Reports from the Economic Research Centre

On 5 and 6 December 2002 the Monetary Stability Foundation *(Stiftung "Geld und Währung")* staged its first conference in collaboration with the Bundesbank and the Federal Ministry of Finance. The Foundation's aim is to promote basic research in the fields of economics and law with a view to securing monetary stability and stable financial systems. To this end research facilities affiliated to a university are to be set up. A total of €51 million is available for this purpose in the form of the Foundation's endowment capital, which was raised by the issue of a commemorative DM 1 gold coin from the Bundesbank's monetary reserves. The subject of the conference was "An institutional framework for monetary stability" (see also the conference programme on page 61). The choice of this subject was intended to underscore the importance of defining the right institutional framework. This has been demonstrated very clearly in recent years by economic theory, particularly in the field of monetary policy. Prominent representatives of international organisations, central banks, commercial banks, regulatory bodies and the academic world took part in the discussion.

An institutional framework for monetary stability

Monetary stability and stable financial systems as goals of economic policy

The first session of the conference established the framework for the subsequent discussion. The defined objective was to answer the following questions. What do we mean by price stability and a stable financial system? Why are these goals important in an economy? How do these goals relate to one another? There is now a general consensus that monetary stability is a key basis for the welfare of a country or currency area. There was also broad agreement that an inflation rate of under 2% is compatible with monetary stability. Monetary stability relates to the overall price level, not to individual prices. Relative prices must be able to change if they are to fulfil their steering function. By contrast, economic theorists still find it hard to come up with a simple and concise definition for the stability of the financial system. It is clear, however, that stability should not be confused with rigidity. On the contrary, the ability to adjust to new circumstances is a key feature of any system that promises lasting stability. In this context the conference participants also considered the interrelationship between efficiency, competition and stability.

In recent years financial systems worldwide have been confronted with crises more than in the first few decades after the Second World War – despite the marked progress that has been made in combating inflation. Nevertheless, the dominant view at the conference was that safeguarding monetary stability is the best contribution that central banks can make to avoiding financial crises. This is the most direct way in which monetary policy can help ensure transparency and efficiency in the financial system. This does not rule out short-term disruptions and exaggerations in the financial markets, however. In this context the participants also discussed to what extent central banks can integrate early warning systems into their strategies to detect such dangers. In particular, it was pointed out that the growth of monetary aggregates and bank lending may serve as an indicator of unhealthy developments. Financial market bubbles are often accompanied by a steep rise in bank liabilities and bank claims. This opens up an additional perspective which may also be of interest in the discussion on the first pillar of the ECB's monetary policy strategy.

Central bank laws important for lastingly safeguarding price stability

After initially defining the goals in detail, the conference then addressed the question of what institutional framework is best suited to realising these aims. The debate focused at first on monetary stability. In this respect the precise formulation of central banking legislation is of key importance. Germany's positive experience of an independent central bank, which had a particularly successful track record in the field of stability policy, and the academic debate going back more than a decade jointly paved the way to today's situation in which central banks the world over enjoy greater autonomy than used to be the case. This went hand in hand with two other developments: the commitment of central banks to enhanced transparency and their greater public accountability.

First conference of the Monetary Stability Foundation: An institutional framework for monetary stability *

Programme of the conference held on 5 and 6 December 2002

Welcoming address by Ernst Welteke (Deutsche Bundesbank) and Hermann Remsperger (Deutsche Bundesbank and Chairman of the Foundation's Supervisory Board)

Session I

Chair: Hermann Remsperger (Deutsche Bundesbank and Chairman of the Foundation's Supervisory Board)

Why stable prices and stable markets are important and how they fit together

Stanley Fischer (Citigroup Inc)
Otmar Issing (European Central Bank)
Allan Meltzer (Carnegie Mellon University)

Institutions for stable prices: How to design an optimal central bank law

Jean-Victor Louis (University Paris I)
William Poole (Federal Reserve Bank of St Louis)
Nout Wellink (De Nederlandsche Bank)

Session II

Chair: Reiner König (Deutsche Bundesbank and Chairman of the Foundation's Executive Board)

How relevant are institutional arrangements in labour markets and fiscal policy for a stability-oriented monetary policy?

Alberto Alesina (Harvard University)
Wolfgang Franz (Centre for European Economic Research, Mannheim)
Pedro Solbes (European Commission)

Which institutions and regulations for a stable financial system?

Arnoud Boot (University of Amsterdam)
Charles Goodhart (London School of Economics)
Jochen Sanio (Federal Financial Supervisory Authority)

Session III

Chair: Wolfgang Bühler (University of Mannheim)

Law, finance and stability

Gerd Häusler (International Monetary Fund)
Friedrich Kübler (Johann Wolfgang Goethe University, Frankfurt and Clifford Chance Pünder)
Colin Mayer (University of Oxford)

Panel discussion
Institutions for stability:
Current and past experience

Facilitator: Axel Weber (University of Cologne)

Alan Blinder (Princeton University)
Andrew Crockett (Bank for International Settlements)
Barry Eichengreen (University of California, Berkeley)

* The conference proceedings can be viewed on the Foundation's website (http://www.stiftung-geld-und-waehrung.de) or that of the Bundesbank (http://www.bundesbank.de).

Deutsche Bundesbank

Although it appears uncontested that the amendments to central bank statutes played an important role in the stability policy success of the recent past, speakers at the conference underscored that this was not an automatic process. Not least the history of the Federal Reserve System and the Deutsche Bundesbank clearly shows that public support, as well as skill and resilience on the part of the policy makers at the central banks, have been major factors in their success.

The importance of the institutional setting on the labour markets ...

Central bank laws define the available scope of monetary policy action in the narrower sense. But other institutional conditions, too, need to be examined. Two further areas were discussed during the conference, namely labour markets and fiscal policy. The relationship between monetary policy and the institutional setting on the labour markets appears complex. In the run-up to European monetary union, for example, some people speculated that the single monetary policy in Europe might change the way labour markets in the euro area are organised and function. On balance, however, such influences seem to have been very limited so far. On the other hand, labour market rigidities that often stem from institutional factors may increase the costs of a stability policy. In some cases this may lead to greater political pressure on central banks.

... and in fiscal policy

The discussion on the interrelationship between monetary and fiscal policy focused on the pros and cons of the European Stability and Growth Pact. EC Commissioner Pedro Solbes and Federal Finance Minister Hans Eichel stressed the Pact's importance for the smooth functioning of EMU. This does not preclude improvements in the Pact's implementation. Mr Solbes specifically called for greater attention to be paid in future to ensuring that the principles of a responsible medium-term fiscal policy are also taken to heart during economic upswings. This demands greater fiscal policy restraint whenever the level of business activity is above average. Critics of the Pact, by contrast, cited two principal dangers. They argued, firstly, that the Pact prevents due account from being taken of the different requirements in the individual euro-area economies and, secondly, that it diverts attention from the real challenges that Europe's countries will face in the future. In particular, the Pact's critics claim, it is more urgent to lower the general government spending ratios than just to reduce the general government deficits.

Unresolved issues concerning financial market stability

Whereas price stability was at the centre of discussion during the first part of the conference, the focus later turned to the question of what precautionary measures are most conducive to minimising the danger of financial market crises. The intellectual challenges in this field now appear just as great as in the discussion on safeguarding price stability. Besides the difficulty of defining financial market stability, there is at the moment no generally agreed and closed model for determining what instruments and approaches are best suited to predicting or preventing crises. The ongoing development of the financial systems and the intensified competition which, though important for efficiency, can also pose risks to stability, are additional challenges which call for new approaches to prudential supervision. Nonetheless, there is evidently agreement about some basic principles.

Key importance of transparency

For example, various speakers emphasised that transparency plays a key role in modern systems of financial market supervision by promoting responsibility and facilitating, for instance, functioning early warning systems. The concrete design of accounting standards could force firms inter alia to adopt a more open disclosure practice, which in turn would help to safeguard the stability of a given financial system. Most participants took the view that attempts to regulate the market directly are only of limited usefulness in a constantly changing world. This is often associated with a tendency towards harmonisation which fails to address the differing individual needs and hence may impair efficiency. These misgivings about overregulation were highlighted by examples from the financial system.

Organisation of financial market supervision

Another issue examined during the conference was how the supervision of financial systems can best be organised. The discussion focused on conditions in Europe. There was a broad consensus that even in a monetary union supervision should remain a national responsibility, although a close exchange of information is necessary between these national authorities. There was likewise a large measure of agreement that central banks should be integrated into the supervision of financial systems; for a number of reasons central banks are especially suited to contributing to the stability of the overall system. In this context the German solution, under which the Federal Financial Supervisory Authority collaborates with the Bundesbank in the field of prudential supervision in an efficient and economical partnership, was also discussed extensively.

Approaches to solving international financial crises

Finally, the conference also considered the best way of tackling international financial crises. Resolving this issue has acquired major significance given the huge growth in international capital flows of private-sector creditors. For example, the IMF has proposed a "Sovereign Debt Restructuring Mechanism". It was also pointed out, however, that all such approaches require broad support if they are to be successfully implemented.

The conference showed that a number of questions remain unresolved, particularly in respect of creating an efficient and stable financial system. In other areas, such as gaining acceptance for the goal of monetary stability, a greater degree of unity and certainty prevails today. But in this field, too, it is already apparent that the future will bring new challenges. Against this background the new Foundation's objective of studying and promoting the conditions for stable prices and a sound financial system seems well chosen.