Mario Draghi: Opening remarks at the session “Rethinking the limitations of monetary policy”

Speech by Mr Mario Draghi, President of the European Central Bank, at the farewell conference honouring Professor Stanley Fischer, Governor of the Bank of Israel, Jerusalem 18 June 2013.

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Ladies and gentlemen,

The topic for this session – “the limitations of monetary policy” – is one that has attracted a great deal of attention since the beginning of the financial crisis. Circumstances have forced all major central banks to resort to instruments and policies carefully tailored to the unusual situation. Alex Cukierman and Michael Woodford, who will present their views on the issue in a few minutes, are among the prominent academics that have written about it extensively[1].

Before handing the floor to them, let me say a few words about the current situation in the euro area, about our perspective at the European Central Bank (ECB) on today’s topic and about longer-term issues for the euro area.

In terms of the current situation, the euro area economy is still in a phase of adjustment. Real GDP fell by 0.6% in the fourth quarter of 2012 and by 0.2% in the first quarter of 2013. Output has thus declined for six consecutive quarters, labour market conditions remain weak and public and private sector balance sheet adjustments continue to weigh on economic activity. Unacceptably high levels of unemployment, particularly youth unemployment, are the prime concern of economic policy-makers.

Recent survey data suggest some improvement, but from low levels. Export growth should benefit from a recovery in global demand. Domestic demand should be supported by accommodative monetary policy; by the recent real income gains from lower oil prices and lower inflation; and by the confidence and wealth effects stemming from the improvements in financial markets since last summer.

The ECB’s Governing Council has stressed that that monetary policy will remain accommodative for as long as necessary. In the period ahead, we will monitor very closely all incoming information on economic and monetary developments and stand ready to act if necessary.

In the meantime, it is important to note that economic and financial fragmentation in the euro area has declined significantly since last summer. This has had beneficial effects for the real economies of all euro area countries.

Banks in stressed countries have been able to regain access to interbank and capital markets – and they have raised funds as well as capital. Larger corporations have benefited from lower borrowing costs in capital markets. And small and medium-sized enterprises have seen borrowing costs from banks somewhat reduced. All of this should support investment.

Target balances, which provide a powerful summary indicator of fragmentation, have declined by almost 300 billion euros or 25% from their peak. The costs of protection against

[1] See, for example, Cukierman, A., 2013, Monetary policy and institutions before, during, and after the global financial crisis, Journal of Financial Stability, in press, and Cúrdia, V. and Woodford, M., 2011, The central-bank balance sheet as an instrument of monetary policy, Journal of Monetary Economics, 58(1), 54–79.

risks of deflation have fallen from peaks twice their long-term average last summer to slightly below average now[2].

Overall, monetary policy has regained steering capacity, which had become lost for large parts of the euro area in mid-2012. This is an important positive development.

Let me turn now to the limitations of monetary policy. Here I see two possible dimensions.

The first is positive and refers to the effectiveness of central bank actions at the margin – for example, when interest rates are close to zero.

The second is normative and refers to the constraints imposed on us by our mandate and to the fears that boundaries between central bank policies and other policies might become blurred.

I will not dwell on the first dimension because I do not think that we are materially challenged in our ability to deliver our objective of price stability by the low level of interest rates.

Looking back, despite extraordinarily testing economic circumstances, inflation in the euro area has remained on the whole consistent with the ECB's objective of below but close to 2%.

Looking forward, Eurosystem staff project annual HICP inflation at 1.4% in 2013 and 1.3% in 2014, but medium-term inflation expectations remain anchored in line with our definition of price stability.

One reason why inflation expectations have remained broadly stable is that we – and other major central banks around the world – have prevented the materialisation of deflation risk by adopting both standard and non-standard measures as and when necessary.

In the euro area, one such non-standard measure was the introduction of the outright monetary transactions (OMT) programme last year, the stabilising effects of which are widely recognised.

There are numerous other measures – standard interest rate policy and non-standard measures – that we can deploy and that we will deploy if circumstances warrant.

At the same time, I have also made clear that some of those measures may have unintended consequences. This does not mean that they should not be used, but it does mean that we need to be aware of those consequences and manage them appropriately. We will look with an open mind at these measures that are especially effective in our institutional setup and that fall within our mandate.

This leads me to the second dimension of discussion of the limitations of monetary policy, namely the risk of a blurring of the boundaries of central bank policy.

To approach this question, it is useful to refer to the framework put forward by another prominent scholar in central bank matters. Marvin Goodfriend classifies central bank actions into three categories[3].

The first category is what he calls "monetary policy" proper – changes in the size of the monetary base via purchases and sales of government securities.

Second comes "credit policy" – changes in the composition of the central bank's assets between government securities and claims on the private sector of various kinds.

[2] See P. Praet, Monetary policy in the context of balance sheet adjustments, Speech at Peterson Institute for International Economics, 22 May 2013.

[3] See Goodfriend, M., 2011, Central banking in the credit turmoil: an assessment of Federal Reserve practice, Journal of Monetary Economics, 58(1), 1–12.

Third is "interest on reserves policy" – changes in the opportunity cost for banks to hold reserves or excess reserves.

Goodfriend argues that all three categories have fiscal implications. And he states that credit policy and interest on reserve policy involve the use of public funds in a way that may imply an allocative role – and which may therefore blur the respective roles of the monetary and fiscal authorities.

In this context, it is worth recalling that the monetary constitution of the ECB is firmly grounded in the principles of 'ordoliberalism', particularly two of its central tenets:

- First, a clear separation of power and objectives between authorities;
- And second, adherence to the principles of an open market economy with free competition, favouring an efficient allocation of resources.

More explicitly, and by reference to another famous framework – the three basic policy functions that Richard Musgrave described as allocation, stabilisation, and distribution, and which aim delivering what Tommaso Padoa-Schioppa later described as efficiency, stability and equity – our policy is concerned only with macroeconomic stabilisation through the pursuit of price stability. We do not and should not play an active role in the functions of allocation and distribution[4].

At the same time, our operational framework has always included elements of what Goodfriend qualifies as credit policy.

The ECB manages liquidity and steers money market rates by lending to banks in temporary credit operations against a broad range of collateral.

Furthermore, we have always remunerated reserves.

Does the fact that our operations entail some credit risk on the balance sheet of the central bank imply a violation of our ordoliberal principles? Does it imply that the ECB policy interferes with credit allocation? My answer is no.

The risks we take onto our balance sheet in the context of our operations are controlled, and they are accepted only insofar as they are strictly necessary for the pursuit of price stability. This is entirely consistent with the concept of monetary dominance, which stipulates that fiscal considerations cannot stand in the way of the achievement of price stability.

Indeed, ECB credit is backed by adequate collateral, which implies that the amount of residual risk borne by the central bank is buffered. There are two layers of protection.

The first is founded on the ECB's recourse to the borrowing institutions and the full credit and guarantee represented by their balance sheets.

The second – when the first is exhausted – is given by the appropriation of the collateral posted as backing of the loan. If a counterparty defaults, the underlying collateral assets allow for the recovery of the amount lent. The use of risk control measures such as valuation haircuts and variable margins further mitigate the exposure to credit risk.

The same risk control principle applies in the context of the OMT programme, through limitations on the maturity of eligible securities (one to three years) and through the strict conditionality for a country to be eligible for the programme.

Another aspect of our operations is that they are designed precisely with the goal of achieving neutrality in credit allocation.

[4] Having said that, the objective of monetary policy being stabilisation does not imply that it cannot contribute to efficiency and equity, and indeed stable prices are a precondition of both (see B. Coeuré, Monetary Policy in a fragmented world", Speech at Oesterreichische Nationalbank, Vienna, 10 June 2013.

The ECB's policy framework was designed with a view to allowing the participation of a broad range of counterparties.

The framework rests on the fundamental principle of equal treatment of counterparties.

Equal treatment is also reflected in the collateral framework, which features a broad range of assets and a set of eligibility criteria that apply to all Eurosystem credit operations without distinction.

A further observation is that lending to banks is consistent with an untargeted monetary policy.

In the euro area, the majority of credit intermediation is processed via the banking system, as opposed to financial markets. Banks lend to households and to financial and non-financial firms of any size across the credit spectrum. Influencing bank funding conditions amounts to influencing credit conditions across the whole economy.

What I have said applies in normal times, but it also largely applies in the specific circumstances of a fragmentation of the financial system – circumstances that we have faced and continue to face, albeit to a diminishing extent.

Financial fragmentation in itself creates a distortion of the allocation of resources. It undermines the concept of a free market economy because it alters the conditions of competition.

In this context, the measures that we have implemented through the crisis do not have an allocative or distributive role. On the contrary, by supplementing financial intermediation where it had become dysfunctional, they have contributed to re-establishing the allocative and distributive neutrality of markets.

The liquidity measures that we took early in the crisis can be interpreted in this light. At that time, central banks had to substitute for the sudden disappearance of interbank market activity by acting themselves as a money market intermediary when necessary.

For the ECB, this task was facilitated by the wide range of counterparties accepted in refinancing operations and by our broad collateral framework. Other central banks had to innovate more through the use of various targeted facilities outside their normal operating framework in order to reach out to the broad economy.

The ECB could also mobilise its collateral framework to relieve the liquidity constraints faced by banks. We expanded the list of eligible collateral, so that banks could liquefy their balance sheets and mobilise assets that had become difficult to trade.

In addition, the ECB could further contribute to alleviating the banks' funding uncertainty by providing banks with assurance that they could rely on our refinancing operations for extended periods.

The maximum maturity of our operations increased from three months to three years. Through these measures, the ECB decisively addressed the liquidity pressures faced by euro area banks and avoided a genuine credit crunch.

Professor Fischer,

Ladies and gentlemen,

What must be clear from what I have said so far is what constitutes the limitations to our actions, consistent both with the letter of our mandate and with the philosophy of the market economy that underpins it. We have been able to regain better control of monetary conditions in the euro area economy, which is very important for providing the appropriate monetary policy impulse to the economy.

Part of this achievement is due to the announcement of the OMT programme. But equally important has been the progress in economic reform and adjustment at both the country level and the euro area level.

Such reforms need to continue. There is still a rich reform agenda, especially structural, at the country level for many members of the euro area. There is also an important reform agenda at the European level. One key aspect of that is the banking union, which rests on single supervision and single resolution, the latter with an effective backstop if necessary.

Preparations for single supervision at the ECB are advancing, and naturally we are working closely with the relevant national authorities. Five work streams are underway: first, on mapping the euro area banking system to identify systemically important banks; second, on the supervisory model to be adopted, which is most likely to be centred around joint supervisory teams; third, on supervisory data reporting; fourth on legal issues; and fifth, on the asset quality review that we will undertake prior to taking any bank under supervision.

Formal adoption of the legal texts by the European Parliament will allow us to formalise the preparations and launch them so that we can be operational one year after adoption.

Effective supervision requires effective resolution, which in turn requires establishment of a single resolution mechanism. We count on the European Commission to make a proposal in due course.

Once these processes are launched, the banking union will be within operational reach. It should provide an answer to many of the challenges currently facing the euro area, including uneven credit conditions and the fragmentation of financial markets.

When observers from outside look at our Economic and Monetary Union, they often emphasise how unfinished it appears compared with fully established unions such as the United States. In so doing, they highlight a number of unresolved issues, for example that in a monetary union of 17 otherwise sovereign states, a credit or transfer across Member States is viewed differently from a credit or transfer within an individual Member State. The equivalent of Target balances, for example, is a non-issue in the United States. However, such observers vastly underestimate the political capital invested in the euro by our leaders, as well as the political significance that such an investment has for the future of Europe.

Of course, much work remains to be done for economic policy-makers across Europe. But I am confident that together we can build a stronger economic and monetary union that ultimately delivers jobs, growth and a return to prosperity for the citizens of the euro area.

Thank you for your attention.