MPI Collective Goods

Martin Hellwig

Financial Stability, Monetary Policy, Banking Supervision and Central Banking

ECB Forum

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Banking supervision and monetary policy

- Issues:
  - Institutions
  - Objectives
  - Operations
  - Substance of activities
- Need for a Broader framework
  - Relation financial stability – monetary policy
  - Relation central bank – private banks
  - Relation monetary policy – oversight over banks

Two approaches

- Greenspan 1990: Turnaround of monetary policy to prevent massive insolvencies of major commercial banks
- ECB 2008/2011: Interest rate policy for pursuit of price stability, unconventional measures for financial stability; interest rate increase in 2011
- ECB 2011/2012: LTRO as a measure to fight the financial crisis, cheap and reliable funding for banks, including banks of dubious solvency
  - „The greatest carry trade ever?"

Banking Union as Santa Claus?

- May/June 2012: Doubts about Spanish banks
- Weakness of bank lending
- Acharya/Steffen: Due to weak capital positions/financial repression
- Fragmentation of financial and monetary systems
- Spanish request for ESM support for recapitalization
- Banking union and the SSM as a panacea
  - To make sure that all problems in banks are dealt with?
  - To improve transmission?
  - To reduce fragmentation?

Remember those MoU‘s

- MoU‘s of the early 2000‘s:
  - Governments and supervisors deal with solvency problems
  - National central banks provide liquidity assistance to individual institutions
  - ECB provides general liquidity assistance through market interventions
- How do you deal with
  - A banking crisis that is so severe that the sovereign is unable to cope with it
  - A banking crisis that is caused by the sovereign‘s own debt crisis
  - The unwillingness or inability of sovereigns to clean up their banking systems

Criticisms of central bank acitivism

- Moral hazard – Remember the effects of the „Greenspan put"!
- The central bank is subsidizing zombies
- The central bank is intervening selectively and benefiting particular banks and sovereigns
- Liability: The central banks is running risks that might come back to hit taxpayers.
- Central bank policy has fiscal implications
- Central bank policies that have fiscal implications need parliamentary approval.

A central bank is a bank 1

- Acts through transactions and contracts, lending and open-market transactions
- Windfalls to counterparties are unavoidable
- Selectivity is unavoidable
  - Banks versus money market funds
  - Private versus public
  - Spanish versus German bonds
- Risk on assets is unavoidable
  - Gold?
  - Other currencies?
- ... But cannot bankrupt the central bank

A central bank is a bank 2

- ... because the central bank‘s „debt“ is not really debt – paper money involves no obligation
- ... Except that there might be an issue for credibility
- Fiscal implications are unavoidable
- ... If profits are distributed to the sovereign
- But historically these fiscal implications have been the reason for making central banks independent
- ... Because the sovereigns had abused the power to obtain seigniorage from money creation

Central Bank Mandates 1

- „Price stability", Maximum employment, stable prices and moderate interest rates
- Defined in terms of macro variables, without reference to how the central bank operates
- Reflect experiences since the 1920s, inflation and depression
- A luxury, feasible only because bank notes no longer are debt (no convertibility problem) and we have flexible exchange rates
- Historically, these mandates are late-comers

Central bank mandates 2

- Historical mandates:
  - Taking deposits from and lending to governments
  - Unifying/monopolizing the note issue
  - Stabilizing.... E.g. Interest rates .... In conflict with business needs (convertibility)
- Central banks as bankers�across banks
- Lender of the last resort (Bagehot)
- .... Good business?
- .... Supervision as a response to moral hazard

Central bank mandates 3

- Macro mandates have superseded the financial stability mandate
- Or have they? Is financial stability subsumed under the macro mandate?
- For example: Price stability requires prevention of deflation and that requires prevention of a breakdown of the monetary system
- What is the transmission mechanism?

Central bank mandates 4

- What is „money“?
- The monetary base? M1? M3? M56?
- Friedman&Schwartz: 1929 – 33: H went up by 15%, M1 went down by 33% - monetary policy was contractionary!?!
- Euro area 2008 – 2013: H: + 100%, M3 + 10%, consumer price index +10%
- F&S: A failure to compensate or to prevent a financial implosion is a *contractionary* policy
- Banks are part of the monetary system – an object of monetary policy?

Do we need a financial stability mandate?

- NO!? because the matter is subsumed under the price stability mandates (or under a full employment mandate)
- YES!! Because there can be a conflict between macro stability and financial stability concerns
- Example: Banks are not lending because they do not trust the economy. The central bank puts pressure on them to lend. If lending is riskier than the alternative investments, financial stability can be harmed.
- The tradeoff should be addressed explicitly

What about Bagehot`s Rule

- Lend freely to solvent institutions against good collateral at penalty rates
- Business necessity at a time when notes were promises to pay specie
- And today?
- In a crisis, a weakening of lending standards can reduce some immediate damage – the decision should hinge on how serious the damage might be.
- BUT: if the solvency problems are not resolved, the crisis may drag on forever
- And the bailout sets bad incentives

Dealing with problem banks

- How do you know whether a bank is solvent?
- Assets versus liabilities: What is the value of a nonperforming loan?
- Management wants to delay any intervention – optimistic valuations
- Political authorities usually also want to delay any intervention – intervention is costly (recapitalization, economic fallout) and creates scandal
- Banks are political: a source of funds, a vehicle for industrial policy, an object of industrial policy

Dealing with a buildup of risks

- Political authorities does not want to interfere if the buildup of risks is due to their very policies, e.g. Light-touch regulation and supervision as a means of building banking as an export industry, or funding of the energy revolution
- Political economy of real estate development
- Political economy of government funding

Dealing with a buildup of risks 2

- Supervisors do not like to interfere with „innovation", securitization, SPVs,....
- Micro versus macro focuses in supervision: Do supervisors see systemic risks from parallel exposures to macro shocks?
- ... Or systemic risks that are hidden in the correlations between underlying and counterparty risks in hedge contracts?
- Would a central bank be better at this?
- ... Or would it have other incentives?

The central bank‘s stakes

- Reducing the threat to monetary dominance
- Weakness of the banking system may force the central bank to intervene if it wants to fulfil its mandate – *financial dominance*
- Or *hidden fiscal dominance*: Weakness of government finances may cause a weakness of the banking system or at least prevent a cleanup, at which point central bank support to the banks may indirectly provide for government funding
- Politicians who understand this mechanism may have even less of an incentive to do a cleanup

The central bank‵s stakes 2

- Or might the central bank itself be willing to maintain weak banks because that way it prevents a shakeup which might hurt its macroeconomic objectives?
- Dealing with problem banks always involves an intertemporal tradeoff: Avoiding trouble today by shoving problems under the rug bears a substantial risk of bigger and costlier problems in the future
- Need to deal with market structures
- Need to eliminate zombies

Banking Union

- Reduce political moral hazard by taking banks out of the national domain
- ... And by making supervision indepndent (could this raise legal/constitutional issues?)
- Align incentives of supervisors with the central bank
- .... Or is the attachment of supervision to the ECB merely a legal trick, the fact that Art. 127 (6) TFEU could be used without a need for a Treaty change?

Central Banking and Supervision

- The central bank must KNOW what is happening in the banking system, how weak or strong the banks actually are.
- There is potential moral hazard in both directions, abuse of supervisory power for monetary policy purposes, as well as supervisory laxness in the hope that the central bank will provide cover.
- If the central bank exploits its power over banks for macro purposes, there is a risk of a give-and-take routine between the central bank and the private sector that undermines the role of supervision

Central banking and supervision

- Central banking and supervision are very different activities with different cultures
  - banking versus administration
  - Macro mandates versus safety and soundness of individual institutions
- Need for Chinese Walls with respect to actual supervision while making sure of transparency about the system
- No evidence that the institutional arrangement made any difference to a country‵s affectedness by the crisis

The elephant in the room

- The best supervisor, inside or outside the central bank, is helpless if there are no means of dealing with problem banks in a satisfactory way
- Need for a viable resolution regime
- Unavailable.... And will not be created by BRRD and SRM
- Issues:
  - Multiple-entry resolution of banks with systemically important operations in different countries
  - Lack of interim funding
  - Lack of a fiscal backstop

Need for a backstop

- „Let the industry pay for itself"
- Unrealistic – if losses are large and the industry is in crisis, it cannot do so.
- If the burden is spread over time, it may simply create a kind of debt overhang
- Resolution needs temporary support through loans with an understanding that these loans may be lost if feasible bail-ins or clawbacks from creditors are insufficient to cover losses

Banking union as a gamble

- The ECB wants to get out of the straightjacket of financial or hidden fiscal dominance
- It runs the risk of being drawn even more deeply into the responsibility for the industry without bein gable to address the underlying problems
- Some national governments might like banking union for this very reason
- As long as resolution is not viable, the odds are against the ECB

Yes, Virginia, there is a Santa Claus

- Yes, Virginia, there is banking union,
- But it will not fulfil all your wishes!