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Lessons for monetary policy from the financial crisis

Keynote Speech

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1 Introduction

Ladies and gentlemen

Due to the worldwide financial crisis a number of conceptual issues have been raised. This also applies to the conduct of monetary policy. I would like to focus on three key aspects of the ongoing debate on what lessons are to be learned from the crisis. The first question is whether central banks should raise their inflation target in order to gain more leeway in times of financial and economic distress. The second question is whether moving to a price-level target would facilitate the conduct of monetary policy. And the third question concerns the role of asset prices and the importance of financial stability for monetary policy in general.

In discussing these issues, however, it is important not to underestimate the dangers to financial stability that still exist. Although it is now in its third year, the financial crisis continues to present us with new challenges, as the focus of markets has shifted in recent months towards concerns about the situation of public finances in a number of countries across the globe.

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Public debt has risen sharply not just in Europe but worldwide. In almost all industrialised countries this has been a consequence of the support measures needed to stabilise not only the financial sector but also the economy as a whole against the backdrop of the sharp economic downturn. Today, there is no alternative to the rapid and credible consolidation of public finances. A lack of confidence would undermine current fiscal stimulation, and correspondingly higher financing costs would make consolidation even more difficult. Furthermore, confidence in the soundness of public finances is a major prerequisite for both the stability of financial markets and the anchoring of moderate inflation expectations. Fiscal policy has to deliver sustainable public debt levels as a key policy priority at the current juncture. Reducing deficits is vital in this context, and a frontloaded credible consolidation strategy is thus of key importance. Given the danger of contagion, safeguarding the stability of the monetary and financial system should be seen as the rationale behind some of the recent liquidity support measures adopted by the Eurosystem. Any such measures have to be implemented in a way that respects the appropriate division of responsibilities between fiscal and monetary policy in the euro area: Providing liquidity and supporting malfunctioning markets essential to ensure a proper conduct of monetary policy is the central bank's contribution to achieving stability. Ensuring sustainable public finances is a fiscal policy issue. For the remainder of my speech, however, I shall be discussing the three issues I have already mentioned concerning the optimal strategy for monetary policy.

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2 Lessons for monetary policy?

2.1 Increasing the inflation target?

Starting with the first question: Should we add a safety margin to the inflation target or the quantitative definition of price stability – as we call it in the Eurosystem? Some prominent economists argue in favour of a somewhat higher figure. For advanced economies with an inflation target of around 2%, the proponents of a higher figure suggest an increase of another 2 percentage points to 4%. The idea behind this is quite straightforward: Increasing the distance from the zero interest rate bound by means of a higher average inflation rate might supposedly create more room for an expansionary monetary policy.

However, enthusiasm for this proposal seems to be fading. One explanation for this might be that recent developments have provided reassurance that the zero interest bound does not constitute a restriction on monetary policy. In our case, the flexibility of monetary policy in Economic and Monetary Union has not been limited during the crisis despite very low interest rates. The success of unconventional monetary policy measures has shown that central banks have more instruments at their disposal than just the short-term interest rate. In the Eurosystem, unconventional measures have allowed us to provide liquidity to market participants and thereby deter deflationary expectations.

Moreover, the costs of higher inflation should in no way be underestimated. Apart from menu costs, these include – as you are all well aware – redistribution effects between, say, borrowers and creditors, as well as the loss of allocative efficiency once the transparency of relative prices has been hampered by the resulting higher volatility of inflation. In addition, most tax systems are far from neutral with respect to the level of inflation.

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The most relevant argument against higher inflation targets is the implicit downside of higher inflation expectations. Such expectations might become instable since the public might expect further increases in the future. In light of the existing concerns that governments will try to inflate away the huge increase in public debt caused by the crisis, the timing of this proposal was particularly unfortunate. Actually, a recent study by Bundesbank staff analyses the incentives that a government has to reduce its real debt burden by increasing inflation temporarily. On the one hand, within their monetary DSGE model, the success of such a policy depends crucially on the maturity structure of public debt. On the other hand, what turns out to be essential is the extent to which monetary policy can use the credibility of its inflation target to exploit expectations of low inflation.[1] Without allowing an un-anchoring of inflation expectations, it is scarcely possible to let actual inflation rise sufficiently.

In this context, we should remind ourselves what efforts it took us to break persistent inflation trends and to anchor long-term inflation expectations at low levels during the past decades. In fact, we do not have to go back as far as the 1970s, the time known as the "Great Inflation", to find inflation rates considerably higher than those today. In the late 1990s, some Latin American countries, among them Brazil, introduced inflation targeting as a monetary strategy and thereby succeeded in driving down inflation rates. Somewhat earlier, EU member states started preparing for Economic and Monetary Union – a project that was crowned by the introduction of the euro as a common currency. In Brazil, as well as in some of the euro area member states, the efforts involved in bringing down inflation are well remembered. In this sense, our two continents share the experience of building up a successful disinflation record. We should not risk this success for the perceived benefits of more flexibility in our monetary policy frameworks.

[1] Krause, M U and S Moyen (2010), Public Debt and Inflation Incentives, Deutsche Bundesbank, mimeo.

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2.2 Price-level targeting

In my view, allowing inflation expectations to rise permanently is not an option. Against this background, let me now turn to the second question: Should central banks switch to a strategy in which inflation expectations are only temporarily raised when needed? In other words, should central banks follow the advice given in the academic literature and think seriously about defining the objective of monetary policy in terms of a target path for the aggregate price level rather than a target for the rate of inflation?

In technical terms, the main difference between the two regimes is that under price-level targeting, the central bank commits itself to correcting deviations of the price level from the target path (over a given horizon), whereas under inflation targeting, the central bank commits to correcting deviations of inflation from target (over a given horizon), but does not respond to one-off shifts in the price level. As a consequence, under inflation targeting, there will be price-level drift – the price level will be non-stationary –, whereas under price-level targeting, the rate of inflation will be stationary, and the price level will be trend stationary.

Hence, price-level targeting would limit uncertainty regarding the future price level and thus facilitate the forecasting of the real value of future payment flows which are fixed in nominal terms (as is the case in the majority of financial contracts). This would be beneficial because it would tend to reduce the risk premiums demanded by risk-averse creditors and thus lower the cost of capital. However, according to conventional wisdom, the potential benefits of the reduction in uncertainty regarding the future price level must be weighed against the potential cost of correcting shock-induced price-level shifts. Bringing the price level back onto the target path may induce additional fluctuations in the inflation rate and real economic activity compared with targeting the inflation rate.

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Whereas this reasoning may persuade us to be sceptical, the recent academic literature has stressed the potential benefits of price-level targeting which arise from the stabilising effect of the price-level target on inflation expectations. In this respect, price-level targeting has gained particular importance in the current period of extremely low policy rates since the stabilising effects of the price-level target on inflation expectations have the added advantage of reducing the probability of hitting the zero interest rate bound.

This argument is based on the following reasoning: A negative aggregate demand shock leads to a drop in the price level to below the target path. If the central bank's commitment to the price-level target is credible, the private sector anticipates that the price level will return to its target. Hence, a drop in the price level will lead to an automatic rise in inflation expectations. This movement of inflation expectations mitigates the effect of the original shock on the inflation rate. Consequently, for a given nominal interest rate, the real interest rate decreases. This stimulates aggregate demand and, in turn, keeps the required nominal interest reduction to a minimum. Hence, a credible price-level targeting regime lowers the risk of hitting the zero bound and falling into a deflationary trap following a negative goods demand shock.

Given these stabilising attributes of price-level targeting, it is hardly surprising that price-level targeting regularly performs well in simulation studies which compare price-level targeting and inflation targeting under the assumption that the central bank is constrained to act under discretion. It may be argued, however, that when considering a fundamental change in the monetary policy regime, the relevant question is not whether the new strategy does better than discretionary inflation targeting, but rather how the proposed strategy compares to the optimal commitment solution which monetary policymakers strive to attain.

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A recent study by the Federal Reserve Board has shown that if explicit account is taken of the zero interest rate bound, optimal monetary policy under commitment may involve considerable price-level drift following a more substantial contractionary demand shock. Consequently, returning the price level to its target path, as required under price-level targeting, is associated with welfare losses. Based on an extension of the New Keynesian model that allows for sector-specific shocks, a recent study by Bundesbank staff confirms the welfare costs of eliminating an optimal price-level drift.[2]

It is not clear at present whether the costs associated with returning the price level onto the target path would be outweighed by the benefits which accrue from the reduction in long-term price-level uncertainty. Against this background, price-level targeting cannot be regarded as a viable monetary policy strategy until we know much more about its potential benefits and costs than we do at present. But it is definitely worth pursuing this line of research further in the future.

2.3 Asset prices, financial stability and monetary policy

Another question that has been raised once again by the financial crisis concerns asset prices and their relevance to monetary policy. First of all, the well known arguments against a "leaning against the wind" strategy are still valid: Financial bubbles are difficult to identify and difficult to moderate using monetary policy instruments.

Nevertheless, there is empirical evidence on the link between money and credit growth and asset price booms. This suggests that monetary policymakers should take due account of

[2] Gerberding, C, R Gerke and F Hammermann (2010), On the Welfare Costs of Price-level Targeting, Deutsche Bundesbank, mimeo.

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developments in the financial markets and in asset prices – as part of their price stability mandate. One of the lessons of the recent crisis may be that the time horizon relevant to monetary policy decisions should not be too short.

Looking beyond credit and monetary developments, there are more interdependencies between monetary policy and the financial cycle. Therefore, we must improve our understanding of the impact of monetary policy on banks' behaviour and vice versa. On the one hand, recent experience has clearly shown that financial imbalances can trigger an economic downturn and thereby endanger price stability as a result of deflationary risk. On the other hand, the financial cycle is not exogenous to the strategic orientation of monetary policy. Monetary policy has the potential to influence risk-taking behaviour, for example. Thus, monetary policymakers taking these factors into account should respond symmetrically to financial cycles. This will not prevent boom-bust cycles in asset prices, but might contribute to somewhat less volatile financial cycles.

Does this imply that monetary policymakers should take responsibility for financial stability? In my view, ensuring price stability over the medium term remains the appropriate objective of monetary policy. In order to fulfil this task, monetary policy has basically one instrument at its disposal, the short-term interest rate. Given that short-term interest rates are too blunt a tool to safeguard financial stability, financial stability should not become an additional independent objective of monetary policy.

Instead, financial stability is best ensured by macro-prudential policy with its own set of instruments. However, this does not mean that macro-prudential policies cannot or should not be carried out by central banks. On the contrary: The expertise already present in

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central banks as well as the interactions between monetary policy and macro-prudential policy I mentioned earlier are arguments that call for central banks to play a prominent role.

Central banks possess comparative advantages of information and action as they combine complementary elements such as oversight of payment systems, their own refinancing operations, their activities in the financial markets and their presence in international committees. In addition, only central banks can perform the vital function of the lender of last resort for the banking sector during financial crises. This, in turn, requires that central banks constantly keep abreast of financial institutions' solvency situations and of liquidity conditions in the money market. They are therefore able to assess possible domino effects. Central banks' market proximity in the regulatory and supervisory process clearly enhances their ability to identify disequilibria and proactively counter potential pockets of instability.

What is needed, however, is a clear distinction between central banks' responsibilities with respect to monetary policy and their financial stability tasks. For example, at the level of the EU, a separate European Systemic Risk Board will deal with macroprudential issues, but it will be situated at the ECB, allowing it to draw on the central bank's resources and analytical capacities. In a similar vein, the Bundesbank has created a new "Financial Stability" department.

3 Conclusion

Ladies and gentlemen

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The financial crisis has stimulated a number of discussions about the optimal conduct of monetary policy. I have touched on only some of them, highlighting the key points. This seminar has provided us with the opportunity to elaborate on the lessons to be learned by monetary policy. And I have learned a lot in yesterday’s and today’s sessions!

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