
ECB in Eurozone policymaking: Going forward

Refet S. Gürkaynak

Bilkent University and CEPR

Since the beginning of the Global Crisis, the ECB has faced a sequence of problems. This column discusses some of these problems. It also highlights the successful first reaction of the ECB to the crisis and its adequate monetary policies. There are still unresolved structural problems in the Eurozone, however. Among them are the lack of a proper banking union and the need for a better fiscal policy coordination. And the job for such a change within the Eurozone cannot be delegated to the ECB.

In the past decade, beginning with the Global Crisis, the ECB faced a sequence of related but distinct problems. These began with a financial crisis due to the US mortgage crisis, continued with a second financial crisis due to the European debt crisis, and is ongoing with a very slow exit from recession with inflation teetering at the border of negative rates. In analysing the efficacy of ECB policies and thinking of what more can be done, it is important to separate the crises from the recession.

ECB successful at crisis firefighting

Central banking was invented as a backstop for banks to help avoid bank runs. It then evolved into cyclical policymaking. The Global Crisis made it clear that central banks are still very adept in fulfilling their initial mandate; many central banks around the world, including the ECB, did an admirable job of doing firefighting by providing liquidity to illiquid institutions. This took place sometimes by finding ways to extend the playbook by creatively providing liquidity to non-bank financial institutions in

need, often despite political pressure against such policies. But it is essential to note that we did not have waves of bank failures due to illiquidity in the Eurozone. ECB has been successful in crisis firefighting.

It appears that the various facilities ECB had in place to assist the banking sector during crises have been useful. In this regard, when a financial shock hits again, the ECB is well placed to get liquidity to the institutions that need it. However, the Eurozone as a whole continues to have difficulties with recapitalising the banks. The US benefited a lot from the forced recapitalisation of its banks during the crisis but a recapitalisation of the banking system to a similar degree did not take place in the Eurozone. This remains a weak point both in terms of financial stability and in terms of creating headwinds for growth.

After the crisis came the recession. This time the central banks had to perform their duties as cyclical policymakers. The Eurozone recession was a double dip one according to CEPR's business cycle dating committee, with a recession due to the Global Crisis between 2008Q1 and 2009Q2 and then a second recession due to the European debt crisis, between 2011Q3 and 2013Q1. The public can be forgiven to think that there has been one long recession since 2008--expansions have been very weak. This at least in part due to the zero lower bound and insufficient fiscal expansion and even retrenchment. So what is monetary policy to do?

Monetary policy of the ECB

My view is that ECB monetary policy has done what it can. The past decade taught us much about the limits of monetary policy. The limit is not only due to the zero lower bound. Barnichon and Matthes (2015), and Tenereyrol and Thwaites (2015) convincingly argue that monetary policy in the US does not work well as an expansionary tool, independently of the zero lower bound. Although it is not as formally documented, it appears that a similar asymmetry is present in monetary policy effectiveness elsewhere as well. Central banks are able to slow economic activity and bring inflation down but

are not as able to do the reverse. Hence, expecting monetary policy to fight against a recession, especially at the zero lower bound, is faith misplaced.

Central banks, including the ECB, have tried. Quantitative easing at the zero lower bound is central banks' way of saying they are the only adults among policymakers and will try to help bolster demand with unconventional policies even when it is not clear why these policies would work, and more importantly, fiscal policy would certainly work. My reading of the evidence is that QE has not directly hurt but has not helped much either. Indirectly there has been at least one important cost.

As central banks are expected to bear the burden of bolstering demand, and volunteer for doing so, fiscal policymakers are left off the hook and focus on their idiosyncratic objectives. Unfortunately, during the recent episodes, those objectives in Europe were not for fiscal expansion. This is a particularly acute case of monetary policy becoming the residual claimant of all policy needs and other policymakers behaving sub-optimally knowing that central bankers will step up and take the blame for the weak economic outcomes. Troy Davig and I discussed the perils of central bankers as policymakers of last resort (2015a, b). The Eurozone case is a sadly good example where the ECB's willingness to improvise policies to support growth has shielded the embarrassingly inept fiscal policies. Going forward, we have to rethink the job descriptions and responsibilities of various policymakers. There has to be more accurate finger pointing for the right policymakers to take the right steps. ECB must be less involved with problems it cannot solve.

Thinking about policy first requires the need for policy. What are the inefficiencies that necessitate policy interventions? Before asking for the ECB to do more, one has to be convinced both that there is an inefficiency and that monetary policy the right tool to address it. Banking (or more broadly financial intermediation) is subject to runs and crises which reduce welfare and call for policy action. The ECB has carried out this policy well and is well placed to continue playing this role as the lender of last resort. For other problems the ECB may not be the best policymaker.

Structural problems of the Eurozone

The crisis laid bare the structural problems of the Eurozone. Some of these were well understood. The Eurozone is not an optimal monetary policy area. Its labour markets are inflexible. Its fiscal policies are uncoordinated. With the crisis, we learned of one very important structural problem that was not as apparent.

- The Eurozone was not an optimal banking union area either.

The common banking passport created a more serious regulatory arbitrage than was thought and the fragmented banking and regulation landscape was a major problem. This issue is now being tackled with the ECB becoming a Eurozone level supervisor for large banks. This is a welcome response to the banking problems we observed and will help make Eurozone banking more resilient. In general, completing the banking union will help both in terms of supporting the real sector equally well in different Eurozone countries and in making European banking much better regulated. If done right, this will be a silver lining of the financial crisis.

Looking at the other inefficiencies, it must be clear that most if not all of them cannot be solved by monetary policy.

- Among other structural reforms, there is obvious need for better coordinated counter-cyclical fiscal policy.

This does not mean a new treaty on cross-country fiscal transfers or a unified fiscal policy. There is a very wide spectrum between the discombobulated and pro-cyclical fiscal policy on display now and a fiscal union. Even small changes in the right direction will produce large welfare gains.

It is important to see that structural reforms are political reforms that cannot be done by central banks. ECB is no exception. Eurozone unemployment by and large has to do with a combination of rigid labour markets in each country, the lack of sufficient intra Eurozone labour mobility, and real wage disparities at the inception of the euro. Some

of these are political preferences: Eurozone citizens may choose to have employment protection and transfers to unemployed, in that case unemployment will be high. Flexible labour markets with less protection of the employed, in the Anglo-Saxon fashion, is also possible, which will deliver lower unemployment with higher churn. There may also be a preference for this. It is important to see that the ECB neither should nor can make that choice.

The Eurozone has a lot in common with emerging market economies with its problematic fiscal policy, deep need for structural reforms, and over reliance on its central bank for all economic policymaking. Similar to them, it will have to find the political will to change. That is a job that cannot be delegated to the ECB.

References

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