Elisa Ferreira: Lessons from the crisis for central banks - a policy view

Remarks by Ms Elisa Ferreira, Vice-Governor of the Bank of Portugal, at the Joint Bank of Portugal and European Central Bank Conference on "Risk Management for Central Banks", Panel 2 "Lessons from the crisis for central banks - a policy view", Lisbon, 25 September 2017.

* * *

Introduction

- Economists and policymakers are still struggling to build a consensus on the long-run economic impact and on the policy implications of the financial crisis, 10 years past its beginning.
- In my view, there are **two major lessons from the crisis**:

  (i.) understanding macroeconomic equilibria requires knowing the interaction/transmission mechanisms of balance sheet positions of all agents in the economy, the behaviour of financial intermediaries and the interlinkages between the financial and non-financial sectors of the economy; this has implications on the design of economic policy, notably monetary and macroprudential policies, and on the need for interaction between monetary, macroprudential and microprudential policies;

  (ii.) the European architecture was unprepared to face the financial crisis and, despite several major steps observed in recent years, we are still living within an incomplete setup; a holistic approach – combining (i) steps in micro and macroprudential policies, (ii) policy action to implement the three interlinked pillars of the banking union; and (iii) further coherent steps in economic integration are warranted.

- In these remarks I would like to briefly touch upon each one of these lessons, having in mind the policy implications that may arise for the euro area.

(i) The return of financial issues to centre stage in economic thinking and the challenges still faced at the current juncture

- One of the insights from the crisis is that real and financial interactions can only be ignored at our peril. This has implications for economic modelling and for the design of monetary and macroprudential policy strategies. In particular, should financial stability considerations be incorporated in the conduct of monetary policy? What is the effectiveness of macroprudential policy when some of the risks for financial stability have already materialized and the macroprudential “buffers” were not build up beforehand? How do monetary policy and macroprudential policy interact in practical terms?
- Issues such as how to optimally coordinate policies and how to avoid time-inconsistency problems in this coordination are still outstanding. This is even more evident in a currency union where monetary policy affects the entire region, but financial imbalances may be local in nature.
- The current consensus is that price stability should continue to be the primary goal of monetary policy and that financial stability concerns should be mainly addressed by macroprudential policy. This is consistent with Tinbergen’s assignment principle. There is also a clear alignment between the goals of price stability and financial stability, as the objective of monetary policy is more easily achieved under financial stability and the latter benefits from price stability.
- Nevertheless, existing instruments are unable to fully address persisting significant

macroeconomic imbalances, and they still persist.

- Monetary policy is not the right instrument as it may lead to substantial deviations of aggregate output and inflation from their desirable levels.
- Macroprudential policy is the most promising tool to tackle financial stability risks. However, it is still quite recent – the underlying "buffers" were not built up before, they were built during the crisis. Additional tools still need to be developed, and more work is still needed to establish a comprehensive macroprudential toolkit beyond banking, which to date is lacking. Last week's announcement by the European Commission calling for a review of the European Systemic Risk Board (ESRB) is a good step in this direction.
- Legacy issues thus need to be tackled also at the micro level, underscoring the need to address the interaction between macro and microprudential policies and guarantee that they are consistent.
- The design of the institutional roles of central banks should hence guarantee the consistency between these different policies, taking into account the existing complementary between them, as well as these policies' interaction with fiscal policy.

(ii) The need to complete the European architecture

- The crisis revealed several gaps in the European architecture which have been addressed to a certain extent during the past decade but still require further decisive work.
- The setting up of the ESM, the Single Rule Book and the two pillars – the supervision and the resolution – of the Banking Union were major achievements. But one should not think that without what is missing still, they can work. They cannot.
- As we stand, the third pillar of the Banking Union, a common deposit insurance scheme, has not yet been implemented, thus leading to severe inconsistencies, as the recent resolution of Banco Popular Español strongly put into evidence.
- One should not underestimate how much was achieved in a short time-span. However, in the rush to solve overarching problems there is always the risk of creating new problems.
- The accountability of recently created European institutions is a good example in this regard where we must ask ourselves if the intrinsic goal of preserving financial stability is being superseded by a strict auto-protective instinct that triggers another interpretation of their mandate.
- The harsh conditions for any State intervention, under precautionary recapitalization, imposed by the BRRD and by state aid rules, accompanied by the supervisory and regulatory requirements for capital and other loss absorption instruments, amidst low profitability, in a context of low interest rates, are conducive to significant transfers of wealth and the destruction of economic value that may seriously jeopardize financial stability.
- Moreover, the ESM's recapitalization instruments are currently limited by the wider EU framework. Direct recapitalization is extremely difficult to be activated and cannot in any case be used on a precautionary basis.
- This is all happening at a time when financial stability is still mostly a national responsibility, despite the much more limited ability for the usage of national tools to safeguard it, in a context where there is a clear misalignment between liability and risk control.
- It is thus essential to guarantee a proper alignment of interests between who is entitled with decisions powers, who bears the liabilities and who is accountable to ensure fair and balanced decisions.

Final remarks and way forward

- Uncertainty calls for a cautious approach but should not be a reason for inaction: the foundations of the European architecture are still not sufficiently robust to withstand the impact of a future crisis and this should be the focus of policy makers. Otherwise, we risk fragmenting the single market and not having a genuine Banking Union.

- Against the background of (i) a significant amount of banks in the euro area with sizable NPL stocks, (ii) MREL shortages in banks with a traditional funding model reliant on depositors and/or elevated stocks of NPLs, (iii) the perceived ‘return’ of the bank-sovereign nexus, and (iv) low levels of banks' profitability, amid fintech challenges, European authorities must seize the opportunity to review the existing regulatory and crisis management framework in a coordinated fashion with a full-information approach instead of each devising their own set of rules.
- A comprehensive re-thinking is required recognizing that the current framework was not set up to address banks with legacy issues and to assess if the existing framework is adequate when legacy issues have been tackled.
- In addition to the necessary holistic approach, encompassing monetary, macro and microprudential policies, we need to move forward with concrete measures to improve the current legal framework, including (i) the setting up of a backstop for the Single Resolution Fund and establishment of the European Deposit Insurance Scheme (EDIS); (ii) the reinterpretation of the ESM treaty to allow the ESM to become a euro area backstop for financial stability purposes, and (iii) the change of the conditions under which the ESM and other stabilization tools can be used.