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Systemic Risks and Central Banks

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"Systemic Risks and Central Banking" is certainly too broad an issue to cover in 25 to 30 minutes. And that's why I would like to draw your attention to just two basic questions this afternoon. The first question relates to crisis management: Can central banks reduce systemic risks in a financial crisis? The short answer is: Yes, they can. However, depending on what they do, the central banks themselves might become an additional source of systemic risk.

The second question is about crisis prevention: Can central banks help to prevent systemic risks from developing in the financial system? And here again the short answer is: Yes, they can. But there is a widespread fear that central banks might lose their independence and compromise their goal of price stability by doing this. Very much depends on the legal framework for central banks with a broader mandate. Thus I will have a look at the draft of the Financial Stability Act at the end of my talk. It was published by the German government only three weeks ago.

With regard to the role of central banks for financial stability, we should differentiate between the time dimension und the cross-sectional dimension of systemic risks: While "cross-sectional" focuses on the structure of the financial system in general and linkages and contagion effects in particular, the "time-dimension" concentrates on the risks which are connected to the ups and downs in the financial cycle.

In addition to this two-dimensional perspective, I prefer to use a broad definition of systemic risk. According to the Basel Committee on Banking Supervision (2012) systemic risk can be broadly defined "as the risk of disruption of key financial services that can have serious consequences for the real economy." With a special regard to the US housing market, Benjamin Friedman (2012) argues that systemic risks do not only lead to financial losses, but also to a misallocation of real resources in a free-enterprise economy. At the same time, there is no doubt that systemic risks are extremely hard to detect and to measure.

Given all the measurement problems, I should actually shy away from taking a closer look at the two questions I started out with. But I am going to try anyway. So let us first turn to the crisis management of the ECB.

Crisis management by the ECB

The ECB itself emphasizes time and again that the financial crisis led to a break in the monetary transmission process (Coeuré 2012). And that is why the ECB did not only reduce policy rates to an all-time low of 1%, but provided unlimited central bank liquidity to banks by a fixed rate tender. Furthermore, the list of collaterals was extended and maturities for refinancing operations were increased substantially.

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On top of this, and due to the sovereign debt crisis in the euro area, the ECB in May 2010 announced the so-called Securities Markets Programme. Last but not least, the ECB conducted two refinancing operations with a maturity of three years. Banks' demand for central bank funds was fully allotted, taking the amount of outstanding monetary policy lending by the ECB to a historical high of over €1100 billion, 90% of which were provided at a maturity of three years. The balance sheet of the Eurosystem increased to more than €3000 billion in March 2012.

When it comes to assessing the unconventional measures in the Eurosystem, there are still two opposing camps. One camp argues that without these measures, the financial system probably would have collapsed. The other camp emphasizes the fundamental risks and side-effects of this kind of crisis management policy.

Risks and side-effects

To me, it is very interesting to note that among those who point to the risks of unconventional ECB policy there are many central bankers. For example, Jürgen Nagel (2012) from the Bundesbank recently underlined that the balance sheet risk of the Eurosystem has clearly increased: The greater volume of monetary policy lending and the lowering of the collateral requirements would entail both more and higher risks to the Eurosystem. Furthermore, the outright purchases realized by the Eurosystem would reflect a permanent transfer of risk from the private to the public sector. By buying securities and holding them on its balance sheet, the Eurosystem would fully bear the default risk of the issuer without protection.

Turning to the inflation risk and referring to Jürgen Stark (2012), the ECB's former chief economist, history shows "that every expansion of the central bank balance sheet which is particularly strong will in the medium-term lead to inflation." In his view, it will not be possible to absorb excess liquidity as quickly as necessary. In contrast, M. Sing and P. Stella (2012) argue in a recently published research paper that "there is good reason not to fear the money multiplier." Jürgen Stark (2012) also criticizes the blurring of lines between monetary and fiscal policy: Even if the purchase of government bonds has monetary policy reasons, the side effects of these measures must be taken into account. Governments in the respective countries have better refinancing conditions at their disposal.

Hervé Hannoun (2012) from the BIS hints at the risk of atrophy of markets: Too dominant a role of central banks in market-making could contribute to an atrophy of markets which means that central banks end up taking over financial intermediation from the private sector. And this brings us very close to the risk of creating moral hazard. If market participants know the central bank will back the financial system, as Thomas Jordan (2012) from the Swiss central bank recently put it, there will be less market discipline to avoid excessive lending, leverage, and risk taking.

And finally, there is the risk of confusion and the reputational risk. According to the governor of the French central bank, Christian Noyer (2012), a wide variety of interventions by central banks could be interpreted as a relative dilution of objectives. "Central banks' activism may create doubts as to their ability to stick to their core mandates – price stability – in the face of increasing pressures and constraints."

Now, of course, you could argue that it is going a bit too far to classify the crisis management of the ECB as a source of systemic risk. But to me it is at least very obvious that just because of the risks and side effects of the ECB´s and other central banks´ crisis management, preventive instruments are increasingly called for.

Pre-emptive role for monetary policy

Crisis prevention is supposed to dampen the upswing in the financial cycle and to cushion the downswing. The idea is to prevent the irrational exuberance, which already carries the seed of its own destruction, from building up in the first place. Against this background, I now would like to repeat my second question from the very beginning of my talk: Can central banks contribute to prevent the emergence of systemic risk in the financial system? As you already know, my answer is: Yes, they can. And let me add that there are many ways for central banks to contribute to crisis prevention. However, some of them are very controversial.

One of the least controversial contributions by central banks is the analysis of systemic risk. Another of the less controversial issues is the role central banks play in the rule-building process in national, European and international micro- and macroprudential institutions. However, there are some complaints here about committees being too top-heavy with central bankers.

What is most controversially discussed is whether central banks should be equipped with special macroprudential instruments. Another moot point is the use of monetary policy for macroprudential goals. To start with the latter point and to give you my key message in advance: Just because of the limits and problems of specific macroprudential instruments I do see a pre-emptive role for monetary policy in the macroprudential framework. In line with Jaime Caruana (2011) from the BIS, I think that to maintain financial stability "is too big a burden to rest exclusively on prudential policies, macroprudential included." And Governor Shirakawa (2012) is surely right when he emphasizes that "the Bank of Japan is probably not alone in trying to incorporate … the macroprudential perspective into the conduct of monetary policy."

The Deutsche Bundesbank (2011), however, is concerned that "adopting an additional explicit financial stability objective harbours the risk of overloading monetary policy and triggering a loss of credibility." I do not want to deny this risk. Nevertheless, I tend to follow Claudio Borio (2011) who argues that monetary policy is so important and has so much weight that it should also be used to achieve financial stability. But I am well aware of the limits of this approach in a monetary union such as the euro area. The single and uniform monetary policy must be oriented towards the currency union as a whole.

With this qualification in mind and now again sharing the Bundesbank line, I think two points are crucial. First, monetary policy should be symmetrical throughout the financial cycle. And second, credit, in addition to money supply, should be understood as an important link between price stability and the stability of the financial system.

At the same time, I hesitate to agree with the view that macroprudential instruments can and should be used to compensate for what a single monetary policy in a currency union cannot deliver: different official interest rates across member countries. Macroprudential policy should not be understood as a substitute for monetary policy. Nevertheless, I am well aware of the fact that the two sets of policy tools, as Ceccetti and Kohler (2012) point out, "have quite a bit in common" .

Macroprudential tools

If we take this one step further, we immediately come to the question whether central banks should be equipped with specific macroprudential tools in addition to their monetary policy instruments. This governance issue is closely linked to the question which instruments this could be. Due to my time constraint this afternoon I cannot deal with all the details and the almost confusing variety of macroprudential instruments such as counter-cyclical capital buffers, leverage ratios, debt-to-income and loan-to-value-ratios or levies on non-core bank deposits. Instead, I confine myself to three general remarks on macroprudential instruments.

First, there are hardly any instruments which would automatically smooth the financial cycle. Even in the case of the anticyclical capital buffer, discretionary decisions are necessary. Whether these decisions would actually be taken to dampen the ups and downs of the cycle is difficult to say. Many experts come to the conclusion that there might be a political bias not to act.

Second, research about the effects of macroprudential instruments is still at the very beginning. This is already true for each individual instrument. And, as Charles Goodhart (2012) and his co-authors showed in a recent paper, this limited knowledge is all the more true for the way these instruments would interact with each other. A recent working paper by the Basel Committee on Banking Supervision (2012 a) concludes: “While work assessing the cyclical properties of capital regulations and the manner in which macroprudential policies interact with monetary policy has contributed to the lively debate discussing macro perspectives on financial regulation, this strand of literature remains in its infancy.”

Third, many instruments which could be used to limit the cyclical dimension of systemic risk come from the tool kit of a monetary policy that has come rather out-of-fashion in advanced economies. I am speaking of quantitative controls. And by the way, I remember very well the discussion about reserve requirements on the growth of specific bank assets and credit ceilings in Germany. They were to give the Bundesbank’s policy more clout in the early 1970s. However, they were never introduced because they would have come very close to a sectoral economic policy.

But now, sectoral instruments are being discussed again in the light of macroprudential policy. Just take the “principles for the development of a macro-prudential framework in the EU”, published at the beginning of April this year by the Chair of the European Systemic Risk Board. Mario Draghi (2012) not only lists some broad requirements such as aggregated capital levels, liquidity requirements and limits to large exposures and to leverage. He also explicitly mentions “more targeted requirements”. These include sectoral capital requirements to address specific vulnerabilities in the household, corporate and real estate sectors as well as in the financial system.

So, in a way, the term macroprudential policy can sometimes be very misleading: In packages labelled macroprudential policy, you will quite frequently find sectoral prudential instruments too. I believe that the lack of a clear line between macroprudential policy and sectoral prudential policy is one of the reasons why it is so difficult to answer the question whether central banks should be given ownership of macroprudential instruments.

Governance of macroprudential policy

Against this background it may come as no surprise to you that major countries are taking very different approaches to the governance of macroprudential policy. They follow the Frank-Sinatra-doctrine "I do it my way."

Yes, the names of the new macroprudential committees in different countries sound pretty similar. But this is where the similarities very often end. The institutional design of the committees is in fact very diverse. For example, there is a world of differences between the Financial Stability Oversight Council in the USA, the Financial Policy Committee in the UK and the Committee for Financial Stability which is planned in Germany.

As I see it, the efforts to integrate financial stability into their mandate leads to an increasing diversity of central banks. Let´s take the UK and Germany as two important examples for this new development. In the UK, the Bank of England will be responsible for macroprudential policy in addition to its monetary policy and microprudential tasks. The macroprudential job will be in the hands of the Financial Policy Committee. It comprises 11 members, six of which are from the Bank of England. The Committee is chaired by the Governor of the Bank of England, whereas the Treasury is only represented by a non-voting member.

It is very likely that the Bank of England's Financial Policy Committee will be given powers of direction over the countercyclical capital buffer, a leverage ratio and last but not least over capital requirements against exposures to specific sectors of the economy. This concentration of power at the Bank of England has already triggered a heated discussion about the independence of the Bank of England. Peter Sands (2012), the group chief executive of Standard Charter, argues that the Financial Policy Committee wants to control how much lending there is in every nook and cranny of the economy, from manufacturing to mortgages, and how much this lending will cost. This reeks, as Peter Sand adds, of 1970s-style quasi-nationalisation of the industry. It certainly would be difficult to criticise the British approach more heavily.

Anyway, it is high time now to have a look at what is being planned for the Bundesbank with regard to containing systemic risks for financial stability.

Financial Stability Act in Germany

According to the draft of the Financial Stability Act, the Bundesbank would be given a mandate for macroprudential oversight. If parliament agrees to the government´s proposal, our central bank would have the right and duty to protect the stability of the financial system in Germany from 2013 onwards. Through monitoring and analysing, the Bundesbank is to detect systemic risks at an early stage and make proposals as to how these risks could be averted. A new financial stability committee at the finance ministry would be responsible for deciding which proposals would be given to the Federal Government or the Federal Financial Supervisory Authority (BaFin).

The Committee for Financial Stability's main job would be to prevent financial crises. Therefore the committee would confidentially discuss all developments which are crucial for financial stability on a quarterly basis. The committee is to have 10 members, 3 of which will come from the finance ministry. These include the chair and vice chair. The Bundesbank and the BaFin would also send 3 delegates each. The speaker of the Federal Agency for Financial-Market Stabilisation would be a non-

voting member. The Bundesbank could veto decisions on the issue of warnings and recommendations and their publication.

Looking at what the government has in mind for macroprudential oversight in Germany, this appears to me quite a sensible compromise. The Bundesbank would get an explicit mandate for financial stability. At the same time its independence would be preserved.

However, our parliament should discuss why in the past years so many options were mentioned as to which legislative "harbour" should be used to anchor the mandate for financial stability. For instance, the Bundesbank in its Financial Stability Report of November 2010, first argued in favour of the German Banking Act. Then the mandate for financial stability was to be part of the Bundesbank Act and now it is to be laid down in a new and separate Financial Stability Act.

Moreover, the Bundestag should also discuss why both the Committee for Financial Stability and the European Systemic Risk Board are to be only equipped with soft communication instruments. The IMF (2011), for example, argues that precisely because the ESRB cannot take any action directly, it is all the more important that the respective authorities at the national level have either direct powers or powers to direct. With the arguments of the IMF in mind, we should however take into account that a committee in which members of the Bundesbank, the finance ministry and the BaFin vote, and whose recommendations and warnings will probably be directed at the BaFin and the Federal Government will have something close to powers to direct. Given the committee's setup and its addressees, its soft recommendations are likely to have more clout than just moral suasion.

Although not on a personal, but certainly on an institutional level, the recipients of the recommendations will generally be identical with those who have contributed to drawing up the recommendations in the Committee for Financial Stability. So in effect, Germany's future financial stability policy will have some elements of a self-referential system. What adds to this is that the Bundesbank will monitor whether the recommendations are actually put into effect. If the addressee does not comply, he has to explain why.

Another aspect of the draft Financial Stability Act that will probably come under scrutiny is that a representative of the finance ministry will be chairing the Committee for Financial Stability. This is in contrast to the view of the IMF (2011, p 40) who sees "the need for regulatory authorities across the EU to be empowered to use and calibrate macroprudential tools in a manner that is independent of the political process." "A risk of a strong role of the Treasury is that this may reduce independence from the political process and willingness to act."(IMF 2011, p 38). In a nutshell, the IMF is arguing that macroprudential policy should be depoliticized. But given the institutional framework in Germany, I think the IMF approach would be problematic. In my view, prudential instruments which might have an impact on the cross-sectional structure of the economy need political approval.

So all in all, I am in favour of the government´s draft of the Financial Stability Act. However, at least one more crucial point needs to be clarified. I doubt whether the addressees of the recommendations by the Committee for Financial Stability do actually have the necessary macroprudential instruments at their disposal. I am thinking, for instance, of the anticyclical adjustment of the capital buffer. As this instrument will be only available in 2016, respective recommendations to the BaFin will fall flat. And this finally shows how important it is that the national legal framework for limiting systemic risks for financial stability is in line with the European and international rule-building process.

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