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Monetary policy after the crisis: A European perspective

Keynote speech
at the Shadow Open Market Committee (SOMC) symposium
in New York City
on 12 October 2010

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1 Introduction

Ladies and gentlemen

It is a pleasure to be here and to speak to such a distinguished audience. Hence, I would like to thank the organisers for their kind invitation.

The Shadow Open Market Committee, founded by Allan Meltzer and Karl Brunner in 1973, can look back on a long and impressive history. The Committee has also served as a role model for establishing similar bodies in Europe.

Karl Brunner was a visiting professor at the University of Konstanz from 1969 to 1973. Regrettably, I missed his lectures at the time since I did not start my economic studies at the University of Konstanz until a few years later. Both his teachings and his research established the reputation of Konstanz as *the* German centre for monetary research and as an "incubator of German monetarism".[1] The "Konstanz Seminar on Monetary Theory and

[1] Monissen, H.G. (1977), Karl Brunner at the University of Konstanz, 1969-1973, in Journal of Money, Credit and Banking, Vol. 9, pp. 251-253.

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Policy", which he also founded and where I met him later, has maintained its status as an exclusive forum for promising young economists and attracts a constant flow of very distinguished monetary experts; it celebrated its 40th anniversary last year. I have enjoyed attending the seminars for more than 30 years. Beyond that, Karl Brunner's work has had a major impact on policy in Germany – something which is strikingly illustrated by the introduction of monetary targets by the Deutsche Bundesbank in 1973.

In the Konstanz scientific manifesto of 1972, Karl Brunner wrote on the division of "monetary theory" and "monetary policy" as distinct academic subjects: "… theory without application to our environment is useless and policy discussion or judgements not based on analysis are dangerous".[2] Over the past four decades, fortunately, both subjects have converged to a large extent, and modern monetary policy has become unthinkable without a state-of-the-art theoretical background.

Having said that, I would like to focus on current und future challenges facing monetary policy, in particular as regards the euro area.

2 A brief review of the Eurosystem's response to the crisis

Central banks in the euro area and in many other industrialised economies had to take bold and decisive action in order to limit the repercussions of the financial and economic crisis. On both sides of the Atlantic, the major central banks have implemented a comprehensive set of standard and non-standard measures both to guarantee the liquidity of the financial system and to counteract deflationary pressures. Nevertheless, every central bank had to

[2] As quoted in Fratianni, M., J. von Hagen (2001), The Konstanz Seminar on monetary theory and policy at 30, in European Journal of Political Economy, Vol. 17, pp. 641-664.

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tailor its response to the crisis to the specific needs of its own economy. When it comes to comparing the response of the Eurosystem with that of the Federal Reserve, or the measures implemented by the ECB Governing Council with those of the FOMC, due account has to be taken of fundamental differences between the financial structures of the economies concerned. In contrast to the U.S. financial system, banks play a dominant role in funding euro-area non-financial corporations. Over the period from 2004 to 2008, bank financing represented, on average, more than two-thirds of total external financing for those corporations, compared with less than one-half in the United States. The Eurosystem's response to the crisis has therefore concentrated on measures to enable liquidity-constrained banks to close their short-term funding gaps and, ultimately, to sustain the ability of the banking sector to lend to the real economy. Under this "enhanced credit support" approach, the Governing Council of the ECB, besides lowering its key interest rates to historically low levels, decided to temporarily extend its liquidity operations in terms of frequency and maturity and to expand the list of eligible collateral. Furthermore, we decided to purchase 60 billion euros worth of covered bonds. As a result of its liquidity measures, the Eurosystem has become the central counterparty of the euro-area money markets.

Compared with, for example, the Federal Reserve or the Bank of England, however, outright asset purchases have played only a minor role in the Governing Council's strategy. The Covered Bonds Purchase Programme I just mentioned represents just 3% of the Eurosystem's balance sheet. The more recently established Securities Markets Programme (SMP) presently amounts to somewhat more than 60 billion euros, which again equates to 3%. There is no evidence that asset purchases have had any significant impact on average euro-area sovereign bond yields on which euro-area monetary policy must exclusively focus as its main transmission channel. But the SMP risks blurring the different responsibilities between fiscal and monetary policy. As the risks associated with the SMP outweigh its

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benefits, these securities purchases should now be phased out permanently as part of our non-standard policy measures.

3 Current and future challenges for monetary policy

3.1 Exit from exceptional policy measures

The challenge facing monetary policymakers now and in the near future is to get the timing and sequencing of the exit from stimulus measures right. This applies to both the non-standard measures as well as the monetary policy stance, and therefore, key interest rates, as the two dimensions of the exit. While we are far from declaring the crisis over, it would be unwise to postpone relevant considerations to the end of the crisis. As regards the Eurosystem's set of non-standard policy measures, these were designed with exit considerations in mind. The overwhelming majority of measures can therefore be easily withdrawn whenever we deem it necessary.

As regards the two dimensions of exit consisting of phasing-out non-standard liquidity measures and normalizing our clearly expansionary policy stance, there are risks both in exiting too early and in exiting too late. I believe the latter are greater than the former. For example, maintaining the accommodative policy stance for too long may risk a de-anchoring of inflation expectations, which is costly to reign in. For the time being, however, the policy stance remains appropriate, since inflation risks remain low over the policy-relevant horizon.

The two dimensions of exit are independent and separated by concept. Thus, a normalization of key interest rates could in principle start before the phasing-out of non-

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standard measures has been finished. The phasing-out of non-standard measures mainly depends on the situation in the financial markets and the interbank money market, in particular. While improved conditions enabled us to embark on a gradual phasing-out of exceptional policy measures at the end of 2009, renewed financial market tensions in early May forced us to reintroduce some measures that had already been phased out. Looking ahead, the situation in the financial markets shows continuing signs of normalization – despite some remaining volatility and fragility. Against this background, it is necessary, from a monetary policy point of view, not to postpone the exit from non-standard measures for too long, in particular since we always emphasized it would be a state-contingent process.

Before I discuss the challenges of the phasing-out in more detail, let me briefly recall some key aspects of our monetary policy implementation. In the euro area, the bulk of liquidity is provided via revolving refinancing operations (collateralized lending) of different maturities, with the main refinancing operation, that is the one week operation, being the most important. Prior to October 2008, refinancing operations were conducted as variable rate tenders, with allotment amounts closely aligned with the aggregate liquidity needs of the banking system (often referred to as 'benchmark allotment'). Conceptually, the liquidity needs of the banking system mainly result from non-banks' demand for banknotes and substantial remunerated reserve requirements. The particular tender procedure means that average short-term money market rates are normally just slightly above the minimum bid rate in the weekly main refinancing operation, which serves as the key policy rate.

However, in October 2008, the variable rate tender procedure with benchmark allotment was replaced by a fixed rate full-allotment procedure, in order to ensure banks' liquidity despite the drying up of the interbank money market following the Lehman collapse. The full allotment policy allowed banks to accumulate substantial amounts of surplus liquidity (or

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excess reserves to use U.S. terminology), which could be lent to other banks or placed in the Eurosystem's deposit facility – an overnight facility to deposit excess reserves. As a result, short-term money market rates usually traded only a couple of basis points above the Eurosystem deposit rate throughout most of 2009 and 2010. This was by design.

Meanwhile, given an ongoing normalization in financial markets, money market rates have increased significantly but smoothly without any monetary policy tightening signals and the corresponding headlines.

Despite the overall improvements in financial market and money market conditions, some financial institutions, however, continue to rely strongly on the liquidity support measures provided by the Eurosystem. In principle, the strong demand for central bank liquidity from these Eurosystem counterparties could lead to elevated tender spreads after the return to a variable rate tender procedure. More specifically, banks with limited market access could place high bids in the variable tender procedure, possibly translating into somewhat higher marginal and weighted average rates than were observed before the crisis. Some observers are worried that such an elevated tender spread could blur the monetary policy signal, which is primarily indicated by the minimum bid rate, and thereby complicate the planned continuation of the gradual phasing-out of those non-standard measures.

However, I do not share these concerns to the same extent. While it seems plausible that banks with limited access to the interbank money market would tend to place higher bids in auctions for central bank liquidity, it should be equally clear that elevated tender spreads would occur only due to the segmentation of the interbank money market and must not be confused with a change in the Eurosystem's monetary policy stance.

In order to facilitate the return to variable rate tender procedures, I believe a good starting point would be to have generous allotment amounts in the main refinancing operations. If these were substantially above the benchmark amount, this would lead initially, in quantitative terms, to a quasi-replication of the full allotment result. In such an environment, the immediate impact on money market rates of the switch to variable rate tenders should be modest. Subsequently, the gradual nature of the phasing-out process would be reflected in a step-by-step reduction of the allotment amounts, broadly in line with the estimated decline in banks' demand for surplus liquidity. Short-term money market rates would, over time, remain close to the level of the key policy rate without undue volatility.

Should additional measures flank the exit from the full allotment policy? I am convinced that any such measures – if needed at all – should not be targeted at individual counterparties. Clearly, monetary policy must act at the macro level, not the micro level. Monetary policy has to be directed at all monetary institutions as a whole. Therefore, any operational measures should apply equally to all counterparties of the Eurosystem. But our operational measures cannot provide the solution to the problems still plaguing that part of the banking sector which has limited access to the interbank market. Shareholders and governments solely remain responsible for resolving remaining undercapitalization and funding issues at individual financial institutions and will have to undertake greater resolution efforts, as non-standard monetary policy measures are gradually being phased-out.

3.2 Monetary policy and financial stability

This illustrates, however, how quickly monetary policy becomes involved in issues that are primarily financial stability issues. During the remainder of my speech, I would therefore like to focus more generally on the interplay of monetary policy and financial stability.

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The question that has been raised in this regard against the backdrop of the worst financial and economic crisis since the end of the Second World War is “Should monetary policy react to asset prices?” Put like that, however, I find the focus too narrow. It would be more appropriate to ask “What is the role of monetary policy in the financial cycle?”.

While it would be misleading to blame the financial crisis on monetary policy, it has to be acknowledged that monetary policy has a significant influence on the financial cycle, including booms and busts. Before the crisis, policymakers neglected the impact of their decisions on the risk-taking behaviour of financial market players. Yet once market participants recognise that expansionary monetary policy reactions are much stronger during downturns than the moves in the opposite direction during upswings, adverse incentives are created.

Hence, monetary policy needs to be more symmetrical. Such an approach would imply taking greater account of the implicit risks stemming from lively money and credit growth, booming asset markets and decreasing risk premiums, especially with regard to their implications for price stability in the long run. In turn, this could imply extending the time horizon of monetary policy beyond the standard projection horizon of roughly two years. This is already part of the monetary policy strategy of the ECB’s Governing Council: The separate analysis of money and credit growth provides a very useful toolset for the early detection of rising risk potential in financial markets. Taking the additional information provided by monetary analysis into account, and possibly even more so than before the crisis, does not, however, imply actively “leaning against the wind” of financial imbalances. Somewhat less volatile financial cycles would instead come as a welcome by-product of a medium-term monetary policy strategy that implicitly takes into consideration the repercussions of financial instability on price stability over the medium to long term.

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Such an approach would, in particular, neither imply nor require establishing financial stability as an additional monetary policy target or downgrading the objective of price stability. I just explained why monetary policy is an inappropriate tool to fix the underlying problems of banks with limited access to the interbank market. Risks to financial stability should be addressed through financial regulation and macroprudential policy rather than using the blunt tool of short-term interest rates.

4 Conclusion

Let me conclude my remarks.

Central banks on both sides of the Atlantic have mitigated the impact of the financial crisis on the financial system and the economy. Monetary policymakers, too, must learn their lessons from the crisis and take greater account of the impact their decisions have on the financial cycle. The challenge ahead is to find the right balance between exiting too early and exiting too late.

Naturally there are other important topics in monetary policy which I have had to leave out. For example, considerable challenges for monetary policy arise from the bad shape of public finances in the euro area – which is, of course, a problem common to many advanced economies – and macroeconomic imbalances and growing heterogeneity within the monetary union. Both can hamper the conduct of the single monetary policy in general and the exit from its very accommodative stance in particular. Maybe we can touch upon some of these issues in the discussion.

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Thank you for your attention.

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