Axel A Weber: Reflections on the financial crisis

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1 Introduction

Ladies and gentlemen

It is an exceptional honour for me to be invited to give this year's Mais Lecture here at City University. And it is a very welcome opportunity for me to present my reflections on the financial crisis.

The events that have been shaking financial markets since the summer of 2007 and which escalated markedly in September 2008 are occupying the attention of governments and central banks worldwide on an unprecedented scale.

While it is certainly true that attempts to contain the financial crisis and thereby prevent financial market tensions from creating a vicious circle for the real economy is a challenge for monetary policymakers in nearly all areas, I would argue that, for monetary policy in the euro area, the challenges may be even larger than for other industrial economies.

When we recently celebrated the tenth anniversary of the launch of the single currency, it was often stated that the first ten years of the euro have been a notable success with regard to price stability, trade and financial integration in Europe. However, it was also said that the years ahead are likely to pose an even greater challenge.

2 Challenges for monetary policy

And indeed, as I have argued before, the challenges we are currently facing are, in many respects, more demanding than anything else in the euro area's first ten years.

To that end, it is my firm belief that the value of monetary union has never been greater than during this financial crisis. Try to imagine what would have happened without the single currency. Probably, foreign exchange markets may have been subject to speculative attacks. Currency fluctuations may have aggravated both the financial crisis and real economic tensions – and do not forget the political turbulence implied by such currency tensions.

The financial crisis confronts policymakers with a situation of uncertainty in a very profound sense. Such Knightian uncertainty means that past experience is not of great value when deciding on appropriate policy measures. In such an environment, policy has to strike a difficult balance between short-term and long-term needs. More specifically, in the case of monetary policy, there is, on the one side, a need for resolute action to counter the consequences of the crisis. On the other side, such actions should not undermine the long-term foundations of monetary policy, such as the central bank's credibility. Striking that balance is not only key to monetary policy, but also to other policy areas, such as fiscal policy and policies that aim to stabilise the financial system. And the appropriate balance is not independent of the institutional background against which these policies operate.

This is all the more true of EMU, where the institutional setting is still comparatively young, the political balance between monetary policy and fiscal policy is more complex than in other mature economies, because it is characterised by the coexistence of a supranational monetary and autonomous national fiscal policies.

These considerations have to be kept in mind when talking about appropriate policy responses. The responses may differ among central banks even in the face of common economic shocks because of the differing institutional frameworks within which monetary and fiscal policy operate.

Thus, I would like to go on to elaborate somewhat on the challenges for monetary policy, on the approach we have taken in the Eurosystem, and on lessons to be learnt for monetary policy in the longer term.

2.1 A brief account of the financial crisis

When looking at the underlying causes of the recent tensions in the global financial system, numerous culprits have been identified: securitisation, quality of risk management, credit rating agencies, compensation schemes, accounting standards and even expansionary monetary policy – to name but a few.

I am extremely sceptical about any monocausal explanation. Instead, I believe that a cocktail of various ingredients generated the shock waves that have rocked the global financial system.

A key factor was a combination of new and complex instruments for transferring credit risks, and the "originate and distribute" business model of credit institutions.

It has now become clear that the "originate and distribute" model can actually improve the resilience of the financial system if, and only if, a high-quality standard is maintained at all levels of the transfer process, and no new concentrations of risk arise. Since the outbreak of the financial crisis, however, we have learned about a series of distorted incentives, which manifested themselves in lax origination standards for products such as subprime mortgages and in some investors' excessive reliance on credit ratings. In the end, securitisation, as Claudio Borio from the BIS aptly put it in 2008, has, ultimately, "distributed fear rather than risks".

However, while financial innovation has undoubtedly magnified vulnerabilities in the global financial system, there is more to the present financial market turmoil than the proliferation of structured finance products. Arguably, the "originate and distribute" model would not have been possible without the benign macroeconomic and financial setting in the years preceding the current crisis: Booming global economic growth, low consumer price inflation, low-level long-term and short-term interest rates, and rising prices of real estate and other assets in many countries – not just in the USA.

The possibility of a mis-pricing of risks and the attendant dangers were perceived by some commentators even before the crisis began. Indeed, central banks, in particular, pointed to such a development. Once the vulnerabilities in the global financial system were revealed in August 2007 and intensified in autumn last year, we all witnessed financial imbalances starting to unwind. Especially after the collapse of Lehman Brothers in September 2008, the process of unwinding of financial imbalances escalated. Frictions spilled over from the core segment of structured products to other asset classes, spreads on credit and bond markets rose dramatically and interbank markets froze.

2.2 Banking stabilisation measures

As solvency risks in the banking system mounted, on both sides of the Atlantic governments in close cooperation with central banks set up rescue schemes that moved away from a case-by-case approach in dealing with troubled banks to broad-based schemes.

The rescue schemes focused primarily on improving the banks' capital position when the ability to raise private capital became virtually non-existent. Moreover, stabilising banks' access to medium-term funding through public guarantee schemes served as an additional tool.

This sketchy characterisation also holds true for Germany. Measures taken in Germany so far by the Financial Market Stabilisation Fund (SoFFin) have focused on the liability side of banks' balance sheets, because it has been recognised that the financial market problems and, not least, the recessionary economic environment ultimately have a dramatic impact on the banks' capital position.

The capital-injection and guarantee programmes have contributed to a stabilisation, but have not been able to entirely eliminate uncertainty about banks' soundness. Hence, the ongoing risk of balance sheet strains as a result of continuing write-downs on problematic assets led to a drying-up of private equity capital issuance and aggravated the issuance of debt (without a government guarantee).

This, together with the fear that these problems could lead to a significantly reduced bank loan supply is likely to be the main reason why governments have recently augmented their previous approaches with plans to provide relief to the asset side of banks' balance sheets. In that regard, in Germany the establishment of a scheme to deal with problem assets is currently in the legislative making.

I do not want to elaborate in detail on the various proposals that have already been adopted or scheduled to be implemented on both sides of the Atlantic. Instead, I would rather discuss some basic requirements which – as I see it – should be fulfilled by such asset-side measures:

- Banks must be restructured in a way which makes them attractive for new capital. More specifically, new equity as well as new debt capital should not be burdened by risks from the time prior to the stabilisation measure.
- Government intervention should stabilise banks, not subsidise the former owners. Measures should provide guarantees for the continuity of the financial system in the form of insolvency protection for systemically relevant institutions. At the same time, investors who provided risk capital prior to the stabilisation measure are fully liable for any extant risks up to the amount of their capital. This is important not just from a fiscal standpoint, but also for creating an adequate incentive structure for the future.
- Given the uncertainty it currently entails, intervention through the stabilisation of asset positions should, as far as possible, avoid the need to value the assets. Or, to be more specific, approaches in which asset valuation plays a major role in the distribution of risks and losses should be complemented by elements which ensure that existing shareholders – not the banks – fully bear the consequences from possible re-valuations of these assets at a later stage.

2.3 Monetary policy measures taken

I would now like to return to the monetary policy responses of the Eurosystem.

Since the financial market turmoil began in August 2007, the Eurosystem has stabilised the European money market by generously providing liquidity above and beyond the benchmark allotment. This has enabled banks to fulfil their minimum reserve requirements early in the reserve period (frontloading). In the early stages, these measures were accompanied by the use of liquidity-absorbing fine-tuning operations at the end of the maintenance period. At the same time, the Governing Council also tried to stabilise the longer-term maturity segments of the money market by introducing refinancing operations with a maturity of up to six months owing to the continued weakness of interbank trading activities in these segments.

From mid-September 2008, however, as the crisis intensified, the yield spread between secured and unsecured quarterly liquidity in the interbank market peaked at more than 1.8 percentage points. Owing to the renewed sharp increase in banks' mistrust, the overnight money market also suffered heavily. Further adjustments to liquidity policy were unavoidable under such circumstances. The transition to fixed-rate tenders with full allotment of all bids decided upon in October 2008, together with a widening of the collateral framework in our refinancing operations, ensured that all banks received the liquidity they needed at the interest rate deemed appropriate from a monetary policy perspective.

The escalation of the financial market turmoil from mid-September onwards and the global shock to confidence led to a considerable change in the outlook for the real economy and price stability changed. Against this background, the Governing Council of the ECB has lowered its main policy rate decisively since October 2008 from 4.25% to 1%.

Moreover, given that very short-term rates are now at an appropriate level, the Governing Council decided at its meeting last week to implement further measures in order to fulfil its primary goal – that is, safeguarding medium-term price stability. These measures include the introduction of tender operations with a maturity of 12 months and outright purchases of covered bonds up to a maximum amount of €60 billion. The Governing Council will provide detailed information on the covered bond programme after its next meeting.

Such "non-standard" monetary policy measures extend the traditional monetary policy toolbox of the Eurosystem. They reflect the bank-based nature of the financial system in the euro area – which implies that monetary policy impulses are predominantly transmitted through the banking system – by aiming to improve funding conditions for banks.

All in all, the monetary policy actions and the rescue schemes for banks in stress have helped to stabilise the financial system at a time when systemic stability was at risk. Thus, they have put a floor under the tail risk of a self-enforcing uncontrolled downward-spiral from feedback effects between the financial and the real spheres.

However, monetary policy has created an enormous expansionary stimulus – not just in the euro area but also worldwide. While this stimulus is currently warranted, we have to keep in mind that it has to be reduced or even inverted very quickly as soon as the overall situation improves. The need for such a quick retraction of the expansionary stance stems from at least two factors. The first is that part of the monetary stimulus will remain in the pipeline for some time due to the usual lags of monetary transmission. The second is that there is a possibility of the recovery taking place in a more dynamic way than currently expected (if the factors that caused the non-linearity in the downswing work favourably in the upswing as well). Both factors could lead to inflationary risks making a rapid and powerful comeback, and we should all be aware of this.

All policy responses, especially the monetary policy actions, cannot – and should not – prevent the necessary adjustment processes in the financial system. Above all, the excessive leverage in the financial system needs to be corrected. Short-term policy measures should do no more than try to manage this deleveraging-process in an orderly way, that is, it should prevent unnecessary collateral damage to the rest of the economy.

Moreover, monetary and fiscal policies are unable to provide shelter for the domestic economy against the global symmetric confidence shock that hit the global economy after the collapse of Lehman Brothers. They can only attempt to dampen some of the second-round effects on the domestic economy by trying to stabilise domestic demand.

Public finances in Germany indeed are contributing noticeably to macroeconomic stabilisation. The German government has implemented discretionary measures in a magnitude of over 2% of GDP for the years 2009 and 2010. Most of the effects of these measures have still come into effect. With regard to fiscal stabilisation it is also necessary to keep in mind that its effects should not only be evaluated by discretionary measures alone. Built-in adjustments in public budgets – so-called automatic stabilisers – provide stimulus through a rule-based fiscal framework. These automatic stabilisers are more important in countries with larger social security systems and progressive tax systems. For example, in Germany the contribution of automatic stabilisers in 2009 and 2010 will be nearly 3% of GDP (including developments in profit-related taxes).

Thus, for a thorough assessment of public finances in its stabilisation role the swing in the overall public deficits is the most adequate measure. According to the latest forecast by the European Commission – which is plausible in our view – the overall public deficit will deteriorate by 6% of GDP over 2009 and 2010. This is somewhat less than in the UK, but it makes clear that – contrary to some popular misperceptions – Germany's fiscal policy is markedly contributing to stabilising the economy.

There is not only a structural adjustment need in the international financial system. In addition to a marked cyclical shock, some real imbalances in the global division of labour are being corrected through the current global downturn. Stabilisation policies should not try to prevent these processes; returning to a status quo ante is not a sensible option.

Given the recent encouraging signs from financial markets and a number of leading economic indicators, I believe there are some grounds for being optimistic that the pace of decline in economic activity will decelerate markedly in the months ahead. However, it is certainly not advisable to be overly optimistic that the recovery process is safely on track. This will most likely be a gradual process with growth rates – notwithstanding some volatility in quarterly figures – lying below potential for a considerable period of time. This means that economic slack measured by very low rates of capacity utilisation will not diminish rapidly.

And we should take into account that, even if in many countries – including Germany – the worst may be over in terms of negative growth rates, the labour market situation will visibly deteriorate in the quarters ahead.

The German economy has been hit hard by the global downturn. Germany as an open and export-oriented economy has its comparative advantage in investment goods. And it has specialised by increasing its degree of openness markedly over the past decade. By doing so, the German economy has benefited from the dynamic global environment of the past few years. Currently, the sharp contraction in the German manufacturing sector makes clear that this kind of specialisation also means a more cyclical overall economy, at least in the face of rare massive common global shocks. An open economy like Germany's cannot insure itself against truly global shocks regardless of how diversified its export portfolio is in regional or product terms.

With regard to measures stabilising the global economy, one aspect that is too often overlooked is the fact that due to the sharp contraction in net exports since summer 2008 the German economy is de facto stabilising the global economy. A decline in net exports means that less income from global trade flows is absorbed by Germany. Then, by definition, in some other countries net exports must rise, de facto stabilising production in those economies.

2.4 Longer-term lessons for monetary policy

Let me turn finally to what are more longer-term lessons for monetary policy to be drawn from the current crisis. In doing so, I shall take a step back from the sort of crisis management I have just described to the more general issue of conducting monetary policy in the face of procyclical behaviour by financial market participants.

As I have already mentioned, in the first half of this decade, monetary policy was expansionary in most industrial countries. This is indicated by interest-rate based measures of the monetary policy stance as well as by indicators based on money and credit aggregates. At the same time, risk premiums on financial markets have been too low compared with traditional economic models based on macroeconomic factors.

There is an ongoing debate on whether low interest rates may have increased financial market participants' risk appetite and played a part the dynamic growth of credit aggregates worldwide via a so-called risk-taking channel of monetary policy. Given this debate, the events of the past few months pose some fundamental questions about the role of monetary policy in the financial cycle.

At this point, I think that some commentators take too narrow a perspective by concentrating solely on the role played by monetary policy during the crisis.

In my view, monetary policymakers should not view boom and bust episodes on the financial markets as unrelated events. Monetary policymakers' responses to upturns as well as to downturns on the asset markets influence the risk perception of the market participants. Therefore, an (expansionary) monetary policy response which is stronger in the downswing than the (restrictive) response in the upswing creates adverse incentives for investors which could increase the amplitudes of the financial cycle.

A more symmetric approach by monetary policymakers would treat boom and bust episodes not as isolated events but would try to look through the financial cycle in order to steady policy. To be more specific, a more symmetric policy would also consider implicit risks in times when money and credit growth is dynamic, asset prices go up and risk perceptions decline, possibly weighing the need to act despite low current consumer price inflation rates.

This, however, does not mean that monetary policy should downgrade the price stability objective for the sake of other objectives. Indeed, financial crises heighten the volatility of macroeconomic variables such as inflation and growth. Rather, it means that central banks should take a longer-term perspective which takes into account the future inflationary consequences of such unfavourable developments. Given the macroeconomic relevance of financial crises, we have good reason to enlarge our monetary policy time horizon and give low-frequency movements in credit and monetary aggregates more weight in our analytical frameworks and our monetary policy decision-making processes.

That is not to say that such an approach would eliminate financial cycles altogether. However, in the medium to long term, a monetary policy that followed a more symmetric course would do more to dampen damaging financial cycles than a monetary policy that merely tries to limit damage after the event using aggressive interest rate measures.

Here, the Eurosystem's monetary policy strategy already possesses such a stabilising element in the shape of its monetary analysis. This is especially suited to the analysis of long-term developments.

The recent financial turmoil has shown that the often-criticised monetary and credit analysis has a valuable role to play in monetary policy analysis.

3 Conclusion

The financial crisis means the greatest challenge for monetary policy in decades. Policy responses have to take into account the specific institutional environment under which it operates. Thus, policy responses might somewhat differ among countries even when the underlying shocks are similar.

The Eurosystem has responded in a decisive way to the emerging financial tensions. These measures have reflected the specific circumstances of the euro area – and will continue to do so.

In the euro area fiscal policy is also contributing to dampen the economic downswing. This is also true for Germany, where automatic stabilisers and discretionary measures cause a massive swing in deficit figures in this year and next year. The fiscal policy in Germany contributes visibly to the stabilisation of the macroeconomy. Automatic stabilisers play an important role in that regard.

In a longer-term perspective one lessons from the current crisis and its causes is that monetary policy should treat financial cycles in a more symmetric way. This means taking account of the financial cycle in the upswing as well as in the downturn. In an operational sense it means enhancing the time horizon for monetary policy and paying paying close attention to money and credit aggregates.