Lessons for Monetary Policy from the Euro-Area crisis

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C.A.E. Goodhart: Need for a banking union

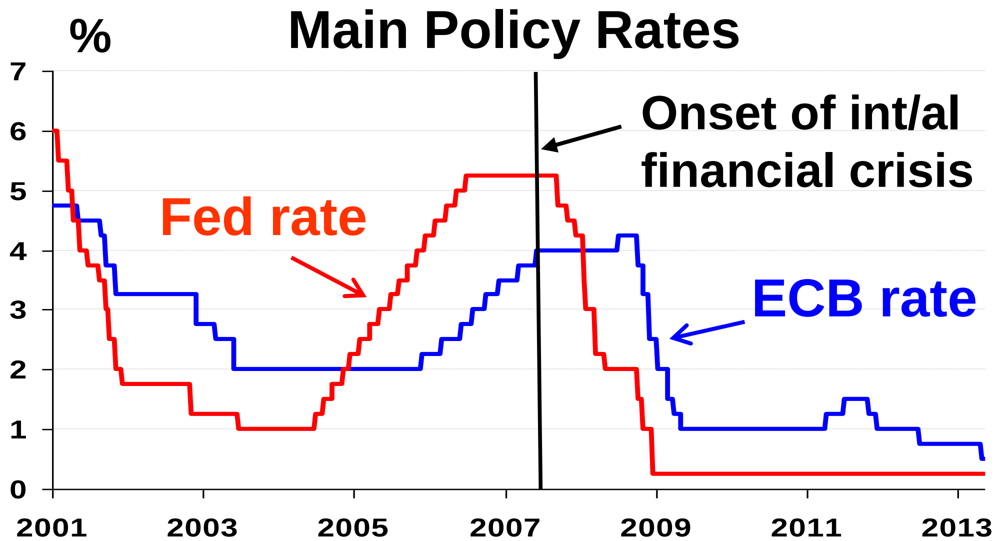
Presentation

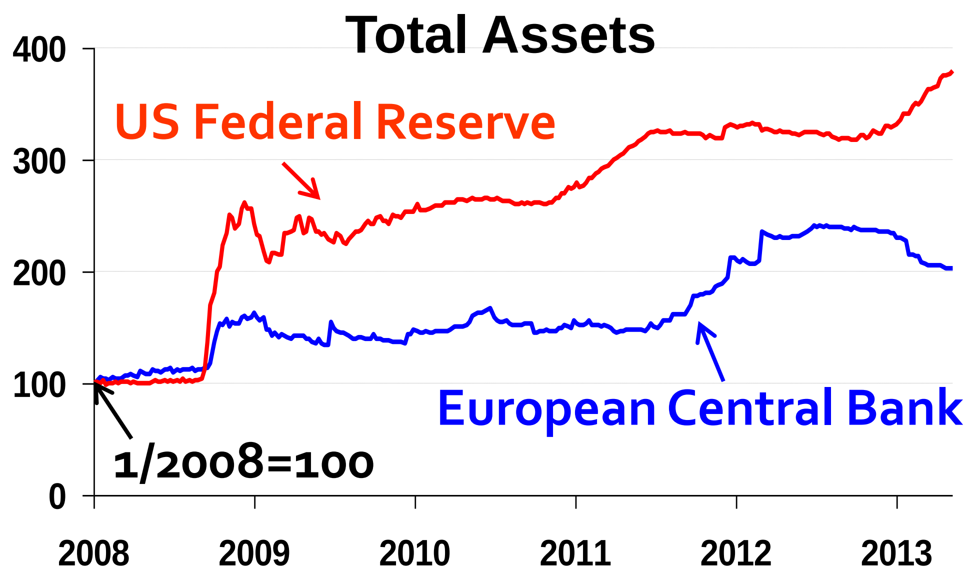
- Compares Euro-Area to USA
- Reviews the new policies instituted after the international crisis
- Argues that the <u>additional</u> lessons to be learned from the Euro-Area Crisis is the necessity of a Banking Union in a single-currency area
- Authors warns: "A banking union involving common deposit insurance and resolution fund may be less attractive to stronger creditor countries than mechanisms of bail-in local bank depositors"

Staying within the context of a strict definition of monetary policy and not expanding into regulatory policy, I will add that we can <u>also</u> learn from the different way the central banks responded to the crisis

Important differences in behavior between Fed - ECB

- ✓ Fed was more aggressive in its response, bringing interest rates down very quickly and expanding its balance sheet much earlier & by more than the ECB
- ✓ Fed used non-standard measures (QE, etc.), particularly after it hit the zero-interest bound, as substitutes to its interest rate policy
- ✓ ECB used non-standard measures as complements to its interest rate policy, in an effort to repair the transmission mechanism
- ✓ ECB worries about moral hazard and its no-standard measures are temporary





Source: Bloomberg

Those differences reflect different institutional set ups

- **In monetary policy, Eurosystem faces different - more - restrictions:**
  - ✓ **Its main target is price stability, unlike the Fed, which looks after unemployment as well**
  - ✓ **Eurosystem has to worry about 17 countries with separate parliaments, autonomous governments and different population cultures, not simply separate states within an Optimum Currency Area**
  - ✓ **Eurosystem needs to defend its independence in a continuous "<u>game</u>" against governments that refuse to reform**
  - ✓ **Financial system in Euro-Area is <u>bank-based</u>, as external financing depends on bank loans, especially so for SMEs,**
    - **Hence main focus of the ECB's transmission mechanism is bank lending, unlike the Fed, which targets the yield curve, or asset prices or market-based inflation expectations**
    - **A structural feature of the crisis is that the financial system in the Periphery – even previously healthy banks - is losing deposits which migrate to the North, thus creating a huge <u>asymmetry</u> in financial intermediation**

ECB crisis policies

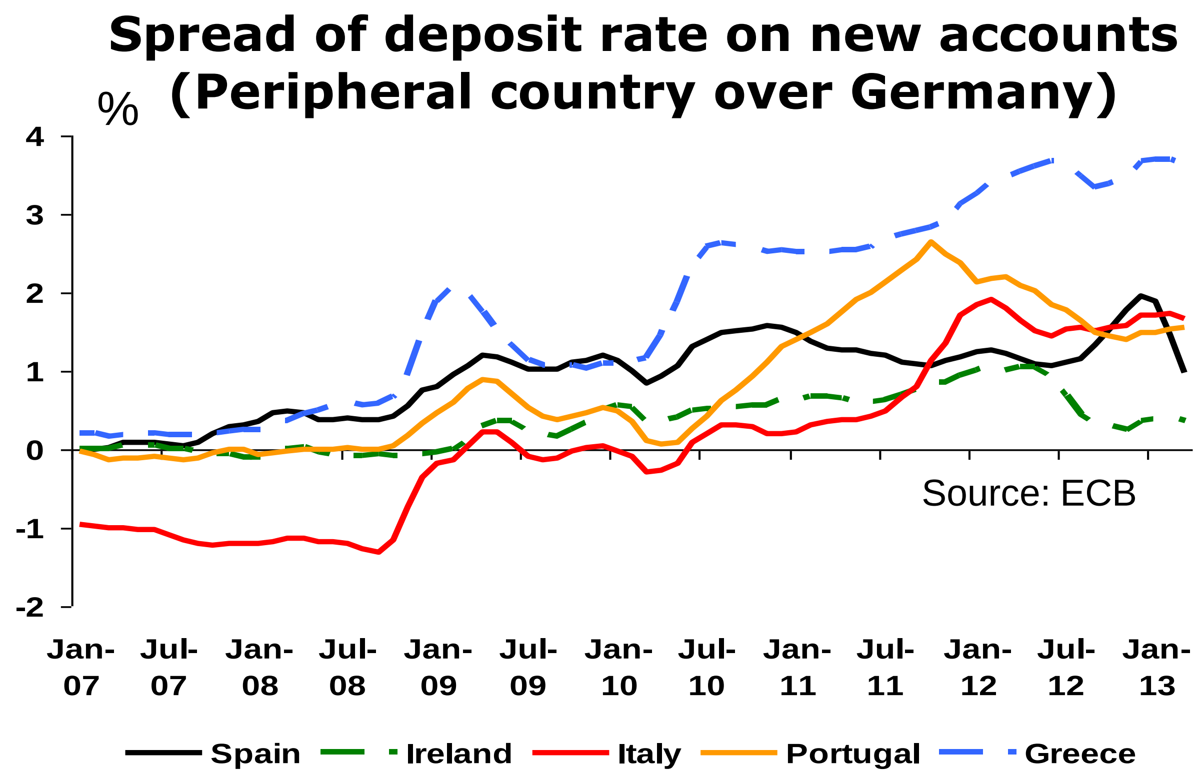
- MAIN QUESTION: Given that the Euro-Area is not an Optimum Currency Area and will not become one soon, can monetary policy adjust to accommodate asymmetric shocks, asymmetric financial structures, crises , etc.?
- ECB moved to non-standard methods from the early days of the international crisis:
  - Fixed-rate full allotment
  - Extension of the maturity of liquidity provision
  - Extension of collateral eligibility
  - Currency swap agreements
  - Covered bond purchase programme (backed by existing mortgages in the balance sheet)
- After the Euro-Area crisis erupted it proceeded with the SMP – this was a sterilized intervention - because the government bond market was too important for the transmission mechanism to leave it alone
- Following the EBA stricter capital standards in 2011, which created a deleveraging risk of ≈ €1tr, it pushed for the LTROs in December (even 460 German banks utilized it)
- When the exit-risk rose, it announced in September 2012 the OMT, under strict conditionality so as to avoid the moral hazard of counterparty governments

Has ECB succeeded?

- ECB has avoided a catastrophe thus far, being generous with liquidity provision to Programme countries

- But there is still a huge problem in its transmission mechanism, as deposit rates are more expensive in the periphery

- The Deauville agreement in October 2010 institutionalized the credit risk premium in sovereign yields and this has affected the bank cost of funds



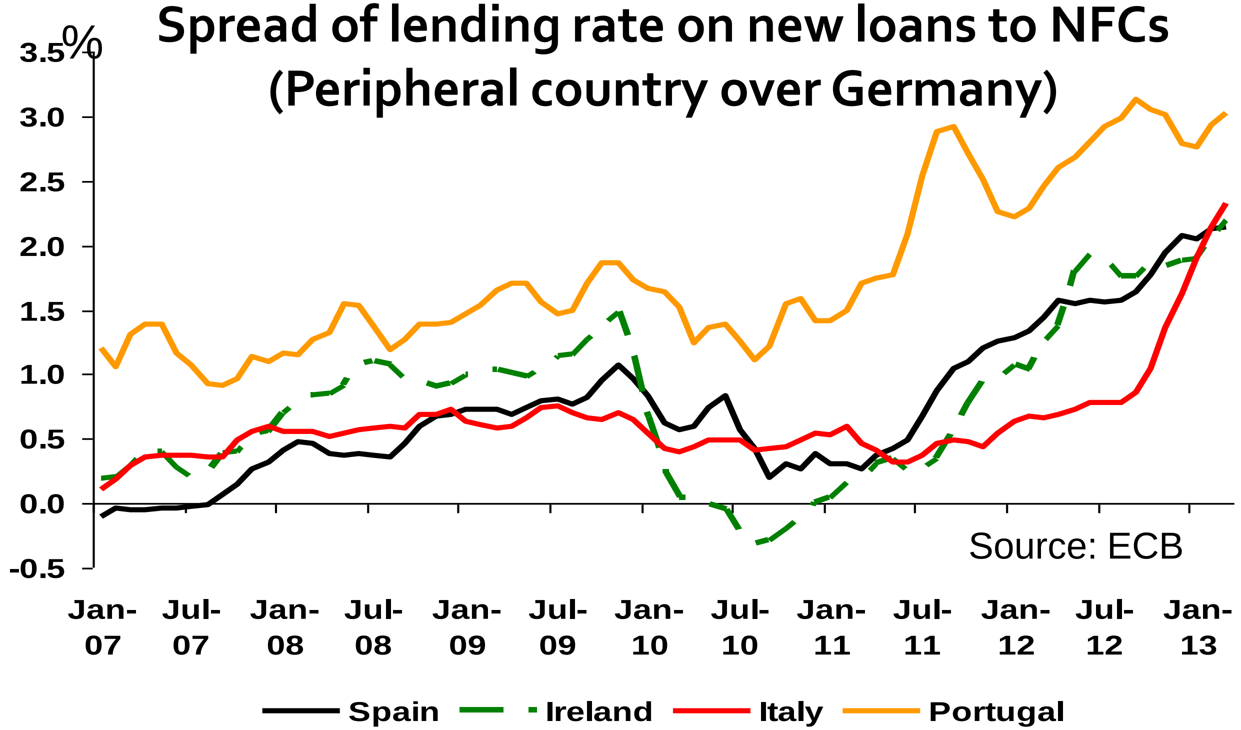
Notes: Rates on deposits refer to household deposits with agreed maturity up to 1 year, new accounts. For Ireland, rates refer to household deposits with unspecified agreed maturity.

- Central banks are still in confusion about the sovereign risk: In the Basel III capital standards, this risk premium does not affect the capital needs of banks in the standard approach, but it does in the other more sophisticated approaches

Is there a solution in a Euro-Area in which the higher Periphery cost of funding is passed on to borrowers?

- Similar spreads in Periphery marginal lending rates over Germany are present
- Will a Banking Union get rid of the spreads?
- <u>Is there a faster - targeted - way to reduce the spreads</u> without involving the local governments?

Spread of lending rate on new loans to NFCs (Peripheral country over Germany)



Notes: Rates on loans refer to new business loans to NFCs, up to €1mn, over 1 year maturity

- ***YES!!! Perhaps, if ECB buys securitized loans in Programme countries that conform to the requirements of their Programme***
- ***But will the pillars of monetary orthodoxy at the Eurosystem allow it?***

Thank you
for your attention

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