Jörg Asmussen: The global monetary policy stance – what are the risks?

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Bruegel Annual Meeting, Brussels, 10 September 2013.

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Dear Chairman, dear Ladies and Gentlemen,

The recent years have been challenging for monetary policy makers around the world, including in Europe. The economic and financial crisis that broke out in late 2008 turned central banks into "unconventional" market players and forced them to be creative.

Since 2007, central banks have adopted a wide range of unconventional policies to repair the transmission mechanism and provide additional accommodation at the zero lower bound. These policies have been different across economic areas and depended on central banks' operational frameworks, mandates and country specific challenges.

Within our mandate, we at the ECB, at the be-ginning under the leadership of Jean-Claude Trichet, acted strongly to prevent a credit crunch and reduce financial fragmentation in the euro area:

- We provided unlimited liquidity to banks, extending the maturity of our operations to 3 years, and allowed our collateral rules to adjust to the new environment. These measures prevented a more severe contraction in credit and reduced divergences across countries caused by bank funding risk.
- We introduced the Outright Monetary Transactions (OMT) to remove financial fragmentation caused by currency redenomination risks that had surfaced due to unfounded fears of a euro break up. The OMT has calmed markets leading to significantly improved financing conditions. As a result, Target 2 imbalances have declined by 1/3 since their peak. Let me also say that the OMT is a policy for the euro area as whole. By reducing financial fragmentation, the OMT contributed to the normalisation of those yields that were excessively compressed by market fears.

While unconventional monetary policy actions were necessary, we also need to pay attention to the related risks. Let me briefly discuss them together with broader challenges for monetary policy.

One risk is complacency. Monetary policy can only gain time for other policy makers to tackle structural problems. This is particularly important in Europe where governments need to continue implementing structural reforms to boost growth potential and employment, especially among the youth, to consolidate public finances, and to strengthen domestic banking systems.

Another risk relates to the side effects of globally low yields, which has already been widely debated in international fora. Risks of capital misallocations, stemming from low risk premia and yields, are not confined to domestic economies. Large capital flows moved to emerging markets searching for yield. As Christine Lagarde recently recalled at the Jackson Hole Economic Symposium, since 2008, cumulative net flows to emerging markets have risen by $1.1 trillion, which is large from an historical point of view.

A third risk relates to exit strategies from monetary accommodation. Exit risks are now taking centre stage in the debate. (But to be clear: for us in the euro area it is too early to start the exit.) On this front, I would like to recall a similar episode from which we can draw some lessons: the 1994 exit of the Federal Reserve.

In early 1994, when the US recovery gained strength, the Fed started a tightening cycle and bond markets crashed not only in the US but al-so around the world. If spill-overs were large in 1994, we can expect them to be even larger to-day in an even more deeply interconnected world.

One striking feature of the 1994 bond market crash is that yields actually overreacted to macroeconomic news, while they did not react strongly to Fed interest rate hikes.

For example, 8 of the 10 largest daily in-creases in the 10 year US Treasury yields in 1994 were related to the release of better than expected economic data.

Anecdotal evidence also suggests that inflation fears contributed to the spike in yields.

Indeed, in 1994, the political pressure on the Fed to slow the tightening cycle was high. All Reserve Bank Presidents were invited to explain their views before the House and Senate banking committees, which was unprecedented. According to commentators, this public dispute damaged the credibility of the Fed, contributing to the inflation scare.

In my view, two important lessons seem to emerge from the 1994 episode:

- First: Clarity regarding central banks' "reaction functions" is crucial to avoid sharp movements in yields. This is because the impact of economic developments on yields depends on markets' expectations on how the central banks will react.
- Second: Inflation fears amplify the impact of economic developments on yields. There-fore, it is important that inflation expectations remain well anchored.

While central banking and the functioning of capital markets have changed since and new challenges and complexities have emerged, the lessons from the 1994 episode remain valid and might help in addressing these challenges.

The first challenge is that monetary policy is currently in unchartered territory. Policy choices of central banks are not any more limited to the single interest rate instrument. As a consequence, communicating exit strategies is more complex than in previous tightening cycles.

At the ECB, the exit is made easier by the policy instruments used. Security holdings of the SMP will be held until maturity. Excess liquidity is sterilised with reverse operations. Banks can pay back long term loans before maturity as market conditions normalise. At the same time, the ECB remains ready to act if conditions deteriorate.

The new role of central banks in preserving financial stability is another challenge. Following the crisis, the prevailing view suggested to as-sign new powers to central banks, in the form of stronger involvement in bank supervision and macro-prudential policies. Some observers argue that conflicts between financial stability functions and the primary goal of preserving price stability might emerge. To safeguard the credibility of the monetary policy function and of the supervisory function we will adopt a governance structure that strictly separates the two. And the hierarchy of goals is clearly set and communicated at the ECB: our primary objective is and will remain price stability.

For example, a central bank might find itself in a difficult situation if an interest rate hike necessary to avert risks to price stability would at the same time impact adversely on some banks. Allegedly, this could undermine the credibility of the central bank. In this context, communicating clearly and designing appropriate institutional frameworks is crucial.

We in Europe are very much aware of these challenges. At ECB, the preparation of the single supervisory mechanism (SSM) is progressing. The asset quality review of banks to be carried out before the SSM becomes operational will ensure that "hot potatoes" will not be handed over to the SSM. To complement the institutional architecture, we also need a strong commitment towards an effective Single Resolution Mechanism, along with efficient and credible backstops. The latter two elements are a necessary complement to the SSM and will ultimately increase its credibility.

Finally, threats to credibility and independence might also make the job of central bankers more difficult. Central banks have fulfilled their man-dates and proven successful through their measures and interventions. As a result of the earned credibility, politicians and the general public have now higher expectations as to central banks' ability to manage crisis and the economy. This might overburden central banks and make them more involved in sensitive areas.

The new challenges and complexities of today's environment make clear that communication strategies will play an increasingly important role in the dialogue between central banks and markets. In this regard, I want to conclude by mentioning two recent developments at the ECB:

The first one is forward guidance. Forward guidance is central bank communication about future policy intentions, not a new monetary policy strategy. It involves two elements of communication: an assessment of the central bank's view of the future, and in-formation on how the central bank may act in response.

In July, the Governing Council announced that it expects the key ECB interest rates to remain low for an extended period of time, on the basis of the outlook for inflation and against the background of economic weak-ness. The ECB's forward guidance is a pronouncement to reassert and clarify the strategy of the ECB and its assessment of the state of the economy.

In our case the forward guidance is geared to reach two objectives: to reduce the volatility in the corridor, in which we have succeeded so far, and to make sure that economic data do not cause overreactions in the market interest rates. On this ground we have been moderately successful. It is still early days and it remains to be seen how this evolves in an environment of improving economic data and a generalised increase in global long-term rates.

The second one is the discussion regarding the publication of the minutes of Governing Council meetings. The increasing role of central banks in crisis and economic management requires greater accountability, which calls for more transparency. The Governing Council is evaluating how to enrich the communication strategy of the ECB. I believe that publishing the minutes of Governing Council meetings would be an important element of a richer communication strategy. In my personal view the minutes, summarising the main policy discussions, should include who voted for what, and the reasoning behind that vote. Publishing the minutes in such a way will sharpen our mandate, because the ECB will then have to explain why its decisions are in line with its European mandate.

One should not overestimate the risk that pressure is exercised of members of the Governing Council, especially governors of national central banks. In my view someone who takes up such a position should be able to withstand such pressure.