The crisis, the ECB and what the future holds

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Queen Elizabeth to LSE scholars “Why did no one see the crisis coming?” (Nov 2008)
An anthology of replies …

- The mainstream reply – Besley & Hennesy (+30 others): “… the prevailing view was that monetary policy was best used to prevent inflation and not to control wider imbalances in the economy… Individual risks may rightly have been viewed as small, but the risk to the system as a whole was vast”.

- The heterodox reply – Hodgson (+9): “the letter by Prof. B&H overlooks the part that many leading economists have had in turning economics into a discipline that is detached from the real world, and in promoting unrealistic assumptions that have helped to sustain an uncritical view of how markets operate”.
… but parallel monologues?

More replies – Th. Palley: “the failure was due to the sociology of the economics profession”; R. Skidelsky: “economics is a moral and not a natural science”; Paul de Grauwe: “macroeconomics … has become a system of beliefs .. about rational and fully informed agents operating in efficient markets. … As a result, it has stopped being science”; Epstein: “… most of the economics profession was utilizing the wrong theories – theories based on efficient markets and rational expectations – rather than the much more informative ideas based on Keynes, Minsky … among others, who see the financial markets as inherently unstable and bankers in need of serious constraints”.
Paraphrasing the Economist – Central Banking: Where it went wrong & how is the crisis changing it?
A historical reminder

- Three eras in the evolution of central banking
  (i) the Victorian era from 1840s to 1914;
  (ii) the government control era, from 1930s to end-1960s;
  (iii) the ‘triumph of the markets’ from 1980s to 2007.

- CB paradigm in 3rd era
  (a) near exclusive concern with price stability, over other areas of policy;
  (b) institutional independence of the central bank from the political authorities and the assumed ‘political business cycle;
  (c) market-based instruments
What about the ECB?

Basic features

- “The ECB appears to be the ultimate ‘narrow’ central bank; it literally has a mandate for price stability and a very small role in ensuring financial stability, confined to the ensuring of the smooth functioning of the TARGET payments system, not the financial system” (Schinasi, 2003:3)

- Further, the independence constitutionally granted to the ECB is the most explicit both in writing and in practice, by comparison to other central banks, such as the Federal Reserve, the Bank of England (Alexander Lamfalussy, 2011)
Main ECB policies & tools

- “Price stability” = ‘year-on-year increase in the HICP for the euro area of below but close to 2% over the medium term’
- “Money” = ‘M3 reference value = 4.5%’
- Two pillar approach – Economic analysis (inflation forecasting) ‘cross-checked’ by monetary analysis (money & credit growth) – Ball(2010): ‘(the two pillars) … usually produce the same prescriptions for policy’
The ECB response to the crisis

- **Three phases** – August 2007 to August 2008; September 2008 to Summer 2009; Summer 2009 to present

- **1st phase** – *Fine-tuning* provision of liquidity to banking sector; swap agreement with Fed to provide $ liquidity; BUT July 2008: Increase in base rate from 4% to 4.25% diagnosing ‘inflationary pressures’ (!)

- **2nd phase** - ‘*Enhanced Credit Programme*’: Unlimited liquidity at a fixed rate in all refinancing operations against collateral; maturity of refinancing operations UP from 3 months to 1 year; asset backed securities accepted as collateral

- **3rd phase** – Outright purchases of covered bonds (€60 billion); ‘*Securities Market Programme*’ - Eurosystem purchases of government bonds in secondary markets (Dec 2010: €13 billion)
## Total balance sheet assets relative to GDP and banknotes in circulation

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<th>Federal Reserve</th>
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<td><strong>Relative to GDP (%)</strong></td>
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<td>June 2007</td>
<td>10</td>
<td>6</td>
<td>16</td>
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<td>Peak (ref. date)</td>
<td>19 (2/1/09)</td>
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<td>23 (31/3/09)</td>
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<td>August 2009</td>
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<td>June 2007</td>
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<td>Peak (ref. date)</td>
<td>231 (2/1/09)</td>
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<td>August 2009</td>
<td>194</td>
<td>232</td>
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“the banks demanded more liquidity than they needed to finance their daily transactions”

Deposits of euro area MFIs with the Eurosystem (Euro mn)
Has the crisis changed the ECB?
Temporary pragmatism, albeit discriminative

- ECB in the role of Lender of Last Resort to the eurozone banking sector
- Important, albeit limited role in public debt crisis
- Reverting to its narrow mandate - The first central bank to raise its base rate from 1% to 1.25% (7-4-2011)
- Financial stability - ECB assigned a ‘specific’ task: provision of analytical, statistical, administrative and logistical support to the newly instituted European Systemic Risk Board (Art. 127.6). To the extent that price stability remains the overarching policy objective, financial stability comes as a poor second
Can we expect a longer lasting effect of the crisis on central banking?

“Whether or not the inevitable ‘blame game’ is worthwhile or justified, the experience of financial crisis, panic in September 2008 to March 2009 and nearly widespread financial collapse, has been so unnerving and shaking that there are likely to be far-reaching changes to the operation and regulation/supervision of the financial system in general and to the role and functions of the central bank in particular.” (Goodhart, 2010:8)
Some thoughts on alternatives

- **Euro Memorandum Group**: From the start of the single currency project it has argued for a discretionary, all-encompassing mandate of the ECB and for its democratic accountability.

- **Financial Stability** needs to be explicitly incorporated in ECB mandate and catered for.

- **Indebtedness of peripheral countries**: potential source of instability. ECB needs to act as LOLR to governments in conjunction with fiscal policy.

- **Analytical tools** need to be adjusted to the complex world of money and finance – Inflation targeting makes unrealistic assumptions; empirically, of no consequence for advanced countries over 1985-2007 (Ball, 2010).
Where do we go from here?

- Widespread feeling that change is needed. E.g., Goodhart & Lamfalussy: (i) central banks need to be given macro-prudential supervisory authority; (ii) this will not impair their price setting role and (iii) they need to work closely with the government.

- Further, economists need to overcome their own ‘confirmation bias’ (tendency to find evidence that supports their point of view) and find a common language.

- Overall, must keep up the pressure for change through the social and political process, as well as on the intellectual level.