



Duisenberg
school of
finance



The Land In Between

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The ECB and its Watchers
12 March, 2014

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The European Central Bank:

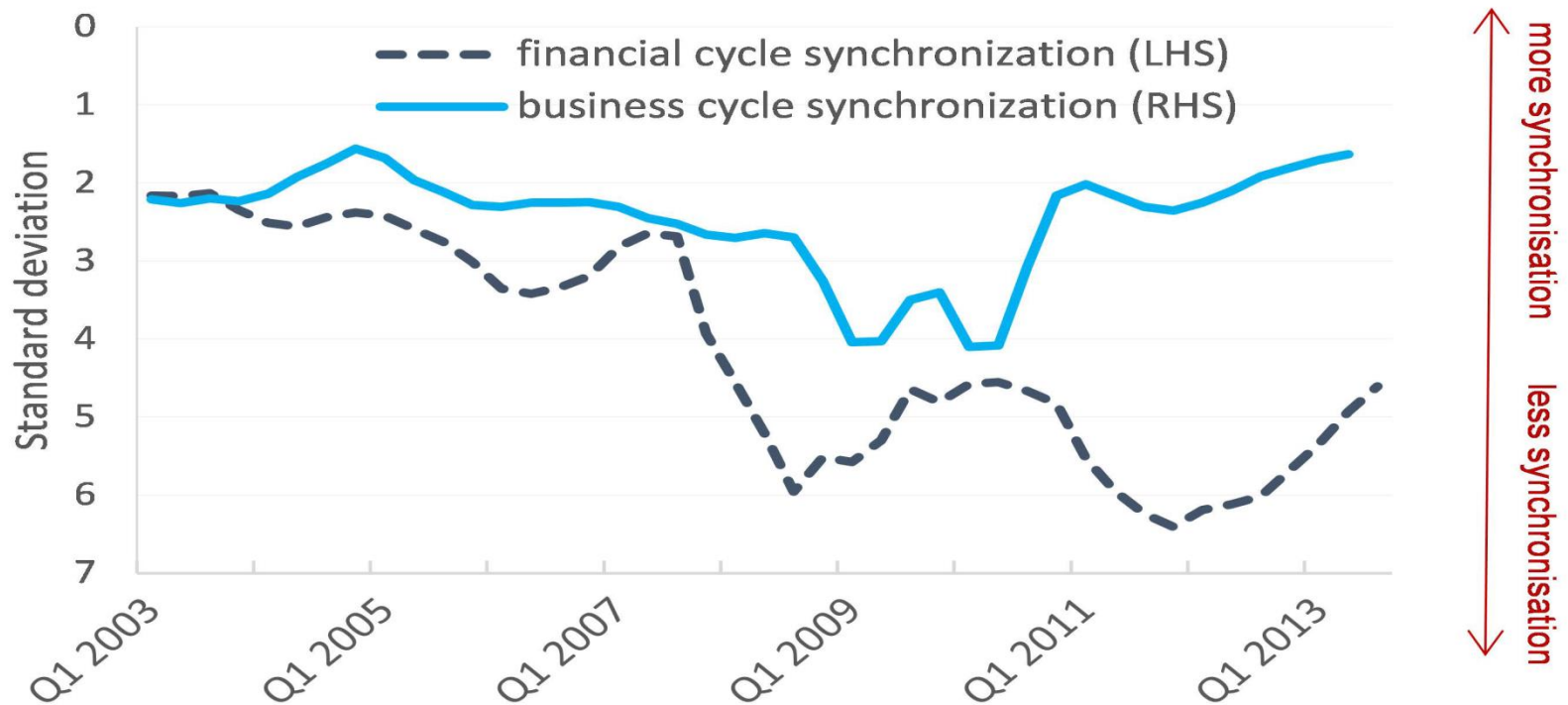
- has a strong track record in monetary policy, and
- is working hard on banking supervision for Banking Union

But what about financial stability?

European financial crisis

- Housing boom-bust cycle caused crisis in Ireland, Spain and Portugal
- Housing prices are rising in major German cities
- One-size-fits-all monetary policy is not helpful
- Need for pro-active macro-prudential policy due to differing financial cycles within euro-area

Divergence of financial cycles in EU

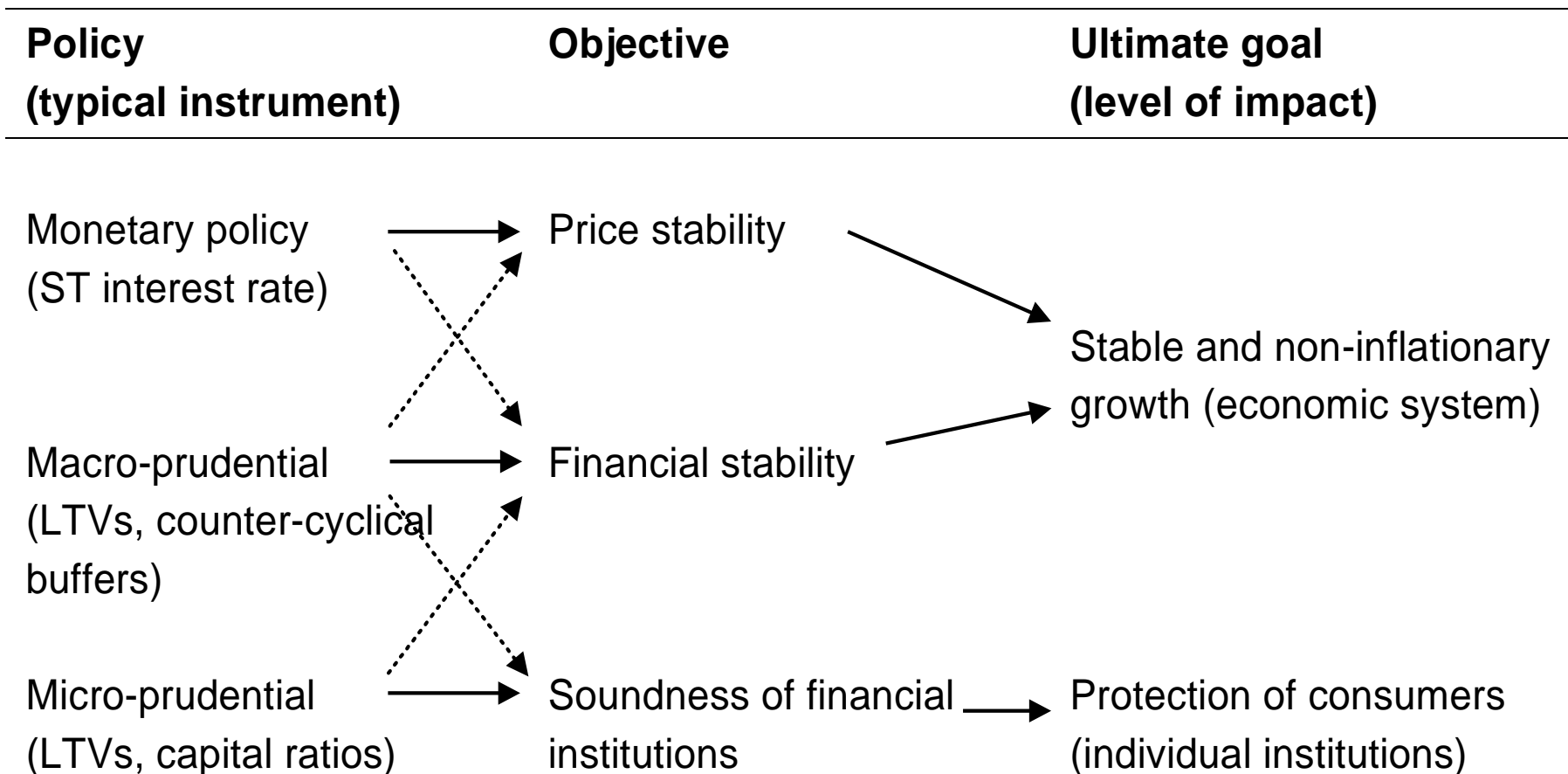


Notes: Financial cycle synchronization is defined as the 1-year cross-country standard deviation in the credit-to-GDP gap (source: Alessi and Detken (2011, *EJPE*)). Business cycle synchronization is defined as the 1-year cross-country 2-year standard deviation in the YoY GDP growth rate (source: national accounts). Sample includes the EU28.

Who should be responsible?

- Effects of alternative allocation macro-prudential power
-> to what authority should it be allocated
- Impact on interaction between macro-pru and monetary policy
- Analyse synergies and conflict of objectives

Overall policy framework



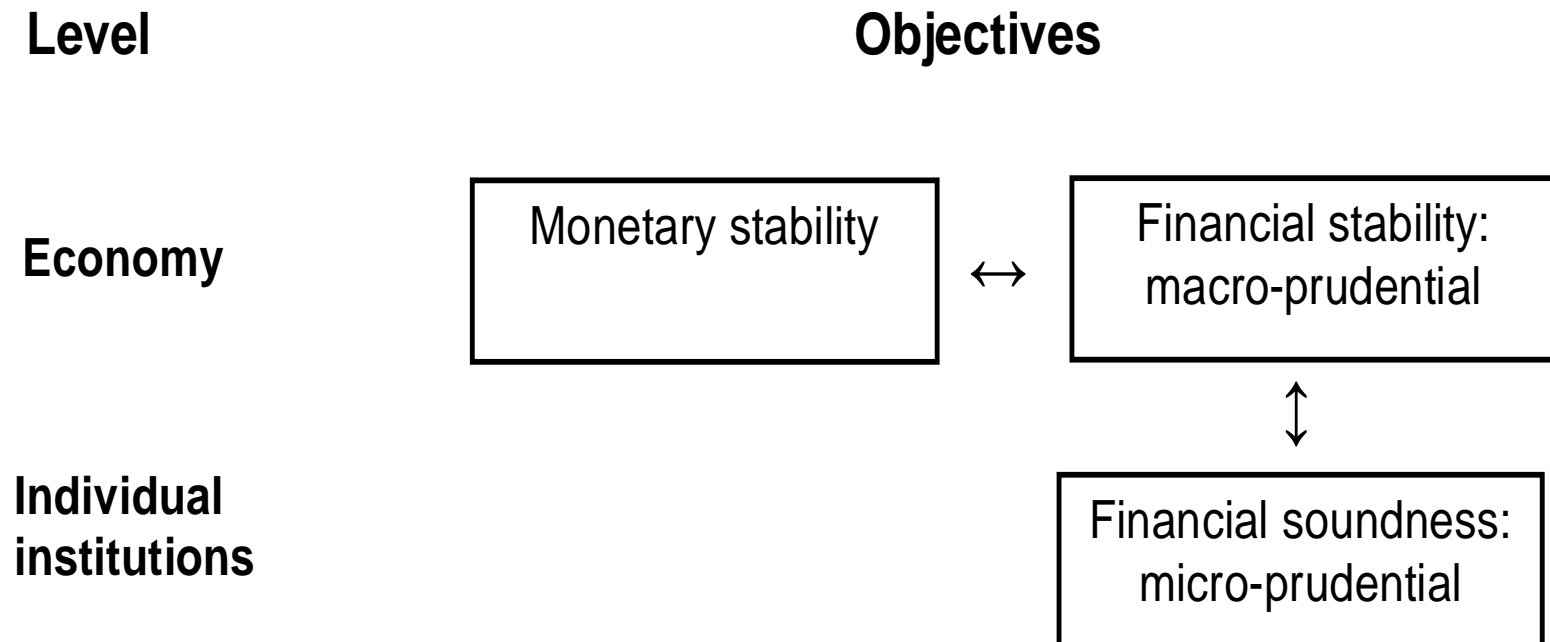
Monetary and Macro-Pru

- Synergy:
 - stable financial system pre-condition for growth;
 - price stability pre-condition for financial stability
- But also conflicts
 - Low interest rate to stimulate demand -> house prices \uparrow ;
but when rate \uparrow -> house prices \downarrow (mortgage under water)
- Macro-pru is targeted at financial imbalances in specific markets, while monetary is more general

Micro- and Macro-Pru

- Synergy:
 - At instrument level, but that is less relevant
- Conflicts
 - Tacit assumption: to safeguard system, it suffices to safeguard individual components:
 - Fallacy of composition (Brunnermeier *et al*, 2009)
 - Distinct objectives and perspectives

Hierarchy of objectives



Institutional models

Model	1	2	3	4
Agency	Ministry of Finance	Central Bank	Financial Authority	Committee
Euro area	0 (0%)	11 (58%)	4 (21%)	4 (21%)
Non-euro area	1 (10%)	6 (60%)	1 (10%)	2 (20%)
Total	1 (3%)	17 (59%)	5 (17%)	6 (21%)

Allocating powers (1)

Government

- ST politics versus LT benefits -> time inconsistency
- But macro-pru (e.g. LTV) impact on economy/households
 - Need for independent agency, but arrange democratic accountability

Central bank

- Macro-economic approach -> same culture and expertise
- But ultimate objectives may differ -> separate divisions and apply different instruments (with coordination)

Allocating powers (2)

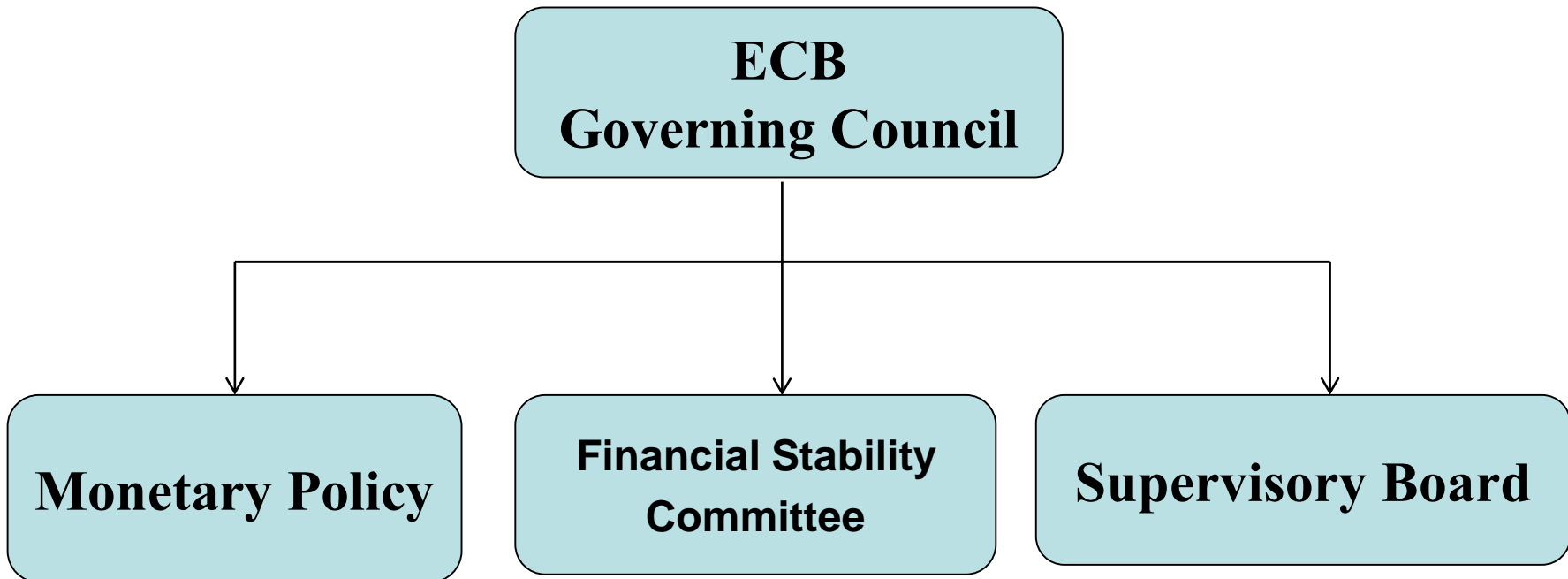
Financial Authority

- Instruments related, but perspective different
- Methodological approach different (macro-economics versus accountancy / legal based) -> culture and expertise different (Goodhart *et al*, 2002)

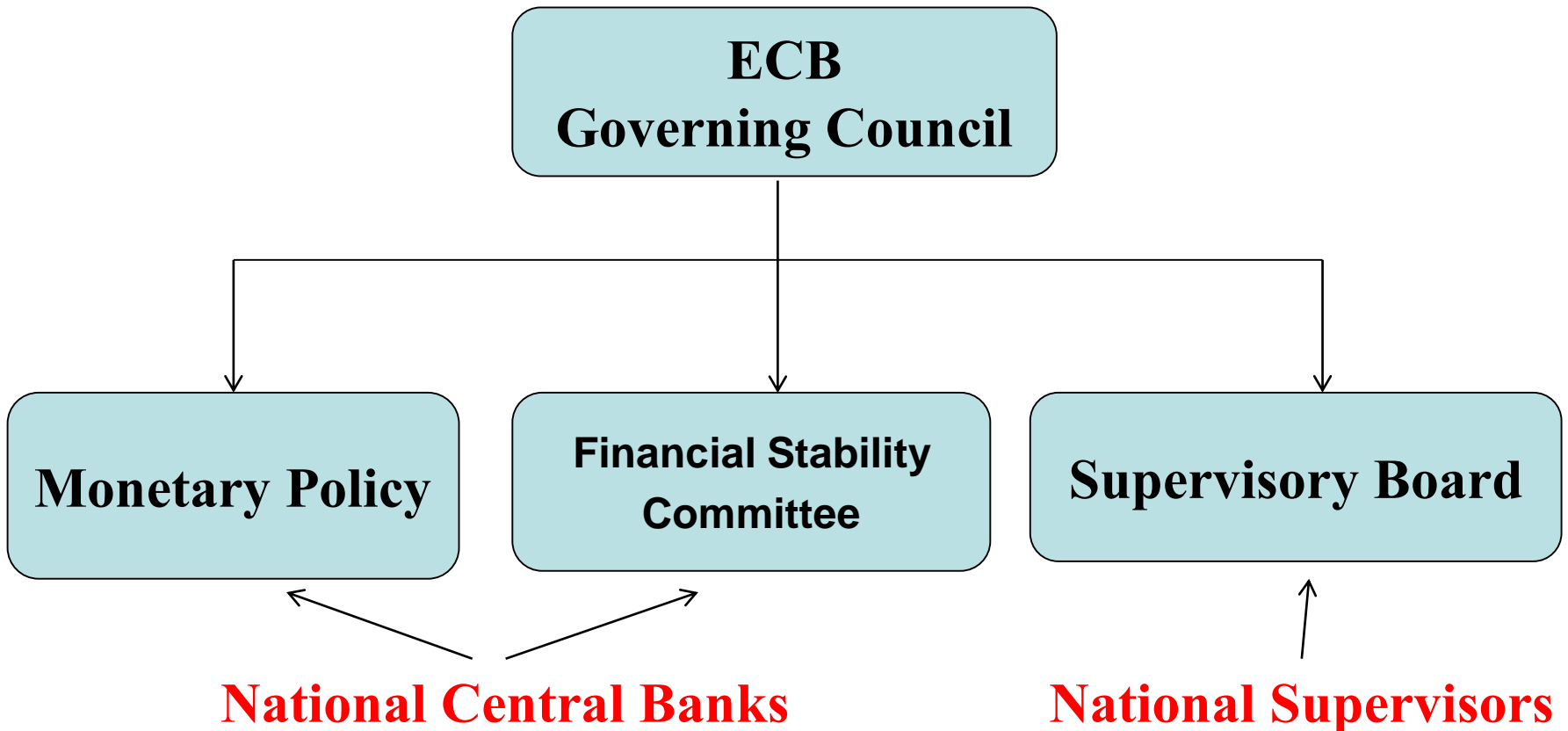
Euro-area with Banking Union

- Macro-Prudential more important, with one-size-fits-all monetary policy (see regional housing bubbles)
- Institutional (no patchwork):
 - National supervisors in ECB's Supervisory Board
 - National central banks in ECB's Financial Stability Ctee

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References

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- Schoenmaker, D. (2013), 'An Integrated Financial Framework for the Banking Union: Don't Forget Macro-Prudential Supervision', *European Economy - Economic Papers* No 495, DG ECFIN, Brussels.

Thank you for your time

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