

**IMFS Interdisciplinary Studies in
Monetary and Financial Stability**

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Central Banking: Where are we headed?

*Edited by
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and Volker Wieland*

IMFS

About the **IMFS**

The Institute for Monetary and Financial Stability (IMFS) is an academic center of Goethe University Frankfurt, Germany. The institute's main objective is to raise public awareness of the importance of monetary and financial stability – a project funded by the Foundation *Stiftung Geld und Währung*.

The IMFS conducts interdisciplinary research on all questions relating to monetary and financial stability. Apart from its focus on excellent research, the institute's scholars are committed to knowledge exchange between the academic world and decision makers in politics, administration, financial industry and central banks.

The IMFS is composed of six chairs of which three are funded by the *Stiftung Geld und Währung*. The research areas of these three chairs – Monetary Economics, Financial Economics, and Money, Currency, and Central Bank Law – are closely linked and designed to stimulate interdisciplinary research and policy work.

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With this series launched in 2012 the IMFS aims to present interdisciplinary work crossing the boundaries between monetary economics, financial economics and central bank and financial law. It serves as a first outlet for joint work by IMFS faculty and researchers. The series is open to contributions to basic research as well as writings providing new policy advice. Importantly, it also provides a vehicle for disseminating the results of IMFS research and policy conferences that are joint initiatives of IMFS faculty. Copyrights remain with the authors. The series is edited by the IMFS professors, Helmut Siekmann and Volker Wieland.

Recent Issues

1/2013, The ECB and its Watchers 2012, eds. Helmut Siekmann and Volker Wieland, August 2013.

This study contains articles based on speeches and presentations at the 14th CFS-IMFS Conference „The ECB and its Watchers“ on June 15, 2012 by Mario Draghi, John Vickers, Peter Praet, Lucrezia Reichlin, Vítor Gaspar, Lucio Pench and Stefan Gerlach and a post-conference outlook by Helmut Siekmann and Volker Wieland.

1/2012, The ESRB at 1, eds. Stefan Gerlach, Ernest Gnan and Jens Ulbrich, December 2012.

This study contains articles based on speeches and presentations at the fifth IMFS Conference on Monetary and Financial Stability organized jointly with SUERF and Deutsche Bundesbank. It includes contributions by Hermann Remsperger, Stephen Cecchetti, Stephan Ingves, Alberto Giovannini, Jens Weidmann, Alexandros Vardoulakis, Stefano Neri, Jürgen Stark, Elöd Takáts and Christian Upper, Claudia M. Buch, Sandra Eickmeier and Esteban Prieto, Abdul Abiad, Giovanni Dell’Ariccia and Grace Bin Li and Francesco Mazzaferro.

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Helmut Siekmann and Volker Wieland Introduction

On February 7, 2013, the Institute for Monetary and Financial Stability (IMFS) and the House of Finance at the Goethe University of Frankfurt organized a symposium on “Central Banking: Where are we headed?” in honor of Stefan Gerlach’s contributions to the IMFS. Stefan Gerlach held the IMFS Endowed Chair for Monetary Economics from 2007 to 2011. He served as IMFS Managing Director in 2010 and 2011.

After completing his studies at the Universities of Lund and Gothenburg in Sweden, the Swedish-born Gerlach earned his doctorate from the University of Geneva. He has been a Visiting Scholar at Harvard University, Visiting Assistant Professor at Brown University, Rhode Island, as well as at INSEAD, Fontainebleau. In 1992, he received tenure as Associate Professor at Brandeis University, Massachusetts. Before joining the IMFS, Gerlach worked for 15 years at the Bank for International Settlements (BIS) in Basel – most recently as Head of Secretariat to the Committee on the Global Financial System – and was the Executive Director at the Hong Kong Monetary Authority and Director of the Hong Kong Institute for Monetary Research. In September 2011, Stefan Gerlach was appointed Deputy Governor of the Central Bank of Ireland. His appointment to this important position also indicates the influence and policy relevance of the work conducted at the IMFS in the area of monetary and financial stability.

This issue of the IMFS Interdisciplinary Studies series brings together several contributions by speakers at the above-mentioned symposium. Central banking has always involved more than monetary policy making alone. At this time, however, many of the uncertainties about the road ahead derive from new responsibilities in the areas of macroprudential policy and banking supervision. In Europe in particular, the new supervisory tasks assigned to the European Central Bank confront the euro area’s monetary policy makers with a host of new challenges. The formation of a “banking union” is

accompanied with great hopes and fears. Thus, one segment of this issue deals with the area of central banking and banking supervision in the euro area. It contains contributions by Sabine Lautenschläger, Patrick Honohan and Benoît Cœuré.

Sabine Lautenschläger, then Vice-President of the Deutsche Bundesbank, discusses the need for improving the arrangements for banking supervision in the context of European monetary and financial union and describes the road to get there. Her expertise as a lawyer with an impressive career in Germany’s banking supervision authority (BaFin) prior to her appointment to the Bundesbank ensures a thought-provoking analysis of these matters. Patrick Honohan, Governor of the Central Bank of Ireland and a Member of the Governing Council of the ECB, expresses five hopes and five fears about European banking union. Based on the experience of the collapse of the banking system in Ireland and the measures taken to deal with this crisis he draws important lessons for the future conduct of banking supervision in Europe. Benoît Cœuré, Member of the Executive Board of the ECB, reviews how monetary policy can benefit from integrating banking supervision in a central bank. He also lays out how to avoid conflicts of interest and manage reputational risks when monetary policy and banking supervision are made under one roof. His extensive experience at the French Treasury and his record in academic and policy analysis guarantee a thorough review.

The other area addressed in this issue concerns the interaction of monetary and fiscal policy and the politics of European Monetary Union. Central banking has always had a political dimension even in those cases where central bankers are free to decide monetary policy independently from fiscal concerns. Due to the unique nature of the euro area as a monetary union of fiscally sovereign member countries, however, the ECB faced special challenges during this period of crisis. In this regard, the issue provides two contributions by Athanasios Orphanides and Michael Burda.

Athanasios Orphanides from the Massachusetts Institute of Technology served as Governor of the Central Bank of Cyprus and a member of the Governing Council of the ECB from 2007 to 2012. His research as an economist at the Federal Reserve, prior to this appointment, has been very influential in the field. While Governor at the Central Bank of Cyprus he criticized publicly the out of control budgetary policy making of the Cypriot government and the lack of structural adjustments. He also warned then-President Christofias that the Greek debt write-down to which he was asked to agree would have serious consequences for the Cypriot banking system. In his contribution to this issue, Orphanides explores how election politics on the national level influenced decision-making on euro area rescue measures and delayed progress on reforming euro area governance.

Michael Burda from the Humboldt University in Berlin provides an outlook with three contrasting scenarios for the resolution of the euro and sovereign debt crisis. His perspective is unique given his background as an American economist who moved to Europe and looks back on an impressive career as academic and researcher in France and Germany. He is the author together with Charles Wyplosz of what is possibly the best-known textbook on modern macroeconomics with a systematic European perspective. In addition, he has frequently served as an adviser to policy makers. He is also a long-time co-author of Stefan Gerlach. Finally, the issue concludes with some remarks by Stefan Gerlach.

Sabine Lautenschläger

European Monetary and Financial Union – What is needed in terms of Banking Supervision?¹

1 Introduction

We come together today to honor Professor Stefan Gerlach's contribution to the Institute for Monetary and Financial Stability. Stefan has certainly proven time and again to be an outstanding scholar who is able to connect theoretical considerations with the requirements of reality. And reality is what is needed, especially in times of stress like these.

The crisis we are experiencing is without doubt the most extensive and worst economic crisis of recent decades. I would not miss it at all; but as we have to endure it, we should all look to fulfil the original meaning of the word "crisis", which is "turning point". And to reach this turning point in the positive sense of the term, we need to seize the opportunity and use the lessons learnt to make the financial system and the monetary union more resilient.

With regard to the banks as one important part of the financial system, we have made some important progress so far. Banks have to comply with higher capital and liquidity standards; the requirements for adequate internal control systems and an appropriate governance structure have also been tightened substantially. Furthermore, the requirements to be met by supervisors have changed significantly, too.

The fiscal and economic state of affairs of the EMU's member states is improving as well. To achieve further progress at the national level, governments need to adhere to their decisions to increase investor confidence and economic competitiveness with fiscal consolidation and structural reforms.

And we have seen some progress regarding the architecture of Europe's financial supervisory system – even if one might ask whether it is sufficient with respect to the risks and liabilities increasingly shared at the European level. National governments seem to have no great wish to give up major parts of their sovereignty, with one exception in my view. Over recent months, the European governments have agreed on

a European banking union or, more specifically, a banking supervisory set-up at European level.

The Bundesbank welcomes the proposal. It has the potential to improve banking supervision and to help strengthen financial stability and the institutional framework of monetary union. I would like to focus on this "Single Supervisory Mechanism" in my speech and talk about the "why" and the "how" of such a European banking supervisory set-up.

2 European banking supervision – the "why"

European banks are financially interconnected to a marked degree. Thus, national banking crises do not stop at national borders but tend to spread across countries. From this perspective, a Single Supervisory Mechanism is a natural response. Compared to national supervision it would operate on the basis of more comprehensive information and with the benefit of cross-border comparison. Thus, it would enable us to pinpoint risks which threaten the banking system or emanate from it more easily and at an earlier stage. Furthermore it would lessen the risks national supervisors are exposed to: sometimes national supervisors are too set in the ways of their supervisory systems and run the risk of being overprotective towards banks for national reasons.

In terms of the current crisis, the Single Supervisory Mechanism might also be a way of resolving one problem that has become apparent: the close link between banks and sovereigns.

If a lot of banks get into trouble at the same time, possibly owing to a large asset bubble bursting, financial stability as a whole is threatened. The government then often has no option but to step in if it wants to prevent a complete meltdown. But, as we all know, such a rescue can place a huge burden on public finances. From a more general perspective,

¹ This text is a speech given on February 7, 2013, at a conference in honor of Stefan Gerlach's contributions to the IMFS.

this point is backed up by an empirical study brought out by Professor Gerlach in 2010, which shows that risks in the banking sector indeed translate into higher spreads for sovereign debt.²

But banking crises do not only place a burden on public finances. Conversely, weak public finances can destabilise banks – directly through their exposure to sovereign bonds or indirectly through worsening macroeconomic conditions.

What are the implications of these insights? It follows from them that loosening the links between banks and sovereigns is vital if the euro area is to be made more stable.

But how do we get there?

First, pinpointing excessive risk concentrations is essential. A European banking supervisor can weaken the nexus between sovereigns and banks by monitoring and putting a brake on the build-up of excessive risks, whether in specific economic sectors or in government financing – even if this can only be done in the medium term.

Second, in order to insulate banks from weak public finances, we need not only appropriate supervision but also suitable regulation; regulation that will prevent banks from taking on excessive risk through state financing. Such regulation should, for instance, include upper limits for lending to governments. It should also encompass appropriate capital backing for government bonds – which is another proposal made by Stefan Gerlach, incidentally.

But the Single Supervisory Mechanism (SSM) and suitable regulation are just two elements of a banking union, and there are also other means available for severing the link between sovereigns and banks. The third tool in this respect is a European recovery and resolution mechanism for banks that has access to “European” funds. In this context, it is necessary that any such mechanism ensure that investors are

first in line to bear the risk of their investment decision. Taxpayers must be spared the burden of other people’s investment decisions – at the national level and even more so at the European level – for as long as there is no proper balance between liability and control.

Ladies and gentlemen, I have very briefly highlighted a few arguments in favour of European banking supervision – the “why”, so to speak. Now, let us take a look at the “how”.

3 European banking supervision – the “how”

The establishment of the SSM will see wide-ranging banking supervisory functions being transferred to the ECB. At least seventeen countries will give up their sovereignty in supervisory matters to the ECB; the ECB will be directly responsible for the supervision of the most systemically important banks domestically and at European level. Nevertheless, national legal systems and national market structures will still be of utmost importance for the welfare and success of these banks. Given the multitude of different supervisory traditions, legal systems and people involved in supervision, the SSM will only be successful if appropriate governance and transparent cooperation and task-sharing are installed.

One of the “hot” topics when swiftly organising a banking supervisory function for the ECB is future cooperation between the ECB and the national supervisors. Organising a European banking supervisory mechanism in such a short time firstly means building upon existing structures. Secondly, supervision will only be successful if the ECB is able to benefit from cross-border comparisons, taking into account the macroeconomic and microeconomic knowledge and experience of national central banks. Even if interconnectedness between banks was and still is one of the major issues of the last five years, a crisis usually originates in national developments. Remember the US subprime real estate market and its effects on globally active banks. Thus, it will be essential to combine the knowledge of global, na-

² S Gerlach, A Schulz, G Wolff (2010), *Banking and Sovereign Risk in the Euro Area*. Centre for Economic Policy Research, Discussion Paper, No 7833.

tional and regional economic conditions, infrastructure and legal systems with knowledge about banks' business and risk profiles, governance structures and control systems. In short, setting up a new European supervisor within a year or so is extremely ambitious, but doable.

However, with regard to the governance structure, there is a problem that cannot be fully resolved under the current framework – the strict separation of monetary policy from banking supervision within the ECB. Such a separation is not possible without amending the ECB's institutional framework as enshrined in primary law – a step that has been carefully avoided so far.

With the goal of strictly separated functions in mind, the current proposal establishes two new bodies within the ECB: first, a Supervisory Board with representatives from the ECB and from national authorities; second, a mediation panel which includes one member from each country that participates in the Single Supervisory Mechanism. Now, what are the tasks of these two bodies?

The Supervisory Board submits proposals for supervisory decisions to the Governing Council. The Governing Council, in turn, can only agree or disagree, but will not be able to amend these proposals. If the Governing Council disagrees, it will be up to the mediation panel to resolve differences of opinion. The panel will decide by simple majority whether to accept the proposal in its original form or not.

And in order to actually separate the two functions, it would be imperative for the Supervisory Board to have the final say in all supervisory decisions. However, under prevailing primary law, the ECB Governing Council must have and will have the last word on banking supervisory decisions.

There are additional problems I would like to focus on: because of prevailing primary law it is problematic that the Governing Council is supposed to only accept or reject deci-

sion-making proposals from the Supervisory Board, but to be unable to influence the proposals. If the Governing Council, consisting of the ECB board members and the governors of the EMU central banks, is responsible for supervisory actions, it also has to be in a position to shape the measures being taken.

Additionally, the independence of the ECB and its Governing Council would be restricted if it were obliged to regard the decision of the mediation panel as binding.

The problems I have just set out highlight the crucial importance of a principle which the founders of the Eurosystem were keen to safeguard: the independence of the ECB, and of its governors. If the governments decide to mandate the ECB with additional tasks, this basic principle still applies, as long as the treaty is not changed. Thus, if the ECB is mandated with banking supervision, the Governing Council of the ECB will be the one deciding on all relevant supervisory matters, as long as there are no changes in primary law. This implies that – following a common principle of reason – those responsible for a decision need to be able to shape that decision.

4 Conclusion

Let me sum up my main points. The Single Supervisory Mechanism is a good step forward towards improving the European institutional framework. There is no doubt about that.

However, the envisaged institutional set-up needs to take into account a basic feature of the Eurosystem – the independence of the ECB and of the members of the Governing Council. Hence I am not only looking forward to working with my supervisory colleagues within the SSM, but also to reading the final regulation governing the new system.

Patrick Honohan

Five Hopes and five Fears about European Banking Union¹

As we work at breakneck speed to construct what is undoubtedly a most ambitious project, European banking union, it is good to stop from time to time and take stock of what we are hoping to achieve and what might stand in the way of success. So today I would like to talk about the potential of a banking union and the pitfalls that might lurk ahead of us.

As I have already pinned my flag to the mast as an enthusiastic supporter of banking union, I will choose today to dwell a little longer on the pitfalls, with a view to exploring how we can best work around them.

But let us start with the potential, and here I will list five hopes that I have for the project. First, I hope that it will go some distance to removing politics from the enforcement of bank supervision. Second, I hope that it brings emotional detachment to the process of supervision. Third, I hope that it manages to lever the diversity of supervisory experience and aptitude across Europe to provide multiple cross-checks on bank soundness, while not limiting into a straitjacket bank behaviour. Fourth, I hope it is effective in breaking the link between sovereign and banks, not only to protect the sovereign but to allow banks to operate effectively and have access to European funding markets on a basis that is not subject to a sovereign risk-add on, but depends only on the bank's own creditworthiness and standing. Fifth, I hope that it helps provide the reassurance to bond and equity investors, both public and private, to underpin and finance needed liquidity and the much higher capital requirements that have been handed down from Basel and which are clearly needed to redress the incentives for excessive risk-taking.

First, I hope that it doesn't get bogged-down in overly complex layering of decision-making structures. Second, I hope that the huge task of transferring knowledge to the centre and building new communications channels between national supervisors and the central team does not result in process overwhelming product in an interim period with the result that some problems remain undetected, hidden by the dust kicked-up by the creation of the new structure. Third, I

hope that the decision-making bodies are truly communautaire and not simply an amalgamation of national interests. Fourth, I hope that moving decisions to the centre and away from national authorities in what can be a very sensitive area will not result in divisive clashes between broad European and national interests. Fifth, I hope that the inevitable mishaps do not discredit the reputation of the ECB as a stability-oriented monetary authority.

I Hopes

Removing politics

Politics and banking don't fit well together but they seem to have a magnetic attraction for one another. One of the most vivid examples of this for me was in a small non-European country that I happened to work in many years ago. Four of the biggest banks were under water and I struggled to understand what common characteristics they had, since the banks seemed to have quite different business models and geographical reach. One was concentrated in the arid north of the country, one in the hilly and fertile west, one was located in the main industrial centre and one in the capital. The business models, with their contrasting emphasis on deposit taking, agricultural finance, SME finance and personal and retail respectively were also quite different. What an unfortunate coincidence that all four had suffered adverse shocks sufficient to cause failure? It was only after digging into the sociological and demographic attributes of the country that I was able to pinpoint that politics was the common driver. In order to retain control of such a heterogeneous and diverse country, the political elite had had to ensure that easy credit was available to all parts of the country and all main segments of society. These banks had been the vehicles for this policy over a period of years and by the time I arrived the bills had come due and the denouement of the situation was at hand. A purely technocratic approach by the country's banking supervisors in such an environment would not have long been tolerated by short-termist politicians, yet it would have saved the economy as a whole from the costs and consequences of

¹ This text is a speech given on February 7, 2013, at a conference in honor of Stefan Gerlach's contributions to the IMFS.

misallocated credit, as measured in tax burden and slow growth in economic wellbeing.

This degree of political interference in the allocation of credit would of course be exceptional. Yet who can doubt that, in some circumstances, the political prominence on the national stage of some bankers can result in implicit pressures to hesitate or second-guess regulatory action. It is, I believe, only a mild over-simplification to say that international experience shows that the best form of regulation for delivering the common good is technocratic and wholly insensitive to national, regional or local politics. That can best be delivered by a regulator who lacks an understanding of, and interest in, such politics – outsiders will often fit this description very well.

Note that the outside regulator still needs to relay on the nose of the local supervisors for the assembly of the relevant information. It is chiefly in making the final decision on regulatory interventions that the need for political distance becomes evident. Indeed, it is not so much in supervision, as in resolution that these issues become decisive – pointing of course to the need to complement to single supervisor with a single resolution authority.

Emotional detachment

Perhaps an even bigger challenge is to creating what I can call emotional detachment between the banking system and the regulator. In contrast to the political issues, which will often relate to isolated firms, what I have in mind here is the problem of the waves of euphoria and over-optimism which have a tendency to sweep through financial systems, often driven by – and driving – property bubbles (and I am not just saying that because of the national experience of Ireland in recent years). If the entire banking system, and the property market gurus, and the beneficiaries of the spin-off economic activity and stock market appreciation all become cheerleaders for the continuation of credit-fuelled bubbles on the ground that “this time it will be different” the regulator may still stand in opposition. All too often, however,

the regulator does not sufficiently suffer from professional deformation and a sneaking suspicion that the market may be wrong is weakened or drowned-out by the plausible chorus of boosters to which the local regulator is daily exposed. Here again one can hope that the outsider will bring untarnished to the party the skepticism that is natural for all regulators.

This hope is to be tempered, of course, by the thought that globalization of ideas and fashions means that boosterism is not reliably confined by national borders. Indeed the great financial crisis from which we are emerging has been an example of cross-border contagion of boosterism. Look again at the Irish case, where external assessors of the quality of Irish financial supervision and regulation provided fulsome endorsement as late in the bubble as 2006 certainly alerts us to the fact that the external eye is not a panacea.

Diversity of experience

This hope is more tentative and a bit more speculative. It derives from the observation that supervisory practice differs quite significantly in Europe. No doubt every supervisory agency thinks it does the job better than every other one, but this is of course impossible. It’s much like asking men to rank their driving skills – everyone is above average.

At the Central Bank of Ireland, we have recently rolled out a nifty computerized tool (called PRISM) for guiding and recording supervisory engagement. We think it provides a great advance especially for dealing in a systematic way with the supervision of financial firms to which an impact factor below the very highest has been applied. Even though we are very happy with this, and think it embodies much of the accumulated experience that has been gained over the years (good and bad) I am sure there are aspects that could benefit from a different approach. It is beyond unlikely that there is any agency that has nothing to learn from the others.

To be sure, supervisors have been talking to each other in Europe and internationally for years in the Basel Committee,

in Europe's CEBS and now in the EBA. Much has been codified. Yet there is no agreed supervisory manual. The banking union will inevitably result in further moves in that direction: after all, the Single Supervisory Mechanism (SSM) will itself embody a single methodology. Of course, a single manual does not mean that banks shall be treated in the same way regardless of the macroeconomic context they are working in – as fretted by some – it means that similar risks should be approached with the same tools, and stringency, everywhere in the union.

But by mixing and cross-referencing the practical experience of many different systems, the combined forces of the supervisory agencies of Europe will surely have the potential to spot and make early detection of novel risks.

The SSM should develop into best practice drawing on the diversity of experience across Europe. Of course we don't want that to ossify: supervisory methods and models should not be rigidly codified, they should evolve, drawing on the disparate experience of all.

Sovereign and banks

My fourth hope relates to an entirely different but well-worn aspect of a banking union. This relates to breaking the pernicious feedback loop between sovereign and banks. Perhaps I do not have to say too much about this. Though I note that various observers have different interpretations about how this would work. What all can agree upon is that the Irish syndrome cannot be allowed to recur. Features of the Irish case were (i) banks which accumulated vast exposures to the Irish property bubble financed with cross-border wholesale funding; (ii) Government stepping in to guarantee the funding (in ignorance of the hidden exposure to crippling loan-losses); (iii) central bank financing of the outflows that occurred when wholesale markets lost confidence in the guarantor; (iv) the Sovereign having to have recourse to official financing to spread out the cash repayment of the indebtedness accumulated as a result of meeting the loan losses and the bank recapitalization. Not only do I hope that

the banking union will be (i) more effective in preventing unsound banking practices on this scale, with interventions that pre-empt a slide into insolvency, but that there will be (ii) a resolution law and institutional arrangements that make bail-out of bank creditors a thing of the past (because of sufficient bail-in-able debt even to cover cases where supervision is insufficient to prevent insolvency); (iii) therefore no risk to the Sovereign from banking weakness; and (iv) where needed, a public financial backstop at European level to top up depleted capital for viable banks who have lost some of their capital.

When it becomes evident that a bank has had made pervasive loan underwriting errors, the market naturally fears the worst, as it can take quite a while for the true extent of the losses to emerge. With no backstop other than the State, this pall of uncertainty has hung over Ireland since the scale of the problem became evident as the initial tranches of loan losses were uncovered during 2010. Only gradually has the Irish Sovereign been recovering the confidence of the market. The process could have been greatly accelerated had there been a backstop mechanism at European level to provide some form of insurance (at expected cost) to absorb the risk of unexpectedly high losses. Bit by bit the necessary components of a European mechanism are being put together to obviate all of these deficiencies. Even if it comes too late to avoid what happened in Ireland, the lessons of the Irish case will have helped protect other European countries in the next wave of crises, however far in the future they may be.

Bond and equity markets

There is no merit in looking to public financing as the long-term solution for European banks. Waves of distrust in European banking have damaged the recovery and increased the degree to which European banks have had to have recourse to central bank funding and Government capital. Here I am not just speaking of the "programme countries". Some of these flows related to market perceptions of systemic risks around the eurosystem itself. Happily these perceptions have

been silenced by policy action. Collective action to supervise, and where necessary intervene and resolve banks where necessary, will not only be reassuring to Governments being called upon to finance backstops, but will also restore more completely than has yet been possible, and on a lasting basis, market confidence in the operation and regulation of the banking system throughout Europe, putting to bed the recurrent concerns that have hampered bank funding for the best part now of six years.

II Pitfalls

Complex decision-making

Let me be more brief on the pitfalls. One is clearly the challenge of delivering a streamlined, decisive and quick-acting institutional machine, against the background of (i) a legal underpinning (in the Treaty) which means that decision-making structures are being grafted onto a governance structure designed for monetary policy decision-making and not at all for banking supervision; (ii) the need to delegate much of the work, but at the same time maintain close lines of communication and authority between the central supervisory entity and the national supervisors (remembering that by far the largest fraction of supervisory resources will remain in the national agencies for the foreseeable future and (iii) the need to take regulatory actions from the centre which may in some cases require the use of national structures for implementation and enforcement.

Interim period

Setting up the Single Supervisory Mechanism is a major operational challenge. If we contrast the decade taken from the report of the Delors Committee to the start of the third stage of EMU with the breakneck speed with which the Single Supervisory Mechanism is being constructed, it has to be acknowledged that avoiding operational risk in this interim set-up period is an important challenge. Observers of the Nordic banking crises of the late 1980s often observe that it occurred during the bedding-down period of new super-

visory mechanisms in that region. But even if we did not have that example before us, we certainly are going through a very complex piece of engineering without being able to remove the fuses.

Work in progress

Creation of a supervisory mechanism is operationally the most demanding element of what is being undertaken, but it does need to be complemented – as has been widely discussed – by a sufficient resolution mechanism and resolution authority. One obvious pitfall then is that, while the SSM is being developed and refined, the other elements of the banking union proposal are not brought into operation, but left embryonic.

Communautaire

The ECB has managed, despite the pressures of the crisis, to deliver on its mandate as an agency which delivers on its clear euro-area mandate of price stability for the common currency area as a whole without fragmenting into a mere clearing house for mediating perceived national interests. Can that exercise of – dare I use the term – supranational decision-making be maintained for the Single Supervisory Mechanism? It must be, for if not, then many of the gains I have spoken of above would be lost, and the mechanism becomes merely a costly overhead, if not in some instances counterproductive. Avoidance of this pitfall will call for decisive leadership and a determination by its governing bodies to be vigilant. The Governing Council will, no doubt, be especially reluctant to see any slippage here.

Regulatory interventions are rarely popular, even when it is the national regulator takes the action. Experience in some developing countries (and indeed past experience in some European countries) shows how effective the owners or managers can be in tying up in lengthy litigation regulatory interventions designed to remove them from control of insolvent or failing banks. During this litigation bad faith, incompetence and worse are typically laid at the door

of the regulator. While more robust legal and democratic structures in the Europe of today may reduce the risk of this happening, especially where the general public is sensitized to the damage which can be done by allowing undercapitalized banks to continue in operation, it is not hard to see that similar pressures may be latent. If not well managed, intervention from a centralized regulatory structure in Europe could become vulnerable to a nationalistic backlash orchestrated by bank managers or owners in a way to which national regulators are not subject. This could be particularly so to the extent that the capitalization backstop is not fully in place with the result that, for example, a call by the Single Supervisory Mechanism for additional capital would result in pressure on the national government. Clearly this is a pitfall that needs to be guarded against by means, for example, of good communication and, of course, completion of all of the envisaged components of the banking union.

Technical reputation of ECB

As a member of the Governing Council of the ECB it is natural, perhaps for me to be concerned that the reputation of the ECB might become contaminated by any mishaps in the operations of the Single Supervisory Mechanism, with all its moving parts, interactions with national and other international regulatory authorities and so on. As the Governor of a national central bank with supervisory responsibilities, of course, I am already well aware of the risks. In a boom, it is up to the central bank to take away the punchbowl before the party becomes too riotous. That will be, on average, every decade or so. But supervision is more granular, the events requiring unpleasantness and intervention more frequent and more diverse. Some firms will fail – a system that was so tight that it ensured absolutely no failures would be a system that would provide very little credit or other financial services. As long as the failures are not so large as to impose damaging side-effects on the rest of the economy, they must be understood in this wider context. Still, management

of expectations and a clear communication strategy for doing so will be essential. This is a different type of communication to that conducted around monetary policy, and the new regime will have to feel its way.

I have not yet spoken about Ireland today. It is not that one bank or another failed in Ireland. It was that the whole system went into an ocean of indebtedness well beyond its ability to survive. The two worst-run banks did not just lose all of their capital. They lost almost half of the value of their balance sheets, and their losses have scarred the Irish economy in a way from which it will not fully recover for a long time. We have been painstakingly rebuilding institutional reputation and working hard to ensure that the banks continue and complete the frustratingly time-consuming process of ensuring the repair of the balance sheets of their borrowing customers. The banking system, for which we will surrender the primary responsibility to the SSM, will be in much better shape than it was three years ago as we prepared our first estimates of loan loss. Not fixed, to be sure, but on its way. If my hopes for the banking union are realized, and the pitfalls avoided, a recurrence in any part of the banking union of a disaster as great as these banks brought to Ireland can surely be avoided.

Benoît Cœuré

The History of Central Banks and the European Banking Union¹

When we look at the history of central banks, contributing to financial stability was one of their roles in most countries, although to varying degrees.² Even when central banks were assigned a relatively narrow mandate, such as that of inflation targeting in recent years, they often played a decisive part as soon as financial instability struck. In particular, their ability to act as lender of last resort in the financial system and to manage liquidity in the interbank market typically made them a key player in crisis management. Even in normal times, the central role of bank deposits in the stock of money makes monetary stability dependent on the soundness of the banking sector. In sum, in the late Tommaso Padoa-Schioppa's words, financial stability has been part of the "genetic code" of central banks.³

There have been many cases of lender-of-last-resort interventions by central banks during the present crisis. For example, when we compare the total emergency liquidity assistance (ELA) that euro area national central banks granted to individual credit institutions last summer with the overall amount of liquidity provided at the same time by the Eurosystem, we can see that the total ELA amounts to almost one-seventh. Just to quote an example from here in Germany: the Bundesbank granted € 35 billion of emergency liquidity assistance to the ailing bank Hypo Real Estate.⁴

More generally, the experience of the last five years has underlined the importance of central banks in financial stability, a task which they have historically performed. But central banks were not always and everywhere tasked with financial supervision, which aims to prevent crises from happening in

the first place. For example, before the present crisis the institutions responsible for banking supervision differed from country to country.⁵ In fact, in the late 1990s there was a trend for financial supervision to be placed outside central banks and entrusted to cross-sectoral authorities in charge of banks, insurance and securities markets. The crisis seems to have reversed this trend, as recent reforms in the US and Europe show. Today, most Eurosystem governors are banking supervisors.

In December 2012 euro area finance ministers reached an agreement to create a Single Supervisory Mechanism (SSM). This is currently under discussion with the European Parliament and it will give the ECB a bank supervisory role.⁶ As a result of the crisis, there is a consensus that a European banking union involving the ECB is an important component to complete the Single Market for financial services and for a genuine Economic and Monetary Union (EMU). Together with the other banking union components – common resolution and harmonised deposit insurance arrangements – this should help to overcome the fragmentation of money markets and break the vicious circle between financial and sovereign instability in Europe.

Since the ECB has not been a bank supervisor and since its primary mandate is and will remain to conduct monetary policy and maintain price stability, it is time to consider how monetary policy and banking supervision are related. I will do so in this speech, by first discussing the benefits a bank supervisory role could offer monetary policy – particularly in terms of informational advantages – and then by considering

¹ I wish to thank Philipp Hartmann for his key contributions to this speech, given on February 7, 2013, at a conference in honor of Stefan Gerlach's contributions to the IMFS. I remain solely responsible for the opinions contained herein.

² See, for example, M. Bordo (2007), *A Brief History of Central Banks*, Federal Reserve Bank of Cleveland Economic Commentary, December; C. Goodhart (2011), *The changing role of central banks*, *Financial History Review*, 18(2), 135-154; and C. Reinhart and K. Rogoff (2012), *Shifting Mandates: The Federal Reserve's First Centennial*, paper presented at the 2013 American Economic Association Meetings, San Diego, 5 January 2013.

³ T. Padoa-Schioppa, T. (2003), *Central Banks and Financial Stability: Exploring a Land in Between*, in V. Gaspar, P. Hartmann and O. Sleijpen (eds.), *The Transformation of the European Financial System*, *Proceedings of the Second ECB Central Banking Conference*, Frankfurt, May, 269-310.

⁴ Hypo Real Estate (2008), *Press release: Hypo Real Estate Group publishing interim financial statements as of 30 September 2008*, Munich, 17 November.

⁵ See, for example, C. Goodhart and D. Schoenmaker (1995), *Should the functions of monetary policy and banking supervision be separated?*, *Oxford Economic Papers* 47(4), 539-560; G. Di Giorgio and C. Di Noia (1999), *Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?*, *International Finance* 2(3), 361-378; and M. Horáková (ed., 2012), *How Countries Supervise their Banks, Insurers and Securities Markets 2012*, Risk Books, May.

⁶ Interestingly, Tommaso Padoa-Schioppa (1999), in a lecture entitled "EMU and banking supervision" at the London School of Economics, *Financial Markets Group*, 24 February, regarded it as "absolutely necessary" even at the start of EMU that cooperation among bank supervisors would over time lead to a type of "collective supervisor" that would act as effectively as if there were a single supervisor. This would also be desirable, he added, because it would "assist the Eurosystem in the performance of its basic tasks".

some design features, which are important when tackling the challenges of putting monetary policy and banking supervision under one roof.

How monetary policy can benefit from integrating banking supervision in a central bank

The banking union will strengthen the governance framework supporting the Single Market and EMU. Obviously, its primary purpose is not to support monetary policy. In fact, as the short history of EMU suggests, price stability can be maintained without the ECB being responsible for banking supervision.

But integrating the SSM in the ECB also creates some new opportunities for the conduct of monetary policy and other functions closely related to it. I particularly see four areas in this respect: the state of the macroeconomy; monetary policy options; interactions with supervisory policies; and the management of the central bank balance sheet. I will argue that these opportunities are greater in turbulent times than in quiet times.

Additional information about the financial sector and the state of the economy

Data collected and analyses conducted as part of banking supervision provide valuable additional information about the banking sector and may feed into the assessment of the macroeconomic situation. According to the proposed SSM regulation⁷ it has been estimated that the SSM would directly supervise approximately 130 to 140 banks in the euro area countries, constituting more than 80% of total euro area bank assets, and well cover the banking sector in all these countries.

This information could complement the data collected for the ECB's monetary analysis. The ECB's monetary policy

strategy is based on two pillars, an economic one and a monetary one, and thereby assigns an important role to money and credit. The broad range of tools regularly used in our monetary analysis already provides valuable information about the build-up and unravelling of widespread financial imbalances. Additional supervisory data and analyses, be they micro-prudential or macro-prudential, would further enhance the breadth, depth and granularity of information about the functioning of the banking sector.

The value added of this information will become even more critical in a crisis, given the important role of banks in severe financial crises and the nature of the data concerned. Moreover, analytical supervisory assessment indicators and early-warning tools can put the new data to work in assessing credit developments.⁸ Additional information on the banking sector is likely to be more important in the euro area than in the US, because in the euro area bank lending accounts for almost two-thirds of the total financing of non-financial corporations, whereas in the US bank lending is only just above one-quarter of total firm financing.

Broader information basis for assessing monetary policy options

Given Europe's bank-based financial structure, monetary transmission channels through the banking sector are particularly important in understanding the effects of monetary policy actions, standard and non-standard. For example, a key feature of the present crisis is the impairment of the monetary transmission mechanism in which fragilities in banks' funding models and their exposure to government debt have played a significant role. A thorough understanding of banks' behaviour and health across jurisdictions facilitates the design and implementation of non-standard monetary policy measures and will also facilitate the exit from these measures when the time is right.

⁷ Document number 17812/12, as published on the Council of the European Union's website, <http://register.consilium.europa.eu>.

⁸ J. Peek, E. Rosengren and G. Tootell (1999), *Is Bank Supervision Central To Central Banking?*, *Quarterly Journal of Economics*, 114(2), 629-653, argued, using US data from the 1990s, that the incorporation of supervisory CAMEL ratings may improve macroeconomic forecasts. CAMEL is an abbreviation for a system of supervisory indicators used in the US describing the conditions of banks aggregating information about capital, asset quality, management, earnings and asset-liability management.

Better consideration of the interactions between monetary, supervisory and regulatory policies

Monetary policy interacts with supervisory and regulatory policies, be they micro-prudential or macro-prudential in nature. If the monetary policy objective and the supervisory objective are distinctly defined and separate instruments are assigned to each of them, then a single institution could take the interdependencies better into account than separate authorities. Interactions can be expected to occur in particular with macro-prudential policies, which increase in importance due to the lessons from the crisis, and operate through channels closely related to monetary policy transmission. The allocation of macro-prudential regulatory instruments under the SSM is therefore an important design feature of the draft legislation.

Research confirms that it is advisable for monetary policy to focus on price stability and prudential policy on financial stability.⁹ Against this background, as an institution with a clear price stability mandate, compliance with which can be easily verified, the ECB will have incentives to intensify the prudential policies seeking to counteract emerging financial imbalances and risks. In turn, and importantly, this would reduce pressures on monetary policy to do so. It will also have incentives to conduct supervisory policies in a way that would reduce the likelihood of crises and therefore of lender-of-last-resort interventions. This would also diminish the possibility of generating adverse incentives for banks, i.e. moral hazard involved with emergency assistance.

A single institution could also avoid conflicts and coordination problems between separate policy authorities, which might be particularly pronounced in a crisis and in a multi-country setting.

Better management of the creditworthiness of counterparties in monetary policy operations

Monetary policy operations expose the central bank to credit (and other) risks, which are controlled through adequate collateral and other risk management techniques. Good banking supervision and prompt corrective action ensure the soundness of counterparties in these transactions and a central bank therefore has particular incentives to make sure its supervision is rigorous. Rigorous supervision, in turn, protects the central bank's balance sheet and gives it greater control over it, also safeguarding the central bank's independence and credibility.

This is an important point. As the central bank has a direct interest in strong supervision, the risk of financial dominance over monetary policy becomes less likely, i.e. the risk that monetary policy operations could be increasingly dominated by the state of the banking sector. This, in turn, reduces also the risk of fiscal dominance over monetary policy, which means the risk that fiscal behaviour forces monetary policy to react in ways that it otherwise would not do. As governments are always reluctant to fund unpopular bailouts or incur the social costs of bank insolvencies, they may prefer to rely on prolonged central bank liquidity provision to keep banks alive. What is crucial for adequate supervisory rigour is of course the independence of the supervisory function in the central bank, a point I will come back to later in this speech. In order to protect a central bank from regulatory forbearance, supervisory rigour is necessary on an ongoing basis, as is the determination to wind up failed banks.¹⁰ In turn, this requires the existence of orderly resolution mechanisms with an adequate financial backstop. I will also come back to that point.

Moreover, a central bank has an incentive to establish rigorous supervision since it would diminish the trade-offs between the need for tightening collateral requirements in

⁹ See, for example, I. Angeloni and E. Faia (2009), *A Tale of Two Policies: Prudential Regulation and Monetary Policy with Fragile Banks*, Kiel Working Papers, No 1569, Kiel Institute for the World Economy, forthcoming *Journal of Monetary Economics*, or D. Beau, L. Clerc and B. Mojon (2011), *Macro-Prudential Policy and the Conduct of Monetary Policy*, Banque de France Occasional Paper, No 8. A summary of the literature is provided in European Central Bank (2012a), *Report on the First Two Years of the Macro-prudential Research Network*, Frankfurt, October.

¹⁰ In the US, 469 banks were closed by the FDIC between September 2007 and December 2012.

downturns to protect its balance sheet and the need for relaxing these collateral requirements to stabilise banks. The tightening of collateral requirements in downturns amplifies the pro-cyclicality of financial systems, while relaxing those requirements increases balance-sheet risks and distorts financial sector behaviour.

When implementing the SSM in the ECB, we will make every effort to use these opportunities to the full. However, we will seize these opportunities only to the extent that they do not create conflicts of interest, reputational risks or risks to the independence of the monetary policy authority, a point I'll consider next.¹¹

How to design monetary policy and banking supervision under one roof

At least three types of challenges and risks need to be managed when integrating supervision in a central bank alongside monetary policy. They relate to potential conflicts of interest, reputational risks and central bank independence.

Avoiding conflicts of interest

The literature on whether adding banking supervision to monetary policy creates conflicts of interest is not well developed.¹² The concern is that a central bank which is also

in charge of supervision would turn into a supervisor with access to central bank liquidity. As recently pointed out by Stefan Gerlach,¹³ it could then occasionally relax its monetary policy, potentially generating an inflationary bias impairing its credibility, and also contribute to more risk-taking by banks (moral hazard), and in turn breed future financial instability. The central bank could in particular be inclined to continue lending to weak banks for fear that winding them up would trigger losses.¹⁴ Although this literature is not conclusive, we take such concerns extremely seriously.

To protect against such effects both the regulation proposed by the European Commission and the ECB's opinion on this regulation call for a governance structure that strictly separates the monetary functions from the supervisory functions.¹⁵ This should entail a separation of the decision-making bodies, including procedures to strictly limit the ECB Governing Council's involvement in supervisory decisions. It should also include distinct objectives for the decision-making bodies and different policy instruments. Eijffinger and Nijskens, for example, recently pointed out that the assignment of separate instruments to the two policy branches would solve potential conflicts.¹⁶

There is one situation in which the distinction between supervisory and some monetary policy instruments is less clear cut, namely, in the case of certain non-standard monetary

¹¹ There are also advantages for banking supervision if it is combined with monetary policy within one institution. For example, because of its role in monetary policy a central bank needs to assess the macroeconomy and its linkages to the financial sector, which implies a natural systemic/macro-prudential orientation. Such an orientation has been largely absent from traditional supervisory practices. Central banks also have a culture of using economic analysis and research, which typically does not exist or barely exists in supervisory authorities (see e.g. P. Dasgupta, C. Goodhart and D. Schoenmaker (2002), *The Skill Profile of Central Bankers and Supervisors*, *European Finance Review* 6, 397-427). Moreover, the role of central banks in payment and settlement systems and their frequent contacts with banks through their market operations provides them with additional sources of information relevant to financial stability.

¹² Examples from this literature are Heller (1991), *Prudential supervision and monetary policy*, in Frenkel, J., and M. Goldstein (eds.), *Essays in honor of Jacques J. Polak, International Monetary Fund*; C. Goodhart and D. Schoenmaker (1992), *Institutional Separation Between Supervisory and Monetary Agencies*, *Giorn. Econ.* 9; C. Goodhart and D. Schoenmaker (1995), *Should the Functions of Monetary Policy and Banking Supervision Be Separated?*, *Oxford Economic Papers* 47(4), 539-560; and Di Giorgio and Di Noia (1999), *Should Banking Supervision and Monetary Policy Tasks Be Given to Different Agencies?*, *International Finance* 2(3), 361-378.

¹³ S. Gerlach (2013), *Banking and Fiscal Union*, *Introductory remarks at a panel session at the EUI conference on "The State of Play in the Euro Area – Fixing the EMU for the Long Term"*, Florence, 21 January.

¹⁴ This argument is put forward by M. Brunnermeier and H. Gersbach (2012), *True independence for the ECB: Triggering power – no more, no less*, *VoxEU*, 20 December.

¹⁵ European Central Bank (2012b), *Opinion of the European Central Bank of 27 November 2012 on a proposal for a Council regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and a proposal for a regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority)*, CON/2012/96, and European Central Bank (2012c), *Towards a banking union*, *Financial Stability Review*, December.

¹⁶ S. Eijffinger and R. Nijskens (2012), *Monetary policy and banking supervision*, *VoxEU*, 19 December.

policy actions in the midst of a financial crisis. However, in such a situation, the outlook for the economy and prices has considerable downside risks, so the direction of financial stability and price stability actions (e.g. to repair a broken monetary transmission mechanism) typically go in the same direction and a conflict between both policy branches is rather unlikely.

The draft legislation also confirms that the other statutory tasks and objectives of the ECB remain unaffected by the SSM, implying that monetary policy will continue to be conducted by the Governing Council in full independence, with the primary objective of maintaining price stability over the medium term. With our quantitative definition of price stability, it will be easy to verify every month that inflation expectations remain well anchored, as they are today. It is hard to see how financial stability dominance over monetary policy could occur if such precautions are taken.

At the same time, in order to exploit the advantages that I was discussing before, it is necessary to put in place mechanisms that allow an adequate flow of data and (independently executed) analyses between the two functions. Of course, this flow of information should not weaken in any form the necessary separation in decision-making, objectives and instruments. In short, separation does not mean isolation.

Managing reputational risks

In order to ensure the success of banking supervision, competencies and policy instruments need to be assigned to the new SSM which would allow it to perform its tasks effectively. Otherwise, reputational risks could arise that might negatively affect the institution as a whole. The current draft legislation would grant the SSM an appropriate mixture of micro- and macro-prudential instruments for it to conduct supervision effectively. For example, on the micro-prudential side it would have all the relevant powers, ranging from

bank authorisation to administrative sanctions, from the control of capital levels to compensation issues, through to structural issues such as business models and mergers.

But even if bank supervisors use their powers effectively, this does not imply that there will never be any bank failures, fraud or other highly visible negative events, which could affect the decision-makers' reputation. This is another challenge in the business of banking supervision. This residual reputational risk should also be managed through an appropriate separation of responsibilities. Beyond the internal functional separation this should be fostered through a corresponding separation in external communication. The Chair and Vice-Chair of the envisaged ECB Supervisory Board will play an important role in communicating publicly and reporting to the European Parliament, as will the heads of the national supervisory agencies belonging to the SSM in their respective jurisdictions.

Ensuring central bank independence

Bank failures and financial fraud often affect small savers or have an impact on public budgets, and lead to the involvement of democratically elected governments and parliaments. While indeed, the highest standard of democratic accountability needs to be ensured, history shows that political interference can also constrain the effectiveness of banking supervision. In particular, if there is political interference to avoid costly bank restructurings or closures and it undermines supervisory rigour, then the beneficial effects in terms of control over the central bank's balance sheet and the avoidance of financial or fiscal dominance risks might not accrue. There should therefore be a strict separation between the supervisor and a resolution authority.

Against this background it is reassuring that the transfer of supervisory responsibilities to the SSM will not have any implications for the independence of the ECB in performing all its tasks. By implication, the necessary internal precautions

against political interference in supervisory matters adversely affecting the ECB's independence in conducting monetary policy have been taken.

But further external precautions need to be taken to ensure that financial and fiscal dominance risks do not threaten the independence of the ECB. A crucial point in this context is the existence of a well-functioning European bank resolution mechanism. Such an outside mechanism provides further protection for the central bank's balance sheet and its monetary policy independence, and has a twofold objective: first, it aims to limit the residual risk to governments' balance sheets, in particular through the timely implementation of bail-in instruments, so that the risk of financial dominance is not compounded by a risk of fiscal dominance. Second, it aims to ensure a strict separation between supervision and resolution. 2013 will be a key year for Europe to make progress with this second leg of the banking union.

Concluding remarks

Let me now conclude. It is essential for Europe to introduce the different elements of the banking union as soon as possible, starting with the SSM involving the ECB, and promptly continuing with a separate bank resolution mechanism. This will not only contribute to the integrity of the euro area and the completion of EMU, but also has some benefits for the conduct of monetary policy.

The current draft legislative framework proposed by the European Commission and the preparatory work done by the ECB, the national central banks and competent supervisory authorities on implementing the SSM also takes a forward-looking approach to handling the challenges of integrating banking supervision in a central bank. This will make sure that the SSM achieves its objectives; that the desirable synergies between banking supervision and monetary policy (and other central bank functions) are realised; and that the primary objective of monetary policy to maintain price stability is fully respected. To achieve this objective, three conditions should be met: the internal governance of the ECB

should strictly separate the two functions; the architecture of the banking union should provide for a separate, common resolution mechanism as soon as possible; and the ECB as a supervisor should not hesitate to enforce capital and liquidity regulations, recognise losses in the banking system and identify failed banks.

Price stability will remain the only needle of our compass for conducting monetary policy in the Governing Council. If we implement the SSM well, taking advantage of the opportunities and carefully addressing the challenges, we have a good chance of further improving our ability to conduct a stability-oriented monetary policy.

Athanasios Orphanides

The Politics of the Euro Area Crisis and ECB Monetary Policy¹

The interaction of politics and monetary policy is a broad topic with fascinating applications to any independent central bank. I will focus on a dimension that is unique to the euro area: the politics that appear to hinder the resolution of the euro area crisis and the impossible dilemma this creates for the ECB in its conduct of monetary policy.

It has been over three years since the epicenter of the global financial crisis moved to the euro area. The crisis brought to the forefront fundamental weaknesses relating to the institutional framework of the euro. Since then we have observed all too well the instability inherent in the original design of the euro and understand the need for change. At the moment, we experience a welcome reduction in tensions relative to the worst tensions experienced last summer. However, the fundamental problems have not been convincingly tackled and the euro area will remain under threat until the governments rise to their responsibilities and adopt the necessary changes to the framework.

There are numerous ways to describe the storm. One way focuses on the disintegration of euro area sovereign markets. We don't need to look at all 17 member states to see the trouble. **Figure 1** presents the evolution of the two year-yields on the sovereign debt of the four largest member states of the monetary union. Together, the four countries shown make up about four-fifths of the economy of the euro area, (the other 13 member states only about one fifth). Note also that none of these four countries are the ones that created headlines in 2009, 2010, 2011 as needing IMF and EU assistance. Indeed, for this reason, focusing on the big four helps us see the systemic nature of the problems in the euro area.

Before the crisis, almost for the first decade of the euro, we had a welcome convergence of markets and financing conditions in the euro area. This was a first best situation for

the euro area but required compatible strong governance that was found lacking. The convergence observed during that period is no longer present and is unlikely to reappear in light of the unfortunate handling of the crisis. What we observe over the past three years is a divergence in the yields and assessments of sovereign risks. We observe strains that cannot persist indefinitely. The divergences in yields, coupled with the national basis of the banking systems, imply unsustainable differentiation in the real costs of doing business in different member states that threaten to break the system apart.

That the sovereign crisis is tearing the system apart can be seen by looking at the increased heterogeneity of how the real economies are doing in the euro area. One way of showing that is to compare the unemployment rates in the four largest member states and see how they have diverged. As can be seen in **figure 2**, particularly in the past two years, there is a noteworthy inverse correlation between the performance of the economy and monetary conditions faced by individual member states. The two member states with the

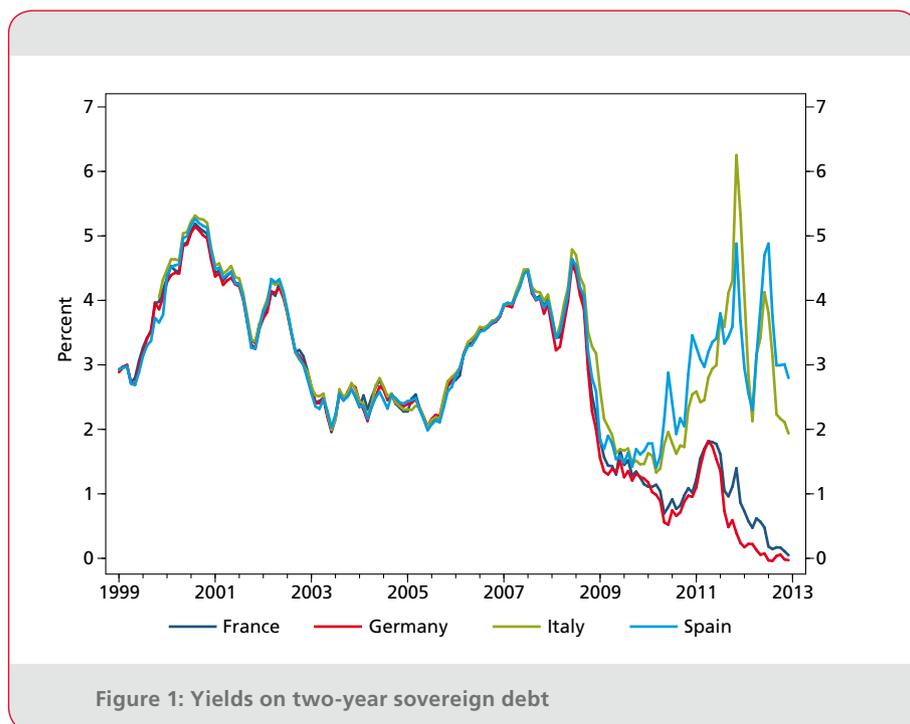


Figure 1: Yields on two-year sovereign debt

¹ This text is a speech given on February 7, 2013, at a conference in honor of Stefan Gerlach's contributions to the IMFS.

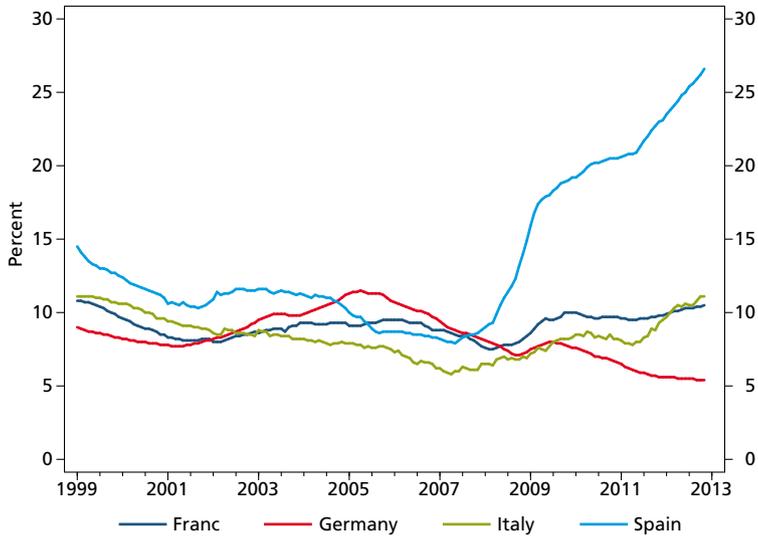


Figure 2: Unemployment rates

worst economic conditions in the figure are also the ones facing the tightest monetary conditions. That is, the single monetary policy does not work as it was meant to. It amplifies heterogeneity, rather than mitigate it as was hoped would be the case when the euro was designed.

This is an existential crisis for the euro area and an existential crisis for Europe as a whole because the euro area is key for deepening economic and political ties in the European Union. The euro is meant to be the capstone completing the single market and completing European integration. At heart, the euro is a political project, not merely an exercise in economic coordination. At the deepest level, this is the reason why the euro is irreversible and this is why any threats to its construction threaten Europe as a whole.

When the EMU was originally designed in the 1990s, it was well understood that the construction was not complete. Some gaps were seen, others not. For example, although many saw the merits of a unified banking sector, with common supervision and regulation, the virulence of the adverse feedback loop between sovereigns and banks in the absence

of a common deposit guarantee and resolution framework was not well understood. However, and this was a key safeguard, it was commonly held that if and when unforeseen challenges arose, the governments would work together, in good faith, and resolve them.

The present crisis is not the first serious crisis in Europe. The European project has a 60-year history and on past occasions, when faced with a crisis, governments worked towards a solution that advanced the European project, deepening the Union. This is how progress could have been made this time as well. But so far during the crisis, this has not happened.

Instead, a number of decisions by governments made the crisis worse and other decisions postponed its resolution. Time and again over the past three years euro area governments have said they would do whatever it takes to save the euro. Grandiose statements go back at least as early as the spring of 2010. When financial turmoil peaks, promises are made, roadmaps developed. But Europe's governments always seem to need a bit more time to put these plans in place. The central bank is then called in to sustain the system, to buy some time for the governments so they can work on implementation of the solution plans by the governments. And time and again, with remarkable consistency, Europe's political leaders find new ways to postpone serious progress, find ways to not deliver on their earlier words. This has been the pattern so far raising questions about the euro area's survival and prosperity prospects.

We can identify numerous culprits that have contributed to the current mess: fiscal profligacy, banking weakness, balance of payments imbalances, competitiveness divergences. All of the above have contributed to the crisis. But all these factors could be seen as symptoms of a more fundamental issue: a breakdown in the governance framework of the euro area. This has been recognized and some attempts to

improve governance have been made over the past two years as demonstrated, for instance, in the adoption of the Fiscal Compact.

Even after the fundamental governance problems in the euro area are understood, however, we need to dig deeper to comprehend why the problems identified have not been resolved once the extent of the seriousness of the crisis has been recognized. The cost of insufficient action is in plain sight. As a result of the mishandling of the crisis, the euro area as a whole is again in a severe recession with the unemployment rate projected to stay in double digits as far as the eye can see. We observe European government tolerate unnecessary economic dislocation and the spreading of misery to millions of our fellow European citizens. Why is this tolerated? On every previous occasion, on every previous crisis in the history of the European integration project since the Second World War, European governments worked together to find solutions and improve Europe. What is different now? What is holding things back?

Above all, I believe that Europe faces a crisis of political leadership. To frame the subsequent discussion, I think it is essential to identify who are the various actors in the play we have been living through, understand their objectives and their constraints. We can then assess the likelihood that we will have a joyful resolution to the crisis going forward and whether the actions of various actors improve these odds or not.

Europe is not a federal state but a confederation of sovereign states governed by a treaty. It is a confederation of states whose leaders decided in the past to unify their economies for economic benefit and also to deepen their political ties. But the states remain sovereign, their relations are governed by treaty and when a problem appears that requires a change in the treaty, unanimous agreement is essentially required to break through. On such occasions, crises can be resolved if governments work together to find a common solution. This may involve incurring short-term political costs for the leaders of some member states. If the political leadership of

any of the most powerful member states is unwilling to risk a short-term political cost, progress is blocked.

The problem, ultimately, is that Europe lacks true common leadership. Europe has many presidents, but has no individual who can take a presidential decision. Europe has no political leadership team that can take decisions that internalize the negative externalities that actions or decisions in one member state impose on other member states. Europe has no leadership with the power and responsibility to protect the welfare of euro area citizens for the euro area as a whole.

The political leadership of each member state have to face their own electorates, report to their voters, protect the interests of their own member states. If leaders have the option to kick the can down the road, is it politically feasible to expect cooperation leading to resolution of the crisis?

Consider two hypothetical examples. Suppose that during 2011 there was a proposal on the table that entailed some short-term costs for the political leadership of France. However detrimental for, say Spain, the stance of the French government might have been, should the French president running for election in the spring of 2012 have been expected to internalize that cost? Suppose another solution was under discussion during 2012 that could have important implications for, say Italy, but entailed short-term political costs for the German Chancellor facing re-election in September 2013. However detrimental postponement might have been for Italy, would it have been unreasonable to expect that the Chancellor facing elections in 2013 would prefer to block any possible progress, postpone any meaningful discussion until after the election?

With asynchronous elections, the political leadership of some member state facing elections may prefer to simply postpone resolution, take a turn at kicking the can down the road. And there is an election in some member state on the horizon all the time. For the four countries in the chart, Spain had elections in 2011, France last May, Italy later this month, and Germany next September. Is it reasonable to ex-

pect governments facing re-election to show the political courage and leadership needed to work together with the governments of other member states and resolve the crisis?

But the political difficulty just described was also present during past crises. Why is it that this time political leaders in Europe fail to make sufficient progress while in the past they managed to work together? Why in the past, whenever European leaders found themselves near the cliff, they stepped back and worked together to resolve a crisis.

One explanation is that such cooperation in the past reflected the roots of the European ideal, the elimination of conflict and the savages of war among the European people. As the generation that experienced the carnage of the Second World War fades into the background and myopic politicians rise to power in some member states, perhaps the notion of solidarity among the people of Europe, as enshrined in the Treaty, loses its meaning. But there is another explanation. The cooperation needed to resolve the crisis, and the acceptance of the short-term political cost some leaders would have to face could be easier to overcome when the

whole European project is threatened with collapse. If the resolution of a crisis could not be postponed, the cost of a collapse could provide just the right incentive to cooperate. Even without resorting to solidarity arguments, the costs of a potential immediate collapse on someone's watch could be devastating. That risk could induce cooperation and a solution, even if that entailed some short-term political cost in a member state.

One critical difference this time is that for the crisis encountered there exists another actor in the play with the ammunition to avert immediate disaster, to help buy more time for the governments: the European Central Bank. The ECB has immense power to diffuse immediate pressures on sovereigns. By interpreting interventions on sovereign markets as monetary policy, it can powerfully counteract speculative attacks against any sovereign, and provide short-term financing relief to any government it chooses to support, so far as that support is deemed warranted.

Four controversial ECB decisions could be highlighted: the Security Markets Program, announced on May 10, 2010; the second phase of the SMP, announced on August 7, 2011; the three-year longer-term refinancing operations, or LTROs, announced on December 6, 2011; and most recently, the Outright Monetary Transactions (OMT) program, announced on September 6, 2012. On each occasion, the action could be seen as designed to support specific sovereign markets and as testing the boundary of the institution's mandate and democratic legitimacy and the ECB has drawn some criticism. Regardless, the short-term stabilization effects cannot be disputed. As **figure 3** demonstrates, the central bank can have a short-term stabilizing effect whenever it wishes to engineer one.

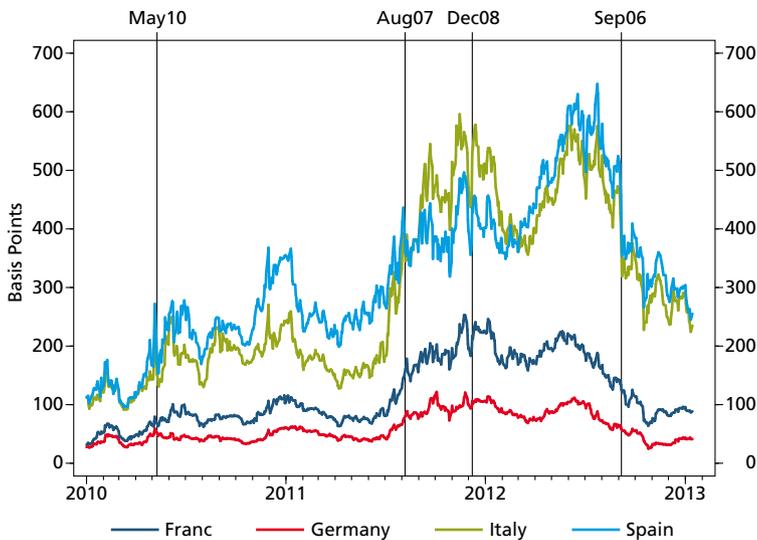


Figure 3: Five-year CDS on sovereign debt

I expect much to be written on the background for each of these episodes, with explanations of the rationale, details of some of the debates, some of the hopes and fears. For present purposes, let me simply just say that on each occasion, the ECB intervened following decisions announced by governments to make progress towards resolving the crisis, and in this way each of these ECB decisions could be seen as providing much needed breathing room for the implementation of well-intended plans the governments had already announced.

In May 2010, the governments had been working on the creation of a euro area crisis management framework (the EFSF). The weekend of May 8–9 was intense for both the governments and the central banks. European governments announced their decision to create a workable crisis mechanism before Asian markets opened on Monday morning. The ECB announced its SMP program shortly after.

Unfortunately, the creation of the EFSF was delayed and in the end proved not very effective for a wide range of issues that had to be handled. Parallel efforts to improve euro area governance in other fronts proved unconvincing to markets. And some decisions, such as the October 2010 introduction of the PSI concept on euro area sovereigns, vastly deteriorated sentiment for all but a few euro area member states.

The turmoil following the implementation of the Private Sector Involvement (PSI) and associated events sustained market tensions and sensitized governments. Concern about a collapse peaked again in June of last year. At their end-June 2012 meeting, the EU Council announced an ambitious roadmap to form a financial union in Europe, with tight schedules to break the „vicious circle“ between banks and sovereigns that previous decisions of the EU Council had generated. Markets remained unconvinced, the threats of the break up became as high as ever.

Once again, governments needed time to implement plans. Once again, the ECB stepped in to make more time. In a speech in London on July 26 ECB President Mario Draghi

was emphatic: „Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.“ The objective was to reaffirm the irreversibility of the euro, preserve the monetary union. On September 6, the Governing Council announced the OMT program to that end.

The market reaction since then suggests that the ECB once again succeeded in calming the immediate tensions. And in so doing removed the risks faced by governments from postponing meaningful progress that might entail potential short-term political costs to any of them. Before September ended, the finance ministers of the member states decided not to adopt a proposal put together by the European Commission to move ahead on the roadmap announced at the end-June EU summit. And in the October and December EU summits that followed, the heads of states of the European Union confirmed their backtracking on important elements of the timetable for the financial union that had been announced in June.

So, one difference with previous crises in the history of the European project is the presence of an actor with the power to diffuse immediate pressures that allows far greater flexibility for muddling through. By diffusing immediate risks of a collapse, the ECB may have changed the political dynamics that in the past would have induced cooperation towards a constructive resolution of the crisis. But diffusing immediate risks prolongs the unsustainable muddle, and likely reduces the odds of a happy end over the long haul.

The ECB faces an impossible dilemma. The ECB cannot solve what is fundamentally a political problem. The ECB has the capacity to buy more time for governments by ensuring that the threat of immediate collapse is averted for a while. ECB interventions give the option to governments to postpone resolution of the crisis. However, by postponing resolution, governments raise the costs of the crisis for the euro area as a whole. The evolution of yields on sovereign debt over the past three years, shown in **figure 4**, is not particularly encouraging about the outcome of this sequence of decisions.

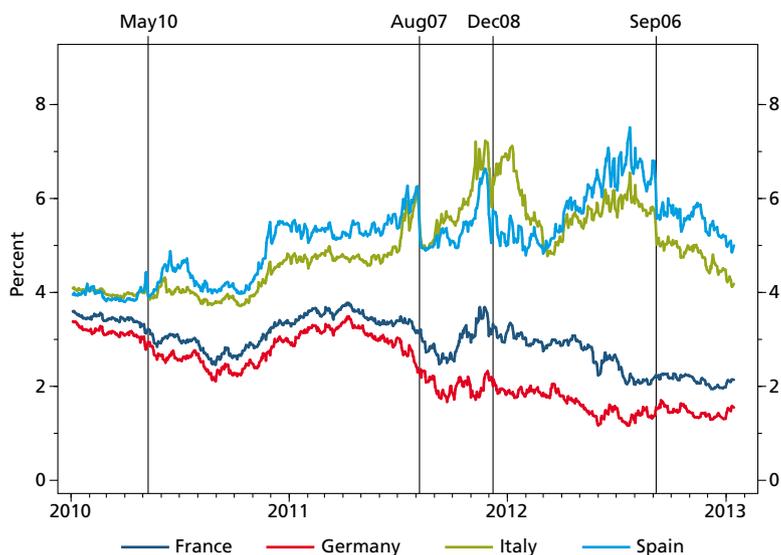


Figure 4: Yields on ten-year sovereign debt

To be sure, this does not necessarily suggest that the ECB could have or should have acted in a different manner while independently evaluating how to best fulfil its mandate. The ECB was created by governments to fulfil a specific mandate, protect price stability in the euro area, and subject to that, advance European welfare more generally. To the extent a decision is properly evaluated by the Governing Council and judged as appropriate to fulfil the mandate of the ECB, it represents the indicated course of action under the circumstances.

The interplay of governments' willingness to resolve the crisis and the ECB actions to stabilize tensions generates more questions. Would the path for Europe have been worse or better if, say in May 2010, the ECB did not provide some more time for governments to live up to their responsibilities? What about in September 2012? How certain can we be that the OMT improved the odds that the euro area will succeed in its current form over the long run?

Is there a path towards resolution of the crisis that can pass the test of political feasibility? I certainly hope so.

Michael Burda

The Resolution of the Euro and Sovereign Debt Crisis: Three Scenarios¹

Stefan, it is wonderful to be here, thank you very much for being such a dear friend all these years. I would also like to thank the IMFS for putting on this wonderful event. I have to take this rare opportunity to send a personal message to Stefan. I can see that he is already laughing. I have known Stefan for thirty years, which is usually longer than anyone cares to know anyone else in life. We met at Harvard when I was a graduate student, and he was a visiting scholar of the department. It was an exciting time. Thomas Sargent had just spent a year in the department and had inspired countless students to work on rational expectations. Robert Barro, a Harvard PhD himself, was in and out. Robert Lucas gave several talks when I was there. Stefan and I met each other at some cocktail party and instantly hit it off immediately. We ended up writing three papers together. I have to say that the most memorable event was a presentation of our work in a research seminar when the inimitable Brad DeLong turned to one of his colleagues and whispered that this is the most ridiculous paper he had ever seen. Unfortunately, Stefan overheard that remark and later told me about it. Despite this discouragement, we ended up sending that paper to the American Economic Review, and after three revise and re-submits the paper was ultimately rejected when John Taylor took over editorship of the journal. So is life. Welcome to the life of a budding academic.

Stefan went on to take a position at Brandeis, worked on many papers with and without me. We published two papers together. One was on the role of durable goods in the dynamics of the current account deficit. It was published in the American Economic Review exactly 20 years ago. We also published a piece on the dynamics of the Ostmark-DM exchange rate just before East-West monetary union, which was probably the most unusual paper I have ever written. Twenty years ago, Stefan. Who would have ever thought back then that you would be sitting in Frankfurt with me two decades later, and you would be such an important person, and I would be just an econ professor? But to be honest with you, I always thought that you had a thing for policy. Like all graduate students, we constantly talked about economics but Stefan had a particular penchant for policy

relevance. And I have not forgotten that, and that is why I am really delighted to be speaking here, so many years later.

So this evening I am going to talk about the future. I want to win your attention just for a few seconds with some speculation about how Europe could look in ten years. I will be less concerned with the wonderful bursting of a nonfundamental bubble that Mario Draghi managed to pull off over the past few months – without in fact actually even doing much besides talking. I want to talk about the longer run. In particular, I would like to perform the following mental experiment: what will Europe look like in ten years? And this is pure fantasy I will relate, a vision that I have already related to Lars-Hendrik Röller's economics team in the Bundeskanzleramt and at the Finance Ministry. In particular, I would like to describe three scenarios. One is fundamentally optimistic, one is very pessimistic and one is utterly realistic. Not accidentally, they are called the Good, the Bad and the Ugly. So Stefan, I will aim these scenarios in your general direction, and you can choose whichever one you like.

The first scenario: "The Good"

The good scenario is my favourite, because this is the one in which the euro survives and does what is supposed to do – to promote European economic integration and peaceful, sustainable European relations. So in 2023 the euro still exists and it is used extensively in international payments; in fact, it is a central reserve currency that rivals the dollar. In many senses it epitomizes the economic success of the European Union. This was the promise I remember when I came to Europe in 1987: that it would someday become the largest internal market in the world and that a common currency was an inherent part of that story. This optimistic scenario sees a functioning banking union as one of the most effective and respected of Europe-wide institutions, just as the Federal Deposit Insurance Corporation, the Food and Drug Administration and the Federal Trade Commission are in the United States. In my scenario, sustained growth returns to all regions of Europe including the south, and a reliable supply of bank credit is available to all regions on an economic, not

¹ This text is a speech given on February 7, 2013, at a conference in honor of Stefan Gerlach's contributions to the IMFS.

political basis. In fact, central banking and credit allocation have transcended the very political borders that impeded Europe's economic integration for more than a millennium.

How we attain this wonderful scenario? First, over a series of different governments, the Greeks and the other indebted countries of the European periphery managed to stick to a policy of controlled government spending, privatization, product and labour market reforms, modernization of tax administration, and intelligent regulation. By 2015 this policy proved so successful that many of the devastating tax increases passed in the years of the troika intervention could be rescinded. Not only does Greece return to growth, but by 2014 we have growth in Portugal, Spain and Italy.

As we just heard in the last talk, persistent differentials on sovereign debt yields, i.e. on government borrowing rates, are a permanent feature of the monetary union. I think that is a good thing – these differentials are not there by accident; they reflect ongoing market assessments of underlying risk associated with lending to governments of differing degrees of credibility and trustworthiness. The compression of yields that we observed during the euro's "Golden Age" might have been Trichet's dream, but it turned out to be the EMU's nightmare. Southern Europe and Ireland used those low interest rates to fund either a consumption binge or a real estate bubble or both. This would not have happened under Bretton Woods. The IMF would have stepped in fairly swiftly and imposed adjustment programs after a few quarters of chronic balance of payments deficits. The euro area is not much different from that arrangement, but it lacks the policeman who makes sure that member countries do not abuse the balance of payment mechanism now known as Target2, which funds temporary intra-European imbalances funded by the only monetary authority, the ECB. It was a big mistake not to have instituted that mechanism in advance. Absent a European Monetary Fund, we need a private mechanism which would cause interest rates to rise in those regions which have accumulated foreign liabilities and to fall in those regions which fund them. We should welcome interest rates differentials as being a reward to risk. Those who want

to lend to governments with bad track records will have to accept that risk and bear the costs when governments fail to deliver conditions which assure debt service and repayment.

My optimistic scenario foresaw a comeback of the no-bail-out clause. Only then will citizens of Eurozone countries trust that Brussels, the ECB and Germany will not deprive them of their sovereignty. Resident banks of the European Monetary Union follow the rules laid down by a common banking regulator, and here I concur absolutely with Benoît Cœuré that this should not be the job of the ECB. There are a lot of potential problems in having the central bank regulate banks, especially in Europe, and it will be a multiple nightmare unless divestiture occurs very, very quickly.

In my good scenario, I foresee a banking union based on a common bank regulatory and resolution regime with deposit insurance as a hybrid system. As in the United States, Europe needs a "federal" insurance which is supplemented by national government funds to face pre-existing conditions in individual countries. The European Banking Authority will need real teeth. More important, the good scenario foresees consolidation of the European banking sector to 15 or so trans-nationally regulated European banks that cross borders and have no recognizable national identity. What matters is what the bank does and what its balance sheet looks like, not the state of indebtedness of its domicile government. I see a system where rediscounting of paper or treatment of collateral by commercial banks at the central bank has nothing to do with politics, with the state of the government's finances or the state of the banking system in that particular country. I do not see that system in place yet, but there is hope.

How do we get there? Benoît will probably need to cover his ears: I see a geographic restructuring of the European Central Bank into five districts, just like in the United States (which has twelve). I envision five districts based on aggregated NUTS-2 regions that have nothing to do with national identity but only with geographic proximity. Political coalitions are impossible in this new central bank board. I would guess

that more than half of the people in this room think that is a great idea. It would clearly mean that Cyprus, Greece, Ireland and Portugal would lose their central bank but then so must Germany, France and Italy! Why should anyone cry about that? It presupposes trust in institutions and the creditor nations' goodwill; it presupposes the wherewithal of the crisis nations which are still in crisis today to reform. It is only going to happen if people realize that those reforms are in their own national interests and not in the interest of Germany, or German banks, or French banks, or the European Central Bank. That is going to take a lot of reform.

And then there is Greece, the poster child of the euro crisis, which has seen a GDP decline of roughly twenty-five per cent since 2008. This is no cakewalk. How could they ever recover from that? Many have argued, in my view incorrectly, that Greece is doomed to live off the charity of other EU regions. I would like to remind those pessimists of the successes of Ireland, a country dubbed in 1988 by Rudi Dornbusch the "Sick Man of Europe", which had lost millions in emigration to America and the UK. In 1988, GDP per capita in Ireland was 75% of France's level, and by 2003, 15 years later, it had reached 127%!

The example proves that sick economies can come out of the hole, if they follow good supply-side policies. The Irish supply-side miracle, which the economic press has more or less ignored, included consensual wage bargaining and dialogue between trade unions and management, product market deregulation and aggressive tax cuts. The big depression we have seen in Ireland is not enough to wipe out those gains. Even after reaching 135% of France's GDP per capita in 2007 – when the Irish miracle had been leveraged by the banks into a full blown real estate bubble, it remains in 2012 123% of French economic performance.

A slower, even more consensual approach was proved possible by the Netherlands. By reforming their labour markets, starting in 1983, this country actually managed to pull ahead of benchmark France on both employment and unemployment measures. This success story took ten years to

accomplish and presumes enormous patience on the part of policymakers, politicians and, now, of the ECB, which has assumed the role of conditionality policeman as a price for bailing out the Eurosystem. It needs to be convinced that short-term austerity is not the only path to long-run redemption.

The second scenario: "The Bad"

The second scenario is not so optimistic. I call it the bad scenario. So those who remember the 1966 spaghetti Western starring Clint Eastwood and Eli Wallach, this is only the beginning. In my bad scenario, not only Greece, but also Portugal, Italy and Spain have abdicated the euro, there are additional candidates which will remain unnamed. They are now using the same national currencies they used twenty-five years previous. The euro survives in this scenario but it is a rump structure consisting of Germany surrounded by satellites, possibly including France. It is the "Neuro." The Germans like to call it the "Nord-Euro". The Neuro turns out to be a disaster because it takes a wrecking ball to international trade, not just within the north-south divide, but also for surviving countries of the euro space. The current prattle that Germany has diversified away from intra-Euro-zone trade enough to survive the shock of a new currency shows a remarkable ignorance of economics and economic history. The progress that we have made in deepening and perfecting the internal market, and reducing costs to consumers would disappear in little time. Export shares will decline and people will miss the old-fashioned integration that we had. An appreciation of the new currency on the order of 50-70% would lead to a generalized deflation like in Japan, with banks and nonbanks alike struggling with perpetually falling prices.

How did that happen? The troika gave Greece another bailout. Banks resisted further debt reduction and forgiveness and the ECB did as well. The recession persists, prices do not fall because people rationally expect that the authorities are not going to go through with a five-year deflation – and expect another bailout. Political frustration leads to

resentment and the Germans are at the butt of it all. It gets worse. Financial markets wager that Greece is going to disappear. And despite the enormous success of chasing away the speculators, they come back. Sovereign bond yields rise again, capital flight renews and the ECB has to stop funding Greece in order to protect itself. And that is something that also scares me. If the ECB stops lending, then Greece has to issue its own money. This is exactly how you exit a monetary union: you start printing your own paper. How else can they pay their civil servants and their soldiers? And then you have Greek bank failures which have to be bailed out by the EU because we are still in the EU. Now, we already saw in Iceland that we had 60% devaluation and actually Iceland looks pretty good now. I mean, people in England were not too happy lending all that money to Icelandic banks but overall it was a pretty successful devaluation. I suspect that five years after leaving the Euro, Greece would look like a more successful version of Argentina.

And then financial markets will punish the other countries that do not follow the Greek path immediately because they know they will, because the politicians know what is needed to survive and will eventually capitulate. So the EMU, the Monetary Union, as I was hoping for it to survive, is dead in the water by 2020. This sounds terrible. Obviously it is not terrible in the medium run for the leavers because they ultimately need either an internal or an external devaluation. That is the only way the real economy can be vitalized. You cannot use fiscal policy on an already over-valued currency. It is not going to help. In the end, the failure occurs because we did not really get it. And the failure is driven by the southern countries.

The third scenario: "The Ugly"

Now you are asking, how could it get worse than that? What can be worse than the good or the bad? Obviously the good is good, the bad is bad, and the third scenario is just plain ugly.

In the ugly scenario, the euro is still being used in 2023 and we are still using it here in this country. Even Greece and Cyprus are still on board. So we are doing what the Germans call "Weiterwurschteln à la Européenne". The transfers that we all thought were temporary become permanent and you can get used to them quite easily. If you do not believe that, just look at the Bundesland Berlin, where I work. The state of Berlin entered German monetary union in 1990 pretty much debt-free. Now it has a debt of more than EUR 61bln. compared with a GDP of EUR 104bln – or a level of debt just at the Maastricht criterion of 60%. It is a third of the Greek level, but came from virtually nowhere. And they had the bailout, the permanent bailout. That is why the Germans have such nightmares about Greece, it is because they have got them in Berlin, Saarland and Bremen already, and as soon as Bavaria, Baden-Württemberg and Hessen turn off the transfer spigot, Berlin will feel the pain. In particular, my university will feel it. That is because we are the first place to cut.

I see this as a very interesting scenario, and the most likely one at the moment. And I hate to say this, but if this scenario comes to pass, it is likely to be accompanied by a political movement in Germany to give up the euro, rather than in southern Europe. And there is a lot of political capital to be made by creating a political party in this country and capitalizing it, because a lot of Germans, maybe even out of misunderstanding the true incentives, will vote for that type of political party. How does that happen? The Greek government gets debt relief, but they do not do anything with it. Without adjustment in traded goods prices, without product and labor market deregulation, without supply-side reforms, the investment flows do not materialize as they did in Ireland in the 1990s and Greece stays on the transfer for the long run. Portugal and maybe Italy and Spain follow suit. But then a supply shock comes along, like the oil shocks in the 1970s, say in the late 2010s, which pushes up inflation. This is the biggest imaginable disaster for the ECB right now. Like the United States in 1973, when Arthur Burns had to raise interest rates, this will be very dif-

difficult. And this is something we do not talk about, and because we do not talk about it, it is going to happen. Economists are really good at not predicting events. We can talk about the past. We fight the battles of the last war, but the new ones are even not on our radar screen. Raising interest rates for countries that are highly indebted with very short-term maturity will be a killer. This is exactly what happened in 1973, after a dramatic increase in global liquidity followed by the US abandonment of the gold standard and the famous Nixon remark about Italy in 1971, which set the stage for the inflation of that decade. I can see in ten years the coalition, whichever party it is, will seriously consider the consequences of a German exit because inflation has risen and the ECB cannot do anything about it.

Let me conclude by drawing some lessons about the right decisions today. In the end, I agree with my ex-colleague and co-author Charles Wyplosz, who has commented extensively on the euro debt crisis. He argues that the only salvation of the ECB, Europe and the euro is a return to the no-bailout principle. It is the only way for a country to preserve its autonomy and protect itself from Germany, from France, from Brussels, from the troika, from the IMF. This is because national politicians and governments ultimately borrow money from abroad and leave the consequences to future generations. This will not work in a monetary union. We need to leverage Europeans' desire for less Europe and more subsidiarity by tying the hands of the politicians today. People do not want to be ruled by Brussels, people do not want to be ruled by the ECB or by the IMF or the diktat of Berlin. But obviously when the ECB is sitting on debt that is about to go bad or is about to be devalued, it has to defend itself. In this sense, Germany should be trying to leverage the view that less Europe is actually better. Yet it seems to be doing exactly the opposite at the moment. When are we going to start? It is going to be very difficult. I am a big fan of the euro; I think it was maybe a bit too widely introduced at the beginning. We ignored the Maastricht criteria, which were actually quite reasonable given that Europe is not a United States of America and it

never will be. The nations of Europe want to preserve their autonomy, and do not want foreigners making their decisions for them, either in Brussels, Frankfurt or Berlin. So the no-bailout principle is the only way to save the European Monetary System from this fate. I think that this applies to all countries, including Ireland. So Stefan, I wish you the luck of the Irish on this happy occasion.

Stefan Gerlach Concluding Remarks¹

Let me start by saying how pleased I am to be back at the IMFS this evening. I am surprised and truly grateful to be honored at this event. I know that others are surprised too. Earlier today someone came up to me at the ECB to say that he had heard that there is an event in my honor at the university this evening, and he added “I didn’t know that you were so old”!

Let me also thank all the participants and organisers of today’s event. Rather than trying to summarise the discussions so far, in my remarks I would like to talk about the IMFS and why I think it has an important role to play. I felt that strongly when I worked here and I feel that equally strongly now.

Some of you will not know the background of the IMFS so let me review it briefly. The institute is fully funded by the *Stiftung Geld und Währung*, a foundation that was established some years ago by the German Ministry of Finance and the Deutsche Bundesbank. The objectives of the IMFS are to strengthen public awareness of the importance of monetary and financial stability. It does so by conducting and promoting research and by encouraging a dialogue between academics and practitioners in this area. To achieve these objectives, the IMFS was established as an interdisciplinary institute with three chairs in central bank law, in monetary economics and in finance.

One might think that there are already plenty of academic institutes, in Frankfurt and elsewhere, working in this area and that the IMFS is an institute too many. But the institute is somewhat different from other institutions in two regards and I therefore don’t think this critique is correct.

First, the IMFS stresses the importance of incorporating legal aspects of monetary and financial stability. I have learned over the years – at the Hong Kong Monetary Authority, as an external member of the monetary policy committee at the Bank of Mauritius and again now at the Central Bank of Ireland – that this dimension is essential when thinking about monetary policy and financial regulation.

Whenever some new policy action is contemplated, the question arises whether it is compatible with the mandate of the central bank or regulator as spelled out in legislation, whether it has the power to take the action in question, and so on. While legal issues are particularly apparent in the case of financial regulation in which both national legislation and EU rules come into play, they also arise in the case of monetary policy. In the case of the ECB, of course, the legal framework is provided in the Maastricht treaty.

The IMFS is thus based on the idea that good analysis and policy advice in the area of monetary and financial stability entails a bit of monetary and financial economics, and a dose of legal analysis. To this of course we must add an understanding of the historical and institutional environment in which policy operates and a heap of good sense. It is important to take a broad and comprehensive view of the issues. While truly interdisciplinary work is difficult, there is no doubt that this is an important criterion by which the success or failure of the IMFS will ultimately be measured.

Second, the IMFS stresses the importance of engaging in the public debate. To do so successfully, it is essential to understand the environment in which policy operates and what issues and constraints policy makers see.

When I was a graduate student, a large body of academic work studied the effects of monetary policy using the monthly growth rate of the monetary base or M1 to measure the stance of policy. As any central banker will tell you, the behaviour of these variables are largely determined by the public’s demand for currency and deposits and are beyond the control of the central bank. A much better measure of the stance of policy, at least until recently, is the level of short-term interest rates. That earlier research was therefore largely irrelevant because the researchers lacked institutional knowledge. To conduct good, policy-relevant research and to engage effectively in the policy debate, it is essential to have close connections to policy makers. The IMFS seeks to achieve that by organising events like today’s, involving both academics and practitioners.

¹ This is a speech given on February 7, 2013, at a conference in honor of Stefan Gerlach’s contributions to the IMFS.

It is the task of academics to be provocative and to ask hard and unpalatable questions. In this way, policy-relevant research and commentary from institutions such as the IMFS can be helpful to central banks and regulators. There is almost unavoidably a risk of group think in such institutions since staff members, irrespectively of their seniority, may feel that it is not a career promoter to challenge the conventional wisdom and past policies and practices.

At the Central Bank of Ireland there was arguably too little focus on ensuring a vibrant internal debate and staff were not encouraged sufficiently to challenge the bank's positions or government policy during the boom years. While that did not cause the crisis, it was not helpful. The bank has now adopted policies in the areas of "speaking up" and is trying to create a culture where members of staff feel invited to "challenge constructively" the bank's views and positions, in the interest of better policy.

To sum up, in my mind the hallmark and indeed the *raison d'être* of the IMFS is its interdisciplinary approach in studying monetary and financial stability and its aspiration to foster close links to the policy community. Of course, Frankfurt, with two central banks, a large university and vibrant financial markets is an ideal location for this activity.

This focus on interdisciplinary scholarship and close contact with policy makers was taken right from the start by Professor Helmut Siekmann, the IMFS' Founding Director. It is important that this good progress is built upon in future years, as I am sure that Professor Wieland will seek to do.

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