Journal of Macroeconomics 39 (2014) 387–400

Contents lists available at ScienceDirect

Journal of Macroeconomics

journal homepage: www.elsevier.com/locate/jmacro

Monetary Policy and Banks in the Euro Area: The Tale of Two Crises ☆

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ARTICLE INFO

Article history:
Available online 14 October 2013

JEL classification:
E44
E58
G21

Keywords:
Economic recessions
Financial system
ECB policies
Bank behavior

ABSTRACT

The paper is a narrative on monetary policy and the banking sector during the two recent euro area recessions. It shows that while in the two episodes of recession and financial stress the ECB acted aggressively providing liquidity to banks, the second recession, unlike the first, has been characterized by an abnormal decline of loans with respect to both real economic activity and the monetary aggregates. It conjectures that this fact is explained by the postponement of the adjustment in the banking sector. It shows that euro area banks, over the 2008–2012 period, did not change neither the capital to asset ratio nor the size of their balance sheet relative to GDP keeping them at the pre-crisis level. The paper also describes other aspects of banks' balance sheet adjustment during the two crises pointing to a progressive dismantling of financial integration involving the inter-bank market since the first crisis and the market for government bonds since the second.

1. Introduction

This paper is a narrative on the monetary policy of the European Central Bank (ECB) in the period 2008–2012 with a specific focus on liquidity operations and the dynamics of the financial sector. Rather than taking the perspective of single countries within the euro-zone [which has been the focus of much commentary since the crisis] I will look at the euro area economy as a whole. Analysis of the collective performance of the union is interesting per se, notwithstanding the heterogeneity it may hide, and is a starting point for understanding the effect of the combination of national and federal policies implemented since 2008.

My narrative starts from the observation that the euro area, unlike the US, experienced a second recession after the global downturn. Since late 2007, the euro area has seen a global financial crisis, a major recession, the sovereign debt crisis and a second recession which followed a brief recovery in 2009–2011. While the first euro area recession was almost coincident with that of the US (see CEPR and NBER dating) and both economies started to recover at the same time, the second recession is specific to the euro area, a rare decoupling of the US and European business cycles in post-war history (see Reichlin, 2005). As I write now, some signs of a timid recovery are eventually appearing in the most recent data releases (see www.now-casting.com). However, the loss of output and employment in the last five years has been unprecedented, as has the stress in the financial sector. The damage from these episodes will not be easily repaired and is likely to overhang the recovery.

☆ Paper prepared for the Bank of Greece conference "The crisis in the euro area", Athens May 23–24 2013. I wish to thank Huw Pill for useful discussion.
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0164-0704/$ - see front matter © 2014 Published by Elsevier Inc.
http://dx.doi.org/10.1016/j.jmacro.2013.09.012

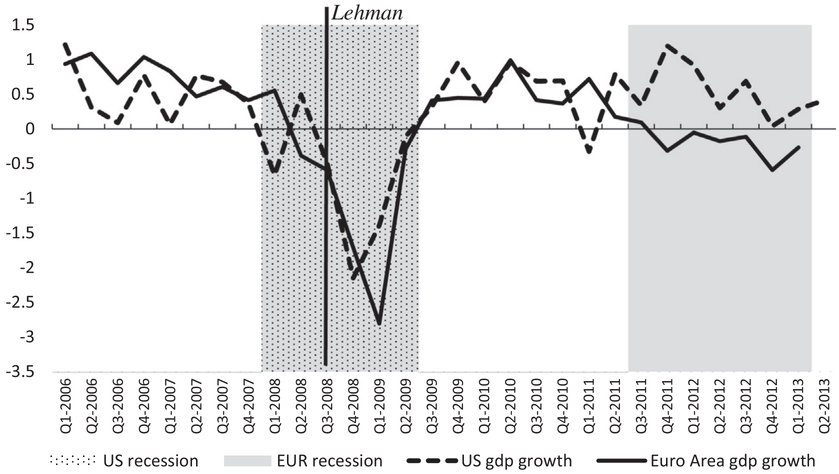

Fig. 1. US and euro area recessions (GDP, QoQ growth rate). *Source*: OECD.

The timing of the recessions and the extreme episodes of financial stress are not identical although there is a significant overlap. In both periods the European Central Bank (ECB) aggressively injected liquidity into the banking sector in an effort to avoid its collapse due to the paralysis of the inter-bank market. The key non-standard monetary policy measures taken by the ECB were liquidity operations, i.e. repo loans against collateral at a fixed rate for up to one year since 2009, and up to three year since 2011 (the so-called Long Term Refinancing Operations – LTRO). As with the quantitative easing measures adopted by other central banks, these operations had the effect of increasing the size of the balance sheet of the euro-system of central banks (ESCB) and increasing its importance as a financial intermediary. Given the predominance of banks as a channel of financial intermediation in Europe, the ECB designed its policy so as to deal directly with banks and focused, in particular, on replacing the wholesale funding market which had come almost to a stop after the collapse of Lehman Brothers in the fall of 2008. As Tommaso Padoa Schioppa correctly anticipated (Padoa Schioppa, 2004) and contrary to claims by some before the crisis, the euro-system proved to be sufficiently robust to be able to face an inter-bank run by providing emergency liquidity and adopting what he called a *'market operation approach'* to its role as lender of last resort.

In the first phase of the crisis, this approach was not only successful in preventing a collapse of the financial system, but also had a significant positive effect on the volume of bank lending and on the real economy (Lenza et al., 2011 and Giannone et al., 2012). In this paper I report data which suggest that this was not the case in the second phase of the crisis when, although the volume of the long term refinancing operations increased and their horizon lengthened to three years, bank lending remained unusually weak, even when taking into account the decline in industrial production and the dynamics of M3.

The correlation between central bank liquidity provision and bank lending has been different in the two recessions, as has that between bank lending and the real economy. This suggests that the transmission mechanism of non-standard monetary policies was different between the two episodes and that in the second crisis these policies lost their effectiveness.

In an attempt to formulate conjectures about this fact, this paper examines data on banks' assets and liabilities as well as on central banks' actions between 2008 and 2012 in order to identify differences between the two crises. In the first section I will briefly describe ECB action. In the second I will report data on the key characteristics of the euro area financial system. I will then review the banks' balance sheet adjustment during the two crises in Section 3 and finally, in Section 4, I will discuss the nexus between ECB liquidity policies and banks' behavior.

2. The crisis and the ECB: a personal view

Fig. 1 plots euro area and US quarterly GDP growth from 2006 to the first quarter of 2012. The shaded areas highlight US and euro area recessions identified, respectively, by the National Bureau of Economic Research and the Center of European Policy Research (CEPR)[1]: while the first coincides, the second is specific to the euro area.

The recessions roughly correspond to two periods of stress in financial markets related, respectively, to the post-Lehman global crisis and to the sovereign crisis in Europe. Fig. 2 shows the secured three-month euribor rate and the unsecured three-month eurepo rate. The shaded area is the spread between the two, which typically signals tensions in the money market. It exhibits two peaks, one just after the Lehman Brothers collapse, the second at the time of the sovereign crisis in 2011.

The financial crisis first erupted in the summer of 2007 but really deepened and spread after the collapse of Lehman in the fall of 2008. The recovery started in the second quarter of 2009, more or less coincidentally with that of the US (see www.cepr.org and www.nber.org).

[1] For criteria on business cycle dating see the website of CEPR <www.cepr.org> and NBER <www.nber.org>.