

Introductory remarks on the concluding policy panel of DG-ECFIN's Annual Research Conference "Government and Markets: Finding a New Balance", Brussels 22-23 November 2010.

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This is the seventh Annual Research Conference, organized by DG-ECFIN and I want to thank the organizers for the opportunity to participate in the concluding panel. I believe I am one of few people who have participated in the previous editions. I make this remark in the hope of being invited again next year.

In my view, the Global Crisis is, at its roots, a crisis of the regulatory and supervisory framework for financial stability. As Xavier Freixas puts it, regulation and supervision are in place to cope with market failures. Market failures are extreme when crisis disrupts the fundamental functions of the financial systems and threatens the regular performance of contracting terms. To be sure, perverse incentives in financial markets played a central role and macroeconomic conditions a supporting role. Regulatory arbitrage led to the creation of balance sheet vehicles; race for return led to excessive leverage; securitization led to a weakening of due diligence in loan origination; short-sighted and one-sided remuneration contracts led to excessive risk taking. These effects were amplified by macroeconomic conditions. In particular, savings in some economies pushed real interest rates low (the savings glut). Moreover, the perception of a Great Moderation, combined with ample financial resources and liquidity, contributed to a systematic under-estimation of risk through the compression of risk spreads. However, it is the case that regulation and supervision should aim to shape incentives in such a way that private profits are made compatible with overall efficiency in resource allocation. Hence, perverse incentives resulting in financial market failures are *prima facie* evidence of failures of regulation and supervision. As Bill White emphasized, the focus on systemic risk and macro-prudential issues on the part of the competent authorities, was insufficient. The increased attention devoted to systemic risk is a very positive development.

For a central banker these are interesting times, as monetary stability and financial stability are both central to central banking. The case for involving central banks on macro-prudential issues and systemic risk is strong. It will be argued below that central banks' responsibility for financial stability requires assigning to it the appropriate regulatory and supervisory instruments. It is important to emphasize that while monetary and financial stability are not separate objectives they are, nevertheless, distinct. Monetary stability aims at maintaining price stability over the medium term. It is abundantly clear by now, if it has ever been in doubt, that price stability is not sufficient for financial stability. Financial stability, in turn, is about

¹ The views expressed are my own and do not necessarily reflect those of the Banco de Portugal or the Eurosystem's.

financial system's resilience. Financial stability is said to prevail when the financial system is able to withstand significant disturbances without disruption to its functions. These are: first, the provision of payments and transactions' services; second, the allocation of savings to investment opportunities; third, the supply of instruments for risk diversification and risk sharing; and, last but not least, the production, processing and dissemination of information relevant for financial transactions.

Before the crisis the standard new Keynesian model had already become the workhorse for monetary policy theory and the basis for best monetary policy practice. When examining the success of Otmar Issing as the ECB's first chief economist, Anil Kashyap and I² stressed that the new Keynesian model provides a strong case for price stability and for the central role of private sector expectations and credibility in the conduct of monetary policy. Nevertheless, the New Keynesian model does not incorporate any active role for financial intermediation and for monetary and credit aggregates. Therefore it cannot rationalize the important role of monetary and financial analysis during Issing's tenure at the ECB. We conjectured that the extension of the model to include finance intermediation would provide such a ground. In the simplest case, the consideration of an intermediation spread between the policy rate and the rate relevant for households' and firms expenditure decisions is enough to underline the importance of finance and financial factors for the conduct of monetary policy. Such analysis is reminiscent of Knut Wicksell who emphasized the importance of the banks' loan rate for prices and economic activity.

Cúrdia and Woodford (2009) do derive a dynamic IS curve, in which credit spreads explicitly appear. Adrian and Shin (2010), Cúrdia and Woodford (2010), Gertler and Kiyotaki (2010) are further examples of research along these lines (Woodford, 2010 provides an overview). At last year's DG-ECFIN's Annual Research Conference, research was presented showing that also at policy-making institutions research was progressing to incorporate financial factors into DSGE models used for forecasting and policy simulation (work was presented by researchers from the IMF, from the European Commission and from the European Central Bank).

In general, the bottom line from this research is that monetary policy should focus on price stability over the medium term. Financial factors should be carefully considered and taken into account in so far as they influence the current economic situation and prospects as well as the monetary policy transmission mechanism. Financial stability is an important element for the conduct of monetary policy but it does not constitute a separate goal.

This point is made very clearly by Jean-Claude Trichet (referring naturally to the European context):

"While the ECB and the central banks of the EU will be heavily involved in the ESRB framework, it is essential to make a clear separation between macro-prudential oversight and monetary policy. The primary objective of euro area monetary policy will remain the maintenance of price stability.

² Gaspar and Kashyap (2006).

Financial stability lays the conditions for the central bank to pursue its task of maintaining stable prices. It is also the outcome of steady macroeconomic stability and confidence, which only stable prices can ensure.”³

The unavoidable conclusion is that financial stability should be pursued through appropriate supervisory and regulatory tools. In line with the theory of second best, the general principle is that regulation should address distortions directly. In case regulation and supervision are effective in doing so the case for monetary policy is unchanged.

Let me just look at one example. One systemic concern is that banking regulation induces pro-cyclicality in the behavior of the financial system. To answer such concern it is possible to conceive counter-cyclical provisioning to attenuate or compensate for such a pattern.

When regulation and supervision are imperfect there is the possibility of trade-offs. On the possibility of trade-offs I will want to state only this: when such trade-off does exist it is very unfavorable (in the sense that evidence suggests that it takes a lot of reduction in economic activity and inflation to obtain a small effect on asset prices or spreads); fortunately in both extreme crises or from a long term perspective it is likely that the goals of price stability and financial stability will be complementary rather than conflicting. One example is the classical case of a business cycle upswing, accompanied by a credit boom, compressed spreads and asset price inflation. *Leaning against the wind* of credit expansion serves to maintain price stability over the medium term, to keep growth sustainable and, at the same time, it favors financial stability.

The specific instruments targeting financial stability pertain, as argued above, to regulation and supervision. These include capital requirements, loan-to value ratios, rules on provisioning, accounting rules, information disclosure, risk management. Instruments also include the rules and procedures that apply in conditions of crisis or trouble. In crises, authorities may act by, for example, intervening and promoting the orderly resolution of financial organizations (first and foremost banks), by providing guarantees, and by engaging in asset purchases and capital injections.

To conclude, I would like to recall that one year ago, at DG-ECFIN Annual Research Conference, Garry Schinasi and I⁴ argued that from the European Union viewpoint the key challenges were:

- To agree and enforce a single set of rules to underpin the Single market – a single rule book;
- To put in place an effective framework for coordination in the areas where cross-border spillovers are most important: first, the resolution of systemically-relevant European cross-border banking groups; and, second, crisis management.

There has been impressive progress in the last year. Legislation has been passed and will enter into force on January 1, 2011. It sets three new European supervisory authorities and also the European Systemic Risk Board. The European Commission has examined many other important

³ Trichet (2010).

⁴ A revised version of the paper presented is available as Gaspar and Schinasi (2010).

issues and complementary regulatory initiatives have either been already proposed or are in the pipeline.

In my view, all of the above should be regarded as a very promising start of a process. In the end, such process will have been successful if it delivers. In other words if it evolves as an effective regulatory and supervisory framework for financial stability in an integrated financial system in the European Union..

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