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Monetary and Banking Policy in a Currency Union

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The title of this year's conference "*More than the Taylor rule: Monetary Policy, Prudential Issues and Central Banking*" provides the grounds for discussing several interesting issues related to the role of central banks, building in particular on the experience acquired before and during the crisis.

To be sure, there is now broad agreement that there is more to central banking than just following Taylor rules or, to put it in another way, to implement a simple inflation targeting regime. Financial stability matters, also for central banks whose primary objective is price stability. Under certain circumstances, the way in which monetary policy is implemented, with a view to achieve price stability, can undermine financial stability and in the end jeopardize price stability itself. Financial stability has to be taken into consideration in the conduct of monetary policy. There seems now to be a broad agreement on this. There is also a broad agreement on the fact that central banks should resort to macro-prudential supervision, as an additional tool to address financial stability issues, and to avoid overburdening the interest rate instrument.

The disagreements may arise when it comes to the institutional framework for achieving financial stability, and to the allocation of specific responsibilities. I would like to touch on some of these disagreements, in particular in the context of a monetary union, namely in the euro area.

The first question I would like to address is whether, aside from macro-prudential supervision, central banks – more precisely the ECB - should have more specific responsibilities in the field of financial stability, in particular with respect to the more traditional micro-prudential issues.

The second question is whether the mandate of the ECB, which currently focuses primarily on price stability, should be changed into a dual mandate, with financial stability being put at the same level as price stability.

My answer is yes to the first question is no to the second – i.e. the central bank (in this case the ECB) should have responsibility not only for macro-prudential supervision but for supervision in general. However, its current mandate should not be changed.

Let me start with the first question, concerning the central bank competence over macro-prudential supervision and the interaction with micro-prudential regulation. I will look specifically at the current European case, in particular the euro area.

In a monetary union like the euro area, there are two distinct issues to solve. The first is the complementarity between supervisory and monetary policy. The second is the level of government, national vs European, at which these powers are exercised.

Let me start by addressing the complementarity between monetary policy and macro-prudential supervision.

If there is any lesson to be learned from the crisis, on which there is probably a lot of consensus, it is that monetary policy alone – in particular the interest rate instrument – is insufficient to achieve price stability in an environment in which asset prices move faster than goods and service prices. A useful way to look at the issue in analytical terms is to use the old Dornbusch model of exchange rate overshooting, first published in 1976 in the Journal of Political Economy. That model explained how asset prices – more specifically the exchange rate - tend to overshoot their long term equilibrium level as a result of the much more rapid speed of adjustment of financial markets compared to goods and service markets. The model was used for exchange rates but can be applied to a closed economy, to analyse the dynamics of house prices or Government bond yields. It can be enriched with a system of equations describing households' and firms' borrowing behaviour and the supply of bank credit. Such a model can help understand how easy monetary policy may fuel asset bubbles and over-indebtedness, which may undermine price stability when the bubble bursts.

The view prevailing before the crisis was that monetary policy should aim primarily at price stability, and focus on the key macroeconomic variables to forecast inflation, while largely ignoring underlying monetary and credit flows or the behaviour of asset prices. Asset prices are too difficult to interpret and targeting them would raise the risk of huge market distortions – that was the argument. In case a bubble burst, the central bank should react immediately and ease monetary conditions as much as possible, in order to compensate for the deflationary effects of the burst.

Experience has shown that this recipe is very difficult to implement, for a series of reasons, including the leads and lags of monetary policy and the zero bound which may constrain monetary policy from providing the adequate necessary stimulus. It is thus preferable to prevent bubbles and their potential effects from happening, rather than letting them build-up and just trying to cure the effects after they burst. The problem is how to achieve this objective with only one instrument, i.e. the interest rate, which central banks traditionally use to implement monetary policy.

This is where the discussion about macro-prudential policy comes in. The aim is to design a set of macro indicators and instruments which can be used to foster financial stability over the cycle. I will not elaborate on the details concerning the type of indicators and instruments which should be used. What is clear to me is that the competence should be allocated to the central bank, given its expertise in the financial and macroeconomic sector and the fact that the objective is ultimately to ensure that price stability and financial stability can be achieved jointly and contribute to one another.

Macro-prudential instruments and policies are closely related to monetary policy, but also to micro-prudential policy. Some of the instruments used in the field of macro-supervision, for instance those aimed at reducing pro-cyclicality, have a direct impact on banks' balance sheets and on the various ratios set by the micro-supervisor. Just think of dynamic provisioning or liquidity ratios.

The question can thus be raised whether there are conflicts between the use of the two instruments, and in case of conflict who should prevail and what should be the mechanism for ensuring that the right decision is ultimately taken.

The conflict may arise when macro-prudential measures affect the stance set by the micro-prudential supervisor. Dynamic provisioning, for instance, aims at inducing more stringent bank behaviour in the provision of credit in the favourable phase of the cycle, and a less restrictive one in the weak phase. While in the former there might be no conflict between the micro and macro objectives, in the latter – i.e. a recession - market conditions may be such that a loosening of macro-prudential measures may not be consistent with the capital and liquidity requirement that the micro-supervisor and financial markets consider appropriate in light of the risks accumulated in banks' balance sheet. In other words, the optimal degree of deleveraging might differ, viewed from the point of view of each individual bank rather than from the system as a whole.

In addition to a potential conflict, there is a risk of moral hazard if the adjustment is conducted with only one instrument. The experience with the current crisis, in particular in Spain, shows that the attempt to ease financing conditions, through the provision of unlimited liquidity by the central bank – a measure which could be comprised in the set of macro prudential tools – may reduce the supervisor's incentive to press for a strengthening of the capital base which is required over the medium term in order to restore banks' access to capital markets.

The way to address these externalities is either to internalize them within the same institution or to set a well-defined framework defining the relationship between the authorities in charge of micro and macro supervision, setting the respective rights, obligations and accountability.

The experience gained before and during the crisis suggests that it is very difficult to define such a framework in a way that ensures that all cases can be appropriately dealt with when a crisis erupts. Experience also shows that legal issues acquire extreme importance during a crisis. Authorities are liable for their own actions, and are reluctant to act unless they are reassured that they are entitled to do so and that they have the appropriate instruments. The Federal reserve and the US Treasury ultimately admitted that they would have liked to avoid Lehman brothers' bankruptcy, but could not prevent it because they lacked the appropriate legal instruments.

By definition, each crisis is different from the previous one and requires some degree of flexibility in the way it is addressed. It is thus very difficult to define in a legal text the precise powers that different authorities are entitled to use in a crisis, and the boundaries of the respective responsibilities.

This is the reason why my preference is for a single institution to be the main responsible for both macro and micro prudential supervision, i.e. the Central bank.

In this respect I slightly changed my mind on this issue, on the basis of the evidence acquired from the crisis. In a book written with Daniel Gros in 2000 ("Open Issues in European Central Banking", McMillan), we stated that "*the institutional framework to promote financial stability in Europe is inefficient and internally inconsistent*", but we expressed doubts that the ECB would be the ideal candidate for exercising supervisory responsibility in the euro area. The main concerns were the interference that supervision, especially micro-prudential, would exercise on the conduct of monetary policy, the risk of moral hazard and the potential problems for the reputation of the central bank. The experience has shown that the central bank does not escape from these risks even if the responsibility for prudential supervision is entrusted to a separate institution. In fact, the risks of taking wrong decisions, such as providing liquidity to an insolvent institution, or not providing adequate liquidity to solvent ones, may actually increase if the supervisor is reluctant to share information on specific banks, even with the central bank.

In a monetary union, with a single monetary policy, the issue is whether and to what extent supervisory authority can be decentralised.

The way in which the Bankia – and other – cases have been managed over the recent past confirms that banking supervision in the euro area cannot continue to be implemented in a decentralized way. The incentives of the national authorities to free ride are simply too high and undermine the stability of the entire euro financial system.

The traditional argument put forward in defense of conducting prudential supervision at the national level is that supervisory authorities have to be accountable to taxpayers, who ultimately bear the economic consequences of bank failures. As long as bank rescue operations are financed by taxes collected at the national level - so goes the argument - supervision should remain national.

In a monetary union, however, the decisions taken by a national supervisor impact not only the country's residents but also the taxpayers and savers of the other countries. Recent events have shown how the uncertainties surrounding the restructuring of Bankia have negatively affected the banking system of the whole euro area and spread to other segments of the financial market, including in countries which had taken action with a view to put their own banking system in order.

The channel of transmission to the other euro area countries has taken several dimensions. First, the contagion through the sovereign risk market has increased government bond yields, thus also raising the implicit tax burden in other countries. Second, the high cross-border correlation of banking risk depressed the value of bank capital in other parts of the euro area, fuelling a credit crunch. Third, when domestic funds are not sufficient to ensure adequate bank recapitalization, as was the case for Greece, Ireland, Portugal, and now Spain, the European facility has to be tapped, which commits other countries' taxpayers.

Decentralized supervision in the euro area also provides incentives to underestimate risks and to shift the burden of adjustment to the other countries' taxpayers. The confidential nature of the information collected by supervisors on their respective banks is often used as a reason for not sharing it with the other countries, thus increasing the probability of underestimating the gravity of the situation and the cross-border implications of crises. Decentralized stress-tests have allowed for different degrees of rigor across countries, undermining the credibility of the entire European supervisory structure. The benchmarks and deadlines for recapitalizations have been set primarily with a view to accommodate national preferences rather than to restore stability across the board.

The current system of cooperation among national supervisors under the European Banking Authority is weak and has no sanctioning mechanism to avoid the risks mentioned above. It is paradoxical that while the governments of the euro area member states have accepted to subject themselves to strict rules and to a sanctioning regime, as foreseen in the fiscal compact for instance, national supervisors can operate with much fewer restrictions. As a result, the incentive to act is linked to market pressure, which experience shows as being the best recipe for doing too little too late.

The current decentralized system of supervision also puts an undue burden on the ECB. The latter has so far relied on the assessment of the national supervisors to judge whether banks are solvent, and can be accepted as counterparties for monetary policy operations. This fuels the temptation by national supervisors to understate solvency risks and to solve problems through the provision of central bank liquidity rather than capital increases. Only in countries under IMF-EU program have national supervisors been requested – I should say forced - to share all the required information. This may be a reason why countries try to resist having an IMF-EU program, until it becomes unavoidable.

I believe that in a monetary union the supervisory authorities should give account of their actions – and inaction – not only to the citizens of their own countries but also to the others. In the current EU institutional framework, it's not clear how such an accountability can be ensured. Financial stability is still largely considered as a national responsibility, which is somewhat paradoxical in a single financial market with a single currency. The role of the European Commission is also unclear. In theory, the supervisory and fiscal authorities of the member states should put pressure on each other to ensure such accountability, in particular in the context of the EBA and the Eurogroup/Ecofin, but in practice they are reluctant to do so, fearing of having one day to abide by the same requirement.

The cost of such an inefficiency is mainly borne by the taxpayers.

The solution is thus to centralize bank supervision at the euro area level, especially for systemically relevant institutions.

There are two ways to achieve this. The first is that the political authorities of the member states take the initiative and agree to implement a more efficient integrated supervisory system. The second way is that the ECB stops relying only on national supervisors and starts conducting its own assessment on the solvency of major banks, before granting them eligibility to monetary policy operations.

This prerogative provides a substantial amount of leverage for the ECB to get more powers on supervisory issues. Incidentally, this does not relate to micro-prudential issues only. Even in the field of macro-prudential supervision, the powers of the ECB are currently quite limited. The ECB chairs and provides support to the ESRB, which is a committee of the 27 EU countries and not restricted to the monetary union. It has the power to make recommendations, while the ultimate responsibility for implementation remains with the national authorities.

The problem with the approach by stealth, through which the ECB obtains more supervisory responsibility, is that the decision ultimately depends on the Governing Council, in which at least 11 out of the 23 members are Governors of National Central banks which currently have supervisory responsibility. They may oppose further centralization of powers to the ECB as has traditionally been the case.

I am nevertheless confident that the current crisis will induce further reflection and encourage those who are more reluctant to cede some of their sovereignty. I am comforted in this by a recent article in the Wall Street Journal by Christian Noyer, Governor of the Banque de France and President of the French Commission Bancaire, who takes a view very similar to the one I just expressed.

The last issue I would like to address is whether financial stability should be put on the same level as price stability, in case the ECB is given the supervisory powers as I mentioned previously. In other words, should the ECB's mandate be changed, from a uni-dimensional one focused primarily on price stability, to a dual mandate, as many seem to advocate.

The problem with having a dual mandate is how to deal with the trade-offs which may have to be confronted over the very short term, between the two objectives, and the degree of independence that the central bank has at its disposal in achieving both objectives.

I would like to make a few observations in this respect.

Financial stability is not an objective that the central bank, acting as supervisor, can achieve on its own. First, prudential regulation is based on legislation which is approved under the responsibility of the political authorities. The central bank can only implement the law which governs supervision. The law establishes the balance that society (and taxpayers) want to set between fostering a competitive financial system and reducing overall risk, including for taxpayers. If the central bank had the exclusive responsibility for financial stability, it could be tempted to over-regulate so as to ensure that no crises ever occurred, or to use monetary policy to solve all crises, which would be another way of using taxpayers' money, through the inflation tax. The second reason is that ensuring financial stability may require, under extreme circumstances, the intervention of the fiscal authorities, for instance to recapitalize banks, and this is ultimately a responsibility for the political authorities.

Therefore, the central bank, acting as supervisor, can only "contribute to" financial stability, through the use of micro and macro prudential tools. It cannot be the only one responsible.

The second issue is whether the contribution to financial stability should be put on the same footing as price stability or be *subject to* the achievement of price stability. The answer to this question depends on whether there may be cases in which the central bank, while contributing to financial stability may as a consequence jeopardize price stability. In other words, under which circumstances achieving financial stability may lead to higher inflation?

This is a fundamental question, which brings us to the core of the current financial crisis and the role of the central bank as lender of last resort to the financial system and to Governments.

Central banks are generally competent for being the lender of last resort to banks, when the latter are solvent. They are not lender of last resort to Governments. This would mean that the central bank should stand ready to lend to the Government, buying Government bonds, if needed on the primary market, when nobody else is ready to do so. This is prohibited in the statutes of the ECB. It is also prohibited for most other central banks, even the Federal reserve which has a dual mandate.

The question is whether central banks have room for maneuver in interpreting their mandate, with a view to influence financial market conditions, including those affecting the Government bond markets, without lending directly to Governments.

The answer to this question is that as long as price stability is ensured, central banks can act as lender of last resort to the financial system, even if – as a side effect - it influences the pricing of Government bonds, to the extent that this is seen as contributing to financial stability. The reason is that without financial stability, price stability can be endangered. The evidence over the past two years confirms this view.

The ECB has conducted its monetary policy through several non-standard instruments such as fixed-rate-full-allotment tenders, which provide banks with unlimited liquidity, against collateral, or direct interventions in the secondary Government bonds market. The Fed conducted two series of quantitative easing, buying Government bonds and other assets on the secondary market.

In both cases the central banks mentioned that these operations were consistent with their monetary policy framework, in which price stability was the primary or key objective. The anchoring of inflation expectations is one of the key indicators used to assess whether these policies were appropriate in light of the price-stability mandate.

So far, there has been no contradiction between price stability and financial stability, and inflation has not been used as a way to try to achieve financial stability.

However, the risk that such contradiction arise under extreme circumstances cannot be excluded. There may be cases in which the central bank is faced with the choice between financing the Government with the inflation tax or letting it default because it cannot sell its debt at sustainable rate. What would the central bank do if faced with such a choice?

Financial markets are probably also looking into these issues. Markets seem to consider that if confronted with such a choice, the ECB would not violate its mandate and would not lend to Governments, and let the political authorities deal with the problem. This would be in line with the way in which the ECB operated over the last few months, pushing the responsibility for refinancing those Governments which had lost access to financial markets primarily to the political authorities. This explains the relative high credit risk on the Government bonds of several euro area countries.

Markets also seem to consider that in the US the Fed would behave differently. In extreme cases, were the Government to lose access to financial markets, the Fed would be expected to interpret its dual mandate as allowing it to intervene, even by resorting to some inflation tax, to avoid instability in the financial system. It's not clear whether this market view is correct. So far, the US Government has been able to access the markets and there are no inflationary pressures yet in the US. I personally doubt that, in case inflation got out of hand, the Fed would be willing to act in such a way. The justification for the low interest rate policy implemented over the last few months has been based on high level of unemployment and the good anchoring of inflation expectations. If inflationary pressures started to rise, dis-anchoring expectations, the Fed would have sooner or later to tighten policy, which could create problems in terms of financial stability. The more the monetary policy adjustment is delayed, the greater is the risk for financial stability. It's not clear how monetary policy would react under these circumstances. Markets seem to believe that it would be dominated by financial stability considerations.

The US history is filled with examples showing that tolerating higher inflation can be risky for financial stability. After the first oil shock, for instance, monetary policy was loosened for a prolonged period of time, leading to rising inflation in the second half of the 1970s. When monetary policy had to be tightened, in the early 1980s, the sharp increase in interest rates contributed to the savings and Loans crisis. Similarly, the delay in tightening monetary policy in the mid-1980s led to the stock market crash of 1987. The burst of the high tech bubble in 2001 and of the housing market in 2007 were also due partly to a prolonged period of low interest rates and a tardive adjustment, which ultimately fuelled financial turbulence.

Interestingly, the academic debate on whether the inflation target should be increased as a way to reduce the high debt in advanced economies, has found a new impetus, especially across the Atlantic. This debate is fuelled by the ease with which the US debt is currently financed, and ignores the safe haven effect which crowds in the US huge amounts of funds from the rest of the world. The crowding-in may last for some time, depending on how quickly Europeans will be able to put their house in order, leading investors to accept to be expropriated of their real returns, in favor of maintaining the nominal value of their invested capital. However, I doubt that under normal market conditions investors can be systematically fooled. They may be perfectly aware of the risks, but are probably convinced that they can manage these risks. That is the typical indication of an upcoming crisis: participants know that some assets are over-priced, but have been burned by shorting them and thus decide to remain long in the expectation that they will be able to sell before everybody else and avoid the capital loss.

The fallacy in the composition is evident, at least to outside observers; and possibly also to those in charge of macro-prudential supervision. They should act accordingly, with a view to avoid the creation of another bubble in some parts of the world economy.

To conclude, the recent crisis has provided new evidence for re-assessing policy frameworks, in particular concerning the allocation of responsibility for prudential policy. Keynes is quoted for his famous sentence, "*When facts change, I change my mind, what do you do?*" (Apparently Keynes never pronounced these words, they are Paul Samuelson's). A good theory should be able to interpret not only the old but also the new facts. What is important, in this debate, is that the new facts do not lead us to forget the old ones. That would be a sure way for repeating the mistakes of the past.

Thank you for your attention.