Boris Vujčić: Challenges for policy responses within the European Union in the context of post-crisis reconstruction

Keynote speech by Mr Boris Vujčić, Governor of the Croatian National Bank, at the international conference "Economic and Financial Cycle Spillovers: Reconsidering Domestic and Cross Border Channels and Policy Responses", organized by the National Bank of the Republic of Macedonia, Skopje, 7–8 April 2016.

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Dear Ladies and Gentlemen,

I am truly honoured to be invited as a keynote speaker at this conference that gathers central bankers and policy makers in the region to discuss issues raised by the heightened levels of distress and volatility in financial markets. With two episodes of severe distress behind us, the global financial crisis, followed by the euro-area crisis, many observers share a conviction that today we might be observing the seeds of a new similar incident waiting to happen. Some point to possible bubbles in asset markets, some to distorted business models in (parts of) the financial industry, and quite a few of them see a new crisis lurking behind emerging market developments, which may start the latest episode of a " crisis trilogy", as recently pointed out by Andrew Haldane from the Bank of England[1]. To circumvent the reoccurrence of a lengthy and costly crisis, we need to improve our understanding of the processes underlying crisis episodes and adjust our policies accordingly. This is a great challenge for our trade, even more so amid the current deconstruction of overarching paradigms and a slow, if any, emergence of new central banking principles. Such principles need fundamental research as a foundation to help redesign the policy frameworks of central banks and to guide our corrective actions.

This is an exceptional opportunity to address the challenges of shaping policy responses in an increasingly integrated and changing world, particularly from a perspective of countries that are or aspire to become members of the European Union and the euro area. I hope I can raise a few relevant issues with the potential to provoke a constructive discussion and obtain much needed research insights.

Allow me to briefly summarize the main points for my discussion, structured here in three interrelated topics. First, real and financial cycles exhibit some regular patterns relevant for designing policy responses in open economies exposed to frequent shocks. Second, it is of major importance for the future of the euro area to advance the institutional design in order to make all of the envisaged protective mechanisms operational and enhance setting the right policy mix, which encompasses both EU and national policies. Finally, such a policy mix should pay a particular attention to careful coordination, given the interdependences among different national and supranational policies and immense potential for cross border policy leakages. I will elaborate briefly on each of the mentioned topics.

1. Economic and financial cycles: five important patterns

The financial crisis in 2007–08 has induced a change in the hierarchy of central bank goals. The concern of central banks for business cycles and economic growth has moved far beyond the extent to which those did, or did not, generate inflationary (or deflationary) pressures. Price stability has proven insufficient to deliver financial stability and the lack of

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[1] Haldane, A. (2015): How low can you go? – speech given at the Portadown Chamber of Commerce, Northern Ireland, 18 September 2015 (http://www.bankofengland.co.uk/publications/Pages/speeches/2015/840.aspx).

the latter has *once again* disclosed the overwhelming economic and social costs generated by the episodes of financial instability[2]. This has altered our view of financial stability issues, inaugurated the notion of systemic risks, and subsequently led to the broadening of our policy mandate. The establishment of the dual mandate for central banks implied that the traditional monetary policy function was “supplemented” by macroprudential policy as a response to the interplay of financial cycles and systemic risk.

The broadening of the central bank mandate and the need to add new measures and instruments to the policy toolkit have opened several avenues for central banks to expand on their knowledge. We need to re-examine the phenomena of regular disturbances, or cyclical processes taking place with different frequencies, as well as their inherent structures. While the nature of shocks and propagation mechanisms still largely remain on the battlefield of economic theory, empirically observed patterns and the consequences of the materialisation of risks necessitate our reaction, which should be based on our best knowledge and abilities. Allow me to get into more detail here.

Optimal policy responses in a multi-country setting require a careful examination of real and financial cycles, both domestic and international. For that purpose, let us look at five important patterns that seem to characterise them. First, *financial cycles seem to have a lower frequency and higher amplitudes compared to standard business (real) cycles*. Credit and asset price cycles may take long to develop their potential to destabilize the financial system. Further on, such a potential may emerge regardless of watchful micro-prudential supervision or stable inflation. The resulting notion of systemic risk may be identified as the interplay of macroeconomic shocks that make financial sector vulnerable, the contagion resulting from financial interconnectedness and endogenous financial imbalances associated with credit booms, credit leverage and risk taking behaviour of financial institutions[3].

Second, there are still no mechanisms in place to engineer sustainable synchronisation of cyclical movements across Europe. The question of cyclical synchronisation arises as particularly important within the international setting. This is the factor that makes policy responses even more complex, especially within a currency union such as the euro area, where the damage of suboptimal policy responses might exceed mere fiscal costs and output losses – they may threaten the future of the euro itself. Due to the recent events, therefore, researchers have focused their attention on testing for the endogeneity of optimal currency areas, further enriching the vast literature on the synchronisation of business cycles[4]. This literature substantiates the conclusion of diverging real and financial cycles across member states, both during the pre-EMU and post-EMU regimes. The single monetary policy has not

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2 D. Miles, Monetary Policy and Forward Guidance in the UK, speech given at the Northumbria University, Newcastle, 2013, D. Kapp, M. Vega, Real Output Costs of Financial Crises: A Loss Distribution Approach, MPRA Paper No. 38988., 2012, A. G. Haldane, The $100 Billion Question, comment by Andrew G. Haldane, Financial Stability, Bank of England, Institute of Regulation & Risk, Hong Kong, BIS Review 40/2010.

3 Constâncio, V. (2015): Financial stability risks, monetary policy and the need for macro-prudential policy; speech at the Warwick Economics Summit, 13 February 2015 (https://www.ecb.europa.eu/press/key/date/2015/html/sp150213.en.html).

4 Grigora, V., Stanciu, I.E. (2015): New Evidence on the Synchronization of Business Cycles: Is there an European Business Cycle?, National Bank of Romania, Macroeconomic Modelling and Forecasting Department, Bucharest University of Economic Studies; Basten, C. (2006): Business cycle synchronisation in the euro area: Developments, determinants and implications, Working Paper Series, Research Notes 22, Deutsche Bank research; Stremmel, H. (2015): Capturing the financial cycle in Europe, Working Paper Series, No.1811/June 2015, European Central Bank; Sybille, L. (2012): Has the Euro Changed Business Cycle Synchronization? Evidence from the Core and the Periphery, Ifo Working Paper No. 122 (www.cesifo-group.de); Gouveia, S. and Correia, L. (***):Some facts about business cycles synchronisation across the euro area countries: the case of small countries, Centre for Transdisciplinary Development Studies (CETRAD), Department of Economics, Sociology and Management (DESG), University of Trás-os-Montes and Alto Douro (UTAD), Portugal.

brought cycles together, although a few efficient and credible shock absorbers were devised at the eve of the euro.

Further on, there is some evidence on the increasing correlation between real cycles and financial cycles across different groups of EU member states, as provided by Meller and Metiu (2015)[5]. Such a pattern emerges regardless of different sources and well-documented differences in frequencies and amplitudes between real and financial cycles. Moreover, researchers from the Bank for International Settlements have shown that the correlation between real and financial cycles gets stronger over time as the duration and amplitude of financial cycles increases. The main explanation for the increasing correlation between the real and financial cycle is the so-called "unfinished recession" phenomenon, according to which globalization and a more activist monetary policy, which fails to take into account the state of the financial cycle, eventually cause a bigger recession down the road[6].

We are left with two more interesting features of cyclical (co)movements. *The degree to which real and financial cycles converge across groups of member states is neither constant, nor does it increase in linear fashion over time.* All the previously described processes might deliver the periods of high synchronisation, followed by rapidly collapsing convergence.

Finally, the (in)famous *duality between the core and the peripheral countries emerges as a theme here as well, as country groups tend to cluster in terms of real and financial cycles*. All of these notions call for further research and better understanding, but they are nevertheless useful information for shaping policy responses.

The expectations of convergence in real and financial cycles due to increased trade and financial integration, pursued strongly within Europe (the euro zone) during the last few decades, have far from materialized. In addition to some old suspects, theoretical and empirical literature have identified some new channels at work to explain for such a phenomenon[7]. The traditional view that increasing trade integration may, or may not be, supportive for the synchronisation of business cycles, depending on the specific trade pattern, has certainly been warranted (Krugman vs. Frankel-Rose hypothesis). Further on, stronger financial linkages have also proven to be an elusive channel for engineering sustainable convergence of real and financial cycles. While debt flows remain a theoretical channel that might increase the extent of international risk sharing, the actual effect depends on what happens during the crises. For example, an increased risk premium and depressed collateral prices in a country hit by an asymmetric shock may reverse capital flows exactly during the period when higher inflows are most needed. Such effect is usually known as a sudden-stop in capital inflows and the mechanics of the process is not too different from the disrupting effect of the financial accelerator on the credit channel of monetary policy in developed countries.[8]

Finally, even an analysis of trade and financial integration, while improving our understanding of complex open economic systems, may fall short of explaining the synchronisation of real and financial cycles. Since cyclical patterns are largely attributable to different cost structures and profitability profiles that affect investment decisions and output volatilities, another

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5 Meller, B., Metiu, N. (2015): The synchronisation of European credit cycles, Discussion Paper No. 20/2015, Deutsche Bundesbank.

6 Drehmann, M., Borio, C., Tsatsaronis, K. (2012): Characterising the financial cycle: don't lose sight of the medium term!, BIS Working Papers No 380, Monetary and Economic Department.

7 Duval, R., Cheng, K., Hwa Oh, K., Saraf, R., Seneviratne, D. (2014): Trade Integration and Business Cycle Synchronization: A Reappraisal with Focus on Asia, IMF Working Paper 14/52; Davis, S. (2011): Financial Integration and International Business Cycle Co-Movement: The Role of Balance Sheets, Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute, Working Paper No. 89.

8 Bernanke B.S., speech at the Credit Channel of Monetary Policy in the Twenty-first Century Conference, Federal Reserve Bank of Atlanta, Atlanta, Georgia, June 15, 2007.

potential explanation should be sought on the production side, which operates in conjunction with trade and finance. What is often left out of the euro area storyline is the fact that the monetary union came on top of diverging trends in total factor productivity (TFP) as the catching-up process in the EU came to a stall during the early 1990s[9]. A reversal in the catching-up process came regardless of high investments in some peripheral countries and high capital output ratios – rather than a sign of success, high investments were an indication of deeper-rooted problems.[10] Many peripheral countries did not need more investments *per se* to restart convergence – what they needed was a more efficient allocation of investments. The efficiency of investments fell victim to poor economic governance, rigid labour and product markets, low investments in information and communication technologies, defunct educational systems and the poor quality of corporate management. What the monetary union accomplished against such a background was to create an illusion of continuing convergence on the back of increasing foreign borrowing and investment in non-tradables, rather than to enact discipline in the economic governance of peripheral countries. The adoption of the single currency, followed by the consistent private sector interest spread, elimination of exchange rate risk and implied fiscal bail-out clause, cemented the duality in the quality of economic governance and boosted the suboptimal reallocation of resources in the periphery. So, we have observed financing low-productivity sectors (via real estate or government spending) with debt inflows, instead of capital flows fuelling further "catching-up". This has produced asset bubbles and large exposures of banks from core euro area countries, as well as world-wide creditors, towards the euro area periphery, and created strong contagion channels that have increased the amplitude of swings in comparison to historical business cycles. Such a phenomenon has in quite a few instances also been observed outside of the euro-area, regardless of the exchange rate regime implemented, which brings me to the discussion of challenges in finding an optimal policy mix in a small open economy.

2. Mutations of the traditional monetary trilemma: policy responses in open economies or "Ray in European clothing"

According to the newly emerging set of principles, this dual central banks' mandate is supposed to function via two independent sets of policies. As real and financial cycles diverge, central banks need a set of two independent policies.[11] Monetary policy should target the real cycle in order to stabilize inflation, while macroprudential policy should be used to tame the financial cycle. The task of maintaining price stability and financial stability should be even easier if central banks adopt a flexible approach to inflation targeting, the one that allows for temporary deviations and the gradual convergence towards the inflation target, as pointed out by Stanley Fischer (2010)[12].

Such a simple story of two independent policies – monetary and macroprudential – aiming at two separate goals, has some weaknesses. Such a framework is underlined by the traditional monetary trilemma theorem launched by the Mundell-Fleming model. The traditional monetary trilemma limits policy choice to only two among the three dimensions: independent monetary policy, free capital mobility and exchange rate stability. However, the usefulness of exchange rate flexibility as the shock absorber has been increasingly questioned over time. A more sceptical view on the usefulness of flexible exchange rates has changed the trilemma into an "irreconcilable duo: independent monetary policies are possible

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9 Gros, Daniel. (2011) What is holding Italy back?, CEPS Commentary, 8 November 2011.

10 Hassan F., G. I. P. Ottaviano (2013), Productivity in Italy: the great unlearning, VoxEU.org, 30 November.

11 Constâncio, 2015. *ibid.*

12 Stanley Fischer (2010): Myths of Monetary Policy, Israel Economic Review, 2010.

if and only if the capital account is managed" (Ray, 2013)[13]. Those who believe that exchange rate flexibility should not be abandoned, even in the cases of small open economies, have largely deflated their expectations of flexible exchange rates to act as shock absorbers[14]. Therefore, the notion that "the global financial cycle constrains national monetary policies regardless of the exchange rate regime" has now become part of common knowledge.

With supranational "one-size-fits-all" monetary policy, the role of national fiscal policy in stabilizing real activity and inflation has, accordingly, increased in euro-area member states. However, the configuration of single monetary policy, coupled with national fiscal sovereignty and the no bail-out clause, has generated suboptimal policies and frictions that threaten the monetary union. With single monetary policy, commitment not to bail-out heavily indebted member states is necessary to eliminate potential for moral hazard. However, the actual euro-area experience demonstrates strong incentives for sovereign fiscal policies to "trespass" on the prudent fiscal stance, either in the expectations of non-enforcement of the no bail-out clause, with the implicit assumption that sovereign default will be politically unacceptable, or through a direct support of common monetary authority through special monetary operations. This uneasy triangle is usually referred to as the fiscal trilemma of the monetary union. Such a "holy trinity" makes impossible the cohabitation of the independent monetary policy of a supranational central bank, national fiscal sovereignty and the no bail-out clause[15]. In order to ease the frictions stemming from national fiscal policies, the monetary framework of the euro area was reconstructed by implementing the elements of the banking union (the Single Supervisory Mechanism and the Single Resolution Mechanism), setting up the European Stability Mechanism (ESM, previously the European Financial Stability Fund (EFSF)) as well as by starting the ECB's quantitative easing program (QE). All these mechanisms should help to decouple bank distress and sovereign debt pressures.[16]

The described trilemmas in the European economic and monetary framework, with the still absent synchronisation of real and financial cycles, have given birth to a specific quadrilemma that demonstrates difficulties faced by policy makers in the euro area. With supranational monetary policy concerned primarily with the overall price stability objective, symmetric (global) shocks transmitted through financial linkages and domestic (national) divergent cycles, the burden of adjustment has to be borne by national macroprudential policy. The absence of other adjustments mechanisms, such as a perfect labour mobility or a transfer mechanism in the form of unemployment insurance[17], adds to the burden on fiscal policy, which is already suffering from moral hazard issues. The Vice-President of the ECB, Vitor Constancio, is right to emphasize that "macroprudential policy is therefore essential in any economy as the business and financial cycles are not synchronised. Even more so in a monetary union where vulnerabilities identified in each country can be addressed with macroprudential policy, allowing for the appropriate heterogeneity, while countries remain subject to a single monetary policy"[18].

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13 Ray, H. (2013): Dilemma Not Trilemma: The Global Financial Cycle And Monetary Policy Independence, Working Paper 21162, NBER Working Paper Series.

14 Couré, B. (2015): Paradigm lost: Rethinking international adjustments, speech atEgon and Joan von Kashnitz Lecture, Clausen Center for International Business and Policy, Berkeley, 21 November 2015.

15 Beck, H., Prinz, A. (2012): The trilemma of a Monetary Union: Another Impossible Trinity, Leibniz Information Centre for Economics.

16 Pisani-Ferry, J. (2012): The Euro Crisis and the New Impossible Trinity.

17 Bernoth, K., Engler, P. (2013): A Transfer Mechanism as a Stabilization Tool in the EMU, DIW Economic Bulletin, 1.2013.

18 Constâncio, V. *ibid.*

There are a couple of other difficulties related to the use of national policies. The shock absorbing capacity of fiscal policy is in too many instances limited by the narrow fiscal space existing before the crises. The recession has further eroded fiscal positions and fiscal rules have failed to tame unsustainable fiscal paths so that the ability of fiscal policies in the EU to deal with another blow of crises is quite limited. Also, a need for national macroprudential policy immediately opens the issues of harmonisation and coordination on the international level in order to avoid unintended consequences, which I will comment in more detail later on. Additionally, for macroprudential policy to be effective it must be intrusive, affecting the "normal behaviour" of agents and markets[19], yielding benefits in reducing long-term costs generated by the systemic risk that makes it hard to attenuate public interest thus creating a central bank's legitimacy paradox[20].

Unconventional expansionary monetary policy, which was pursued after reaching the zero lower bound, and out of the fear of "the risk of doing nothing"[21], may be risk-inducing by fuelling search for yield behaviour. Abundant liquidity and low borrowing costs have the capacity to generate bubbles, confirming a notion that rational individual decisions may lead to irrational social outcomes – albeit as a reaction to highly non-conventional policies. When inflationary impulses eventually pick up, the present monetary support will dry up and trigger a renewed divergence of national real and financial cycles, the phenomenon termed "unfinished recession".

The reconstruction of the euro area is clearly the work in progress. We need to get the policy framework right in order to pursue optimal policies. But given the magnitude of challenges, a good policy framework will not be enough to set the right policies – a lot of talent and ingenuity will be needed as well, making our job an art much more than before.

3. Critical moments in the post-crisis reconstruction of the European Union and specificities of macroprudential policy

The experience of the global financial crisis and more recent euro area debt crisis has motivated the reconstruction of the European economic and monetary framework along the pillars presented in the Fiscal Compact and Five President's Report[22] on completing the monetary union. These issues need to be put into the described perspective in order to value the potential of the new framework to reduce the chance of catastrophic scenarios and provide us with adequate instruments should such a scenario take place.

First, the rebalancing of the euro area has often been associated with reducing labour costs in order to improve competitiveness. Coeuré (2016)[23] vocally reinforces the view that productivity growth is central to competitiveness and to growing out of debt, as opposed to benefits of wage moderation. Seeing rebalancing as being all about cutting costs is misguided as benefits diminish with more countries engaging in such activities. However, pursuing structural reforms to raise productivity, in contrast to wage moderation, benefits substantially and uniformly all countries. "We do not need all euro area countries to adopt identical structural reforms. What we need is a framework that takes into account both how

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[19] Constâncio, V. *ibid.*

[20] Baker, A. (2013): The bankers' Paradox: The Political Economy of Macroprudential Regulation, School of Politics, International Studies and Philosophy, Queen's University of Belfast.

[21] Draghi, M. (2016): How domestic economic strength can prevail over global weakness, keynote speech at the Deutsche Börse Group New Year's reception 2016, Eschborn, 25 January 2016.

[22] European Commission (2015): Completing Europe's Economic and Monetary Union, Report by: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz.

[23] Coeuré, B. (2016): Rebalancing in the euro area: are we nearly there yet?, speech at the Danish Economic Society, Kolding, 15 January 2016, (https://www.ecb.europa.eu/press/key/date/2016/html/sp160115.en.html).

countries differ based on their national conditions, and how they are similar by virtue of being in a monetary union. Within those parameters there are various combinations of country-specific institutions that can produce smooth adjustment." (Praet, 2015)[24].

These notions should, of course, be the key ingredients of the Macroeconomic Imbalance Procedure and the Structural Reform Support Programme (as of 2017). If these conditions are met through institutional reform plans (until 2025), relying on deeper convergence, entailing, for example, Competitiveness Authorities and further financial and fiscal reforms, including the Deposit Insurance Scheme, Capital Markets Union and European Fiscal Board, should help resolve the quadrilemma. In the words of the Report: "...the Macroeconomic Imbalance procedure (MIP) could be utilised as a tool not only to prevent and correct imbalances but also to foster reforms and monitor progress in each euro area Member State towards these common standards. Significant and sustained convergence towards similarly resilient economies should be a condition for access to a shock absorption mechanism to be set up...".

As central bankers we need to be aware of the role and importance of structural reforms. And we also need to communicate this to the general public. However, even if convergence in TFP as a source of sustainable catching up gets kick-started and risks arising from it eventually get ironed-out, fiscal and macroprudential policies will still be needed to take care of residual idiosyncratic shocks. Moreover, we are directly responsible for getting macroprudential policy right, and in order to be able to do that, we need a profound understanding of all the issues relevant for its smooth and efficient implementation. Some of the critical issues for macroprudential policy at this point in time encompass (i) cross-border spillovers, (ii) the coordination of macroprudential and monetary policy and (iii) devising an internally consistent structure of macroprudential instruments.

International policy coordination, harmonisation and the consistent application of implemented instruments are vital to ensure effectiveness and limit the possibility and impact of adverse cross-border spillover effects[25]. The potential spillover of nationally implemented macroprudential policies largely depend on the degree of financial cycle synchronisation, especially within the highly integrated (economically and financially) states, as in the case of the European Union, or even more so within the currency union members with a single monetary policy. Several aspects of the potential spillover should be considered when formulating the policy stance in a highly integrated environment that challenges us in pursuing financial stability. *Outward cross-border spillovers* of systemic risk create a need for countervailing macroprudential measures, clearly emphasising the need for policy coordination and measure reciprocation. In contrast, *inward spillover effect* is a direct consequence of the regulatory arbitrage that motivates internationally operating financial institutions to seek organisational restructuring that minimizes regulatory costs. The issue of converting subsidiaries into branches has recently attracted a lot of attention, as some member states are actively trying to reduce this risk,[26] alongside international efforts directed towards formulating a framework for voluntary cross-border reciprocity[27]. Some countries, for example, try to internalize the costs of registering subsidiaries as branches by increasing depositor and retail consumer legal protection through an option for retail clients to cancel

[24] Praet, P. (2015): Structural reforms and long-run growth in the euro area, intervention on the panel "Long-run growth, monetary policy and financing of the economy" at 43rd Economics Conference of Oesterreichische Nationalbank, Vienna, 15 June 2015.

[25] European Central Bank (2015): A framework for analysing and assessing cross-border spillovers from macroprudential policies, Financial Stability Review, Special features, May 2015.

[26] Czech National Bank (2014): Box 7: Fragmentation, Ring-fencing of Local Activities and Foreign Bank Branches, Financial Stability Report, 2013/2014.

[27] Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macro-prudential policy measures.

liability/claim without penalty, extraordinary contributions to deposit guarantee systems, etc. The potential for intra-banking-group arbitrage could also be diminished if a macroprudential measure is applied at the appropriate level of consolidation and/or exposure location, making reciprocity arrangements a necessary condition for mitigating these effects.

Since it may be difficult to simultaneously hit macroprudential and monetary objectives due to the general low degree of synchronisation between real and financial cycles, the policy coordination of the two is an essential prerequisite for simultaneously stabilizing the general price level and financial movements as there are “important synergies and interactions between the two policy functions” (Constancio, 2015). This is especially evident today in the environment of the anaemic growth and low inflation that require pursuing the expansionary stance of monetary policy, yet at a price of jeopardizing financial stability through the search for yield behaviour that might create new asset bubbles. To tame these risks, the tight stance of macroprudential policy is needed. Still, it remains to be seen how effective macroprudential policy can be in taming the risks that emanate from a long period of ultra-loose monetary policy.

The macroprudential ammunition at the disposal of central banks is another potential source of concern. The CRR/CRDIV has provided us with various tools: supply-side (such as capital and liquidity buffers) and demand-side instruments (such as LTV, LTI or DSTI ratios). However, one should be very careful not to err in calibration of those instrument, whether on the side that leaves insufficient coverage (effectively producing policy inaction) or on the side that creates too much of a burden (exceeding the net benefit of macroprudential policy in the medium term).

Conclusion

I hope this overview comes as a stimulus for further theoretical ad empirical research, regardless of the degree of agreement on the specific issues outlined in this speech. Therefore, I am looking forward to this conference. Hopefully, we will leave with answers to at least some of the questions raised and with a strengthened sense of obligation to continue with demanding work.

Thank you.