Yves Mersch: The changing role of central banking

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Lamfalussy Lectures Conference of the Lamfalussy Award at Magyar Nemzeti Bank (The Central Bank of Hungary), Budapest, 4 February 2019.

* * *

John von Neumann, the Hungarian-born mathematician, once said: “there’s no sense in being precise when you don’t even know what you’re talking about”. I saw Alexandre Lamfalussy in many different roles over the course of 30 years, and I always admired his capacity to be extremely precise because he was professionally knowledgeable.

It is therefore a great honour for me to be awarded a prize in memory of a man who made such an important contribution to European integration.

During many years representing my country of origin in the Belgian constituency at the IMF, I witnessed the intellectual strengths of the Hungarian representatives, especially from the central bank. I therefore feel particularly flattered to have been awarded this prize by the Magyar Nemzeti Bank and its president, Mr Matolcsy.

I also want to express my thanks to Governor Ewald Nowotny of the Oesterreichische Nationalbank, who is also a firm believer in the need to bring the people of our continent together without nations trying to dominate each other.

Indeed, I feel very humble and modest in this environment. I was lucky to be able to develop my views and opinions when accompanying my highest political authorities in their meetings for more than 20 years. Moreover, my family provided me with two solid foundations: resistance to illiberalism during World War II, and the respect of the rule of law.

I have been veering between what Benoît Mandelbrot called “the two poles of human experience”, one driven by my legal background and the deterministic system of order and planning, and the other inspired by my lifelong experience with finance and the stochastic or random systems of irregularity and unpredictability.

Trying to straddle the two poles with insights from political science brings me to today’s theme: the changing role of central banks.

Mandelbrot said of the great financial crisis: “Financial economics, as a discipline, is where chemistry was in the sixteenth century: a messy compendium of proven know-how, misty folk-wisdom, unexamined assumptions and grandiose speculation.”

According to him, “financial markets are the machines in which much of human welfare is decided but so limited is our knowledge of how the financial system functions that we resort not to science but to shamans… a few elderly men, the central bankers. We do not understand what they do or how, but we have blind faith that they can somehow induce the economic spirits to bring us financial sunshine and rain and save us from financial frost and pestilence.”[1]

Are these bitter words from an insufficiently recognised genius battling the hysteresis effects of the “efficient market hypothesis”? Or is this an expression of frustration that finance still largely operates under a Euclidean perception of the world when it comes to measuring risk because new theories take time to become operationally mature and stable?[2]

Whatever the motivation, it points to the difficulties of change management. The same reflections apply to all organisations – while they are designed on the basis of all the knowledge available at the time, their designs age as the world around them evolves, and new experience lays bare weaknesses. Some of these weaknesses can be mitigated; others might be fundamental and need fixing without delay.

But, in the absence of consensus on what is essential, what is noise, what is cyclical and what is structural? These are precisely the questions that come up in view of the changing role of central banks.

The design of the modern central bank dates back to the consensus that arose around the disinflationary path of the 1980s – that central banks should be independent and have a narrow mandate to fight inflation. In Europe, there was a second layer of consensus on how to allocate what is done at national level and what is done at regional level.

However, the decision on shared sovereignty was driven by more political considerations. While the monetary leg was to be supported by an institutional setup, the economic and fiscal leg was left to coordination and a set of common rules. This was fertile ground for critics. Both Milton Friedman and Alan Greenspan gave the euro no more than ten years. But the euro has now been around for 20 years and has been a powerful instrument for keeping the European project afloat.

Nevertheless, the passage of time is inevitable. Globalisation has left its mark and the political factors in Europe have changed. European enlargement, the failures of economic coordination, the imbalances of the policy mix and the evolution of the European Commission from a technocratic body towards a more political one, among other factors, have shaped how the constitutional principles underlying Europe's central banks are used.

But the biggest test was the great financial crisis, which is still shaking the foundations of our societies today.

What has changed for central banks? How have they adjusted? What changes are still needed? And what changes must be resisted?

During the first half of the ECB's existence, it only saw a few changes. One important one was the forward-looking adjustment concerning how the decision-making process worked. A voting rotation principle was proposed, which would cap the number of voting members at 21.

This amendment to the ECB Statute, proposed by the Governing Council, was adopted with no changes by the European Council, Commission and Parliament.

The Governing Council made use of the Statute's flexible adjustment procedure again last year following a suggestion of the General Court on the interpretation of the role of the ECB regarding clearing and payment systems. This time around, the Commission started to interfere with the minimal changes the ECB had recommended, followed by more extensive changes by the Parliament and yet more by the Council, which even added a new objective to this chapter on monetary functions and operations. These amendments – if adopted – would bring monetary policy instruments under the control of the legislators – a clear violation of the independence principle of the Treaty. Obviously, the Treaty's fundamental principles cannot be modified by this simplified amendment procedure. The discussion is ongoing.

Let me now turn to the operational side. In the ECB's first ten years there was only a slight clarification of the quantitative definition of price stability, the ECB's prime objective, which was subsequently defined as headline inflation of below, but close to, 2% over the medium term.

Throughout the crisis, no further attempts to change the strategy, definition or numerical value of our objective gained any traction.

However, during the crisis one could see a trend developing around monetary policy implementation, with major changes to instruments, communication and accountability.

Outside the central bank, but influencing it on the institutional side, the major policy response to the crisis has been to strengthen EMU and to attempt to reinforce economic coordination and amend the fiscal rules. Additionally, a crisis management tool, the European Stability Mechanism, was created as an intergovernmental body outside the Treaties.

At the same time, a banking union was set up with a single supervisor, a single resolution authority and a still-to-be-completed single deposit guarantee scheme. According to an empowering clause included in the Maastricht Treaty activated by unanimity, the ECB received specific supervisory powers, albeit only for credit institutions.

This transfer of sovereignty is still being challenged in the German Constitutional Court. It came hot on the heels of a first move towards greater coordination in the financial sector through the establishment of European agencies for bank, insurance and securities and markets, in which Alexander Lamfalussy played an important role. Indeed, the governance structure of these agencies was modelled on the so-called Level 3 Committees introduced by the Lamfalussy Committee of Wise Men.

During these times, another trend became noticeable: the transfer of an increasing amount of new tasks to national central banks. Some of these had traditionally been performed by the central banks, but others were totally new. As the ECB has to issue an opinion on every change to laws governing national central banks, a conceptual framework evolved which establishes which tasks are governmental tasks, and which tasks are traditional central bank tasks, or which tasks could be considered ancillary to them. An undue transfer of competences to a central bank of tasks that belong to governments could indeed be seen as circumventing the monetary financing prohibition or threatening its financial or resource independence.

NCB consent and the funding of such new activities would therefore need to be scrutinised.

The case law of our adopted opinions over recent years in many countries covers topics as diverse as buying paintings, financing culture, education or investments and the financing of resolution funds. We also gave opinions on establishing a central register of bank account numbers; exercising asset management functions; insurance premiums; protection of competition in the mortgage loan market, to name but a few.

However, the biggest change in terms of conceptual evolution, strategic thinking and interaction with different policy fields concerns financial stability and macroprudential policy.

Under monetary policy, the Treaty foresees that the ECB shall contribute to the policies of competent authorities relating to banking supervision and the stability of the financial system. The Statute lists this as one of the tasks of the ECB. The concept of a financial cycle, as distinct from the business cycle, was only developed much later with the increasing financialisation of our economies.[3]

The emergence of this reality of a financial cycle and its relation to central banking was acknowledged with the establishment of the European Systemic Risk Board (ESRB) at the ECB and supervisory tasks being conferred on the ECB, including some macroprudential instruments under the supervisory legislation.

The monetary response to the crisis, with negative interest rates and quantitative easing, sharpened the focus around who is responsible for financial stability, but numerous tensions are still unresolved. Since financial systems are largely determined by national features, questions arise about what should be done at the national level and what at the centralised level.

Who should be responsible for the use of which kinds of instruments?

Other elements of the multi-dimensional macroprudential and financial stability discussions relate to the interaction with microprudential and monetary policy actions, not to speak of the fiscal policy capacity in this respect.

While Alexander Lamfalussy as late as 1993 still supported a narrow mandate for monetary policy to safeguard its independence, banking supervision aside, just one year later he was claiming that “central banking has never been a static business. Throughout its long history it has performed different tasks in different periods.” He also mentioned systemic stability in this context.

But he firmly sees financial stability enshrined in monetary policy. In 2010 under the shadow of the crisis he called for “central banks to not regard their macroprudential duty as being less important than their mandate, to pursue price stability”. Still, he also saw risks, saying: “The macroprudential mandate requires for the central bank a type of relationship with, and therefore a type of independence from the government that is different in substance from the one governing monetary policy.”

In the past, I have advocated an interpretation of functional independence, distinguishing between monetary policy and prudential supervision. Should we also apply this to macroprudential supervision, which is currently still mostly enshrined at national level?

A recent discussion on a possible macroprudential stance that is separate from the monetary policy stance would lend credit to this idea.

On the one hand, it is true that banking systems will remain determined by national features for as long as banking union is not completed and the sovereign-bank nexus still exists. On the other hand, monetary policy supports the credit cycle euro area-wide, particularly through unconventional measures.

Challenges ahead: the interaction of monetary policy with macroprudential policies

While a stronger systemic orientation is essential if financial stability is to be assured, the definition of the problem to be solved is still blurred. Even if we can agree on a macroprudential objective, such as increased resilience of the financial system, we are still failing to measure the goal or define an operational target. Moreover, there remains a need to clarify the range of available tools, calibrate the balance between rules and discretion, and clarify governance arrangements, both nationally and internationally, as well as the potential interaction with other policy areas.

Many believe that central banks are best equipped to do this job. In pursuing their goal of preserving price stability, central banks are attentive to the evolution of real and financial markets, they are familiar with the credit and banking channel and their institutional independence shields them from political interference.

However, as central bankers we have to perform our tasks with the utmost responsibility. Before adjusting the conceptual framework underpinning possible policy action, we need tested, robust analyses.

In macroprudential policy we still lack this certainty that would allow for a macroprudential stance that is similar but different to monetary policy.

We have no consensus on the definition and measurement of the objective. So how can we identify clear and well-defined policy goals linked to metrics and potential target levels?

In the absence of a proper understanding of the transmission channels of different instruments and their potential interactions and spillovers, how can we credibly discharge our accountability requirements?

At this stage, the conceptual foundations lack the robustness to pursue a standalone or non-quantified objective with instruments that have unknown consequences based on assumptions and models full of unobservable factors and multidimensional equilibria.

Another open question in the European context addresses the level of governance and decision-making. Since we cannot measure risk or define resilience, how are we to distribute competence between the national level and the currency area level, or even the EU as a whole?

Currently, country-specific features of financial cycles certainly exist due to national financial systems and institutional, legal and fiscal frameworks. Financial booms and asset price bubbles indeed often occur within national borders, in spite of a union-wide single monetary policy stance. But is deeper integration and Banking Union not around the corner?

At the national level, the institutional architectures are a patchwork, the use of instruments a “Tower of Babel”. I doubt that adding an additional European layer without a clear view of who is in charge with what instruments and for what objective will advance the issue.

While modesty is advisable in the context of macroprudential ambitions, monetary policy has the more stable conceptual framework. And through our “two pillar strategy”, which takes account of real economic developments and money and credit, monetary policy is able to integrate financial stability concerns. By doing so, the ECB can assess the longer-term implications for future inflation and economic growth.[4]

Conclusions

Fast-moving times sometimes require adjustments. Central banks are not excluded from this.

Sometimes minor amendments are sufficient, like the introduction of a rotation scheme across the larger currency union. Other changes might call for bigger reforms – as the financial crisis painfully highlighted. But often conceptual pendulums swing too far.

While ambition is justified to acknowledge the importance of financial stability, humility is warranted when it comes to policy conclusions. The time is not ripe for an operationalized standalone macroprudential approach – inside or outside the central bank.

Completing the European deposit insurance scheme (EDIS) and the banking union, making progress with the capital markets union and deepening economic and monetary union will lead to a financial cycle that is less determined by national structures. So the most efficient level at which to address these issues will change. But that would not, in and of itself, warrant a separate institution making separate financial stability decisions and complicating the tasks of existing institutions.

In any case, the monetary policy function will need to be closely involved, and is probably best placed to contribute to the development of a more robust conceptual framework. This is a precondition for operationalising a macroprudential stance that would do more than just neutralise an efficient and effective monetary policy stance.

Until these preconditions are met, the best solution is to integrate financial stability concerns into monetary policy at the European level – including possible corrections with instruments at national levels.

Such a transitional equilibrium is, however, subject to necessary changes depending on three factors:

1. Deeper knowledge of the determinants of the financial cycle.
2. Better understanding of macroprudential transmission mechanisms and policy instruments’

consequences, taking into account the institutional evolution of European integration.

3. A continuous reassessment of the evolution of the monetary policy toolbox and the consequences of its use for the financial cycle.

---

[1] Mandelbrot, B. and Hudson, R. (2004), *The (Mis)behaviour of Markets: A Fractal View of Financial Turbulence*, p. 298.

[2] For background information, see: Oesterreichische Nationalbank (2005), "The European Integration Process: A Changing Environment for National Central Banks", *Proceedings of OeNB Workshops*, No 7, 21 October.

[3] See de Larosière, J. (2018), *Les 10 préjugés qui nous mènent au désastre économique et financier*, Odile Jacob, Paris.

[4] See Issing, O. (2003), "Monetary and financial stability – is there are trade-off?", speech at the conference on "Monetary Stability, Financial Stability and the Business Cycle", Bank for International Settlements, Basel, 28–29 March.