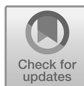


The Role of European Central Bank in the Dilemma of Economic Crisis

Xuanhe Zhou[1*]

[1]Beijing Royal School, Beijing, 100020, China

*Corresponding author. Email: zhouxuanhe@st.brs.edu.cn

Abstract. The attitude and actions of the European Central Bank during the Russo-Ukrainian War have exacerbated and compounded the economic situation. The well-being of mankind and issues with sovereign debt have put many nations in danger. The inability of incrementalism to stop inflation and currency devaluation has been raised as a critique. Inadequate economic integration is the situation's main issue. In order to improve the effectiveness of monetary policy and the future direction of policy cooperation, the Fiscal Union has been proposed. The crisis in the EU will become a new opportunity to develop itself to fight against internal economic problems and external sanctions.

Keywords: Policy coordination, economic sanctions, human well-being, cost-push inflation, Fiscal and Monetary Union.

1 Introduction

As the effects of the coronavirus are gradually eliminated, the global economy is beginning to recover. However, the world economy is once more in disarray as a result of the commencement of the conflict between Russia and Ukraine in 2022. For its part, the European Union deemed the Russian-initiated conflict to be illegitimate and levied a number of economic sanctions.

The European Council acknowledges that it will do everything in its power to restrain the growth of the Russian economy while preserving the survival of the Russian people. Significant restrictions have been placed on the export of Russian energy, including oil, coal, steel, and lumber. Additionally, the EU has made the decision to stop exporting to Russia a number of products, such as cutting-edge technologies, products and services for the aviation and aerospace sectors, as well as tools, technologies, and services for the energy sector [1]. However, it is evident from the outcomes that European sanctions were unable to stop the start of the Russian conflict. Instead, an unprecedented energy and food crisis is affecting the eurozone countries. The EU's action was deemed unwise and outright harmful by several leaders [2].

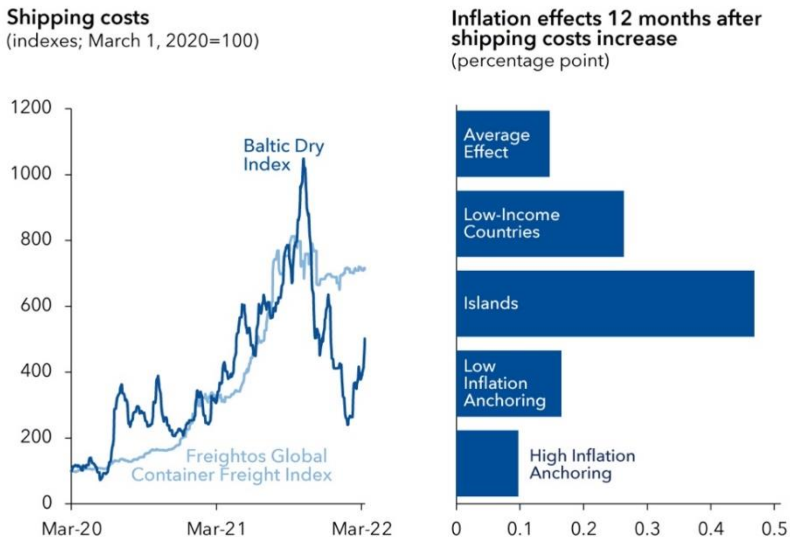
© The Author(s) 2023
H. Mallick et al. (Eds.): ICEMCI 2022, AEBMR 231, pp. 1950–1960, 2023.
https://doi.org/10.2991/978-94-6463-098-5_220

1.1 The energy crisis

The impact of the new coronavirus is causing general shipping cost to trend upward, which is troubling for the EU countries (figure 1). Additionally, nations have closed their seaports to prevent the virus from spreading, making the outlook for global energy exports exceedingly gloomy.

Despite the fact that the EU economic integration is basically well established, the actual situation is still very complicated. In the first scenario, EU countries could share the gas market; market energy prices would skyrocket as Russia stops exporting gas. The energy companies will gain a lot of profit in a short time, but most of the producers using natural gas will face higher production costs. In the second scenario, the market is disconnected and countries will still not have access to natural gas regardless of price increases. However, in the long run, the world economy in circulation will share the energy pressure on Europe. The EU would receive serious repercussions in the short term. The effects can be clarified by looking the dependency of energy from Russia as shown in figure 2. The higher a country's dependence on Russian gas, the faster the price of that country's energy will raise in the short term.

Cargo crunch
Global shipping costs surged during the pandemic, and are likely to continue boosting inflation through year-end.



Sources: Haver Analytics and IMF staff calculations.
Note: The right panel is based on estimates in Carrière-Swallow and others (2022), and presents the impact of a one standard deviation increase in world shipping costs (+21.8 percentage points) on domestic headline inflation after 12 months.

Fig. 1. The shipping costs variations [3]

1.2 Eurozone inflation crisis

In 2022, eurozone countries are generally experiencing cost-push inflation. Prices are generally rising in the countries and the purchasing power of the currency in people's hands is constantly eroding. The external shock is consistently affecting European countries. In addition, the internal shock, people's demand within Europe is reverting due to the lifting of travel restriction orders. The demand-pull has further amplified the impact of inflation in the economies. The territory of the EU nations that have completely adopted the euro as their national currency, the Eurozone, experienced average inflation that is widely projected to have risen to 8.9 percent in July from 8.6 percent in June [5].

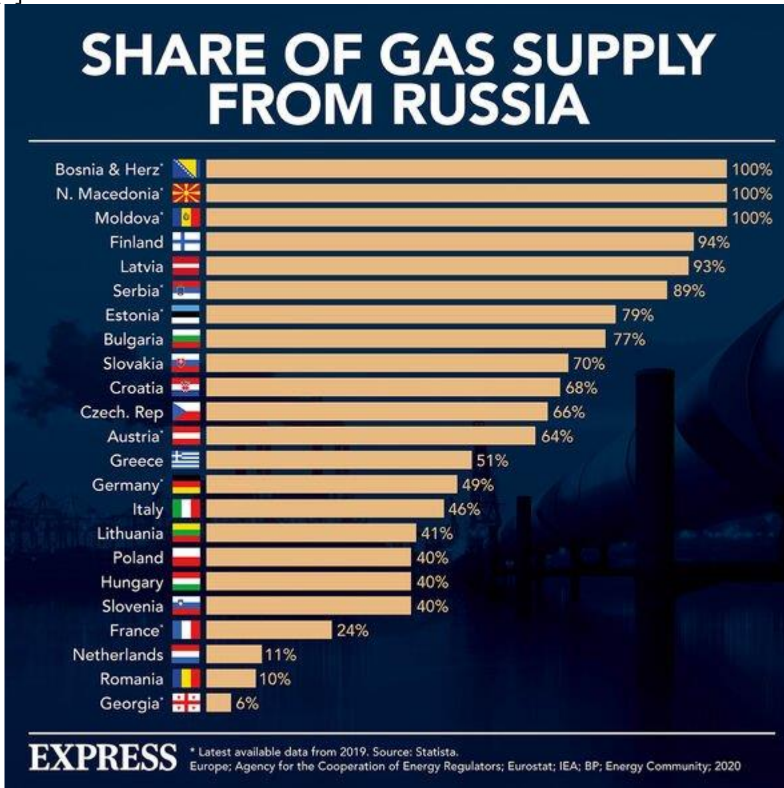


Fig. 2. Share of Gas supply from Russia [4]

2 The European central bank tactics

On 2022 July 27th, the European central bank first starts increasing the interest rate in the recent decade. Moreover, the Governing Council decided to end net asset purchases under its asset purchase program (APP) as of 1 July 2022. The APP has been in operation for about eight years as a component of a set of unconventional monetary policy measures launched in mid-2014 and commonly referred to as Quantitative Easing (QE).

At the end of May 2022, the total net purchases stood at 3,419 billion euros [6]. It is obvious that the central bank's current approach is skewed toward inflation management rather than economic growth. The economy will become unstable as a result of high inflation. In order to reduce inflation, short-term demand constraint is a generally steady strategy. However, the European economy would not effectively benefit from this tactic.

2.1 Risks and limitations

First of all, the European Central Bank does not solve the central problem. European industries are uncompetitive and their productivity is extremely dependent on external energy imports. However, reducing the pressure on the inflationary station by blocking consumer spending will itself only work for a short time. If this is done in the long run, economic growth will not see results.

If people's borrowing costs rise further, the overall standard of living in Europe will once again decline. People are especially vulnerable to energy bills. The total monthly minimum wage in Greece is 713 euros, which is considered low compared to other European countries. Greeks are struggling to get by, with monthly electricity bills exceeding 1,000 euros [7]. People are afraid to use the necessities of life. The struggle between pay growth and inflation is causing workers to inquire about wage growth as inflation destroys their real income. However, it goes without saying that the covid significantly curbed the development in worker productivity and business revenue, therefore there are no justifications for workers' wages to increase. So, it is the responsibility that the European central bank should provide their analyst to give deeper problems recognitions in order to meet each country's central problems.

It is important to note that businesses also seem to be affected. Companies are experiencing higher production costs, at the same time, the cost of borrowing has risen. Companies need to borrow extra money to continually operate their businesses, but they can't afford to the cost of borrowing.

But it is the countries with large sovereign debts that have been hit the hardest. Italy, for example, has a sovereign debt-to-GDP ratio of about 148%, [8] and is already paying back more debt than it can afford. Because of the further rise in borrowing costs, there are widespread fears that Italy will not be able to afford its debt and have opted out of buying government debt rolls. However, the Italian government can only rise interest rates on bonds to attract more lenders in order to continue to meet government spending and budgets. Therefore, the European Central Bank interest rate increases still give many countries sovereign debt pressure, laying a potential risk for it.

The question that remains is whether the European Central Bank benchmark lending rate is facing insufficient tightening. Inflation cannot persist and constant inflation will only continue to undermine the incentive for business action. The 0.75 borrowing rate will be too slow compared to the US Federal reserve's latest borrowing rate of 2.25-2.5 [9]. Considering the crisis shown above, high borrowing rates will also cost the economy, so the central bank is really in a dilemma. But the positive thing is that this small interest rate adjustment is not enough to set off a dramatic market reaction, the European Central Bank has enough time to assess the market's reaction. But there is not

much time left for the European Central Bank. In observing the labor market situation in Europe, laborers as a whole have been affected by the covid to shift from offline to online work; companies are less productive and threatened by rising operating costs, with no hope of wage increases for workers; and new refugees from Ukraine are still entering the European labor market, accepting refugees is tantamount to competing with locals for labor opportunities. The well-being of working people has become a bigger problem, with labor's wages being further ruined by inflation, even jobs are taken away. (Labor market image shown in Figure 3, the supply of the labor market because of the refugees; the demand has decreased due to lesser productivity; Ceteris Paribus)

Although the unemployment rate in the labor market has remained relative stable, the labor force has not been able to tolerate such treatment for a long time. Companies cannot maintain high wages, so they have to cancel their contracts in order to survive. In addition, the actual output of factories is still not optimistic because the productivity of European labor is hampered by the epidemic.

3 Well being of people

The well-being of mankind in Eurozone countries has been a significant social problem. Comparing the well-being of people and refraining the inflation of the market (The growth of the gross domestic production) seem to be contradictory for the policy maker. In Germany, on July 18th, the third strike of dock workers at major German seaports is happening. Governments can't let inflation goes high because it will lead to massive strikes and social and economic trouble.

Figure 3: Labor market of Europe

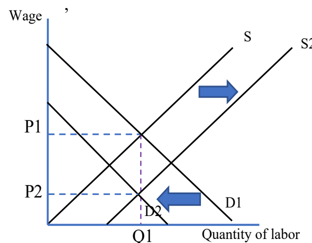


Fig. 3. the labor market in Europe

Photo credit: Original

3.1 Struggling of ECB

The European Central Bank is particularly inefficient to deal with the contradiction. The European Central Bank focuses on the regulation of the demand side; but the supply problems just like the stagnated productivity are not sensitive to the regulation of the ECB. The regularity behind the crush of well-being of people is because of the total wages has been ruined by the inflation which can't let them sustain the energy bill. The

energy price has gone so fast so that people in no way to keep their normal expenses than before. The companies can't find the worker in the labor market so that they will choose offering higher wages to workers, and recover their profit by putting their prices up. The market falls into the recessionary cycle which the price uncontrollably increase. The strengths of the European central bank so far can't modify the micro-situation by changing the total supply of money and the interest rate. The situation to be the responsibility of the government to provide, for instance, the price cap or subsidy.

More likely, it is also heart-breaking to say that the rise in interest rate would get people's well-being harsh. The further increase in the interest rates no doubt increases the pressure on people's spending. People can't sustain the standard of living if inflation continually rises. It can be clarified that the rise in interest rate is reasonable – people can't afford to the energy bill further if the inflation continually rises, we should control the inflation right now, preventing the inflation even though people might not be happy with their current life. Since it reveals the limitations of the European central bank in front of the external shock. The collapse in the international market can't just be coordinated by the European central bank. The resolution would be reaching out the more assistance from outside of Europe. Eurozone countries can construct more infrastructure to connect the alternative path for import of the energy resource which contacts more stable supply from outside and reduce the reliance on Russia. China's belt and road initiative can be a traditional example of reducing the reliance on one energy supply path. China provided more disposable funds to low-income developing countries to build up their infrastructure and deliver more long-term economic growth and returns. For China, more infrastructure such as railroad, airport, and seaports from the Asian or European countries will help China to reach more trade between countries, expand the competitiveness of China's local suppliers and take more advantage from increase the specialization of the trading. Building great friendships in countries would touch more energy suppliers and gain aid from any given economic conflicts and sanitations from other countries.

4 International market

Conversely, in the euro exchange rate market, the continued depreciation of the euro remains to be expected. Since several months ago, the euro exchange rate has been declining and is currently at parity with the US dollar. One euro cost $1.20 in 2021, and by the start of 2022, it had already fallen to $1.13. Since then, the currency has depreciated steadily, reaching a momentary parity with the US dollar on July 12 before falling below $1 the next day.

4.1 Devaluation of Euro

The continued devaluation of the eurozone cannot be separated from its economic situation and the actions of the European Central Bank. First, inflation in the eurozone has increased under the impact of the ongoing energy crisis. Imagine that investors do not want to see the value of their investments destroyed by inflation, so the economic

downturn in the eurozone has driven away most speculators. Speculators are looking forward to a more stable investment area, more predictable and optimistic economic patterns. Furthermore, with the Eurozone exchange rate remaining at around 0%, speculators will not receive a large return on their investments. Compared to the U.S. Federal Reserve's intention to rise the interest rates by 0.75 in 2022, the relative return for investors is higher compared to interest rates in other economies. Despite the European Central Bank's elevated rate in 2022, it is still not effective in attracting other investors. But along with the continuous devaluation of the euro, it seems to bring more competitiveness to the economies of the eurozone. The constant devaluation of Eurozone goods will be cheaper for other currency economies, so the lower prices may be a relatively optimistic result of the constant devaluation. Still, the devalued euro seems to bring more external demand for European producers, will inflation also increase? Thus, the European Central Bank's inappropriate interest rate increases seem to have had contradictory economic effects. (As shown in figure 4, the overall demand to EURO had been decreased, the value of Euro has been decreased from P1 to P2; Ceteris Paribus)

Figure 4: Euro to Dollar Currency system

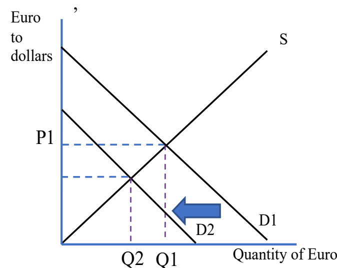


Fig. 4. Euros to Dollars currency system

Photo credit: Original

Conversely, the depreciation of the Euro increases the sovereign debt of the Eurozone countries. Because of the depreciation, foreign borrowers are more likely to receive lesser returns compare to the others. Using Euro as the returning way made the bonds lesser attractive. But fortunately, it eases the pressure to severe sovereign debt countries to return back.

Here, it is needless to emphasize that the European' central purchase power had been ruined by the further depreciation of the Euro. In the international market, the bad news is that the price goes more terrible for imported goods and services. Normally, Eurozone countries always rely on the import of energy and food resources to supplement the unfulfilled demand in the domestic market. The specialization increases the efficiency of resource allocation is definite. Right now, the domestic supply should undertake the responsibility to produce because the external price goes higher at Q 3 as shown in figure 5 (Ceteris Paribus).

Figure 5: The Eurozone countries international market

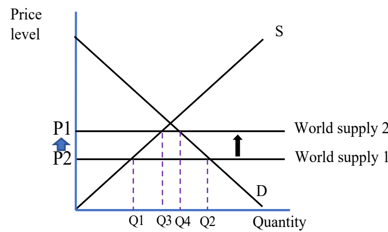


Fig. 5. The Eurozone countries international market

Photo credit: Original

The total supply for domestic suppliers was in Q1 before the depreciation happens, but the price goes high as depreciation made the domestic undertake the responsibility to produce the goods and services in Q3. It can be said that more inefficient market suppliers entered the market. Because the supplier before the depreciation can efficiently use the raw materials to produce enough quantity of low-priced goods, their cost of production is lower than the domestic supplier. However, as the price goes higher, more suppliers are attracted by the higher price and seemed to be capable to produce with a profit, so they came to produce. The specialization efficiency is destroyed by the depreciation of the currency which makes the whole economic system get into a bad circle (Ceteris Paribus).

5 ECB insurance tool and proposals

As we mentioned before, the countries like Italy and Greece have been disturbed due to the increase in the borrowing cost. The enhancement of the interest rate would amplify the sovereign debt of the countries which arise more problems. The completion of the economic integration makes the countries share the same currency, so, any given monetary policy that might affect them should be in consideration. Since then, the European Central bank has released a new device for preventing Anti-fragmentation [10]. The new device is the transition process to meet the ending of the Quantitative easing which is called The Transmission Protection Instrument. TPI might be implemented as the European Central bank evaluates the sustainability and the reasonableness of certain countries' fiscal policies. TPI aims to purchase 1-10 years of government bonds which give the support of the government implementations and prevent the debt crisis of the countries. TPI becomes a tool for the European central bank to avoid the singleness of the monetary policy arising a series of problems.

5.1 Fiscal Union

The 19 countries that make up the euro area—each have their own economic system, system of governing society, and fiscal policy. The inevitable result is that each euro

area nation is affected differently by shocks that strike the euro area, whether they be financial crises, pandemics, or wars.

The further development of the Anti-fragmentation tool would be the construction of the Fiscal Union to meet the limitations of the singleness of the monetary policy. The risk premia were different from each other because of the debt to GDP ratio and the long-term economic development further. The difference between the sovereign bond yield would make challenges to the policy maker. Sometimes, the unstable political factors and the conflict between countries would soon increase the financial instability leading to fragmentation. Though, the singleness of the monetary policy would be hard to regulate and meet the demand perfectly. The economic crisis or instability in one country might soon infect others and evolve into a systematic shock.

Even though these diversities behind the single monetary union are solved by introducing the tools of Outright Monetary Transactions (OMT) and Pandemic emergency purchase programme (PEPP). When a government of the Eurozone requests financial assistance, the European Central Bank takes OMT into account. To address the issues of the European debt crisis, the Eurozone established the European Stability Mechanism and the European Financial Stability Facility rescue funds [11]. PEPP is the emergency support of purchase to the public sectors and private sectors in front of the crisis of the pandemic. However, these temporary actions would not consecutively meet the characteristic of so many countries in Europe; the limitations of the monetary policy, such as the inability to the supply side regulation and the damage further of well-being made the ECB can't effectively reach the optimal situation. In 2020, European leaders came to realize that it was in the economic best interests of all euro area nations to implement a robust, symmetric fiscal response to counteract the economic harm brought on by the epidemic [12].

Therefore, the fiscal union has been pushed to discussions. A coalition of eurozone nations integrated to make fiscal choices is known as a fiscal union. In a fiscal union, participating governments share in the decision-making process that affects taxation and spending. The concentration of fiscal policy choices at the supranational level is not implied by a fiscal union. By managing debt at the supranational level, centralization of these decisions would promote economic stability as well as the possibility of sharing underlying risks through supranational tax and transfer systems. In order to prevent fragmentation of policy implementation, a fiscal union would collaborate with the central bank to reach beneficial decisions. Developing euro countries would benefit from sharing the same euro bonds as the more creditworthy countries, and national debt problems would be shared among countries. Addressing the limited nature of monetary policy and further addressing the regionalization implications of intra-country differences.

6 Conclusion

Due to restrictions in its monetary policy, the European Central Bank has not been successful in combating inflation. People's well-being has been destroyed by higher interest rates, which have also made it impossible for people to maintain normal

consumption and have discouraged the growth of businesses. Some countries have also been negatively impacted country with high levels of sovereign debt. The labor market's slow rise in labor productivity and the flood of refugees have denied local workers job prospects, and rising pay are not a given. Due to the severe reliance on imports from Russia and the lack of infrastructure and supply-side development, inflation has risen quickly in the near run.

However, the limitation European Central Bank is unable to successfully alter the economy from a micro perspective. More cooperation from local governments is requested to meet the demand for better economic conditions. The full range of transportation costs and the constrained supply has a greater inflationary impact on the global market. Because of the economy's uncertainty and a slow rise in interest rates, the euro fell in value, and inflation grew even more. Central banks have therefore established TPI instruments to support specific countries to effectively address a variety of consequences; the creation of fiscal unions is also on the table. In the coming period, the fiscal union will be a hot issue of discussion regarding whether it offers the best way to enhance European economic integration and address monetary homogeneity.
Note: Figure 3, 4, 5 are originally generated by author.

References

1. European Council, Council of the European Union. “EU Sanctions against Russia Explained.” Consilium, 12 Aug. 2022, https://www.consilium.europa.eu/en/policies/sanctions/restrictive-measures-against-russia-over-ukraine/sanctions-against-russia-explained/.
2. Michels, E-mailJosué. “Are Sanctions Harming Europe More than Russia?” TheTrumpet.com, 2022, https://www.thetrumpet.com/25888-are-sanctions-harming-europe-more-than-russia.
3. Haver Analytics and IMF staff. “How Soaring Shipping Costs Raise Prices around the world.” IMF blog, 28 Mar. 2022, https://blogs.imf.org/2022/03/28/how-soaring-shipping-costs-raise-prices-around-the-world/
4. Paul, Jacob. “Energy Crisis Horror: UK’s ‘Toxic’ Gas Export to EU Spark Supply Panic.” Express.co.uk, 9 Aug. 2022, https://www.express.co.uk/news/science/1652752/energy-crisis-uk-toxic-gas-exports-national-grid-interconnector-limited-beligum-netherland
5. Eurostat, Euroindicators. “Annual Inflation Rates (%) in June 2022.” Annual Inflation up to 8.6% in the Euro Area, 2022, https://ec.europa.eu/eurostat/documents/2995521/14644638/2-19072022-AP-EN.pdf/fff35147-c9b3-a915-7bf0-b09202bbd130.
6. Hua, Xia. “Economic Watch: ECB's Unconventional Monetary Policy Comes to an End.” Economic Watch: ECB's Unconventional Monetary Policy Comes to an End, 11 June. 2022, https://english.news.cn/20220611/3a57edadc4cf4e1fb5235f20bf077b3c/c.html.
7. Magda, Panoutsopoulou. “Greeks Grapple with Energy Costs.” Anadolu Ajansı, 2022, https://www.aa.com.tr/en/economy/greeks-grapple-with-energy-costs/2658171.
8. Eurostat, Euroindicators. “Fourth Quarter of 2021 Government Debt down to 95.6% of GDP in Euro Area.” Eurostat, 22 Apr. 2022, https://ec.europa.eu/eurostat/documents/2995521/14497745/2-22042022-BP-EN.pdf/90896015-2ac1-081a-2eef-ad8d5f2c0da1.

9. Jeff, Cox. "Fed Hikes Interest Rates by 0.75 Percentage Point for Second Consecutive Time to Fight Inflation." CNBC, CNBC, 27 July. 2022, https://www.cnbc.com/2022/07/27/fed-decision-july-2022-.html.
10. European Central Bank. "The Transmission Protection Instrument." European Central Bank, 21 July. 2022, https://www.ecb.europa.eu/press/pr/date/2022/html/ecb.pr220721~973e6e7273.en.html
11. Isabel, S. "United in diversity – challenges for monetary policy in a currency union." European Central Bank, 17 Aug. 2022, https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220614~67eda62c44.en.html
12. Fabio, Panetta. "Europe's Shared Destiny, Economics and the Law." *European Central Bank*, 6 Apr. 2022, https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp220406_1~643fc94dab.en.html.

Open Access This chapter is licensed under the terms of the Creative Commons Attribution-NonCommercial 4.0 International License (http://creativecommons.org/licenses/by-nc/4.0/), which permits any noncommercial use, sharing, adaptation, distribution and reproduction in any medium or format, as long as you give appropriate credit to the original author(s) and the source, provide a link to the Creative Commons license and indicate if changes were made.

The images or other third party material in this chapter are included in the chapter's Creative Commons license, unless indicated otherwise in a credit line to the material. If material is not included in the chapter's Creative Commons license and your intended use is not permitted by statutory regulation or exceeds the permitted use, you will need to obtain permission directly from the copyright holder.