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Maximilian Fandl

# Monetary and Financial Policy in the Euro Area

An Introduction

 Springer

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## Preface

About 10 years ago, cracks started to appear in the monetary and financial system. In the fall of 2008, the global financial crisis brought the system to the verge of collapse. Citizens and policymakers alike were taken by surprise how this could have happened. Sufficient safeguards were thought to be in place: Central banks that would provide emergency liquidity when needed, supervisors that would prevent banks from taking excessive risks and a deposit guarantee system that would protect depositors from losses. In the fall of 2008, the confidence in the stability of the system was shattered by an unprecedented crisis only few people had seen coming.

Crisis management dominated monetary and financial policy in the euro area in the years that followed. Unlike the Great Depression of the 1930s, central banks reacted with a bold monetary policy response, significantly increasing the liquidity provision to the banking system through conventional and unconventional measures. Governments provided unprecedented fiscal support to the banking sector in the form of public bailouts and other measures. Many observers share the view that the monetary and fiscal policy response prevented the financial system from collapsing. Nonetheless, the European financial crisis deepened in the years thereafter and morphed into a sovereign debt crisis in several countries, followed by public bailouts and lengthy economic adjustments.

As of the time of writing, the euro area remains in an environment of low growth, low inflation, high unemployment and crisis legacies. Euro area member states are also confronted with new policy challenges and adverse global developments, such as increased geopolitical tensions or the slowdown in some emerging markets. In the field of monetary and financial policy, the last 10 years have been characterized by a myriad of changes. Yet, the question remains whether current policies provide us with adequate comfort to overcome both the current and the structural challenges in the euro area.

A proper understanding of the monetary and financial system is essential to form an educated opinion about some challenges we face in the euro area. Many observers acknowledge the central role the monetary and financial system plays for an advanced economy such as the euro area. Nonetheless, the subject is still not covered adequately in many economics curricula at universities. In addition, the number of policy-oriented books that provide a useful overview of the ‘nuts and bolts’ of the system stands in stark contrast to their relevance for the broader economy.

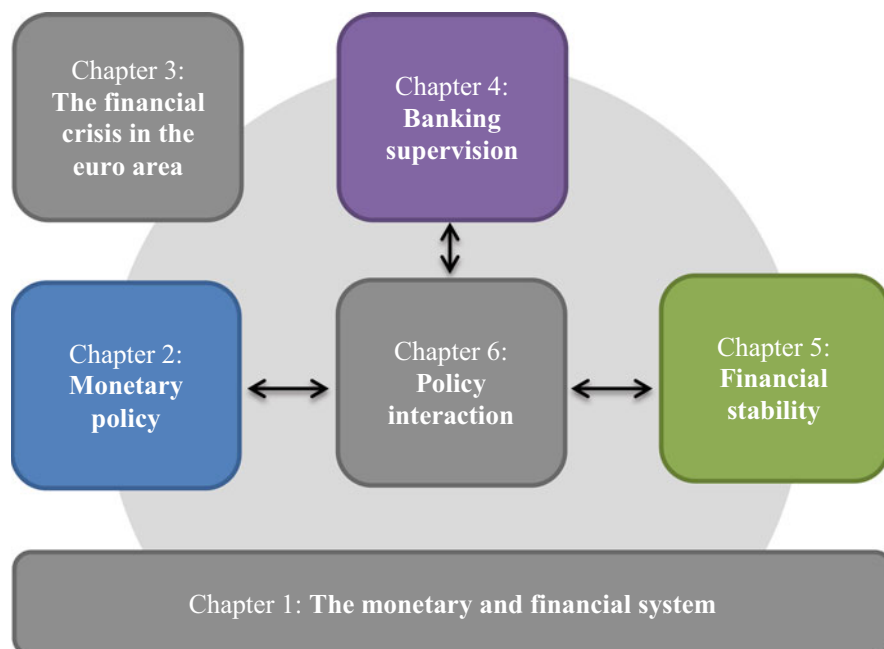
This book provides an introduction to monetary policy, banking supervision and financial stability in the euro area from a policy perspective. In line with this purpose, it has a focus on:

1. *Real-world observations* instead of theories or formulas. The reason is to separate the process of making observations from proposing solutions to perceived problems. While the latter is obviously important, it is not the focus of this book. At the same time, the book may facilitate the process by pointing to various alternative policy choices and raising questions along the way, which are meant as ‘food for thought’.
2. *Descriptions in plain English*, while explaining technical terms where needed. The reason is simply to provide a guidebook for a broad audience, including university students, journalists, finance professionals and the interested public that may not have an academic background in economics or finance.
3. *Euro area policies*. The book does not discuss monetary and financial policy in non-euro area countries in Europe or other parts of the world. Nonetheless, it also covers the international dimension of the three policy areas from the perspective of the euro area.

The book is structured as follows: Chap. 1 provides the ‘lay of the land’ for the monetary and financial system in the euro area. Chapters 2, 4 and 5 discuss the three stated policy areas: monetary policy, banking supervision and financial stability. As the policy framework for the latter two was revamped due to the crisis, their discussion is preceded by an overview of the main crisis episodes in the euro area since 2007 (Chap. 3). Chapter 6 integrates the main findings and discusses the interaction of the three policy areas (see Fig. 1).

This book benefited from comments and helpful thoughts by various people. In particular, I would like to thank Veronika Arnold, Gregor Eperjesi, Stefan Schmitz, Ralph Spitzer, several anonymous reviewers in the field of central banking and my brothers Albert, Konrad and Ulrich, all of whom read and commented on various chapters. Special thanks go to Kevin Kalaugher for his kind permission to use some of his cartoons in the book. I am also grateful to Rocio Torregrosa, Irene Barrios-Kezic and other colleagues at Springer International Publishing for showing confidence in my work and for their patience and help. Any remaining errors and omissions are my sole responsibility. While the book is mainly based on real-world observations, any views expressed are solely those of the author and do not necessarily reflect those of the European Central Bank or the Eurosystem.

Most issues in the field of monetary and financial policy are interconnected. Suitable policies therefore need to be based on a thorough understanding of the objectives and interaction of the various policy functions. The book can hopefully provide some clarity on this issue to readers who are new to the field. As regards taking the next step and developing new policies, a lot of analysis still needs to be done. There are no shortcuts in developing well-thought-out policy alternatives, despite the tempting calls by some people that offer simple panaceas or grand solutions. With sufficient openness, understanding and diligence, I am sure that



**Fig. 1** Structure of the book

readers will have an intellectually fascinating and liberating experience to investigate further the policies that would be needed to shape the monetary and financial system of the future in an appropriate manner.

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M. Fandl

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## List of Abbreviations

ABS	Asset-backed security
ABSPP	Asset-backed securities purchase programme
ATM	Automated teller machine
Basel I–III	Basel Capital Accord I–III
BCP	Basel Core Principles for Effective Banking Supervision
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BRRD	Bank Recovery and Resolution Directive
CAC-40	Main French stock exchange index
CBM	Central bank money
CCyB	Countercyclical capital buffer
CCP	Central counterparty
CET1	Common Equity Tier 1
CD	Certificate of deposit
CDS	Credit default swap
CGFS	Committee on the Global Financial System
CHF	Swiss franc
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
CSD	Central securities depository
CSPP	Corporate sector purchase programme
DAX	Main German stock exchange index
DGS	Deposit guarantee scheme
DGSD	Deposit Guarantee Scheme Directive
EAPP	Extended asset purchase program
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EFC	European and Financial Committee
EFSD	European Financial Stability Facility
EIOPA	European Insurance and Occupational Pension Fund Authority
ELA	Emergency liquidity assistance

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EMS	European Monetary System
EONIA	Euro Overnight Index Average
EP	European Parliament
ESAs	European Supervisory Agencies
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
Euribor	Euro Interbank Offer Rate
EWG	Eurogroup Working Group
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee
FVC	Financial vehicle corporation
FX	Foreign exchange
G-7	Group of Seven
G-20	Group of Twenty
G-SII	Globally systemically important institution
GBP	British pound
GDP	Gross domestic product
HICP	Harmonized Index of Consumer Prices
HUF	Hungarian Forint
IASB	International Accounting Standards Board
IBAN	International Bank Account Number
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
JPY	Japanese yen
JST	Joint supervisory team
LCR	Liquidity coverage ratio
Libor	London Interbank Offered Rate
LSI	Less significant institution
LTRO	Long-term refinancing operation
LTV	Loan-to-value
M1–3	Monetary aggregates 1–3
MEP	Member of the European Parliament
MLF	Marginal lending facility
MOC	Market Operations Committee
MPC	Monetary Policy Committee
MREL	Minimum requirement for own funds and eligible liabilities
MRO	Main refinancing operation
NCA	National competent authority
NDA	National designated authority

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NPE	Non-performing exposure
NPL	Non-performing loan
NSFR	Net stable funding ratio
O-SII	Other systemically important institution
OMT	Outright monetary transactions
OTC	Over-the-counter
P&L	Profit and loss
PSPP	Public sector purchase programme
RWA	Risk-weighted asset
SEPA	Single Euro Payments Area
SI	Significant institution
SIFI	Systemically important financial institution
SMP	Securities Markets Programme
SPV	Special purpose vehicle
SRB	Single Resolution Board, Systemic risk buffer
SRF	Single Resolution Fund
SREP	Supervisory review and evaluation process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TARGET2	Trans-European Automated Real-time Gross Settlement Express Transfer 2
TBTF	Too-big-to-fail
TLAC	Total loss-absorbing capacity
TLTRO	Targeted long-term refinancing operation
US	United States
USD	US dollar

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