Jean-Pierre Landau: The role of central banks – lessons

Remarks by Mr Jean-Pierre Landau, Deputy Governor of the Bank of France, at the VIth International Symposium of the Banque de France on "Which regulation for global imbalances?", Paris, 4 March 2011.

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I am going to talk about the relationship between monetary policy and financial stability. This topic is abundantly debated. I will take, however, a modest approach and deal only with some operational aspects. These are, nevertheless, crucial since the essence of modern Central Banks is their *operational* independence. It is therefore relevant to ask how it might be affected or impacted by the search for greater financial stability.

The starting point is that financial frictions matter. They matter both for financial stability, which is obvious, and for the transmission of monetary policy, a point which should have been obvious but was somehow forgotten. Prior to the crisis, most of our macro models tended to represent the transmission mechanisms through a simple, immaculate, inter-temporal substitution effect whereby changes in policy rates would induce expenditures shifting across time. Money and financial institutions play almost no role in that mechanism, as credit was implicitly supposed to respond only to interest rate movements.

What do the words "financial frictions" exactly mean? I will interpret those terms as encompassing the conjunction of maturity transformation and leverage which drives the expansion or contraction of financial institutions' balance sheets, thus the overall equilibrium in credit markets, including securitized markets.

Those dynamics obviously have a direct impact on financial stability. Financial fragility comes out of excessive leverage and maturity transformation, fueling asset price increases. And, conversely, liquidity shocks and deleveraging are the symptoms and channels behind financial crises.

As importantly, and less recognized until recently, those dynamics also have a major impact on the transmission mechanism of monetary policy. The functioning of the credit channel, but also the interest rate channel depend on financial intermediaries being able to fund themselves and arbitrage across different market segments, instruments and maturities. Dysfunctional credit markets were a major reason why Central Banks embarked into exceptional liquidity provision, credit easing and asset purchases.

One important point, here, is that the same dynamics affect both financial stability, on the one hand, and monetary transmission channels, on the other. Now, presumably, any macro prudential policy would try and influence the evolution of maturity transformation and leverage. By doing so, however, it would also have a monetary impact. And, conversely, changing the monetary stance, by moving policy rates, also may have an influence on financial stability.

The relative strength of those influences is not empirically known. Those of us who would use monetary policy with a financial stability objective implicitly assume that leverage and maturity transformation are very sensitive to interest rates. I am not sure this is true. At the very least, during the crisis, we have seen deleveraging proceeding at an accelerated pace, although interest rates have been brought down – and this is the reason why there has been a zero lower bound problem. I suspect that, symmetrically, interest rate hikes would have been powerless to stop the incredible build up in leverage prior to the crisis.

This is the very reason why we need additional – macro prudential – tools to deal with financial instability. But this analysis also shows that macro prudential and monetary tools are not independent. So we have to give up the ideal vision of a world where two objectives – price and financial stability – would be pursued with two independent set of instruments. The reality is somehow messier and this has important consequences. Operating two different policies with two sets of *interacting* instruments is definitely a challenge. Once we move away from the pure "Tinbergen" world, preserving the operational independence of monetary policy may require particular attention.

Add to this that mandates and accountability regimes are very different for price and financial stability. Central Banks are independent, but macro prudential authorities are not. In all major jurisdictions, Governments, and Parliaments, are deeply involved in the organization and management of macro prudential supervision. Likewise, while price stability mandates are precisely defined and often quantified, financial stability mandates are specified in very broad terms. There are good reasons for this situation. In devising and implementing macro supervision, authorities are facing delicate trade-offs between efficiency and stability in the financial system. Deep social choices are involved, which, arguably, can differ across countries and periods of time. Also, as recent experience has shown, financial stability may ultimately involve fiscal commitments.

Finally, and most importantly in my view, we lack the analytical framework upon which both a financial stability mandate and operational independence could be validly and legitimately anchored. Central Bank independence has closely followed theoretical breakthroughs, in the 1970s, in our understanding of inflation dynamics. It was made possible because societies reached a common – and easily communicable – agreement on the lack of trade-offs involved, on the long run, between inflation and growth. That robust, and commonly shared analytical background on what monetary policy could – and could not – achieve was essential in establishing the primacy of price stability and the legitimacy of independence in monetary policy making. We are very far away from such a theoretical agreement on the causes of financial instability, on the real trade-offs between efficiency and stability in finance, on the role of innovation and, finally, on the origins and detection of asset and credit bubbles. It would therefore be illusory, and dangerous, to expect that a precise mandate for financial stability could be defined, let alone quantified, in a foreseeable future.

The situation is therefore somehow confusing and this raises important challenges for the future. At the risk of oversimplifying, Central Banks associated with – or responsible for – financial stability may find themselves with:

- two separate missions: price and financial stability
- two different accountability regimes: full independence for monetary policy; coordination or subordination mode for financial stability
- two interacting sets of instruments: interest rates and macro prudential tools (a situation made even more complicated when unconventional monetary policies are implemented)

The potential for confusion is real. It is not difficult to imagine situations where actions that Central Banks take on pure monetary policy grounds are nevertheless contested in the name of financial stability. To some extent, this has always been a possibility. The difference, now, is that institutional frameworks exist through which – implicit or explicit – challenges to Central Banks operational independence can materialize.

It might be tempting to conclude, then, that Central Banks should stay away from financial stability and concentrate exclusively on ensuring price stability. This, unfortunately, is impossible, if only for reasons that Charles Goodhart has well explained in a previous paper: ultimately, Central Banking is about providing liquidity and liquidity provision is an essential and central component of financial stability.

What can we conclude?

- First, central banking is not only about monetary policy but also involves an essential component of financial stability. This seems to me a broad consensus coming out of the crisis.

- Second, monetary policy is about setting interest rates, but also involves observing and analyzing leverage and liquidity. Monetary aggregates as well as the volume and modalities of maturity transformation reveal very useful information on the transmission mechanism. This is actually the conventional wisdom within the Eurosystem, through the use of the second pillar. Although less acceptable outside the euro area, I conjecture that the lessons of the crisis will trigger some rethinking here and there.
- Finally, the debate on whether monetary policy should also aim at financial stability must give more consideration to the awkward interaction between instruments and the diversity of accountability regimes. Both create the potential for additional confusion about the ultimate objectives of each policy. It seems to me that most of the discussions are conducted under the implicit assumption that price stability will be as easy to maintain in the next decade as it was in the past. So, there would not be much to lose in "diverting" some of the power and credibility of monetary policy to seeking financial stability. It is very clear that this assumption is severely tested, perhaps sooner than we thought. It will be important, in this environment, to maintain clarity of purpose and robustness in institutional arrangements in order to limit the risk of weakening the benefits of Central Bank independence, which were so hardly won over the last decades.