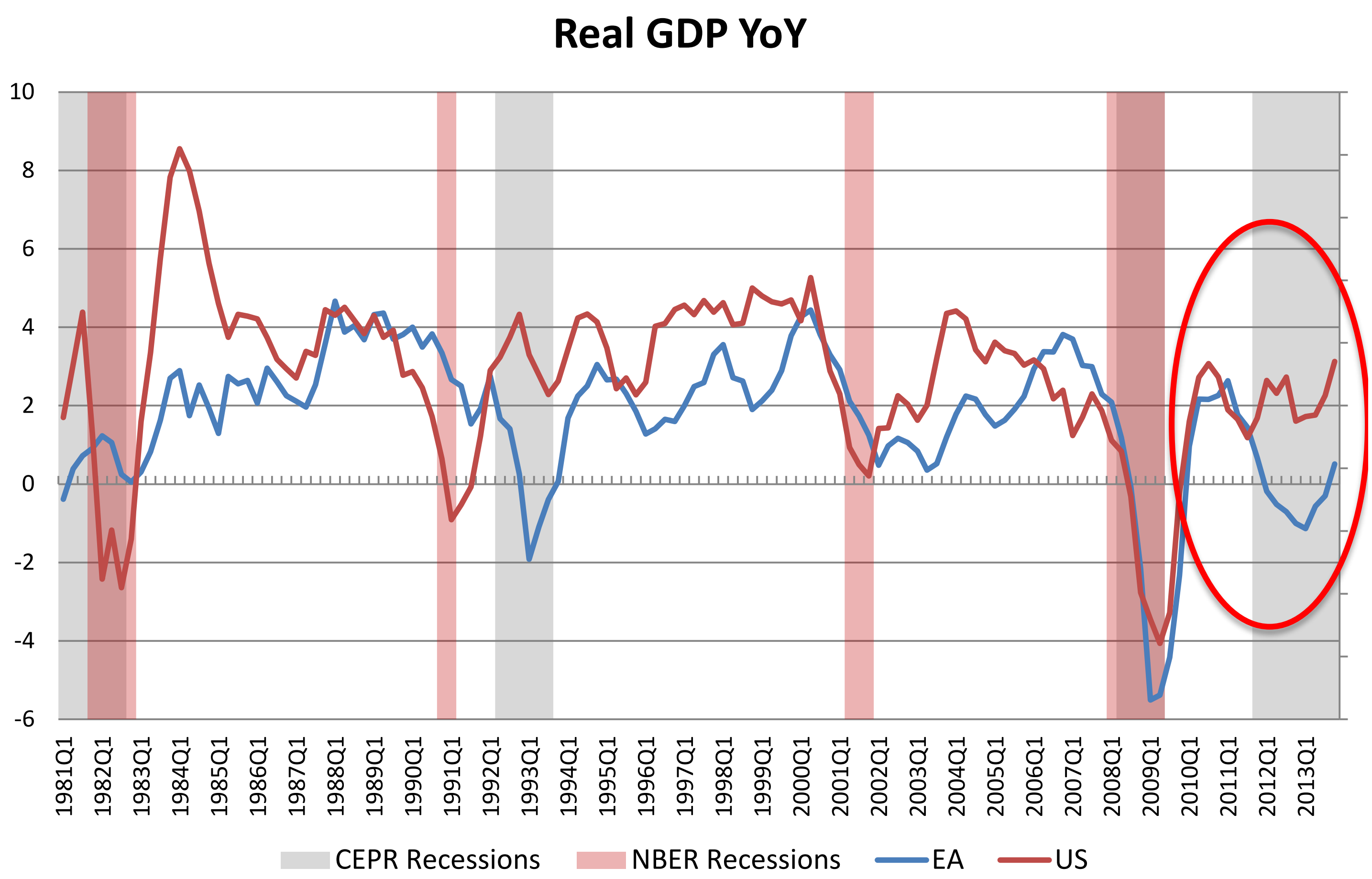
The ECB, the banks and the sovereigns

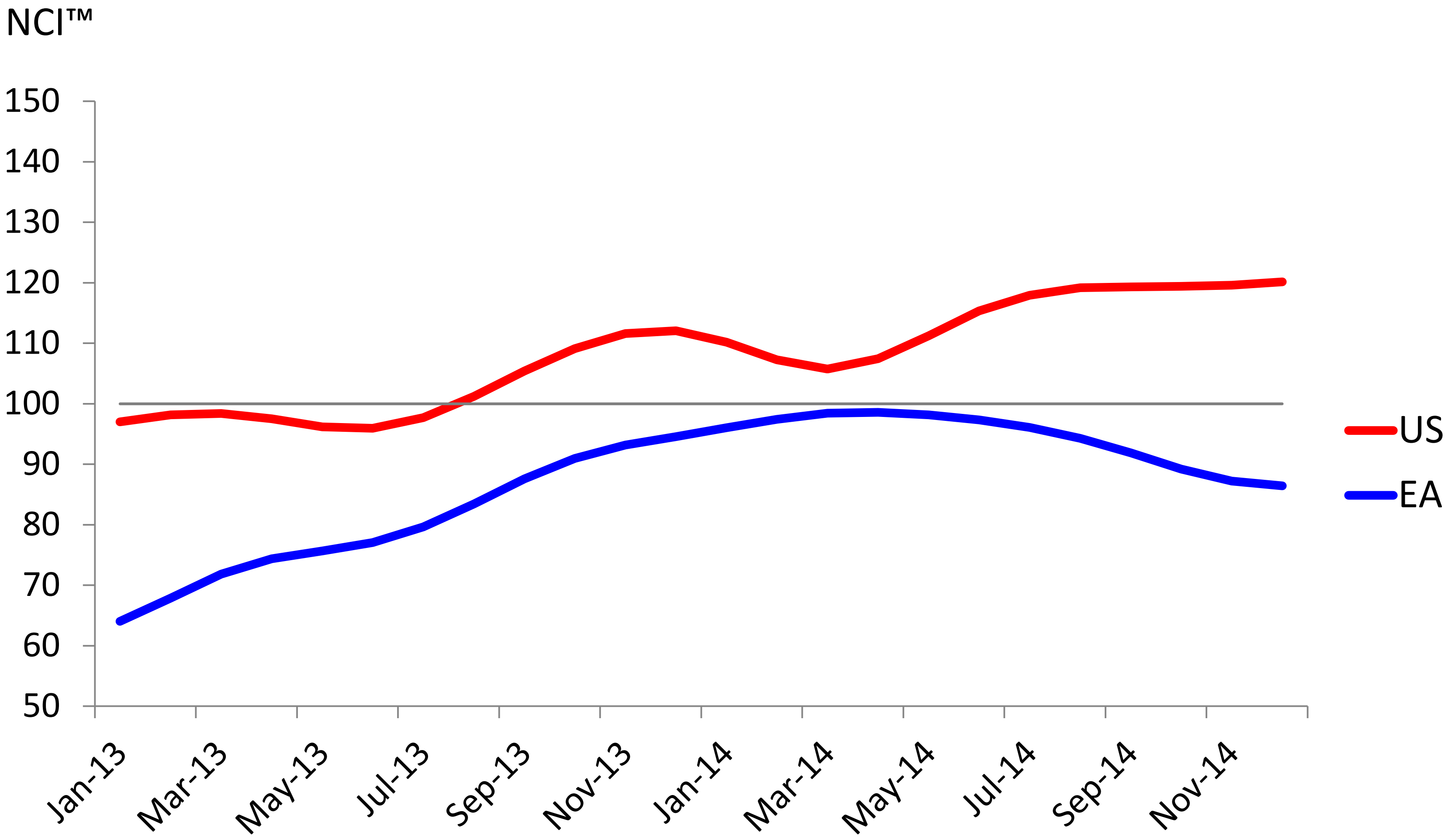
Lucrezia Reichlin
London Business School and CEPR

National Bank of Austria
Vienna
November 25th

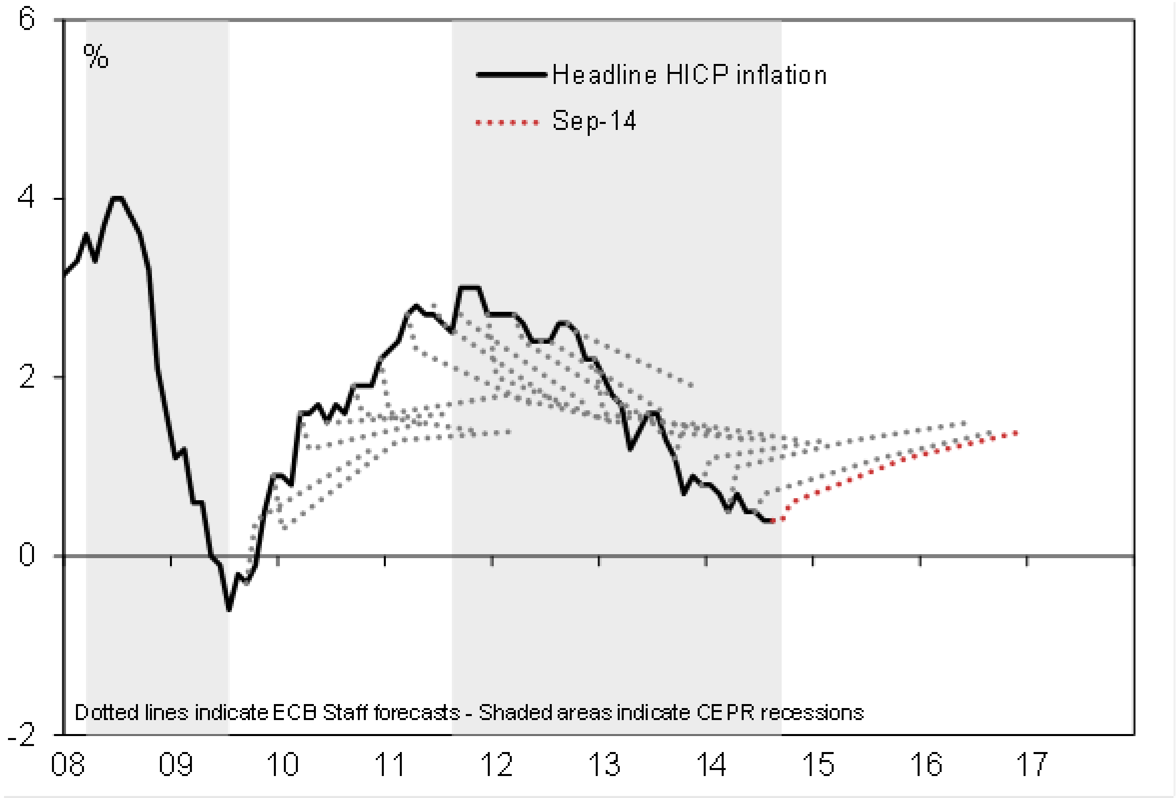
The euro area not out of its 2011q3 recession – its second since 2008



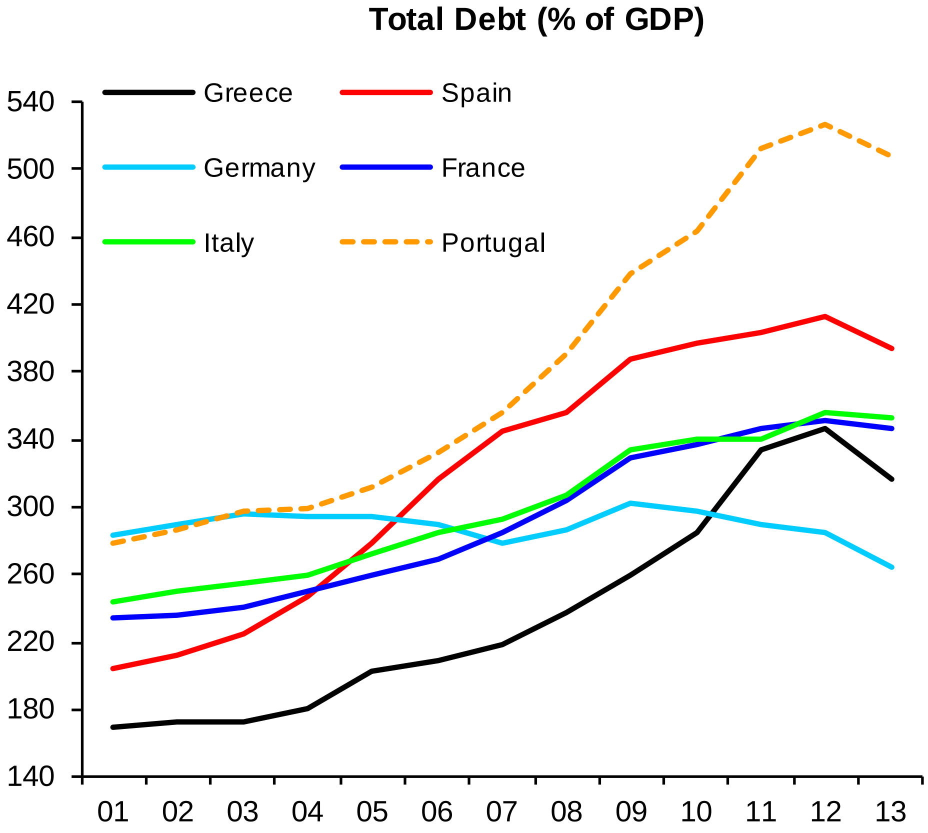
New Euro Area Slow-Down
Now-Casting Index (NCI)



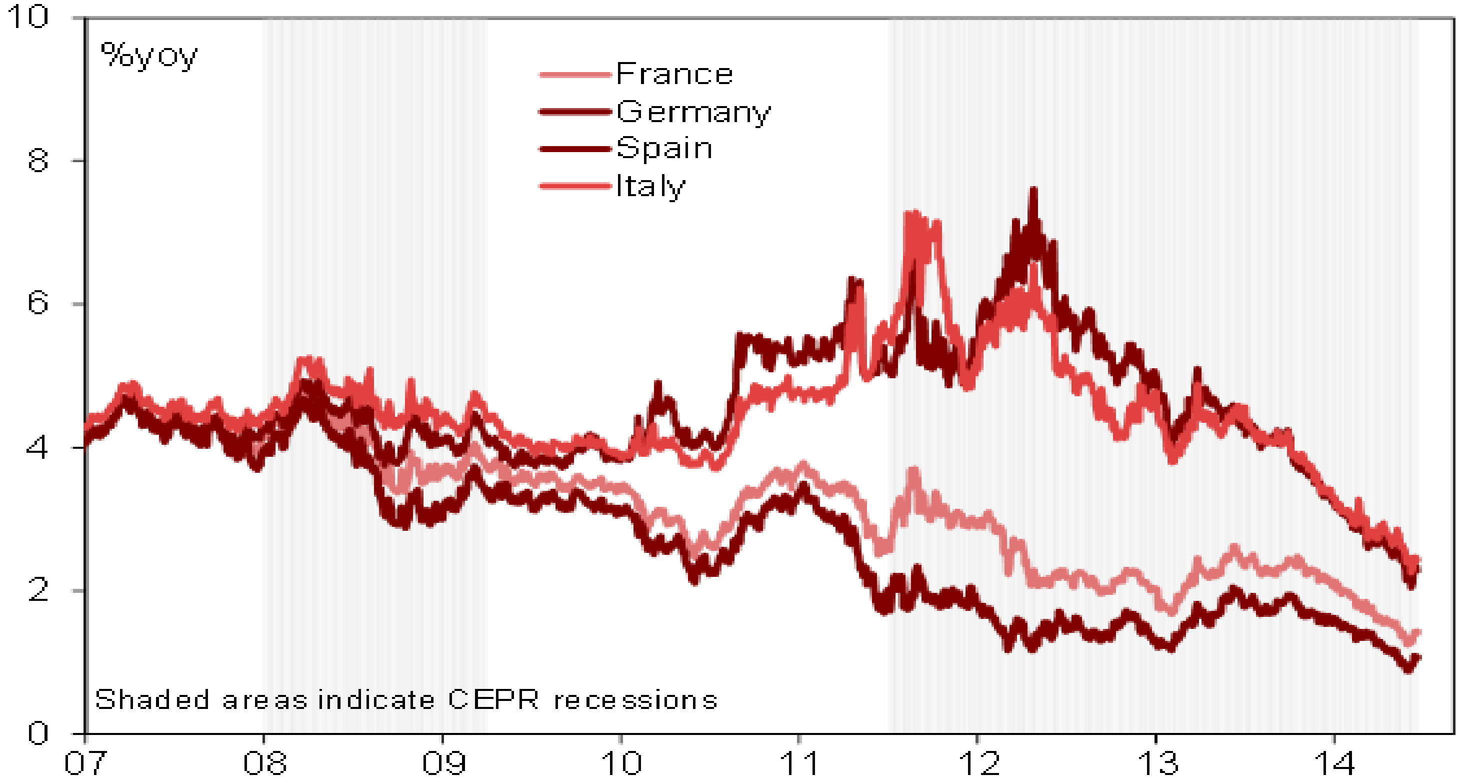
Inflation and expected inflation is declining - the ECB is under-shooting its target and has been systematically over-predicting the outcome



Debt overhang still a threat to financial stability



Although long term interest rates are at historical low



Questions

- What went wrong?
- What part has monetary policy in this story?
- What are the options for the ECB at this point?

Focus: interaction between the ECB, the banks and the sovereign

Talk based on several papers

- Reichlin, 2014
- Pill and Reichlin, 2014
- Giannone, Lenza, Pill and Reichlin, 2012
- Lenza, Pill and Reichlin, 2010
- Giannone, Lenza and Reichlin, 2014
- Colangelo, Giannone, Lenza, Pill and Reichlin, 2014
- Garicano and Reichlin, 2014

Since 2008 three different phases, with different lessons learnt

- 2008-2010: liquidity crisis in the interbank market
- 2010-2012: the sovereign crisis
- 2012-2014: the attempt to construct a new framework

… and what now?

1. 2007-2008 Liquidity crisis (1)

- The funding crisis involved the inter-bank, not the retail sector
- No generic break-up of the inter-bank market but a drying-up of its non domestic component

  In particular, "other euro area" countries

➢ *The first effect of the crisis was financial segmentation within the Union*

- The ECB responded with what Tommaso Padoa Schioppa defined a "market operation approach to the lender of last resort"

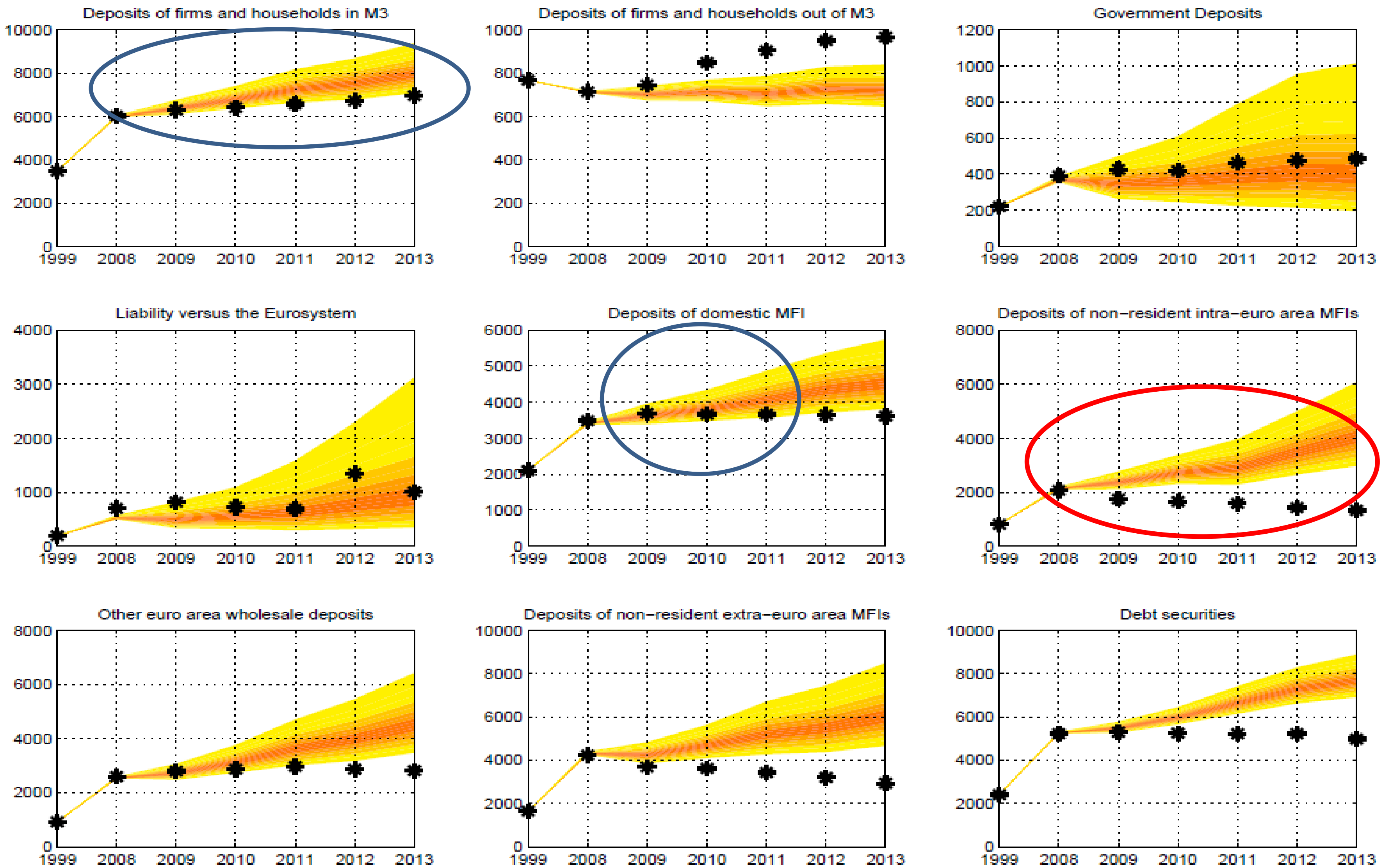
1. 2007-2008 Liquidity crisis (2)

- The ECB did not adopt the rhetoric of “quantitative easing”, but it expanded its balance sheet, increasing reserves on the liabilities side against (largely) conventional assets (repos) on the asset side
- ❑ The ECB largely dealt with banks by applying the pure version of the Bagehot rule
- ❑ The ECB was the most conventional but also the most aggressive of the central banks

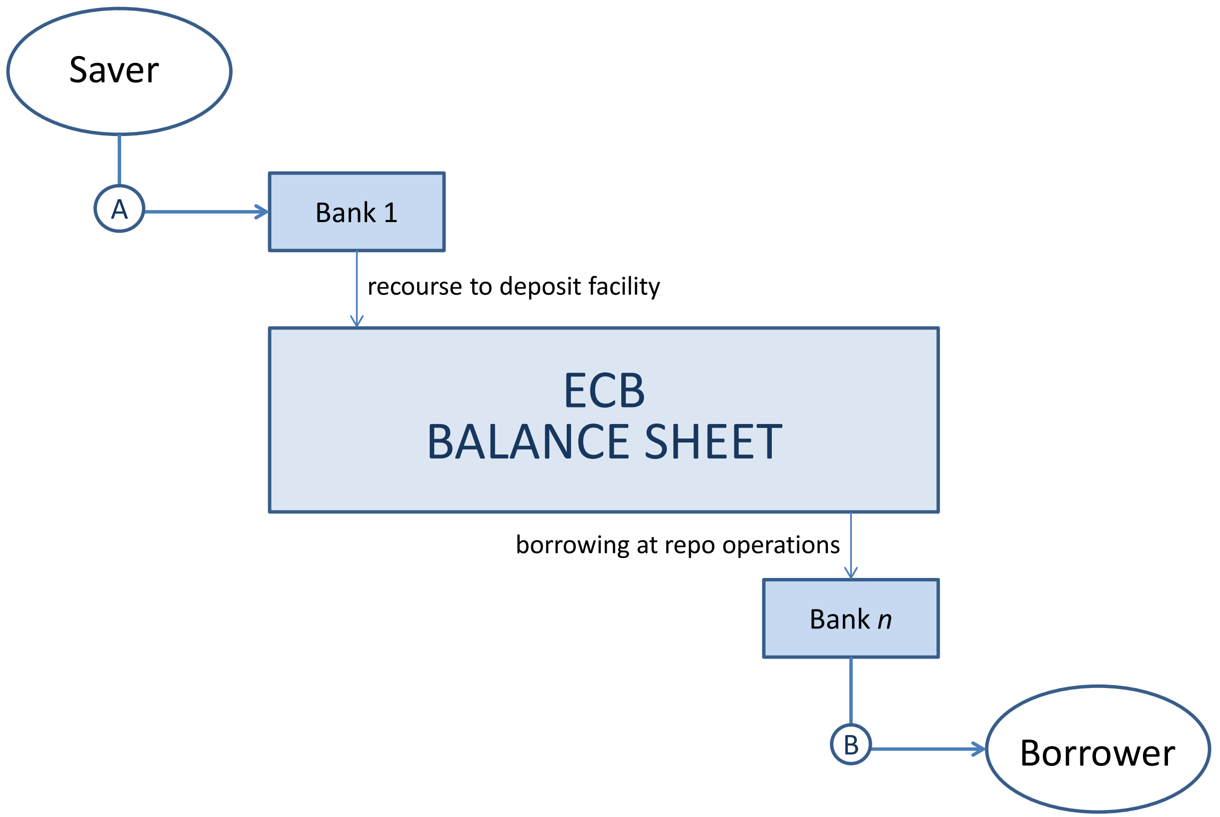
- Successful on both macro and financial stability grounds

Banks' balance sheets: how unusual since 2008?
Liabilities: funding stress is from non-residents

Colangelo et al (2014) – counterfactual experiment



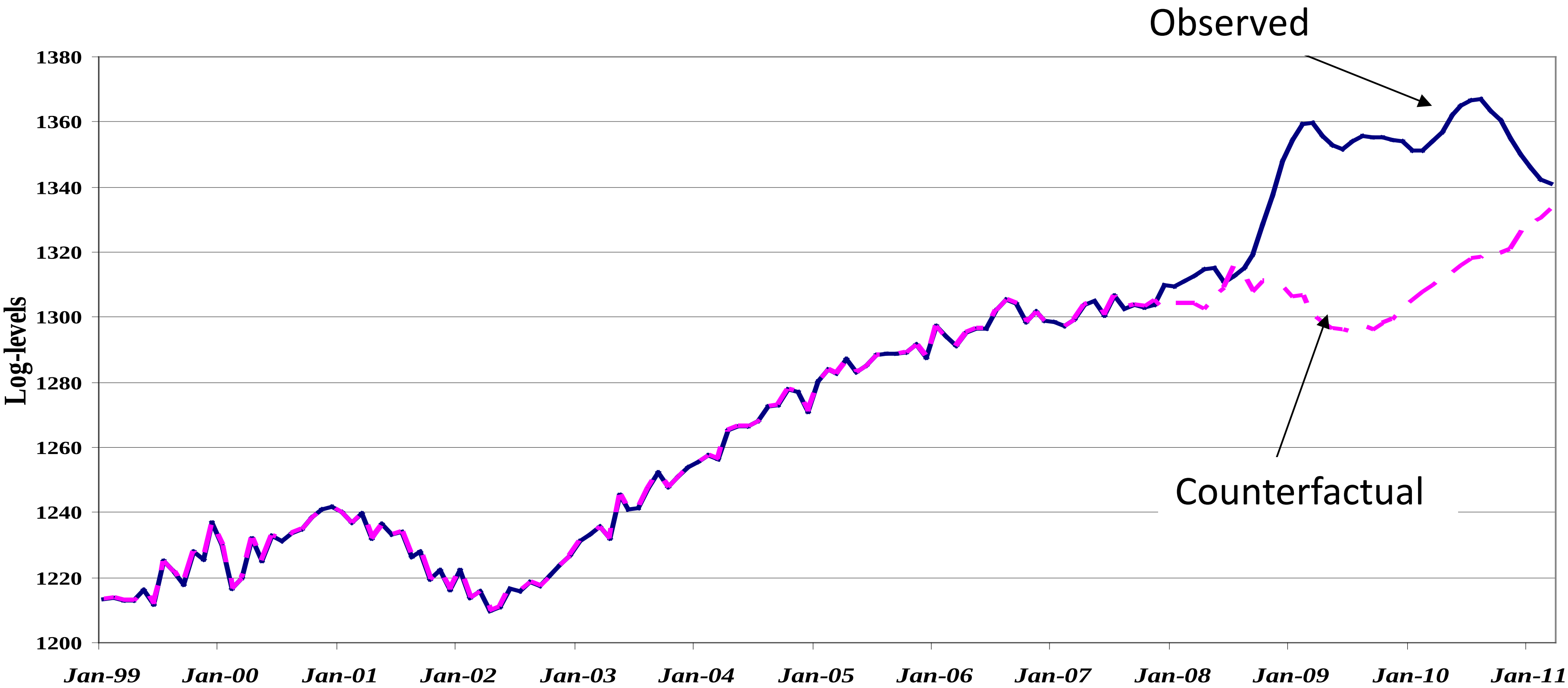
The ECB as intermediary of last resort



POSITIVE EFFECTS ON LENDING

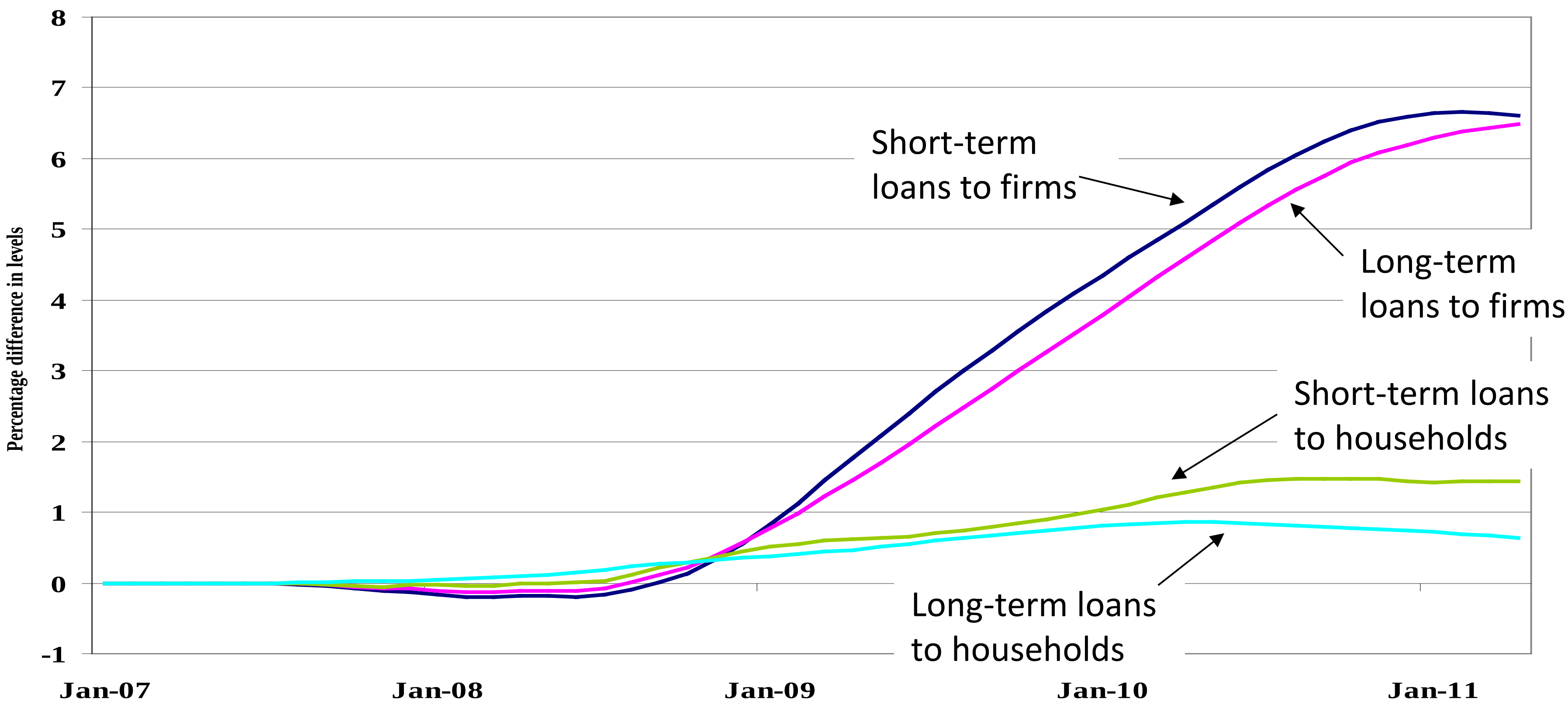
Lending from the Eurosystem: observed and counterfactual

Quantitative analysis based on *Giannone, Lenza, Pill and Reichlin, Economic Journal, 2012*



Macro effects: loans to households and firms

Quantitative analysis based on *Giannone, Lenza, Pill and Reichlin, Economic Journal, 2012*



Quite sizable effects on loans to firms; more subdued on loans to households

Takeaways

- Rapid and effective response to a liquidity crisis. Followed the Bagheot rule: providing unlimited liquidity against collateral
- Financial stability function: avoided the melt-down
- Monetary policy function: some macro effects

What was missing?

Tommaso Padoa Schioppa writing before the crisis, correctly predicted that

- If a run were to occur in the EA, it would be in the inter-bank market and not in retail deposits
- the euro-system was going to be capable to act in providing liquidity through repo operations

HE WAS RIGHT!

However, like others, he had not seen the limits of the "market operations approach" to lender of last resort in in a market where

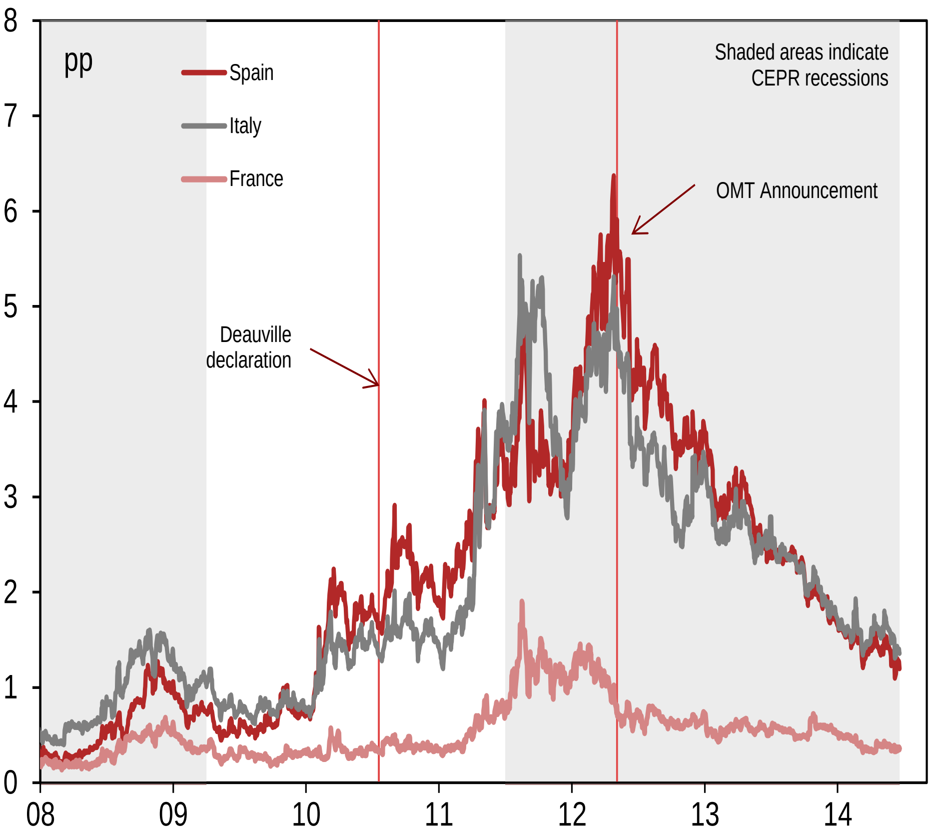
(i) banks are dominant in the financial market

(ii) they have (traditionally) a large role as intermediaries in the sovereign bond market

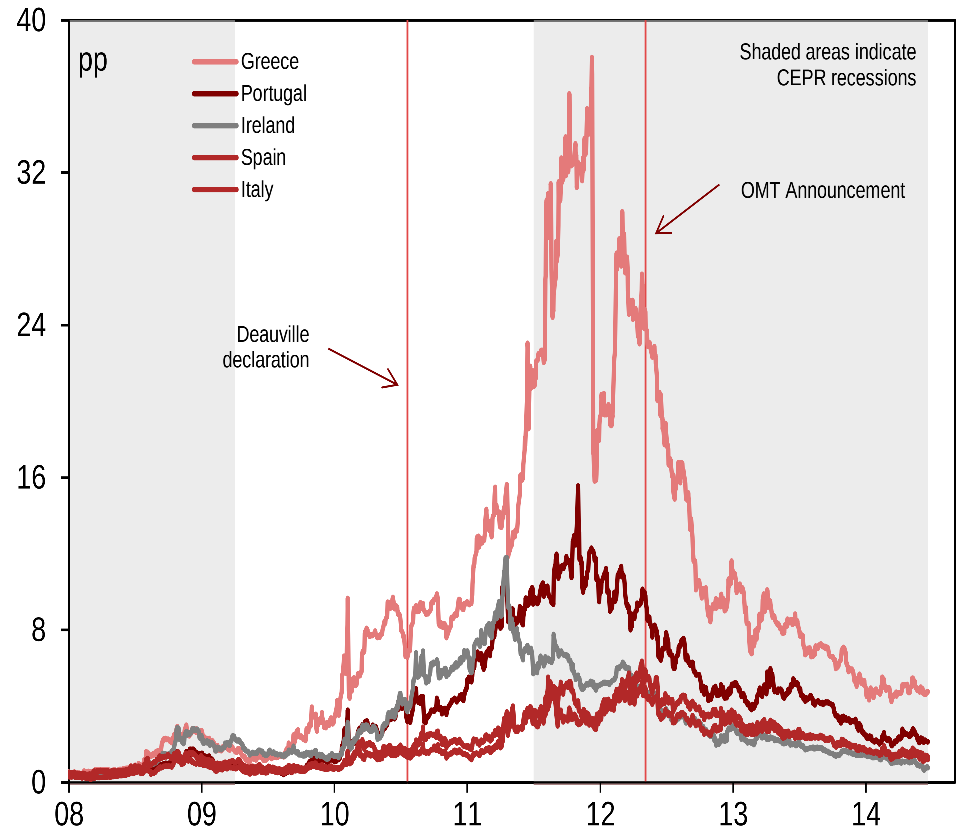
(iii) solvency issues (especially banks) are not dealt with because of lack of tools at the European level

2. 2010-2012 - Sovereign crisis: Greece, Deauville and contagion

Spain, France and Italy



Greece, Portugal, Ireland, Spain and Italy



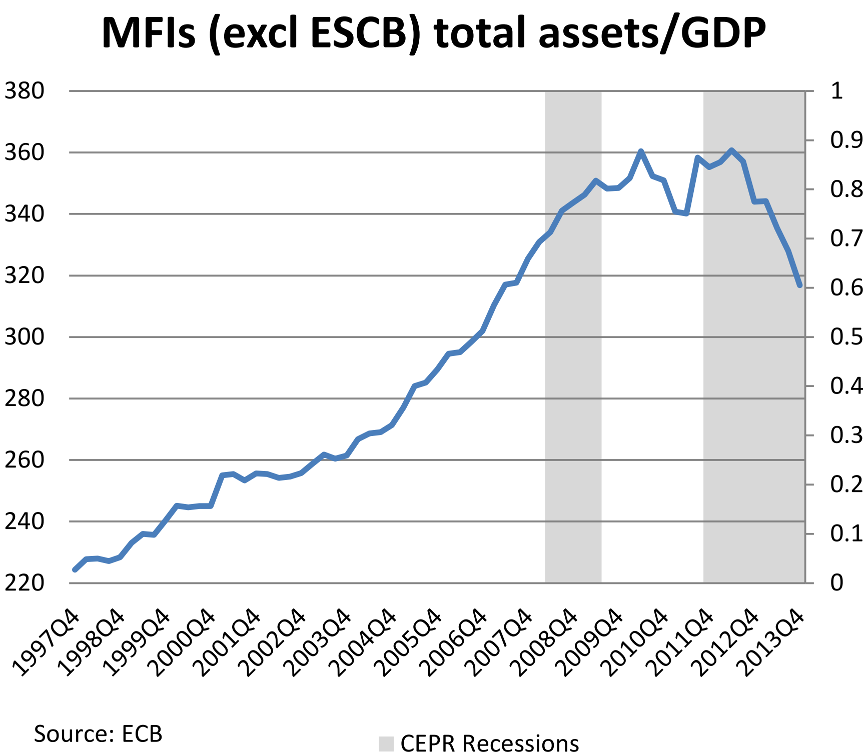
2. 2010-2012 - Sovereign crisis and solvency issues in the banking sector

The crisis involved both liquidity and solvency – banks and some sovereigns

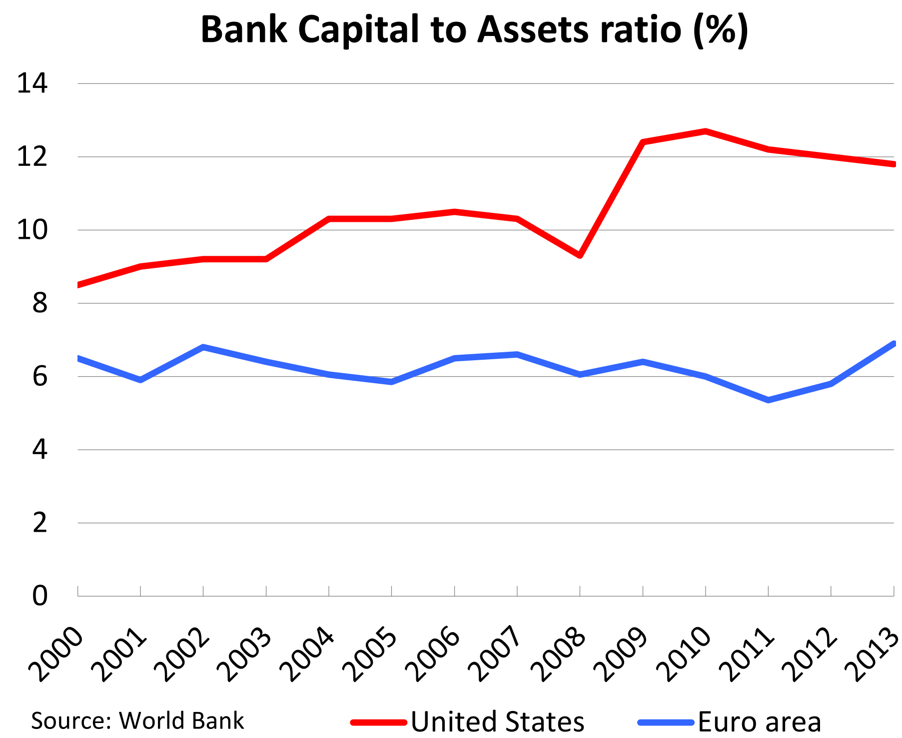
- Banks: difficulty to address the problems of the banks without a banking union … EA banks, unlike US banks, did not start recapitalizing until 2012/13 in preparation for the AQR
- Sovereigns: the messy solution of the Greek crisis and the Deauville agreement led to a new wave of “risk on” linked to fear of collapse of the euro
- Without a clear backstop, the EA revealed its vulnerability to “self-fulfilling” liquidity crises

Solvency of banks

unlike in the US, European banks delayed recapitalization and deleveraging



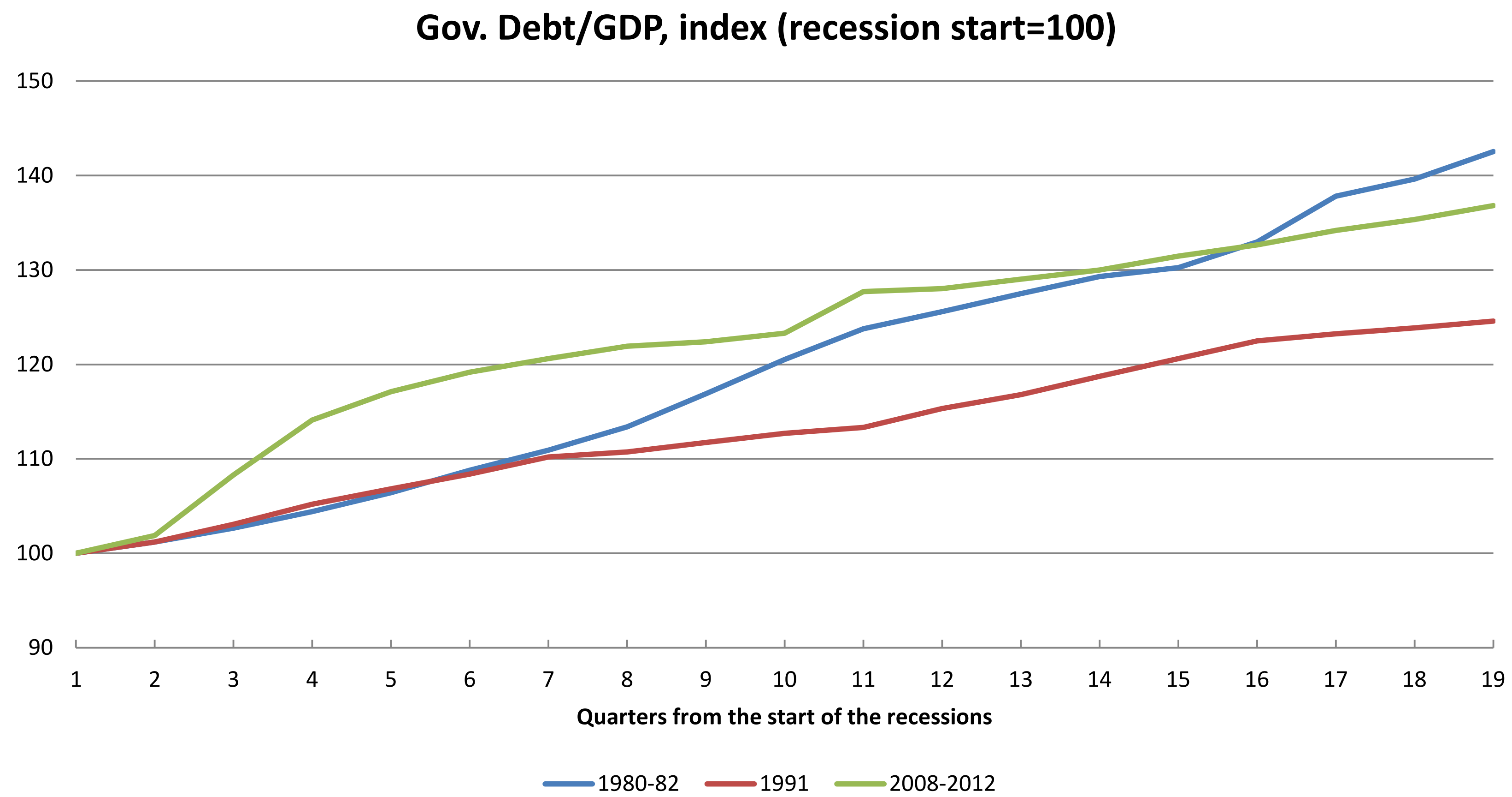
Source: ECB



Source: World Bank

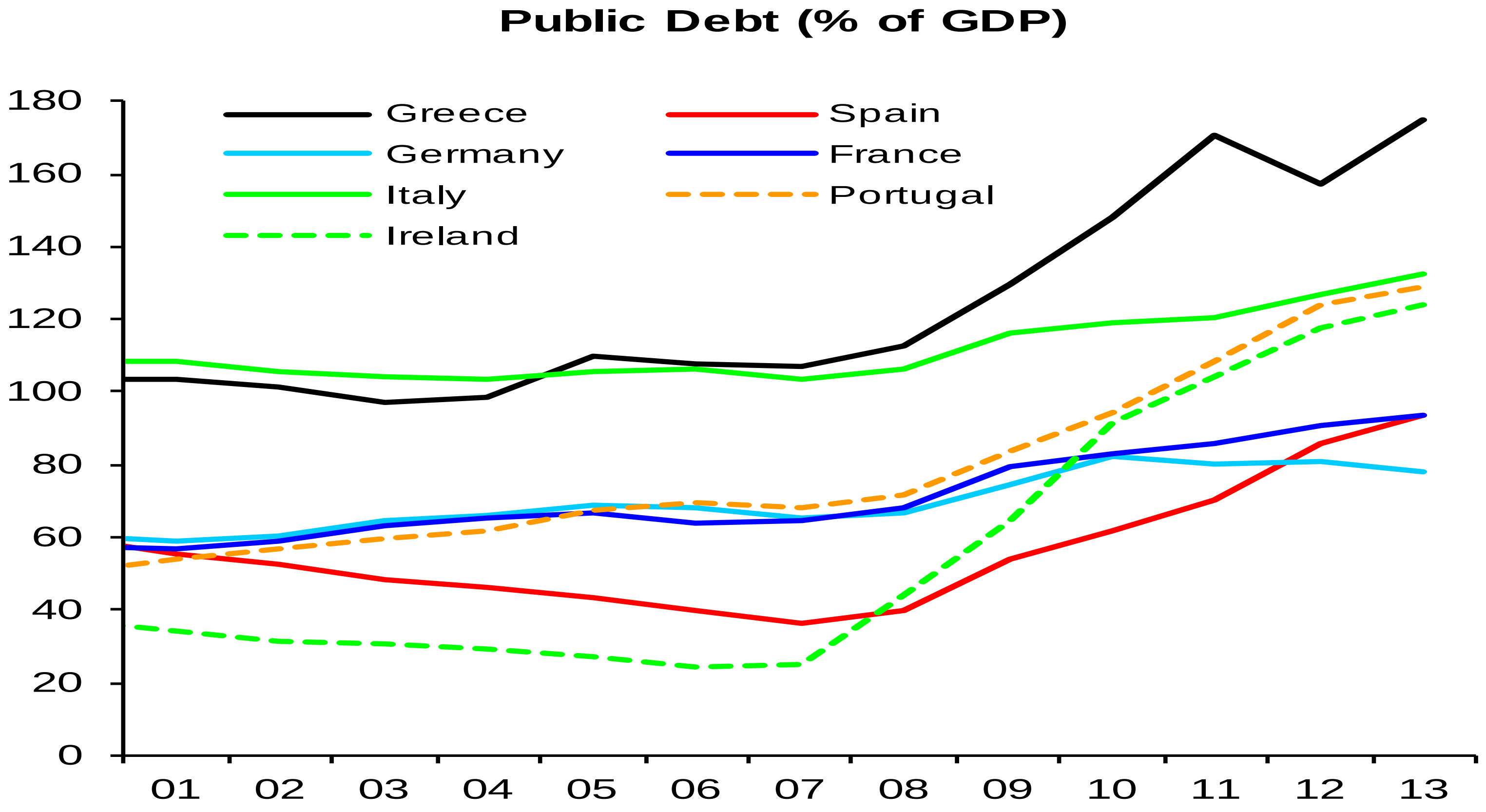
Solvency of sovereigns

Debt-to-GDP ratio not exceptional if compared with other recessions …..



Solvency of sovereigns

Mostly a distributional issue



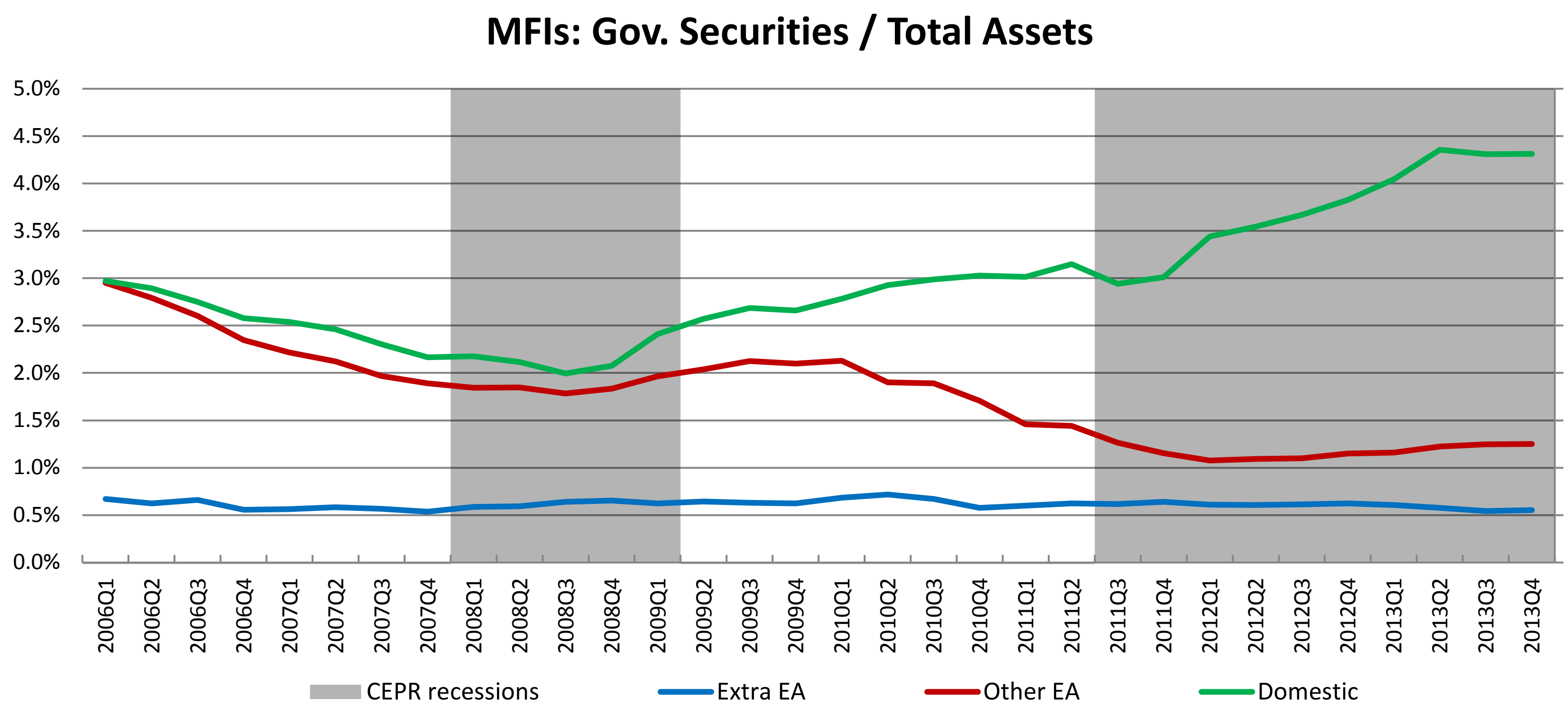
2. 2010-2012 - Sovereign crisis - consequences

1. **HOME BIAS:** New wave of financial segmentation, now involving the asset side: banks buy their own sovereign's bonds
   - correlation of risk between banks and sovereigns and "diabolic loop"
   - geographical heterogeneity of retail rates

2. **FINANCIAL REPRESSION:** Uncertainty about crisis resolution and banks' under-capitalization led to substitution from loans to sovereigns

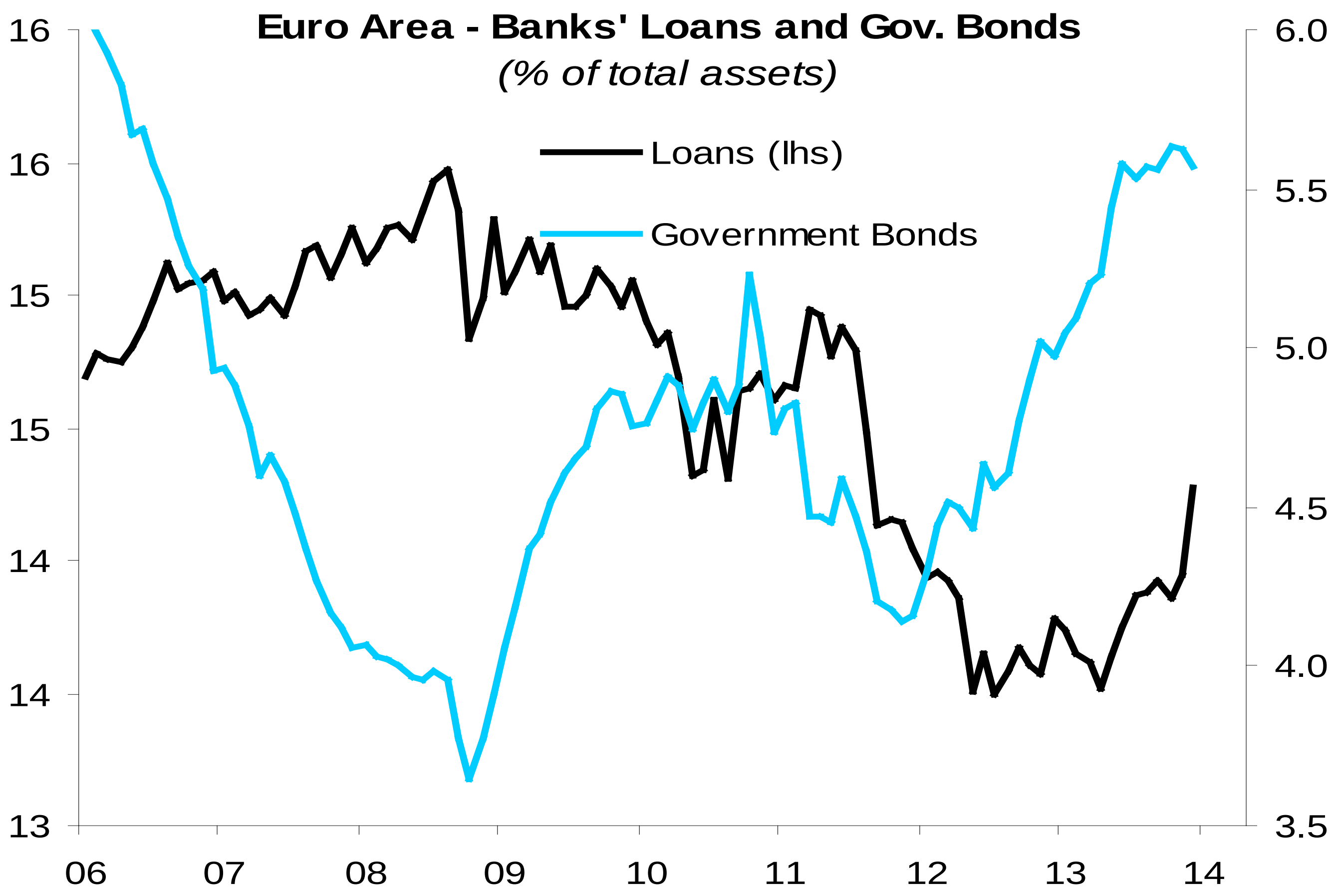
3. **MONETARY TRANSMISSION**: In this context ECB liquidity operations less effective

Home bias in sovereign holdings by banks



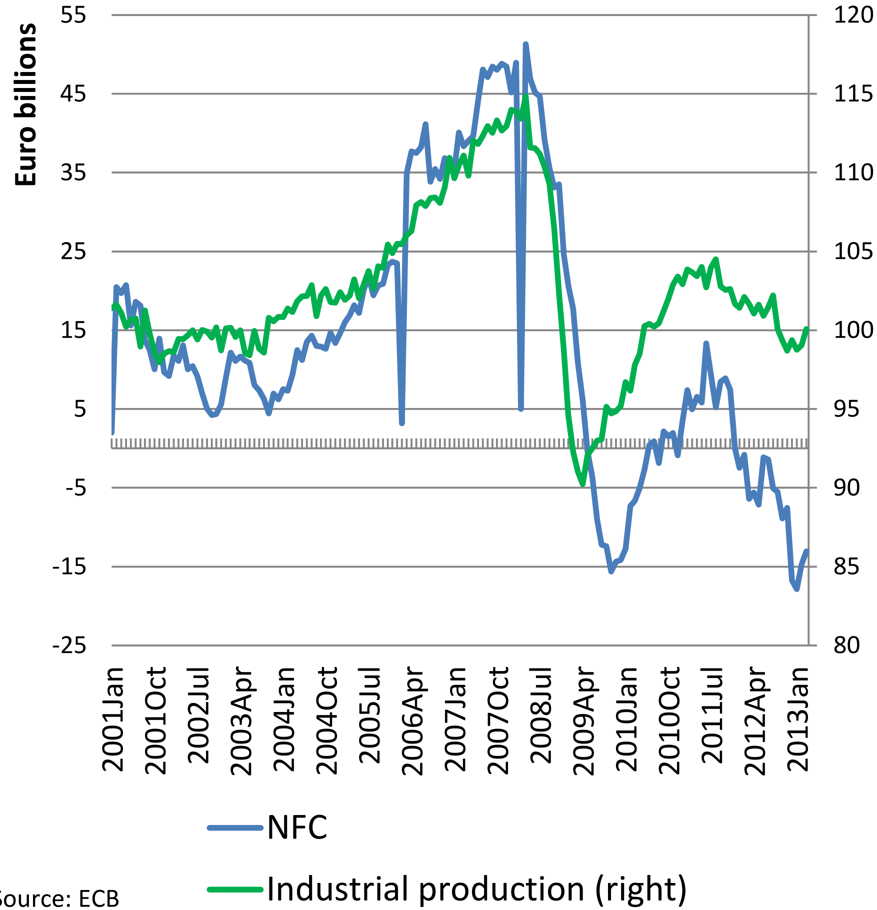
Source: ECB

Financial repression: banks buy government bonds



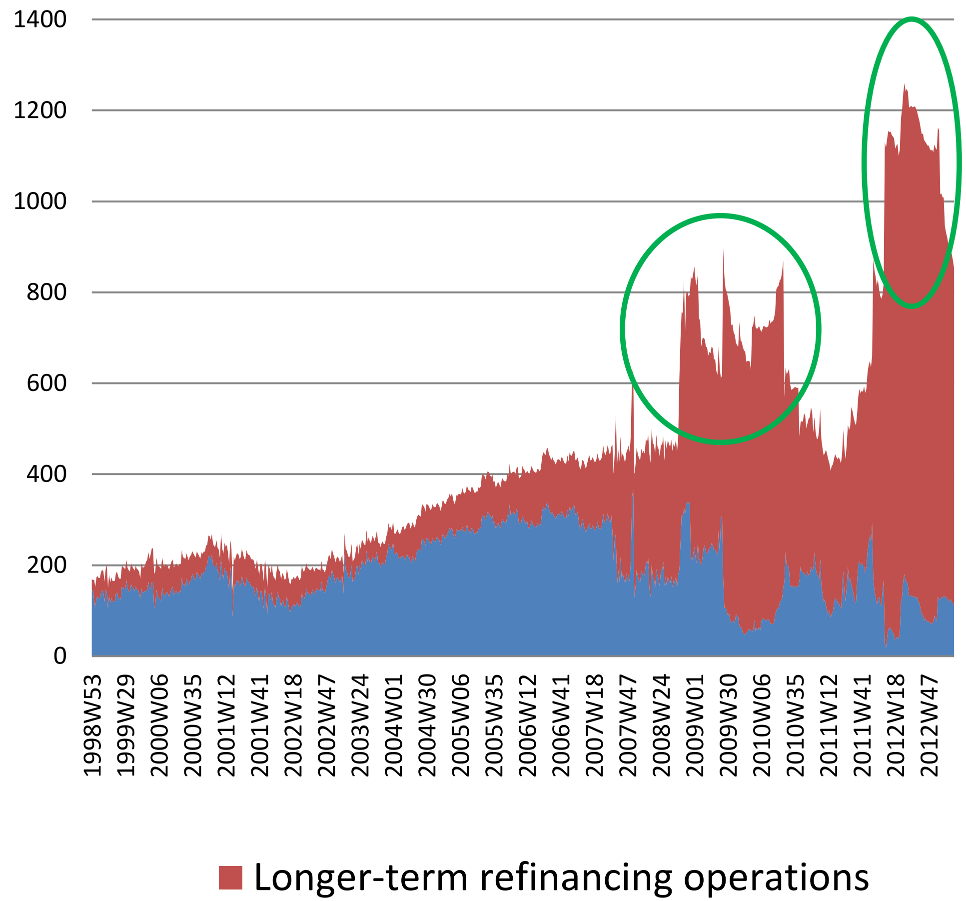
Weak loans 2011-12: a puzzle, given aggressive ECB action?

Loan flows (6m MA) and industrial production



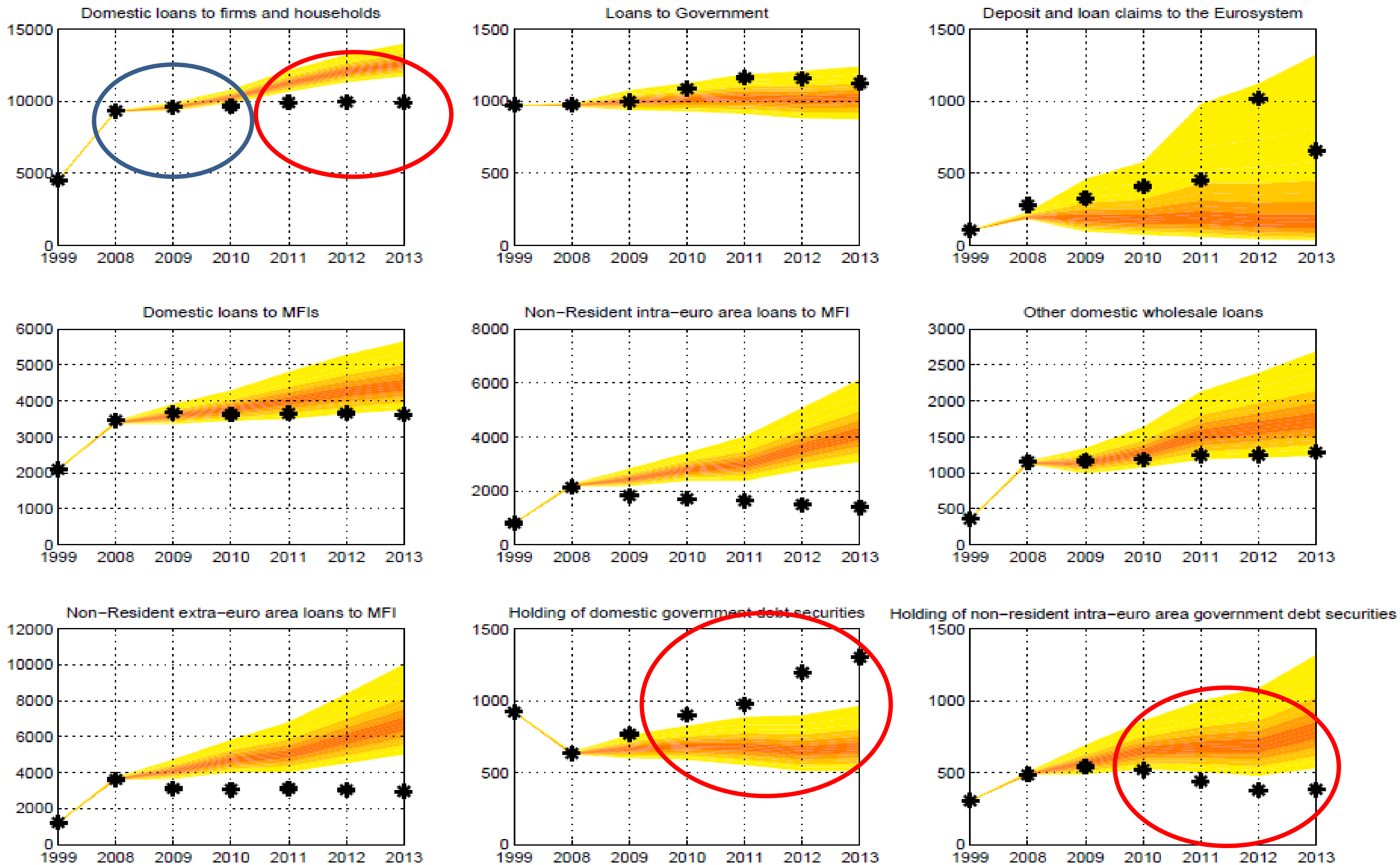
Source: ECB

ECB balance sheet



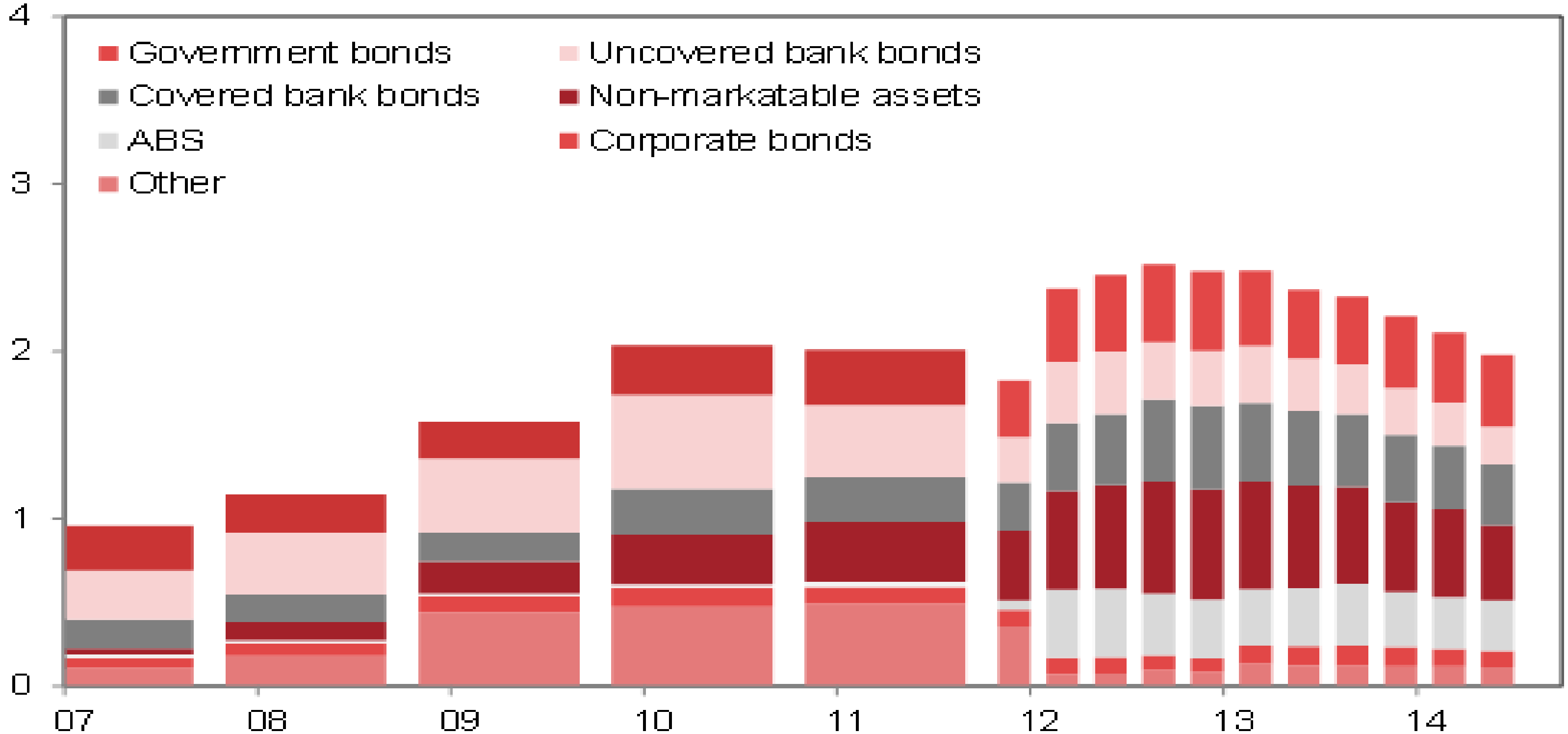
Banks' balance sheets: big changes since 2008
Assets: shift from loans to own government bonds since 2011

Colangelo et al (2014) – counterfactual experiment



Then pledged as collateral at ECB monetary policy operations

Collateral pledged at ECB monetary policy operations



Takeaways

- Liquidity and solvency strictly related
- In a MU a crisis leads to home bias. Therefore: given treatment of government bonds for collateral and regulatory purposes, saving the banks is similar to saving the sovereign
- But if markets doubts the soundness of the implicit deal, “things happen” - [“risk on”]
- Monetary policy has always fiscal implications, especially in exceptional times. In the euro area this implies redistribution effects across countries

3. The attempt to find a new framework 2012-14

The key pillars of the new framework:

1. July 2012: OMT announcement and “whatever it takes” … successful in dampening risk premia

   However untested and controversial

2. Banking Union … with the AQR eventually banks start recapitalizing [5 years after the crisis!]

   However the BU is still unfinished business and non performing loans are looming

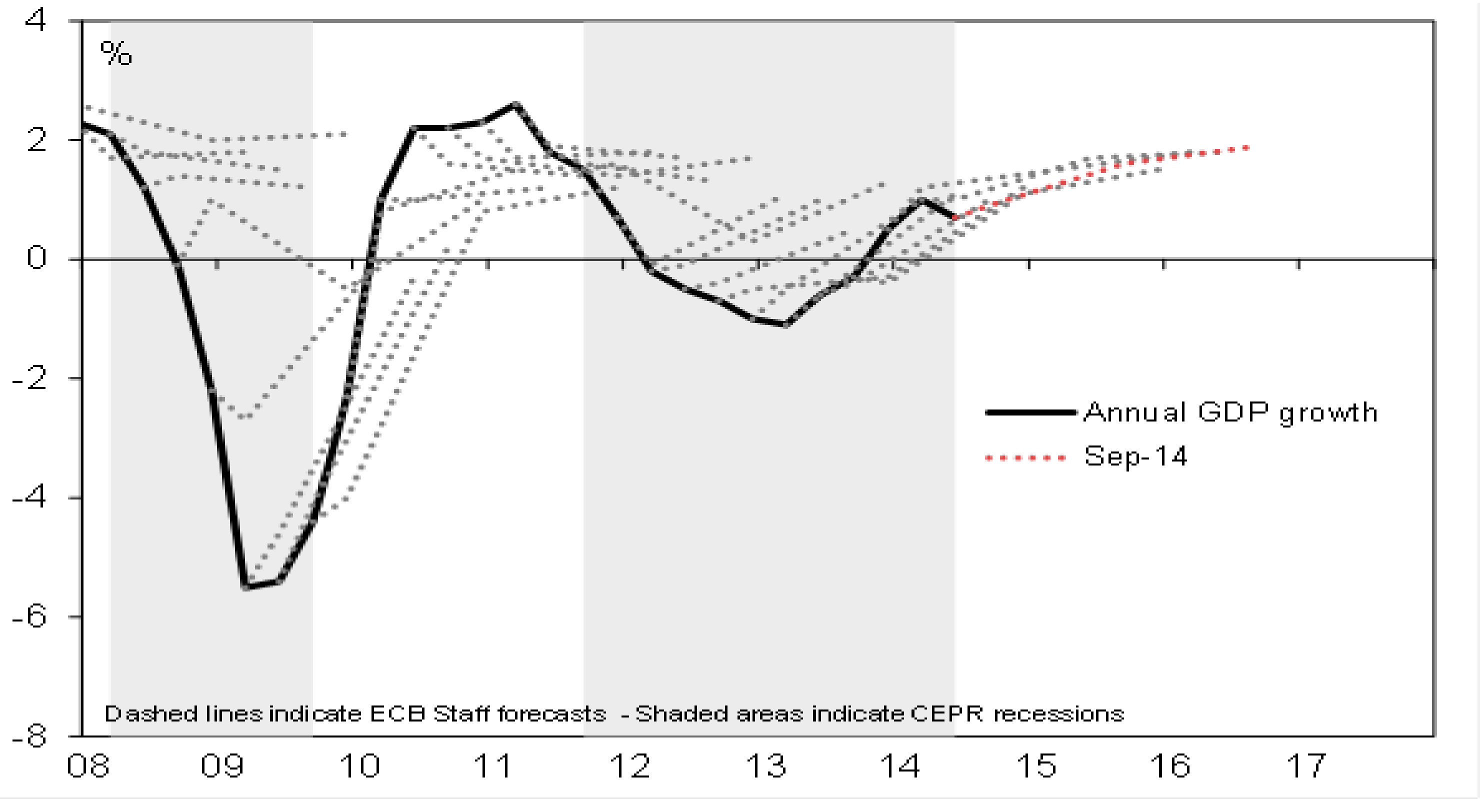
Notwithstanding this ….

Spreads at almost pre-crisis levels which suggest market is pricing an implicit guarantee by the ECB

From excessive risk aversion to excessive complacency!

But in the meantime the macroeconomic outlook has deteriorated

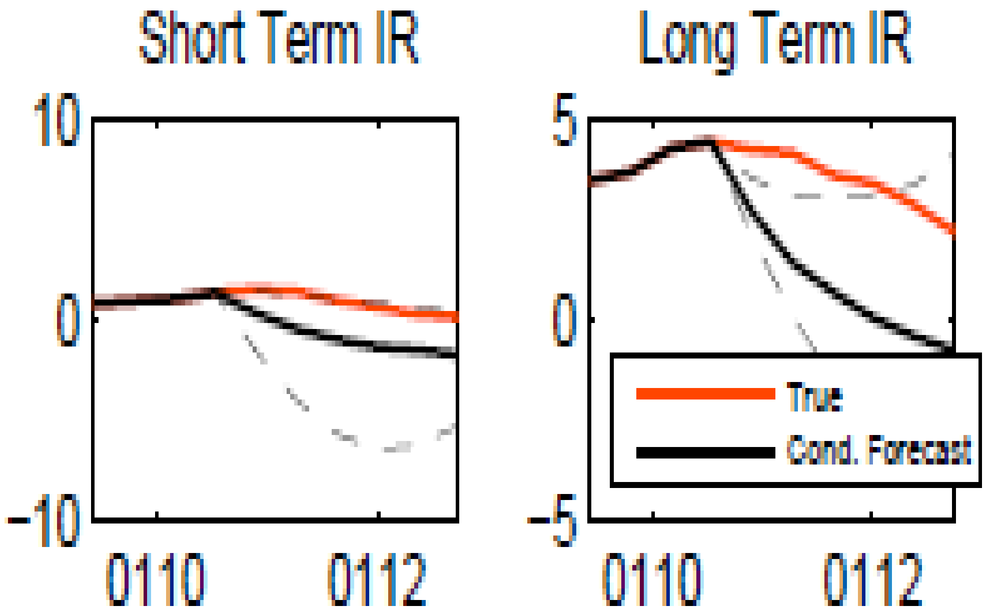
and the ECB did not see it coming



While its balance sheet has been shrinking and it is now at the zero lower bound

Running out of options?

Zero lower bound and risk premia



QE or not QE?

Two fundamental difficulties

1. NO EURO AREA SAFE ASSET
   What to buy?

2. MORAL HAZARD

With QE the ECB will end up buying a large proportion of government debt

- Which means assuming sovereign/credit risk on the ECB's balance sheet
- Which will make restructuring impossible in any state of the world

➢ QE would effectively mean the ECB is insuring the private sector from sovereign risk

➢ This would eliminate market discipline, as the threat of debt restructuring would be eliminated

What can be done?

- ON ISSUE 1:

Need to force the banks to diversify the geographical origin of the sovereign fixed income portfolio

(For the functioning of the EMU it is crucial that banks have a diversified portfolio of sovereign debt)

- ON ISSUE 2:

….. Need to have a safe asset and deal with the moral hazard problem

Garicano-Reichlin proposal

A SAFE ASSET FOR QE

Monetary Policy Aspect

- QE should use a synthetic safe bond formed by the senior tranches of a set of national bonds in fixed proportions

Regulatory Aspect

- The ECB and the Single Supervisory Mechanism (SSM) would announce that only the senior tranche of the security so produced could be counted as risk-free for the purposes of the risk weighting and liquidity coverage ratio calculations, which implies changing the current treatment of sovereign bonds for these purposes

Advantages

- Reduces substantially the geographic bias in the flight to safety, as the safe asset would be (regulatorily) a Europe-wide one
- Eliminates the moral hazard that the “risk on/risk off” mechanism induces: governments CAN default in this world, as the banks are protected from the fallout—markets will thus monitor the governments instead of second guessing the (bailout) intentions of the ECB
- Eliminates the diabolic loop, since a sovereign in trouble does not jeopardize its own banks
- Reduces geographic segmentation of the Eurozone markets
- Creates a large safe asset potentially to be targeted by QE

It is important to emphasize here that this synthetic debt would not involve any risk sharing among different governments or any debt mutualization : each government would continue to issue its own debt and face its own interest rates in the market

Conclusion

- The crisis has been a learning experience on the functioning of monetary policy in a bank-centric currency union in exceptional times
- Some new institutional steps have been taken
- But not enough
- Monetary policy is being lagging behind in its core function because of multiple constraints
- Need a new framework to go forward