

20100903 ECB: Lessons from the crisis for monetary policy and financial stability (Board Member González-Páramo Speech)

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Speech by José Manuel González-Páramo, Member of the Executive Board of the ECB, Annual Money, Macro and Finance conference, Limassol, Cyprus, 3 September 2010

It is a great pleasure to participate in this panel, especially in the company of such an esteemed group of colleagues.

The topic that has been selected for this session – ‘Lessons from the crisis for monetary policy and financial stability’ – manages to be simultaneously: extremely topical; extremely interesting; and extremely ambitious.

In the interests of time, I will focus on three issues, where the ECB’s perspective may be of particular value:

- first, the design of central banks’ operational frameworks for the implementation of monetary policy;
- second, monetary analysis, a distinctive, and at times controversial, feature of the ECB’s monetary policy strategy;
- and third, the role of central banks in macroprudential supervision, where a number of important initiatives are being undertaken in Europe.

These three issues stand at the intersection between monetary policy and financial stability. They thus represent areas where, at least potentially, the lessons of the financial crisis are particularly acute.

1. The design of central banks’ operational frameworks

Non-standard monetary policy measures

One set of lessons drawn from recent events concerns crisis management.

Exceptional times call for exceptional measures. During the financial crisis, the ECB has implemented a range of non-standard monetary policy actions. [1] We recognize that these measures entail risks: by their nature, non-standard measures explore uncharted territory, and such explorations are always risky. But we have judged the risk of inaction to be greater.

In particular, in addressing the financial crisis, central banks have actively used their operational frameworks for the implementation of monetary policy to sustain financial market functioning, thereby supporting both financial stability and monetary policy, in its pursuit of price stability.

To be concrete, allow me to recall the ECB’s actions in the money markets. Modern banking systems rely heavily on wholesale funding. In particular, with the growth of the originate-to-distribute business model and expansion of securitization, the money market has become the marginal source of funds for the expansion of bank loans.

In this environment, any lack of confidence in bank solvency first becomes manifest in a funding problems in the money market. As concerns about counterparty risk multiply, this can lead to “freezing” of the interbank money market, which in turn interferes with monetary policy transmission and the expansion of bank credit.

In the face of the financial crisis – and, in particular, after the failure of Lehman in September 2008 – central banks acted promptly and decisively to contain financial distress, pre-empting a destructive, self-sustaining contractionary cycle.

At the ECB, the main objective of the non-standard measures that were introduced was to expand central bank intermediation. This was intended to substitute for interbank transactions that could no longer take place owing to the malfunctioning private money market. Allowing greater

intermediation across the Eurosystem balance sheet prevented a collapse of the financial sector and mitigated the impact of market turmoil on the real economy.

If you like, the ECB's actions can be seen as the modern-day equivalent of a 'lender-of-last-resort'. Rather than providing cash to banks so that they can meet retail deposit runs, the ECB set out to provide 'intermediation-of-last-resort' as the interbank money market froze, with the goal of preventing a fire-sale of marketable assets and the costly premature liquidation of loans.

How was central bank intermediation increased? The ECB expanded a number of services:

- its maturity transformation, offering operations out to one year maturity while funding these through the accumulation of overnight deposits;
- its liquidity transformation, by accepting illiquid assets (such as mortgage-backed securities) as collateral in its operations, against which it provided cash;
- its distribution of liquidity within the financial sector, through conducting operations with a very wide range of counterparties; and
- its contribution to addressing information problems, by conducting operations in a manner that protected counterparties' anonymity and thus avoided the danger that some banks are stigmatized.

Fortunately, switching to this "crisis management mode" required relatively minor adaptations to the Eurosystem's operational framework. Some characteristics of the Eurosystem's framework therefore appear to have made it particularly adept for times of crisis.

Experience has shown that the Eurosystem's operational framework provides automatic stabilisers in the context of crisis management, in part by allowing an elastic intermediation role to the central bank. These have proved to be very helpful features in dealing with recent challenges.

Challenges for the design of central bank operational frameworks

Looking forward I believe that central banks' operational frameworks should keep or introduce such features. Of course, the details may differ across currency areas reflecting the different characteristics of domestic financial markets and banking systems. Nonetheless, I believe that the ECB's framework provides a valuable blueprint.

However, the danger exists that the support offered to the financial system at a time of stress morphs into a lasting dependence of banks on central bank financing, blunting incentives for necessary structural change in the financial sector. Such support may also increase the direct financial and balance sheet risks of the central bank itself. And ultimately the creation of central bank money may pose inflationary risks, if it is not withdrawn in a timely and effective manner once broader economic conditions normalise.

With regard to the operational aspects, an important issue concerns how to provide the right incentives for proper liquidity management by banks, without jeopardizing the flexibility of the framework. In this regard, the recent agreement reached on the liquidity enhancement measures proposed by the Basel committee, in particular the Liquidity Coverage Ratio, will strengthen the resilience of banks to liquidity crises and enhance their liquidity risk management frameworks.

Turning to the question of exit from our non-standard measures, exceptional facilities and interventions should – by their nature – be of a temporary nature and, ideally, would expire automatically when they are no longer needed. One way to achieve this is to price them at rates that embody a premium that makes them unattractive once market conditions normalise. This has the additional advantage of providing the right incentives for market participants.

Concerning the incentives facing the private sector, allow me to elaborate on a specific example – the role of collateral frameworks for central bank operations.

A broad collateral framework, such as that adopted by the Eurosystem, has considerable merits in crisis times. But, at the same time, it poses significant challenges going forward.

First, such an approach implies risks to the central bank's own balance sheet. Broad collateral

frameworks therefore require constant monitoring. The central bank's risk control framework needs to be adjusted continually in order to counteract any undesirable practices by counterparties in their use of collateral. Discretionary measures to restrict undue collateral practices must be part of the central bank's toolbox if it generally accepts a wide collateral set.

This requires a very sound information base and sufficient human resources: to monitor financial market practices and innovation; to develop pricing models; and to refine risk control measures. From the onset of financial crisis, the ECB has been aware of increasing residual financial risks stemming from its collateral framework, and has continuously redefined its risk control framework to manage these risks.

Second, as the Bank for International Settlements warned in its 2008 Annual Report, [2] the large-scale intermediation of ailing capital markets by the central bank may create price distortions in the longer term. Making a wide range of liquid and illiquid assets eligible for central bank refinancing may – if not adjusted for by the central bank via risk control measures and adequate pricing policy – lead to a preferential treatment of illiquid assets relative to liquid ones, raising the relative price of illiquid assets and leading to an oversupply of such assets and consequent impact on credit allocation.

Third, a collateral framework that allows the "own use" of secured instruments in central bank operations (i.e., the submission of asset-backed securities based on loans originated by the borrowing bank) could reduce incentives for bank issuers to revive their third-party investor base and to reactivate markets.

Finally, a broad collateral framework may distort the incentives for banks to manage liquidity risk properly, by allowing them to replace highly liquid assets such as government bonds with illiquid assets. Again, risk control measures and valuation standards should be used to address this risk.

Preserving the collateral framework as an effective crisis-mitigating tool, while at the same time containing unwarranted market distortions and preserving incentives for prudent risk management, is an important challenge that we continue to explore.

International cooperation among central banks

Given the global scope of the financial crisis, the need for central bank cooperation has come to the fore. Of course, this issue is not new: central banks have a long history of cooperation. Coordinated foreign exchange interventions are perhaps the most visible example.

However, the recent crisis has intensified, initiated or revived other forms of inter-central bank cooperation, notably the close and frequent exchange of information and analyses about market developments and economic and financial conditions. Moreover, precisely because of their novel nature, the design and introduction of non-standard policy measures during the crisis benefited considerably from an exchange across central banks of experience and expertise.

And, in the current crisis, even interest rate decisions were coordinated on one occasion, in early October 2008. This can be seen as truly exceptional – reflecting the special needs of the crisis – given the prevailing flexible exchange rate regime among the world's major currencies.

Importantly, I should also refer to the important role that the bilateral swap lines arrangements involving among others the US Federal Reserve System, the Swiss National Bank, and the ECB to provide US dollars and EUR respectively to ECB counterparties and SNB counterparties. These lines were needed during periods of mal-functioning in the foreign exchange market and proved to be instrumental in facilitating the cross border flow of liquidity contributing also to smooth domestic money market conditions. These instruments represent important tools in our armoury for exceptional times.

2. Monetary policy operations and monetary analysis

Another key feature of the ECB's approach to managing the financial crisis has been its adoption of a fixed rate / full allotment tender procedure in its operations. This implied that the ECB accommodated the banks' demand for liquidity and central bank intermediation in full. One implication of this intermediation was an increase in the monetary base, as central bank balance sheets expanded in the face of very strong demand for such intermediation.

But the expansion of the balance sheet should not be seen as an attempt to expand the money supply directly by “printing money”. Rather it was a by-product of a set of non-standard measures aimed at supporting the functioning of crucial segments of the financial markets, thereby promoting effective monetary policy transmission and avoiding a financial collapse.

But such measures clearly have the potential to influence monetary dynamics and monetary policy. This begs further questions about how central banks should assess the transmission of financial shocks and imbalances, such as those at the heart of the recent crisis, to the financial system as a whole, to the wider real economy and, ultimately, to price developments.

This is where the ECB’s monetary analysis comes in. The prominence we have given to monetary analysis is a distinctive characteristic of our monetary policy framework. In the past, it was much criticized by academics and other observers. But we have always found it valuable to keep a close eye on developments in bank balance sheets, and – by implication – in the evolution of the monetary aggregates and their counterparts.

We see these as an indicator of imbalances in the economy, which may have implications for price developments over the medium to longer term. And the value of such analysis has multiplied of late: both in the run up to the financial crisis and during the financial stress itself.

To give some sense of monetary analysis in practice, it is useful to pick up the story of our non-standard measures, focusing now on how these have been transmitted to the real economy.

In some quarters, concerns have been expressed about the “transmission” of the ECB’s expansion of its monetary base to the economy as a whole. In particular, it is doubted whether the expansion of central bank money has “passed-through” to stronger broad money and bank credit growth, as a traditional text book “money multiplier” view of the world would imply.

Such views rely on a mechanical application of various accounting identities to describe the interactions among central bank measures, bank behaviour, the decisions of borrowers and lenders in the productive sectors, and the evolution of the real economy.

Our monetary analysis sets out to replace these accounting identities with a richer, behavioural view of how monetary impulses are transmitted through the financial sector to the real economy, and ultimately to longer-term price developments. It offers a lens to understand this transmission process, taking a structural view of the behaviour of banks, borrowers and money holders.

Taking this perspective, an entirely different view of the impact of our non-standard measures emerges. This starts from the recognition that the expansion of the monetary base reflected the ECB’s attempts to ‘bridge the gap’ created by the disappearance of the interbank money market, rather than a mechanism to expand bank balance sheets mechanically.

Viewed in this light, non-standard measures aimed at insulating monetary and credit developments from the immediate impact of the financial crisis on the money market. Their success should thus be judged on whether they prevented a dis-orderly deleveraging – associated with a premature calling of outstanding bank loans – not on whether they induced a renewed expansion of bank credit equi-proportional to the expansion of the monetary base.

Research undertaken at the ECB demonstrates that the behaviour of bank loans to corporations and households in recent years can be explained on the basis of pre-crisis regularities in the data, once developments are conditioned on the actual path of economic activity. [3] In other words, one does not need to rely on exceptional or aberrant bank behaviour to explain developments in money and credit following the failure of Lehman. The ensuing weakness of economic activity suffices to account for what was observed.

These results constitute evidence that the non-standard measures introduced by the ECB following Lehman’s demise were largely successful in insulating the real economy from a breakdown of financial intermediation in the interbank money market. And, as such, they demonstrate that the measures achieved their goal.

As this example illustrates, the monetary analysis offers an important window into the behaviour of the financial sector and its implications for the wider economy. As such, the monetary analysis provides insights relevant for both monetary policy and financial stability.

By implication, we should be wary of calls to re-orient our monetary analysis exclusively to financial stability purposes. Doing so would limit the potential value of such analysis.

Viewing financial and asset price dynamics through the lens of monetary developments integrates them into an overall framework directed towards the achievement of our goal: price stability. At the same time, it provides crucial insights into the slow accumulation of financial imbalances over longer periods, which may be neglected by traditional macroeconomic forecasting techniques. And pursuing monetary analysis may also embed some implicit leaning against excessive money, credit and asset price growth in our interest rate decisions, helping to stabilise the economy – both with regard to price developments and in the financial system – over longer horizons.

3. Central banks' role in macroprudential supervision

Even if interest rate decisions can help to contain financial imbalances over time, they are too blunt an instrument to deal with the build-up of systemic risks and asset price bubbles that appear to have characterised the pre-crisis period.

Especially in their formative stages, such phenomena demonstrate important cross-sectional variation: across regions; across sectors; and across markets.

Interest rate decisions cannot accurately target those 'hot spots', where financial imbalances may be emerging – at least not without imposing collateral damage on the rest of the economy. Complementary and more focused instruments are needed for such tasks.

This is where development of a macroprudential approach to financial supervision, complementing traditional micro supervision of individual institutions, comes in.

Macroprudential policy aims at containing the build-up of financial imbalances and ensuring the financial system is able to withstand their unwinding, minimising potential costly externalities to economic activity and stability.

As reflected in the de Larosière report, [4] central banks have an important role to play in the development of macroprudential supervision. They have a deep knowledge of macroeconomic and financial issues. Conducting monetary policy necessarily entails developing insight into the behaviour of the financial system and its interaction with the wider economy: issues which lie at the core of macroprudential policies.

Nonetheless, assumption of new macroprudential responsibilities by central banks entails some important challenges. Among these, allow me to highlight two.

First, the governance of the macroprudential framework needs to be carefully designed. It is vital that the primary nature of the ECB's price stability mandate is preserved, even as it assumes greater responsibilities in the macroprudential and financial stability spheres. This has both institutional and organisational aspects, as well as raising communication issues.

Central bank independence in the pursuit of its price stability mandate must be preserved, notwithstanding the assumption of greater responsibilities for financial stability. A macroprudential supervisor may recommend restrictions on credit growth and/or leverage, possibly differentiated on a geographic or sectoral basis. Being party to such recommendations will expose the central bank to political pressures. The conduct of monetary policy in pursuit of price stability must be insulated from such pressures.

I would therefore emphasise that central banks make their best contribution to supporting financial stability by continuing to credibly deliver price stability. Over the medium term, price stability and financial stability are always complements. Even in the short run, we should not entertain trade-offs between price stability and financial stability: via expectational channels, any compromise in the pursuit of price stability would endanger its achievement and, by implication, threaten financial stability which rests upon it.

Second, an operational framework for macroprudential analysis and policy needs to be defined. This poses another set of practical challenges.

As ECB experience attests, price stability can be defined in a transparent, quantitative manner. But defining financial stability is different. There is no simple quantitative definition. Nor is there a

single indicator against which to be held accountable.

By contrast, a large and diverse set of financial intermediaries and markets need to be monitored and assessed. These cannot straightforwardly be aggregated into a single measure of the financial soundness and stability. Moreover, the tools and frameworks of analysis are far less well developed than is the case for monetary policy.

How can a central bank, in this environment, make its macroprudential supervision tasks operational?

We need to acknowledge that financial stability is a multi-dimensional concept. Financial instability can originate from many sources. Financial crises typically reflect the slow accumulation of imbalances over a long period, often with multiple sources and manifestations. By their nature, crises are episodic. While financial crises share some features, they also exhibit key differences.

For all these reasons, we should not have the ambition to create simple, formalised strategies, assuming that 'one-size-fits-all' for all circumstances. Rather we need a comprehensive and encompassing approach, even if this comes at the expense of greater complexity and allows for more discretion.

To give content to this framework, a large set of instruments will be needed: financial indicators; early-warning systems for the unwinding of financial imbalances; financial contagion models; stress-testing frameworks; and dynamic stochastic general equilibrium models of the macroeconomy, which include feedback effects between the financial sector and real economy. At the ECB, we are working to develop the required suite of tools in view of our support of the European Systemic Risk Board (ESRB).

Concluding remarks

The financial crisis has posed new and significant challenges to central banks. In large part, I think we can be proud of how we have dealt with them. Nonetheless, the experience has certainly taught us some important lessons.

Summing up the various issues I have discussed today, I would emphasise two points by way of conclusion.

First, it has become increasingly obvious that central banks have the responsibility to support financial stability and market functioning. This makes a valuable contribution to economic stability and performance in and of itself. But – by maintaining the effective transmission of monetary policy – such activities also offer crucial support to the central bank's pursuit of its primary objective, maintaining price stability.

Second (and by implication), the pursuit of price stability and financial stability are complements. Over the longer term, the best contribution monetary policy can make to support financial stability is to preserve the price stability on which a well-functioning financial system relies. And even at shorter horizons, measures to support market functioning and understand the behaviour of the financial system benefit both financial stability and monetary policy in its pursuit of price stability.

Thank you for your attention.

NovaRes Team