Uncomfortable Exits: A Tale of Two Lenders of Last Resort

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Introduction

In 2008, governments and central banks faced an unprecedented crisis. In response, they reacted swiftly and adopted policy measures that were until then considered heresy. Huge budget deficits and quasi-unlimited liquidity provision became widely considered as necessary by policymakers. And these were the right decisions that prevented the Great Recession from turning into another Great Depression. However, the recovery has remained weak in the U.S., and the eurozone has and continues to face a severe sovereign debt crisis. This has prompted policymakers on both sides of the Atlantic to pursue even more unconventional policies.

Policymakers and experts debated the effectiveness of these policies and many expressed concerns about the unwinding process. Most considered that such "unconventional measures" could not last forever and yet here we are. Fed Chairman Bernanke suggested in May, and confirmed in June, that the Fed would be "tapering" its massive program of GSE and bond purchases with a view to end it in the summer of 2014. Although a sort of toning down came from the Fed in July 2013, policymakers, experts and investors know that an "exit" strategy will have to be designed. The initial announcement, even cautiously wrapped within many conditions, made markets uncomfortable. Capital flows to emerging markets abruptly started to reverse and many today foresee that we are entering a completely new phase of the financial crisis. The goal of this article is to discuss the different challenges facing the Fed and the European Central Bank (ECB) when "exiting" their previous policies.

Central Banks with a Mission

We start with the dramatic increase in the size of central banks balance sheets, a distinctive feature of the present global economic outlook. Due to different policies in the past, total accumulated assets (measured as a proportion of GDP) in 2007 was much lower for the Fed or the Bank of England (BoE) (5 percent) than for the ECB (15 percent) or the BoJ (20 percent or so). The Bank of Japan had already been involved in aggressive monetary expansion for more than a decade as it worked to extract the Japanese economy from its deflationary trap; the ECB traditionally holds large amounts of gold and currency reserves. In 2008, following the collapse of Lehman Brothers, the Fed, the BoE, and the ECB simultaneously adopted extraordinary measures to flush the financial system with cash. This was a time of decisive actions that stopped a crisis that was threatening the global financial system. Jean-Claude Trichet summarized this experience by saying, "We have witnessed the abyss and we (*the central bankers*) will not allow it to happen again." But the return of the balance sheets to more normal levels would not happen soon. Further actions to increase the monetary base proved necessary for the years ahead in order to fight the weakness of the recovery in the U.S. and the sovereign debt crisis in Europe. The Fed and the BoE expanded their respective monetary bases by purchasing bonds while the ECB and the BoJ—reflecting the bank-centric structure of their respective financial systems—focused their programs on direct lending to banks. Despite the different contexts, these "unconventional measures" have strikingly similar consequences on balance sheets; the typical balance sheet of a western central bank in 2013 amounts to somewhere between 20 or 25 percent of the GDP, 35 percent for the BoJ. This is why these policies have been frequently labeled with the same expression, "quantitative easing". But this common expression is misleading because the Fed and the ECB fundamentally have different missions: fueling the recovery on the one side and contributing to the rescue of the European monetary union on the other.

In the U.S., after the initial massive stimulus, the implementation of which coincided with the beginning of the Obama administration in 2009, Congress neither wanted to add new expansionary fiscal measures nor start reducing the deficit. Marching from debt ceiling stalemate to fiscal cliff paralysis, fiscal policy proved more or less neutral until 2012. On the monetary side, the Fed has a "dual mandate", which means trying to keep the economy at full capacity as well as trying to ensure price stability. In light of the low inflation expectations, the main concern until the summer 2012 remained the weakness of the labor market. Conventional monetary policy had reached its limits with short-term interest rates practically reduced to the zero bound as early as in December 2008. As perfectly expressed by Chairman Bernanke, inflating the balance sheet through large-scale asset purchases (LSAPs) and targeting the whole yield curve appeared to be the best available decision to help a failing recovery. After all, lowering interest rates of longer-term securities could be described as "monetary policy by another name".

The eurozone story is very different. After the initial answer to Lehman's failure, the dominant goal of economic policies in the eurozone quickly became the design of the rescue operations following the Greek debacle. The disaster was a surprise for policymakers as well as for markets. But, after its acknowledgment, action should have followed the design of traditional IMF-style principles. Applied to a country that represents a small proportion (2 percent) of the eurozone's GDP, the Greek crisis normally would not have turned into major systemic risk. But there were two big differences between the eurozone and previous experiences in Latin America, Asia and elsewhere as emphasized in the ex-post IMF assessment of the crisis. First, the risks of contagion between Greece and the others were threatening; and the others were OECD countries that nobody, in particular the U.S. Treasury, was willing to see default. Second, the monetary union had been built as a currency "without a state" and based on a "no bail-out" principle; the definition of "IMF-style" principles of intervention adapted to the case proved a difficult political exercise, particularly in Germany. Absent a eurozone Treasury, the eurozone institutions that would have been needed to organize a rescue were nonexistent and had to be created at the same moment that they had to be fully operational. Once the doctrine had been adopted and the institutions created, IMF-style programs were implemented by the Troïka (the European Commission, the ECB and the IMF) but this chaotic process extended the crisis to major European countries, specifically Spain and Italy. As a result, the risk of a eurozone breakup was seriously considered by market participants in the fall of 2012. Obliged by its single mandate, acting under the suspicion of its German members (think of Axel Weber and Jürgen Stark's resignations), the ECB constantly and successfully acted within the limits of its mandate. It maintained a cautious monetary policy; and despite loud calls from the markets and from the financial press, the ECB did not use a "big bazooka" to cure tensions on Southern European countries' financing conditions before credible governments' commitments had been made. The ECB certainly did not duplicate what the Fed did, a decision that would have ignited a major political crisis between eurozone governments; but far from being shy, the ECB, the only federal institution in the eurozone, always undertook decisive action when needed. As regularly stated by ECB officials, the constant goal has been to ensure depth and liquidity in dysfunctional securities markets and, in so doing, to restore a proper functioning of the monetary policy transmission mechanism.

Different policies have different results. One way to look at them is to compare the respective evolutions of the monetary base and the money stock (M2). In times of crisis, "unconventional measures" increase liquidity, causing the relationship between the monetary base and the money stock to be much looser than in conventional times. The traditional linkage between the monetary base and M2 continued until the fall of 2009, but the subsequent deviation in the evolution of the indexes calls for two observations. First, there was no explosion of M2. The monetary base, however, increased in much greater proportion in the U.S. and, until now, in successive permanent steps; in the summer of 2011, for example, the U.S. monetary base had grown 2.5 times faster than M2, taking Q1-2007 as starting point. In contrast, the reversal of exceptional ECB financing reduced the monetary base index in the eurozone almost to that of the M2 index. As Mario Draghi rightly emphasized, it was simply not right to say that the ECB's balance sheet had grown in extraordinary proportions as compared with the Fed's; at that date, the ECB's policy was close to being back to "normal". But the eurozone in the summer of 2011 took a turn for the worse with the sovereign debt crisis that spread from Greece to all southern countries and set up a vicious circle between banks and sovereigns. The acute phase of the debt crisis warranted additional measures from the ECB and these measures explain the sudden and extraordinary expansion of the monetary base after the summer 2011.

Unconventional Monetary Policies

Extraordinary policies should by definition remain extraordinary. What both central banks did in the aftermath of the Lehman's failure when quickly and massively inflating their balance sheets was extraordinary. It was a perfect example of the "lender of last resort", providing liquidity to a banking system threatened by the freeze of the inter-bank market. Once confidence is restored, banks start to lend each other and extra-funding is reimbursed to the central bank. This can be risky for the central bank, which can suffer losses (Chairman Bernanke proudly notes that the lender of last resort program has been reversed without any cost to the taxpayer); if too lengthily implemented, this can also affect the credibility of the central bank. But it is well recognized that this is what the central banks are made for in extraordinary times like the one we went through. Interventions in the bond and credit markets are of a very different nature.

Chairman Bernanke suggested that buying securities through the large-scale asset program that amounted to $2 trillion had nothing to do with "printing money"; that is confirmed by the modest expansion of M2. But if the monetary base is not "printed money", neither is it a "resource" that the institution has received and can use to buy securities on the market as if it were a portfolio choice; it is money creation by the central bank as well. A major tool of monetary policy being the short-term interest rate, it has also been argued that targeting longer-term interest rates follows the same logic. However, this is highly debatable. First, conventional monetary policy relies on the expansion or contraction of the balance sheet in a way that respects asset-liability maturities. Second, the conventional role of a lender of last resort is to refinance banks, not to help finance the Treasury or other governmental agencies at lower rates. Are interventions on the bond and credit markets respecting these principles? Yes, but under a strict—and rather implausible—condition that the assets purchased by the central bank are only temporarily parked on its balance sheet and will be sold to the market in due time. This looks like the Bagehot principle—lending to the banks with the expectation that these loans will be shortly reimbursed—but the risks involved are very different. Action made to directly finance the Treasury or the government-sponsored enterprises is not an answer to a temporary liquidity shortage; it is explicitly devoted toward reducing their rates. "Quantitative easing" in that sense has a long track record; it is conventionally called "monetary financing of the Treasury".

Contrary to the Fed's policy, the ECB never announced a target for sovereign debt purchases under the securities market program and the total amount remained limited to €300 billion at their peak. In fact, most of these have been sterilized, thus reversing the impact on the monetary base. The bulk of these purchases were made during two episodes of particular tensions in the eurozone negotiations: first in the summer of 2010 (with a focus on Greek, Irish, and Portuguese debt) and second in the fall of 2011 (with a focus on Italian, Spanish, Portuguese, and Irish debt). The expansion of the ECB's balance sheet mostly reflects the impact of the main refinancing operations (MRO) and the long-term refinancing operations (LTRO) programs. Why did the banking sector need such a massive refinancing?

The ECB as a Substitute to a Failing Interbank Market

One of the most fascinating features of the monetary movements in the eurozone in recent years is linked to the so-called TARGET2 imbalances. Hans-Werner Sinn and his colleagues have attracted attention toward the massively diverging positions of the Bundesbank and Southern European economies' accounts in the ECB's books. At the end of 2012, the Bundesbank was in effect on the hook vis-à-vis the euro system for more than €700 billion. There is a very inconvenient reality beyond these figures: would the monetary union collapse, these claims would become unrecoverable and that would raise immense risks for Germany. This is possibly one of the most discernible reasons explaining why, despite its reluctance toward what it sees as the many ill-doings of its partners, Germany has never been tempted to go it alone. Pushing the argument ahead, these authors subsequently produced a much more controversial analysis, claiming that the Bundesbank was "financing deficit countries" through these TARGET2 accounts. The essence of their argument is summarized in the comparison between the evolutions of diverging current accounts and TARGET2 accounts for Germany and Southern European countries. The debate remained confused for months but, in the end, it clearly concluded that the TARGET2 accounts had little to do with "financing" current account deficits. Here is the simplest form of the argument. The only way for Greek customers and companies to pay for German goods is to use resources that have been previously properly financed. How? Either by current incomes (exports, transfers…) or by capital inflows. A deficit of the current account in Greece can only be financed by capital inflows; this is precisely the result of decisions made by the "Troïka" to rescue the Greek government and, good or bad, these are financial not monetary decisions. Where then do TARGET2 imbalances mostly come from?

Within a monetary union, the concept of balance of payments is properly qualified as irrelevant.[1] If we take the U.S. Federal Reserve system as an example, there could naturally be districts with "trade or current account deficits". This can happen for a variety of reasons but always because they receive funds from other districts; pensioners transfer their resources from Wisconsin to Florida during the winter, investment decisions to relocate the car industry fuel capital inflows into Alabama, or the federal government spends in red deficit states money collected in blue surplus states. In terms of "balance of payments", the resulting current and capital flows are necessarily balanced and the equivalent of the TARGET2 accounts only reflects the erratic result of day-to-day interbank operations[2].

It is striking to observe that things were working exactly along these lines in the eurozone until 2008: between 2000 and 2007, German exporters accumulated hundreds of billions of trade surplus vis-à-vis the Southern European countries without any significant movement in the TARGET2 accounts that remained close to zero. The difference thereafter is the result of precautionary behaviors that moved financial assets from southern-based banks to German ones. Cecchetti et al (2012) from the BIS described this as largely due to "hedging against the redenomination risk". This can be the case because southern agents became afraid of the "vicious circle between banks and sovereigns" or because banks simply flew for security toward a safe haven. The BIS has shown that British banks in particular have had in that way a much bigger impact than usually suspected. The BIS goes on to say "TARGET2 balances reflected something more akin to a currency attack than current account financing or credit reversal". At that time, the German banks did not lend anymore the excess resources flowing into their accounts to Greek or other southern banks. Since trust was severely damaged, the North-South compartment of the interbank market froze. Funds held in German banks were parked into the ECB through the Bundesbank and the central bank balance sheet had to substitute for the failing interbank market.

Exiting Unconventional Policies

Where are we now after these extraordinary measures? There are two alternative narratives. Five years after the start of the global financial crisis, the U.S. and the EU are still suffering from high output gaps. Growth and unemployment figures nonetheless suggest a better economic performance between 2010 and 2013 in the U.S., which is enjoying a fragile recovery, than in the eurozone, which is in stagnation and close to recession in 2013. This comparison is a frequent reason to commend the boldness of the Fed and it is only one of the many criticisms addressed to the ECB for not having followed this American example, for having been obsessed with inflation, for having been reluctant to use a "big bazooka" and much more.

But how much did the quantitative easing help the recovery in the U.S.? The short answer is: somewhat, but not much. The yield curve has surely been pushed down; thirty-year mortgage rates have been reduced below 4 percent, which at historically low levels. But four years after the bottom of the cycle, real GDP remains significantly below what it should be according to the average historical recovery profile. However, demand has remained sluggish. Improved credit conditions have helped support the housing market but numerous structural factors still prevent a robust recovery in the housing market. The business sector is still suffering from excess capacity, which has discouraged investment and made cash hoarding attractive. Limited job creation, modest increases in income and efforts by households to deleverage continuously have weighed on consumption growth. The best news has undoubtedly come from the financial markets; in contrast with real economic indicators, the stock market topped its previous peak in the early months of 2013; was it another episode of irrational exuberance? Optimists see that as a promise of a progressively reinforcing recovery in 2013 and 2014, and this is the basis on which the Fed is (cautiously) preparing the "tapering" of the LSAP. Prudent observers emphasize the weakness of the recovery, as exemplified by the IMF, which has recently reduced its growth forecast. Regarding the exit strategy, the important point is that the assets purchased by the Fed should have launched a robust recovery so that they could "at some point be sold back to the market". If the recovery turns out solid enough, stocks and credit markets will be able to absorb a progressive return to a more conventional monetary policy and the Fed would have restored the conditions for growth at no cost. If the markets mirror the fear that characterized the 1994 and 2004 policy reversals, 2014 could see another rocky adjustment. As market reactions illustrated after the "tapering" announcement, this is the biggest question mark the Fed is now facing.

The eurozone in 2013 has entered calmer times. Since the spring 2012, its balance sheet has been shrinking and is now 15 percent below where it was one year ago. In fact, banks are starting to repay the three-year loan they took in the winter 2011-12. This success is frequently attributed to Mario Draghi's July 2012 statement that the ECB would do "whatever it takes to preserve the euro". Although this was a major turning point, this bold declaration should not be considered in isolation. There is a constant dialectic relationship between the posture and actions of the ECB on one side, and the vision and decisions of governments on the other. In a testimony before the German constitutional court on the OMT program, it has been argued "it was not in the power of the ECB to decide to rescue the monetary union"; true enough. But the commitment by Draghi was precisely made possible only because the European Council had confirmed in its June 2012 decision its willingness to do whatever was needed to build a more resilient monetary union and to push integration further through the "four unions". The ultimate responsibility to confirm the "irreversibility" of the euro was in the hands of the governments and the subsequent duty of the ECB was to preserve the integrity of the monetary union and give time to adopt the necessary reforms. If governments adequately deliver, trust will be restored and the ECB will have saved the euro at no cost, but the major existing challenge facing the ECB is if markets conclude that policy actions do not follow; the major risk now facing the eurozone is a political one, complacency.

Conclusion

I have emphasized the important differences in the way the Fed and the ECB have implemented "unconventional policies". Far from introducing a new concept in monetary theory, the expression "quantitative easing" rather obscures the very fact that the policies of the Fed and the ECB are fundamentally different in their motivations as well as in their implementation. We have identified three major differences between the Fed and the ECB policies: the economic and political contexts, the logic and operational design of balance sheet expansions, and the results in terms of monetary and financial conditions. The Fed has designed a substitute for conventional easing once the policy rate reached the zero lower bound while the ECB has preserved a proper transmission mechanism of monetary policy in a particularly troubled context. The former has taken on its books a vast amount of sovereign assets with a view to reduce longer-term interest rates and fuel the recovery; the latter has mostly offered generous loans to banks in order to substitute a failing interbank market with a view to give time to the necessary policy decisions to build a better monetary union. They both have successfully managed the challenges following the first and the second phases of this crisis, the initial reaction to the Lehman's failure and then a weak recovery or a dysfunctional monetary union. This is ample proof that central banks have new and immense responsibilities in the wake of the crisis. But they still have to find the proper exit strategies.

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Endnotes

[1] This statement is different from any judgment regarding "competitiveness" which was one of the unsustainable weaknesses of the southern economies in the decade before the crisis; this is not the place to elaborate that argument.

[2] The accounting summary of these operations is reported within the « *Inter-District Settlement Account* » whose operations are defined as follows: "At the close of business each day, each Reserve Bank aggregates the payments due to or from other Reserve Banks. These payments result from transactions between the Reserve Banks and transactions that involve depository institution accounts held by other Reserve Banks, such as Fedwire funds and securities transfers and check and ACH transactions. The cumulative net amount due to or from the other Reserve Banks is reflected in the "Inter-district settlement account" in the Statements of Condition." Source: Kansas City Federal Reserve Bank's statement of conditions.