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Concluding Remarks

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1 Introduction

In delivering the concluding remarks after two days of in-depth and productive discussions my working assumption is that you all expect me to interpret the Roman philosopher and dramatist Seneca correctly who believed that *It is a great thing to know the season for speech and the season for silence.*

And as it is one of our most important tasks as central bankers to take due account of public expectations as an input for our decisions I shall adhere to this principle and be as brief as possible. But I think that, looking back over the past two days, listening to all your contributions has clearly been worthwhile.

One of the issues we touched upon was “What kind of research should central banks conduct?”. Here, opinions might differ. There is no doubt, however, that for a decentralised system like the Eurosystem, pooling research efforts and organising conferences like this one with our colleagues from Finland is a course that we should follow and will be following more closely in the future. Therefore, I want to thank the organisers at both the Bundesbank and Suomen Pankki for matching such an impressive number of outstanding researchers with a well-focused and structured programme. Particularly, I would like to thank the organisers Heinz Hermann and David Mayes for their formidable effort and success in putting this event together.

As my final introductory remark, allow me thank our conference staff. As usual, it has mastered the whole range of logistical and operational issues behind the scenes.

2 Current challenges for monetary policy

Forrest Capie started his paper (“Some scattered thoughts from history on evolution and design in central banking”) on the history of central banking by asking whether there is anything left to say. In the past few days, presentations and discussions have clearly shown that there are still important challenges in terms of the nitty-gritty business of central banking. This holds true despite all the documented progress in central banking concerning the trend towards independent central banks, and the widespread consensus on the merits of price stability as a primary objective of monetary policy.

But a historical *tour de table* as provided by Forrest Capie and Alex Cukierman (in his paper “Central bank independence and monetary policy making institutions – past, present and future”) serves an important purpose. It reminds us that, for colleagues who have experienced at least one complete cycle in monetary theory, what some younger colleagues call a current challenge is, in fact, just a forgotten lesson from the past. I therefore certainly agree with him that it is useful for us to be reminded of an old truth.

Forrest Capie identified two core purposes in the history of central banking: price and financial stability. The focus in the nineteenth century was financial stability and in the twentieth century the focus changed to price stability. For most central banks, price stability has become the primary objective. It is well accepted nowadays that inflation is ultimately a monetary phenomenon and that there is no long-run trade-off between output and inflation.

Thus, central bank independence became something of a “great mantra” in the twentieth century. But this seems to be no reason for politicians to call into question the independence of central banks from time to time. Public backing of the central bank’s quest for price stability is indispensable for a sustained culture of low inflation. And, in an era of historically low inflation rates, the damaging effects of inflation might easily be forgotten. One of the current challenges facing central banks is to uphold public acceptance for achieving price stability.

2.1 Price stability as the primary objective

Price stability and output stabilisation

One closely related aspect in this context was pointed out by Alex Cukierman in his comprehensive survey on central bank independence: once the public becomes accustomed to low inflation rates, it is quite conceivable that central banks feel more inclined to concentrate their instruments on other goals, such as stabilising output.

I do not want to dig too deeply into this issue, but just focus on what – in my view – seems to be a fair account of the existing literature. While globalisation has had some impact on inflation in industrialised countries, it is certainly a more stability-oriented monetary policy that deserves the main credit for the decline in inflation rates worldwide over the past 15 years.

Then, however, we should be highly sceptical about interpretations based on reduced form estimates of flatter Phillips curves indicating a possibly more lax attitude towards risks to inflation. Because not reacting in a timely manner in the face of those risks entails the danger that the very reasons for a seemingly more benign inflationary impact of shocks – solidly anchored inflation expectations due to improved monetary policy – are jeopardised. This would entail a loss of credibility.

Given the clear mandate of the Eurosystem, the Governing Council has to take into account the increased inflation risks. At the current juncture, the sharp increase of inflation – due to high oil and food prices, along with some signs of increase in manufactured goods prices and service prices and ongoing strong monetary expansion – is of particular concern to the Governing Council. We will do our utmost and we stand ready to act in a timely manner to make sure that it does not affect inflation expectations. This objective automatically entails that we will not tolerate the emergence of second round effects.

But let me deliver some more insights into the Governing Council's decision making process: Yesterday, we cross-checked the information from our economic and monetary analysis. The sharp rise in inflation has fully confirmed our assessment that the outlook for prices is subject to upside risks. By contrast, the economic fundamentals have remained sound and the medium-term outlook is still favourable, with real GDP in the euro area being expected to grow at around trend potential in 2008, albeit subject to downside risks.

Monetary policymakers have two eyes: one for the baseline scenario and the other for the associated risks and uncertainty. In that respect, ongoing financial market turbulence and a continuing reappraisal of risks increases the uncertainty surrounding our inflationary assessment.

All in all, our analysis has shown that we face upside risks to price stability and downside risks to economic growth and - in my view - that both risks have augmented in comparison to the September staff projections. At the same time, uncertainty is at the current juncture somewhat larger than usual in prognostic terms. As you know, these staff projections are part of our information gathering process. They are set up and made public four times a year, hence the next projection will be available in December.

In a period of rapidly moving markets, our September assumptions are likely to undergo substantial changes. So far, oil prices have continued to hike and reached new record highs. Moreover, the euro has continued to appreciate since September, both vis-à-vis the US-Dollar, but also against a broad number of trading partners. The recent financial market turmoil is likely to decelerate the pace of economic growth in several economies – although the global economy as a whole is still on a growth path. Thus, the driving forces tend to shift from the USA to Asia and Europe (which, by the way, will help to reduce global imbalances).

Given these changes in the euro area's economic environment, chances are that both upside risks to inflation and downside risks to output growth will continue to remain elevated in the next few weeks. Given this outlook, we have reiterated that we will act in a firm and timely manner in order to deliver price stability over the medium term.

At this point, it is of particular relevance that second-round effects are avoided and that long-term inflation expectations remain anchored at levels consistent with price stability.

Appropriate measures of price stability

But back to my original subject: The aspect of volatile energy and food prices has been taken up in this conference from another angle – one that is highly relevant to monetary policy: the question of the appropriate measure of inflation (see: Mark A. Wynne: How should central banks define price stability).

The appropriate treatment of supply shocks by central banks with price stability as their primary goal certainly does not mean that monetary policy should counteract each and every short-term price shock. Owing to the well-known time lags of monetary policy, this would introduce short-term volatility in interest rates and output that might be regarded as unwelcome.

The monetary policy strategy of the Eurosystem takes this aspect into account in that it defines price stability as a medium-term objective. This, in my view, goes a long way towards reaping the postulated benefits of defining price stability by core measures rather than by headline figures, while avoiding some of the pitfalls of targeting core inflation, such as communication and accountability issues or observable trend inflation in excluded components, e.g. oil prices.

Thus, I completely agree with Mark A. Wynne when he states that measures of headline inflation at the consumer level are best for defining price stability. In addition, Mark A. Wynne's paper touches upon a highly relevant issue in the context of asset prices when discussing the treatment of owner-occupied housing.

Here, I have repeatedly argued that the euro area HICP should include owner-occupied housing. But, just as an aside, I would prefer not to discuss this issue in the context of asset prices. Including owner-occupied housing using the net acquisition approach is focused on housing as a consumption good, not as an asset price.

2.2 Monetary policy and financial stability

Central banks as liquidity providers

As Forrest Capie already outlined in his survey paper, financial stability has been a key defining historical feature of central banking. Central banks acted and continue to act as lender of last resort, that is, as the institution which comes to the aid of markets in times of a liquidity shortage. This is still relevant nowadays, as the recent financial market turbulence has shown.

The Eurosystem has been called on as a “liquidity provider of last resort”. And our interventions have had a stabilising effect on euro money markets. Our focus in this respect is not on helping financial markets *per se* or even on bailing-out distressed institutions, but on alleviating tensions in financial markets where malfunctioning would pose a serious macroeconomic risk to achieving our objective of price stability.

Therefore, contrary to comments that are sometimes made to the effect that the central bank can do more, namely reduce interest rates below the level normally deemed appropriate, there are good economic reasons why we make a strict separation between the two aspects of liquidity provision, on the one hand, and signals about our general policy stance, on the other. In short, a central bank’s interest rate policy is the wrong instrument for combating tensions in money markets.

While our liquidity providing operations helped to smooth difficult market conditions, the financial turbulence of the past few months will certainly offer the opportunity for some further debate on the appropriate lessons to be learnt for monetary policy in general.

Monetary policy and asset prices

One aspect that has been debated throughout the past couple of years and also at this conference – a debate which, at a first guess, will intensify – is the question of the proper role of asset prices in the conduct of monetary policy.

Boom-bust cycles in asset prices with ensuing liquidity crises are of special concern for monetary policymakers for (at least) two reasons. First, to the extent that changes in asset prices affect consumption and investment, there might be spill-over effects on inflation. Second, the transmission of monetary policy actions to the economy works largely through the financial system. Undoubtedly, asset price increases unrelated to economic fundamentals have the potential to reduce the overall welfare of an economy and should be avoided wherever possible.

However, there remains the question of how far this is feasible and how it should be achieved. Financial market imbalances are often the result of underlying structural imbalances which should be appropriately addressed through policies other than monetary policy. In particular, regulatory measures represent an obvious candidate for suitable *ex ante* action.

Nonetheless, it has been argued that central banks might prevent asset price bubbles in the first place by responding to asset prices over and above their expected effect on inflation. Yet, such an approach requires that the central bank is able to identify an asset price bubble in real time, which means it has to resolve the “diagnosis problem” and must be able to affect the path of asset prices, which means it has to overcome the “policy problem”. In general, central banks will not be able to recognise bubbles in real time with a sufficient degree of confidence. This applies even more forcefully to the early stages of a bubble, when monetary policy should be most effective.

Nevertheless, there is the proposal that central banks should respond very cautiously to asset prices because there is some probability that a bubble might be at the root of asset prices changes. According to this argument, a central bank that leans against changes in asset prices would buy some insurance in case a bubble is on the way.

However, this argument remains debatable. First, raising interest rates to prevent bubbles does not come without cost. Second, it is far from obvious whether monetary policy is at all effective in dealing with bubbles. Even a comparatively sharp rise in interest rates may be no more than a minor nuisance to investors; on the other hand, such an upsurge in the policy rate may already be a serious burden in other parts of the economy. Moreover, it might entail the risk of not meeting our traditional primary objectives. Making an insurance analogy, the premium may simply be too costly relative to its benefit. In other words, the adoption of other policy measures may be more appropriate in times of potential bubbles.

In summary, in a world in which asset price bubbles are very difficult to identify and in which it may be very costly in terms of inflation and output to lean against asset prices, the central bank should remain focused on price stability.

Of course, this does not mean that central banks are ignorant of what is going on in financial and real estate markets. At the Bundesbank, as at other central banks, we observe a large number of indicators which give us an idea of financial imbalances and also help us to predict macroeconomic conditions. Just to remind you, in the Eurosystem we have a strategy that deliberately takes account of credit and monetary factors.

Financial stability, central banks and banking supervision

Let me finally elaborate on some of the policy implications or lessons learnt from the recent financial turmoil. During the past few months, it has

proved useful that central banks play an active part in banking supervision. Access to supervisory information has enabled us to respond quickly and appropriately to the liquidity demands of the banking system. As I pointed out earlier, the lessons learnt for central banks are more on the regulatory side. It is not an issue of reassessing our general monetary strategy.
Some of the most pressing regulatory issues include the role of credit rating agencies, the treatment of off-balance-sheet conduits, and valuation issues of highly complex structured products.

This conference has taken up another hot topic in banking supervision and financial stability, that is appropriate regulation in a world of cross-border banking institutions (see: Mattias Persson: Achieving financial stability in a world of cross-border institutions). He has given us a comprehensive overview of the challenges and open issues in the supervision and crisis management of cross-border banking groups in Europe. I would agree with the bottom line of Mattias Persson's paper: supervisory structures should follow market structures and not *vice versa*.

Acknowledging that cross-border banking structures in Europe will increase in the future, I also see possible future challenges in supervision arrangements. But, at the current juncture, I would argue that the structures currently in place are appropriate to dealing with regulatory issues. And, as these structures are relatively new, they should be allowed to demonstrate their functionality and to evolve over time rather than being subject to a quantum leap to a unified European supervisory agency. This is even more important as many key issues are not yet resolved yet, for example, the harmonisation of deposit insurance schemes or bankruptcy laws.

3 Conclusions

All this makes clear, that important challenges for monetary policy remain and they certainly will influence the future design of central banks. Arguably, the current design of central banks has been influenced by academic research more than that of any other public institution. Thus, conferences like this, in which policy makers and academics come together to exchange views, are of utmost importance. Thus, let me thank once again all participants involved and the organisers.

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