The ECB, THE BANKS AND THE CRISIS: WHAT HAVE WE LEARNED?

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Professor Reichlin has put together a coherent story of understanding the crisis. We have to be thankful for her presentation as well as the insights that she provided.

Rightly the focus is on

(i) the predominance of banks in the financial market and
(ii) their role as intermediaries in the sovereign bond market: they

create correlation of risk that central bank action alone cannot de-correlate.

New possibilities arise of course in connection with modeling dynamic correlations (by extensions of traditional dynamic factor models). The other possibility is the measurement of systemic risk by a common factor of the correlations when it rises.

The contagion literature is a good starting point.

Main points in my view

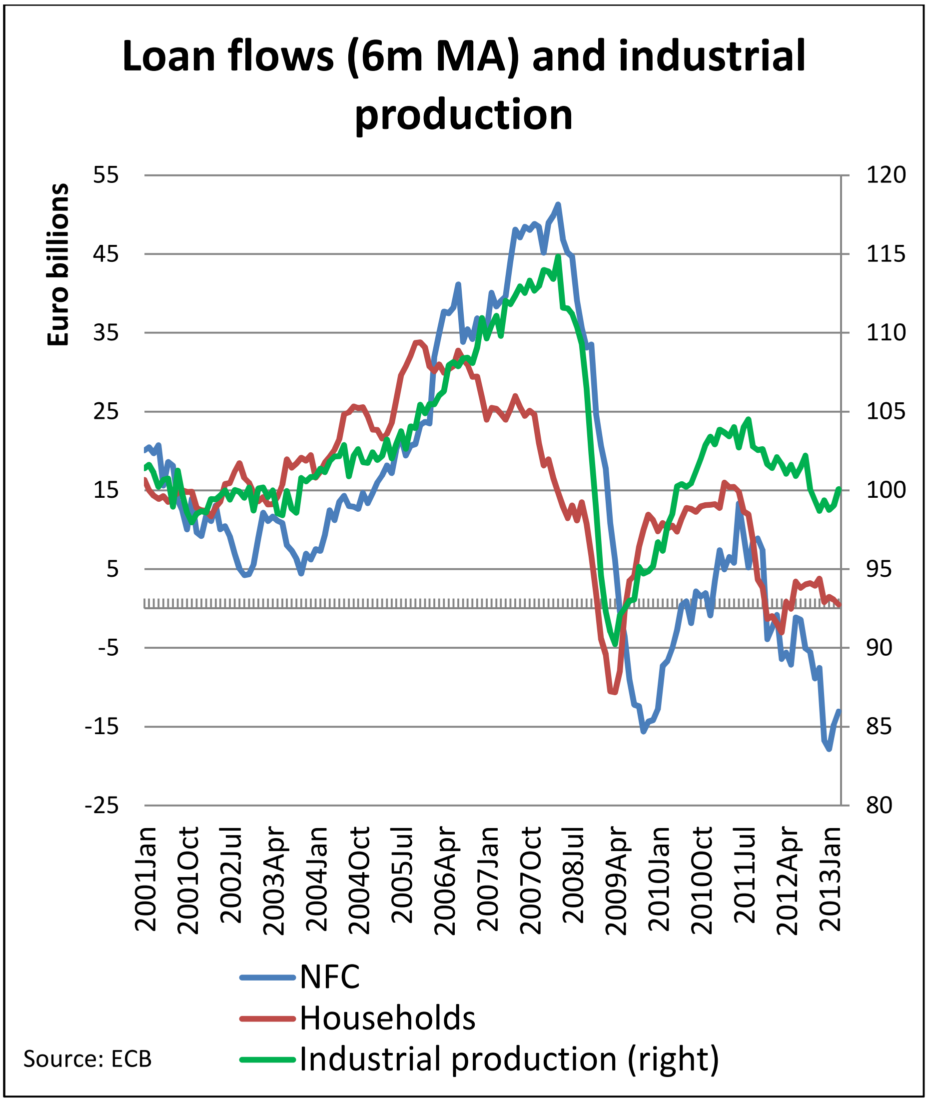
- Of course the ECB has to deal with commercial banks. Without intervention it would undermine its main role.

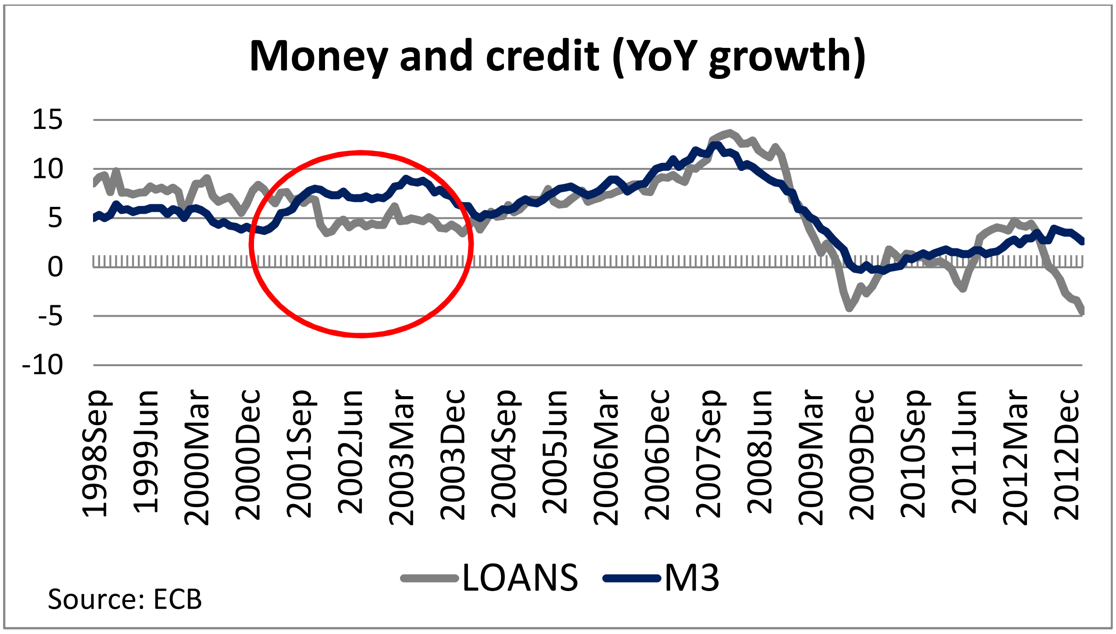
- It has been the expansion of credit and the policy of low interest rates that started all this and aggravated the sub-prime crisis.

- The system will not equilibrate with low interest rates and before the malinvestment generated by the long period of cheap credit has been liquidated.

- Correlation between bank risk and sovereign risk: Cheap credit is responsible for the first and irresponsible fiscal policies for the second.

- I cannot emphasize cheap credit more than is already available in Reichlin's presentation:


Loan flows (6m MA) and industrial production
Euro billions
55
45
35
25
15
5
-5
-15
-25
120
115
110
105
100
95
90
85
80
2001Jan
2001Oct
2002Jul
2003Apr
2004Jan
2004Oct
2005Jul
2006Apr
2007Jan
2007Oct
2008Jul
2009Apr
2010Jan
2010Oct
2011Jul
2012Apr
2013Jan
NFC
Households
Industrial production (right)
Source: ECB



Sometimes the evidence is in front of us but we can fail to see it! A view along the lines suggested by Mises and Hayek seems to me the most persuasive. Cheap credit creates misalignment of investment and gives rise to the business cycle.

Professor Reichlin makes some other interesting remarks.

- The central bank by providing liquidity to banks in the periphery in order to deal with financial stability risks ends up assuming fiscal risk (link between monetary and fiscal policy). The central bank is not free to do nothing else.
- This allows the safer North to extract the rent (the risk of their banks is transferred to the ECB and interest rates are depressed by the scarcity of safe assets). If safe assets are more scarce their price should go up not down.
- Standard monetary policy (geographical transmission of interest rates) is impaired. But no one prevents an expansionary monetary policy in the form of more credit.
- Banks become increasingly dependent on the ECB. To say it boldly that was the whole deal since the conception of the central bank.
- The ECB replaces the market. Precisely but see previous point.
- Loan rates to corporations reflect interest rates on government bonds. Very interesting point although the correlation is less during the sub-prime crisis. Interest rates falling sharply just before the depression –one may think this goes against all economics. But it does not.

  The overall alignment with bond rates reveals the importance of some macro factors that are at work here. What factors? Credit and the interest rate policies of the ECB.

  There is an institutional framework that shapes up the entire constellation of policies in the Eurozone. This cannot be ignored. There is also enough evidence that credit and low interest rates aggravated what went on after mid 2008.