Hermann Remsperger: Monetary stability - institutions matter

Speech by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank and Chairman of the Supervisory Board of the Monetary Stability Foundation, at the first conference of the Monetary Stability Foundation, Frankfurt, 5 December 2002.

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The first conference of the Monetary Stability Foundation is dealing with the role of institutions for monetary stability. This is certainly not a new topic. Economists have thought about this for centuries and have come up with a wide range of answers. While the questions remain the same, the answers change as the monetary and financial system evolves.

Rather than going into the details of each of the sessions, let me start the conference off by referring to two issues. The first concerns the involvement of central banks in safeguarding the stability of the financial system. The second is the relationship between fiscal and monetary policy in a monetary union.

In my view, a good opportunity to start thinking about price and financial stability is a paper by Friedrich A. Lutz on “The Basic Problem of the Monetary Constitution”, first published as early as 1936. Its starting point is the observation that money and credit are essentially two sides of the same coin as money results from bank lending.

On the credit side, competition between banks should ensure an optimal allocation of resources. On the money side, however, this competition could lead to an excessive creation of money and hence to inflation and instability of the financial system. As a consequence, money is best controlled by a monopolist, while credit is best granted by competing banks.

The key idea of the Lutz paper is still interesting today, because it explicitly recognizes the link between price stability and financial stability. As Lutz himself emphasized, having two very different principles of order for each side of the balance sheet in the banking system does not appear to be a problem in normal times.

In periods of crisis, however, a problem appears. To quote Lutz once more: State guarantees for deposits and bailouts nationalize bank liabilities, while keeping the asset side in competition. To put it in today’s words: The result is a considerable moral hazard.

Lutz‘s insight may not be surprising given that he wrote in the aftermath of the severe banking crises in Germany and the US of the early 1930s. It is perhaps more of a surprise that his discussion seems to have been somewhat forgotten afterwards. As recently as in the early 1990s, conventional wisdom appears to have been “keep prices stable and you will minimize the danger of a financial crisis”.

After several financial crises, and in particular with the Japanese experience in mind, few would subscribe to this view. We have learned that it is not only movements in the general price level that matter, but also movements in a specific class of prices, namely asset prices.

The example of Japan shows that the price stability of the late 1980s was not sufficient to ensure financial stability in the decade that followed. Conversely, financial instability can lead to price instability, in particular deflation.

Financial stability is therefore an essential condition for a successful monetary policy. Any central bank that wants to take its price stability mandate seriously also needs to have a direct interest in financial stability. We are therefore interested in developing tools that help us to ensure the stability of financial markets and financial institutions. Without financial stability, price stability cannot be guaranteed.

Still focussing on banks’ balance sheets I would like to add that the money creation process through the asset side of the banks can be dampened or even endangered by a high volume of non-performing loans. That’s what we have learned from the Japanese experience.

And the experience in the Eurosystem has made clear that a strong expansion in monetary aggregates is not necessarily the result of a high increase in bank lending. A large increase in money supply may reflect a low monetary capital formation, which is heavily dependent on the expectations in the financial markets.

Thus we have to take account of the fact that the financial system has become much more complex. In Germany, this has had essentially two effects. First, the role and size of financial markets have grown dramatically, providing both new sources of finance and investment opportunities. Although banks remain at the centre of the financial system, they are much more dependent on financial market conditions than in the past.

Second, our financial system is far more closely integrated with the rest of the world than it used to be. On the one hand, this provides both profit opportunities and permits a more ample diversification of risk. On the other hand, it makes us more sensitive to shocks from abroad.

Against this background, I believe it is worthwhile expanding the basic problem of the monetary constitution as described by Lutz. Whereas he concentrated on bank balance sheets we have to pay special regard to the ever increasing importance of financial markets. There might be a conflict between the interplay of market forces in the financial markets on the one hand, and financial stability on the other, just as there could be a clash between competition in bank lending and monetary stability.

The past has taught us that it is important to adopt a fairly broad approach when developing tools to protect the stability of the financial system. In particular, we cannot discuss this topic without looking at the institutional framework. Institutions matter. Any discussion that ignores this is of little use to the real world. Two issues are important. The first is, the design of the individual institution, and the second is the relationship between different institutions.

Let me focus on the second of these issues. The classical view of the relationship between institutions is to let each institution concentrate on its own task. For example, price stability would fall into the responsibility of the central bank, while the stability of the financial system would be the task of another government agency. Separating tasks, it is argued, makes institutions more accountable and helps to limit agency problems. While there is much merit in this view, we have become aware that tasks often cannot be separated so clearly.

Let us recall the example of the central bank and financial supervision. Under certain circumstances, there may be a short-term conflict of interest between price stability and financial stability. In some cases, low inflation may call for a cut in interest rates, while financial imbalances may warrant a rate hike. What should the central bank do?

If you take the idea of separating responsibilities to the extreme, the central bank should simply cut interest rates and forget about the impact on the financial system, the protection of which would be the regulator’s job. Few would consider such a policy optimal.

The reason for this is that a conflict between price stability and financial stability is not necessarily an agency problem. Instead, we may be faced with a short-term trade-off between price stability and financial stability. Strictly separating these two tasks could thus lead to worse outcomes than coordinating the tasks between institutions.

Most non-Europeans would stop here. In Europe, we have to consider an additional factor: the geographical dimension. Different institutions are subject to different jurisdictions. For example, prudential supervision is at the national level, monetary policy at the EMU-12 level, and the regulatory framework within which both supervision and monetary policy take place at the EU-15 level.

Let me turn now to the relationship between monetary and fiscal policy. It is not too long ago that interest rates in many countries were set by the finance ministry. One of the reasons behind combining monetary and fiscal policy decisions in a single institution was the idea that this would result in a better policy mix.

Today, in contrast, virtually all central banks in the developed world are independent, and it is hard to think of a country were the treasury decides on the level of interest rates. The last two decades have witnessed an enormous paradigm change on the role of central banks in monetary policy.

What are the reasons behind this paradigm shift? A key insight was the expectation-augmented Phillips curve. It said that monetary authorities may have an incentive to trigger off a boom by relaxing monetary policy. However, you cannot surprise agents too often. They soon will learn to anticipate this expansionary bias and adjust their behaviour accordingly. The result is high inflation and no expansion. The way out of this time-inconsistency trap is to install a “conservative” central banker who sets interest rates independently.

Central bank independence reduces the time-consistency problem, but it cannot prevent the possibility that monetary policy may be dominated by an unsustainable fiscal policy and thus be ineffective. This was first shown by the “unpleasant monetarist arithmetic” of Sargent and Wallace in the 1970s and, more recently, by the “fiscal theory of the price level”.

At the EMU-level, the relationship between monetary policy and fiscal policy becomes even more complex. There is only one monetary policy for the whole euro area, yet there are as many fiscal policies as there are countries. As a consequence, in addition to the problem of a possible fiscal dominance, there is a free-rider problem as it is possible for countries to reap all of the benefits while bearing only some of the costs of an unsustainable fiscal expansion. This shows how quickly the geographical dimension turns into a political dimension, with important implications for sovereignty.

The Stability and Growth Pact is the mechanism designed to mitigate this problem and thus an important part of our monetary constitution.

Let me conclude by saying that monetary stability consists of both price stability and financial stability. From this perspective the two-pillar approach of the ECB provides an excellent analytical framework. It does not only allow the ECB to integrate asset prices as an indicator of other variables in the second pillar. The ECB’s approach also allows it to analyse some aspects of financial stability within the broad framework of the first pillar.

As financial instability is very often created by a credit expansion that is too rapid, we have to pay particular attention to the counterparts of money supply. That is what Lutz told us many years ago. And that’s one of the reasons why I support the first pillar. In my view, the macro prudential element in the first pillar should be emphasized more than has been the case in the past.