Erkki Liikanen: At the interface of research and monetary policy

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at the meeting of the Finnish Economic Association, Helsinki, 17 May 2016.

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My purpose today is to discuss the use of economics for policy advice in light of four examples. Thinking about the relationship between theory and practice, there are some unavoidable differences, or even tensions, between how economic scientists on the one hand, and decision makers on the other see the policy process.

Both perspectives are necessary and in fact complement each other.

Cameron Cobbold, who was the Governor of the Bank of England in the 1950's, has been quoted as saying, "the Central Bank is a bank, not a study group" (Capie 2010, p. 99). It is important for central bankers to remember that they are employed to deliver results, and should not be victims of the so-called "paralysis by analysis".

At the same time, it is dangerous if policy makers do not realize how dependent they actually are on economic thinking. As Keynes wrote, "practical men who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist." (Keynes 1936, p. 383)

It is much better if policy makers are aware of where they stand in relation to current economic thought.

How can this awareness be created and maintained in a changing world?

There is a certain basic, perhaps mechanical view of the use of economics in policy making that goes back to Jan Tinbergen. This view considers mainly the kind of economic analysis that is done inside policy organizations such as ministries, central banks and the like.

This kind of policy advice consists of forecasts and quantitative policy analyses. These help, for example, monetary policy decision makers to set their given policy instruments to achieve the desired results. (Tinbergen 1955).

The role of this kind of policy planning processes inside central banks and finance ministries is important, but it is by no means the only type of interaction between professional economists and policy makers.

In addition to these processes, I would like to highlight the informal interaction between economists and policy makers which, in the longer scheme of things, might be even more important than the internal policy processes within institutions.

What I am talking about here is the dialog that takes place between professional economists and policy makers, in which political doctrines and ways of thinking develop parallel to the latest currents in economic science.

The research community, in fact, has more influence on discussions within the monetary policy community than the academics themselves probably believe.

The central banking community is an international group of well-connected people. They are by no means always in agreement on policy alternatives. However, the members of the community regularly keep in touch with each other, as they like to know what their peers think.

The central banking community also pays close attention to the views of leading academic economists on current monetary policy issues. The academics want to be heard and to contribute to monetary policy making. At the same time, the central bankers (and I include the senior staff of international organizations such as the IMF, BIS and others) are also keen to listen to what academics have to say. There is a mutual interest in each other's views.

If anything, this interaction between policy and research has increased during the last two decades. This is partly a result of globalization, which creates similar international peer groups also in other areas of life.

The increase in this research-policy interaction is also due to the fact that central banks have become more independent. As independent decision makers, the central banks are now able to use more, and indeed need more insights from research and cooperation with the academic world.

There are many interesting examples of the influence of research on monetary policy making, as well as examples of influence flowing in the opposite direction: problems encountered by monetary policy makers have in turn forced researchers to reconsider old approaches and to alter their assumptions.

I would now like to describe four such instances, all of which have a fundamental importance from today's perspective. The first three cases are from one of the most important forums where there is interaction between research and monetary policy makers: the Jackson Hole symposium.

This event, officially the Annual Economic Policy Symposium of the Federal Reserve Bank of Kansas City, takes place annually in Jackson Hole in Wyoming. The symposium is particularly remarkable due to the expertise and experience of the speakers and to the relative isolation in which the discussions take place.

Central bankers want to be there, as do academics. The symposium has also become an important source of information and inspiration as well as a place to network. As an event, it is no longer in a league of its own. The ECB has already twice organized a very high quality conference in Sintra, Portugal. The third one will be in June.

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The first discussion that made a particularly strong impression on me took place in 2005. I had just begun my second year as governor of the Bank of Finland. That year's theme at Jackson Hole was the appraisal of Alan Greenspan's era as the chairman of the Federal Reserve.

At the symposium, Raghuram Rajan, then director of research at the IMF spoke on the topic, "Has financial development made the world riskier?" (Rajan 2005, pp. 313–369). Contrary to the accepted wisdom and consensus of the day, Rajan answered three times in the positive. Financial development has made the world riskier. The speech was prophetic.

In his presentation, Rajan noted how securitization, markets for transferring risks, and bad incentives were leading to a dangerous accumulation of risks in the global financial system. He also worried about the amount of liquidity. Let me quote:

> "If banks also face credit losses and there is uncertainty about where losses are located, only the very few unimpeachable banks will receive the supply of liquidity fleeing other markets. If these banks also lose confidence in their liquidity-short brethren, the interbank market could freeze up and one could well have a full-blown financial crisis."

This is precisely, word for word, what happened three years later, after the failure of Lehman Brothers.

Many in the audience reacted in a very hostile manner to Rajan's presentation. He was seen as a killjoy, and an opponent of innovation and progress. He was even called a "Luddite," a machine breaker. His proposals for reform were thought to be destined for failure.

The policy community was not in the mood to change course just because of a single conference presentation, even if it was a comprehensive and balanced contribution. It took a major international catastrophe for the policy community and the majority of academic opinion to adjust its views. And we have not seen the end of the catastrophe yet.

Rajan's speech was an excellent example not only of professional competence but also of professional integrity and courage.

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Another example that all who were present will recall, was the issue of whether it was sufficient to adhere to the inflation target alone even if asset prices begin to soar.

During the period of the Great Moderation, from the 1990s up until about 2007, the academic literature on macroeconomics had developed a very streamlined view of what central banks should be doing. The literature generally emphasised the view that policy should focus on the stabilization of a single indicator, the medium term inflation forecast, by using a single instrument, the short-term money market interest rate.

Practical policy never became quite as simplified as this, but the general trend during the high years of the inflation targeting doctrine was towards such a regime. This meant a departure from the more traditional thinking, when central banks were very interested in the behaviour of the money and credit aggregates.

The ECB, which almost alone insisted that there was a role for monetary and credit aggregates in its monetary policy strategy, was sometimes thought to be more than a little old-fashioned.

What some practical bankers worried about was what to do if the objective of stabilizing the inflation outlook came into conflict with the stability of the credit market. There was no unanimity on this issue. It was even debated whether such a conflict of objectives was a realistic scenario.

The question can be posed for example in this manner: should monetary policy be tightened in response to a credit boom even if there seems to be nothing to worry about on the inflation front? What if bubbles are developing in the economy?

At the 2007 Jackson Hole symposium, Rick Mishkin, then a member of the Board of Governors of the Fed, gave a presentation on "Housing and the monetary transmission mechanism" (Mishkin 2007, pp. 359–413). Among other things, he dealt with the possibility of real estate bubbles and what to do about them.

Mishkin took a straight inflation-targeting view in his presentation. He said that should central banks respond to suspected bubbles, they would be forgetting their basic mission of sustaining price stability. This, he said, could prove extremely costly both in terms of what monetary policy does and what the general public thinks it is doing.

Opinion was divided at the symposium. Some, like Lars Svensson, supported Mishkin's view and stated that there were insufficient grounds to deviate from a price stability policy even if it was suspected that a bubble was developing.

Others were not so sure. Some, like Stanley Fischer, asked why should one wait for a bubble to burst and then plunge into a major crisis. Some thought that the cost of a financial crisis could be so great that monetary policy should "lean against the wind" in order to prevent bubbles from growing too big to handle.

As we all know, the events that have occurred after 2007, in the form of the financial crisis, have forced both academics and the policy community to take a broader view than before the crisis:

- The costs of financial crises are taken much more seriously than in 2007. Hardly anyone now says that we should not worry about possible bubbles as they are developing; that it is enough to concentrate on mopping up the mess afterwards.

- Also, a common view now is that price stability alone does not ensure financial stability. Markets are not that well behaved.
- It is also recognized as a fact that strengthening prudential regulation of banks, even though it has been necessary, is not alone sufficient to ensure that bubbles and crashes do not occur in the asset and credit markets.

The answer to the policy dilemma between price stability and controlling credit cycles and property bubbles is now sought from another direction: macro-prudential policy.

The use of macro-prudential policy instruments is not now considered to be a part of monetary policy proper. It is, however, generally accepted that central banks should play a key role in the development and use of macro-prudential tools.

The use of macro-prudential policy instruments can be an essential complement to monetary policy. In many instances, effective macro-prudential tools may be even a prerequisite for successful monetary policy.

To summarize: the more the central banks can trust macro-prudential policy to do its part, the better can monetary policy support the recovery of economic activity and normalization of the inflation rate, in the euro area and elsewhere.

It is clear that in the years since the symposium of 2007, the mainstream of economic research has had to adjust its assumptions for monetary policy and the behaviour of financial markets in a more pragmatic and realistic direction than before. It is recognized that, on this matter, theoretical research still has much to learn from the practical experience of central banks' attempts to preserve both price and financial stability at the same time.

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My third and final example from the discussions at Jackson Hole has to do with a problem that is quite pertinent at present, that is, what kind of monetary policy should be practised in a situation of ultra-low interest rates.

The present situation is unique in history. In many countries, including the euro area, the short-term interest rate is close to or even slightly below zero. According to the traditional way of thinking, rates could not go much lower without causing problems in the form of speculative investments in currency (banknotes).

Just how low the nominal short-term rate can be in practice is not certain. Central banks have been feeling their way ahead in this area.

Academics, of course, recognized the problem of the "zero lower bound", and provided some answers to the problem. And policy makers have listened. A particularly influential idea was put forward by Reifschneider and Williams (2000), well before the financial crisis and the related decline in interest rates. They recommended a solution that is now called "forward guidance." By promising to postpone the interest rate hike beyond the expected time, the central bank can give some monetary stimulus to economic recovery.

If this promise to postpone the coming rise in the interest rate is credible, it will affect economic prospects now. In a world with forward-looking firms and markets, this will stimulate current spending and activity.

This brings me to my third example from the Jackson Hole symposia. At the symposium in 2012, Michael Woodford presented a policy paper which contained some practical recommendations on how forward guidance should be implemented (Woodford 2012, pp. 185–288).

Woodford is one of the most respected academic authorities on monetary policy, so everyone listened closely. In his presentation, Woodford stated that it is better to announce very precise and firm commitments about future policy intentions rather than make vaguely worded statements. In particular, he recommended including strict economic conditionality in the forward guidance.

According to Woodford, central banks should not merely commit to keeping the interest rate at its lower bound until a given future date. Rather, they should make a binding, but conditional, statement on future monetary policy. Woodford stated that there should be transparent and objective economic criteria for the steering rate lift-off.

Such precise commitments were actually tried in practice soon after Woodford and some other academics had recommended the conditional approach.

In December 2012, the Fed's Open Market Committee declared that: "this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."

The Bank of England also introduced several declared numerical lift-off criteria – knockouts – in 2013. These were related to the inflation forecast, the prevailing inflationary expectations, and the stability of the finance sector.

Experiences with these precise lift-off criteria have been mixed. The quantitative indicators are not quite as precise and reliable as might be hoped, and they do not convey the full picture of the state of the economy. So there may be "false alarms" or at least suspicions of "false alarms" related to the selected indicators. If this happens, the forward guidance based on numerical indicators may be less clear than was hoped for.

The ECB has not taken that route. Instead, the forward guidance of the Governing Council of the ECB is based on the long-term target of price stability according to which inflation in the medium-term is below but close to 2%.

By doing so, the ECB Governing Council has managed to avoid some of the problems related to very precise numerical lift-off criteria. The ECB's forward guidance has worked. At the same time, it must be admitted that the prolonged period of lower-than-intended inflation, which is still ongoing, remains a cause for concern.

This is one reason why the ECB reinforced its forward guidance with a comprehensive set of policy measures in March. The monthly purchases of €80 billion are intended to run until the end of March next year, or beyond that if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation rates to below but close to 2 % in the medium term. Additionally, the ECB Governing Council has announced that it expects the key ECB interest rates to remain at present or lower levels well past the horizon of our net asset purchases.

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The examples I have cited from the Jackson Hole symposium, each in its own way, show that the interaction between researchers and policy makers has been active and very timely in recent years.

More importantly, this interaction has been forward-looking. All three of the examples were such that the interaction between researchers and policy makers focused on problems that came to a head soon after they were discussed at the conference.

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I would like to raise a fourth issue that resides at the interface between policy and research which has arisen in the aftermath of the financial crisis.

In 2012, I led a high level expert group established by the EU Commission whose task was to consider the regulation of banks' structures in Europe and to make proposals concerning it.

The issue of bank structures entered the EU agenda as part of a wider development of regulations concerning the banking industry. As separate but interconnected projects, these included the reform of capital adequacy and liquidity regulations, the strengthening of the banks' crisis resolution system and the concentration of banking supervision within the euro area under the ECB's responsibility.

The practical task for our working group was to consider which forms of business and securities trading should be allowed for deposit banks. The proponents of structural regulation think that the safety nets, formal and informal, present in deposit banking might encourage large deposit banks to take excessive risks and to be overly active in the securities markets. The consequence would be the banks' increased propensity to fall into crisis and tax-payers' increased exposure to banks' risks. To avoid this, the involvement of deposit banks in risky business activities should be restricted.

At the same time, there are experts who argue that sufficiently good results could be achieved by tightening the regulations on banks' capital requirements and dismantling the safety nets that protect them. Thus, the scope for moral hazard would be reduced to such an extent that restrictions on deposit banks' scope of business would not be necessary.

The banking sector itself has generally been lobbying against both restrictions on activities and tightened capital requirements.

Structural regulation has a long history especially in the United States where the Glass-Steagall Act, passed in the 1930s, restricted banks' securities trading up until the 1990s, when it was repealed. As a consequence of the financial crisis, however, there has been renewed interest in structural regulation, and the United States has now adopted the so-called Volcker Rule, which prohibits banks from engaging in proprietary securities and derivatives trading. There are, however, some significant exceptions to this rule.

Britain took a slightly different approach to structural regulation. This was guided by the principle of insulating basic banking activities within banking corporations from other functions (i.e. ring-fencing) so as to prevent the transfer of risk, for instance, from securities trading to basic banking.

One of the recommendations of my work group was that banking groups should isolate proprietary trading within separate companies. The financing of such companies should be separated from the deposit bank so as to prevent at least large-scale proprietary trading at the risk of the deposit bank, trading that would occur indirectly under the protection of the deposit guarantee scheme (Liikanen et al., 2012).

What connections did our working group have with academic research?

Professor Marco Pagano, who currently chairs the Advisory Scientific Committee of the European Systemic Risk Board (ESRB), has in one of his papers wondered why it is that academic research has so little to say about the effects of the structural regulation of banks (Pagano 2014a). Pagano has not used this idea to argue against structural regulation: for example, at the European Parliament hearing in 2014, he strongly defended the proposals of our work group (Pagano 2014b).

We were able in our group, however, to make use of earlier research concerning several aspects of the problem at hand, and our report includes a survey of the relevant literature. As this survey shows, the research on the banking sector has dedicated specific effort in looking into economies of scale in the banking sector, and in asking whether there are significant synergies (economies of scope) between various business areas in the banking industry.

These are indeed key questions in considering the imposition of restrictions on the size of banks and in demanding the separation of banking activities into unrelated institutions. The answers would bear on the possible efficiency losses that this kind of stability-seeking regulation might cause.

Our conclusion based on the evidence was that our regulatory recommendations would not cause a loss of efficiency to the extent that would outweigh the increased stability of banks gained by structural regulation.

One central problem whose consideration within our group was affected by the research literature was the question of how to treat market making.

In his research on the United States' Volcker Rule, Stanford University Professor Darrell Duffie drew attention to the difficulty in practical monitoring work in separating market making activities from proprietary trading.

Duffie recommended the regulation of market making primarily through prudential and liquidity regulations, or alternatively, by separation of this activity from the core bank through "ring-fencing" (Duffie 2012). In our working group, we ended up suggesting the latter solution, where market making activities are on a large scale. This would have made it possible to handle proprietary trading and market making in a uniform way and therefore reduced the problems of monitoring compliance with the regulations.

The proposal by the EU Commission on the structural regulation of banks, which is currently before the Parliament and the Council, differed on this point from the proposal of our working group.

The Commission proposed the prohibition of proprietary trading altogether (apart from government bonds etc.) – this has been called the Barnier Rule after the commissioner at the time, Michel Barnier.

The proposal of our working group on the obligation to separate securities activities would, in the Commission's proposal, be effected at the discretion of the banking supervisors (in the euro area, the ECB). The supervisory authority would determine whether securities trading constituted a threat to the stability of the bank, and if the bank could not prove otherwise, the authority could demand that the activities be separated (European Commission 2014).

The Commission's proposal on banking structures drifted into a peculiar situation in the European Parliament when the rapporteur responsible for the proposal lost the vote in the committee. The fate of the proposal remains open.

A lot has been happening in the markets themselves. Many so-called universal banks have substantially limited their proprietary trading because it has caused significant losses for them. Banks are on the look-out for a new business model.

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What do the cases explored here tell us about the connection between research and policy making?

In the real world, things do not follow a simplistic model according to which economic scientists first provide objective advice to policy makers, who then choose from the proposed alternatives the ones they prefer, and then put these into practice. The internal procedures of the official policy planning machinery have this model as its aim, but it is not the complete picture.

Without belittling at all the official mechanisms for policy preparation, it is important for the research community and the central banking community to engage in wide ranging and close interaction in more informal forums. It is my belief that the bond between the research and policy communities is getting even stronger at present, as the problems of the financial markets show little sign of subsiding.

The influence of the research community is especially significant when the discussion is about strategies and policy doctrines, the appropriate mandates for institutions, and the selection of policy instruments. But this influence occurs as a dialogue in which policy makers and researchers both influence each other's views.

It is important also to remember that monetary and economic policy interaction between policy makers and researchers happens in real time, in which economic history provides one surprise after another to both sides of the policy dialogue. There are always new factors coming into view, factors which had previously been overlooked but suddenly occupy centre stage.

History will always shake the policy frameworks from some unexpected angle and start yet another phase in the on-going dialogue between policy makers and economic theorists.

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