Would a more active European Central Bank (ECB) have been able to solve the Euro crisis?

Introduction

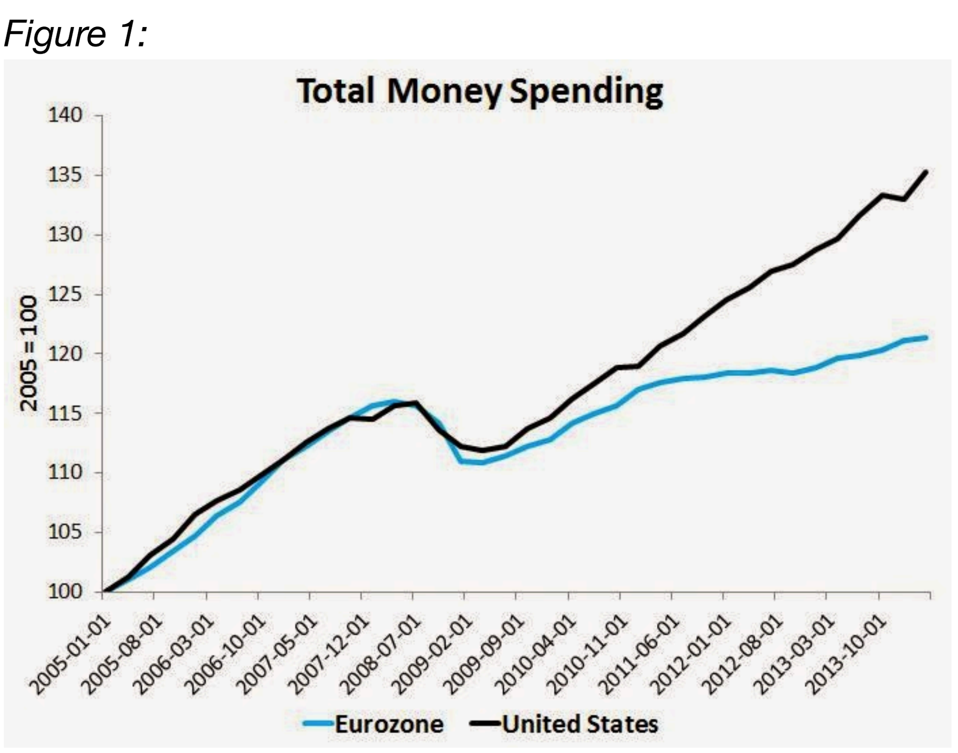
Since the Euro crisis, the central claim of **Svensson's (1995)** theory of flexible inflation targeting - that by stabilising the price level, the central bank also stabilises the output level - has been proven unfaithful. The subordination of the ECB to inflation targeting derives from inherited monetarist concepts of central banking, *based on the letters of the treaties.* The disregard for financial stability, growth and employment stems from the ECB's narrow mandate. **(Lorenzo Bini-Smaghi, 2012)**. This is despite, as **Paul De Grauwe (2012)** argued, being the only institution that [could] prevent countries falling into a "bad equilibrium" on account of panicked sovereign bond markets.

Thus, given the ECB's capacity as a money creating institution, should it have been more active in solving the Euro Crisis? And if so, would it have been successful? If the ECB had not raised interest rates in 2008 and 2011, but had lowered them; or began QE back in 2009, would there now be a brighter future for the Eurozone?

The Eurozone Counterfactual

Comparing total money spending growth between the US and Eurozone suggests that the answer to this counterfactual question, is yes. The Fed cut interest rates quickly and implemented QE programs, unlike the ECB, meaning it was able to promote total money spending in the economy and put it back on a stable growth path (Figure 1). The criticism would be that ECB could have done the same for the Eurozone. In reality, interest rates were raised in the aftermath, and Eurozone GDP growth faltered.

Figure 1:



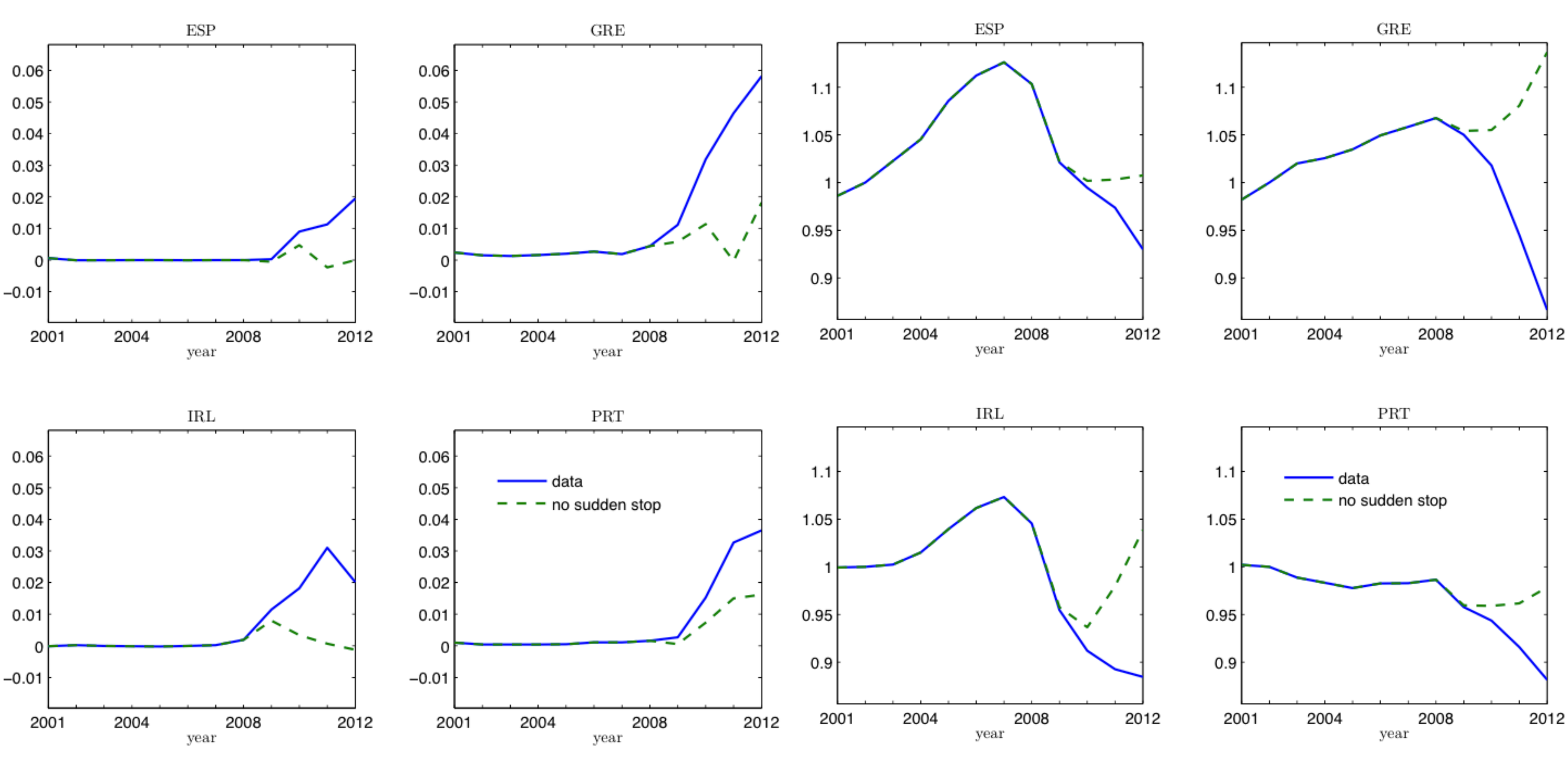
Source: *Macro Market Musings - David Beckworth (2015)*

If the ECB had mirrored the Fed's aggressive monetary easing it would have addressed the issue of real appreciation in the periphery, a key Eurozone problem. In theory, monetary easing should cause inflation to rise relatively more in those parts of the Eurozone that were at, or closer to, full employment. These tended to be core regions such as Germany. If the ECB had been more active in providing liquidity earlier, price levels would have increased more in Germany than in the troubled periphery of the Eurozone, making goods and services from the periphery relatively more competitive. The ECB could have achieved a real depreciation of the periphery - instead, monetary easing was not tried and so the periphery attained a real depreciation through painful deflation, exacerbating the Euro Crisis.

Martin and Philippon (2014) run counter-factual simulations of the effects on the PIGS had the ECB's OMT program and Draghi's declaration to do "whatever it takes" been instigated in 2008 and not late 2012. If the ECB's 'lender of last resort' announcement (effectively eliminating the dramatic rise in spreads experienced by periphery countries) was soon after the onset of the crises, *instead of waiting until the brink of despair*, this would have enabled countries to reduce their borrowing costs - avoiding fiscal austerity and stabilising employment. Figures 2 and 3 reveal that spreads would have been significantly lower if the ECB had been more active, and that employment would also be higher for all countries. They conclude that if these ECB programs had come earlier, then the PIGS would have been able to avoid the latest part of the slump.

Figure 2 & 3:

Figure 26: Spreads with Early ECB Intervention   Figure 27: Employment with Early ECB Intervention



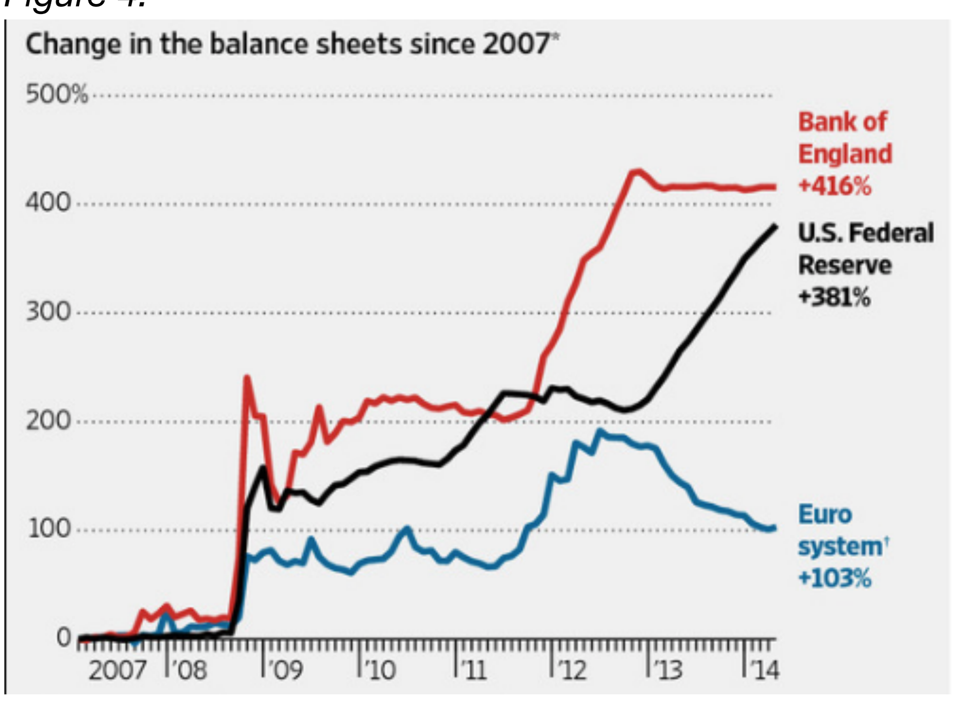
Source: Inspecting the Mechanism: Leverage and the Great Recession in the Eurozone - Philippe Martin and Thomas Philippon (2014)

Simon-Wren Lewis (2014) agrees, positing that if the ECB's OMT programme was implemented in 2010, rather than 2012, the degree of austerity required would have been far lower. OMT would have limited fears of contagion and meant austerity needn't have been so harsh. Eurozone countries would have had fiscal space to counter the crisis, and unemployment would have been reabsorbed, bestowing a "better recovery from the Great Recession" as a result.

Comparing Central Banks in the Crisis.

A comparison of central bank emergency measures reveal the ECB's non-standard monetary action to have been tame. **Pronobis (2014)** argues that the European approach was conservative relative to other, more aggressive, central banks. Examining the financial size of these monetary policy programs shows this to be true: ECB bond purchases up to the end of 2012 amounted to only 3.5% of the Eurozone's GDP. In the same period, Fed spending for asset purchasing programs came to 22.1% of GDP, the Bank of England to 26.3% GDP, and the Bank of Japan to 37.3% GDP **(Fawley & Neely, 2013).**

Figure 4:



Source: WSJ

Figure 4 reveals ECB policy to be significantly more cautious compared with other central banks. **De Grauwe (2012)** notes that balance sheet expansion is comparatively less pronounced, and only when banks were at risk did the ECB start providing massive liquidity support to prevent collapse. Given the Euro Crisis was arguably a time when principle actors should have been more proactive and taken larger risks to counteract such negative consequences, **Rodríguez and Carrasco (2014)** deem the ECB's strategy to have been "backward looking".

The ECB's announcement to become a lender of last resort to the banking sector prevented any prospects of a bank run and the subsequent liquidity crisis and fire sale that would ensue. **Wren-Lewis (2013)** suggests that the fiscal positions of some Eurozone economies became critical because of the ECB's hesitancy, however, taking responsibility four years after the crisis' outbreak. In fact, **De Grauwe (2011)** attributed this reluctance as the single most important factor explaining why the contagion in the Eurozone's sovereign bond markets had not been stopped. **Rodríguez and Carrasco (2014)** go further, suggesting that the ECB's caution had perverse effects, mutating the sovereign crisis into a bank solvency crisis. Draghi's words avoided a collapse of the system, but by then southern countries were already seriously contaminated.

Countering the Counterfactual

Richter and Wahl (2011) propose that despite its initial prudence, ECB action has been quite pragmatic in the crisis. Central bankers deviated from strict monetarist principles in order to stabilise the system. **Giannone, Lenza, Pill and Reichlin (2011)** found evidence suggesting that the ECB's non-standard measures supported "financial intermediation, credit expansion and economic activity" during the crisis. The ECB thus prevented banking system collapse, as well as curbing the deflationary spiral in the EU. **Pronobis (2014)** argues the ECB has managed to avoid the worst-case scenario in Europe, as all European countries remains solvent and their economic conditions are gradually improving.

Giannone, Lenza, Pill and Reichlin (2011) rationalise the ECB's anti-crisis strategy by pointing to the various barriers to action it faced. It was perhaps unrealistic to expect more, given it was acting in a very difficult legal and structural environment during the crisis, and therefore encountered obstacles in implementing more unconventional measures. Constant disagreement among European politicians and strong German objection was a decisive obstacle for the ECB in their attempts to implement more aggressive monetary operations. Holding the ECB accountable to Fed standards may also be unfair, as **Lenza, Pill & Reichlin (2010)** attest to the different model of financial markets in Europe (bank-oriented) and the US (market-based).

Conclusion

Counterfactualists like **Beckworth (2015**) and **Wren-Lewis (2013)** would conclude that had the ECB introduced its OMT programme two years earlier than it did, the crisis might well have dissipated very quickly and we would be looking at a much brighter future for the Eurozone. Perhaps this is a little too harsh, however - **Pronobis (2014)** points to the ECB's "straitjacket" and narrow mandate - price stability. Francesco Saraceno echoes this view that the real problems with the Eurozone are institutional. The ECB delayed acting as a sovereign lender of last resort for two years, creating a Eurozone crisis out of what should have been just a Greek problem.

Coming full circle, the ECB's success in maintaining price stability during the last decade did not translate into financial stability. **Borio, English and Filardo (2003)** recognise that the ECB's pre-emptive monetary policy strategy leaves price stability open to risks that *stem from* financial imbalance. The flip-side is that a narrow focus on price stability could *engender* financial instability: a stable, low interest rate environment may induce more risk-taking behaviour, giving rise to financial imbalances. The apparent price/ financial stability trade-off has been reconciled by **De Grauwe (2009),** who proposes a 'two-pillar strategy'. The ECB would continue to target inflation under the first pillar; whilst financial stability would be maintained though reserve requirements and macro-prudential controls, in the second pillar

This means a change in the legal framework of the ECB to include not only its function as a lender of last resort, but a triple mandate: price stability, maximum employment, and banking supervision and regulation (Christophe Blot et al., 2014**).*

The ECB's 2015 QE announcement and its subsequent ramifications on European markets have prompted Draghi to announce the crisis' official end (footnote). If we believe what Draghi says, then surely a more active ECB could have solved the crisis sooner? Regardless of how easy monetary policy is, however, the ECB is unable to resolve all structural problems that the Euro Crisis excavated. **Feldstein (2013)** submits that getting European economies back on track will require sound economic policy and fiscal consolidation at the national level. Final recovery also depends on policymaker decisions and the future shape of European integration.

Bibliography

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