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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Monetary Policy and Banking Supervision

NOTE

Abstract

Now the ECB will become responsible for micro-prudential supervision there are consequences for its primary mandate. Separating these two tasks may be necessary. Conceptually, both functions are related and a mutual prerequisite in the short- but especially the long-term. However, clear conflicts of interest may arise when the ECB is both bank supervisor and monetary policymaker; we cannot be sure which of the two functions will prevail. To solve this we need to separate the two functions by either setting up a Supervisory Board, operating independently within the ECB, or by appointing national supervisors as alternates to NCB governors in the Council. In both cases, a member of the ECB's Executive Board should be responsible for supervision and the ECB should have a new solvency instrument orthogonal to the interest rate, for early intervention in potential problem banks. This is, however, not the ultimate solution to the problem, as ECB president Draghi will be ultimately responsible for both monetary policy and supervision. In the end both should be independent from each other as well as from politics, coupled with clear accountability. Only when supervision is not influenced by politics it can be optimal.

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AUTHOR

Sylvester C.W. EIJFFINGER, CentER and EBC, Tilburg University and CEPR
with research assistance performed by Rob Nijskens, Tilburg University

RESPONSIBLE ADMINISTRATOR

Rudolf MAIER
Policy Department A: Economic and Scientific Policy
European Parliament
B-1047 Brussels
E-mail: Poldep-Economy-Science@europarl.europa.eu

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ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its newsletter please write to:
Poldep-Economy-Science@europarl.europa.eu

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INTRODUCTION

Besides the fact that many central banks are already involved in banking supervision, ample arguments in favour and against such an involvement can be found in the literature. Assigning the task of banking supervision to the European Central Bank (ECB) raises questions regarding the relationship of its primary mandate, the monetary policy, and the newly attributed supervisory powers. The institutional separation of the monetary policy tasks from banking supervision (e.g. organisational, staffing etc.) and safeguarding the independence of the monetary policy, while making the supervisory function subject to parliamentary and judicial control is a challenging task and raises many questions regarding the exact institutional design. These can concern the experience of other states with banking supervision as part of the tasks of the central bank, the operational separation between monetary policy and banking supervision (governance structure, Chinese walls etc.) and any possible overlaps or synergies which make cooperation between these two functions necessary. Additionally, one could ask how the conduct of monetary policy and banking supervision within one institution will affect the effectiveness and credibility of its policies, and which additional skills and instruments the ECB would need for its new task.

Before asking these questions (and possibly answering them) we may have to take a step back. Why do we need a separation between monetary policy and micro-prudential supervision? As I have argued before, in the financial crisis they have become more intertwined.[1] The danger of this is that banks, the central bank and the political system have become closer to each other. This can especially be dangerous to monetary policy, as it may run the risk of no longer being independent. Therefore, it has to be ensured that the functions of supervision and monetary policy are clearly separated and independent from political control; legally and in practice.

However, is this possible? We may need to take another step back, by looking at the conceptual features of monetary and financial stability, their relation and possible interaction. This shows us that they are very much related and that they mutually reinforce each other; especially in the longer term. On the basis of these observations I conclude that, in the long-term, it is not possible to separate monetary policy and financial stability (including supervision) completely within one institution. Especially in the long-term these two objectives are dependent on each other, and we should thus be able to reconcile them in the end.

[1] Eijffinger, Sylvester C.W. and Masciandaro, Donato (2011), Introduction, in Eijffinger, S. & Masciandaro, D. (Eds.) Handbook of Central Banking, Financial Regulation and Supervision, pp. 485-530, Edward Elgar Publishing.

1. CAN WE SAFEGUARD MONETARY POLICY IF WE SEPARATE IT FROM SUPERVISON?

The European Commission (EC) has proposed a central role for the ECB in banking supervision. According to the Commission proposal from 12 September 2012 the ECB will ultimately become responsible for supervising all banks in the euro area (although doubts exist about the feasibility of this plan[2]), starting with the most systemically important ones. It will implement a Single Supervisory Mechanism, together with the European Banking Authority (EBA), and it will receive more powers, such as authorising banks, mandating higher capital buffers and even early intervention (to prevent crises). Centralising supervision in Europe is absolutely necessary to safeguard financial stability. However, there may also be dangers to price stability: if both goals conflict, which one will prevail in ECB decision making? How do supervisory developments affect the ECB's reputation and credibility? How can we separate supervisory decisions from monetary policy ones, and how can both be made independent? These are questions to deal with when giving the ECB a broader mandate.

To assess the consequences for monetary policy making, we should take a look at the transmission mechanism that the ECB uses in its conduct of monetary policy. The mechanism is depicted in Table 1 below: The ECB influences the short-term interest rate to affect various intermediate variables in order to ultimately achieve its goal of price stability. However, several intermediate variables pertain to financial stability, especially bank rates and asset prices. Here we can see that monetary and financial stability are not independent, as the conduct of monetary policy can also affect financial stability.

Table 1.: Monetary transmission mechanism

Monetary Instruments	Operational variables	Intermediate variables	Ultimate objectives
Standing facilities (deposit and marginal lending facility), Open market operations (fixed term and frequency), Minimum reserve requirements (with averaging facility)	Short-term (inter-bank) money market rates, not quantified	Money growth (M3), (expected) inflation, bank rates, asset prices, exchange rates	Primary objective: price stability (increase of HICP below 2%)

Source: Adapted from table 3.5 in Eijffinger and De Haan (2000) and "Transmission mechanism of monetary policy", ECB, http://www.ecb.europa.eu/mopo/intro/transmission/html/index.en.html.

As consequence, it is impossible to achieve long-term independence, as monetary and financial stability are influencing each other. In the case of the ECB, its responsibility for financial stability is subordinate to that for price stability.[3] The reason behind this is that price stability will guarantee financial stability in the long run, as the ECB mentions this in its monetary policy document: "*Price stability is a precondition for financial stability*", and they reinforce each other in the long run.

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[2] See my note for the October 2012 Monetary Dialogue: http://www.europarl.europa.eu/committees/en/econ/studiesdownload.html?languageDocument=EN&file=76691.

[3] ECB (2011), The Monetary Policy of the ECB, European Central Bank.

The crisis has shown that however, in the short run this is not enough. Therefore the ECB has taken measures such as the Longer-Term Refinancing Operations (LTROs) and the Outright Monetary Transactions (OMTs), which have helped in alleviating distortions to the transmission of the monetary policy[4]. However, these measures may also impair the transmission mechanism, if they are not easily reversible. For instance, banks may become dependent on central bank liquidity and may postpone necessary structurally changes. As I have stated before, this is one of the main challenges the ECB President has faced since he came into office a year ago[5]. Fortunately, the setup of the European Systemic Risk Board (ESRB) was a step in the right direction. By detecting macro-prudential risks, it can help the ECB to guarantee financial stability and ensure a smooth transmission of monetary policy.

However, with the advent of micro-prudential supervision as a new task for the ECB, new problems may arise. Masciandaro and Quintyn (2009) have named a few costs and benefits of centralising supervision in one institution. The costs encompass moral hazard as the ECB gets more power, more bureaucracy and conflicts of interest between different goals. Specifically they state: "*the more the central bank is involved in supervision, the greater the risks of conflict among different goals*". Among the benefits they name, economies of scale and scope and easier international cooperation (unified supervision) are the most relevant for the case of the ECB.

Conflicts of interest, or the trade-off between monetary and financial stability, are one of the main problems associated with giving supervisory powers to the ECB. As I have argued in my previous note, these problems may arise in the short as well as the long-term.[6] The reason is that the ECB only has one instrument: the interest rate.

In the context of macro-prudential measures, Ueda and Valencia (2012) show that a central banks doing **macro-prudential** supervision may face a time inconsistency problem[7]. While ex ante it will set the correct monetary and financial policies, ex post it will have an incentive to keep interest rate low to protect the financial sector (by inflating away private debt). This leads to suboptimal high inflation. Additionally, the authors show that this is the result of combining two objectives in one agency, in which they are not independent. Separation of the two objectives may help, but this works only if the central bank is completely free of political control.

In the short- to medium-term, combining monetary and **micro-prudential** policy can lead to trade-offs as well. Banks are constrained in their lending by capital requirements. When the economy is in a recession, monetary policy may serve to increase lending as to stimulate economic growth (though this is not the ECB's primary objective). However, as found by Cecchetti and Li (2008) capital requirements can hinder the conduct of monetary policy if the latter does not take into account the former. Capital requirements will be procyclical as bank lending cannot expand in a recession: banks are therefore constrained by regulation. Cohen-Cole and Martinez-Garcia (2008) suggest that in this case, regulatory authorities have an incentive to lower capital requirements (or ease constraints more

4 Cœuré, Benoît (2012), Challenges facing financial integration and financial stability, speech delivered at the 3rd Pan-Asian Regulatory Summit organised by Thomson Reuters, Hong Kong, 28 November 2012.

5 Eijffinger, Sylvester C.W. (2011), Changing of the Guards, Note for the October 2012 Monetary Dialogue.

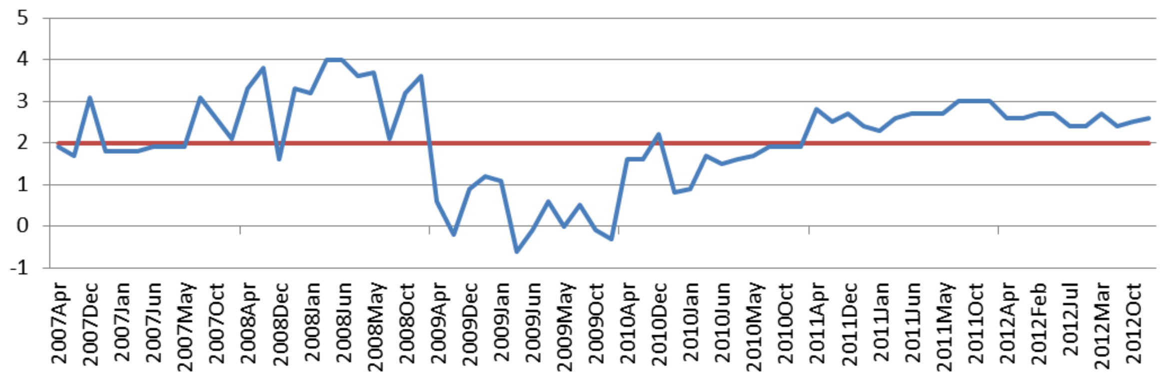
6 Eijffinger, Sylvester C.W. (2012), Banking Union and a Single Banking Supervisory Mechanism, Briefing Paper for the Monetary Dialogue of October 2012.

7 Valencia, Fabian and Ueda, Kenichi (2012), Central Bank Independence and Macro-prudential Regulation, IMF Working Paper 12/101, International Monetary Fund.

generally) to facilitate monetary transmission again.[8] However, this may also lead to more risk taking by the financial sector.

In the context of the ECB's new responsibilities a situation may arise in which the ECB exercises forbearance. To reach its financial stability goals (macro- or micro-prudential) it may need to increase mandatory capital buffers. It can do this as it will have early intervention powers. However, as this will impair the monetary transmission process (bank lending) the ECB may decide not to intervene. Furthermore, the current situation in sovereign debt markets complicates the process. As already indicated by Borio (2011), balance sheet policies blur the lines between monetary policy, fiscal policy and financial stability. As the ECB buys government bonds (or enables banks to do this by extending liquidity) it achieves financial stability but endogenises the involved governments' fiscal policies. Additionally, it buys time for structural change in the financial sector, but this change is not close to happening.

Figure 1: HICP inflation, overall

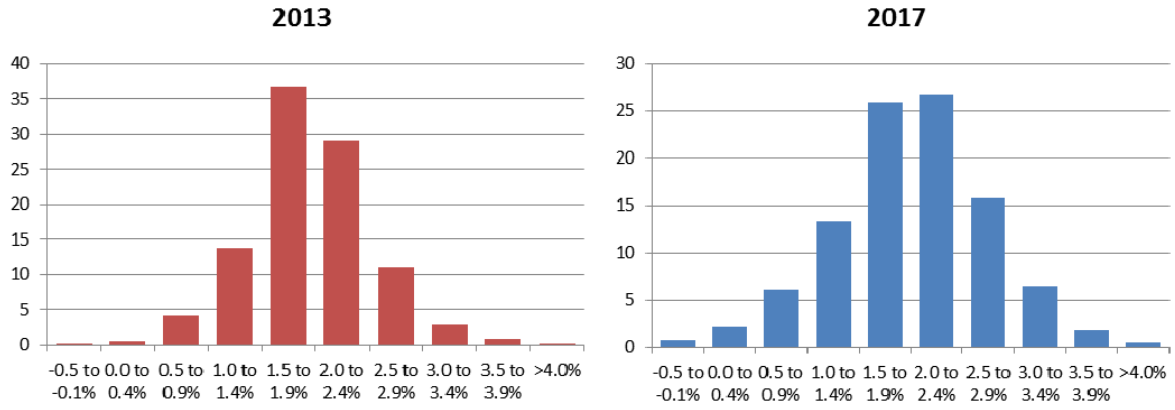


Source: European Central Bank.

A final concern is that the quest for financial stability and the accompanying measures are inflationary. In Figure 1 we can see that inflation has been above the target of 2% for 2 years consecutively. The two histograms in Figure 2 show inflation expectations as forecast by the ECB's Survey of Professional Forecasters; the vertical axis shows the percentage of forecasts in the corresponding range of inflation. These figures show that inflation expectations are around 2% for 2013, but for the longer term (2017) the average forecast lies above 2%. Going forward this expectation may even increase, as the ECB has made its balance sheet endogenous for the next 2 years by its massive LTROs interventions. At the moment there is not much room for accommodation, especially considering the new OMTs programme that may be very hard to exit from. With the on-going sovereign debt crisis it is difficult for the ECB to determine the right moment to start its exit strategy. As a consequence, banks, governments and financial markets are getting used to liquidity from the ECB and will be reluctant to implement structural reforms. In the long-term, this will lead to liquidity addicted banks and unsustainable governance forms in both banks and government.

[8] Cohen-Cole, Ethan and Martinez-Garcia, Enrique (2008), The balance sheet channel, Risk and Policy Analysis Unit Working Paper QAU08-7, Federal Reserve Bank of Boston.

Figure 2.: Inflation expectations



Source: ECB's Survey of Professional Forecasters; http://www.ecb.int/stats/prices/indic/forecast/html/index.en.html

2. HOW SHOULD THIS PROBLEM BE TACKLED?

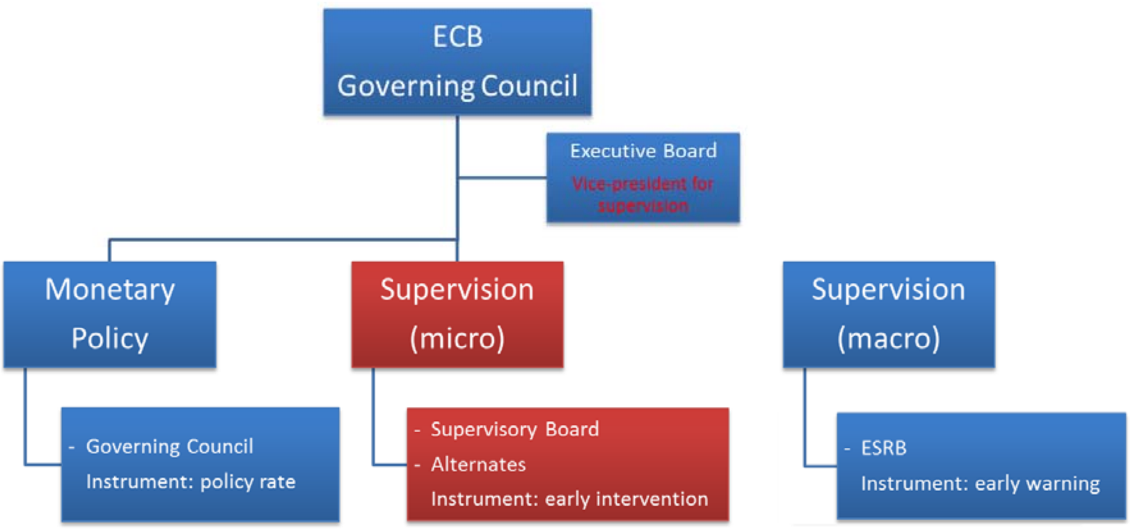
Now, as the ECB is being appointed as a micro-prudential supervisor, it is important to separate this task from monetary policy as much as possible. This will minimise the occurrence of conflicts of interest between the different mandates of the ECB.

Macro-prudential policy is tackled by the ESRB, which should also remain independent from the ECB. It must be able to issue warnings and recommendations without the risk of political interference, in the same way as with monetary policy. This protection makes sure that the ESRB is able to "*take the punchbowl away as the party gets going*" and creates a clear mandate of crisis prevention (Borio, 2011).

The ECB's mandate will be augmented with micro-prudential crisis prevention. However, to perform this task the ECB has to dispose over a new instrument; in particular, this instrument should influence the solvency position of individual financial institutions. The early intervention powers the ECB will receive can fulfil this criterion, as long as the ECB can use them without political interference. Additionally, they have to be completely independent from the policy rate (Tinbergen rule); a requirement that needs significant institutional change.

This means that financial supervision (macro as well as micro) should be separated from the decisions about monetary policy in the Governing Council. This may prove to be difficult, as the Maastricht Treaty requires the Council to be ultimately responsible for all decisions made under the ECB roof. Nevertheless, there are solutions that (at least partly) fulfil the requirement of independent decisions. These are depicted in figure 3, where the parts in red represent new elements in the mandate of the ECB.

Figure 3.: Supervision - Schematic Overview



Source: Author's elaboration; the parts in red indicate the new parts in the ECB's mandate.

One solution proposed by the Commission (and others) is to set up a separate Supervisory Board responsible for micro-prudential supervision. This Board will consist of members from the ECB and national supervisors, who jointly (and independent from monetary policy) make decisions about micro-prudential supervision. Its chair and vice-chair will be elected from the ECB Governing Council and will have a non-renewable term of five years. Another solution may be to make use of the accompanying persons, or alternates, to the NCB governors in the Governing Council. At the moment these are often monetary experts that either join or replace the governors of their NCBs in Governing Council meetings. However, when these meetings concern supervisory policy they can be replaced by supervision experts that are made explicitly responsible for micro-prudential supervision. The advantage of this setup is that no extra layer has to be created in the ECB's governance structure; a Supervisory Board will require this. On the other hand, a Supervisory Board may be more independent from monetary policy.

The solutions above also share some features. For instance, it is sensible to make a member of the Executive Board responsible for supervision. This can be the vice-president, one of the other members or perhaps a newly appointed board member with specific supervisory expertise. Furthermore, both supervisory setups will dispose over the same instrument, namely early intervention, as is described in the figure.

3. INSTITUTIONAL SEPARATION IS NO ULTIMATE SOLUTION

There are no Chinese walls in the head of ECB president Draghi, who will be ultimately responsible for monetary policy as well as banking supervision. In the end he will always have to choose for either price stability or financial stability if they clash; this holds in the short as well as in the medium term. In sum, it is not possible to make monetary and supervisory policy completely independent of each other as they are interdependent in the long run. However, it is possible to separate a large part of the decision making for both mandates, especially when the ECB has two (largely) orthogonal instruments at its disposal.

Furthermore, both supervision and monetary policy should be independent from political control, within a clearly defined legal framework. For monetary policy this independence has long been established; supervision should have the same status. Ex post, the ECB should be accountable to the European Parliament for both monetary and supervisory policy; a new procedure has to be set up for this (Masciandaro et al., 2012).

This independence from political control is necessary to avoid regulatory forbearance and diminish the chances of regulatory capture. For politicians this may be tough to swallow as they are very reluctant to give up control over supervision, especially intervention powers.[9] Freeing supervision from political influence may prove to be even more important than independence between monetary and supervisory policy.

[9] Thanks to Lorenzo Bini Smaghi for suggesting this angle.

4. CONCLUSION

Now the ECB will become responsible for micro-prudential supervision, while the ESRB remains in charge of macro-prudential supervision, we have to carefully assess the consequences for its primary mandate. If being a micro-prudential supervisor can affect the ECB's monetary policy, separating these two may be necessary.

Conceptually, the two are related and a mutual prerequisite; the ECB states so itself by saying that price stability is necessary for financial stability. However, especially in the long-term a stable financial system is also required for proper transmission of monetary policy. By taking measures during the financial crisis the ECB has protected this mechanism. However, clear conflicts of interest may arise when the ECB is both bank supervisor and monetary policymaker. If necessary, it may sacrifice financial stability for price stability or, perhaps even worse, the other way around.

To circumvent this we need to clearly separate the two functions. This can be done by setting up a Supervisory Board, operating independently within the ECB, or by appointing national supervisors as alternates to National Central Banks governors in the Council. In both cases, a member of the ECB's Executive Board should be responsible for supervision. Also, the new supervisors should dispose over a solvency instrument that is independent of the interest rate and allows for early intervention in potential problem banks.

Note that this is **not** the **ultimate solution** to the problem, as ECB president Draghi will be ultimately responsible for both monetary policy and supervision. Separating both functions is, however, a step in the right direction. In the end, both supervision and monetary policy should be independent from each other as well as from politics. This must be coupled with clear accountability to i.e. the European Parliament. Only when supervision is outside the political sphere of influence it can genuinely take into account social welfare and take the optimal decisions.

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