Erkki Liikanen: The economic crisis and the evolving role of central banks

Speech 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, to the Paasikivi Society, Helsinki, 25 November 2013.

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Introduction

One of the consequences of the most recent international economic crisis has been the more prominent role of central banks in economic policy. The central banks have played a pivotal role in crisis management. With the various initiatives currently underway to strengthen economic governance, the central banks of the euro area, in particular, will be assigned new responsibilities.

An extreme interpretation of this dynamics was put forward by the American journalist, David Wessel. In his excellent book on the outbreak of the financial crisis, "In Fed We Trust", the subtitle on the cover reads "How the Federal Reserve Became the Fourth Branch of Government", ie alongside Congress, the President and the Supreme Court. Similar thoughts have also been voiced elsewhere, including in Europe. The central banks have even been referred to as being "the only game in town". To central bankers, this has been a cause of concern rather than delight.

The financial crisis brought about changes in the operation of central banks and will continue to do so. It has forced a rethinking of central banking in terms of both functions and instruments. The crisis has even raised the question of how central bank independence, which has become well established in the past couple of decades, can be reconciled with the new position of heightened influence.

Major financial crises have also in the past had an epochal impact on the perception of the tasks and capabilities of economic policy and, especially, the role of central banks. The Great Depression of the 1930s and the great inflation of the 1970s mark significant turning points in this respect. Each resulted in big changes from which there was to be no return.

The past five years may very well be comparable in significance to the depression of the 1930s or the stagflation of the 1970s. The former governor of the Bank of Israel, professor Stanley Fischer recently made a remark that this crisis will rewrite economics textbooks. It is indeed possible that the changes in economic policy practices and institutions initiated in this period will be assessed as equal to those following in the wake of previous crises.

The shaping of the role of central banks

It is too soon to attempt today a comprehensive assessment of the consequences of the most recent crisis on economic policy and, in particular, monetary policy doctrines in the longer term. Certain trends can nevertheless be discerned.

Let me first briefly recount the various stages passed globally on the way to the current division and definition of economic policy responsibilities.

Following the experiences of the 1930s and the war-time command economy, monetary policy was, for several decades to come, integrated within the coordinated approach to general economic policy, and the focus of monetary policy was shifted away from maintenance of price stability (under the gold standard) towards aggregate demand management, ie towards a policy aiming at full employment and rapid growth. The theoretical foundation of this approach was derived from Keynesian macroeconomics. The result was a significant loss of central bank independence, which in the United States happened as early

as 1933 as a part of Roosevelt's New Deal policies, and in the United Kingdom and France immediately after the war, when the Bank of England and Banque de France were nationalised.

New policy instruments emerged as central banks were assigned broad regulatory powers over foreign capital movements, retail banks' interest rates and the investment of banks' asset portfolios . Financial market regulation was tightened, but there was little need for active financial stability policy as understood today, given the high level of stability of banking systems overall. Occasional balance-of-payment crises still took place, however.

This regime, which had became established after the Second World War, nevertheless hit a wall in the 1970s. Inflation accelerated to two-digit rates in all leading industrial economies (except for Germany), while unemployment surged to levels higher than ever recorded since the 1930s. The situation grew unsustainable to the point of prompting a fundamental reassessment of economic policy in all Western economies by the early 1980s.

The lesson learnt from the 1970s inflation and the measures to curb it in the following decade was that monetary policy has its own special role to play in the context of economic policy. Its most important function is to maintain confidence in the value of money. Failing this, monetary policy cannot make an effective contribution to any other economic policy objectives such as sustainable growth and employment.

The redefinition of the functions of monetary policy was, on the one hand, conditioned by the advances in economic theory and, on the other hand, by German monetary policy experience. In economics, a greater emphasis was given to the role of expectations in the inflation process. Germany, whose central bank enjoyed an exceptionally high level of independence, weathered the storms of the 1970s better than other countries. This was attributed to the consistent anti-inflationary economic policy of the Bundesbank. This was of great relevance to the monetary policy of other countries, in general, and to the future structure of European Monetary Union, in particular.

Hence, in the aftermath of the 1970s inflation, maintenance of confidence in the value of money, in other words stabilisation of inflation expectations at a low level, surfaced as the key function of monetary policy. This is commonly referred to as the "anchoring" of inflation expectations. It was appreciated that this is the very objective that defines the role of the central bank in the division of economic policy responsibilities. In the 1980s and 1990s, more and more countries modelled their monetary policy institutions and practices upon this approach.

The new central bank doctrine has perhaps best been recapitulated by Stanley Fischer in his famous paper "Modern Central Banking", delivered in London in 1994 at the Tercentenary Symposium of the Bank of England. The then professor at MIT later served as First Deputy Managing Director of the IMF and Governor of the Bank of Israel.

Fischer outlines the following principles of modern central banking.

Central banks must have a clearly defined mandate, which is to maintain price stability, and they must make a public commitment to honouring this objective.

Central banks must enjoy operational independence in the deployment of monetary policy instruments, such as interest rates, to achieve their objective. Independence also requires that central banks must not be obliged to finance the government fiscal deficit.

As a counter-balance to central bank independence, Fischer underscored the accountability of central banks, ie their responsibility to achieve their objective.

While these principles were gaining ground in monetary policy, the advanced economies entered a highly favourable period of economic development, now referred to as the Great Moderation. This period of low inflation and stable economic growth persisted for more than ten years, until the emergence of the financial crisis.

The seemingly favourable developments, nevertheless, masked mounting risks, such as global economic imbalances, as well as the huge expansion of banks' balance sheets and risks, which was partly facilitated by the weaknesses in the regulatory framework for banks. The emergence of the international financial crisis in 2007 and its escalation in 2008 revealed the fragility of the world economy and the credit system as never before.

It may come as a surprise that, despite its gravity, the economic crisis of recent years has not undermined the foundations of monetary policy. The principles of "modern central banking" formulated by Fischer remain unchallenged. Indeed, it is astonishing that central banks have been so successful in achieving their primary objective of price stability and solid anchoring of inflation expectations amidst these highly extreme circumstances. This is probably in essence attributable to central bank independence and the confidence that this builds.

At the same time, the central banks have had to actively step up to safeguard financial stability in a way not necessary since the early 1930s, when catastrophic banking crises wrecked the economies of both the USA and Germany, then triggering a steep global deflationary spiral.

Although a traditional function of central banks, ensuring financial stability has not been to the forefront in normal times. With the severity of the crisis and the moderation of inflationary pressures, financial stability and the related policy choices have now entered the very centre stage in the practice of central banking.

Phase one of the crisis: from subprime crisis to systemic crisis

It is useful to briefly discuss how central banks have responded to the various phases of the crisis and how each phase has affected the role of central banks in economic policy.

Phase one of the crisis, which can be called ***the subprime crisis***, began in the United States in summer 2007 and landed in Europe on 9 August. Money market turnover virtually came to a halt and risk premia rose drastically. At the time this seemed dramatic, although, compared to later developments, this was merely the overture.

This phase was characterised by a collapse in the value of investments in mortgage-backed securities and their liquidity. Housing prices began to decline in the United States, which affected the value of packaged and structured securities based on residential mortgages. At the same time, this created widespread and harmful uncertainty about the real value of the structured loans. The turbulence spread in summer 2007 to Europe, because by then it had become evident that many financial institutions had purchased structured loans on their balance sheets or these loans had been purchased by special purpose vehicles owned by them.

The crisis was not entirely unexpected, as the under-pricing of risk on the global markets, which was one factor that triggered the crisis, had been noticed. For example the then President of the ECB, Jean-Claude Trichet, had already before the onset of the crises pointed out in public that some investors did not take full account of the possible risks at a time of general asset price increases. Central banks discussed the dangers of a possible uncontrolled correction, but they were unable to predict the timing and scale of the problems that they were about to face.

Already in September 2007, the British bank Northern Rock, which specialised in mortgage lending and was dependent on short-term market funding, faced a liquidity crisis, which triggered the first bank run in Britain in 150 years. The Bank of England had to grant massive liquidity support to Northern Rock, which was subsequently nationalised. The euro area interbank money market also froze, due to the growing uncertainty, and the ECB had to increase the amount of central bank money on the market by conducting a series of non-standard refinancing operations.

In the United States, the most famous victim of this phase of the crisis was the investment bank Bear Stearns, whose bankruptcy the US Federal Reserve (Fed) prevented with the help of large refinancing operations in March 2008. Bear Stearns was subsequently merged with another investment bank (JP Morgan).

The financial crisis entered phase two, ***the systemic phase*** in autumn 2008. The milestone in this phase was the collapse of the investment bank Lehman Brothers on 15 September.

The message of the Lehman collapse was that even a large financial institution can collapse. This immediately raised financial market uncertainty and the lack of confidence to completely new levels globally. The interbank money market, on which banking liquidity was largely based on, came to a virtual standstill.

Many banks that were dependent on short-term market funding ran into difficulties and had to resort to central bank financing. Particularly vulnerable was the banking system of Iceland, whose entire business model hit the buffers. The Icelandic financial system collapsed in October 2008.

It was clear that the drying up of the credit market would cause great damage. One way that central banks responded to the situation was, of course, by using their main instrument, the policy rate. In early November, the ECB began to lower its key interest rates drastically. The interest rate cuts began from a level of 4.25%, but within six months the policy rate had already been lowered to 1.0%. The United States reacted even more rapidly and drastically – by the end of 2008, the Fed had cut the federal funds rate to 0.25%.

The crisis awareness that arose following the failure of Lehman is characterised by the unprecedentedly swift and smooth international cooperation at the point when the crisis escalated. Cooperation between central banks, in particular, was very efficient. In Europe, banks were hit by the drying up of dollar-denominated funding, and therefore the ECB and the Federal Reserve agreed on large swap lines, as a result of which the ECB obtained dollars in exchange for euro, to be lent on to euro area banks. The ECB, the Fed and four other major central banks also conducted an unprecedented coordinated interest rate cut in October 2008.

In terms of the topic of this presentation, ie the changes in the role of the central banks during the crisis, even more significant were the measures that the central banks took in addition to the interest rate cuts.

It was clear that central banks had to focus not only on interest rates but also on safeguarding banks' liquidity. In October 2008, the ECB launched its full-allotment policy, under which it has since then provided to banks as much refinancing as they want, at the prevailing key interest rate, as long as they have the necessary collateral, approved by the ECB. The list of such eligible collateral has also been extended during the crisis.

Moreover, the ECB began to provide banks with credit with longer maturities than before. Before the crisis, the ECB's refinancing operations usually had a maturity of one week. To alleviate banks' uncertainties about their liquidity positions, the ECB has during the crisis increased the provision of credit against collateral to banks on longer maturities, too. At times, credit has been provided with a maturity of as long as 36 months.

The longer-term refinancing operations have played an important role in increasing the liquidity of the banking system, and particularly in decreasing the uncertainty involved. But now, as the situation has calmed down somewhat, a large part of the excess liquidity provided has returned to the central bank.

Central banks' actions to safeguard the operation of the markets would hardly have been possible without the support of governments. In November 2008, the G20 committed to supporting the liquidity of the banking system, but, at the same time, they also committed to reinforcing the regulation and supervision of the financial markets. This has triggered very significant processes, regulatory initiatives, that go further than crisis management and that

aim to reinforce financial market structures in order to prevent a recurrence of the crisis of 2008.

At least in terms of financial sector regulation, the world has entered a new phase.

Experience of the 1930s and the current financial crisis

The swiftness of central bank responses in the early stages of the crisis and their decisive actions as the crisis continued were mainly due to the experiences of the 1930s. A key role in formulating monetary policy in 2008 and the years that followed was played by the Chairman of the Federal Reserve Board, Ben Bernanke, who before his career as a central banker specialised in research on the Great Depression of that decade.

Bernanke's leadership was of major importance in preventing the total collapse of the financial system. Without his vision of the reasons behind the Great Depression of the 1930s, formed during his career as a researcher, the Fed's response would probably have been much slower and more timid.

Already before Bernanke's work, research had begun to emphasise the role of monetary policy errors in deepening the 1930s' depression. The key publication was the famous "A Monetary History of the United States, 1867-1960" by Milton Friedman and Anna Schwartz, published in 1963. The book claimed that the severity of the Great Depression was due to the fact that, following the onset of the crisis, monetary policy, particularly in the United States, was too tight and allowed a steep decline in the stock of money.

Friedman argued that the Fed's failure was due particularly to its collateral requirements, ie the fact that it held to the ***"real bills"*** doctrine. According to this doctrine, the central bank issued credit only against notes, drafts and bills of exchange arising from actual commercial transactions. Such securities were not available in sufficient amounts following the onset of the recession in the '30s, and so the Fed could not increase its lending. According to Friedman, the Fed should have used extensive purchases of government securities (open market operations) to prevent a decline in the stock of money, but this was prevented by the real bills doctrine. This resulted in a fall in the money stock, a collapse in aggregate demand and a deflationary spiral.

Ben Bernanke published his first research papers on the 1930s' depression already in the early 1980s ("Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression", American Economic Review, 1983). Bernanke's research emphasised that the depth of the Great Depression cannot be explained only by monetary aspects (interest rate level and amount of money), but was mainly due to the banking crisis. Banks were not helped, and their mass failure led to a collapse in the availability of credit. In the United States, approximately half of the banks failed in 1930–1933. Bernanke concluded that the credit crunch caused by the banking crisis and the wave of bankruptcies that followed deepened the early 1930s' recession in the United States into a full-blown economic crisis. He criticised the Fed for its failure at that time to act as lender of last resort in order to ease the banks' distress.

Research on the 1930s crisis has also focused on the importance of the international monetary system. In a speech on the experiences of the 1930s (given in 2004), Bernanke notes that the depth and extent of the contraction in the global economy is explained by attempts to remain on the gold standard. Bernanke refers to studies by eg ***Barry Eichengreen*** (Golden Fetters, 1992), in which the gold standard is regarded as the main reason for the global slump, and he takes the view that, in those circumstances, abandoning the gold standard was a prerequisite for recovery from the Great Depression.

The gold standard helped spread the depression around the world, as it prevented countries with a balance of payments deficit from loosening their monetary policy even when their internal economic situation had required it. On the contrary, they had to tighten their monetary policy to remain on the gold standard, and, moreover, their central banks, bound

by the gold standard, were unable to act as lenders of last resort and support the liquidity of their domestic banking systems. As a result, the recession spread from the countries with a surplus, which in the 1930s were the United States and France, to countries with a weak balance of payments (at the time eg Germany and the United Kingdom).

Bernanke and Eichengreen emphasise that, in the 1930s, the international monetary system did not have a clear leader that would have been responsible for the operation of the entire monetary system. In particular, the United States, to which the world's gold reserves were flowing, did not bear its international responsibility. The idea that the stability of the international monetary system needs leadership and the conduct of monetary policy from an international perspective originates from research by ***Charles Kindleberger*** (The World in Depression, 1973).

It is clear that the traumatic memories of the 1930s and the related understanding that the task of monetary policy is to safeguard the operation of the market largely explain the policy choices of all central banks, and particularly US monetary policy during the current economic crisis.

The fact that the experiences of the 1930s have again become topical does not necessarily contradict with the doctrine that was formulated after the 1970s, ie the conduct of monetary policy geared towards price stability and conducted by independent central banks. We can expect that the monetary policy thinking and approach towards which the world is apparently now shifting will be some synthesis of these two. As trust in the self-adjusting properties of unregulated markets has receded, the monetary and financial market policies of the future will consist of BOTH the pursuit of price stability (monetary policy conventionally defined) AND a more systematic and better-organised pursuit of financial market stability.

From financial crisis to sovereign debt crisis

It turned out that even though the financial system remained in operation and no systemic meltdown occurred in autumn 2008, this did not prevent the global economy from falling into a deep recession, as everybody attempted to reduce their excessive debt ratios and risky investments. This led to the third phase of the crisis – the ***global economic crisis or "Great Recession"*** – which hit with full force in 2009.

The force with which the financial crisis hit the real economy came as a surprise to everybody, and the forecast error made must have been the greatest of all time. Global trade came almost to a halt at the turn of 2008–2009, and in the next year GDP plunged in almost all developed economies with magnitudes not experienced after World War II.

GDP contracted by over 3% in the United States and 4½% in the euro area. Finland's GDP plummeted by as much as 8½%, which was considerably more than in 1991 – during the worst year of Finland's previous economic crisis. The dive in aggregate demand in the global economy also affected prices, and in several countries inflation even slipped into negative territory for some time.

However, the severe economic downturn did not affect people's everyday lives to the extent one might assume on the basis of the GDP figures, at least not at the beginning. Private demand was maintained by lower interest rates and the increasing government budget deficits, despite the strong decline in exports and industrial output.

The large general government budget deficits constituted very expansionary fiscal policies, which could not, however, continue for long. The limits of fiscal policy were reached first in countries where government finances had been in a poor state already from the very beginning, as in Greece, or where the collapse of the banking sector and the related bailout measures had suddenly pushed the government debt burden to excessive levels, as in Ireland. This led to the next phase of the crisis.

The fourth phase of the crisis – the ***sovereign debt crisis*** – came to a head in spring 2010, when Greece's high deficits led to evaporation of market confidence, initially in Greece itself, and subsequently also in other euro area countries with the weakest economic positions. In this situation, euro area countries' economic developments and credit risks diverged from each other, and the ECB's monetary policy, which was already at that time accommodative to growth, was not transmitted evenly across the euro area.

The repricing of sovereign risk hampered the functioning of markets and the transmission of monetary policy. Euro area financial markets became regionally fragmented and banks' problems increased. In this situation, the ECB launched a Securities Markets Programme (SMP) to alleviate the tensions prevailing on the markets. In the context of the SMP, the ECB purchased government bonds in those market segments that were most dysfunctional. During the approximately one and a half years the programme was running, total SMP purchases amounted to around EUR 200 billion.

In order to alleviate the tensions arising from the sovereign debt crisis, banks were also offered exceptionally long (3 years) longer-term refinancing operations (LTROs) in December 2011 and March 2012. To ensure the availability of liquidity, the range of collateral eligible in the ECB's credit operations was also expanded. The Eurosystem applies haircuts in the valuation of collateral, so as to manage the credit risk inherent in collateral policy.

As the euro area crisis protracted, the fifth stage of the crisis – the ***European confidence crisis*** – began in summer 2012, as nervousness in the sovereign bond markets culminated and fell even upon large euro area countries, namely Spain and Italy. The markets began to speculate that one country or a number of countries might even have to exit monetary union.

Weakening confidence in the integrity of the euro highlighted the importance of a common policy stance for the stabilisation of the situation. At the end of June 2012, euro area finance ministers issued a statement in which they committed to breaking the vicious circle between banks and sovereigns and also – as already proposed by the European Commission – to set up a single banking supervisory mechanism for the euro area, which would be headed by the ECB.

This was one of the starting points for the EU process referred to as "Banking Union", the lack of which had proven to be one of the shortcomings in the design of Monetary Union, one reason for its fragility. The declaration also showed that more political capital had been invested in the euro than had probably been assumed by those who doubted its irreversibility.

On 26 July – one month after the Eurogroup statement – the President of the ECB, Mario Draghi, gave a speech in London containing a statement that has already become famous: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

The speech had a very powerful and positive impact on the markets. In retrospect, it has even been regarded as revolutionary, and with good reason. Pressures on the Spanish and Italian government bond markets began to ease, even though no detailed programme had yet been presented to concretise President Draghi's statement.

The concrete content became public at the beginning of August, when the ECB Governing Council announced a new programme concerning the creation of a programme of government bond purchases. The details of the programme were communicated during autumn. Called "Outright Monetary Transactions" (OMTs), the programme was designed to eliminate such risk premia from the markets as were based on speculations about a country's exit from the euro area.

No ex ante limits were set on the size of OMTs, but certain conditions were attached to the programme to ensure its effectiveness and safeguard the ECB's monetary policy. The most important condition was that the purchases would only concentrate on government bonds of countries that had signed an economic adjustment programme monitored by the IMF, EU

and the ECB and that, according to the ECB's independent assessment, also adhered to the programme.

The OMT programme has so far fulfilled its purpose well, as it were: it has considerably calmed the markets, even though there has been no need to activate the programme.

Evaluation of non-standard measures

The most important forms of expanding the ECB's monetary policy tools in the recent crisis years can be summarised as follows: elastic provision of credit – ie the "full allotment policy" – in monetary policy operations, expansion of the list of eligible collateral, the conduct of long-term credit operations and also, to a certain extent, securities purchases (including also, last but not least, the so-far unused OMTs). In addition to the Eurosystem's common measures, some national central banks have conducted certain operations to address bank-specific solvency problems in their respective countries.

The "forward guidance" introduced this year can be regarded as the newest addition to this list. Forward guidance refers to regular statements on monetary policy, which for the moment have been aimed at increasing the efficiency of accommodative monetary policy.

Even though the range of tools for different central banks differs to some extent, non-standard central banks measures during the crisis have everywhere resulted in considerable growth in central bank balance sheets and hence to growth in central bank liquidity. This has stimulated criticism, particularly from commentators who fear that growth in central bank liquidity will lead to higher inflation. This debate has been under way in the United States and the euro area alike.

However, there have been no signs of an acceleration in inflation, at least not in the euro area. Even though the amount of central bank money has increased, this has not led to a general increase in the money supply. In fact, the latest indications tell of further diminishing underlying price pressures in the euro area over the medium term, starting from currently low annual inflation rates of below 1%.

If changes in the money supply are examined using the concept of broad money, which means that, in addition to central bank liquidity, bank deposits are also included, we note that growth in the money supply has recently remained moderate despite the relaxed monetary policy, and that growth in bank lending to the public has also been weak, often even negative.

The fact that the increase in central bank liquidity has not been accompanied by an increase in bank lending and broad money has signalled uncertainty on the money markets and banks' need to cut their balance sheets, which had often expanded to excessive levels prior to the financial crisis. Banks strive to increase their liquidity reserves and prefer to keep them in the form of central bank deposits rather than invest the reserves on the interbank money markets, as was the case prior to the crisis. This has resulted in a simultaneous increase in the demand for central bank liquidity and a contraction in bank lending.

At present, a most pressing concern with regard to money supply is that corporate credit growth is too sluggish rather than too strong. However, if there were any signs of excessive lending growth in future, the ECB has the means to absorb bank liquidity rapidly, if necessary.

Charles P. Kindleberger, the famous researcher in the field of financial crisis, has written that "too little and too late" is one of the saddest phrases in the lexicon of central banking, but that "too soon and too much" would not be much better. Have central banks and the ECB among them acted too slowly and parsimoniously, or too generously and hastily?

It is my view that, after the problems that have also hit the European economy in recent years, the ECB needs to be able to give a positive response to the question of whether it did, within its mandate, its share and all it could to solve the problems. Decisions are taken on the

basis of the information available at the time. The measures that have been taken have been necessary in light of the available information. The non-standard measures have even encompassed notable risks, but the measures have been well considered and, it seems, we have been able to contain the risks.

Banking union

Alongside crisis management, politicians and public authorities have begun work to reform financial market regulation, supervision and structures. This reform work will also impact the position of central banks, albeit differently in different central bank constituencies worldwide.

As regards the euro area, the status and tasks of the ECB will change significantly next year, as single banking supervision begins and the ECB assumes responsibility for oversight of all euro area banks. A Single Supervisory Mechanism (SSM) to be set up on these lines will be part of a wider framework of reforms, the Banking Union. In addition to single supervision, this also includes a single crisis resolution framework, which is approaching the decision-making stage at EU level, as well as harmonised deposit protection.

Banking Union is a correct and necessary step. It would have been best if it had already been built twenty years ago when the financial markets were deregulated and the foundations of Economic and Monetary Union were laid.

The EU's single banking market was established by the Second Banking Directive, which entered into force at the beginning of 1993. It was part of the EU's single market programme, and its idea according to the single market logic was that a banking licence obtained from any Member State authorised the bank to operate throughout the territory of the EU.

In connection with the adoption of the Banking Directive and the establishment of Monetary Union, there was fairly extensive discussion among experts as to whether the single banking market and Monetary Union also required concentration of banking supervision. But the matter did not move forward. Banking supervision remained the responsibility of the "home country" (the country granting the licence). The Maastricht Treaty did, in fact, state that the ECB shall "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions", and that tasks concerning banking supervision could be conferred upon the ECB via a Council Regulation.

It must be remembered that at that stage large European countries (perhaps with the exception of Spain) had for decades not had much experience of serious banking crises. So, the question was not perceived as being a sufficiently burning issue. Big differences in national supervisory structures also played a role in why supervisory convergence did not make headway.

The political preconditions for single banking supervision were only born out of necessity as a result of the escalation of the financial crisis. On account of its independence, expertise and market knowledge, the ECB proved in practice to be the only possible location where single supervision could be established.

The ECB will conduct banking supervision in cooperation with national supervisors. In the final instance, the ECB is responsible for the oversight of all banks. Only the largest banks will come under its direct supervision, however. Supervision of smaller banks will be delegated - with recourse - to national financial supervisors. Supervision of the larger banks, too, will require and make use of the efforts of national supervisors.

Monetary policy and banking supervision have significant synergies, particularly in the domain of information. Even so, decisions concerning these two areas are different in nature and based on different objectives. For this reason, the supervisory architecture of the ECB will be built in such a way that monetary policy and banking supervision are kept separate in order to avoid conflicts of objectives. Key responsibilities on supervisory decisions will be conferred upon a new Supervisory Board, of which national banking supervisors will be

members. The Governing Council of the ECB, which is essentially a decision-making body for monetary policy, will ultimately approve or reject decisions by the Supervisory Board. Banking supervision work will be led by the Supervisory Board.

Macroprudential stability and structural regulation

Simultaneously with Banking Union, other new measures to safeguard financial stability are also being developed in Europe. I will mention here two of these integrated sets of initiatives.

On the one hand, Member States are in the process of introducing new macroprudential tools aimed at reducing the financial system's vulnerability to crises and increasing authorities' potential to address, if necessary, threatening developments within the banking system as a whole or on the assets markets.

Typical macroprudential tools include the new capital buffers that banks are required to hold and which can be required to be increased in the face of overheated credit markets, or which may be graduated according to bank size so that systemically important banks are required to maintain higher capital levels than others. Responsibility and competence in the field of macroprudential policy will be both at Eurosystem and national level.

The other area of initiatives is regulation of banking structures, for which the European Commission is expected to submit a proposal in the immediate weeks ahead. The idea is that financial operations involving the highest risk are to be separated from ordinary deposit banking, to be carried out by special-purpose subsidiaries. This type of structural regulation seeks to prevent deposit protection provided to deposit banks from turning into an incentive for unhealthy risk-taking, where speculators benefit privately from profits, but do not take losses, "privatising profits and socialising losses", as the saying goes.

The Commission's proposal for structural regulation will take a stand on the propositions made by the EU's High-Level Expert Group of which I chaired. Legislation relating to structural regulation, similar to those outlined in our report, is already underway in, for example, France, Germany and the UK. I hope the Commission's forthcoming proposal will lead to as uniform legislation as possible on this issue in Europe.

The Eurosystem, a special case

The range of central bank tasks is becoming wider than it was before the onset of the crisis. This is a global phenomenon. The Eurosystem – in other words, the ECB and the euro area central banks – form in this context a special case of their own, which is explained by the structure of Economic and Monetary Union and also by Europe's internal political dynamics.

The status assigned to the ECB and its practical policy-making have largely corresponded to the principles of "Modern Central Banking" crystallised by Fischer that I mentioned at the beginning: a clearly defined mandate, independence including safeguards against demands from governments pressing for central bank credit, and accountability.

However, the ECB is different from the world's other leading central banks. As a central bank common to many countries, its independence is of particular relevance. This is because the countries in Monetary Union have given up their monetary policy sovereignty. They made their decisions on joining Monetary Union as sovereign decision-makers, and, upon accession, decided to unite or pool their monetary policy powers. In order to make such a far-reaching decision, the countries naturally had to know in advance what kind of monetary policy the ECB would conduct.

It was possible to establish Monetary Union because the countries were ready to pool their sovereignty, on the condition of certainty over the stable value of money. For this reason, too, it was necessary to commit the ECB in a credible manner to objectives set in advance and to provide it with a sufficient degree of independence, with a view to ensuring that it could pursue the set objectives, free of any national or other political pressure.

The independence of the ECB and the decision-making procedure employed in the Governing Council prevent individual Member States from dominating monetary policy, and the assignment of a clearly defined objective for price stability prevents the independent ECB from abusing its independence in an arbitrary manner. The independence is supplemented by the ECB's accountability to the European Parliament and by the national central banks' arrangements for accountability at national level, such as supervision of the Bank of Finland by the Finnish Parliament.

Euro area stability and the ECB

The independence of the ECB and the definition of its role – or mandate – are interrelated. An independent institution bestowed with a public function cannot be assigned powers defined too loosely or an overly broad range of tasks in a democratic society. Such an extension of responsibilities would before long erode the political preconditions for central bank independence and the legitimacy of the central bank itself. A central bank is not the fourth branch of government; rather, it acts as if it were a "trustee" who performs the task entrusted to it.

Central bank independence has proven to be the correct solution for the successful conduct of monetary policy. Bearing in mind the lessons of the 1970s will be important in the future, too.

As the independence of a central bank thus remains one of the criteria for defining its tasks, the conclusion is that particular caution needs to be exercised in expanding the ECB's responsibilities, in order to avoid jeopardising the prerequisites for its independence. An example of tasks that could jeopardise central bank independence is those of a resolution authority empowered to recapitalise banks and/or wind them up. The existence of such a body is an important element of the upcoming Banking Union, but the ECB considers it as self-evident that this body cannot operate in connection with banking supervision or monetary policy.

Non-standard monetary policy measures in times of crisis and the forthcoming performance of tasks relating to banking supervision are necessary for the ECB and the Eurosystem, and useful steps forward for the euro area as a whole. At the same time, however, it must be ensured by other means, too, that tensions on financial stability do not become excessive. There are many reasons for this, but one of them is that ensuring monetary policy independence requires that the ECB should not be left alone as a guardian of stability.

This concerns two issues, in particular: firstly, bringing government indebtedness back onto a sustainable path and keeping it on a stable footing, and, secondly, safeguarding adequate levels of bank capital. Both are matters over which the ECB has no direct influence; they do, however, affect its ability to discharge its widened scope of responsibilities without coming into conflict with its own institutional status.

The role of national central banks

Within the Eurosystem, the national central banks have a role of their own, not only as parties implementing monetary policy, but also as participants in the preparation of the single policy. The Governing Council of the ECB takes its decisions considering the situation in the euro area as a whole and is not a forum for national interests. Even so, the role of the national central banks in policy preparation is highly valuable. It both contributes to the quality of policy and increases its legitimacy.

The ECB's monetary policy and its activities in the area of financial stability can make use of research and analysis performed by both the ECB and the national central banks. In times of crisis, in particular, but also at other times, it is important that each Eurosystem participant make its own unique contribution to the preparation of common analysis and policy. Drawing on its own research and expertise, the Bank of Finland has provided its input to this work.

Effective implementation of monetary policy, separation between monetary policy operations and their risk management as functions of their own, the preparation of structural reforms in banking and the promotion of transparency, among other things, are areas to which the Bank of Finland's preparatory work has made a contribution. As a member of the Governing Council, I am independent but, of course, all the Bank of Finland's competence is shared within the ECB.

The Bank of Finland's experience and preparation have been of particular significance in the initiation of the full allotment policy and in designing certain features of the programme of Outright Monetary Transactions (OMTs), among other areas. We have also argued for greater transparency in the decision-making of the Governing Council. This is the more important, the greater the central bank's responsibilities and influence become.

We have also been active in developing forward guidance for monetary policy. This is not only a variety of transparency; forward guidance, when used properly, is actually another active policy tool that can be used to increase the effectiveness of monetary policy. I believe, it was a good thing that the Governing Council adopted more explicit forward guidance last July, when the chairman stated that interest rates would remain at the level prevailing at that time or lower for an extended period of time.

This new type of communication provided since last summer has proven effective, as the inflation outlook continued to dampen this autumn. Thanks to the context created by forward guidance, we could implement the necessary lowering of interest rates at our meeting of 7 November as a consistent part of the ECB's accommodative monetary policy geared towards price stability.

Forward guidance will retain its role in the future, too. The euro area economy will take time to recover. Moreover, in the context of globally integrated financial markets, any divergence in economic activity between Europe and the United States will increase the challenges for the communication of monetary policy. Although the exit from central banks' non-standard measures and the normalisation of interest rate levels are currently only on the distant horizon, the experiences of last summer show that the approach of the turning point and related speculation could cause turbulence on the markets. Central banks will need to be able to respond to such developments with precise communication.

Following the latest interest rate decision, the euro area policy rate has already been brought very close to zero. This does not, however, mean that the ECB's room for manoeuvre in monetary policy or the tools at its disposal have been exhausted. Experience has shown that, where the situation so demands, we can count upon the capacity of the Eurosystem to find solutions. However, the division of responsibilities between the central bank and other actors must be clear, in order to avoid the central bank becoming subject to expectations that it can neither fulfil nor should be responsible for fulfilling.