Nout Wellink: Towards a new framework for monetary policy? Lessons from the crisis

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the workshop "Towards a new framework for monetary policy? Lessons from the crisis", Amsterdam, 21 September 2009.

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Over the past two years, we have all been surprised by the fast pace at which events have unravelled. But ideas have also evolved rapidly. Only one year ago, at our monetary policy workshop we were discussing whether financial imbalances ought to be incorporated in monetary policy making. Since then, there has been an increasing consensus that monetary policy should lean against the wind. At today's workshop, we will not focus on whether but on how monetary policy can be used to lean against the wind.

In my remarks, I want to address three questions. First, what have we learned about the run-up to the crisis? Second, why did monetary authorities not lean against the emergence of massive financial imbalances, which turned out to have disruptive macro effects? And third, how can we use the answers to the first two questions to think about the next approach to monetary policy?

What have we learned about the causes of the crisis?

Let me start with what we have learned about the run-up to the crisis. Looking back at the years before this crisis – and more in general at all major crisis episodes in industrial countries – five main, interrelated ingredients of an accumulating imbalance stand out.

1. The first – and in my opinion root – ingredient of the crisis lies in the large US external imbalance and the high levels of US international debt. I consider these to be a reflection of a country having lived beyond its means and, in particular, an over-leveraged private sector.
2. Second, low interest rates relative to a natural rate of interest – especially in a context of a buoyant economy and low inflation – suggested that monetary policy had been too easy in the years before the crisis. Fiscal policy was probably also too easy.
3. Third, global imbalances and too low interest rates supported very strong credit growth and excessive risk taking.
4. Fourth, asset prices rose sharply, particularly in equity and housing markets.
5. Fifth, a high level of private debt resulted from a prolonged period of strong credit growth.

What we have learned is that it is necessary to recognize that the combination of these five elements can have catastrophic consequences and to act upon this recognition.

Why did monetary policy not lean against the wind?

In the past, I have stated that "many of the risks that crystallised in the past year were on our radar screen long before the crisis started".[1] At the same time, I argued that these risk

[1] Nout Wellink (2008) "It's the incentive, stupid!" Speech at the conference on "Integrating micro and macroeconomic perspectives on financial stability", University of Groningen, 26 May 2008.

assessments were not translated into an efficacious preventive action – at least not by monetary authorities. But why did we not lean against the wind? I believe that this happened for five main reasons.

1. First, there was an inability – by both academic researchers and analysts in the policymaking world – to pay sufficient attention to the role of stocks. In 2007, high levels of debt had resulted from a prolonged period of strong credit growth and excessive risk-taking. These made the economy vulnerable to negative shocks, such as the collapse of the US subprime mortgage market. The importance of the stock of debt in the lead-up to the crisis is a manifestation of a more general phenomenon, whereby in a context of disequilibrium – such as the accumulation of financial imbalances – stocks dominate flows as determinants of macroeconomic dynamics. This phenomenon cannot be captured in standard macroeconomic models based on linear relationships.

   In tranquil times, the relevance of stocks is modest, and flows as well as prices of flows matter. Under these circumstances, policy is about fine tuning – mostly through the anchoring of expectations. However, "ordinary" monetary policy that is based on flows (monetary flows) and prices (inflation) cannot deal with the implications of stocks that are typical of periods in which massive financial imbalances can accumulate. We now know that looking after stocks is necessary during good times as a means to prevent financial crises.

2. Second, macroeconomics and policymaking have focused on decision-making in conditions of measurable risk, rather than immeasurable risk or what is known as Knightian uncertainty. The concept of measurable risk may be appropriate during "normal" times. But when we face a build-up of massive financial imbalances, it is impossible to measure risks correctly because, like Keynes said, "we simply do not know" the future.

   The crisis has taught us that there are always events that – although possible – are not accounted for in policy analysis. In the years before the crisis, the historically low volatility observed in financial markets was seen as equivalent to no uncertainty. And successful monetary policy – in the sense of low and stable inflation – was seen as a guarantee of stability. In such a context, a global recessionary trend, such as the one we have experienced this year, was unthinkable.

   Accounting for such immeasurable risk would require a marked change to macroeconomics. It implies moving away from the principle of optimizing agents, to one of agents that would aim to insure against uncertain events. Rather than aiming at identifying the best solution to a given problem, the aim would be to do "well enough" – across a series of different problems irrespective of how likely they maybe. This would not be without costs: it would insure against the effects of undesirable events at the expense of a better performance in normal times.

3. Third, the existing monetary policy framework focuses on medium-term price stability – defined over a horizon of two years. In the run-up to the crisis, this meant that financial imbalances were left to be handled by micro prudential policy. But financial imbalances are procyclical, and also have strong macro-dynamics and implications for the macroeconomy. This calls for a macro prudential policy in addition to a micro prudential response – a theme that will be picked up by some of today's policy panellists – and, in addition, a role for monetary policy.

4. Fourth, it is important to acknowledge that policy makers are part of the environment in which they operate. We now know that the prevalent behaviour in the years before the crisis embodied an important element of irrationality. Like all members of society, policymakers are partial to the prevalent consensus, and share its key values and behavioural characteristics.

5. Finally, from a political economy point of view, it was hard for policymakers to sell an unconventional line of action in a situation where inflation was well-behaved and there was no firm proof that something was actually going severely wrong in the financial sector.

How can we draw lessons for monetary policy?

I believe that monetary policy requires two fundamental changes. First, we need a new culture that puts more emphasis on the role of stocks in creating potential macro-risks – in particular for monetary authorities, risks for price stability in the medium-run. The new culture would also focus on decision-making under uncertainty.

Second, central banks either need a shift in their monetary policy framework to deal explicitly with financial imbalances, or interpret their current framework in a way that gives them more freedom in pro-actively trying to avoid that financial imbalances burst, with major macroeconomic consequences.

One approach would be to keep a mandate of price stability – that is not introduce financial stability or asset prices as a second goal for monetary policy – but follow a two-track approach to monetary policy. The first track would be a sufficient guide of action when no imbalances accumulate. Under these conditions, the "traditional" monetary policy could be followed. The second track would focus on monitoring the build-up of stocks (for example the debt to GDP ratio) and associated potential macro-risks (in particular risks for price stability) in the medium-run.

This approach would require greater flexibility, since at times the policy rate could be changed even if inflation looks perfectly anchored. It would also require a horizon longer than two years, since the cycle of accumulation and unwinding of imbalances typically draws out further than two years. Greater flexibility and a longer horizon imply a more challenging role for communication. How should we communicate a tightening of monetary policy when inflation is low but there are some concerns that financial imbalances are accumulating, which have a very small chance of unwinding in a very disruptive way five years ahead? Another important ingredient of this approach is the close coordination, both with supervisory authorities and, once a crisis erupts, with fiscal authorities.

Do central banks need to abandon their current monetary framework to follow the approach I have outlined? I believe not. In practice, both the ECB's second pillar and the Bank of Japan's long-term perspective can lend themselves to – and in fact already capture elements of – this new approach. The same might be true for a flexible inflation targeting framework as it is currently followed by the Reserve Bank of Australia.

I hope that the academic scholars, policymakers and market participants that are joining us today for this workshop, will help us gain further insights into these important issues.