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Comment on "Lessons for Monetary Policy from the Euro-Area Crisis"

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ABSTRACT

This comment discusses and extends the paper: "Lessons for Monetary Policy from the Euro Area Crisis," by Charles Goodhart. The comment claims the Eurosystem was more sluggish in responding to the crisis than the Federal Reserve due to restrictions originating from its mandate. Yet today's challenge runs deeper, as the absence of a banking union in the Euro Area has allowed a large fragmentation in financial intermediation. The critical question is: "Given that the Euro Area is not an Optimum Currency Area and a banking union will take a long time to materialize, can the Eurosystem find a way to alleviate the fragmentation in lending rates without compromising its independence?" The comment offers a solution, which would expand the monetary toolbox.

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1. Introduction

The international crisis of 2007–2009 and the subsequent Euro Area crisis, which is still with us in mid-2013, have caused a lot of soul searching among macro and monetary economists. Many dogmatic beliefs of the way monetary policy operates and relates to inflation and financial stability were shattered by the economic consequences of the multiple crises. The lessons for monetary policy are, indeed, many and are nicely summarized by Charles Goodhart in his paper, "Lessons for Monetary Policy from the Euro Area Crisis."

Goodhart (2013) draws on his theoretical and practical experience with monetary policy over the last four or five decades to claim that most of the lessons to be learned originate from the earlier international crisis, and not so much from the on-going Euro Area crisis. In his view, the new lesson from the Euro Area crisis is the need for a banking union in a single-currency area. Thus before I discuss the main topic of monetary policy in the Euro Area and the current problematic fragmentation of its transmission mechanism, I will briefly review his summary of the lessons learned from the international crisis.

2. Lessons from the international crisis

The major lesson from the international crisis is that price stability does not guarantee financial stability. Prior to the 2007–2009 crisis, few economists worried about financial stability as they took comfort in the low inflation and high growth environment of the previous two decades.[1] The crisis revealed the lack of perfect correlation between the two stability concepts and forced the G-20 leaders to move quickly and adopt – besides expansionary fiscal measures – new and extended Basel rules on bank behavior.

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[1] For the view that the two concepts are not identical see earlier work by Borio and Lowe (2002) or Hardouvelis (2003).

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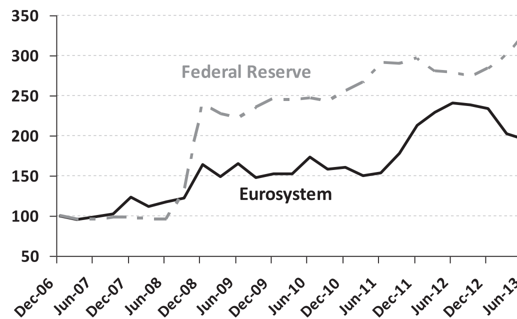

Fig. 1. Central bank assets as % of GDP (Index, Dec 2006 = 100). Notes: In December 2006, Eurosystem assets were 13.6% of EMU GDP and Fed assets were 6.5% of US GDP. In June 2013, Eurosystem assets were 26.5% of EMU GDP (they almost doubled) and Fed assets were 21.4% of US GDP (more than tripled). *Source*: Fed, ECB, Eurostat

Charles expresses a number of doubts on whether the countercyclical BIS macro and micro prudential rules can work in practice. He points to the political difficulty of ruling against the interests of bankers, enterprises and households during the euphoric periods and brings as an example the Spanish dynamic provisioning rules, which were nice in theory but proved ineffectual. He does propose an interesting idea worth exploring more, namely, that regulators should target the numerator of Capital Adequacy Ratio, say the nominal value of Core Tier I capital, and not the ratio itself. He argues this is a way to avoid deleveraging in an economic downturn. He also criticizes the low level of the minimum capital-to-assets ratio in Basel III (3%), as it allows a huge maximum leverage factor of 33.3, being in close spirit with current efforts by US regulators, who propose stricter US rules on this particular ratio. In general, he criticizes Basell III as continuing to be too dependent on the risk-weighted-asset approach, which in the past proved inadequate as it was gamed by the banks. He also discusses how the zero-bound on nominal interest rates brought quantitative easing, credit easing, etc., pointing to the fact that the increase in the monetary base due to QE-II and QE-III in the US has increased excess reserves and has not led to an equivalent percentage expansion of the broader monetary aggregates.

I do share some of Charles' skepticism on the effectiveness of the new regulatory tools, yet I am more optimistic than he is. First, the crises have freed policy makers to think out of the box and devise new and innovative tools of intervention. Second, Basel III rules are extensive, detailed and flexible. For example, they are not completely symmetric during economic upturns and downturns, so the political factor may not play a critical role in their implementation. Basel III imposes a cushion of higher capital requirements in normal periods, not necessarily in "bubble" periods. This cushion can automatically absorb losses in a bust period and the banks do not have to raise new capital then. Also, the Spanish dynamic provisioning did help the large Spanish banks avoid a major catastrophe early on in the international crisis. I would not discount them that easily. There is a lot more one can say on those issues, but given the space requirements, let me turn to the main topic of the paper's title, which refers to lessons from the Euro Area crisis.

3. Lessons from the Euro-Area crisis and the core-periphery asymmetry

The new lessons for monetary policy from the Euro Area crisis become apparent once we compare the Eurosystem with the Federal Reserve. The Eurosystem faces different – more complicated – restrictions: First, the Eurosystem has to worry about 17 countries with separate parliaments, autonomous governments and different social cultures, not simply separate states within an Optimum Currency Area like in the US. Thus, the Eurosystem needs to be on guard and defend its independence against (a) Fiscal dominance, i.e. politicians who refuse to reform their economies, (b) Bank dominance, i.e. bankers who insist on targeting the return on equity despite the calamity around them, and (c) Court dominance, i.e. judges of some countries who worry mainly about moral hazard and pre-existing rules and do not understand the needs arising from the collapse in Europe's Periphery.

Second, the Eurosystem's main macroeconomic target is price stability, whereas the Fed also looks after the rate of unemployment, thus enjoying more flexibility in its response. During this crisis, the Eurosystem went at lengths trying to justify its interventions based on its financial stability mandate. But it definitely lagged behind the Fed as it brought down interest rates much later and not completely down to zero (and remember the increase in August 2008, prior to the Lehman collapse). And, although relative to the size of the economy, it has a bigger balance sheet, it expanded its balance sheet less aggressively and much later than the Fed did (Fig. 1). Put differently, the ECB used non-standard measures (SMP, LTROs, OMT) as complements to its interest rate policy, in an announced effort to repair the transmission mechanism, whereas the Fed used non-standard measures (QE) as substitutes to its interest rate policy, particularly after it hit the zero-interest bound.[2]

[2] Cour-Thimann and Winkler (2013).

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