

CHALLENGES OF THE EURO AREA

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Abstract:

Any attempt to follow a practical path for adopting euro, in the case of EU member state enjoying the waver in order to reach the stage fully complying with the Maastricht criteria, has to pay attention to the changing environment in many terms, which can influence a good preparation. In fact, in the case of Romania, the present time is not an easy one to follow the political engagement for adopting euro. We can consider that there exists a political decision backed with a quite consistent national support. There is plan for preparations consensual adopted by the representatives of the parties attending the works of the special National Commission dedicated to work out several important documents supposed to unify the efforts Romania being able to be approved as member state of Eurozone in 2024. In this presentation, we concentrate on the topics recalling some of the main challenges confronting Eurozone, considered important for the time being. The list of them is more extensive. In a study worked out in 2020 within the Institute of World Economy of Romanian Academy they should be treated appropriately.

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Introduction

Any political momentum of accession to the euro area by adopting the single currency needs always to be completed with analyses of the challenges of the euro area. At any moment, either of the preparation of the adoption of the euro or of the adoption itself, we need an assessment of the "environment" in continuous change - internally, of the Union and of the international one - in which Romania will continue to fulfil its political and economic commitments, assumed by its membership in the European Union (EU). An even closer proximity to the Economic and Monetary Union (EMU) implies a clearer and more direct convergence to the sustainable economic model, which can contribute to the normal functioning of the euro in the Community area. The adoption of the single currency does not exonerate a new member from the obligations of the states of the Union where the euro - the euro area - is already circulating, but, on the contrary, they must complement and strengthen them at the required quality level. As we currently have a political statement doubled by a national action plan for the preparation of the euro adoption by Romania in 2024, a relatively tight deadline, with what the euro area is currently facing is of particular interest. This is explained by the nature of the interactions of the Eurozone challenges with the very preparation of Romania to move to the single currency.

As a general remark, we believe that many of the challenges of the Eurozone are related to the design of the euro. It is recognized as incomplete by his parent (Otmar Issing), but with the hint that this design was expected to be corrected after the initial period of application and with the recognition that the benefits of the single currency had to be strengthened by the fiscal pillar. Its shortages became known pertinently together with the impact of the financial crisis, but even this recognition did not make the road to a solution of the type of a fiscal union in the euro area to be

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less difficult and conflicting and with a solution far too simplified. About the challenge of the euro design, a separate analysis has to be done, as the attention being focused on the challenges that affect from inside and outside the euro area economy, of which we will stop at only three of them.

The aftermath of the financial crisis

After more than 10 years of searching for solutions and explanations, the consequences of the financial crisis continue to be a challenge with deep echoes and prolonged effects. According to many analysts, they are determined by the way, in which the sanitation of the crisis has been attempted and overcome, more under the pressure of urgency and not of a vision adapted to the new realities imposed by globalization. These include the speed of contamination through international financial links, an area in which the escalation of risks in favour of the largest and fastest profits has exceeded any capacity for prevention. As a result, the recovery from the financial crisis has shown that the traditional theoretical kit applied in such a situation is surpassed by the scale and depth of the crisis manifested. Global financial integration was lacking uniform rules and behaviours and many innovations in the area were forced to the limits of a perpetual mobile: the money is reproducing by itself!

The orthodox or conservative economists, subjugated by the old theoretical models, have argued that fiscal austerity could reinvigorate the lost confidence in the financial system and ensure a robust economic recovery. But, after a decade of observing the economic growth at EU level and in particular the economic growth at the euro area level, following financial market fractures, serious questions have arisen regarding the quality and continuity of the recovery in order to be transformed into robust growth. The recovery was hesitant and its fragility could not reach the expected potential, the latter being affected and sensitized by the very own vulnerabilities of an anemic economic growth. The economic crisis has sharpened the "saw teeth" seen in any graphical representation of the economic cycle. The steep slope of the economic decline revealed the lack of commitment for sufficient resources for recovery.

Attempts to explain "the disappointment" become more complicated with the spectre of the risk of a new recession determined by "aggressive mercantilism of the US government" (Weeks, J., 2019, in its "Shadow of recession deepens over Eurozone"), which, among others, had as a result the contraction of the German economy, the leader of the undisputed economic power (for how long time?) of the European Union. Weeks, a contributing analyst at Social Europe magazine, comparing incomplete recoveries with repeated failures in the resumption of the euro area's economic growth in the post-crisis period, tells us that, beyond short-term explanations, one should find the underlying causality of a decade of developments with such of features. The underlying cause, shared by more and more economists, is fiscal austerity understood as a strong constraint of public spending, with the question on which this constraint was actually applied.

Weeks also, in his book "The Debt Delusion", mentions that the EU has assumed a specific, imposed and forced meaning of fiscal austerities, that of balancing total spending with total revenues without net borrowing. This mathematical understanding eliminated the anti-cyclical role of fiscal policy, giving the public expenditures the endogenous character of growth as they force to buy the domestic output exclusively. The endogenization of expenditure explains that a public budget not only does not contribute to economic growth, but also reduces it, if the spending to stimulate the economy from its own budgetary resources was restricted precisely because of strangling the investments needed for a larger base of public revenues. Adding to this, the ECB's exclusive mandate for price stability (inflation target near 2% and not beyond this level) and the freedom of the market to determine the euro exchange rate, both looked as macroeconomic policy issues, have practically deprived the governments of tools that can support and strengthen economic growth by their contribution.

It is possible, according to the IMF's opinion, that the EU may have applied an "expansive austerity" with ideological and / or historical connotations imposed by many countries on others (Germany, for example, followed by Italy and Spain, has passed strict rules in constitution as to the budget deficit). After good years since the financial crisis of 2008 erupted, another problem arises from the type of measurements of the economic growth based on the austerity with the meaning to combat macroeconomic imbalances and debts. Thus, the statistical data released by Eurostat on

quarterly gross domestic product (GDP) indices, for the period 2007-2019 (Q1), reveal a more visible divergence between the impact of the austerity program in EU countries from the euro area and those outside the euro area (Weeks). The indices of the weighted average GDP for the euro area show a good overlap with the indices of the weighted average GDP for the non-euro area during the period 2007 (Q1) - 2011 (Q2), after which, depending on the austerity programs, less systemic in non-euro countries, the two curves of the cumulative growth are departing. From 2012 to 2019 (Q1), the cumulative economic growth of euro area countries was 9.7% (equivalent to 1% per year), while the same growth in non-euro countries was of 20% (equivalent to 2.3% annually).

The figures show two things: a) it confirms the hypothesis of depressive economic growth caused by austerity; b) the fact that the price stability within the target of 2% annual rate of inflation has become problematic in managing the single currency. Weeks is concluding that fiscal expansion in the Eurozone countries could have been a more appropriate solution to growth than austerity and, in the absence of resetting the fiscal rules, the spectre of a Eurozone crisis cannot be too far. Economists such as Zoltan Darvas, Xavier Ragot, Philip Martin and others tell us that the simple rules of a coherent common fiscal policy prove better for the euro area and this approach should become a priority if euro design correction is really desired. They state the current fiscal framework suffers from three problems: complexity, which makes rules difficult to be internalized by policy makers; they are pro-cyclical, which gives them a destabilizing potential; compliance is difficult, which makes them untrusted as effects.

Risk sharing

In 2010, at the Franco-German summit in Deuville, the euro area member states considered that they should not benefit, at first instance, of any aid the Union institutions can provide in managing public and private debt risk. The first measure recommended was the involvement and the responsibility of the private sector in assuming the economic and financial losses of their companies. That recommendation was aimed at avoiding the spread of the global financial crisis from one-member state to another, forgetting about the benefit of a risk sharing between those with private debt problems. A risk sharing "technology" should be based on some common stabilization resources in the euro area (named by analyst Marcello Minenna, a "mantra", see "The nationalization of risk in Eurozone", 2019), which is still an issue under unfinished debate between member states of the EU. A stabilization fund remains yet a problem even for Banking Union, with the impact of "risk segregation" at the level of the euro area member states. By "nationalizing" the risks within the euro area creates the impression that the same euro is measuring differently the debts in different euro area states. Or, the euro has no longer the same value for all those indebted. That consideration is the main cause of blocking the creation of euro bonds at the level of euro area. A formula of reaching a common denominator for the governmental obligations of the different member states of the EU, respective they use or not the single currency is a must in our opinion.

Risk sharing in the euro area has become, finally, a political battleground as risk segregation has both advantages and disadvantages in terms of competitiveness of the products and services created in the euro area due to the different financing costs (interest rates spread). Or, this puts in conflict the states with the larger debts (the peripheral ones) with those with the smaller ones (the Nordic ones), forgetting, leaving aside who benefited from the euro and who did not. The basic problem raised by Minenna is how to resist to an unequal competition when the costs of goods and services differ as a result of the financing costs to deliver them in the same currency - euro. Minenna studied the problem mentioned in the case of Italy compared to that of Germany (having years of significant trade surpluses), demonstrating a strong correlation between the spread of debt financing interest and Target 2 balance of payments transfers between the euro area countries through their central national bank accounts. It is known that the real spread is the excess yield (without inflation) between the government bonds of the euro area countries compared to those of German government. This differentiation can be eliminated (also in Marcello Minenna's opinion) by gradually shifting to medium and long-term sovereign risk sharing within the euro area. It is necessary reform some actions, closer to market rules, of some super-operational bodies / instruments of the Monetary Union, such as the European Stabilization Mechanism (ESM). It is desirable for the European Central Bank (ECB) to give up the "key" by which it currently

determines the level of bond purchases under its quantitative easing (QE) policy. Now, it is based on the relative size of economies and population. According to some opinions, it would be more useful to find a correlation between the real interest rates spread of public debt financing or the level of public debt in relation to national GDP.

The ECB's role and mandate

The meeting of European economic policy makers at the Business Forum of Anbrosetti, Italy (September 5-6, 2019) outlined the concerning perceptions. The slowdown in economic growth in the euro area is more than the prelude to a recession, but there are too much delayed fiscal measures to support the economy in spite of existing resources (fiscal spaces). The ECB will continue the quantitative easing policy, considered vital for the period ahead, but not sufficient to stimulate inflation at the level of price stability definition. In addition, Brexit, although perceived as a collateral factor for the euro area's underlying issues, blurs the overall economic outlook of the EU. The ECB's strategy, since Mario Draghi became president in 2012, consists in a single sentence, imposed by the time of the financial crisis: "Within its mandate, the ECB is ready to do whatever it takes to save the euro and this will be enough" (Draghi, 2012). Draghi's conviction for saving the euro has come to be real, but the limits and effects of the ECB's policy have shown the difficulty in freeing the euro area economy from deflationary pressures.

The mandate and role of the ECB are enshrined in strict rules, imposed by Germany, for the functioning of a currency half designed: real political and financial independence of the central bank and price stability, to which financial stability has been added as a side objective. While monetary policy is unique for the euro area, fiscal policy remains the responsibility of the governments of the euro area member states, and the so called euro zone budget at present, admitted by Germany at the insistence of France, is insignificant in size to make up for the lack of the euro's fiscal pillar. If it is to continue with the insistence of blocking fiscal transfers within the euro area, then what remain valid are the strong discipline and the individual contribution of the euro area countries to the economic stimulation through their own fiscal policies. Divergences still persist in a simple question: who is really willing to do it if it still enjoys of fiscal space and how much it wants to use it to make up for the lack of fiscal space of the others.

The moment of the "crisis" in the conduct of the ECB's single monetary policy is recalling the history of the euro. Philip Stephens reminds us of the euro support of former German Chancellor Helmut Kohl, who said that the single currency is an honest price for Germany's reunification and stabilization in Europe. The euro will mark the way for a European Germany and block the one of a Germanized Europe, the Financial Times quoted, which, at the same time, titled the fact that Germany has hid to people the uncomfortable truth about the role of the euro (FT opinion: "Germany hides the awkward truth about euro"). The reality is otherwise, that Germany has become the biggest beneficiary of European integration through democratic stability and the economic certainties ensured by larger European market endowed with so many facilities of free movements. That means that German voters have not even now understood or was hidden from them the meaning of the "agreement" to which Chancellor Kohl referred. Stephens's effort to remind us the story is the argument that if Germany would be the worst hit country because of a possible EU dismemberment, a Union to which Germany owes its prosperity, then Germany has "a proportionate responsibility for EU stability" from now on. To continue the "Berlin mantra" of not accepting a fiscal transfers union, as a symbol of the non-benefits sharing of EU, opposed to the non-risks sharing, that means that Germany will lose in front of the European electorate in both cases.

In reality, the ECB's unorthodox monetary policy (QE and negative interest rates) is a shadow fiscal transfer or shadow transfer union, represented by the "mountain of liabilities" reaching already 40% of the euro area GDP. ECB Target 2 balance clearly indicates that an economic union "must admit the role of fiscal policy in managing economic demand as the drive of the economy. The battle of the 22 from euro area is carried by between those who have fiscal space (Germans and North neighbors) and refuse to use it and those who advocate for fiscal expansion (the group of countries led by France) which do not have fiscal space". Stephens rightly states that there has never been a better opportunity for all Eurozone countries to understand the need for faster implementation of structural reforms and to invest in the future of Europe. Inflation is almost non-

existent, borrowing costs are close to zero or negative and the investment gap is at its maximum, at a time when big and new business opportunities are available. They are determined by the communications revolution, by changing the economic profile of the European continent in front of climate change, digitization and artificial intelligence, domains where the EU is still behind the US and China.

The loss of these opportunities due to the narrow-mindedness of some euro area member states questions the ECB's mandate and independence. Draghi's legacy, as well as the recommendations made by former FED President, Alan Greenspan, will lead central bankers or politicians to better understand the usefulness of a close cooperation of central bank leaders with governments, which does not necessarily mean political interference and loss of independence of a central bank. Larry Elliott, arguing that leaders of central banks were always a political choice ("so their 'independence' doesn't mean much", in *The Guardian*), reiterates the views of many experts that the "neoliberal status" of separation of monetary and fiscal policies may not survive a future financial crisis. Elliott says that what the central banks have shown with their independence has been the failure to stop the accumulation of the biggest asset bubble started in 2000 and, instead of preventing the formation of huge mortgage debt, they were happy to keep inflation down, focusing only on price stability issue.

In the case of the ECB, also is added the delay in reaction to the crisis and when it came through monetary incentives (QE and record negative interest rates) it succeeded only in slow down the economic recession or keeping the recovery only within fragile limits. But even so, one could see the benefits of a productive mix of monetary and fiscal policies. In the case of governments, it was admissible, among other things, that the quantitative easing policy had the capacity to stimulate on long-term a favourable economic environment if more bonds were issued, for example, for costly environmental protection projects with an impact on all technologies which could be financed with zero interest etc.

The big taboo on the belief that monetary and financial policies are attributes of totally separate institutions and that central banks operate independently of any political interference is about to dissipate. There are deeper analyses, resulting from the increasingly insistent assault of the politicians against this taboo. United States President, Donald Trump, spoke on the FED policy, mentioning the danger to the economy of the rapid increase in monetary policy interest. Bernie Sanders criticizes the FED for its policy, as it remains captive to Wall Street interests. Marvin King, while it was the governor of the Bank of England, allowed himself to criticize the English government for not implementing austere policies and delaying reforms, while he was also claiming its independence in setting interest rates. Commentaries that are more political are already on the agenda and reveal the beginning of the myth's decline, as central banks are depoliticized. By taking their judgments further, US economist Thomas Palley decrypts central bank independence as a product of the neoliberal views advanced by the "Chicago School of Economics."

From the perceptions of the aforementioned school, it is noted the treatment of fashionable contradictions in liberal doctrine. If employees are struggling for higher employment, then they have greater bargaining power. Instead, employers prefer more unemployment to keep wages low and increase profits. From this conflict, it turns out that central banks keep the part of the capital, when they claim that if the natural rate of unemployment has reached its target, any further stimulation of the economy will lead to rising inflation, which is in their mandate to stop it. Elliott declares his premonition in a more pragmatic than visionary manner: "When the next crisis comes, it will become a far too political subject to be left to the care of unelected technocrats. If this crisis is to be managed effectively, then the era of independent central banks will end".

ECB monetary policy and international impact

The measures to reduce interest rates and buy government bonds within the quantitative easing program in euro area started late compared with the US and the UK due to a conflict of vision that is still ongoing and which has had the effect of some resignations from the Board of Governors of the ECB. The inefficiency of reaching the inflation threshold of 2% with impact on the economic growth of the euro area has created confusion for the business environment through the controversies in the ECB Governing Council debates on the quantitative easing policy, applicability

and size, stopping, continuing, or reducing the level of quantitative relaxation, when, how and why etc. These entire were linked with the fragile and unconsolidated economic developments in the euro area, the conclusions of many analysts showing failures in the face of deflation danger and the economic stagnation in the euro area. The ECB's recent measures to practically revive the troubled economy of the euro area - through higher interest rates in a negative territory and the promise to buy more bonds without any clear term to stop them, with the effect of pushing down credit costs, will at least two effects. It will decisively influence the mandate of the future ECB President - Christine Lagarde, Mario Draghi's successor, from November 1, 2019 - and will create political pressure on the FED and the Bank of Japan to take further steps to relax the policy monetary in the perspective of slowing global growth, including under the threat of protectionism.

What Draghi recalled in the latest comments on the ECB's decision of 12 September 2019, regarding the conduct of monetary policy: "you remember saying that we have all the tools on the table, ready to use them". That gives the perception that he has achieved what he has proposed from the point of view of the available instruments. It remains to be seen, however, whether their combination will be sufficient to strengthen the Eurozone in the face of the effects of Brexit and the US-China and US-EU trade war. Reuters reports that Draghi's ideas are confronted with the opposition of the representatives of Germany and France and a council member on the relaunch of the quantitative easing program with an immediate stimulus effect. However, more than that, he induced a virulent reaction of the US president who, in his battle with the Fed to adopt and keep relaxed monetary policy, appreciated that the EU is trying to depreciate the euro against a strong dollar affecting US exports. It is interesting Trump's statement regarding the FED policy in this context: "The Fed sits, and sits, and sits. They get paid to borrow money, while we (the US government - n.n.) are paying interest!" obviously high.

The reduction by 10 basis points of the monetary policy interest, at minus 0.5%, was expected by analysts and had the majority of the ECB council. What was surprising in the markets was the impossibility to link the purchases of government bonds (at a level of 20 billion euros a month) with a possible resumption of growth of ECB interest rate, in the context in which the economic growth of the euro area was amended down to 1%, well below its potential. This has precisely created the perception of continuing the ECB's QE policy indefinitely and of increasing the feeling of its uncertainty. The negative reaction of commercial banks in terms of their costs when depositing overnight unused currency surpluses at the ECB did not delay, although the ECB promised to establish multiple overnight interest rates (multi-tier deposit rate) in order to mitigate the costs of not using the money. However, here remains the problem of the losses of commercial banks from their lending to the economy, in the context of extremely low interest rates which will reduce their presence on the market.

The context of the limits of action of the central banks in the world points out that what remains to stimulate the economy are only fiscal policies, which means that governments have to spend more on cheaper contracted debts. Thus, the Draghi's call, more and more repeated at the end of his term, has the purpose of emphasize the government's task to remove the economies from the impasse of slowing growth. The appeal, however, embarrasses Germany with the obsession of a balanced public budget at a time when it's budgetary and current account surpluses are at embarrassing high levels, as an expression of the benefits of its EU membership. However, a number of analysts speak of the adverse risk, of lowering negative monetary policy interests, namely the increase of savings / deposits in commercial banks (which is already happening in Germany), whereby the purpose of the euro depreciation to contribute to the inflation increase becomes irrelevant.

We believe that the most important legacy of Draghi's mandate, after the last package of measures taken by the ECB, is to renew the pressure on the governments of the euro area countries to take fiscal policies seriously. This, although repeated in another context by former ECB President Jean-Claude Trichet, upsets or confirms the doubts of direct decision-makers within the ECB (we are witnessing resignations and rising votes against) and confirms that investors' doubts of any kind and economist attention are more likely to be focused on the effectiveness of the ECB's latest stimulus package, and less on what the political governments should have done long ago. This further indicates that the euro area could work better if there was a more serious political bent, at EU level, to resolve fiscal transfers, which would also be in the benefit of improving the euro design. In this way, the architecture of the single currency and its unique and well-focused role for

development could be complemented, being eliminated or greatly reduced the dichotomy between the independence of the ECB's monetary policy and the individualism, becoming already selfishness, in the independent fiscal policies of each EU member state.

What emerges from the comments on the latest package of measures taken by the ECB is the focus on Draghi's message: "it is time for fiscal policy to assume its role", but there is concern that a delay in implementing its role will no longer have the effect expected. The euro area inflation forecast is 1% for 2020 and 1.5% for 2021, which means that a QE policy term in relation to the quantitative definition of price stability remains at least distant. This should take into account the governments, at least for cheaper financing of large public projects, whether or not they have sufficient fiscal space to do so. But, after the development of the economies of the euro area, more influenced by international factors, the opportunity of the low financing costs seems to be of no interest in the normal theoretical judgments of the mechanism of transmitting the monetary impulse. As a result, more or less seriously, it is said that Lagarde will have to have more discussions with finance ministers than with the ECB Governing Council, considering market reactions as soon as the ECB measures are communicated.

When announcing the ECB package, the euro increased with impact on bond yields - a correct manual response - so that after three hours the euro would depreciate. In this case, as an explanation, it was the high volatility of investor confidence (rather of its lack) in the long-term unclear effect of the ECB's last-ditch efforts, with Draghi as president. Needless to say, the ECB has become a prisoner of its future guiding policy, creating market expectations that have not been met for years, such as economic growth and inflation, with the growth of the promised future demand being swallowed by an uncertain present. Some experts talk about the fact that the QE policy was effective at the beginning of the application in order to avoid a drastic slowdown in economic growth, but we cannot "borrow" infinitely from future economic growth for the present, as the business cycle itself is disrupted (says Ian Hislop, Head of Global Equities at Merian Global Investors).

If there is a perception that the ECB's QE policy only inflates asset prices without bringing anything into the real economy, then, says Hislop, a capitalist perception is attacked, that investors usually support strong companies, and weak ones usually let them die. The QE policy no longer makes this distinction, supporting all and inducing false realities regarding the durability of companies. Draghi himself confirmed his concern about the unintended negative consequences of QE policy, while its side effects are less visible than those of interest rate cuts. Or, such a message shows that, in the end, "doing whatever is necessary", as a promise to anchor inflation at the level of price stability definition, could no longer satisfy markets or bring about real sustainable economic growth.

An inventory of the challenges must be made as complete as possible, which seems never to be complete, as long as some are answered late and seem careless, as the old ones that are not resolved in time attract others that are more difficult to tackle in a world too divided, which is the characteristic also of the euro area.

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