Michael C Bonello: Securing financial stability - problems and prospects for new EU members[1]

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Financial Stability Seminar, St. Julians, 27 March 2003.

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In today's globalized world where private financial flows, facilitated by market deregulation and electronic trading, have become a substantial multiple of merchandise trade, safeguarding financial stability represents an increasingly complex policy challenge. For the central banking community in the accession countries, the wider scope of liberalisation implied by the rules of the Single Market and, in particular, by the EU Financial Services Action Plan, adds a further dimension to this challenge. Of particular relevance in this regard are the liberalisation of capital flows and the free movement of services, processes which are already well underway in our countries. It is, therefore, particularly appropriate that central bankers, regulators and others having an interest in financial stability should come together on the eve of EU enlargement to assess the adequacy of the institutional and policy frameworks within which they operate.

Current issues in financial stability

It is today generally accepted that a well-developed and healthy financial system is a prerequisite for sustained growth, not least because of its intermediary role between savers and borrowers and its ability to diversify risks. A sound financial system also contributes to exchange rate stability by way of its stabilising effects on external trade and financial flows and is, of course, necessary for the effective transmission of monetary policy.

As the size and importance of financial systems have grown, so have the sources of potential threats to their stability. Apart from the magnitude of short-term private funds which move across the globe daily, financial stability stands to be undermined by the emergence of such factors as asset price bubbles and by the blurring of the erstwhile distinction between financial markets and institutions, developments which complicate the task of the authorities charged with overseeing the financial system.

Clearly, "financial stability" has assumed a much broader meaning than that implied by the terms "financial supervision" and "banking stability", with which it used to be associated in the past. These wider ramifications of the concept are well captured, I believe, by the definition proposed by Mr Malcolm Knight, the Senior Deputy Governor of the Bank of Canada who is soon to take over as General Manager of the Bank for International Settlements. He defines a stable financial system as one in which all economic agents - households, business firms, financial services firms and government - can confidently hold and transfer financial assets without experiencing serious risks of disturbances that undermine financial values or repayment prospects.[2]

The notion which this definition conveys very clearly is that risks to stability need not originate within the financial system itself. In particular, while a sound clearing and payment system and regulatory framework remain vital prerequisites, a healthy macroeconomic environment characterised by stable prices, interest rates and exchange rates is equally necessary for financial stability. These variables also affect the exposures of different entities to various categories of risk. This is very much what we observe in practice, where even imbalances arising in some other sector often create ripple effects throughout the financial system and, where this is not robust enough, in the rest of the economy.

Consistently with this view, it can be argued that financial stability is best pursued by implementing a coherent set of policies which respond to the underlying macroeconomic fundamentals. Recent episodes of financial crisis, for example, have shown that through their effects on expectations and on

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2. Knight, M. 2002. "The Central Bank's Role in Fostering Financial System Stability: A Canadian Perspective", in Financial Risks, Stability, and Globalization; ed. O.E.G. Johnson. Washington, D.C.: International Monetary Fund. pg. 314.

asset prices more generally, unchecked variations in property prices can contribute to precipitating a crisis. Similarly, it is often forgotten that a combination of excessive public deficits with an over reliance on short-term capital flows and an overvalued currency is the perfect recipe for a turnaround in market confidence, and consequently for sudden reversals in capital flows.

Nonetheless, of all the possible links between financial stability and the other objectives of macroeconomic policy, it is the one between the two key functions of central banks - price stability and financial stability - which has received most attention. And this for very good reasons. For a start, we know from experience that inflation brings about distortions in the allocation of resources, and such misallocation is incompatible with the achievement of financial stability on a sustainable basis. We have also learnt that the efficiency of monetary policy depends on the effectiveness of the transmission channels. Central banks can only influence short-term interest rates. The ultimate impact on prices of monetary policy decisions travels over time through various channels in the financial system, and uncertainty could ensue if these do not function efficiently. Another reason for this focus of attention could be that while the supervisory function has been relocated outside central banks in many countries, responsibility for the maintenance of systemic stability remains with central banks.

The relationship between financial and monetary stability is not, however, necessarily limited to complementarities. In a situation characterised by both rising inflationary pressures and tight liquidity conditions, for example, a decision to raise interest rates would be consistent with the central bank's price stability objective but could also affect the profitability of credit institutions. It is thus hardly surprising that one of the topical issues facing central banks today concerns the appropriate weight that should be given to financial stability considerations in the formulation of monetary policy. From a broader policymaking perspective, moreover, there is also the question about the role that financial stability concerns should play in the formulation of macroeconomic policy more generally. I am sure that the second seminar session will provide further insights in this regard, when the interrelationship between fiscal policy, monetary policy and financial stability will be considered.

Policy transparency, good governance and market discipline

The relationship between macroeconomic policy and financial stability also serves to highlight the importance of policy transparency and good governance, both at the national and corporate level. In fact, it is generally agreed that the likelihood of disturbances to the financial system can be greatly diminished if the authorities manifest their policy intentions clearly, and explain the rationale behind policy measures once decisions have been taken. This helps to reduce the chances of investors and creditors making uninformed decisions, only to reverse them later. This aspect has become especially relevant in the context of capital account liberalisation, particularly in those countries that operate variants of fixed exchange rate regimes. It is even more so in countries which are simultaneously engaged in efforts to place public finances on a stable footing and to gain credibility for the central bank's monetary policy. Here, a sudden shift in investor confidence could have serious repercussions, not only for financial stability but also for the conduct of monetary and fiscal policy. Within this context it is relevant to note that while in general accession countries have made significant progress towards achieving macroeconomic stability, this progress has been far from uniform and challenges remain in this respect too. The paper to be given by Dr Lipschitz and the presentations on EU country experiences should provide some interesting perspectives on these issues.

The relevance of transparency and good governance also applies at the corporate level, not least because financial difficulties in large corporations could undermine the well-being of individual financial institutions and markets. This is especially the case in small jurisdictions. Now it is a fact that corporations will always know a lot more about their financial position than any outside entity charged with monitoring them, and financial intermediaries are no exception in this regard. This is particularly true at a time when the complexity of financial products and the intensity of cross-market risks are stretching the capacity of central bankers and supervisors to remain fully in control. Several recent episodes in the financial world indeed confirm that the innate human predisposition to maximise self-interest can induce behaviour that is not in harmony with the public interest.

The implications of this are two-fold. While rules and regulations continue to play an important role in preventing systemic shocks, they will increasingly have to incorporate incentives and credible deterrents to discourage excessive risk-taking and moral hazard. Second, the efforts of central bankers and supervisors need to be supplemented with direct oversight by the stakeholders of financial institutions themselves, be they shareholders, creditors or customers. Stated otherwise, good governance and market discipline are becoming at least as important as prudential controls for the

well-being of the financial system. That, in turn, calls for a host of other measures ranging from the regular disclosure by the institutions of detailed information about their performance and the adoption of international accounting standards to the enforcement of shareholder rights, the creation of deposit insurance and investor protection schemes and the simplification of judicial procedures. In this regard, I believe that Dr Summer will be explaining how accession countries score in terms of some of these criteria.

EU financial market integration presents new opportunities but also some risks

While it is recognised that the well-being of the financial system has come to depend on a host of factors, the regulatory and institutional framework in place continues to play an important role both in crisis prevention and management. The prospect of EU membership has already contributed significantly in this regard, spurring accession countries to evaluate the adequacy of the framework governing the financial sector. Perhaps more important is the fact that the on-going harmonisation of rules and practices with EU standards in the area of financial stability will provide market players with an added assurance that this framework will continue to evolve in line with international best practice.

This assurance should also facilitate the further development of the financial sector in these countries, as foreign banks and other financial services providers seek to tap what is soon to become an enlarged market of almost 500 million people, either directly by setting up shop in these countries or indirectly through the cross-border provision of financial services. The advantages for financial stability of a diversified financial structure are well-documented. Suffice it to recall that because different financial market segments react differently to economic shocks, the presence of different types of intermediaries and markets functioning alongside each other should strengthen the financial system's capacity to absorb liquidity shocks emanating from specific institutions or market segments. For accession countries, the scope for diversification presented by EU membership is significant, not only because the financial sector tends to be small relative to their economic size, but more so because intermediation in these countries is dominated by the banks. In fact, a recent ECB report concludes that the financial sectors of accession countries could assimilate a fifteen-fold increase in absolute terms.[3]

Financial integration in the euro area, moreover, may also promote financial stability in the accession countries through the advantages inherent in a single currency area. For a start, the disruption arising from currency risk is eliminated, domestic economies become immune to currency misalignment episodes that disturb trade and currency risk premiums disappear from interest rates. A large currency area, furthermore, means deeper and more liquid financial markets, which allow participants to diversify their risks and, in the absence of currency risk, to focus more on credit risk.

Another contribution which EU membership should make to financial stability in accession countries stems from the increased competition which will result from the entry of foreign service providers, particularly if this induces indigenous institutions to find innovative ways to hedge risks and diversify asset portfolios, and to adopt international best practices generally. While cross-country studies on this aspect remain sparse, a recent World Bank study[4] reveals instances where foreign bank entry did lead to improved operations and to greater access to foreign capital. Drawing on data for 80 countries, this study also shows that foreign bank entry does tend to reduce domestic bank profitability, non-interest income and, to some extent, overall expenses. Coupled with the finding that the presence of foreign banks contributes to a higher level of loan-loss provisioning, this leads the authors to conclude that, through its effects on competition, foreign bank entry improves the efficiency and functioning of indigenous banks. While there is nothing automatic about the realisation of such benefits, one might reasonably expect that in the long run the completion of the Single Market in financial services should contribute to the emergence of a healthier financial system in the accession countries.

Now it could of course also be argued that the extension of the "single passport" to most aspects of the provision of financial services foreseen by the Financial Services Action Plan could well expose the accession countries to new risks, particularly those emanating from within the EU itself, with which

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[3] Caviglia, G., Krause, G & C., Thimann. 2002. Key Features of the financial sectors in EU accession countries, in Financial Sectors in EU Accession Countries. ed., C. Thimann C. Frankfurt: European Central Bank.

[4] Claessens, S., Demirguc-Kunt, A & H. Huizinga. 1998 (rev 2000). How does Foreign Entry Affect the Domestic Banking Market? World Bank Working Paper No. 1918. Washington: World Bank.

these countries are already closely integrated. Indeed, the ECB has itself recently stated that the integration of financial markets in the region could increase the chances of systemic disturbances affecting more than one Member State.[5] In this regard, Dr Buch's paper on the implications for financial stability of foreign bank entry should help to place the discussion in an empirical context.

Another important aspect of financial market integration relates to regulation and supervision. As the process intensifies, the distinction between different types of financial institutions and markets will become increasingly blurred. In such a scenario, it will be even more important for all institutions with financial stability responsibilities - be it the central bank, supervisory authority or other government agency - to co-ordinate their efforts in the area of system oversight and to share any information which could be relevant to the proper fulfilment of their respective functions. Indeed, whereas until recently the prevailing concern related to the choice of institutional arrangement for the supervision of the financial sector, it is now sometimes argued that it is not the institutional framework which matters most, but rather the existence of adequate mechanisms guaranteeing the exchange of information and policy co-ordination between the entities responsible for overseeing systemic stability and those that monitor the health of individual financial institutions. Beyond that, it is claimed, any institutional set-up can work. Likewise, any one can fail.

While this conclusion might be valid from a national point of view, it does little to address the question of whether information exchange and policy co-ordination relating to financial sector developments affecting the EU as a whole would be more appropriately addressed by a supranational EU institution with supervisory responsibilities, or whether such tasks are best handled by the national authorities of member countries. This issue has certainly gained in importance in recent years with the increased recognition of the links between supervision and monetary policy. It has served to highlight the anomaly between, on the one hand, the institutional framework governing monetary policy in the region, which is centralised in the ECB, and, on the other hand, the framework governing financial sector supervision, which is largely decentralised. The signing earlier this year of a Memorandum of Understanding on co-operation in the area of crisis management between the supervisory authorities and the central banks of the 15 Member States has underlined the links between these two functions even more.

Now some might conclude that if it has been possible to devise a mechanism for crisis management in the EU without the need to create a supranational supervisory body, it should be equally possible to develop a similar co-operative arrangement for crisis prevention. On the other hand, it could also be argued that, not having had the experience of a financial crisis in the region, it is still too early to say whether such an arrangement would work in practice. This topical issue relating to the pros and cons of the unification of supervisory structures at the EU level will be addressed by Dr Gruenbichler. Accession countries have a special interest in this matter, not only because their central banks and supervisory authorities will be invited to sign this accord, but because they will in time also have to adhere to whatever institutional arrangements are adopted by the EU in this area.

Conclusion

The issues being discussed during this seminar are wide-ranging indeed. And though they are not of interest exclusively to policy makers in accession countries, financial stability issues are especially pertinent for these countries, since they aim to meet the requirements for adopting the single currency as soon as possible after joining the EU in May 2004. First, because the existence of a positive link between financial system stability and economic growth means that anything that harms stability would slow down the pace of real convergence with the EU economy. Second, because the break out of a systemic crisis has immediate effects on asset prices and other price variables, it could also imperil the nominal convergence process and, with that, an early entry in Economic and Monetary Union (EMU).

Accession countries, therefore, have a specific interest in keeping at bay forces which are known to be inimical to financial stability and in adopting structures and practices which have proved effective in countries which have already completed their journey to EMU. It is thus appropriate that the seminar

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[5] European Central Bank. 2003. Press Release on the Memorandum of Understanding on high-level principles of co-operation between the banking supervisors and central banks of the European Union in crisis management situations. Frankfurt. 10 March.

should be brought to an end with presentations on the experiences of three euro area member countries.