Jens Weidmann: Crisis economics – the crisis as a challenge for economists

Lecture by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Annual Gala Meeting of the Munich Volkswirte Alumni, Munich, 13 June 2013.

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1. Welcome

Mr Baader

Members of the Munich Volkswirte Alumni-Club

Ladies and gentlemen

I would like to extend a very warm welcome to you here at the Deutsche Bundesbank in Munich.

At the same time, I wish to thank the Volkswirte Alumni-Club for inviting me to give this year's lecture. Even at the Bundesbank, it is not every day that so many economists are gathered together, and the Bundesbank employs a large number of economists.

I would therefore like to take this as an opportunity to talk about economists and their role in the crisis. Before that, however, I would like to offer my sincere congratulations to this evening's prize winners on receiving their awards.

2. Have economists failed?

On 6 April 2009, a severe earthquake occurred in the central Italian town of L'Aquila with the tragic loss of more than 300 lives. Only six days earlier, there had been a meeting of a national commission for the forecast and prevention of major risks. Afterwards, the experts made a public declaration that, despite a few tremors over the past few days, there was currently no heightened risk of an earthquake in the region.

Ladies and gentlemen

I am telling you about this incident because it is possible to draw instructive parallels with the role played by economists in the crisis. In much the same way as seismologists are accused of not giving ample warning about the possibility of an earthquake, economists are accused of not giving ample warning about the looming financial and debt crisis.

And much as engineers are accused of making buildings that are not earthquake-resistant, economists are accused of building design flaws into the financial and economic system, with whole nations now suffering under the consequences.

Economists have never had the best of reputations, even in the academic world. Many may feel that the topics which occupy economists are too common or vulgar – such as money.

As Silvio Gesell wrote in 1911, "Lofty idealists can easily find subjects of investigation more attractive than money. Religion, biology, astronomy, for example, are infinitely more edifying than an investigation of the nature of money."

By the way, Silvio Gesell himself found this object of investigation interesting enough to develop his own theory of money, even though, from today's perspective, it cannot exactly be classed as part of the mainstream. Fortunately, there have been a sufficient number of other "lofty idealists" in the ensuing 100 years who have found it attractive and edifying to study money and the economy.

Over the course of time, economists have gained a fair amount of influence in policymaking, too, while the opponents of this development have long been branding it as the “economisation” of politics and society. With the 2007 financial crisis and the ensuing critical developments, unease about economists clearly grew, however.

It has become fashionable to berate economists. For instance, Philip Stephens, the associate editor of the Financial Times, recently wrote that “The economy is too important to be left to economists”.

In my view, the accusations levelled against economists are, at best, only partly justified, however. Allow me to use the events at L’Aquila again by way of illustration.

The global financial crisis has often been described as a “quake on the financial markets”. But that is an unsatisfactory metaphor. And that is because the financial crisis, unlike an earthquake, is not a natural disaster. On the contrary, the crisis is 100% man-made.

Economics is not an exact science: it is a social science. The laws of economics are not laws of nature. Earthquakes can be explained as natural phenomena. When, where and with what force an earthquake strikes cannot be predicted with any accuracy, however. It is nevertheless possible to say in advance which regions are at severe risk from earthquakes and which are less exposed.

Certainly, financial stability reviews and other economic studies prior to the crisis contained some hints at shifts in the financial system. BIS, for example, gave repeated warnings about the setback potential stemming from the rapid growth in the credit securitisation and credit derivatives segments. Just to refresh your memory: between 2001 and 2007, the volume of credit default swaps grew by the factor of 100.

The macroeconomic risks arising from this development on the financial markets were scarcely perceived, if they were perceived at all, however. One key reason for this is likely to be the fact that the financial markets were modelled, at best, in a rudimentary manner in the macro models that serve as an important basis for economic projections.

Looking back, it is possible to say that financial economics and macro economics have made impressive progress over the past few decades – but unfortunately more in parallel than in cooperation with each other. It is only recently that research has switched to focusing more strongly on the interactions between the financial sector and the real economy.

Talking of progress: The ongoing refinement of statistical-econometric methods and their application in economic research have brought to light significant insights. Nevertheless, the crisis has aroused some doubts about the triumphal progress of mathematics in the economic sciences. By contrast, economic historians, who were already thought to be in something of a backwater, are now attracting more attention again.

Having said that, modern economic historians do indeed also make use of methods of empirical economic research, but look back further into the past than is customary. The book “This Time is Different” by Carmen M. Reinhart and Kenneth S. Rogoff is not only one of the best-selling books in the crisis literature; it has also been a reminder that financial and debt crises have been a constantly recurring phenomenon for centuries.

One classic of financial history, “Manias, Panics and Crashes” by Charles P. Kindleberger, is rediscovered in every crisis. In it, Kindleberger shows in numerous episodes that earlier centuries repeatedly witnessed speculative bubbles and exaggerations on asset markets: tulip mania in 17th century Holland, for example, or the South Sea Bubble and the Mississippi Bubble in the 18th century, which perhaps triggered the first international financial crisis.

Kindleberger cites one banker who invested in shares of the South Sea Company in 1720 as saying that, if the rest of the world takes leave of its senses, one must join in to a certain extent. That is very reminiscent of Chuck Prince, the former CEO of Citigroup, who, in 2007, came up with the legendary remark that “As long as the music is playing, you’ve got to get up and dance”.

There’s nothing new under the sun, one might say in summary.

3. Do economists have to rethink?

3.1 Financial market regulation

Yet, the crisis has also called into question a number of economic policy paradigms. First and foremost, the financial and debt crisis has revealed design flaws in the financial and monetary systems.

The liberalisation of the financial markets is now viewed much more critically than before the crisis. Confidence in the efficiency of the markets has been severely shaken by the financial crisis and many financial market products have failed to demonstrate that they promote macroeconomic welfare. Now, financial market regulation is being tightened because the negative macroeconomic consequences of financial crises have moved into the spotlight again.

Lord Turner, the former Chairman of the British Financial Services Authority (FSA) came straight to the point in 2010 when talking about financial innovations and regulation, admitting self-critically “We were philosophically inclined to accept that if innovation created new markets and products that must be beneficial and that if regulation stymied innovation that must be bad. We are now more aware of the instability risks which might offset the benefits of such innovation.”

3.2 Role of the central banks

Since the financial crisis, there has also been more discussion about the role played by central banks. First, experience of the financial crisis has again raised the question of how monetary policymakers should deal with asset price bubbles.

The prevailing opinion before the crisis was that monetary policy is a blunt sword when dealing with exaggerations in the asset markets. To “prick a bubble”, interest rates would have to be increased so sharply that it would entail severe macroeconomic collateral damage.

As a further argument against pricking bubbles, it was claimed that central banks were unable to identify the emergence of such bubbles any better or earlier than other well-informed market players. Instead, the central banks should clear up the mess, so to speak, after the bubble had burst by means of massive interest rate cuts and injections of liquidity.

However, this approach, or as it is also known the Jackson Hole consensus, the Greenspan doctrine or simply the “mop-up strategy” was discredited by the crisis. Even though those in favour of bursting speculative bubbles are few and far between, a policy of actively leaning against the wind is now gaining more widespread support. This approach is often referred to as “more symmetrical monetary policy". However, this does not mean that monetary policy should assume responsibility for financial stability. Macroprudential policymakers have a more appropriate toolkit for safeguarding financial stability.

In this context, the Act on Monitoring Financial Stability (Gesetz zur Überwachung der Finanzstabilität) assigns the Bundesbank important tasks in the field of macroprudential oversight. The Bank is responsible, in particular, for analysing factors that are key to financial stability, identifying risks, making proposals to the Financial Stability Committee regarding the issuing of warnings and recommendations, and evaluating the implementation of such warnings and recommendations.

Nonetheless, in keeping with their mandate of safeguarding price stability, the monetary policymakers can also contribute towards the stability of the financial system by not encouraging financial market excesses. Monitoring the effect of credit aggregates on long-term price developments regularly and meticulously, as the Eurosystem does as part of its monetary analysis, brings forth valuable information.

It is a well-known fact that financial crises are typically preceded by excessive credit growth, or to quote Charles Kindleberger once again, “Most increases in the supply of credit do not lead to a mania – but nearly every mania has been associated with rapid growth in the supply of credit to a particular group of borrowers.”

The extremely low interest rates we are currently seeing in many economies are associated with risks over the long term. The Chairman of the Federal Reserve, Ben Bernanke, highlighted this not long ago. Thus, all central banks are faced with the challenge of timing the tightening of the extremely loose monetary policy currently in place, should any risks to price stability emerge.

Against the backdrop of low price pressures and weak economic growth in the euro area, the ECB Governing Council loosened its monetary policy stance once again in May, cutting the key interest rate to a new record low.

It is not only in the euro area that monetary policy has buttressed the economy and financial system so greatly and on such an unprecedented scale since the outbreak of the crisis. As well as cutting interest rates to a record low, the Eurosystem has also adopted some unconventional measures, the most significant being a virtually unrestricted allotment of central bank liquidity, extending the maturities on central bank refinancing operations to three years, broadening the Eurosystem’s collateral framework and introducing outright transactions, which include sovereign bond purchases.

In the course of the crisis, central banks were entrusted with ever more responsibility – both officially and unofficially. ESCB central banks play a central role in macroprudential supervision, ie as part of the European Systemic Risk Board, and the Bundesbank forms an integral part of the German Financial Stability Committee (Ausschuss für Finanzstabilität). The European single supervisory mechanism is to be placed under the aegis of the European Central Bank (ECB).

Furthermore, in the wake of the crisis, policymakers, the markets and the media have talked up the Eurosystem as the only body capable of taking action.

However, this entails the risk of overloading central banks with too many tasks and too much responsibility.

The crisis management measures taken by central banks have set a debate in motion, both in the euro area and in other economic areas. It is a debate which is anything but pleasant, and, above all, one that seemed to be long since over. Following the inflation shocks in the 1970s, the 1980s saw a consensus gradually emerging that central banks should be primarily responsible for safeguarding price stability and need to be as independent as possible to perform this task.

Independent central banks such as the Bundesbank or the Swiss National Bank proved to be more successful in combating inflation than other central banks which were under political direction. As a result, central banks around the world were granted independence so that they could credibly carry out the task of fighting inflation.

However, of late, central banks’ independence and their price stability orientation have been called into question again. Indeed, central banks are not completely innocent with regard to this issue. They, too, have greatly stretched the boundaries of their mandate at times in the crisis.

Otmar Issing fittingly commented on this problem recently, saying, “It is clear that the more tasks central banks take on which go beyond the policy framework established to safeguard price stability, the more they come into the firing line of political disputes. Central banks also endanger their independence when they promise more than what they are actually capable of delivering with the monetary policy instruments available to them”.

3.3 European monetary union

The roots of the current crisis in the euro area notably include excessive lending fostered by insufficient financial market regulation, inadequate compliance with fiscal rules, inefficient use of capital inflows and a cumulative loss of competitiveness in several euro-area countries.

Much like an earthquake exposes design flaws in a building's construction, the financial crisis has clearly brought to light the dangerous cracks lurking in the structural framework of the monetary union.

The cornerstones of the Maastricht framework include the concept of an independent central bank with the primary objective of safeguarding price stability, and national sovereignty in fiscal policy matters. The framework assigns liability for and control over national finances to national governments.

The framework sets out fundamental principles to ensure compliance with this agreement. Member states commit themselves to maintaining sound public finances; they are strictly prohibited from providing each other with financial assistance (no-bail-out rule), although some exceptions were allowed; and central banks are not permitted to finance governments. However, the crisis management measures have seriously called into question the binding force of these rules.

When monetary policy is called upon to carry out fiscal tasks, it will sooner or later lose its ability to maintain stable prices. Furthermore, we should only go down the avenue of comprehensively mutualising liability if the shift in liability to the European level is accompanied by the transfer of control. However, there are no signs that member states are willing to hand over veritable control and intervention rights to Brussels.

It is impossible to say with absolute certainty whether a monetary union is crisis-proof. Economists had identified design flaws and pointed them out beforehand. In many respects, however, policymakers at the time ignored the advice given by economists.

In his book "Making the European Monetary Union" the economic historian Harold James also made use of an engineering analogy. He stressed that "the monetary union without a well-established base in fiscal regime and without a stable financial system had a very high centre of gravity that made for vulnerability and instability".

Before the Maastricht framework was established, the Bundesbank, too, pointed out that monetary integration would not be sustainable in the long term without bringing about political integration. In its statement of 19 September 1990 on the establishment of economic and monetary union, the Bundesbank made its position clear by saying that a "monetary union is an irrevocable community of solidarity which, on the basis of experience, needs a more far-reaching commitment in the form of a comprehensive political union for it to be permanent". However, instead of political union, the above-mentioned Maastricht framework was established, which since has proven to be vulnerable.

As long as political union does not enjoy the backing of the European general public and their governments, however, then strengthening the Maastricht framework by introducing something like "Maastricht 2.0" is the right approach to return stability to monetary union.

So what does "Maastricht 2.0" mean for me?

- It means strengthening the principle of national responsibility by reinforcing the regulatory framework and, in doing so, realigning liability and control.
- It means keeping the crisis mechanism as a last resort for staving off threats to financial stability in the euro area. Nonetheless, sovereign default and bank insolvencies must be possible in future without posing too large a risk to financial stability; this includes, I believe, bringing an end to the regulatory privileges enjoyed by sovereign debt.

- It also means establishing a banking union, encompassing both a single supervisory mechanism for systemically important financial institutions and a clear-cut resolution and restructuring regime.

The necessity to recognise and acknowledge a banking union is without a doubt one of the greatest lessons learned from the euro-area crisis. Therefore, the establishment of a European banking union, which is already beginning to take form, is a key component in a stable monetary union. Combined with efficient regulation, it would lessen the burden placed on the single monetary policy and reduce the interdependencies between banks and sovereigns which have escalated the effects of the crisis.

4. Conclusion

I would like to conclude with a few remarks.

The crisis which we have experienced in various forms since 2007 poses a huge challenge to economists. It has cast doubt on so many issues which were beyond debate before the crisis. It has also raised many new questions.

Economists need to face up to these questions and critically assess their own roles and responsibilities. And they need to adopt a new mindset in many fields.

- We need an intelligent financial market regulation.
- We need to keep a closer eye on the stability of the financial system and
- We need a crisis-proof framework for monetary union.

Yet, at the same time, there are areas where a paradigm shift would not be appropriate. Independent monetary policy that is geared to safeguarding price stability and is clearly segregated from fiscal policy, has not been rendered obsolete by the crisis – quite the opposite, in fact, it is more important than ever before.

So there is no need for economists to call everything into question as it were. Even Philip Stephens, FT associate editor, who I already cited above, offers some comfort in his Financial Times opinion piece when he remarks, “Economists are not always wrong”.

Thank you for your attention.