Peter Praet: The (changing) role of central banks in financial stability policies

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 14th Annual Internal Banking Conference, organised by the Federal Reserve Bank of Chicago and the European Central Bank, Chicago, 10 November 2011.

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More than four years have passed since the onset of the financial crisis. Over these years, central banking functions have been stretched to the limits.

Recent developments demonstrate how fragile our financial system remains, not only because of debt legacy but more worrisome because of its mere design.

The public debt crisis in a number of advanced economies is also raising fundamental questions about the role of public debt instruments in our financial system.

Looking backwards, one can say that disciplining mechanisms in debt markets have clearly failed, often as a result of mutually reinforcing market and government failures. Too much debt in the public sector is the symptom of both ineffective public governance and market discipline. Budget rules, such as the no-bail-out provision of the Maastricht Treaty, didn't contain the accumulation of debt. In the banking sector, the disciplining role of sight-deposits has proven to be time-inconsistent in the presence of the negative externalities that the failure of a large institution would create. Although the role of monetary policy in the build up of the crisis is still debated, it does influence in an important way the price of leverage.[1]

Lack of attention and preparedness to tail-events has been particularly striking. While central banks have always paid attention to the possibility of extreme events in payments and post-trade infrastructures, too little efforts have been devoted to the prevention of the conditions under which emergency liquidity assistance would be provided to the financial sector. Other authorities were concerned, such as supervisors at the micro-level and ministries of finance. The necessity of constructive "ambiguity" was also invoked to keep a low profile.

Achieving and preserving financial stability has now become a key policy objective in our societies. Building up separate macroprudential policy functions is considered one of the main elements of the wide ranging policy reforms in pursuit of this objective. The idea is to entrust the authority in charge of macroprudential policy with the task of monitoring, identifying and mitigating systemic risks as they emerge. Macroprudential policy, by taking a system-wide perspective, thereby complements microprudential policy which is mainly oriented towards ensuring the health of individual institutions or markets. But the way to organise the macroprudential function is still work in progress in particular on the role of central banks. There are different views on how to design such a framework and how they should relate to central banks, their governance structures and their monetary policy strategies.[2] This is essentially related not only to the difficulty to define financial stability in an operational way (contrary to price stability), but also to the number of authorities concerned (central banks, bank supervisors, insurance supervisors, market supervisors, competition authorities, consumer protection authorities, Ministries of Finance, Ministry of Justice,

1 See Adrain, T. and H.S. Shin (2011), "Financial intermediaries and monetary economics", in: B. M. Friedman and M. Woodford (eds.), Handbook of Monetary Economics, Vol. 3A, Elsevier.

2 See Nier, E., J. Osinkski, L.I. Jacome and P. Madrid (2011), "Institutional models for macroprudential policy", IMF Staff Discussion Note, SDN/11/18, November and also Eichengreen, B. et al. (2011): "Rethinking central banking", Committee on International Economic Policy and Reform, September.

resolution authorities) and to the variety of possible tools often assigned to several objectives.

Central banks should undoubtedly assume important roles in macroprudential policies. Central banks bring in essential expertise in analysing financial systems from an aggregate perspective. They also have proper incentives to mitigate systemic risk ex ante since central banks typically have to deal with the fallout from financial crises. Last but not least, involving central banks in macroprudential policy should foster effective coordination between monetary policy and financial stability policies in a manner that preserves their autonomy. Policy coordination is likely to become important in light of the strong mutual interdependencies between the financial and the real sectors and thereby between both policy functions. I will come back to policy coordination later on.

A wide range of different approaches exist to institutionalise central banks' role in the new financial stability frameworks. The different approaches taken largely respond to country-specific circumstances. A "one size fits all" approach simply doesn't exist. This is also in the European Union where individual countries have adopted different approaches.

At the level of the European Union as a whole, a new financial supervisory architecture became operational at the beginning of 2011. It includes three new European supervisory authorities (ESAs) for banking, insurance and securities markets – which aim to strengthen micro-prudential supervision – and the European Systemic Risk Board (ESRB) responsible for macroprudential oversight. The ECB ensures the Secretariat function for the ESRB – without prejudice to the principle of central bank independence –, and is also in charge of providing analytical, statistical, administrative and logistical support to this new EU body. Moreover, central bankers hold the majority in the ESRB's decision-making body, the General Board.[3] The main tasks of the ESRB are to monitor and assess systemic risk and to issue warnings and, where necessary, recommendations to the relevant policy-makers which are not legally binding but depend on the principle of "comply or explain".

However, the ECB's contribution to achieving and maintaining financial stability does not rely exclusively on its responsibilities for an effective functioning of the ESRB. Obviously, the way the ECB conducts monetary policy also impacts on financial stability. Some people call for vast changes in central banks' institutional setup and their monetary policy strategies with a view to pursue price stability and financial stability as coequal objectives. In my view, by contrast, major changes in the institutional and strategic framework of monetary policy are not necessary. But business as usual in central banking will not do it either.

Business as usual would imply adhering to what has become known as the "Jackson Hole consensus". According to this pre-crisis consensus view, central banks should only respond to asset prices and financial imbalances to the extent that they affect the shorter term inflation forecast.[4] If financial imbalances still emerged, central banks should follow a "mop up" or "cleaning" strategy after the burst of the bubble. Maintaining price stability is simply the best central banks could do to contribute to financial stability.

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[3] The General Board consists of the following members with voting rights: the President and the Vice-President of the European Central Bank (ECB); the Governors of the national central banks of the Member States; one member of the European Commission; the Chairperson of the European Banking Authority (EBA); the Chairperson of the European Insurance and Occupational Pensions Authority (EIOPA); the Chairperson of the European Securities and Markets Authority (ESMA); the Chair and the two Vice-Chairs of the Advisory Scientific Committee (ASC) of the ESRB; the Chair of the Advisory Technical Committee (ATC) of the ESRB; and the following members without voting rights: one high-level representative per Member State of the competent national supervisory authorities (the respective high-level representatives shall rotate depending on the item discussed, unless the national supervisory authorities of a particular member State have agreed on a common representative), and the President of the Economic and Financial Committee (EFC) of the Ecofin, which is the only representative of finance ministries.

[4] See, for example, Bernanke and Gertler (1995) and the response by Cecchetti et al (2000).

This view implied a strict separation between monetary policy and financial stability policy. Central banks had been well aware of the importance of financial stability for the smooth conduct of monetary policy and of their varied responsibilities in ensuring financial stability on the other hand. Yet, the importance of the possible implications of financial imbalances were underestimated and not systematically integrated in the analytical apparatus supporting monetary policy. This flaw in the intellectual underpinning misled central banks to downplay their financial stability functions and supported the general view that monetary and microprudential policy can be conducted separately, with monetary policy instruments geared towards achieving macroeconomic stability, and financial regulation and supervision aimed at preserving financial stability in the spirit of Tinbergen's policy assignment rule.[5]

However, it has become clear by now that this strictly dichotomous view is flawed since monetary policy and financial stability policy are intrinsically linked to each other, given the powerful interactions between financial and economic conditions. As the recent crisis forcefully demonstrated, the previous mainly microprudential orientation of financial regulation and supervision proved unable to curb the tendency of the ever more complex and opaque financial system to generate excessive amounts of systemic risk. The unravelling of the associated financial imbalances brought about the biggest financial and economic disaster since WWII which, in turn, severely impacted on the conduct of monetary policy. As the monetary policy transmission mechanisms were affected, central banks had to take unconventional measures.

The crisis also taught us that "cleaning" rather than "leaning" against financial imbalances can simply become too costly to be ignored ex ante. In addition, we also learned not to underestimate the moral hazard associated with the asymmetry in the previous consensus view of monetary policy.

In the light of the obvious breakdown of the Jackson Hole consensus, the view has become more popular that under certain circumstances, central banks may be well advised to actively lean against the emergence of financial imbalances in order to mitigate systemic risk and the associated longer term risks to price stability and economic welfare.[6]

At the ECB, we have always emphasised one tool which helps us maintain a medium to long-run orientation: the "monetary analysis". The monetary analysis is one element of the ECB's two-pillar framework – in addition to the economic analysis – for the regular assessment of risks to price stability. But we have always foreseen that monitoring monetary and credit developments is also part of an overall framework for addressing asset price misalignments. The analysis of low-frequency trends in money and credit developments has always been associated with the emergence of imbalances, because it allows us to assess risks to price stability well beyond the typical shorter term forecast horizons.

This notwithstanding, for what concerns the monetary policy strategy, significant efforts are still to be undertaken in building up an appropriate analytical framework linking the various sources of systemic risk to economic outcomes over long policy horizons. This may robustify the ECB's two-pillar monetary policy strategy to better cope with risks of highly uncertain, low probability but very costly events such as financial crises.

A better understanding of the transmission channels that exist between the financial and the real sectors is therefore of the essence. While some headway has been made in studying non-conventional transmissions channels such as the risk-taking channel, other issues still

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5 See F. S. Mishkin (2010): "Monetary policy strategy: Lessons from the crisis", Paper presented at the ECB Central Banking Conference, "Monetary policy revisited: Lessons from the crisis", Frankfurt, November 18–19.

6 See, for example, Borio, C. (2011): "Central banking post-crisis: What compass for unchartered waters?", BIS Working Paper No. 353, September.

remain work in progress.[7] For example what is the influence of interest rates on risk tolerance? What is the interrelation between funding and market liquidity? What are the determinants of the leverage cycle, and which role is played by financial innovation? Given the complexity of the issues involved one has to admit that the development of an operational framework linking monetary policy to the various forms of systemic risk is extremely complicated and poses severe intellectual challenges.

Financial stability risks may also arise from excessive monetary policy activism geared toward buying insurance against adverse macroeconomic and/or financial stability conditions. For instance, central banks might threaten future economic and financial stability if they keep policy rates too low for too long in the aftermath of a crisis.[8] In the context of the present crisis, the risk of missing the right time to exit from unconventional monetary policy measures offers a case in point.

In the light of these insights, it should be clear that monetary policy cannot do it alone. Financial stability should mainly be pursued by microprudential and macroprudential policies.[9]

Also, in order to achieve price and financial stability a pairing of appropriate policies by all relevant authorities is indispensable. One avenue might be to give an agent the specific mandate to assess the financial stability impact of regulatory and tax changes when relevant.

However, policy coordination is in general not easy. Coordination might be impaired by problems of time inconsistency when the objective functions of the authorities involved may differ. For instance, governments may succumb to the temptation to respond to electoral pressures or lobbying activities from the financial industry. A macroprudential authority might also be endowed with too much discretion in its instrument setting. These potential policy failures may therefore favour a more rules-based approach towards the macroprudential policy. This applies both to policy tools addressing the time dimension of financial stability (like counter-cyclical capital requirements or loan-to-value ratios) and tools relating to the cross-section dimension (like surcharges for SIFIs, leverage ratios, bank merger and acquisition policy, limits to business organisation, etc.). As the financial system is highly adaptive one has to be aware that only controlling the time dimension of financial stability is not sufficient. For example, similar rates of asset price inflation in the real estate markets may not imply similar risks to financial stability even when occurring at similar points in the financial cycle. A proper assessment of systemic risk always requires a thorough analysis of borrower and lender fragilities as well as of the whole intermediation process.

Policy coordination is also particularly challenging in a currency union when credit cycles (eg. real estate cycle) are not synchronized. Moreover, monetary integration in the European Monetary Union has advanced at a much higher pace than the integration of financial stability and fiscal policies. An important step forward was allowing the ESRB to make country-specific recommendations but a further strengthening of its powers might still be needed.

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7 For a recent overview see Adrain, T. and H.S. Shin (2011), "Financial intermediaries and monetary economics", in: B. M. Friedman and M. Woodford (eds.), Handbook of Monetary Economics, Vol. 3A, Elsevier.

8 See, for instance, Maddaloni, A. and Jose-Luis Peydro (2011), "Bank risk-taking, securitisation, supervision, and low interest rates: Evidence from the Euro-area and the U.S. lending standards", Review of Financial Studies, Vol. 24, No. 6.

9 In fact, such a division of labour receives support from latest research conducted within the Macroprudential Research (MaRS) network of the European System of Central Banks. Under most circumstances it turns out that financial imbalances are better addressed by macroprudential policy measures (e.g., counter-cyclical loan-to-value ratios) rather than by a monetary policy "leaning against the wind". See Beau, D., L. Clerc, and B. Mojon (2011): "Macro-prudential policy and the conduct of monetary policy", Banque De France, Occasional Papers No. 8, and Lambertini, L., C. Mendicino, and M. T. Punzi (2011): "Leaning against boom-bust cycles in credit and housing prices", Banco de Portugal, Working Paper 8/11.

To conclude, challenges are immense both on the technical side as well as on the governance side to safeguard financial stability. In essence, the task consists in reinforcing disciplining mechanisms in private and public debt markets. There is a need to act in a number of areas. Central banks have an important role to play as coordinator/ facilitator/ initiator. They also have the proper incentives to do so in order not to overburden monetary policy.