

# The European Central Bank and the Euro

## Lecture 11

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- The Euro was introduced as a unit of account in 1999 and became physical currency in 2002 for 11 European Union member states.
- The European Central Bank (ECB) was established to oversee monetary policy within the Eurozone.
- The ECB's primary goal, as outlined in the Treaty on European Union, is to maintain price stability across the Eurozone.
- It supports other economic policies of the EU, provided they do not compromise its main mandate of price stability.

# Independence of the ECB

- The ECB is politically independent and free from the influence of EU institutions or national governments.
- Its independence ensures that decisions focus solely on long-term monetary stability without political interference.
- The ECB's structure and mandate protect it from short-term political pressures.

# Mandate of the ECB

- The ECB's main responsibility is to maintain price stability across the Eurozone by keeping inflation low and stable.
- Secondary objectives include supporting sustainable growth, high employment, and other EU economic policies, provided these do not conflict with price stability.
- The ECB focuses on ensuring economic predictability and reducing inflation volatility.

# Euro Exchange Rate Fluctuations

- The Euro has experienced significant exchange rate fluctuations, particularly with the US dollar, since its introduction.
- Initially valued at 1.1674 in 1999, it dropped to 0.8285 in 2000 before rebounding to over 1.20 by 2004. Factors contributing to these fluctuations included differences in monetary

- The ECB consists of three main decision-making bodies:
  - The Executive Board, which manages daily operations.
  - The Governing Council, which sets monetary policy.
  - The General Council, which includes non-Euro EU member states' central bank governors.
  
- Its design emphasizes continuity and independence to minimize political influence.

# Monetary Policy Framework

- The ECB's monetary policy is guided by two key pillars:
  - Economic analysis, focusing on inflation, growth, and broader economic trends.
  - Monetary analysis, targeting money supply stability to align with inflation goals.
- This dual approach ensures a balanced focus on short-term and long-term economic stability.



# Measuring Price Stability

- The ECB uses the Harmonized Index of Consumer Prices (HICP) to measure inflation across member states.
- The HICP provides a standardized measure, helping the ECB maintain its inflation target of 2
- This uniform measurement ensures transparency and consistent policy application across the Eurozone.

# Challenges in Inflation Control

- Inflation rates in some countries, such as Greece, Ireland, and Spain, exceeded the 2
- The "Balassa-Samuelson effect" illustrates how higher inflation in less developed regions challenges overall price stability.
- These disparities complicate uniform monetary policy implementation across diverse economies.

- The ECB employs several instruments to manage liquidity and ensure monetary stability:
  - The discount rate, influencing short-term borrowing costs for banks.
  - The deposit rate, determining returns on excess reserves held with the ECB.
  - Open market operations, regulating money supply through bank auctions.
- These tools allow the ECB to manage liquidity effectively and influence market conditions.

- The ECB successfully maintained price stability, with inflation rates near the 2
- The Euro facilitated trade and investment across the Eurozone, enhancing economic cohesion.
- The ECB's consistent policy approach has strengthened the Euro's acceptance as a global currency.

# Criticisms of the ECB

- Critics argue that the ECB's focus on inflation neglects broader economic challenges, such as unemployment and uneven growth.
- The ECB's independence can make it less responsive to political and economic crises.
- Balancing inflation control with inclusive economic growth remains a persistent challenge.

- The ECB has been instrumental in stabilizing the Eurozone economy and maintaining price stability.
- While challenges remain, the Euro represents a cornerstone of European integration.
- The ECB's ability to adapt to evolving conditions will shape the future of the Euro and the European Union.