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"Monetary Policy and Stability"

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In my remarks today I would like to reflect on the role of central banks, especially the ECB during the financial crisis and the segmentation between monetary policy and financial stability responsibilities. One of the consequences of the crisis was that this segmentation has been reverted and central banking is returning to a role it played 300 years ago, when the first Central Bank was established in Europe.

In 2005 when Othmar Issing, the chief economist in its early years, left the ECB monetary policy was on a steady path. Not that the first few years of the ECB had been boring-which is considered as the ultimate success of central banking. To the contrary: in 2000 the free fall of the Euro had to be stopped by massive interventions – remember the € stood at 1.88 in October 2000.

September 11 and the bursting of the dot.com bubble required forceful liquidity injections, interest rates were lowered. In the US fear of deflation was a concern.

After a wave of food and energy price increase the ECB communication was: Supply shocks do not lead to inflation as long as they are not passed on to wages and prices. The credibility of the ECB as an independent institution fighting inflation had been established by then – inflationary expectations were solidly anchored around the 2% benchmark.

Monetary expansion however was strong and a debate took place whether this mattered at all. The ECB concerns and conclusion that it mattered led to interest increases starting in December 2005 and by then highly controversial in the public debate.

Experiences like in the US 1994 – when interest rate increases led to turbulences on the market for government bonds – should be avoided this time. On both sides of the Atlantic interest rates were raised in homoeopathic doses of 25 BP at a time.

Situation prior the crisis: monetary policy/competitiveness/growth

Credit expansion was strong- the only instrument available in a monetary union with different levels of growth. Regulatory measures were used to a limited degree only. By then the widespread belief was: it is difficult for a central bank to identify a bubble, better wait until it bursts and mop up the result of this century.

The concerns in the early years were price stability and the recovery, the return to growth – not competitiveness. Fiscal policy and financial stability were defended as national domains.

Why? Growth was the concern in Germany and it reacted with structural measures which turned out to be successful and put other countries under pressure to do the same especially with regard to labor markets. Easy access to credit compensated for the lack of reform and low interest rates were like a warm rain in a number of countries. But there is one growth engine which was one of the reasons why this period is considered as the period of Great Moderation – it is China and we could add Central and Eastern Europe at least for Germany and Austria.

The new division of labor between high and low income countries had a deflationary effect and kept inflation under control. At the same time investments in the faster growing southern part of Europe with higher inflation rates became less attractive.

The reinvestment of current account surpluses on a global scale kept long term interest rates low. Low interest rates for a long period increases risk taking by the financial sector. Risks are priced too low – a warning repeated time and again by central banks and international organizations. I remember a warning expressed by Professor Streissler in 2004, in the middle of the period of cross border and domestic credit expansion, euphoria and global integration.

Still in 2005 and 2006 banks, insurance companies and fund managers as well as rating agencies reassured their supervisors – the risks are not in our balance sheets anymore, we are save. We do not know where the risks are. What a fallacy! The widespread use of credit insurance was the magic tool to increase leverage. Risk Models were designed to evaluate individual banks risk, left aside tail risks and systemic contagion. Rating agencies relied on models in a similar way. The ability of the system to generate liquidity via repoing securities created the illusion that market liquidity would always be available.

Why was competitiveness not a concern?

It was – in the technical discussions of the Economic Policy Committee and in regular appeals to governments. Maybe the idea of a monetary union becoming an optimal currency area after a certain period was very powerful – there was the assumption countries would adjust in their own interest even if it required unpopular measures. Low interest rates and no visible sanctions for delaying reforms created a false sense of security.

What about fiscal policy?

The idea of central surveillance was destroyed to a certain degree in 2003 when the large countries decided that they would not accept to be bothered too much by Brussels. Investors were ready to finance European governments with low risk spreads and the assumption that a bailout would take place irrespective of the rules stating the contrary. In 2004 investors raised the question whether the ECB would exclude countries from it´s refinancing operations if they did not apply fiscal discipline. The answer was no and rating categories were referred to instead.

You cannot replace fiscal union by central bank judgment and sanction. But this gap, the uncertainty about creditor countries readiness to set up a stability mechanism, the uncertainty about debtor countries economic policy course created a huge opportunity for investors to benefit from volatility on the market for European government bonds. This is the reason why the system will remain vulnerable until the institutional set up is set in stone e.g. firm commitments.

Situation prior the crisis – financial stability/financial sector

It was in the late nineties when the chairman of the Basel Committee, a leading supervisor and influential central banker in the US urged his European colleagues to overhaul the regulatory framework of Basel I, the crude standard for bank capital decided in the eighties. If we do not act banks will use the techniques they have developed to reduce bank capital and the system will become more vulnerable. He was right. The next 10 years were spent discussing Basel I – a few years less and the system could have avoided some of the damage. Nevertheless systemic risks, liquidity risks and the level of capital needed would have been insufficient in retrospect.

In the run up to Monetary Union political union was out of the question. Despite many efforts to integrate the financial sector and create a single market for financial services supporting the single market for goods the financial market remained fragmented – national exemptions in rules and regulations, informal hurdles to cross border banking, fragmented supervision. Despite the huge capital market which was created as a result of the introduction of the € and which was primarily based in London cooperation between supervisors remained focused on rule making and relied on instruments like MOU and colleges of supervisors for day to day supervision. Apart from efforts to attract business by tolerating regulatory abitrage a comprehensive risk assessment was more difficult due to institutional fragmentation not only along national borders but between central banks and supervisory agencies as well. When the Bank of England was granted independence banking supervision was separated to avoid too much concentration of power. Meanwhile in Germany supervisory tasks were not entrusted to the Deutsche Bundesbank for fear of compromising its independence.

This separation of monetary and financial stability considerations -despite all the joint meetings which were organized-was one of the institutional inadequacies in Europe which were changed after the crisis.

But the origin of the crisis is elsewhere, in the institutional set up of e.g. the mortgage market: The argument that models were used to assess the risk and that these models did not contain negative price developments because they had not been observed since WWII is hardly convincing in retrospect.

It was the leverage, the maturity mismatch and the neglect of liquidity risks which brought the system close to a catastrophe in 2008 -the best description can still be found in the De Larosiere Report from February 2009.

The crisis response: Monetary Policy

Lowering interest rates is what a central bank would do in an upcoming recession. Unlimited access to liquidity is already a more unconventional measure and it is still- four years after the outbreak of the crisis the most important lifeline for the banking sector. Expanding the pool of collateral is an accompanying measure.

The crisis response: Fiscal Policy and Financial sector

Basel III as a code word for higher capital, better quality of capital and rules for liquidity is on the way and has become the new standard. A limit to leverage is an important step. More needs to be done for shadow banking. Transparency through mandatory clearing of derivatives is welcome.

The loss of revenues during the crisis, bank recapitalization and government expenditures to fight the crisis needed a reversal in fiscal policy. Without monetary union and the -however insufficient – monitoring of deficits the Eurozone would have entered the crisis in a much worse situation .In the meantime most countries are recovering gradually with the exception of Greece and most recently Spain.

Why did it not succeed so far?

Monetary policy has succeeded in stabilizing economic activity by lowering interest rates -a few months after the drop in sentiment and foreign trade in the aftermath of the Lehman event the recovery started in spring 2009

But: low interest rates have negative side effects – they distort the allocation of capital, drive commodity and equity prices and make saving for retirement more difficult. The search for higher yields increases risk taking.

Central banks can act as LOLR in the traditional sense - lending freely against good collateral at penalty rates.
During the systemic crisis of 2008 until now low interest rates are charged to all banks and liquidity is provided to all banks. Because the stigma of central bank credit is more and more irrelevant and the disincentive of low interest rates is high the central bank has to negotiate an exit strategy and implement it by not renewing certain liquidity operations.

In spring 2010 it had worked-the beginning of an exit became visible – 400bn € taken of central bank liquidity were taken out of the market.

But by then Ireland and Portugal had hesitated for too long to address their structural problems.

By then banks had started to redress their balance sheets and to stabilize their P&L, but government bonds – until then the risk free asset by definition – became the new panacea. The pure idea of a Greek default has rocked the boat of a number of banks in Europe and triggered a new crisis. The idea of private sector involvement, asking investors for burden sharing has confirmed this new assessment of sovereign risk and a new round of provisioning and additional write offs has weakened share prices of financials.

Banks have made progress in transforming capital into capital which meets the stricter definition of Basel III and some of them have reduced their risk weighted assets. Tighter regulation should make the system more resilient. But there is still one threat – that the establishment of a fiscal and political union takes more time and the needs of individual governments and banks in these countries to refinance themselves can be satisfied at high costs.

There is however still one hurdle. As long as government bonds are traded under different names the system will not stabilize easily without additional measures.

Why is there a new debate about missing European Institutions?

Until the establishment of the European Banking Authority 1 year ago there was no central policy implementation. Having an institution with restructuring and funding power would complement the powers of the European Commission in the field of competition policy. What is necessary is the power to restructure and wind down banks in an early stage of their difficulties.

The long term

The role of central banks has changed considerably since the start of the crisis. Price stability is the primary objective of the ECB, financial stability has become a more explicit task due to the coordinating role in the European Systemic Risk Board. Any discussion about accepting higher inflation rates to "inflate away" the debt burden will not find the consent of the ECB.

The growth of the balance sheet of the ECB is of concern to some. It is the result of the disfunction in the market for bank funding and the withdrawal of deposits.

Had the central bank not provided extra liquidity banks in at least two countries would have closed their doors two years ago with all the potential of disorderly conditions and depression as possible consequences.

Can this policy continue?

If the financial sector cannot perform its role sooner or later it will be bypassed by nonbanks or the central bank will provide funding to banks or the economy directly. Should the central bank finance non-banks as the Federal Reserve and the Bank of England have done so? The ECB has seen banks` continued lending as a priority and is not allowed to buy government bonds at issuance. Of course it is more difficult for the European banks to stabilize as long as bad assets are in their balance sheets. This can be observed in the case of Spain these days.

Let me return to the question: What has prevented a lasting impact of all the stabilization efforts undertaken by the European economic, financial and political system so far?

Lending to the public sector is assessed completely differently compared to a few years ago. Only the public sector can change this by reducing financing needs and by lending to each other. The financial crisis has increased debt and deficits considerably, the financial sector is reluctant to buy government bonds.

Global investors had made the assumption that the creation of the single currency would be defended by governments and that it is possible to combine high returns and full recovery.

Conclusion

Monetary Policy

Monetary policy has played its role and has taken unconventional measures to recreate macroeconomic stability. The fear of inflation has not materialized because the aftermath of a financial implies certain deflationary risks and a slowdown of global economic activity can be observed.

Deleveraging over indebted governments, banks and households has a dampening effect on growth. Could the deleveraging of banks cause a credit squeeze? It might rather be the lack of demand for loans which could create a problem.

Financial Stability

As a lesson from the financial crisis regulatory standards were tightened. It is in a certain sense a return to the thinking before deregulation and liberalization. A study by the BIS has shown the effectiveness of regulation in reducing the probabilities of banking crises.

We should never forget the situation we were in in fall 2008 and spring 2010.

- customers did not trust banks
- banks did not lend to each other(cross border) – investors did not lend to governments in certain countries

Who can cut the Gordian Knot now?

Central banks by providing liquidity to banks, not solvency support. Governments by supporting each other if investors hesitate because there will be demand for sovereign bonds again the financial sector by recreating trust in its business models and its corporate governance.

Let me close with a Chinese Saying:

"On a 100 mile journey, you will find wind coming from different directions."