Monetary Policy within the New European Financial Regulatory Architecture

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My task this morning is to comment on three questions:

1. *How has the ECB managed the challenges resulting from its double role as monetary policy maker and financial supervisor?*
2. *What are the challenges of macroprudential policies for central banks? What (possibly new) role should financial stability play in the monetary policy strategy?*
3. *What are the likely effects of the new regulatory framework on the structure of the European financial system? Will the monetary transmission mechanism be affected by these changes? If so how?*

The first question is about how organization structure affects the ability of an institution to meet its objectives. I believe that the question of whether supervision should reside inside the central bank is settled. And, the answer is yes. Prior to the crisis, those advocating separation seemed to carry the day. Their most compelling argument for placing supervision outside the central bank was (and is) that there is a conflict of interest. There are circumstances, the argument goes, in which the central bank will be hesitant to impose monetary restraint out of concern for the damage it might do to the banks it supervises. That is, the day may come when policymakers will protect the banks rather than the public interest. Making banks look bad makes supervisors look bad.

Today, most people see the benefits derived from central bankers having expertise in evaluating conditions in the banking sector, the payments systems, and capital markets more generally. During periods when financial stability is threatened, the central banker *cum* supervisor will be in a position to make informed decisions about the tradeoffs among its goals, knowing whether the provision of liquidity to institutions or markets will jeopardize its macroeconomic stabilization objectives. When faced with threats to financial stability, appropriate actions require that monetary policymakers and bank supervisors internalize each other's objectives. Separation makes this difficult.[1]

The overlap is particularly important when it comes to the lender of last resort. It is critical that central banks do not knowingly lend to insolvent institutions. Not lending to a bankrupt entity requires knowing if it is bankrupt. It is the job of the supervisor to know which banks are healthy and which are not. Transmitting this information quickly and efficiently to those inside the central bank who are responsible for emergency lending decisions is best done when the two are in the same institution.[2]

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[1] For a slightly more detailed discussion, see Stephen G. Cecchetti, "Subprime series, part 3: why central banks should be financial supervisors," www.voxeu.org, November 30, 2007. And, for a formal model, see Stephen G. Cecchetti and Marion Kohler, "When capital adequacy and interest rate policy are substitutes (and when they are not)," International Journal of Central Banking, Volume 10, No. 3, September 2014, 205-232.

[2] For a recent discussion of the lender of last resort, see "Rethinking the lender of last resort," BIS papers No. 79, September 2014.

The ECB is managing the challenges posed by potential conflicts by distancing supervision from monetary policy. The fact that the Governing Council, originally responsible solely for monetary policy, has the final word on microprudential supervision makes sense. Then there is the fact that this same body has authority over macroprudential regulation – a responsibility that is in some way shared with the ESRB and something to which I will return in a moment. Like most European Union governance, this is complicated. But here, I would say, the complications are not just unavoidable, they are desirable. That said, like the walkways between the towers of the ECB's spectacular new premises on the banks of the river Main, it is essential that information flows freeing between those making monetary policy decisions and those making prudential decisions.

The second I have been asked to consider is about the relationship of monetary and macroprudential policy. We all agree that monetary policy is the use of the central bank's balance sheet to influence current and future interest rates, as well as term and risk spreads. At least, that's how I would put it. Macroprudential policy does not yet have a similarly agreed upon definition. So, before I address the question of the relationship, I need a definition. Here I follow Paul Tucker, and define macroprudential policy as dynamic adjustment of regulation with the objective "sustaining the resilience of the financial system in the face of material changes in financial and economic conditions."[3]

People have generally interpreted the macroprudential policy toolkit to contain a broad array of instruments. These include capital ratios, risk weights, profit distribution restrictions, loan-to-value limits, liquidity requirements, and foreign currency lending restrictions, just to name a few.[4]

Given this definition and these instruments, I have two questions: Are they going to be effective in meeting policymakers' objectives? And, who has legitimacy to use them?

On the first, I am quite skeptical of our ability to effectively employ time-varying discretionary financial regulation. Even if we could overcome the high information requirements, long transmission lags and significant political resistance, the evidence for their efficacy is not terribly favorable. I have argued elsewhere that as banks raised capital to meet the new Basel III standards, there has had virtually no discernable impact on lending and macroeconomic activity.[5] That is, no impact outside of Europe.

The problems in the euro-area are consistent with the commonly held belief that banks with debt overhangs do not lend. A quick look at some country data bear out this view. The accompanying chart plots the ratio of bank capital to risk-weighted assets in 2006 (computed using national definitions) on the horizontal axis, against the change in overall credit to GDP from 2006 to 2013 on the vertical axis. The simple correlation between these two series is 0.47.

The Comprehensive Assessment is an important step toward rectifying this problem. I am very optimistic that the Single Supervisory Mechanism is creating a race to the top inside of Europe, forcing institutions

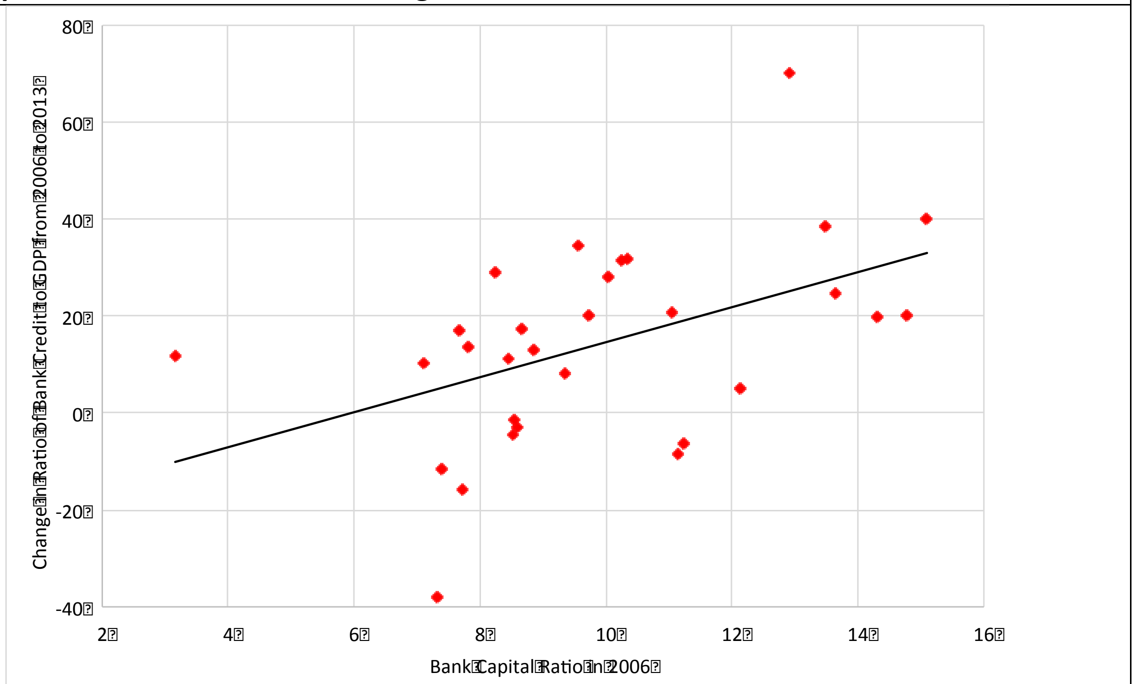
[3] Paul Tucker, "Regulatory reform, stability, and central banking," Hutchins Center at the Brookings Institution, January 16, 2014.

[4] For an exhaustive description of macroprudential tools see Committee on the Global Financial System, "Macroprudential instruments and frameworks: a stocktaking of issues and experiences," CGFS Papers No. 38, May 2010.

[5] Stephen G. Cecchetti, "The jury is in," CEPR Policy Insight No. 76, December 2014.

in jurisdictions that have historically been relatively less demanding to meet more stringent standards going forward.[6]

Bank capital ratio in 2006 and the change in bank credit relative to GDP from 2006 to 2013



Source: BIS.

Returning to the imperceptibly small macroeconomic impact of the transition to higher capital requirements, I see this as bad news for the Basel III's countercyclical capital buffer.[7] The idea of the buffer is that, when confronted with a credit boom, authorities should temporarily raise capital requirements both to increase financial system resilience if a bust comes and to limit the credit expansion. The evidence that I have seen suggests that this will have very little impact. And I suspect that the same is likely to hold for other time-varying discretionary policies as well.

Once you think about it, this actually makes quite a bit of sense. If a bank is doing a good job of asset and liability management, it will equate the marginal return to its various assets and the marginal cost of its liabilities. So, for example, a the margin, with the marginal cost of issuing an additional unit of debt equal to the marginal cost of issuing an additional unit of any of its liabilities, a change in the capital requirement should have a minimal impact. The same will be true of changes in risk weights on banks' asset composition. This marginal argument seems likely to hold for the small changes considered by policymakers are considering, so it is no wonder that when you look at recent experience it is hard to see any macroeconomic impact.

[6] See Stephen G. Cecchetti and Kermit L. Schoenholtz, "A primer on bank capital," www.moneyandbanking.com, November 3, 2014.

[7] See Stephen G. Cecchetti and Kermit L. Schoenholtz, "Who does macropru for nonbanks?" www.moneyandbanking.com, September 2, 2014.

That said, the financial system can and should be made more resilient simply by setting equity capital requirements higher on a permanent, through-the-cycle basis. (This is a goal of the recent proposals for total loss absorbing capacity, but simply requiring more common equity would be better.[8])

My second question about macroprudential policy concerns who has the legitimacy to use it. Again, I turn to Paul Tucker who has been written and spoken extensively on the general issue of delegation of powers to an independent authority in a democratic society. Tucker's two conditions for legitimate delegation are that it solves or mitigates a problem of credible commitment, and that it does not entail first-order distribution choices. Monetary policy clearly meets this test, as do a number of other regulatory tasks. But I seriously question whether macroprudential policy as normally construed meets the second Tucker requirement. The more you think about the details of what people propose – varying risk weights, adjusting loan-to-value limits, restricting concentration and currency mismatches – the more you realize that these are policies designed to explicitly favor one group – an industries, sectors or households – over another. Societies hardly shy away from such policies, but they don't delegate them either.

Furthermore, delegation of policy to an independent body such as a central bank is generally done quite carefully. There are clearly stated objectives (like a numerical inflation objective), limited tools and well-defined boundaries (extending in some cases to specific restrictions on the composition of the central bank balance sheet), and requirements for reporting and transparency to ensure accountability (such as publication of balance sheets and standing for questioning by elected officials). I seriously question our ability to implement a macroprudential policy framework in an analogous manner today.

This leaves us in a position where it will be difficult both to formulate time-varying discretionary financial regulatory policy and to legitimately delegate it to an independent authority. Instead, I would focus attention on macroprudential policy designed to ensure sufficient resilience in the system on a permanent basis. Because such policies will not change much over time, they will be easy for elected representatives to monitor and oversee. Such transparency allows for democratic oversight, creating the sort of accountability that we all feel is essential.

To the extent that we need time-varying policy that stabilizes the financial system, as well as growth and inflation, I would turn to traditional policy tools – specifically, interest rates.

The third and final question I have been asked to address is whether the change can help to encourage the further development of capital markets. I start from the premise that we all believe this would be a good thing. It would improve the efficiency of finance in Europe, enhance the effectiveness of monetary policy, and mitigate the effects of disruptions in the banking system.

But why is it that financial markets flourish in New York and London in a way that they do not thrive in Paris, Frankfurt and Rome? One answer is that New York and London have a first mover advantage and there are network externalities. If this is the case, then a big push from the European authorities could get them over the hump. This is possible. But a more likely answer is that the American and British legal systems provide particular fertile ground for financial markets to develop and thrive. It is the combination of financial, corporation and bankruptcy law that together protect investor property rights. If this is right,

[8] See Financial Stability Board, "Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in resolution," November 2014.

then harmonization and change in the legal framework is the key to creating thriving pan-European capital markets.

Much of the recent focus of European officials has been on finding ways to improve financing to small and medium-sized enterprises (SMEs). The view is that growth in the EU can be enhanced by improving SME lending. And, that financial markets are the solution. This is definitely the impression one gets when reading the recent publications from the European Commission on capital market union.[9]

But, in thinking about growth, I doubt we should be focusing on SMEs per se. Careful examination of the case of the US reveals that it is new firms that are the sources of growth, not small firms per se. All new firms are small, but not all small firms are new. To understand what I mean, start with the example of a family run bakery that has been in business for generations. Their product is excellent, they provide jobs (and bread), and they are small. Compare this to what was going on in Paul and Clara Jobs garage in 1976 when their son Steve and his partner Steven Wozniak were building the very first Apple computer. Giving a loan to the bakery is something banks do, but it is unlikely to yield much growth. Finding a way to finance the next Apple is not only going to spur growth, it is going to make you rich. But banks don't do it.[10]

There are reasons new firms have difficulty obtaining debt financing: they are just too risky. In the US, it is difficult, if not impossible, for small businesses to obtain uncollateralized bank financing. (The bakery has ovens it can pledge to back a loan.) And startups, who are almost surely the real engines of growth, can't get loans at all.

What is true for individual loans is true for securitization as well. We all love stories about the securitization of music royalty revenue, movie box-office receipts, and even pub profits. But the truth is that the vast majority of securitizations are government guaranteed. In the US today, over 80% of all securitizations carry a government guarantees. And the remainder are primarily auto loans and credit card debt.[11]

To be clear, I strongly favor the creation of a pan-European debt and equity market. This is the best way to ensure that resources in Europe go to where they are the most productive and risk is borne by those best able to bear it. But if such a development is to support growth, it must do it in a way that encourages entrepreneurship and firm formation. One sign of success will be when we start to see effective pan-European venture capital firms and initial public offerings of the equity in young firms. The true value of a vibrant capital market is in its ability to provide resources to new projects and new firms. In Europe today, the external finance that exists is debt- and bank-based. This can and should change. But, in my view, the change will only come with changes that way in which property rights are defined and enforced in way that makes investors secure that if they give someone money, they will be able to get it back.

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[9] See European Commission, "Building a Capital Market Union," 18 February 2015.

[10] For a discussion of the relationship between firm formation and growth, see Stephen G. Cecchetti and Kermit L. Schoenholtz, "Growth and dynamism: troubling facts," www.moneyandbanking.com, June 23, 2014.

[11] See Stephen G. Cecchetti and Kermit L. Schoenholtz, "How Securitization Really Works," www.moneyandbanking.com, June 30, 2014.

Returning to where I started, in considering the excellent questions that the organizers posed, I come to the following conclusions:

1. The ECB should see its new role as financial supervisor as an opportunity to improve monetary policy at the same time that it helps to reinforce financial stability.

2. I am skeptical of the efficacy of time-varying discretionary prudential policy, and I question the legitimacy of delegating macroprudential policy to an independent institution.

3. For capital markets in continental European to develop a role analogous to the one they play in the US and the UK, the focus needs to be on ensuring property rights are universally and uniformly defined and protected.

Thank you.