Central banking after the Crisis: Challenges for the ECB

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The global and Eurozone crises differ. This column discusses how these differences throw up particular challenges for the ECB. Faced with dysfunctional financial markets and lacking a fiscal counterparty, the ECB has been progressively drawn into using its fiscal capacity proactively. However, each use undermines the credibility of attempts to limit recourse to that capacity in the future. Returning to the conventional allocation of liquidity problems to central banks and solvency problems to governments will be difficult.

Financial and sovereign crises in Europe have left the ECB facing three inter-related challenges (Shambaugh 2012):[1]

- A large and stubborn shortfall in aggregate demand.
- Segmented euro financial markets that impair the transmission of monetary policy to the periphery.
- Limited scope for further conventional monetary easing due to the zero lower bound on interest rates.

Many of these challenges are familiar in other parts of the world; a number are specific to Europe. Two idiosyncratic elements stand out.

1 See Pill and Smets (2013) for more detailed analysis.

Financial-market dysfunctionality and institutional lacunae

First, due to successive sovereign-debt crises starting with Greece in 2010, financial market dysfunctionality was both more profound and more prolonged in the Eurozone than elsewhere. Since late 2009, financial markets have been reasonably functional in the US and the UK, but they have been dysfunctional in the Eurozone since early 2010.

The reasons for the financial-market dysfunctionality are known:

- With concerns about fiscal sustainability and euro breakup growing, capital fled the periphery.
- Banks, as well as sovereigns, were unable to obtain funding as euro markets segmented along national lines.
- Credit creation in bank-centric peripheral financial systems ceased, and the financial sector seized up.

Second, the Eurozone suffered from institutional lacunae on the fiscal side. While the Federal Reserve and Bank of England faced cooperative and functional national treasuries, the ECB had no natural fiscal or regulatory counterpart.

- At the national level, fiscal capacity in the most severely affected peripheral countries was exhausted.

The poor – in some cases, catastrophic – state of public finances implied that governments lacked the resources to solve or contain difficulties arising in the financial sector.

- At the EZ-wide level, the ECB faced a disparate and ill-coordinated set of national finance ministries and bank regulators.

Many were unwilling and/or unable to adopt a Eurozone approach that internalised the significant cross-border externalities created by spillovers and contagion.

Due to these asymmetries, Eurozone authorities faced challenges that their Anglo-Saxon colleagues did not:

- They had to re-establish market functioning rather than simply engineer monetary policy easing to sustain demand.
- The burden of meeting this challenge fell to the ECB to a greater extent than it did to central banks in other advanced economies.

The ECB was the only functioning Eurozone institution with the autonomy, flexibility and financial resources to act effectively.

The grey area between liquidity and solvency: Conventional wisdom

There is always a grey area between liquidity and solvency problems, but conventional wisdom drew a sharp distinction in allocation of these problems.

- Central banks should be in charge of liquidly problems.

Central banks can create unlimited liquidity, so they are uniquely placed to deal with liquidity crises.

- Fiscal authorities should be in charge of solvency problems.

Restructuring insolvent banks and/or sovereigns is essentially an exercise in distributing unavoidable (and potentially very large) losses. Independent and unelected central bankers are ill-suited to taking fiscal decisions with such significant distributional consequences; they have no mandate to do so.

The conventional wisdom is continuously pushed by a well-known incentive problem. Central banks have access to fiscal resources (seignorage) that might be used to deal with solvency issues. The resources are limited, however. A central bank that exceeds its fiscal capacity runs the risk of undermining its price stability mandate.[2] To manage these incentive problems, normal central-bank practice has been to refrain from directing seignorage on a discretionary basis in this way. In the Eurozone, these norms

2 See Durré and Pill 2010, Pill 2011.

took an institutionalised form in the Lisbon Treaty's prohibition of monetary financing (Article 123).

Crisis-testing the conventional wisdom

Experience during the financial Crisis has tested this established thinking. Looking forward, two questions arise:

- Can central banks re-establish the pre-Crisis conventional-wisdom regime?
- Is a new doctrine required to govern the quasi-fiscal activities of central banks?

The Crisis has created a rationale for a more activist central-bank response to financial crises.[3] Here several points must be kept in mind.

First, distinguishing liquidity and solvency problems is difficult in real time, but markets allow no time for procrastination. Second, in the context of multiple equilibria and self-fulfilling prophecies, liquidity problems can morph into a solvency problem (and vice versa). As a consequence, central-bank action can work by selecting among equilibria. For example, sufficiently generous liquidity provision can delete an equilibrium where rollover risk triggers a solvency problem. Central-bank action can determine whether it faces a liquidity or a solvency problem.

Finally, other actors respond to central bank actions, so the central bank's efforts to select equilibrium may not be definitive. For example, governments or banks with liquidity guarantees may act in ways that ultimately amplify solvency problems. The risk therefore is that central banks' activism can exacerbate the underlying problems and/or create new ones, especially over longer horizons, by accommodating unsustainable bank and government behaviour.

3 For a discussion of ECB behaviour since the crisis, see Giannone et al 2012, and Lenza et al 2010.

EZ-Crisis challenges facing the ECB

The ECB's response to the Eurozone Crisis has been less effective than its response to the fall of Lehman's. A number of reasons account for this.

- Solvency concerns have been more important in the EZ Crisis than the Lehman's crisis.

With credit risk a larger concern, the grey area between liquidity and solvency is more difficult to navigate.

- Governments, not just banks, have been at the root of the tensions.

This throws up extra challenges, since managing moral hazard in the sovereign sector is more difficult. There is no supervisory system to close down a misbehaving government. Political mechanisms to establish conditionality have generally proved inadequate.

- Measures to address the EZ Crisis have, by their nature, important cross-border dimensions.

Dysfunctional Eurozone financial markets mean that support to banks takes on a more national hue than was the case with the immediate post-Lehman support.[4] Given the political structure of the Eurozone – as single currency for 17 distinct countries, each with their own electorates and tax bases – this cross-border element weakens the political support for central-bank action.

Where we stand and what is to be done

The current situation is marked by an excessive reliance on the ECB and its fiscal resources. Adding to this was the ECB's announcement of its Outright Monetary Transactions programme. This has helped to stabilise sovereign markets. But it does so by, in essence, casting sovereign-debt market tensions as a liquidity problem to be

4 Concerns expressed regarding the emergence of TARGET 2 balances over the post-2010 period testify to this.

solved with potentially unlimited support subject – subject, of course, to conditionality. Nevertheless, this has failed to reactivate and reintegrate private credit markets, hindering transmission of the very easy monetary-policy stance established by the ECB to the periphery where the stimulus stemming from that stance is most needed.

Efforts are underway to address the problems underlying this impasse. The important elements of this process are:

- Establishing a banking union.
- Deepening risk sharing; and
- Improving economic governance at the Eurozone level.

These long-term efforts are consistent with the view that a better functioning Eurozone will be able to avoid the excessive reliance on the ECB. And in turn, this will facilitate the re-establishment of a more limited role for the central bank, more in line with that envisaged in the Maastricht framework for the monetary union.

But what should be done in the meantime, when Europe faces growing macroeconomic difficulties in the periphery and a slow pace of deeper institutional reform?

One solution is for the ECB to pursue credit-easing schemes that amount to employing the central bank's fiscal resources to subsidise credit creation, as other central banks have done in different institutional settings. Arguably, the need for this is greater in the Eurozone, given the lack of fiscal resources in the countries that most improved credit supply and the absence of alternative EZ-wide mechanisms to finance that support.

This is no panacea. Using the ECB's fiscal capacity more proactively now undermines the credibility of attempts to limit recourse to that capacity in the future. As we have seen in the past, resolving such time-consistency problems lies at the heart of a central banker's job.

Author's note: The views expressed here are those of the author and do not necessarily represent those of the institutions with which he is affiliated.

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