Discussion of Position Paper

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Monetary Policy and Prudential Regulation: In Search of a New Normal

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The views expressed in this presentation are my own and do not necessarily represent those of the ECB/SSM and the Eurosystem.

Outline

- **What is “New” (for the ECB)?**
- **From 1 to 3 Policy Functions: Objectives and Tools**
- **What is not “New” (for the ECB)?**
- **Comments on the “7 Remarks” postulated in the paper**

What is New?

- With the start of the Single Supervisory Mechanism on 4 November 2014 the ECB has assumed a role as prudential banking supervisor for Member States participating in the SSM.

- SSM grants **broad range of additional tasks & powers** to ECB (regarding micro- **and** macro-prudential supervision)

- SSM Regulation: overall objective "to protect the safety and soundness of credit institutions and the stability of the financial system" (Recital 65 and Article 1)

From One to Three Policy Functions (I)

- Before SSM: **monetary policy** the only policy function

  <u>1. Primary objective:</u> to maintain price stability (Art.127(1) TFEU) .
- With the start of the SSM: two additional prudential policy functions
- **<u>2. Macro-pru objective:</u>** contribute to the stability of the financial system; implies containing systemic risks emerging from the banking sector (e.g. Art. 5(2) SSM Regulation and Recital 4 ESRB 2013)
- *<u>Systemic Risk</u>*:
- FSR 2009: “the risk that financial instability becomes so widespread that it impairs the functioning of (part of) the financial system to the point where economic groth and welfare suffer materially”
- (CRD IV): “a risk of disruption in the financial system with the potential to have serious negative consequences for the financial system and the real economy” (Art. 3(10)).

From One to Three Policy Functions (II)

- **3. Micro-pru objective:** contribute to the safety and soundness of credit institutions (see SSM Regulation, Art. 1).

- Ensure that credit institutions fully internalise all costs caused by their activities and avoid that they take excessive risks which may lead to disorderly failures, impose undue costs on deposit guarantee schemes or cause other damages.

What is Not New?

- ECB has always paid attention to systemic risk and financial stability (e.g. Financial Stability Review since 2004)

- ECB has always monitored financial imbalances and asset prices in its monetary policy framework (e.g. via monetary pillar)

- ECB has considered "leaning against the wind" to address financial imbalances

- ECB has developed and used analytical tools for analysis of financial stability and systemic risk

- Top-down Stress-Test infrastructure since 2011 (e.g. ECB Occasional Paper 152 "*A macro stress testing framework for assessing systemic risks in the banking sector*", *2013)*

- Dynamic Balance Sheet Analysis (going beyond EBA methodology)

Preview: Main Conclusions

- Monetary Policy and Macro-prudential policy both have a system- wide dimension
- Price stability is not sufficient for financial stability (Business Cycle and Financial Cycle de-synchronised)
- Monetary and Macro-pru policies need to be coordinated
- Need for mutually consistent policies:
- Already at policy preparation level, monetary policy needs to be aware of macro-prudential policies ‘in the pipeline’
- Potential impact of macro-prudential policies should be well understood
- Rich synergies between monetary and macro-pru policy analysis
- Micro-prudential policy aims at safety and soundness of individual institutions – not at smoothing the financial cycle
- Strong arguments for Macro-pru being under responsibility of central bank function.

Remark 1: Operational Separation

Issue

- **Do not target the two objectives of monetary policy and macro-prudential policy with the same instrument, i.e. policy interest rate.**

- Widespread agreement:
- Technical argument: “Tinbergen Principle” - need at least one instrument for each objective
- No convincing theory how interest rates can systematically steer asset prices
- Mervyn King: it would be highly controversial if a restrictive central bank policy adopted for reasons of asset market risks would create “mini-recessions” in real activity and unemployment, when the level of inflation would be compliant with the defined and publicly-known target.
- “Raising interest rates across the economy to limit speculation in a particular area is the rough equivalent of weeding a garden with a bulldozer.” (Janet Yellen, 2014)

Remark 2: Adequate macro-pru policy

Issue

- **Macro-pru may support / complement monetary policy in achieving its objective but not always**

Challenges

- **(Lack of) synchronisation of business cycle and financial cycle**
- **Identification of current stance**
- **FC ↑ BC ↑ FC ↓ BC ↓**

  counter-cyclical / complementary policies

- **FC ↑ BC ↓ FC ↓ BC ↑**

  Pro-cyclical / contradictory policies

- **Coordination / synergies between monetary policy and macro-pru!**

Remark 3: Tool Setting

Issue

- **Monetary policy: interest rate setting => objective price stability**
- **Financial stability: macro-pru instruments => objective financial stability**

Challenges

Both policies have a macro or system-wide dimension …BUT:

- **What is financial stability?**

“Financial stability can be defined as a condition in which the financial system – intermediaries, markets and market infrastructures – can withstand shocks without major disruption in financial intermediation and in the effective allocation of savings to productive investment.” (ECB).

Quantifiable objectives?
Price stability “close but below 2%” but what about Financial Stability???

Optimal monetary policy versus optimal macro-pru policy

- Business cycle versus financial cycle
- Optimizing policy functions, optimal policy rule?
- More research needed for optimal macro-pru

Remark 4: Centralisation

Issue

- **Monetary policy and prudential policy “under one roof”**

Several Examples

e.g. ECB (although in different buildings), BoE…

Remark 5: Institutional architecture

Issue

- **Responsibility of macro-prudential supervision to SSM?**

Challenges

- ➢ Mon-pol and macro-pru both share systemic perspective: focus on macro economy / financial system
- ➢ Coordination of monetary policy and macro-pru might therefore be more efficient when organised jointly under central banking function (**see Remark 2**)
- ➢ One objective of macro-pru policy: smoothening of the financial cycle
- ➢ Therefore (potential) **conflict of interest with micro-pru supervision**: supervisory measures on individual institutions should not be driven by considerations about system-wide financial cycle.
- ➢ ECB/SSM: Macro-Prudential Coordination Group (quarterly discussions at the GovC, joint fora with Supervisory Board)
- ➢ Regulatory Forum
- ➢ Several sub-groups for internal coordination and exchange of information

Remark 6: Lack of Responsibility

Issue

- **ECB has decided to overlook systemic component of risks**

Challenges

- Macro-prudential policies of the Member States participating in the SSM are <u>shared</u> between their national macro-prudential authorities and the ECB (Art. 5 SSM Regulation).
- Common legal framework, still not completed…but not “delegated away” to NCA’s
- In order to address systemic (or, equivalently, macro-prudential) risks the ECB may impose – at the level of credit institutions – more stringent measures than those introduced by national authorities (Art. 5(2)).
- Macro-Pru policy function implemented at ECB
- Macro Prudential Report (country perspective)
- CA + ST where deliberately designed as <u>micro-pru</u> exercises, pre(!)-SSM.
- Systemic risk analysis part of macro-pru top down stress testing infrastructure

Remark 7: Early Warning Systems

Issue

- **(Further) development of EWSs needed for systemic analyses**

Challenges

- Widespread agreement
- One source of systemic risk is originated in contagion that may stem from default of a few financial institutions as a result of the growing interconnectedness within the system.
- Lesson from the crisis: good capital and liquidity situations at individual level (and monitored by micro-supervision) is not sufficient for the stability of the financial system

- EWS operating at ECB (e.g. Alessi and Detken)
- More research in progress
- Data challenges, improved by access to supervisory data
- Various initiatives, Central Credit Registers / AnaCredit
- … … …

Main Conclusions

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- Need for mutually consistent policies:
- Already at policy preparation level, monetary policy needs to be aware of macro-prudential policies ‘in the pipeline’
- Potential impact of macro-prudential policies should be well understood
- Synergies between monetary and macro-pru policy analysis
- Micro-prudential policy aims at safety and soundness of individual institutions – not at smoothing the financial cycle
- **Strong arguments for Macro-pru being under responsibility of central bank function.**