CONFERENCE

THE ECB AND ITS WATCHERS X

5 September 2008
Frankfurt am Main

This year, the CFS celebrated the ten-year anniversary of "The ECB and Its Watchers" conference. This series, which was initiated in 1999 by Otmar Issing in his role as Chief Economist of the ECB and Axel Weber as CFS Director, has evolved into a well-established forum for the public exchange of views between ECB decision makers and leading ECB observers and critics. Many ECB watchers have commented on the usefulness of this platform for a two-way dialogue with policymakers. Perhaps, the greatest compliment to the ECB and the conference organizers has been the start of similar conference series in the United States in 2007 and in the United Kingdom in 2008.

A range of prominent speakers from the ECB, other central banks, academia and the private sector debated the role of the central bank in dealing with liquidity and solvency problems in the financial system and the proper policy responses to asset prices, inflation and economic growth or weakness.

More than 250 participants actively took part in the discussions along with more than 60 media and press representatives who reported widely on the event. Part of the conference and selected interviews were again broadcasted live on business TV channels.

JEAN-CLAUDE TRICHET

It has now become a tradition that the ECB President JEAN-CLAUDE TRICHET opens the conference with a key note address. This year, Trichet spoke on the topic "Risk and the Macro-economy" and investigated the fundamental connection between financial risk and macroeconomic performance. He began by explaining that after a time of ample financial liquidity and exceptionally low rewards to risk, the loss of value of whole classes of real assets has led to a sharp reduction in investor appetite. In addition, rising commodity prices have reduced households' income prospects and raised their aversion to risk. "To the extent that the more recent turn in the markets correct past excesses, this is a welcome – if painful – process that we had anticipated and asked market participants to prepare for in past interventions," noted Trichet.

The decline in risk valuation, which has been partly reversed in the recent financial turmoil, started 25 years ago along with a similar decline in macroeconomic uncertainty. Trichet suggested that "to the extent that this moderation in macroeconomic fluctuations – in aggregate risk – would be confirmed as a permanent acquisition of modern economies, there is some reason to believe that the trend to lower risk valuations – beyond the needed corrections of the more recent excesses – could in the end reassert itself." Consequently, it is important to analyze what determined this compression of risk in effectively all markets and, whether the compression of risk reflected permanent shifts or transient ones.

Turning to the recent financial crisis Trichet noted that "spreads on financial institution debt, in particular, have widened in the Euro area and in the U.S. reflecting uncertainty over the extent of future credit write-offs, the full recognition of off-balance-sheet commitments, and future earnings capacity." The results are that intermediaries save on capital, assets are sold and lending conditions get squeezed. According to Trichet, the recent corrections and expenditure reductions of the financial markets convey two lessons: (i) non-fundamental market dynamics have grown out of fundamentals and the feed-back loops that these have created, and (ii) excessive leverage was the mechanism which turned an efficient process of risk diffusion into a dangerous spiral of risk amplifications and concentration. Finally, Trichet

CONFERENCE PICTURES: HANNELORE FÖRSTER

VOLKER WIELAND, JÜRGEN STARK, MARVIN GOODFRIEND

JÜRGEN STARK

clarified the difficulties in dealing with a sequence of supply shocks that may become engrained in inflation expectations and turn into a sustained demand disturbance. The financial turbulences, which began last summer, as well as the increases in commodity prices, have challenged central banks to simultaneously deal with the fragilities of the financial fabric and fight inflationary pressures and economic weakness. In such "testing times", the advantages of a monetary system, which is anchored in price stability, have become very visible.

The remainder of the conference program was organized in form of four debates between ECB policy makers and observers.

MONETARY POLICY DURING THE FINANCIAL TURMOIL: WHAT HAVE WE LEARNED?

JÜRGEN STARK (ECB) admitted that the past months had been the most challenging in the ten-year history of the ECB. The ECB was confronted with a "trilemma", consisting of rising inflation rates, a slow-down of economic activity and threat to financial stability. In his presentation, Stark discussed not only how the principles incorporated in the ECB's monetary policy framework have guided the ECB's decision making through these times but also how to face the challenges still lying ahead.

Stark emphasized that sound monetary policy making is anchored in a set of principles. Next to having a clear and unambiguous mandate to maintain price stability, a central bank must also be credible in its commitment to deliver this objective. The central bank must be a politically-independent institution and transparent in pursuing its objective. Furthermore, monetary policy should keep a medium-term orientation and should be strengthened by a comprehensive analytical framework. Finally, there must be a clear separation between the determination of the monetary policy stance required to maintain price stability and the provision of liquidity to the money market, such that market participants do not interpret liquidity operations as signals of future changes in the policy stance.

Reviewing decision making during one year financial turmoil Jürgen Stark noted the following: With the beginning of the financial pressures the ECB's outlook for inflation and economic growth became increasingly uncertain. In this situation, it was not clear what consequences high market interest rates would have for spending and pricing decision, as well as the availability of credit. Thus, having a single, clear and unambiguous objective supported the ECB's credibility and ensured that a policy stance appropriate for containing inflation expectations could be maintained.

Simultaneously, the ECB acted to sustain the functioning of the money market by making a clear distinction between the determination of the monetary policy stance and its implementation through liquidity operations. The turmoil also encouraged and strengthened central banks cooperation through improved information exchange, as well as joint supervision of market developments.

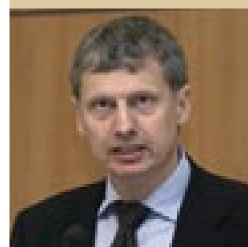
Stark's debating partner, MARVIN GOODFRIEND (Carnegie Mellon University), then presented his view more from a U.S. perspective. Goodfriend first gave the audience some important background information about the U.S. mortgage market before the onset of the turmoil. In this market 50% of home mortgages are securitized. Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac held or guaranteed 50% of all mortgages. The near-bank capital markets financed long-term mortgage-backed securities with short-term commercial paper. At the beginning of 2004, asset-backed commercial paper had amounted to US$ 600 billion but rose to US$ 1200 billion by August 2007. The asset-backed commercial paper market collapsed in August 2007 and contracted by about US$ 400 billion by November. At that point, the intransparent, tailored and tranched mortgage-backed securities traded at deep discounts, commercial and investment banks faced increasing capital shortages, widening interest rate spreads and elevated interbank interest rates.

Goodfriend then turned to the challenges for U.S. monetary policy.

MARVIN GOODFRIEND

The U.S. economy is affected by two opposing forces: aggregate demand is hurt by the deflation in house prices and the elevated external finance premium, while large, sustained increases in fuel and food prices have driven inflation to 5%. According to Goodfriend the capital shortage in the banking system that is at the core of the credit turmoil is more

JULIAN CALLOW (BARCLAYS CAPITAL):



This annual conference is a truly unique occasion which offers the entire community of "ECB Watchers" – academics, financial market participants, and the media – a special opportunity to congregate together with central bank officials from the Eurosystem and beyond, and so foster greater mutual understanding of contemporary issues in European monetary policy.

ELGA BARTSCH (MORGAN STANLEY):

The combination of academic researchers, market practitioners, financial journalists and central bank representatives makes the ECB Watchers conferences a unique event. The two-way dialogue between the ECB and those who observe, analyze and comment its actions from their different vantage points the Watchers conferences helped to create are very stimulating.

protracted and more serious than might have been expected and may still last for a while.

Goodfriend noted that central banks should be viewed as executing two independent policies: monetary and credit policy. Monetary policy (i.e. the size of the central bank's balance sheet) should be used to set interest rates in order to stabilize aggregate employment and inflation. Credit policy (i.e. when central banks make loans to individual banks to stabilize financial markets) should be executed to stabilize financial markets. If the Fed keeps the two policies separate, credit policy changes the composition of the securities in its portfolio, but not the size of its portfolio.

He concluded that the Fed needs an "Accord" for credit policy with the following principles: (i) the Fed undertakes credit policy actions only as lender of last resort, (ii) the fiscal authorities cover the Fed against balance sheets losses incurred, (iii) Fed credit policy should not fund loans or expenditures that ought to get explicit authorization from the fiscal authorities, and (iv) the Fed should otherwise stick to the Treasuries-only policy.

ULRICH KATER (DEKABANK):

Nowhere else can you discuss with so many ECB-experts from outside and within more effectively.

SOLVENCY, SYSTEMIC RISK AND MORAL HAZARD: WHERE DOES THE CENTRAL BANK'S ROLE BEGIN AND WHERE DOES IT END?

LORENZO BINI SMAGHI (ECB) started the debate by re-iterating the ECB's "separation principle" namely to pursue the separate objectives of price stability and the smooth functioning of the money market with separate instruments that are the interest rate and market operations. In other words, the interest rate is not considered an appropriate tool to deal with liquidity or solvency problems, because it is too "blunt" as an instrument for financial stability targeting. It might generate conflict with the primary objective of price stability and un-anchor inflation expectations.

LORENZO BINI SMAGHI

Next, Bini Smaghi, reviewed the Bagehot Principle that states that central banks are to lend freely at a high rate against good collateral in order to support illiquid but solvent institutions. Thus, the central bank should avoid dealing with solvency problems that would threaten its financial independence and increase moral hazard in the financial system. However, they should lend to illiquid institutions. Illiquidity problems can lead to insolvency even when intermediaries are fundamentally sound. The central bank should act to preserve social welfare, because it is the only economic agent who is not subject to liquidity risk.

With regard to liquidity provision central banks must avoid actions that would put at risk its own balance sheet and set up adequate risk control measures. A risk control measure in the Euro area is that it accepts as collateral only assets that fulfill high credit standards. The broad range of collateral accepted by the Euro system includes non-marketable assets (i.e. credit claims), as well as marketable but less liquid assets (i.e. ABS) making it necessary to develop theoretical pricing capabilities For credit claims, NCBs can either compute a theoretical price or use the outstanding amount (in which higher haircuts apply). In order to revise the risk control measures, the ECB will introduce a number of new procedures to be implemented February 1, 2009.

WILLEM H. BUITER (LSE) began by remarking that the role of the central bank in the maintenance of financial stability is liquidity management. The reason is that the central bank is not subject to domestic liquidity risk. Any country whose banking system is large und who has a large foreign currency exposure may face liquidity problems. Buiter mentioned in particular the recent experience of Iceland but also included the U.K. in this group of countries since the British Pound is not any more a major reserve currency. There are only two such currencies left the US Dollar and the Euro.

WILLEM H. BUITER

In general, financial stability may be threatened by three types of disfunctions: bubbles, illiquidity and insolvency. With respect to bubbles Buiter recommended against using the official policy rate for targeting asset prices or any form of leaning against the wind, but proposed regulatory tools instead. With regard to liquidity he differentiated funding liquidity and market liquidity. As to funding liquidity the central bank ought to provide liquidity to systematically important institutions. However, the provision of capital to insolvent institutions, Buiter noted, is a fiscal task and should not be taken on by the central bank.

Financial stability also has an important temporal dimension. There is the need to minimize the implications of the current crisis that is the "putting out of fires". Buiter reiterated that the central bank should put its expertise, its resources and reputation on the line with regard to the provision of liquidity, i.e. its lender or market maker of last resort function. The central bank should at most use its expertise as an agent of the government in dealing with solvency problems. It should not risk its own resources or reputation to save insolvent institutions.

Buiter then acknowledged that the central bank may find it hard to keep separate the provision of liquidity to illiquid but solvent and to insolvent institutions. Thus, there always exists the risk of a capital loss to the central bank if the borrower and the issuer of the collateral put up by the borrower default simultaneously. Buiter recommended as a partial solution that the central bank should eliminate ex-ante quasi fiscal actions, that is, when it lends it should take sufficient collateral and price it punitively such that the central bank does not provide a subsidy to the borrower. There may still occur ex-post capital losses to the central bank but these should be fiscalized immediately and automatically.

HARALD UHLIG (University of Chicago), the third speaker in this debate, set out to characterize the links between what he called the subprime innovation and the moral hazard crisis. The subprime innovation allowed young home owners to borrow on future incomes, a good thing. The securitization of mortgages by standard Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac proved risky. Associated derivatives, MBS, CDO were particularly risky with some parts well characterized as "toxic waste". With the houses still there, Uhlig said, it is a crisis of the financial markets about involuntary redistribution and bailouts. In this context, he brought up two

MACCARIO AURELIO (HYPOVEREINSBANK - UNICREDIT GROUP):

I have to say that proximity to ECB policymakers clearly enhanced my understanding of the bank's decision-making process as well as the theoretical and operational framework in which the ECB is actually operating. Moreover, I liked very much the heterogeneous background of the conference participants: exchanging ideas and opinions not only with other market practitioners but also with policymakers and with academics greatly stimulated my research toward non-conventional and new directions. The CFS' and ECB's effort to establish a fruitful relationship with different type of observers can only be praised.

10 years

HARALD UHLIG

LORENZO BINI SMAGHI, VOLKER WIELAND, WILLEM BUITER, HARALD UHLIG

old principles with new additions. First, if something is too good to be true, it probably is. Second, as Bagehot suggested in 1873, in a crisis a lender of last resort should lend at a penalty rate to solvent but illiquid banks that have adequate collateral. New additions seem to be the "too big to fail doctrine" and "there is systemic risk which requires action".

For the remainder of his presentation Uhlig discussed several aspects of the recent crisis and the associated moral hazard in more detail and promised to deliver three new principles. His review led Uhlig to a number of insights. First, the risks in the real estate market are smaller than in the stock market, and smaller than exchange rate risks, but those risks were not allocated properly. Second, implicit government guarantees create moral hazard and in turn, lack of regulatory information creates fear at central banks. Third, it is a fact that there are macroeconomic risks as it is a fact that banks can go bankrupt. Not everything can be insured thus it is important to help the appropriate allocation and pricing of macroeconomic risks. Uhlig emphasized that in an emergency, central banks need to understand the consequences before acting.

Uhlig concluded with three new principles for central banks. Principal 1: Do not provide insurance for free. Principal 2: Practice gentle prodding through information advantage. Principal 3: Aid the appropriate allocation and pricing of macroeconomic risks.

ASSET PRICE BUBBLES AND MONETARY POLICY: WHAT CAN OR SHOULD THE CENTRAL BANK DO ABOUT THEM?

HANS GENBERG (Hong Kong Monetary Authority) began by stating the claim that "a central bank concerned with stabilizing inflation about a specific target level is likely to achieve superior performance by adjusting its policy instruments not only in response to its forecasts of future inflation and the output gap, but also to asset prices." Or in other words, the question is whether a central bank should take into account movements in asset prices "over and above" their influence on the inflation gap and the output gap? This, in turn, depends very much on what is meant by "over and above". If the objective of the central bank is defined as minimizing the discounted sum of expected fluctuations of inflation and output around their respective target levels, we cannot debate "over and above", because all applicable information, including that embedded in asset prices, is implicitly considered.

The question makes sense when a policy reaction function defines the policy rate with respect to inflation and output gap forecasts at a specific horizon (generally two years). The proposal is not to stabilize asset prices directly, i.e. making it an additional target in the objective function. This would necessitate very large adjustments in the policy interest rates and destabilize inflation, output and employment. Yet the debate is more about a "muted" leaning against the wind. Directly targeting an asset price would be risky, if not dangerous, because we do not know for certain what its equilibrium

MARKUS KRYGIER (CREDIT AGRICOLE ASSET MANAGEMENT):

Year after year the conference has provided a unique forum to gather and exchange intelligence on the ECB. The ECB's active participation has opened a valuable window to better understand the bank's policies and its communication. The conference has also provided a great opportunity to establish a network of like-minded ECB watchers.

MICHAEL BINDER, HANS GENBERG, THOMAS MAYER

ATHANASIOS ORPHANIDES

is. With the uncertainty about the equilibrium value, we must allow for mistakes.

THOMAS MAYER (Deutsche Bank) elaborated further on the pros and cons of taking asset prices into consideration when making monetary policy decisions. One reason why not is that the central bank's mandate for price stability refers to CPI inflation. In following this mandate, the central bank already considers asset prices to the extent that they affect CPI inflation. A reason for considering asset prices arises from the fact that asset prices reflect the price of income streams in order to finance future consumption. This price should not be separated from the definition of price stability. Moreover, asset price cycles can threaten the economy without first affecting CPI inflation.

Mayer gave a number of suggestions how central banks can respond. They should form an opinion on how bubbles develop. Positive as well as negative bubbles are triggered by large cyclical swings in the willingness to tolerate risk. Mayer also proposed to "tilt the risk free central bank rate against large swings in risk appetite." By doing so, central banks will hopefully recognize developing bubbles. The ECB's two pillars strategy is "tilting in practice" but seems too narrow in that it "consists of a detailed analysis of monetary and credit developments with a view to assessing their implications for future inflation and economic growth." Besides the monetary analysis, a comprehensive analysis of the different risk attitudes among professionals and private investors must include an evaluation of changes in applied credit standards and credit quality; bond, credit and equity risk premia; various asset valuation indicators in equity and real estate markets, as well as various measures of "risk appetite".

LOOKING AHEAD: HOW TO REIGN IN INFLATION AND MAINTAIN STABLE GROWTH?

ATHANASIOS ORPHANIDES (Central Bank of Cyprus) started by pointing out that inflation in the Euro area has remained considerably above the level consistent with price stability since the fall 2007 which poses a critical challenge for the ECB. The peak of 4 % observed in June and July has been unprecedented in the history of the Euro system. The increase in inflation reflects more the global

ANGEL UBIDE (TUDOR INVESTMENT CORP):

"The ECB and its Watchers" has played a critical role in allowing a brainstorming of the relevant issues pertaining to the ECB with the participation of the key actors, policy makers, market participants and academics. One day at the conference is much more effective than weeks of individual research. It has also created a very extensive and useful network of people interested in ECB matters.

increase of the prices of food, energy and other commodities than an underlying trend. Looking at the measure of core inflation that excludes energy and unprocessed food for example, the recent pick-up in inflation is less dramatic, though still worrisome. This difference between total and core measures of inflation is a manifestation of an adverse supply shock not dissimilar to earlier experiences of such shocks. High and volatile stagflation, coupled with rising unemployment and anemic growth, are not items on any policymaker's wish list. Adverse supply shocks all have a similar initial impact but the damage caused beyond that in the economy depends on various factors. Importantly, it depends on the responses of monetary and fiscal policy and the underlying policy strategy.

What should be expected beyond the first round? According to Orphanides an important lesson of the experiences of the 1970s is that the eventual economic consequences of an adverse supply shock depend crucially on whether monetary policy allows the first round of inflation effects to propagate further into a wage price spiral. Tolerating second round effects on inflation can be devastating to the economy and can result in both lower growth and higher inflation over time. It is all too easy to fall into the trap of pursuing over expansionary policy. Slower growth for some time may be a discomfort that should be tolerated rather than resisted to avoid accumulating imbalances that may be costlier to address later. To avoid the materialization of second round effects it is imperative for policymakers to do what it takes to keep inflation expectations well anchored. This can be achieved at a lower cost, if structural elements are in place that prevent the propagation to further wage and price increases.

The ECB's strategy must exactly be seen in this context. This is why the Governing Council has taken a resolute stance against the materialization of broad based second round effects in the Euro area. Orphanides concluded that allowing expectations to become unmoved from the price stability objective will be detrimental not only to price developments, but also to employment and growth down the road. Thus, the ECB's aim must be to avoid this trap.

LAURENCE MEYER (Macroeconomic Advisers) provided a U.S. perspective on the question of reigning in inflation and maintaining sustainable growth. In terms of principles, Meyer firmly supported an explicit (qualitative) dual mandate for the central bank that covers inflation and growth. The inflation objective should be for the medium-term and although the target should be set for headline inflation, the central bank should monitor the success by focusing on core inflation. Meyer recommended a forward looking Taylor rule as strategy. In this context, it is important to anchor the long-term inflation expectations and communicate consistently.

JÖRG KRÄMER (COMMERZBANK AG):

The ECB Watchers conference brings together central bankers, academics and bank economists. This mixture delivers a very good understanding of the ECB's monetary policy.

PETER HOOPER (DEUTSCHE BANK):

Especially for any observer from across the Atlantic, this series has been an excellent source of information about how policy-oriented thinking and research on critical issues at the euro area's central bank have progressed over its first ten years.

Meyer then turned to the current situation of the U.S. economy. It has slowed down significantly due to three shocks: a housing correction, a credit shock and a long rise in energy prices. While GDP shortly expanded in the second quarter by 3.3% compared to a long-run trend of 2.5%, Meyer sees it slowing to zero in the second half into "a danger zone for monetary policy." Although optimistic that the economy will return back to trend next year he noted enormous uncertainty and emphasized that unemployment is clearly on an upward path. In August, the unemployment rate rose from 5.7% to 6.1% and FOMC projections indicated a rise in the unemployment rate that lingers considerably and suggest very limited progress in 2009 and the year after given appropriate policy. Thus, in order to deal with the consequences of core inflation being elevated the FOMC is willing to tolerate a period of below trend growth and a high and lingering unemployment rate. Meyer argued that the FOMC may be more transparent than the ECB by publishing three-year-ahead projections of inflation, unemployment and growth.

In thinking about how the Fed should be responding to the current situation Meyer presented detailed information on recession probability models and own forecasts pointing to a significant risk of slipping into a recession in the near term while inflation is high. Although core inflation is expected to rise beyond 2.5% in the second half of the year Meyer expects a moderation of inflation in the future. Energy prices are declining and prospects have improved that they will remain stable in the next two years. The dollar has stabilized and will perhaps slightly appreciate, and slack in the economy will reduce inflation.

Meyer concluded by discussing the policy implications of the credit crisis, inflation and unemployment outlooks through the lens of a forward-looking Taylor rule. Credit spreads and risk premia are factors that should lower the real neutral funds rate. He believes the Fed has therefore little insurance built into the funds rate setting. The response of the funds rate to the adverse supply shock then depends very much on how well-anchored inflation expectations are. With well-anchored inflation expectations the funds rate does not need to be raised in response to an adverse supply shock but could even ease in order to offset some of the growth impact of this shock.

Celia Wieland (CFS)

HARALD UHLIG (UNIVERSITY OF CHICAGO):

The forum has been the central open venue for communicating and discussing the results of leading ECB watchers. For example, I have had the opportunity to co-author several "Monitoring the European Central Bank" (MECB) reports for the CEPR in London. While these reports were presented elsewhere too, and while we were also particularly grateful to then ECB council member and director of economics and research, Prof. Dr. Otmar Issing, to always grant us an open-minded discussion about our findings with him and the ECB staff, the forum was the final, critical venue for discussion. The forum therefore played a crucial role for the debate on monetary policy in Europe.

Interview with Pervenche Berès (Deputy of the European Parliament) and Axel Weber (President of the Deutsche Bundesbank) on the Financial Turmoil

Interviews

taken on August 18 & 20, 2008

Ms. Berès and President Weber, what are the most important lessons that we should draw from the recent experience regarding monetary policy during financial turmoil?

Berès: The ECB's strategy to inject right in the beginning of the crisis liquidity and to maintain interest rates, contrasting with the Fed's important rate cuts was welcomed as a level-headed response. This might very well be true in the short term, but on the long run, with the crisis hitting the real economy and with the additional rise of commodity prices, that I characterize as the emergence of a second age of globalization, this strategy is put into question if it is acting alone and harshly reminds us of the Eurozone's Achilles' heel: it's lack of economic coordination and of intervention tools when it comes to mastering a crisis.

Weber: It has become clear over the past year that there is more to central banking than just taking interest rate decisions. Liquidity operations, financial stability concerns, and banking supervision issues have kept us busy. Not mixing-up these distinct issues was key. Our clear separation of monetary policy and liquidity provision has helped us to ease strains in the money markets whilst at the same time remaining alert to/on guard against the substantial inflation risks.

How should monetary policy respond when the next housing or asset price bubble comes?

Berès: The tackling of the next bubble (actually commodities have already become the new bubble) shouldn't be an issue that falls into the only realm of monetary policy. As legislators and political actors, we should make sure well in advance that the next bubble is used to allocate investment properly, answering the needs of the real economy for sustainable financing.

Weber: We should reduce the likelihood of re-occurances. We are using our regulatory powers to adjust the capital adequacy and liquidity management framework for banking in the light of recent events. Aligning incentive structures and reducing the pro-cyclicality of the banking and credit business is key to avoiding a new round of problems.

Is the Euro area regulatory framework ready to deal with the collapse of a major European bank?

Berès: It is obvious that we are not only witnessing a massive market failure, but also a severe regulatory and supervisory failure. Both call for strong responses from policy makers and regulators. I believe that long ago the Commission should have delivered a comprehensive analysis of the existing EU regulatory and supervisory framework in the light of the pre-existing deficiencies that have been highlighted by the crisis. After the creation of the Euro and the ECB, the strategy for financial market's integration lacks a supervisory structure where the responsibility of the ECB is crucial.

The link between macro prudential oversight (macro-economic stability analysis) and micro prudential oversight (the actual supervision of financial institutions) has been neglected in both national and European supervisory architecture. I therefore advocate for the creation of a pan-European structure for prudential super-vision of the major cross-border financial groups, on top of but closely linked to the existing system of cooperating national supervisors. The main argument for the transfer of the prudential supervision of these groups to the European level is the systemic risk that such financial groups pose to the entire EU financial system. This proposal would also offer a response to regulatory competition, where Member States trying to attract the head quarters of financial institutions not only with fiscal incentives but also with light regulatory regimes.

Weber: The Eurosystem's swift and continued intervention in money markets has substantially reduced the likelihood of such an event materializing: As for the future, I am convinced that the high degree of connectivity and established joint decision-making processes make the Eurosystem the natural nucleus for any timely and coordinated response to potential banking problems in Europe.