Monetary Policy and Financial Stability – Summary of the 33rd Economics Conference of the Oesterreichische Nationalbank

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The 33rd Economics Conference of the Oesterreichische Nationalbank (OeNB)[1] on May 12 and 13, 2005, was motivated by the increasing globalization of the banking sector, which raises questions concerning the division of supervision-related costs and the potential burdens of financial crisis management. In order to fulfill their mandate to maintain price stability, central banks have to attach paramount importance to monitoring financial stability. Although the level of central bank involvement in banking supervision differs across the EU, central banks continue to play an important role in guaranteeing financial stability and carrying out banking supervision. Thus, it is vital to integrate financial stability analysis in the wider context of monetary and economic analysis. The OeNB promoted the exchange of views on these issues during its Economics Conference by inviting speakers, who addressed related questions from different points of view, presenting the perspectives of central bankers, supervisory authorities, academics and the financial industry.

As pointed out in the opening speech by Governor *Klaus Liebscher* (OeNB), monetary stability and financial stability are closely interrelated: The primary objective of monetary policy is to maintain price stability. Financial stability contributes to price stability. Deep, liquid and integrated money markets as well as smooth-functioning, efficient and reliable payment systems enhance the effectiveness of monetary policy implementation. In addition, financial stability contributes to the smooth conduct of monetary policy. Stable financial institutions and markets reduce uncertainty with respect to the impact of monetary policy on the real economy, as financial institutions and markets play a major role in monetary transmission, be it via the credit, investment or wealth channels. Questions of financial stability gained prominence when the Bretton Woods environment of regulated foreign exchange markets and strict capital account controls ceased to exist. Liebscher stated that he viewed the years from 1945 to 1970 as a period of exceptional financial stability. Though financial liberalization removed structural inefficiencies and provided opportunities for improved capital and risk allocation, a number of countries experienced severe financial instability and banking crises in the wake of financial deregulation and the liberalization of the capital account. Governor Liebscher concluded that financial and monetary stability should be analyzed and assessed together and underlined that macroprudential financial analysis was of paramount importance for central banks.

The first keynote address was delivered by Governor *Svein Gjedrem,* Norges Bank. He pointed out that more than ten banking crises had occurred in high-income countries in the period from 1977 to 1998. These crises had resulted in average cumulative output losses of about 20% of GDP. Gjedrem highlighted the importance of macroprudential supervision in assessing financial stability, before he went on to discuss one of the dominant topics of the conference: How should European supervisors react to the increasing internationalization of financial institutions? Recent examples of the growing internationalization in the banking sector are the Icelandic Kaupthing Group and the Swedish Nordea Group: The Kaupthing Group op-

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[1] *For more details see the proceedings of the 33rd Economics Conference (also available at www.oenb.at).*

erates in ten countries and holds assets which are twice as high as its home country's GDP, while the Nordea Group controls large market shares in all Nordic host countries. Gjedrem advocated close cooperation and efficient information exchange among national supervisory authorities. Then, he turned to the second prominent topic of the conference, i.e. the question how financial stability considerations are incorporated in monetary policy decisions. He pointed out that, in many cases, financial and monetary stability objectives were complementary. Nevertheless, there were periods in which asset price surges were accompanied by monetary stability. According to Governor Gjedrem, proactive monetary policy responses to asset price bubbles are not feasible and not desirable, as the latter are difficult to identify and because the required interest rate increases might be very high. He explained that Norges Bank incorporated financial stability considerations, and thus asset price developments, into the monetary policy decision process for two reasons: to reflect the fact that financial imbalances are important for inflation and output, and to ensure that financial stability issues receive the attention the subject calls for.

The first session of the conference focused on "Macroeconomic Policies and Financial Stability." *Charles Goodhart,* London School of Economics and Political Science, argued that excessive fiscal deficits could pose a potential threat to financial stability. He stressed that financial markets were ineffective in monitoring EU governments with respect to the sustainability of national fiscal deficits, and that the Stability and Growth Pact had proved unenforceable. In addition, he pointed out that financial regulators had strong incentives to assign low risk weights to public debt in capital adequacy regulation, regardless of the currency debt was denominated in. According to Goodhart, these incentives stem from the fact that regulators are often subordinate to the finance ministers of their respective countries. As a consequence, banks have high concentrations of national debt in their books, which could pose a threat to banking stability. Goodhart thus proposed establishing a panel of independent experts to assess the sustainability of national deficits. His discussant Thomas Wieser (Austrian Federal Ministry of Finance) questioned the effectiveness of such a panel, which, owing to a lack of democratic legitimacy, could not be equipped with the necessary enforcement powers. According to Wieser, the fact that yields on the government bonds of highly and increasingly indebted countries did not increase commensurately could also demonstrate that higher and increasing debt levels are still considered sustainable by the markets. Above all, he asserted that the probability of an EU Member State to default was effectively zero and that any related debate was merely of academic interest.

In the conference's second keynote address, *Takatoshi Kato,* Deputy Managing Director at the IMF, presented an overview of the Financial Sector Assessment Program (FSAP), which was introduced in 1999. The program covers a wide range of topics, including the main sources of macrofinancial risk and their potential impact, the main institutional and regulatory frameworks and the smooth functioning of financial markets' infrastructure (i.e. payment systems). Takatoshi Kato said that the FSAP would be fine-tuned in light of recent experience with the program. In particular cross-border and cross-sector linkages will receive more attention in future FSAPs. Kato also confirmed the positive conclusions of the FSAP for Austria, which was completed in July 2004. The assessment stated that the Austrian banking system was sound and resilient and that it enjoyed a high level of observance of international standards and codes. In line with the observations of the OeNB, the IMF also mentioned that the high level of foreign currency lending warranted attention by supervisors. In addition, the IMF pointed out that the exposure of Austrian banks to Central and Eastern European countries (CEECs) needed to be monitored closely. The FSAP exercises in CEECs found that recent reforms of institutional and regulatory frameworks had increased the soundness and resilience of the respective banking systems.

The second session addressed questions that feature prominently on the EU policy agenda, namely "Institutional and Regulatory Issues." *Karel Lannoo,* Centre for European Policy Studies, pointed out that the regulatory framework for banks focused solely on solvency, based on the assumption that liquidity problems are no issues once solvency problems have been addressed adequately. To clarify the discussion, he distinguished between microeconomic liquidity, i.e. the liquidity of a particular market or financial institution, and macroeconomic liquidity, i.e. the creation and mobilization of previously unexploited financial capital. While the first type of liquidity is widely considered to have predominantly positive effects, the impact of the second type is often considered to be potentially destabilizing (e.g. asset price bubbles). According to Lannoo the share of tradable assets on banks' balance sheets has risen in recent years, thus increasing their exposure to common macro-liquidity shocks. Setting aside regulatory capital to address this kind of liquidity risk could prove problematic. In times of a macro-liquidity crisis, banks might face difficulties in liquidating their liquidity buffers. While EU financial market regulation remained largely silent on liquidity risk, the ECB framework for the implementation of monetary policy contributed to its reduction. Lannoo said that the harmonization of minimum reserve requirements and of acceptable collateral as well as the provision of standing facilities helped mitigate potential liquidity shortages for the participating institutions. He added that minimum reserves and collateral holdings could be employed to obtain intraday credit in the large value payment system TARGET and to increase banks' flexibility in handling potential liquidity shortages in the very short run. Given the current supervisory framework at the EU level, Lannoo concluded that there was no immediate need for further harmonizing liquidity requirements. Nevertheless, the Basel Committee's principles for liquidity management could provide the basis for a set of similar minimum guidelines within the EU.

In her remarks *Daniéle Nouy,* Secretary General of the Commission Bancaire, focused on the international dimension of financial supervision. She pointed out that increases in financial institutions' cross-border activities made it necessary for financial supervisors to improve international cooperation. She added that in the banking sector, the Committee of European Banking Supervisors (CEBS), which was established as a Level 3 committee within the Lamfalussy framework in 2004, addressed this requirement by acting as a formalized, decentralized banking supervisory framework. According to Nouy, CEBS promotes supervisory cooperation and the exchange of information, and contributes to the consistent implementation of EU directives as well as the convergence of supervisory practices. Her discussant, *Jukka Vesala,* Deputy Director General of the Finnish Financial Supervision Authority, compared potential institutional models for prudential supervision in the EU. He rested his analysis on the incentive structures and externalities that emerge from different supervisory approaches, specifically from a lead supervision model and a model based on a network of competent supervisors in which the home country supervisor has a coordinating role. Under the lead supervision model, the home country supervisor is responsible for the prudential supervision of the whole group (including branches and subsidiaries). Vesala, however, identified a potential conflict of interests which may arise under this model: If the subsidiary or branch is systemically important in the host country's financial system and host country public money is at stake, the home country might lack sufficient incentives to ensure a solution that is efficient for both the home and the host country. A network of competent supervisors, on the other hand, preserves an active role for the host supervisor and ensures effective home-host cooperation. Hence, all potentially affected parties should have the appropriate incentives. Vesala argued that, in order to reduce the burden for banks and to avoid the duplication of efforts, the home country supervisor should be in charge of the overall coordination responsibility. He concluded that a framework for supervisory cooperation should ensure the consistency of supervisory and crisis management arrangements.

The third session centered on "Micro-Challenges for Financial Institutions." The keynote speech was delivered by *Jaime Caruana,* Governor of the Banco de España and Chairman of the Basel Committee on Banking Supervision. Caruana stressed that the New Basel Capital Accord (Basel II) was going to enhance the efficiency of the monetary transmission mechanism by contributing to the stability of the banking sector. He also explained that Basel II would not increase the procyclicality of bank behavior. According to Caruana, lending behavior has traditionally been procyclical and the question to address is whether Basel II will increase or decrease the positive correlation of bank lending and GDP. He said that critics maintained that the New Basel Capital Accord would force banks which experience unexpected loan losses and deteriorating credit quality to replenish and increase regulatory capital. Consequently, they would have to decrease bank lending. Caruana, however, argued that the most effective measures against unexpected loan losses and credit quality deterioration were improved risk management and financial supervision. Both measures should reduce the trend and volatility of unexpected loan losses, and shocks to regulatory capital should become less likely. According to Caruana, Basel II furthermore encourages banks to take account of uncertainty over the full cycle in their rating processes. Thus, a smoother adjustment to new macroeconomic data can be expected. Currently banks tend to hold more capital than required. These capital buffers will further insulate regulatory capital requirements from negative shocks and reduce the probability that regulatory capital will be binding even in downturns. Caruana then turned to the role of asset price developments for financial stability and monetary policy. Despite the potentially strong impact of financial imbalances on financial stability and on the monetary transmission mechanism, he argued that central banks should not directly target asset prices, as the remedy could be worse than the illness. Nevertheless, he stressed the importance of asset price developments in the risk management approach to monetary policy.

In the subsequent panel discussion the costs of financial regulation were debated vigorously. *Karl Sevelda*, Member of the Managing Board of Raiffeisen Zentralbank Österreich AG, estimated that the implementation of new regulations (in particular Basel II) would cost the Raiffeisen group around EUR 100 million. However, other participants disputed the validity of this estimate, as it includes investments in improving risk management, which would also have been necessary without Basel II.

In her presentation on financial stability and banking supervision *Eva Srejber,* First Deputy Governor of Sveriges Riksbank, concentrated on the future institutional structure of European banking supervision. While, according to Srejber, most determinants of systemic crisis are only present at the national level at the moment, certain manifestations of integration could pose systemic threats at the EU level in the future, e.g.: banks which are systemically important in more than one Member State; countries in which predominantly foreign banks are of systemic importance; banks that are of systemic importance in the home country but also keep a large share of their assets in the host country, where they are considered not systemically important; significant interbank credit exposure vis-á-vis banks in different euro area countries; integration of financial infrastructure. National supervisory and regulatory authorities have incentives to focus on their respective national financial systems, which might prove suboptimal in the presence of negative externalities of financial instability. Macroprudential supervision is limited to national financial systems owing to the underlying information requirements. Srejber said that, as a consequence, she considered Memoranda of Understanding a very valuable tool for improving cooperation and information exchange in the near future. She also pointed out that the creation of a European financial supervisor was neither feasible nor desirable in the short to medium term; in the long run, however, the establishment of a European financial supervisor would be the logical solution. She outlined three potential institutional arrangements: lead supervisors with full responsibility for all EU operations, branches and subsidiaries; lead supervisors with an EU mandate from a decision-making agency of European financial supervisors; or a single European financial supervisor, which would only be responsible for large cross-border banks. According to Srejber, a lead supervisor with a full EU mandate would minimize the regulatory burden for cross-border banks, however without addressing the conflicts of interest between home and host supervisors. The introduction of a central decision-making body might tackle these problems. However, the coordination of 25 regulatory authorities by a central decision-making body could render the latter inflexible, inefficient and bureaucratic. Srejber argued that, in the long run, a single European financial supervisor was the best solution for overcoming conflicts of interest between national supervisory authorities. In order to ensure the proximity to the markets in which the supervised entities operate, this institution should have a decentralized organization. In addition, the authority would need to be backed by financial resources for effective crisis management. Srejber also called for the harmonization of the rules governing crisis management in the EU Member States.

Her discussant, *Isabel Schnabel*, Max Planck Institute for Research on Collective Goods (Bonn), explained that financial integration was very high in Europe before World War II. There was very little financial regulation and supervision and virtually no coordination of crisis management. Schnabel raised the question whether the financial crises which struck during the Great Depression, could have been prevented by the cooperation of national authorities. She explained that the systemic risk of cross-border banking had been considerable after World War II (e.g. Herstatt crisis). She moreover stated that she favored a centralized authority, which would ensure the convergence of regulation. On this basis, the centralization of supervision would lead to the internalization of externalities, would make it possible to exploit economies of scale, and would improve the framework for monitoring systemic stability. It should, however, not be forgotten that also centralized supervision would require informational input by national authorities. An appropriate institutional arrangement would have to address the related incentive problems.

To sum up, three issues featured prominently in virtually all presentations: the future institutional structure of financial supervision in Europe, the role of asset prices in monetary policy, and the role of macroprudential supervision by central banks. There was broad agreement among conference participants that the establishment of a European financial supervisor would only be feasible in the long run – if at all – and that such an institution should have a decentralized structure. Its tasks should not be confined to large cross-border institutions as this could lead to competitive distortions. Furthermore, sufficient financial backing of such an institution would have to be ensured to enable it to deal with financial crises at the EU level. As far as the second core topic of the conference was concerned, participants agreed that asset price developments are relevant for the conduct of monetary policy and that liquidity conditions can be regarded as indicators of potential asset price bubbles. The Eurosystem takes liquidity conditions explicitly into account under its two-pillar strategy. Most participants, however, shared the opinion that fundamental practical problems hamper a more explicit targeting of asset prices in the conduct of monetary policy. The Eurosystem's credible commitment to a long-term strategy of price stability and its two-pillar approach were considered the most effective contributions to containing expected future inflation and, thus, asset price bubbles fueled by inflation expectations. Finally, the conference highlighted the paramount importance of macroprudential supervision by central banks in preventing financial instability. This prevention is essential for the effective conduct and implementation of monetary policy owing to the close interrelation between monetary and financial stability.