

TO FORM A MORE PERFECT UNION

BY STEPHEN G CECCHETTI, BRANDEIS INTERNATIONAL BUSINESS SCHOOL, NBER and CEPR*

Over the past few year, we have discovered that financial stability in a common currency area requires more than just monetary union. If there is to be a truly integrated financial market, a financial union in every sense, there must be other unions as well. The first is a banking union. And the foundation of a true banking union is a number of other unions; the union of regulation, the union of supervision, the union of resolution and the union of deposit insurance. Now, these unions may themselves require further unions. To ensure the homogeneity of broad money in the currency union, deposit insurance will require sufficient, common, funding; funding that that is jointly and severally guaranteed by the member states of the union.¹ A deposit insurance union creates increased fiscal interdependence, which then creates a need for some degree of fiscal union. I could go on, but the focus of my comments is narrower. I wish to discuss the organization of banking supervision.

But before I do, it is important to recall the situation in which we find ourselves. The key challenge for the euro area today is to reverse the fragmentation that took hold several years ago. One measure of the extent of this is by August 2012, the balances in the Target 2 system exceeded €1 trillion. The primary deficit countries being Greece, Italy and Spain, who were in debt to Finland, Germany, Luxembourg and the Netherlands. For Greece, the Target2 deficit was equal to 24.6% of the assets of their monetary financial institutions (MFIs); Portugal 12.7%; Spain 12.0%; and Italy 6.8%. For Finland, Germany and Luxembourg, the numbers were relatively large as well, representing 9.6%, 8.6% and 11.4% of their MFIs assets respectively (see Table 1).

In the last two years, this situation has improved, but not much. By March 2014, the most recent data available, the equivalent number for the deficit countries are Greece 11.4%, Spain 7.3%, Portugal 11.7%, and Italy 4.8%. For the surplus countries, they are Finland 3.7%, Germany 6.3%, and Luxembourg 11.3%. Overall, the balances are down to €700 bn.

The size of these surpluses and deficits represents the fact that people had lost faith not only in their country's banks, but in the ability of their governments to make the banks whole in the event of a collapse. As a consequence, depositors came to believe that there was a difference between a deposit in Frankfurt or Amsterdam and one in Madrid or Rome. The speculative attack has been stopped, but the legacy remains.²

* Professor of International Economics, Brandeis International Business School; Research Associate, National Bureau of Economic Research; and Research Fellow, Centre for Economic Policy Research. These remarks were prepared for the ECB Forum on Central Banking 2014, "Monetary Policy in a Changing Landscape," Sintra, Portugal, 25-27 May 2014. I thank, without implicating, Kim Schoenholtz and Paul Tucker for very helpful comments and discussions.

¹ In these short comments, I do not have the space to discuss the issue of resolution. What I will say is that it is essential that the system be set up so that banks fail in a way that their bondholders truly risk losses. And, that cross-border issues be resolved in such a way as to reduce the push toward deglobalization of finance that will come otherwise.

² See Cecchetti, McCauley McGuire (2012).

Table 1		
Ratio of Target2 Balance to MFI Assets		
	August 2012	March 2014
Austria	-4.2%	-4.2%
Belgium	-3.0%	-1.5%
Cyprus	-7.6%	-8.0%
Finland	9.6%	2.8%
France	-0.1%	-0.6%
Germany	8.6%	6.6%
Greece	-24.6%	-12.8%
Ireland	-7.8%	-5.2%
Italy	-6.8%	-4.7%
Luxembourg	11.4%	11.3%
Netherlands	4.9%	1.8%
Portugal	-12.7%	-11.2%
Spain	-12.0%	-7.4%
Source: Target2 data are from www.eurocrisismonitor.com . MFI data are from www.ecb.int .		

Complementary to the challenge of fragmentation is the fact that the health of bank balance sheets continues to diverge along country lines. Looking at the ratio of market capitalization to bank book equity, we see that France and Germany continue to lag well behind the other with price-to-book remaining at close to 0.5.³ And finally, I will simply note that putting in place solutions to the underlying causes of these problems must take account of the fact that banks are a more important source of finance in some euro area member states than in others.

What I am saying is widely understood. But the construction of the single European financial system remains incomplete. One critical aspect of this is governance. How should regulation, supervision, resolution and deposit insurance be organized? Specifically, what should their relationship be to the central bank?

At this point, I wish to digress and discuss a series of short essays that I wrote in November 2007. At the time, I thought of them as lessons from the crisis. This was before Bear Stearns, before Lehmann and before I joined the BIS. It is fair to say that the essays clearly reflect the hubris of an academic who had not spent enough time inside of the community of central bankers and supervisors. For today, I will focus on the two essays that examine the consequences of the 14 September 2007 run on Northern Rock: "Deposit insurance and the lender of last resort," and "Why central banks should be financial supervisors."⁴

³ See the chart in Cecchetti and Schoenholtz (2014b).

⁴ All four essays, which appeared between 26 November and 3 December 2007, can be found at <http://www.voxeu.org/person/stephen-cecchetti> under the heading "Subprime Series."

These as contributions to two related pre-crisis debates, one on whether you needed deposit insurance if you had a lender of last resort, and the other on whether the supervisor should be inside or outside the central bank. On the first, I concluded that deposit insurance is essential to financial stability. Discount lending requires discretionary evaluations based on incomplete information during a crisis, and hence on the decisions of inevitably fallible people. By contrast, deposit insurance is based on a set of preannounced rules that are then simply put into practice. The lesson I took away from this is that if you want to stop bank runs— and I think we all do – rules are better.

But the presence of a deposit insurance scheme does not obviate the need for a lender of last resort. As Paul Tucker describes clearly in his remarks at the BIS on 15 May 2014, if we are going to have institutions that offer liquidity insurance – what I think of as the key role of depository bank – then we need a liquidity reinsurer.⁵ And, the only institution that can guarantee liquidity in all states of the world is the central bank, so it is naturally their role. So long as we have fractional reserve banking, and without it I don't see how we have private lending, then we will need a lender of last resort.⁶

This brings me to my primary question: should central banks be supervisors? Again, this question has been debated for some time. There are two primary arguments for separation. The first that there is a conflict of interest – there may be times when the central bank's interest rate decisions are made to protect banks' balance sheets rather than benefit the public at large. Second, separation reduces the chances that poor supervisory performance will damage the reputation of the central bank in its conduct of monetary policy.

The argument for inclusion is about efficiency in the production and use of timely information; the ability to internalize the trade-off between prudential and monetary policy; and the fact that as the lender of last resort, the central bank has to know his or her customer. Starting with information, separation leads quickly to something akin to the children's game of "Chinese whispers" or "telephone," where a message is whispered from one child to the next, getting slightly distorted at each step until it becomes unrecognizable. Timely and accurate information requires that bureaucratic barriers be minimized.

The second reason to insist that supervision be in the same institution as monetary policy is the need to ensure consistency of macroprudential and monetary policy. It is worth noting that these have quite similar transmission mechanisms. They both influence the willingness of lenders to supply credit and the inclination of borrowers to take it on. That is, they are both directed at aspects of the supply and demand for loans, influencing both prices and quantities.⁷ This means that monetary and prudential tools can come into conflict.⁸

The experience since 2007 leads me to the third argument for putting supervision into the central bank: know your customer. If the central bank is the lender of last resort, it is critical that liquidity support be only be provided to solvent borrowers. There are three reasons that a central bank should strive not to lend to a bankrupt institution. First, by lending secured to an insolvent commercial bank, the central bank further subordinates bond holders and depositors (or the deposit insurer). It does this both by allowing short-term depositors to run and also by inserting itself ahead of others in the queue for claiming repayment when failure inevitably

⁵ See Tucker (2014a).

⁶ For recent discussions of on this point, see Cecchetti and Schoenholtz (2014a), Tucker (2014b).

⁷ For a comprehensive discussion of this relationship, and its implications, see Brunneimeir and Sannikov (2014).

⁸ See the examples in Cecchetti and Kohler (forthcoming).

comes. As Paul Tucker writes, “it is quite simply wrong for anyone to knowingly lend secured to a firm with negative net assets, as the lender is making others worse off.”⁹

Second, lending to an insolvent institution by itself does not put an end to fragility. Ultimately, the institution must be liquidated or re-capitalized regardless of whether it obtains a loan from the central bank. And by postponing resolution, the resulting mix of uncertainty and poor incentives damages both the financial system and economy.

Third, when it becomes known that the central bank is willing to lend to insolvent banks – and people will find out – banks that borrow will be suspected of being bankrupt. The resulting stigma will impair the functioning of the lender. In the end, only those that are bankrupt will borrow and the central bank’s lending facility will become useless.

Solvency support is the province of the elected government, not an independent central bank.

How are central bankers to know if a potential borrower is solvent? How can they be sure they know their customer? They can never be certain; but to ensure that they know as much as anyone, they should be the supervisor.¹⁰ It doesn’t matter how many memoranda of understanding there are, or agreements for meetings and information exchange. During a crisis, it is essential that the lender of last resort have a good sense of is solvent and who is not. This means that the central bank is de facto involved in supervision. It is really just a matter of degree.

As every good bureaucrat knows, information is power. And, when disaster strikes the financial system, information is at its most valuable and time is short. I firmly believe that it is unwise to rely on generosity in those circumstances. It is only when everyone is in the same institution, when supervisors are in the central bank working for the same person or group of people, that such hesitancy can be quickly overcome.

By maintaining that monetary and prudential (micro and macro) policy should all be in the central bank, I am arguing for the creation of a very powerful, independent and technocrat institution. This raises two complementary issues. First, how can we moderate the power of individuals inside of the organization? And second, what do we do to create democratic accountability and ensure that the institution serves the public good?

On the former, we see two solutions in practice today, overlapping committees and duplication of responsibilities. The first is exemplified by the structure in the Bank of England. There are three committees: the Monetary Policy Committee has 9 members (5 internal, 4 external), the Financial Policy Committee has 10 members (5 internal, 5 external), and the Prudential Regulatory Authority Board has 7 members (4 internal, 3 external). The MPC and FPC have 3 members in common, the FPC and the PRA share 4 members, and overall, the Governor and the Deputy Governor Financial Stability are on all three. The idea behind this arrangement is to internalize the spillovers of one group of policy decisions to the other two while guarding against the risk that a single individual, or even a group, will come to dominate all decisions.

Duplication of responsibilities is an alternative to a system of interlocking committees. This is the structure in the US, where the Federal Reserve is a supervisor, as is the deposit insurer, the

⁹ See PMW Tucker (2014b).

¹⁰ Central banks must follow a version of the Know Your Customer rule. That is, they have to know who they are doing business with. But unlike a private intermediary, the central bank has to abide by a broader version of KYC. Not only must they ensure that they are not facilitating criminal activity, and have balance sheet knowledge, they must know counterparty’s management practices in making a judgment on lending.

treasury and each of the states. Every bank is examined by at least two of these 53 authorities.¹¹ Having more than one supervisor clearly addresses problems associated with concentration of power, at the same time that it mitigates the potential for conflicts of interest. And, regardless of how it is organized, the lender of last resort will be a supervisor either de facto or de jure.

With such a powerful institutions, one that concentrates monetary, macroprudential and microprudential policy all inside a single body, we need to develop strong mechanisms for transparency and accountability. Central bank independence is fundamentally at odds with representative democracy.¹² How can we give so much power to unelected technicians? For conventional monetary policy, we found an answer: clear, easily monitored objectives. And the result has been price stability. This is surely one of the main reasons that the popularity of inflation targeting endures, especially in emerging markets. We need to work on finding an analogous framework for financial stability. One with something akin to a price index.¹³

Returning to where I started, creating an economic and financial union of sovereign states is extraordinary difficult. People often look at the United States as an example of a success of sorts. But it is important to keep in mind that what you see today is not where things started. The Articles of Confederation and Perpetual Union were agreed among the original 13 states in 1781. They left substantial sovereignty with the individual states, creating a central authority only for the purposes of defence and diplomacy. The confederation served as the basis for fighting the Revolutionary War, but in the end was too weak to provide for adequate governance of the new country. So, in 1789, it was replaced by the Constitution of the United States; which, as its preamble states, was established “to form a more perfect union.” Importantly, over the succeeded two hundred plus years, the constitution has been tested, amended and reinterpreted.

As I write, European Monetary Union in its 15th year. Granted, it has been a bumpy ride. But I believe that those managing the Eurosystem, as well as the leaders of the member states of the union, understand where the problems lie. They know what to do to form a more perfect European union, one that promotes the general welfare through a common and unified financial system. They know that it is essential that the monetary union be complemented and supported by other unions. The banking union is the first. In the end, this will mean that the member states will need to seed their regulatory and supervisory powers over all of their financial institutions and financial markets to a common authority inside of the common central bank. To be as clear as possible, this means that the supervision of all banks, insurance companies, asset managers and securities dealers in the euro area must somehow be placed inside the ECB and, as is the case with the Single Supervisory Mechanism (SSM), under the control of the Governing Council of the ECB.

And, finally, I believe that the leaders of Europe and the people of Europe have not forgotten what those who brought us monetary union understood when they set out on this road. To quote Helmut Kohl (1996), “*The policy of European unification is in reality a question of war and peace in the 21st century.*” And, as tensions in Europe continue to wax and wane, we can see the importance of the project of insuring that Europe is a robust union of consequence, not a frail group of irrelevant individual states.

¹¹ Kohn (2014) provides a very complete description of how the two systems are organized.

¹² For a more detailed discussion of these issues, see Cecchetti (2013).

¹³ There is the hope that mechanisms like stress tests will deliver for financial stability what inflation targeting delivered for price stability.

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