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Central banking following the crisis

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Thank you Mario and Benoît for inviting me to this conference. And my congratulations on your decision to hold it before rather than in the middle of the summer holidays: that might give you a competitive edge in the years to come.

In her remarks yesterday evening, Christine Lagarde provided me with a linking theme for what I am going to say. It was nice of her to describe central bankers as heroes. I would agree; I think she is right that the innovations by each of the major central banks have made a huge difference over the past few years in keeping a great depression at bay and in regaining a semblance of stability.

Nevertheless, as central bankers, you should be deeply disturbed if you are the only game in town. More important, citizens will be deeply concerned if you – independent, powerful, but unelected – are the only game in town. My remarks are, therefore, going to be largely about political economy, not positive economics. If there is one key point it is that for unelected, independent, powerful agencies to have legitimacy, the regimes within which you operate need to be clear. That means that they might need to be better articulated given what we have learned or, in some areas, had to rediscover about central banking policy during the crisis.

I think that central banks could face a slow-motion problem of legitimacy if, when the crisis is eventually behind us, the regimes for three parts of central banking are not clearer: the lender of last resort (LOLR), using the balance sheet to implement "credit policy" and macro-prudential policy. Some of those issues are probably more pressing outside the euro area. But the general issue has salience for the ECB because, as I shall briefly summarise, persistent flaws in the design of EMU raise the probability of recurrent crises.

A durable monetary union requires at least two things of the economy's money. First of all, by definition, base money has to be homogenous – and, of course, it is. But secondly, broad money – the private money of bank deposits – has to be homogenous as well. Deposit money – most of the money we all use – needs to be regarded as safe. That means that it has to be "information insensitive", so that there are no returns to be made from ferreting out information on some or other bit of deposit money. That can in principle be delivered by a regulatory regime. But in fact, notwithstanding moves towards banking union, retail deposit money will still not be homogenous across the euro area.

To be clear, good things are being done. Moving prudential supervision to the centre is sensible and necessary, not least because it will help to overcome problems – real or perceived – of capture in a number of capitals. Further, putting prudential supervision within the ECB is sensible given that banking stability is part of broader monetary stability; it is not a branch of consumer protection.

Nevertheless, I do believe that the resolution regime – the most important part of which comes via the directive giving Member States a hugely enriched toolkit – is definitely a considerable improvement. So on resolution, I am much closer to Mathias than to Martin. In fact, the resolution arrangements being introduced can do something quite profound, which is to separate banks' monetary liabilities from their other liabilities by making the bonds that they issue information sensitive – *by making them risky*. If that does not happen, the monetary union and all other currency areas are in very deep trouble indeed. But I think we can escape that: as and when the G20 authorities deliver in this area, one great benefit is that it will be possible for retail deposits to be safe without exacerbating moral hazard.

Having said that – and I think Steve Cecchetti made this point earlier – I am afraid that the euro area deposit insurance regime is still flawed, and is fundamentally inadequate for a sustainable monetary (and banking) union. The insurance in one country is not the same as in another. These arrangements stand in the way of having homogenous broad money across the monetary union. Only a collective deposit insurance scheme can deliver that. It should be funded by the banks themselves, in order to ensure defaulters contribute something. A funded scheme can also shield the taxpayer somewhat. I recognise that that would be a step towards some kind of fiscal union. But without that step, the monetary union will remain fragile: an incipient fracture in the credit system will persist, even when the current crisis has finally passed.

You, as representatives of the central bank, should be deeply dissatisfied with that. I do not doubt that you are unable to do anything about it in the short run. But it ought to be something – and I am sure it will be – that you will want to come back to as the years pass, again and again if necessary. The initial sin of not addressing the fault lines in the monetary union should not be repeated.

What then about the three areas of innovation during the crisis: LOLR operations, balance sheet policy, and macro-prudential policy?

First, the LOLR. On both sides of the Atlantic there are people who – rightly or wrongly – say that central banks have been providing solvency support to fundamentally bust firms. Even if this were quite wrong, it could gnaw away at the legitimacy of the central banks, unless it is consigned to history. Effective, credible resolution regimes are fundamental to setting central banks free from such accusations in the future. Bust firms can go into resolution. The lender of last resort role can then be seen to be pursued with integrity, because it means that central banks can be liquidity providers and not closet providers of solvency support.

Central banks should, therefore, be the greatest champions of effective resolution regimes, because they will enable them to make the lender of last resort function the necessary adjunct to monetary policy that it should be, rather than a perceived branch of fiscal policy.

Second, balance sheet policy more generally, where perhaps I should make it clear that I am going to say nothing conjectural whatsoever.

When this crisis has eventually passed, it would be quite surprising if there were not a much greater demand for reserves than before. That will partly be because of the liquidity coverage ratio, and regulation more generally. But it will also partly be because, even in the absence of regulation, banks have realised – and for a while will remember – that they are in the liquidity insurance business, and therefore self-insuring by holding some high-quality liquid assets is sensible, common prudence. And the most liquid assets of all are, of course, central bank reserves. So demand for reserves will likely be higher than in the past.

This, I think, presents you – as representatives of the ECB – with an interesting question. When the economy and financial system eventually emerge out of the crisis, do you really want to keep reserve requirements? And, if you do, what are they for? Since you moved to paying interest (at more or less your policy rate) on reserves, you have not actually needed to set reserve requirements. You could allow banks themselves to choose their reserves target for each maintenance period, with the resulting aggregate target varying from one maintenance period to another.

If you were to keep reserve requirements, then I think your institution, in common with other central banks, effectively has three operational instruments: the short-term policy rate; the size of the balance sheet, determined by the reserves requirement; and the composition of assets, i.e. how risky they are, their maturity, whether they are held outright or on repo, etc. So there are three regimes you will need to specify. The second and third are related because, to the extent that you use your choice of assets to pursue a credit policy, your chosen reserves requirement would determine the scale – and so the force – of your intervention in credit markets. Some of this has been done, of course, but it probably needs refreshing for peacetime: what operations will be employed routinely, what will be held back for contingencies and what will be placed out of bounds.

But, before discussing central banks' asset/credit policy, I want first to stress that the balance sheet policy regime needs to be somehow aligned with the macro-prudential policy regime, since that is also a set of interventions in banking and credit markets.

I think of macro-prudential policy as a branch of inter-temporal stabilisation policy. Given the importance of broad money to stability in a monetary economy, the stability of the money credit system needs to be maintained. Of course, the base requirements for making the system resilient are set in a potentially timeless way. But from time to time a credit cycle becomes more exuberant and poses risks greater than those that are factored into the *static* regime. In those circumstances policy is adjusted *dynamically* in order to maintain the *same* desired degree of resilience. That may affect the upswing itself, but the core goal is to leave the system able to weather the bust, avoiding the implosion of the credit system and moderating the macroeconomic downturn.

Employing macro-prudential policy in that way and with that explicit goal is preferable to turning to monetary policy as the main means of avoiding financial crisis. And it is preferable to a central bank using its balance sheet to try to drive up risk premia in order to contain a boom, although in theory that is also potentially available if macro-prudential policy proved ineffective and a major threat remains.

But I have to say that it is not yet clear exactly what the macro-prudential regime for the euro area is. I know what the macro-prudential regime for the EU is. It is based on national macro-prudential regimes with a constraint of not undermining the EU's single market. For the euro area, the monetary regime is clear of course, and the new *micro*-prudential regime is too. But, for example, it is not yet clear, at least to me, whether there will be a *macro*-prudential policy for the euro area as a whole and who would set any such policy. This is something that will need to be clarified as the ECB beds down its new responsibility for micro-prudential supervision.

Against that background, I can return to balance sheet policy. First of all I think that in normal circumstances – so, again, thinking beyond this crisis – it is better to operate via repos – i.e. collateralised lending – than outright purchases, because that reduces the exposure to loss and it reduces the extent to which the central bank is in the credit allocation business, both of which shade into fiscal policy.

But to the extent that, during the crisis and beyond, asset purchases are employed, I think that this central bank, like other central banks, needs somehow to resolve a dilemma around what kind of assets to purchase. Should a central bank prefer purchases of government bonds – in the euro area according to the capital key – or is that off limits because it threatens to *look like* monetary financing, and therefore threatens to *look like* fiscal dominance, even if the scale of the monetary injection is 100% under the control of the central bank? Or should central banks prefer purchases of private sector assets, which would avoid that set of risks but actually gets into credit allocation and the risk of loss, which of course would be transferred to governments and taxpayers (if only via lower seigniorage income). Put like that, the second course amounts to a difficult choice of a central bank avoiding the risk of perceived fiscal dominance, but only by getting into fiscal policy more directly itself. And if a central bank were ever to opt for that course, should it get the consent of elected politicians – in the ECB's case, the Council of Ministers or the European Parliament – in order to underpin the democratic legitimacy of its policy regime?

Now, I do not know the answer to those questions, which I suppose might justifiably vary from one polity to another. But I do think, as we look ahead a few years, central banks everywhere will have to stake out where they are on all of those issues, and ensure that elected representatives are content. Just as proved to be the case with monetary policy, framing regimes is vital to both credibility and legitimacy.