

Dr Jens Weidmann
President
of the Deutsche Bundesbank

**Managing macroprudential and monetary policy – a challenge
for central banks**

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1 Introduction

Ladies and gentlemen,

In the event of an earthquake, the question that decides between life and death is whether the buildings are stable enough to withstand the tremor of the earth. In the event of a financial shock, a crucial factor for the severity of the crisis is to what extent the financial sector is stable, and whether it is possible to contain negative feedback effects within the macroeconomy. The financial system's recent track record in this respect has not been wholly convincing, to put it mildly. Therefore, one central question on the global political agenda is "how to better ensure financial stability?".

Comparing the stability of our financial and monetary system with a building that has to withstand a substantial earthquake, the two columns monetary policy and microprudential supervision – which supported that building and which we believed to be strong enough – turned out to be insufficient. Shocks caused by turbulences on local markets may propagate much more quickly

and widely than it had been previously expected. Hence, an explicitly systemic view on financial markets is needed as an additional element in our policy-making building, namely macroprudential policy.

In the following, I would like to elaborate on the question as to how this new column should be designed. First, I will address the more conceptual aspect of the interrelations between financial stability and monetary policy, and point out that, since both policy fields pursue separate objectives, an individual set of instruments for macroprudential policy is needed. Second, I will concentrate on operational aspects of macroprudential policy. In particular, I will highlight that macroprudential policy will rightly gain in importance and that central banks ought to make a substantial contribution without, however, compromising their main objective – price stability – and their independence. Finally, I will outline that, in addition to this, the European sovereign debt crisis poses a much more fundamental question: How can central banks fulfil their mandate if risks to macroeconomic and financial stability emanate from unsound public finances and structural economic weaknesses, yet policymakers do not succeed in putting these deficiencies right?

2 Interrelations between financial stability and monetary policy

The question as to what extent monetary policy can contribute to financial stability is certainly not new. However, the answer had to be and has been adjusted in the light of experiences throughout the recent crisis. In the decade preceding the financial crisis, central banks kept interest rates at very low

levels, partly due to an environment of seemingly exceptional macroeconomic stability. Another important factor was certainly the widespread opinion prevailing at that time, that monetary policy should not lean against a bubble that is building up, but intervene after a bubble has burst. From today's perspective we know that by applying such an asymmetric monetary policy approach two important aspects were underestimated. First, in the low interest environment the search for yield caused market participants to take riskier positions and contributed to the build-up of systemic risk. Second, the turbulences when the bubble burst could not easily be contained by making use of traditional monetary policy instruments but necessitated unconventional measures in several policy areas. In addition, serious repercussions in the financial sector and the real economy could not be prevented.

Against this background, the role of monetary policy has been stated more precisely. There is still no doubt that price stability should be the key goal of a central bank. Fulfilling this mandate forms the basis of our credibility, and we must not lose sight of this goal when becoming involved in crisis management. In addition, we should be aware that monetary policy is not able to fully avoid the build-up of bubbles and the event of crises. Pretending otherwise would lead to expectations in monetary policy that cannot be satisfied, and this would ultimately undermine central banks' credibility with negative consequences for our ability to maintain price stability.

However, as a central lesson from the crisis, monetary policy has to take a closer look at the possible build-up of financial imbalances – because these have implications for price stability. In the case of the Eurosystem, this implies that monetary analysis, which already focuses on longer-term risks for price

stability stemming from increasing money supply, will gain in importance. This will allow monetary policy to extend its horizon and to apply monetary policy more symmetrically across the financial cycle, in line with the fact that financial imbalances regularly build up over a longer period of time.

Such a more symmetric approach to monetary policy is based on central banks' primary goal of price stability, and will contribute to financial stability. However, while price stability is a necessary prerequisite for financial stability, it is far from being the only one. In addition, central banks equipped with only one main instrument, i.e. the interest rate are not able to meet several goals, that is price stability and financial stability at the same time. For monetary policy to be able to concentrate on price stability, it is therefore indispensable that macroprudential policy is equipped with an individual set of instruments.

This notwithstanding, monetary and macroprudential policy cannot be seen completely separately from each other due to potential spillovers. Therefore, some coordination between both policy fields is warranted, although without blurring the individual objectives.

3 How to design macroprudential policy

With this in mind, I would like to turn to the more practical issues associated with the question “how to design macroprudential policy?”. For efficient macroprudential policy, two things are crucial: a thorough analysis of the build-up of systemic risk to be able to issue warnings and recommendations, and the translation of such warnings into policies and action.

In order to facilitate the transition from analysis to action, a clear mandate for macroprudential supervision is needed. And there are good reasons why central banks should be involved as long as their independence and the hierarchy of their objectives, with price stability as the primary goal, are respected. Their extensive knowledge of financial markets and the macro economy is very valuable for macroprudential purposes, and their participation will facilitate forming a consistent view for both monetary and macroprudential policy. In this regard, I highly welcome that the Bundesbank is to be given an explicit macroprudential mandate.

With the introduction of countercyclical capital buffers, the first truly macroprudential instrument will be at the disposal of national supervisory authorities. By dampening excessive credit growth, countercyclical capital buffers will make it possible to “lean against the wind” beyond the scope of monetary policy and thereby enable monetary policy to better focus on price stability. This is especially important in a monetary union such as the euro area. As the common monetary policy has to ensure price stability for the euro area as a whole, it is not suitable as a means of preventing excessive credit growth in single countries, which is often aligned with the build-up of systemic risk. For example, it is beyond the reach of monetary policy to counteract regional overheating in housing markets, which often goes along with excessive credit growth. In such a case, nationally calibrated countercyclical capital buffers may prove to be effective.

However, we have to make sure that monetary and macroprudential policy complement rather than counteract each other. For example, it would be inefficient and detrimental to both objectives if macroprudential policy tightened

its stance to dampen credit expansion, while at the same time monetary policy was loosened because there is no medium term inflation risk and an expected economic downturn may contribute to even reduced price pressure. In order to avoid an inconsistent, suboptimal policy mix, a close exchange of assessments in both policy fields is necessary – however, it should not lead to a blurring of the responsibilities of the respective policy areas. It goes without saying that to ensure a comprehensive surveillance of the financial system, such an exchange of information is also necessary between macroprudential policy and microprudential supervision, not just in order to take on board the expertise of microprudential supervision but also to share any relevant information.

While final decisions about the use of macroprudential policy instruments, such as the calibration of countercyclical capital buffers, should be taken on the national level, which has the greatest expertise on the national financial system and has to bear the cost of regulatory failure, a purely national perspective of macroprudential oversight remains too narrow. As became all too clear in the course of the crisis, systemic risk does not respect national borders and the close integration of capital markets and the risks of regulatory arbitrage require international cooperation, for instance in the design of macroprudential instruments.

In this process, the European Systemic Risk Board (ESRB), whose anniversary we celebrate with this conference, is a key player. About one year after it was established, its tasks as central guarantor for financial stability within Europe have increasingly taken shape. Consisting of representatives of national central banks and microprudential surveillance bodies, the ESRB builds on the expertise of national authorities with the task of assessing

systemic risk on the European level and issuing recommendations and warnings across Europe. In addition, its scope is about to be broadened to playing a coordinating role for macroprudential policies and guarding against protectionism in the regulatory framework.

4 Challenges from the sovereign debt crisis

While the work on a better framework for ensuring global financial stability is in full progress, the European sovereign debt crisis has turned the focus to the foundations on which the stability of our monetary and financial system rest: a sound and competitive macroeconomic base and solid public finances. The specific challenge for monetary and macroprudential policy in the current debt crisis stems from the fact, that while both policy goals are affected the possibilities to contribute to crisis resolution are limited. Specifically with respect to monetary policy, there is the substantial risk that involvement in crisis resolution may entail a burden shifting from fiscal to monetary policy, and the ultimately necessary political action to address the root cause of the crisis might be delayed, incomplete, or not happening at all.

One of the severest forms of monetary policy being roped in for fiscal purposes is monetary financing, in colloquial terms also known as the financing of public debt via the money printing press. In conjunction with central banks' independence, the prohibition of monetary financing, which is set forth in Article 123 of the EU Treaty, is one of the most important achievements in central banking. Specifically for Germany, it is also a key lesson from the experience of the hyperinflation after World War I. This prohibition takes

account of the fact that governments may have a short-sighted incentive to use monetary policy to finance public debt, despite the substantial risk it entails. It undermines the incentives for sound public finances, creates appetite for ever more of that sweet poison and harms the credibility of the central bank in its quest for price stability. A combination of the subsequent expansion in money supply and raised inflation expectations will ultimately translate into higher inflation. In a monetary union of independent countries, one additional aspect that is often missed in the current discussion is particularly relevant. Monetary financing in a monetary union leads to a collectivisation of sovereign risks among the tax payers in the monetary union. It is equivalent to issuing Eurobonds. However, the redistribution of such risks and the related transfers between the members of the monetary union are clearly the task of national fiscal policies, and only the national parliaments have the democratic legitimation to make such decisions. For this reason, the Eurosystem's mandate to ensure price stability rightly involves the prohibition of any kind of monetary financing.

Proposals to involve the Eurosystem in leveraging the EFSF – be it through a refinancing of the EFSF by the central bank or most recently via the use of currency reserves as collateral for an SPV buying government bonds – would be a clear violation of this prohibition. Incidentally a support of this scheme by governments would have also circumvented the parliamentary approval for additional rescue funds provided by Germany. These proposals have met the staunch opposition of the Bundesbank. The current crisis cannot be solved by destroying its stability oriented basis. Hence, I am glad that also the German government echoed our resistance to the use of German currency or gold reserves in funding financial assistance to other EMU members.

It is sometimes requested that Germany should contribute more strongly to international stabilisation. However, in my view the most important contribution at the moment is that Germany remains a stability anchor in EMU with regard to fiscal sustainability and with regard to its stability orientation. For example, the new national fiscal rules in Germany may increase confidence in sound public finances, which I believe is currently more important than any short-lived fiscal stimulus. Therefore, I would advise the German government not to weaken its fiscal stance by spending any revenue windfalls, but rather to continue the timely consolidation of the budgets at all levels of government.

From a short sighted perspective flirting with monetary financing may be perceived as a seemingly easy way out, but policymakers have to implement a true long-term solution to the crisis. The course of the crisis leaves no doubt about what this requires. First, on the national level the determination of the affected countries to return to a sustainable path of public finance and to undertake the necessary structural reforms is required. Second, as such action will inevitably entail painful and initially contentious adjustments, we need a framework within the monetary union which ensures sufficient incentives for the member states to follow this way nevertheless. So far, the decisions taken for crisis resolution within the monetary union have not addressed these issues sufficiently as the recent aggravation of the crisis has shown.

The October summit dealt with a number of important crisis issues. One definitely positive outcome of the summit was the decision to ensure sufficient capitalisation in the banking sector, given that contagion effects are a major reason for the severity of the crisis.

However, as we currently see, even positive outcomes of the summit fall short of expectation without the necessary consolidation and structural adjustments in the countries which are at the heart of the crisis. More generally, the euro area is currently caught up in the fact that its framework has, in the course of the crisis, increasingly lost consistency. This is harming the credibility of the current rescue packages. While risks stemming from undesirable and self-inflicted developments in individual countries have been increasingly communalised by the assistance packages, the ultimate decision-making power has remained on the national level and the conditionality that was intended to rein in national policymakers has been increasingly relaxed.

As a first step, a consistent strategy requires strict conditionality of the agreed financial help to be enforced in order to prevent the incentives to implement painful reforms and consolidation measures from weakening further. In the case of Greece, this must imply that the financial help, which is bound to strict consolidation and reforms, will be halted if Greece decides against the agreed adjustment process. It is an important and promising signal that policymakers from EMU member countries have stressed this point, too. What is often overlooked, however, is that uncertainty about the future of the adjustment programme can quickly make untenable the situation of central banks which continue to provide liquidity to Greek banks.

Furthermore, however, policymakers have to decide which direction the currency union is to take. As I have discussed in more detail in earlier speeches, there are in principle two conceivable ways to a consistent and economically sustainable framework for the monetary union. While the first would be a return to the founding principles of the system, but with an

enhanced framework that really ensures sufficient incentives for sound public finances, the second way would imply a major shift entailing a fundamental change in the federal structure of the EU and involving a transfer of national responsibilities, particularly for borrowing and incurring debt, to the EU. Only a clear decision for either option lays the foundation to preserve the monetary union as a stability union in the long-run. It is up to governments in Europe to make this decision

5 Conclusion

Ladies and gentlemen,

Before we had time to implement all the lessons learnt from the financial crisis, the European sovereign debt crisis has posed new and substantial challenges. This is particularly true for central banks, as their primary mandate of ensuring price stability not only has to be internally reconciled with efforts to better ensure financial stability, but is at the same time exposed to a crisis situation in which the line between monetary and fiscal policy is growing increasingly blurred.

In this situation, we are well advised not to overburden central banks. Primarily, they should continue to focus on maintaining price stability, a task at which they have an excellent and proven track record. In addition, central banks will play an important role in macroprudential policy, both at the national and at the international level, for example as members of the ESRB. But, as I said before, the stability of our financial and monetary systems depends on more than

these columns and microprudential supervision. A sound macroeconomic and fiscal basis is equally important, and it is not central banks but policymakers that have the means and the legitimacy to ensure this basis.

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