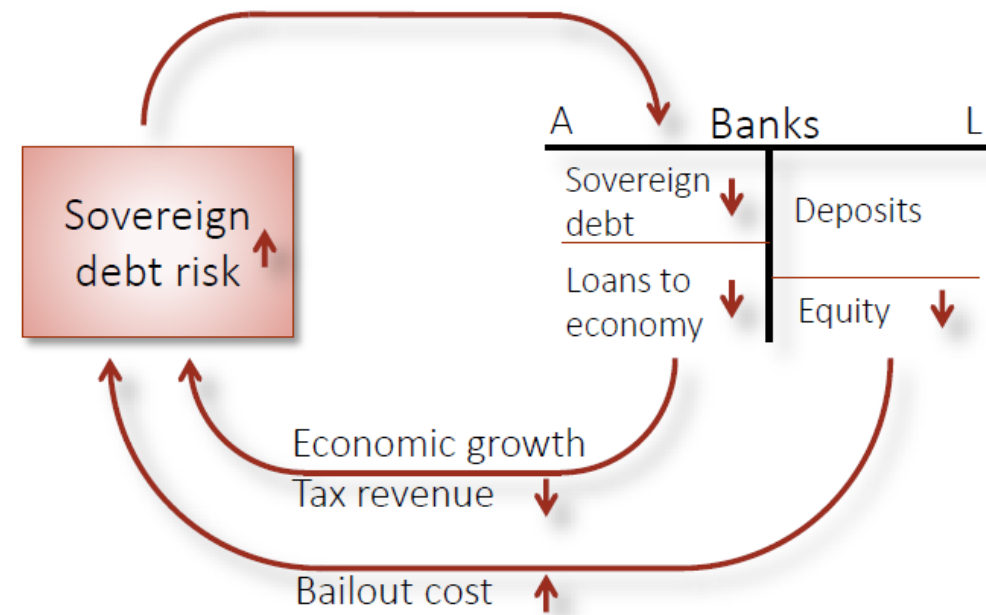
"The I Theory of Money"



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**
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- 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)
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