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Comments on Charles A. E. Goodhart, "The Links between Fiscal and Monetary Policies on the One Hand, and Financial Stability on the Other"

Charles Goodhart has presented a paper on the influence of fiscal and monetary policies on financial stability. I would summarise the stylized facts as follows:

- Dirigiste governments force banks to extend loans to specific sectors, and to hold government paper. This increases the danger of monetising debt, and thus financial instability through high deficits.
- Without observance of the Stability and Growth Pact (SGP) financial regulators, under pressure from their governments, have no appropriate risk weighting for concentrations of bank holdings of debt of a single obligor. Thus, in the case of default of a euro area Member State its financial sector would thus be overexposed to this asymmetric risk.
- Fraud in or even by banks cannot be contained by additional capital requirements, and only partly by independent supervisors.
- Systemic risk beyond a certain point should be covered by governments.

- Enhanced competition leads to falling profit margins, then to lower capital ratios, thus to even lower profit margins, thus to excessive search for yield, and thus to financial fragility.
- Money supply and credit growth tend to overshoot with relation to cyclical developments through extrapolation of prevailing trends. Regulators, however, have consistently failed to introduce countercyclical prudential controls, and

Basel II may further amplify procyclicality. Present growth of M3 may foreshadow financial fragilities.

I will deal with the most important of these points in turn. I will do this in the context of what I consider to be the policy areas most in need of attention. I will in general confine myself to a European perspective.

First, what is financial stability? We define this as a financial system capable of absorbing severe shocks without triggering a financial crisis, i.e. financial stress that has cross-sectoral spillovers with negative macroeconomic effects. Conditions (though none of them is in theory necessary and sufficient) for achieving financial stability in the context of this paper are

- fiscal policies that satisfy sustainability constraints, also in intertemporal terms;
- monetary policy conducive to a low inflation environment with stable expectations;
- financial regulators equipped with the instruments and the political independence in order to
- assess risk of excessive borrowing/lending, and concentrations of such risk;
- analyse portfolio changes in household net lending/borrowing and their links to interest rate movements;
- understand shifts between internal and external financing of nonfinancial corporations.

Stress in the financial sector matters for two principal reasons. First, it hinders growth because it may lead to poor allocation of resources within an economy. The real rate of return falls. Japan is a particularly striking illustration of this, in part because of the length of time over which its financial sector weaknesses have inflicted harm on the economy. Japanese deflation has, of course, made the problem far worse.

But, as the Asian crisis showed, financial sector stress also increases vulnerability to a crisis. Research has shown that a country with a weak financial sector is more at risk from contagion effects.

Second, at the domestic level, governments must take steps to ensure a sound banking system, since a weak banking system may lead to large negative feed-back-effects (e.g. liquidity shortages). That means addressing issues such as non-performing loans, capital adequacy ratios and effective regulation. It means ensuring there is proper competition within the banking sector. And it means ensuring that there are incentives in place so that financial institutions develop the appropriate skills needed to assess and manage credit risks and returns.

There appears to be positive correlation between growth and financial

sector development (empirical evidence is mixed as there may be reverse causality).

In a European context increasingly integrated financial markets should reduce the possibility of major shocks through diversification on both sides of the balance sheet, though once a crisis occurs there is a higher risk of spreading beyond national borders.

What Is the Role of Fiscal Policy?

I have yet to meet an economist who has anything good to say about the SGP. One half says that it inhibits countercyclical fiscal policies, keeps deficits at too low levels, and thus there is no role left for aggregate demand management. The other half says the Pact has been an abysmal failure because it failed to curtail deficits. So, obviously, deficits are too high and too low simultaneously.

In a best of all possible worlds free of political cycles and with intertemporal constraints fully respected there need not exist limits on annual deficits, neither for nation states with national monetary policies, nor for euro area Member States. It would obviously suffice if governments respected an upper limit for national debt levels. The 60% limit of the Maastricht Treaty, as any number, is obviously arbitrary, and was conditional on a certain constellation of growth and inflation. Today, the same calculation would yield a lower number.

Debt sustainability is essential not only for rating and pricing of government paper, and the level of long-term interest rates, but also for overall financial stability through portfolio effects. As we do not live in a best of all possible worlds, deficit constraints are necessary, however, due to policy myopia. Thus, the SGP.

Recently, discussions on market-based mechanisms as substitutes for the SGP have re-emerged. Analysis undertaken a few years ago on their feasibility was not encouraging, however.

An additional feature of monetary union where politicians (and many economists) have been unwilling to engage in an economic debate is that tax rates have clearly taken over the role of exchange rates. Changing corporate rates has the same effect as a de/revaluation of a national currency, albeit with different sectoral impact and transmission channels. The consequences of this are still little understood by most, unfortunately.

The mythology of unconstrained national sovereignty in tax matters will have consequences on financing conditions in the medium term. Most governments are and will be ill equipped to deal with this issue when it becomes more pressing.

At present, yields have not reacted to deficit levels in Germany, and not even to debt levels in Italy. This may be because sustainability conditions are still satisfied. Alternatively, the reaction function of markets may not be continuous, and could kick in at deficit levels beyond say 4% or 5%. A logical consequence is that also spreads have not reacted; some analysts have speculated that this could be changed by the European Central Bank (ECB) not taking all government debt as collateral at the same conditions. This would make a difference, though the ECB on its own is not likely to go this route.

Goodhart suggests an independent panel of economists analysing the debt sustainability of countries: this is something any economist is free to do. The difference in this model would presumably be that these

economists' pronouncements through the authority invested in them would be expected to

- produce market reactions (little likely, see above);
- make governments through naming and shaming produce better policy outcomes (also little likely, as there are even less consequences than under the SGP).

The linkages to financial market fragility in Europe could thus be as follows: As markets tend to react excessively

and abruptly (and sometimes too late), and here I fully agree with Goodhart, financial market stress could follow from a constellation where

- debt levels are high and rising in country A;
- financial markets at some unknown level of debt, or debt increase, suddenly expect pricing changes in government A's paper uncorrelated to the euro area average;
- because of expected declining perfect substitutability of government bond A for government bond B in investors' portfolios bond holders will incur losses on stocks of A;
- which, if heavily concentrated in certain institutions' portfolios will lead to distress in the balance sheets of these institutions. The Feldstein-Horioka puzzle on home bias lends support to this hypothesis, though it is doubtful that concentration rates in portfolios are as high as implied. Furthermore, default risk in the European Union may be presumed, despite all the academic discussion about default, no bail-out and the like, to be zero. Political institutions in all Member States can safely be assumed to be adequately mature to provide adequate reactions in times of real crises. They are obviously often ill equipped to deal with secular problems that are not an imminent crisis.

How likely is this to happen, and what are the dangers of contagion? And what is the danger of default? The answer is that we do not know how likely this is; the dangers of contagion would under this model of transmission of effects be limited, as for most institutions with an otherwise healthy return on equity (ROE) holdings of such paper can be assumed to be a manageable part of the portfolio. If such a scenario were to include two or more major euro area Member States the results may well be less benign. And default does not seem likely.

What Is the Role of Monetary Policy?

An independent central bank with one monetary policy ("one size fits all"), liberalised movement of capital and goods (and labour and service markets that are not fully liberalised), and an area-wide average inflation target form the background to a monetary policy that has to contend with

- differing stances of fiscal policies;
- differing stages in the cycle;
- differing productivity developments; and
- differing wage developments.

Thus, we logically have asymmetric monetary policy consequences if national inflation rates are not highly correlated with the euro average inflation rate. Actually, we had expected a higher degree of price and cyclical

convergence from monetary union at the outset. The conclusion at present would seem to be that structural policies and productivity shocks may be more important for inflation – and growth – than monetary policy.

Goodhart argues that *"one of the most reliable predictors of future systemic financial crises is the rate of expansion of broad money and bank lending."* He goes on to argue that the present growth of M3 may thus foreshadow financial fragilities. Is this addressed to the ECB, or at regulators? To me it would seem to be more aimed at regulators, though these are often not easy to distinguish from the European System of Central Banks (ESCB). Is this a potential conflict of interest? Opinions differ.

A monetary policy aimed at price stability would be hard pressed to shifting its policy stance on the basis of evidence that certain real cycles are amplified by monetary cycles. The monetary stance is obviously correlated to growth in M3 and bank lending, but over the decades the correlation has sunk dramatically. Monetary policy, even if it wanted to and even if we better understood the causes for high growth in some monetary aggregates would face an assignment problem it is not equipped to deal with.

Goodhart succinctly describes the problems of monetary policy in dealing with signals that may herald financial fragility, even though conventional banking wisdom sees them as leading inflation indicators.

The present state of affairs of M3 growth seems to be, however, less induced by overoptimism and relaxed credit controls, but more due to increased uncertainty and higher risk aversion. The way I read the data is that 2001 to 2003 portfolio shifts may thus have been a more logical reason for M3 growth. And in 2004 the low interest rate environment.

Loan growth relative to growth would appear to be a better indicator for Goodhart's theory, though one would have to factor in past and present savings rates of private households and the enterprise sector in order to see whether we are witnessing

– a change in the quality of loan portfolios; or
– the beginning of an upswing in consumption that begins to reverse past under consumption by households in many European economies; or
– the increased availability of other financing instruments.

The evidence of credit growth to private households in the euro area at an annualised rate of 8% in the last months may herald a return to self-sustained domestic demand rather than a deterioration of the quality of loan portfolios. In some European economies with highly leveraged households, and collateral highly concentrated in the housing sector, the situation may be different. Again, monetary policy can do little to counteract these issues where they exist or loom on the horizon.

If such shocks were to occur, the risks for contagion appear to be containable as long as we have national bubbles. Financial stress through portfolio deterioration through excessive credit growth compared to the quality of collateral will remain for the foreseeable future a phenomenon that will not be euro area wide.

This leaves central bankers with an obligation to observe closely, but I would draw no policy conclusions for monetary policy proper. In terms of cooperation with policymakers in order to make them observe emerging

bubbles and other problems our experience with the ECB is, though little publicised, very positive.

What Is the Role of Supervisory Policy?

The international financial system in the last years has been relatively stable, and most analysts concur that this has to do with more advanced risk management techniques. Obviously, one always guards against the causes of the last crisis, and not against the next one. But we have learnt lessons that go beyond anecdotal evidence.

This does not mean there will be no next crisis; this would actually by unhealthy.

One of Goodhart's main contentions with respect to regulators and their responsibility for financial stability is that they require too high capital ratios with respect to risk-taking *("require banks to hold so much capital that they could survive a re-run of the inter-war debacle? If so, they could take on very little risk.")*

Furthermore, market driven processes undermine the stability of the system according to Goodhart. In a highly competitive environment profit margins decline, capital ratios fall, search for yield produces excessive risks, and thus we are vulnerable to – or actually have – financial sector fragility.

What is the core problem here? Is it that competition reduces (excess) profits? This is the case in every sector, and the underlying rationale of our economic system driving for efficiency through competition.

Or is it a problem germane to the financial sector? If so, what are the underlying reasons? Are they to be found in the specific structure of the sector that fragilities are carried into other parts of the economy through monetary linkages? Or that pricing of risk and taking of risk is inherently different than in other sectors?

It would seem that it is the nature of the sector that causes these troubles in Goodhart's model. The conclusion would thus be to

- limit competition (take the case of certain still protected national markets in Europe); or
- regulate the risks you can take and how you provision for them.

I have a strong sympathy for the latter, and actually believe that with all its short comings Basel II is a step towards a more risk sensitive financial sector. But we should not forget that it is not the regulator who is at fault in the first instance, it is the management of the financial institution. And any calls to governments to socialise the risks of excessive credit expansion will produce exactly these effects we are trying to regulate away. Governments with deposit insurance schemes socialise part of the risk at present, and even there we are confronted with aspects of moral hazard.

I fully agree with Goodhart as he speaks of "over-optimism" in good economic times, and in theory that we need stronger incentives for more "counter-cyclical policies", which may prove difficult as I have yet to meet a policymaker intent on dampening an economic upswing.

Financial markets tend to over- or undershoot, because they are driven by expectations – rather linear interpolations – and herd-behaviour exists. We will therefore continue to have to accept some form of financial market

swings, as markets react to new economic data and permanent change of expectations. We do need sound financial supervision to prevent and manage systemic risk and contagion. But calls on regulators to produce anti-cyclical supervision practices will fail for all the reasons that anti-cyclical fiscal policies were not a huge success. Know your automatic stabilisers and let them work, should be the motto.

Where have regulators and the European Union more work to do? One issue is that there are still certain Member States who do not adequately enforce the rule that beneficial owners of financial institutions should be known. The European Commission and the Council seem to be oblivious to this problem.

What can the market do? Financial institutions with highly diversified product groups (corporate clients, retail customers, wealthy customers, bonds, equities, derivatives) are obviously better equipped to escape prolonged market declines. The downside is that such financial conglomerates can also lead to a series of unmanageable conflicts of interest as recent cases have shown (AIG, Citigroup).

Also, management needs to be in a position to take a long term view on profitability of their institution. This is not state of the art. Shareholder value is, though often maligned nowadays, a sound economic principle; but it is long-term shareholder value that should be pursued. Instant gratification is bad for children and for markets.

Risks need to be better understood by institutions, and long-term potential consequences factored into decisions. Here, Goodhart has a more than valid point.

What Is Left for National Economic Policies and What Can Policy Do for Financial Stability?

What is left for national economic policy in order to influence variables which also have a bearing on financial stability?

Despite all the dire warnings that there is no room left for national policies to function we still have numerous areas where the quality (or lack) of policies count:

- wage policy (inflation);
- iscal policy (sustainability);
- structural policy (productivity);
- education/innovation (human capital); and
- inancial markets policy (financing conditions).

Whilst increasing financial market integration may indeed limit national room for manoeuvre, more integration is a precondition for more competitive pressures in the sector.

What is the role of economic policy in supporting financial stability?

There emerge a number of central propositions:

- no unexpected policy changes (no stop-go-policies): time-consistent economic policy (stabilising of expectations, setting of long-term economic goals);
- no procyclical fiscal policy, and subscribe to sustainability of fiscal policy;
- monetary policy cannot be overburdened with aim of financial sector stability, though policy dialogue with regulators and policymakers is vital;
- financial markets work best, when all actors are well informed (better education concerning financial market issues to prevent asymmetric information distribution);
- availability of liquidity in case of crises (“the quicker the better”);

- consolidation of financial sector in Europe not a policy goal per se, but act against monopolistic behaviour (concentration ratio of banks should be analysed) and segmented national markets;
- continue work on question of European financial sector supervision;
- clearing/settlement very important for cost efficiency of financial services; there are huge differences for the provision of basic retail banking services per year across Europe (according to recent data from Capgemini they range from 25 EUR in the Netherlands to 113 EUR in Italy): more competition in retail banking seems necessary;

- high flexibility of the economy to absorb shocks more easily (higher labour force mobility and more competition in service sector in Europe);
- stronger global economic coordination to prevent unilateral measures which hurt world trade growth (and weaken domestic economies);
- especially under the auspices of the International Monetary Fund in relation to the Fund's work on transparency and financial stability; and
- more coordination in EU tax policy, otherwise tax revenues will decline due to tax competition (this may lead to new taxes which may impact negatively on financial markets).

Concluding Remarks

Charles Goodhart has produced a thought-provoking paper. Some of the conclusions are obviously aimed at emerging markets, and not at the European Union, see the discussion on monetising debt.

The need for independence of regulators is underlined by the picture that Goodhart paints about captured regulators forced to accept large holdings of national debt, and thus increasing dangers of contagion. For the Economic and Monetary Union (EMU), this seems to rest on assumptions that are not realistic, though for emerging markets they would appear to hold.

The dangers of profligate fiscal policies are well described, though the conclusions on the SGP and possibilities of sovereign default within EMU are a bit overdone. The transmission channels may be slightly different, but the end-result is the same: we need fiscal discipline in order to contain spillovers through differing channels.

The pro-cyclicality of supervisors would appear to me to be a pro-cyclicality of the sector that supervisors only to a degree can be called upon to regulate away. Markets and management need to bear the consequences of myopic behaviour.

All in all, the paper implicitly shows up numerous areas where further research and even more policy advice is needed – from academia to policymakers, and from regulators to markets.