Journal of Macroeconomics 39 (2014) 378–382

Contents lists available at ScienceDirect

Journal of Macroeconomics

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

Lessons for Monetary Policy from the Euro-Area Crisis

C.A.E. Goodhart *

London School of Economics, Houghton Street, London WC2A 2AE, United Kingdom

ARTICLE INFO

Article history:
Available online 28 August 2013

JEL classifications:
E52
E44
F36
G01

Keywords:
Price stability
Financial stability
Banking union
Zero lower-bound

ABSTRACT

The earlier 2007/2008 financial crisis generated the main lessons for monetary policy, notably that price stability does not necessarily guarantee financial stability. Nevertheless, the on-going Eurozone crisis has pointed to further lessons, notably that a single currency covering diverse states does need a Banking Union; and to problems of zero risk-weighting for sovereign debts. Without such a Banking Union, economic divergences between the Eurozone states have continued and look likely to persist.

1. The 2007/2008 crisis

The crisis with the most lessons for monetary policy was the original 2007/2008 crisis, not the subsequent Eurozone crisis. This initial 2007/2008 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:

(i) Price stability does not necessarily guarantee financial stability.

As Hyman Minsky demonstrated, price stability may even conflict with financial stability, rather than complement it. This is because a reduction in macro-economic 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 macro-prudential instruments. The use of these would be relatively new, and remains unproven. In particular, macro-prudential 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, macro-prudential 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.

* Tel.: +44 (0)20 7955 7555.
E-mail address: c.a.goodhart@lse.ac.uk

0164-0704/$ - see front matter
http://dx.doi.org/10.1016/j.jmacro.2013.08.014

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 micro-prudential measures go hand-in-hand; but in a bust, the micro-prudential authorities will want to toughen regulations, while counter-cyclical macro-prudential measures would need to involve the opposite. The banking industry fears that macro-prudential measures will be tightened in the boom period, but not then relaxed in the bust period; so that such macro-prudential 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 provide much of a mitigant to the Spanish housing cycle.

(ii) 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 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 33–1, 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 manipulation. 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 (2013), entitled *The Bankers' New Clothes*; and also the work by Miles et al. (2013), 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.

(iii) 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.

(iv) 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 refinance 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.

(v) 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.