Jens Weidmann: The role of the central bank in a modern economy - a European perspective

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 University of South Africa (UNISA), Pretoria, 12 February 2019.

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1 Introduction

Professor Makhanya,

Professor Mogale,

Governor Kganyago,

Ambassador Schäfer,

Ladies and gentlemen,

Thank you very much for the kind introduction and your warm welcome. I am very happy to be here in South Africa. I am also glad to say that the Bundesbank and the South African Reserve Bank have developed a good cooperation and close working relationship over the past years.

It is my privilege today to give a speech at Africa's largest open distance learning institution, and the continent's university with the most enrolled students. I am pleased that some of these 400.000 students are with us today. I feel very fortunate to have this opportunity to gain a glimpse of your ideas and passion for your country.

About a year ago, I was intrigued by the superhero movie "Black Panther" – maybe some of you have seen and enjoyed it as well. The film plays in Wakanda, an extraordinary fictional country in Africa. Hidden from the rest of the world, the people of Wakanda live in peace and prosperity, having preserved their traditions while developing highly advanced technology (by means of an imaginary resource called "vibranium", and through good governance). This Hollywood fiction – despite all its exaggerations – offers a bright and captivating image of Africa that opens our eyes for future possibilities. Your country has enormous economic potential, and it was probably not by accident that, in the movie, the people of Wakanda speak isiXhosa, one of South Africa's official languages. Wakanda is also known for the "heart-shaped herb", a plant that gives the Black Panther his superpowers. And this, actually, brings me to the topic of my speech.

In recent years, superpowers were often attributed to central banks as they struggled with the fallout from the financial crisis. While other institutions were perceived as being incapable of action, independent central banks had to step in and save the day. A successful crisis response raised expectations, and with them came disappointment and discomfort.[1]

As a result, many people in advanced economies have come to question the role of an independent central bank in a modern economy. This role is the key issue I want to address today. And since I am a European central banker, I will discuss it from that particular perspective.

2 What monetary policy can do and what it cannot do

2.1 Lessons from history

Ladies and gentlemen,

In the 16th century, when conquerors robbed the gold and silver treasures of the Americas and brought them to Europe, they also paved the way for inflation. Early economists (such as Jean Bodin and David Hume) learned that the supply of money has an impact on the price level. As long as an economy operates below capacity limits, a larger money supply can result in a higher output of goods and services. But once full employment is reached, more money will ultimately lead to higher prices.

With the adoption of fiat currency, it was possible simply to print legal tender. This posed a permanent temptation to governments, as they could use the printing press to finance their spending. Giving in to this temptation led to some of the most terrible episodes of hyperinflation, such as in Venezuela today, in Zimbabwe a decade ago, but also in Germany in the distant past.

In my country, the enormous government spending during the Great War and in the following years eventually brought about hyperinflation. Inflation peaked in 1923, when prices doubled in less than 4 days.[2] Such astronomically high price increases deeply interfered with people's everyday lives. This was expressed in John Maynard Keynes' quip that people got used to ordering two beers at a time, because the price would rise faster than the beer became warm.[3]

Extreme cases illustrate one aspect of the costs of inflation. Indeed, many people lost their financial wealth in these times. On the other hand, the burden of debtors – the government, in particular – was easily wiped out. It is the weakest groups of society who typically suffer most from inflation. Wage earners and transfer recipients like pensioners have only limited possibilities to hedge against it. Governor Kganyago explained it in a recent speech when he said: "Where monetary policy tolerates higher inflation, this tends to reduce spending power, especially for the poor."[4] Distributional shifts and the overall economic damage of elevated inflation often create social unrest and political instability.

However, history has taught us that deflation, a general, sustained and self-reinforcing decline in the price level, can also be devastating for the economy, as the Great Depression demonstrated in the 1930s. Price stability is a socially desirable goal.

A few decades later, economists perceived a seemingly stable trade-off between inflation and unemployment: the Phillips curve. It was thought that unemployment could be lowered by accepting higher inflation. Thus, policymakers were under the impression that they could simply choose a combination of inflation and unemployment that fitted social preferences – or rather their preferences. Former German Chancellor Helmut Schmidt once famously claimed that the German people would rather accept 5% inflation than 5% unemployment. But in the 1970s, the previously downward-sloping Phillips curve turned vertical. Efforts to reduce unemployment simply raised inflation and contributed to stagflation, the combination of stagnation and inflation. What had happened?

2.2 The problem of time-inconsistency

Central to monetary policy is a problem that permeates many areas of economic policymaking: time-inconsistency. Princeton professor and former Fed Vice-Chairman Alan Blinder once illustrated this problem with an example that fits very well with today's venue.[5]

Let's assume that a university professor has two goals. On the one hand, he wants his students to learn as much as possible. On the other hand, he wants to spend as little time as possible marking exams. The professor announces an exam to be held at the end of the semester and hopes this will induce his students to learn.

Given his students have indeed studied, the best decision for the professor would be to cancel the exam to save himself the hassle of grading the exam papers. Thus, his optimal discretionary behaviour is time-inconsistent. But if the students see through the professor's incentive, they might not study hard, and all of them end up worse off. What's the way out of this dilemma? University examination rules which make end-of-semester tests compulsory instead of leaving them to the discretion of the professor.

In a seminal paper, the economists Finn Kydland and Edward Prescott once explained why time-inconsistency gives rise to an inflation bias.[6] A surprising increase in inflation causes real wages to fall, firms to hire and the economy to expand. Using monetary policy to create surprise inflation can thus be tempting politically. However, like the students who see through the professor's incentive, economic agents understand the incentives of the monetary authority. If they anticipate a monetary policy stimulus, inflation will rise, but real wages will remain constant. In the expectation of inflation, trade unions will already have negotiated a wage increase. The result will be a world with higher inflation, high unemployment and low growth, just like the 1970s in advanced economies.

What's the way out of it? The solution to overcome the political incentive to create surprise inflation is similar to the case of the professor: a credible and firm commitment. An independent central bank tasked with ensuring price stability is a precondition.

2.3 Monetary policy consensus

Today, there is consensus in economic thinking around the world that price stability is the best contribution a central bank can make to enhance social welfare and to support sustainable growth.[7] Most economists agree that, in general, monetary policy is neutral in the long run. It can mitigate the cyclical fluctuations of growth and unemployment, but it cannot steer an economy onto a permanently higher growth path, nor can it permanently reduce joblessness to below the natural rate of unemployment. Structural unemployment, for example, can only be addressed by economic policy measures.

Hyperinflation episodes were one of the reasons why central banks should be prevented from printing money in order to finance public expenditures. Monetary policy and fiscal policy need to be separated.

In pursuing price stability, there is also consensus among economists that central banks should aim for low but non-negative inflation rates to have a safety margin against deflation. Advanced economies typically strive for inflation rates of around 2%,[8] while emerging market and developing economies usually aim for somewhat higher inflation in order to allow for economic catching-up.

Nevertheless, even if a central bank has the mandate to deliver price stability, there is a strong temptation to exploit monetary policy instruments for other objectives, even though the benefit is only short-term. And that makes independence and a time-consistent commitment so important.

Both economic theory and history have shown that independent central banks are better equipped to keep inflation in check than central banks that are less shielded from the influences of a political cycle focused on the short term.[9]

The Bundesbank has been among the most independent central banks from its inception. Over decades, Germany enjoyed low inflation rates. Even during the inflation-ridden 1970s, Germany kept inflation rates at comparatively modest levels. While the average German inflation rate of 5% was quite high, other industrialised countries with the exception of Switzerland, which also used to have a very independent central bank, had to cope with significantly higher inflation rates. The United States had an average inflation rate of 8%, France 10%, Italy and the United Kingdom 14%.

During the 1980s and 1990s, many central banks were granted independence. The European Central Bank, which was established during that era, has been independent from the outset.

3 The euro at 20

Ladies and gentlemen,

On 1 January, the single European currency – the euro – turned 20. Against the yardstick of the ECB Governing Council's definition of price stability of "below but close to 2%", the euro has been a success. The average euro area inflation rate over the first 20 years was 1.7% per year. The promise of stability was kept. Compared with the average loss of purchasing power of its legacy currencies like the Deutsche Mark or the French franc, the euro is even more of a stable currency.

Key to this success, in my view, has been the monetary framework of our currency union. It rests on two cornerstones – the mandate and the independence of the Eurosystem, which is made up of the European Central Bank and the national central banks of those EU countries that adopted the euro as their currency.

Both the mandate and independence are stipulated in the EU Treaties. This protects the two cornerstones from legal changes, because any changes to the Treaties would require unanimity among all EU member states. The primary objective of the Eurosystem is to maintain price stability. Without prejudice to this goal, the Eurosystem shall support the general economic policies in Europe. So there is a clear hierarchy of objectives.

The independence of the ECB and national central banks is also enshrined in the Treaties which, in addition, prohibit the monetary financing of governments.

This strong monetary framework has been the sound foundation of monetary stability. Nevertheless, the euro area experienced a significant economic and fiscal crisis over the past decade.

Figuratively speaking, you could say that the euro had an easy childhood but difficult teenage years. Or, as Martin Wolf recently wrote in his FT column: "Like many people of 20, the European currency has experienced a traumatic adolescence."[10]

The underlying causes of the sovereign debt crisis were considerable macroeconomic imbalances in euro area member states: too much borrowing, too much unproductive spending, the loss of price competitiveness, a lack of structural reform.

However, the crisis was also borne out of institutional weaknesses. You could say that the monetary union has a strong leg and a weak leg. The strong leg from the outset has been the monetary framework which I have already elaborated. The weak leg is the fiscal and economic policy framework, the lack of a genuine economic union.

This framework, which was set up in the 1990s, was neither able to prevent the adverse economic developments in member states nor was it ready to resolve a crisis. When the crisis occurred, fiscal emergency measures were taken to prevent it from escalating. And the Eurosystem was forced to act as a "crisis response unit". Understandably enough, this helped to stabilise the situation.

The flipside was that some of the measures – in particular, the sovereign bond purchases – took the Eurosystem to the outer limits of its mandate.

While I am convinced that – properly designed – government bond purchases are a legitimate monetary policy instrument, I have always emphasised the specific problems that they entail in the euro area, with its peculiarity of a single monetary policy and national fiscal policies.

In this particular set-up, government bond purchases involve the fundamental risk of mutualising sovereign liability risks through the central banks' balance sheets, blurring the lines between fiscal and monetary policy in the euro area. On that note, it is good that we have cut back risk sharing to only a small degree in the latest purchase programme. The central banks of the Eurosystem have nevertheless become the most important creditors to their governments. This might ultimately call our independence into question.

Regarding the resolution of the crisis and its underlying causes, a lot has happened in the euro area in recent years. The countries that were hit the hardest tackled important problems at the root and have since regained competitiveness.

Much has changed for the better in institutional terms as well, albeit not enough so far. One important development is the establishment of a permanent euro rescue facility that can grant conditional financial aid to member states in the event of a crisis. Another essential achievement is the creation of a European banking supervision, which is a great leap forward on the path to a more integrated Europe.

Together with stricter financial regulation, economic adjustment and reforms have without doubt made the euro area more stable. If there were new upheavals in the financial system or in individual member states, we would be considerably better equipped to deal with them today than we were in 2010.

Yet we have not yet done enough to crisis-proof the euro area once and for all. Certain issues like the lack of credibility of fiscal rules or the harmful sovereign-bank nexus still have to be adequately addressed. The unfinished business of euro area reform entails risks for the Eurosystem. It could be forced to act repeatedly as a "crisis response unit". At the end of the day, it could become more and more difficult for the European Central Bank to focus on its promise of a stable currency.

4 Central bank independence in a democracy

Ladies and gentlemen,

From the vantage point of politics, the central bank as "crisis response unit" has clear advantages. First, central banks allegedly have powerful tools and deep pockets. And second, central banks decide independently and can act quickly, which saves governments from organising parliamentary majorities for unpopular decisions.

However, if unelected technocrats like independent central bankers take such important decisions, the question can be raised of how to square this with democratic principles. And indeed, if certain conditions were not met, independence would become hard to justify, in my view.

One condition is that central bankers explain their policies to the public. As Alan Blinder, whom I just mentioned, put it: "(…) public accountability is a moral corollary of central bank independence. In a democratic society, the central bank's freedom to act implies an obligation to explain itself to the public. Thus independence and accountability are symbiotic, not conflicting."[11]

A second condition that needs to be met in order to make central bank independence compatible with democracy is a narrow interpretation of the mandate. It's true what the NGO "Transparency International" wrote in a report on the ECB: "If independence is one side of the coin, the flipside is a narrow mandate."[12]

And indeed, if independence is used for purposes other than those given by the mandate, we shouldn't be surprised if the central bank is increasingly put under scrutiny. Acting beyond the mandate would also undermine people's trust in the central bank.

Trust is not an item you'll find on a central bank's balance sheet, but ultimately it's a central bank's most valuable asset. Trust helps to anchor longer-term inflation expectations, which in turn can help to lower what economists call the "sacrifice ratio". Increasing trust in central banks reduces the loss in GDP or employment that has to be accepted to reduce inflation by a certain amount.[13]

Trust, by the way, goes beyond reputation. The reputation of a central bank largely hinges on its track record in fulfilling its mandate. However, trust also depends on individual factors. Some people tend to trust more in public institutions than others. People also have different preferences, different attitudes regarding inflation, different personal inflation experiences biasing their future expectations.[14]

Surveys show that knowledge about central bank and monetary policy has a positive impact on trust in the central bank.[15] Effective monetary policy communication relies on people having a basic grasp of concepts such as inflation and interest rates. Ensuring the public has a basic knowledge of these issues is therefore important for the success of central banks.

The Bundesbank has been strongly engaged in the field of economic education for many decades, and we have stepped up our efforts in recent years. Our main aim is to enhance the public's knowledge about the role of central banks, and the Bundesbank in particular. For that purpose, we organise seminars for teachers and lectures for school classes; we publish teaching aids; and we run a money museum as a place to learn about the world of money and central banking.

In a similar vein, increasing financial literacy was also a key topic during the German G20 presidency two years ago, and the declared objective – in times of digital finance – was to make financial services accessible to people who didn't have access before (the buzzword here is "financial inclusion"). In such an environment, financial illiteracy is an important channel through which financial instabilities could potentially arise.[16]

Of course, central banks on their own cannot provide for economic and financial education; we can only contribute. If the general public is the addressee, easily understandable information is crucial – most people are not economists.

There is some evidence that relatively "simple" and unsophisticated entertainment programmes can effectively transport economic and financial education messages. I've heard of a popular soap opera called "Scandal!" on South African television, which embedded a storyline on excessive borrowing some years ago and which is considered to have had a positive impact on the viewers' financial knowledge.[17] And recently, the central bank of Jamaica got a lot of attention for tweeting reggae-inspired music videos with lyrics like: "Low and stable inflation is to the economy what the bassline is to reggae music".

Beyond the benefits of price stability the public also needs to understand the limits of monetary policy. For central banks to deliver price stability on a lasting basis, they are ultimately dependent on sustainable public finances and a stable financial system. Otherwise, even independent monetary policy risks becoming subject to fiscal or financial dominance, respectively.

Fiscal dominance refers to a regime where monetary policy ensures the solvency of the government. As interest rates will rise in the process of normalisation, this danger could come to the fore in Europe in the years ahead.

Financial dominance refers to the risk that monetary policy becomes increasingly concerned with adverse short-term developments in the financial system.

The crisis made it obvious that price stability is not a sufficient condition for financial stability. Thus, many central banks' mandates were extended by at least some aspects of preserving financial stability. However, we know from Tinbergen's rule that every economic policy objective requires its own instrument. So it is important to keep the toolboxes separate when tackling the two objectives. Inflation risks should be addressed with monetary policy instruments, and financial stability risks should primarily be addressed with macro-prudential instruments. That said, monetary policymakers are well-advised to take the implications of financial imbalances into account, since they can pose serious risks to price stability in the long run.[18]

5 Conclusion

Ladies and gentlemen,

Nelson Mandela wrote in his autobiography "Long Walk to Freedom": "I have discovered the secret that after climbing a great hill, one only finds that there are many more hills to climb."

Central banks all over the world were forced to climb great hills over the last decade. And there are more hills on the horizon. But central banks should beware of overburdening.[19] We are not superheroes. Indeed, our powers are limited. Neither can we compensate the adverse effects of demographic changes nor can we hasten the invention and adaption of new technologies. We cannot lift long-term growth. And we cannot erase inequality.

Wim Duisenberg, the first President of the ECB, once said: "Don't ask for monetary policy to perform tricks it cannot deliver." Too much power undermines support for central bank independence.

Even fictional superheroes have drawn criticism when their feats involved considerable side-effects. In the movie "Captain America: Civil War", the first film featuring the Black Panther, the United Nations created the Sokovia Accords in order to regulate the activities of the Avengers.

In order to defend their independence, central banks should interpret their mandates narrowly and seek the support of the broad public. People's trust gives us scope to take decisions that are not always popular in the short run.

Two years ago, Janet Yellen, the former Chair of the Fed, told a congressional hearing something very important. She said: "Sometimes central banks need to do things that are not immediately popular for the health of the economy."[20] Indeed, it's not our job to be everybody's darling. This gives us all the more reason to continuously explain to the people, in a comprehensible way, why our work is nevertheless beneficial for society.

The case for connecting applies even more strongly to our economies and nations in general – and that's what brings me here in the first place. The message is eloquently conveyed by the Black Panther himself. At the end of the movie, when King T'Challa opens up Wakanda to the rest of the world, he says: "(…) more connects us than separates us. But in times of crisis, the wise build bridges, while the foolish build barriers. We must find a way to look after one another as if we were one single tribe."

I think in times of rising protectionism and unilateralism, we should take these words to heart.

Thank you very much for your attention. I now look forward to answering your questions.

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