Macroeconomic Regulation: Optimizing a Currency Area

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Colloquium in Honor of Lucas D. Papademos

Based on “Report: Monitoring the ECB”
with C. Goodhart, P-O. Gourinchas and R. Repullo
Two Challenges

1. Financial Stability
   - Build up of risk during bubble phase
   - Materializes in crisis
Two Challenges

1. Financial Stability
   - Build up of risk during bubble phase
   - Materializes in crisis

2. Price Stability Dispersion

![Graph showing price stability dispersion over time for various countries including Greece, Spain, Ireland, Portugal, Italy, Euro area, France, and Germany.](image)
Overview

1. Redefine second pillar = financial stability pillar
   - Lean against credit bubbles
   - Redefine monetary and credit aggregates

2. Make currency area optimal
   - More than one instrument -- regional
Current Rationale of Second Pillar

- Monetary analysis
  - Focus on money aggregates/supply
  - Long-run/medium term view
    - Note: strictly speaking introduces a second objective
      - Short-term (Pillar 1)
      - Medium/long-term (Pillar 2)
  - Cross checking

- Quantity theory of money
  \[ M_t V_t = P_t X_t \]

- Prediction (after high money growth):
  - High inflation in the very long run

How to weigh them?
New Rationale for Second Pillar

- **Financial stability**
  - Lean against (credit) bubbles
    - High credit growth (partially reflected in M3)

- **Prediction** (after high credit growth):
  - Financial crisis impairs monetary transmission mechanism
  - Crisis binds hands
    - one is driven by events and hence not in control

  **High de-/inflation volatility**
  - Deflationary pressure
  - Inflation due to monetization after bailouts

*Note difference to Quantity theory!*
Arguments for “Benign Neglect Policy”

1. Difficult to identify bubble
   - Any policy is a decision under uncertainty
   - Risk management approach
2. Lean versus clean
   - Symmetric treatment
   - Asset bubble vs. credit bubble
3. Interest rate is not most effective tool to prick bubbles
   - Effective when combined with “open mouth policy”
     - in early phase +
     - when term spreads are thin and bubble driven by yield curve carry trade
4. Too crude – not surgical
   - Bubbles affect large part of economy
   - Use in conjunction with other instruments
5. Pricking bubble led to disastrous outcomes
   (US 1928, Japan 1989)
Financial versus Monetary Stability

- **When is there a trade-off?**
  - Times of “great moderation”:
    - Inflation is (seems to be) contained
    - Credit and asset price expansion – “credit bubble”
    - *Build-up of risk*, which will only materialize later
    - After burst,
      - deflationary pressure
      - monetary transmission mechanism can be impaired
      - bailouts + government deficits (potentially leading to long-run inflation?)
  - Should interest rate be increased
    - Price stability (inflation targeting)  No
    - Financial stability  Yes

- New rationale  modified monetary aggregates
Quantitative Aggregates

- Credit aggregates
  - Credit (growth) aggregates
  - Credit lines
    - Excessive draws on credit lines are signs of upcoming troubles
    - Newly extended credit lines
  - Shortening of maturity structure
  - Repo growth
  
  + asset bubbles + “bubble anecdotes”
  
  - Features
    - Maturity structure
    - Counterparties (levered banks vs. households)

- Money aggregates (related)
  - Portfolio shifts to shorter maturity, safer assets

Soundness of balance sheets
1. Financial Stability
   - Build up of risk during bubble phase
   - Materializes in crisis

2. Price Stability Dispersion

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Optimal Currency Area - reconsidered

- Currency union
  - Loss of instrument: same interest rate in whole area
    (+ “loss of a valve”, since exchange rate is fixed)

- Traditional view: optimal currency area if
  - No large asymmetry in shocks
  - Fiscal integration
  - Labor mobility

- Hence, Euro area is not an optimal currency area
- How can the ECB make it an optimal currency area?
  (transfer union is politically not feasible)
The Insight

- Same short-term interest rate
  ... but what counts for economy is ‘risky long-term rate’

- Affected by haircut policy + macroprudential regulation
The Idea

- Use regional ...
  - Collateral policy (haircuts)
    - E.g. haircuts for mortgages in country X (with housing boom) are higher
  - Haircut/margin regulation (analog to US-Regulation T)
  - (Purchase regional assets)
  - Macroprudential regulation (through ESRB)

as an active policy instrument
- Too lean against regional bubbles/imbalances

Justifies larger currency area, but needs clear governance structure
- Details to be worked out in Brunnermeier-Gourinchas (2010) “Monetary Policy is a Non-Optimal Currency Area”
How Can ECB-ESRC Affect Macroprudential Regulation?

- Adjust Maastricht criteria
  - Ireland satisfied the Maastricht criteria, but ...
  - private debt is subject to “bailout risk” for government
- Define ‘expected’ public debt
  - Public debt + \( \text{Prob}(\text{bailout}) \times \text{bank debt} \)
  - \( \text{Prob}(\text{bailout}) = f(\text{quality of bank regulation}) \)
- Advantage: ESRB gets some teeth control, how member states conduct bank regulation
Conclusion

1. Financial Stability = second pillar
   ▫ Modify monetary/credit aggregates
2. Optimize currency area
   ▫ Using haircuts/macroprudential regulation as active policy instruments (to distort)