Yves Mersch: The euro and the ECB – perspectives and challenges ahead

Keynote address by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, Journée Boursière, Luxembourg, 6 May 2013.

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Ladies and Gentlemen, dear friends and guests,

It was fifteen years ago, in May 1998, that the first Executive Board of the European Central Bank was constituted and commenced its work in Frankfurt. This anniversary is passing almost unnoticed. Some may say this is not a good moment for cheerful celebration. Indeed we have little room to pause as we are confronting new challenges every day. Nonetheless, I would like to take a step back and start off my remarks with a tribute to the founding fathers – and founding mother – on the Executive Board of the ECB. They have set us on the right course. The ECB, for its part, has delivered on what it has been asked to do.

The same cannot be said for other policy areas. Partly because of its success in establishing itself as a credible institution, the ECB has been in a position to step into the breach during the crisis as a guarantor of stability and is now being asked to shoulder additional responsibilities. As back then, when the first Board prepared for the launch of the euro, today the ECB is steering a course into uncharted territory. As it was back then, today we need to be guided by firm principles and a clear compass to serve as an anchor of stability.

Once again we are engaging in a process of institution building, like the pioneers fifteen years ago – including, in our own modest perimeter, the setting up of the Banque Central du Luxembourg.

Once again the Executive Board and the Governing Council need to be mindful about the limits of what can be asked of monetary policy, what can be asked of central banks and what must not be asked. This will be a main theme of my remarks tonight on the perspectives and challenges that lie ahead for the ECB and the euro. Equally though, other policy areas need to be mindful – and be reminded – of their respective responsibilities for the stewardship of the euro.

A sound institutional framework for the euro

Let me be perfectly clear: the Euro, the promise of a single and stable currency for Europe – from its inception – has been both a political and economic project. With the establishment of the ECB fifteen years ago and the creation of the euro on 1 January 1999 monetary policy was centralised and safeguarding the euro's stability was delegated to a strong and independent central bank. The ECB has delivered on its primary objective of price stability and will continue to do so. By contrast, responsibilities for fiscal policy, economic policies and supervision remained located at national level, while being subject to common rules and procedures. In the end this arrangement has proved insufficient in preventing the build-up of financial and economic imbalances in the euro area, associated with divergence in competitiveness as well as unsustainable trends in public and private debt and associated banking crises.

For this reason last year the Van Rompuy report by the four presidents put forward the case for complementing and completing monetary union with further "four unions" to ensure that all relevant policy areas fully live up to the common responsibility that sharing a common currency implies. These are important steps towards overcoming the "institutional solitude" of the ECB, in the words of the late Tommaso Padoa-Schioppa.

First, banking union was a missing element in the original Maastricht design. It is essential to provide a durable foundation for monetary and financial stability and to ensure a level playing field. Counterparties remaining under different national regulatory regimes can be a significant source of financial fragmentation and an impediment to the transmission of the single monetary policy.

Second, we need further steps towards fiscal union as well as a strengthening of the governance of economic union. Ultimately, this should also be reflected more broadly by elements of political union. Much progress has been made, namely in the first two domains to provide a sound basis for financial integration and financial stability as well as to ensure fiscal sustainability.

Further efforts are clearly needed on structural reforms to restore competitiveness and promote lasting economic growth and employment creation. In the end, well-functioning institutions at both national and European levels – including, in particular, forceful application of the macro-economic imbalances procedure and credible enforcement of the fiscal rules – are essential, alongside the ECB as the guarantor of a single and stable currency. Together they provide the appropriate foundation ("Ordnungsrahmen") for a genuine monetary and economic union underpinning durable wealth creation in the euro area, based on a sound financial system, sustainable public finances and a competitive market economy.

Essential elements of banking union

Progress on the four unions set out by the four presidents is necessary, first and foremost, for crisis prevention, i.e. they will help to avoid the build-up of economic imbalances and financial vulnerabilities that have led to the present crisis. Setting out a strong commitment and a clear framework for improved future governance also facilitates crisis resolution and crisis management. At the same time we should not put the cart before the horse in the transition period and responsibilities must be clearly defined.

This applies in particular to the main elements needed for a banking union.

A single supervisory mechanism (SSM) ensures effective supervision and a level playing field across the euro area, underpinning financial integration and safeguarding financial stability. The SSM regulation is nearing adoption subject to the necessary parliamentary approvals in a number of jurisdictions.

A single resolution mechanism (SRM) is essential to break the link between banks and their respective sovereigns and to ensure that non-viable banks can be wound down in an orderly manner. A draft regulation for the SRM is expected from the Commission by the summer.

SSM and SRM are like Siamese twins, on cannot survive without the other. A supervisor can only credibly do his job if liquidation is possible without undue risks to financial stability. Conversely, the resolution mechanism must be able to rely on the well-founded and impartial judgement of the supervisor before putting any funds at his disposal.

While a common fiscal backstop is needed for the SRM, resolution funds could come from the private sector, namely the financial industry and the banks eligible for the SRM. To achieve fiscal neutrality this could be done via private sector pre-funding or via a mechanism that would re-reimburse any loans from the SRM ex post via a bank levy. In this way recourse to taxpayer funds could be limited and remain temporary for the SRM.

The European Council has decided to entrust the SSM to the ECB. This has been seen by some as a testimony to the credibility that the ECB has built up as an institution. Others regard it as a poisoned chalice, which might put into doubt the very credibility and independence that the ECB has earned itself in the monetary domain.

With the ECB set to assume supervisory responsibilities, indeed much has been made of possible conflicts of interest between monetary policy and financial stability, and supervisory tasks in particular. To my mind, such conflicts are pertinent and should not be ignored. Hence it is essential that the SSM and all reporting lines for supervisory functions to the

Governing Council are clearly separated from other ECB tasks. The Governing Council's commitment to deliver on its primary mandate must not be put in doubt.

At the same time, a successful banking union in the euro area will help crisis prevention in future. It will also be helpful for crisis resolution at present. On both counts swift implementation of SSM and SRM would reduce, not increase, the risks of overburdening monetary policy. Over the medium term, and in most circumstances, monetary and financial stability are complementary. This also applies to the task of supervision to maintain sound financial institutions. Conflicts arise once one or the other objective is put in jeopardy and if appropriate instruments are not in place to achieve the respective objectives. Today, most countries have adopted arrangements where possible conflicts are appropriately managed and internalized inside the central banks.

What monetary policy can do and cannot do

This brings me to the role of monetary policy in times of financial crisis.

We need, again, to distinguish three aspects: crisis prevention, crisis management and crisis resolution.

On *crisis prevention*, maintaining an environment of price stability is the best contribution that monetary policy can make to supporting financial stability. The attention paid to money and credit variables in the ECB's monetary policy strategy also helps to take into consideration the build-up of financial imbalances and associated development in asset markets. These in turn can imply risks to both financial stability and price stability over the medium term.[1]

On *crisis management*, in a financial panic there is a legitimate and well-established case for central banks to step in to provide liquidity as a lender of last resort. The well-known principles established by Bagehot in the 19th century remain a valuable guidepost: "lend freely, to illiquid but solvent institutions, against adequate collateral, at a penalty rate". While this is easier said than done in practice, these principles remain a salutary reminder of the need to guard against moral hazard in central bank crisis measures.

Responsibility for *crisis resolution* lies outside the domain of monetary policy and is up to supervisory and fiscal authorities. More precisely, while the SSM is to be entrusted with the analytical role performed inside the central bank, the SRM needs to take the financial and redistributive decisions that belong to the political sphere, when it comes to winding down non-viable banks. More broadly, addressing the root causes of the crisis, both economic and financial, is up to other policy domains, it namely lies in the hands of governments and regulators.

Against this background, monetary policy measures in a crisis can serve a critical role in guarding against disorderly self-fulfilling disruptions. They can buy time for other policy domains to undertake the necessary adjustments and reforms. But they cannot substitute for such actions. They must also be mindful of adverse longer-term consequences of short-term support provided.

Here is my "to do" and "not to do" list on monetary policy in crisis times, expanding a little on Bagehot.

- Provide liquidity, not solvency support. Recapitalization is the task of shareholders and governments.

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[1] For early expositions of the need for a medium-term stability-oriented monetary policy to take into account the build-up of financial imbalances, see O. Issing, "Why stable prices and stable markets are important and how they fit together", First Conference of the Monetary Stability Foundation, 5 December 2002 and O. Issing, "Monetary and financial stability: Is there a trade-off?", Bank for International Settlements, March 2003.

- Prevent disorderly deleveraging and fire sales of assets, do not delay unduly necessary balance sheet adjustments.
- Provide temporary backstop to markets under stress, do not replace market functioning for too long.
- Provide short-term liquidity support, do not enter long-term credit allocation to be left to financial intermediaries.
- Act as lender of last resort to the banking system based on the traditional role of central bank refinancing, do not confuse this with LOLR to governments or inappropriate fine-tuning of financial markets.
- Support functioning monetary transmission mechanism (via banks and markets), do not guarantee uniform financing conditions or suppress fundamentally justified risk premia.
- Preserve singleness of monetary policy, do not compensate need for political commitment to keep composition of currency area intact.
- Buy time and pre-empt self-fulfilling dynamics (tail risks), do not distract from need by other policy domains to undertake structural reforms and address underlying fundamentals, avoiding wrong incentives and moral hazard.
- Fulfil the duty of fire-fighting in crisis to preserve financial and ultimately price stability, but keep a medium-term perspective and do not neglect unintended consequences and adverse side-effects from protracted non-standard measures on financial institutions and functioning.
- Take responsibility and credit for averting Armageddon, but do not overstate what monetary policy can and cannot do.

The ECB's non-standard measures

In living up to these "ten commandments" sketched out before it is well understood that in practice central banks need to perform a balancing act when carefully assessing the costs and benefits of unconventional measures.

Against this background let me briefly review the main characteristics of the non-standard measures adopted by the ECB in the wake of the financial crisis. Most measures are mirrored in the size and composition of the Eurostem balance sheets, reflecting its role as liquidity provider of last resort in the crisis: to monetary counterparties, to markets and ultimately to the real economy.

- The bulk of liquidity support has been via lending operations (against collateral), rather than via outright purchases. This practice is closer in line with the ECBs operational framework, limits balance sheet exposure and facilitates endogenous exit. At the same time, both modalities are in principle also part of the toolkit of traditional instruments for monetary policy operations.
- With the adoption of fixed-rate full allotment in liquidity provision, lending is almost done freely against collateral to deal with impaired money markets, while quantities respond endogenously to the degree of stress in interbank markets.
- Extension of LTROS maturities up to 1 year in 2009 and to 3 years in 2011/12. This lengthening of the maturities still remained broadly within the realm of short-term liquidity provision while addressing uncertainty on bank funding.
- Covered bond purchase programmes were limited in size and duration. They were targeted to malfunctioning markets and are important bank funding instruments. This

was done with a view to act as catalyst for market activity (notably in 2009) rather than replacing private market activity.

- The securities market programme in place from 2009-2012 again aimed at specific dysfunctional government bond markets, where volatility had increased and liquidity diminished. Purchases were not aimed at targeting specific yields and were fully sterilized to offset impact on the size of the Eurosystem balance sheet.
- The Outright Monetary Transactions announced last September to address unwarranted tail risks, allow for *ex ante* unlimited interventions, but are subject to strict conditionality (IMF/EU programme) to address concerns over moral hazard. They are also restricted to maturities up to three years.

All of the ECB's non-standard measures seek to balance the benefits and possible adverse side effects of what monetary policy can and cannot do. This pertains, for example, to the maturity of operations, the duration of liquidity support, the role of conditionality.

Scope and limits of non-standard measures

Most of the ECB's non-standard measures have been motivated by impairments in the transmission of monetary policy, in particular with respect to impaired interbank markets, bank funding and bank lending channels as well as financial market segments with particular relevance as benchmarks (governments bonds) or as a bank funding instrument (covered bonds).

Additional obstacles to the smooth transmission of the ECB' monetary policy stance across the euro area arise from financial fragmentation that exacerbates heterogeneity across countries that may exist in part for fundamentally justified reasons.

The objective of restoring a better or more uniform transmission of a given stance of the single monetary policy is conceptually distinct from the objective of using unconventional monetary policy to impart additional monetary policy stimulus when standard policy rates are constrained by the zero lower bound. In practice this distinction is the more difficult to draw, the more widespread transmission impairments become and the closer policy rates are to the lower bound.

In both dimensions, it is nonetheless useful to recall again the limits of monetary policy. Monetary policy transmission may be hampered at times where banks, in particular, but also non-financial sectors need to repair their balance sheets. At times of uncertainty and lack of confidence liquidity may be hoarded rather than be put to use for investment. These are cases where standard monetary policy may be "pushing on a string" (in the words of John Maynard Keynes). These are also impediments that need to be fundamentally addressed by regulators and government entities, via the strengthening financial balance sheets and via confidence-enhancing economic and structural policies.

One example of the need for action in the respective domains to help unclog specific transmission and funding channels concerns impediments to SME funding and possible measures to re-activate securitisation markets. The latter may be impaired by a combination of unwarranted stigma due to the fall-out form the US subprime crisis, by stringent regulatory requirements and by a range of structural and practical factors. These have to be addressed primarily outside the realm of monetary policy, even if the latter could potentially perform a catalytical role in some circumstances.

Regulatory impact on financial markets and monetary policy: the financial transaction tax

Finally, let me turn briefly to the financial transaction tax (FTT), as an example where government regulation may have adverse consequences on financial markets and monetary policy transmission. I would not like to enter into the case for or against the FTT.

Reservations are well known, while it is appropriate for us to take a neutral view on the objectives of this measure.

Looking at the specific FTT proposal published by the EU Commission on 14 February, nonetheless attention needs to be drawn to possible negative implications for the implementation of monetary policy and financial stability:

- Incentives to replace secured market funding (subject to FTT) with central bank liquidity (exempt from FTT), which may hamper market liquidity and increase banks' recourse to the Eurosystem funding.
- The possible distortion will be largest on the shortest maturities in the secured money markets, i.e. repo market (given FTT does not take into account maturity).
- Reduced liquidity in secondary fixed income markets (including government bonds) which may hamper smooth monetary policy transmission and worsen market fragmentation at a time when many of these markets remain fragile.

For these reasons a careful impact assessment warranted in these respects and some modifications in the current proposals merit consideration.

Some decades back, long before the financial crisis, James Tobin gave us four definitions of financial market (in)efficiency (in his Fred Hirsch Memorial lecture 1984)[2]:

1. information arbitrage efficiency – accepted by Tobin in its weak form.
2. fundamental valuation efficiency: do financial asset prices reflect rational expectations of future payment flows? – very much doubted by Tobin.
3. full insurance efficiency: do financial markets support Pareto efficient, complete markets Arrow-Debreu allocations? – very much questioned by Tobin, since incomplete financial markets interact with inefficient goods and labour markets.
4. Finally, Tobin proposed a notion of "functional efficiency", i.e. do financial markets and intermediaries provide value to society at large? Do they channel savings to the most productive investments, by pooling risk and allocating it to those best placed to bear it?

It is this fourth notion (not much found in our finance textbooks) that we need to revert to assess the financial system in the wake of the crisis and its service for the real economy. While he was critical of the considerable resources that tended to be devoted to "churning", to "gambling" and endogenous, self-referential activities in financial market, he was a lifelong critic of the Tobin tax named after him.

Concluding remarks

Fifteen years after the setting up of the ECB, we need to press on with the ongoing relaunch of the institutional underpinning to put the euro on a sounder footing. Such a relaunch should not put into question the achievement of the single monetary policy, the ECB's clear and unequivocal mandate and the clear division of roles and responsibilities among different policy areas. In particular, a fully-fledged banking union, as complement to monetary union supports financial integration and monetary policy transmission and hence ultimately reduces the burden on monetary policy.

At fifteen, the ECB, and the euro, are approaching adolescence. In the crisis the euro area had to grow up very quickly amidst daunting challenges to its identity, even its very

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[2] James Tobin: "On the Efficiency of the Financial System", Lloyds Bank Review, No. 153, 1–15, as recalled by Willem Buiter in his 2009 blog on "Useless finance, harmful finance and useful finance". http://blogs.ft.com/maverecon/2009/04/useless-finance-harmful-finance-and-useful-finance/#axzz1evYuSi2t.

existence. Further turbulence cannot be ruled out. But I am confident that we, at the ECB, will do all that is needed for the euro to have a long and prosperous life. After very difficult years of adjustment and renewed institution building, the euro will stand on solid feet and emerge stronger, provided that all in the family of stakeholders live up to their respective responsibilities.