Ready *or* Not?

Critics charge the European Central Bank is unprepared in the event of another global financial crisis. Fair criticism?

To be sure, President Mario Draghi and his colleagues deserve credit. The eurozone economy has recovered. For the first time since the introduction of the euro, all eurozone countries by early 2018 could satisfy the 3 percent fiscal deficit limit of the Maastricht Treaty.

Critics charge, however, that the ECB, particularly when compared to the U.S. Federal Reserve, is not prepared in the event of another financial crisis. To be sure, the U.S. financial and economic systems have their vulnerabilities. Nevertheless, the Fed has ended its asset purchases, let its balance sheet begin to shrink, avoided the introduction of negative interest rates for banks, and lifted the Fed funds rate to 1.75 percent and likely to 2.5 percent by year-end. By comparison, critics charge, the ECB could be at risk of looking like the weaponless generals trying to survive the last war.

Then there's the issue of the viability of the banking sector. In the period after the 2008 crisis, the U.S. Congress enacted the TARP bank bailouts to bolster the balance sheets of their banks. Though stress tests were conducted, the eurozone governments did not initiate such a bailout.

Are the critics exaggerating the eurozone's vulnerability in the event of a crisis? Or should ECB officials be concerned? After all, in most other countries policymakers across various governmental institutions are in a position to use a wide variety of tools, including fiscal policy, in the event of a crisis. In the eurozone, crisis management is left almost exclusively to the monetary authorities.

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220 I Street, N.E., Suite 200
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Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

I. A Speedier Normalization Would Have Provided the ECB More Options

JÖRG ASMUSSEN
Managing Director and Head of Financial Institutions for Continental Europe, Lazard, and former Member of the Executive Board, European Central Bank

In light of my personal background, it would be rather self-righteous to emphasize that from my point of view, the European Central Bank has mastered its tasks in the crisis by and large well. One can certainly argue over single measures, and the taken steps were not without risks and side effects, but taking no action at all would have seen greater risks and side effects. A long-term reason for worry is that the right counter-crisis measures—the SMP, OMT, and the QE programs—have led to an alienation of the largest country—namely Germany—from European institutions such as the ECB and European Commission. One will have to watch and see whether a process reminiscent of the one that began decades ago in the United Kingdom and that we can see unfold in the coming Brexit has commenced here. It may be the case that the sentiment in Germany will limit the scope of the ability of the ECB to react in the next crisis, or delay the necessary response.

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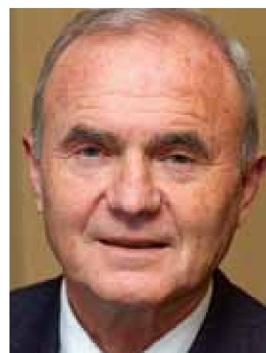
As right as the actions of the ECB have been, the way of normalization is slow, maybe too slow, even if inflation data for the entire eurozone support the argument for a slow exit. For reasons of financial market stabilization, I could have imagined a different sequence of phasing-out: First, normalize the negative deposit rate, then initiate the phasing-out of the QE program. It is not binding to follow the pattern of the U.S. Federal Reserve in the phasing-out, but I understand well that the ECB's forward guidance effectively forces it down on this path. No doubt, a speedier normalization would have provided the ECB more options in the event of the next global crisis.

Essentially, however, the crisis management capabilities of the ECB depend on the next ECB president and his closest team: Will he or she look at the eurozone as an integral whole and have the courage to renew Mario Draghi's "whatever it takes" words and actions at the decisive moment? If willingness and foresight prevail, the ECB will find instruments to deploy in future crises like it has in the past. Each global financial crisis of the past has changed and enlarged the central banks' tool boxes. What were non-standard measures yesterday may well be the standard measures of tomorrow. It all depends on the ECB president. That is what makes the selection of Draghi's successor key.

II. The Euro Area Still Seems Fragile



OTMAR ISSING
President, Center for Financial Studies, Goethe University Frankfurt, and founding Member of the Executive Board, European Central Bank

The European Central Bank—like other major central banks—certainly has sufficient tools to react to a potential crisis. To be in a more powerful position, it would certainly help to have exited from its very expansionary monetary policy in order to gain more latitude for interest rate policy and, if needed, for new quantitative easing. In any case, the best the ECB can do in the case of major adverse shocks or a renewed crisis is to deliver on its mandate, that is, maintain price stability. While this is beneficial, beyond this contribution the ECB has neither the tools nor the responsibility to ensure a high level of economic resilience and economic prosperity. Governments that act carelessly and irresponsibly should hope that the ECB can do their job in this respect.

Structural reforms in almost all euro area member states have been insufficient in light of the major challenges faced.

So the question of whether the ECB is prepared for another global crisis seems to distract from the key problem, namely whether euro area member states have done enough, both in terms of national economic policies and in terms of strengthening the eurozone framework, to ensure a high degree of economic resiliency as well as strong potential growth.

And here I have some doubts. In my view, structural reforms in recent years—as regards product, labor, and financial market regulations, and institutional quality—in almost all euro area member states have been insufficient in light of the major challenges faced.

For example, the euro area has experienced positive growth since 2013, but in many countries government debt as percent of GDP remains higher than before the crisis, and has continued to grow. This has been a lost opportunity to build fiscal buffers. Similarly, one of the key drivers of the euro area crisis, namely the sovereign-bank nexus, seems not yet to have been decisively addressed. We are now ten years past the start of the global financial crisis, and some European banks still seem far away from reaching the final so-called MREL (minimum requirement for own funds and eligible liabilities) requirements of bail-in-able instruments or having largely worked out their non-performing loans. Why have banking regulators and bank owners not yet achieved high overall buffers (including MREL) and moderate sovereign exposures in all euro area banks?

The good economic situation of recent years—the time bought by expansionary policies—has mostly not been used by member countries to speed up structural reforms that enhance economic resiliency and conditions for productivity growth. To the contrary, apart from France, structural reform implementation is stalling and in several cases measures or plans have been announced that even undo or roll back past reforms.

To conclude, I am convinced that the ECB will be able to act forcefully in case of a new crisis. However, I cannot see that governments in member countries have come close, individually and collectively, to having done enough to make their economies and financial sectors and thereby also the euro area sufficiently prepared for major adverse developments. In other words, the euro area still seems fragile. As monetary policy cannot remove rigidities, nor ensure real convergence, high long-term productivity, and income growth, this is a major concern not only regarding a potential new crisis.

III. Is the ECB Prepared? The Answer Is No!

HEINER FLASSBECK
Director, Flassbeck-Economics, and former Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

Is the European Central Bank prepared in the event of another global financial crisis? The answer is clearly and simply: no! Is the ECB responsible for the state of affairs in Europe? The answer again is no. Sometimes the famous TINA principle applies—there is no alternative. The ECB was not able to act in the same way as the U.S. Federal Reserve and to normalize its use of extraordinary instruments. And the reason for that is obvious: There was—compared to the United States—virtually no recovery in Europe since the end of the global financial crisis.

The ECB can be blamed for acting too late and not aggressively enough when the crisis broke out in 2008. But ever since ECB President Mario Draghi's promise in 2012 to do "whatever it takes," the stance of monetary policy in Europe has been adequate. Clearly, the eurozone is still vulnerable today, but responsibility for this has to be put on the shoulders of the euro area finance ministers, not on those of the ECB. The dramatic failure of the Eurogroup of finance ministers to tackle the recession is at the bottom of the trouble. The purely ideological approach to fiscal policy ("restrict whatever it takes") and the misled attempt to restore in all countries "competitiveness" at the expense of domestic demand has brought about an enduring weakness of domestic demand and with it an enduring problem of non-performing loans and vulnerable banks in countries such as Italy, where the recession spanned more than six years.

The eurozone is still vulnerable, but responsibility for this has to be put on the shoulders of the euro area finance ministers, not on those of the ECB.

Today, after a recovery of one and a half years, new signs of a weakening of the European economy are turning up. With the strengthening of the euro, the stimulus that brought about the turnaround in 2016 is fading. Fiscal policy has not stepped in, again led by the misguided attempt to finally fulfill the Maastricht criteria. The political leadership in Europe is unable to understand that in times of high net savings of the company sector and private households in almost all economies, the government can only reduce its lending if a mercantilist (a German) "solution" with high current account surpluses is possible. But the German approach is impossible for Europe as a whole, because either its currency will appreciate sharply, or U.S. President Trump will stop the European beggar-thy-neighbor approach by other and much more brutal means.

Thus, there is no way for the ECB to normalize its balance sheet or its interest rate policy. Being unprepared compared to other central banks for a new global crisis plus recession is the price the ECB has to pay for the glaring ignorance of European fiscal policy under its German hegemon. However, the price is not too high to prevent new and energetic action. Even at this stage of the cycle, the ECB is totally able to do whatever it takes to stabilize the system and do its job as lender of last resort. The balance sheet is elevated, but the traditional interpretation of central banks' balance sheets is ambiguous. Look at Japan or Switzerland, where the balance sheets of the central banks are close to the annual GDP or even beyond. Are there signs of vulnerability in these countries?