# Conference 2009

THE ECB AND ITS WATCHERS

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## IMPRINT


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# Conference Program 2009

## THE ECB AND ITS WATCHERS XI

**To be held at:** Deutsche Nationalbibliothek, Frankfurt am Main, Friday, September 4, 2009

**Organization:** Volker Wieland (Center for Financial Studies)

**08:15-08:45** Registration and Coffee

**08:45-08:50** Welcome
Volker Wieland

**08:50-09:30** *President's Address "Exit from the Crisis"*
Jean-Claude Trichet (European Central Bank)

**Morning Session** Chair: Volker Wieland

**09:30-11:00** 1st Debate:
*Monetary policy in the financial crisis: How to deal with the threats of a deflationary spiral or re-bounding inflation?*
Jürgen Stark (European Central Bank)
Vincent Reinhart (American Enterprise Institute)
Eric Nielsen (Goldman Sachs)

**11:00-11:30** Coffee Break

**11:30-13:00** 2nd Debate:
*Macro-prudential supervision: Does the ECB have the appropriate instruments? Is there a trade-off between monetary and financial stability?*
Lucas Papademos (European Central Bank)
Markus Brunnermeier (Princeton University)
Michael Dooley (University of California, Santa Cruz)

**13:00-14:15** Lunch

**Afternoon Session** Chair: Michael Binder (Center for Financial Studies)

**14:15-15:45** 3rd Debate:
*Government bail-outs in the euro area: Much-needed rescue from fiscal collapse or deadly threat to long-run stability of EMU?*
José Manuel González-Páramo (European Central Bank)
Paul De Grauwe (Katholieke Universiteit Leuven)
Michael Burda (Humboldt University Berlin)

**15:45-16:15** Coffee Break

**16:15-17:00** *Some lessons from the financial market crisis*
Otmar Issing (Center for Financial Studies)

**17:00-17:05** Closing Remarks

Speaker Biographies 2009

## BRIEF SPEAKER BIOGRAPHIES 2009

(In order of appearance on the program)

### JEAN-CLAUDE TRICHET

(European Central Bank)

Jean-Claude Trichet is President of the ECB and Chairman of the Group of Ten Governors since 2003. In 1987 Trichet became a member of an influential Washington-based financial advisory body, the Group of Thirty. Later, in 1993 he was

appointed governor of Banque de France. He was the chairman of the Monetary Policy Council of the Banque de France as of 1994, a member of the Council of the EMI from 1994 to 1998 and thereafter a member of the Governing Council of the ECB. Trichet is a graduate of the Ecole nationale supérieure des Mines de Nancy, of the Institut d'études politiques de Paris and of the University of Paris in Economics.

### JÜRGEN STARK

(European Central Bank)

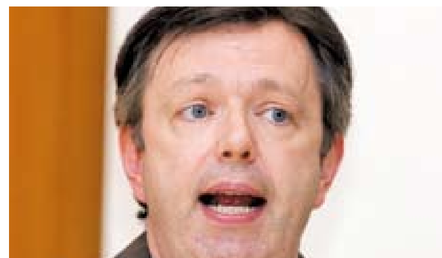
Jürgen Stark became a member of the ECB's Executive Board in 2006. Within the Executive Board he is responsible for the Directorate General Economics, its economic and monetary analysis and the preparation of monetary policy decisions. He received his doctorate at the Eberhard Karls University of Tübingen in 1975. From 1995 to 1998 he was the state secretary of the Federal Ministry of Finance and personal representative

of Chancellor Helmut Kohl in preparations for the G7/G8 Economic Summits after which, he served two consecutive terms as vice president of the Bundesbank.

### VINCENT REINHART

(American Enterprise Institute)

As former director of the Federal Reserve Board's Division of Monetary Affairs, Vincent Reinhart has spent more than two decades working on domestic and international aspects of U.S. monetary policy. He held a number of senior positions in the Divisions of Monetary Affairs and International Finance and served for the last six years of his Federal Reserve career as secretary and economist of the FOMC. Reinhart worked on topics as varied as economic bubbles and the conduct of monetary policy, auctions of U.S. Treasury securities, alternative strategies for



monetary policy, and the efficient communication of monetary policy decisions.

### ERIC NIELSEN

(Goldman Sachs)

Eric Nielsen is the firm's chief European Economist and Managing Director responsible for the economic research teams for Europe, Russia, Middle East and Africa. He joined Goldman Sachs in 1996 as a senior economist for Russia. He transferred to London in 1997, to build the eco-

nomic research team for the New Markets in the European time-zone and for Western Europe as well. Previously, Nielsen worked in Washington, D.C. first at the IMF and later for the World Bank. Before leaving his native Denmark, he worked as an economist at the central bank and taught at the Copenhagen School of Economics and Business Administration. He graduated in economics from the University of Copenhagen in 1981.

### LUCAS PAPADEMOS

(European Central Bank)

Lucas Papademos is the Vice President of the ECB since 2002. Papademos attended MIT, gaining a degree in Physics in 1970, a Master degree in Electrical Engineering in 1972, and a Doctorate in Economics in 1977. He pursued

an academic career at Columbia University, and served as senior economist at the Federal Reserve Bank of Boston in 1980. He joined the Bank of Greece in 1985 as chief economist, rising to deputy governor in 1993 and governor in 1994. Papademos has been a member of the Trilateral Commission since 1998. He is also a member of the Academy of Athens, as well as professor of the University of Athens.

### MARKUS BRUNNERMEIER

(Princeton University)

Markus Brunnermeier is the Edwards S. Sanford Professor at Princeton University. He is a faculty member of the Department of Economics and affiliated with Princeton's Bendheim Center for Finance and the International Economics Section. He is also a research associate at CEPR, NBER, and CESifo, as well as an academic consultant to

the Federal Reserve Bank of New York. He was awarded his Ph.D. by LSE, where he was also affiliated with its Financial Markets Group. His research focuses on financial crisis, bubbles and significant mispricings due to institutional frictions, strategic considerations, and behavioral trading.

### MICHAEL DOOLEY

(University of California, Santa Cruz)

Michael Dooley is Professor of Economics at the University of California, Santa Cruz and Research Director at Cabezon Capital, an investment management firm specializing in emerging markets. He is also a Research Associate of the NBER and is a Managing Editor of *the International Journal*

*of Finance and Economics*. He previously held positions at the Federal Reserve Board's International Division and in the Research Department of the IMF. His published research covers a wide range of issues on global imbalances, crises in emerging markets, debt restructuring, and capital flight. Dooley received his Ph.D. from Pennsylvania State University.

### MICHAEL BINDER

(CFS and Goethe University Frankfurt)

Michael Binder received a Ph. D. in Economics from the University of Pennsylvania in 1995. Upon completion, he joined the faculty of the University of Maryland, where he was an assistant professor. Since 2003 he is a Professor at Goethe University Frankfurt (holding the Chair for

International Macroeconomics and Macroeconometrics), and founding director of Goethe University's Ph.D. Program in Economics. At the CFS he directs the research program on International Economics.

### JOSÉ MANUEL GONZÁLEZ-PÁRAMO

(European Central Bank)

José Manuel González-Páramo is a member of the ECB's Executive Board since 2004. Prior to receiving his M.Phil. and Ph.D. in Economics at Columbia University, he studied Economics at the Universidad Complutense in Madrid. He served as economic adviser to the Ministry of Economy and Finance from 1985-1986, after which he

became senior economic adviser at the Banco de España. He was a member of the Governing

Council as well as the Executive Board at Banco de España for 10 years before joining the ECB.

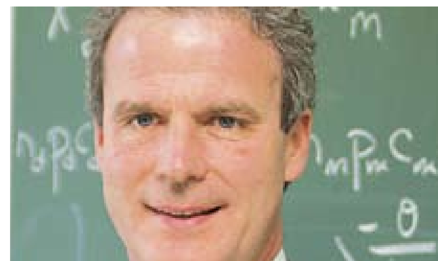
### PAUL DE GRAUWE
(Katholieke Universiteit Leuven)

Paul De Grauwe is a Professor in the faculty of Economics and Applied Economics at Katholieke Universiteit Leuven in Belgium, and Research

Coordinator for International Money and Finance at CESifo. From 1993 to 2003 he was serving at the Belgian Parliament as senator, member of the House, as well as chair of the Economic and Finance Committee. De Grauwe serves on the editorial boards of a number of influential journals. He is a regular *Financial Times* columnist and author of numerous books. He received his Ph.D. in Economics at Johns Hopkins University in 1973.

### MICHAEL BURDA
(Humboldt University Berlin)

Before joining Humboldt University in 1993 as a Professor of Economics, Michael Burda was a visiting professor of Economics at the Economics Department, Haas School of Business, University of California at Berkeley. He was, as well, a professor of Economics at INSEAD for more than five years. Michael Burda is one of the leading researchers in the empirical analysis of labor markets and economies in transition. He identified the rigidities of the German labor market



as a cause for the persistent unemployment. His analysis helped to understand the labor market problems in Eastern European countries.

### OTMAR ISSING
(CFS and Goethe University Frankfurt)

Otmar Issing is a former member of the board of the Deutsche Bundesbank (1990-1998) and

of the Executive Board of the European Central Bank (1998-2006). He developed the ‚two pillar' approach to monetary policy decision making that the ECB has adopted. He was appointed as President to the CFS in June 2006. Since 2007 he is an Honorary Professor of the Goethe University Frankfurt as well as International Advisor of Goldman Sachs. His book *Der Euro. Geburt – Erfolg – Zukunft* about the creation of the new European currency was published in 2008.

### VOLKER WIELAND
(CFS and Goethe University Frankfurt)

Volker Wieland is Professor of Monetary Theory and Policy at Goethe University Frankfurt since 2000. He received a Ph.D. in Economics from Stanford University in 1995. Prior to coming to Frankfurt, he spent five years as economist and senior economist at the Federal Reserve

Board in Washington, D.C. He also served as a consultant at the ECB from 1999 to 2004. This summer, Wieland completed an 11-months Wim Duisenberg Research Fellowship at the ECB. He was director of the CFS 2003-2009 and remains as Program Director for Central Banking and Monetary Economics. He has been hosting "The ECB and Its Watchers" Conference for six years.





## FOUR QUESTIONS
Questions

1. *Deflationary versus inflationary risks: When and how to exit quantitative easing and credit support?*

2. *Macro-prudential supervision: Does the ECB have the appropriate instruments? Is there a trade-off between monetary and financial stability?*

3. *Government bail-outs in the euro area: Much-needed rescue from fiscal collapse or deadly threat to long-run stability of EMU?*

4. *Financial regulation: What are the regulatory changes necessary to reduce moral hazard in the future and ensure an appropriate attitude towards risk-taking?*

## THE ANSWERS
Answers

1. *Deflationary versus inflationary risks:*

### ULRICH KATER:
(DekaBank)

"In history there are more examples for failed than for successful exit strategies after periods of

extreme monetary policy stance. It seems one can only choose between ‚too early' or ‚too late'."

### DANIEL GROS:
(Center for European Policy Studies)

The monetary exit strategy should be implemented once financial markets start working normally again. Credit spreads and the remaining deleveraging efforts should be the main indicators.

**HARALD UHLIG:**
(University of Chicago)
Avoiding a financial meltdown is top priority for now. When the risks shift towards inflation and away from systemic financial risk, the ECB and the Fed need to get the genie back in the bottle and avoid the build-up of inflationary pressure. Overall, a price-path targeting strategy would be more sensible than inflation-targeting: We know from recent research (e.g. Eggertson and Woodford), that this can help against deflationary risks too. It is time to modernize the ECB strategy.

**GERTRUD R. TRAUD:**
(Helaba)
"Inflation risks are likely to rise as the ECB will probably minimize the risk of tightening policy prematurely. Only in the second half of 2010 should it start to move the refi rate from the current 1 % towards 2 %. Before the tightening cycle begins, the ECB has to let its quantitative measures expire. This pertains primarily to the purchases of covered bonds. It will be harder to tackle bank refinancing – the ECB has recently provided banks with ample liquidity for up to 12 months. Whether the ECB will be able to

return to its normal tender operations next year depends on whether the banking system will have sufficiently shored up its core capital."

**AURELIO MACCARIO:**
(UniCredit Group)
So far, the ECB's ‚credit easing' policy has proven effective in unclogging the money market and in preventing an outright credit crunch. However, flows in the crucial interbank market remain modest and the covered-bond purchase program has only started to address the issue of seized banks' funding at medium to long-term maturities. Pressures on banks to deleverage and increase their capital endowment persist and, if not accompanied by an extraordinary support from monetary policy, may result in further credit rationing throughout the next quarters.

ECB officials have repeatedly made clear that in their exit strategy, interest rate hikes will be the last step, after the unconventional measures expire. In my view, this approach is justified by the inflation outlook. A deflationary spiral is no longer a concrete threat – current negative HICP readings will prove temporary. However, inflation will remain well within the ECB's definition of price stability throughout the forecast horizon. Furthermore, core inflation has just started its descent that will be driven by the massive widening of the output gap in recent quarters. With growth set to stay below potential until the end of 2010 and rising unemployment, underlying price pressures simply do not exist. The ECB can afford to remain accommodative on rates until the end of next year.

**MARKUS KRYGIER:**
(Crédit Agricole)
"As long as the financial sector remains impaired, a premature exit from quantitative easing and credit support policies bears disproportionate deflationary risks in a world where global rebalancing is likely to slow traditional euro area growth engines (i.e. exports). In contrast, reemerging inflation pressures will be a welcome sign of econo-

mic and financial sector healing, to be addressed by an ECB whose inflation-fighting credibility and effectiveness is beyond question."

**CHARLES WYPLOSZ:**
(Graduate Institute, Geneva)
Quantitative easing and other attempts to restart bank loans are conducted under the assumption that there is a supply problem. In theory, therefore, they should be stopped when the problem is solved. There is little or no public analysis of where the problem would be since the information, if known to supervisors, is kept confidential. One of the problems is that bad prospects make most borrowings risky; in that case, quantitative easing and credit guarantees should stop when there is enough evidence that the recession has ended.

My fear is that the ‚problems' are not solved because banks have not yet recognized all of their losses. Quantitative easing and credit guarantees then merely help banks conceal (to themselves and the supervisors) the exact situation but does not really encourage them to resume normal lending. If these fears are justified, then quantitative easing and credit easing play a negative forbearance role.

## 2. Macro-prudential supervision:

**DANIEL GROS:**
(Center for European Policy Studies)
Yes and Yes. Sometimes monetary (or price stability) can endanger financial stability. This happens typically during a credit boom not accompanied by inflation. Unfortunately, however, the danger to (future) financial stability from excessive credit expansion is difficult to measure and usually disregarded. The ECB has an instrument to combat excessive credit expansion since it can set reserve requirements.

**ULRICH KATER:**
(DekaBank)
The ECB would certainly be well equipped for conducting supervisory tasks. Conflicts between monetary and financial stability are manageable. But nevertheless: Bearing the whole load of responsibility for financial stability would not be a very sensible policy assignment for a central bank.

**GERTRUD R. TRAUD:**
(Helaba)
Without financial stability there can be no monetary stability. In so far there is no trade-off.

**HOLGER SCHMIEDING:**
(Bank of America Merrill Lynch)
"The trade-off between monetary and financial stability is largely imaginary. As the recent crisis has shown all too clearly, major financial instability has a clear and severe impact on economic stability and the outlook for inflation, even if it may come with some lag. One lesson is that the ECB should do what it had only advocated but not really implemented in the years leading to the recent financial turbulence, namely to ‚lean against

the wind' if a pronounced surge in credit growth goes along with an unusual spike in asset prices. The ECB has the right instruments to do so. Old-fashioned changes in reserve requirements may be an instrument to influence the degree of leverage in the financial system on top of the influence exerted by the level of short-term interest rates itself."

**HARALD UHLIG:**
(University of Chicago)
The ECB is not supervisory authority or lender of last resort. Despite the CEPR warning about this crucial issue in its very first *Monitoring the European Central Banks Report* as well as later reports, too little progress has been made to date by policymakers - and much of the catastrophic developments during the last two years can be blamed on politicians not taking our early warnings seriously. For academic observers, this is very frustrating: What is the point of warning, if warnings are ignored? The ECB should have pushed the issue more forcefully too - but again, it was not their responsibility in the first place (in contrast to the Fed). Does it have the appropriate instruments? It has more instruments than the Fed for e.g. quantitative easing, but less regulatory authority.

**CHARLES WYPLOSZ:**
(Graduate Institute, Geneva)
"Macro prudential supervision should be conducted by the ECB, which has neither the authority, nor the instruments to do it. The de Larosière proposals go in the right direction, but they stop short of providing the ECB with what is needed and, anyway, they will be further watered down before being adopted. Once again, turf defense and protectionism will prevail at the expense of public welfare (much the same will happen in the US).

There is a trade-off between price and financial stability. There may be times when central banks need to focus on financial stability and let price stability become a secondary objective. Central banks around the world have tended to reject this responsibility - although nearly all of them are

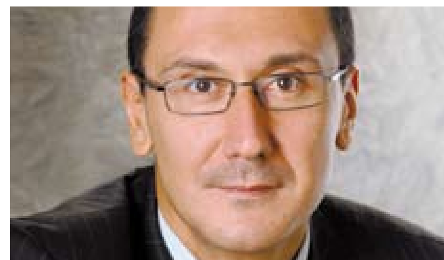
formally in charge of financial market stability - for obvious reasons: It is much easier to target inflation than to anticipate financial turmoil. Their comfort is not acceptable.

One argument by central banks is partly correct: They have one instrument and cannot pursue more than one objective. It is wrong in the sense that they already pursue two objectives, price stability and output gap stability, even when some (like the ECB) do not acknowledge this.

The argument is correct in the sense that, if they recognize the existence of a bubble, central banks are ill-equipped to burst it. In my view, bursting a bubble calls for non-monetary measures, for example dynamic provisioning of margins by the market authorities or even transaction taxes. Yet, central banks have the technical capacity to identify bubbles, and they should do so very explicitly. They will occasionally make mistakes, and this is what they fear because this could dent their reputation. True, but doing nothing as they just did, does not really raise their reputations."

**AURELIO MACCARIO:**
(UniCredit Group)

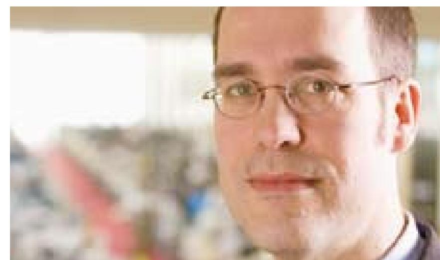
"The recent proposal of reform of European financial supervision is not sufficient to deal with the challenges that have arisen in the wake of the financial crisis. The ECB should be given authority to determine whether any Large and Complex Banking Group (to use the ECB's Financial Stability Review's definition) poses a threat to financial stability. The central bank should be given the power to supervise these companies by collecting periodic reports and information in order to act swiftly, in conjunction with national authorities, to prevent systemic damages."



## 3. Government bail-outs in the euro area:

**JÖRG KRÄMER:**
(Commerzbank AG)

"The Maastricht treaty forbids inter-government bail-outs for good reasons. Even before the outbreak of the financial crisis some EMU countries had deep structural growth problems which rendered their public finances a huge burden. The ultimate solution for such crisis is to implement the necessary reforms. Unconditional bail-outs would damage the incentive to reform."



**ULRICH KATER:**
(DekaBank)

No bail-out was yesterday. Today we have mutual solidarity. The euro has new rules of procedure.

**DANIEL GROS:**
(Center for European Policy Studies)

Fortunately no bail-out was needed so far in the euro area. Moreover, no national government can be certain that it will be bailed out if there is not a global systemic crisis going on at the same time. Hence there is no threat to the long-run stability of EMU.

**HOLGER SCHMIEDING:**
(Bank of America Merrill Lynch)

Within a tightly knit club such as Economic and Monetary Union, it is in the interest of members to offer each other conditional support. After all, the fate of one member has an impact on the other members, for instance through market risk premia and potential exchange rate gyrations. If others support a fellow member that has succumbed to exceptional problems, and if this support comes with clear IMF-style conditions, both the recipient and the suppliers of such emergency funds within the club can benefit, especially if the alternative would be the risk of EMU break-up. Offers of conditional support thus enhance the long-run stability of EMU, as the turbulence in February/May 2009 and the subsequent easing of market tensions has demonstrated.

**MARKUS KRYGIER:**
(Crédit Agricole)

Markets have long assumed an implicit bail-out commitment of individual euro-area members. Without it, the global financial crisis and the ballooning fiscal strains in many member countries could have severely threatened the stability of the euro area. In the long-run, stability will require that a unified fiscal policy and funding framework will render the bail-out discussion immaterial.

**AURELIO MACCARIO:**
(UniCredit Group)

There has been new speculation about countries leaving the euro zone. This involved profligate countries on the (wrong) idea that swelling deficits would increase their incentives to leave, as well as fiscally sounder members. Exiting from the euro zone is not a viable option, though not for the most-cited reason that economic and political costs are just too high. The main obstacle to exit is procedural: Investors of the defaulting country trying to avoid a forced conversion of their assets into a new domestic currency would create a bond-market crisis with unpredictable contagion effects.

## 4. Financial regulation:

**HOLGER SCHMIEDING :**
(Bank of America Merrill Lynch)

Attitudes towards risk taking are cyclical and influenced by the state of financial markets and the level of interest rates. An appropriate monetary policy would help to dampen somewhat the mostly inevitable trend swings in risk appetite.

**DANIEL GROS:**
(Center for European Policy Studies)

"What is desirable might not be feasible: Booms with vanishing perceptions of risk cannot be regulated away. All that can be done at the regulatory level is to ensure that the regulator has a (very) conservative bias. Moral hazard can also not be regulated away. One lesson for banks and financial markets after this crisis is certainly that in a deep crisis no bank is small enough to be allowed to fail. Hence moral hazard can only have increased."

**HARALD UHLIG:**
(University of Chicago)

"It would have been better to let more financial institutions fail. We have now built up a huge moral hazard problem that is going to haunt us for a long time to come. We already see the first signs of that in form of huge bonus payments in the US: Given the faulty policy, nobody should have been surprised by that.

The industry together with academic experts and regulatory authorities need to identify players who may pose systemic risks. Systemic risks will evolve in the future, so creative thinking and vigilance is needed. Measures have to be found to contain these risks (regulation or break-ups, for example). All other institutions, even large ones, must be allowed to fail. Hard thinking needs to be applied to the issue whether to be serious about the limits on deposit insurance (and how to organize deposit insurance in an actuarially fair way, without bailing in the tax payers, in contrast to the situation now). The decentralized rush to all-out insurance in October 2008 could have easily been avoided with more sensible policy beforehand and by listening to experts more carefully, but perhaps that is the nature of politics."

**CHARLES WYPLOSZ:**
(Graduate Institute, Geneva)

Ideally, we should not have banks too big to fail. The social benefits of mega banks have to be established; if they are not found, the best route is to cut banks into small pieces and establish conditions that would prevent their growth.

Basel II relied on banks auto-control using their own models and failed. It is enormously complex and allows shrewd bankers to bypass hapless supervisors. It involves the credit rating agencies, giving an important role to private companies that almost never get turning points right. The underlying idea was to minimize capital costs to maximize profits. Basel III should turn Basel II on its head. The goal should be to provide disincentives to build up risk that potentially has macro implications, no matter how costly this would be for banks. It should be simple, even crude, so as to avoid rediscovering that financial theory is a lot of sophisticated math built on unrealistic assumptions. It should make no use of ratings by credit rating agencies but require that supervisors do what they are supposed to do: Evaluate the institutions that they supervise. A small tax on banks would allow hiring top-guns from markets.

*Interviews taken: August 7-14, 2009*

# The 10-Year Anniversary Conference 2008

In 2008 the Center for Financial Studies celebrated the ten-year anniversary of "The ECB and Its Watchers" conference. This series, which was initiated in 1999 by Otmar Issing in his role as chief economist of the ECB and Axel Weber as CFS director, has evolved into a well-established forum for the public exchange of views between ECB decision makers and leading ECB observers and critics. Many ECB watchers have commented on the usefulness of this platform for a two-way dialogue with policymakers. Perhaps, the greatest compliment to the ECB and the conference organizers has been the start of similar conference series in the United States in 2007 and in the United Kingdom in 2008.

CFS director Volker Wieland who organized the conference for the fifth time in 2008 invited a range of prominent speakers from the ECB, other central banks, academia and the private sector to debate the role of the central bank in dealing with liquidity and solvency problems in the financial system and the proper policy responses to asset prices, inflation and economic growth or weakness. More than 250 participants actively took part in the discussions along with more than 40 media and press representatives who reported widely on the event. Part of the conference and selected interviews were again broadcasted live on business TV channels.

10 Years

## SEPTEMBER 5, 2008
## IN FRANKFURT AM MAIN

It has now become a tradition that the ECB President **JEAN-CLAUDE TRICHET** (ECB) opens the conference with a key note address. In 2008 Trichet spoke on the topic "Risk and the Macro-economy" and investigated the fundamental connection between financial risk and macroeconomic performance. He explained that after a time of ample financial liquidity and exceptionally low rewards to risk, the loss of value of whole classes of real assets has led to a sharp reduction in investor appetite. In addition, rising commodity prices have reduced households' income prospects and raised their aversion to risk. Thus a long phase of high risk tolerance has come to a halt. "To the extent that the more recent turn in the markets correct past excesses, this is a welcome – if painful – process that we had anticipated and asked market participants to prepare for in past interventions," noted Trichet.

*Monetary policy during the financial turmoil: What have we learned?*

**JÜRGEN STARK** (ECB) admitted that the past months had been the most challenging in the ten-year history of the ECB. The ECB was confronted with a ‚trilemma', consisting of rising inflation rates, a slow-down of economic activity and threat to financial stability. In his presentation, Stark discussed not only how the principles incorporated in the ECB's monetary policy framework have guided the ECB's decision making through these times, but also how to face the challenges still lying ahead. Inflation remains high and financial pressures continue. The recent ECB experience offers some useful lessons: One of them is to follow the above-mentioned "longstanding principles of sound central banking". Besides the primary objective being to maintain price stability, "safeguarding the credibility of the central bank's commitment to deliver this price stability is of the essence," repeated Stark.

Stark's debating partner, **MARVIN GOODFRIEND** (Carnegie Mellon University), then presented his view more from a U.S. perspective by turning to the challenges for U.S. monetary policy. Goodfriend noted that central banks should be viewed as executing two independent policies: Monetary and credit policy. Monetary policy (i.e. the size of the central bank's balance sheet) should be used to set interest rates in order to stabilize aggregate employment and inflation. Credit policy should be executed to stabilize financial markets. If the Fed keeps the two policies separate, credit policy changes the composition of the securities in its portfolio, but not the size of its portfolio. Credit policy actions, then, do not affect the federal funds rate target. In the past, the Fed has not really made use of credit policy.

*Solvency, systemic risk and moral hazard: Where does the central bank's role begin and where does it end?*

**LORENZO BINI SMAGHI** (ECB) started the debate by re-iterating the ECB's ‚separation principle' namely to pursue the separate objectives of price stability and the smooth functioning of the money market with separate instruments that are the interest rate and market operations. In other words, the interest rate is not considered an appropriate tool to deal with liquidity or solvency problems, because it is too ‚blunt' as an instrument for financial stability targeting. Moreover, the central bank should avoid dealing with solvency problems that would threaten its financial independence and increase moral hazard in the financial system. It should act to preserve social welfare by preventing the negative externalities of a liquidity squeeze, because it is the only economic agent who is not subject to liquidity risk. Furthermore, it can limit its credit exposure through unilaterally imposed eligibility criteria and collateral haircuts.

**WILLEM H. BUITER** (LSE) began by remarking that the role of the central bank in the maintenance of financial stability is liquidity management. The central bank should at most use its expertise as an agent of the government in dealing with solvency problems. It should not risk its own resources or reputation to save insolvent institutions. According to Buiter central bank insolvency is a real issue. Of course, the treasury in most countries ultimately owns the central bank and may tax or subsidize the central bank. However, there is the danger that the central bank's ability to pursue its objectives with regard to price and

financial stability may become impaired. He concluded that all financial institutions that can obtain access to liquidity from the central bank should be subject to a common regulatory framework. Such a framework would help minimize moral hazard.

**HARALD UHLIG** (University of Chicago) set out to characterize the links between what he called the subprime innovation and the moral hazard crisis. Uhlig emphasized that in an emergency, central banks need to understand the consequences before acting. In such a situation, a global data base on cross-investments by financial institutions is needed. More regulation is not good as it will hurt current mortgage markets. Also, moral hazard should not be encouraged as in the case of Fannie & Freddie i.e. insurance should not be costless. However, the market for new credits should be stabilized in the U.S. As for the ECB, Uhlig warned not to turn the institution to a lender of last resort, but instead increase the knowledge of regulatory data, transactions and cross-holdings in form of a global database. He also thought it better not to change collateral requirements now and save this decision for more tranquil times.

*Asset price bubbles and monetary policy: What can or should the central bank do about them?*

**HANS GENBERG** (Hong Kong Monetary Authority) reviewed the conventional argument that monetary policy should not be concerned with the build-up of asset prices, but must respond promptly and vigorously to the bursting of the bubble. Instead Genberg stressed that he is "not arguing for neglecting of risks due to financial market stress, but only for symmetry in treating excesses." This is not the same as adding financial stability to the central bank's objective. In that, an additional instrument would be needed in order not to overburden interest rate policy. Such prudential policies, however, should be coordinated with interest rate and fiscal policy.

**THOMAS MAYER** (Deutsche Bank) provided a markets perspective and elaborated further on the pros and cons of taking asset prices into consideration when making monetary policy decisions. Mayer gave a number of suggestions how central banks can respond. They should form an opinion on how asset price bubbles develop. Positive as well as negative bubbles are triggered by large cyclical swings in the willingness to tolerate risk. Mayer also proposed to "tilt the risk free central bank rate against large swings in risk appetite." By doing so, central banks will hopefully recognize developing bubbles. The ECB's two pillars strategy is "tilting in practice" but seems too narrow in that it "consists of a detailed analysis of monetary and credit developments with a view to assessing their implications for future inflation and economic growth."

*Looking ahead: How to reign in inflation and maintain stable growth?*

**ATHANASIOS ORPHANIDES** (ECB Governing Council) started by pointing out that inflation in the euro area has remained considerably above the level consistent with price stability since the fall of 2007 which poses a critical challenge for the ECB. An increase in oil prices coupled with downward rigidities in the levels of other prices, brings about an increase in the aggregate price level, the largely-unavoidable first round effect on inflation. Tolerating second round effects on inflation can be devastating to the economy and can result in both lower growth and higher inflation over time. It is all too easy to fall into the trap of pursuing over expansionary policy, if policymakers fail to account for the deterioration of the economies' potential in such circumstances. Slower growth for some time may be a discomfort that should be tolerated rather than resisted to avoid accumulating imbalances that may be costlier to address later. To avoid the materialization of second round effects it is imperative for policymakers to do what it takes to keep inflation expectations well anchored. This can be achieved at a lower cost, if structural elements are in place that prevent the propagation to further wage and price increases.

**LAURENCE MEYER** (Macroeconomic Advisers) provided a U.S. perspective on the question of reigning in inflation and maintaining sustainable growth. In terms of principles, Meyer firmly supported an explicit (qualitative) dual mandate for the central bank that covers inflation and growth. Meyer discussed the policy implications of the credit crisis, inflation and unemployment outlooks through the lens of a forward-looking Taylor rule. Credit spreads and risk premia are factors that should lower the real neutral funds rate. He believes the Fed has little insurance built into the funds rate setting. The response of the funds rate to the adverse supply shock then depends very much on how well-anchored inflation expectations are. In the 1970s inflation expectations adjusted very quickly to changes in inflation. In the 2000s, when inflation goes up and down inflation expectations have not moved at all. The policy regime is different now. Thus, with well-anchored inflation expectations the funds rate does not need to be raised in response to an adverse supply shock but could even ease in order to offset some of the growth impact of this shock.

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