Lessons for Monetary Policy from the Euro-Area Crisis

By C.A.E. Goodhart
Financial Markets Group
London School of Economics

A. The 2007/2008 Crisis

The initial 2007/8 crisis originated in the US housing market and was not specifically European. The resulting financial debacle entailed numerous important lessons for monetary policy. Amongst these were:-

•Price stability does not guarantee financial stability (Minsky).
•Hence the need for counter-cyclical macro-prudential instruments. Can they work well enough?

- Basel II CARs were insufficient loss absorbers.
- <u>Hence</u> the need for Basel III. Does this go far enough (Admati and Hellwig, Miles et al.)?
- At times of crisis funding liquidity via wholesale markets dries up.
- <u>Hence</u> need for LCR and NSFR.
- In crises the ZLB becomes a reality.
- <u>Hence</u> need for QE, CE, LTRO, Abenomics, etc.
- But the money multiplier can collapse in a crisis; expansion of M0 does not guarantee expansion of M2.
- <u>Hence</u> need for IOER? Need to understand, and nudge, incentives of bank managers.

B. The On-going Eurozone Crisis

It is far less clear what additional lessons for monetary policy were provided by the specific Eurozone crisis, starting in 2010 and continuing.
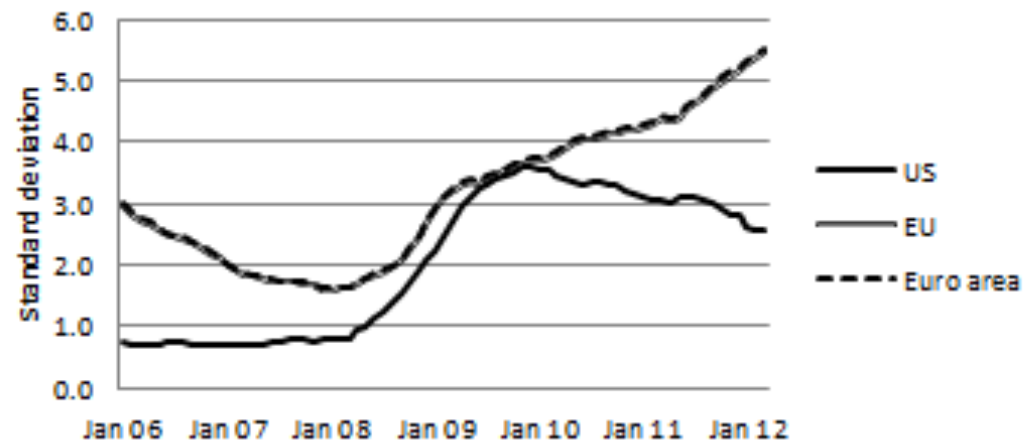
The main lesson, in my opinion, is that a single currency covering several diverse States does need, inter alia, a Banking Union.

What were the main differences between US and European States? Initial housing shock much the same in both, but US then converges, whereas Eurozone diverges, at least in UE.

Differences:-
- Wage flexibility
- Migration
- Fiscal federalism
- Cross-border (federal) banking and the doom-loop

Chart 1: Standard deviation of unemployment rate (population-weighted)
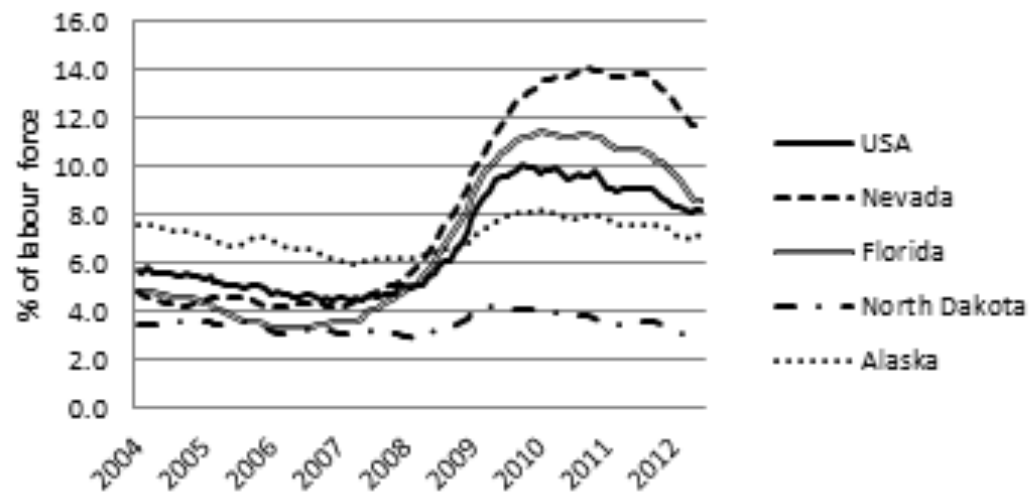

Chart 2: US unemployment rate

6

Chart 3: Europe unemployment rate
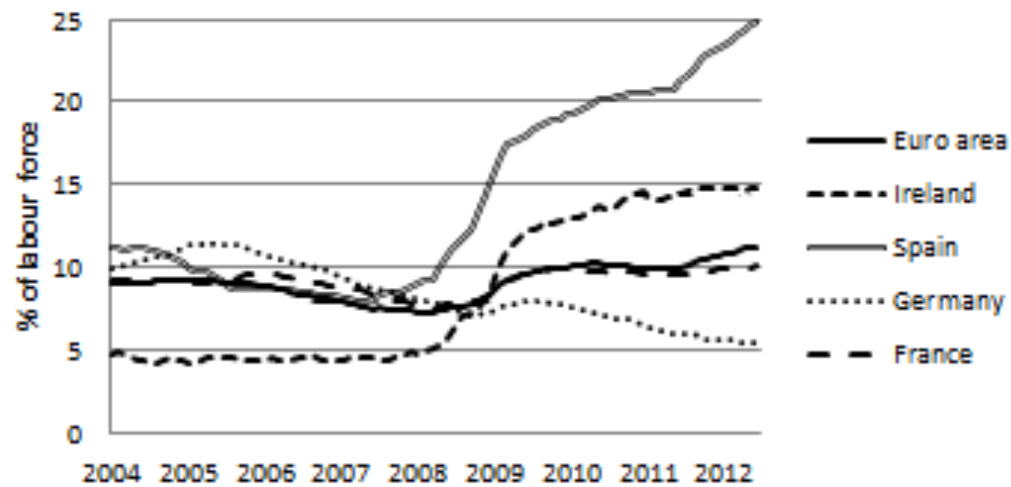
Y-axis: % of labour force

Legend:
- Euro area
- Ireland
- Spain
- Germany
- France

X-axis: 2004 2005 2006 2007 2008 2009 2010 2011 2012

Chart 4: Standard deviation of housing price index

Y-axis: standard deviation

Legend:
- US
- EU
- Eurozone

X-axis: 2006Q1 2006Q3 2007Q1 2007Q3 2008Q1 2008Q3 2009Q1 2009Q3 2010Q1 2010Q3
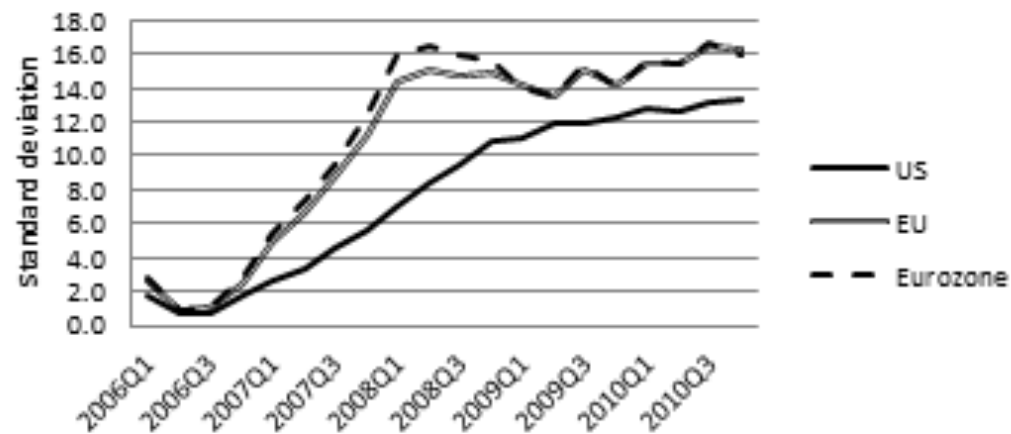
Chart 5: US HPI for chosen states and federal

Index 2005=100

Arizona
Utah
Ohio
Michigan
USA
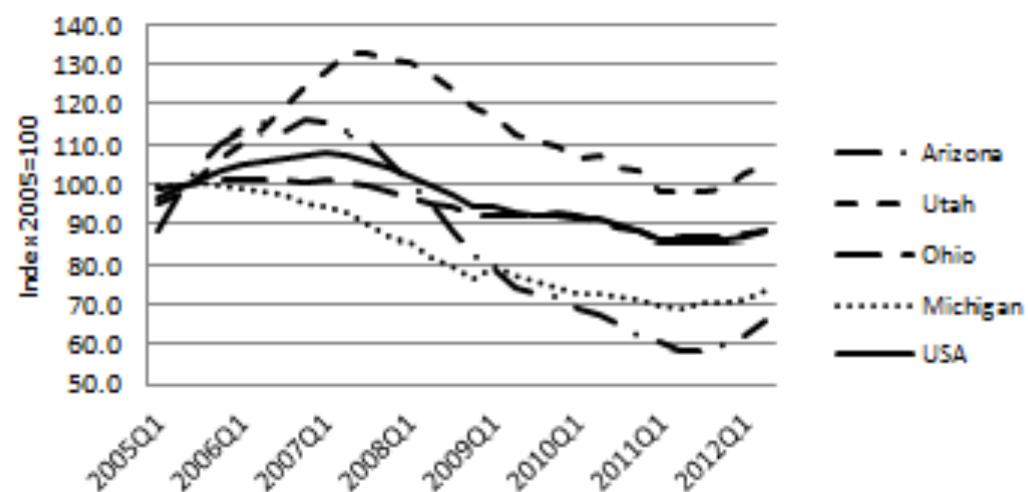
Chart 6: Euro zone HPI chosen states and federal

Index 2005=100

Ireland
Spain
Euro area
Germany
UK

8
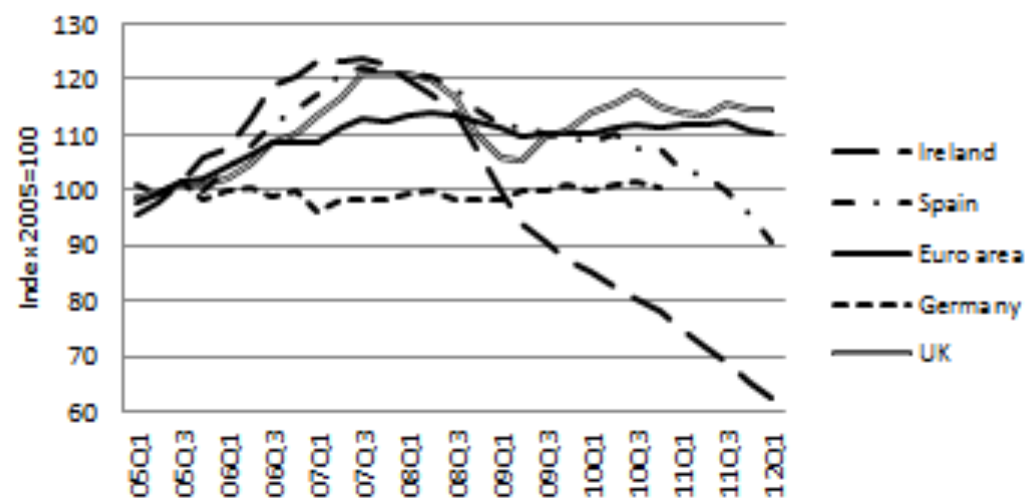
But a banking union, involving common deposit insurance and resolution fund, may be less attractive to (stronger) creditor countries than mechanisms to bail-in local bank creditors, (exacerbated by ECB study on relative wealth). Cyprus example. German position.

Worsening divergence. What will turn it around?