EUROPEAN CENTRAL BANK
EUROSYSTEM

# OPENING SPEECH AT THE CONFERENCE "LEARNING FROM THE FINANCIAL CRISIS: FINANCIAL STABILITY, MACROECONOMIC POLICY AND INTERNATIONAL INSTITUTIONS"

## ROME, 12 NOVEMBER 2009

## "The road less travelled: exploring the nexus of macro-prudential and monetary policy"

### Introduction

Ladies and gentlemen, dear colleagues,

I am delighted to be here today in this beautiful venue of the Einaudi Institute for Economics and Finance participating in an outstanding conference aimed at drawing lessons from the financial crisis. Being in Rome, one can witness numerous signs of the ability of ancient Romans to be skilled architects and builders. The Romans were particularly adept in constructing and maintaining roads – the *viae romanae*. The Roman roads played a pivotal role in maintaining the stability of the empire, ensuring communication and fostering its expansion. However, the other side of the coin was that their effectiveness was such that in the last period of the empire, they made it easier for their enemies to move quickly to the Roman territory. Similarly, the linkages among intermediaries in our financial system foster the efficiency and the stability of the system in normal times. However, in times of tensions, they can also contribute to the fast spreading of problems. In my remarks today I will talk about roads or linkages in the financial

system, but also about the new roads of policy-making on which we are embarking and the challenges lying ahead on these less explored paths.

It has now been more than two years since the financial crisis started in August 2007. During this period, the actions taken by policy-makers have been mainly aimed at preventing a meltdown in the financial sector and at containing pernicious spillovers to the real economy. Recent indicators point to a stabilisation or a slight pick-up of economic activity in several major economies, suggesting that the most acute phase of the crisis might be behind us. Thus, it seems to be the right time to review what went wrong, to take stock of the lessons learned and to propose ways to reduce the likelihood of similar events occurring in the future.

In my remarks today, I will argue that the crisis has shown us that policy-making is faced with new challenges and needs to take some new, less explored paths. We need to develop and put to work new tools aimed at mitigating the threats to the safety and stability of the financial system, while preserving the efficiency arising from technological advances. In this context, the knowledge of the linkages between monetary policy and financial stability is of particular importance. At the same time, we need to understand thoroughly how macro-prudential regulation and supervision interact with monetary policy. In particular, we need to understand how systemic risk and policies put in place to mitigate it may affect the transmission of monetary policy.

I will first recall the market and policy failures brought to the surface by the crisis and argue that we need to address the fundamental causes of these failures. I will then describe what we know about the interaction between prudential regulation and supervision and monetary policy. At the same time, I will emphasise those mechanisms that are still less known. Finally, I will suggest a way to proceed and to explore the new road lying ahead.

## Lessons we have learned from the crisis

Before taking a new path, it is good to know exactly where we are and how we got there. So in order to define more clearly our possible upcoming tasks and challenges, let me first start by recalling briefly the sources and the amplification mechanisms of the recent financial crisis.

Ultimately the crisis was a combination of the accumulation of major imbalances in the years running up to the crisis with the incentives provided by the existing regulatory framework. Low inflation, low interest rates and abundant liquidity prior to the crisis were conducive to an excessive accumulation of risk. Banks and other investors had increased their appetite for risk and engaged in a "search for yield" supported by the exponential growth of complex and opaque financial products. The excessive risk-taking was also encouraged by the inadequate corporate governance of financial intermediaries and by regulations that did not keep up with the technological advances, also due to the emergence of a shadow banking system which was largely unregulated. When the crisis was triggered by the drop in the value of certain structured products, it quickly spread through interbank linkages, transforming it into a system-wide financial and economic crisis.

In my view, the general lessons learnt from this experience are the following:

First, the financial crisis has reminded us how important it is to look at the links and connections of the financial system. We saw that major disruptions such as the failure or near-failure of certain institutions rapidly spilled over to the whole financial system. Therefore, the systemic nature of individual institution's risk-taking has been largely underestimated. The consequences of this must be that macro-prudential regulation and supervision are improved and extended. Systemic risk is, generally, outside the control of each individual institution. But, with a macro-prudential framework subjecting all systemically important institutions to a stricter prudential framework, which may include capital or liquidity surcharges, these institutions can contribute to an increase in the resilience of the system as a whole.

Second, the impact of systemic risk depends very much on the collective behaviour of financial institutions and their interconnectedness, as well as on the interaction between financial markets and the macroeconomy. Systemic stability is a public good. The recognition of this public good property underpins the recent emphasis on a macro-prudential approach to regulation and supervision. For this, we need to establish an effective framework for macro-prudential analysis aimed at containing systemic risk.

And third, monetary policy concerns and macro-prudential concerns are interconnected. During the recent crisis, financial instabilities spilled over into the real economy with substantial consequences for the risks to price stability. Central banks around the world, including the ECB, have reacted to these diminishing risks to price stability by significantly lowering their key policy interest rates. Therefore, it appears that in a post-crisis world, financial stability considerations will have to be taken into account to a greater extent in the conduct of monetary policy. New tools may be needed, as well as an organisation of policy-making such that the interactions between macro-prudential regulation and supervision and monetary policy are brought together.

Allow me to elaborate on this last point.

## Exploring the nexus between macro-prudential regulation/supervision and monetary policy

As just mentioned, price stability and financial stability are interconnected. While it is certainly true that financial stability does not necessarily imply price stability and vice versa, the recent crisis has made it clear that large-scale financial instabilities can significantly affect the development of prices in the economy.

Therefore, a natural question arises as to whether monetary policy and macro-prudential supervision and regulation are related and interlinked with each other.

I see monetary policy and macro-prudential supervision and regulation as being linked in two ways. First, monetary policy can have an impact on financial market developments and thus can affect the stability of financial markets. And second, the regulatory framework that governs financial markets can have clear macroeconomic implications – as witnessed in the recent crisis – which may trigger a response with respect to monetary policy.

Let me elaborate on these two points in more detail. The objective of monetary policy is to maintain price stability. Generally, an environment of stable prices reinforces the stability of the financial system as well. This, however, is not always the case. An environment of low interest rates coupled with low inflation may be conducive to asset price bubbles and the build-up of excessive leverage. In particular, recent research has emphasised the impact that monetary policy, and especially low short-term interest rates, may have on the risk appetite of financial intermediaries and investors at large. This in turn may favour the build-up of imbalances threatening financial stability, even when price stability is preserved. Therefore, the question arises whether monetary policy may have to take this effect into account, and consequently should possibly "lean against the wind" of unsustainable asset price and excessive credit bubbles.

Let me clearly say that the interest rate instrument of monetary policy is a rather blunt tool in preventing such bubbles from appearing. Let me add in this context that in my view the credit boom prior to the recent crisis was more triggered by a lack of adequate risk controls, low credit standards and reduced collateral requirements than by the environment of low interest rates. In this sense, macro-prudential supervision and regulation are certainly the best policies to keep asset price developments in line with financial stability objectives.

However, central banks should certainly become more wary of systemic financial risks affecting the macroeconomic environment. For this, the strengthening of the analysis of asset prices and credit developments is essential. The monetary policy strategy of the ECB is well founded to take these considerations into account. On

the one hand, the analysis of asset prices is part of our economic analysis. While asset prices are only one of many indicators considered in this analysis, the recent crisis has taught us that we need to pay closer attention to potential misalignments and the potential formation of asset bubbles. On the other hand, in our monetary analysis we analyse the developments in money and credit indicators. In particular, our analysis of loan developments, and particularly developments in loans to the private sector, looks at the impact of our monetary policy on the financial sector, as well as the role of these developments in our assessment of risks to price stability. However, the lesson we can take away from the crisis is that this analysis of monetary counterparts, i.e. the developments in private sector borrowing, must become more thorough and systematic in the future.

Let me turn to my second point, namely how macro-prudential regulation and supervision may affect the macroeconomic environment and hence monetary policy-making.

It has been widely acknowledged that the regulatory framework has been contributing to the amplification of the natural fluctuations of the economic cycle. This phenomenon – known as pro-cyclicality – can for example be linked to the time-varying risk parameters for the calculation of capital requirements or the accounting framework.

The need to address this excessive pro-cyclicality is a concern now shared by policy-makers globally. After their meeting in Pittsburgh last month, the G20 leaders stated "*we want growth without cycles of boom and bust and markets that foster responsibility not recklessness*." In other words, we need to preserve the efficiency gains arising from advances in financial development, but we also need to find ways to reduce threats to financial system safety and stability which seem to be inherent to the new developments and avoid, or at least limit, "roller-coaster" paths.

Moreover, there may be mechanisms through which macro-regulation may affect the provision of credit and ultimately output and inflation. For example, by requiring financial institutions to hold large capital and liquidity buffers or by limiting leverage, their cost of capital and lending may be impacted, which in turn may affect, at least in part, the provision of bank credit. These are only a couple of examples of how the regulatory framework may affect the provision of credit. There are many more rules and regulations that affect the supply of and demand for credit, thereby impacting broader macroeconomic outcomes.

Overall, the above examples clearly show that the regulatory framework can have important implications for macroeconomic outcomes and thereby can have direct consequences for monetary policy-making. At the same time, the regulatory framework may equally affect the transmission of monetary policy through its impact on the aggregate behaviour of the banking sector and, hence, also affect the effectiveness of monetary policy.

Looking forward, the question arises how the currently envisaged global reform agenda of the G20 will affect the macroeconomic environment. For example, will the general increase in capital and liquidity requirements or the introduction of a leverage ratio reduce the available resources for credit creation? How will the introduction of counter-cyclical capital buffers and more emphasis overall on risk management frameworks affect the behaviour of banks and the real economy? And more generally, are additional measures needed to make the regulatory framework more flexible and dynamic depending on the state of the economy?

These questions and many more on the potential impact of the regulatory framework on macro outcomes seem to me of high interest for the research community for the years to come and I encourage everyone in the room to develop new analytical tools and models that help to understand this interaction better.

## The way forward

Given the interactions and linkages between macro-prudential supervision and regulation and monetary policy, having the task of the former close to or within a central bank is in my view a sensible way forward, not least because central banks have the necessary analytical capabilities to analyse the broad perspective that I outlined earlier. For us, such analysis will be of crucial importance. As you know, a European Systemic Risk Board (ESRB) will be established with the mandate to map financial risks and their concentration at the system level for the macro-prudential supervision of systemic stability. The ECB will provide the necessary input for the ESRB to carry out the work under its mandate. In particular, the ESRB will be instrumental in the analysis of systemic risks and will issue risk warnings and policy recommendations to address financial stability concerns.

The primary objective of the ECB's monetary policy is to achieve and maintain price stability. This will remain our primary objective and the forthcoming tasks in macro-prudential supervision will not conflict with this objective. In my view, the new macro-prudential task and the existing monetary policy responsibilities can be mutually supportive.

In order to achieve this objective and to avoid any potential conflict of interest, it is crucial that the instruments of monetary policy and macro-prudential supervision be clearly separated. Our policy rate will be set according to our assessment of risks to price stability and the ESRB will issue macro-prudential policy recommendations with regard to financial stability risks. In practice, each of these mandates may involve taking a different path. However, as I mentioned earlier, the roads may cross from time to time. Therefore, policy-makers need to be aware of the possibility of these paths crossing, i.e. of the linkages and interactions that I have mentioned. Let me stress once more that from this point of view, the ECB is in a good position to evaluate the interactions between the two paths. Our two-pillar strategy involves the analysis of asset prices as well as the analysis of money and credit aggregates. This may provide useful indications on the nature of the

interactions. However, more work is needed to better understand the interactions and to make our analysis more thorough and systematic on this point.

The policies supporting monetary and financial stability should remain two distinct areas of action, but there are synergies to be gained from the analysis supporting both. All in all, I believe that the objectives of price and financial stability are complementary, at least in the long run, and that the policies supporting both should be seen as mutually supportive.

## Conclusions

The recent financial crisis has strikingly illustrated the interconnectedness that characterises the global financial system. In providing a framework for strengthening financial stability, policy-makers are currently not only refining the regulatory and institutional set-up, but also looking for new analytical tools that help to better identify, monitor and address sources of systemic risk.

I have described how the crisis has reaffirmed the need for an enhanced macro-prudential approach to regulation and supervision. It also emphasised how important it is to improve our knowledge of the interactions between financial and monetary stability policies.

Faced with these challenges, policy-makers are taking less travelled, less explored roads. Additional work is needed to pave these new paths so that they can stand the test of time, like the Roman roads have done. But the past has shown that a return to the roads taken before the crisis is not an option. Pursuing in isolation policies aimed at financial and price stability may lead to conflicting paths. Taking different roads, but being wary of their junctions, is the way forward, which eventually will lead to the achievement of the same aim: an efficient financial system promoting economic growth and less prone to pro-cyclicality.