

Christian Noyer: Monetary policy and the crisis – some lessons for the future

Keynote address by Mr Christian Noyer, Governor of the Bank of France, at the Paris-Europalace Financial Forum, Tokyo, 16 November 2009.

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Central banks have been very active over the last two years in containing the impact of the financial crisis. Monetary policy has made an important contribution to stabilizing financial markets and the real economy. Today, however, I will not talk about our response to the crisis, whether by conventional or unconventional measures. I will rather focus on the longer term and address two questions: "Was monetary policy the cause of the crisis?" and "How can it contribute to preventing future crisis?" These are two different questions. And they call for differentiated answers. While I doubt very much that monetary policy played a major role in triggering the crisis, I also believe that it can – and should – help in the future to better contribute to financial stability.

Was monetary policy the cause of the crisis?

One major success in the two last decades has been the achievement of price stability in most industrialized and many emerging economies. This success has rightly been ascribed to the monetary policy framework almost universally adopted in the world, which, beyond national differences and specific features, is based on two common pillars: Central bank independence and price stability as a primary objective. Price stability itself has coincided with – some would say produced – a prolonged period of strong growth and low output volatility, which, as you know, has been dubbed the "great moderation".

One major disappointment however, has been that price stability has not led to financial stability. On the contrary, it seems that, over the last two decades, financial crises have become more frequent, with increasingly serious consequences for growth and welfare.

To get a sense of this puzzle, it may be useful to look at the intrinsic dynamics of the financial system. Both in normal times and times of stress, amplification mechanisms are at work, which exacerbate the impact of any specific shock. These mechanisms act through changes in leverage, liquidity, and risk aversion. These three factors interact in a complex and sometimes unpredictable way. For instance, growth in leverage may be fuelled by an increase in risk appetite. In turn, larger balance sheets of financial intermediaries give rise to liquidity expansion and growing risk appetite. It is easy to see how these dynamics can create strong procyclicality in the evolution of asset prices and credit aggregates. It is also likely that procyclicality is partly created, or accentuated, by our accounting and prudential regimes.

If financial procyclicality was a short-term, mean-reverting, phenomenon, there would be little cause for concern. Unfortunately, those same mechanisms allow for the progressive build-up, over a long period of time, of significant imbalances and deviations in asset prices. At some stage, the correction becomes unavoidable, and is generally abrupt. That's where the crisis starts. It is important to note the asymmetry in these developments: imbalances are slow to build up but very fast to unwind. And the adjustment process can be disorderly and traumatic.

What role does monetary policy play? In a very basic sense, monetary policy is about determining the level of short-term interest rates. And it is equally basic to state that the interest rate is the price of liquidity. Therefore, it may happen that, because inflation is contained, interest rates are kept at a low level, and liquidity is cheap and easily accessible for financial intermediaries. In turn, abundant liquidity may increase risk appetite, induce

maturity transformation and lead to growth in leverage. This has been called the "risk-taking channel" of monetary policy. Ultimately, it creates a link between the level of interest rates and those of risk premia. And this, of course, means that movements in interest rates have, all other things being equal, a bigger (and possibly less predictable) impact on the financial system, credit aggregates and asset prices. A lot of work remains to be done to precisely quantify that channel and disentangle its effects from those of the more "traditional" credit channel. Nevertheless it is clear that, in the future, central banks will need to pay greater attention to the impact of their decisions on the level of risk in the financial system.

Some analysts would go a step further. They would state that the ultimate responsibility for the crisis rests with monetary policy. Specifically, according to this view, by keeping interest rates too low for too long a time, central banks have tolerated – or even condoned – the build-up in risk and financial imbalances. They "created", so to speak, the credit bubble which burst in 2007.

Let me state clearly that I don't share this view. It is very apparent that some features of recent financial innovation – including securitisation – have contributed to excessive risk taking and increased financial fragility. They explain why the crisis has been so severe. It is also striking that real – not only nominal – interest rates have stayed at low levels for an extended period of time. Over the medium run, long term real interest rates are beyond the control of monetary authorities. They have been driven by the continuous increase in saving rates which occurred over the last decade, especially in emerging economies. This created a demand for safe and liquid assets which could not be met by equivalent supply in those countries. Because of this "asset shortage", saving flows were directed towards industrialized countries, first of all the USA. At the same time the financial system in those industrialized countries worked to produce "complex" assets which *looked* safe and liquid – and were rated as such. Apparently, supply matched demand. But we know now that this was an illusion. Complex assets were neither safe nor liquid. The root causes of the crisis, therefore, are deeply structural. There was a combination of excess savings and asymmetry in financial developments between countries which was conducive to the formation of bubbles. This disequilibrium was amplified and compounded by distorted financial innovation. There was little, or no, role for monetary policy in that process.

Looking to the future, however, it is legitimate to ask **how monetary policy can better contribute to financial stability.**

Here, I would make four points

1. Financial instability should first be addressed and dealt with by specific tools. Those tools come in many forms, such as capital or margin requirements, loan to value ratios and liquidity constraints. Most are currently available to regulators and supervisors. They have been used, however, with one objective: ensuring the robustness and viability of individual institutions. There is now a need, which is widely recognized, for a change in perspective. Regulation and supervision should be designed and implemented in a broader, systemic perspective, with the objective of ensuring the stability and integrity of the financial system as a whole.
2. There is a strong case for giving central banks a pivotal role in this new "macro financial supervision". They have intimate knowledge of financial systems and markets. They have an incentive to act since monetary policy works better when financial institutions are robust and financial markets are stable and efficient. And, finally, they are well placed to have an integrated view of the economy and its interaction with the financial sector. Indeed, in many countries, it is envisaged to make the central bank the "systemic supervisor" or, at least, a central pillar in the macro-supervisory architecture.
3. A key question, however, is how this new financial stability function would interact with monetary policy. In theory, things are simple. Central banks would have several tools available for different objectives. One set of tools (interest rates, international

reserves) would, as now, be used to fulfil the price stability mandate. On the other hand, macro-prudential tools would support and foster financial stability. In such an ideal “Tinbergen” world, each instrument would be precisely assigned to a single objective.

Things may be more complex in the real world because these instruments are not independent. For instance, changes in capital requirements will affect credit growth and the transmission channel of monetary policy. Conversely, as I said, levels of or movements in monetary policy rates may increase or decrease the level of risk inside the financial system, hence its vulnerability to shocks. Finally, there may be circumstances in which the objectives of price and financial stability may not be fully compatible.

4. When instruments overlap and the objectives possibly conflict with each other, the potential for confusion is real and significant. To avoid any damage to central banks' credibility and ability to fulfil their mandate, it is essential that a clear and transparent framework should be in place. It should be made clear, in particular, that, whatever the new tasks and functions of central banks, price stability should remain the primary objective of monetary policy. As I said, this may not be a sufficient condition to ensure financial stability. But it is certainly a necessary one. Looking at recent events, the credibility of central banks has enormously helped to contain financial instability and its effects, both directly and indirectly. Directly, because their credibility has allowed central banks to act forcefully in the knowledge that they could do so without “disanchoring” inflation expectations. And indirectly, because, with expectations firmly anchored, the risk of a deflationary spiral has been considerably reduced. Indeed, even when instant inflation turned negative in many countries for several months in a row, long-term inflation expectations remained remarkably stable.

To maintain and preserve this necessary clarity, we are fortunate, in the Eurosystem, in having an appropriate and efficient framework. The Treaty specifies that the primary objective of monetary policy should be to achieve price stability; and that other goals can only be pursued without prejudice to this primary objective. The financial stability function fits naturally into this hierarchy. It cannot be pursued at the expense of the main objective.

As you know, our approach to monetary policy making is organized around two “pillars”, with one specifically focused on monetary and credit aggregates. We have mainly used this second pillar to detect potential long-term risks to price stability. It has long been known, however, that strong growth in credit and money aggregates often signals or accompanies the emergence of bubble-like asset price movements or incipient financial imbalances. We can therefore expect to obtain useful insights, in the future, from this second pillar in the fulfilment of our financial stability mission.

Looking ahead, central banks face significant challenges. They are well equipped, however, both in terms of expertise and institutional framework, to take on new responsibilities without in any way compromising their core mandate, their independence or their credibility.

Thank you.

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