Jens Weidmann: Welcome remarks - "Frontiers in Central Banking - Past, Present and Future"

Welcome remarks by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Bundesbank Policy Symposium "Frontiers in Central Banking - Past, Present and Future", Frankfurt am Main, 14 June 2017.

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1. Introduction

Ladies and gentlemen

I bid you all a warm welcome here today at the Bundesbank Policy Symposium entitled "Frontiers in Central Banking – Past, Present and Future".

Conferences like this one feed off the knowledge and experiences of their participants. And that's why I'm proud that so many high-ranking academics and policymakers have accepted our invitation to be here today. Let me therefore extend my cordial thanks to all the panellists and moderators who are involved in this event. I am particularly indebted to Otmar Issing, who will make some concluding remarks at the end of today's proceedings.

But as Karl Popper once pointed out, no matter how knowledgeable we are: to find out whether our ideas are sound, we need other people to try them out on. That's the reason for today's symposium, and that is why I would like to thank the organisers of the symposium and, especially, Emanuel Mönch and his team, who arranged the programme.

Ladies and gentlemen, I'm quite sure I'm telling you nothing new when I say that (modern) central banking is a consequence of crises.

The Federal Reserve is a prominent example. It was established in 1913 as an answer to financial panics. When, in the 19th century, bank deposits began to emerge alongside banknotes, financial soundness became an issue for central banks. Banks operating in a fractional reserve system are susceptible to a bank run. That is why the function of the central bank as a lender of last resort gained importance – a development which was described in particularly lucid terms by the British journalist, businessman, and essayist Walter Bagehot in his book "Lombard Street".[1]

Financial panics and bank runs were a recurring feature at the time, particularly during the second half of the 19th century and the early years of the 20th century – not only in the United Kingdom but also in the United States and other countries. The sole original purpose of the Fed, then, was to preserve financial stability.

According to Robert Latham Owen, one of the authors of the Federal Reserve Act, 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."[2]

Today, however, we know that placing the primary focus on financial stability turned out to be problematic. When speculative lending ballooned in the late 1920s, the Fed, in pursuit of its mandate, tightened monetary conditions in a situation when inflation rates were already 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.

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, by contrast, dropped off monetary policymakers' radar.

The Deutsche Bundesbank is another example of the role which crises played in the definition of a central bank's mandate. When the Bank was established exactly 60 years ago, there was a broad understanding that its primary objective should be to "maintain the stability of the currency". After the German population had suffered the loss of their savings twice in the first half of the 20th century – in the early 1920s due to hyperinflation, and after the Second World War due to the suppressed inflation caused by the wartime economy and the ensuing currency reform – they held price stability in very high store. And so it was widely appreciated by society that the Bundesbank interpreted its mandate as meaning that it should maintain price stability.

The oil crises of the 1970s and 80s were further events that shaped central banking. It was during this time that the merits of politically independent central banks like the Bundesbank and the Swiss National Bank came into sharp focus. They were able to disconnect their economies from the worldwide inflation train by pursuing policies which were aimed squarely at preserving price stability. As a consequence, their institutional design formed the basis for the global consensus about monetary policy – a consensus which is still in place today:[3]

1. Central banks should primarily aim to maintain price stability, that is to say, consumer price stability.

2. Central banks should be independent of their governments.[4]

3. The credibility of central banks' commitment to low, but slightly positive inflation – by anchoring inflation expectations – is key to their ability to deliver on their price stability objective.

This consensus shaped the statutes 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. This was in keeping with the then-reigning consensus: that monetary policy cannot be used effectively to deflate a bubble, but it can clean up afterwards if a bubble bursts. A consensus which was called into question after the crisis.

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.

2. Benefits and boundaries of unconventional monetary policies

Central banks all over the world reacted in classic Bagehot fashion when the financial crisis erupted. As soon as mistrust between private money market players began to take hold and the spread between the risk premiums for secured and unsecured money market transactions skyrocketed, the volume of money market transactions fell and the number of participants in monetary policy operations soared.

The Governing Council of the ECB reacted swiftly and decisively by switching its refinancing operations to tenders with full allotment. As long as banks were able to pledge adequate collateral, they received unlimited amounts of liquidity from the Eurosystem. In practice, this

allowed them to bypass the strained interbank market. The Governing Council also offered additional longer-term refinancing operations, including the three-year refinancing operations at the end of 2011 and the beginning of 2012 in particular.

This way, the Eurosystem took over much of the money market's role as an intermediary. In so doing, it made sure that monetary policy impulses would still find their way into the real economy. And by lending freely, it helped dispel concerns about banks' liquidity and thus prevent a run.

By providing oxygen to the economy, central banks are able to offer vital support. But in the long term, an oxygen supply is no substitute for a healthy heart. Quite the opposite, in fact: if a tank of oxygen takes the place of exercise and a healthy diet, it might prolong the condition if it is administered for too long.

Hence, if the abundant injections of central bank money are used not only to bridge temporary liquidity shortfalls but, in extremis, to keep insolvent banks on long-term life support, matters could get tricky.

The more the central bank safeguards banks against risks and promises them central bank funding even in dubious situations, the more they will have an incentive to take on excessive risks, of course. Raghuram Rajan[5] and Jean Tirole[6], amongst others, have convincingly argued that the implicit promise of a central bank to step in by lowering interest rates and injecting liquidity when banks default whets banks' appetite for risk.

This also shows that selecting an appropriate strategy for liquidity provision is something of a balancing act. Being too restrictive in granting liquidity can cause a spark to turn into a fire. Granting liquidity too liberally, on the other hand, and propping up institutions without sustainable business models, may also mean that the water used to extinguish the fire ends up causing more damage than the fire itself. This is all the more relevant as it is hard to determine ex ante whether an institution is illiquid or insolvent.

By the same token, another unconventional policy comes with risks attached, too. I am talking about the large-scale purchases of sovereign debt which have been deployed by many central banks in response to the crisis.

By buying up large quantities of sovereign bonds, central banks are able to push down long-term interest rates. This provides additional monetary policy stimulus, but at the cost of potentially becoming a sovereign's largest creditor. In a currency union like the European one, with a single monetary policy but national economic and fiscal policies, sovereign bond purchases blur those all-important boundaries between monetary and fiscal policy.

At the end of the day, this can lead to political pressure being exerted on the Eurosystem to maintain the very accommodative monetary policy for longer than appropriate from a price stability standpoint. After all, in the context of these asset purchases, changes in monetary policy impact more directly on governments' funding costs than interest rate moves. And they are naturally also more problematic in view of the disciplining effect of the capital markets on government finances. This is a risk for the euro area in particular, as risk differentiation between the different countries is significantly reduced.

3. The hot potato of policy intervention

Still, the risk-reward profile of sovereign bond purchases certainly differs depending on the institutional set-up of the policy area in question. A central bank buying up federal bonds to drive down the long-term risk-free interest rate with a view to speeding up inflation is a different kettle of fish from one acting as a lender of last resort to governments. And this brings me to the issue

debated in today's second panel: "Who is willing to act? Passing on the hot potato of policy intervention."

Economists like Paul de Grauwe[7] argue that monetary policymakers should channel their inner Bagehot when it comes to sovereign debt.

In his view, a sovereign that is actually solvent but suddenly falls prey to the sceptical gaze of the market can be driven into insolvency by the rising interest burden. Downgraded market perceptions can amount to a self-fulfilling prophecy, a phenomenon which economists refer to as markets with multiple equilibria.

In such cases a central bank should come to a country's aid, according to de Grauwe. Just as acting as the lender of last resort to banks serves to safeguard financial stability, so, too, could central bank intervention in the government bond market fulfil the same purpose.

But for me, this stretches the analogy too far. Lending to governments is different in that it is not collateralised. Walter Bagehot advised central banks to lend to banks only against adequate collateral, such that moral hazard is minimised. Buying up sovereign bonds amounts to lending to governments without mitigating the risks of moral hazard that come with it.

A second difficulty stems from the fact that it is exceedingly difficult to determine the fundamentally justified price for sovereign debt – in other words, it is all but impossible to judge whether the market reaction is justified or overblown. In determining the price by themselves, central banks are setting themselves up for pressure from governments who tend to think that they deserve better rates.

It follows that the notion of central banks acting as a lender of last resort to governments is less in keeping with the Bagehot tradition than is sometimes assumed.

And it runs into arguably far greater problems with moral hazard, especially in a monetary union with fiscally sovereign member states, as I mentioned before.

Incentives to reform public finances and the real economy are stunted. If action is taken at the national level but accountability is located at the European level, chances are that euro area growth will atrophy rather than accelerate.

Research also suggests that providing a central bank backstop for government finances can have detrimental effects on capital allocation by the financial sector. A recent study by Viral Acharya[8] and others looks at the real effects of the announcement of the OMT programme and finds that while it stabilised the banking system, it also increased zombie lending by banks to unproductive firms. Creditworthy firms in industries with a prevalence of zombie firms suffered significantly from credit misallocation, which slowed down the economic recovery.

Who, then, should take on the hot potato of policy intervention to avoid the pitfalls of last resort lending when a country runs into financing troubles? It might help to look at what can be done to mitigate the ill-effects of central bank lending to banks. The answer here is an effective bank recovery and resolution regime. If banks turn out to be not temporarily illiquid but truly insolvent, they will need to be restructured or resolved. As the late Allan Meltzer once quipped: "Capitalism without failure is like religion without sin. It doesn't work." This holds for banks and for companies in general. In the euro area, progress has been made in terms of requiring banks to hold higher capital buffers as well as establishing the Single Resolution Mechanism.

But similar progress is lacking when it comes to the possibility of restructuring sovereign debt. The ESM could function as a vehicle for such a regime. But crucial elements are still missing.

One such element is changing the contractual terms of government bonds in the euro area by

introducing an automatic maturity extension for all bonds, which would be activated the moment a government applies for an ESM programme. Ongoing deficits would therefore be financed, but original creditors would not be paid off for maturing bonds.

Not only would this continue to provide incentives for private creditors to lend cautiously, it would also significantly reduce the need for financial aid under an ESM programme. Furthermore, it would vastly broaden the scope of the rescue mechanism. Had it been possible to automatically extend the maturity of bonds back in 2011, Portugal would only have needed around €43 billion to cover its entire budget deficit until 2014, rather than the €76 billion in total that it received in assistance loans.

This solution would allow the ESM to work as a restructuring regime. Automatic maturity extension buys time to figure out whether a country is merely facing a liquidity shortfall or is, in fact, insolvent. Bonds bought by private creditors can still be restructured at a later date, while official support can be used to smooth the economic adjustment process.

Of course, the financial system must also be able to withstand a debt restructuring. Otherwise, precious little would have been gained. Because privileged regulatory treatment allows banks to buy almost unlimited amounts of government bonds, which they are not required to back with capital, a haircut is particularly risky for banks. That has got to change.

Not until banks have begun to hold sufficient capital against government bonds and the size of individual exposures has been limited, will banks be able to effectively cope with the process of restructuring sovereign debt. And only then is there likely to be any concrete political will to take such action. Government bonds are far from being risk-free. Banking regulation should acknowledge this fact once and for all.

Capping the size of individual sovereign exposures in bank balance sheets would provide much of the diversification benefits that are envisaged by the European Safe Bond proposal the European Commission has recently taken up. That proposal conceives a diversified security where member state sovereign debt is pooled and divided into a safe tranche and a junior tranche, thereby providing for risk-free assets.

But a European Safe Bond created by an official European entity could be perceived as a stepping stone towards full-blown Eurobonds, i.e. mutual liability.

To avoid that perception, European Safe Bonds would have to be constructed by market participants.

It would be easier still to split new sovereign bonds into senior and junior bonds at the time of issuance, sensibly adding a maturity extension feature for the junior bond. Combined with effective regulation of sovereign bonds, this solution would offer the same advantages of diversification and safe-asset generation while being arguably much more feasible politically.

These are steps that would allow the potato to be taken when it's hot. But, of course, it would be better still to not let matters come to the boil in the first place. And this means strengthening sustainable growth.

I'm convinced that we all share the view that it's not central banks which can put the economy on a higher growth path. It's up to governments to unlock economic growth. What's needed are reforms fostering competition and innovation to make investment more profitable. With regard to Europe, the finalisation of a common services market and a single digital market are promising initiatives. Studies suggest that this could yield double the growth effects unleashed by the creation of the common market for goods.[9] [10]

By the same token, unleashing the forces of the market would not only serve growth. More

geographically diversified investment would strengthen risk sharing as well, as profits and losses are shared more across borders. The euro area has some catching up to do when it comes to private risk sharing, and this is why we need to press ahead with the capital markets union.

Lowering the barriers that prevent enterprises from exiting the market will likewise foster growth. It would facilitate what Joseph Schumpeter called "creative destruction". OECD research suggests that policy-induced exit barriers matter for productivity growth, because fewer exits lead to less scope for productivity spillovers and to the misallocation of labour, capital and skills. It concludes, for instance, that insolvency regimes should be streamlined.[11] This is also important when it comes to financial market integration and private risk sharing.

And investing more in skills and education promises to deliver rich rewards, too. This would not only boost labour productivity, but also make workers less at risk of losing their jobs. And this in turn would be the most effective antidote to the widespread sense of being fundamentally threatened by globalisation and technological progress.

Fortunately, many of the measures that foster growth also make the economy more resilient. And more resilience is needed, because long recessions can reduce potential growth.[12] But more can be done to bolster resilience, for instance, by shoring up the shock-absorbing capacity of public finances. With regard to the euro area, this implies stronger fiscal discipline and compliance with the fiscal rules of the Stability and Growth Pact.

4. How do new technologies shape the future of central banking?

Ladies and gentlemen, getting the issue of policy intervention right still seems to be a formidable task. But while no effort should be spared in addressing this topic, central banks need to be aware that, more often than not, change is not the result of crisis, but of technology.

Every technology comes with technical risks – the recent WannaCry cyber attacks are a case in point. But the main challenge for central banks will probably lie with the tectonic shifts triggered by digitalisation. Digitalisation will spawn new forms of financial intermediation. While this might be a boon to the economy, central banks will be faced with questions regarding the transmission of their monetary policy.

Some even suggest that privately issued digital currencies might do away with our currencies altogether. However, closer economic analysis indicates that this scenario is likely to be overblown. As a medium of exchange and unit of account, money is subject to substantial network externalities that alternative currencies seem unlikely to overcome. I am also pretty confident that central banks are better able to deliver price stability than a rigid monetary rule or an algorithm.

But even if private digital currencies do remain a fringe phenomenon, central banks are urged by some to consider embracing the new era by issuing their own digital currencies. This would mean that non-financial corporations and even households would have access to the central bank balance sheet in the form of digital balances which – unlike cash – have no noteworthy storage costs.

What might appear intriguing from a technological point of view raises fundamental questions about the nature of the financial system and our economy at large.

Allowing the public to hold claims on the central bank might make their liquid assets safer, because a central bank cannot become insolvent. This is an feature which will become relevant especially in times of crisis – when there will be a strong incentive for money holders to switch bank deposits into the official digital currency simply at the push of a button. But what might be a

boon for savers in search of safety might be a bane for banks, as this makes a bank run potentially even easier.

But in taking deposits away from banks, it also removes their ability to engage in maturity and liquidity transformation and make loans.

A new technology therefore reopens an old debate in economics: does maturity transformation enhance welfare, or should banks be prevented from creating liquidity?

My personal take on this is that central banks should strive to make existing payment systems more efficient and still faster than they already are – instant payment is the buzzword here. I am pretty confident that this will reduce most citizens' interest in digital currencies.

5. Conclusion

At this point I would like to conclude. (Modern) central banking itself is the consequence of economic crises, but it is certainly not the answer to end all questions. And for the host of an economic conference like this, that is not necessarily a bad thing!

On that note, I am now looking forward to the answers our esteemed participants come up with!

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