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# Lessons for Monetary Policy from the Euro Area Crisis

## 1 The 2007/08 Crisis

The crisis with the most lessons for monetary policy was the original 2007/08 crisis, not the subsequent euro area crisis. This initial 2007/08 crisis, however, originated in the US housing market, and was not specifically European. Nevertheless the resulting financial debacle entailed numerous important lessons for monetary policy. Amongst these were:

### 1.1 Price stability does not necessarily guarantee financial stability

As Hy Minsky demonstrated, price stability may even conflict with financial stability, rather than complement it. This is because a reduction in macroeconomic volatility may seem to reduce risk, and therefore make financial institutions raise their leverage, and reach for yield.

Hence, there is a need for counter-cyclical macroprudential instruments. The use of these would be relatively new, and remains unproven. In particular, macroprudential counter-cyclical measures would have to be imposed against the momentum and grain of the market. If an asset price boom was perceived to be unsustainable, it would immediately subside under its own weight. Accordingly, the majority of those involved must be believing that further price increases in the relevant asset market(s) may well continue. Politicians may believe that the asset markets have risen because of their own successful policies. Consequently, macroprudential counter-cyclical policies would have to be introduced at a time when they are likely to be opposed by many politicians, most borrowers and lenders, and many, probably most, commentators in the press.

It will be hard enough to be counter-cyclical in a boom; it will be almost impossible to do so in a bust. In a bust, counter-cyclical measures would suggest reducing capital and liquidity requirements. But the availability of bank capital and liquidity has just been shown, almost by definition, to have been insufficient in the preceding bust.



In a boom, macro- and microprudential measures go hand-in-hand; but in a bust, the microprudential authorities will want to toughen regulations, while counter-cyclical macroprudential measures would need to involve the opposite. The banking industry fears that macroprudential measures will be tightened in the boom period, but not then relaxed in the bust period; so that such macroprudential measures would get continuously ratcheted up. Moreover, since they would be operating against the trend of the market, the likelihood is that they would not be sufficiently vigorously and aggressively introduced in order to provide much of a mitigation of the cycle. The example of the Spanish dynamic pre-provisioning scheme comes to mind; this was a well-designed counter-cyclical measure, but of insufficient scale and extent to pro-

vide much of a mitigant to the Spanish housing cycle.

### **1.2 The Basel II Capital Adequacy Requirements (CARs) were insufficient loss absorbers in the crisis**

Hence, there was a need for reinforced and extended CARs under Basel III. Even so, there remains a question whether this has gone far enough, and has been sufficiently radical. The main shortcoming of the banking system prior to 2007 was its extended leverage. But the backstop simple leverage ratio imposed under Basel III still allows that to be up to 33 to 1, which is surely too high. Similarly, Basel III still puts its main reliance on a Risk Weighted Asset approach to CARs, although the RWA regime has been shown to be faulty and capable of manipula-



tion. There is, therefore, a serious question whether the reform and increase in CARs has gone far enough. This is the main burden of the new book by Admati and Hellwig, entitled *The Bankers' New Clothes*; and also the work by Miles et al. in *The Economic Journal*.

Moreover, the attempt to strengthen the equity basis of the banking system has been badly mishandled in Europe. The banks have been requested to raise their equity ratio. This has been done at

a time when the incentives for bank senior officials remain focussed on the desire to maintain a high Return on Equity (RoE). With bankers simultaneously focussing on RoE, and being forced to improve their equity ratios, the inevitable implication is that this has reinforced the pressure to deleverage and reduce the outstanding volume of assets on banks' books. This sharp reduction in leverage has had a significant negative effect on the ability to recover from the financial crisis.

### **1.3 At times of crisis, funding liquidity via wholesale markets dries up**

Hence, there has been a need to introduce liquidity ratios again, for the first time since they became dropped after wholesale markets developed in the 1970s. These new liquidity ratios include the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR has already been introduced; but its introduction has not had a deleterious effect in further putting downwards pressure on bank assets. This has been because the collapse of many wholesale funding markets has been offset by a massive expansion of central bank balance sheets, providing a similar huge increase in commercial bank deposits (reserves) at the central bank, which has in most cases more than sufficed to meet the new required LCRs. With the volume of loans having expanded faster than the volume of deposits in the run-up to 2007, (Schularick and Taylor), much of the excess in loans over deposits was financed through relatively short-term wholesale deposits. The introduction of an NSFR would most likely have put further downwards pressure on credit expansion by banks; but its introduction has been deferred, and it remains unclear when, and with what parameters, it may eventually be introduced.

#### 1.4 In crises the zero lower-bound to interest rates becomes a reality

Hence, there has been a need for unconventional expansionary monetary measures in the forms of quantitative easing (QE), credit easing (CE), long-term refinancing operations (LTRO), and Abenomics, etc. The initial introduction of these measures in 2009 and 2010 did lead to a considerable immediate recovery in confidence, and brought the initial sharp downturn in economic output to an end. It also led to a further reduction to official interest rates on government debt, and to some, albeit somewhat minor, reduction in the enhanced risk premia. But with official interest rates having already being reduced to levels close to zero by the first round of such measures, it has not been clear whether subsequent rounds of these expansionary monetary measures has actually done very much additional good to our economies.

#### 1.5 In particular, the increase in the monetary base did not lead to a wider increase in either bank credit expansion or the broader monetary aggregates

The expansion of M0 does not guarantee an equivalent expansion of M2; the money multiplier can, and did, collapse in this crisis. Hence there was a greater need to consider the incentives and underlying driving forces that would lead banks to expand credit, rather than just hold the resulting vastly increased reserves on deposit at the central bank. More consideration might have been given to the (relative) remuneration of such commercial bank deposits at the central bank. The interest payable on such excess reserves (IOER) might have been cut faster and further. More generally, there was more need to understand, and perhaps to nudge, the incentives of bank managers towards credit expansion, especially to SMEs.

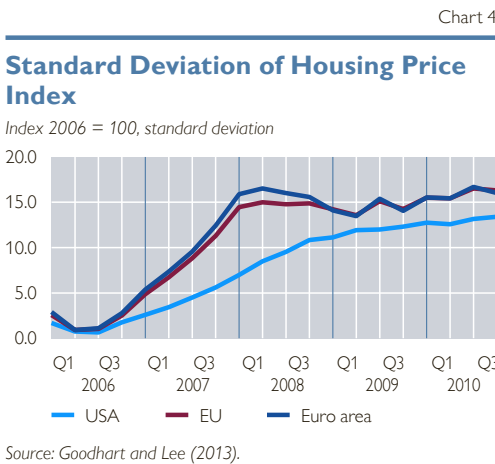
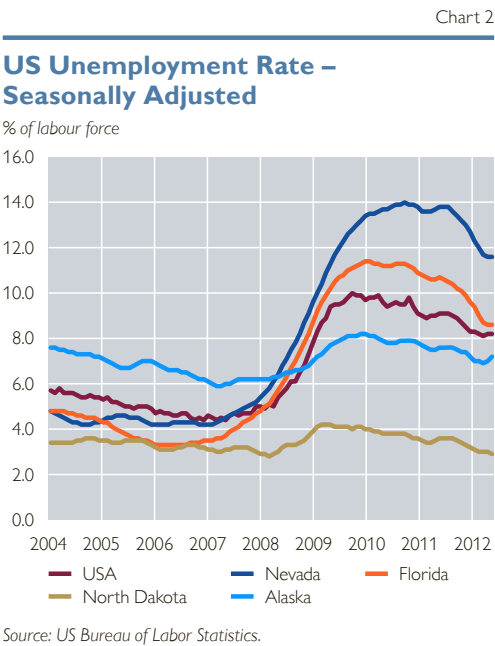
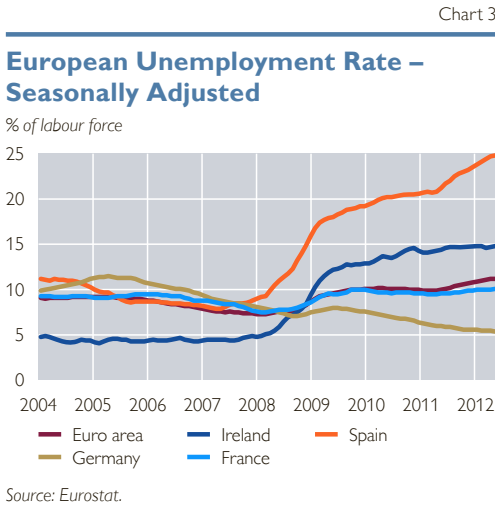
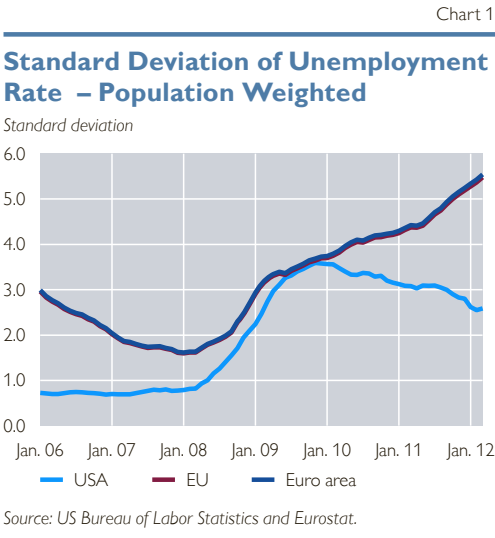
## 2 The On-Going Euro Area Crisis

It is far less clear what *additional lessons* for monetary policy were provided by the specific euro area crisis, starting in 2010 and continuing thereafter. This crisis underlined the failings of the risk-weighted asset approach, notably the zero-risk weight on all developed countries sovereign bonds, with Greek sovereign debt, held by the private sector, being restructured, and the credit risk of many other peripheral countries declining sharply; but we knew that already. The main lesson, in my opinion, is that a single currency covering several diverse states does need, inter alia, a Banking Union. As noted earlier, the initial financial crisis hit the USA just about as badly, or perhaps more severely, than Europe. Nevertheless, the economies of the various states in the USA has, since then, converged back, and the USA as a whole recovered, whereas in the euro area the states continue to strongly diverge, certainly in their unemployment experience. What then were the main differences between the experiences of the USA and of European states? As shown in the charts below, the initial housing shock was much the same in both, but the USA then converged, whereas the euro area strongly diverged. Why, then, has the USA been such a much more successful currency union than the euro area?

The main adjustment mechanisms in the face of asymmetric shocks in a currency union are:

- Wage flexibility
- Migration
- Fiscal federalism
- Cross-border (Federal) banking, thereby breaking the doom loop between the sovereign and the banks in each state.

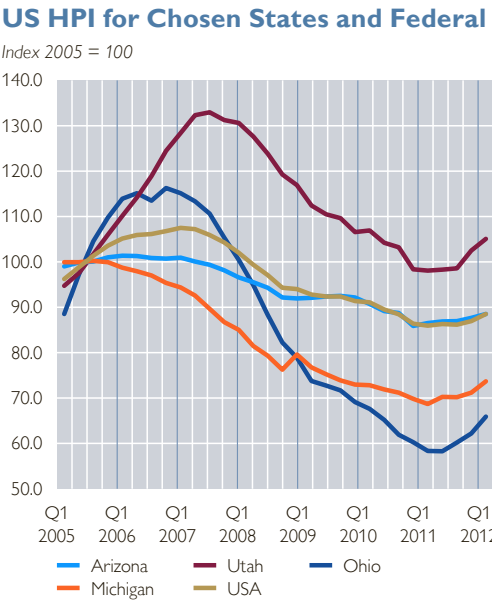
This is not the place to go at any length through the differences between the



USA and the euro area; I have done so in a recent separate paper (2013) in *Open Economies*. Nevertheless, it may just be worth noting that wage flexibility is no more a major mechanism for adjustment in the USA than it has been within the euro area. Indeed, it is possible that in the last few years the adjustment in terms of wage flexibility has been greater in some European states than it was in the USA. Meanwhile migration is somewhat easier in

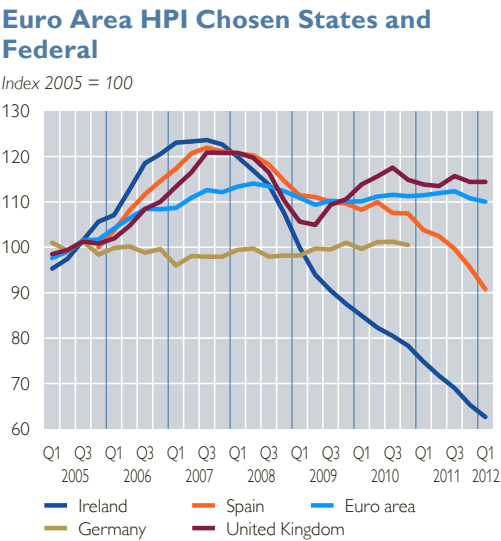
the USA than it has been in the euro area; nevertheless there has been much more flexible labour migration within Europe recently, than there used to be previously. A large proportion of the Latvian working population, for example, moved out of Latvia to other countries in the course of the crisis. What is, perhaps, more striking about differences between Europe and USA in this respect is not so much the flexibility of migration, but how it is perceived. In the USA the willingness of people to move from areas of low job opportunities to areas with better job opportunities is regarded as a good thing, an indication of the entrepreneurial, get-up-

Chart 5



Source: Goodhart and Lee (2013).

Chart 6



Source: Goodhart and Lee (2013).

Again, I need not emphasise the difference between the fiscal federalism in the USA, and the fiscal state nationalism within Europe, a distinction which was highlighted for me by the dinner speaker at this conference.

In states in the USA which were badly affected by the housing shock,



such as Arizona and Nevada, there were many small banks which were headquartered in those states. And several of these may have failed during the financial crisis. But the main providers of banking services in these states, were the federal, cross-state-border banks such as Citi, Bank of America, JP Morgan Chase, and Wells Fargo. Although there will have been many non-performing-loans in those states on the balance sheets of these large cross-border banks, their overall funding costs will have been determined nation-wide. Their credit-expansion criteria will again be determined nation-wide, so those seeking new loans in Arizona will not necessarily have that much worse a set of credit and financial conditions, e.g. for collateral, than those seeking loans from the same banks in Texas or New York.

and-go characteristics of the American population, while within Europe, the disadvantages of migration both to the receiving and to the departing countries are emphasised much more. Clearly the barriers to migration in terms of differences in language, culture, law and other social conditions are much greater in Europe.



In contrast, most banking within euro area states was done by banks which were headquartered, and very frequently entirely operating, in those states. Thus all Spanish banking, or virtually all such banking, was done by Spanish banks; and most of these banks, excluding Santander and BBVA, had very little exposure and activity outside of Spain. Thus, when Spain got particularly badly hit by the housing shock, the Spanish banks became particularly badly hit. With the Spanish banks being particularly badly hit, and no banking union, there was no alternative then, but that the local state government would have to bear the main burden. In contrast, the states of Arizona, Nevada, or Florida bore virtually no extra burden from the particular difficulty of housing in their own states. But the euro area member states were not re-



ally in most cases strong enough to bear this additional burden without their own credit rating being adversely affected. The worsening credit rating of the Irish and Spanish governments in turn dragged down the credit ratings of their banks yet further. This meant that the terms and conditions and interest rates at which the local banks could provide new credit to the local state population worsened; this then further reduced economic activity, yet further

reducing the tax revenue of the state, and enhancing the weakness of the economy more generally. To take a counter example, in Latvia banking is half done by Swedish banks and half done by local Latvian banks. When the Latvian crisis took hold, the external Swedish banks did three quarters of the additional new credit expansion, on the base of half of the local deposits.

So, one answer for dealing with asymmetric shocks within a currency union, is to ensure that there is a banking union over the whole of that currency area.

But a banking union, involving common deposit insurance and a common resolution fund, may be less attractive to the (stronger) creditor states within a currency union than would be mechanisms to bail-in the local bank creditors. Thus, the example of Cyprus, whereby local uninsured depositors took a major hit in order to recapitalise the local Cypriot banks, has been perceived as a possible template for future measures to recapitalise banks which might otherwise be failing. This reduces the possible call on taxpayers and banks in the wealthier and stronger states of northern Europe from having to support banks in the weaker countries. Such a bail-in of uninsured depositors is much more likely both to impose losses on local residents and thus reinforce the doom-loop, and also to enhance the likelihood of contagion, with large depositors fleeing northwards whenever a crisis appears imminent. This reluctance of northern creditor states to come to the support of banks in the weaker southern states has, of course, been reinforced by a recent ECB study suggesting that the median German household had less net financial wealth than households in the southern states. The German position appears to be that whereas a banking

union might be desirable in the long-run and in principle, it should not be introduced in the short-run, nor seen as a mechanism for dealing with current (legacy) problems of adverse downwards spiral interactions between the economy, banks and the local government within the euro area.

As was shown in the earlier charts, divergences in economic conditions, especially in employment and labour

markets, throughout the euro area, have been continuing throughout these crisis years. It is not clear what is going to stop this divergence continuing, even if pressures for further austerity recede. What is going to make the weaker peripheral countries begin to grow faster than the core countries? That is one question that I wish to leave with you.

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