Vítor Constâncio: Opening remarks at the second conference of the ESCB Macroprudential Research (MaRs) Network

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the second conference of the ESCB Macroprudential Research (MaRs) Network, Frankfurt am Main, 30 October 2012.

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Ladies and gentlemen,

It is a pleasure to be here today and open the second conference of the Macroprudential Research Network (MaRs). I am particularly happy to see that our conference has attracted such a large and diverse group of speakers and participants, combining intellectual brilliance with practical experience. All the relevant institutions and sectors having an interest in, and a contribution to make to, the macro-prudential field are represented in this room.

“Setting the scene” today, let me start my remarks by recalling what MaRs is about and illustrating a few key directions in the endeavour.

1. The origin and purpose of the ESCB Macroprudential Research Network (MaRs)

As you know, MaRs is a research initiative involving central banks from the whole European Union, i.e. from the European System of Central Banks. It was established by the ESCB in the spring of 2010, upon the proposal of our Heads of Research.[1]

Against the background of the crisis, which started in the summer of 2007 and reached systemic dimensions in September 2008, a stimulus was required to push forward our research on systemic risk and on analytical tools supporting macro-prudential oversight. So, we set up MaRs with the objective of “developing core conceptual frameworks, models and/or tools that would provide research support in order to improve macro-prudential supervision in the EU”.

This is not to say that central banks did not have any systemic risk and macro-prudential research before the crisis. Quite the contrary is true: it is the very tradition of central banks to take a systemic perspective, in particular in financial stability matters. Most central banks already had their own Financial Stability Reviews for which many analytical tools were developed.

MaRs, however, puts our systemic risk work on a much broader basis than was previously the case. As you know, central banks treasure the strong scientific foundations of their policies very much. In my view, our interaction with the academic community, based not only on substantial state-of-the-art in-house research, but also on continuous “peer review” of central bank policies through external research is a major asset.

2. Some main orientations and selected first messages of MaRs

Let me now illustrate MaRs’ three main orientations. The network has three work streams:

1. macro-financial models linking financial stability and the performance of the economy;
2. early warning systems and systemic risk indicators; and

[1] A brief overview of the network can be found on the ECB’s website here at: http://www.ecb.int/home/html/researcher_mars.en.html.

3. assessing contagion risks.

As regards the first work stream, MaRs identifies the lack of widely accepted theoretical and empirical frameworks that thoroughly integrate realistic characterisations of widespread financial instability in aggregate models as one of the main weaknesses of contemporaneous economics laid bare by the crisis. It is true that there were already some effects that had been included in macro models, basically related to the Financial Accelerator developed by Bernanke and Gertler. This is, however, only a mechanism that would aggravate a crisis, but was not strong enough to trigger one. Recently, Adrian, Colla and Shin examined which frictions should, at a minimum, be included to be relevant.[2] They concluded from the evidence of the crisis that five stylized facts should be reflected in macro-financial models: coexistence of bank and bond finance, substitution from bank to bond financing, increasing credit spreads, stickiness of equity prices and procyclicality of bank leverage.

Other researchers point to some different factors. We need the academic community and policy authorities engaged in research to improve this situation. Only when we have detailed and well-tested models and frameworks with this feature will we be on safe ground to base macro-prudential regulatory policies to contain systemic risk on the scientific foundations that we aspire for. The benefit from a policy perspective is that with such an approach, one can compare the benefits and the costs of new or scrapped and tightened or loosened regulation.

The network has developed several theoretical and empirical tools that integrate widespread financial instability into models of the aggregate economy. These develop the transmission channels between financial instability and the overall economy in detail, and assess the performance of alternative policies to address systemic risk. The network is also engaged in a joint cross-country project involving ten euro area central banks to develop a quantitative model for assessing alternative macro-prudential regulatory policies.

A second main orientation of MaRs has been to develop early warning systems and systemic risk indicators further. Many of the tools it developed are already used in ESCB members' policy work. For example, the Composite Indicator of Systemic Stress (short CISS),[3] which was developed here at the ECB, has been used in our Financial Stability Review and has now been included in the new Risk Dashboard that the ESRB released after its last meeting in September.[4]

Research in this direction has also led to the creation of a homogeneous database of various types of crisis in EU countries. This database, which was established by researchers from the Czech National Bank with the input of all ESCB members, has just been made available to interested researchers on the ECB's website.[5]

A last major orientation of MaRs is the assessment of contagion risks. This concerns particularly the cross-border connectedness of banks and associated contagion risks in Europe, notably via dysfunctional money markets. In view of the experiences of the last few years in Europe, sovereign contagion effects received considerable attention. A whole "battery" of models and analytical tools for measuring and assessing sovereign contagion was developed. Several of these models are regularly run here in the ECB as part of our surveillance of contagion risks.

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[2] Tobias Adrian, Paolo Colla and H. Song Shin (2012), "Which financial frictions? Parsing the evidence from the Financial Crisis of 2007–2009", Federal Reserve of New York Staff Reports.

[3] See D. Hollo, M. Kremer and M. Lo Duca (2011), CISS – A composite indicator of systemic stress in the financial system, ECB Working Paper, no. 1426, March.

[4] European Systemic Risk Board (2012), ESRB risk dashboard, issue No 1, 20 September (http://www.esrb.europa.eu/pub/pdf/dashboard/120920_ESRB_risk_dashboard.pdf?).

[5] The link to the database is http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1485-annexes.zip.

The assessment of contagion risk is one field where borrowing from disciplines other than economics can be useful. A number of promising efforts use the theory of complex networks to model interbank exposures, showing how asset fire sales can amplify interbank contagion. For our Financial Stability Review and in our work for the ESRB, We are already using one of this models to assess the second-round impact of banks' cross-exposures to complement the top-down stress tests that we regularly conduct on a sample of 90 EU banks.

3. A few policy developments on the use of macro-prudential regulatory instruments in Europe

In parallel with the research efforts undertaken to develop the scientific foundations for macro-prudential instruments further, there is important policy work going on in Europe regarding these instruments. The European Systemic Risk Board (ESRB), under the aegis of its Advisory Technical Committee, has established an Instruments Working Group that is looking into a range of issues relating to those policy instruments.[6] This includes, for example, an ongoing effort to define a "core set" of instruments that should be available for macro-prudential policies throughout the EU.

A dedicated work stream under the Instruments Working Group will also work on ESRB guidance for the use of the counter-cyclical capital buffer as contained in the EU's proposal for a capital requirements directive and regulation (CRD IV/CRR), planned to come into force in the EU in 2013.[7]

The group has worked on guiding principles for the macro-prudential mandate of national authorities. This resulted in an ESRB recommendation that was published in December 2011. It requires Member States to ensure that their macro-prudential authorities have control over appropriate instruments for achieving their objectives.[8]

Given the panel discussion tomorrow, I will not dwell much on the progress with Europe's banking union. Let me just recall that the Commission's proposal for the Single Supervisory Mechanism – apart from the obvious micro-prudential aspects – directly affects macro-prudential policy and its implementation. It suggest that the ECB would have the exclusive competence within the euro area "to set counter-cyclical buffer rates and any other measures aimed at addressing systemic or macro-prudential risks in the cases specifically set out in Union acts".[9] A priori, the combination of aspects of micro-prudential, say for large and complex banks, and macro-prudential instruments in a common hand can be a good thing. Most of the macro-prudential instruments discussed so far are very similar or identical to micro-prudential instruments. Simply put, they are used with a different, broader, objective to contain systemic risk. By putting both sets of instruments in the same hands, conflicts in their use could probably be avoided.

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6 See ESRB (2012), Annual report 2011, May 2012.

7 Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, COM(2011) 453 final, Brussels, 20 July 2011, and Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms, COM(2011) 452 final, Brussels, 20 July 2011.

8 Recommendation of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3).

9 Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, COM(2012) 511 final, Brussels, 12 September 2012.

4. Concluding remarks

Let me to conclude by quoting Oscar Wilde: "You know more than you think you know, just as you know less than you want to know". ESCB Governors are very pleased with the MaRs report and how much progress the network has made. The interaction with "the rest of the world" today and tomorrow should fertilise the work further. I wish you many fruitful discussions in this regard.

Thank you for your attention.