Vítor Constâncio: The governance of financial stability in the euro area

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the "ECB and its Watchers XIII" conference, Frankfurt am Main, 10 June 2011.

*   *   *

Introduction

Ladies and gentlemen,

It is a pleasure to take part in this thirteenth edition of the ECB and its Watchers conference.

I would like to use my intervention today to reflect on how the economic and financial crisis should ***alter policymakers' conception of the governance of financial stability in the euro area.***

Prior to the crisis, financial stability was often viewed in a rather abstract manner, as a condition that flowed from other well-defined pre-conditions – for example, low inflation – or as a concept that could only be addressed after the fact – for example, once bubbles had burst. However, the crisis revealed that financial stability warrants much more prominent attention:

- First, it became clear that financial stability depends on a much broader range of sources than was previously acknowledged, from both macroeconomic imbalances in the real economy and imbalances in the financial sector.
- Second, it was revealed that the channels through which financial instability could spread are various and complex, with negative consequences for both the financial and real sectors, thus requiring *ex ante* and not only *ex post* policy responses.

These two findings militate in favour of a ***more comprehensive policy framework for governing financial stability in Europe, which should comprise in my view the following***.

First, the ***full implementation of the economic governance reform***, which is presently under discussion. It is unquestionable that a sound and credible framework of economic governance is fundamental for financial stability, as, for example, public debt developments have demonstrated.

Second, a ***strengthening of financial supervision in the euro area***. This should be understood as an essential component for the overall effectiveness economic governance alongside the strengthening of the fiscal pillar, the surveillance of macro-economic imbalances, co-ordination of economic policies, and the European Stability Mechanism.

I will organise my remarks today as follows.

I will begin by examining how the crisis unveiled the shortcomings of economic governance in what regards in particular the channels through which financial instability can propagate in the euro area.

I will then propose what should be, in my view, the five key components of financial stability governance, highlighting in particular the necessary ***euro area dimension of such governance***.

Economic governance and financial stability

The crisis provided some important lessons for economic governance in the euro area – lessons that were not fully understood at the inception of EMU.

The ***first lesson*** refers to the ***sources of financial instability*** in the euro area. Euro area economic governance had been constructed primarily to prevent negative spillovers via the public finance unbalances and we learned that this was not enough.

As a response, the economic governance in the euro area is being reformed.

The Stability and Growth Pact is being strengthened to focus more on fiscal sustainability and reducing government debt levels, with a clearly defined debt reduction rule and sanctions. A surveillance procedure for macroeconomic imbalances is being instituted which will include a new "Excessive Imbalances Procedure" and a special focus on the euro area. This is complemented by the European Semester and Euro Plus Pact, which aim to improve *ex ante* policy co-ordination. If crises are still relevant, a permanent mechanism, the ESM, is being put in place to provide bridge funding while countries with liquidity challenges implement a deep adjustment programme, correct imbalances and regain market access. These measures represent an important step forward towards providing a more comprehensive economic governance framework in the EU and the euro area.

But there is also a ***second lesson*** revealed by the crisis, which I would like to highlight. It falls outside what I might call the "conventional" economic governance debate and refers to the ***channels through which financial instability can spread*** in the euro area.

Monetary union was associated with a structural increase in financial integration in the euro area. The resulting interconnectedness, coupled with the balance sheet structure of the financial sector, constitutes a powerful mechanism to propagate economic shocks between sovereigns and the financial sector.

Negative feedback loops are the key transmission mechanism. Rating downgrades of sovereigns often translate into comparable downgrades of their domestic banks, reflecting the diminished ability of the government sector to support domestic banks. At the same time, funding vulnerabilities and impaired capital positions of domestic banks translate into a higher need for government support, putting further pressure on sovereign debt.

Monetary union naturally increases cross-border holdings of sovereign debt as banks move to diversify their sovereign risk. This creates exposure, not only to the risk of their domestic issuer, but to the *average* risk in euro area government debt. One country's fiscal challenges can, by undermining bank balance sheets, potentially become a liability for other euro area sovereigns.[1]

Indeed, this relationship between the sovereign and the financial sector has led some US academics and policymakers to suggest that the sovereign debt problem in Europe is mostly a banking problem, being ultimately a reflection of the insufficient capital buffers of European banks. This view is based on the reasoning that, should banks be better capitalised, they could be partially decoupled from the fiscal condition of the sovereign and thus relieve the drag of the financial sector on the sovereign signature.

Although I would be careful in attributing causality in this way, I concur that increasing the robustness of the financial sector is key to solving sovereign debt concerns. For this reason, the "conventional" economic governance debate can only be half the story. It may prevent negative feedback loops emerging via the public sector, but to prevent also their emergence in the financial sector – as we have seen in the Irish case – a broader remit for governance is needed.

Imbalances in the euro area would not have developed in the same scale if the behaviour of the banking sectors in all countries, in core and peripheral countries, had been better supervised. Some banking sectors distributed too much credit and others provided a

1 Bolton, P., and O. Jeanne, "Sovereign default risk and bank fragility in financially integrated economies", CEPR Discussion Paper No. 8358

significant part of the funding that then dried-out when the crisis came and the credit risk was suddenly reassessed.

All this implies necessarily that effective economic governance needs also to address the financial sector, in order that imbalances, externalities and spillovers are tackled effectively. Conceptually, financial supervision needs to be exercised as much as possible at the European level. It cannot be left, as presently, in the domain of exclusive national competences.

The components of financial stability governance in the euro area

Accordingly, let me now propose what are, in my view, the key components to achieve reinforced governance in the euro area for financial stability.

First: macro-prudential risk monitoring and assessment

The first component is enhancing the capacity of public authorities to ***identify and address systemic risk at the European level***, both from an analytical and an institutional perspective.

Prior to the crisis, the lack of an institutional mechanism to translate the financial stability analysis made by central banks and the ECB into policy actions was a major lacuna. In response, the European Systemic Risk Board (ESRB) has been set up to monitor and assess ***macro-prudential risks***. Given that the new framework began operating in January this year, it is difficult to assess its effectiveness comprehensively.

However, it could be instructive to review *ex ante* the robustness of the analytical toolbox assigned to the ESRB, and consider *ex post* whether such a toolbox would have enhanced policymakers understanding of systemic risk prior to the crisis.

Before doing so, I should make clear that the purpose of the ESRB is not to *predict* crises. The academic literature on early warning signal models, developed over the years, suggests that, for a number of reasons, the scope for error in predicting crises is substantial. Either the eruption of a crisis is missed or a period is wrongly identified by the start of a crisis. For this reason, the ESRB's analytical toolbox is based on early warning models and indicators designed to identify emerging vulnerabilities or imbalances that could lead to financial instability.

These models aim to perform three functions in particular.

First, ***to identify the variables which are associated with financial instability***. To this end, an index of aggregate macro-financial imbalances, or of institution-specific vulnerabilities, is tested against variables such as credit growth, property price changes, private sector leverage and current account deficits, to discover which variables predict that index. Measures of bank leverage, balance sheet growth and maturity mismatches may also be used in order to gauge the extent to which the financial sector is driving developments.

Second, ***to assess the relative importance of different risks for financial stability***. This is done using "adverse scenarios" that are designed and macro stress-tested to establish the potential severity of different types of risk and the overall resilience of the financial system to severe shocks. Such models, including top-down stress test of individual institutions, allow risks to be assessed more broadly and at a higher frequency than is possible with bottom-up exercises run by financial institutions, thus enhancing the "real time" information on systemic risk available to policymakers.

Third, ***to assess the financial channels through which risk can be propagated***, thereby factoring-in potential second-round effects. The use of contagion and spillover models allows, for example, the assessment of the impact on the financial system of the failure of a particular financial institution or of turbulence in a particular sovereign debt market.

We could consider how this framework would have functioned if applied retrospectively. For example, the monitoring of the credit-to-GDP ratio as an early warning indicator of widespread asset-price misalignments ***would have initiated early warning signals as early as mid-2005***. If the ESRB had been operational at this time, a risk warning would have been issued drawing attention to substantial price misalignments in mortgages and equity prices. Corrective measures could then have been recommended to curb credit growth, potentially distinguishing across countries depending of the magnitude of the imbalances. If followed, these policy measures could have deflated the asset price bubble before its dramatic burst in 2007.

This example suggests that the analytical framework employed by the ESRB could significantly strengthen macro-prudential risk assessment. At the same time, whilst its policy recommendations are not legally binding, they should carry weight as they are addressed predominantly to the ESRB's members, who would have to **"*comply-or-explain" in front of their peers***. Additional pressure could derive from the publication of recommendations.

Ultimately, the effectiveness of the ESRB's recommendations will depend on the quality of the analysis behind them. Macro-prudential authorities will face a heavy burden of proof to justify concrete policy changes, and so their analysis must be beyond reproach. For this reason, in order to support the work of the ESRB, the ECB is enhancing its analytical tools with regard to risk surveillance and assessment. We have now operational models and tools to fulfil the three functions previously mentioned and we continue to work hard to improve them.

Looking ahead, the area in which I see a need for particular focus from policymakers is to ***strengthen the link between stress testing of bank capital and recapitalisation***. Steps are currently being taken in this direction via public and private sector solutions, but these remain essentially ad hoc and not part of a well-established framework for maintaining and restoring, when needed, levels of capital commensurate to the needs of the European banking sector.

Second: a European framework for micro-prudential supervision

A more comprehensive European-wide understanding of systemic risks needs to be complemented by an effective ***micro-prudential supervisory framework*** to monitor and prevent these risks. This implies a more consistent set of regulatory and supervisory rules across Member States, together with stronger rules and practices for co-operation between supervisory authorities on cross-border groups, both in normal and crisis situations.

In this context, the ***European Supervisory Authorities*** have been allocated a significant set of competences related to rule-making, enforcement of rules and co-ordination of supervision. All together, through these tools, the ***ESAs are expected to develop a single "EU rulebook" which is enforced consistently throughout the single financial market***. This should address a major weakness in the current framework, namely the divergences across countries in key regulatory elements – for example the different components of regulatory capital used across Member States.

Furthermore, the ESAs have the power to take legally binding decisions addressed to national supervisors or, in case of non-compliance, to specific financial institutions if warranted by financial stability considerations. These powers can be triggered by a breach of EU law by supervisors; disagreement between national supervisory authorities in cross-border situations; and the declaration of an emergency situation by the Council. However, in the latter two cases ***the ESAs' powers are subject to the "fiscal clause"***, which provides that the ESAs' powers cannot impinge on the national fiscal responsibilities.

Third: reinforced financial supervision within the euro area

So far, I have argued for two pillars of financial stability governance, which are widely consensual, that is, macro and micro-prudential supervision with a true European scope. Taking however into account what we are experiencing with the sovereign debt problems and the needed reform of economic governance, I believe that we must take a further step forward and reinforce substantially financial supervision specifically within the euro area.

The tools at the disposal of the EBA and the ESRB, which for most part are of a co-ordinating nature in a decentralised setting, are appropriate for the EU as a whole given the several monetary policy jurisdictions and the less strict framework of economic governance, particularly for the conduct of fiscal policies. However, such tools may fall short of ensuring the necessary degree of supervisory intensity to implement micro and macro-prudential rules in a consistent manner across the euro area with a single monetary policy, single liquidity provision, and single lender of last resort, a perfectly integrated money market, and close interconnectedness among financial institutions, markets and market infrastructures.

Moreover, the effectiveness of the economic governance framework requires, as I mentioned before, a "financial stability pillar". The sources of systemic risk that may originate from the interplay between the financial sector and real economy imply that safeguarding financial stability is essential for ensuring fiscal sustainability and co-ordinating economic policies, and also in the context of any potential financial assistance by the ESM.

Accordingly, it is essential in my view to also enhance the supervisory framework within the euro area. This could be achieved through several institutional steps.

One possibility would be to grant the EBA specific powers for the euro area, including wider possibilities to take mandatory decisions in certain fields addressed to national supervisors and financial institutions. Nevertheless, it is worth remembering that in 12 out of the 17 members of the euro area, the respective Central Banks have full responsibilities in banking supervision. After the crisis, the trend in several countries has been to change the system of banking supervision by giving that responsibility to the respective Central Banks. Regarding macro-prudential policies the Eurosystem (the ECB plus the National Central Banks) was already given a special role in supporting the mission of the European Systemic Risk Board.

All this opens the opportunity to an alternative future development in the direction of giving a more significant role to the Eurosystem in the supervision of banks, in particular of large cross-border banking groups

An enhancement of the role of the Eurosystem would not need to represent a major overhaul of the institutional setting. As mentioned, twelve of the seventeen national central banks of the Eurosystem are prudential supervisors, while the others are also involved in supervision. The Treaty and the Statute of the ECB and the Eurosystem also foresee the activation of a role in prudential supervision. Therefore, it would be an alternative step which would be also fully consistent with the institutional requirements of a financially integrated monetary area.

Fourth: financial crisis management and resolution

A fourth pillar for financial stability governance in the euro area is crisis management and resolution. This is a very challenging process. Public authorities must aim to "square the circle" of preserving financial stability in a highly integrated financial area, while the competent authorities maintain national mandates reflecting their fiduciary responsibility to domestic taxpayers.

Nevertheless, important progress is being made within these constraints. The recent Commission proposal on cross-border crisis management, for example, foresees a mediation role for the EBA in order to facilitate compromise in situations where national interests and assessments diverge.

Whilst these proposals should contribute to effectiveness, in the longer term, I would also favour a more centralised framework for resolution within the euro area, as a necessary counterpart to the enhanced supervisory function for the euro area that I have just advocated. *Ex ante* burden sharing by public authorities appears unworkable as it creates misaligned incentives as well as the risk of moral hazard and free-riding.

However, the ***establishment of an Euro Area Resolution Fund***, funded by *ex ante* ***private sector contributions***, is an avenue that could be considered. Such a fund could both mitigate the systemic impact of bank failures and help to solve the burden sharing problem, which could allow a swift intervention in a crisis. Naturally, clear, stringent and properly communicated conditions for the use of the fund would be a crucial component of the scheme, outlining that any form of bail-out is to be excluded.

On a more fundamental level, moving towards a true euro area regime of supervision and crisis resolution requires a ***stronger concept of the euro area as a legitimate entity*** requiring separate treatment. Prior to the crisis, this concept was underdeveloped. Since the crisis, a stronger focus on the euro area has been evident in, for example, the meetings of the European Council in euro area composition and the agreement of the Euro Plus Pact.

Ultimately, to give the euro area dimension real impetus requires a permanent political centre of gravity. In my view, ***institutionalising the European Council in euro area format*** would go a long way towards creating the specific economic governance concept that the euro area merits.

Fifth: involvement of central banks in financial stability

Finally, a comprehensive discussion on how to ensure financial stability within the economic governance framework should, of course, also look closer to home and to the ***proper involvement of central banks***. One of the most important lessons from the financial crisis is that ensuring price stability is necessary but by no means sufficient for financial stability. The conventional wisdom of central banking that prevailed before the crisis – the Jackson Hole Consensus – had not foreseen that price stability and financial stability could be de-linked, if only occasionally. Consensus had solidified on two axioms.

First, ***stabilising inflation would be a sufficient prescription for overall stability***.

The second axiom was largely a consequence of the first: ***central banks should only pick up the pieces after the bubble had burst***, in those rare cases in which the central bank had failed to check the bubble in the financial exuberance phase, because of inattention for inflation or because of other factors occasionally blurring the connection between the markets, demand and inflation.

The large output losses during the financial crisis have clearly demonstrated that for policymakers to intervene *ex post* is suboptimal. And the financial distress accumulated before the crisis was just too colossal to be attributed to insufficient attention for inflation on the side of central banks. A more plausible explanation is that an exclusive focus on inflation is not enough to define a robust policy strategy. It needs to be reinforced through a perspective of a leaning-against the wind to avoid monetary policy becoming pro-cyclical in relation to boom-bust credit and leverage cycles.

After the crisis occurs, the policy has to be conducted according to the ***separation principle*** that allows a central bank to separate the decision on the appropriate monetary policy stance and the decision on the support of the financial system. We clearly demonstrated this in April when we decided to leave the non-standard measures unchanged, but at the same time decided to increase our key policy interest rates. In the future we will continue to live up to our mandate. We will do whatever is necessary to deliver price stability in the medium term, using our policy interest rates, and continue to contribute to the stability of the financial system, using our non-standard measures.

Conclusions

To sum up, significant progress is being made in Europe to produce a more comprehensive and encompassing concept of economic governance.

Looking forward, I believe however that it is crucial that the ***euro area dimension of economic governance is further reinforced*** in order to be commensurate with the wide range of sources and channels of financial instability, which has been made evident by the financial crisis.

This reinforcement should involve two main institutional moves:

- Closing the gap between the economic and financial aspects of euro area governance by fully integrating financial supervision within the concept of economic governance; and, consequently
- Significantly strengthening the arrangements for financial supervision within the euro area, which could be supported by the establishment of a pan-euro area resolution fund.

De facto, we are already seeing some progress in the integration of financial stability within economic governance through the European Financial Stability Facility and the future setting-up of the European Stability Mechanism. The use of these facilities to provide loans for banking sector recapitalisation reflects the recognition that crisis management for sovereigns and for financial institutions is increasingly intertwined.

Perhaps over time this will provide the foundation for a more integrated European system of crisis prevention and management for the public and financial sectors. Ultimately, it is every euro area country’s interest that the collective governance arrangements reflects the reality of economic and financial integration. Following this path of necessary gradual reforms is essential for the efficiency and welfare of the whole euro area.