Ernst Welteke: Cross effects between monetary policy and financial markets

Lecture by Mr Ernst Welteke, President of the Deutsche Bundesbank, held at the Belgian Financial Forum in Brussels, 14 June 2001.

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Ladies and gentleman,

It is a pleasure for me to speak today on “Cross effects between monetary policy and financial markets” to such a distinguished audience here at the Belgian Financial Forum in Brussels.

The heading looks like an obvious choice for a central banker. The issue of cross effects is of ongoing interest for policymakers and market participants alike. The introduction of the single currency and concomitant changes in integrating European financial markets have brought these cross effects even more into the spotlight. Not least, the BIS has – in its latest annual report – devoted considerable space to these issues. Furthermore, – I trust you will grant me the quote – “irrational exuberance” in major stock markets has reinvigorated the debate about financial market prices and their appropriate role in monetary policy.

I

The European Central Bank (ECB) has been given a clear mandate to keep inflation in check. In choosing the monetary policy framework for the euro area, the Governing Council has kept this concept to the fore. Open market operations and the standing facilities play a prominent role. Thus, in terms of monetary policy in the euro area, the European Central Bank makes ready use of financial markets to get its policy across into the real economy – just as any other modern central bank does.

Monetary transmission is a complicated and permanently changing process. It is not yet fully understood and is therefore always a field of fruitful research. Conceptually, the transmission process can be broken down into two stages. Changes in official interest rates first affect financial markets. Those markets react fast. In the next stage, a policy move makes itself felt in the broader economy, thereby exerting the desired influence on consumer prices. That is by no means a straightforward process. And it takes time. These time lags explain why the Eurosystem adopts a medium-term perspective when shaping monetary policy.

Those parts of the European financial markets that are crucial for the transmission of the Eurosystem’s monetary policy are already integrated to our satisfaction. The wholesale market for interbank liquidity in the euro area is now a single European money market.

Any change in official interest rates first affects the money market. Then rates along the entire yield curve adapt. In addition, equities are repriced after a policy move due to two factors:

- First, a change in the discount factor
- and, second, revised earnings expectations stemming from changes in firms’ financing costs and prospective sales.

The adjustments in financial markets then translate into the broader economy via cost, income and wealth effects. The speed and the relative weight of the transmission channels identified depend on the structural conditions in the economy. Habits in finance and investment among businesses and private households are important. As is overall flexibility of the economy. As the euro area as a whole is a relatively closed economy – about 17 % of GDP is generated by exports –, the exchange rate channel is of minor importance for monetary transmission.

II

Financial markets are dynamic and innovative; structural change is everyday business. Recently, the introduction of the single currency in Europe has been seen to coincide with changes in investment and financing habits. As central bankers, we in the European System of Central Banks monitor these developments closely for their potential impact on monetary transmission.

The relative importance of banking systems vis-à-vis financial markets as a source of corporate finance still varies in the euro area economies. So, consequently, does monetary transmission, although not to a degree that would hamper the single monetary policy.

On the contrary, we see euro-area-wide disintermediation generating further convergence towards a truly European monetary transmission mechanism. Companies are now tapping capital markets more intensively. In other words, firms have begun to rely less on banks for corporate finance.

Capital markets are gaining importance as a means of obtaining corporate finance, as opposed to bank credit. The amount outstanding of (domestic currency denominated) corporate bonds by euro-area residents rose one-fifth last year; for short-term paper the figure is even two-fifths. Banks are increasingly adapting to this trend. More and more they are providing corporate clients with

access to capital markets. The banks themselves profit from securitisation. It helps them to make more efficient use of their capital and to generate the desired fee income. The role of banks in monetary transmission is therefore changing.

Faced with competition from firms directly tapping capital markets, banks are now setting their interest rates for lending more closely in line with prevailing market rates. Shrinking interest rate margins are the result. Any change in official interest rates will therefore translate faster into adjusted spending plans of the economic agents in the non-financial sector. Thus, there is an acceleration of monetary policy transmission.

However, there is also a factor that potentially works towards slower transmission. Those countries in the euro area with a history of higher inflation rates tend to rely more heavily on short-term lending and on variable rates. In those countries, monetary policy stimulus affects the non-financial sector considerably faster. As these countries are now experiencing a higher degree of price stability, market participants will feel secure about shifting towards longer-term contracts and fixed rates. This will result in monetary transmission being slowed down.

The ultimate effect of those two opposite trends is still uncertain. I tend to lean towards expecting monetary transmission to accelerate. Capital markets are dynamic; they are innovative and they permanently create new instruments that increase flexibility in terms of finance. In flexible financial markets, however, monetary impulses should be passed through at a faster rather than a slower pace.

Disintermediation in corporate finance coincides with the institutionalisation of savings. Private households shift funds from bank accounts into pension funds and mutual fund shares. Share ownership – direct and indirect – is on the increase. As the value of equities tends to be more volatile than that of other financial assets, changes in financial wealth may impinge on consumption decisions with greater frequency. However, the wealth effect for the euro area is considered to be rather small. In Germany we estimate the marginal propensity to consume out of financial wealth to be about 1%. That is, an increase in financial wealth of 100 euros would spark additional demand of 1 euro.

Given this change in investor attitude, should central banks actively target asset prices? The potential influence of asset prices on the economy and concerns about financial market stability lie behind such considerations. However, objections against targeting asset prices by far outweigh any potential benefits.

- First, there is the issue of knowing the appropriate asset price level. There is no way for a central bank to know that better than the market.
- Second, stabilising consumer prices and stabilising asset prices may call for diverging policy paths. Central banks may well find themselves faced with the dilemma of having to decide to which goal to give priority.
- Third, targeting asset prices creates “moral hazard”.

Therefore, it would be unwise for monetary policy to even try to target asset prices.

Nonetheless, monetary policy contributes to a sound development of asset prices. The ECB’s monetary policy strategy emphasises money supply in the first pillar of its strategy. An adequate money supply – that is, money supply which is in line with potential output growth – is a necessary condition for preventing the emergence of speculative bubbles. In addition, a low inflation rate of itself fosters long-term investment and helps to stabilise asset prices.

III

Financial markets naturally play a part in shaping monetary policy. In the second pillar of the ECB’s monetary policy strategy, a broad set of indicators for the medium-term outlook for price stability and for economic growth are observed.

It is in three respects that financial market prices are particularly valuable for monetary policymakers. First, they provide us early on with leading indicators as to market expectations about macroeconomic developments. For example, changes in the term structure of interest rates relate to future economic growth. A steepening of the yield curve typically forecasts stronger economic growth.

Such an increase in the term spread would, however, not convey unambiguous information. Higher long-term rates could also reflect expectations of higher future inflation or a change in risk premia. Additional information from asset and money markets may therefore be necessary to interpret market expectations in this regard.

Second, measuring the expected volatility of future financial market prices shows us the degree of uncertainty attached to expectations. Implied volatility derived from options on long-term bonds is an example. However, there is no consensus on how to read volatility exactly. We do not know for sure which particular component of the long-term bond yield – the real interest rate, expected inflation or risk premia – determines volatility. Thus, the informational value of these measurements is limited.

Third, financial market prices give us insights into the expectations of market participants with regard to monetary policy action. EURIBOR rates are especially helpful in this respect. They allow us to construct a yield curve for the money market. Additional information can be derived from three-month futures. Thus, we havea pretty good picture of anticipations prevailing in the market with regard to monetary policy moves. All in all, financial markets provide central bankers with helpful information.

The use of market information is, however, subject to some caveats. Financial market prices are open to a whole host of influences – including distortions by institutional features, irrational behaviour and herding behaviour, for instance.

Market expectations can therefore never be a substitute for the central bank's own independent assessment of the economic situation and of future developments. We use financial market prices to complement and cross-check our own economic assessments.

While we try to figure out what the markets think, the markets are busy trying to figure out what we think. We watch them – and they watch us. If the central bank always met market expectations, destabilising circularity could occur. Monetary policy decisions have to be based mainly on fundamental economic data.

Reducing uncertainty as far as possible is clearly one of the aims of the Eurosystem. The Eurosystem therefore communicates extensively with the markets. Which is why, for example, we decided to publish our staff economic projections.

The increased role of communication and transparency reflects a change in the relationship between monetary policy and financial markets. Monetary policy today makes use of financial markets a lot more actively and openly than it did in earlier times.

IV

Ladies and gentlemen, having presented you some general remarks on monetary policy let me now get down to the specifics of the current situation of monetary policy in the euro area.

The Governing Council of the ECB is, at present, taking its decisions in a climate of considerable global economic uncertainty. In a situation like this it is particularly important to pursue a clear and consistent rule-based policy. The monetary policy strategy developed by the Governing Council of the ECB meets precisely that need. The public is right to expect the Governing Council of the ECB to stick to its strategy and to present its own interest rate assessments.

Let's start with the money supply. It plays a prominent role as the "first pillar" of monetary policy, the underlying perception being that inflation is, in the long term, essentially a monetary phenomenon. The money supply in the euro area increased by 4.6 % from February to April, compared with the same months one year previously. This increase is roughly in line with the 4½ % reference value – in other words, the level which is in keeping with price stability and trend economic growth.

Monetary growth has been tending to slow down since the spring of 2000. Because of some statistical distortions, even more, in fact, than was initially expected. There are two main causes of these distortions.

First, non-euro-area residents have considerable holdings of money market fund units. However, the money supply concept relates to euro-area residents, mainly because the amount of cash residents hold in the euro area is relevant in terms of expenditure. The latest figures from the ECB currently put this distortion at 0.5 percentage point. The money growth rate figure I mentioned a moment ago has already been adjusted.

Second, other short-term money market instruments, which are likewise held by non-euro-area residents, also exaggerate the extent of monetary growth. Precise statistical data for this category of instrument are still being collected by the ECB and will be published at the end of the year.

If all these facets are taken into account, monetary growth is well below the quoted figure and cannot therefore be described as expansionary. From a medium-term perspective, there is no indication of price risks.

In connection with the second pillar of the ECB's strategy, the data point to decreasing pressure on prices. This would appear to be at odds with the current unsatisfactory price trend; euro-area inflation was 3.0 % in April. However, this was largely due to special factors, the effect of which is likely to subside in the coming months. Basically, these factors are the higher prices of crude oil and, as a result, of fuel, together with the effect on prices produced by the crisis in the food sector.

Wage negotiators have been right to assume that the inflationary effects are temporary, as there have been no second-round effects so far. In stating that, I refer to the most recent wage settlement in the German banking sector. Negotiators have agreed on a wage increase of slightly less than 3 %. Now that economic risks can no longer be ignored, it is extremely important to negotiate moderate wage settlements.

The rise in the cost of energy is currently driving overall prices up, while at the same time putting the brake on the economy. The outlook and forecasts in the euro area for this year have had to be adjusted. Industrial output and capacity utilisation have already declined somewhat. Surveys show that industrial sentiment, in particular, has become far more gloomy. Viewed from this angle, this could also entail limited price risks for the period ahead.

While the economic outlook is running counter to inflationary pressures, the euro exchange rate must be watched very closely for possible risks to price stability. Let me again stress our utmost interest in a strong currency. The external value of the euro is an important indicator in the second pillar of the ECB's monetary policy strategy.

Financial markets share our medium-term expectations for price developments. Capital market rates are still at a low level – a reflection of the expectation that possible inflationary pressure will be under control over the longer term. Interest rates, at least, are not an impediment to an economic upturn.

After weighing up all the factors and taking account of the medium-term orientation of monetary policy, I have reached the conclusion that the current monetary policy stance is appropriate at the present juncture.

V

Ladies and gentlemen,

Let me now try to summarise the main features of the interdependence between monetary policy and financial markets:

- Central banks need well-functioning financial markets. They work as the crucial link between monetary policy-setting and its ultimate goal, price stability. Disintermediation further heightens the importance of financial markets in the transmission mechanism of monetary policy. Therefore, monetary policymakers need to analyse structural changes in financial markets thoroughly.
- Central banks acquire information about the expectations of financial market participants by monitoring financial market prices. They cross-check their own forecasts against these data.
- Finally, in order to avoid misperceptions of the policy stance in the markets, there has to be a consistent communication policy.

With capital markets integrating and habits in the fields of finance and investment changing, as central bankers in the euro area we have now entered a period of heightened uncertainty. The ECB has opted for a monetary policy strategy that anchors the markets' expectations of future price stability. The two-pillar approach to assessing the outlook for prices is appropriate in times of structural change, as it is not only credible, but also highly flexible. Financial markets therefore have a reliable partner in the Eurosystem – one that is well equipped to meet current and future challenges.