# Ernst Welteke: Financial market disturbances - a challenge for monetary policy

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at Market News International, London, 24 September 2002.

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## I.

Playing the financial markets has been anything but an easy thing to do recently. During the late 1990s, many investors enthusiastically embraced the idea of a “new era” of systematically increasing returns. Now that the flaws in that concept have become evident, many of them have had to abandon a significant portion of their wealth. Confidence in financial markets has been severely shaken.

Monetary policymakers are concerned when financial markets are as shaky as they are at present. Monetary policy has a vital interest in the stability of the financial markets. The Maastricht Treaty assigns co-responsibility for the stability of the financial system to the euro-area central banks. The measure of responsibility assigned to them reflects the use that monetary policy makes of financial markets for the transmission of monetary policy. I would like to outline a number of major fields of responsibility in which financial market disturbances affect central banks.

## II.

Let me first put the turbulence in the financial markets into perspective. The turmoil has been felt most keenly in the equity markets. Since peaking in March 2000, major stock indices have been hit hard. The Dow Jones EuroStoxx 50 and the German Dax 30 have both roughly halved since reaching their all-time highs. The US Standard and Poor’s 500 Index has shed about 40 per cent, while the technology-heavy Nasdaq Composite index has shrunk to almost one-quarter of its peak value.

Remember, in an environment of healthy corporate profits, soaring asset prices took price-earnings ratios up to hitherto unknown heights. Equity markets looked overvalued, but the “New Economy” paradigm enticed investors into not regarding them as overvalued. Experience shows that a bubble can scarcely be identified with certainty until it bursts.

The price-earnings ratios for major stock indices peaked at about twice their historical averages. Individual stocks, especially from the bubble-plagued TMT sector, experienced much higher price-earnings ratios. For the EuroStoxx, the S&P 500 and the German Dax 30, the ratios are now close to their historical averages. The bubble has been deflated to a certain extent.

Booming fixed income markets mirror the faltering stock markets. As investors became more risk-averse, they switched from equities to bonds. The upshot of this is that government bond yields are close to their historical lows.

Volatility in equity and bond markets has itself been volatile. We have witnessed a number of pronounced spikes in volatility. In early August and again in early September, volatility was almost as high as it had been during major international financial crises such as the “Russian crisis” four years ago.

For the euro area, the equity market downturn arrived in the midst of an increasing capital market orientation on the part of financial investors and the corporate sector. Should we now write off the markets in the same way as we have written off many of our investments in the past? No, I do not think so. Disintermediation is an unbroken trend, as may be seen in corporate bond issuance, which has held up fairly well.

Furthermore, financial markets have proved they are fit to serve investors’ needs. To some disappointed investors, this may seem cynical. But think of it in the context of the accounting cheats. Once the true figures became known to investors, equity valuations were aligned to the correct fundamentals. Once we had transparency, the markets worked their magic. The markets themselves cannot be blamed for the wrongdoings of some dishonest market participants. But we definitely need to adjust the incentives for better transparency. Balance sheet fraud is a criminal offence, not a trivial one. Tougher sentences might help to make that clear. Strange as it may sound, market turbulence in the wake of faulty accounting is an indication of how effective financial markets are.

## III.

Turmoil in financial markets is not confined to the equity markets of the advanced economies. Emerging markets have suffered a host of financial crises during the past decade. The most recent crises occurred in Turkey, Argentina, Uruguay and Brazil.

In contrast to earlier financial crises, today's investors discriminate better between individual borrowers. Emerging market economies can protect themselves to a certain extent from contagion by pursuing sound policies. When Argentina defaulted last December, the vast majority of emerging market countries that had pursued better macroeconomic policies escaped unscathed.

The stability – or instability – of international financial markets owes much to the framework for crisis prevention and crisis resolution. Monetary policymakers have made a major contribution to the international financial community's thoroughgoing approach to crisis prevention. With regard to crisis prevention, there exists a broad consensus. All necessary steps should be taken to get the incentives right — and that means the incentives both for creditors and for debtors.

What measures can a country take to strengthen its resilience? The basic recommendation is to pursue sound and consistent policies. Liberalising capital flows is beneficial for emerging markets. But the sequencing has to be right. They should start with more stable long-term capital flows, such as FDI, and deregulate volatile short-term capital flows last. As capital-account liberalisation progresses, financial supervision needs to keep pace. Supervision needs to become ever more effective in order to reduce the vulnerability of the domestic financial sector. The Asian countries in crisis, for example, grossly neglected the link between capital-account liberalisation and independent banking supervision.

Prudent public debt management is another key measure in crisis prevention. Governments need to contain short-term external debt, particularly if it is denominated in foreign currency. Over the longer term, stable capital inflows into emerging-market countries can only be secured by pursuing sustainable policies. But that is not quite enough. Transparency counts. Financial market players want to base their decision-making on hard facts. Countries seeking access to financial markets must provide reliable economic and financial data on a timely basis – just like companies do. The Financial Stability Forum has summarised these and other good practices in a list of 12 key Standards and Codes. Implementing such standards and codes is an effective tool for making countries less prone to crisis.

Focusing solely on emerging markets in the prevention of international financial crises gives no more than an incomplete picture, however. It would obviously be helpful if the advanced countries were to grant more liberal access to their product markets. The current round of trade negotiations set in motion at Doha late last year therefore has some bearing on the stability of the international financial markets, too.

During the 1990s, there was a rapid increase in lending to emerging markets. Moreover, the composition of the lending community changed. In the 1990s, the private sector accounted on average for almost 80 per cent of net capital flows to emerging markets, compared with 35 per cent in the 1980s. As bond issues supplemented – or in some cases all but replaced – international bank lending, the number of creditors increased. Therefore, the days when a handful of creditors could negotiate a debt workout in what was known as the "London Club" definitely belong to the past. Finally, since the mid 1990s private capital flows to emerging markets have been dominated by foreign direct investment flows, which is a more stable external financing source in comparison to volatile portfolio investments and bank lending.

Since the mid-1990s, crises have usually been resolved by the provision of – sometimes extremely large – financial assistance packages by the IMF. This practice, however, sets the wrong incentives for all participants. International financial market will only proper function if private creditors and investors not only reap the benefits of their decisions but also bear losses caused by unfavourable developments. Violating this principle by having the IMF inject massive financial aid at times of crisis inevitably encourages excessive risk-taking by investors. Such behaviour – also termed moral hazard – contributes to emerging market economies overwhelmed by debt and undermines the willingness to reform in borrowing countries.

Therefore, we need to rearrange the incentives in an improved framework for crisis resolution. This framework must provide for an orderly debt workout in the event of a financial crisis and comprise a more balanced burden-sharing between the private and public sectors in line with their respective roles.

Limiting access to official lending will be at the core of any future framework for crisis resolution. Greater ex ante clarity about the scale of official financing will help to guard against both debtor and creditor moral hazard. Exceptional financing should be reserved for truly exceptional cases requiring substantial justification ex ante and ex post.

Strict and credible limits on access to IMF financing call for private sector involvement on a regular basis. This is the key to an improved functioning of the international financial markets. Investors who cannot reasonably expect a bail-out have greater reason to practise effective risk management. In the same way, debtors have greater reason to undertake necessary adjustments and reforms in order to secure access to financial markets. If such a framework is put in place, moral hazard will not distort investment decisions.

Private sector involvement in crisis resolution can and should take a variety of forms. Priority should be given to approaches which foster cooperation between debtors and creditors. That would include voluntary approaches such as “collective action clauses” in private debt contracts. Such clauses can substantially reduce the risk of litigation and asset attachment, once a majority of creditors has agreed on debt restructuring.

The IMF has proposed a Sovereign Debt Restructuring Mechanism similar to national bankruptcy codes for enterprises. However, as so many questions of both a practical and legal nature remain open, such a statutory approach will not be available for years. Any reshaping of the international financial architecture should therefore concentrate on adjusting incentives by revamping IMF lending policy in the way I have set out. This would automatically entail an enhanced role for the private sector in crisis resolution.

## IV.

Financial market turmoil also raises concern about the stability of the national financial systems. Prudent financial regulation and supervision are the foundations of financial system stability. Why and how central banks should be involved requires constant clarification. There are good reasons for advocating central bank involvement in financial regulation and supervision.

Let’s start with financial supervision. Financial system stability is a prerequisite for the efficient conduct of monetary policy. Consequently, the EC Treaty calls for the European System of Central banks to contribute to the stability of the financial system (Art. 105(5)EC). Macro-prudential supervision is in the best interests of central banks. In conducting monetary policy and in operating payment systems, central banks gain valuable information on the stability of market participants. "The marrying of micro- and macro-prudential analysis", as BIS General Manager Andrew Crockett once put it, allows us to exploit synergies of monetary policy and financial supervision.

In the field of financial regulation, the EU is currently deliberating whether to introduce the “Lamfalussy model”, which is now applied in securities regulation in the banking and insurance sectors as well. The ECOFIN Council and the European Parliament would thus make a decision only on the framework for envisaged legislation – known as “level 1” – while a regulatory committee would decide on the technical details of new laws – “level 2”. In the “Lamfalussy model”, this regulatory committee comprises only representatives of the ministries of finance. However, “level 2” needs to draw on the expertise of central banks. Why is that so?

For the banking industry, one of the main tasks of European regulators consists in translating internationally agreed standards into European law: Basle II, the new minimum capital requirements, will be next. Central banks are experts on Basle II, since they are substantially involved in negotiating the new Capital Accord in the Basle Committee on Banking Supervision. They are truly familiar with the details of the new framework and such knowledge is indispensable for the EU legislative process.

But it is not only the details that count. The regulation of the banking industry has an even larger bearing on the real economy than the regulation of the securities industry does. Banking regulation may affect the competitiveness of the overall economy in various ways owing to the national specifics of financial systems. Central banks are experts on the national financial systems. Exploiting the specific knowledge central banks have to offer in the regulatory process – as is currently the case in the well-established Banking Advisory Committee – is something I regard as crucial.

Attempts to rid either financial regulation or financial supervision of central bankers’ influence will backfire at some point in the future. Prudent risk management would prevent such a risk from materialising.

## V.

Besides raising issues of systemic stability, financial disturbances also affect the real economy, irrespective of what generated the turbulence in the first place. Transmission to the real economy works via three main channels.

The channel that received most attention during the latest market downturn is also the least effective one in the euro area: the wealth effect. As their portfolios shrink in line with stock valuations, consumers tend to cut their expenditure, so the theory goes. European consumers hold a smaller portion of their portfolios in stocks. For example, the ECB estimates that a 10 per cent permanent decline in stock prices in the euro area would reduce consumption by a maximum of 0.19 per cent. This compares with significantly higher estimates for the US. As investors' habits change in the euro area, the wealth effect should be expected to gain slowly in importance.

The second channel – and probably the most important one for the euro – is the direct and indirect impact that fickle stock markets have on business financing costs. Equity financing becomes more expensive, as investors are less eager to buy new shares and demand higher risk premia. Bank credit is harder to come by, as potential collateral shrinks in value. And, as investors become more risk-averse, rising spreads for corporate bonds may make capital market financing more expensive. Given surging capital costs, marginal investment projects become unprofitable.

The third channel through which adverse financial developments may impinge on the real economy can be described by "negative sentiment". A certain sense of crisis will tend to weaken confidence. However, in the current situation it is not entirely clear whether the financial market disturbances are predominantly a cause or an effect of the downward revision of high-flying expectations. The impact, I suppose, works in both directions.

Both financial markets and the real economy are suffering from post-bubble blues. Businesses and consumers are short on confidence and long on worries. Financial, economic and political uncertainty have risen in parallel. After the "golden nineties" the pendulum now is swinging back. It may even swing back too far and overshoot like exchange rates tend to do. Unfortunately, there is no Prozac to alleviate post-bubble blues.

An in-depth analysis of the data may help to clarify the picture. The situation is better than the sombre mood suggests, although admittedly not as good as we had hoped for.

Economic growth in the euro area economy is subdued this year. Expectations were running far ahead of the economic recovery. The downward revision of earlier upbeat expectations has narrowed the unusually large gap between high-flying expectations and the assessment of the current situation. The business and consumer climates now suggest a slower start to a less vigorous recovery. Leading indicators do not, however, point to another economic downturn.

Recent price developments are bolstering consumption. The euro area inflation rate at 2.1 % (August) is almost back in the range which the ECB Council regards as price stability. Both short-term and long-term real interest rates are below average and do not hamper investment. Liquidity is ample, and monetary conditions are favourable. Monetary policy is expansionary.

What, then, is standing in the way of a more decisive economic recovery? We need to be honest: the euro area has not been able to produce a self-sustained economic recovery without the US first pulling us out of the economic trough. This time, our overseas business partners are still struggling to unwind the economic and financial imbalances that built up during the "golden nineties" and the late bubble economy. The unwinding process is taking longer than was expected in the rather optimistic assessments early this year.

Home-grown structural weaknesses are being felt all the more keenly in the euro area. There is no shortage of analysis. There is a "to do" list lying on the desk of everyone concerned. There is a backlog in terms of concrete action, especially in the field of labour market flexibility. Adjusting incentives, reducing regulation and eliminating rigidities should help to unleash the forces of economic growth. The euro area must put itself in a position to kick off a self-sustained economic upswing. Tackling reforms decisively is important not least in terms of bolstering confidence, which is a more appropriate – and, incidentally, more effective long-term – antidote to the post-bubble blues than any "Prozac" might be.

## VI.

In times where uncertainty abounds, monetary policy needs to be a stabilising factor. Euro area monetary policy is geared to maintaining price stability.

Given financial market turbulence, should monetary policymakers broaden their focus to include share prices in their definition of price stability? Well, in my opinion, that is not a good idea. The objections to targeting asset prices weigh more heavily.

To begin with, there is the issue of defining the appropriate asset price level. There is no way in which central banks can make a “diagnosis” superior to that of the market.

Then, even if the matter of diagnosis issue could be solved to our satisfaction, stabilising consumer prices and stabilising asset prices might call for diverging policy paths. Central banks could well find themselves faced with the dilemma of having to decide to which goal they should give priority. The fact that bubbles tend to occur in periods of low inflation only accentuates that potential conflict.

And, last but not least, there is the question of “moral hazard”. Central banks would need to respond in perfect symmetry to overshooting and to undershooting stock prices. Financial markets would become severely distorted if market participants were to come to the conclusion that the central bank would let them enjoy returns when the markets are up but bail them out once the market goes downhill.

Instead, we should stick to our tried and tested approach of stabilising the general price level in the product and services markets.

Nonetheless, monetary policy contributes to a sound development of asset prices. The Eurosystem’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. Also, a low inflation rate in itself fosters long-term investment and helps to stabilise asset prices.

This summer, euro area monetary policy has been confronted with conflicting signals: monetary growth continues to be strong. Its high growth rate owes much to low opportunity cost and ongoing portfolio reallocation. Given weak final demand, the risk of ample liquidity being channelled into inflationary pressure is regarded as quite low.

A more serious risk to price stability is the price of crude oil, which has begun to climb upwards in the wake of increasing political tension in the Middle East.

Further non-negligible risks to price stability stem from a potential weakening of the Stability and Growth Pact. Some European countries, among them my own, need to make intensified efforts to balance their budgets. The pact is symmetrical with a lower limit: balancing the budget over the economic cycle requires governments to run a surplus when the economy is doing well. In the trough of the economic cycle, governments can then allow automatic stabilisers to develop their full effect up to the budget deficit ceiling of 3 per cent of GDP. Not least, demographic developments require the budget to be balanced over the economic cycle as a whole.

Despite these uncertainties, both the markets and the Eurosystem expect the recovery to continue. The euro area cycle is unlikely to experience a double dip. In actual fact, the moderate pace of economic expansion in the euro area is set to continue, not least because macroeconomic policy is supportive:

1. Monetary conditions are favourable to growth: liquidity is ample. Real interest rates, both long- and short-term, are below their historical averages.
2. The euro area does not display fundamental imbalances – the labour market being the notable exception. The balanced current account reflects the sustainable savings rate.
3. The world economy is set to stay on its – admittedly, not very steep – path of growth.
4. Both investors and consumers will soon have to make up for the investment and consumption spending that was put off during the downturn.

Bearing these facts in mind, the Governing Council of the ECB believes the risks to price stability to be balanced. Therefore, we decided to stay on hold when we last assessed the monetary policy stance two weeks ago.

## VII.

Financial turbulence does not leave monetary policy makers cold. As you undoubtedly knew already, central bankers are a cautious lot. We do not easily buy into market euphoria nor do we buy into gloomy scenarios.

In order to contain financial market disturbances, we need to improve the international financial architecture, to conduct financial regulation and supervision in a prudent manner, and to adhere to a stability-oriented monetary policy.