Axel A Weber: Challenges for monetary policy in EMU

Text of the Homer Jones Memorial Lecture by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Federal Reserve Bank of St Louis, St Louis, 13 April 2011.

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1. Introduction

President Bullard
Ladies and gentlemen

First of all, let me thank you for the opportunity to speak here today. It is a real pleasure and a great honour for me to give this year's Homer Jones Memorial Lecture, all the more so as this lecture series is named for such a prominent monetary economist. In his capacity as research director and senior vice-president of the St. Louis Fed, Homer Jones played a significant role in shaping this institution's monetarist reputation.

Four years ago, I was invited to give a speech in Paris. Its title − "From academic to policymaker" − referred to the fact that I started out as an academic.[1] I began that speech by mentioning a number of other academics who went on to become central bankers: Mervyn King, Ben Bernanke, Janet Yellen, Bill Poole and Otmar Issing, to name but a few.

I continued by analysing why there are so many academics in monetary policy. James Bullard, by the way, is another case in point, whom I did not mention at the time because he was not yet in his current position. One of the main reasons why, over the past years, academic researchers have been taking up leading positions at central banks is that monetary policy itself has been heavily influenced by the findings of academic research. During the financial crisis, monetary policy and economies across the world have benefited significantly from these insights, since they have helped us to swiftly apply the appropriate policy responses to contain the crisis. Conversely, the crisis has also raised important issues for academic research, in monetary economics as well as in other fields.

As of next month, after seven years as a policymaker, I shall be taking up the position of a faculty member of the University of Chicago Booth School. In spite of this upcoming transition "from policymaker to academic", my remarks today on the challenges for monetary policy in EMU will be given from the policymaker's perspective.

2. The financial crisis and its lessons for monetary policy

The crisis has brought the "monetary policy consensus" formed in the years prior to the crisis under scrutiny.[2] The framework of monetary policy differed significantly from one central bank to another. Nevertheless, across the board their primary objective was price stability – defined as a stabilisation of the inflation rate at around 2% across a horizon of approximately two years. Steering short-term interest rates was considered a sufficient means of achieving this target. Central bank forecasts played a key role in monetary policy decision-making, with monetary aggregates increasingly taking a back seat in many forecast models.

Furthermore, capital markets were mostly assumed to be efficient, meaning that financial imperfections and their potential macroeconomic effects were not taken into account.

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[1] See A A Weber (2007), From Academic to Policy Maker, CEPR-CEPREMAP Lectures on Policy Making, Paris, 29 May 2007.

[2] See C Bean, M Paustian, A Penalver and T Taylor (2010), Monetary Policy after the Fall, Jackson Hole 2010 Symposium Proceedings, Federal Reserve Bank of Kansas City.

Temporary inefficiencies, such as asset price bubbles, were considered possible, but the majority view was that monetary policy could do little to counteract such developments. Microprudential supervision was regarded as a sufficient means of containing risks in the financial sector. Monetary policymakers should intervene only after a financial crisis had occurred, minimising the macroeconomic damage through resolute interest rate cuts.

Even though monetary policy proved indispensable and highly successful in containing the crisis and in preventing a meltdown of the financial system, events have cast doubt on this consensus. The question now is whether, and to what extent, monetary policy should take account of financial market developments before a crisis occurs.[3] Let me elaborate on some aspects of this in greater depth.

2.1 A stronger role for financial markets in monetary policy analysis…

Given the genesis of the crisis, it is undeniable that monetary policy with too short a policy horizon can fail to take account of financial imbalances that eventually spill over to the real economy, thus jeopardising price stability. So, how should monetary policy incorporate the experience of the crisis into its decision-making process?

In the pre-crisis phase, monetary policy decisions were often based on models in which the financial sector played only a minor or no role at all. Therefore, an obvious and important lesson from the crisis is that the theoretical and empirical foundations of monetary policy must place a greater emphasis on both the banking sector and financial imperfections.

As regards the Eurosystem's monetary policy strategy, the monetary pillar already contains major elements of such an approach. In the more recent past, the Eurosystem has stepped up its efforts to continually enhance its monetary analysis.[4] The aim is to identify irregularities in the patterns of a number of variables, since an unusual pattern in loan developments and monetary aggregates can provide valuable indications of excessive credit growth. This requires, among other things, an extension of the usual decision-making horizon, as financial distortions often build up over a fairly long period of time. As a result, monetary policy should become more symmetrical over the financial cycle and can thus make a key contribution to financial stability.[5]

2.2 … but a separate toolkit is needed for financial stability …

However, this alone is insufficient to ensure financial stability. Until the crisis, the majority view had been that asset price bubbles are difficult to identify in a timely manner and that interest rates are too blunt a tool to burst such bubbles at an early stage. These reservations have not been invalidated by the crisis and, therefore, the debate on how to better prevent financial crises turned to the specific incentives within the financial system and the existing supervision, which focuses primarily on individual institutions, as these may have encouraged the build-up of debt-financed imbalances. Thus, a greater emphasis should be placed on macroprudential analysis and regulation.[6] The aim of macroprudential policy is to contain systemic risk, thus strengthening the resilience of the financial system as a whole. This is designed to ensure that externalities within the financial system, notably the

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[3] See also Deutsche Bundesbank (2011), The implications of the financial crisis for monetary policy, Monthly Bulletin, March 2011, pp. 53–68.

[4] See L Papademos and J Stark (eds), Enhancing monetary analysis, ECB, Frankfurt am Main, 2010.

[5] See A A Weber (2010), Comment on Jordi Galí – The Monetary Pillar and the Great Financial Crisis, colloquium held in honour of Lucas Papademos, 21 Mai 2010, Frankfurt am Main.

[6] See Deutsche Bundesbank, Approaches to the measurement and macroprudential treatment of systemic risk, Monthly Report, March 2011, pp. 37–52; Basel Committee on Banking Supervision, BASEL III: A global regulatory framework for more resilient banks and banking systems, December 2010.

procyclicality and interconnectedness of financial institutions, can be addressed appropriately.[7] Consequently, existing supervisory tools must be expanded or adjusted so as to prevent systemic risk from arising in future and to considerably reduce the likelihood of credit and asset price bubbles.

2.3 … and price stability remains the primary objective of monetary policy

Against this background, monetary policy and its tools must remain focused on price stability and should not be overburdened with other objectives. In fact, the credibility of monetary policy depends not only on the clarity of its objectives but also on transparency regarding its limitations. Adopting financial stability as an additional, independent monetary policy objective runs the risk of arousing unrealistic expectations about the effectiveness of monetary policy tools. Nevertheless, central banks as institutions may still be given the additional task of pursuing financial stability, as long as they also have the appropriate set of additional independent tools available to them. Indeed, central banks' expertise constitutes a forceful argument for them continuing to play a prominent role in analysing and assessing financial stability. The advantage of having independent tools for price stability and financial stability is evident when there is a need for monetary and macroprudential policies to be adjusted in different ways. Nevertheless, as developments in money and financial markets are of key importance for both monetary policy and macroprudential policy, there are likely interdependencies between them that should be taken into account. For example, banks' lending is not only important for the monetary transmission process but is also a link for macroprudential policy. This opens up the opportunity for policy decisions in both spheres to complement each another, but it also harbours the danger of them counteracting each other or even cancelling each other out.

There is no single answer to the question of how necessary or advantageous a coordination of policy areas would be.[8] Recent research has provided some initial clues and corroborates the view that the inflation rate can be stabilised quite well if macroprudential policy has its own tools and works alongside monetary policy.[9]

However, harmful effects with respect to inflation rate volatility can arise if monetary policymakers ignore the impact of macroprudential tools on the financial markets.[10] If central banks take decisions regarding both macroprudential and monetary policy tools, additional fluctuations in the inflation rate compared with the monetary policy *status quo* can be virtually ruled out, and such fluctuations could even be reduced overall.[11]

These preliminary results should be interpreted with caution. First, the underlying dynamic stochastic general equilibrium (DSGE) models only approximately reproduce the complex interactions between the real and the financial sectors. Second, such research is only in its infancy; at present, only a few models allow a simultaneous analysis of monetary and

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7 A range of tools aimed at curtailing both procyclicality and network risk is currently under discussion. See BIS (2010), 80th Annual Report; G Galati and R Moessner (2011), Macroprudential Policy: A Literature Review, BIS Working Paper, No 337.

8 See Committee on the Global Financial System (2010), Macroprudential instruments and frameworks: a stocktaking of issues and experiences, CGFS Paper 38.

9 See, for example, D Beau, L Clerc and B Mojon (2011), Macro-Prudential Policy and the Conduct of Monetary Policy, Banque de France, mimeo; I Christensen, C Meh and K Moran (2010), Bank Leverage Regulation and Macroeconomic Dynamics, Bank of Canada, mimeo.

10 See, for instance, P Angelini, S Neri and F Panetta (2010), Grafting Macroprudential Policies in a Macroeconomic Framework: Choice of Optimal Instruments and Interaction with Monetary Policy, Banca d'Italia, mimeo.

11 See P Angelini, S Neri and F Panetta (2010), op cit; C Bean, M Paustian, A Penalver and T Taylor (2010), op cit.

macroprudential policy.[12] Nevertheless, the results confirm that there should be a clear allocation of objectives and tools in order to achieve the aims of both policies. Assuming that there will be a satisfactory exchange of information between both monetary and macroprudential policymakers in the future, the existing studies give no cause to fear that the objective of price stability will have to be compromised.

2.4 Price stability should still be understood to mean low inflation rates

Even though the pre-crisis consensus regarding price stability as the primary objective of monetary policy remains valid, it can be asked whether experience of the crisis should have implications for the specific form that the objective of price stability takes. Specifically, there have been concerns that the credible commitment to ensure a low rate of inflation might restrict the leeway for monetary policy stabilisation, since, in the event of the massive interest rate cuts, the lower bound for nominal interest rates would be hit quite quickly. Two competing approaches have been suggested to deal with this alleged shortcoming: A higher inflation target,[13] and a switch to targeting the price level or, more precisely, the price-level path.[14] Neither of the two alternatives convinces me.

As regards a higher inflation target, it is not only the substantial and ongoing welfare losses accompanying a rise in the inflation target that argue against this proposal but also, above all, the loss of credibility for monetary policy associated with such a discretionary measure.[15] The resulting destabilisation of inflation expectations would make it significantly more difficult for the central bank to achieve its (possibly higher) inflation target and to safeguard macroeconomic stability.

Compared with a strategy of inflation targeting, price-level targeting does display a number of advantages, at least in theory. It opens up the option of influencing private sector inflation expectations and thus of combating deflationary risks in the event of a crisis. However, it is doubtful whether a change in the target specification in the event of acute deflationary risk would be suitable for achieving the desired positive effect on private sector inflation expectations.[16] A more serious problem is that a strategy of price-level targeting is associated with a few additional drawbacks compared with optimal monetary policy, casting doubt on whether such a change of strategy would be beneficial.[17]

All in all, this means that neither raising the inflation target nor switching to price-level targeting would be appropriate from an economic stability point of view. Instead, this problem must be tackled at root; the existing wrong incentives and regulatory loopholes must be eliminated in order to make crises less likely and less severe. It is, in any case, questionable whether the leeway available to monetary policy at the lower bound of the nominal short-term money market rates actually was that limited. Central banks' experience of the effectiveness

[12] See also D Beau, L Clerc and B Mojon (2011), op cit.

[13] See J C Williams (2009), Heeding Deadalus: Optimal Inflation and the Zero Lower Bound, Brookings Papers on Economic Activity 2, pp 1–37; O J Blanchard, G Dell'Ariccia and P Mauro (2010), Rethinking Macroeconomic Policy, Journal of Money, Credit and Banking 42, pp 199–215.

[14] Eggertsson and Woodford already proposed price-level targeting in connection with the deflation experienced in Japan; see G B Eggertsson and M Woodford (2003), The zero bound on interest rates and optimal monetary policy, Brookings Papers on Economic Activity 1, pp 139–211.

[15] See A A Weber (2010), Der IWF spielt mit dem Feuer (The IMF is playing with fire), Financial Times Deutschland, 25 February, 2010 (available in German only).

[16] See C Walsh (2010), The future of inflation targeting, University of California, Santa Cruz, mimeo.

[17] See Deutsche Bundesbank, Price-level targeting as a monetary policy strategy, Monthly Report, January 2010, pp 31–45; C Gerberding, R Gerke and F Hammermann (2010), Price-level targeting when there is price-level drift, Deutsche Bundesbank Research Centre, Discussion paper, Series 1, No 23/2010.

of unconventional measures during the crisis give no cause for viewing the lower bound of the interest rate as a binding restriction on the effectiveness of monetary policy.

3. Particular lessons for monetary policy in the euro area

All the issues I have been talking about up to now concern more or less all central banks and every monetary policymaker. For the remainder of my speech, I would like to focus on the particular challenges for monetary policy in the euro area. These arise from the sovereign debt crisis, which is the major challenge for economic and monetary union. The circumstances surrounding the debt crisis are aggravating the conduct of the Eurosystem's common monetary policy, which is geared towards maintaining price stability in the euro area as a whole.

3.1 Heterogeneity as a challenge for monetary policy

One of the aggravating factors is heterogeneity in terms of growth, inflation and competitiveness. With regard to the euro-area countries' economic performance, we are currently observing a widening divergence. Broadly speaking, there is a considerable growth gap between the core and the periphery, or to put it more precisely, some peripheral countries of the euro area.

In my view, the economic heterogeneity of the euro area is a non-issue. Why should heterogeneity be a problem for the single monetary policy? After all, the dispersion of growth rates, as measured by the weighted standard deviations of quarterly growth rates, is not significantly greater than in the first years of EMU. With regard to inflation variance, we see even lower values than then. Furthermore, the US economy is characterised by considerable heterogeneity, too, and that does not impede the Federal Reserve's monetary policy, either. And in much the same was as the FOMC is focused on the US as a whole, the Governing Council of the ECB has to take a euro-area-wide perspective: While national developments have to be taken into consideration, monetary policy cannot be tailored to the specific needs of individual member states.

The real problem with heterogeneity, and that is a concern to me, is that a number of countries have obviously failed to meet the obligations and requirements of a currency union. The persistent problems of countries in refinancing their debt are only the symptoms of the problems, not the problem itself. The financial crisis has revealed unsustainable developments in some member countries – developments which were already in existence before the crisis: too much public spending, unproductive use of capital inflows, losses of competitiveness. Those were just some of the shortcomings which had been carelessly neglected, not least by the financial markets. Painful adjustment processes, including structural reform and budget consolidation, are essential to restore the ability of the countries concerned to live up to the demands of the single monetary policy.

3.2 Fiscal stabilisation measures were necessary but they undermined the basic founding principles of EMU

Ensuring financial stability in the euro area required and justified fiscal aid for Greece and the establishment of a temporary stabilisation mechanism. Nevertheless, these particular measures have undermined the foundations of EMU.

The establishment of EMU was based on principles that were deemed necessary in order to make the euro a stable currency. According to the principle of subsidiarity, economic policies other than monetary policy remain the responsibility of national governments. With regard to fiscal policy, rules and institutional arrangements were established to ensure sound fiscal policies in the member states. Furthermore, a "no bail-out" clause stipulated national responsibility of each country for repaying its own public debt.

Rules for sound public finances are of particular importance in a monetary union since the incentives for excessive borrowing are even greater in a monetary union than they are anyway. Excessive borrowing can also place a strain on the conduct of a stability-oriented monetary policy. Unsound public finances are the Achilles heel of a monetary union of independent states.

Purchases of government bonds for monetary policy purposes, for example, harbour the risk of blurring the boundaries between monetary and fiscal policy, particularly given high government deficits and debt levels. This might harm the credibility of monetary policy. A little earlier I said that monetary policy must remain focused on price stability and should not be overburdened with other objectives. This principle applies not only with respect to financial stability, but also fiscal policy.

During the financial crisis, the Eurosystem – like the central banks of other major economic regions – took unconventional monetary policy measures on an unprecedented scale. The ample provision of liquidity was effective in offsetting the consequences of the abrupt decline in market liquidity, in maintaining monetary policy transmission, and, ultimately, in helping to prevent the real economy from sliding into a prolonged depression. On the other hand, unlimited provision of central bank liquidity to banks without a sustainable business model cannot be a long-run solution. Again, monetary policy should not act as a substitute for tasks of other policy areas. In particular, monetary policy should not and cannot persistently replace the repair of banks' balance sheets. The phasing-out of non-standard measures has to be continued; the objective is to return to the pre-crisis operational framework which has proven its effectiveness and flexibility during the crisis.

3.3 Economic governance in the euro area needs reform

Since the fiscal stabilisation measures in favour of euro-area peripheral countries have undermined the basic principles of EMU, it is obvious that there has to be a fundamental and far reaching reform of economic governance in the euro area. The European leaders agreed that the fiscal rules have to be tightened since their application in practice had proven to be too weak. They agreed, secondly, that macroeconomic imbalances should be addressed earlier and more effectively. The crisis demonstrated that sound public finances are a necessary, but not sufficient condition for financial and economic stability. Ireland, for instance, was among the least indebted countries of the euro area before the crisis erupted.

Finally, the leaders agreed to establish a permanent stabilisation mechanism since it is an illusion to believe that a reform of economic governance might prevent the reoccurrence of fiscal crises in the future.

In March, the leaders agreed on what they view as a comprehensive package. The measures it contains certainly represent a step in the right direction, but they are not a "quantum leap towards strengthening the institutional framework of EMU"[18] which is required to reinforce economic governance in the euro area. Ultimately, the future success of EMU will hinge crucially on the member states' willingness to comply with the tighter set of rules.

4. Conclusion

Tomorrow, it will be 17 years ago to the day since Helmut Schlesinger, one of my predecessors as President of the Bundesbank held the Eighth Homer Jones Memorial Lecture. In his speech on "On the Way to a New Monetary Union" he explained to the

[18] European Central Bank (2010), Reinforcing economic governance in the euro area, http://www.ecb.int/pub/pdf/other/reinforcingeconomicgovernanceintheeuroareaen.pdf, p. 4.

audience in St. Louis the historic dispute between "monetarists" and "economists".[19] In the particular context of European monetary integration, these terms had a totally different meaning to our general understanding. "Monetarists", he explained, "believed that monetary integration has to start first and that economic and political integration would follow." "Economists", however, "believed that economic convergence between the national economies must occur before … a monetary union."

The "monetarists" prevailed, but they erred in their belief that the introduction of the single currency would automatically act as a locomotive for the political union of Europe. There is no political union so far and there is little expectation that this might change significantly in the foreseeable future. Therefore, national executive and legislative branches will remain responsible for economic and fiscal policies over the medium to long term. Intergovernmental fiscal transfers beyond the rather moderate and earmarked payments from the EU budget (approximately 1% of GNP) are hardly acceptable; overburdening the financial solidarity of the people might jeopardise the idea of European integration.

The "economists", on the other hand, had a point in demanding more economic convergence. Their worries were, by the way, taken into account by the implementation of convergence criteria that have to be fulfilled before a country can join the euro area. The underlying problem of the current crisis is, however, not a lack of convergence ex ante or heterogeneity per se; rather it is the lack of willingness on the part of a number of member states to meet the requirements of the membership in a monetary union. If they fail to correct these deficiencies swiftly and thoroughly, stability oriented monetary policy in EMU will become increasingly difficult, all the more so as monetary policy has been profoundly challenged by the financial crisis.

The major lessons that central bankers in the euro area and elsewhere should take to heart are the following: Firstly, monetary policy has to consider the implications of financial instability for price stability; monetary and credit aggregates can provide helpful information in this regard. Secondly, since the policy rate remains too blunt a tool to tackle financial imbalances, the objective of financial stability requires its own, macroprudential set of tools, whereas maintaining price stability should remain the primary objective of monetary policy. Thirdly, price stability should continue to be seen as a stable and low inflation rate.

Finally, without stability oriented prudent fiscal policy monetary policy will find it increasingly difficult to ensure price stability at low interest rates.

Thank you for your attention.

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[19] See H Schlesinger (1994), On the Way to a New Monetary Union: The European Monetary Union, The Federal Reserve Bank of St. Louis Review, Vol. 76, No. 3, May June, pp. 3–10.