Jörg Asmussen: Stability guardians and crisis managers – central banking in times of crisis and beyond

Distinguished lecture by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the House of Finance, Goethe University, Frankfurt am Main, 11 September 2012.

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Ladies and Gentlemen,

It is a great pleasure to be here today at the Institute for Monetary and Financial Stability and I would like to thank Prof. Siekmann and Prof. Wieland for their invitation. I know that the Institute was founded in November 2007, only three months after the outbreak of what would become the worst financial and economic crisis of the post-war period. Truly timely, I would say. The Institute's objective to highlight the significance of monetary ***and*** financial stability impressively reflects the practise and the challenges of monetary policy over the last five years.

Let me in today's remarks take the opportunity to reflect on the double role of central banks as stability guardians and crisis managers. Had I been here before August 2007, this title would have mainly implied discussing the central banks' role as guardian of price stability. But there cannot be stability without adequately managing the crisis.

So, why have central banks assumed such an important role in crisis management? Well, responding to the sudden financial tensions, central banks crisis measures have contributed to calming and avoiding highly detrimental feedback loops between financial markets and the real economy. These measures needed to be implemented rapidly and central banks were in an advantageous position for acting swiftly due to their vicinity to financial markets, their operational framework and their clear and independent decision structure. But these measures ultimately have their limits in terms of effect and legitimacy. The risk of undermining the primary mandate of central banks needs to be taken into account. Yet, I will argue that indeed crisis management and, hence, the preservation of financial stability is an integral part of our role as central bank, serving ultimately to fulfil our mandate. The Treaty commits the ESCB *primarily* to maintain price stability in Article 127/1 and confers the task on the ESCB to contribute to the stability of the financial system in Article 127/5. Our mandate is clear, it is comprehensive, it is adequate and it should not be questioned.

Clearly, central banks should not be overburdened. In the ECB's case, short-term stabilisation measures were important and necessary. However, structural problems require a structural response. These deficits need to be addressed by reinforcing the available policy instruments ***outside*** the purview of the central bank. The work for the report by the four presidents of the European Council, the Commission, the Eurogroup and the ECB, which will be submitted to the Heads of State and Government at the end of this year, is an important step to address the economic misalignments and institutional shortcomings in the euro area.

Still, we have to reflect on the future role of central banks, both as stability guardians and crisis managers. This crisis has somewhat shaken up our pre-crisis understanding of the role central banks have for both monetary policy ***and*** financial stability. Central banks will not be able to just switch back to the status quo ante of before August 2007. I will therefore first take a step back and briefly review the pre-crisis consensus on the role of central banks. I will then discuss the ECB's role as crisis manager and guarantor for stability in the current crisis, before reflecting, in the final part, on the future role of the ECB for both monetary and financial stability.

The pre-crisis consensus

Before reflecting on where we have to go, let me start by reviewing where we stood ahead of the crisis regarding the role of central banks.

By the 1980s, the global economy had experienced two oil price shocks and found itself in a stagflationary environment. The academic literature and policy watchers concluded that monetary policy could not contemporaneously control both, inflation and the level of unemployment. In this environment a consensus on the role of central banks emerged with two key elements.[1]

The first element: central banks should focus on maintaining price stability. As you know, for the European Central Bank price stability over the medium term is the primary objective. Other central banks – though with differing emphasis in their mandate – clearly follow the same understanding. Only recently, the Fed and the Bank of Japan have announced a numerical inflation goal.

The second element: central banks should be independent on legal and operational grounds. Indeed, the independence of central banks is enshrined into primary law in a number of advanced and emerging countries and has been key for a stability oriented monetary policy.

For crisis management, the so-called Jackson Hole consensus[2] of the 1990s and early 2000s foresaw only a limited role for central banks. Following the logic of the consensus, monetary policy should react to financial imbalances only to the extent that they affect the inflation forecast. Yet, as asset price build-ups are often accompanied by relatively contained inflation rates,[3] “ex-ante” monetary policy reactions were considered difficult. Effectively the consensus implied that central banks would only intervene “ex-post” to counter potential deflationary risks and risks to financial stability. The dot-com bubble of the beginning of the century was an illustration of such strategy.

The ECB with a special emphasis on monetary developments

The ECB’s standpoint differed from the Jackson Hole consensus. We have always emphasised that focusing on money and credit developments provides for a medium- to long-term perspective. It was believed that the monetary pillar would release warning signals and hedging against the building up of financial imbalances.[4] Indeed, as of 2005, on the basis of its monetary pillar, the ECB has repeatedly warned on the observed strong credit growth and the accompanied under-pricing of risk.[5]

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1 An additional element has been exchange rate targeting which was based on an external anchor. Effectively, this represents an intermediate objective if domestic credibility of the central bank may be weak.

2 See Greenspan (2002), Blinder (2005), Mishkin (2007) and Bean, Paustian, Penalver, and Taylor (2010), “Monetary Policy after the Fall”, Federal Reserve Bank of Kansas City Annual Conference, Jackson Hole, Wyoming, August.

3 See the discussion in Christiano, Ilut, Motto, and Rostagno (2010) on “Monetary policy and Stock Market Booms.”

4 See “A Monetary Policy Strategy in Good and Bad Times: Lessons from the Recent Past” Fahr, Motto, Rostagno, Smets and Tristani, ECB Working Paper Series No. 1336, May 2011.

5 See the evidence in Fischer, Lenza, Pill and Reichlin (2008): “Money and monetary policy – the ECB experience 1999–2006” and Trichet (2008): “Risk and the Macro-economy”, Keynote address at the conference “The ECB and its watchers X”.

Nonetheless, I think it is fair to say that nobody – including central bankers – has expected a crisis of the dimension that we have been experiencing since five years.[6] The overall favourable macroeconomic constellation from the Great Moderation, with low volatility and robust growth, has certainly induced some benign neglect – also on the policy side.

While the main ingredients for successful central banking – clear mandate and independence – have proven highly effective for central banks to become guardians of price stability, they were not sufficient to ensure the more general stability of our economic systems. I would therefore like to turn to the ECB's policy reaction, its challenges and limits to stabilise the euro area.

The ECB's policy during the crisis

The financial crisis erupted in summer 2007, was magnified by the collapse of Lehman Brothers in September 2008 and eventually precipitated the global economy into recession. It was characterized by a drying up of liquidity in the interbank market, plunging asset and security prices as well as a sharp increase in risk premia for banks' unsecured lending. Extreme risk aversion and contagion across numerous markets were the consequences, revealing a substantial fragility of the financial system and also shattering confidence in the self-correcting mechanisms of financial markets.

At the beginning of 2010, the interaction of adverse conditions in financial institutions and their sovereigns brought the crisis in the euro area to new levels. The financial crisis first weakened banks' balance sheets, reduced their lending capability and led to an economic slump. In turn, the fiscal support to the economy substantially worsened public finances.[7] The mutual weakening of private and public finances ultimately undermined the possibilities for a fast healing of the financial system. Also, insufficient financial sector policy reaction on the side of governments exacerbated the detrimental dynamics and represented itself as a source of risk and uncertainty during the crisis, ultimately fostering dynamics of self-fulfilling prophecies.

The ECB's non-standard measures

In this environment the ECB took bold and decisive action. The disruptions in banks' short-term funding led to a strong tightening of credit standards to both businesses and households. This threatened to undermine bank lending to the real economy with risks of a severe credit crunch. In turn, the transmission of monetary policy became seriously impaired. And, central banks were less effective in steering term money market rates via the setting of their policy rates. Ultimately, the interest rate set by the central bank did no longer reach the real economy across the euro area in the same way.

The size of the shocks and the extent of global and intra euro area adjustments required exploiting the ECB's full toolkit to implement a wide range of non-standard measures. Here, we always had to keep in mind the importance of the banking system for the financing of the economy. In the euro area, two-thirds of external financing – and even a larger share for small- and medium-sized enterprises – originates from banks. Our measures included the provision of unlimited funding support to banks at maturities up to three years, the extension

[6] The Japanese experience since the 1990s was widely seen as an exception. Although it helped understanding the potential risks and developments during the crisis, it did not serve to identify the imminence and the depth of the global financial crisis.

[7] In Greece it were public finances that placed a burden on the domestic banks. In a later stage, due to the deteriorating valuations of Greek sovereign bonds, financing of the government become more difficult due to impaired bank balance sheets.

of the list of eligible collateral, and outright purchases of covered bonds and debt securities through the Securities Markets Programme.

The two long-term refinancing operations (LTROs) with a maturity of three years implemented in December 2011 and February 2012 allowed banks to satisfy their additional liquidity needs. They relaxed banks' funding constraints and – owing to their long maturity – addressed impairments in the monetary policy transmission mechanism to longer rates. Beyond the direct effect of averting a major credit crunch, the full effects of the three-year operations will unfold over time and may be gauged only as time proceeds due to the usual lags in monetary policy.

The Securities Markets Programme was initiated back in May 2010 and offered necessary support to the monetary transmission but did not address the incentives for governments to engage in the necessary reforms and to rebalance their public finances. While the SMP counts for a significant share of the ECB's balance sheet, it did not stabilise the situation in a sustainable way. In addition, the SMP had unintended side effects such as a perceived preferred creditor status of the ECB vis-à-vis other creditors. The Governing Council therefore decided last Thursday to terminate the SMP.

Nevertheless, the current situation in sovereign bond markets continues to be characterised by

a) heightened aversion of non-resident investors to hold sovereign bonds of some euro area countries,

b) extreme illiquidity and yield volatility in these bond markets and

c) widespread concerns over redenomination risks.

This all reflects a general fragmentation in financial markets; but excessively high and volatile risk premia hinder the effective working of monetary policy. In this environment, monetary policy signals do not reach all parts of the euro area in the same way.

In light of these continued severe malfunctionings and to counter the risks of redenomination, last Thursday the Governing Council established Outright Monetary Transactions – or OMT – as an additional monetary policy tool.

The OMT is introduced to contribute in safeguarding the monetary policy transmission mechanism to the entire euro area to ensure the singleness of monetary policy.

The OMT is in no way a substitute for continued efforts in structural reforms and fiscal consolidation on the side of governments. They are essential steps to regain trust and to ensure the sustainability of the euro area in the long-run. This is also the reason why strict and effective conditionality and adherence to an appropriate EFSF or – later hopefully – ESM programme is a necessary condition to activate the OMT purchases. For the ECB, conditionality is key in order to ensure long-term sustainability of the fiscal, structural and macroeconomic adjustment path and to minimize concerns of moral hazard.

Let me elaborate on the main elements of the Outright Monetary Transactions programme.

- The programme has been designed to ensure full compatibility with European law, and in particular with the prohibition of monetary financing. The Programme will operate exclusively on the secondary bond markets and the ECB's primary mandate to ensure price stability over the medium-term remains entirely untouched. To ensure transparency, the aggregate OMT holdings and their market values will be published on a weekly basis and the average maturity together with the country breakdown of OMT holdings will be published on a monthly basis. On a personal note I would like to add that I am convinced that central banks more generally should further increase transparency of their actions and decisions as a means to enhance credibility and confidence.

- In order to be effective, the Programme will only operate if a country first adheres to the strict and effective conditionality of an EFSF or ESM macroeconomic adjustment or a precautionary programme and provided that they include the possibility of EFSF/ESM primary market purchases. The ECB *may* subsequently intervene in bond markets. I say *may*, because monetary policy remains fully independent and the Governing Council decides independently when to activate the OMT, entirely on the basis of monetary policy considerations.
- To avoid possible issues related to a preferred creditor status, securities bought under the OMT will accept the same treatment (pari pasu) as purchases by private or other creditors, in accordance with the terms of such bonds. This ensures that any interventions via the OMT do not impinge on the status of private investors. The aim of the programme is to accompany countries and their sovereign to regain stable access to capital markets.
- The programme focuses mainly on the shorter end of the yield curve and in particular on sovereign bonds with a maturity between one and three years. Steering short-term market rates falls squarely into the realm of monetary policy. The interventions address disorderly market conditions and are aimed at reducing excessive market volatility.
- The Governing Council will monitor the conditions for interventions based on a large set of indicators and will assess their effectiveness to decide on the continuation of interventions.

I am convinced that the new elements in sum make the OMT a much better programme than the SMP previously was. This new programme is a clear example of how far the ECB fulfils contemporaneously the role as a stability guardian and as crisis manager. By guarding the stability of the euro in the entire euro area and countering redenomination risks, the ECB plays a central role in managing expectations in the crisis.

A question remains: What will be the role of central banks after the crisis?

The role of central banks after the crisis

From a central bank's perspective three lessons can be drawn that appear to be crucial for its future role in crisis prevention and resolution.

First, in a financially integrated market like the euro area, contagion risks are large with financial instability rapidly spreading to other market segments.

Second, the sudden materialisation of financial instabilities can lead to strong recessionary forces that carry downside risks for medium-term price stability. This has taught policy makers that "cleaning" rather than "leaning" against financial imbalances can simply become a very costly strategy.

And third, a stable macroeconomic environment with stable prices – though being a necessary condition – is not a sufficient one for the preservation of financial stability. Neither the implemented "ex-ante" policy measures by national authorities nor those by central banks were enough to deal with the build-up of risks and imbalances that led to the current crisis.

So, what does this imply for the future role of central banks as stability guardians and their role as crisis managers?

The future role of central banks: financial stability and supervision

The importance of financial stability for central banks has been acknowledged in the European Treaty. Article 127/5 reads: "The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".

The ECB has already taken over some tasks in European macro-prudential supervision which was established with the European Systemic Risk Board (ESRB) in January 2011. The ECB is an integral part of the ESRB, providing analytical, statistical and administrative support. This is a clear recognition of the important role that central banks have gained over time in monitoring financial stability and the acquired stock of financial market expertise. In principle, the active use of macro-prudential policy could provide a new array of “ex-ante” policy instruments which can lean against financial imbalances and asset bubbles. As it may require time to unfold its strength and it is yet too early for a thorough assessment, the impact of the ESRB, as far as I perceive it, seems rather limited so far.

The recent events in the crisis have revealed vulnerabilities in the monetary union, reflecting an incomplete financial architecture. Two prominent examples are the sudden and large reversals of financing flows and the degree by which banks and their own sovereign have become intertwined. Effectively, these developments endanger the financial stability in the euro area as a whole. Neither the financial resources of some member states nor the institutional framework proved adequate to solve the problems on the level of the member states. Therefore we are invited to rethink elements of the financial architecture at the European level, including the tasks of the central bank.

In my view, a future European financial architecture should include a fully-fledged financial market union which rests on three pillars.

- First, a European banking supervisory authority with sufficient instruments and competencies to implement on a level playing field the regulatory framework in the euro area. This authority should in particular have the competence to order the closure and the resolution of non-viable institutions. The resolution of non-viable banks should no longer be a rare exception in Europe. Here we can learn a lesson from the US where 464 banks were closed since 2008.[8]
- Second, a resolution authority and a coherent regulatory framework for the resolution of systemically important banks. The costs of a resolution shall ultimately be borne by a fund. This fund needs to be financed by the financial sector itself to unwind systemically relevant financial institutions without relying on public finances and ultimately taxpayers’ money.
- Third, deposit insurance should be organised or at least further harmonised at the European level.

While it is clear that moving towards a financial market union cannot be achieved overnight, it is important to stress that we need all of the just mentioned three elements. The banking supervision can only work efficiently if it has access to the relevant information, for example on the deposits. It can only act effectively if it has the adequate instruments in its toolbox, such as the closure of a non-viable bank.

As you all know, Commissioner Barnier will present the Commission’s proposal for a banking supervision in Europe tomorrow and it is no secret anymore that the ECB will be tasked with an important role.

The ECB and the national central banks have made it clear that they stand ready to take over responsibilities in banking supervision. However, we have made it also very clear that certain conditions have to be fulfilled:

- Firstly, any new task in banking supervision may not prejudice price stability as our primary objective. Monetary policy and banking supervision have to be kept separate. This calls for separate decision making bodies and Chinese Walls within the institution. 14 out of 17 national central banks in the euro area engage in

[8] http://www.fdic.gov/bank/individual/failed/banklist.html

banking supervisory today already without any negative impact on their monetary policy mandate.

- Secondly, the ECB's independence may not be impaired by the new task. Monetary policy by definition is independent. Banking supervision by its very nature is not. It must be subject to parliamentary and judicial control. We're open to this request to show accountability to the European parliament and the council of ministers.
- Thirdly, the ECB must be equipped with all instruments it needs to perform banking supervision effectively and efficiently. The ECB will only engage in banking supervision if it gets a comprehensive tool box, because the reputational risk lies only with one institution, it lies with the ECB.

These and many more questions need to be addressed in the months to come. Let me only mention the most obvious:

- A European banking supervisor only for the euro area or for the EU 27? A well-functioning financial market union is primarily in the interest of the monetary union. Nevertheless, non-euro area member states should be welcomed to put their institutions under the control of the European banking supervisor.
- A European banking supervisor for all banks or for the systemically important banks only? From my personal perspective, the European banking supervisor should only be entrusted with the supervision of the systemically important institutions on European or domestic level, at least at the beginning. Anything more is neither feasible nor desirable at the beginning of 2013.
- What shall be the division of labour between the ECB and the European Banking Authority (EBA)? From my perspective, EBA could be tasked with any future work on the Single Rulebook in the single market, ie for the EU 27.
- And finally, what shall be the division of labour between the ECB and the national supervisory authorities? It will be key to strike the right balance between relying on local know-how and expertise while safeguarding a single standard of supervision and a level playing field.

The implementation of a European banking supervision is closely linked to the possibility of direct banking recapitalisation via the ESM in the future and should not least therefore be advanced without undue delay. However, the task is complex and banking supervision in itself is too important to present solutions under time pressure that will not work in practice. We should therefore take the time it takes to get it right.

Financial stability and monetary policy

Having reviewed the additional tasks that central banks are asked to take over, a question regards the implications for the practice of monetary policy. I will hence explain in the following how the two responsibilities will complement each other. The crisis has clearly demonstrated how essential financial stability is for the effective conduct of monetary policy. Financial market developments have always been an integral part of our monetary policy considerations and have influenced the design of our non-standard measures. Nonetheless, in my view and looking forward, monetary analysis and financial market analysis should play an even greater role for the conduct of monetary policy – particularly with regard to financial imbalances and financial fragilities. Here I would see three main areas in which further work is needed to incorporate the lessons from the crisis.

First, we are faced with the fact that the smooth functioning of the financial sector is key for macroeconomic outcomes and monetary policy transmission. We saw that adverse financial conditions can have strong and impairing effects on the effectiveness of monetary policy. Academia and central banks have already taken up this research agenda and macroeconomic models and monetary policy assessments are refined in that regard. For instance, the work by Cúrdia and Woodford (2010) has provided an important advancement by introducing central bank balance sheet considerations into the New-Keynesian framework. Corsetti *et al.* (2012) complemented this with interlinkages between the sovereign and the real economy. Moreover, many new modelling approaches now account for liquidity and credit constraints in macroeconomic models.[9] Still, the links and the channels between the financial sector, the real economy and their ultimate impact on output and inflation still leaves many questions open. This is for central bankers and academics to work on in the years to come.

Second, as you know, our two-pillar monetary policy strategy foresees that we take into account monetary and credit developments – particularly to ensure a medium- to long-run orientation. Over time monetary analysis at the ECB has been continuously refined and deepened. In the crisis it was crucial to better gauge short-term risks from financial flows and imbalances. And also in the future, its scope and methodology needs to be kept continuously updated.

In particular, the analysis should encompass not only a detailed understanding of banks' behaviour, but also developments in the shadow banking sector as provider of private sector liquidity.[10] In order to conduct these types of analyses detailed data on financial intermediaries and their transactions is crucial.

And third, a flexible framework to implement monetary policy has allowed us to react swiftly to the instabilities during the crisis. In fact, most of our non-standard measures have focused on providing adequate liquidity to financial institutions and did not require changes to our operational framework. The adjustments were merely on the parameters of the existing framework.

Yet, the provision of liquidity by central banks needs to be linked to a clear assessment of solvency of the counterparties. Only by being able to distinguish solvent from insolvent financial institutions can central banks continue to fulfil their mandate of being lenders of last resort to the financial system. Detailed information on the health of financial institutions and the capacity of the central bank to resolve insolvent banks would ensure that liquidity provision is kept to the circle of solvent banks.

Conclusion

Let me conclude.

During the financial crisis central banks assumed an active role as crisis managers. The ensuing episodes from the subprime crisis with the collapse of Lehman Brothers to the debt crisis has left the ECB as one of the few actors in guaranteeing stability over the past five years. One may argue that central banks are in an extremely difficult position, that they may suffer from the outcome of the recent crisis and that "paradise is lost".[11] If paradise is lost, it may however be the right time to take on a new and a pro-active role in "the real world" or in the "new normal". We will not turn the clock backwards.

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[9] The contribution by Kyotaki and Moore on credit cycles in 1997 served only recently to numerous macroeconomic extensions. Gertler and Kiyotaki (2009), Gertler and Karadi (2011), Queralto, Gertler and Karadi (2012) are recent examples of this work stream with empirical applications as in del Negro, Eggertsson, Ferrero, and Kiyotaki (2010).

[10] A thorough understanding of the generation and provision of liquidity by the private sector's own means is still at the stage of infancy. First promising conceptual frameworks appear to emerge. Important work has been made by Adrian and Shin (2010) on "Financial intermediaries and monetary economics" and a promising example of theories for liquidity is "The I Theory of Money" by Brunnermeier and Sannikov (2011).

[11] O. Issing, Central Banks – Paradise Lost, CFS Working paper No. 2012/06.

The new normal requires a new communication policy of central banks (in the past it was not always clear that central banking and communication should be mentioned in the same sentence). The crisis was a game-changer in the communication of central banks: We now are faced with the potentially explosive interplay between markets and politics, we have to actively communicate with a broader public, we have to face up to the public and market discourse. We must argue with counterfactuals and navigate the short-term versus the long-term. To sum our new communication strategy up: We have to listen, explain and convince.

Given the complexities of today's financial markets, a deeper and more detailed financial market analysis is an important contribution to the conduct of monetary policy in the pursuit of maintaining price stability. This requires to further expand the monetary pillar to include a thorough analysis of the financial sector as a whole. In particular, monetary analysis should encompass not only an understanding of banks' behaviour, but also detailed developments in the shadow banking sector as provider of private sector liquidity.

The crisis has exposed the shortcomings of the European governance framework, reflecting an incomplete architecture of the monetary union, both in terms of crisis prevention and crisis resolution. The institutional setup – enshrined in the Treaty – allocated the mandate for price stability to the ECB. Instead, the responsibility for financial stability is not uniquely allocated. While the ECB has crisis management tools at hand, financial stability was originally envisaged as a national task. But the crisis has shown that it has a clear euro area dimension.

The ECB will gain in importance for financial stability in the context of the current institutional overhaul of the euro area. This process needs to be democratically legitimised and the ECB needs to receive the full set of instruments and authority to fulfil its new responsibilities in independence and without risks to its reputation.

Today, we are called to work on a longer-term vision for Europe, to rectify the recognised shortcomings and to implement a fully functioning Economic and Monetary Union. I am convinced that we will succeed to ensure that EMU can provide the stability and prosperity to the citizens of Europe for which it was created.

Thank you.