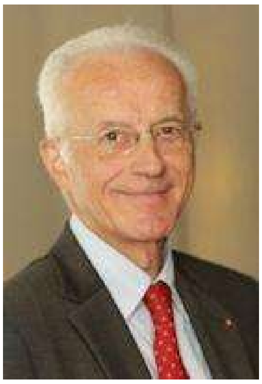
Belgian Financial Forum

Learning about Macroeconomic and Financial Stability



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ABSTRACT

Report of the speech given by Peter Praet[1], Former Chief Economist and Member of the Executive Board of the ECB, at the Belgian Financial Forum in Brussels on June 5th, 2019.

Towards stronger international institutions

Monetary policy can really be effective only if it is supported by strong institutions, in particular those dealing with competition, with crisis management and resolution, sound fiscal policies, etc... At this moment the multilateral framework with institutions as IMF, WTO, World Bank, G7, G20, ... is put in question. We may not forget that those institutions are key assets of the post war period and have governed the developments worldwide.

The euro crisis in 2011-2012 has put the single currency and the single market in danger. The weak institutional framework for crisis management has amplified the real consequences of the correction of imbalances accumulated over the years. New institutions such as the SSM, SRM, BRD, were created, but are not yet tested during a new crisis period. Many years ago one of the fathers of Europe, Jean Monnet declared that Europe could only be built via crises. Of course a crisis can lead to two reactions:

[1] Taking into account that the speaker is not anymore in office, his speech can not be used to conclude in one or another direction of what could be decided during the meeting of the ECB in Vilnius on June 5 and 6. This intervention is also based on the presentation on the 20 years of the euro, the speaker has to do in Sintra during the yearly meeting of the ECB and representatives of economic and academic areas.

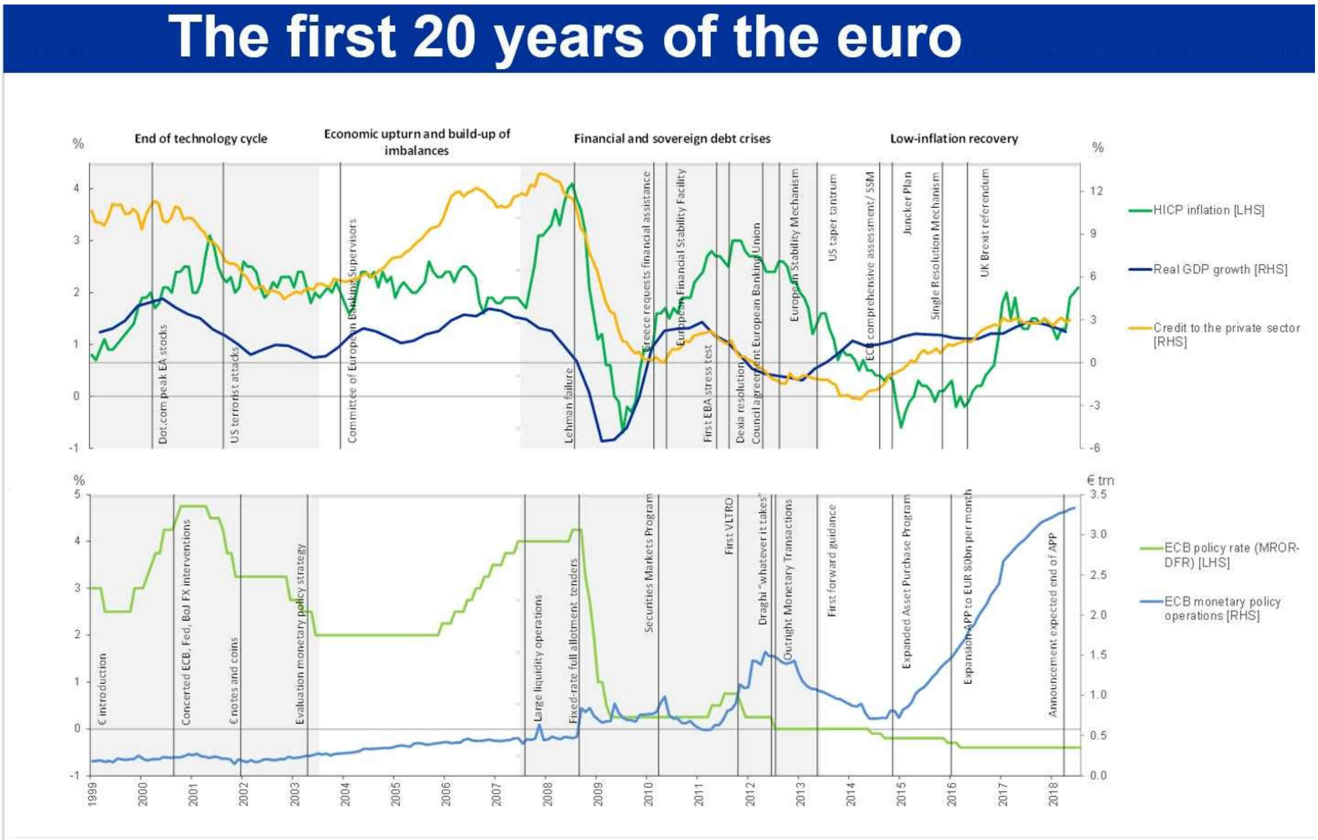
destruction or invitation for new effort of more integration. In 2012 politicians sticked together to save the euro.

We observe a big contrast in the perception of the population on the euro. On the one hand there is a large majority (some 75% of the survey responses) in favour of the euro, but the trust in the institutions is very low, even if some pick-up is observed recently. The possible reactions are either to go for more national – centered policies or to improve our current multilateral framework. Problem is that those pushing for more and deeper European integration do not agree on the way forward. In international relations the rise of protectionism has so far not led to very strong market reactions. This is because there remains ambiguity in the US foreign trade policy. Is the trade action of the US president Trump a good negotiation tactic in favour of free and fair trade relations or is it a zero sum game resulting in no further international cooperation? Those believing in the first possibility are supporting the markets, while others are more hesitating and are reducing their positions. Of course other elements, such as migration, prosperity, security, ... are influencing the trust in international institutions. Looking to the migration debate in Italy there is the believe that a solution must be found on the European level, but at the same time the Italians do not believe that the actual European framework can do it. A lot if this ambiguity is created via the tabloid journals in some countries of which the visions are quick wide spread via the social media. It often results in black and white, good and bad, winner and loser visions which are harmful for a reasonable discussion and search for sustainable solution .

All these evolutions do have serious consequences on business. The US-Mexico debate about the 5% tariff on Mexican imports in the US in order to tackle migration coming via Mexico is accordingly to some analysts not a real handicap because a correction can be made via the exchange rate. But it is clear that the business is looking for a stable framework. Many realise that the US-China problematic issues go well beyond trade. This is leading to system wide uncertainty affecting business. Markets are fluctuating very strong due to this uncertainty. It is quite certain that many of those issues can be settled, others not and therefore the risk for a negative impact on the world economy may not be neglected. Another example is of course Brexit where initially the sentiment was of an orderly exit, but after 3 years we are in a vicious circle and the outcome is not yet clear. Hoping that in the end people will be reasonable is the overall sentiment, but meanwhile uncertainty is huge which has a negative impact on investment and is a handicap for growth and creation of jobs. All these evolutions are happening in an economic cycle which is slowing down, not dramatically, but the trend is downwards.

There is a contrast between consumer confidence which is quite high and mistrust in the political system. How do we explain this? Job creation has been quite strong in the present cyclical upswing, but the feeling of insecurity remains high. Positive evolutions are however observed as employment is still rising, not only thanks to short term flexible jobs, but also to durable long term jobs. Hired people are trained within the companies, which is an investment for the long term even at a moment that the investments in plants, machinery and offices are slowing down. This reflects a kind of optimism while the pessimistic scenario implies an overall slowing down of investments and of job creations, further lowering of interest rates, etc. The new European commission and the national governments do have a huge task to stabilise the economy as soon as possible in order to rebuild trust in the institutions and to avoid a deterioration of the negative sentiment fuelled by the populists.

The 20th anniversary of the euro



Source: Hartmann, P. and F. Smets (2018), "The first twenty years of the European Central Bank: monetary policy" ECB Working Paper 2219, Dec. 2018

There are a lot of people expressing nostalgic views on the currencies in order to re establish trust and economic growth and higher welfare. We may not forget that the creation of the euro was a response on decades of monetary disorder with free floating currencies after the breaking up of the Bretton Woods system in 1971. Devaluations and revaluations intervened regularly. The currency crisis in 1992-1993 was a real danger for the single market due to protectionist barriers which were installed via the manipulated

currencies. Clever consumers saw the opportunities to exploit these anomalies between inflation differentials, weak and strong currencies. Arbitrage possibilities were present. Devaluations disturbed the trade within the single market and often were the fundament for higher inflation, because they corrected underlying surge of costs and lagging productivity, but in the end the consumers paid the bill. Unexpected inflation evolutions were destructive for the welfare. Therefore the inflation targeting, below but close to 2% for the ECB, was launched in order to clean up the disturbed markets. Central banks of other European countries do have also inflation targets even if their currencies are floating. The Swiss central bank bought a lot of securities (bonds and equities) in foreign currencies to stop the upwards movement of the Swiss Franc.
When the monetary union was created in the context of the German reunification there was insufficient political will to put in place strong institutions to support the single monetary policy. The opinion was that the single currency would incentivise economic agents to internalise the new regime into their behaviour (wage behaviour, public finances, etc...).

The first 10 years were in fact not easy ones. The way from high inflation expectation towards a normal inflation environment was more difficult than expected due to the turbulences of the oil prices, which were increasing steadily with ups and downs. A sustainable supply shock created a platform for inflation. The interest rate increase in July 2011 to tackle this danger was in fact not the best decision taking into account the sovereign debt crisis in the monetary union at that time. Tensions in the banking sector had to be tackled via an increase of liquidity hoping this could stop the deleveraging movement. 2012 was characterised by some panic. The Mario Draghi statement "What ever it takes" in his speech in London in July 2012 was a turning point because it added a major element to the decision about the creation of the banking union which has been taken a few weeks earlier. The risk of deflation and of a banking crisis was neutralised by the growing conviction that the ECB would do everything to save the monetary union. The toolbox was large and fairly new in order to maintain liquidity in banking sector. The dollar swaps played a crucial role because the ECB decided to offer at a low price liquidity in order to help banks in trouble. Of course the moral hazard problem was crucial. But the meltdown of the system could be avoided.

The G20 summit in Pittsburgh confirmed the engagement to increase liquidity in combination with a more severe regulation. It underlined also the need of structural reforms in order to tackle the public finance problems. So Italy and Belgium were in a catch 22 situation due to their very high debt level.

It is clear that the institutional framework must be deepened. The completion of the European banking union and the European capital markets union is needed. The Belgian position on the completion of the banking union reflects the trauma that the country had as a result of its banking crisis. In home/host relations Belgium defends a position where progresses can only be achieve if there are very clear arrangements for crisis management and resolution. This is not yet the case today. Among the important issues to be addressed is the question of liquidity provision in resolution.