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Business as usual in Frankfurt?

Roberto Tamborini | Oct 5, 2008

Apparently yes. The press release after the Governing Council (GC) decision to keep interest rates unchanged contains the usual clever account of the "economic and monetary developments in the euro area" the balance of which leads to the final decision. Following the usual two-handed style, we understand that: *on the one hand* "economic activity is weakening, with contracting domestic demand and tighter financial conditions", *on the other hand* "annual inflation rates are likely to remain well above levels consistent with prices stability for some time". Result: upside risks for price stability are deemed to exceed downside risks for economic activity, hence, no cuts. The decision was hunanimous. Yet the doves may have some relief knowing that the GC "discussed extensively the recent intensification of the financial market turmoil" and that one option was to cut interest rates. Some observers interpret these nuances as a premise for taking that option in the proximate future - when? (see A. Maccario here)

Anything else to say about "the recent intensification of the financial market turmoil"? Not much more than "the extraordinarily high level of uncertainty stemming from latest developments". Or the awareness that the ensuing large portfolio shifts towards liquidity may inflate M3 growth statistics. These on the other hand show signs of moderation, as desired. To the question whether economic activity in the EA is falling faster than expected, President Trichet answers affirmatively, adding however that this is deemed insufficient to curb upside risks for inflation.

If one of the aims of central banks' governing bodies is to transimit the feeling that the economy is in safe hands, this time our GC has grossly missed the mark. Problem is that this is not time for business as usual. The ECB decision, and even worse, *the way in which it has been explained*, can only enhance worries about a serious deficit of world leading institutions in the face of the most dramatic systemic crisis ever since 1929.

What I am talking about is not the hypothetical role of the ECB in the solution of the problems of the financial system, but just about its mandate for macroeconomic stabilization. True, the ECB has done, and is doing, its own part to satisfy the enormous liquidity needs of bank and non-bank financial institutions. But is this really enough? Is there in Frankfurt a correct perception of the economic situation, of its prospective evolution, and of the best course of action?

It is clear that the ECB's decision still reads the macroeconomic scenario as one of stagflationary shock, with limited involvement of the EA in the US financial breakdown (Trichet's account is almost entirely *backward-looking* at the EA as depicted by the September Monthly Bullettin, i..e. the actual situation as of late summer). In this perspective, the ECB policy is to let aggregate demand fall as much as necessary to curb the oil cost-push on the supply side. To this effect, interest rates are kept tight while (hopefully) taking into account other endogenous factors whereby inflation may reduce demand (e.g. nominal wages lagging behind inflation, real balance effect, fiscal drain, etc.). This policy stance conveys the message that the ongoing financial crisis does not deserve any special action. Indeed, in this view the domestic and imported real effects of the financial crisis could even be welcome as they help restrain demand and curb inflation faster!

Remarkably, the ECB decision has arrived soon after the unprecedented debacle of four major financial institutes in a row, and a catastrophic response of continental stock markets. Trichet himself has announced that the "limited involvement" illusion is over, and all main European institutions now view recovery of financial stability as a top priority. What is the connection between the passive stance held by the ECB and this situation? If there is any, it is not adequately explained in the available official documents. All that we know about the real effects of financial crises tells us that they stretch well beyond some cuts in expenditure plans, and they do need some special care on the part of the central bank. For a quick reading see Roubini's "Twelve Steps to the Disaster", some of which are already behind us not only in the US but also in Europe. The issue at stake is not the trade-off between the pace of economic activity and that of inflation, but the basic vital functions of the monetary system, which are *integral part* of the mandate of the central bank. True, as the US experience shows, cutting interest rates is not enough, which does not mean that it is unnecessary. It is necessary for three main reasons (I ignore other reasons related to the international context).

1) *Prevent the interbank market from drying up.* Interbank market conditions are extremely tense all over the world (see here). The data in the September Monthly Bullettin of the ECB already indicated that the EA interbank market was rapidly overheating. Transactions are getting thinner and thinner and

are continuously pushed towards the upper edge of the corridor of the official rates. On Friday, October 3rd, the 3 months Euribor reached the historical peak of 5.20%, in practice the same level as the ECB marginal rate. Pouring liquidity into this market is like Sisifo's work for at least one simple reason: the corridor's floor is too high. Earning a safe 3.25% by just leaving money in Frankurt is a very attractive deal for bank liquidity managers that are totally unconfident one with the other. "Liquidity trap" is out of fashion in textbooks, but is something real in this moment. Repositioning the corridor of rates downwards would reduce the incentive to hoard liquidity, would ease marginal refinancing conditions, and would drive the interbank rates back towards the middle of the corridor where they should stay normally.

2) *Prevent credit crunch.* As a consequence of the tight monetary policy of the ECB, the non-bank private sector has been facing constantly worsening loan conditions at growing costs throughout 2007 and 2008 (see the last ECB Bullettin). In early September, however, E. Parisi Capone reported here on mounting signs of credit crunch in the EA. Technically, a credit crunch is not just the effect of bank rates being high, but the effect of banks cutting credit lines altogether. Consequently, credit crunches amplify the effects of monetary restrictions. A credit crunch in the EA is all the more likely because banks are undergoing large portfolio reshuffling in order to rebalance total risk exposure, which means cutting credit lines to specific classes of borrowers. As a consequence of the peculiar nature of the present crisis, the first class of borrowers that has been cut off are fellow bank counterparties. The tronado that has swept the top floors of the European banking system provides eloquent evidence. In the typical credit-crunch pattern, next comes the non-bank sector. Lower interest rates may not have direct effect on the decisions of banks of cutting specific credit lines, but they may be beneficial indirectly in that a) they ease the financial position of debtors, b) they sustain the market valuation of assets, and hence the creditworthiness, of both the bank and non-bank sectors.

3) *Prevent bankruptcy chains.* Credit crunches are dangerous because they typically trigger a domino effect. A crunched borrower, if s/he can, will most likely crunch her/is debtors. It is easy to see that this domino effect unfolds faster across banks, as indeed happened in the last few weeks. When the credit crunch comes to the non-bank sectors, credit lines among firms are another vehicle of diffusion, whereas households are the final victims. Firms and households in financial distress in their turn damage the balance sheets of their banks thereby closing the vicious circle. Though the global balance-sheet position of the non-bank sectors is healthier than in the US, EA small businesses and households are already in financial distress owing to other by-products of tight monetary policy, in addition to high interest rates: the strong euro, falling employment rates, stock market and real estate losses, and growing mortgage installments and collaterals. Under particularly severe conditions, like the present ones, the whole process may generate bankruptcy chains across banks, firms and households. Not only do bankruptcy chains restrain demand, they just destroy resources (and sometimes human lives). Moreover, this kind of resource destruction has very little to do with the "creative destruction" of capitalism whereby better resource allocation is obtained. Resources are just waisted. Most of the people involed in these system failures are not victims of their own mismanagement but of someone else's mismanagement of the economy.

The disruptive phenomena described above are developing rapidly. We hope that the next GC meeting of the ECB will prove to be commensurate with the situation.

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