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Introductory statement

at the Sino-German High Level Workshop

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1 Welcome remarks, background

Dear Mr YI Gang, dear guests, it is a great pleasure to welcome you to this Sino-German workshop, which is being held within the framework of the Financial Stability Forum in Frankfurt. Our goal of an in-depth exchange of ideas and experience relating to financial stability is part of the overall project of closer cooperation between China and Germany, as agreed last summer during Chancellor Angela Merkel's state visit to China. This closer cooperation is evidenced both by the first Sino-German intergovernmental consultation in Berlin that took place from 27 to 28 June 2011 and by this workshop.

Both countries share many features. One outstanding common factor is that China and Germany occupy the top two spots on the list of leading export nations and, as countries that routinely run up a current account surplus, therefore sometimes hear calls to contribute to global "rebalancing" by strengthening domestic demand.

The two countries also display clear differences, especially in terms of the openness, depth and diversification of their respective financial systems and financial markets. Germany is part of a monetary union, while the Renminbi is beginning to gain in importance as an international currency. This is where an exchange of views on the lessons learned during the current financial crisis is likely to be of particular mutual interest today.

The structure of the workshop programme and the range of issues covered ensure that specific aspects of financial stability policy in China and Germany will be given sufficient space.

In this introductory statement, I would like to focus on the following four points:

- Strengthening the international financial system
- Interactions between monetary policy and macroprudential policy

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- Risks of the low-interest rate environment
- And developments in commodity prices

2 Strengthening the international financial system

My first point relates to the current debate on potential recommendations and measures to strengthen the international monetary system during the French presidency of the G20 group of countries. As you know, these issues are currently being discussed in a G20 working group, particularly measures to manage international capital flows and global liquidity. Public political statements and comments reflect clear differences between some emerging market economies and the advanced countries, although a greater consensus on several of these issues has been achieved in recent months.

These relate, in particular, to different assessments of what is the right way to respond to the increasing volume and volatility of international capital flows, and especially attitudes to capital controls. Many emerging economies point to the need for a policy mix that is tailored to their country's specific economic and financial structures in order to protect internal price stability and financial stability against the consequences of large capital inflows and sudden stops. The range of measures deployed is correspondingly broad. Some countries intervene on the foreign exchange markets, others resort to interest rate cuts in order to discourage capital inflows, another group focuses mainly on macroprudential measures in a bid to strengthen the ability of their domestic financial systems to absorb inflows, while yet other nations mainly or partly employ capital controls.

This broad variety of national responses inevitably begs the question of whether and to what extent they are consistent with global financial stability. Greater cooperation, for instance through a (non-binding) framework or guidelines both at the national and the global level,

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might be a more effective way of safeguarding financial stability. Moreover, it has to be further clarified whether an incorporation of Capital Flow Management into the surveillance mandate of the International Monetary Fund could contribute to better outcomes on the global level. As Jaques De Larosière recently highlighted: An international monetary system worthy of the name should ensure that national interests and measures lead to globally stable solutions. In my view, this is much the same way that, in a market economy, the sum of individual decisions should add up to a rational macroeconomic whole.

It is well known that Germany is a firm proponent of a free movement of capital. This position is not anchored in its general belief in a market economy but also reflects its own past experience with capital controls. As an export nation, Germany was particularly interested in rapidly achieving full convertibility of its own currency. It has completely liberalised its capital exports back in the early 1960s. However, it proved impossible to sustainably liberalise capital imports in the same way. Operating within a fixed exchange rate regime, Germany on several occasions imposed temporary restrictions on capital imports in response to large speculative capital inflows during the 1960s and early 1970s. This measures aim of assuring the effectiveness of the Bundesbank's monetary policy with its primary objective of safeguarding domestic price stability.

Several emerging market economies are currently in a comparable situation to that of Germany in the 1960s and early 1970s, in particular in terms of the state of development of their financial markets. However, looking back at these events objectively in the mid-1980s, the Bundesbank concluded that capital controls had proved ineffective, even as a temporary shield for monetary policy. In the long term, the parallel opening up of product markets and financial markets has proved to be an enduring model of success in Germany.

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3 Monetary policy and macroprudential policy

The second issue that I would briefly like to highlight here is the interaction between monetary policy and macroprudential policy, which is sure to be discussed in greater depth during the workshop. The international debate to date has indicated agreement that monetary policy must always be focused primarily on the objective of price stability. There is much less of a consensus on what role monetary policy can effectively play to prevent financial crises, and whether and to what extent it can intervene early to help combat the emergence of financial market distortions and asset price bubbles – the "lean versus clean debate" is just one aspect of this issue.

What is clear, meanwhile, is that the financial crisis has significantly increased the overlap between monetary policy, prudential supervision and macroprudential policy. Macroprudential policy has to play a key role in dampening the procyclicality of the financial system. But its toolbox includes instruments that have an immediate impact on the monetary policy transmission channel, eg the credit channel. This interaction between monetary policy and macroprudential policy will be one of the most important areas for research over the next few years. The overriding aim must be to achieve sustainable and practicable results that can quickly and effectively underpin monetary policy. This fast implementation would enable it to pursue a steady monetary policy course geared to anchoring inflation expectations.

Macroprudential policy requires its own instruments and must be clearly delineated from microprudential policy. Under the German government's ten-point plan, the Bundesbank has a key role to play in macroprudential policy. This role is to be steadily expanded in order to strengthen the Bundesbank's ability to act in this field. It must be "permanently able to identify systemic risks on the financial markets". The Bundesbank is currently considering how best it can effectively implement this mandate both materially and organisationally.

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4 Risks of a low-interest rate environment

Third, I would like to mention an issue to which the Bundesbank devoted a whole chapter in its most recent Financial Stability Review: the risks to financial stability associated with a low-interest rate environment. Recent empirical studies show that low interest rates encourage excessive risk-taking. This aspect not only represents a new and effective transmission channel for monetary policy, but is also highly relevant for financial stability policy. This also applies to the international bond markets which – as seen in similar earlier phases – are strongly boosted by currency carry trades and leveraging, but then prove extremely sensitive and fragile when the interest rate trend reverses, as witnessed in the bond market turmoil of 1994 and thereafter. Back then, an unexpectedly small Fed rate hike was seen as a trigger of the bond market turmoil.

The recent financial crisis has added an important new element: the structure of the international bond markets has shifted considerably in recent years, partly in response to financial market crises. For example, the Fed is now the largest investor on the US Treasury market, ahead of China and Japan. Low interest rates and the risk channel not only point to the need for an early exit from non-standard monetary policy measures – even if no risks to price stability are on the horizon. The current monetary environment in some advanced economies also point to the vital importance, in view of the aforementioned risks, of carefully and skilfully communicating the monetary policy exit strategy.

5 Greater amplitudes of commodity price trends

Low interest rates and plentiful global liquidity are frequently cited as causes of the growing amplitudes of commodity prices – and this is the fourth aspect that I would like to touch upon. Global investors – some commentators say – are driving up commodity prices in their

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quest to maximise yield and diversify their portfolios through speculative investment. The issue of “commodity price trends”, which is also on the G20’s agenda during the French presidency, should - in my view - be given high priority for two important reasons. First, it directly affects the poorest sections of the world’s population. And second, it has a direct and much larger impact on price stability than asset prices. This is particularly true in the emerging market economies, in which commodities have a large weight in price indices and therefore force monetary policymakers to raise interest rates more quickly, thereby attracting more short-term capital inflows.

That makes it all the more important to analyse the commodity markets and derive the corresponding policy recommendations in a non-dogmatic and systematic fashion. First of all, it should be noted that real supply and demand factors have, for several years, shown a co-movement towards making commodities scarcer and pushing up commodity prices. Moreover, trade restrictions in several commodity-exporting countries and subsidies are impairing the effectiveness of the price mechanism on the commodity markets. The empirical studies published to date leave a key question unanswered, however, namely the extent to which speculative investment in the commodity markets amplify price cycles. Nonetheless, there is growing evidence that financial investments do indeed amplify price cycles and at least sometimes help ensure that price trends, despite the underlying parallelism, are being determined more by the futures than the spot markets. With this in mind, the Bundesbank broadly supports proposals aimed at significantly improving the data on, as well as the transparency and efficiency of, the markets and a more intensive monitoring. In addition, supervision of the commodities markets and market infrastructure might be strengthened – as market participants have occasionally suggested themselves.

Ladies and gentlemen, even this short overview shows what a long way we have to go to achieve financial stability. Developing a viable monetary policy operational strategy has taken several decades; we will not have that much time to come up with a sustainable

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macroprudential strategy. Nonetheless, expectations should be anchored at a realistic level; the crucial requirement is to make sustainable and lasting progress. The exchange of experience between countries is an important element in this process.

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