Jens Weidmann: An impossible trinity? The interplay of monetary, financial and fiscal stability

Welcome remarks by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Bundesbank Spring Conference “Monetary, financial and fiscal stability”, Eltville, 10 June 2016.

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1. Introduction

Ladies and gentlemen

I would like to welcome all of you to the Bundesbank Spring Conference. It is a great pleasure to have you here.

An old joke about economics is that it’s “the only field in which two people can win a Nobel Prize for saying exactly the opposite thing”. But sometimes, it is also a field in which people say exactly the same thing – and even Nobel-prize-worthy things – without having ever talked to one another beforehand.

That was the case with Robert Mundell and Marcus Fleming – at least if anecdote is to be believed. They conducted research on the same topic – stabilisation policies for open economies; they worked at the same institution – the IMF; and they came to basically the same conclusions. But they did not join forces to produce the insights that form the basis of our understanding of open-economy macroeconomics to this day.

One of the insights offered by what is known as the Mundell-Fleming model is that you cannot have it all – a fixed exchange rate, free movement of capital and an independent monetary policy – at the same time. This insight came to be known as the impossible trinity. Our conference today will not be dealing with the ramifications of this trinity, although it remains the subject of academic debate, as the research work by Hélène Rey, for example, shows.

Instead, it’s another trinity, the trinity of monetary, financial and fiscal stability, that is the focus of today’s conference. And while this trinity should not be an impossible one, the recent financial and sovereign debt crises suggest that it might be a more improbable one than everyone perhaps thought ten years ago.

Even if Robert Mundell and Marcus Fleming are counter-examples, I think that economic research benefits from an exchange of views. More often than not, it’s discussion with others that produces a new idea or uncovers a flaw in reasoning, whereas a breakthrough is seldom achieved working alone.

What is true of economic research in general seems to be particularly true of research on the interplay of monetary, financial and fiscal policies, which is currently on the research agenda of so many different institutions. As a case in point, the Deutsche Bundesbank initiated the Trinity research network along with the Sveriges Riksbank, the Bank of Canada and the Federal Reserve Bank of New York under the auspices of Markus Brunnermeier (of Princeton University) and Eric Leeper (of Indiana University).

The aim of the network is to foster high-quality research on this topic and to boost interactions among the organising institutions as well as external researchers. Consequently, this year’s Spring Conference is dedicated to the Trinity research network, and I am absolutely confident that it will make an important contribution towards achieving the aim of the network.

2. Monetary and financial policy

Ladies and gentlemen

In the years before the financial crisis, we had almost forgotten that generations of economists had grappled with one central question: how to achieve macroeconomic stability.

For many people, the success of the so-called "Great Moderation" provided the answer to this question. Inflation had apparently been conquered, and large swings in economic output seemed a thing of the past as well. By keeping prices stable, central banks also appeared to be able to moderate the business cycle, thereby providing for overall macroeconomic stability.

In hindsight, it looks as if, for a while, confidence had turned into complacency. But the financial crisis has reconnected everybody with the reality that the success of monetary policy depends on conditions it cannot create on its own. In particular, it is dependent on a stable financial system. And as the sovereign debt crisis has reminded us, sound fiscal policies remain as important as ever for monetary policy to be able to deliver price stability.

In recent years, however, academic progress has been made on all counts: with regard to the effects of unconventional monetary policy instruments, the principles of a stable financial system and of sound fiscal policies. And one additional insight is that, while the instruments for these three policy areas are different, the areas are nonetheless interdependent.

True to the adage that central bankers are concerned more with what they cannot control than what they can, in my remarks I will touch upon a few selected issues regarding monetary, financial and fiscal policy. These are: the interdependency between the monetary transmission process and financial market conditions, the minimum standards for bail-inable capital, the distortions stemming from the privileged regulatory treatment of sovereign debt, and the possible use of GDP-linked bonds as a tool through which private investors would bear fiscal risks.

The financial crisis has shown in no uncertain terms that the transmission of monetary policy depends heavily on financial market conditions. When the financial markets were disrupted in autumn 2008 after the collapse of Lehman Brothers, the traditional interest rate pass-through of our conventional monetary policy measures was obviously hampered.

But even today, the effectiveness of our monetary policy depends on financial market conditions. This can be illustrated, for example, by the role asset managers play in how non-standard monetary policy measures impact on longer-term interest rates.

Recent research by Morris and Shin[1] suggests that, in trying to avoid ranking last in short-term performance tables, asset managers' portfolio choices could lead to large jumps in risk premiums in anticipation of small future changes in central bank policy rates. Due to their own payment arrangements, asset managers cannot usually afford to be the last to notice a switch in monetary policy, because the financial loss in the funds under management increases if many others try to sell their securities before them.

Consequently, they might become increasingly nervous the longer monetary policymakers try to maintain the low-interest-rate policy. This, in turn, could raise the probability of a sudden hike in risk premiums, the longer forward guidance is in place and the more aggressively quantitative easing is pursued. Monetary policymakers have to take this into account in order to avoid unintended consequences.

[1] See Stephen Morris and Hyun Song Shin (2015), Risk Premium Shifts and Monetary Policy: A Coordination Approach, Princeton University – William S Dietrich II Economic Theory Center Research Paper No 075_2016, 2015.

But it is not only the behaviour of asset managers that is relevant to monetary policy. The crisis has reminded us that financial exuberance, too, is potentially a harbinger of unstable consumer prices. But this does not mean that monetary policy is the way to go in terms of pre-empting financial instability as well.

Tinbergen's timeless insight continues to apply: to reach each policy goal reliably, at least one separate instrument is needed for each policy area. The crisis has therefore spawned a whole new set of instruments – macroprudential policies – designed to target specific sectors of the financial system. Rather than focusing on individual financial institutions, macroprudential policies that seek to prevent exuberance in entire financial sectors can take systemic interdependencies into account.

What is a treasure trove for researchers – the host of questions surrounding the functioning of the new set of instruments – is tricky terrain for policymakers, and for central bankers in particular. Shedding light on the use and effectiveness of different macroprudential instruments therefore remains an eminent task of economic research, and I am positive this conference will provide a valuable contribution.

Does this mean that monetary policymakers can ignore the financial stability implications of their actions? I don't think so. While I am not in favour of a dual monetary policy mandate, I am convinced that monetary policy cannot stand on the sidelines when financial imbalances build up.

First, we cannot be sure that macroprudential policies will eliminate financial imbalances. The experience with macroprudential instruments is still limited, and the toolkit is still incomplete.

Second, the crisis has vividly demonstrated how financial instability affects inflation developments and the capacity of the central bank to safeguard price stability. Therefore, monetary policy would be wise to take the implications of financial imbalances for price stability into account.

As a first line of defence, however, it is financial regulation that has to bear the brunt of the financial stability burden. With regard to traditional microprudential regulation, the direction for reform seems clear: realigning risk and reward in a way that sets incentives for sustainable action. Privatising gains and socialising losses is not only socially corrosive: it also produces bad economic results, as financial actors are encouraged to take on excessive risks.

A cornerstone of the international efforts to ensure the resolvability of systemic banks is the standard for bail-in debt, the so called Total Loss Absorbing Capacity (TLAC). It requires those banks to hold a minimum of debt that can absorb losses in the case of a bank resolution. This shields the taxpayer from footing the bill.

Europe already has a bail-in standard of its own, the so called minimum requirements on eligible liabilities (MREL). For efficiency and financial stability purposes, one could argue that TLAC and MREL should be as similar as justifiable.

Systemically relevant banks pose a special challenge when it comes to resolving them without creating substantial repercussions for the wider financial system. For that reason, the Single Resolution Fund exists. When resolving a systemic bank, the Single Resolution Board, which is the relevant European authority, can draw on the resources of this fund – but only after at least 8 % of the banks' liabilities have been bailed in. It seems therefore sensible that MREL for systemically important banks is guided by this threshold.

When it comes to bailing in creditors, the fear of contagion is probably the most important reason for refraining from doing so. Naturally, contagion risk is high when the creditors who are to be bailed in are banks themselves. Currently, the MREL standards do not discourage banks from holding another institution's bail-in debt. In the interests of financial stability, this has to change.

3. Fiscal and financial policy

The importance of realigning risk and return has come to the fore with regard to yet another issue: the research of Todd Walker and of Sascha Steffen and Joseph Korte[2] – both works will be presented at this conference – are examples of a growing body of scientific evidence that the zero-risk weighting of sovereign debt distorts capital allocation and therefore acts as a drag on growth. The absence of exposure limits also encourages loading up on sovereign debt, potentially creating cluster risks that can pose a threat to financial stability as well.

The research is there; what is needed now are political results. The regulation of sovereign exposures is under discussion at both the European and the Basel level. And while progress at both levels is desirable, it is particularly urgent in the euro area.

In contrast to other jurisdictions, the Eurosystem is forbidden to act as a lender of last resort for governments. Such a function would be tantamount to mutualising sovereign risk, which would be incompatible with the decentralised Maastricht framework. The risk profile of euro-area sovereign debt is therefore different.

Doing away with sovereign debt as a cluster risk would also pave the way for the orderly restructuring of sovereign debt. If necessary, an orderly restructuring would be possible without endangering the stability of the overall financial system – and this would be good not only for euro-area countries but for other countries, too. In this case, financial risks would be borne by those who took them: the private investors. But an orderly restructuring of sovereign debt is not the only way in which financial market participants can be involved in bearing fiscal risks in a structured way.

A recent initiative by the Bank of England is pushing for the introduction of standardised GDP-linked bonds. By tying coupon payments, and potentially the principal as well, to a country's growth rate, investors share both the upside and the downside risk of a country's economic development. That way, a country can potentially retain fiscal space even when faced with adverse economic events. GDP-linked bonds exhibit equity-like features, which of course gives rise to questions as well.

How would a financial system cope with the fact that sovereign debt would cease to exist as a "safe asset"? How many investors would be interested in GDP-linked bonds and, leading on from there, how would a GDP-linked bond be priced? These are the questions that need to be answered before GDP-linked bonds can ever become a widespread vehicle for transferring fiscal risks – upside as well as downside ones – to private investors. But it is an avenue worth exploring.

Limiting fiscal risks, however, should be the first line of defence. An effective mechanism to achieve this aim would be to pursue a sound fiscal policy. This would also help to plug a constant source of uncertainty, at least in the euro area. As Eickmeier, Metiu and Prieto[3] show, this might help to increase the effectiveness of monetary policy as well. When uncertainty is reduced, actors behave in a less risk-averse manner, which heightens responsiveness to monetary policy impulses.

The benefits of pursuing sound policies in a particular area are therefore not confined to that area, but extend to other policy areas as well. Triggering a virtuous cycle of sound monetary, fiscal and financial policies therefore seems like the surest and fastest way to resolve the conundrum the euro area faces right now.

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2 Korte, J, and S Steffen (2014), "Zero Risk Contagion – Banks' Sovereign Exposure and Sovereign Risk Spillovers", Working Paper.

3 Sandra Eickmeier, Norbert Metiu and Esteban Prieto (2016), "Time-varying volatility, financial intermediation and monetary policy", IWH Discussion Papers No. 19/2016.

The euro area still has a long way to go, especially with regard to fiscal policy. Unfortunately, the spill-over from monetary policy – savings through lower interest expenses – has not been used as much as it could to press ahead with improving public budgets.

4. Conclusion

Ladies and gentlemen

Macroeconomic stability is multidimensional, and this is essentially what this year's Spring Conference seeks to capture. While sound policies have to be pursued in each area to safeguard overall economic stability, the benefits of pursuing a sound policy spill over to other areas as well.

A virtuous circle of sound monetary, financial and fiscal policies is without doubt an enticing prospect, not only for the euro area, and I am confident this conference can enrich our understanding of how to make it happen.

I wish us all an exciting conference.