Collegio Carlo Alberto

UNIVERSITÀ DEGLI STUDI DI TORINO

# 12th Onorato Castellino Lecture

## "The European Central Bank and the Crisis"

## Lucrezia Reichlin

November 23, 2020

An account of the event by *Gregory Viscusi*

The European Central Bank was born in era when the prevailing consensus was that central banks should have limited mandates and complete independence.

That script was ripped up as the Central Bank developed ever expanding tools to confront a series of emergencies starting with the 2008 financial meltdown and continuing with the euro crisis and now the Covid pandemic.

Will the ECB ever return to its original conception ?
Almost certainly not, according to Lucrezia Reichlin, economics professor at the London Business School. ``Going back to the old ways will be impossible,'' she said on Nov. 23 as she delivered the ``Onorato Castellino'' lecture for the Collegio Carlo Alberto.

The Collegio Carlo Alberto, a Turin-based teaching and research institution, is a joint initiative of the University of Turin and the Compagnia di San Paolo, the foundation that controls Italy's largest bank.

From the ECB's creation until Lehman Brothers' 2008 bankruptcy, its role was to target inflation by setting interest rates and to provide liquidity for banks.
But when banks stopped lending to each other after Lehman's collapse, the ECB found itself stepping in to replace the interbank market. And in 2010, when interest rate spreads between nations using the euro went haywire, the ECB stepped in again to buy government debt and support bank recapitalizations because the euro zone lacked joint mechanisms to deal with troubled financial institutions. Those interventions raised the issue of whether the ECB was a lender of last resort for banks, or for countries as well.

The expanded role for the ECB isn't unique, Reichlin said. The Federal Reserve, Bank of England, and Bank of Japan have all seen their balance sheets soar since Lehman's collapse. Their combined assets are now equal to about 50% of GDP after being below 20% for most of the post-war period. The ECB can't go back to its pre-2006 status because all the premises that underpinned its original role have been undermined, she said.

Walter Bagehot's 19$^{th}$ century rule that during a liquidity crisis the central bank should provide unlimited lending to good banks against solid collateral no longer applies, she said. That's because it's no longer immediately clear if a bank is facing liquidity or solvency issues.

The idea that central banks derive their credibility from achieving price stability was disproven during the euro crisis. The ECB spent 200 billion euros on the Security Market Program in 2010 to prevent the euro crisis spreading beyond Greece. It failed because there was no political unity behind it. When Mario Monti presented Outright Monetary Transactions in 2012 it had an immediate impact, even though not a cent was spent. What mattered was that in the meantime a political consensus had developed, Reichlin said.

And while the ECB has played an essential role in stabilizing economies since 2008, its ability to hit its own inflation targets has been disappointing, she said. With interest rates hovering around zero, the ECB has little traditional ammunition left. And Reichlin warned against expectations that interest rates will rise, given demographic changes and high precautionary savings.

As a result, quantitative easing will remain an established part of the ECB's response to stressed markets. Relying on QE brings its own hazards, but there's little alternative, Reichlin said. ``There is no return, instead we have to learn how to manage these risks,'' she said.

***Gregory Viscusi*** *is a freelance writer and television commentator who has reported on European politics and economics for three decades for leading U.S. media such as Bloomberg News, Dow Jones, and France24.*