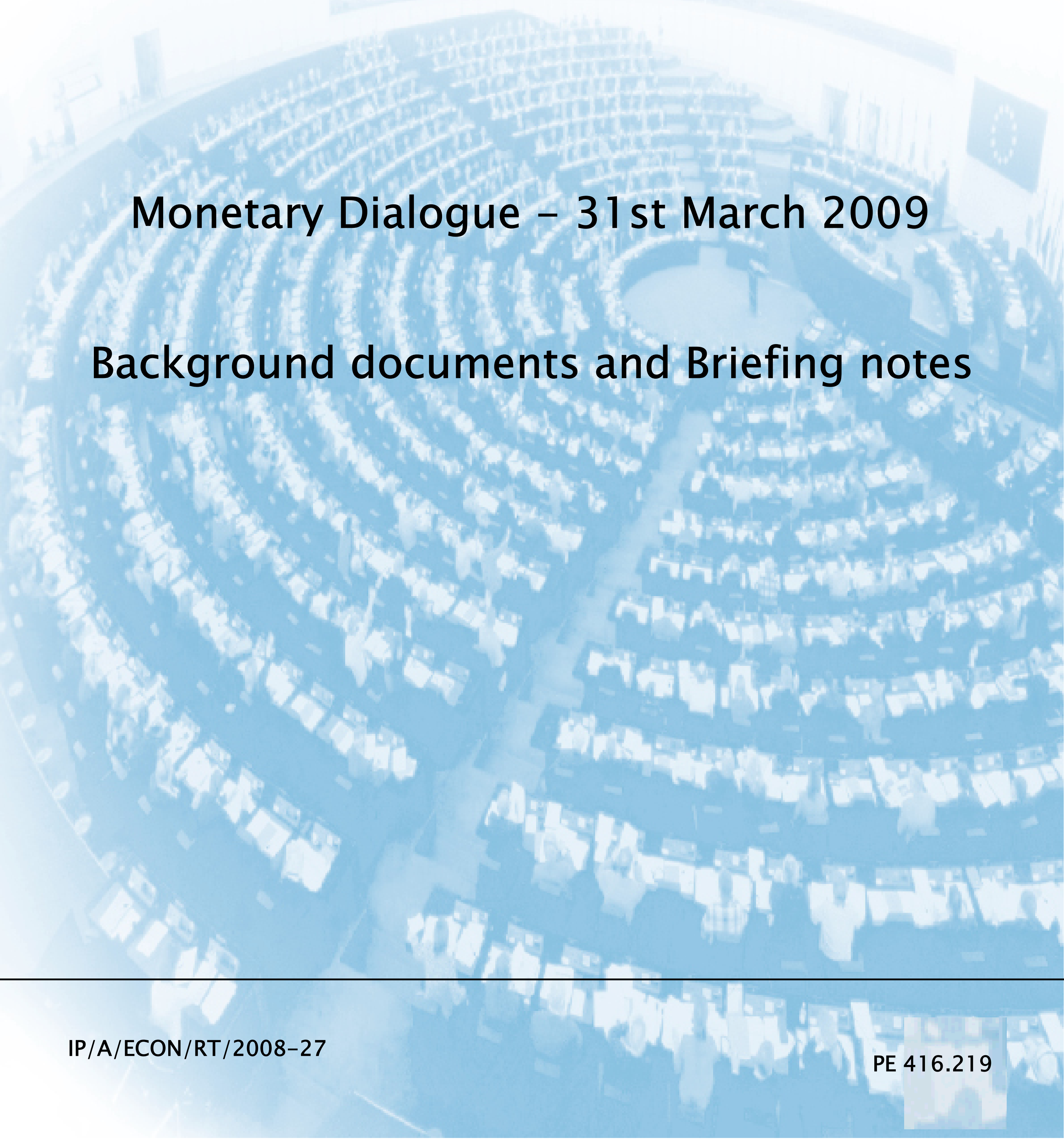
EUROPEAN PARLIAMENT

REPORT

Policy Department
Economic and Scientific Policy



Monetary Dialogue - 31st March 2009

Background documents and Briefing notes

IP/A/ECON/RT/2008-27

PE 416.219

This series of briefing papers was requested by the European Parliament's Committee on Economic and Monetary Affairs.

Only published in English.

Administrators:

Christine BAHR
Policy Department Economy and Science
DG Internal Policies
European Parliament
Rue Wiertz 60 - ATR 00L042
B-1047 Brussels
Tel: +32 (0)2 284 07 22
Fax: +32 (0)2 284 69 29
E-mail: christine.bahr@europarl.europa.eu

Arttu MAKIPAA
Policy Department Economy and Science
DG Internal Policies
European Parliament
Rue Wiertz 60 - ATR 00L006
B-1047 Brussels
Tel: +32 (0)2 283 26 20
Fax: +32(0)2 284 69 29
E-mail: arttu.makipaa@europarl.europa.eu

Manuscript completed in March 2009.

Table of Contents

DG INTERNAL POLICIES OF THE UNION
- Directorate A -
ECONOMIC AND SCIENTIFIC POLICY
POLICY DEPARTMENT

MONETARY DIALOGUE MARCH 2009

Summary of Monetary Experts' Panel Briefing Papers

for the Preparatory Meeting – 25 March 2009, 14.30-16.30hrs, Strasbourg, LOW S 4.5

The following summary presents the respective topics of the briefing papers followed by brief points on the main answers of the experts to the questions asked. Only selected main points are mentioned here. For a complete argumentation, please refer to the subsequent papers.

Topic 1) Implications of the current crisis for euro zone enlargement

The present financial crisis has had two immediate and contradicting impacts on the discussion on the successes of the euro and of the EMU. The prevailing view has been that the euro and the ECB have been "beacons of stability" in tumultuous times and that things would have been much worse in their absence. The other view, held by a minority, has identified sharp divergences in the impacts of the crisis across Europe, arguing that after the stability-related benefits of the short term have evaporated, the euro area, in particular some of its members will be confronted with major constraints due to increased divergences.

The supporters of a strengthened EMU in the post-crisis period see the fact that Iceland and Denmark (as well as to a lesser extent Sweden) are now discussing euro adoption as important evidence in their favour. Moreover, New Member States such as Poland have been announcing concrete timetables for their planned euro adoption. On the other hand, the crisis hits different economies in Europe differently, inter alia because the credit expansion prior to the crisis had very different real impacts in GDP across the EU.

The experts were asked which of the above trends prevailed. In response, they were generally of the opinion that in all candidate countries for the euro, the willingness to adopt the common currency has increased. This holds true for Central and Eastern European (CEE) countries, but also for Denmark and Sweden, and possibly also the UK. However, practically all experts also agree that it would not make sense to abandon the spirit of the criteria for an overly hasty euro adoption, which would serve neither existing nor new members of the zone. Much rather, it seems sensible to keep an eye on the sustainability of the criteria in applicant countries. One immediate step could however be to credibly announce and commit to more concrete timetables for euro accession for all relevant euro-applicant countries.

In any case, the EU should show solidarity and be ready to help its structurally weaker members. As to strategies how to deal with the most urgent issues in the crisis, some would see the help of the IMF as a shame and a sign of EU failure to handle its own affairs (Patat), while others would welcome the help of the IMF stand-by agreements (Walter). The main lesson of the crisis is a reminder of a main rationale for the creation of the euro: a fully integrated single market works better with a single currency (Wyplosz).

While the first nine years of the euro passed under relatively mild economic conditions, and now the benefits (and risks) of the single currency become clearly visible.

Jean-Pierre PATAT - Fast euro adoption is not the solution, but more concrete and credible messages about the timetable for adoption should be given

The present crisis does not change the fact that most CEE countries could not, at the moment, endure the constraints of what would be for them a too strong currency. Also, within the euro zone they would not benefit from fiscal transfers as for example the ex-GDR did after reunification. Nevertheless solidarity needs to be shown within the Union and the EU has to show that it can deal with these problems alone without the need to submit the file to the IMF.

Although immediate or accelerated membership is not a good solution, a credible and visible message about the timetable for euro accession needs to be given. This will help to strengthen market confidence and contribute to stability.

Norbert WALTER - Euro adoption only beneficial for well-positioned candidates, membership will never solve structural problems

Well positioned candidates include the Czech Republic, Poland, Denmark and Sweden and they should benefit from fast euro adoption. For other CEE countries, the will to join is driven by short-term needs stemming from risks to financial stability but the underlying structural weaknesses remain. Adoption without proper preparation may even increase risks in some countries. Nevertheless, the formulation of a credible catch-up strategy will be beneficial for structurally weaker euro candidates.

For the existing members of the euro zone, euro zone enlargement would primarily have noticeable institutional implications as the ECB Council rotation system should start when membership exceeds 18. Also, euro zone members with strong export or banking sector links to CEE countries would benefit from a more rapid enlargement.

Charles WYPLOSZ - Reminder of the crisis: a fully integrated single market works better with a single currency

Euro area membership simply displaces where market pressure is applied. Disturbances that normally affect the exchange rate will have to work out their effects through other channels and the only disturbance that is eliminated is monetary policy. After nine years of mild economic conditions, in the present crisis this leads to an enhanced role of fiscal policy as a macroeconomic stabilization tool, and consequently accentuates market concerns about debt service.

Non euro-area member countries have split into two groups. One group of countries have maintained their pegs *vis-à-vis* the euro at the cost of sharply increased interest rates. This aggravates the recessionary effect of the financial crisis. Another group of countries have seen their exchange rates depreciate *vis-à-vis* the euro. By boosting their competitiveness, this alleviates the recessionary effect of the financial crisis. However, this bears the danger of currency mismatches and further distortions within the EU.

Topic 2) What role for the ECB on financial market supervision?

The future architecture of supervision in Europe is one of the main issues following the crisis. The de Larosière group came out with a report at the end of February which proposed modest advances in supervision, inter alia the creation of a European Systemic Risk Council (ESRC) at the ECB. This topic will be further discussed in the March European Council and during the informal ECOFIN in April 2009.

During the last Monetary Dialogue (21/01/09), Jean-Claude Trichet concluded his introductory remarks by saying that "*as underlined in particular by a number of Members of Parliament, Article 105(6) of the Treaty explicitly mentions the possibility for the Member States to decide to confer upon the ECB specific tasks in the domain of financial supervision. Reflections have started on the specific role that could be played by the ECB and its Governing Council should this provision of the Treaty be activated. At this stage the Governing Council has not taken yet position on this topic. I will not miss to report to you the outcome of these reflections*".

The experts were asked the following questions in this context:

<u>EU supervisory repair</u>

- How to best combine micro surveillance of individual institutions and macro prudential oversight?
- Should a step forward be enhancing the role of the 3L3 Committees and systematising the colleges for the largest cross border entities? Or should the EU move toward a system of supervision with a common structure that could also provide binding guidance?
- What role should the ECB and ESCB play? What role for the national central banks in relation to the supervisory authorities?
- Shall a cross-sectoral approach be chosen, and if yes, at which level?
- Should prudential activities and consumer protection be separated?
- How should EU supervision link to international institutions, such as the IMF and FSF?

<u>Regulatory repair</u>

- How to correct the regulatory inefficiencies?
- How should Basel 2 be revised?
- How to improve the incentives to avoid "quick money orientations"?
- How to make it possible not to over-regulate the markets?
- What are your views on counter cyclical capital charges in order to avoid pro-cyclicality?
- How should the shadow banking system be regulated?
- Can the roots of the problems be ruled out by regulation, or are we dealing with more fundamental "ethical" and human issues? How can we best avoid that the wrong kind of regulation simply sows the seeds of the next instabilities?

In the responses of the experts, the main recommendations by the de Larosière group are seen by some as a political compromise which should be taken only as a point of departure. Eijffinger calls the recommendations of the de Larosière group as "*not path-breaking but a very modest, first step to European supervisory authorities"*.

Most experts favour an enhanced role of the ECB in financial supervision. For de la Dehesa, there is ample evidence that those countries where the supervisor is not the central bank but the government or an independent agency, the crisis hit the banking systems much harder. Where the central bank is the financial supervisor, banking systems have kept much better.

The only exception to the opinion that the ECB role in financial supervision should be enhanced is by Podkaminer, who believes that the ECB should not play any supervisory role at all. In his opinion, Europe needs a return to "narrow-banking" (a term coined by Paul de Grauwe) which includes splitting cross-border financial conglomerates into pieces so that they can be effectively supervised nationally: "*what proves to be too hard to regulate and supervise, should be forbidden*". Consequently, also surveillance of institutions should be left to the national bodies that should collaborate with each other. However, for macro-prudential oversight also Podkaminer prefers a separate body such as the ESRC, however affiliated e.g. to the European Commission and not the ECB.

All other experts (Eijffinger, de la Dehesa, Sibert) advocate to increase the competences of the ECB, albeit under certain conditions, incl. the existence of appropriate institutional structures. For example, the ECB should only be responsible for macro-prudential supervision by participating in the ESRC while the micro-prudential supervision is left to enhanced market authorities (Eijffinger). De la Dehesa, in turn, favours the so called twin-peak approach (see below). The powers of the ECB should not be increased "for free": if gaining more powers, the ECB should become more accountable and less independent than it is in monetary policy-making (Sibert). Moreover, it is difficult for the ECB to take a larger macro-prudential financial stability role before the issue of how the Eurosystem is to be recapitalised in the event of capital losses realised is addressed and resolved (Sibert).

Guillermo DE LA DEHESA - A twin-peak approach should be adopted

Twin peak: Central banks should be supervising the health and conduct of all financial entities while independent agencies supervise the health and conduct of all financial markets and consumer protection. National central banks that are members of the ESCB should be in charge of the micro-prudential supervision of all financial institutions in their own member states, with a high degree of coordination among them, while the ECB should take the role of the macro-prudential oversight for the euro area financial system as a whole

Sylvester EIJFFINGER - Results of the de Larosière working group are very modest, but nevertheless first steps towards European supervisory authorities

In a first stage, national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU. In a second stage, the EU should establish an integrated European System of Financial Supervision (ESFS). The level 3 Committees should be transformed into three European Authorities: a *European Banking Authority*, a *European Insurance Authority* and a *European Securities Authority*. The Authorities should be responsible for micro-prudential supervision, while the ECB should take care of macro-prudential supervision by participating in the ESRC as suggested by the High-Level Working Group.

Leon PODKAMINER - The ECB should not play any role in supervision

As long as the fiscal costs of failures of financial firms are borne nationally, supervision must remain national. Should there be a common fiscal arrangement for the entire EU, with fiscal costs in question borne by the EU as a whole, things would be different. An ESRC could play the role of macro-prudential supervision in the EU, but it should be affiliated e.g. to the European Commission rather than the ECB.

Anne SIBERT - More competences for the ECB should come at the cost of more accountability

The General Council of the ESCB should be the forum where the macro-prudential financial supervision policies of the EU central banks should be discussed and decided. If the ECB were to be given greater responsibility and authority in the area of macro-prudential supervision, then it must be required to be less independent and more accountable than it is when making monetary policy.

Arttu MAKIPAA *Christine BAHR*
Administrator (Tel. 32620) *Administrator (Tel. 40722)*

Topic 1

Implications of the current crisis for euro zone enlargement

Implications of the current crisis for euro zone enlargement

Briefing Paper for the Monetary Dialogue of March 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Jean-Pierre Patat

Executive summary

The crisis is raising again the question of the non-optimal nature of the euro area. In the absence of a federal budget which can overcome the regional divergences by transfers, the instrument alone devoted to such a mechanism is the Stability and Growth Pact. So the current crisis admittedly causes market suspicion vis-à-vis countries which did not respect the Pact rules until now and will suffer from very difficult future evolutions with the spontaneous impact of the recession. But if the spreads have enlarged for some countries, they remain far below the ones observed for some non member states. The "euro shield" is bending but not breaking. However, a solidarity mechanism is necessary as some countries in which the bubble bursting was dramatic could be in a very serious situation. Whatever its form, such a procedure must have sufficient visibility and credibility, for it would be disastrous for the credibility of the zone if a member state would be obliged to ask for the assistance of the IMF.

Concerning the position of the CEE countries in view of an eventual accession to the euro zone, the strict assessment of the respect of the criteria delivered mixed results. Some countries had very high inflation rates and contrasted fiscal situations but generally very high current account imbalances (which is not a criteria but is the sign of a severe macroeconomic disequilibrium and have caused wide exchange rates depreciations). Beyond the formal aspects of the criteria, strong reasons –poor real convergence, weak financial sector, fragility of the growth factors, saving deficits – were advanced for arguing that the accession of most of these countries was realistic at a medium-term horizon.

The current crisis is causing a violent deterioration of the situation of the CEE countries with foreign investment flows turning around, exports dramatically decreasing, general impoverishment of the economic agents, risk of banking system collapse and perhaps of quasi state bankruptcy. Some analysts think that the best solution would be to integrate, at least some of these counties, into the euro zone in order for them to benefit from the euro shield. But the crisis does not change the fact that these countries could not endure the constraints of a strong currency for, different from the ex GDR, they would not benefit from compensatory mechanisms provided by a national budget. Furthermore, an early accession would imply putting the criteria aside. Setting this precedence, it would be very difficult in the future to maintain credibility of recommendations and procedures for restoring sound public finances. In addition, a common monetary policy would become very difficult to manage with countries whose inflation rates exceed 10%. Finally, one can estimate that an early integration, by its brutal and totally off-norms characteristic would weaken the euro durably and structurally. However, these countries must be strongly helped. And the question of rescuing states can be asked in the future. Once more, it would be damaging for Europe to abandon the file to the IMF. It would be good to give to markets and observers a clear message about a time table for the accession of these countries, as it was undertaken for the introduction of the euro.

The question of the UK accession is different since this country has an opt-out clause and did not express any intention to join the euro zone, and its situation, while very serious, does not show the fragility symptoms of the CEE countries.

Yet the question of an accession has been raised as the monetary independence of the pound has been relative and its dependence apparently broken by a sharp depreciation, which is globally, in our view, a bad thing, and could worsen the market appreciation of the UK signature, all the more so in that the UK government will have to finance huge deficits. But the country is not respecting, by far ,the criteria, and it would be very difficult to determine what could be the good exchange rate of the pound against the euro.

1) Paradoxical and even contradictory analyses are presently circulating about the consequences of the current crisis on the euro area situation.

On the one hand, it is asserted that the crisis is a stress test which reveals the weakness of the zone, with limited homogeneity of economical, financial and banking structures and of economic actors' behaviours, a situation which is supposed to confirm the presumption that the single currency area is not an optimal economical zone. On the other hand, one can read and hear claims for the urgency of making the integration in the euro area of Central East European countries easier and faster, such a decision being considered as the best solution for avoiding the quasi collapse of these countries. But this solution would objectively, if achieved, make the zone even less optimal.

It is true that the crisis is the first big test for the euro area solidity and that some member states like Ireland, or Greece, seem right now, to some extent, not less affected than Eastern European countries. Many questions arise: What could be the real impact of these evolutions on the whole area's credibility? Are the current institutional mechanisms sufficient for dealing with such problems? Has the enlargement problematic changed? What could be the positive and negative effects, for the zone and for the presently European non-euro area member countries, of an early integration of some of them?

I will deal with the following questions:

- What could be the objective assessment of the impact of the crisis on the euro area situation?
- How can the CEE countries financial, fiscal, banking and economical current context be judged in the eyes of the accession process?
- Is there an opportunity for accelerating the process and what would be the result of such a choice for the zone and the concerned countries?
- Finally, I will devote some paragraphs to the specific case of the United Kingdom whose situation is of course very different from that of the CEE countries but for which the question of integration is also raised.

2) The question of the euro area homogeneity and of its optimal or non-optimal nature has been asked right from the single currency's creation. Such an issue was not really debated during the preparatory period as it was for a long time assumed that only a small number of countries – mainly, Germany, France, Belgium, the Netherlands, Luxembourg – would join the euro at the first stage. The situation seemed to have changed when eleven countries were finally considered as compliant for the single currency introduction, some of them having led very strict and courageous policies in order to meet the criteria for admission.

There is no shortage of arguments to support the view that the zone is rather heterogeneous: double or triple level differences in the per capita GDP exist; strong differences in the growth rates, shares of the banking and financial sector in the economy; inflation rates; differences in the financial structures and in economic agents' behaviours which cause unequally rapid and effective transmission channels of the monetary policy.

But beyond the negatively connoted view of a non-optimal area, one has to assess the real impact of these discrepancies on the stability of the global area.

Divergences are mainly the fact of small countries whose weight in the GDP of the total zone is small. The extreme levels of GDP per capita are those of Luxembourg, or Ireland, and Portugal. At the end of 2007, the widest inflation gaps were also observed in relatively small countries, except for Spain. Similarly, only one country, Ireland, was characterized by a larger than average banking sector weight. If one considered the block of the largest economies (Germany, France, Italy, Netherlands, Belgium), which represented 75% of the global GDP, per capita GDP and inflation rates gaps have been very small.

Therefore, if the relative heterogeneity of the zone may be a handicap for some countries it doesn’t endanger the global stability of the area.

The financial and banking practices applied in Ireland and Spain, which strongly differ from those applied in the other countries, have been more serious. The use, on a large scale, of diabolic Anglo-Saxon practices like indexed credit interest rates and sophisticated instruments has objectively strengthened the bubble formation, its brutal collapse and the dramatic banking system problems in Ireland.

3) All monetary integrated zones are non-optimal areas. In France, the pure economic logic would imply the “Ile de France” currency to be different from the “Creuse” currency. But a unified economy and a common budget contribute to overcoming these divergences in mutualising the assets and handicaps of heterogeneous regions. In the euro zone, the sole instrument devoted to such a mechanism is the Stability and Growth Pact. But with the Pact, compulsory individual discipline (the non-respect of which can cause penalties) is making up for fiscal transfers that a federal budget allows. In other words, governments which respect the main heart of the Pact, that is to say the obligation to have balanced and even positive budget results when the economic situation is good, benefit from spontaneous resources when the economy is worsening.

So the current crisis admittedly caused market suspicion vis-à-vis countries like Ireland or Spain whose fiscal policy had been sound but in which the bursting of the bubble suggests dramatic deterioration of the fiscal situation (in Spain, a surplus of 2.7% of GDP in 2007 would be replaced by a 6% deficit in 2010). But markets are also punishing countries like Greece, Portugal, Italy and even France to some extent, less affected by the crisis but in which the poor respect of the Pact and the current high level of debt suggested very difficult future evolutions with the spontaneous impact of the recession on public finances. As a consequence, spreads on the ten year debt vis-à-vis the Bund rate are now for the three first countries respectively 252, 127, 128 basis points, when they were insignificant six months ago.

Should we conclude that the euro zone does not resist to the crisis? In my view it is not the case. To some extent one has to ask if it was not the previous situation which was abnormal. What has been called the “euro shield” consisted in all member states of benefitting from the credibility of the better-rated countries, with spreads sometimes not exceeding 15 basis points. It is not surprising that such a situation changes with the crisis. The shield is bending but not breaking as shown by the current long term interest rates in some European non-euro area members whose fiscal situation is not worse than in some member states.

4) But a stronger deterioration cannot be excluded and the absence of a solidarity mechanism could be more felt than during the past.

The proposition for creating a common European agency which would borrow collectively for all member states is probably doomed to failure. Indeed, if such an entity would lower the interest rates paid by the downgraded countries, it would probably increase the interest paid by the best signatures.

On the other hand, the existence of a mechanism for rescuing countries facing serious difficulties seems necessary. Currently, an intra-European entity devoted to this purpose does not seem to be accepted by all member states since bailing out is prohibited in the Maastricht Treaty and since such an apparently quasi automatic mechanism could create moral hazard behaviours (but is it possible to free oneself of moral hazard when one rescues banks and invoke it for states?). In any case, case by case approaches seem to be favoured, as shown by the French/German press release at the end of the last meeting of the two countries' finance ministers. Whatever the adopted solution, it is crucial for the concept to have sufficient visibility and credibility so that all observers and analysts can be convinced that the zone has the willingness and the effective means for resolving its own problems itself. It would be disastrous for its credibility if a member states would be obliged to ask for the assistance of the IMF.

5) Concerning the positions of the CEE countries in view of an eventual accession to the euro zone, the strict assessment of the respect of the criteria delivered, before the crisis, mixed results.

Except in Poland, inflation was in all these countries well above the average price increase in the euro area. Hence, in last July, while euro zone inflation was 4%, prices increases of 6.8% were observed in the Czech Republic, 7% in Hungary, and between 12 and 16% in the Baltic States.

Fiscal situations were more mixed. The Baltic countries, and more or less, the Czech Republic were in a relatively good situation for the budget balance, while Poland was on the verge of the criterion, and Hungary clearly above the 3% limit (5%). This country was also exceeding the 60% of the GDP limit for the debt while other countries were below.

But most of these countries were showing often huge current account deficits: 6,4% of the GDP in Hungary, 18,5% in Estonia, 22,5% en Bulgaria, “only” 4,6% in Poland. Admittedly, the current account balance is not a criterion for the admission in the euro zone but excessive imbalances reveal severe macroeconomic disequilibria.

Except for the Baltic countries whose currencies joined the ERM 2 and to a certain extent Bulgaria, other states have suffered from wide exchange rates fluctuations, with, for instance in 2008, 15% and 16% depreciations of the Hungarian Forint and of the Polish Zloty.

Finally, the Czech Republic (which did not seem urging for joining the euro), and the Baltic states could be considered to be in a situation of joining the zone within a reasonable time table (that is to say 2 or 3 years) provided they do serious effort for reducing their inflation.

6) But, beyond the formal aspect of the criteria, strong reasons were advanced for arguing that the accession of most of these countries was, at the best, a medium-term horizon problematic.

Real convergence was improving but remained very far from what would have been needed for belonging to a relatively high income monetary zone. On average, the per capita GDP of these countries is 50% of the euro area level, while in the zone only one relatively small country has a per capita GDP below 75% of the area level.

In the financial sector, it is obvious that banks, even owned by euro zone financial institutions don't reach the level of solidity and governance requested by the "Copenhagen Criteria" as these criteria were assessed with more political than technical bias when these countries joined the EU. In addition these banks are promoting on a large scale foreign currencies operations (mainly in dollar and euro) with their domestic customers.

Another source of concern is the relative fragility of the growth factors: a disastrous demographic situation is worsened by a low activity rate (58 % on average against 64% in the euro area). So the potential growth is almost exclusively resulting from investment and productivity. Equipments are largely financed by banks and foreign investments whose stock can reach 60% and even 95% of the GDP, a situation which can be bearable when things are fine but which becomes very fragile when things worsen.

Finally one must observe that these countries don't seem to do great efforts for their future as they devote only 0.76% of their GDP to R&D (1.90% in the euro zone).

In its annual report for 2007, the BIS was noting this alarming weakness and concluded that, with a saving deficit of 4.4% of the GDP in the 3 largest CEE countries (14% for the others), annual foreign investment reaching in some countries 8% of the GDP (3% in France, and in the euro zone), and foreign currencies debt between 60 and 120% of the GDP (with spreads on three years CDS above 400 points for most of them), CEE countries were already on a high level risk scale.

7) The current crisis is causing a violent deterioration of the situation of the CEE countries as foreign investments flows turn around, exports dramatically decrease and financial situations of economic agents are worsened by the fall in the currencies exchange rate. In most of these countries, the growth is supposed to drop from more than 5% compared with its present variation rate, with a sharp decline in investment and strongly rising public debts.

Facing these evolutions two opposite conclusions can be made

- Considering the fragility of these countries which could be a factor of an explosive evolution with general impoverishment, banking system collapse and quasi state bankruptcy, and insofar as a fall of the exchange rate of the currencies is an important factor of worsening, the best preventive solution is to integrate at least some of these countries in the euro zone in order for them to benefit from the euro shield.
- Inversely, one can argue that the present context does not change the fact that these countries could not endure the constraints of a strong currency, with probably an unemployment explosion and that the medicine would be worse than the trouble. Indeed, different from the ex GDR, these countries would not benefit from compensatory mechanisms provided by a centralized national budget.

Furthermore an early accession of some CEE countries to the euro zone would imply, whatever procedure was applied, to put the criteria aside, or for using a more diplomatic expression, to assess their compliance with flexibility. Moreover, a leader of a great CEE country clearly asked for this in a recent statement: those who plead for this solution argue that there is no more justification for requiring the respect of the criteria from the new members since the criteria are currently broken by almost all member states. But these member states respected the criteria when they joined the zone and until the second half of 2008, almost all member states were respecting the criteria. In addition one can imagine that it would be very difficult in the future, if not impossible, to ask member states to have credible plans for restoring their public finance soundness, if these criteria were officially broken.

In addition, the euro zone is a single currency and a single monetary policy area. It is already observed that in the present limits of the zone, monetary policy has not the same effectiveness everywhere as, in some countries with relatively high inflation rates, real interest rates are lower than in the others, and even sometime negative. With the integration of countries which currently have inflation rates between 6 and 16%, monetary policy would become very difficult to manage.

Finally, and even if CEE countries represent less than 10% of the global euro zone GDP, one can fear that their early integration would destabilize the zone by its brutal and totally off-norms characteristic. The euro would be durably and structurally weakened as, unlike the dollar for which fits of weakness are never fatal, the European currency has not the same political, diplomatic and strategic assets. This weakening would globally impoverish the euro zone citizens, and would not at all be an asset for facing the crisis as the worldwide demand is falling. In addition the currency depreciation would probably contribute to damage the effective competitiveness of the zone which would be handicapped when the recovery would occur.

7) In spite of these arguments CEE countries must be strongly helped.

If responsibility for facing the crisis is firstly in the competence of the CEE countries' governments with adequate measures (others than reducing the civil servant salaries which is the best means for introducing a deflationary process!), these countries must count on the other EU governments' solidarity.

The ECB already granted euro credits to Hungary. It is obvious that renewing such operations would show evidence that CEE countries are not let alone for facing exchange rate crisis.

The European Commission already engaged 6 billion euros in favour of these countries and emphasises that the management of such a crisis is not within its competences, but instead within the IMF ones. On has to ask about the pertinence of such a position, caused by the fact that these states issue national currencies. It would give a very bad signal as it would show that Europe is unable to conceive a rather large scale solidarity scheme. One can estimate that the integration of most of the CEE countries into the EU was premature, but now it is necessary to assume the collective responsibility of the Union. For the moment, it seems that the rescue projects have to be concentrated in favour of the CEE banking system (with the assistance of the EIB and of the EBRD), as some euro member countries banking sectors, mainly, Germany's and Austria's, are heavily engaged in CEE banks. But the question of rescuing states can be asked in the future and, once more, on this question, it would be damageable for Europe to abandon the file to the IMF.

Coming back to the question of accession to the euro zone, if an early accession with flexible assessments of the criteria would be a wrong response, it would be good to give to the markets and the observers a clear message about a timetable for the integration of these countries. As it was undertaken for the introduction of the single currency, one can imagine to determine two appointments (which could be different for each country), in order to assess the ability for adopting the euro, the second being considered as the ultimate date. Such a procedure could be a good way to recall that joining the euro area is, according to the Treaty, a duty for these countries.

8) The question of the accession of the UK to the euro area is arising differently than that regarding the CEE countries.

First, the UK has an opt-out clause in the Treaty and, consequently, is not obliged to adopt the euro as the other members of the EU are (except Denmark and the Swedish). Secondly, its government did not express any intention to join the euro zone (a large majority of the UK citizens are presently against such an issue). Thirdly, the economic and financial situation of the UK is very serious but the country does not show the fragility symptoms which characterise the CEE countries: importance of the foreign investments, local banks operating mainly in foreign currencies, strong dependence on the other European countries' demand and industry.

Yet, a lot of economists have recently raised the question of an accession, some pessimistic analysts even argue that the UK could become rapidly a gigantesque Iceland. It is of course an exaggerated worry but some elements could justify the question to be raised.

First, the monetary freedom of the UK had until the end of 2008 had become rather theoretical. It has been calculated that since 2002 the pound variations on the exchange market have been bound to the euro fluctuations in a proportion of more than 90%. This dependence was apparently broken for three or four months but the new situation is worse with a sharp depreciation of the currency (the euro/£ rate has risen from 0.70 to 0.90). How to assess this evolution? For some analysts, it is a good thing and will allow the UK to improve its exports and so limit the crisis impact. We consider it is a wrong opinion, for we are no more in the thirties as some analysts seem to believe. In the sixties and the seventies, things have already changed and the frequent UK uses of the depreciation of its currency for trying to overcome its economic problems gave very poor results for growth and a negative incidence on industry which lost competitiveness and attractiveness in becoming more and more “banal”, while the country was dramatically impoverished.

It is obvious that an important element of the rise of the British economy at the end of the nineties and during the first years of the century has been the solidity of the pound. So, from this point of view, the UK would take interest in joining the euro area in order to benefit from a solid currency.

Secondly, and this element is closely linked to the previous, the size of the recession and the expenses already engaged for rescuing banks will cause a massive deterioration of the fiscal position (a deficit of 8% of the GDP is forecasted for 2009). A part of this deterioration is perhaps temporary if the government manages in the future to sell its shares in banks capital provided the situation of these banks improves. But during a relatively long period the UK will be in a delicate situation vis-à-vis the markets and could suffer from a heavy downgrading of its signature with unfavourable consequences for the long-term interest rates. Such an evolution would be of course softened if the UK could benefit from the euro shield.

In addition, it could be argued that an accession would give the exchange rate anchor which the UK has missed since it left the EMS, and has obliged the central bank to implement a special monetary policy with interest rates permanently higher than in the euro zone.

Finally there are relatively strong arguments in favour of a UK accession, furthermore since the crisis, whatever its conclusion, will probably contribute to reduce the relative importance of the financial sector in worldwide activity and, in this way, weaken the UK specificity.

But there are arguments against a UK accession. The first is that the country does not, by far, respect the criteria, especially in the fiscal field. The second is that it would be very difficult to determine what could be the good exchange rate of the pound against the euro. The third is not politically very correct but is obvious: even if a British government succeeded in convincing financial circles and the opinion of joining the euro zone, it is not assumed that the euro member states would be enthusiastic about this prospect (even if they declare they would be very pleased), as the off norm character of the UK could create governance problems in the Eurosystem and perhaps, considering the importance of the London financial centre, reassess the widely decentralized framework of the monetary policy implementation.

Implications of the current crisis for euro zone enlargement

Briefing Paper for the Monetary Dialogue of March 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Norbert Walter

Executive Summary

In all candidate countries for the European Monetary Union (EMU) the economic crisis has increased the willingness to join EMU. This holds true for Central and Eastern Europe (CEE), but also for Denmark and Sweden. The fact that some EMU members are suffering from the impacts of the global financial and economic crisis does not blur the view held by EMU candidate countries that EMU is a *safe haven*.

However, not every EMU candidate seems to be adequately prepared for EMU membership in terms of structural reforms and stability culture. This does not hold true for the Czech Republic, Denmark, Poland and Sweden. In some CEE countries the will to join EMU is driven by short-term needs stemming from risks to financial stability.

Well positioned EMU candidates like the Czech Republic, Denmark, Poland and Sweden should benefit from fast EMU entry. EMU entry of those well positioned EMU candidates could strengthen the stability orientation within EMU.

EMU entry and EMU membership does not solve structural problems. As structurally weaker EMU candidates from CEE are suffering from the same structural weaknesses as some current EMU members a fast EMU entry would not solve their structural problems. EMU entry without proper preparation might even turn out to be a risk factor for those countries given their strong focus on catching-up to EU levels. However, structurally weaker EMU candidates might profit from a credible catch up strategy to EMU and the needed stability-oriented policies.

For the EMU, eastward expansion would primarily have noticeable institutional implications. The European Central Bank (ECB) will switch to a rotation system should EMU membership exceed 18 member states. Economic implications for EMU itself as well as the ECB's monetary policy will be negligible. Apart from that, some EMU insiders with a strong export or banking sector exposure to the CEE countries might benefit most from eastward EMU enlargement.

EMU enlargement assessment should focus on sustainability issues. Focusing purely on the nominal Maastricht criteria will cause disincentives, as one-off compliance with numerical rules becomes important – and not sustainable compliance. This might bring further structurally weak and unprepared economies into EMU that might suffer afterwards. A stronger focus should be attached not only to the sustainability of Maastricht compliance but also to the sustainability of the external position as an indicator of international competitiveness. The latter has been neglected for years in some EMU members as well as in some EMU candidates.

Outline

Europe's economy is suffering from the impacts of the global financial and economic crisis. Both the real economy and the financial markets are affected substantially. This has implications for the economic performance of the member states of the European Monetary Union (EMU) on the one hand and the aspirations of EMU candidate countries on the other.

As regards EMU candidates, the economic crisis has increased the willingness to join EMU - not only in Central and Eastern Europe (CEE), but also in Denmark and Sweden[1]. In the cases of Sweden and Denmark there is no need to catch up due to the high degree of development in relation to EMU as well as developed stability cultures. In contrast, economic conditions among the CEE countries differ greatly. For those countries that show a low degree of economic development and economic stability a rush into EMU is a double-edged sword.

The situation in the current EMU member states paints a different picture. Increasing economic tensions mirror accumulated differences in competitiveness as well as large differences in fiscal discipline and the quality of public finances.

This study will address the questions asked in the tender by examining two leading questions in the framework of two sections:

- The first part will outline the implications of the current crisis for EMU candidates and EMU insiders.
- The second part will focus on the consequences of EMU enlargement for EMU outsiders and EMU insiders.

The leading question of each part will be answered from two perspectives: The perspective of EMU candidates and the perspective of EMU insider countries.

We will argue that the EMU candidates' uniform will to join the *safe haven* of EMU is not backed by uniformly solid economic conditions and EMU readiness in terms of international competitiveness. Moreover, we will show that within the *safe haven* of EMU, economic conditions differ significantly, too.

Part One:
Implications of the current crisis for EMU insiders and outsiders

Among the EMU accession candidates, but also within EMU, the current economic crisis has supported the view that EMU is a *safe haven* for EMU candidates and provides a *safe shelter* for EMU insiders. But the uniform picture of both *safe haven* and *safe shelter* does not seamlessly apply to reality. A closer look shows that a simple differentiation between "*relaxed EMU insiders*" and "*desperate EMU candidates*" misses the point: We see divergences in the impact of the economic crisis within EMU and at the same time different economic positions among the EMU candidates.

[1] EMU candidates covered within this study are Denmark and Sweden as well as the eight remaining EMU outsiders from CEE (i.e. Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Romania).

a) EMU candidates: Crisis influences EMU entry strategies

For all current EMU candidates, the economic crisis is shifting their policy preference towards stability. For all new member states (NMS) from CEE **stability arguments are increasingly significant** as the immediate effects of the financial crisis have been substantial. Even less vulnerable CEE countries like the Czech Republic and Poland, which are not exposed to strong macroeconomic vulnerabilities and economic imbalances, experienced extreme exchange rate volatility.

Free-floating currencies of EMU candidates have depreciated strongly. Hungary and Romania needed massive external financial support to avoid a full-blown financial crisis. Latvia also needed a massive international support package to preserve its currency peg. Hungary, Romania and Poland experienced strong sell-offs on their local bond markets as investors were shied away from the sovereign and currency risk. Banks in CEE (especially those without foreign ownership) were unable to secure funding in foreign currencies as swap markets in the CEE currencies became illiquid. The national banks of Hungary and Poland signed swap lines with the European Central Bank (ECB) and the Swiss National Bank to secure foreign-currency liquidity in their financial systems.

In contrast, the recent smaller EMU entrants like Cyprus, Malta, Slovenia, and Slovakia clearly felt the shelter of EMU membership, which provided them access to euro capital markets. Especially, EMU membership of the regional peers Slovenia and Slovakia (based on well prepared EMU entries backed by sound past wage and fiscal policies) increased political pressure to speed up euro adoption in CEE – regardless of the fact that some other EMU insiders are also under strain currently. Therefore, strategies like that practiced by Sweden (i.e. intentionally not fulfilling the Maastricht criteria) have lost their attractiveness.

Given the repercussions of the global financial crisis in CEE, we think that all CEE countries will be keen to join EMU sooner rather than later. They have realized that adopting the euro is superior to any other monetary policy option available over a medium-term horizon. Moreover, the CEE economies can take it on a positive note that their prospects of fulfilling the nominal Maastricht criteria (especially the inflation criterion, which has been the stumbling block in the past) will likely improve in the years ahead. Therefore, the incentives for politicians to speed up euro introduction in the NMS from CEE will be great. Accordingly, the uptick in the preferences to join EMU is much more crisis-driven in CEE than in Denmark or Sweden.

Leading countries: Crisis has motivated quick accession plans – so far.

Structural preconditions for joining EMU differ significantly among the remaining EMU outsiders from CEE. Countries like the Czech Republic and Poland pursued sustainable growth and disinflation policies based on **external sustainability**, including **international competitiveness**, over the last few years. **Current account deficits** were manageable. From a regional perspective, wage and price flexibility are among the highest in these two countries and **unit labour cost** growth has remained moderate in relation to the EMU average and in relation to other CEE countries. The signal function of prudent public-sector wage growth supported wage settlements in line with productivity growth within the entire economy. Thus, the Czech Republic and Poland are among those CEE countries (including Slovakia and Slovenia) that have increased their market shares in total world imports substantially over the last few years. Moreover, **fiscal prudence** is in place in the Czech Republic and Poland. Central banks and political elites have followed **stability-oriented policies**, including fruitful cooperation with each other, while respecting central bank independence.

Hence, despite the economic crisis, the Czech Republic and Poland are in a relatively good position to fulfill the nominal EMU entry criteria. The risk of speculative attacks against their currencies (i.e. the Czech Koruna or the Polish Zloty) within the Exchange Rate Mechanism II (ERM II) can be regarded as low.[2] Stability-oriented macroeconomic policies would allow for gradual exchange-rate adjustments within the +/- 15% ERM II fluctuation band (at least under normal financial market conditions). In case parity changes will be needed, they could probably be carried out in an orderly way. From this perspective, the smooth participation of Slovenia's and Slovakia's currencies in the ERM II is an encouraging precedent - although these currencies are not as voluminously traded as the Czech Koruna or the Polish Zloty.[3]

Heterogeneous labour cost development reflects changes in relative competitiveness

Index: 2000 = 100

	2000	2005	2006	2007
EU-27	100	120.0	123.6	128.1
EMU 12	100	116.2	119.0	122.1
EMU:				
France	100	118.2	122.2	126.3
Germany	100	109.8	111.6	112.9
Greece	100	127.7	137.6	142.6
Italy	100	116.2	117.2	119.5
Portugal	100	119.9	121.9	126.7
Spain	100	125.7	130.7	136.0
EMU and CEE:				
Slovakia	100	157.5	169.2	182.1
Slovenia	100	143.5	152.5	160.7
CEE:				
Bulgaria	100	132.0	139.2	162.9
Czech Republic	100	142.1	151.1	162.5
Estonia	100	163.8	191.4	230.0
Hungary	100	161.2	175.7	192.4
Latvia	100	162.3	200.2	260.9
Lithuania	100	127.5	151.0	182.5
Poland	100	136.8	144.8	161.1
Romania	100	286.0	340.4	412.2

Source: EUROSTAT

2 In the case of the speculative attacks against the British Pound during its participation in ERM I in 1992, the floating band was narrower and the duty to intervene by other participating central banks was less explicit than in the current ERM II arrangement with its wide standard fluctuation bands and the European System of Central Banks (ESCB) as a main counterparty.

3 Moreover, some modification of the exchange-rate criterion (i.e. to allow revaluations on the stronger as well as on the weaker side) might strengthen the function of the ERM II as search engine for the most appropriate exchange-rate and as clear indicator of the quality of national policies. The current reading of the exchange rate criterion considers a revaluation of the central parity on the weaker side to be a breach of the criterion. Thus it would push out EMU membership for at least two more years after devaluation.

Given their sound economic position the Czech Republic and Poland are those two NMS from CEE that certainly have a credible perspective for successful EMU entry in the next few years. In fact the Czech Republic or Poland compare favourably with structurally weaker EMU economies (like Portugal or Greece). For instance fiscal prudence is on the top of the policy agenda in both countries. This underlines that sound economic policies are not a question of being an EMU member or not. Thus, the Czech and Polish willingness to join EMU will not be affected by the current problems of structurally weaker EMU member countries.

Inflation rate: catch-up dynamics apply

Harmonized indices of consumer prices (HICP), geometric mean

	2000-2004	2004-2008
EU-27	2	2.4
EMU 15	2.2	2.3
EMU:		
France	2	2.1
Germany	1.5	2.1
Greece	3.4	3.4
Italy	2.5	2.4
Portugal	3.3	2.5
Spain	3.2	3.4
EMU and CEE:		
Slovakia	7.2	3.7
Slovenia	6.6	3.4
CEE:		
Bulgaria	5.7	7.6
Czech Republic	-1.4	2.8
Estonia	3.2	5.2
Hungary	6.9	5.4
Latvia	3	8.5
Lithuania	-0.9	3.8
Poland	3	2.6
Romania	23	7.7

Source: EUROSTAT

Public opinion as regards euro adoption has turned more favourable in the Czech Republic and Poland in recent months. It might turn negative again when financial markets and economic conditions normalize and safe haven arguments will become less relevant. Moreover, the Czech Republic and Poland have not been hit as hard by the financial crisis as other CEE economies. In the context of the financial crisis **spreads on credit default swaps (CDS)** or **Eurobonds** of well positioned EMU candidates like the Czech Republic and Poland (or EMU members from CEE like Slovakia and Slovenia) even inched below the CDS spreads or bond spreads of the most strongly hit Western European EMU members like Ireland, Greece or Portugal.

Given their solid economic position the Czech Republic and Poland are likely to participate in the recovery of the European economy in the years ahead. Moreover, the Czech Republic and Poland perceived the Maastricht criteria as too strict for catching-up economies over the last few years. Both countries have shown that they can achieve real GDP growth rates of 4-5%, with annual inflation rates of 2-5% without a deterioration of macroeconomic stability and public finances – provided that external sustainability and a stability-oriented policy consensus prevails. The attractiveness of EMU for those well positioned EMU candidates might suffer from uncertainties regarding the future of the Stability and Growth Pact (SGP). The Czech Republic and Poland have always voiced concerns over strong fiscal loosening in EMU member countries.

The laggards: Without structural and fiscal discipline, quick EMU-accession is no panacea

The group of the well performing EMU candidates stands in contrast to a bigger group of reform laggards comprising countries like the Baltics, Bulgaria, Hungary and Romania. Those countries pursued **unsustainable growth models** marked by excessive **current account deficits** and **wage expansion** (in particular strong public-sector wage growth) that was **not mirrored by productivity growth**, which impacted negatively on the whole economy. These countries feature the largest current account deficits, the most rapid wage increases and the highest inflation rates among the CEE economies and within the EU. Hungary is a poor performer in terms of **public deficits**.

Due to their **weak external competitiveness** the Baltics as well as Bulgaria and Romania have failed to post significant gains in their market shares in total world imports over the last few years. Nevertheless, EU entry was associated with a certain living standard. But the catch-up to EU levels was mostly credit-financed, while most of the household credit expansion for consumption purposes was externally financed on international capital markets. This growth model based on low savings, high consumption, strong capital inflows and strongly increasing external indebtedness lacks sustainability. Moreover, subprime-style lending elements had been visible in some countries as low-income groups are heavily burdened with consumer and mortgage loans.

Thus it is not surprising that the **stability benefits of EMU accession** are strongest for CEE countries with greater need for macroeconomic and structural reforms.

Current account balances
average % of GDP (year over year)

	2000-2004	**2004-2008**
EMU:		
France	1.3	-0.7
Germany	1.4	6
Greece	-6.4	-10.5
Italy	-0.7	-2
Portugal	-8.4	-9.7
Spain	-4	-8.2
EMU and CEE:		
Slovakia	-4.8	-6.1
Slovenia	-1	-2.5
CEE:		
Bulgaria	-5.1	-16.7
Czech Republic	-5.4	-2.5
Estonia	-8.9	-13.2
Hungary	-7.6	-7.2
Latvia	-13.7	-34.8
Lithuania	-6	-10.9
Poland	-0.9	-1.1
Romania	-5.1	-10.5

Source: EUROSTAT

Although, the Baltics, Bulgaria, Hungary and Romania are willing to join EMU quickly, EMU entry without proper preparation in terms of structural reforms and proven stability would result in similar experiences to those EMU insiders currently under severe strain. Major economic imbalances that need to be corrected in a medium-term perspective should be reduced or at least on a declining path before ERM II membership. Entering the path to EMU without some adjustment of economic imbalances increases the risk of speculative attacks in the framework of the ERM II.[4]

In the case of the Baltics there is a strong political will to accept painful necessary adjustments (e.g. wage deflation via real wage cuts). Thus EMU readiness of the Baltics might improve in the years ahead, while these countries have now been ERM II members for years. However, the financial crisis also showed that there is no safe "fast-track" to EMU based on financial stability reasons.[5] In contrast, in the cases of Bulgaria, Hungary and Romania current efforts to reverse past policy faults and to speed up euro adoption are mainly **crisis-driven** stemming from **systemic risks to financial stability** due to the widespread use of the euro in their financial systems.

To summarize, we think that the problems in structurally weaker EMU countries that became apparent in the context of the financial crisis should be a warning sign for EMU outsiders to rush into EMU only after proper preparation. EMU entry does not solve structural problems at the country level. EMU entry should not be seen as a purely political process without a deeper understanding of the need for prudent macro policies and appropriate wage discipline. However, a window of opportunity for decisive reforms might open up as a result of the economic crisis. For example, the presence of IMF Stand-By agreements may act as a catalyst for stability and reforms.

b) EMU insiders: Crisis discloses structural weaknesses and need for reform

Not only EMU candidate countries are affected to different degrees by the crisis – a different economic impact also prevails among the current EMU members: The shock of the economic and financial crisis has hit the economies of EMU in a highly asymmetric manner. Whereas some countries faced **shocks** to their global and European export markets (e.g. Germany, France), other countries (e.g. Austria) faced increased risk exposure as regards their investments in the financial sector of CEE and CIS countries strongly affected by the financial crisis. Another group of countries (e.g. Spain, Ireland and the UK) suffered domestic problems such as the collapse of the national real estate markets which was even amplified by the global drop in asset prices.

[4] Although ERM II membership has some disciplinary effects it should be seen as period of fine-tuning. Far-reaching reforms with time-delayed and uncertain outcomes have to be implemented before. ERM II was not designed as purely legal requirement, but as a training room to test whether a country could cope with a system of fixed exchange rates while being already close to overall EMU readiness.

[5] In the wake of the Latvia bail-out it was discussed to allow the country directly into EMU (i.e. immediately after a currency devaluation to bring down external imbalances). However, EU authorities opposed such a move, given its inconsistency with the Maastricht Treaty and its potential to set an example with moral hazard implications. For more details see IMF (2009). *Republic of Latvia: Request for Stand-By Arrangement*. Country Report No. 09/3, January, p.26-27, Washington.

Most relevant from an EMU point of view is a changed risk perception of international investors regarding the sustainability of public finances in some countries and their implications for state refinancing costs. **Widening sovereign bond and CDS spreads** in the EU indicate growing concern over some countries' ability to (re)finance their debt amidst the economic recession, bold fiscal stimulus packages, rising contingent liabilities from the banking sectors and high risk aversion of investors. Greece, Ireland, Italy, Portugal and Spain have seen the biggest widening of spreads so far.

Surging **government borrowing** is still an issue, as net borrowing, i.e. budget deficits, and accordingly gross borrowing is rising strongly across the board in the EU. Some countries are being hit particularly hard, though according to EU estimates, the increase is particularly strong in Ireland (from a surplus of +0.2% of GDP in 2007 to -11% in 2009), Spain (from a surplus of +2.2% of GDP in 2007 to -6.2% in 2009) and the UK (from -2.7% to -8.8%).[6] Nevertheless, neither the exit of a member state nor the break-up of EMU is a rational scenario, as exit costs would be prohibitive.

Widening spreads show that structural differences within EMU continue to exist and that it would be wrong to assess EMU as a "*fortress of goodness*". Some EMU insiders would not pass the Maastricht examination today, neither in a legalistic interpretation of the Maastricht thresholds, nor in an assessment against the "soft" criterion of sustainability.

Beside fiscal aspects, increasing internal **tensions in relative competitiveness** are putting EMU to the test. Countries such as Germany have continued to perform well in fiscal terms – despite recent burdens on public finance. In parallel, they kept their economy competitive by effective cost cuts. This development is reflected in the development of unit labour costs and current account balances, which are depicted in the adjacent table. Strong **current account imbalances** between individual members are not a problem for monetary policy purposes as the aggregate EMU current account has been more or less balanced in the past years. They point, however, to severe structural problems in those countries facing the deterioration of their current accounts. To some extent, the divergence of the member states' current account balances also mirrors the disparate developments in **unit labour costs** since 1999. Tellingly, the low commitment to implement fiscal reforms in the countries referred to above is accompanied by a lacking will of structural reforms in order to increase competitiveness. EMU insider countries which had been sluggish in their fiscal policies also feature a relative deterioration in their competitiveness and external position.

These examples show that the economic crisis has hit differently prepared countries within EMU. In the short run, differences in real competitiveness will prevail, and any compensation therefore at the EU level is unrealistic. Against this background, EMU is indeed a safe haven. Nevertheless, this safe haven has to be continuously defended by peer pressure on poor performers to finally carry out urgently needed structural reforms and measure up in terms of competitiveness.

[6] Concerns over rising refinancing requirements have also mounted. As a percentage of GDP, gross borrowing requirements are the highest in Ireland, Belgium, Italy and Portugal (over 20% each). Furthermore, the markets have questioned the sustainability of fiscal policy given high government debt, especially in Italy (109% of GDP) and Greece (96%).

EMU as a s*afe haven*? It's up to the candidates and member states

The considerations above underline the central challenge of EMU which has not yet been solved: Centralized monetary policy meets decentralized fiscal policies, differing national stability cultures and different levels of reform-mindedness. Without the possibility to use the exchange rate as a means to compensate for (price-)competitive weaknesses, the member states will suffer from competitive disadvantages as long as they do not measure up with their peers in terms of structural reforms.

Regarding the challenges of the current economic crisis, the final success of EMU as a safe haven is up to the member states and EMU candidates. Some EMU members as well as EMU candidates face the same challenges – though with different intensities. Both structural reforms and fiscal consolidation are the key to stronger cohesion - both within EMU and between EMU and the candidates. Although structural EMU readiness is not directly covered by the explicit (nominal) Maastricht assessment, it should not be underestimated as shown by the current repercussions within EMU. For the candidate countries, this means that they should themselves determine their accession strategy backed by necessary reforms. From this point of view, EMU accession could become an important catalyst for institutional reforms in the accession candidates.[7]

Most political agents are fully aware of the necessary economic adjustment processes in some EMU candidates from CEE. These adjustments range from macroeconomic stabilization to bringing down large-scale economic imbalances to questions like overall competitiveness and stability-oriented policies. These adjustments might even be prolonged due to negative impacts of the economic crisis.

Part Two:
Consequences of EMU enlargement

a) Consequences of euro adoption for new member states

As outlined above, the effects of the adoption of the euro in the NMS depend on the preparations carried out by the respective country. This implies that for NMS from CEE with sufficient **structural preparation** and **stability culture** medium-term risks from price level convergence, which might translate into an above-EMU-average inflation rate and thus a loss of international competitiveness with EMU, are manageable. Moreover, the potential impact of the Balassa-Samuelson effect should not be overestimated there.[8] Countries like the Czech Republic and Poland have shown that strong productivity growth in the services sector can counterbalance the Balassa-Samuelson effect. Moreover, well prepared EMU candidates should be able to secure appropriate conversion rates that will secure some dampening effect on inflation in the initial period after EMU entry. All in all, well positioned NMS should experience net positive effects from EMU membership due to their full integration into the Single European Market:

[7] Moreover, against the background of demographic change and its implications for fiscal policy, reforms of the social security systems are all the more necessary.

[8] Catching up to the income levels of more advanced countries is driven by productivity gains stemming from increases in both capital-labour ratios and total factor productivity. As these gains are faster for tradables than for nontradables and wages in the tradables sector rise with productivity, they also bid up wages in the nontradables sector. To maintain profit margins, nontradables' prices must increase relative to those of tradables (cf. Becker, W. and Mühlberger, M. (2006). *Estonia, Lithuania, Slovenia: Poised to adopt the euro.* EU Monitor 33, Deutsche Bank Research, Frankfurt).

- Currency risks will be eliminated, while the euro itself is much more immune to excessive currency swings.
- Price transparency and competition in the domestic market will increase, which should translate into productivity growth effects.
- States and firms have access to euro capital markets, which results in cheaper financing as well as an improved availability of capital (especially equity capital for companies)
- Intercompany integration within European production networks will increase. This might improve the production factor mobility and thus increase productivity.
- Negative effects of EMU entry should be minimal as the degree of monetary policy independence has been limited for most EMU outsiders anyway: In the case of the CEE countries currency pegs and/or widespread use of EUR and CHF in bank operations, the still low credit-to-GDP ratio as well as the strong presence of foreign banks (mostly from EMU countries) limit the independence and effectiveness of domestic monetary policy.

However, the overall net positive effects of euro adoption for structurally stronger CEE economies should not be overestimated as these countries are already highly integrated with the EMU both economically and financially.

For structurally weaker EMU candidates the medium-term effects of euro adoption (without) sufficient reforms are a double edged sword. Many of the structurally weaker economies need substantial wage deflation (i.e. strong real wage cuts) to restore their external competitiveness in the absence of nominal exchange rate depreciation. For such economies – some with currency boards in place - EMU membership should not be seen as a panacea. On the other hand, the costs of no reform, with or without EMU, will likely be very high.

However, structurally weaker economies could profit from a credible convergence perspective to the EMU. Those countries would profit from the benefits of monetary and economic stabilization needed prior to well prepared EMU membership. Sustained interest rate convergence would also help solve their foreign currency problems in their financial systems. Foreign currency loans will lose their attractiveness.

b) Consequences for EMU insider countries and EMU institutions

Whereas the economic effects of EMU accession will be considerable for the acceding countries, EMU enlargement will have only small economic effects on the current EMU insiders. Taking the aggregate **EMU perspective**, the influence on EMU monetary aggregates (i.e. the reference for the ECB) will be small to negligible. The effects on the real economy, by contrast, will be more noticeable: At least, those economic sectors with large exposures of their exporting sector or their financial sector in the accession countries will benefit from EMU enlargement. This is due to a reduction of transaction costs and the abolition of exchange rate risk.

From a **country perspective**, the positive effects differ depending on the trade interdependence of the respective insider country with the accession states. This applies particularly to Slovakia as the desired scale effects have not yet materialized to the aspired degree – the country would benefit particularly from EMU enlargement.

The **institutional implications** will be more noticeable. In December 2008, the ECB Council decided to introduce the rotation system only in case the number of member states exceeds 18. EMU states are assigned to two groups on the basis of their share of EMU GDP and the relative size of their financial system measured in terms of aggregate total assets of the financial institutions in EMU. The size of the economies is weighted with a factor of 5/6ths and the size of the financial system with a factor of 1/6th. The first group, consisting of the five largest countries, has four votes and the second group, consisting of the rest of the countries, has a total of 11 votes. The grouping is designed to ensure that the national central bank governors of the first group have the right to vote no less often than those of the second group. The fine-tuning of the groups depends on the actual number and size of the new EMU states. Should the number of EMU member states exceed 22, the rotation procedure will be amended again towards a scheme of three groups.[9]

Conclusions

a) Implications of the current crisis for EMU candidates and EMU insiders

The current economic crisis has clear **implications for EMU enlargement**. Aspirations of EMU outsiders to join at an early date have increased across the board in the context of the economic crisis. However, not all EMU candidates are well prepared for accession. The countries with the best economic and structural preconditions to cope with EMU accession have been hit less hard by the financial crisis than structurally weaker EMU outsiders and some EMU economies. Thus, substantial economic and structural differences persist among the EMU candidates - and among EMU members. The EMU candidates should take a close look at the policy faults made by the EMU members currently under pressure.

Focusing purely on the **nominal Maastricht criteria** may lead to negative incentives for EMU candidates and may bring structurally weak economies into EMU that might suffer afterwards. This is particularly true as some EMU members no longer met the criteria after entry, and the incentive persists to meet the criteria just at the time of assessment.[10] Rather, a stronger focus should be placed on **sustainability** of **Maastricht compliance** as well as

the **sustainability** of a country’s **external position** as an indicator for **international competitiveness**. The latter has been neglected for years in some EMU members as well as in some EMU candidates. Given the harsh repercussions of the crisis on structurally weaker EMU members and EMU outsiders any future EMU readiness assessment should be based not only on the nominal Maastricht criteria but also on an explicit assessment of the sustainability of the fiscal and wage policy mix.[11]

[9] See Becker, W. (2008). *The Euro turns Ten: Growing Up*. EU Monitor 57, Deutsche Bank Research, Frankfurt.
[10] One example is price indexations in order to comply with the inflation criterion, as happened in Slovakia or the postponement of adjustment of administered prices beyond EMU membership.
[11] In the case of Lithuania EU institutions rejected EMU entry in 2006. The rejection was based above all on the outlook for a rise of inflation under the currency board arrangement although the breach of the inflation criterion was only 0.1 of a percentage point. External imbalances as well as strong credit growth were also cited (see European Central Bank (2006). *Convergence Report May 2006.* Frankfurt, p. 7-8).

Not every EMU candidate seems to be adequately prepared for EMU membership in terms of **structural reforms** and **stability-oriented policies**. However, also in CEE countries with weaker positions, the temptation to speed up euro adoption has increased dramatically due to large foreign currency risks within their financial systems and risks to overall financial stability. But such **crisis-driven thinking** based on short-term economic needs should not obscure the risks posed by **structural problems** in some EMU applicants. These structural problems should be solved first. EMU entry of a country that cannot successfully pass the current stages of preparation (including the ante room ERM II) will be beneficial neither for the country itself nor for EMU. In those cases, ECB swap lines or substantial EU participation in joint IMF/EU support packages may be a more constructive way to address crisis-related stability issues.

b) Consequences of euro adoption by CEE countries for these countries and EMU insiders

The adoption of the euro will cause positive effects for the acceding countries. The main advantages for the accession countries are lower financing costs and lower transaction cost due to increased price transparency and the elimination of exchange-rate risks.

For **structurally weaker EMU candidates**, the medium-term effects of euro adoption (without) sufficient reforms might turn out to be negative. For such economies in particular EMU membership should not be seen as a panacea, despite its current attractiveness. Structural reforms and stability-oriented policies should pave the way for a sustainable path towards accession.

In turn, the economic effects for EMU insiders will be rather small. Only **institutional implications** apply, with the ECB Council implementing a complex rotation system.

For those **countries** which are **structurally prepared** for a quick accession process along the agreed set of rules, the financial crisis has opened a unique window of opportunity to enlarge EMU and to strengthen the stability culture within EMU. Moreover, crisis-driven EMU entry aspirations in structurally weaker countries could be taken as an opportunity to embark on a reform path.

Euro or Not? Early Lessons from the Crisis

Briefing Paper for the Monetary Dialogue of March 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Charles Wyplosz

The Graduate Institute, Geneva and CEPR

Executive Summary

The adoption of the euro has modified the way economic disturbances are transmitted through financial markets, but it has not eliminated these disturbances. The current crisis well illustrates this change.

The enhanced role of fiscal policy as a macroeconomic stabilization tool means that market concerns about debt service are large. The disappearance of the exchange rate means that these concerns directly affect government bond yields, possibly triggering a vicious cycle whereby larger interest rates raise the debt burden, which pushes interest rates further up.

An associated implication is that fears of destabilizing effects may, perhaps, explain why most euro area member governments have made so limited a use of the fiscal policy instrument.

Non euro-area member countries have split into two groups. One group of countries have maintained their pegs *vis-à-vis* the euro at the cost of sharply increased interest rates. This aggravates the recessionary effect of the financial crisis. Another group of countries have seen their exchange rates depreciate *vis-à-vis* the euro. By boosting their competitiveness, this alleviates the recessionary effect of the financial crisis. On the other hand, the build-up of large currency mismatches presents many countries with a serious risk of the vicious cycles that led to the Asian crises a decade ago.

These developments serve as a reminder that a fully integrated Single Market works better with a single currency. Mild economic conditions during the first nine years of the euro have translated into a reasonable degree of exchange rate stability, pushing this consideration out of policymakers' attention. The current crisis brings to the fore an old truth and should lead to a rethink.

Introduction

First and foremost, the euro was created to eliminate the risk of currency crises within the EU. This has been achieved. This success raises two important questions:

- Did the euro completely shield euro area member countries from diverging financial pressure?

- Did the non-euro area members suffer from their situation and, if so, is this a source of concern for the euro area members?

The answers given here are: no and yes.

Financial turmoil in the euro area: principles

Euro area membership implies that disturbances that normally affect the exchange rate will have to work out their effects though other channels. The range of potential disturbances is unbounded. It includes anything that can alter a country's external competitiveness, the health of domestic financial institutions, the saving/borrowing behaviour of residents, including national governments, political instability, and many more possibilities. The only disturbance that is eliminated is monetary policy, although the effects of the common monetary policy may still be a source of tensions if economic conditions differ widely. The list of potential disturbances is so huge that, in fact, we should expect them to occur routinely. Most of the times, they are small and go therefore largely unnoticed, but it is only a matter of time until the next "big one" will occur.

The current financial crisis is bound to create tensions. To start with, a good example is that not all banks are equally affected. If large banks suffer losses that require some bailout, the home budget is bound to be affected. This in turn raises the question of how large deficits will be financed. Without the common currency, the exchange rate might well depreciate as traders expect that part of the financing will have to come from abroad, which require an improvement in the current account to serve the debt. Note that, initially the exchange rate might appreciate as foreign capital flows in, but it could depreciate instead if foreign investors are strongly concerned about debt service.

In the absence of the exchange rate channel, foreign financing from within the euro area will not eliminate the need to serve the debt and therefore to run a current surplus. The surplus will have to be achieved through a restraint of domestic spending, which will be the natural implication of tax increases or public spending cuts required for debt service. Lower demand, in turn, could exert a moderating effect on prices, which would produce a real depreciation and thus partly mimic the now-impossible nominal depreciation. Demand contraction and relative price decline instead of a depreciation is the normal consequence of having lost the exchange rate instrument.

In addition, however, markets may be concerned that this relatively demanding response might be unpalatable to the government and its citizens. This will affect interest rates on public debt instruments. On the surface of it, this is no different from what would be the case when exchange rates exist, since a depreciation might be accompanied with rising interest rates. Two qualifications are in order, though. First, in the latter case, the interest rate increases will affect all borrowings in the domestic currency, not just those by the government.

The single currency thus stands to shield private borrowers from market concerns about debt service. Second, because the government will not be able to depreciate or devalue the currency, debt service may be politically more difficult since it will necessarily involve tax increases or public spending reductions, which may alarm markets and lead to large risk premia. This, in turn, may further destabilize the budget and trigger even larger risk premia. This shows that vicious circles may operate with and without exchange rates.

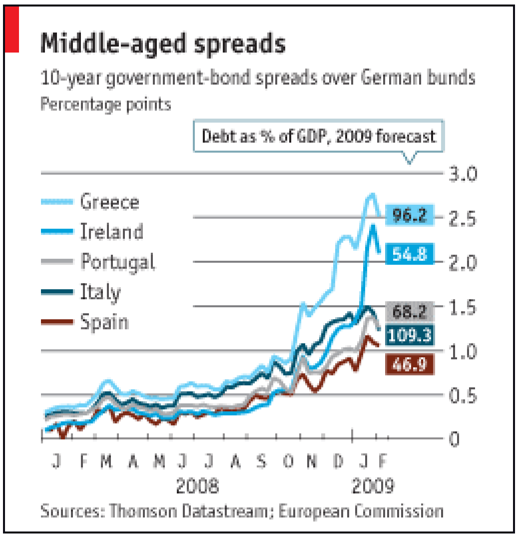
Another aggravating factor is that fiscal policy is the only macroeconomic management tool. This is by design, of course, for eliminating the exchange rate is a way of eliminating beggar-thy-neighbor uses of the exchange rate. On the other hand, this sharpens uncomfortably the choice between fiscal policy inaction and fiscal expansions. In both cases, the deficit is bound to widen and markets may become concerned, imposing higher risk premia no matter what is the chosen course of action.

More examples may be imagined, but the general lesson should be clear: euro area membership simply displaces where market pressure is applied. Market concerns simply adapt to different variables. The concerns may be heightened or lessened by the absence of the exchange rate, but there is no general presumption as to what will the case be. The euro may help but it may be a destabilizing factor. An associated lesson is that fears of destabilizing effects may, perhaps, explain why most euro area member governments have made so limited a use of the fiscal policy instrument.

Financial turmoil in the euro area: outcomes and policy responses

We have witnessed several of these destabilizing forces. The sharp interest rate increases on public debts may have come as a surprise, and they may have been excessive, but they should have been expected. The countries first affected by this phenomenon – Greece, Portugal, Ireland, Italy and Spain – do not necessarily share large deficits and debts but they do have in common large shocks and current account deficits. This suggests that markets look for any evidence of weakness, as is confirmed by the more recent surge in Austrian rates, driven by potential bank losses on lending in non-euro area member countries.

Interest rate spreads of public debts



Source: The Economist, 5 February 2009

The possibility that this evolution developed in a vicious circle is very real. The worst-case scenario would include partial or all-out defaults by governments unable to simply roll-over their existing debts. The consequences on the euro area as a whole need not be drastic, as long as markets distinguish between the monetary union as a whole and particular members. Such a fine distinction, however, might be lost on panicky markets. In this case, the euro might depreciate significantly, which is not necessarily a bad thing when the economy is in recession and inflation is very low, possibly even negative. More damaging would be a contagion to all other interest rates, on private borrowings in the affected countries and on public debts in the other countries.

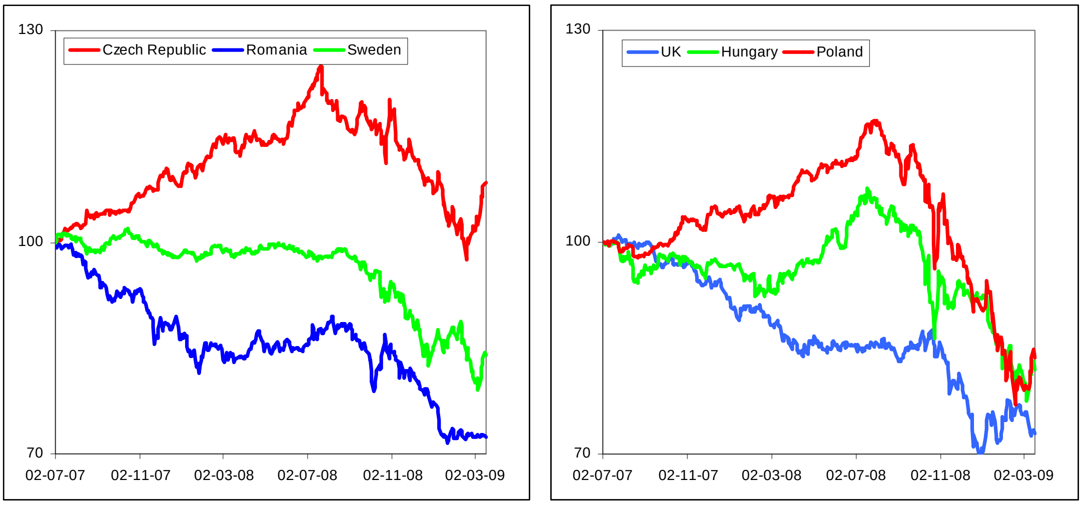
Such fears have led to a number of proposals, including the issuance of bonds underwritten by all member governments or the monetization of existing public debts by the ECB, either directly through purchases or through guarantees. Such moves are bound to carry high costs in the longer run, in the form of moral hazard and reduced central bank credibility. The worst-case scenario is not necessarily the most plausible, so such measures should not be implemented prematurely. Yet preparations are required to allow fast reaction in case of emergency, with a view of incorporating clauses that minimize the moral hazard component. Examples of such clauses include a requirement that the IMF be involved, along with conditionality, or the imposition of above market rates to countries that make use of euro-area facilities.

Financial turmoil outside the euro area

The usefulness of the euro is amply demonstrated by the sizeable depreciations that have been observed outside the euro area, as the following figures illustrate. With the exception of the Czech Republic and of the countries that peg to the euro, all other countries have seen their nominal exchange rates fall by 20% or more *vis-à-vis* the euro. The countries that peg to the euro have all had to raise their interest rates to high levels.

The reasons for this pressure are diverse, a further illustration of the vast list of potential disturbances. Particularly unsettling is the fact that the countries that resisted depreciation are facing an additional source of recession because of high interest rates while those that let their exchange rate float benefit from enhanced competitiveness.

Exchange rate indices (100 = 2 July 2007)



Source: ECB

Yet, enhanced competitiveness may come at a cost. This is the case in countries where firms and households have succumbed to the temptation of borrowing in foreign currencies (chiefly the euro and the Swiss franc) at lower nominal rates than on domestic loans. Given that the building of such a currency mismatch has been identified as the key cause of the Asian crisis a decade ago, it is difficult to believe that national authorities have allowed this to develop to any significant extent. It is also surprising that the European Commission and the IMF, both of which carry out regular supervision, have not identified this major source of weakness. It is even more surprising has been condoned – in fact encouraged, according to some reports – by the banks that provided the loans.

At any rate, these developments carry important policy implications. First, those countries that intend to maintain a peg *vis-à-vis* the euro suffer greatly from not being in the euro area. Unsurprisingly, this may produce a change of heart in the Danish public. More surprising is the continuous refusal by current euro area members to alleviate the plight of the other countries, on the basis of dubious principles.[12] The pressure on banks from outside of these countries that have built up significant exposure is a reminder of the dangers of local financial instability within the EU. The emergency loan to Latvia by the ECB indicates that this danger is not ignored.

Second, the sharp depreciations reported in the figure above are bound to distort competition within the Single Market, at the expense of the euro area countries. In the past, intentional or *de facto* beggar-thy-neighbour policies have translated into political frictions among EU member countries, and there is no reason that this will not be case again this time around. The ECB loan to Hungary shows that this danger is not ignored either.

The main lesson here is simply a reminder of the second main rationale behind the creation of the euro: a fully integrated Single Market works better with a single currency. Mild economic conditions during the first nine years of the euro have translated into a reasonable degree of exchange rate stability, pushing this consideration out of policymakers' attention. The current crisis brings to the fore an old truth and should lead to a rethink. Should countries with an explicit or explicit opt-out be allowed to remain outside the euro area for an indefinite period? Should not the incumbents make efforts to attract new members, for example by overlooking some of the Maastricht criteria? The economic answers to these questions are rather uncontroversial, but political considerations have been so far overwhelming. The costs, present and future, of these considerations may be a silver lining if they prompt policymakers to change their views.

[12] This argument is developed in my Briefing Notes of 2002 (second quarter), 2005 (third quarter) and 2007 (third quarter).

Topic 2

What role for the ECB on financial market supervision?

What role for the ECB on financial market supervision?

Briefing Paper for the Monetary Dialogue of March 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Guillermo de la Dehesa

Chairman of the Centre for Economic Policy Research, CEPR
Chairman of the Observatorio del Banco Central Europeo, OBCE
Member of the Group of Thirty, G 30

Executive Summary

The present financial crisis has clearly shown the strengths and weaknesses of the actual system of financial supervision in the EU and in the Euro Area. As a general outcome of the crisis it can be said that, in almost all of the member countries where the financial supervisor is not the central bank, but a government or independent agency, their banking systems have shown the worst results of a weak supervision in terms of failures or even bankruptcies of some of their larger banks. By contrast, in almost all of the member countries where the financial supervisor is the central bank, supervision has proved to be much more efficient and their banking systems have kept up much better having very few minor or no failures.

The main lesson coming out of this crisis is that the system of supervision in the hands of governments or independent agencies has proved to be quite deficient while that made by central banks has proved to be quite efficient in terms of soundness and stability. Therefore it seems obvious that going forward central banks should take the leading role in supervising all financial entities, not only banks but all the other financial institutions as well (insurance, funds, brokers and dealers) while another independent agency should take the leading role of supervising the conduct of financial markets and consumer protection. This is called the “twin peaks” approach: central banks supervising the health and conduct of all financial entities while independent agencies supervising the health and conduct of all financial markets and consumer protection.

Applying these lessons to the case of the Euro Area means that national central banks members of the ESCB, the NCBs, should be in charge of the micro-prudential supervision of all financial institutions in their own member states, with a high degree of coordination among them, while the ECB should take the role of the macro-prudential oversight for the Euro Area financial system as a whole. Other less radical or step by step ways of solving this problem, without a major change from the present situation will not be as efficient in terms of avoiding similar crises in the future.

Recent Supervisory Trends

Recent tendencies followed by the changes in supervision, have been characterized by two distinctive features: consolidation and specialization.

In the last two decades, some EU member states have been moving towards unifying supervision taking it away from the central banks and concentrating it in the government or an independent agency. The first were some Nordic countries such as Denmark (1988) and Sweden and Finland (1991), then the UK (1998), Austria and Germany (2002), Belgium (2004) and Poland (2006). Other member states have gone the opposite trend, maintaining or even concentrating banking supervision in the national central bank. Among those maintaining it were France, Italy, Spain, Netherlands, Portugal and Greece, while among those concentrating it were Ireland in 2003 and the Czech and Slovak Republics in 2006.

Some member states have also merged two or three sectoral supervisors into one and trying to go toward a “twin peaks” system based on having the central bank as supervising the safety of all the financial institutions and an ad hoc independent agency supervising the conduct and transparency of the financial markets.

As a result, the present supervisory landscape is more diversified and complex than ever before. At the Group of Thirty we have tried to classify the existing approaches to supervision in the world into four categories:

First, the institutional approach, by which, the legal status of each financial firm determines the supervisor which will oversee its activity. This is the system with more difficulties and strains to survive at present given the rapid changes in financial markets and the increasing blurring of product lines across financial sectors.

Second, the functional approach, by which, the supervisory oversight is determined by the business that is transacted, and not by the specificity of the financial institution. This system works better than the previous one, but it needs a high level of coordination among the different supervisors and it is becoming increasingly a suboptimal structure and it is moving progressively towards the “twin peaks” approach.

Third, the integrated approach, by which there is only a single universal supervisor for every financial institution. This system of supervision is proving to be very effective in the case of small financial markets, but it becomes more difficult to apply the larger and more complex the financial markets are. It has the advantages of being simple and of avoiding supervisory arbitrage, confusion and conflict among supervisors but it also creates the risk of a single point of supervisory failure.

Fourth, the “twin peaks” approach, by which supervision is based on the two different objectives of supervisory policies: One supervisor takes care of the safety, soundness, stability and solvency of the financial system and another one takes care of financial business and markets being conducted in a proper and transparent way and of consumer protection. This system is becoming increasingly considered to be the most efficient given that it has most of the efficiencies of the integrated approach and, at the same time, addresses the inherent conflicts that arise between the objectives of safety and soundness of the financial entities and the objectives of consumer protection and transparency.

My personal view is that the “twin peaks” approach is the most efficient for the Euro Area, provided the central bank is the “peak” that takes care of the supervisory role of the soundness, safety and stability of all financial entities leaving the other supervisory policy role of transparency and consumer protection to the government (or another agency independent from the government).

Central banks have a very important advantage for taking such a role given that they have a direct and intense relationship with the banks, they operate daily with them supplying or retiring liquidity to and from them and are the ones that have the best and more critical information about them. Therefore, any integration of the supervisory role of financial entities into one single supervisor should be based on the central bank and not on a government or an independent agency.

Are monetary policy and supervisory roles of central banks conflicting?

Most empirical evidence suggests that it is better to integrate the financial supervisory powers in the central bank than in other agencies because of its informational economies of scope advantages, its longer experience, the higher quality of its human capital and its well proved independence. Nevertheless, as in every economic issue and policy, there are different points of view in the economic literature creating a permanent debate about it but at the same time, showing some wider consensus.

On the one side, there is some research that shows the potential conflicts between the two goals of a central bank, that is, between monetary policy and banking supervision in terms of moral hazard, of too much bureaucratic power given to central banks away from elected political institutions as well as in terms of creating a conflict of interest among both goals. The main case for separation of the both goals is that the optimal provision of incentives for self-interested bureaucrats and the advantage of having agencies with well defined missions and with enhanced accountability.

Bureaucrats worried about their professional career may fail to take decisions that, although necessary, call into questions the quality of their work. For example, if the authority for supervision and intervention of banks is the same the person in charge of supervision may be reluctant to accept that a bank must be closed down since closure will reflect unfavourably on its supervisory task, so that it would be better to separate both roles. Moreover, by definition, an institution with multitasks or multi roles is more difficult to control and to be accountable than another with one single task or role.

There is also a fear that the combination of control of monetary policy and the role of lender of last resort (LOLR) may give rise to the abuse of the second one with inflationary consequences. But, in principle, the central banks can always sterilize the injections of liquidity necessary for the stability of the system in the event of a crisis so that there is no increase in the money supply.

Another potential conflict of interest may arise when many banks have problems and the supervisory authority tries to ease credit by lowering interest rates to help the banks which it may be in conflict with the aim of price stability. But, usually, when banks have serious problems with non performing loans are in recessions, where high unemployment and low consumption levels tend to produce low inflationary pressures and monetary stance should be eased.

A more serious conflict may arise when the central bank is the guarantor of currency stability as well as the guarantor of the stability and solvency of the financial system. The combination of both functions may produce in some cases a problem of credibility and reputation for the central bank. There is some empirical evidence showing that central bank's involvement in supervision tends to deliver a higher rate of inflation, irrespectively of the degree of its independence.

By contrast, there is also other research that shows exactly the opposite view, that is, that having supervisory powers may assist the central bank in both making monetary policy more effective, making crisis management more efficient and in producing a much higher quality supervision, by being able of producing and or attracting more skilled supervisors by having the means of educating them in house or selecting and paying them better than any other government or non government and independent bodies.

The strongest argument to keep supervision within the central bank lies in the presence of high informational economies of scope and synergies between its monetary policies, its lender of last resort and its supervisory roles. The monetary policy role of the central banks is so essential that there is not any dispute about it. The central bank is also a natural candidate to have the LOLR role. Its unique capacity as crisis lender is due its capacity to commit unlimited liquidity resources as well as to act with the necessary speed. Another important role for the central bank is as crisis manager, helping to solve the coordination problem among creditors or asking other safe banks to rescue o distressed bank, or helping the insurance deposit fund with temporary loans to deal with a high rate of disbursement following a crisis.

If these two central bank roles are accepted, then there are several arguments in favour of having the supervisory role as well. Such a role will help to distinguish between problems of liquidity and of solvency in order to minimize the losses associated with loans granted. Its supervisory capacity may make it easier to determine the best kind of intervention (open market or discount operations). There are also economies of scope in the acquisition of information between the function of providing liquidity and that of supervising. By being able to supervise the central bank becomes highly knowledgeable about the liquidity requirements of the banks.

There are as well synergies between its monetary policy role and that of its supervisory role. Some banking supervisory information such as early warning problems with non performing loans or changes in bank lending patterns is very useful for being more accurate in its macroeconomic forecasts. Finally, there are also synergies between the LOLR function and the supervisory role, because, central banks will tend to be stricter and more risk averse in their supervision if they will take the risk of having to use their LOLR function if banks become distressed, than if other agency or the government is responsible for that function.

Micro-Prudential and Macro-Prudential Supervision

The objective of macro-prudential supervision is to limit the risk of episodes of financial crisis with significant losses in terms of real output for the economy as a whole. The objective of micro-prudential supervision is to limit the risk of episodes of financial distress at individual financial institutions, regardless of their impact on the overall economy. So the macro-prudential approach falls into the realm of the macroeconomics tradition and that of micro-prudential approach is best rationalized in terms of consumer, investor and depositor protection.

The macro-prudential approach is top-down. It sets first the relevant threshold of systemic crisis and then calibrates the prudential controls on the basis of the marginal contribution of each institution to the systemic crisis risk as well as the correlations across all the institutions in order to distinguish between systematic and idiosyncratic risk. That means that some financial institutions large and operating in many countries have a larger probability to produce systemic financial risk than the rest.

The micro-prudential approach is bottom-up. It sets prudential controls in terms of each financial institution and the total is added ignoring correlations among them. The macro-prudential approach assumes that risk of systemic crisis is in part endogenous with respect to the behaviour of the financial system while the micro-prudential assumes that that risk is exogenous.

The present financial crisis stress more than ever the importance of macro-prudential supervision not only at the Euro Area level but worldwide. The US financial crisis has contaminated the rest of developed countries and caused eventually a major global slowdown given the high degree of financial globalization and the large degree of integration of financial markets around the world. This crisis has shown the tension between both approaches. The failure of individual institutions spreads through a variety of contagion mechanisms, such as financial and real asset prices, inter-linkages between balance sheets and inter-bank markets and then through amplification mechanisms such as over reaction by investors driven by imperfect or asymmetric information, lack of confidence in financial institutions and eventually, risks become endogenous and end in a systemic and almost global financial crisis with huge consequences for the world real economy.

Macro and Micro-Prudential Supervision at the Euro Area

The Treaty of the European Union opts for the separation of the monetary policy authority from the supervision of the banking system. Supervision is, in principle, in the hands of the national governments while monetary policy is in the hands of the European System of Central Banks (ESCB). Regulation is national, supervision is also national and mainly in the hands of their governments. But in six Euro Area (EA) member countries central banks continue to have the supervisory role of their national banks.

The ECB is not entrusted with any direct responsibility related to prudential supervision of credit or financial institutions or the stability of the EA financial system, although, according to the Maastricht Treaty it could have some potential supervisory powers if the European Council so decides. This means that the ECB could be assigned supervisory powers without the need to reform the Treaty and that the NCBs should keep having supervisory powers or being transferred to them from the governments.

Therefore, the present situation in the EU and the EA is that financial markets are integrating through the freedom of capital movements and freedom of establishment, but not enough, while, paradoxically, financial regulation and prudential supervision is still national (but somehow harmonised through minimum capital requirements, concentration of risks and investor protection and coordinated through exchange of information and cooperation among different bodies). The LOLR is supposed to be in the hands of each national central bank (NCBs) but it is not clear because national governments are taking an increasing role in that function and the deposit insurance role is also under national jurisdiction. The end result is that EU financial markets do not integrate fast enough remaining still segmented, mainly because of different national regulatory and supervisory arrangements.

There have been several proposals to improve the present supervisory system in Europe. The ESCB has called for banking supervision in Europe to be entrusted to central banks and being coordinated through the existing Banking Supervision Committee (BSC) of the ECB by making the BSC independent of the ECB and report to the ECOFIN. Another one has been made by the financial industry proposing the creation of a European FSA (EFSA) with a decentralised structure similar to the ESCB.

In any case, the present financial crisis has made evident the need of a radical change of the present European financial architecture and also the need of a much larger centralized fiscal authority that issues European debt and can act in case of a major European wide recession to avoid a depression.

It seems clearer now that the ESCB should assume the LOLR function given that large and more systemic financial institutions are operating in many European member states affecting various LOLR national authorities. It is also evident that the NCBs should become the micro-prudential supervisor authorities in each member state, coordinating among themselves as members of the ESCB. Finally is also evident that the ECB should become the macro-prudential supervising authority to be able to react speedily in extreme systemic crisis as the present in the same way that the US FED does. Now it is only a question of taking the opportunity of this crisis to do it.

It is not yet clear if this major but necessary supervisory step can be done through a mere interpretation of the Treaty or if it needs to change it but it is without any doubt the best and more efficient option of all other alternative proposals.

The most recent proposal is the High level Group of Experts charged by the President of the EU Commission with reviewing the EU financial regulatory framework, chaired by Jacques de Larosière. But this report is more evolutionary than revolutionary in the sense that it does not propose a single EU supervisory structure but it focuses on enhancing existing structures. It proposes setting up a European Systemic Risk Council (ESRC) to be chaired by the President of the ECB to pool and analyse data on macro-prudential policy and composed of members of the Governing Council of the ECB, members of the European Commission and members of the three existing pan European committees of banking, insurance and securities supervisors. Finally, it expects to create by the end of 2009 supervisory colleges for all major European cross-border financial firms. It is a step forward in the right direction but yet still far from what should be an optimal supervisory European structure.

What role for the ECB on financial market supervision?

Briefing Paper for the Monetary Dialogue of March 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Sylvester C. W. Eijffinger

CentER and European Banking Center, Tilburg University and CEPR

Executive Summary

The main recommendations made by the High-Level Working Group chaired by Jacques de Larosière are a political compromise between the EC, ECB, EU national central banks and supervisors and ministers of Finance and should be taken as the points of departure. A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logical support of the ECB. – The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as the European Commission. High-level alternates to the central bank Governors should take part in the discussions, in particular when insurance or securities markets issues are discussed. An effective risk warning system shall be put in place under the auspices of the ESRC and of the EFC. – The ESRC should issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU. In a first stage, national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU. The European Commission should carry out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This should lead to concrete recommendations, including on the funding of national authorities. In a second stage, the EU should establish an integrated European System of Financial Supervision (ESFS). The level 3 Committees should be transformed into three European Authorities: a *European Banking Authority*, a *European Insurance Authority* and a *European Securities Authority*. The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years. The Authorities are responsible for micro-prudential supervision, while the ECB takes care of macro-prudential supervision by participating in the ESRC as suggested by the High-Level Working Group. This should be realized under clear mandatory arrangements for information and knowledge exchange. The recommendations of the Working Group are not path breaking but a very modest, first step to European supervisory authorities.

1. Introduction[13]

The future architecture of supervision in Europe is indeed one of the main issues following the crisis. The *De Larosière group* has been set up to deal with this question, and has come out with a report on February 25th, 2009[14]. The President of the European Central Bank (ECB), Mr Jean-Claude Trichet, has been heard by this group. This topic will be discussed in the meeting of the *European Council* in March 2009 and during the informal meeting of the *Ecofin Council* (ministers of Economic Affairs and Finance) in April 2009. The ECB is in the process to finalize its official position on the question. During the last Monetary Dialogue in the European Parliament on January 21st, 2009, Mr Trichet concluded his introductory remarks by saying that "*as underlined in particular by a number of Members of Parliament, Article 105(6) of the Treaty explicitly mentions the possibility for the Member States to decide to confer upon the ECB specific tasks in the domain of financial supervision. Reflections have started on the specific role that could be played by the ECB and its Governing Council should this provision of the Treaty be activated. At this stage the Governing Council has not taken yet position on this topic. I will not miss to report to you the outcome of these reflections*". This Briefing Paper analyzes how to (re-)organize financial supervision on the European Union (EU) level. Section 2 of this Briefing Paper focuses first on the current system and its flaws. In Section 3 we will consider the possibilities to enhance EU-wide supervision. Section 4 discusses a European system of financial supervisors and the role of the ECB in the review process. In Section 5 we evaluate the pros and cons of the ECB model versus European Financial Services Authority (EFSA) model. Finally, in Section 6 we draw some conclusions.

2. What does the current system look like?

The current system of supervision is characterized by the concept of home country supervision, which is recognized by host country supervisors. The latter only has supervision over subsidiaries (separate legal entities) of financial institutions in their country. However, the effect of this on financial stability is limited in practice, as most important decisions are often taken by the parent company in the home country. Additionally, the financial health of the group as a whole greatly affects the well-being of the subsidiary[15]. The important question is whether this system is still sustainable in an integrating market, with large cross-border financial groups and the centralization of management functions at the company headquarters incorporating insurance and banking in the same entity. This system of supervision also has a financial stability component. This is organized at the EU level, as described in Table 1. The coordination of supervision exists of cooperation between national supervisors through the 3L3 committees from the *Lamfalussy framework*, to prevent financial crises. The ECB and the ESCB also play an important role here. Crisis management and crisis resolution is mainly coordinated through Memoranda of Understanding, to foster cooperation between the national supervisory authorities and the ministries of finance.

The Lamfalussy system has recently been reviewed by the Ecofin Council. The results of this review should lead to a better coordination of European-wide financial supervision. The changes also facilitate the transition to a new system of EU-wide financial supervision, as the 3L3 committees get more responsibilities.

[13] The author gratefully acknowledges the excellent research assistance of Mr Rob Nijskens, MSc.

[14] De Larosière Group (2009), *Report by the High-Level group on financial supervision in the EU*, February 25th, 2009.

[15] Schoenmaker, Dirk and Sander Oosterloo (2008), 'Financial Supervision in Europe: A Proposal for a New Architecture', in: Lars Jonung, Christoph Walkner and Max Watson (Eds), *Building the Financial Foundations of the Euro - Experiences and Challenges*, Routledge, London, pp. 337-354.

The first change to be made is strengthening the legal basis of the Level 3 committees, to clarify their role in promoting supervisory convergence and cooperation. Secondly, the accountability of the committees is to be enhanced by a specification of their objectives and a

Table 1: The EU framework for safeguarding financial stability[16]	
Functions	*Structures for cross-border cooperation between authorities*
Crisis Prevention	
Supervisory functions	Level 3 Committees for the convergence of supervisory practices Colleges of Supervisors
Financial stability monitoring by central banks	ESCB Committees
Crisis Management	
Supervisory measures	Colleges of Supervisors EU MoUs
Provision of liquidity by central banks	Eurosystem
Actions on payment systems	ESCB Committees EU MoUs
Crisis Resolution	
Private sector solutions	EU MoUs
Public sector measures by finance ministries	EU MoUs
Reorganization and winding-up of financial Institutions	Bilateral relationships between the competent authorities of Member States
Deposit guarantee schemes	Bilateral relationships between the competent authorities of Member States

periodic reporting scheme to the European Commission, the Ecofin Council and the European Parliament. In the light of this second suggestion, it may also be wise to explicitly burden national supervisors with fostering EU-wide supervisory convergence. Thirdly, qualified majority voting can improve the decision-making process within and between the 3L3 committees.

However, the recent turmoil has revealed increasingly more weaknesses in the EU supervisory system, which has been assessed by the High-Level Working Group led by Jacques de Larosière. Below, we will address the main problems with the current system.

To start with, having many different systems of supervision in each country creates duplicated rules and information inefficiencies that bring extra unnecessary regulatory costs for internationally oriented financial institutions. Furthermore, the legal structure in supervision is no longer in line with the organizational structure of financial institutions, due to cross-border activities.

[16] ECB (2008), 'Developments in the EU arrangements for financial stability', *Monthly Bulletin*, April, pp. 75-87.

In other words: the regulators have not adapted the supervisory structure to market developments, and this has led to the above-mentioned inefficiencies. The High-Level Working Group has identified loose monetary policy as one of the main causes of the financial crisis. Admittedly, this has been the case mostly in the US but also in the EU the current system may allow for conflicts of interest. The current system also allows for moral hazard on the side of financial institutions, as the supervisor is also the one that has to finance a bailout. Furthermore, there is has been insufficient attention for systemic stability and the examination of macro-prudential risk at the EU and global level. This has occurred under a lack of coordination between supervisors EU-wide and globally; a problem that a new system for financial supervision will have to solve. In the next section we will explain what aspects are needed for a more coordinated EU-wide system of supervision.

3. A new approach to EU-wide financial supervision

The question of restructuring the European supervisory system pertains mainly to financial and systemic stability, and thus we are not as such concerned about coordination of conduct of business supervision. We will focus attention on prudential supervision in the text below. As we have seen in the previous section, there are important reasons why the European Union needs a new system of financial supervision. Besides the obvious failures during the financial crisis, there are several other reasons to form a system of integrated financial supervision[17].

First, it is already mentioned above that financial institutions have increasingly expanded internationally. Supervision should follow this trend, to prevent inconsistencies or gaps in oversight. Second, there is the need (especially in the EU) to create a level playing field in regulation. This will eliminate regulatory arbitrage and regulatory advantages for financial institutions in one country over those in another. Finally, efficiency has to be improved, by reducing duplication of supervisory effort and thus lowering the overall costs of supervision. But how should we realize this coordination of supervision at the European Union level? Different suggestions have been made for coordinating EU-wide supervision[18]. A first one is strengthening cooperation between home and host countries. This has been arranged in the EU via the Lamfalussy framework, such that home and host supervisors can effectively communicate about regulating cross-border financial groups. However, this system has proven to be insufficient during the crisis. Furthermore, it is questionable whether this improvement of cooperation will reduce duplication and overlap of supervision. As mentioned before, this leads to a high regulatory burden and hampers competition and expansion within and outside of the EU. An additional problem with this framework is that it is unclear where responsibilities for crisis management and bailouts lie.

A second suggestion, also made by the *European Financial Services Round Table* (EFR), is the definition of a lead supervisor for prudential supervision of cross-border financial institutions. This supervisor would be the contact point for all issues related to prudential supervision. Next to this supervisor, colleges of supervisors for each specific cross-border financial group should be set up to advise the lead supervisor.

[17] Herring, Richard J. and Carmassi, Jacopo (2008), 'The Structure of Cross-Sector Financial Supervision'. *Journal of Financial Markets, Institutions & Instruments*, 17 (1), pp. 51-76.
[18] Schoenmaker, Dirk and Sander Oosterloo (2008), 'Financial Supervision in Europe: A Proposal for a New Architecture', in: Lars Jonung, Christoph Walkner and Max Watson (Eds), *Building the Financial Foundations of the Euro - Experiences and Challenges*, Routledge, London, pp. 337-354.

This has also been suggested by the High-Level Working Group. Although this solution takes care of coordination and inefficiencies, it does not solve the lack of attention paid to cross-border externalities and systemic stability. The third suggestion, recently made by both the EFR and the High-level Working Group, is a *European System of Financial Supervision* (ESFS). This can level the playing field, and foster an efficient exchange of information between supervisors, especially on large cross-border institutions. It consists of a central body, coordinating supervision and information exchange, and the 27 national supervisors that will conduct day-to-day supervision. Since this solution has the possibility to solve all the problems mentioned above, we will examine the option further in the next section.

4. A European System of Financial Supervision

The proposed system of financial supervision at the EU level should satisfy certain requirements. To begin with, the system and its central agency should be independent; they should be free of political influences, but accountable to a democratic institution such as the European Commission, the Ecofin Council and the European Parliament. Second, the day-to-day (micro-prudential) supervision should take place close to financial institutions. This can be done by the national supervisors, since they usually already have a good relationship with their home financial institutions. Thirdly, decision-making should be based on unanimity or qualified majority voting, except in times of crisis; there should be some discretion in this. Furthermore, there should be made clear arrangements for burden sharing in crisis management[19]. Finally, a mandatory exchange of information is desirable. This can be arranged in EU legislation, to level the playing field and take care of cross-border financial groups. The High-Level Working Group has suggested a system to be implemented in the medium term. It consists of two blocks: a *European Systemic Risk Council* (ESRC) and a *European System of Financial Supervision* (ESFS). The first body will pay attention to macro-prudential risks and systemic stability, and it will closely work together with the ECB. It can also issue risk warnings with mandatory follow-up by national supervisors. The second body will cover micro-prudential supervision, and consists of the transformation of the 3L3 committees into 3 new European authorities, that will take care of common supervisory standards and coordination of supervision and will closely cooperate with the ESRC to bring in line macro- and micro-prudential supervision.

The High-Level Working Group has suggested to implement this framework in two stages: a preparation phase (2009-2010) and the establishment of the ESFS legal system (2011-2012). Furthermore, a periodic review should be undertaken to determine whether further development may be necessary. What should the ESFS look like? We suggest the creation of a *European Financial Services Authority* (ESFA) to serve as the central authority in this system. This EFSA will be responsible for the direct supervision of internationally active financial institutions and national financial institutions that can affect financial stability internationally. National supervisors will be responsible for smaller institutions, although they will be accountable to the EFSA. They can also help the EFSA in gathering information, so the EFSA will be the umbrella organization for national supervisors. The system also entails uniform supervisory rules for national supervisors, to create a level playing field and to prevent regulatory competition within the EU. Furthermore, this leads to lower information costs and prevents regulatory arbitrage by large financial institutions.

[19] Goodhart, Charles and Dirk Schoenmaker (2006) "Burden Sharing in a Banking Crisis in Europe", Economic Review, No. 2.

The structure of the ESFS and EFSA can be designed by using the ESCB and the ECB as a blueprint: key supervisory decisions and the design of policy can be made at the centre. This should be done by a Governing Council consisting of the Executive Board of the EFSA and the Chairmen of the 27 national supervisors. It should be clear, however, that the EFSA is a federal institution operating independently from the ECB or any other institution. This does not mean that they do not cooperate: it is crucial that there is a legally binding information exchange between the EFSA and the ECB or the ESRC, when using the suggestion by the High-Level Working group. Finally, this EFSA will be only responsible for supervision and not for bailouts in times of crisis. It will not get any funds to save financial institutions; instead, the costs of these actions will have to be shared by the involved Member States. To prevent moral hazard clear arrangements for burden sharing have to be made, as mentioned in the beginning of this section. The implementation of this new system of EU financial supervision can be done according to the recommendations made by the High-Level Working Group. This means that during 2009 and 2010, national supervisory authorities should be strengthened with the aim to upgrade the quality of supervision in the EU. This can for instance be achieved by examining the degree of independence and by working towards a strong European supervisory culture. Furthermore, EU should develop a set of harmonized rules on financial regulation and supervision.

The second stage, in 2011 and 2012, could see the establishment of an integrated European System of Financial Supervision (ESFS) in the shape of a European Financial Services Authority (EFSA) having political independence. This should be underpinned by legally binding mediation between national supervisors, supervisory standards, technical decisions and mandatory cooperation with the ESRC to take care of systemic stability. In this system, national supervisory authorities remain responsible for the day-to-day supervision of smaller financial firms, while the EFSA supervises large cross-border financial groups.

The most important part of these suggestions at this moment is that their implementation should start immediately, since it has become clear that coordination and cooperation at a higher level has become indispensable. Additionally, it may be wise to intensify cooperation at the global level, i.e. in the *Financial Stability Forum*. However, EU supervision should be strengthened first in order to have a stronger bargaining position at the global regulatory playing field.

5. The ECB model versus the EFSA model

It has also been suggested to direct the task for EU-wide supervision to the ECB. However, the High-Level Working Group mentions several reasons not to do this. The most important one is that loose monetary policy has been a problem and thus conflicts of interest are an important issue.

This can be mitigated by not giving the ECB responsibility for financial supervision, but instead separating the tasks of macro- and micro-prudential regulation. Furthermore, centralized supervision should cover the whole European Union, not only EMU, to prevent the perverse effects that have lead to opaqueness and the recent systemic failures. Also, financial institutions are not confined to the borders of EMU. An additional advantage of focusing on the EU, instead of only on EMU, is that financial supervision will not be easily related to monetary policy.

Below, in Table 2, we delineate the pros and cons of both the ECB model and the EFSA model. As we can see, advantages of the ECB model are its emphasis on system-wide stability, the information synergies and expertise and the possibility of firm action in case of crisis. However, the disadvantages, mainly concerning micro-prudential supervision, are considerable. To start with, the arrangement may lead to a concentration of power in the ECB. The responsibilities for financial supervision and monetary policy in one body decrease transparency, and may lead to situations of moral hazard. Finally, adverse developments in the financial stability domain may lead to reputational damage for monetary policy. The EFSA model can easily create a level playing field for the whole EU, lower the information costs, reduce problems of moral hazard caused by bailout possibilities, reduce the probability of mistakes when more institutions look at a case during crisis management and, most importantly, eliminate possible conflicts of interest and reputation effects as it separates monetary policy and financial supervision. Although a large disadvantage is that this model pays little attention to systemic stability, this can be solved by introducing mandatory information exchange between the EFSA and the ECB or ESRC.

Table 2 The ECB model vs. the EFSA model

	Pro	***Con***
ECB model	+ Attention for systemic stability + Information synergies, knowledge and expertise + Independence + Higher transparency due to absorbing 3L3 committees + Effective crisis management	- Possible conflict of interest - Reputational concerns for monetary policy - Moral hazard problems - Less transparency due to mix financial and monetary stability - Concentration of power - No EU legal basis for insurance supervision.
EFSA model	+ Level playing field for the whole EU, not only EMU + No conflict of interest + No concentration of power + More transparency: only one task + Less moral hazard concerns + No reputational effects for monetary policy + Crises are assessed by different authorities: fewer mistakes.	- Not much attention for systemic stability - ECB has the knowledge and expertise already; information exchange mandatory - Less decision/acting power in crises: more institutions involved - Needs a EU constitutional change

6. Conclusions

The main recommendations made by the High-Level Working Group chaired by Jacques de Larosière are a political compromise between the EC, ECB, EU national central banks and supervisors and ministers of Finance and should be taken as the points of departure.

A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logical support of the ECB. - The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as the European Commission. High-level alternates to the central bank Governors should take part in the discussions, in particular when insurance or securities markets issues are discussed.

An effective risk warning system shall be put in place under the auspices of the ESRC and of the EFC. - The ESRC should issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU.

In a first stage, national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU. The European Commission should carry-out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This should lead to concrete recommendations, including on the funding of national authorities.

In a second stage, the EU should establish an integrated European System of Financial Supervision (ESFS). The level 3 Committees should be transformed into three European Authorities: a *European Banking Authority*, a *European Insurance Authority* and a *European Securities Authority*. The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years.

The Authorities are responsible for micro-prudential supervision, while the ECB takes care of macro-prudential supervision by participating in the ESRC as suggested by the High-Level Working Group. This should be realized under clear mandatory arrangements for information and knowledge exchange. The recommendations of the Working Group are not path breaking but a very modest, first step to European supervisory authorities.

References

De Larosière Group (2009), *Report by the High-Level group on financial supervision in the* EU, February 25th, 2009.

ECB (2008), 'Developments in the EU arrangements for financial stability', Monthly Bulletin April, pp. 75-87

Herring, Richard J. and Carmassi, Jacopo (2008), The Structure of Cross-Sector Financial Supervision. Journal of Financial Markets, Institutions & Instruments, 17 (1), pp. 51-76.

Schoenmaker, Dirk and Sander Oosterloo (2008), 'Financial Supervision in Europe: A Proposal for a New Architecture', in: Lars Jonung, Christoph Walkner and Max Watson (Eds), Building the Financial Foundations of the Euro - Experiences and Challenges, Routledge, London, pp. 337-354.

Goodhart, Charles and Dirk Schoenmaker (2006) 'Burden Sharing in a Banking Crisis in Europe', Economic Review, No.

What role for the ECB on financial market supervision?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Leon Podkaminer

Summary

To neutralize the uncertainties about the ways in which the risks and the capital adequacy are quantified under Basel 2, one may postulate raising the level of the risk-weighted capital adequacy ratio from the current 8%. Other revisions may include the introduction of multiple safeguards, making adjustments for the size and complexity of banks, and the introduction of cyclically-adjusted regulatory requirements.

Systemically important hedge funds must not be left unregulated – though this may require compliance from the tax/regulation havens. The rating agencies sector must be also regulated. There are many other valuable recommendation which, when implemented, would make things much better. But the complexity and non-transparency of the financial system is likely to outpace the development of the system's regulation and supervision.

The opinion is expressed that what proves to be too hard to regulate and supervise, should be forbidden. Because it is difficult to efficiently regulate and supervise large, sufficiently complex and non-transparent financial conglomerates active in many jurisdictions, the legislation should require splitting such conglomerates into independent entities which would be more easily regulated/supervised with proven routines. This opinion agrees with Professor De Grauwe's recent advocacy of the return to narrow banking.

Policies limiting the development of the assets price bubbles are essential. However, the monetary policy should control these bubbles by means of credit rationing instead of interest rate hikes.

The tendency for asset price bubbles to become more frequent and violent is related to the profound structural changes initiated over 30 years ago. Apart from liberalisation/deregulation, the rise of bubble economy has been fed by the ongoing changes in income distribution, with the ballooning size of private liquid wealth – which is eager to engage in speculative activities. Undoing the changes introduced by the policies of the last thirty years would require unusual circumstances. The radical changes (comparable e.g. to the ones introduced under the New Deal) could come only if the world economy plunged into a long and deep depression

The surveillance of individual institutions should be left to the national bodies currently in charge. The national supervisors should of course collaborate with one another.

The macroprudential oversight in the EU could be the responsibility of a separate international body (called e.g. European Systemic Risk Council) affiliated to e.g. the European Commission.

Supervision must remain national – as long as the fiscal costs of failures of financial firms are borne nationally. Should there be a common fiscal arrangement for the entire EU, with fiscal costs in question borne by the EU as a whole, things would be different. The idea of colleges of supervisors for cross-border firms is also problematic. The ECB should not play any supervisory role. The relationship of national central banks to their supervisory authorities should remain the national prerogative (lending of last resort is still national).

Prudential activities and consumer protection should be separated.

Linking EU supervision to international institutions should proceed via '*close cooperation*' of ESRC with FSF, BIS and IMF.

On Regulation

Revision of Basel 2

For several years now it has been pointed out that the Basel 2 rules (specifying the requirements for individual banks' capital adequacy ratios) is deficient. Among others, these deficiencies include:

1. Reliance on internal statistical models specified with historical data for the assessment of asset risks. But data on very rare events (e.g. insolvencies) are rather scarce. Statistical modelling of such events cannot be reliable. Similarly, given the innovative character of too many assets, making use of the historical statistics for the evaluation of their risks is tricky, to say the least;
2. Alternatively, reliance on ratings produced by hired external ratings agencies is recommended. But – as is now obvious – these agencies are not paragons of professional competence and integrity;
3. Common sense & individual judgement is subordinated to (1) and (2) above;
4. The implied homogenisation of banks' behaviours, unification of rules governing their responses. This is often paraded as a virtue ('*harmonisation*'). In fact this is likely to strengthen the lemming-like behaviour in the financial markets, resulting in the tendency for the build-up of bubbles, to be followed by busts/crises;
5. Systemic (or endogenous) risk is ignored and cyclicality is induced (or strengthened). The Basel 2 stipulates that a bank facing increased risk/losses goes on the defensive (e.g. disposes of problematic assets, calls in credits etc). This is a good recommendation for a single bank – though this could have devastating (and unanticipated) effects on other banks. Such (systemic) risks are not allowed for in Basel 2. Moreover, Basel 2 is actually pro-cyclical/destabilising. The actions prescribed (e.g. under a downswing in the real economy, with rising risks to banks) when followed simultaneously by a large number of banks would be reinforcing the contraction in the banking sector – and thus would amplify the real economy downswing. (Under an upswing, the same logic produces excessive expansions).

It is not clear at all how to deal, *systematically*, with the deficiencies 1-3 above. It would be naïve to hope that a radical reform of the rating agencies sector (necessary as it is) could bring such qualitative improvements as to make their ratings reliable. The situation seems to be pretty hopeless[20] – at least as long as the financial system itself remains complex - beyond the intellectual capacity of an average, normally intelligent, banker.

Other deficiencies of Basel 2 seem more capable of being constructively reformed:

[20] For example, the de Larosière Group Report's recommendation concerning risk assessment (p.16) reads as follows: '*Future rules will have to be better complemented by more reliance on judgement, instead of being exclusively based on internal risk models. Supervisors, board members and managers should understand fully new financial products and the extent of the risks that are being taken; stress test should be undertaken without undue constraints* (?)*; professional due diligence should be put right at the centre of their daily work'*. The question is how to make sure that the bank people fully understand the products/risks. What if they misunderstand them?

Higher capital adequacy ratios

To neutralise the uncertainties about the ways the risks and the capital adequacy are quantified under Basel 2, one may simply postulate a much higher level of the risk-weighted capital adequacy ratio (currently 8%). Should it be 10%, or more – perhaps 14%? That's a good question to ask e.g. the Research Department of the ECB.

Regulatory amendments beyond the Basel 2

1. Multiple safeguards: Whatever the level of the Basel 2 (whether revised or not) capital adequacy ratio, it is advisable to impose on banks (and other financial sector firms) some *additional* quantitative requirements, to be observed *simultaneously* with the CAR. These requirements could relate to e.g. minimum levels of the overall leverage[21], liquidity, maximum allowable exposures to specific risks, maturity mismatches, derivative position limits, maximum speeds of expansion of some assets etc.

2. Size/complexity adjustments: The requirements should perhaps be differenced – with more demanding requirements imposed on large, systemically important banks and other large complex financial conglomerates (and other financial institutions – such as e.g. hedge funds). More demanding requirements (which are essentially a form of taxation) would better reflect costs (e.g. in the form of public support) of insolvencies triggered by systemically important institutions. (These costs tend to be disproportionately large for large/systemically important institutions). Besides, there are obvious moral-hazard disadvantages of having large/complex financial institutions. They tend to take advantage of being large/complex to be allowed to go bankrupt. Moreover, the very existence of large/complex institutions is likely to restrict or distort competition. In particular, such institutions are in position to manipulate the market. This may have unpleasant *macroeconomic* effects (e.g. the large/complex entities are more capable – than small/transparent ones – of generating destabilising speculative booms).

3. Cyclical adjustments: The regulatory requirements (CAR, leverage ratios, and the like) should be varied according to the aggregate (macro) conditions. This should mitigate the systemic risk and the pro-cyclicality inherent in any constant (over time) requirements. The idea, of which many specific variants have been proposed in the literature, is fairly simple. In very good times somewhat more restrictive requirements would weaken the market excesses. By the same token, the sufficiently less restrictive requirements (administered as the good times are about to end) should attenuate de-leveraging and the severity of the approaching bust. (In the long bygone days the monetary policy in many places attempted to contribute to the stabilisation of economic cycles by varying the obligatory *reserve* requirements, charged on banks' *liabilities*[22]).

[21] Incidentally, it has turned out that the European banks happen to have *higher* leverage levels – i.e. are in fact *more* fragile - than their US partners.
[22] Some new EU Member States still actively manipulate the reserve requirement for the stabilisation purposes. Thus in Bulgaria the basic reserve requirement ratio was raised strongly at mid-2007, amid clear signs of euphoria on the domestic market, and lowered – for obvious reasons – in Nov. 2008.

4. Avoiding quick-money orientations? It is believed that the prevailing systems of remuneration of top managers in the financial sector favour excessive risk taking and making quick profits. This hit-and-run orientation is proposed to be mitigated upon the implementation of '*sensible deferred compensation plans*'. Firms adopting such compensation plans would be offered lower capital requirements. A version of this idea is alluded to in the de Larosière Group Report (p. 31). This is a nice idea, but I am not quite sure it is practicable. The regulatory requirements are now expected to perform many new tasks: provide safeguards complementing the Basel 2 CAR, affect the size/complexity in financial sector, mitigate pro-cyclicality. That would seem to be a rather demanding workload. Can the rules governing the requirements be simultaneously instrumental in changing the behaviour patterns? Possibly. Realistically though, one could fear that a system trying to achieve all these worthy goals at the same time may eventually become inefficient and/or overregulated. One should perhaps try to induce *slow-money* orientation by means of somehow modified system of personal income taxation.

Not only the shadow banking to be regulated

It has been generally accepted that the *systemically important* hedge funds must not be left unregulated. This is a sensible idea – provided there are at least some minimum standards for such funds enforced globally. Would the tax and regulation 'heavens' (outside the EU – but also inside) comply? This remains to be seen.

If the rating agencies are to play a role in the (revised) Basel 2 rules, it is essential that they too are subject to a supervision. Besides, their business model must be changed. Rating agencies cannot issue ratings in exchange for a fee paid by a party seeking a rating for its own security. This is a corrupting arrangement. One can think of many less corrupting schemes. For example, the rating agencies might get paid for their services by the regulatory bodies (e.g. the Committee of European Securities Regulators) who would charge the fee on the security's issuer.

The regulation of financial sector institutions cannot ignore the existence of the off-balance items. Such items must be consolidated into the official balances. By the same token, the regulation cannot be fooled by the practice of hiding the toxic assets in the institutions' own 'vehicles'.

Finally, the specific suggestions commonly advanced (also by the de Larosière Group) to 'civilise' the securitised 'products' and complex derivative markets deserve support.

The root question: can the regulation and supervision keep up with growing complexity of the financial system?

It is highly probable that the changes in regulation currently under consideration could – upon being implemented – make things much better. But it would be presumptuous to claim that these changes would rule out financial crisis in the future. One must have confidence in the power of human inventiveness. Complexity and non-transparency of the financial system is likely to progress further – and to outpace the development of the system's regulation and supervision. Sooner or later smart people will find ways to outwit the regulation.

This is not to say that this will happen anytime soon. But, as one learns from Professor Hyman Minsky[23], a sufficiently long spell of financial stability is likely to erode the mechanisms and instincts safeguarding that stability. The tendency for financial innovation – often initially beneficial but then increasingly potentially destructive – would then come to the fore, with speculative and Ponzi finance expanding at the expense of productive hedging of risks.

Limiting the gap between the financial system's complexity and the ability to control it

How to limit the gap between the financial system's growing complexity and the authorities' ability to regulate and supervise it? I am of the opinion that what proves to be too hard to regulate and supervise, should simply be outlawed. For example, I do not believe that it will be possible to efficiently regulate and supervise large, sufficiently complex and non-transparent financial conglomerates simultaneously running numerous types of activities and – to make things even less controllable – active in many jurisdictions. Rather, I would suggest the legislation should require splitting such conglomerates into independent entities – each running separate type of business, each supervised by a single national authority, each more easily regulated/supervised with well established routines.

I am fully sympathetic to the views expressed by Professor De Grauwe who advocates the return to narrow, traditional banking: '*Allowing banks – which inevitably borrow short and lend long – to get deeply involved in the financial markets is a recipe for disaster. The solution is to restrict banks to traditional, narrow banking with traditional oversight and guarantees…*'[24, 25]

Would the fragmentation of financial conglomerates (and more effective regulation and supervision) bring some measurable economic losses in the form of less efficient allocation of resources or less desirable aggregate volume of investment in the productive fixed-assets? Of that I have not seen any proof. Historical experience suggests that such a fragmentation would bring sizeable gains rather than losses. This is one of the lessons of the Golden Age of Capitalism (the years 1950-70). That lesson needs to be relearned now.

[23] As explained in his book '*Stabilizing an Unstable Economy'* (published first in 1986, most recent edition in 2008).

[24] Paul De Grauwe: '*Returning to narrow banking*', in the booklet edited by B. Eichengreen and R. Baldwin: '*What G20 leaders must do to stabilise our economy and fix the financial system*', www.voxeu.org, 10 Nov. 2008.

[25] It is worth remembering that the traditional narrow banking is based on personalized relationship with the banks' clients. Under relationship banking, the bank officers do not have to run econometric models or purchase grades from the rating agencies to be able to assess their clients' creditworthiness. Nor are they supposed to engage in predatory lending that is certain to ruin the customers. Of course it is cheaper to *originate-and-dispose-of* asset-backed-securities, without ever caring to assess the quality of the underlying assets. In this context 'cheaper' banking is simply 'low quality' banking.

Fragmentation and downsizing of financial conglomerates could also be important for safeguarding systemic stability. The fall of Lehman Brothers would not have had the global consequences it has had, had it (the Lehman Brothers) been much smaller in size – and much more focussed on a narrower array of activities.

Limiting the financial sector complexity to manageable proportions is only one fundamental recommendation that seems to be missing from many recent reform proposals. But there are others, also deserving consideration.

Controlling the asset price bubbles?

The speculative asset price bubbles are potentially destructive. The monetary authorities need to become asset-bubble averse. Unlike in the past, they cannot watch passively as the major bubbles balloon and then burst. It is hard to accept the opinion that it is impossible to identify such bubbles. Monetary authorities should try to prick such bubbles as soon as these are identified. However, I do not believe the central banks should do it by hiking their interest rates. Propelled by speculation, the asset prices tend to rise exponentially. The interest rates that could perhaps discourage borrowing for speculative purposes might have to be astronomic. Pushing the real economy into a severe recession (possibly combined with deflation) seems to be a rather unwise method of counteracting the bubbles' build-up. A natural bursting of a bubble may be less damaging than its early termination achieved by excessive interest rate hikes. Instead, the monetary authorities should try to limit the speculative build-ups with *direct credit controls* imposed – when a need arises – on commercial banks.

Some deeper structural determinants of the bubble economy

During the recent decades the asset price bubbles seem to have become more frequent and more violent. In my opinion this tendency is related not only to the progressing deregulation and liberalisation (going beyond the financial sector, as exemplified e.g. by the liberalisation of capital flows and abolition of the system of managed exchange rates). Perhaps equally important has been the (related) tendency for the stagnation of the labour income – and the dynamic rise in non-labour income – i.e. profits[26]. Add to this the progressive cuts in taxation of high incomes/profits. The result has been the ballooning size of the private liquid wealth. That wealth proves eager to engage in speculative activities (which promise extraordinary returns) rather than in the mundanely productive ones. Too much wealth (private as well as semi-public[27]) chasing too few assets – this is a prescription for the asset price inflation.

It would be naive to expect meaningful reforms now. Some corrections (e.g. concerning regulation) are of course likely. Also, a review of the pension system reforms may be realistically anticipated. But only cosmetic changes may be expected as far as policies affecting income distribution are concerned. Undoing the changes introduced by the policies of the last thirty or so years would require unusual circumstances. The truly radical changes (comparable e.g. to the ones introduced in the 1930s under President Roosevelt's New Deal) could perhaps come only if the world economy plunged into a long and deep depression.

---

[26] For example the hourly compensation of an average non-supervisory worker in the USA has stagnated since the late 1970s. But the hourly productivity of that worker has risen by close to 80% in the meantime. The developments elsewhere (and in Germany in particular) have not been any better.

[27] Unfortunately, among the big '*players*' there are also private managers of the pension funds, gambling with money contributed (obligatorily) by the employees. I am referring here to the so-called capital pillar of the pension system, which was recklessly introduced in a number of OECD countries.

On Supervision

1. *Combining micro surveillance of individual institutions and macroprudential oversight*: I suppose the surveillance of individual institutions should be left to the national offices that are currently in charge of surveillance. The national regulatory/surveillance bodies of individual countries should of course collaborate with one another, directly (e.g. exchanging information of important financial institutions with activities in many countries), or through the 3L3 Committees (or the successors to these Committees). The macroprudential oversight for the EU should be the responsibility of a separate international (EU) body (called e.g. European Systemic Risk Council) affiliated to e.g. the European Commission. (Rather than to the ECB, which should concentrate on doing its own job more efficiently).
2. *The 3L3 Committees, cross-border colleges, etc.*: It has been proposed (in the de Larosière Group Report) to transform the 3L3 Committees into new European Authorities (that would replace the existing CEBS, CEIOPS and CESR). The benefits of renaming, or reorganising the existing bodies are not clear to me. Besides, a new institution is to be set up: European System of Financial Supervisors, with largely undefined duties. All this smacks of another bureaucratic excess – especially if one does not favour a centralised EU supervisory system. Supervision must remain national – at least as long as the fiscal costs of failures of financial firms are borne nationally. Should there be a common fiscal arrangement for the entire EU, with fiscal costs in question borne by the EU as a whole, things would be different. The idea of colleges supervising large EU cross-border financial firms seems also problematic. Has someone determined how many such colleges would be needed? And what about foreign (to the EU) firms active in the EU?
3. *The role of ECB and national central banks in relation to the supervisory authorities*: ECB should *not* play any supervisory role. The relationship of national central banks to their supervisory authorities should remain the national prerogative (lending of last resort is still national).
4. *Prudential activities and consumer protection separated?*: Yes, and the consumer protection agencies must react aggressively to fraudulent financial market practices (e.g. predatory lending).
5. *Linking EU supervision to international institutions*: This should proceed via cooperation (close, to be sure) of ESRC with FSF, BIS and IMF.

What role for the ECB on financial market supervision?

Briefing Paper for the Monetary Dialogue of January 2009 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Anne Sibert

Executive Summary

- The General Council of the ESCB should be the forum where the macro-prudential financial supervision policies of the EU central banks should be discussed and decided.
- Article 105(6) should be amended. The words "… with the exception of insurance undertakings" should be removed.
- If the ECB were to be given greater responsibility and authority in the area of macro-prudential supervision, then it must be required to be less independent and more accountable than it is when making monetary policy.
- It is difficult for the ECB to take a larger macro-prudential financial stability role before the issue of how the Eurosystem is to be recapitalised in the event of capital losses realised while the ECB plays this role is addressed and resolved.

1. *The General Council of the ESCB should be the forum where the macro-prudential financial supervision policies of the EU central banks should be discussed and decided*

Article 105(1) of the Treaty emphasises that the principle role of the ESCB is the provision of stable prices:

> The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.

Until the emergence of the credit crisis on 9 August 2007, the ECB and the ESCB played no important role in the supervision and regulation of financial institutions or markets. With the surfacing of the global financial crisis in September 2008, however, it became apparent that a broader role for the ECB and ESCB might be desirable. The door has been left open for this in Articles 105(5) and 105(6) of the Treaty. Article 105(5) states

> The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the Financial system.

Article 105(6) says

> The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

In his introductory remarks for the first quarter 2009 Monetary Dialogue with the European Parliament, Jean-Claude Trichet referred to Article 105(6) and said, "Reflections have started on the specific role that could be played by the ECB and its Governing Council should this provision of the Treaty be activated." President Trichet's referral to Article 105(6), rather than Article 105(5) is somewhat perplexing.

Article 105(5) is more important to the future of EU financial supervision and regulation than Article 105(6) because it addresses the ESCB, which speaks for the entire EU and not just the euro zone: the General Council of the ESCB is made up of the President and the Vice President of the ECB plus the Governors of the 27 EU national central banks – including the 11 national central banks that are not part of the euro zone. From the point of view of the EU as a whole, the General Council of the ESCB – not the ECB – should be the forum where the macro-prudential financial supervision policies of EU central banks should be discussed and decided.

It is important to note that Article 105(6) allows the Council, the Commission and the European Parliament to grant the ECB specific prudential supervision tasks. The article does not, however, mention any regulatory tasks. This distinction between a supervisory role (enforcing the rules) and a regulatory role (making the rules) is an important one.

2. *Article 105(6) should be amended to include insurance*

The exclusion of insurance from the potential supervisory remit of the ECB is unfortunate: perhaps even more than the 14 September 2008 collapse of Lehman Brothers, it was the failure of American International Group (AIG) two days later that marked the beginning of the global financial crisis. AIG (the subject of the largest government bailout of a private company in US history) is a global insurance company with a balance sheet of more than a trillion dollars – the 18th largest publicly owned company in the world in 2008. Regulated by the New York State Regulator of Insurance, it developed a rogue investment banking unit that sold credit default swaps out of sight of the Fed, the FDIC or the SEC.28 As Fed Chairman Bernanke, commented, "A.I.G. exploited a huge gap in the regulatory system. There was no oversight of the financial products division. This was a hedge fund, basically, that was attached to a large and stable insurance company."29

In addition to AIG, insurance companies across Europe and the United States have been engaged in excessive financial innovation and credit exposure. On 28 October 2008, the Dutch Ministry of Finance and De Nederlandsche Bank injected 3 billion euros of capital into the AEGON Group, one of the world's largest suppliers of life insurance, investments and pensions. Moody's, Standard & Poor and A. M. Best have all downgraded Swiss Re, with A. M. Best commenting that "Swiss Re's overall risk-adjusted capitalization does not have sufficient cushion to weather more negative effects of the continuing turmoil in the financial markets and other unexpected events." 30 The problems with Fortis Group affected its insurance, as well as its banking units. The list of troubled insurance companies is lengthening. Clearly, many insurance companies have encountered problems similar to those encountered by other highly leveraged institutions and it is important that large cross-border insurance companies be included in any EU-wide supervisor or regulator's remit.

3. The ECB is excessively independent and not accountable enough to be a financial market supervisor

The ECB is probably the most independent central bank in the world and this is the main obstacle to it being a financial supervisor. No government or government agency – national or supranational – can tell it what to do. Its Executive Board members and the heads of the national central banks cannot be fired except for gross misconduct. (Gross incompetence will not do.) The ECB is more than operationally independent: it gets to choose the definition of price stability. This is unusual among modern central banks: the government chooses the inflation target for the Bank of England and Norges Bank; the Bank of Canada and the Reserve Bank of New Zealand agree a definition of price stability with the government.

[28] The New York State Department of Insurance was out of its depth, insisting in late August 2008 that, "AIG continues to meet New York's solvency standards, and is able to honor its obligations to policyholders." (spokesman quoted in "Is your insurance safe with AIG?" *Wall Street Journal*, 22 Aug 2008.)

[29] Quoted in Stout, David and Brian Knowlton, "Fed chief says insurance giant acted irresponsibly," *New York Times*, 3 Mar 2009.

[30] Quoted in "Best downgrades Swiss Re's ratings," Insurance Journal, 2 Mar 2009.

The ECB's independence has resulted in a lack of accountability. A perusal of its website shows that to the ECB, "accountability" is synonymous with "reporting obligations". It appears to believe that it fulfils its accountability obligations by publishing its annual report, monthly bulletin, consolidated weekly financial statements and some task-related publications.31 Fulfilling one's reporting obligations is only a necessary condition for accountability. Real accountability also requires that those who hold you responsible can reward or punish you for your actions. The extreme independence of the ECB means that in practice, it has no real accountability.[32]

In its defense of its independence on its website, the ECB says, "The independence of the ECB is conducive to maintaining price stability. This is supported by extensive theoretical analysis and empirical evidence on central bank independence." The ECB is likely correct in this assertion, but the supervision of financial institutions and the provision of stable financial markets is an inherently political activity – involving a substantial redistribution of income – and is not consistent with a lack of answerability. Thus, if the ECB were to be given significant supervisory powers then the nature of the ECB must change. Those officials of the ECB involved in supervision must be substantively accountable with regard to this activity.

4. *This issue of funding must be addressed*

The current crisis reminds us that a central bank without adequate fiscal backing can be powerless in the pursuit of macro-prudential stability and even in the pursuit of price stability. That fiscal backing for the central bank might be a necessary condition for the central bank to achieve price stability was not an issue for the ECB until the current crisis. However, as the crisis has deepened, the exposure of the ECB/Eurosystem to private credit risk through its exposure to repos and other collateralised lending has become a pressing issue. Defaults from the German arm of Lehman Brothers Holding and three Icelandic bank subsidaries were among the reasons the ECB reported recently that it is owed more than 10 billion euros by various counterparties. Even though the insolvent counterparties had submitted eligible collateral in return for ECB funding, their collateral, which mainly consisted of asset-backed securities, was in the words of an ECB press release "... of limited liquidity under the present exceptional market conditions and some of the [asset- backed securities] need to be restructured in order to allow for efficient recovery, ...".

[31] The ECB's terse description of accountability can be found on its website by clicking successively on "European Central Bank", "Organisation" and "Accountability". Its rather more enthusiastic description of its independence is found under "Organisation" as well.

[32] An example that reveals the ECB's stance on accountability was its attitude toward the Committee on Economic and Monetary Affairs of the European Parliament when the Committee expressed concerns about the ECB's lack of procedural transparency during its quarterly dialogue with the ECB. For years members pressed unsuccessfully for details about the decision-making process, without engaging the ECB's representative in serious discussion. (See Sibert, Anne, "The European Parliament's quarterly dialogue with the ECB and its panel of experts," briefing paper prepared for the Committee on Economic and Monetary Affairs of the European Parliament, Oct 2005.)

If the ECB's policy rate nears zero, the ECB may have to engage in quantitative and qualitative easing: the outright purchase of private securities funded by an increase in the monetary base. Without a fiscal indemnification for the resulting credit risk, the ECB will be unable to address the excessive private-public yield spreads and the credit rationing that are symptoms of dysfunctional credit markets. The Bank of England can turn to HM Treasury and the Fed can turn to the US Treasury, but to what body does the ECB turn to for fiscal backing? Is it the 16 euro zone Treasuries or ministries of finance? Or the 27 EU Treasuries or ministries of finance that are the shareholders of the ECB? Currently there is a vacuum behind the ECB and the Eurosystem with respect to losses incurred by the Eurosystem as a result of monetary operations, liquidity interventions and credit-easing policies. While obviously politically difficult, this is a problem that needs to be addressed urgently.