Guy Quaden: Towards an integrated macro-finance framework for monetary policy analysis

Introductory speech by Mr Guy Quaden, Governor of the National Bank of Belgium, at the Biennial NBB Conference "Towards an integrated macro-finance framework for monetary policy analysis", Brussels, 16 October 2008.

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It is my great pleasure to welcome you to this biennial NBB Conference.

At a time when we are experiencing the biggest financial crisis since the 1930's, it doesn't take much motivation to explain why it is extremely important for central banks to have at their disposal a coherent framework that can explain and analyse the interaction between financial markets and the real economy. The theme of this conference – "Towards an integrated macro-finance framework for monetary policy analysis" – is now even more up to date than we could have anticipated at the time it was chosen. Although I would have preferred a different course of events, even if that would have meant a less topical conference today, it is quite clear that the current crisis poses important challenges for monetary policy.

Central banks around the world have at least two immediate concerns in this respect: providing sufficient liquidity to keep the financial system functioning, and adopting the appropriate monetary policy stance in a highly uncertain and rapidly changing environment. Let me summarise briefly the approach that has been taken by the ECB over the last 15 months.

Our first challenge was (and still is) to make sure that solvent financial institutions obtain the liquidity they need. As the liabilities of financial intermediaries are more liquid than their assets, they are by nature subject to liquidity shocks. If the effects of such shocks are not properly managed, illiquidity problems can lead to bankruptcy, even when the intermediary is fundamentally sound. Therefore, it is important to make sure that solvent financial institutions can obtain liquidity with the central bank.

So far, we have coped with this challenge. One stabilising factor has certainly been the fact that, well before the start of all this financial turmoil, the Eurosystem already accepted a broad range of assets as collateral in its refinancing operations. Another element was that we were able to flexibly adapt the existing framework to new challenges. We did so by adopting an ample allotment policy in our main refinancing operations, particularly at the beginning of each reserve maintenance period, by having wider recourse to fine-tuning operations when market conditions were rapidly changing, and by increasing the share of long-term refinancing operations. Last week, for our main refinancing operations, we decided to switch from a variable-rate tender with a minimum bid rate to a fixed-rate tender at the policy rate with full allotment, implying that financial intermediaries no longer face uncertainty about the share they will be allocated. Together with our decision to narrow the interest rate corridor for the standing facilities, this should also improve our ability to stabilise the overnight money market rate close to the policy rate and to adequately signal our monetary policy stance. Since December of last year, we have also provided liquidity in US dollars against ECB-eligible collateral, as part of a coordinated action by the central banks of several major advanced economies, including notably the United States' Federal Reserve. The amount of US dollar liquidity provision has in the meantime been increased, in view of the growing tension.

Yesterday, the Governing Council decided to further enhance the provision of longer term financing operations through fixed rate tenders with full allotment. Taking into account the substantial extension of the liquidity, as well in euro as in dollars, provided by the

Eurosystem and as there were signs that some counterparties were getting constrained by collateral, it was further decided to expand the list of Eurosystem collateral.

In a climate of generalised distrust, some financial institutions have come under particularly strong pressure. When they are systemically relevant, public authorities had to intervene in order to avoid contagion effects. In the euro area, it is up to national central banks to provide emergency liquidity assistance and to governments to reinforce the solvency of such institutions in order to restore confidence. Governments have recapitalised some institutions and have provided public guarantees to restore confidence in the interbank market. Smooth cooperation among all players involved is crucial. In particular, when the central bank does not directly supervise credit institutions, it is essential for it to receive without delay all relevant information.

Our second concern is that, at the same time, we need to think about and choose the appropriate monetary policy stance. In doing so, we have to take a somewhat longer perspective and weigh up the implications of the financial turbulence for the consumption and investment decisions of the various sectors in the economy, as these will in turn determine future outcomes for economic growth, employment and inflation. Eventually, the policy stance is set to optimise macro-economic outcomes, given *all* ongoing shocks (and that includes other shocks like rising oil and commodity prices which have also been buffeting the economy) and taking into account the underlying structure of the euro area economy.

One question that could arise here is whether the massive injections of liquidity into the banking system come at the price of either an inappropriate monetary policy stance or a less than optimal signalling of it. In practice, this is very unlikely to be the case. Indeed, since the beginning of the financial turmoil in August 2007, the ECB has repeatedly emphasised that the policy stance is defined in terms of the interest rate at which financial intermediaries can obtain liquidity, rather than by fixing the quantity of liquidity which is provided. As early as 1970, William Poole's classical analysis of the instrument-choice problem taught us that using the interest rate as policy instrument is desirable when short-term uncertainty stemming from instability in the money multiplier or from money demand shocks is high relative to the uncertainty stemming from aggregate demand shocks. The provision of liquidity then becomes an endogenous variable as it is steered in order to stabilise the money market rate at its desired level. In this framework, the sometimes substantial liquidity injections by the Eurosystem should be seen as simply offsetting the sudden and sharp declines in the money multiplier induced by the financial crisis.

As far as our monetary policy decisions are concerned, they depend on our medium-term assessment of the risks to price stability and are based on our two-pillar strategy, which enables us to cross-check developments in the money, credit and financial markets with the signals provided by economic analysis. Given existing upward inflationary pressures from oil and other commodity prices and the associated likelihood of second-round effects, euro area monetary policy was until recently faced with predominantly upward risks to price stability. However, as the financial crisis intensified further, financial conditions for the private non-financial sector have tightened – independently of monetary policy – and the supply of credit from financial institutions might be reduced. As a result, expectations regarding economic activity have rapidly deteriorated over the last two months and the upward inflationary pressures have eased, partly as a result of lower commodity prices but also because of the change in the outlook for domestic economic activity. Therefore, the coordinated interest rate cut of 50bp last week was also the appropriate response for the euro area to the materialisation of previously identified downside risks to growth and the associated decline in the upward risks to price stability. For the near future, we will continue to closely monitor all relevant economic, financial and monetary developments and act firmly whenever necessary.

Particularly at the current juncture, we expect monetary analysis to provide us with relevant information about how banks' balance sheets are adjusting to the financial crisis and what this implies for credit and money and, eventually, for economic activity and inflation. The

present situation is indeed exceptional in this regard, as financial frictions or constraints, which might seem only marginal in normal times, may now suddenly become predominant for understanding and forecasting economic developments. This comes on top of regular empirical analysis and reduced-form models which show systematic and quite robust relationships between monetary and financial developments and future economic activity and inflation. Money and credit developments tend to precede long-run inflation developments. Current asset prices influence future investment decisions, and measured risk premiums predict future cyclical developments.

These aspects are poorly developed in our standard econometric macro-models, as well as in the benchmark new-Keynesian model which is so prominent in the academic literature. For the time being, it is difficult to reproduce these statistical relationships and their time-varying nature in state-of-the-art structural models. That is the main reason why the Eurosystem's monetary policy strategy now deals with these aspects in a separate pillar. But it would obviously be extremely useful to have models that can integrate these relationships in a structural way. This is clearly the way forward for research on these issues. I firmly believe that this kind of conference helps to encourage research work on such integrated models and that policymakers will eventually benefit from these research efforts.

Let me conclude by stressing that the financial developments unfolding before us also reveal that we face important challenges beyond the business cycle horizon. Indeed, we have to rethink the role of asset prices, risk premiums and money and credit developments for the systematic conduct of monetary policy, for ensuring financial stability and for re-designing the regulation of the financial sector. Here again, we could clearly benefit from models which integrate real, monetary and financial developments. If there are actually common cycles in monetary, financial and real economic activity and inflation, it would be appropriate to adopt a longer-term perspective that concentrates on avoiding boom-bust cycles. Structural models that incorporate these interactions should be helpful to answer a crucial question: to what extent can monetary policy contribute to preventing excessive liquidity and financial bubbles from building up in prosperous times? They should also help clarify the role of financial regulation and the extent to which it should be designed to avoid any excessive accumulation of risk during good times and prevent binding capital constraints from adding to deflationary pressures during bad times.

It is important to better outline the relative role of monetary policy and financial regulation for price and financial stability, both in terms of strategies and institutional design. In today's integrated financial world, international coordination at appropriate level seems desirable for policies to be effective in this respect. In Europe, the organisation of banking supervision at quasi purely national level contrasts with financial market integration and the existence of cross-border financial institutions.

The current crisis raises all these challenges much more strongly than before. I am convinced that academic research in these domains will be boosted in the near future and that new and clarifying insights will result from this work. I sincerely hope our conference can help stimulate research in these directions.