Jürgen Stark: Towards a stability-oriented policy framework

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the conference “Reconstructing the world economy – redesigning the macro-framework”, organised by the Korea Development Institute and International Monetary Fund, Seoul, 25 February 2010.

*   *   *

Ladies and Gentlemen,

In discussing the current macroeconomic framework, I will focus on the institutional aspects that have proved successful, in particular, from the European perspective. These are central bank independence, the centrality of price stability for monetary policy and the need to adopt a medium-term, rules-based perspective in the conduct of monetary and fiscal policies. The financial crisis has not contested or discredited these three principles.

However, it is certainly true that other aspects of the international consensus framework merit some deep re-thinking. I will take this opportunity to share my thoughts on four such elements, namely inflation targeting, central banking as risk management, monetary policy and asset prices, and fiscal policy.

The reference model

Inflation targeting, together with the canonised version of the New Keynesian model on which it is predicated, is perhaps the main building block of the pre-crisis consensus paradigm. Although they are closely connected, I wish to separate the policy prescriptions from the underlying model, and address each in turn.

The shortcomings of the New Keynesian modelling paradigm have been recognised before. But addressing them has not yielded a paradigm shift to overcome them.

The first shortcoming of this paradigm is its inability to explain and recognise the importance of financial frictions and the role of money. Money is at best ignored – and at worst derided – as a redundant and unnecessary complication. This has to do with the fragile theoretical foundations of the mechanisms which – in this paradigm – account for the connection between the real economy, financial imbalances, and the state of confidence and inflation.

This disregarding of money goes hand-in-hand with the assumption of the absence of risk. The mainstream model excludes default. If assets are formulated at all, they all net out. No risk generated in the financial sector can affect the real economy. The financial crisis has clearly exposed the flaws in this assumption. It has led to a misapprehension of the root causes of the crisis and its propagation mechanism.

Liquidity and money are key for the ECB’s monetary policy strategy. Far from showing that the ECB’s strategy lacks theoretical foundations, the crisis has borne out our broad-based approach and exposed the incompleteness of the transmission mechanism in the reference model.

The second shortcoming of this paradigm is its undue focus on small economic fluctuations around benign states of the economy. This left economists unprepared in terms of being able to predict the crisis and its impact.

Third, the paradigm rests on the built-in assumption that the announcement of an inflation target automatically yields credibility. The canonised version of the model does not allow for an understanding of how institutional strength and a track record affect credibility. Institutional strength requires central bank independence, for which, in turn, legal independence is a necessary, but by no means sufficient prerequisite.

Inflation targeting

The reference model has been at the heart of inflation targeting approaches. In brief, inflation targeting can be summed up as follows:

First, take inflation and output gap forecasts as summary statistics of the state of the economy.

Second, ignore a host of variables, particularly money and credit. Assume that these adjust to the state of the economy, but do not influence it independently.

Third, fine-tune the policy instrument so that inflation forecasts – whatever the nature of the shocks that might have caused them – are stabilised, and output volatility is minimised, at a pre-set horizon.

It has long been known that it is misleading to limit the information set to output gap and inflation forecasts. Output gaps are ill-defined and cannot be accurately measured.

Furthermore, inflation forecasts are not summary statistics of the state of the economy. Different underlying shocks – even though they might lead to the same inflation forecast – can have vastly different implications for policy.

Risk management

It has frequently been argued that central banks should act as risk managers by organising their framework around events with a high deflationary impact. To minimise the likelihood of deflation, central banks should err on the lax side and aim at significantly higher inflation rates. With this in mind, the IMF asks whether a permanent inflation target of 4% is appropriate. The proposal is nothing less than asking whether in the pursuit of price stability central banks put macroeconomic stability at risk.

I do see the temptation for governments to ask for higher inflation in order to monetise the dramatic build-up of public debt in nearly all advanced economies. This is why calling on central banks to raise inflation rates permanently is most unhelpful. It deflects from the most pressing problem that, currently, macroeconomic stability is threatened by the unsustainable position of public finances in nearly all advanced economies. I can only reject the idea of raising inflation rates permanently. I would not like to imagine the consequences if, on top of the current financial fragilities and in an environment of high public debt, the general public were to lose trust in the purchasing power of money.

There is no evidence whatsoever to support that deviating from price stability and aiming at an inflation rate of 4% would enhance economic prosperity or growth. On the contrary, no one would seriously deny that inflation has a detrimental impact.

The inflation tax does not constitute just another tax distortion. It greatly exacerbates distortions from existing taxes, contributing to a misallocation of resources and a rise in the tax burden, especially for lower-income households, and ultimately depresses economic growth.

It is an irrefutable empirical fact that inflation variability rises with the level of inflation, which in turn increases uncertainty for investors and long-term interest rates through a rise in the inflation risk premium.

A permanent increase in inflation curtails, rather than stimulates, long-term growth. A considerable body of empirical research finds that the Phillips curve has a negative bent in the long run: inflation and inflation volatility penalise capital formation and thus detract from the economy's growth potential.

Empirical evidence confirms this negative relationship, with a 100 basis point permanent increase in inflation being associated with a 10–30 basis point decrease in trend output growth. Hence, if this is applied to the euro area, a 4% inflation target would shave no less than half a percentage point per year off trend growth!

As for using monetary policy to manage macroeconomic risk, it should be recognised that this would introduce harmful asymmetries. It avoids policy restriction when positive supply-side shocks reduce inflation, fuelling asset price booms; and when the asset price boom finally turns into a bust, it leads central banks to overreact to negative demand-side shocks. So, financial instability meets two formidable multipliers, the first being a pro-cyclical monetary response to expansionary disinflations in good times and the second being moral hazard in financial markets, namely the expectation that the central bank will aggressively protect the markets from “tail events” in bad times. These expectations encourage markets to tend towards risky strategies, over-exposures and exuberance.

Monetary policy and asset prices

It is worth mentioning the role of asset prices in the conduct of monetary policy. A long series of booms and busts over the past four decades have demonstrated that asset price developments can pose serious threats to macroeconomic and price stability, and that, therefore, central banks cannot simply neglect them. In this respect, it appears that a comprehensive monetary policy strategy, which also gives prominence to money and credit developments, might be better able to “lean against the wind” of financial exuberance. Central banks should be equipped with a broad-based analytical framework for monitoring and analysing in detail such developments. At the ECB, this approach is underpinned by the monetary analysis, the second pillar of our monetary policy strategy.

Fiscal policy

For many commentators, the financial crisis has underlined the need for a return of the State in managing macroeconomic developments. Of course, together with central bank liquidity support, discretionary government intervention has been key in forestalling a repeat of a 1930s-style depression. However, we are observing a drift in public liabilities that will prove hard to correct with the usual stabilisers. In some countries, this drift actually has nothing to do with the financial crisis. It is rooted in the policy hyper-activism that was already in place before the crisis. And this despite the obvious dangers of an overreactive fiscal stance, which cannot be decided and implemented without long lags.

Here, fiscal rules, such as the Stability and Growth Pact in the European Union can help. If given enough authority, rules can induce symmetric behaviour.

It remains to be seen how the discretionary fiscal measures adopted in response to the crisis can be wound down and reversed to support fiscal sustainability in the longer run. Since the ECB has started to gradually phase out its extraordinary liquidity support measures, fiscal authorities should also start to withdraw stimulus to safeguard public solvency over the medium term. To support this, we have the right mechanisms in place in Europe. Governments will have to comply with and, as experience shows, even re-enforce the fiscal rules enshrined in the Stability and Growth Pact.

Concluding remarks: some lessons

From this quick overview, I draw two lessons for monetary policy.

The first lesson to be learned is that central banks need to broaden – not restrict – their overview of the economy. Monetary data are critical in warning against risks that are slow to appear in inflation forecasts. Monetary analysis at the ECB consistently sent early signals that risk was broadly under-priced, when inflation was quiescent and measures of slack were moderate.

The second lesson is that price stability is the only anchor which can pin down the economy in turbulent times. It is not sufficient to guarantee financial stability, but it is certainly necessary to prevent financial instability.

Increasing the level of inflation that central banks should aim at would be a step in the wrong direction. Our price stability mandate has not constrained us from responding forcefully and successfully to the biggest disinflationary shock experienced in generations. With inflation rates in the euro area currently projected to be slightly above 1% in the short to medium term, deflation risks continue to be absent, and price stability has been maintained. Most importantly, of course, price stability has not compromised macroeconomic stability.

Thank you.