



**MONETARY AND FINANCIAL STABILITY: A DUAL ROLE FOR A CENTRAL BANK
RECENT LESSONS**

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Introduction

1. It is an honor to be speaking at such a distinguished conference on the occasion of the 75th anniversary of Central Bank of the Republic of Argentina.
2. Anniversaries of central banks are special. It is so because time is inherent to central banking.

Indeed, time is at the root of a Central Bank credibility and is essential to its tool kit. Time plays a great role in many aspects of a Central Bank action. Let me just take three concrete examples:

- the first and obvious one is inflation : time is necessary to firmly anchor expectations;
 - foreign exchange interventions played a great role in the European construction: time is necessary for a Central Bank to play against the market;
 - time will also be necessary to monitor systemic watch responsibilities; this new approach of the risks will require the Central Banks to develop their capacity to take “the long view”.
3. Being the first speaker in this session, I will focus my remarks on the dual role of central banks in terms of monetary and financial stability.

I will address three main points closely interlinked in the light of our recent experience. The first tells that an efficient monetary policy requires financial stability. The second that financial stability cannot be achieved irrespective of fiscal conditions. The third, that financial stability is contingent on a sound regulatory framework agreed upon at the internationally level and robust supervisory management at the domestic level.

I. AN EFFECTIVE MONETARY POLICY REQUIRES WELL-FUNCTIONING FINANCIAL SYSTEMS

4. All the decisions taken by the European Central Bank during these last three years had the primary goal to secure the transmission of monetary policy. Three channels could affect these mechanisms through :
 - the **price channel**: the increase in government bonds yields may spill-over to the cost of financing of the private sector. Under normally functioning bond markets, sovereign bonds provide a floor for the funding conditions of the private sector.
 - the **liquidity channel**: government bonds are the primary collateral used by banks. Interruptions in the sovereign debt market reduce the function of government securities as liquidity buffers. This in turn impedes banks' capacity to issue loans and refinance the real economy.
 - the **balance sheet channel**: falling bond prices induce valuation losses on assets and balance sheets of financial and non financial actors. For banks, these losses reduce their capital base, decreasing, hence, their supply of loans to the economy. For borrowers, the losses on assets held, diminish their creditworthiness, affecting, thus, their capacity to borrow.
5. A core motivation, for the quick actions taken by central banks during this crisis, has been to restore an orderly functioning of money markets. High volatility, high risk premia, impaired interbank and funding markets hurt the normal transmission of monetary impulses. Starting in the summer of 2007, Central Banks were confronted with major and unprecedented tensions. Increasing uncertainty led to liquidity hoarding by financial institutions. Banks severely limited the maturity, the scale and the number of their counterparties, severely affecting the functioning of the interbank market.

These interventions were adjusted to the specific structures of the financial system in which central banks operate. In the US, where financial intermediation is heavily dependent on securitized credit markets, this involved significant asset purchases by the Central Bank. By contrast, in the Euro area, where financial intermediation occurs mainly through the banking system, ECB actions were aimed at providing banks with sufficient liquidity through repo operations to secure the flow of credit to the economy.

6. In the Eurosystem, we have entered the crisis with a large set of tools. From the outset, our operational framework was based on a broad list of eligible counterparties and collateral. So, we could adjust rapidly to the shocks in money and credit markets even if the environment in which we had to operate has changed profoundly.
7. Following the intensification of the financial crisis in Autumn 2008 – and against the background of rapidly receding inflationary pressures – we have taken monetary policy measures that are unprecedented in terms of nature, scope and magnitude. These measures fall into two categories: first, standard measures in the form of interest rate changes (Since October 2008, our key policy rate has been cut from 4.25% to 1%); second, what is known as “non-standard” measures, encompassing a policy of fully accommodating banks’ liquidity needs, enlarging the list of eligible assets, lengthening maturities for refinancing operations, the provisioning of liquidity in foreign currencies but also the purchasing of covered bonds and, more recently, government bonds.
8. Let me add that we never ruled out to implement asset purchases, when it appeared necessary to repair dysfunctional markets to ensure a proper transmission of monetary policy impulses. Indeed, in 2009, the ECB embarked into a program of covered bonds purchases, which is now completed. Although modest in size (60 bn euros), this program has been fairly successful in reviving a market segment which in turn supported bank funding at a time where bond issuance were secure.
9. The recent decision to purchase Government securities should be seen in the same light. The objective of this program is to address the malfunctioning of securities markets to restore an appropriate monetary policy transmission mechanism. These

interventions are sterilized as liquidity injected is exactly drained, thus fully neutralizing the effect on the banking system.

10. In taking these initiatives, the Eurosystem has maintained a clear separation between monetary policy and financial stability operations. This clear separation has ensured that we kept fulfilling our primary mandate to safeguard price stability. My sense is that we have been successful. In the Euro area, at no time during the crisis have inflation expectations significantly deviated from our price stability objective. This was most crucial, when headline inflation stayed in negative territory, the output gap was strongly negative and the risks of deflation about to materialize.

II. FINANCIAL STABILITY CANNOT BE ACHIEVED IRRESPECTIVE OF FISCAL CONDITIONS

11. Recent developments in Europe have proven that disorder in public finances could lead to disorder in financial systems. This did not come as a surprise. Central banks have long been concerned with fiscal positions in Euro area countries. Indeed, we, at the Banque de France, as well as many ECB members, have regularly called upon policy makers to pay due attention to debt dynamics.
12. Delay in addressing long-lasting fiscal imbalances is primarily responsible for the situation, but the financial crisis has exacerbated the problems. The first trigger was the mechanism of automatic stabilizers that resulted in rapidly declining fiscal receipts due to the synchronized recession. Secondly the imbalances have been aggravated by greater public spending via unprecedented fiscal stimuli plans and large public financial commitments, in particular via capital injection into the banking sector and debt guarantees schemes. Public interventions have been massive to contain the scale of the turmoil but in return have implied a cost and led to a transfer of risk out of the banking sector onto the public sector balance sheet. For instance, interventions from European governments amounted to about 1800 billion EUR or 14% of the European GDP.
13. Let me also underline that –like in many previous financial crisis such as the Latin American ones- financial markets ignoring the long term risks of their investments helped accommodate unsustainable financing requirements of many countries. A major assumption underpinning our fiscal governance frameworks in Europe has been that markets would impose discipline earlier on. Experience reveals that this has not been the case: the market discipline was imposed, far too late.

14. All this emphasizes that sound fiscal frameworks are essential to sound financial regulatory frameworks. Indeed, no longer will be raised the question of the importance of the Stability and Growth Pact and the role it plays in anchoring market confidence.
15. Let me add how fiscal problems in Europe have been addressed. First, the Greek adjustment package, relying on IMF financing and conditionality plus bilateral loans has been decided. Beyond Greece, the European Financial Stabilization Facility provided the Euro area with massive resources to fight contagion risk within the area. Elsewhere in Europe, governments have embarked into sizeable fiscal consolidation efforts and in many cases have frontloaded their efforts.
16. Against this background, no alternative solutions –sometimes advocated by advisers referring to the Latin American previous crisis- were suitable options for the Euro area. In fact, the Euro area is not only built with a single currency ; it has also developed into a highly integrated economic and financial area. In this context, debt restructuring would hammer the banking sector impair financial markets and destabilize the real economy.
17. In addition, an EU stress test exercise was instrumental in alleviating pressures as we have observed significant spread reduction in the wake of the release of their results. Tensions on sovereign spreads have indeed abated somewhat as a result of an unprecedented transparency effort leading 91 European banks to disclose their detailed exposures to EU sovereigns. The severity of the stress scenario, which beyond assumed adverse macroeconomic conditions also incorporated assumption of losses due to renewed and persistent tensions in sovereign long term interest rates, revealed that even under extremely adverse conditions, European banks capital would still be maintained well above minimum regulatory requirements.

III. FINANCIAL STABILITY IS CONTINGENT ON SOUND INTERNATIONAL REGULATION AND ROBUST DOMESTIC SUPERVISORY MANAGEMENT

18. The financial crisis has taught us some clear lessons which force us to review in depth the way the financial system is regulated and effectively supervised.

The crisis has revealed weaknesses in the international regulatory framework.

19. The main flaws fall into three broad categories.

20. The first relates to the **scope** of the regulatory framework.

- We entered this crisis with many unregulated entities and opaque and complex financial products playing a major role in the financial system. There were, therefore, huge "black holes", including what has been called a "shadow banking system" where most of the excesses of securitization took place. Regulation was not reaching far enough and when it applied it did not always ensure an adequate risk capture.
- The G20 has fostered coordinated efforts by industrialized and emerging countries to bring the most important financial actors under the umbrella of supervision, while rating agencies and hedge funds were receiving closer attention. Beyond these actions, the G20 and the Financial Stability Board (FSB) have focused their efforts on the systemic importance of certain institutions or markets, due to their size or their interconnection. One example is the necessary reform of OTC derivatives markets that has gained traction with a clear roadmap designed by the G20. Efforts aimed at integrating these markets into regulated and supervised market infrastructures are an essential policy response to monitor the risks accumulated in these markets.

21. The second problem highlighted by the crisis is the **procyclicality** generated by the interplay between prudential and accounting rules. Some of this procyclicality can be trimmed through prudential regulation. I therefore strongly believe that our first line of defense against procyclicality should be the accounting framework. We, at Banque de France, firmly support the current focus on reducing the scope of mark-to-market accounting and moving from an incurred loss model to a forward-looking model for provisioning. We expect that accounting standards will converge but this should not come at the expenses of these two dimensions.

22. Thirdly, the crisis also raised questions about the **nature of our regulatory frameworks**. There is a trend towards complementing the micro-prudential supervision with macro-prudential oversight. In Europe we are putting in place a Systemic Risk Board at the European Union level that will combine expertise from Central Bank Governors and supervisors in charge of banks, insurance companies and securities markets. In the US, the Financial Stability Oversight Council is also a landmark in the overhaul of the financial supervision architecture.

23. Soon, the European Council will grant the ECB a special assignment regarding financial stability with the responsibility to run the European Systemic Risk Board. This should not be seen as constituting an additional objective of monetary policy. Rather, the creation of this Board does not change the clear allocation of responsibilities enshrined in the Treaty.

The international initiatives about to be finalized will strengthen prudential frameworks and make financial systems less prone to systemic shocks.

24. One such initiative is the commitment by all G20 jurisdictions to implement Basel II by 2011 and to finalize this year a new package aimed at strengthening bank capital and liquidity standards. This is a great achievement. The challenge, now, is to calibrate and phase in the new framework in a way that does not impede the recovery. The macroeconomic assessment of the reforms underway will help us strike the optimal balance.

25. Beyond capital and liquidity, other important initiatives are aiming at addressing systemically important financial institutions and cross-border resolutions. To better deal with the problem associated with systemic firms, progress is being made to improve the capacity to resolve them orderly, and to strengthen ex ante preparedness, contingency planning, cooperation and information exchange among the relevant authorities.

26. There is a broad agreement for an approach that may have two pillars. One is about tools and measures to limit the risk of their failure; the other is about tools and measures to limit the consequences of their failures. Discretion is required to allow national authorities to strike the balance between the two pillars and tailor regulatory and supervisory actions to domestic conditions. The challenge is to ensure that national policies to address the risks associated with these firms are consistent, mutually supportive and thus avoiding regulatory arbitrage.

But beyond international initiatives, enhancing supervision at the domestic level remains very critical.

27. Higher and better capital and liquidity standards are not sufficient conditions to secure the stability of the financial sector. Changes in the practice of micro-prudential oversight are also needed. Indeed, a lesson from the crisis is that the way supervision was performed prior to the crisis has likely contributed to it. This is

recognized by the G20 leaders, at their recent Summit in Toronto, which make more effective supervision the second of the four pillars of its strategy towards more resilient financial systems. The FSB is engaged in a thorough review of supervisory practices.

28. With hindsight, the way supervision is conducted should be enhanced in two directions:

29. - First, supervision should be **intrusive** into the affairs of regulated firms.

- Weak intrusiveness was a problem because supervisory rules such as Basel 2 rely extensively on banks' own risk valuation, management and governance. It was also a problem because discipline imposed on banks by investors did not always work: due diligence was weak and rating agencies were conflicted. If market discipline does not bind early on and if supervision is not intrusive because it follows a light-touch approach, then failures in banks' internal oversight and systems are mechanically imported into supervisory assessments, without adequate checks and balances. The consequences of this have been dramatic for some financial systems.
- In practical terms, being intrusive for a supervisor means having the capacity to go beyond off-site control and engage frequently and consistently with banks through on-site inspections.

30. - Second, supervisors should develop a **proactive attitude**; why?

- Regulated entities have powerful incentives to arbitrage regulation, to keep complying with formal regulation while at the same time maximizing returns through unheeded risk taking. As time flows and risks are moved outside of the regulatory radar, supervision loses its grips on risks to financial stability.
- To overcome these difficulties supervisors need to look ahead, be sensitive to changing practices in banks, and anticipate the impacts of emerging risks not only to new products but also to new or disproportionate sources of income. I believe that some sort of "benevolent skepticism" towards them is warranted from supervisors. Indeed, the potential costs in terms of financial stability and economic output of not digging deeply enough into complex products or not controlling that firms do understand their own risks may simply be too high.

Supervision should spur better risk analysis and control at the firm level

31. Regulated financial entities are complex and evolving institutions. Internal governance processes are the first line of defense against excessive risk-taking whether at the management or technical level. To make sure that this first line of defense is solid, supervisors should pay attention to compensation and governance issues.
32. Under the aegis of the Financial Stability Board, major advances have been made to ensure that **compensation policies** in financial firms are better aligned with long-term value creation, and do not support excessive short term risk-taking. Principles for sound compensation practices have been published at the end of last year. Endorsed by the G20 they will be incorporated into supervisors' rule book. Supervisors will have the responsibility to review firms' compensation policies and structures with institutional and systemic risk in mind and, to apply corrective measures, such as higher capital requirements, to those firms that fail to implement sound compensation policies and practices. Supervisors would also have the ability to modify compensation structures in the case of firms that fail or require extraordinary public intervention.
33. As I already alluded to, supervisors should pay a major attention to financial firms' **governance**. As it stands, prudential regulation to a large extent is build on trust in their ability to value, manage and control their risks. Supervisors should have the power to hold boards responsible for the performance of their institutions. They should ensure that boards and individual directors are sufficiently empowered and informed to understand and to respond appropriately to their risk taking policy.
34. In light of the crisis, proper **liquidity risk** management should also stand high in firms' own agenda. In many respect, the recent crisis revealed wrong liquidity pricing and poor liquidity risk valuation by financial firms. There is ample evidence that in an environment of excess global liquidity prior to the recent crisis many financial institutions were led to (i) overestimate the liquidity of their assets, (ii) have overly optimistic assumptions on their ability to refinance, and (iii) ignore, or pay insufficient attention to, liquidity risks in their internal pricing processes.
35. One should never forget that liquidity has a price. But the pricing of liquidity risk was either non-existent or inadequate in fully incorporating the maturity and currency

mismatch, contingent and market liquidity risks embedded in the various banking business lines.

36. But liquidity is not only a matter of individual firm's supervision; it is also of huge importance for the functioning of a whole system, which mainly relies on the liquidity management of a few firms. It is because of inaccurate liquidity risk pricing methodologies that large financial firms have built critical cash flow mismatches, and held substantial holdings of illiquid instruments with overestimated profitability profiles, based on unsustainable leverage strategy.
37. The Basel Committee's renewed attention to liquidity issues is very topical. A major innovation of the proposed reform package deals with liquidity. In principle, no one will challenge the need to implement liquidity regulation for banks. Indeed, the new regulation will be calibrated and designed to help raise banks' awareness of the cost of liquidity.

Conclusion

38. In the past, financial crises have always triggered important changes in the organization and practice of Central Banking. The latest one is for me not an exception. Central banks have managed to adjust and confront several new, unprecedented challenges rather effectively and, it should be noted, with unprecedented degree of coordination and cooperation.
39. In many countries, the need to develop stronger macro-prudential policies has resulted in new assignments. As for my home county, I can say that having both monetary policy and financial stability responsibilities under the same roof has proved rather useful.
40. This expanded role reminds us that the monitoring responsibility of a Central Bank is crucial. Our dedication to stability and our forward looking approach in a globalised financial world is a challenging task.

Long lasting cooperation among Central Banks and stimulating conferences like this one largely contribute to this achievement.

Thank you for your attention.