

# International Economic Overview

Year 27 / No. 10 / July 2014

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Closing date: July 18, 2014

The measures announced by Mario Draghi, the president of the BCE, in the first week of June are not so different from the monetary policy that was studied and taught years ago.

## A "New" Monetary Policy

On occasion I look back with a certain fondness at the bygone years when citizens knew little about the economy, newspapers featured scant economics data or information and, as my colleague Prof. Juan José Toribio put it, "well-mannered people did not talk about exchange rates" (except, of course, when the government of the day swore that it would never devalue the currency, which effectively meant that devaluation was just around the corner).

Those were indeed happy years, when economists were listened to and at times even respected. Granted, we got things wrong just as much or perhaps even more than we do now, but most citizens didn't realize, because we could hide our ignorance behind economic jargon. Those times have now gone and they will not be coming back any time soon.

I say this because a few weeks ago I had the opportunity to test myself on what I thought I knew about monetary policy, and what I believe I know now. The reason behind this thought experiment was the spate of measures announced by ECB President Mario Draghi in the first week of June. At first I thought they bore little resemblance to the monetary policy that I had studied and taught for so many years. However, after a brief moment of crisis, I came to realize that deep down they were perhaps not so different after all. Let me explain why.

### Traditional Monetary Policy

Put simply, monetary policy is the management of the quantity of money and credit in an economy by its central bank, through the control of short-term interest rates. Let

me repeat: "*Money and credit*". When I was (much) younger, all the talk was about controlling the quantity of money; later the emphasis was shifted to interest rates; now, the ECB all of a sudden is concerned about "credit". These changes in words reflect important changes in theoretical perspectives.

How did monetary policy function, say, in the 1990s? Well, families and companies all needed credit to pay for their houses or their investment plans, so they would go to the bank. The banks in turn had a keen interest in extending credit, since it was one of their main sources of profit – assuming, that is, that the underlying risk was kept under control. The banks were willing to increase their volume of credit, but to do that they needed liquidity – that is, the reserves (deposits) that the banks hold at the central bank.

These reserves were required for two main reasons: first, because the central bank mandates it (although the mandate does not exist in all countries, and in some countries it amounts to very little); and second, through these reserves banks can settle their receipts and payments and, most important of all, lend to or borrow from other banks.

**Traditional monetary policy fell apart for four reasons: a lack of solvent credit demand; the severing of banks' normal finance flows; uncertainty among many banking entities; and a dramatic cut back on lending.**

**The ECB is trying to encourage banks not to apply overly strict conditions to their household and business lending, by offering them abundant liquidity – albeit on the condition that they make it available to the private sector.**

**The central bank is also trying to ensure that interest rates remain low for the foreseeable future.**

That way, the central bank had an instrument to control bank lending, which had a huge impact on a host of economic variables, including the rate of consumption and investment; GDP growth; the control of inflation; the value of the currency, as well as the financial health of the banks themselves. In some cases the financial health was jeopardized by a bank's excessive zeal for lending, leading to accumulation of too much debt, which in turn often results in a financial crisis.

### **Sound Familiar?**

The main instrument available to the central bank for controlling bank lending was through the expansion or contraction of credit to the banks, in order to increase or decrease their liquidity and, by extension, their ability to lend out to the private sector. In effect, it was the same policy that my father used on me when I was a teenager: every weekend he would give me a *duro* (five pesetas, then a princely fortune) for pocket money. In this way he kept my spending in check, just as the central bank does – or at least used to do – with the banks.

### **The End of Traditional Monetary Policy**

The system worked fairly smoothly for a number of decades, but then fell apart in the early stages of the recent financial crisis – for four main reasons. First, there was not enough “solvent credit demand” from the private sector. As I've already explained, the process began with families and companies requesting loans from the banks. However, during a recession, with the resulting over-indebtedness, wealth destruction, unemployment and economic uncertainty, banks were loath to assume the risks of lending to most potential debtors. As a result, they tightened their conditions or, at least, that's what their clients felt was happening.

Second, the banks' normal finance flows were severed. Until then their primary source of finance was loans from other financial entities. But all of a sudden those loans came to a standstill – at first because creditors did not know the real situation of the banks' financial health, and then later because they did!

That was also the third cause of the breakdown of the ordinary mechanism of monetary policy: the outlook of many banks was terribly uncertain. They had made too many loans, their clients could not pay them back on a regular enough basis and the value of their assets had

plummeted. In other words, many entities were either bankrupt or on the brink of bankruptcy.

Which brings us to the fourth factor: given that it was so risky to lend out money and that banks' external sources of financing had run dry and there was no guarantee that they would pick up in the future, banks had little choice but to severely cut back on their lending. Instead of lending out funds, banks used the liquidity they received from the central bank to beef up their deposits at the same central bank and/or buy up public debt, which had special treatment in financial institutions' solvency requirements. So it was that the private sector suddenly found itself starved of credit – even for relatively safe business projects. This problem was felt particularly strongly during the Great Recession.

### **The “New” Monetary Policy**

As soon as these problems began emerging, the authorities went into action. The problem, however, was that traditional monetary policy operated through the banking system, through banks' willingness to satisfy credit demand from households and businesses. However that mechanism, as I've already mentioned, had been obstructed. The “new” monetary policy came about as a result of this failure of traditional policy.

Faced with a massive reduction in solvent credit demand, the ECB is trying to encourage banks not to apply overly strict conditions to their household and business lending, by offering them abundant liquidity – albeit on the condition that they make it available to the private sector. The economic recovery will no doubt help to improve the credit markets, although it will all depend on how much faith the banks have in their own financial situation as well as their potential clients'.

If the banks do not get sufficient funding from their traditional sources, the ECB will offer them a very generous credit line (400 billion euros), both for a prolonged period (of up to four years) and at very favorable rates (the nominal interest rate is now 0.15 percent, and, in cases of emergency, 0.40 percent). The central bank is also trying to ensure that interest rates remain low for the foreseeable future. To get the banks to lend out the extra funds, rather than hoarding them, the ECB will charge them a 0.1 percent rate on all the deposits they hold at the ECB.

If all else fails, there remains one more drastic solution, which has already been applied by the U.S. Federal Reserve: namely to bypass



the banks altogether and lend directly to the markets and other entities, by buying up public or private debt and backstopping credit to companies, especially SMEs.

It's worth also mentioning at this juncture the crucial role of macro-prudential policy, which should accompany or compliment monetary policy, and which seeks to prevent excessive credit growth in the expansionary phases and excessive shrinkage in the contractionary phases. This can be done through the regulation of the banks' capital demand and incentives, such as mortgage credit.

Good doctors use conventional treatments when an illness develops with normal symptoms, but resort to emergency procedures whenever necessary. The central banks have done the same: like doctors, some have been more aggressive, and others more conservative. Their results may prove to be spectacular, or just satisfactory... or perhaps even catastrophic. But at least for now, we have a little cause for optimism.

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**Antonio Argandoña**, Professor of Economics,  
IESE Business School

**Like doctors, some central banks have been more aggressive than others. Their results may prove to be spectacular, or just satisfactory, but at least we have a little cause for optimism.**

## A Fresh Look at Financial Crises

*House of Debt* (University of Chicago Press, 2014) by Atif Mian and Amir Sufi, is a significant book and deserves to be widely read. In straightforward fashion, the book presents the results of a series of academic papers. Here, I will discuss the authors' main thesis and discuss Spain as an example.

### The Mainstream View

The usual explanation of a bubble, its consequences and the appropriate policy actions to be taken are as follows: when the bubble bursts, whatever the nature of the initial shock, it causes a sudden fall in the price of some assets, which appear in the form of loans on the asset side of the banking system. Inevitably, this results in a credit crunch, which has the largest impact on investment.

Since a drop in investment triggers a subsequent recession, policy measures should aim to restore the lending capability of the banking system. This means either by providing extra liquidity – which is at most a temporary measure - or by the government relieving bank balance sheets from bad assets, through the creation of “bad banks” or by straight purchases of assets by the central bank. This has been the script followed, with varying degrees of alacrity, by the monetary authorities of the main economic actors during the current crisis.

This point of view – which Mian and Sufi call the banking view - has, of course, important elements of truth. It posits that a bubble will have no serious consequences unless it involves the financial system, that is, unless banks participate in the financing of asset purchases. This

is because dangerous bubbles are financed by credit.

It also identifies the turning point of a bubble, what Minsky called the “distress” phase. This is when banks look at their balance sheets and decide to unload on the market the asset which had been so fashionable on the way up. Moreover, it highlights the inevitability of a credit crunch, the usual result of bank de-leveraging, and indicates why the bursting of a bubble puts downward pressure on all financial assets due to investors' change of mood.

However, it does not provide a satisfactory explanation for the severity of the recessions that follow.

### The Role of Debt

It has been recognized, at least since Kindleberger's work<sup>1</sup>, that all financial crises have been preceded by an abnormally high expansion of credit.

The most recent crisis has made monetary authorities aware that they cannot remain content with watching the consumer price index, which gauges the market for goods and services. They also have to pay attention to developments in asset markets.

**What Mian and Sufi call the banking view has some elements of truth about bubbles. However, it does not provide a satisfactory explanation for the severity of the recessions that follow them.**

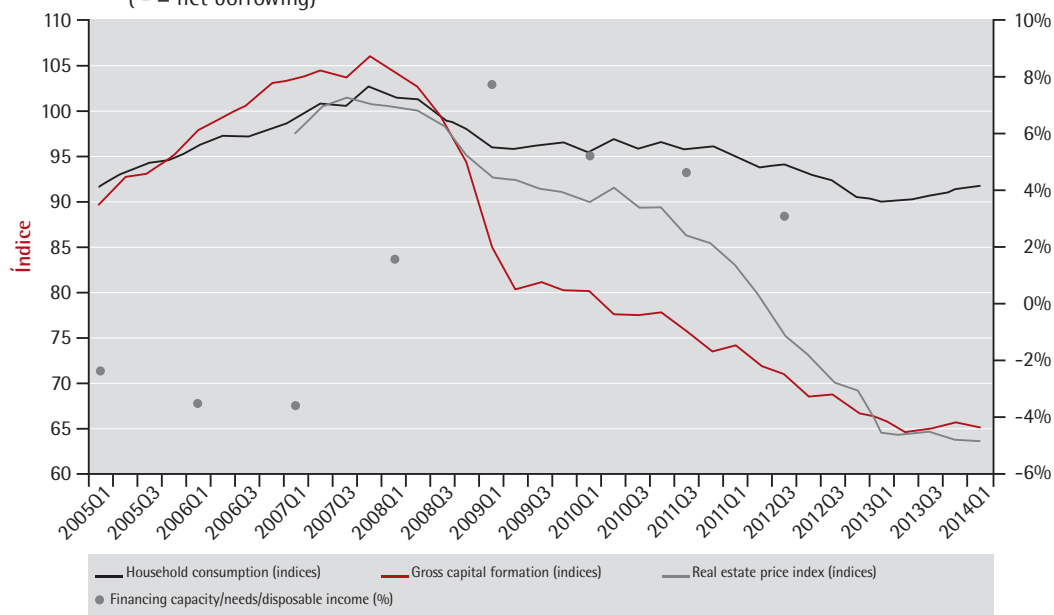
**The most recent crisis has made monetary authorities aware that they cannot remain content with watching the consumer price index, which gauges the market for goods and services.**

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<sup>1</sup> Kindleberger, C.P.: *Manias, Panics and Crashes* (1978; last edition, Basic Books, 1989).

**Figure 1. Households, Quarterly Data, 2005-2014**

Spain: Consumption, housing prices, investment, household borrowing needs, 2005-2014  
(- = net borrowing)



Source: National Institute of Statistics, Bank of Spain, 2014.

\* Gross capital formation and household consumption/disposable income = Base 2008, Real Estate Index = Base 2007

Financing capacity or needs/Disposable income based on financing capacity/needs (households) and adjusted gross disposable income (households)

With the bursting of a bubble, households experience a sudden fall in their net worth, which will be especially felt by highly indebted households.

The need to reduce debt, to deleverage, is not equally distributed among income classes. Highly indebted households tend to be low net-worth households, those who have the highest propensity to consume.

A recession results from a fall in aggregate demand. In considering what happens in the initial phases of the crisis, it is easy to be misled by the fact that the fall in investment is sharper than the fall in consumption.

Not enough attention is paid to the other side of a credit expansion, which is debt expansion. Once a bubble bursts, one aspect of the debt issue is focused on: the stock problem. And this centers on how to pay for the mountain of debt left behind by the bursting of a bubble.<sup>2</sup>

But high debt or high leverage has a *flow effect*. That is, it has an impact on aggregate demand. With the bursting of a bubble, households experience a sudden fall in their net worth, which will be especially felt by highly indebted households.

As in the current crisis, households that have purchased a house with a mortgage with a high loan-to-value ratio are likely to have their equity in the house wiped out. If, for instance, the mortgage covers 90 percent of the value of the house (LTV= 0.9), a fall in housing prices of 10 percent is enough to bring their equity to zero. A larger drop will put them into negative-equity territory (*underwater mortgages*).

This fall in net worth will reduce spending for three main reasons: first, as housing prices decline, household wealth declines, along with consumption; second, if defaults or foreclosures concentrate in specific areas, as is often the case, this has an added effect (an externality) on

housing prices in the area and hence on household wealth; third, households will feel the need to economize, and this will lead to higher savings and therefore lower consumption.

Furthermore, the need to reduce debt, to deleverage, is not equally distributed among income classes. Highly indebted households tend to be low net-worth households, those who have the highest propensity to consume. Thus, the combined effect on consumption will be higher than it would have been if deleveraging had been uniform across the whole income distribution.

A recession results from a fall in aggregate demand. In considering what happens in the initial phases of the crisis, it is easy to be misled by the fact that the fall in investment is sharper than the fall in consumption. This seems to make sense since investment is the most volatile area of the economy.

In most advanced economies, investment accounts for about one-fifth of aggregate spending, with consumption accounting for two-thirds. So the effect of a given percentage change in consumption should be about three times that of the same percentage change in investment. Thus, it seems plausible that many

<sup>2</sup> In past crises, debts – especially bank debts – are usually restructured or reprofiled; this has not happened so far in the current one. S. Gorton, G.: *Misunderstanding Financial Crises* (2012), pp. 98-99.



recessions are consumption-driven, or, at the bottom, debt-driven.

### An Illustration: Spain

Fig. 1 tells the story: the three indices plotted (left-hand scale) represent housing prices, investment and consumption levels from the start of the crises to the end of 2013. It shows that housing prices peaked in the third quarter of 2007, while investment and consumption peaked in early 2008.

The Spanish economy suffered the impact of the crisis a little later than other economies such as the US or Germany. This was because Spain was not directly affected by the crash in the subprime market.

When the crisis halted the re-financing of Spain's external debt, pressure was finally felt.<sup>3</sup> Both investment and consumption fell. The fall in investment was precipitous, from a little over 100 to 65 or 35 percent.

In contrast, consumption appears to have been more stable. In percentage terms, it spans just 12 percent from peak to bottom. In absolute terms, however, both had the same impact on aggregate demand.

Lastly, it seems that the 2009-2010 recession was largely debt-driven. Households, which had consistently increased their leverage up

until the first half of 2007, switched from borrowing the equivalent of 3.5 percent of their disposable income in the first quarter of 2007 to reducing their debt by the equivalent of 8 percent in the first quarter of 2009. This dramatic adjustment was certainly one of the main causes of the drop in consumption.

Needless to say, a graph is not proof, merely a suggestion. Hopefully, further research will be carried out.

### Policy Implications

In conclusion, two main implications may be drawn which may be useful for future crises.

The first is that household debt relief may be more important than bank debt relief in preventing a sharp recession. The second is that current debt contracts, in which the burden of adjustment falls entirely on the debtor, might one day be replaced by contracts that would apportion the risk of a fall in asset prices between debtors and creditors.

Such a change would certainly result in more expensive mortgages, but cycles might become smoother and many costly ups-and downs might be avoided.

**Alfredo Pastor.** Professor of Economics,  
IESE Business School

The Spanish economy suffered the impact of the crisis a little later than other economies because it was not directly affected by the crash in the subprime market.

Two implications may be drawn from Spain's situation: first, household debt relief may be more important than bank debt relief in preventing a sharp recession; and second, current debt contracts might one day be replaced by contracts that would apportion the risk of a fall in asset prices between debtors and creditors.

<sup>3</sup> The Spanish authorities consistently denied there was a crisis coming until the fall of 2008. This may have had an influence on expectations, especially on consumption.

## Is Competition in Banking Good for Society?

The financial crisis has induced a revision of the regulation of the banking sector. One aspect of the debate is to what extent should market mechanisms prevail in banking. This issue connects with the old question of whether competition is good or bad in banking.

Competition was thought to be damaging to financial stability from the Great Depression up to the 1970s, when the liberalization process started in the US. In this period, central banks and regulators in a range of countries tolerated collusion agreements among banks and preferred to deal with a concentrated sector characterized by soft rivalry. This changed when the idea that competition enhances efficiency (in

productive, allocative, or dynamic terms) took hold in the financial sector, and liberalization and deregulation followed. Since then, the idea that competition is also good for stability gained ground up until the financial crisis. In the period of financial repression post-World War II until the 1970s, very few crises occurred while there has been much more instability in the second period, culminating with the 2007-8 crisis. (See Figure 1)

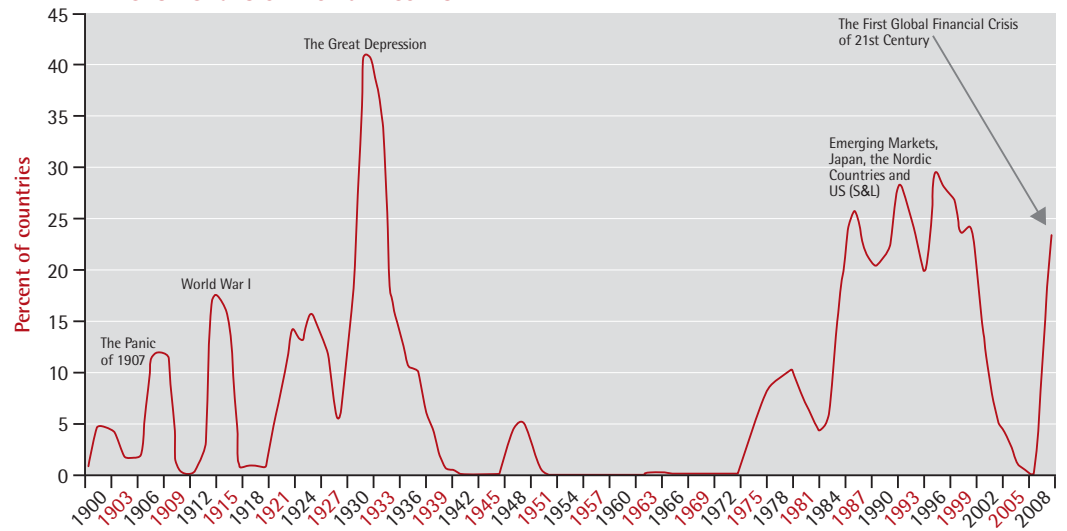
Competition was thought to be damaging to financial stability from the Great Depression up to the 1970s. This changed when the idea that competition enhances efficiency took hold.

There is a trade-off between competition and stability: greater competitive pressure may increase the fragility of banks' balance sheets and make investors more prone to panics. It may also erode the charter value of institutions.

The crises in the US S&Ls (savings-and-loan institutions) in the 1980s and in Japan and Scandinavia in the 1990s showed that financial liberalization without proper regulation induces instability, crisis and even fraud.

Pushed by information technology, banking is a sector in evolution from the traditional loan, deposit and maturity transformation intermediation operations to a services-oriented industry with a higher market-based component.

**Figure 1. Proportion of countries with banking crises: 1900–2008, weighted by their share of world income**



Source: Figure 1 in Reinhart & Rogoff (2008), "Banking Crises, An Equal Opportunity Menace", NBER WP 14587.

There is a trade-off between competition and stability. Indeed, greater competitive pressure may increase the fragility of banks' balance sheets and make investors more prone to panics. It may also erode the charter value of institutions.

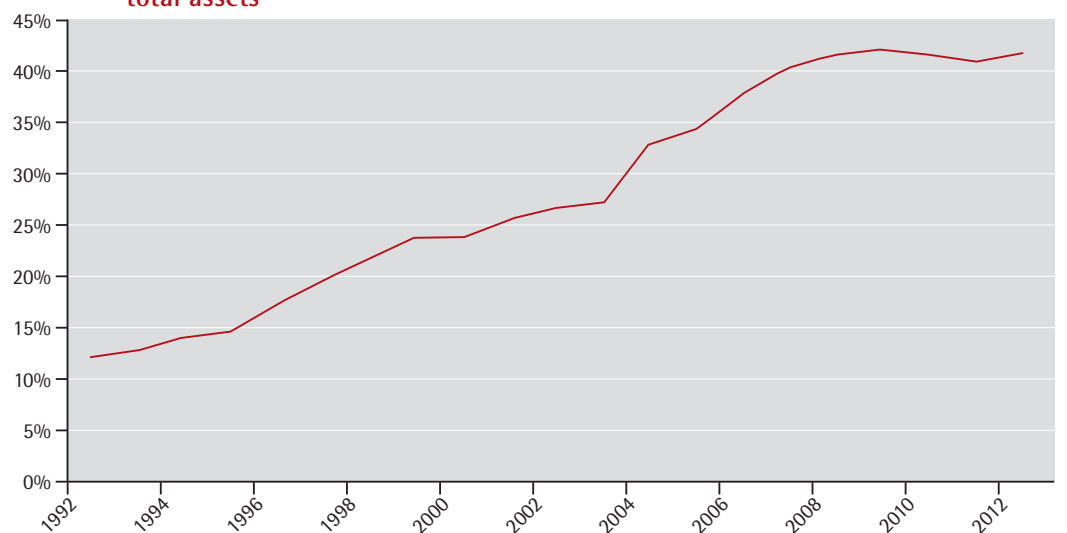
A bank within margins and limited liability does not have much to lose, and will tend to gamble – a tendency that is exacerbated by deposit insurance and too-big-too-fail policies. The result will be excessive incentives to assume risk. For banks close to failure in liberalized systems, the evidence of perverse risk-taking incentives is overwhelming. This is not unrelated to why crises began to increase in number, and severity, after financial systems in the developed world started to liberalize in

the 1970s without tightening properly regulation and supervision. The crises in the US S&Ls (savings-and-loan institutions) in the 1980s and in Japan and Scandinavia in the 1990s showed that financial liberalization without proper regulation induces instability, crisis and even fraud.

The recent crisis poses further questions about unfettered banking competition. Indeed, pushed by information technology changes, banking is a sector in evolution from the traditional loan, deposit and maturity transformation intermediation operations to a services-oriented industry with a higher market-based component.

A more extensive use of hard information in modern banking erodes traditional relationship

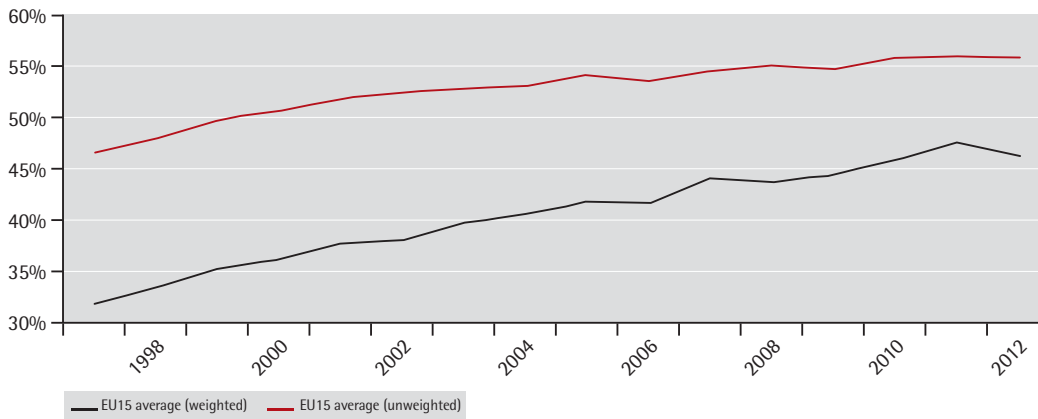
**Figure 2. US CR5 ratio. Market share of the five largest depository institutions in % of total assets**



Source: FDIC and Federal Reserve.



**Figure 3. EU-15 CR5 ratio (as a % of total assets)**



Source: ECB and EU structural financial indicators.

banking, which is based on soft information, and increases the weight of trading in the balance sheet of banks. This implies lower per unit operation profits but makes a larger scale possible. The result is an increased capacity of modern banks to take risk at the same time that more competition is allowed since a higher proportion of activities are based in the market. Furthermore, the moderating effect of concentration on risk-taking incentives through increases in charter value is more limited in banks more exposed to trading. The reason is that those institutions may have incentives to leverage their retail franchise value to increase their profits.

The crisis and the response of authorities with massive support for the sector have added further distortions to competition. For example, the state aid programs created an uneven playing field in terms of the cost of capital for entities deemed too-big-to-fail (TBTF). The forced mergers and restructuring of entities in many countries have typically added to the trend of increased consolidation within countries, across countries, and across business lines (e.g. in financial conglomerates). (See Figures 2 and 3 for the evolution of concentration in the US and the EU, respectively.)

The question is whether the increased concentration will impair competition and end up hurting consumers and investors or, on the contrary, will contribute to stabilizing the system. There is broad evidence that higher concentration in relevant deposit and loan markets leads to worse terms for customers and to cost inefficiencies.

At the same time, concentrated banking systems like those in Australia and Canada have fared better in the crisis than unconcentrated

ones, such as those in the US or Germany. However, countries such as Belgium, the Netherlands or the UK (in retail banking), with concentrated systems, also ran into severe trouble. While a concentrated banking system with a few large banks may be easier to monitor and banks are potentially more diversified, large banks may be TBTF, receive larger subsidies, and have incentives to take more risk. On top, large banks tend to be more complex, harder to monitor, and more interdependent, increasing systemic risk. All in all, we face a complex picture which is not amenable to simplifications.

The crisis, with pervasive regulatory failure, has put both regulation and competition policy in banking, as well as its relationship, into question. There is consensus that before the liberalization process the status quo was far away from the optimal balance between the benefits of competition (in terms of efficiency, quality provision, innovation and international competitiveness) and the potential increase in instability. A new consensus has yet to emerge post-crisis.

A preliminary conclusion is that competition is unequivocally socially beneficial provided that regulation is adequate but that in practice a trade-off between competition and financial stability arises due to regulatory imperfections or outright regulatory failure. However, there is ample room to improve both competition and stability in banking with better regulatory design. This would minimize the potential discrepancies between private and social incentives in banking. The challenge for the regulators is as tall as ever.

**Xavier Vives**, Professor of Economics,  
IESE Business School

A more extensive use of hard information in modern banking erodes traditional relationship banking, which is based on soft information, and increases the weight of trading in the balance sheet of banks.

The crisis and the response of authorities with massive support for the sector have added distortions to competition.

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## Selected Activities

### ALUMNI

#### **Combatting the Commoditization Process and How to Face a Price War**

Buenos Aires, July 30  
Prof. Mario Capizzani

This special Continuous Education session will be led by Prof. Mario Capizzani of IESE's Department of Marketing.

#### **The Global Macroeconomy**

Santiago de Chile, August 5  
Prof. Pedro Videla

Prof. Videla of IESE's Department of Economics will provide an overview of the current macroeconomic scenario.

#### **On the Challenges of Strategic Innovation and Organizational Evolution** (Session with Prof. Michael Tushman, Harvard Business School)

Barcelona, September 15  
Moderator: Prof. Joan Enric Ricart

This session will explore the relations between technological change, senior teams, and organizational evolution. We will discuss the linkages between streams of innovation and contrasting organizational architectures. Because dynamic capabilities are at least partly rooted in both exploiting existing capabilities and exploring into uncertain spaces, senior teams must be capable of hosting contradictory strategies and associated organizational forms. We will discuss structural ambidexterity as a tool for hosting innovation streams even as they pose challenges to incumbent senior teams. Finally, we will also explore open and community forms of organizing and the associated shifting locus of innovation.

### SHORT FOCUSED PROGRAMS

#### **Finance and Accounting for Non-Financial Managers**

Barcelona, October 6-10

This intensive program provides a comprehensive understanding of the basic principles in finance & accounting. We address the management of working capital requirements and how this relates to the firm's liquidity and sustainability in terms of growth and competitiveness. Participants also learn how financial decisions themselves can create value and apply a holistic view of the company (using our 10-step approach) to obtain an accurate financial diagnosis, which is essential in the comprehensive decision-making process.

#### **Making It Work: A Power Approach to Strategy Execution**

New York City, October 6-8

When a business strategy fails, shortcomings are often exposed – not necessarily in the strategy itself – but in its execution. The ability to *make it work* is critical for business leaders and it is the overriding factor in determining a company's long-term success.

This program features the expertise of IESE Professors Fabrizio Ferraro (Academic Director) and Marco Tortoriello, as well as the vast experience of Stanford University Professor Jeffrey Pfeffer, a world-renowned expert on management, leadership and human resources.

 *The International Economic Overview* is also available online, in Spanish as well as English. Access the publication at [www.iese.edu/alumni/coyunturaeconomica](http://www.iese.edu/alumni/coyunturaeconomica)

#### International Economic Overview

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