COMMUNICATING STATISTICS IN THE CONTEXT OF BANKING UNION – A MACRO USER'S PERSPECTIVE

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I   THE BENEFITS OF BANKING UNION[3]

Dysfunction in European financial markets lies at the heart of the 2007-13 euro area economic and financial crises.[4] Given the bank-centric nature of the continental European financial sector, the banking system has served as both an important source and a significant amplifier of the shocks that have destabilised the euro area throughout this period.[5]

To address the euro area's current malaise, as well as to build a more stable and workable new regime for the future, three challenges need to be met: (1) the stability, resilience and efficiency of the European banking sector as a whole must be improved; (2) area-wide markets must be reactivated and reintegrated, so as to ensure a more uniform availability and pricing of credit (and other financial services) across the euro area; and (3) legacy balance sheet problems at banks need to be dealt with thoroughly, so that banks can move forward unencumbered by the mistakes of the past.[6]

The European authorities have presented "banking union" as the solution to these challenges. Banking union has several dimensions: a Single Supervisory Mechanism (SSM) at the ECB, a Single Resolution Mechanism (SRM) to deal with failing banks, more transparent and uniform application of state aid rules to government support for the banking sector, and a clearer definition under the Bank Recovery and Resolution Directive (BRRD) of when and how the authorities can intervene to support troubled banks.[7]

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3   This paper was prepared for the seventh ECB statistics conference "Towards the banking union: opportunities and challenges for statistics" held in Frankfurt am Main on 15 October 2014. The views expressed in this paper are those of the authors and do not necessarily reflect the views of Goldman Sachs.
4   See, for example, the description in Giannone et al. (2011).
5   Pill and Reichlin (2014) provide a narrative of the recent financial crises, highlighting the important role played by banks both (i) following the failure of Lehman Brothers in 2008 (when concerns about bank counterparty credit risk led to a seizing up of the interbank money market), and (ii) in the context of the 2011-12 sovereign debt crisis (when the vicious interaction between sovereign and bank balance sheets posed existential risks to the euro area).
6   See Pill (2014) for a longer discussion of these issues.
7   Other elements originally defined as part of the banking union – notably a common area-wide deposit insurance scheme – appear, at least at this stage, stillborn.

To illustrate the benefits of banking union, consider the possible implications of the SSM for the euro area banking sector. Unifying responsibility for bank supervision at the ECB offers scope both (1) to raise the average quality of supervision (e.g. by spreading best practice and/or breaking the capture of regulators by "national champions"), and (2) to ensure common application of standards and rules across euro area countries (e.g. by imposing common definitions of non-performing loans), thereby establishing a level playing field to enhance competition among banks. Moreover, the recently completed ECB/European Banking Authority (EBA) comprehensive assessment of euro area bank balance sheets (consisting of an asset quality review and stress test exercise) has served to clarify the extent of legacy programmes and allow them to be addressed.

Thus far, the reaction of market pricing and financing to the announcement and implementation of banking union has largely been positive. Funding access and costs for peripheral banks have improved significantly over the past year, as has their ability to raise private capital. It is to the credit of those building the banking union at the ECB (and elsewhere) that such credibility has been established from scratch so quickly. In general, markets remain sceptical of the ability of European authorities – at both supranational and national levels – to create a more workable monetary union. But the creation of banking union appears to be an exception. Accumulation of such credibility means that there is a lot for the new SSM to live up to in a potentially difficult market and economic environment.

2   THE CONTRIBUTION OF STATISTICS (AND THEIR COMMUNICATION) TO BANKING UNION

To meet these high expectations, the SSM needs the necessary raw materials for policy-making: well-qualified staff, an efficient decision-making process and, above all, the required data. If we are to have "evidence-based policy-making", then we must have the evidence. And quantitative evidence relies on the collection of data and the construction of policy-relevant statistics.

Other contributions to this volume describe the impressive progress made in creating a granular framework for data collection at the level of individual institutions. And, as has been demonstrated elsewhere, ample scope exists for synergies with the construction of statistics underlying macro-prudential policies and monetary analysis.

Assuming that the relevant information is available in a timely and comprehensive manner, the issue addressed in this paper is how it should be presented to external audiences. We aim to provide the perspective of financial market participants analysing the euro area economy and financial system from a macro standpoint.

Communication can be a very important channel supporting the transmission of central bank policy decisions. Recent experience in the monetary policy domain – e.g. President Draghi's "whatever it takes" intervention in July 2012 – provides ample evidence in this direction. Effective communication can help to stabilise expectations and improve both the legitimacy and efficacy of policy actions.

Communication supports policy through several channels, notably by improving the transparency, accountability and clarity of central bank actions. Through these channels, communication can improve the effectiveness of policy.

One should not confuse means with ends: in our view, the contribution made to policy effectiveness is the appropriate criterion on which to judge the quality of central bank communication. We are sceptical of arguments that assign specific transmission channels a value in and of themselves. For example, we do not share the view that transparency is a "moral imperative", which should take precedence over other potential channels or (still less) the underlying goal of ensuring that policy objectives are met efficiently.

On the basis of this approach, the remainder of this paper develops two arguments.

First, we suggest that the impressive efforts underway to collect supervisory data on banks' balance sheets – a necessary *input* to the policy process – should be complemented by efforts to develop statistics that provide a convincing real-time assessment of the effectiveness (and thus success) of these policies – the *output* of the process. For most macro observers, it is reassurance about outcomes that is key.

Second, we argue that trade-offs exist among the various channels by which communication can influence policy effectiveness. The quality of central bank communication largely reflects how well these trade-offs are managed. We illustrate this point by exploring the interactions between transparency and clarity in communicating policy decisions and their rationale.

3   COMMUNICATING OUTCOMES MATTERS

Nothing succeeds like success. The credibility (and thereby the effectiveness) of economic policies is bolstered if their success can be readily demonstrated. Market participants' response to a credible signal of success creates a virtuous feedback loop: for example, depositors do not make runs on sound banks.

Demonstrating success means being explicit about the objective of policy and providing timely statistical information to allow policy performance to be judged easily and in real time.

This insight lies at the heart of inflation targeting regimes for monetary policy (and, in the ECB's case, underpins its definition of price stability). Having a clear, published, quantitative target for a specific inflation measure allows policy analysis to be focused and ensures that policy-makers are held to account. The credibility of monetary policy has been bolstered as a result. Empirical studies demonstrate that the stability of observed inflation and inflation expectations has (thus far) been higher in inflation targeting regimes than in the preceding, typically more discretionary, monetary policy frameworks.[8]

8   That said, this conclusion may be challenged by recent data and the threat of deflationary dynamics in some parts of the world (potentially including the euro area). For the earlier (more benign) period, see the empirical evidence provided by Bernanke et al. (2001).

Statistical considerations played an important role in the design of such inflation objectives. Issues such as the measurement bias in inflation indicators, the independence of the institutions producing the statistical series, the coverage of the series across countries and activities, and the timeliness of publication all influenced the design of the target.[9]

Can this broadly successful experience be translated into the context of banking union? Supervisory and macro-prudential policies aim at maintaining financial stability. But offering a quantitative definition of financial stability is more challenging than designing an inflation target to characterise monetary policy's price stability objective. Perhaps illustrating the point, Charles Goodhart – a leading scholar on such issues – has made reference to practitioners defining financial stability as "the absence of financial instability".[10]

Yet this merely shifts rather than addresses the problem. How to define financial instability? This is an equally challenging task. Financial instability is episodic in nature and non-linear in character. It is multi-dimensional. Characterising financial (in)stability in terms of a single statistical indicator is much more difficult than using an inflation measure to define price stability.

Nevertheless, reaping the credibility benefits stemming from communication requires efforts in this direction. Particularly from the perspective of a macro observer in financial markets, reassurance is sought that financial instability is distant (permitting us to maintain our usual focus on traditional macro analysis, at least for the present). A "data dump" of (for example) balance sheet, profitability and pricing information cannot provide this reassurance: how should we interpret it? Rather a reliable, synthetic, summary real-time indicator is required.

Building on work in the academic literature,[11] we have used the price of bank credit default swaps to construct measures of the probability of systemic financial tensions. Moreover, we have related these measures to macro-financial variables and explored whether they offer early signals of forthcoming financial tensions. These efforts are reflected in Chart 20.

This is not the place to enter into the technical details of how our indicators are constructed. And even a cursory inspection of our results gives many reasons for caution when considering whether they can be seen as a reliable measure of financial stability. But while our and others' efforts in this direction remain preliminary and incomplete, we nonetheless view attempts to construct summary statistical measures as an important complement to the ongoing collection of underlying supervisory information. It is only through progress in this direction that policy credibility can be signalled to the wider, non-specialist community.

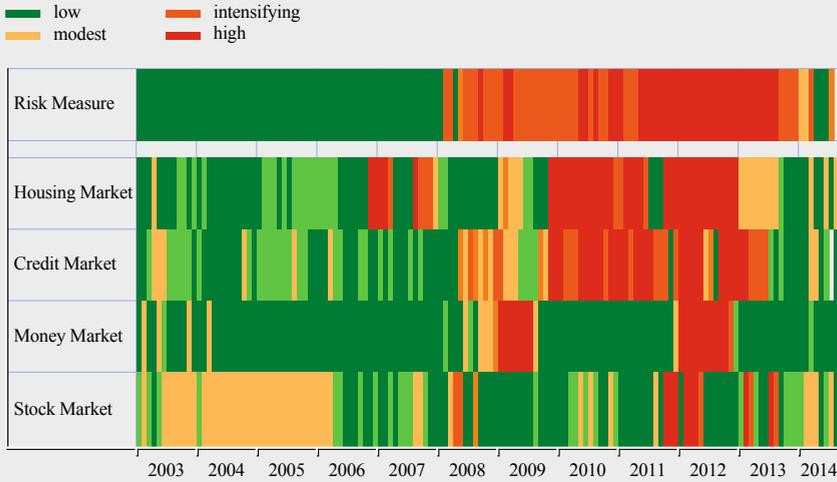9   See Issing (2003), especially Chapters 2 and 3.
10 See Goodhart (2004).
11 See, for example, Segoviano and Goodhart (2009).

4 MANAGING TRADE-OFFS AMONG DIFFERENT CHANNELS OF COMMUNICATION

To illustrate the need to manage potential trade-offs among the various channels through which communication initiatives can support policy effectiveness, we explore the relationship between transparency and clarity.[12]
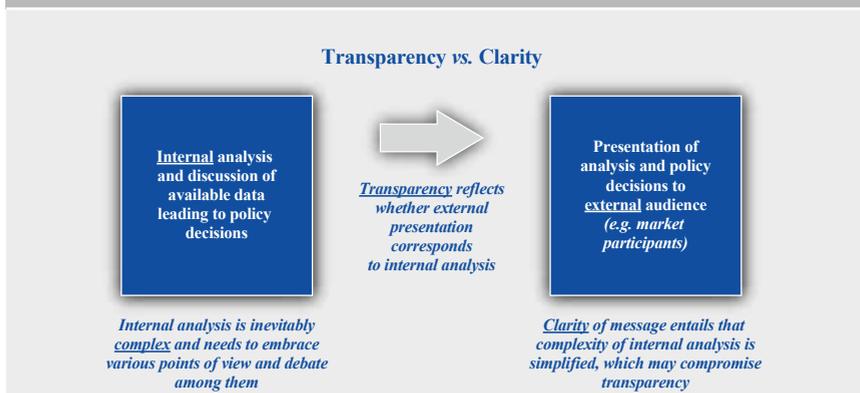
Any policy framework has two aspects: (1) *internal* analysis and discussion of the available data, leading to policy decisions, and (2) presentation of those policy decisions and their rationale to *external* audiences (e.g. the general public, market participants, etc.). A natural definition of the transparency of the policy process is the extent to which the external presentation of decisions corresponds to the internal preparation of those decisions. Full transparency entails that the former perfectly replicates the latter (Chart 21).[13]

But internal analysis is necessarily complex, perhaps especially in the often detailed and controversial discussions surrounding financial stability and bank supervision. The information to be assessed is voluminous and complicated. Moreover, successful policy-making requires a healthy confrontation of different views and arguments that tests the robustness of individual decisions.

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12 For a richer analysis of the multiple potential trade-offs in this domain, see the discussion in Winkler (2000), upon which this section heavily draws.
13 In the context of bank supervision, this implies that full transparency is not consistent with respect to the confidentiality of information provided by individual institutions. That represents another interesting trade-off.

Transparency *vs.* Clarity

Internal analysis and discussion of available data leading to policy decisions

Transparency reflects whether external presentation corresponds to internal analysis

Presentation of analysis and policy decisions to external audience (e.g. market participants)

Internal analysis is inevitably complex and needs to embrace various points of view and debate among them

Clarity of message entails that complexity of internal analysis is simplified, which may compromise transparency

In this context, it is (almost) inevitable that providing all the underlying information, as well as the minutiae of how it is analysed and assessed, will come at some cost in terms of the clarity with which the final policy decision is presented to the public. Full transparency therefore hinders genuine clarity. Central bank communication in general – and the construction and presentation of statistics in particular – needs to manage the resulting trade-off.

With this in mind, in the external presentation of policy decisions there is a need to *simplify* the complexities of the underlying decision-making so as to make the presented rationale for policy decisions digestible and clear to outside audiences. The nature of that simplification will have to be tailored to each target audience. Even when users express the desire (in principle) to have "all the information", in general they will (in practice) lack the technical capacity to process the volume of internal information and analysis underlying decisions.[14] Some filtering and organisation to simplify – and thereby clarify – the policy message is always needed. Nowhere is this more apparent than in the presentation of data and statistical information.

Yet the danger exists that efforts to create a *simple* policy message out of the underlying internal analysis will degenerate into the formulation of a *simplistic* external communication. By nature, a simplistic message – while probably clear in itself – is likely to be misleading. It may provide false reassurance if complacent, or threaten to destabilise expectations if alarmist.

Managing the trade-off between transparency and clarity requires policy communication to be simple, but not simplistic. Given the potential power of signalling and feedback effects, the choice of how to filter and organise communication so as to achieve this balance is itself a crucial policy decision.

Recent experience with the publication of the ECB's comprehensive assessment of euro area bank balance sheets illustrates some of these issues. For each of the

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14 Despite the availability of modern technology, which has significantly eased and facilitated the management and analysis of "big data".

roughly 120 banks that were part of the exercise, more than 12,000 pieces of information were published. Simple arithmetic dictates that the release of stress test results entailed publication of around one and a half million individual data points.

This was certainly an impressive (and important) exercise in transparency. Many of our colleagues who focus on the "bottom-up" analysis of individual banks benefitted over the subsequent weeks from the extraordinarily rich set of information that was made available.

But for the (more casual) macro observer, this volume of data was simply indigestible. Attempting to draw conclusions from a data set of 1.5 million observations in the course of a Sunday afternoon may lead us in directions other than those the policy-makers intended. Transparency may have come at the expense of clarity – at least for the macro audience – on this occasion.

5   CONCLUDING REMARKS: FORM SHOULD FOLLOW SUBSTANCE

In the monetary policy domain, communication has been shown to play a key role in enhancing the effectiveness of policy measures. It is unsurprising that this issue has again arisen upon the ECB's assumption of new supervisory and macro-prudential responsibilities in the context of banking union. Communication of statistical information and data underlying bank supervision and financial stability analysis are central to this debate.

We are sceptical that communication constitutes an independent channel of policy transmission. In our view, the design and presentation of statistics and data needs to be fully embedded in the overall policy framework. Communication of statistics should be understood as an amplifier of well-designed policies, rather than a substitute for them. However well communicated, a bad policy choice is still a bad policy choice.

Communication needs to be the catalyst for positive, stabilising feedback from market participants, financial institutions and the general public. To achieve this, communication needs to support both the predictability and the credibility of policy decisions: you need to "say what you do" and "do what you say".

But the most important issue remains making the right policy choice. For all the potential benefits of the communication of statistics and policy choices, it is crucial that statistics prompt analysis that leads to the correct decision. In the end, form must follow substance – not lead it.

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