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# Monetary Policy and Prudential Supervision – From Functional Separation to a Holistic Approach?

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# Monetary Policy and Prudential Supervision – From Functional Separation to a Holistic Approach?*

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Today, hardly anyone would doubt that monetary policy and the stability of financial institutions are highly interrelated. In fact, the tradeoffs between inflation-targeting monetary policy and stability-orientated prudential supervision might have a positive or negative influence on another.[1] Monetary policy determines the supply of money to banks and their refinancing conditions, thereby setting the frame for the supply of credit.[2] The amount of credit has an impact upon financial stability. Conversely, prudential supervision has an impact on the transmission of monetary policy as it affects the capacity of banks to create money through lending.

During the decades preceding the Financial Crisis, the theory and practice of central banking frequently disregarded the tradeoffs between monetary policy and financial stability and favored an institutional model that assigned central banking and financial supervision to separate entities. This approach owes its popularity and spread across the world to the historical experience that independent central banks were eventually able to control the high levels of inflation coinciding with the economic recession of the 1970s and early 1980s. But the experience of the financial crisis has called this model of "functional separation" into question. An overly strict separation would jeopardize the effective protection of financial stability and price stability. This has prompted calls for a more holistic approach that unites the diverging policy objectives and reopens questions of institutional design.[3]

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* SAFE policy papers represent the authors' personal opinions and do not necessarily reflect the views of the Research Center SAFE or its staff.

[1] Ben S. Bernake, 'The Effects of the Great Recession on Central Bank Doctrine and Practice' Speech at the Federal Reserve Bank of Boston 56th Economic Conference, Boston, Massachusetts <https://www.federalreserve.gov/newsevents/speech/bernanke20111018a.htm>, 12; Ferre De Graeve, Thomas Kick and Michael Koetter, 'Monetary policy and financial (in) stability: An integrated micro–macro approach' 4 Journal of Financial Stability (2008) 205; Itai Agur and Maria Demertzis, 'Will Macroprudential Policy Counteract Monetary Policy's Effects on Financial Stability?' IMF Working Paper WP/15/283 (2015).

[2] B. S. Bernanke and M. Gertler, "Inside the black box: the credit channel of monetary policy transmission", National bureau of economic researc, Working Paper No. w5146 (1995) (1995).

[3] Olivier Blanchard, Giovanni Dell'Ariccia and Paolo Mauro, 'Rethinking Macroeconomic Policy', IMF Staff Position Note SPN/10/03 (2010) 11; Committee on International Economic Policy and Reform, 'Rethinking Central Banking', Brookings Institution (2011); Martin Hellwig, 'Financial Stability, Monetary Policy, Banking Supervision, and Central Banking', Preprints of the Max Planck Institute for Research on Collective Goods (2014), Bonn 2014/9; Rosa M.

A holistic approach, where monetary policy decisions pay due regard to financial stability concerns, and where supervisory decisions account for monetary policy effects, would not necessarily require rebuilding the institutional setup and unifying supervision and monetary policy in one institution. It would suffice to ensure consistency between monetary policy and financial supervision to render both effective.[4] Hence, the holistic approach mostly concerns the way in which institutions exercise their respective mandates.[5] It could even be implemented under a separation model if the central bank and the supervisory authority coordinate their decisions.

## Legality of a Holistic Approach to Monetary Policy and Supervision

The preferability of a holistic approach is a question for economists that will ultimately be decided by central bankers. The salient legal issues are whether a holistic approach to monetary policy would be in conformity with the current legal framework of the Economic and Monetary Union (EMU), and whether monetary considerations are legitimate within the framework for prudential supervision, should the SSM wish to opt for a holistic approach in that respect as well. In my view, both questions are to be answered in the affirmative. Both the monetary policy mandate and the supervisory powers of the European Central Bank (ECB) are drafted in a relatively abstract, open manner, leaving the European Central Bank sufficient scope for holistic approaches. The ECB can take due account of its monetary policy within the scope of its supervisory functions (or to take due account of supervisory concerns within the frame of its monetary policy) as long as such influence remains proportionate to the supervisory (or monetary) policy objective. It thus turns out that the legal framework of the EMU is rather neutral if it comes to the choice between strict functional separation and more holistic approaches and does not necessarily subscribe to the premises of the theory of functional separation.

Concerning the monetary policy mandate, the legal argument is as follows: Looking at the wording or the systemic structure of the Treaty on the Functioning of the European Union (TFEU) and the ECB Statute alone does not provide a conclusive answer as to whether a holistic approach is admissible. The latter therefore depends on a purposive reading of the relevant provisions in the ECB legal framework. The European Court of Justice (ECJ) clarified that the stabilization of the Euro area as such is not a goal of monetary policy, but an economic policy objective.[6] Instead, the objective of monetary policy is price stability. Nevertheless, the court recognized the interplay between monetary policy and

Lastra and Charles Goodhart, 'Populism and Central Bank Independence', Centre for Economic Policy Research Discussion Paper No. 12122 (2017).

[4] R. M. Lastra, International financial and monetary law (2nd edn., 2015) 125.

[5] David Green, 'The Relationship between Micro-Macro-Prudential Supervision and Central Banking' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), Financial Regulation and Supervision (OUP 2012) 63 (3.32).

[6] ECJ Pringle, C-370/12, EU:C:2012:756, para. 56; ECJ Gauweiler, C-62/14, ECLI:EU:C:2015:400, para. 64.

financial stability[7] and confirmed that measures of the ECB aimed at ensuring the effective transmission of monetary policy are covered by its monetary policy mandate.[8] This is corroborated by Article 127(5) TFEU.[9] It therefore seems plausible to argue that the ECB, in the discharge of its monetary policy mandate under Art. 127(1) and (2) TFEU, may legitimately take into account financial stability considerations as long as the overall objective of such policy is price stability, i.e. as long as it enhances financial stability to further price stability, and not as an end in itself. In that sense, financial stability would be an intermediate, second-order goal of monetary policy.

Concerning the supervisory mandate, the SSM Regulation seems at first sight to strictly separate the ECB's monetary and supervisory functions. However, despite a lot of public debate focusing on this issue during the drafting process, the exact significance of that separation remains somewhat unclear. I argue that this separation does not stand in the way of a holistic approach to supervisory decisions which would give due consideration to monetary policy concerns.

To begin with, the wording of Article 25(2) of the SSM Regulation does not preclude a holistic approach. Accordingly, "[t]he ECB shall carry out the tasks conferred on it by this Regulation without prejudice to and separately from its tasks relating to monetary policy and any other tasks. The tasks conferred on the ECB by this Regulation shall neither interfere with, nor be determined by, its tasks relating to monetary policy." This seems to rule out any negative influence of supervisory decisions on monetary policy, but not necessarily beneficial ones. In that respect, it seems apposite to recall the logic of the holistic approach, which consists in exchanging short-term disadvantages against long-term mutual benefits. Making both financial supervision and monetary policy more effective in the long run can hardly be considered as prejudice or interference. The term "separate from" seems to refer to the organizational structure of the SSM within the ECB alone.

The result of the textual analysis is confirmed by the context of the other provisions of the SSM Regulation as it does not establish a completely separate supervisory institution but leaves considerable linkages between supervision and monetary policy.[10] Given the mentioned interplay between monetary policy and financial supervision, and taking into account the fact that financial stability also depends on smooth monetary transmission and thus the ability of the central bank to provide liquidity, at least three additional reasons support a holistic approach.

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[7] ECJ Gauweiler, paras 51 and 52.
[8] ECJ Gauweiler, paras 49-50.
[9] Cf. Christoph Ohler, Bankenaufsicht und Geldpolitik in der Währungsunion (Beck 2015) 74.
[10] In this sense also Jörn Axel Kämmerer, 'Bahn frei der Bankenunion? Die neuen Aufsichtsbefugnisse der EZB im Lichte der EU-Kompetenzordnung' Neue Zeitschrift für Verwaltungsrecht (2013) 830, 832; Niamh Moloney, 'European Banking Union: Assessing Its Risks and Resilience' 51 Common Market Law Review (2014) 1609, 1635; Eilis Ferran and Valia SG Babis, 'The European single supervisory mechanism' 13 Journal of Corporate Law Studies (2013) 255, 266.

First, the clinical separation of monetary policy and financial supervision may lead to decisions that defeat each other to some extent. This dilutes responsibility for a certain policy outcome. Second, in trying to avoid contradictory decisions, the Governing Council of the ECB – which may only accept or reject decisions proposed by the Supervisory Board – may reject supervisory decisions which it believes would get into the way of monetary policy.[11] This would indeed avoid self-contradiction, but it also gives precedence to monetary policy over financial stability which would be difficult to justify economically, politically and constitutionally. Under a holistic approach, the Governing Council could take a decision which would better balance monetary and supervisory considerations. Third, contradictory decisions might damage the ECB's reputation and endanger price stability. The holistic approach seeks to avoid that risk by allowing for consistent decision-making. In conclusion, contrary to the impression one might gain from the public debate, the SSM Regulation would hardly prevent a more holistic approach to financial supervision, should the ECB opt for it.

## Democratizing an Independent ECB

The realization that the ECB's monetary policy and the SSM might follow a holistic approach raises the question whether the ECB enjoys sufficient democratic legitimacy for that purpose. Article 130 TFEU ensures the independence of the ECB, which is justified by the functional necessity to protect monetary policy from time inconsistencies. The allocation of supervisory powers to the ECB increases its democratic deficit as financial supervision has enormous distributional consequences.[12] The adoption of a holistic approach to monetary policy and financial supervision would intensify the problem. While one cannot say that the holistic approach would favor financial stability over price stability, or vice versa, as it works in both directions, it is yet unclear how the ECB would balance financial stability and price stability in a specific situation, should it ever adopt a holistic approach. As necessary as one might deem a holistic approach for the effective fulfilment of the ECB's two principal functions, it increases the ECB's discretionary powers – those for which democratic legitimacy is most needed. This calls for a rethinking of the democratic legitimacy of the ECB.

In light of these difficulties, some take a radical step and call into question the value of the ECB's independence. However, to the author's knowledge, new solutions for the time inconsistency problem that would make an independent central bank superfluous are unavailable. Moreover, the independence of the European institutions – the Commission, the CJEU and the ECB – is of great importance for the European integration.[13] Instead of stripping the ECB of its independence, the

[11] Cf. Art. 26 (8), SSM Regulation.
[12] Cf. Raphaël Franck and Miriam Krausz, 'Why separate monetary policy from banking supervision?' 36 *Journal of Comparative Economics* (2008) 388, 389.
[13] Antoine Vauchez, *Démocratiser l'Europe* (Seuil 2014), especially at 45-6.

democratic control over the ECB should be strengthened. This might be achieved by increasing the ECB's output legitimacy through more transparency, such as the publication of its assessments of the legal situation in cases where the legality of ECB acts is in question. Further, the parliamentary scrutiny of the ECB might be enhanced, as the restriction of its accountability towards the European Parliament is difficult to justify in view of the close links between monetary policy and supervision.[14] And ultimately, to strengthen the ECB's electoral accountability, one might give the European Parliament the right to appoint the members of the Executive Board in a single, comprehensive vote.

[14] Thomas Beukers, 'Constitutional changes in Euro government and the relationship between the ECB and the executive power in the Union' in Federico Fabbrini (ed), What form of government for the European Union and the Eurozone? (Hart 2015) 95, 109 (on Draghi defying accountability before national parliaments).