THE ROLE OF INSTITUTIONS IN ECONOMIC ADJUSTMENT:
THE ECB

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WHAT IS IN THE HANDS OF CENTRAL BANKS

- Monetary policy:
  - Liquidity management
  - Interest rate setting
- Regulating the banking sector
- **Lessons of history and initial decisions**
  - The Great Depression and Japan’s lost decade showed the need to
    - provide unlimited liquidity
    - keep interest rates low
  - The Lehman débâcle showed the dangers of closing down big, interconnected banks

NEW LESSONS

- Need for unconventional monetary policy tools: injecting cash into the financial system through direct liquidity provision and purchases of assets aiming at
  - stabilizing financial markets
  - continuing to provide monetary policy assistance when interest rates reached zero or near zero lower bound
  - indicating their longer-term intentions through *forward guidance*. This is based on the idea that, by lowering forecasts of future interest rates, this will reduce the rates paid on fixed interest longer-term loans, and will give those thinking of taking out a loan on variable rates more confidence that rates won’t rise shortly, encouraging more spending

ECB ACTIONS

- The ECB has been applying these tools, as well as specific measures directed at “doing whatever it takes” to keep the monetary union together
- The OMT (Outright Monetary Transactions) program, launched in September 2012, belongs in this group and allows the purchase of short-term bonds (up to 3 years) in the secondary market
- Purchases under the OMT program will be unlimited, but subject to "strict and effective" fiscal conditions
  - important to prevent the perceived weakness of the previous ECB bond-buying plan, the Securities Markets Program, which was both limited in its scope and unconditional
- The ECB dropped any claim to seniority in this program
- The intention is to bring down the market interest rates faced by eurozone countries subject to speculation that they might leave the euro

BEYOND THE CENTRAL BANKS

- The main problem facing the ECB is that the improvement in financial markets has not helped firms in southern Europe where bank lending to companies is falling at a worrying rate and corporate loan rates are much higher than in Germany
- Governments and banks should use the breathing space provided by unconventional policies to move forward with needed fiscal, structural, and financial sector reforms
- This is not just a Eurozone problem. In March 2013 *The Economist* wrote:
    - *Lending remains a big problem. Although the Bank of England has pushed rates down to record lows, banks charge firms much higher rates, which helps explain why borrowing by businesses has been shrinking since 2009.*
    - *Despite a colossal reduction in output, few firms have folded: banks are unwilling to take losses, owners shun the stigma of going bust and cheap money allows them to avoid it. But the undead firms keep capital away from outfits with better ideas. Looser takeover rules for small firms would allow winners to absorb losers. And failure should be less costly: Britain still lags America in enabling entrepreneurs to make a fresh start.*

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- Clearly, the crisis makes it even more necessary to undertake **reforms that support the level and growth rate of potential output growth.**
- Such reforms are diverse and mutually supportive.
- Action can be taken to improve participation in the labour market, to make tax structures supportive of private investment and to make sure that fiscal consolidation plans do not sacrifice socially profitable public investment. Total factor productivity can benefit from support to higher education and research and from educating and training the young and low-skilled workers.
- **All of this is essential but it is not in the hands of central banks.**

CONCLUSION

- As Hyman Minsky explained, lower observed macroeconomic volatility in the short term encourages greater financial risk-taking.
- The longer the perceived good times last, the more fragile the economy becomes.
- Some might say that Minsky's insight is irrelevant because we have the ability to quickly deal with downturns that occur when the private sector is highly indebted. Unfortunately, the actual track record suggests otherwise.
- **Economists should invest more effort in figuring out how to minimise the impact of these devastating episodes in advance. The question is whether real prevention is possible.**

The Economist, "Central Banking: Doomed to Fail?", March 2013.