

# Challenges for Central Banks as Supervisors: A European Perspective

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# Introduction and Outline

- ▶ Basic arguments for the organization of supervision and its relation to the central bank deal with one state, one economy, one central bank and one bank supervision authority.
- ▶ Look briefly at pluses and minuses for combining bank supervision and monetary policy as functions of the central bank in that setup.
- ▶ Then focus on the idiosyncracies of the construction of the euro area and the role of the ECB in the light of the crisis and the ongoing debate.

# Pluses in the base case

- ▶ Informational synergies.
- ▶ Coordination during crisis
- ▶ Independence of bank supervision is strengthened under the central bank as CBs are granted independence for monetary policy.
- ▶ Possible conflicts in prudential supervision and monetary policy can be internalized and resolved better by a single institution.

# Minuses in the base case

- ▶ Possible conflicts in prudential supervision and monetary policy may compromise price stability.
- ▶ Independence of monetary policy may be compromised as CB independence more difficult to defend in bank supervision matters.
- ▶ Central bank may be politicized and bank supervision weakened.
- ▶ By overburdening the central bank away from its primary focus on price stability, we may end up with worse performance on monetary policy and no better or even worse performance on financial stability.

# A Broader Question on Institutional Design

- ▶ Is one institution, run by a benevolent social planner with the appropriate objective and operational independence, sufficient to achieve the social ideal?
- ▶ How much power and responsibility should be delegated to a single institution in a democracy?
- ▶ Who are these mythical creatures, fair, just, benevolent, who can help implement this?
- ▶ How can we ensure proper monitoring and democratic accountability if one all-powerful institution is responsible for all?

# The euro area

- ▶ A confederation of sovereign states where local politics may dominate common good.
- ▶ No institution has power or authority to resolve differences in an efficient manner.
- ▶ Noncooperative behaviour among governments.
- ▶ In this environment, ECB may be drawn into disputes among member states and become highly politicised.
- ▶ A narrow mandate focusing on price stability in the euro area as a whole becomes crucial to defend ECB independence and effectiveness.

## Just how bad can local politics get?

- ▶ The crisis has heightened risks for involving ECB in disputes among member states.
- ▶ The euro area has gotten worse as some governments leverage euro construction for local political benefit.
- ▶ Latest example: mismanagement of Cyprus crisis.
- ▶ Local politicians in Cyprus created the mess (the communist party ruled for five years—it lost the election and left office on March 1, 2013).
- ▶ The September 2013 election in Germany and political considerations there determined the outcome.

# What made Cyprus unique?



- Five-year CDS on sovereign, as of end February

# The communist government's refusal to act



- ▶ Markers show when assistance was sought and agreed.

# The domination of German politics over Europe

"We don't like this business model and we hope it is not successful ... In the case of Cyprus we have leverage that we don't have with other tax havens."

Wolfgang Schaeuble, April 5, 2013 (Reuters)

# Merkel's election problem

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**Bailing Out Oligarchs**

## **EU Aid for Cyprus A Political Minefield for Merkel**

*By Markus Dettmer and Christian Reiermann*

**The EU is likely to bail out the banks of tiny member state Cyprus with 10 billion euros of credit. But a secret German intelligence report reveals that the main beneficiaries of the aid would be rich Russians who have invested illegal money there. It's a big dilemma for Chancellor Angela Merkel.**

5 November 2012

# A solution for Merkel's government

- ▶ A binding constraint on any deal for Cyprus was that it had to be structured so that Merkel's government could avoid any political cost.
- ▶ This could be achieved if losses were imposed on depositors (preferably "Russian oligarchs").
- ▶ The German government could use its leverage to inflict permanent damage to the financial sector in Cyprus.

Does any european institution want this role?



# Banking Union

- ▶ An essential element for solving the crisis
- ▶ Three elements are necessary
  - ▶ Common supervision
  - ▶ Common resolution
  - ▶ Common deposit guarantee
- ▶ Resolution is highly political. In crisis we had problems even in the Benelux.
- ▶ Does a piecemeal approach make sense?

# The risk of complete politicization of the ECB

- ▶ ECB can be a positive force in Europe as long as it stays free of local politics and focuses on the euro area as a whole.
- ▶ If forces involve the ECB in disputes among member states in a political manner, the ECB becomes part of the problem of Europe, instead of part of the solution.
- ▶ The ECB can help with SSM if the banking union is complete. This requires a common resolution and common deposit guarantee scheme. Otherwise ...