Jens Weidmann: Turning points in history – how crises have changed the tasks and practice of central banks

Welcome remarks by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Bundesbank Conference “Turning points in history: How crises have changed the tasks and practice of central banks”, Frankfurt am Main, 9 July 2015.

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1. Introduction

Ladies and gentlemen

Let me warmly welcome you all to the Bundesbank Conference entitled "Turning points in history: How crises have changed the tasks and practice of central banks". It is the Bundesbank’s first historical conference, and I am delighted it has met with such great interest.

“History will teach us nothing”.

I usually quite like the songs written by the English musician Sting, but I think he’s definitely barking up the wrong tree with this provocative song title. My view is that we can indeed learn a great deal from history. So I’m rather more inclined to see things like Confucius, who said: "Study the past if you would define the future."

The history of central banking is highly instructive when it comes to defining the future of central banking. That is why some of the most renowned and influential economists have delved into monetary history. Drawing lessons from the past, however, requires both a profound knowledge of central bank history and a thorough understanding of the challenges that currently face central banking.

That’s why we are proud that this conference has brought together some of the most eminent experts in both economic history and macroeconomics, as well as active and former central bankers, and – last but not least – two acting finance ministers. Let me therefore cordially thank all the speakers, panellists and moderators who are involved in today’s event.

My special thanks go to Harold James, who helped to develop the idea for this conference, and who provided valuable input during the planning phase.

I would also like to thank the organisers of the conference and, particularly, Heinz Herrmann, who arranged the programme. Heinz Herrmann was the Bundesbank’s Head of Research until he retired at the end of last year.

As we today entered the quiet period before the next monetary policy meeting of the ECB Governing Council, my remarks should not be construed as containing any comments on the current monetary policy stance.

Instead, I would like to share my thoughts on the current and future challenges faced by central banking against the backdrop of central bank history, taking the pre-crisis consensus on monetary policy as a starting point.

2. The global consensus on monetary policy ...

The recent global financial crisis has sparked intense debate among economists and central bankers over the future shape and role of monetary policy. Just like previous crisis episodes did, which likewise sometimes marked turning points in the role and functioning of central banks.

Before the financial crisis erupted, there was a consensus of a sort regarding the core principles of monetary policy.[1]

1. Central banks should primarily aim to maintain price stability, that is to say, consumer price stability.
2. Central banks should be independent from their governments.[2]
3. The credibility of central banks' commitment to low inflation – by anchoring inflation expectations – is key to their ability to deliver on their price stability objective.

This consensus shaped the statute of many central banks, not least that of the European Central Bank, which was agreed upon in 1991.

But this view was fundamentally challenged when the crisis struck. Central banks around the world intervened on a massive scale: interest rates were slashed to all-time lows, and unprecedented non-standard measures were rolled out.

In the euro area, where the financial and economic crisis evolved into a sovereign debt crisis in 2010, monetary policymakers repeatedly came under pressure to prevent the crisis from escalating. Sometimes they went to the very limits of their mandate, and some believe even beyond.

Now that the worst of the crisis appears to be over, questions are being asked about what lessons central banks should learn and whether the pre-crisis consensus is still valid. Therefore, I would like to use the remainder of my speech to look in greater detail at three lead questions:

1. What role should monetary policy play with regard to financial stability? Put differently, have central banks been too negligent about financial imbalances?
2. Should monetary policy set a higher inflation target to reinvigorate an ailing world economy and, more generally, to create greater leeway for interest rate policy in times of severe economic distress?
3. Have central banks become too powerful a political player for an independent institution outside democratic control?

3. ... and how the financial crisis challenged it

3.1 Monetary policy and financial stability

Let me start with the relationship between monetary policy and financial stability: Should monetary policy lean against the wind in the case of an asset price bubble, or should it stand aside and clean up the mess afterwards when the bubble has burst? Or, as William White put it more succinctly: "Should monetary policy 'lean or clean'?"[3]

According to the pre-crisis consensus, monetary policy should not even attempt to deflate asset price bubbles. In this vein, Alan Greenspan said in 2002 at the Jackson Hole symposium: "The notion that a well-timed incremental tightening could have been calibrated to prevent the late 1990s bubble is almost surely an illusion."

[1] See M Goodfriend (2007), How the World Achieved Consensus on Monetary Policy, in Journal of Economic Perspectives, Vol 21, No 4, pp 47-68.

[2] See A Alesina and L H Summers (1993), Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence, Journal of Money, Credit and Banking, Vol 25, No 2, pp 151-162.

[3] See W R White (2009), Should Monetary Policy "Lean or Clean"?, Federal Reserve Bank of Dallas, Globalization and Monetary Policy Institute, Working Paper No 34.

However, if we look back in time, we see that traditionally, central banks had their minds on financial stability issues.

When, in the 19th century, bank deposits began to emerge alongside banknotes, financial soundness became an issue for central banks, because banks operating in a fractional reserve system are susceptible to a bank run. This is why the function of the central bank as a "lender of last resort" gained importance at the time.

Financial panics and bank runs were reoccurring events, particularly during the second half of the 19th century and the early years of the 20th century. Indeed, the lessons learned from financial panics, notably the crisis of 1907, were a major catalyst in the establishment of the Federal Reserve in 1913.

The original goal of the Fed, then, was to preserve financial stability. According to one of the authors of the Federal Reserve Act, Robert Latham Owen, the Fed was established to "provide a means by which periodic panics which shake the American Republic and do it enormous injury shall be stopped."[4]

As Carmen Reinhart and Kenneth Rogoff note, "there is no mention of a price stability mandate in the original version of the legislation. Indeed, the word inflation does not appear at all in the document. A full employment macroeconomic goal is not even remotely alluded to."[5]

However, the tight focus on financial stability turned out to be problematic.

When in the late 1920s speculative lending ballooned, the Fed in pursuit of its mandate tightened monetary conditions in a situation when inflation rates were slightly negative.

While the Fed could not stop asset prices from soaring, its interest rate moves contributed to an economic downturn. This disconnect threw into sharp relief the mispricing in the asset markets. The crash of October 1929 was then followed by waves of bank failures.

On the occasion of Milton Friedman's 90th birthday, the then Governor Ben Bernanke conceded: "Regarding the Great Depression. You're right, we did it. We're very sorry. But […] we won't do it again."[6]

Having seen the impact of the Great Depression, central banks increasingly shifted their focus towards macroeconomic objectives: price stability and – in the case of the Fed – employment. Financial stability, in contrast, dropped off monetary policymakers' radar – I already mentioned the consensus achieved among central bankers.

The latest financial crisis, however, has cast serious doubts – not least from the Bank for International Settlements (BIS) – on this "benign neglect" approach to financial imbalances – all the more so as the 'mopping up afterwards' approach has proven to be costly:

This approach set incentives to incur excessive risks that played an important part in fuelling the crisis, and once the bubble burst, the economic fallout was so severe that monetary policy was overwhelmed.

In contrast to the pre-crisis consensus, some have therefore argued that financial stability should be adopted as a monetary policy objective on a par with, or even ahead of, price stability. However, such a dual mandate creates difficult trade-offs, especially as financial stability is a much more complex concept than price stability and hard to operationalise. I fear

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4 As quoted by B S Bernanke (2013), A Century of US Central Banking: Goals, Frameworks, Accountability, in Journal of Economic Perspectives, Vol 27, No 4, pp 3-16.

5 C M Reinhart, K S Rogoff (2013), Shifting Mandates: The Federal Reserve's First Centennial, presented at the American Economic Association Meetings, San Diego, January 5, 2013.

6 B S Bernanke (2002), On Milton Friedman's Ninetieth Birthday.

that in the end, this might undermine the credibility of monetary policy to maintain price stability.

Moreover, monetary policy is not the best instrument for addressing financial stability risks. Macroprudential policy uses more targeted instruments, which makes it better suited to addressing growing imbalances in financial markets.

The question is whether or not a clear separation of responsibilities – in terms of "macroprudential policy takes care of financial stability" while "monetary policy only pays attention to price stability" – actually makes sense.[7] In other words, is monetary policy out of the woods?

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 the financial cycle is longer than the business cycle this comes down to extending the policy horizon. To quote from the latest BIS annual report, "Shifting the focus from the short to the longer term is more important than ever."

In any case, a more symmetrical monetary policy stance over the financial cycle seems to be warranted. On the one hand, the monetary policy stance should be eased aggressively during a marked downturn. On the other hand, monetary policy should be aware of its implications for financial stability, and so it should tend, in upswings, to be stricter than short-term inflationary developments would suggest.

Claudio Borio, the current chief economist of the BIS, said: "The more you concentrate on the long-term perspective, the more price stability and financial stability complement each other and the less they contradict each other".

3.2 Monetary policy and price stability

This brings me to the second lead question: Should the monetary policy target be changed?

Some academics[8] have suggested higher inflation targets, given that central banks have reached the zero lower bound (ZLB) in response to the crisis, and they see the need for further expansionary impulses, and more generally the need for a greater distance from the ZLB.

As The Economist once wrote, "Asking a central banker to accept higher inflation may seem like asking a cardinal to accept more sin". But on a more serious note, the issue is about the relative merits of low inflation versus having more monetary policy leeway in times of crisis.

I believe that increasing central banks' inflation targets would be to draw the wrong conclusion.

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7 See V Constâncio (2015), Financial stability risks, monetary policy and the need for macro-prudential policy, speech at the Warwick Economics Summit, 13 February 2015; Deutsche Bundesbank (2015), The importance of macroprudential policy for monetary policy, Monthly Report, March, pp 39-71.

8 See eg O Blanchard, G Dell'Ariccia, P Mauro (2010), Rethinking Macroeconomic Policy, IMF staff position note, SPN/10/03.

First of all, it has to be noted that the ZLB is not hard and fast. Several central banks have set negative deposit rates without immediately spurring a flight to cash, because holding cash in large volumes is not free of charge, either.

Moreover, central banks have shown during the crisis that they can choose from a repertoire of unconventional measures to further loosen the monetary policy stance when interest rates are already close to zero – although some of the unconventional measures are more problematic than others.

What is more, results from macroeconomic models advise against inflation targets of more than 2%. The optimal inflation rate derived from such models is around 2% – if the ZLB is explicitly taken into account.

What is the underlying intuition for this result? Higher inflation targets reduce the risk of being restricted by the ZLB. But while these events are rather rare, higher inflation targets actually increase the welfare costs of inflation – period by period! To quote a paper by Coibion and co-authors: "(…) raising the inflation target is too blunt an instrument to efficiently reduce the severe costs of zero bound episodes."[9]

A key point from an economic policy perspective, though, is this: Behind the low interest rates are the low inflation pressure and the modest growth outlook – not only in the euro area but worldwide. What is needed, therefore, are strategies for boosting trend growth. And these strategies should not rely on ultra-loose monetary policy or more debt-financed expansionary fiscal policy, but first and foremost on structural reforms that enhance productivity.

In this respect, I share the view of the BIS, which, in its current annual report, calls for a rebalancing of economic policy. "The aim is to replace the debt-fuelled growth model that has acted as a political and social substitute for productivity-enhancing reforms."

Hence, there are good economic arguments against higher inflation targets – and not the oft-cited German Angst when it comes to inflation. This is not to deny that, for Germans, price stability is of particular importance.

In this regard, it is also instructive to look back to Germany one century ago.

When the First World War was over, the German state was heavily indebted, and to finance the mounting debt service, the Reichsbank printed more and more money. Hyperinflation was the outcome.

At the start of the First World War, the US dollar was worth 4.20 marks. From then on, the German currency steadily depreciated, and in the summer of 1922, it went into free fall.

We can be sure that most Germans, unlike Bavarian comedian Karl Valentin, did not see the funny side of this. When the dollar rose to 40 billion marks in autumn 1923, he quipped: "Well, it certainly isn't worth more than that."

Seen from this perspective, Valentin was in fact wrong. By mid-November 1923, when a new currency was introduced, the dollar stood at 4.2 trillion marks.

It is often argued that the travails of hyperinflation have been burnt into the collective memory of the German people, just as the experience of the Great Depression has become etched into the collective memory of Americans. This, and the suppressed inflation during the Second World War which led to a second currency reform in 1948, certainly go a long way towards explaining why Germans appreciate monetary stability so much.

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[9] O Coibion, Y Gorodnichenko, J Wieland (2012), The Optimal Inflation Rate in New Keynesian Models: Should Central Banks Raise Their Inflation Targets in Light of the Zero Lower Bound? Review of Economic Studies 79, pp 1371-1406.

Perhaps a factor at least as important, though, is the positive experience Germans had with the D-Mark and its stability-oriented central bank. The young Bundesbank was successful in gaining credibility as a guardian of the currency, even in difficult times.

Later on, during the inflation-ridden 1970s, Germany kept inflation rates at comparatively modest levels. While the average rate of 5% was quite high, other industrialised countries with the exception of Switzerland had to cope with significantly higher inflation rates: for instance, the United States 8%; Japan 9%; France 10%; United Kingdom and Italy 14%; Spain 15% on average.

3.3 Central banks' more prominent role

The final issue I would like to briefly touch upon is what many see as the increasing powers of central banks, which also has a bearing on their independence.

According to Harold James, "the pendulum is (...) swinging back" towards more politically controlled central banks. "The new post-crisis vision of the central bank," he continues, "is often a very different sort of institution from the 1990s vision of a mechanism for guaranteeing price stability."[10]

As a result of the most recent crisis central banks have assumed a much broader role and been assigned new functions. The far reaching implications of central bank decisions have prompted a debate about the limits of their mandates and the legitimacy of their actions.

With respect to the euro area, some have even dubbed the ECB the only game in town. These days the ECB's role in Greece's fate has spurred an intense debate.

Greece is certainly the focal and dominating topic at the moment. And no one can seriously say right now if these days will mark a turning point in European monetary history, challenging the irreversibility of euro membership or heralding the move towards a transfer union.

Greece is a topic that shows us in no uncertain terms that, despite the deeper integration that the crisis brought about in Europe, the euro-area member states are ultimately still responsible for their own affairs. They can decide for themselves not to service their debts, to collect taxes inadequately, and – this is something I particularly fear in the case of Greece – to lead their country's economy into deep trouble.

The Greek government has not only walked out on the previous agreements, but has been widely criticised as an unreliable negotiating partner. A little over a week ago, the assistance programme finally came to an end, and the Greek government has stopped honouring its payment obligations towards public creditors such as the IMF.

In addition, a clear majority of the Greek general public have spoken out in a referendum against contributing any further to the solvency of their country through additional consolidation measures and reforms.

What is the role of central banks in this situation?

Central banks – although they have the means – have no mandate, in my view, to safeguard the solvency of banks and governments. That kind of implicit redistribution is a matter for governments or parliaments, if at all.

Despite the practical difficulties involved in telling illiquidity from insolvency in real time, central banks need to show where their limits lie. Besides, in Greece doubts about the solvency of banks are legitimate and rising by the day. It needs to be crystal clear that responsibility for further developments in Greece and for any decisions on transferring

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[10] H James (2012), Making the European Monetary Union – the role of the Committee of Central Bank Governors and the origins of the European Central Bank, Cambridge, Mass.

financial resources lies with the Greek government and the countries providing assistance – not the ECB Governing Council.

The Governing Council recently ensured that the provision of emergency liquidity assistance (ELA) was frozen, and I welcome the fact that further deposit outflows have been stemmed by the capital controls. ELA is no longer being used to finance capital flight caused by the Greek government. This certainly represents a step forward, and shifts the responsibility to where it belongs: with the governments and parliaments.

In any case, the Eurosystem should not increase the liquidity provision, and capital controls need to stay in force until an appropriate support package has been agreed by all parties and the solvency of both the Greek government and the Greek banking system has been ensured.

In the event that further short-term assistance is thought to be desirable or necessary, it is up to fiscal policymakers to provide ad hoc financial support.

Ever growing expectations with regard to the contribution of central banks and the increased role they actually play are more a curse than a blessing. Undoubtedly central banks are powerful institutions, but they are well advised to stick to a narrow interpretation of their mandate if they wish to preserve their credibility and independence.

4. Conclusion

On that note I would like to conclude.

In my view, it is plain to see that the core principles of monetary policy I mentioned earlier are still valid. However, one important lesson to be learned, is that we need to pay greater attention to the long-run implications of financial imbalances on price stability.

I am confident that this conference will deal with a lot of the aspects I have mentioned in my speech. I firmly believe that this conference will prove that history will teach us more than nothing.

Thank you very much.