Swiss bankers since 1873

The ECB and the crisis

Stefan Gerlach
Chief Economist and
Senior Vice President

Hong Kong Institute for Monetary Research
29 February 2016

BSI

DL2

Outline

1. Introduction and background
2. The crisis
3. ECB's policy choices
4. Questions and concerns
5. Conclusions

1. Introduction and background

- The collapse of Lehman in September 2008 was the start of a turbulent period for the ECB (and other central banks):
  - Recessions in the “core” of the euro area.
  - Collapses and fiscal crises in the “periphery.”
  - Interplay between sovereign risk and weaknesses in the financial system:
    - Perceptions of sovereign risk led to large falls of bond prices and impaired the balance sheets of financial institutions.
    - Government support to the financial system led in some countries to very large deficits and triggered sovereign risk.

- Useful to ask why the crisis was so severe in the euro area.

1. The epicenter was in the financial system:

   - Led the shock to be transmitted rapidly across the globe:
     - Rare example of a severe international downturn.

   - It weakened the monetary transmission mechanism at precisely the moment more stimulus was needed.

   - The lessons from the collapse of the Japanese bubble in the early 1990s not heeded.
     - Cut rates aggressively – don't *keep the gun power dry.*
     - Paradoxically, to avoid having the zero lower bound become a constraint, cut rates to zero!

2. The ECB faced a difficult economic environment:

- Overriding objective is headline inflation.
  - Pronounced swings in energy prices since 2008 became the dominant driver of monetary policy.
  - Core inflation better measure of inflation trend (Draghi 2015).
  - Looking back, helpful with a framework that attached more weight to underlying inflation in policy formulation.

- Banks more important in the euro area than in more market-oriented systems.
  - Banks adversely affected by sovereign risk perceptions and NPLs.

- Little experience dealing with heterogeneity:
  - Countries with severe fiscal problems small and contributed little to EA averages … but their debts were held across the EA.

BSI

3. Institutional difficulties:

- The financial architecture of the euro area was incomplete.
  - Constrained information flows and hampered policy making.

- “One monetary policy but many fiscal policies”.
  - Monetary policy unavoidably involves redistribution *within* the economy – in the case of the ECB it also involves redistribution *across* the euro area which raises important issues of legitimacy.
  - Amplified the tension between fiscal and monetary policy that is always present.

BSI

- Nevertheless, much has gone right!

  - ECB quickly adjusted to the situation and used new and innovative tools:
    - Cut rates to zero,
    - Broadened market operations.
    - Expanded the collateral framework.
    - Adopted *forward guidance*.
    - Adopted *quantitative easing*.
    - *Increased transparency*.

  - Economic collapse was avoided; inflation remained broadly under control.

2. The Crisis

- The crisis evolved in two phases:

  I. Financial crisis
  - Money market tensions in August 2007.
  - Collapse of Lehman in September 2008.

  II. Sovereign debt crisis
  - Greece, May 2010; Ireland, December 2010; Portugal, May 2011; Cyprus, March 2013.
  - Concerns government default led to a slowdown from 2011 onward.

BSI

- Sovereign credit risk impairs transmission mechanism through three channels:

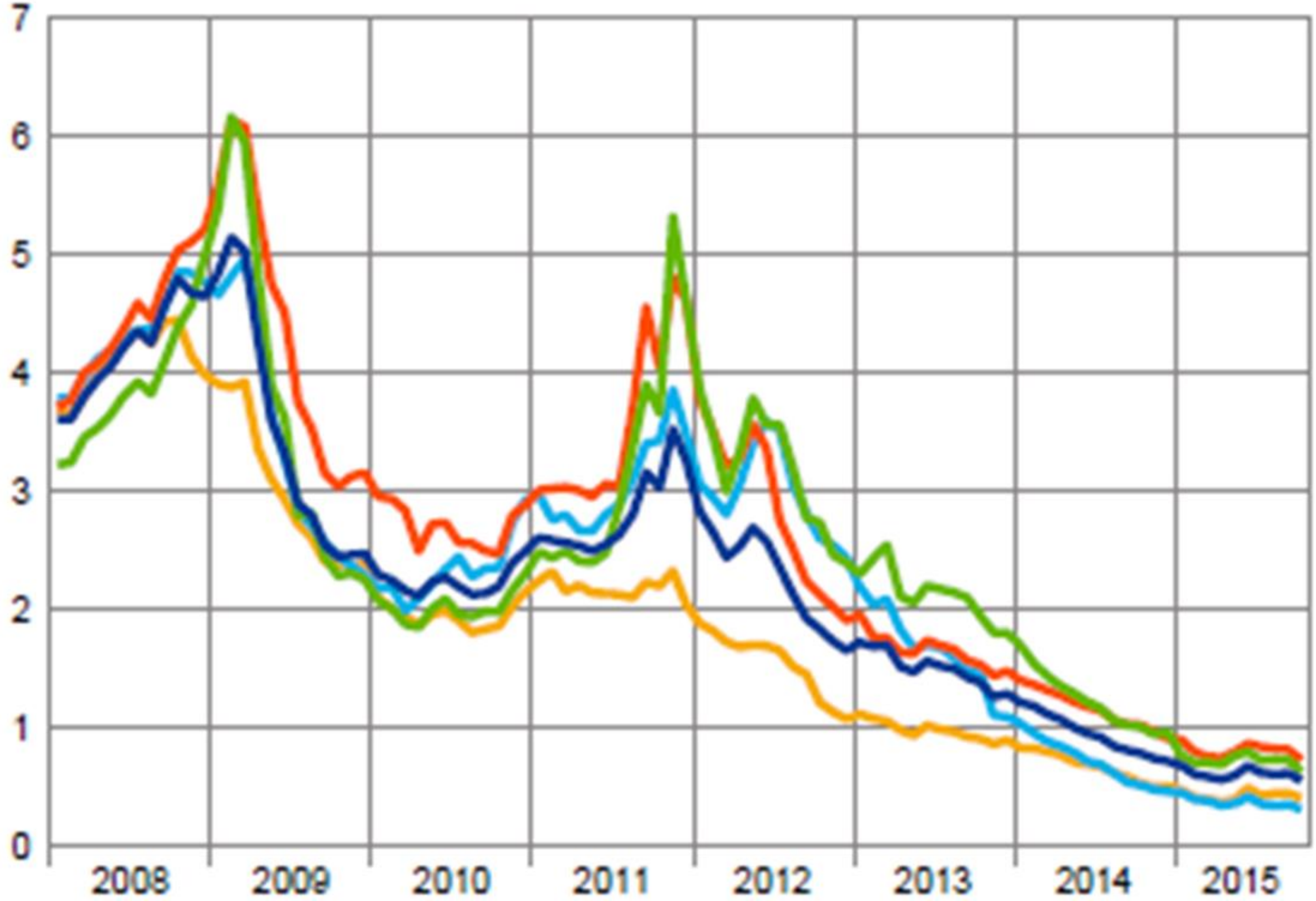
  I. Price channel:
     - Sovereign yields influence lending rates by affecting banks' cost of funding.

  II. Liquidity channel:
     - Government bonds collateral for banks' borrowing.
     - Sovereign credit risk leads to increased haircuts and reduces liquidity.

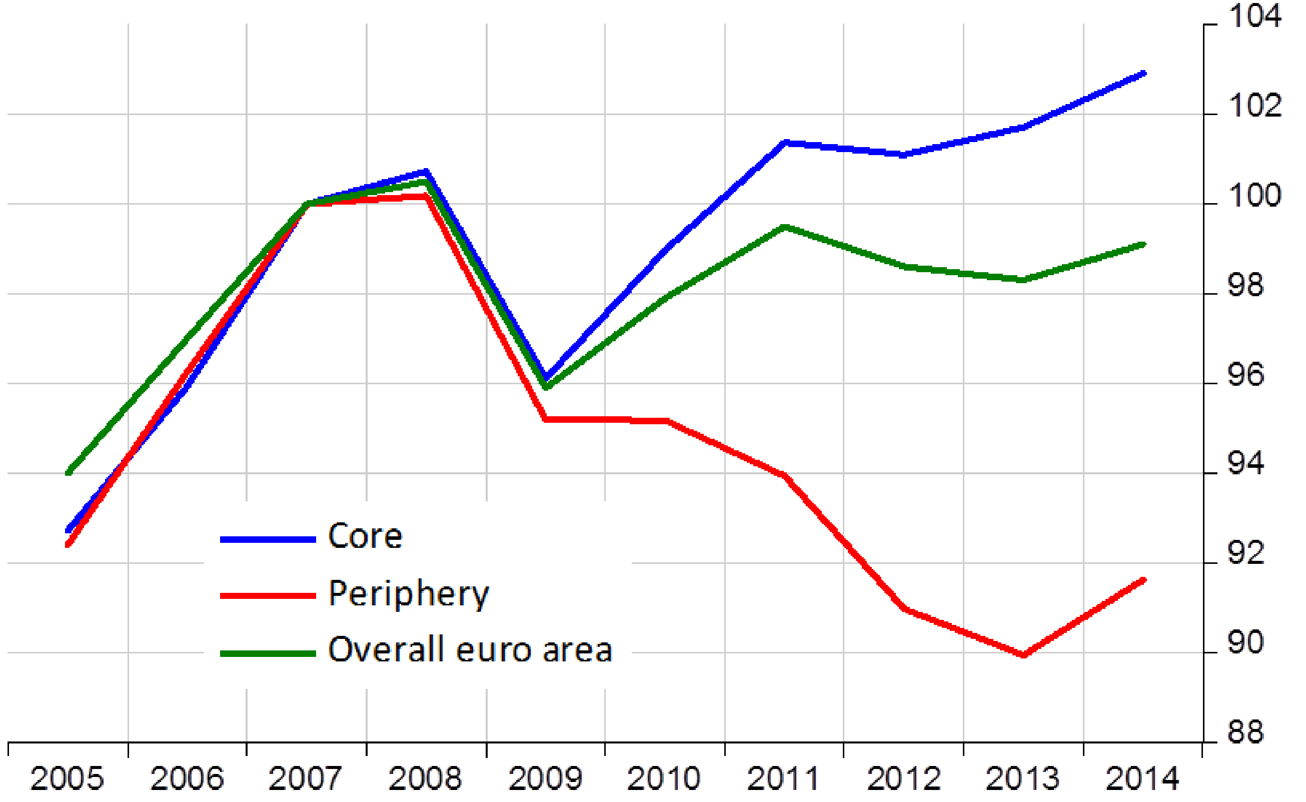
  III. Balance sheet channel:
     - Lower bond prices reduce bond holders' net wealth.

BSI

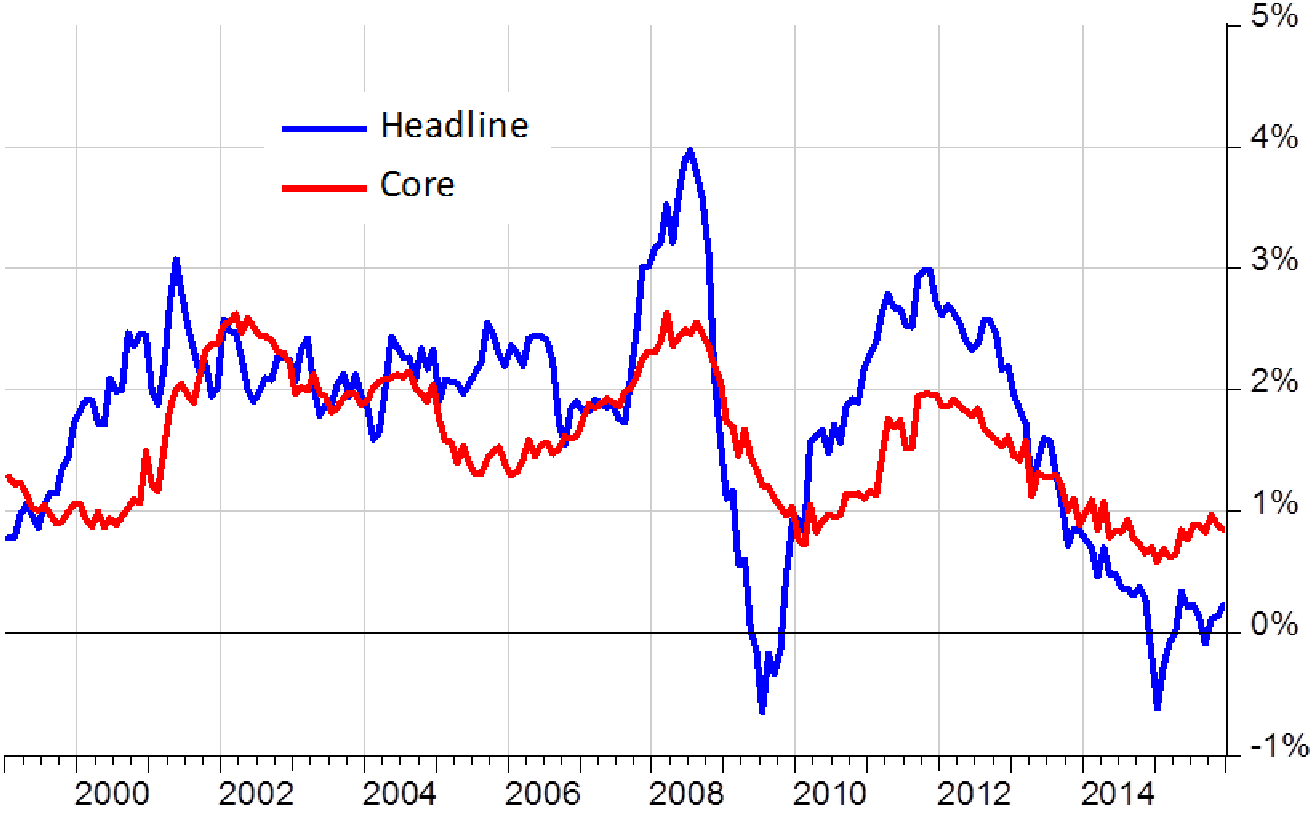
- Dramatic increase in banks' composite cost of financing



- Collapse of economic activity in periphery



- Gradual decline in HICP and core inflation since 2011



3. ECB's policy choices during the crisis

- Initially, ECB adopted a two-pronged approach:
  - *Interest rate policy* geared to macroeconomic outlook.
  - *Liquidity policy* focused on tensions in money markets.

- Distinction moot as the outlook deteriorated rapidly:
  - ECB cut rates by 275 bps, reaching 1% in May 2009.
  - FRFA and longer-term operations.

- Asset purchase programs (PP):
  - 1st Covered Bond PP: July 2009 – June 2010; 60 billion.
  - SMP: May 2010 – Feb 2012; 220 billion.

- The 2011 slowdown led to a series of policy initiatives:
  - Interest rate cut repeatedly to 0.05%.
  - Adoption of forward guidance in July 2013:
    - *Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time.*
  - 2nd Covered Bond PP:
    - Nov 2011 – Oct 2012; 16 billion.
  - 3-year VLTRO:
    - Dec 2011 and Feb 2012; ca 500 billion each.
  - TLTRO
    - 2014-15; 420 billion.

- The refinancing operations allows liquidity to be demand determined.

BSI

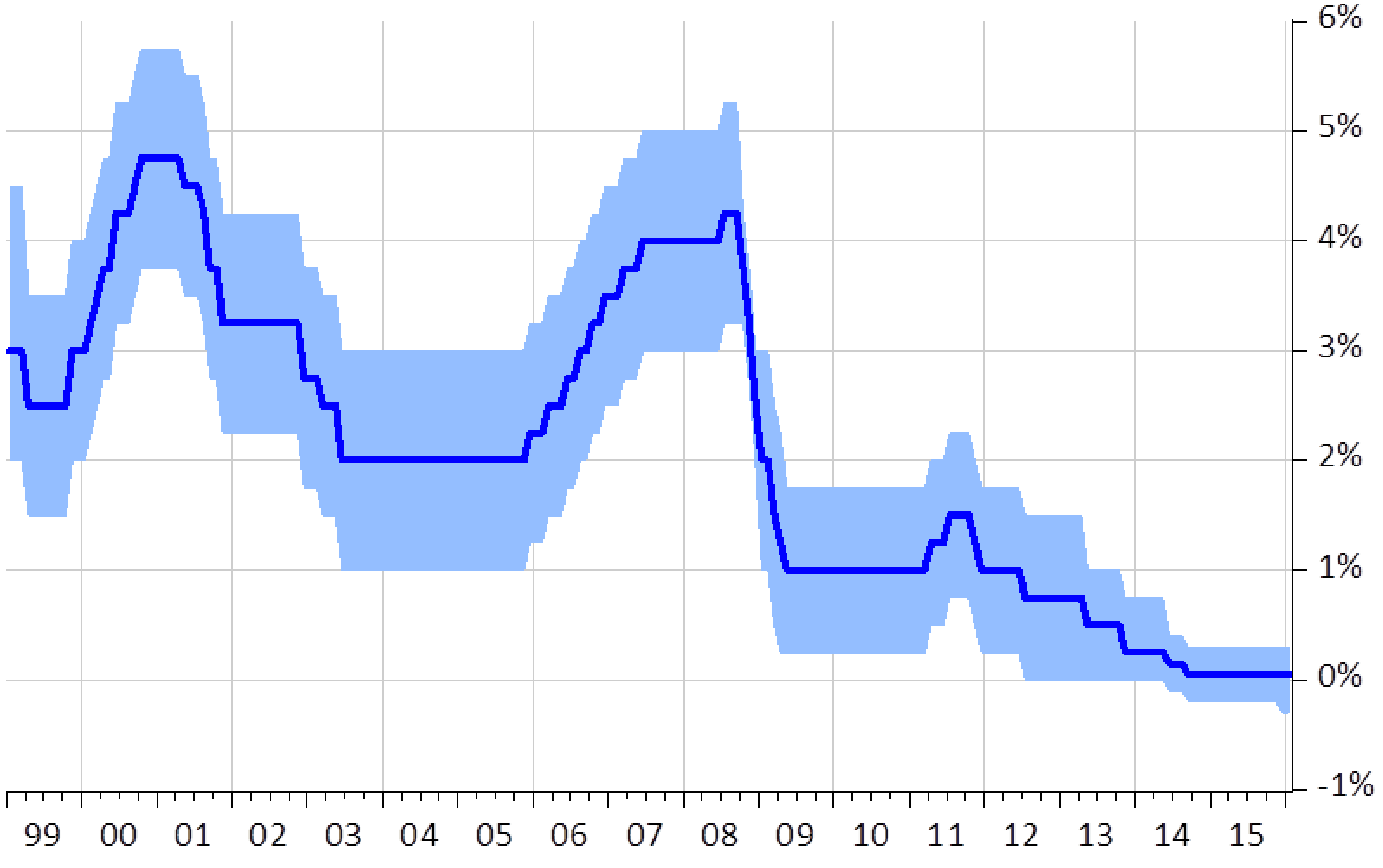
- Main tool: *Expanded Asset Purchase Program*:
  1. 3rd Covered Bond PP:
     - Oct 2014; now 150 billion.
  2. Asset-backed securities PP:
     - Nov 2014; now 16 billion.
  3. Public Sector PP:
     - Jan 2015; 450 billion.

- Purchases to be carried out until March 2017 *“and in any case until the Governing Council sees a sustained adjustment in the path of inflation … ”*
  - ➢ 60 billion/month.

BSI

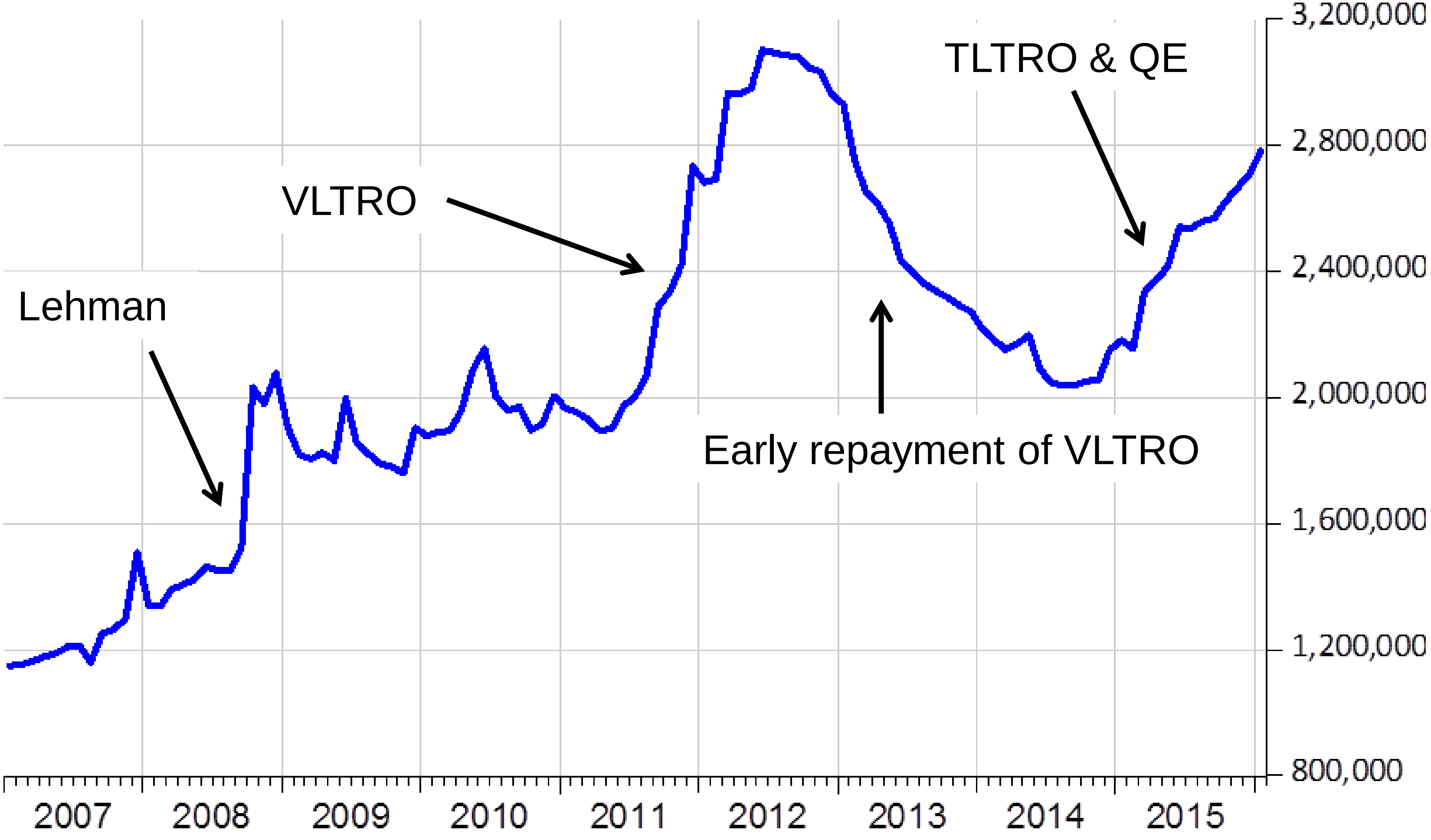
DL2

- Repo rate and corridor



DL2

- ECB's balance sheet



DL2

4. Questions and concerns

- The ECB's monetary policy raises a number of questions and concerns.

1. Is policy better suited to some EA countries than others?

    - True.
    - In any large economy conditions will vary across regions and the euro area is no exception.
    - The ECB gears monetary policy to the overall euro area and not to individual euro area economies.

2. How effective are the ECB's policy choices for stimulating the euro area?

- Policy appear to be less effective than normally.

- Several hypotheses:
  1. The need to deleverage exerts strong contractionary force.
  2. Policy is always more effective in slowing than in boosting the economy.
  3. Forward guidance and quantitative easing less effective than traditional interest rate policy.

- Difficult to assess the relative importance of these hypotheses.
  - Nevertheless clear that 1. and 2. are important.

BSI

3. Are the side effects on asset markets – in particular for equities and housing – dangerous?

- Monetary policy works by lowering interesting rates.
  - Increases interest-rate sensitive spending.
  - Increases the PDV of future income streams and therefore raises asset prices.

- House and equity prices should be expected to rise.
  - The extent of the rises in house and equity prices is presumably related to how stimulatory policy is.

- These are not “side” effects, they are “main” effects.

4. Do the current highly accommodative policies raise inflation risks?
   - Highly expansionary policies are necessary to neutralise the effect of financial crises, which are highly contractionary.
   - No indications of inflation rate to date.

5. Do they raise financial stability risks?
   - Yes; they require active use of macro prudential policy.

6. Do they raise inequality?
   - Not clear whether they do.
   - If they do, offset this in other ways.

5. Conclusions

- During the crisis the ECB had to contend with a more difficult environment than many other central banks.
  - ➢ The sovereign crisis in 2011 amplified the financial markets shock.
  - ➢ The institutional framework initially inadequate and complicated effective policy responses.
  - ➢ The ECB cut interest rates to 1% after Lehman.
  - ➢ It adopted over time a full range of unconventional measures.
  - ➢ It is now facing a situation in which growth is returning but inflation remains below the objective.

BSI

This document is for information purposes only. It is not and may not be interpreted as an offer, invitation, solicitation or recommendation (generic or personal) to buy or sell any type of financial instrument. Furthermore, it must not be regarded by recipients as a substitute for the exercise of their own judgment and appropriate due diligence. This document was prepared by BSI SA with information available at the date on which it was written. Therefore the information, opinions and estimates contained in this document refer exclusively to the date of writing and may be subject to variation at any time, without any obligation on BSI SA and/or any other entity belonging to the BSI corporate group (hereinafter ”BSI”) to make any subsequent communications and/or updates. The information, opinions and estimates contained in this document are based on data and research derived from public or publicly accessible sources which are considered, as of the date hereof, to be reliable. However, BSI does not in any way guarantee their correctness, truthfulness, accuracy or completeness, and does not assume any responsibility for any direct or indirect loss which may originate or in any way derive from use of the material contained in this document. The investments and strategies discussed in this document may not be suitable for every type or category of investor. In general, it should be noted that all investments involve a certain degree of risk. The value of any investment could rise or fall considerably, and the investor might not be able to recover the entire amount invested. It should also be noted that past performance does not in any way constitute a guarantee of future results. Where indicated, the prices reported in this document are purely for information purposes and do not necessarily correspond to BSI’s internal accounting data or records. No guarantee is made that a transaction could be or could have been carried out at the reported prices. Differing assumptions, by BSI or another source, could lead to substantially different results. Finally, variations in, among the others, forex rates may impact the value and prices indicated in this document. In some countries, certain products and services are subject to legal, regulatory and/or fiscal restrictions; the information regarding these products is therefore solely intended for those countries where such restrictions do not apply. Reproduction or publication of this document, in full or in part, is only permitted if BSI is quoted as the reference and is in any case subject to BSI’s prior written consent.