Jürgen Stark: Financial stability – the role of central banks. A new task? A new strategy? New tools?

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the Frankfurt 12th Euro Finance Week, Session on "Restructuring the Global Financial Architecture – The Road Ahead", Frankfurt am Main, Tuesday, 17 November 2009.

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Introduction

It is a great pleasure for me to participate in the 12th Euro Finance Week conference which brings together such well-known experts in banking and finance.

The subject of my talk, "*Financial stability – The role of central banks. A new task? A new strategy? New tools?*", will not have come as a surprise. But I should perhaps warn you that you should not be surprised either, if my answers to these questions sound rather sober to you.

The severity of the economic crisis demonstrates the need to profoundly improve the functioning of the global financial system. Central banks have an important role to play in making this process a success. Public expectations appear to be running high on how central banks will cope with what has come to be perceived as a whole range of new tasks.

Where do we stand?

Recent economic and financial information is encouraging. The free fall in economic activity has stopped and there is hope that the global recession has bottomed out. The recovery of global trade, the rebuilding of inventories and the positive impact of policy stimulus and liquidity support measures are, at the moment, the main drivers of economic activity. Moreover, money market tensions have eased, government and corporate bond spreads are declining, and stock market volatility has fallen. Yet, even if confidence is slowly returning, uncertainty remains high, and economic activity and employment are likely to remain volatile for a while.

Are these favourable developments in economic and financial conditions genuine improvements, or are they due only to supportive fiscal and monetary policies? Is the economy on a path of sustainable recovery? Finding answers to these questions will demand a very close and ongoing monitoring of all economic and financial market developments over the period ahead.

There are still a number of uncertainties involved, and these uncertainties will not simply resolve themselves over time. The answers largely hinge on the success of the measures taken in response to the crisis, and on the need for their being phased out in a timely manner. The response to the crisis should not sow the seeds for new imbalances. After extended discussions, we are moving closer to phasing out our liquidity measures, as not all of them will be needed to the same extent as in the past.

Meeting the following challenges will be crucial:

- formulating and implementing medium-term-oriented macro policies as a precondition for sustained and more balanced global growth;
- intensifying efforts to undertake structural reforms;
- correctly timing and implementing exit policies so as to ensure fiscal sustainability and maintain price stability; and

- strengthening the financial system and the global financial architecture so as to safeguard financial stability.

How can we ensure financial stability in the future?

The most recent discussions on financial stability have focused on regulation and the role central banks should play therein. Unfortunately, the change of market participants' behaviour is not on top of the agenda.

As the crisis is the result of many failings, let me recall the various lines of defence that should be in place in order to secure financial stability.

The *first line of defence* is that market participants must be liable for their actions. They have to bear in mind the long-term risk that their actions might impose on financial institutions, and on the financial system as a whole. Economic and financial incentives have to be aligned with this simple principle.

As yet, I have, however, not seen any significant change in the behaviour of market participants.

The *second line of defence* rests on the transparency of the financial system, including its institutions, products and markets. It rests on the implementation of coherent international supervisory and regulatory standards. This requires an overhaul of supervision and regulation at both the macro and the micro-prudential level.

The *third line of defence* rests on safeguarding liquidity conditions for markets and solvent institutions.

The *fourth line of defence* involves governments applying clear and harmonised procedures to resolve matters when insolvencies of systemically important financial institutions occur.

How is the global financial architecture changing?

On the institutional side, we are seeing many encouraging developments, both globally and across Europe. In fact, some far-reaching changes in the global financial architecture are unfolding. All main central banks in the world are actively involved.

The Heads of State or Governments have decided that the G20 would now be the premier international forum for international economic cooperation. At the recent summits in Washington, D.C., London and Pittsburgh, five areas were identified for joint action to improve global regulation and oversight, including:

- the strengthening of transparency and accountability;
- the establishment of a sound regulatory framework and, in particular, the enhancement of Basel II;
- the promotion of integrity in financial markets;
- the reinforcement of international cooperation; and
- the reform of international financial institutions, such as the IMF whose tools, funding, governance structure and mandate have all been upgraded.

Initiatives to safeguard financial stability are being coordinated at the global level by the Financial Stability Board (FSB). Central banks like the ECB are actively involved in this dialogue. But there are also important new initiatives in the area of both macro and micro-prudential supervision at the level of the European Union.

Macro-prudential supervision in the EU is to be entrusted to the European Systemic Risk Board (ESRB). The ECB will provide analytical and logistical support to the ESRB. The main task of the ESRB will be to identify, monitor and assess potential risks to financial stability in the EU that arise from the macroeconomic environment, as well as from developments within the financial system itself. If any risk appears to be significant, the ESRB would issue risk warnings and make recommendations. The ESRB will, however, not have regulatory powers, nor will it have any operational tools at its disposal.

At the micro-prudential level, the European System of Financial Supervisors is to be established. It will consist of three European Supervisory Authorities to deal with banking, securities and insurance respectively. It will promote supervisory convergence and coordination at the EU level. The same objective is being pursued through the establishment of groups of supervisors for large international financial corporations.

How will the ECB contribute to safeguarding financial stability?

The best contribution central banks can make to ensure financial stability is to maintain price stability. Price stability is a precondition for financial stability. At the same time, financial stability, by ensuring an orderly functioning of the transmission mechanism of monetary policy, helps a central bank in fostering price stability. Hence, from a longer-term perspective, financial stability and price stability are mutually reinforcing policy objectives.

At shorter horizons, financial stability and price stability may not always go hand in hand. Developments in the run-up to the crisis have shown that low and stable inflation rates may well be consistent with the build-up of financial imbalances which, in turn, can create serious risks to price stability. There are, however, safeguards that a central bank can build into its policy framework.

One of the lessons central bankers can learn from the crisis is that a monetary policy with a pre-specified, fixed-term policy horizon runs the risk of having too short-sighted a perspective of the economy. We have always argued that our monetary policy strategy provides for a safeguard against such short-termism.

We have defined price stability as an objective that is to be maintained over a medium-term horizon. This medium-term orientation is underpinned by our monetary analysis. A key aspect of monetary analysis is the identification of low-frequency trends in inflation, as determined by monetary developments. Financial imbalances that lead to excess credit growth, high leverage, loose credit standards, booming asset prices and an under-pricing of risk create the conditions for abrupt market corrections, which ultimately endanger the maintenance of price stability. Analysing developments in credit, the counterpart to money on monetary financial institutions' balance sheets, is useful in identifying such imbalances.

In situations of excessive money and credit growth, monetary policy needs to be more restrictive than warranted on the basis of short-term inflationary trends. While such a "leaning-against-the-wind" approach would depress short-term inflation, it would be effective in maintaining price stability over the medium to long term. It would attenuate further rises in asset prices and credit growth and thereby forestall subsequent adverse effects on price stability once a correction takes place.

The Governing Council had already agreed in the spring of 2007 – i.e. before the crisis started – to enhance and broaden the monetary analysis along four main avenues:

1. improving and broadening money demand models to detect any possible build-up of financial imbalances;
2. developing money-based indicators of risks to price stability;
3. incorporating money and credit in structural general equilibrium models to signal possible financial vulnerabilities; and
4. further deepening the framework for cross-checking between the economic and monetary analysis (the two pillars of the ECB's monetary policy strategy).

Bearing these considerations in mind, it is rather straightforward to answer the questions posed by the organisers of this conference.

First question: Will we have a new or broadened mandate?

The primary objective of the ECB is the maintenance of price stability. This mandate, which has been given to us in the Treaty, will remain unchanged. The Treaty also clarifies that there is no trade-off between this objective and the support that the ECB can lend to the general objectives of the Community.

The assignment to the ECB of specific tasks concerning the functioning of the ESRB is welcome, but does not constitute an additional objective for monetary policy. Nor does the creation of the ESRB change the clear allocation of responsibilities enshrined in the Treaty. The integrity of the overall macroeconomic analysis conducted within the European System of Central Banks (ESCB) will remain untouched.

The ESRB and its members will be provided with a high degree of independence from political influence. In this regard, the ECB's activities in supporting the ESRB will not affect the ECB's institutional, functional and financial independence. Nor will it affect the ESCB's performance of its tasks under the Treaty and the Statute of the ESCB and of the ECB.

From the perspective of the ECB's monetary policy, the envisaged establishment of the ESRB will have both potential benefits and risks. The fact that the ECB will be able, through its analytical and statistical infrastructure, to contribute to the pursuit of financial stability in the EU is a great opportunity. In turn, the risk analysis of the ESRB can provide the ECB with useful additional information for the fulfilment of the latter's mandate to maintain price stability.

Second question: Do we need a new strategy?

Our strategy has proven to be sufficiently comprehensive and robust. What we have seen in the run-up to the crisis, and also during the crisis, is that the monetary analysis provides a channel through which elements pertaining to financial stability can be taken into account. Our strategy provides us with a framework to ensure that potential imbalances in credit developments are not neglected.

Third question: Do we need new tools?

According to our mandate, our primary objective is to maintain price stability. The tool at our disposal for achieving this is sufficient: setting short-term interest rates. As the ECB's mandate remains unchanged, there is no need for any additional tools.

What we need for macro-prudential assessment instead is a further development of the available analytical framework. Some of the elements we already use to assess threats to price stability are also relevant for the assessment of threats to financial stability. The monetary analysis is a case in point.

The analytical frameworks used for monetary policy and financial stability purposes have, however, thus far reached very different stages of "maturity". Compared with price stability, financial stability has remained a rather elusive concept. In supervision – not least at the cross-border level – the allocation of responsibilities, democratic legitimacy and the appropriate design of incentive structures have remained debatable issues. The framework for macro-prudential analysis still needs to be "mapped out" and tested in full.

Some final remarks

Let me conclude.

Expectations are running high on how central banks will cope with what some anticipate will be a whole range of new responsibilities.

Hence, the questions posed in the title of my talk. As we need to be clear about what we can and what we cannot do, my answers to these questions are rather sober. We do not have a new mandate. We do not need a new strategy. We do not need a new operational tool. Most importantly, our commitment to maintaining price stability remains unchanged, especially in today's challenging environment.

The costs of the crisis are staggering. Our current efforts will affect the future magnitude and duration of its legacy costs. The challenges could not be more demanding. We have to remove incentives for moral hazard and ensure that financial market participants are accountable for their decisions. We must not add new incentives for moral hazard by creating an "emergency fund" for banks, financed or co-financed by taxpayers' money. Now is the time to act; to ensure that financial institutions can never again hold hostage the economic well-being of people who had no part in those institutions' irresponsible business decisions.

Thank you for your attention.