The Trilemma of Financial Stability

by

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CFS-IMF, 26 September 2008, Frankfurt

Overview

1. Motivation
2. Components of trilemma
3. Model
4. Examples
5. Policy challenges

1. Motivation

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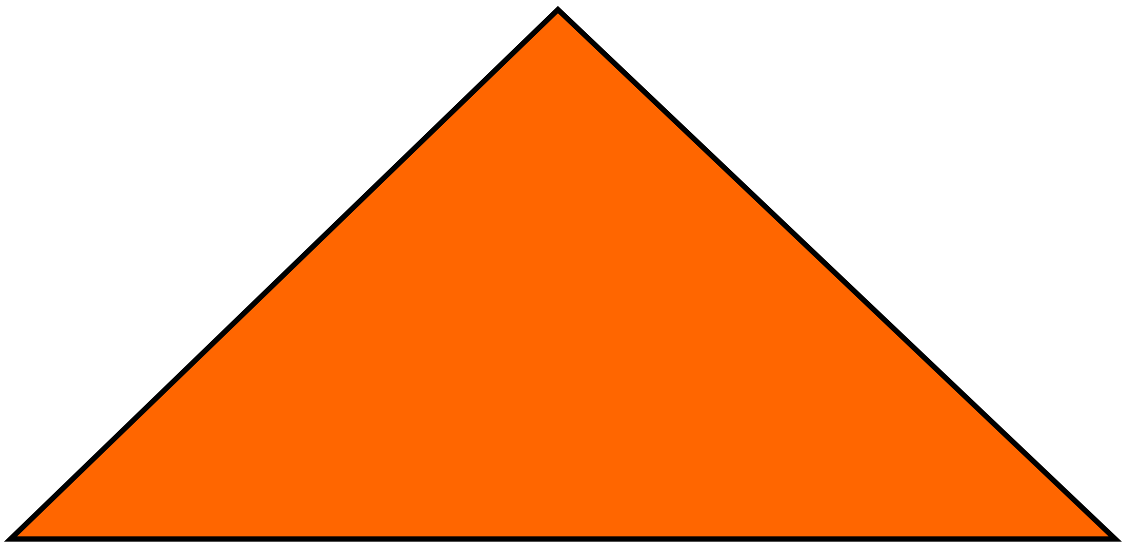
- Need for clear exposition to alert policy-makers
- Academic challenge to set new trilemma

2. Trilemma

1. Stable financial system



2. Integrated financial system

3. National financial stability policy

Ad 1. Financial stability

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Two elements

- Capacity of financial markets to clear financial imbalances without major disruptions
- Capacity of financial institutions to provide financial services (credit) without major disruptions

Ad 2. Integration

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Market segment	Degree of integration
Money market	High degree
Bond markets • government bonds • corporate bonds	 Considerable degree Considerable degree
Equity markets	Increasing integration
Banking markets • interbank/wholesale activities • capital market related activities • retail banking activities	 Increasing integration Increasing integration Fragmented

Emerging European banks

Figure 5. Division of assets of Nordea (2007 figures)

Countries	Geographical division of Nordea's assets	Market share in national market
Nordic countries	99%	
• Denmark	26%	16%
• Finland	32%	33%
• Norway	13%	14%
• Sweden	28%	13%
New Member States	1%	
• Estonia	-	10%
• Latvia	-	10%
• Lithuania	-	7%
• Poland	-	2%
Total	100%	-

3. Modelling the trilemma

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- Markets dimension
- Institutions dimension

Markets dimension

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- Model of interbank market with role of central bank to clear the market
- Policy instrument: general LOLR by CB

➢ Integrated money market: general LOLR at supranational level

Institutions dimension

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- Freixas-model of refunding cross-border bank

- Policy instrument: contribution of funds (individual LOLR by CB and/or recapitalisation by government)

➢ Emerging European banks:
  - At national level insufficient refunding, if $h<1$, $e>0$
  - Refunding at supranational level needed

4. Examples

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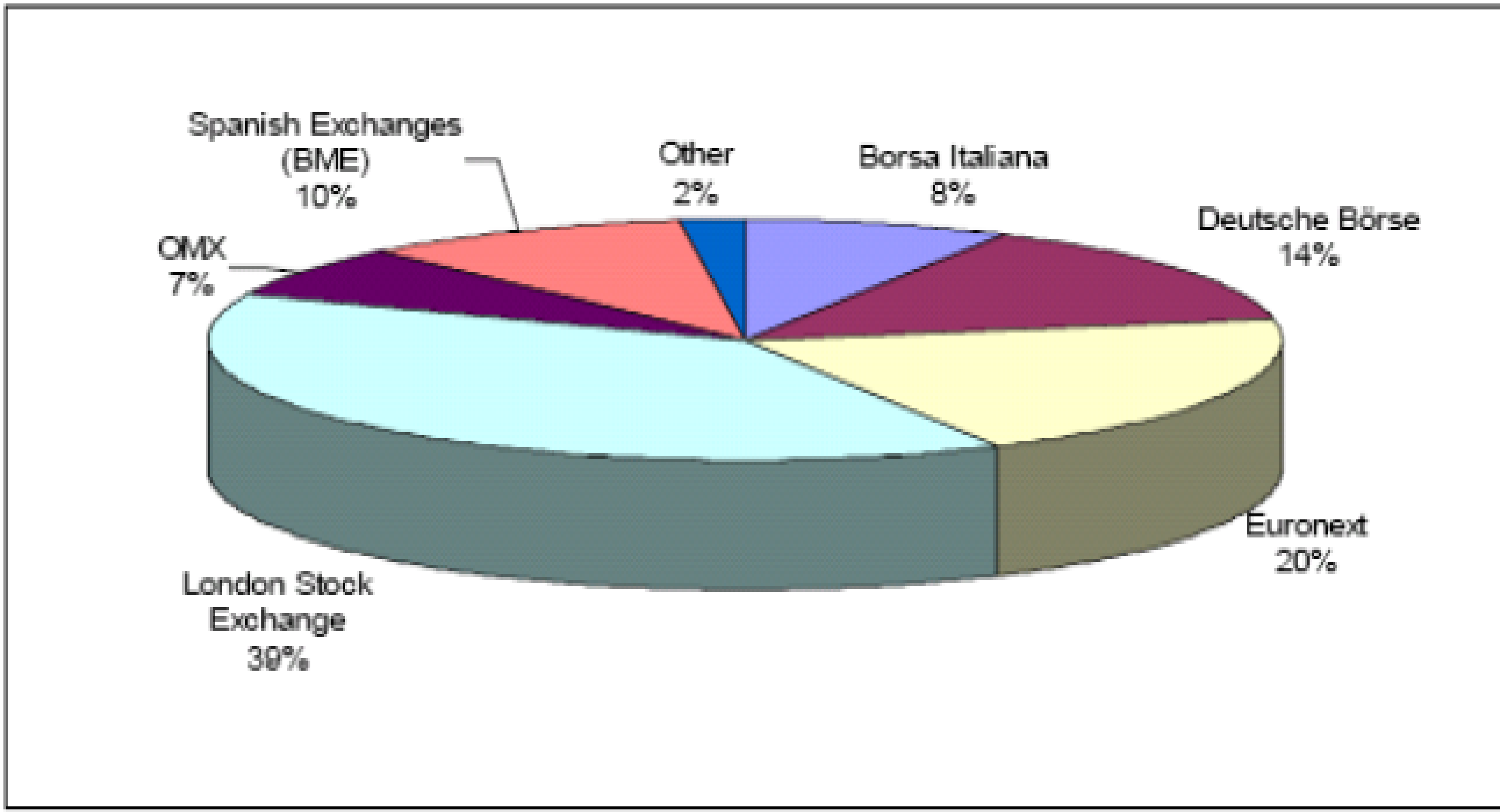
- Interbank problems
- Stock market crash
- Failure of systemic cross-border bank

Which level?

- Euro-area level, or
- EU level?

Stock markets

Figure 4. Market share of EU stock exchanges by stock turnover (2006 figures)



5. Policy challenges

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Which objective of the trilemma has to give?

1. Abolish financial stability policy: free banking

2. Resist further integration: only subsidiaries, no branches (reverse Single Market + forego synergies)

3. Move power to supranational institutions: ECB (general + individual LOLR) and Ecofin (burden sharing)

Policy instruments

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Figure 7. Current state of play for the various policy instruments

Instruments	National	Cooperation	Coordination	Supranational
Preventive policy				
• Financial stability review	X			X
• Financial supervision	X	X	X	
Crisis management				
• General LOLR				X
• Individual LOLR	X	X		
• Recapitalisation	X	X		

6. Assessment

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Financial stability trilemma strongly suggests that we should move to **supranational** financial stability policy because of ongoing integration

- Markets: we are coming close -> ECB is doing a good job

- Institutions: situation is not stable -> need to consider *ex ante* burden sharing rules at EU level