Erkki Liikanen: Independence of monetary policy and the banking union

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Lamfalussy Lecture Conference, organised by Magyar Nemzeti Bank (the central bank of Hungary), Budapest, 2 February 2015.

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One of the lasting lessons we have learned from the monetary policy experience of the last decades is the value of the independence of central banks. What does this independence mean today? Why should we have it? What are the current problems involved?

The modern idea of central bank independence was born from the lessons learned in the fight against the high inflation of the 1970s and the 1980s. The Bundesbank became the role model which has not been forgotten. The supporting theory was later developed by the great economists of the day: Stanley Fischer, Kenneth Rogoff, Carl Walsh and others.

The fight against inflation was successful and the lessons learned from this fight inspired great reforms in the central banks. In Europe, those lessons inspired the writing of the statutes of the ECB. Securing central bank independence and preserving the hard-won price stability were key ingredients.

Today's monetary problems are very different. In some respects they are almost a mirror image of the problems of the great inflation era. But I am convinced that central bank independence is equally important in today's environment.

Still, it is interesting to think once more what exactly this independence means and what it requires in today's different context.

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In research, it is usual to distinguish two types of central bank independence: goal independence and instrument independence.

Just a few comments on goal independence.

Goal independence would mean the ability of the central bank to formulate the ultimate objectives of its policy. In democratic systems, goal independence is typically quite limited, and the objectives of central bank are given by elected bodies. This is how it should be. It gives the central bank's activities the necessary democratic legitimacy.

The ECB has been given price stability as its primary objective. The treaty left to the Governing Council to give an operational definition of what price stability means. As you know, the current definition, unchanged since 2003, is that inflation should be "below but close to two percent over the medium term".

The words "close to" were added to the ECB's definition of price stability in 2003, after a serious and thorough consideration. These words have now gained increasing weight, as inflation in the euro area has been clearly below 2 per cent for quite some time.

We have been forced to think carefully what the expressions "close to" and "over the medium term" mean. The Governing Council has remained committed to the definition of 2003, and with a good reason. The definition of price stability in the medium term must provide a credible anchor to expectations. So we must follow it to the letter.

Now on the other level of central bank independence, the instrument independence, before I return to price stability.

Instrument independence means that the central bank has a great deal of freedom to use its monetary policy instruments in order to achieve its policy goals. Without such freedom, the ability of monetary policy to achieve its objectives would not be credible and the policy itself could become ineffective.

Modern central banks have a very high degree of instrument independence since the 1990s. This was taken for granted, and remained so, as long as the main instrument was the interest rate. Now, after the central bank interest rates have reached their lower bound – close to zero – monetary policy has had to turn to other means. This is by now a global phenomenon in the advanced countries.

The use of "unconventional monetary policy tools" such as large-scale bond purchases has restarted the discussion of instrument independence. What can the central bank do under its instrument independence? For example, there have been some, however not many, critics claiming that the ECB's bond purchase programmes could go beyond the definition of monetary policy.

The ECB's case for the legality of its various bond purchase programmes has been argued elsewhere and I will not go into that here. I just want to reiterate that in the Governing Council, we all agreed that the Extended Asset Purchases Program decided on 22 January is a monetary policy tool.

But instrument independence is not only about what the law allows the central bank to do.

Independence also requires that the environment where monetary policy operates is such that a successful monetary policy is possible and viable. And this is where it becomes really interesting and where the present very low inflation environment makes a difference.

We usually distinguish two such threats to independence. They are called "fiscal dominance", and "financial dominance".

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Fiscal dominance is the older concept of the two. Fiscal dominance would arise if the government financing constraint would become an overriding influence on monetary policy.

The idea that tight monetary policy may become impossible without accompanying fiscal adjustment was well understood when the blueprints for the EMU were being prepared. This is why the Maastricht treaty had its fiscal policy clauses and also why the Stability and Growth Pact was concluded. Also the famous prohibition of direct central bank credit to the government, and the institutional independence of the central banks, are in effect protections against fiscal dominance.

Now we know that the fiscal framework as put in place before the start of the EMU was not strong enough to prevent fiscal problems from emerging. Some have been worried that fiscal dominance has taken hold when the central banks have used government bond purchases, both to stabilize the markets and to produce additional monetary stimulus with "Quantitative Easing" when the interest rate instrument has already been used to the maximum. The Extended Asset Purchase Programme of the ECB announced in the week before last is an example.

As to the euro area, there is no evidence of fiscal dominance. The acid test for fiscal dominance is: does monetary policy break its price stability objective for the sake of maintaining the solvency of the government sector. This is not the case. The price stability objective has not been and will not be abandoned.

The bond purchases of the Eurosystem are directed to make monetary policy more effective, not less. In particular, we want to move closer to our definition of price stability, and the bond purchases are contributing to that end.

We have had well known fiscal problems in some of the euro area countries. Still, the traditional symptom of fiscal dominance, accelerating inflation has not materialized, nor have inflation expectations risen. Inflation expectations remained well in line with the price stability objective until last summer, when they started to show signs of declining, not increasing.

Does this mean that the risk of fiscal dominance has become obsolete? Certainly not. The idea that monetary policy should be able to concentrate on its primary objective is relevant also now. But it manifests itself in a slightly different way than in a high inflation environment.

Solvency of governments is a self-evident condition for sustainable policies. But striving for our definition of price stability now requires very accommodative monetary policy, which includes exceptionally low interest rates, and also bond purchases. There have been worries that such a policy could make it too easy for governments to engage in excessive deficits and fiscal irresponsibility. Is the ECB, for its part, making life too easy for governments which should continue their consolidation efforts?

It may well be that the financing of government deficits is made easier by an accommodative monetary policy. But the primary goal of monetary policy is price stability, which includes avoiding the threat of deflation. The responsibility for fiscal discipline is with the governments, and in the EU also with the Council and the Commission in their particular roles.

Prudent fiscal policy and abiding by the fiscal rules is essential, but we cannot have a trade-off between fiscal discipline and price stability. We can and must have both. The division of responsibilities between the ECB and the governments is clear, and each must do their part.

We should beware of the danger that problems which are fundamentally political could be pushed to central banks to solve. A division of responsibilities between appointed officials and elected politicians should be preserved. That division of responsibilities is one of the forms that the central bank's instrument independence takes today.

Monetary policy can neither micromanage the needed structural transformation in the real sector of the economy nor solve excessive deficit problems of governments.

In the euro area, the countries which have their public finances in order will benefit more from the accommodative policies of the ECB. The experience of the last years shows clearly that if there is any doubt about the long run solvency of a government, monetary policy will not be transmitted fully to that country's private sector either.

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Let me turn next to consider the other potential threat to the independence of monetary policy, the threat of financial dominance.

Financial dominance means the possibility that the condition of the banking system could become a constraint, or dominant influence, on monetary policy. The idea is that a weak banking sector could force the central bank to pursue second- or third-best monetary policies in order to prevent a banking crisis.

In theory it is easy to see how this could happen. One can imagine a central bank which would have to tighten its monetary policy for price stability reasons, but is prevented from doing so for the fear that the value of the assets of the banking system would decrease and a financial crisis could ensue.

Episodes which fit that kind of financial dominance have been observed, in the past, especially in the emerging economies. And in my own country, the severe crisis in the banking system was one of the main reasons which forced a devaluation of the currency in 1991.

But looking at the more recent experience, this has not really been the case in the advanced economies. The bust in 2008 of the last credit boom did not lead monetary policy to tolerate a higher-than-mandated rate of inflation. Instead, in the large advanced economies at least, the bursting of the bubble coincided with a contraction of private demand and a deep recession.

The negative effect of the crisis on economic activity actually reduced inflationary pressures. The main problem has since then been how to prevent the deleveraging process from

starting a deflationary spiral. In such conditions, monetary policy which eases the strain on the banking sector has at the same time supported price stability.

Now, almost five years later, do we have a trade-off between price stability and financial stability? By conducting a monetary policy of extremely low interest rates, combined with exceptional measures such as bond purchases, are we stoking asset price bubbles and encouraging too risky lending practices by banks?

Very low interest rates may encourage risk taking by the investors. This is actually one of the objectives. Our economies need more productive investments.

The low interest rate environment will also affect bank lending. This is also desirable, and it is hoped that business lending to job-creating SMEs will be stimulated.

However, we hear worries that the incentives could be too strong. This is based on the fear that banks will finance investments which are too risky, or the stimulus could be unduly concentrated on, say, the real estate sector.

Of course, successful monetary policy requires a stable financial system. If stability is not there, the transmission of monetary policy can hardly work smoothly. This is one of the lessons of the financial crisis.

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Here we see how the problem of possible financial dominance is manifested in today's economic environment. Now it is not the question can the banking system endure a hard, disinflationary monetary policy. We must pose the question in another way: how can we make sure that the banking system is able to operate prudently under a monetary policy that seeks to maintain price stability "from below", with an accommodative, even expansionary stance?

There was a famous discussion on how monetary policy should relate to credit booms and asset prices in the Jackson Hole conference of 2007. At that time, the prevalent thinking in central banking circles was what it is better for monetary policy only to "clean" (up after the bursting of the possible bubbles) than to "lean" (against the wind).

The strategy of the ECB includes the so-called second pillar of monetary analysis, which focuses on signals from money supply and credit creation. This means we are committed to consider the sustainability of the developments in the banking sector and their compatibility with price stability.

After the hard lessons we learned over the last five years, the case for benign neglect of asset booms and only picking up the pieces afterwards is not very attractive. The crisis experience supports rather the idea that financial excesses are better prevented as they happen than only managed after they have caused a recession.

One option is leaning against the wind. That would mean taking the price stability objective in a more flexible way and paying more attention to asset prices in monetary policy formulation. But there are difficulties with that:

One difficulty is the problem of detecting the credit cycle in time, and correctly timing the monetary policy response. Another problem is that price stability might get too little attention. If the price stability objective had to be compromised because of the developments in the banks and in the financial markets, we would actually have a case of financial dominance.

How can this be avoided? Naturally, it is the quality of commercial bank management and the internal incentives built into the banks' management systems that are the first line of defence. But we have also learned that prudent management practices need to be supported by good and effective regulation.

This leads to my other main point today. In today's environment, the effective independence of monetary policy requires good regulation which ensures that the banking system as a

whole remains stable and solid through the interest rate cycle, not only in times of tight monetary policy but also in times of very accommodative monetary policy.

Like the fiscal discipline of governments, which protects monetary policy from forms of fiscal dominance, effective banking regulation protects monetary policy from financial dominance. We can see how these prerequisites for independent monetary policy are as important for today's accommodative monetary policy as they were for a disinflationary monetary policy when the concept of independence was developed.

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Fortunately, major progress has been achieved in the field of banking regulation, not least in the euro area with the banking union.

There are three aspects of the developing banking regulation that I want to mention in this connection.

First, the prudential regulation of banks is now stronger and more uniform than before. Banks' capital ratios have been strengthened a lot since the crisis, and the responsibility for supervision has been centralized at the ECB. This has already made banks more resilient in the face of any future shocks.

The new bank recovery and resolution framework is also part of the banking union. Its purpose is to reduce the moral hazard problems which are linked to the problems of explicit or implicit government guarantees and the too-big-to-fail. It strengthens the incentives for prudent risk management and the correct pricing of risks. It will make banks more resistant to the temptations which the low interest rate environment may entail.

Second, the EU and the member states are now implementing new macro-prudential instruments which are designed to improve the stability of the financial system as a whole. Macro-prudential policies are very closely related to the problem of ensuring the independence of monetary policy from financial dominance.

Especially interesting are those macro-prudential tools which can be adjusted according to the situation in the asset markets and the credit markets. Such instruments include, in particular, the countercyclical capital requirements, as well as the adjustable restrictions on Loan-to-Value ratios.

The connection between macro-prudential policy and monetary policy is so intimate that central banks must be closely involved in macro-prudential analysis and decision making. In the banking union, macro-prudential policy is a shared competence between the member state authorities and the ECB. Member states can react to national developments with national measures, and the ECB has an option to require additional restrictive measures where it deems that necessary. The national component is important and valuable since especially the real estate markets behave often differently in different countries.

Third, while macro-prudential policy is important, it would benefit from the kinds of structural reforms which would make the banking system more resilient, and – I emphasise – less prone to unstable behaviour.

By separating the most risky securities and derivative activities from deposit banking, the spill overs from deposit protection to speculative risk taking in the securities markets would be prevented. This would reduce any distorted incentives to expand trading activities in the universal banking groups. Several European countries have already implemented legislation which seeks to separate some parts of the securities business from deposit banking. The EU level proposals are under discussion between the Council and the European Parliament. I hope that a solution will emerge which ensures as level a playing field within the EU banking market as possible, while contributing to the resilience and stability of the financial system.