Banking structure and monetary policy – what have we learned in the last 20 years? (by Erkki Liikanen)

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As Mr Erkki Liikanen mentioned, twenty years ago a number of factors were at work shaping the world we know today. The year 1993 saw the EMU project becoming political reality. It was also a time when the mainstream approach to monetary policy was beginning to converge on flexible inflation targeting framework.

In the sphere of banking regulation, too, a new era was beginning. In the framework of prudential regulation of banks, a significant reorientation was seen, moving away from regulating the conduct of banks and towards the new risk-based approach. That regulatory trend, based on increased freedom for banks but subject to risk-based capital requirements, would continue right up until the outbreak of the financial crisis in 2008.

In the EU, the Second Banking Directive took effect from the beginning of 1993, creating a single market in banking. The directive sought to prevent discrimination and to increase efficiency through competition. There was quite a bit of discussion on the implications of this for supervision, but little action. So, while European banking markets were becoming integrated, financial supervision remained a national competence.

In the US, deregulation was also moving forward. For instance the Glass-Steagall Act, separating banking from securities and insurance, was under growing criticism and ultimately would be repealed.

Twenty years ago was also the time when the striking improvement in macroeconomic performance, later termed "the great moderation" by chairman Bernanke, was spreading to the whole developed world. The success of monetary policy in improving price stability and reducing fluctuations in economic activity, while keeping interest rates at historically low levels, was considered a victory for the art of economic policymaking.

We now know that there was trouble brewing under the surface. The underpinnings of global financial stability were weakening. Global indebtedness increased, fuelled by current account imbalances and the "deepening" of international financial markets (read: recycling the same funds several times over).

The decline in inflation was due not only to monetary policy, but also to the avalanche of cheap consumer goods from emerging economies such as China.

For banks, the new financial environment was characterised by low interest rates and low perceived risks. It also turned out that the new risk-based capital requirements allowed banks to expand their balance sheets enormously without increasing their equity capital in the same proportion.

So, the large banking groups started to increase their trading portfolios. This development happened in a gradual fashion throughout the 1990s but accelerated dramatically from about 2004. Banks shifted their business focus from interest margins to fee-based and trading activities.

Only now, from the perspective given by the worst financial crisis since the Second World War, do we see the fragility and weakness of the regulatory arrangements which came into force in the 1990s. From today's point of view, they seem good-weather arrangements, which performed well only so long as no major systemic risks materialised.

Then came 2007 and the collapse of the US property market; 2008 and the collapse of interbank money markets, following the Lehman

Brothers crisis; and 2009 with the global collapse of economic activity. The painful process of competitive deleveraging started.

The reassessment of economic policies pursued in the last two decades has also begun. Financial regulation especially has been reconsidered and is being strengthened in many ways.

Monetary policy and financial stability

There is a common dictum about price stability and financial stability which says that a stable financial system is a necessary condition for successful monetary policy, and that price stability in turn creates the best preconditions for financial stability. Still, the experience of this crisis has taught us a lot more.

First of all, we now know that price stability does not by itself guarantee financial stability. Risks can accumulate in the banking system even if monetary policy succeeds in maintaining price stability and controlling inflationary expectations really well.

Second, we also know that central banks can maintain an admirable degree of price stability even when financial stability is under a lot of strain.

Do these two points mean that financial stability and monetary policy are not connected after all? That would be too hasty a conclusion. Actually they are very closely related, as Mr Liikanen explained.

Independence of monetary policy

One of the lasting lessons learned in the past decades is the value of the independence of monetary policy. The independence of central banks has been essential in keeping inflation expectations as well anchored as they have been in this crisis, despite all the turmoil in financial markets. Independence has also made it easier for central banks to act quickly when necessary in order to maintain financial stability.

There are many aspects to the independence of central banks, but from the aspect of financial stability, it is especially important to avoid two threats to this independence: **fiscal dominance** and **financial dominance**.

Fiscal dominance is the older concept of the two. It would arise if the government financing constraint would become an overriding influence on monetary policy. The idea that tight monetary policy may become impossible without accompanying fiscal adjustment was also well understood when the blueprints for the EMU were being prepared. This is why the Maastricht Treaty had its fiscal policy clauses and also why the Stability and Growth Pact was concluded. Also the prohibition of direct central bank credit to the government and the institutional independence of central banks are in effect protections against fiscal dominance. Now we know that the fiscal framework put in place before the start of the EMU was not strong enough to prevent fiscal problems from emerging.

As to the euro area, there is now no evidence of fiscal dominance. Fiscal dominance implies that monetary policy would break its price stability objective for the sake of maintaining the solvency of the government sector. This is not the case. Price stability has not been and will not be abandoned.

The parallel idea of **financial dominance** is more recent than fiscal dominance. Financial dominance refers to the possibility that the condition of the banking system could become a constraint, or dominant influence, on monetary policy, forcing the central bank to pursue second- or third-best monetary policies in order to maintain financial stability.

Is the spillover from financial instability to monetary policy a realistic threat? In principle it is easy to see why it could be so. One can imagine a central bank which would have to tighten its monetary policy for reasons of price stability, but is prevented from doing so for the fear that the value of assets of the banking system would decrease and a financial crisis could ensue.

Looking at recent experience in the developed economies, however, it seems that the main impact of the banking crisis on monetary policy has not been that suggested by the financial dominance scenario. The bust of the credit boom has not led monetary policy to tolerate a higher-than-mandated rate of inflation. Instead, in the large developed economies at least, the bursting of the bubble has coincided with a sudden contraction of private demand and a deep recession.

The negative effect of the bust on economic activity has actually reduced inflationary pressures and in some cases (such as in Japan in the 1990s) created a real danger of deflation. The main problem has then become how to prevent that credit contraction from triggering a deflationary spiral. In such conditions, there is no immediate conflict between maintaining price stability and financial stability: the same monetary policy will then both ease the strain on the banking sector and support price stability.

This observation does not mean that financial instability would not pose a serious challenge to monetary policy. On the contrary, the downward impact of a bust, if it is large, may be more difficult to control than the preceding period of credit expansion.

Unconventional tools and independence of monetary policy

In the case of the ECB, the new tools have included a transition to full allotment auctions, long-term refinance operations of up to three years, widening of the scope of eligible collateral, and various bond-purchase programmes. The most recent of these is the OMT programme announced last summer but not yet triggered in practice.

The development of new tools has been necessary. However, there are also certain problems with relying on central banks' enlarged toolkit. The ability to act in a crisis has led to the central banks even being called "the only game in town". We should resist this idea and beware of the danger that problems which are fundamentally political could be pushed to central banks to solve. The division of responsibilities between nominated officials and elected politicians should be respected. Monetary policy cannot administer the needed structural transformation in the real sector of the economy or solve the excessive deficit problems of governments.

Despite these concerns, there are situations where central banks simply must act and do their best to stabilise the economy, even if they have to use tools that go beyond just adjusting the short rate of interest or the aggregate liquidity of the banking system. The present financial crisis constitutes one such situation.

Avoiding the busts which seem to follow credit booms and periods of "financial exuberance" would make the tasks of monetary policy much easier and would protect the independence of central banks.

One idea which cannot be dismissed outright is that asset price booms might be moderated by "leaning against the wind" with monetary policy instruments. But there are also difficulties with leaning against the wind. One has to do with the problem of detecting the credit cycle in time, and correctly timing the monetary policy response. Another problem is that price stability might get less attention from monetary policy. Therefore, Mr Liikanen believes, monetary policy in the narrow sense needs to be complemented with new macro-prudential instruments which could be used to control credit booms.

Now it is important to establish an effective toolkit for both European and national authorities. We must also create institutional conditions that do not prevent these tools from actually used when needed. Therefore, we need clear decision-making competences at all levels. The connection between macro-prudential policy and its time dimension with monetary policy is so intimate that central banks must be closely involved in macro-prudential analysis and decision making.

The structural reform proposals

In order to prevent the present crisis from ever repeating, governments and authorities have begun on a wholesale overhaul of financial regulation. The regulatory agenda can be broadly divided into the following areas:

- Strengthening prudential regulation of solvency and liquidity.
- Improving the institutional basis for supervision and crisis management.
- Introducing macro-prudential instruments to prevent systemic risks in the banking system and financial markets.
- Regulating the structure of the banking sector.

The structural reform proposals, which appear as the last item on this list, seek to separate the riskiest securities and derivatives business from the deposit banking activities. This is the essential content of the proposals by the EU High-Level Expert Group, published last autumn.

It must be emphasised that the structural reform we proposed is not a cure-all, but should be seen as a part of a comprehensive regulatory agenda which is already under way. This includes better solvency and liquidity rules. Also, the EU will finally get supervision and resolution frameworks at the Union level. The different components of the current regulatory agenda complement and support each other.

Why banking structure matters for monetary policy

First, from the aspect of monetary policy, financial stability is very important. While monetary policy has proven capable of pursuing price stability even under rather strained financial conditions, central banks are not able to insulate the real economy completely from the after-effects of financial crises.

Second, the most important part of stability policy is crisis prevention; and that may require other ways than standard monetary policy to influence the state of credit markets. Improving the loss absorbency of banks and the crisis management powers of authorities are necessary steps, but it is even more important to make sure that excessive growth of credit and indebtedness can be better controlled in the future. In this way, credit crunches and banking crises can be made less likely – and milder, should they happen.

Third, financial stability would benefit from structural reform of the banking system. By separating the most risky securities and derivative activities from deposit banking, the spillover from deposit protection to speculative risk taking would be prevented.

Finally, structural reform of banking is a complement to, not a substitute for other regulatory improvements. For central banks, the development of macro-prudential policies and instruments is especially relevant. Those macro-prudential instruments that can be adjusted over time to manage conditions in the credit market will offer a way to better control the accumulation of excess risk and help prevent future crises.

These instruments operate so close to monetary policy that central banks should be very closely involved, if not themselves responsible, in developing and using them.

(Compiled by Tomáš Kendera)