Erkki Liikanen: Banking structure and monetary policy – what have we learned in the last 20 years?

Presentation by Mr Erkki Liikanen, Governor of the Bank of Finland and Chairman of the Highlevel Expert Group on the structure of the EU banking sector, at the conference “Twenty years of transition – experiences and challenges”, arranged by the National Bank of Slovakia, Bratislava, 3 May 2013.

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How is today’s perspective on monetary policy different from what prevailed 20 years ago?

Twenty years ago, the world of today was being formed in many ways.

1993 was the year when the Economic and Monetary Union project was becoming political reality: the Maastricht treaty had been signed and was in the process of being ratified.

It was also the time when the mainstream approach to monetary policy was beginning to converge to the flexible inflation targeting framework. A number of countries had then just adopted an explicit inflation targeting strategy.

In the sphere of banking regulation, too, a new era was beginning. A significant reorientation was going on, away from regulating the conduct of banks and towards the new risk-based approach. The regulatory trend, based on increased freedom for banks but subject to risk-based capital requirements, would continue all the way to the eruption of the financial crisis in 2008.

In the EU, the second banking directive took effect from the beginning of 1993, creating a single market in banking. The directive sought to prevent discrimination and to increase efficiency through competition. There was discussion on the implications of this for supervision, but little action. So, while European banking markets were being integrated, financial supervision remained a national competence.

In the U.S., deregulation was also moving forward. For instance the Glass-Steagall Act, separating banking from securities and insurance, was under growing criticism and would be ultimately repealed in 1995. One reason for the dissatisfaction with the Glass-Steagall system in the US was competition from European banks which were less restricted in what they could do.

Twenty years ago, the striking improvement in macroeconomic performance, later named “the great moderation” by chairman Bernanke, was spreading to the whole developed world. The almost surprising success of monetary policy in improving price stability and reducing fluctuations in economic activity, while also keeping interest rates at historically low levels, was interpreted as a major victory for the art of economic policy making.

Now we know that there was trouble brewing under the surface. The underpinnings of global financial stability were becoming weaker. Global indebtedness increased, fuelled by current account balances and the “deepening” of international financial markets (read: recycling the same funds several times over).

The decline of inflation was not only due to monetary policy, but also the avalanche of cheap consumer goods from the emerging economies such as China contributed to it.

For banks, the new financial environment was characterized by low interest rates and low perceived risks. It also turned out that the new risk-based capital requirements allowed the banks to expand their balance sheets enormously without increasing their equity capital in the same proportion.

So, gradually the large banking groups started to increase their trading portfolios. This development happened in a gradual fashion in the 1990’s but accelerated dramatically from about 2004. Banks redirected their business focus from interest margins to fee-based and trading activities. Universal banking, as it had been known in Europe, started to change. The asset mix of the largest banks changed so that securities portfolios activities grew more and more important.

Only now, from the perspective given by the worst financial crisis since the Second World War, do we see clearly the fragility and weakness of the regulatory arrangements which came into force in the 1990s. From today's point of view, they performed well only as long as no major systemic risks materialized. Even worse, they allowed risks to accumulate in the financial system which were only waiting to be realized.

Then came 2007 and the collapse of the US property market; 2008 and the collapse of interbank money markets following the Lehman Brothers crisis; and 2009 with The Great Recession. The painful process of competitive deleveraging started.

The reassessment of economic policies followed in the last two decades has also started. Especially financial regulation has been reconsidered and is being strengthened. We need to think of monetary policy, too, especially in its connection to financial stability.

Monetary policy and financial stability

There is a common dictum that a stable financial system is a necessary condition for successful monetary policy, and that price stability in turn creates the best preconditions for financial stability.

I agree. Still, the experience of this crisis has thought us a lot more.

First of all, we now know that price stability does not by itself guarantee financial stability. Risks can accumulate in the banking system even if monetary policy succeeds in maintaining price stability and controlling inflationary expectations really well.

Second, we also know that central banks can maintain an admirable degree of price stability even when financial stability is under a lot of strain. Do these two points mean that financial stability and monetary policy are not connected after all? No. They are very closely related.

Independence of monetary policy

One of the lasting lessons learned in the last decades is the value of the independence of monetary policy. The independence of central banks has been essential keeping inflation expectations as well anchored as they have been in this crisis despite all the turmoil in the financial markets. Independence has also made it easier for central banks to act quickly when it has been necessary in order to maintain financial stability.

It is especially important to avoid two threats to independence: ***fiscal dominance*** and ***financial dominance***.

Fiscal dominance is the older concept of the two. It would arise if the government financing constraint would become an overriding influence on monetary policy. The idea of fiscal dominance was formalized by Tom Sargent and Neil Wallace in 1981, but of course the worry that deficit financing may cause inflation has much longer roots in monetary thought.[1]

The idea that tight monetary policy may become impossible without accompanying fiscal adjustment was also well understood when the blueprints for the EMU were being prepared. This is why the Maastricht treaty had its fiscal policy clauses and also why the Stability and Growth Pact was concluded. Also the prohibition of direct central bank credit to the

[1] Sargent, T.J., and Wallace, N.: Some unpleasant monetarist arithmetic. The Federal Reserve Bank of Minneapolis Quarterly Review, 1981.

government and the institutional independence of the central banks are in effect protections against fiscal dominance.

Now we know, of course, that the fiscal framework as put in place before the start of the EMU was not strong enough to prevent fiscal problems from emerging. Some have argued that fiscal dominance has taken hold in the in the big industrialized countries during the crisis when the central banks have used government bond purchases in order to stabilize the markets (as the ECB) or to produce additional monetary stimulus when the interest rate instrument has already been used to the maximum (like the Federal Reserve and the Bank of Japan).

As to the euro area, for me there is now no evidence of fiscal dominance. Fiscal dominance implies that monetary policy would break its price stability objective for the sake of maintaining the solvency of the government sector. This is not the case. Price stability has not and will not be abandoned.

We have well known fiscal problems in some of the euro area countries. Still, the ECB's ability to go on maintaining price stability has not been weakened. In particular the inflation expectations, which are the most essential indicators of the credibility of monetary policy, have remained well in line with the price stability objective.

The parallel idea of ***financial dominance*** is more recent than fiscal dominance.[2] Financial dominance refers to the possibility that the condition of the banking system could become a constraint, or dominant influence, on monetary policy, effectively forcing the central bank to pursue second- or third-best monetary policies in order to maintain financial stability.

Is the spill-over from financial instability to monetary policy a realistic threat? Can financial stability considerations lead the central banks to tolerate too high inflation, just to keep the banking sector afloat?

In principle it is easy to see why it could be. One can imagine a central bank which would have to tighten its monetary policy for price stability reasons, but is prevented from doing so for the fear that the value of the assets of the banking system would decrease and a financial crisis could ensue.

Episodes which fit the description of financial dominance have been observed in emerging economies after some banking crises in the past.

But looking at recent experience, this has not been the case in the developed economies. The bust of the credit boom has not led monetary policy to tolerate a higher-than-mandated rate of inflation. Instead, in the large developed economies at least, the bursting of the bubble has coincided with a sudden contraction of private demand and a deep recession.

The negative effect of the bust on economic activity has actually reduced inflationary pressures and in some cases (such as in Japan in the 1990's) created a real danger of deflation. The main problem has then become how to prevent the credit contraction from starting a deflationary spiral. In such conditions, the same monetary policy will then both ease the strain on the banking sector and support price stability.

This observation does not mean that financial instability would not pose a serious challenge to monetary policy. On the contrary, the downward impact of a bust, if it is large, may be more difficult to control than the preceding period of credit expansion.

[2] An early exposition of financial dominance is in Fraga, A., Goldfajn, I., and Minella, A.: Inflation Targeting in Emerging Market Economies. NBER Macroeconomics Annual, 2003.

There was a famous discussion on how monetary policy should relate to asset prices in the Jackson Hole conference of 2007, where Rick Mishkin introduced the topic.[3] At that time, the prevalent thinking in central banking circles was what professor Issing later called "the Jackson Hole consensus", meaning that it is better for monetary policy only to "clean" (up afterwards) than to "lean" (against the wind). After the hard lessons we learned over the last five years the case for benign neglect of asset booms and only picking up the pieces afterwards is not so strong any more.

The crisis experience supports rather the idea that financial excesses are better prevented as they happen than only managed after they have caused a recession. This would be the best way to prevent "downward financial dominance" which could arise if monetary policy could not effectively counteract credit contraction.

Unconventional tools and the independence of monetary policy

Recent experience shows that the central banks' box of potential tools is actually very deep, and if it has become necessary to utilize unconventional tools, as in the present crisis, these new tools have been developed and deployed.

In the case of the ECB, the new tools have included the transition to full allotment auctions, the long term refinance operations up to three years, widening of the scope of eligible collateral, and the various bond purchase programmes. The most recent of these is the OMT programme announced last summer but not yet commenced in practice.

The development of new tools has been justified. The slip of the depressed economies to dangerous deflation has been averted, and the debt and banking problems have not developed into systemic financial meltdowns in the affected countries.

We have seen that central banks can pursue successful price stability policy also under very difficult conditions. The events around the world since the collapse of Lehman Brothers are evidence of that. Deflation has been avoided despite a severe recession in many countries.

However, there are also certain problems with relying on the enlarged toolkit of the central banks.

The ability to act in crisis has led to the central banks being even called "the only game in town". We should resist this idea and beware of the danger that problems which are fundamentally political could be pushed to central banks to solve. A division of responsibilities between appointed officials and elected politicians should be preserved.

Monetary policy cannot administer the needed structural transformation in the real sector of the economy or solve excessive deficit problems of governments.

There are situations where the central banks just have to act and do their best to stabilize the economy, even if they would have to use tools which go beyond just adjusting the short rate of interest or the aggregate liquidity of the banking system. The present financial crisis has constituted one such situation.

Avoiding the busts which seem to follow credit booms and periods of "financial exuberance" would make the tasks of monetary policy much easier and protect the independence of central banks.

But there are also difficulties with the leaning against the wind. One has to do with the problem of detecting the credit cycle in time, and correctly timing the monetary policy response. Another problem is that price stability might get less attention. To mitigate these

[3] Mishkin, Frederick: Housing and the Monetary Transmission Mechanism. In: Housing, Housing Finance and Monetary Policy. Federal Reserve Bank of Kansas City, 2008 (Proceedings of the Jackson Hole Symposium of 2007).

problems, something else besides more vigilant interest rate policy is needed to prevent low and stable interest rates from leading to excesses in banks and financial markets.

One development can be the development of macro-prudential instruments which are designed to improve the stability of the financial system as a whole. The major work in this field was done by the de Larosière group. Otmar Issing was a member of the group.

Especially interesting are those macro-prudential instruments which have a time dimension so that they can be adjusted according to the changing situation in the credit markets. Such instruments include, in particular, the countercyclical capital requirements, as well as the adjustable restrictions on Loan-to-Value ratios. The CRD IV directive will make the former instrument obligatory in the EU countries; implementation of the latter is left to national discretion.

Now it is very important to establish an effective toolkit for both European and national authorities. We must also create institutional conditions which do not prevent these tools to be used when needed. Therefore, we need clear decision making competences at all levels. The connection between macro-prudential policy and its time dimension with monetary policy is so intimate that central banks must be closely involved in macro-prudential analysis and decision making.

Macro-prudential policy is important, but it needs to be supported by structural reforms which would make the banking system more resilient, and - I emphasise - less prone to unstable behaviour.

The Structural reform proposals

In order to prevent the present crisis from being ever repeated, governments and authorities have started a large-scale overhaul of financial regulation. The regulatory agenda can be broadly divided into the following areas:

- Strengthening of the prudential regulation of solvency and liquidity
- Improving the institutional basis for supervision and crisis management
- Introduction of macro-prudential instruments to prevent systemic risks in the banking system and financial markets
- Regulating the structure of the banking sector

The structural reform proposals which appear as the last item on this list aim to separate the riskiest securities and derivatives business from the deposit banking activities. This is the essential content of the proposals by the EU High Level Expert Group, which I chaired, published last autumn. It is also at the core of the Volcker rule which is being implemented in the US, and the Vickers proposal in the UK. The current legislative proposals which are underway in France and Germany are also in the same vein.

A particular concern of these proposals has been to limit the extent of explicit or implicit public guarantees, so that they would not induce additional risk taking. This kind of competitive distortion could result in securities trading getting concentrated in the largest deposit banks, and these deposit banks becoming enormous risk concentrations built on implicit or even explicit public guarantees. Separation proposals try to isolate securities business from the sources of this distortion and reduce the incentives to excessive risk-taking and risk concentration.

In must be emphasized that the structural reform we proposed is not a cure-all but should be seen as a part of a comprehensive regulatory agenda which is already moving forward. This includes better solvency and liquidity rules. Also, the EU will finally get supervision and resolution frameworks at the union level. The different components of the current regulatory agenda complement and support each other.

In this European context, the structure and stability of the banking sector is of vital importance to the economy. It is imperative to improve its resiliency.

The High Level Expert Group report contains five main recommendations on how to reform the banking sector.[4] I will just refer to three of them here:

- The first is to separate any significant proprietary trading in securities and derivatives from deposit banks. These activities could be carried out in a separately capitalized and funded subsidiary, a trading entity, which could belong to the same banking group as the deposit bank. We proposed that also market making be allocated to the trading subsidiary in order to prevent the use of trading inventory to circumvent the prohibition on proprietary trading.
- The use of trading subsidiaries would allow the banking groups to offer "one-stop banking" to their clients, but without the possibility of funding trading activities with insured retail deposits. Financial linkages between the deposit bank and the trading unit would have to be restricted in accordance to normal large exposure rules.
- Another of our proposals is to develop specific, designated bail-in instruments to improve the loss absorbency of banks. A requirement to issue such bail-in debt would help ensure the participation of investors to the recapitalization of a bank if this should become necessary. Such designated bail-in instruments would clarify the hierarchy of debt commitments and allow investors to predict the eventual treatment of the respective instruments in case of recapitalization or resolution.
- The group also proposed that the capital requirements on trading assets and real estate related loans be reviewed. Both of these asset categories came to have very low risk weights in the Basel II regime, mostly because the way internal models were applied.

Why banking structure matters for monetary policy

Let me recapitulate my main points.

First, for monetary policy, financial stability is very important. While monetary policy has proven to be able to pursue price stability even under rather strained financial conditions, the central banks are not able to insulate the real economy completely from the after-effects of financial crises. A more stable banking sector which is less prone to crisis will reduce the likelihood of crises and therefore protect the balance sheets of the central bank from financial risks and thereby protect its independence and credibility.

Second, the most important part of stability policy is crisis prevention. Improving loss absorbency of banks and the crisis management powers of the authorities are necessary, but it is even more important to make sure that excessive growth of credit and indebtedness can be better controlled in the future. In this way, credit crunches and banking crises can be made less likely – and milder, should they happen.

Third, financial stability would benefit from structural reform of the banking system. By separating the most risky securities and derivative activities from deposit banking, the spill over from deposit protection to speculative risk taking would be prevented. This would reduce the distorted incentives to expand trading activities and concentrate risks in deposit banks because of their privileged position in the deposit market.

Finally, the structural reform of banking is a complement, not a substitute for other regulatory improvements. For central banks, the development of macro-prudential policies and

[4] High-Level Expert Group on reforming the structure of the EU banking sector. Final report. Brussels, 2 October 2012.

instruments is especially relevant. Those macro-prudential instruments which can be adjusted over time to manage the conditions in the credit market will offer a way to better control the accumulation of excess risk and help prevent future crises. These instruments operate so close to monetary policy that central banks should be very closely involved, if not themselves responsible, in developing and using them.