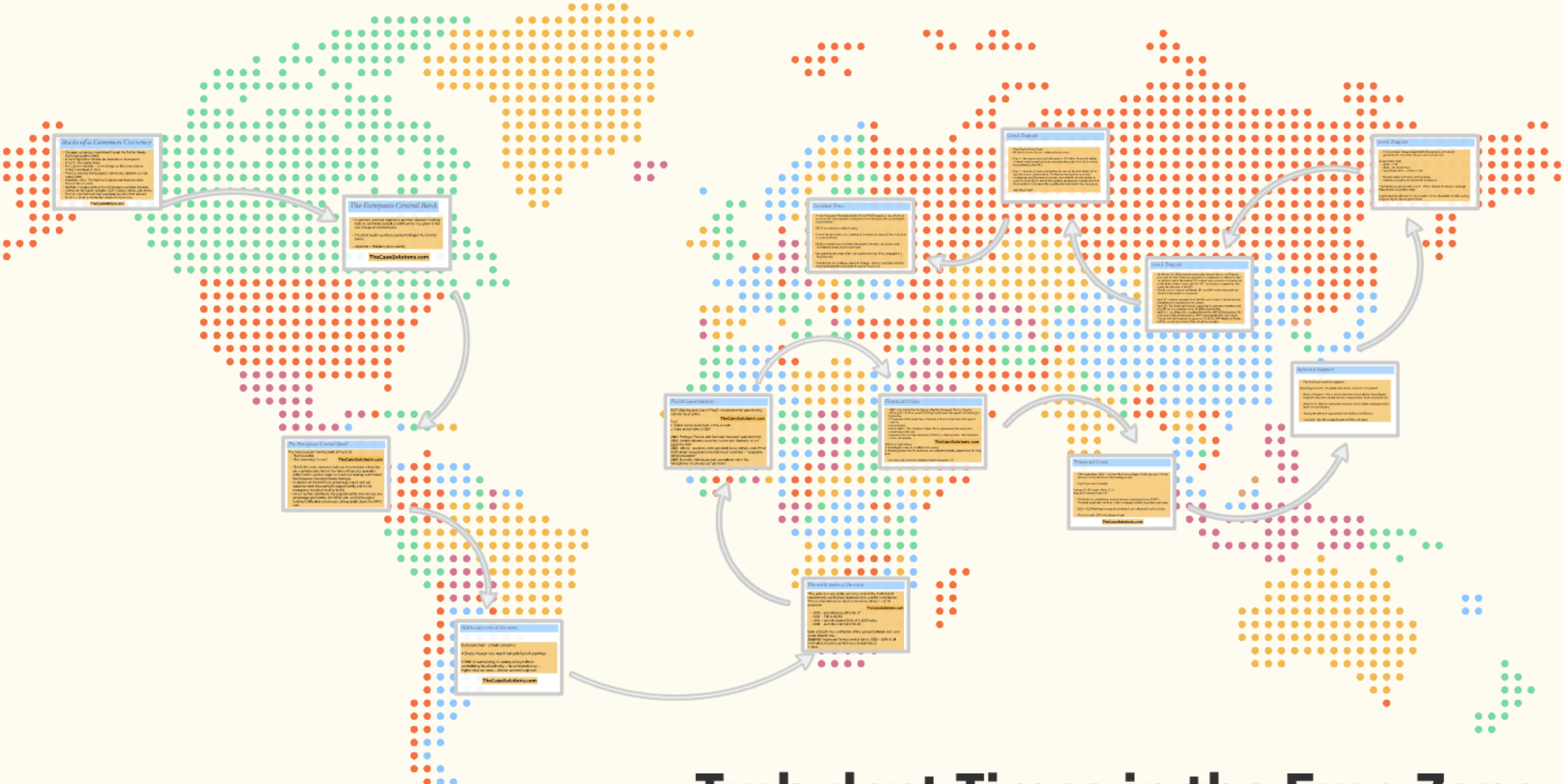

Turbulent Times in the Euro Zone

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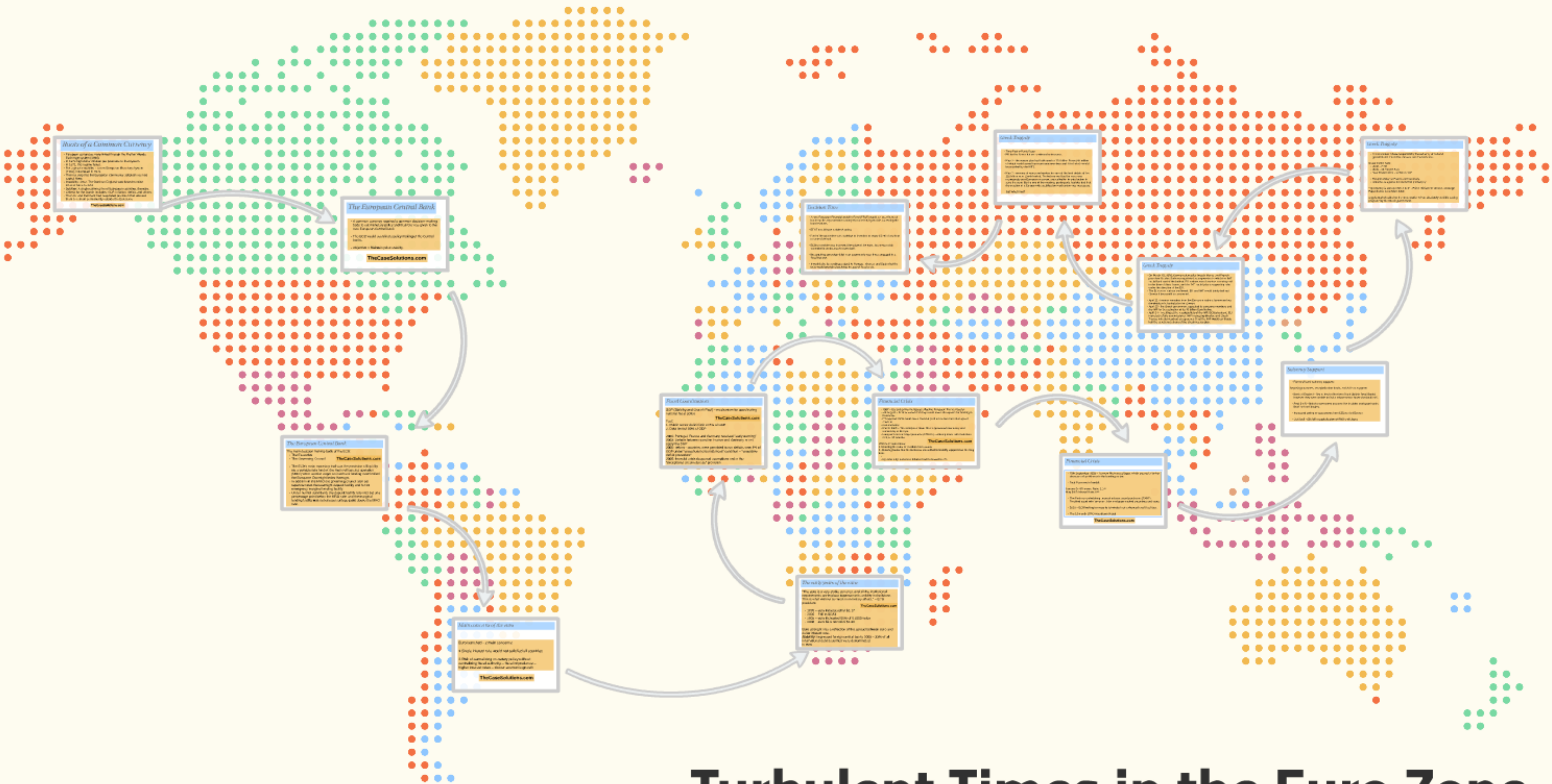

Turbulent Times in the Euro Zone

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Roots of a Common Currency

- European currencies were linked through the Bretton Woods Exchange system (1994).
- In 1970 high dollar inflation put pressure on that system.
- In 1971, this regime failed.
- For a greater stability > a new European Monetary System (EMS), introduced in 1979.
- The first step that the European Community adopted was free capital flows.
- Instability: 1992. The Bank on England was forced to raise interest rates to 12%
- Solution: A single currency for all European countries, the euro.
- Criteria for the launch includes: GDP, inflation, deficit, and others.
- The U.K and Denmark had negotiated provision that allowed them to remain permanently outside the Eurozone.

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The European Central Bank

- A common currency required a common decision- making body to set monetary policy and that role was given to the new European Central Bank.
- The ECB would coordinate policy making of the Central banks.
- Objective > Maintain price stability.

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The European Central Bank

The main decision making-body of the ECB:

- The Executive
- The Governing Council

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- The ECB's main monetary tool was the provision of liquidity via a variable rate tender: the main refinancing operation (MRO) Were used to target an interbank lending rated called the European Overnight Index Average.
- In addition to the MRO the governing council also set separate rates the overnight deposit facility and for an emergency marginal lending facility.
- Under normal conditions, the deposit facility rate was set one percentage point below the MRO rate, and the marginal lending facility was set one percentage point above the MRO rate.

Main concerns of the euro

Euro launched - 2 main concerns:

1.Single interest rate would not satisfied all countries

2.Risk of centralizing monetary policy without centralizing fiscal authority – fiscal imprudence – higher interest rates – slower economic growth

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The early years of the euro

"The euro is a very stable currency, and all the institutional requirements are in place to preserve its solidity in the future. This is what defines success in monetary affairs." – ECB president.

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- 1999 – euro introduced for $1,17
- 2000 – Fall to $0,83
- 2003 – euro increased 50% of it 2000 value
- 2008 – euro hit a record of $1,60

Euro strenght was a reflection of the spread between euro and dollar interest rate.
Stability: impressed foreign central banks 2008 – 33% of all international debt securities were denominated
in euro

Fiscal Coordination

SGP (Stability and Growth Pact) – mechanism for coordinating national fiscal policy

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Pact:
1. Public sector deficit limit of 3% of GDP
2. Debt limit of 60% of GDP

2001: Portugal, France and Germany received “early warning”
2003: Debate between sanction France and Germany or not apply the SGP
2005: reform - countries were permitted to run deficits over 3% of GDP under “exceptional circumstances” condition – “excessive deficit procedure”
2008: financial crisis deepened exemptions under the “exceptional circumstances” provision

Financial Crisis

- 15th September 2008 – Lehman Brothers collapse, which created a further decrease of confidence in the banking sector.

- Real Economy in freefall:

January 2008 Interest Rate: 1.1%
May 2008 Interest Rate: 0%

- The Fed was undertaking unusual actions: asset purchases (TARP) Troubled asset relief program. Also mortgage-backed securities purchases.

- 2010 – ECB looking for ways to terminate their enhanced credit facilities.

- The 12-month LTRO was discontinued

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