The Banker's Comment

Quarterly Central Bank Watch

Euro Zone – March 2018

Each quarter, Jean-Pierre Patat, Honorary Director-General of the Banque de France and a TAC ECONOMICS advisor, focuses on monetary policies and major central banks' behavior. The document also includes a brief statistical review and graphic illustration of central banks' policies. Email: jppatat@taceconomics.com

Ambitious reform projects which do not exempt one from respecting existing rules

The euro, a sizeable political success for France but born in ambiguity

The *crowning* (Germany) versus the *institutional* (France)

The great misunderstanding

The French president supports sweeping "improvements" for the euro zone's functioning: a budget for the zone, a Finance Minister, a parliament for those countries that have the euro as their currency. What are the chances of success for these suggestions? The so-called "northern" countries have already made known their disinclination, at the very least, for such steps towards greater supra-nationality at a time when the "populists" in several States – including some in the zone, and not necessarily economically and socially disfavoured at that – are gaining notable electoral successes. As for Germany, vital to such an endeavour, the Chancellor's instinctive sympathy for our leader here across the Rhine cannot mask the fact that even with a governmental coalition more Europhile than the one initially envisaged, our neighbours are not too keen on upsets of such breadth.

Above all, nobody says it openly but all are thinking it – a country which has broken existing budgetary rules almost without interruption since the creation of the single currency – is it legitimate and credible when making such revolutionary suggestions?

To recall now the background of the process of the single currency's creation and what was at stake during that time might well be worthwhile

The euro, a sizeable political success for France but born in ambiguity.

Before the single currency was created, several drafts (the Werner report among others) had sketched the outlines of a monetary union but without formulating a precise calendar and the mandatory rules needed to achieve it. Things changed radically with the Maastricht treaty which not only set out most rigorously the structure of the monetary union (with, notably, the creation of the European Central Banking System- ECBS – which brings together the European Central Bank- ECB – and the central banks of the States belonging to the union) but also established a binding and inescapable calendar for its setting up: 1997 or at the very latest 1998.

This diplomatic feat was the outcome of a French idea, but it's coming about was not self-evident. The idea came because the French political leaders could no longer bear to see that within the exchange rate mechanism of the European Monetary System (EMS), the Deutschmark continued to be the currency of reference and the Bundesbank the real central bank for this grouping, whose lines the others must follow. This had been tolerable when the French inflation rate was three times higher than the German one, but the situation worked with difficulty when price increases in France were mastered and moved even below those of Germany. A context that could last long with financial markets are "as timid as rabbits and as spiteful as elephants". Hence the idea of "mutualising" the monetary policy, which would be conducted by a collegial body in charge of managing the single currency.

An idea that was not self-evident. To the Germans first of all, who were in no way asking for such procedure (of course not). It was the unanimous esteem enjoyed by Jacques Delors as President of the European Commission, who led a working party whose report largely inspired the treaty, and the friendship that existed between French President Mitterrand and German Chancellor Helmut Kohl to get the Germans to agree to a process which dilutes that which has been their pride – a strong currency and a prestigious central bank.

Nor was this idea evident to a number of players in economic and financial circles: first to the players in the markets (Anglo-Saxon above all) who had previously sparked exchange crises of unheard of violence, destined to destabilise the French franc - a great way to shut down the process of monetary union; but also to economists, including some renowned ones, who felt that it was counter-productive to create a "non-optimal" monetary zone.

The "crowning" (Germany) versus the "institutional" (France).

Having adopted the idea of a monetary union, the Germans - despite the requirement for a few concessions, one symbolic, the seat of the future European Central Bank (ECB) at Frankfurt, the other fundamental, the independence of this central bank - showed fair play, and their parliament ratified the Maastricht treaty without difficulty. They did though believe (insist?) that the union could only intervene at the end of a substantial economic and financial convergence by candidate countries. The French could not oppose this without difficulty but, fearing that this procedure might indefinitely slow down the process, they wanted the rapid creation of an institutional milestone showing the project's irreversibility. Finally, this was the obligation to respect the "indicators of convergence" (budgetary deficit limited to 3% of GDP, public debt at 60%, reasonable long term interest rates, stable exchange rates) with three successive phases marking the move towards the single currency which would be introduced bindingly in 1997 or 1998; with, also (and this is the "institutional" point) the creation, as early as the second phase, of the European Monetary Institute (EMI) which prefigured an ECBS independent of the political powers.

But the Germans wanted to go further, and this was to be the setting up of the "Stability Pact", destined to entrench the obligations related to the convergence indicators. The French insistence that "and Growth" be added to the Pact's title was not insignificant. It showed a fundamental misunderstanding (or a deliberate lack of comprehension?) in respect of the scope and spirit of the Pact.

The great misunderstanding.

Soon, informed examination of the Pact would show its true reach - that of a substitute for a federal budget and for the transfer of funds that such a body can make in a federal State to briefly ease the difficulties of communities affected by economic shocks in a member of the federal group. For that, when economic activity is on-going, fiscal receipts must be abundant and the opportunities must be taken to reduce the deficit to the maximum, to drop it well below the 3% threshold so as to gain margins of manoeuvre in order to be able to bring into play subsequently the "automatic stabilisers" when the economic climate falls.

Clearly, that is what the northern countries understood, but what others refused to understand, including France where the limit of 3% of GDP as a budgetary deficit has been tacitly interpreted as a cruising speed and not as a maximum threshold only to be reached exceptionally. Witness the reoccurring itching of the "fiscal kitty" opened in 1999 and, today, reawakened. Clearly, this is a determinant in the so-called northern countries' opposition to French projects for the euro zone, especially regarding that of creating a federal budget. Let us first respect what already exists and is pertinent say those countries, who are possibly expressing the fear that a federal budget is only a first step towards killing off the Stability and Growth Pact.

Exhibit 1

Central Bank Economic Indicators Dashboard

US Federal Reserve Bank

	2007M12	2016M12	2017M11	2017M12	2018M01	2018M02	2018M03
Fed total Assets (bn. $)	879	4 446	4 456	4 439	4 449	4 419	4 393
Federal Funds target rate (%)	4.25	0.75	1.25	1.50	1.50	1.50	1.75
3-month treasury bill minus fed funds	-0.96	-0.25	0.00	-0.13	-0.06	0.13	-0.04
Excess reserves (bn. $)	9	1 925	2 191	2 121	2 088	2 115	--
Monetary Base (bn. $)	837	3 532	3 908	3 851	3 825	3 855	--

Source: Federal Reserve Bank

European Central Bank

	2007M12	2016M12	2017M11	2017M12	2018M01	2018M02	2018M03
ECB total Assets (bn. €)	1 297	3 566	4 371	4 441	4 472	4 493	4 512
Euro ST repo rate (%)	4.00	0.00	0.00	0.00	0.00	0.00	0.00
Euribor 3-month minus euro repo rate	0.68	-0.32	-0.33	-0.33	-0.33	-0.33	-0.33
Excess reserves (bn. €)	1	706	1 159	1 187	1 151	--	--
Base Money (bn. €)	842	2 366	3 108	3 139	3 122	3 136	3 150

Source: European Central bank

Bank of Japan

	2007M12	2016M12	2017M11	2017M12	2018M01	2018M02	2018M03
BoJ total Assets (tn. Yen)	111	471	518	522	519	527	533
BoJ Policy rate (%)	0.50	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
3-month interbank rate minus policy rate	0.40	0.05	0.08	0.08	0.06	0.04	0.05
Excess reserves (tn. Yen)	--	240	326	323	323	326	321
Monetary Base (tn. Yen)	89	430	477	479	478	481	--

Source: Bank of Japan

Bank of England

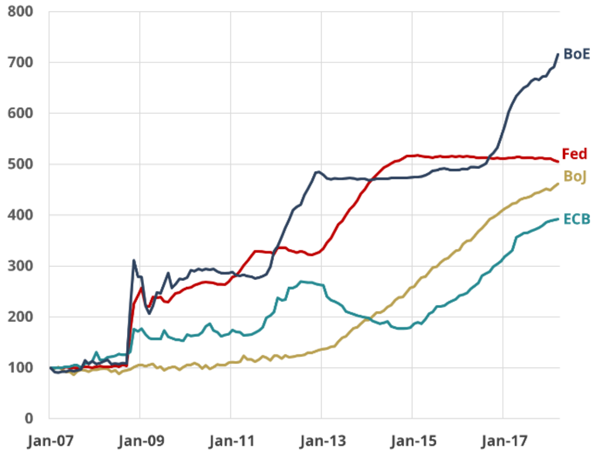
	2007M12	2016M12	2017M11	2017M12	2018M01	2018M02	2018M03
BoE Assets (bn. Pound)	92	414	555	556	567	571	591
BoE Base rate (%)	5.50	0.25	0.50	0.50	0.50	0.50	0.50
3-month interbank rate minus base rate	-0.19	-0.24	-0.15	-0.23	-0.26	-0.25	-0.16
Monetary Base (bn. Pound)	75	450	540	545	551	562	--

Source: Bank of England

Exhibit 2

Central Bank Total Assets

base 100 Jan. 2007, in local currency



base 100 Jan. 2017, in local currency

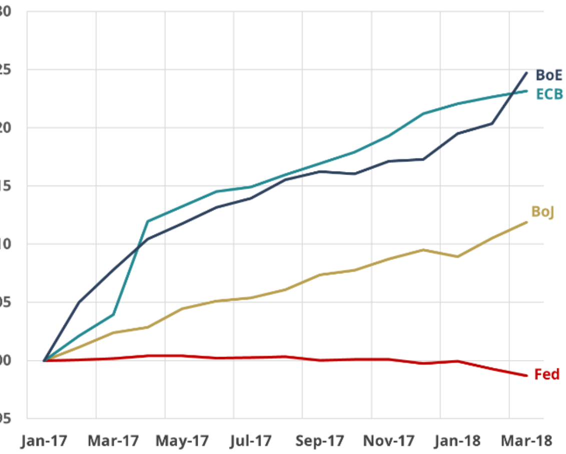
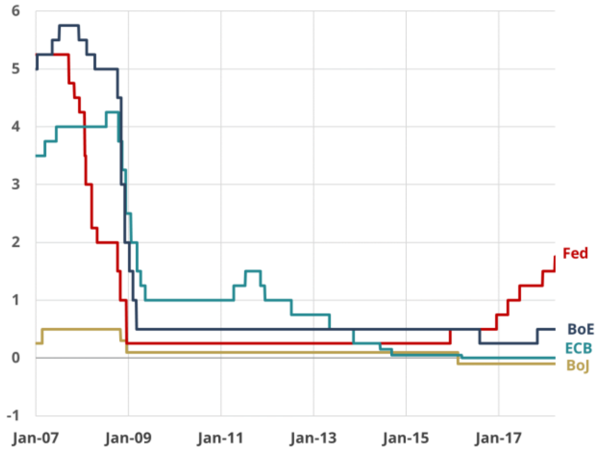


Exhibit 3

Central Bank Policy Rate (%)

from Jan. 2007



from Jan. 2017

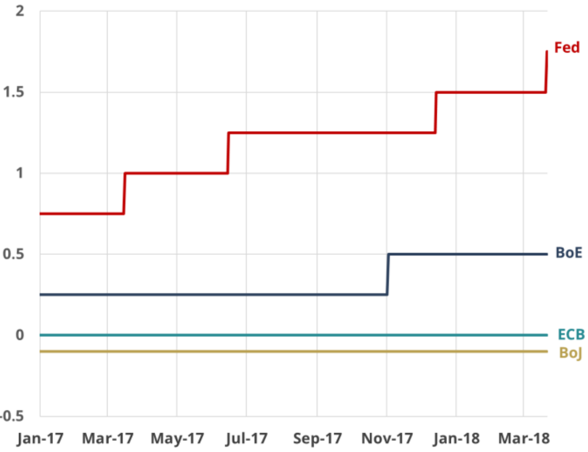
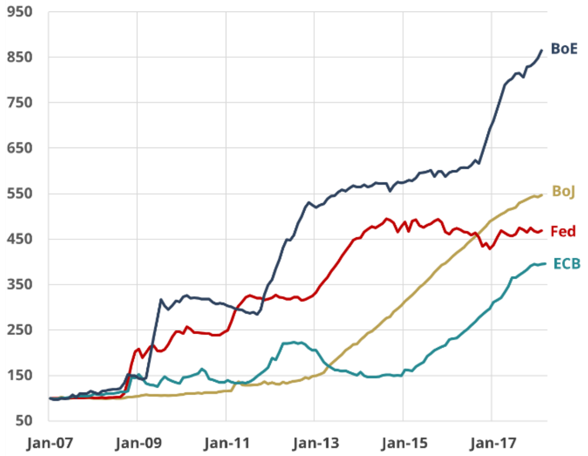


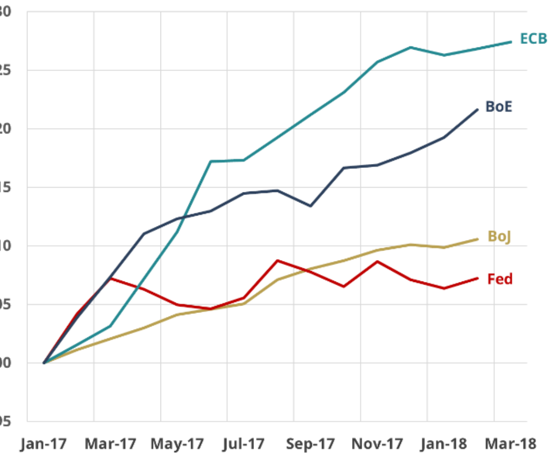
Exhibit 4

Central Banks Monetary Base

base 100 Jan. 2007, in local currency



base 100 Jan. 2017, in local currency



Source: TAC ECONOMICS, Central Banks

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