Christian Noyer: Monetary policy – how to cope with the current financial crisis?

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Five years into the crisis, central banking does not look the same. Numerous and significant changes have occurred in the way in which central banks perform their duties and fulfil their missions. Whether we are witnessing temporary departures from normality or irreversible transformations is hard to tell. According to one view, frequently expressed, the crisis has ushered in a new era for central banking where independence, in particular, cannot be taken for granted. I do not share that assessment. True, central banks all around the world have taken on exceptional responsibilities. But they have also faced exceptional circumstances. And they have done so in a fully independent capacity and in accordance with their mandates.

I also believe that, without such actions, the crisis would have inflicted much greater damage upon advanced economies. On numerous occasions, determined interventions by central banks have stabilised financial markets as spirals and panics were developing. Central banks have constantly dealt with dysfunctions in credit and capital markets, borne out of excessive risk aversion.

These interventions have largely succeeded in avoiding deflation and a cumulative fall in GDP during the most acute phases of the crisis. It remains true, however, that, contrary to past episodes which followed deep recessions, the current recovery appears sluggish, uncertain and fragile. The global growth environment remains affected by significant uncertainties. Today, I would like to reflect upon these developments and focus on the challenges facing central banks in the post-crisis environment.

1. Let me start with a few stylised facts

The first, and most visible, is the spectacular expansion in central banks' balance sheets. In all advanced economies, their size has been multiplied, over four years, by a factor of two to five. This is an unprecedented development. Beyond advanced countries, central banks in emerging economies have also, to a lesser extent, expanded their balance sheets, mainly, but not only, as a result of foreign exchange interventions.

A second, and related, feature is the diversification of central banks' interventions. Prior to the crisis, central banks would conduct monetary policy by determining the policy rate, and, in some countries, by imposing compulsory reserve requirements on banks. The crisis has led to the development and proliferation of so called "non-conventional measures", with two objectives. First, to remedy financial market disruptions; and second, to provide further monetary accommodation once policy rates have been brought down to very low levels and hit the so-called "zero lower bound".

Most, but not all, non-conventional measures have led central banks to use and expand their balance sheet in order to influence a broader set of financial parameters: long-term interest rates, credit spreads and credit volumes. In the euro area, the bulk of interventions have aimed at providing unlimited liquidity to the banking system, first through the "fixed rate full allotment" procedure adopted in 2008, then through a progressive extension of maturities, culminating in the two three-year LTROs decided on in December 2011. Other central banks, and more recently, the Eurosystem, have resorted to asset purchases, both private and public, sometimes on a large scale. So-called "forward guidance" on interest rates has been

used, especially in the United States, to influence interest rate expectations and bring down the yield curve.

Most recently, additional innovations have been introduced in the United Kingdom and Japan, where central banks have taken actions to directly stimulate private credit to the economy. These actions have involved a mix of regulatory measures and targeted liquidity providing operations, such as the "funding for lending" scheme implemented in the United Kingdom.

2. It is important to note that none of these developments were imposed on central banks by governments. In all countries, non-conventional measures and the consecutive expansion of balance sheets were a deliberate and voluntary response to financial market developments that threatened their integrity, their functioning and overall economic stability.

Nor were these measures planned in advance. Central banks had to react to unforeseen developments with very little recent historical experience to guide their decisions. Overall, the response to the crisis was largely a "learning-by-doing" process.

With hindsight, however, there appears to be an underlying logic to all these interventions.

First, after the bursting of the credit bubble, all advanced economies entered a phase of deleveraging, in an attempt to reverse and absorb the excesses of the pre-crisis period. Deleveraging, which is basically a balance sheet contraction, has affected almost all sectors in our economies: banks, obviously, households (in the United States and United Kingdom) and, now, governments. Deleveraging is unavoidable and necessary. Both borrowers and lenders need to re-establish sustainable debt positions in order to restart credit and restore the normal financing of the economy in the long run. But deleveraging creates huge difficulties in the short run. It may be extremely deflationary as it involves both a contraction in credit and money and an increase in savings rates. To some extent, central banks have counteracted this development. By expanding their balance sheets, they increased their leverage when other economic agents (with the exception of large corporates) were all deleveraging simultaneously.

Second, the uncertainty created by the crisis has led to an increase in the demand for safe and liquid assets. At the same time, the supply of these assets has been significantly reduced, especially in Europe, since credit risk has appeared on government debt. To some extent, central banks have partly narrowed this gap between demand and supply by providing financial intermediaries with the safest and most liquid assets of all: their own liabilities, in the form of deposits and reserves held by banks. The importance and usefulness of this function is illustrated by the significant amounts still outstanding in the Eurosystem deposit facility or in the form of non-compulsory reserves.

It is, indeed, in the essence of central banks' historical function to step in when dislocations in financial markets appear and to contain long-lasting damage to the economy. If they fail to act, then self-fulfilling expectations could lead to panic and financial dislocation.

A good example is the situation in the euro area in the second quarter of this year. Week after week, there were growing signs of a perceived "convertibility risk" between different parts of the euro area. However unfounded, these self-fulfilling fears destabilised capital flows and led to the rapid and increasing segmentation of financial and credit markets. Financial conditions were increasingly divergent across the euro area, irrespective of the quality of borrowers and the level of policy rates. If left unchecked, this process would have rendered monetary policy totally powerless to combat both inflation and deflation, if either of these risks had materialised. This was, for the Eurosystem, an unacceptable situation. It led the Governing Council to announce in September the introduction of the Outright Monetary Transaction (OMT) programme, whereby the Eurosystem may purchase government debt with a maturity of up to three years. As you know, OMTs, while ex-ante unlimited in time and amount, are strictly conditional upon the country implementing a programme making it eligible to financing from the European Stability Mechanism.

3. By definition, "non-conventional" policies are highly innovative and central banks have made great efforts and devoted large resources to explaining their rationale and modalities. Nevertheless, there remain some misperceptions and concerns which I will briefly try to dispel and address.

First, there are fears that the whole process of balance sheet expansion is inflationary. Indeed, one important effect of non-conventional policies is to significantly increase the quantity of central bank money in the economy. Since, ultimately, inflation is always and everywhere a monetary phenomenon, it may seem natural to anticipate further inflationary pressures down the road. While I understand these preoccupations, I do not see, in the current situation, any reason for concern. True, there has been a strong increase in central bank money and the situation should be monitored accordingly. What matters, however, for inflation, is the changes in broad monetary aggregates, which determine private agents' ability to purchase goods, hence the price level. These broad aggregates have either remained unchanged or grown very slowly. What has happened, in fact, is that broad money has been substituted by central bank money as economic agents have felt the need to hold more liquid and safer assets. This expansion in central bank money has not affected inflation expectations, which have remained well-anchored.

Should the situation change, nothing has been done that would impair our ability to fulfil our primary mandate and preserve price stability. Many tools are available to absorb liquidity, if it proves necessary.

Concerns are also expressed in the euro area about purchases of government debt as a form of "monetary financing" of the government. As you know, such purchases are explicitly allowed for in the Treaty. There is no legal issue, here. What about the economics? This question can be broken down into two. First, the market impact. True, these purchases may lead to lower interest rates. This is their purpose. OMTs will only take place if and when the Governing Council has determined that bond markets are no longer functioning properly, hence interest rates are distorted. A last, serious, concern is moral hazard. Lower interest rates triggered by secondary purchases could give rise to bad incentives, impede market discipline and delay necessary fiscal adjustment efforts. This is the very reason why strict and explicit conditionality is attached to OMTs.

4. Central banks have been active; they have been audacious; but they do not have unlimited power. This may be a good time to reflect upon what monetary policy can and cannot do. I will concentrate on one specific question: the so-called "decreasing returns" of non-conventional monetary policy. The argument goes as follows: balance sheet expansion and low interest rates create potential imbalances in the financial sector. Past a certain stage, the potential cost and instability stemming from these imbalances far outweigh the short-term benefits for the economy.

There is, indeed, a difficult trade-off. The very purpose of non-conventional policies is to induce some risk-taking, encourage portfolio rebalancing and stimulate lending by the private sector. The danger, of course, is that "wrong" risks are being taken with no credit to the productive economy and low interest rates causing a search for yield in speculative assets. The situation, therefore, requires a very subtle calibration of our overall stance. It seems crucial today that we carefully consider the joint effects of monetary and prudential policies – both on capital and liquidity requirements – to make sure that they do not produce unintended effects on capital allocation.

5. Central banks' actions are not limited to fighting the crisis and stabilising the financial system. In the euro area, under the impulsion of the European Council, we are working on building a more robust and efficient financial system. One major weakness revealed by the crisis is the strong link between banks and sovereigns. As a result, any negative fiscal shock or bad news has an immediate adverse effect on the overall financing conditions for the private sector. And, at the same time, difficulties experienced by banks give rise to expectations of a public bail-out and lead to a deterioration in the perceived creditworthiness

of the sovereign. Such very powerful and perverse feedback loops have been at work during critical phases of the crisis, over the last two years.

The purpose of the banking union, decided on in June, is to break that link and create, as a first stage, a single supervisory mechanism in the euro area under the auspices of the ECB. It is essential that the banking union be rapidly implemented, covering all credit institutions. It will restore confidence in the banking system. It will re-establish the normal functioning of monetary policy. It will de-segment financial markets and allow for normal private capital flows within the euro area. It will ultimately allow for a disengagement of the euro system from interbank and financial intermediation. Moving decisively towards a Banking Union is one major contributing factor in reducing uncertainty and boosting confidence.

Conclusion: the ability of monetary policy to fight uncertainty

Uncertainty is a major cause of the current weak recovery. One may point to the paradox in the present environment characterised by very low interest rates, very large cash reserves in the hands of corporates, but very little investment. The good news is that a small spark could have huge effects. The bad news is that this spark has not occurred.

Monetary policy cannot by itself remove economic uncertainty. It can contribute to limiting and attenuating its effects. It is also essential that other sources of uncertainty be dealt with, especially when they stem from government policies. In the euro area, fiscal consolidation must continue and crisis management mechanisms must be made operational. In other countries, such as the United States and Japan, future fiscal uncertainties must be eliminated. Finally, stable regulatory regimes, first and foremost in the financial sector, are also essential.

For its part, monetary policy must be predicable, not in the sense that each and every move of the monetary authorities be precisely anticipated, but rather, that their objectives be clear and their actions fully understandable by economic agents. Strong, independent and responsible central banks are, more than ever, necessary to price and financial stability.