Jens Weidmann:: From extraordinary to normal - reflections on the future monetary policy toolkit

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the European Banking Congress, Frankfurt am Main, 16 November 2018.

* * *

1 Introduction

Dear Mr Sewing,

Ladies and gentlemen,

It is always a pleasure to be here at the European Banking Congress; thank you for having me back.

In October 1929, the great US economist Irving Fisher declared that stock prices had reached what looked like a permanently high plateau. Just days later, the stock market crashed.[1]

This vividly underlines that the present can be a poor guide to the future. When thinking about an economic “new normal”, we should always be mindful of possible pitfalls like this one.

The lead question of today’s conference – “Back to normal – what does it mean?” – can be applied to various aspects of monetary policy. In my remarks today, I will focus on the Eurosystem’s future toolkit, the instruments designed to enable us to achieve price stability.

Where do we come from? Where are we going?

Dan Brown has written a suspense-packed novel of 500 pages around these questions. Within the operational framework of monetary policy, I will stay on this thread for the next quarter of an hour.

In Brown’s novel “Origin”, the character who set out to answer these questions in a presentation was assassinated right after the salutation. Thankfully, I seem to have already cleared that particular hurdle.

2 Where do we come from?

Prior to the financial crisis, the Eurosystem’s framework was based on refinancing operations with competitive bidding procedures and limited allotment volumes, a wide and symmetric standing facilities corridor around the main policy rate and a relatively small balance sheet.[2]

Then the financial crisis occurred, and in its wake a sovereign debt crisis ensued, followed by a period of subdued inflation.

The monetary policy response to these challenges was unprecedented. It entailed not only a series of interest rate cuts, which eventually moved the deposit rate into negative territory, but also the introduction of a broad range of non-standard measures. The Eurosystem switched into crisis mode.[3]

The most recent and most significant of these measures is certainly the so-called Asset Purchase Programme (APP). In the opinion of the Governing Council, the APP was warranted by the risks implied by an overly prolonged period of low inflation.

Today, ten years after the financial crisis escalated, policy rates are still at historic lows. The Eurosystem has accumulated a huge portfolio of securities of various kinds, and refinancing operations offered to banks have remained more than generous.

As a result, excess liquidity stands at a level nine times higher than after the Lehman collapse, and monetary policy is roughly as expansionary as it was when the crisis was raging. Put differently, the remaining policy space is rather limited.

3 Where are we going?

Given where we are now, a well-known joke comes to mind: A tourist in a big city asks one of the locals for directions to the train station. The local replies, “Well Sir, if I were you, I wouldn’t start from here”.

But where are we going? Or to be more precise, where should we be going?

To some observers, our destination, the “new normal”, should not look that different from the status quo. Among other things, they argue that non-standard measures such as large-scale asset purchases proved their worth during the crisis. Therefore, they should remain in the monetary policy toolbox and be applied under normal conditions as well.

3.1 Guiding principles

Ladies and gentlemen,

The Scottish philosopher David Hume postulated that we cannot derive the “ought” from the “is”, the so-called Hume’s law. Admittedly, we all know that “the normative force of the factual” can be strong. But this force arises from a general acceptance of the current state.

Instead of pre-determining details of the new normal or ruling out potentially relevant alternatives based on the status quo, we need to resort to guiding principles which are well-established and generally agreed upon.

Admittedly, acting in accordance with a principle should not be viewed as an end in itself. But at a time when many European citizens seem to be falling prey to scepticism about the historical project of European integration, I would like to highlight the positive and optimistic guidance that is laid out in the European Treaties.

The European Union aims at promoting the well-being of its citizens, ensuring economic and social progress, and improving the living and working conditions of our peoples. To achieve these broader aims, the Treaties provide guidance for policymakers by setting objectives and principles such as price stability, sound public finances, and market orientation.

In particular, the Treaties set two essential cornerstones for the design of the monetary policy framework.

The first cornerstone is the mandate. The primary objective of the Eurosystem is to maintain price stability. This establishes the criterion of effectiveness, as it implies that the monetary policy toolkit has to be designed in a way that allows the Eurosystem to achieve its goal.

Aiming at other objectives would risk blurring responsibilities and overburdening monetary policy. Moreover, central banks have been granted independence only with a view to achieving price stability. Thus, independence also calls for a narrow interpretation of the mandate. Otherwise, this would undermine the principle of democracy and, ultimately, call independence into question.

In addition, the Treaties set a second cornerstone for the Eurosystem: It has to act in line with the principle of an open market economy with free competition. The Treaties even provide a reason why – because respecting market principles favours an efficient allocation of resources, helping to promote prosperity and achieve the broader aims of the European Union.

When it comes to evaluating the appropriateness of monetary policy measures, this means that effectiveness is the primary criterion. But the set of monetary policy instruments we use has to leave enough room for private sector market activities.

I would formulate that in the following rule: The balance sheet should be as large as necessary to give monetary policy sufficient power to ensure price stability and as lean as possible so that, in pursuit of its goal, it does not overly impede market activity.

From my point of view, therefore, the pre-crisis framework represents a normative orientation in the normalisation process. Under normal monetary policy conditions, it struck a sound balance between the effectiveness of instruments and the efficiency of markets.

3.2 Changing environment

Of course, the immediate question then is: Can we expect to return to the pre-crisis environment – or have the events of the past few years changed the environment fundamentally?

Some are concerned that monetary policy may not be sufficiently effective if the Eurosystem reverts towards the pre-crisis approach of a lean central bank balance sheet and steering only short-term rates. Such concerns are primarily based on the assumption that structural changes and frictions in financial markets call for a broader toolkit in order to maintain monetary policy effectiveness.[4]

In particular, it is argued that the so-called natural real rate of interest has fallen significantly over the past decade. If this were true, it would imply a higher probability of hitting the lower bound of short-term interest rates. The room for manoeuvre for conventional monetary policy would thus be narrowed. In addition, fragmented interbank markets could hamper the pass-through from conventional policy rates to longer-term interest rates.

Another argument points to non-banks playing a more important role in the transmission of monetary policy and highlights the divergence of short-term rates for banks and non-banks. And, finally, the demand for safe assets is said to have risen markedly.

Ladies and gentlemen,

I do not rule out the possibility that structural shifts and frictions in financial markets and the broader economy may require some tinkering with the operational framework. But it is too early to draw such conclusions now at the beginning of the normalisation process.

It is quite obvious that the non-standard monetary policy measures themselves have created – or at least added to – the perceived challenges I have just highlighted. Let me give you three examples.

With the APP, the Eurosystem itself reduced the amount of safe assets in the hands of the non-bank private sector. Secondly, by creating large quantities of excess liquidity, the Eurosystem has contributed to persistently weak interbank market activity. And, thirdly, the ultra-expansionary monetary policy compressed long-term interest rates for a prolonged period of time, which may also feed into natural rate estimates. Apart from that, a Bundesbank analysis has stressed – and other studies have come to the same finding – that those natural rate estimates are highly uncertain.[5]

For a figurative comparison, let’s look at hospitals. Critically ill patients often receive mechanical ventilation. After some time, this can weaken their respiratory muscles. In order to prevent this, best practice suggests not prolonging support unnecessarily, as it involves increasing risks for the patient and a reduced quality of life. Instead, physicians apply a gradual liberalisation from mechanical ventilation, the so-called “weaning”.[6]

Admittedly, medical reality is much more complex than economists and bank managers may think. Hence, my wife – a practising physician – has advised me to refrain from medical analogies because we are prone to misinterpreting them.

Thus, I risk trouble at home – kind of disregarding her advice –, but I think you get the point.

3.3 Reconciling effectiveness and efficiency

It goes without saying that monetary policy implementation should not ignore relevant changes in its environment but may have to adapt to new economic and financial market conditions, digitalisation, or changes in the regulatory framework.

However, I am not convinced that monetary policy should routinely respond to changes in the environment by intervening in a growing number of market segments.

If and how monetary policy should adapt its toolbox can only be assessed after we have progressed on the path of normalisation. And even if a problem should persist, it would have to be demonstrated that central bank intervention was superior to other solutions. Finally, any intervention must be covered by our mandate.

For example, I would not consider the provision of safe assets a task for monetary policy. I would like to suggest that it is up to governments to make sovereign bonds safe assets again, especially by reducing the heavy burden of public debt in the euro area.

In a monetary union with independent national fiscal policies, a clear separation between monetary and fiscal policy is particularly important. As I have stressed many times before, sovereign bond purchases blur the line between the two policy areas. Their risks and side effects need to be taken into account when considering whether to add them to the regular toolkit.

In my view, sovereign bond purchases are – if rightly designed – a legitimate instrument, but in the specific context of the euro area an instrument which should only be used in exceptional cases to fend off a deflationary spiral.

A lean balance sheet in normal times would also help the Eurosystem to retain or regain sufficient policy space for cases of future need, i.e. future emergencies.

4 Conclusion

Ladies and gentlemen,

“It’s hard to make predictions, especially about the future.” – This is a truism that is so full of common sense that it has been attributed to personalities as diverse as Niels Bohr, Mark Twain, and the legendary US baseball player Yogi Berra.

Economic cycles progress, trends can shift, and markets evolve. We cannot know what lies in store for monetary policy once non-standard measures have been cut back.

However, our monetary union should rest on sound principles that will guide us on our way forward.

For me, a monetary policy framework that achieves effectiveness in reaching our primary mandate and that, at the same time, leaves enough room for market activities is the most desirable. Until it is proven that a return to the pre-crisis framework constrains effectiveness of monetary policy in a non-trivial way, I see no reason to depart from the pre-crisis framework.

Thank for your attention.

---

1 See, for example, R. W. Dimand (2007), Irving Fisher and Financial Economics: The Equity Premium Puzzle, the Predictability of Stock Prices, and Intertemporal Allocation Under Risk, Journal of the History of Economic Thought, 29, pp. 153–166.

2 The framework was mainly in accordance with the international consensus among central banks on monetary policy implementation. See U. Bindseil, Evaluating Monetary Policy Operational Frameworks, Jackson Hole Symposium, 2016.

3 Deutsche Bundesbank, Implications of the Eurosystem's monetary operations during the financial crisis, Monthly Report, April 2014, pp. 37–59.

4 For an overview of the various arguments, see B. Bernanke, "Should the Fed keep its balance sheet large?", Bernanke's Blog at Brookings, 2 September 2016; M. T. Kiley and J. M. Roberts, Monetary policy in a low interest rate world, Brookings Papers on Economic Activity, 48(1), 2017, pp. 317–396; D. Quint and P. Rabanal, Should conventional monetary policies become conventional?, Deutsche Bundesbank Discussion Paper No 28/2017.

5 C. Borio, P. Disyatat, M. Juselius and P. Rungcharoenkitkul (2017), Why so low for so long? A long-term view of real interest rates, BIS Working Papers, No 685; Deutsche Bundesbank, The natural rate of interest, Monthly Report, October 2017, pp. 27–42.

6 P. A. F. Magalhaes, C. A. Camillo, D. Langer, L. B. Andrade, M. do Carmo M. B. Duarte and R. Gosselink (2018), Weaning failure and respiratory muscle function: What has been done and what can be improved?, Respiratory Medicine, 134, pp. 54–61.