Yves Mersch: Economic and legal limits of central banking

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the IMFS (Institute for Monetary and Financial Stability) Conference on Monetary and Financial Stability, Frankfurt am Main, 26 November 2013.

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Dear Professor Wieland,

dear Professor Klump,

dear Professor Remsperger,

Ladies and Gentlemen,

The Financial Crisis has confronted us with major challenges. For central banks this has not only meant testing new waters, moreover it has opened up new responsibilities and tasks. But we indeed have to remind ourselves of our limits.

We need to accept the economic limits what monetary policy can achieve, and we need to respect the legal boundaries of our mandate.

In today's remarks, I will talk about the institutional and legal foundations of the Economic and Monetary Union. The ECB's independence and the price stability mandate conferred upon us by the EU Treaty provided a firm anchor for our action during the stormy times of the crisis. But there were also shortcomings in the EMU institutional framework that the crisis has revealed.

For some it might be tempting to go now for myopic reforms. However, we need to take the longer view. Therefore, we need to stay ambitious to continue institutional and structural reforms in order to facilitate the economic recovery and reduce fragmentation in the euro area.

In this vein the banking union has to ensure a functioning European financial market, where banks are properly supervised and can be wound up efficiently if necessary.

This will not only ensure greater integration and stability for the financial market. It also means putting EMU as a whole on a sounder footing. And for us as central bankers, this avoids compromising the primacy of price stability.

Sound institutional framework and legal framework crucial for sound money and sound monetary policy

The legal set-up of the European Economic and Monetary Union acknowledged that a sound institutional framework is conducive to a stable and prosperous economy.

In fact, this is the spirit of the Freiburg School and its conception of "Ordnungspolitik" that puts strong emphasis on sound institutions as a pre-condition for sound money that underlie the construction of EMU.

Indeed, it was one of the founding fathers of the Freiburg School, Walter Eucken, who has – in his book, "Grundsätze" – provided the blueprint of a competitive order, for which he views stability oriented monetary policy as crucial pre-condition.

> "*Alle Bemühungen, eine Wettbewerbsordnung zu verwirklichen, sind umsonst, solange eine gewisse Stabilität des Geldwertes nicht gesichert ist. Die Währungspolitik besitzt daher für die Wettbewerbsordnung ein Primat*" (Grundsätze, p. 256).

["*All endeavours to realize a competitive framework are in vain unless a certain level of monetary stability can be ensured. Monetary policy thus has primacy for the competitive order.*"]

These principles entail stringent rules that restrict discretionary policy intervention. They thereby provide a predictable environment for private savings, consumption and investment decisions.

But this rule-based approach should not be understood as restrictive or oppressive. By contrast, it defines the scope of economic freedom and aims at setting incentives to the benefit of the individual *and* the whole society. In fact, economic freedom requires a sound legal structure and a law-enforcing system to protect the property rights of owners and enforce contracts in an even-handed manner.

The EU Treaty adheres to these ordo-liberal principles. The conduct of monetary policy was made independent. The members of the decision making body of the ECB, the Governing Council, were shielded from external influence on the highest level (Art. 130[1]).

The independence of monetary policy should however not be confused with a "carte blanche". The Treaty clearly defines boundaries.

To counter-balance this high degree of freedom, the tasks are clearly defined. The ECB was assigned a precise mandate: to maintain price stability[2]. Likewise, the scope of action is limited and some tasks are explicitly prohibited, e.g. the outright purchases of government bonds on the primary market, i.e. the monetization of public debt.[3]

The EMU implied, however, a historically rare asymmetry. Monetary policy is conducted at the European, supranational level, whereas most other areas remained largely under national sovereignty.

Would that asymmetry matter? There was a broad-based understanding that no tensions would arise, because:

- First, fiscal safeguards were set up. The Stability and Growth Pact should ensure solid and sustainable public finances.
- Second, national policies would counter regional imbalances, peer pressure would prevent negative spillover effects, and markets would discipline complacent national policies.
- Third, the prevailing consensus assumed that financial crises would not occur in advanced economies but only in faraway places.

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1 "When exercising the powers and carrying out the tasks and duties conferred upon them by the Treaties and the Statute of the ESCB and of the ECB, neither the European Central Bank, nor a national central bank, nor any member of their decision-making bodies shall seek or take instructions from Union institutions, bodies, offices or agencies, from any government of a Member State or from any other body. The Union institutions, bodies, offices or agencies and the governments of the Member States undertake to respect this principle and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks in the performance of their tasks." (Art. 130 TFEU)

2 "The primary objective of the European System of Central Banks (hereinafter referred to as "the ESCB") shall be to maintain price stability." (Art. 127 (1) TFEU)

3 "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as "national central banks") in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."(Art. 123: (1) TFEU)

The first decade of the EMU was promising. The favourable economic environment covered any weaknesses. Now we are wiser. The design of the institutional framework proved porous in particular in four places:

- First, the binding effect of the Stability and Growth Pact was insufficient to establish appropriate incentives for prudent fiscal policies and to contain national developments which can cause damage to the union as a whole.
- Second, the framework lacked a mechanism which obliges national economic policy to a long-term growth strategy.
- Third, our framework turned out to be incapable of recognising risks in the financial sector at an early stage and to prevent imbalances that in the end destabilised entire economies.
- Finally, the disciplining function of the financial markets failed: Even countries with drastic losses in competitiveness and exuberant debt levels had to pay only marginally higher interest rates on their government bonds than countries with sound fiscal positions.

We painfully experienced how welfare is compromised if market principles are violated and the institutional framework proves inconsistent.

Our institutional framework is being revised. While much remains to be done, the reform effort and steps toward a re-design in EMU architecture are taken at a speed and dynamic that is unprecedented in European Post-War history.

For this to be a success, we have to ensure a framework that sets the incentives both for private and public actors towards a competitive economy within a system of stable prices, reminding ourselves of core principles and to respect the respective limits of public policy for sustainable growth and employment.

The treaty mandate is the guidepost for all monetary policy action

Although the crisis shook our economies, driving the euro area into a period of deep recession and financial instability, the institutional framework on monetary policy has provided us with the necessary guidepost for action.

It is precisely this pre-condition of price stability for economic welfare that has been at the heart of the monetary policy decisions by the ECB's Governing Council. Monetary accommodation and wide-ranging non-standard measures are in place for good reason to fulfil our given mandate explicitly defined in a pragmatic way.

Moreover, all measures were in full compliance with the legal boundaries laid down in the Treaty. Only the European Court of Justice has competence to issue a binding opinion on the boundaries.

However, the effective and successful conduct of monetary policy must not be used as a pretext for complacency in other policy areas.

First, it is up to the governments adopting the necessary reforms to increase competitiveness as well as addressing structural obstacles impeding growth and freeing resources for sound fiscal policies.

Second, as regards the banking sector, the ECB should ensure that its liquidity smoothly flows to the banking sector. Excess liquidity policy, however useful and necessary it has been – and still is, should not become a permanent feature. It should be limited in time to avoid dressing-up non-performing loans or ever-greening bad assets that would undermine incentives to restructure or to address structural weaknesses in banks' balance sheets.

Let me add in this context, that also with respect to our most recent monetary policy decisions, it is now up to the banks making use of the favourable financing condition that we provide, passing this on to households and firms to ultimately revive the flow of credit in the euro area. The ball is in the court of the private sector and the euro area governments.

So let me turn to how we can rethink the financial sector architecture in Europe for long-lasting stability and integration of the banking sector.

Missing elements in architecture: the banking union

The path towards a more sustainable architecture of EMU is still under-way. But much has been achieved.

Indeed, the crisis revealed the fragilities and flaws in the foundations of the European construction, especially in the financial sector. We understood that national laws and regulatory frameworks proved inadequate. The lack of harmonised policies and centralised provisions at European level caused a situation in which banks operated not on a level playing field. More importantly, there was no institutional framework to deal with systemic risks in the banking sector, be it domestic and cross-border. In fact, some of the biggest players virtually eluded any form of control or limits to their activity.

The establishment of the banking union is therefore an important milestone towards genuine stability and integration of financial markets in the EMU. Just a few weeks ago the regulation establishing the Single Supervisory Mechanism (SSM) entered into force and the construction of the Single Resolution Mechanism is on its way.

The establishment of the SSM is a fundamental step within the new EMU architecture. Not only because it will be vital for banking stability in the euro area, but because it will be housed in the ECB. This implies both major institutional and logistical consequences for our institution.

Just as for single monetary policy, common supervision must be built on solid institutional and legal footing. Again, a stringently defined institutional framework will set out a clear mandate, but also provisions that specify the boundaries of the tasks and responsibilities needed for banks to operate in a system of effective supervision providing a level playing field across the euro area.

Article 127(6) TFEU provides that the Council may confer specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the explicit exception of insurance undertakings.[4]

Let me mention the foundation stones on which we have built the SSM and which will serve to ensure effective supervision:

First, the ECB should remain independent in carrying out all its tasks. This includes the supervisory tasks conferred to the ECB. Independence is a key element to avoid leniency to any type of political pressures. Such pressures would undermine the effectiveness of the supervisory actions, which should only be guided by economic and technical considerations.

Second, the ECB should be able to carry out the tasks assigned to it effectively and rigorously without any risk to its reputation.

Third, there must be a strict separation between the ECB's new tasks concerning supervision and our monetary policy tasks assigned by the Treaty (Art. 25 SSM Regulation). ECB staff involved in supervisory activities shall be organisationally separated and have separate reporting lines. The operation of the Governing Council will be completely differentiated as

[4] "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." (Art 127 (6) TFEU)

regards monetary and supervisory functions. This includes strictly separated meetings and agendas. In this way, the new tasks will not interfere with the overriding price stability mandate.

Fourth, consistently with the principle of conferral laid out in Article 5 of the Treaty and in line with the subsidiarity principles and proportionality, the SSM will be able to have full recourse to the knowledge, expertise and operational resources of national supervisory authorities and to use the national know-how as much as possible.

Fifth, the SSM should operate in a manner fully consistent with the principles underpinning the single market in financial services and in full adherence to the single rulebook for financial services. The envisaged involvement in the SSM of non-euro area Member States on a voluntary basis shall be seen as a further element fostering integration in the EU.

Sixth, the ECB is committed to comply with the highest standards of accountability for the supervisory tasks. Accordingly, Inter-Institutional Agreements between the European Parliament and the ECB on the cooperation of procedures related to the Single Supervisory Mechanism obligate the ECB to engage in hearings, reports, answers to MEP enquiries, information disclosure which will enhance transparency. Likewise, the ECB signed a Memorandum of Understanding (MoU) with the EU Council of Ministers. Therein the cooperation on procedures related to the SSM is defined, similar to the Inter-Institutional Agreement (IIA) with the European Parliament.

At the same time preserving confidentiality is necessary when dealing with highly market-sensitive matters. Indeed, Article 27 SSM Regulation provides that the ECB, for its supervisory tasks, is subject to the professional secrecy regime in the ESCB statute and CRD IV. The professional secrecy regime of the SSM Regulation does not allow the disclosure of confidential information.

Now, looking at the future, what needs to be done next?

While the ECB has already started to build up the new house, a number of challenges lie in front of us.

Before officially taking up the new supervisory task, the ECB will conduct a comprehensive assessment of the banks' balance sheets. This exercise will include three components. The first is a supervisory risk assessment addressing key risks in the banks' balance sheets, including liquidity, leverage and funding. The second is the asset quality review that will assess credit exposures, on- and off-balance sheet positions and domestic/non-domestic exposures. The third component is the stress test that will build on and complement the asset quality review by providing a forward-looking view of banks' shock-absorption capacity under stress.

This process has already started. After a pilot phase during which the ECB called for – and subsequently integrated – feedback from the banks, the ECB on 18 November sent out the templates for data collection.

Finally, let me mention the second, indispensable pillar of the banking union: the Single Resolution Mechanism (SRM), which will represent a necessary complement to the SSM. In parallel with the centralisation of supervision at the European level, it will be necessary to create adequate instruments to intervene on troubled banks at a centralised level as well. Discussions on the rules of the SRM are still on-going and difficult, but we strongly support the envisaged time-line for the SRM to become effective in January 2015.

The combination of these elements will be key to achieve a higher degree of transparency, to make the necessary repairs to balance sheets and to regain confidence. A more robust and safer financial sector in a strengthened monetary union will be the outcome under the new rules.

Conclusions

The legal foundations of the EMU and in particular the independence of monetary policy enshrined in the Treaty served as crucial guideposts for the ECB's monetary policy also during the course of the crisis. Other parts of the EMU institutional framework, however, proved to be porous. Those foundations should also guide our work on the design of the banking union. The aim is to create a level playing field for all banks with no uncertainties or loopholes distorting competition in the Single Market.

Both banking supervision and monetary policy share a number of institutional foundations that will ensure their effectiveness: a precise mandate, independence from euro area governments and strong accountability towards the European people.

But let's be also reminded that both banking supervision and monetary policy face limits to their effectiveness. Structural reforms fostering economic growth, sound fiscal policies ensuring sustainable public budgets and an effective resolution mechanisms to deal with non-viable banks without the involvement of tax-payers are the best to ensure both effective and stringent supervisory policies and – what Walter Eucken has called – the primacy of monetary policy, that is a monetary policy fully focused on the delivery of price stability.