Designing A Central Bank For The 21st Century Eurozone

Monday 10th February 2014
16:00–17:30
(followed by a networking reception)

The University of Warwick Brussels Office
6th Floor
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1040 Brussels

The ongoing financial crisis in the Eurozone has focused attention on designing central banking institutions that promote sustainable economic growth, high employment, stable public finances, and financial stability.

However, debates over the direction of monetary policy and responses to sovereign debt and banking crises point to the challenges of balancing national interests with pan European or Eurozone objectives. Recent research on institutional design sheds new light on these trade-offs and provides lessons for how European monetary policymaking and bank supervision might look in the twenty-first century.

Professor Kris Mitchener will discuss the tensions that are built into the emerging European banking union and how other countries have confronted similar challenges in the past.

Dr Michael McMahon will talk about how the size and composition of central banks' policy committees influences the performance of monetary policy and how the relative "transparency" of committee decision making improves the preparation of participants.

The lecture will be followed by a lively debate with:

- **Mr Olivier Debande** - Senior Economist - European Investment Bank
- **Mr Vasco Cal** – Economic Adviser - BEPA Analysis Team, European Commission
- **Mr Paul Kutos** – Head of Unit 'Monetary and exchange rate policy of the euro area' - DG Economic Development, European Commission

The discussion will be moderated by **Mr Richard Tuffs**, Director of the European Regions Research and Innovation Network.

Lessons from History for the European Banking Union – by Kris Mitchener

Background

The European Banking Union has three pillars. The first is the Single Supervisory Mechanism (SSM), which will go into effect in November 2014. Roughly 130 systemically important banks consisting of approximately 85 percent of all commercial banking assets will be directly supervised by the ECB. These are banks with assets of more than €30 billion or 20% of country's output. 5,900 banks will be supervised by national regulatory authorities, but the ECB will have the power to intervene in some circumstances. The second pillar is a joint deposit guarantee scheme. An agreement reached December 18, 2013 maintains deposit insurance at the national level, but cements a EU minimum repayment to depositors of €100,000 ($137,680) when banks fail. National funds will need to cover 0.8% of a country's deposits and repay depositors within seven days of a bank failure, but the agreement stops short of a common EU deposit insurance fund. The third pillar is a joint resolution mechanism with a single, independent authority. The Eurozone backstop, also agreed in mid-December, uses bank contributions to fund a backstop and wind up insolvent banks. The proposal states that funds will be built up at the national level to roughly €55 billion, with funds being merged gradually over a 10-year period. Non-Eurozone members will be able to opt into the banking union.

Although increasing banking market integration within Europe had exposed a gap between institutions and practice, the current push for reform in Europe has largely been a response to the ongoing banking and sovereign debt crisis in Europe. In particular, the connection between troubled banks and public finances has propelled EU policymakers to move forward on all three pillars of the banking union to shore up the financial system and provide greater long-run stability.

Research findings

What does history have to tell us about creating bank supervisory institutions in response to crises? The experience of the United States provides a reasonable historical analogy for understanding how economic states gradually ceded control of supervisory institutions to union-wide agencies. Much as in Europe, each American state had initially developed its own regulatory and supervisory system with the legal right to charter banks.

A survey of the facts suggests Europe's accelerated approach differs from the U.S. case. It took more than a century for modern supervisory institutions focused on systemic stability and depositor welfare to emerge in the U.S. and close to 150 years for two of the pillars (a common supervisory agency and deposit insurance) to emerge at the federal level. In the U.S., institution building at the federal level moved slower than present-day Europe for several reasons: (1) capital markets were less integrated and cross-border banking was limited and (2) banks were initially note issuing entities rather than deposit taking. By contrast, what Dirk Schoenmaker and Sander Osterloo call the "financial trilemma" – the incompatibility between national bank regulation and supervision, capital market integration, and financial stability – presented itself sooner in Europe, creating pressure for reform.

Similar to Europe, policymakers in the U.S. initially focused on the competitive landscape of the banking system rather than on designing institutions to promote systemic stability. However, as in Europe, crisis eventually triggered more interest in reforming cross-border institutions. U.S. Federal deposit insurance and a common supervisory agency emerged after the complete collapse of the U.S. banking system in 1933.

Lessons for Europe from U.S. experience

- Maintaining a fragmented supervisory system was unsuccessful.
- Federal deposit insurance had a calming effect on the immediate situation.
- Winding up banks does not imply a "standing fund."
- Design stress tests to avoid market stigma of recapitalization funding.
- Agency specialization allows for speedy resolution.
- Backstops can be designed to adjust to size of future crises.
- Common resolution was not instantaneous.

Related research

Mitchener, Kris (2007), "Are Prudential Supervision and Regulation Pillars of Financial Stability? Evidence from the Great Depression." *Journal of Law and Economics* 50(2), pp. 273-302.

Mitchener, Kris, and Matt Jaremski (2014), "The Evolution of Bank Supervision: Evidence from U.S. States". CAGE Working Paper no 181. University of Warwick.

Mitchener, Kris, and Joseph Mason (2010), "Blood and Treasure: Exiting the Great Depression and Lessons for Today." *Oxford Review of Economic Policy* 26(3), pp. 510-39.

Mitchener, Kris, and Gary Richardson (2013), "Skin in the Game? Risk, Leverage, and Consequences of New Deal Financial Legislation?" *Explorations in Economic History* 50(4), pp. 508-525.

The Who and the How of Monetary Policy Institutions – by Michael McMahon

Background

Expert committees within independent central banks are the dominant institution for setting monetary policy throughout the world. By 2000, 79 of 88 central banks surveyed by the Bank of England used committees to decide interest rates. For example, committees are used at the European Central Bank (ECB), United States Federal Reserve (Fed) and the Bank of England (BoE). But different central banks make use of different committee structures. Although there is a broad consensus on the merits of monetary policymaking by independent committee rather than by politicians, many open questions of central bank design remain.

Research issues

The Bank of England and the Riksbank both make use of monetary policy committees (MPCs) with similar remits. However, the former has a committee of nine members, four of whom are external experts appointed by the government solely for the purpose of monetary policy decision making. The remaining five members are internal members of Bank of England staff who have executive responsibilities within the Bank. At the Riksbank, only internal members are used as part of a six member committee. In one strand of my research, I try to understand whether such differences matter for the effectiveness of the committee. In particular, I try to answer the question of how large MPCs should be, and whether a mixture of central bankers and external experts should serve on the committee.

Another question is to what extent new central bankers use the early part of their tenure to try to convince markets that they will be tough on inflation. This “signalling” to establish a “hawkish” reputation was particularly a concern when, in the middle of the financial crisis during which the euro area required lower interest rates, it looked like Mario Draghi would become ECB president. The concern was that Draghi, as an Italian, would try extra hard to dispel market fears that he might conform to national stereotypes and not be tough on inflation. As Stephanie Flanders (BBC News, 5 May 2011) commented “If you're sitting in Spain and Portugal, you might well wonder whether you would have been better off with a German in charge, trying to show off his inner Italian – than an Italian desperate to prove he's German underneath.”

Finally, my research asks how much information about the committee and their decision making should be made public. Central banks also differ along this dimension. The Fed releases unattributed minutes a few weeks after the meeting and releases *verbatim* transcripts after five years. The BoE only releases minutes. The ECB, one of the least transparent central banks, releases neither. Using computational linguistics tools, I examine how the extra transparency from releasing transcripts affects meeting deliberation.

Research findings

- Committees outperform individuals because they pool the views of lots of individual experts on the state of the economy, allowing the committee decision better to reflect economic conditions.
- By appointing sufficiently expert committee members, the committee does not need to be that large; a committee of between five and seven is typically large enough to reap the gains of pooling information while avoiding costs of deliberation and communication that come in larger committees.
- We find little evidence to support the appointment of external experts (as used by the BoE).
- We find evidence consistent with reputation signalling. Inherently more hawkish MPC members are less affected by such signalling. Nonetheless, signalling does not change the hawkish ranking of members.
- While many people argue that transparency of decision making is necessary for reasons of democratic accountability, the concern is that it stifles discussion and deliberation. We find that transparent discussion improves incentives for committee members to accumulate information before they meet. While they are also somewhat less dynamic in their discussions, the added information effect likely dominates.

Implications for the ECB

- The 24-person ECB Governing Council, which makes monetary policy decisions for the euro area, is probably too large.
- The Governing Council does not necessarily need economic experts from outside central banking.
- Even if a dovish ECB President Mario Draghi had to try hard to convince markets he could be tough on inflation, the ECB would not have been better served appointing a hawk to the position.
- The ECB can benefit from following Mario Draghi's declaration that “it would be wise to have a richer communication about the rationale behind the decisions that the governing council takes” (*Financial Times*, 1 August 2013). The ECB should consider going as far as the Fed in committing to release transcripts of their discussions with a lag.

Related research

Hansen, Stephen, Michael McMahon, and Carlos Velasco Rivera (2012), “Preferences or Private Assessments on a Monetary Policy Committee?” Under review at the *Journal of Monetary Economics*.

Hansen, Stephen, and Michael McMahon (2013), “First Impressions Matter: Signalling as a Source of Policy Dynamics.” Under review at the *Review of Economic Studies*.

Hansen, Stephen, Michael McMahon and Andrea Prat (in progress), “Transparency and Communication within the FOMC: A computational linguistics approach.”

About Kris James Mitchener

Kris Mitchener is Professor of Economics at the University of Warwick, Research Associate at the National Bureau of Economic Research (NBER), and Research Fellow at the Centre for Competitive Advantage and the Global Economy (CAGE). His research focuses on economic history, international economics, macroeconomics, and monetary economics, and he is a leading expert on the history of financial crises. His path-breaking study published in 2003 demonstrated how the size of credit booms influenced the severity of the economic downturn during the worst financial crisis of the 20th century – the Great Depression. He is a current recipient of an Institute for New Economic Thinking (INET) grant, and from 2009-11, he was the W. Glenn Campbell and Rita-Ricardo Campbell Hoover National Fellow at Stanford University. He has held visiting positions at the Bank of Japan, the St. Louis Federal Reserve Bank, UCLA, and CREi at Universitat Pompeu Fabra. He is associate editor of Explorations in Economic History and presently serves on the editorial boards of the Financial History Review, Cliometrica, and Economics. He received his B.A. and Ph.D. from the University of California, Berkeley.

About Michael McMahon

Michael McMahon is Assistant Professor of Economics at the University of Warwick, having previously taught at Stanford University, INSEAD, New York University, Chicago GSB, and the London School of Economics (LSE). He has also worked for the Bank of England, with spells at the European Central Bank and the Central Bank of Ireland. His research interests include the macroeconomics of business cycles, monetary economics, inventories and applied econometrics. He is a research affiliate of the Centre for Economic Policy Research (CEPR), the Centre for Macroeconomics at LSE, the Centre for Economic Performance at LSE, CAGE at Warwick and the Centre for Applied Macroeconomic Analysis at Australia National University. He is on the advisory Committee of the Money-Macro-Finance research group. He was formerly an advisory board member to the UK Higher Education Academy's Economics Network. In 2011 he gave a TED talk on the challenges of both research and teaching at university. He holds an undergraduate degree from Trinity College Dublin, and an MSc, MRes, and PhD from the London School of Economics.

About the Centre on Competitive Advantage in the Global Economy (CAGE)

Established in January 2010, CAGE is a research centre in the Department of Economics at the University of Warwick. Funded by the Economic and Social Research Council (ESRC), CAGE is carrying out a 5 year programme of innovative research.

The centre's research programme is focused on how countries succeed in achieving key economic objectives such as improving living standards, raising productivity, and maintaining international competitiveness, which are central to the economic wellbeing of their citizens.

Our research analyses the reasons for economic outcomes both in developed economies like the UK and emerging economies such as China and India. We aim to develop a better understanding of how to promote institutions and policies which are conducive to successful economic performance and endeavour to draw lessons for policy makers from economic history as well as the contemporary world.

Research at CAGE examines how and why different countries achieve economic success. CAGE defines 'success' in terms of well-being as well as productivity. The research uses economic analysis to address real-world policy issues. The centre is distinctive in providing a perspective that draws on economic history as well as economic theory and is applied to countries at various different stages of economic development. Research themes are organised under three questions:

- What explains catching up, forging ahead or falling behind in economic growth over the long run?
- What permits countries to adjust successfully to new opportunities and challenges presented by global economic development?
- When does succeeding in the global economy translate into reduced deprivation and enhanced general wellbeing?