

# Lessons for Monetary Policy from the Euro-Area crisis

Presentation

by

**C.A.E. Goodhart**

London School of Economics

Discussion

by

**Gikas A. Hardouvelis**

Un. of Piraeus & Eurobank



**BANK OF GREECE**

EUROSYSTEM

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

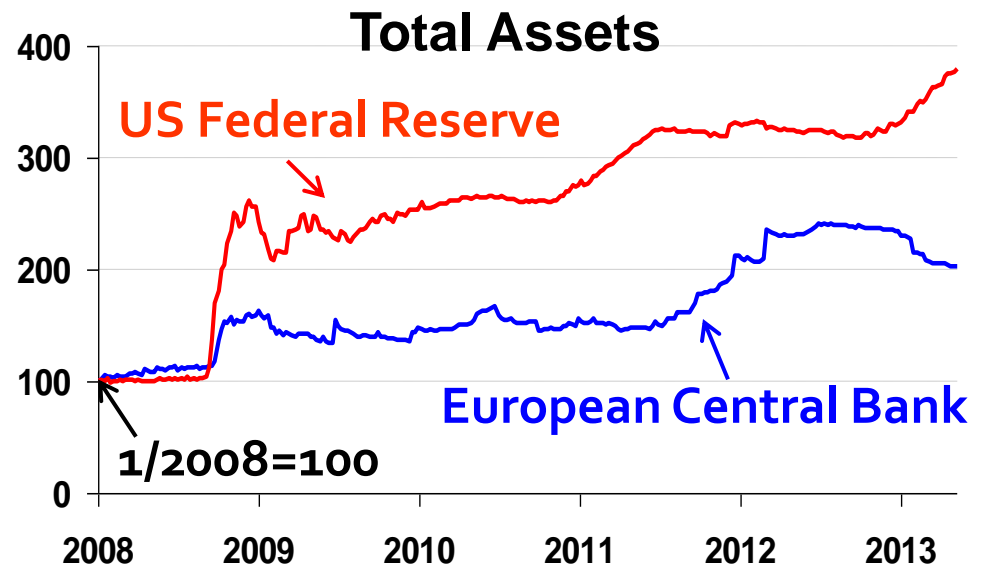
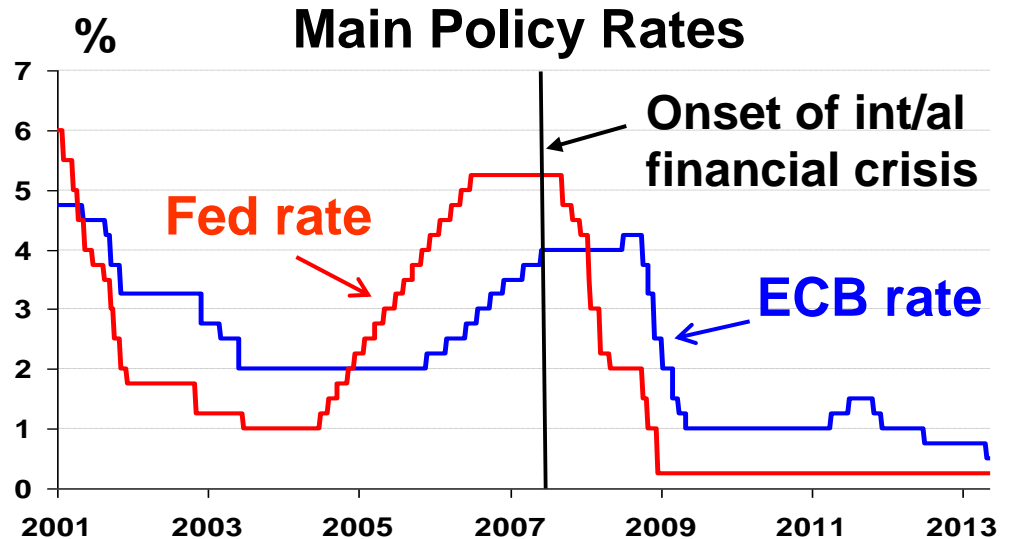
## Presentation

- ❖ Compares Euro-Area to USA
- ❖ Reviews the new policies instituted after the international crisis
- ❖ Argues that the additional 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 also 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 non-standard measures are temporary



# Those differences reflect different institutional set ups

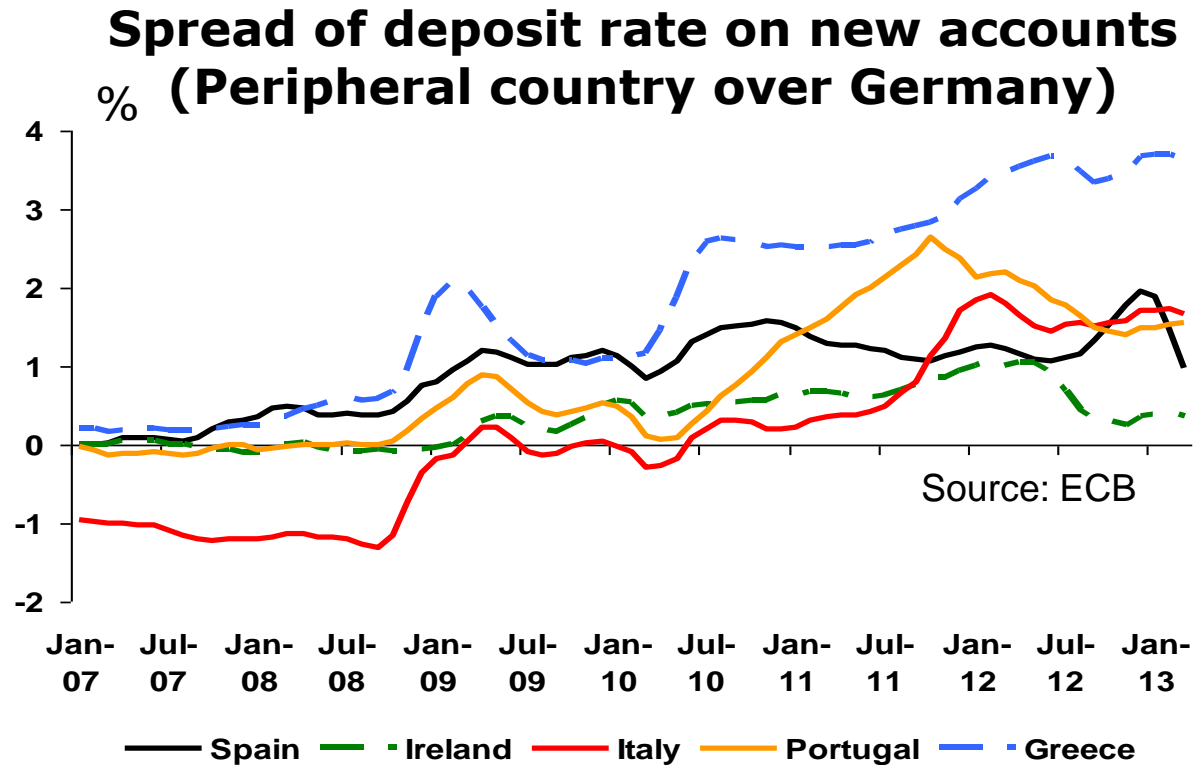
- ❖ In monetary policy, Eurosystem faces different - more - restrictions:
  - ✓ Its main target is price stability, unlike the Fed, which looks after unemployment as well
  - ✓ Eurosystem has to worry about 17 countries with separate parliaments, autonomous governments and different population cultures, not simply separate states within an Optimum Currency Area
  - ✓ Eurosystem needs to defend its independence in a continuous “game” against governments that refuse to reform
  - ✓ Financial system in Euro-Area is bank-based, 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 asymmetry 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 – 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  $\approx \text{€}1\text{tr}$ , 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
- ❖ 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

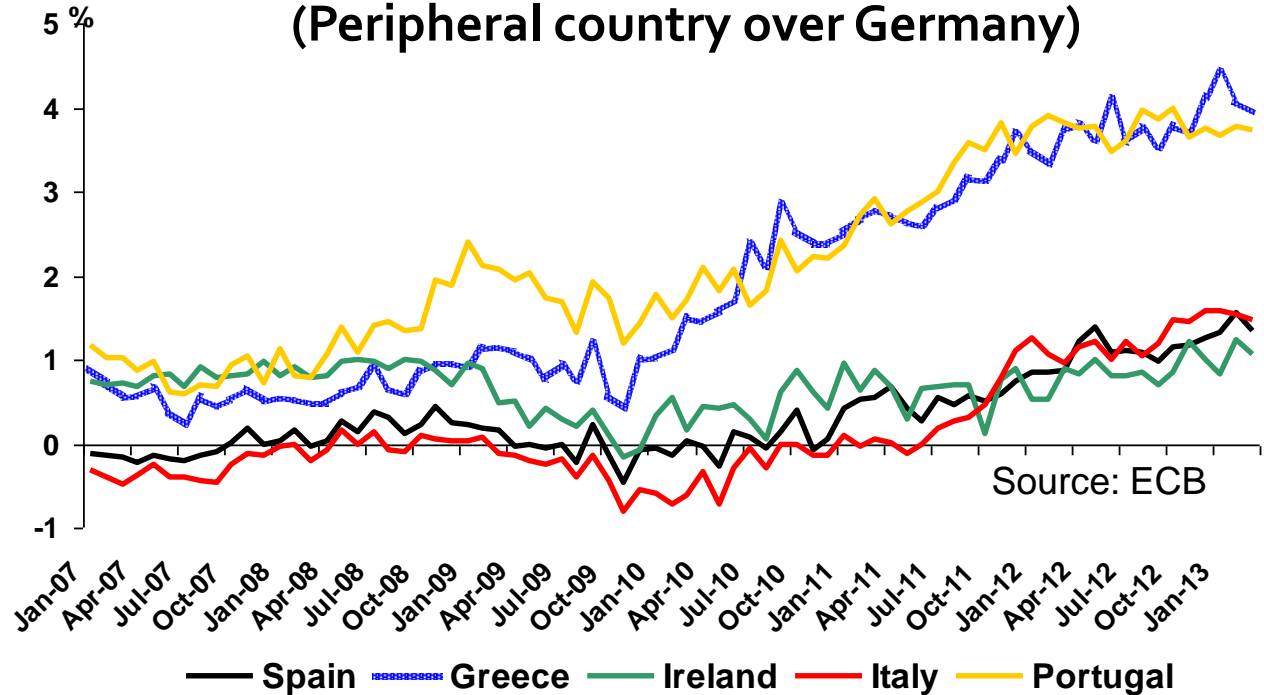


Notes: Rates on deposits refer to household deposits with agreed maturity up to 1 year, new accounts. For Ireland, rates refer to household deposits with unspecified agreed maturity.

# 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?
- ❖ Is there a faster - targeted - way to reduce the spreads 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 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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