# François Villeroy de Galhau: The role of monetary policy

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Global Interdependence Center – Central Banking Series "Inflation expectations, implications and policy response in a new paradigm for commodities", Session I "Central bankers outlook", Paris, 21 March 2016.

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Since the financial crisis, central banks have been tested on several levels: their ability to keep the transmission channels of monetary policy active; their ability to deliver on price stability; their ability to support the economy. Central banks in many jurisdictions have done a lot to reach their objectives. And their role has largely been hailed as positive in exiting the crisis. But faced with inflation remaining below the target, commodity markets going persistently through bear territory and growth momentum losing steam, central banks' action is now called into question: how effective is monetary policy and how effective can it be in the future? Aren't central banks running out of ammo? Monetary policy faces challenges, that is true; but these challenges can be mitigated. Central banks have proven that they were ready to do their part; but my conviction is that they cannot remain the only game in town. Let me focus my remarks today on the case of the euro area. Jeffrey [Lacker, President of the Federal Reserve Bank of Richmond] will certainly give you more insight into the US situation. I would first like to elaborate on the challenges we face as central bankers, then on our instruments and their effectiveness.

## I. Let me start with the challenges

a) As you all know, the Eurosystem's primary objective is to maintain price stability, that is inflation rates below, but close to 2% over the medium term. However in the euro area, like in most advanced economies, inflation remains too low, despite the historically low interest rates: the harmonised index of consumer prices (HICP) indeed returned to negative territory, standing at –0.2% in February 2016, and underlying inflation, i.e. excluding energy and food, is only 0.7%. A certain number of factors are currently contributing to low inflation. Primarily, the euro area is faced with ***deflationary pressures*** associated with a series of economic shocks: firstly, the fall in oil prices, as well as the overall decline in commodity prices; secondly, the slowdown in growth in emerging economies and chiefly China; and, lastly, inadequate growth in the euro area with persistently high unemployment, which curbs wage rises and weakens demand and price growth. Moreover, structural factors, such as the ageing population, are also likely to exert downward pressure on the "natural" – or "Wicksellian" – interest rate. This rate can be defined as the interest rate consistent with the full employment of the factors of production. In this case, in order to achieve the right balance between savings and investment, markets rates must come down too. In normal times, central banks cut their key rates, and this passes through to the yield curve. However, in order to deal with the financial crisis, the ECB like other central banks have brought their key interest rates to very low levels, around zero. This means that our traditional monetary policy tools had to be supplemented by other instruments, known as non-standard instruments, in order to reach our prices stability objective. I will return to this point later.

b) What is more with regard to the challenges we currently face, these deflationary pressures create the ***risk of an unanchoring of expectations,*** which would make it harder for us to achieve our 2% target again. Indeed, if inflation stayed too low for too long, economic agents may revise downwards their inflation expectations, which would create second round effects. Lower inflation expectations influence economic agents' price- and wage-setting behaviour, which in turn keeps inflation low. It can even raise the risk of deflation, defined as a cumulative process of falling prices, including those of assets, or even wages and production, as the world economy experienced in the 1930s or Japan partially underwent in the 1990s. Such deflationary dynamics are not at play today. But this risk is the reason why our inflation target is symmetrical. We consider too low inflation to be just as costly as too high inflation. And, therefore, it is more risky for central banks to act too late than too early. Since the start of the year, we have observed that market-based measures of inflation expectations have fallen. Nevertheless, the latest forecasts provided by the ECB continue to point to a gradual rise in inflation over the coming years: 0.1% in 2016, 1.3% in 2017 and 1.6% in 2018.

c) Some argue that these challenges mean that the Eurosystem can no longer achieve its price stability mandate. I don't think so. ***Current challenges do not call into question our mandate, but they change the way in which we fulfil it***. Some argue that the Eurosystem should rather change its objective. I don't think so either. For the credibility of monetary policy, this objective must be maintained: this 2% target is a medium-term "anchor", at a time when there is so much volatility and short-termism affecting the economy. Most central banks in advanced economies share this medium-term 2% objective, including the United States and Japan. This has been the ECB's objective since 2003, when it was proposed by the German former chief economist, Otmar Issing.

## II. This brings me to my second point: how effective is our monetary policy?

a) Since the summer of 2014, we have implemented a series of non-standard monetary policy measures to complement cuts to key interest rates. These non-standard measures ***have produced tangible results***. They have translated into a substantial easing in borrowing conditions for euro area companies. Since June 2014, the cost of borrowing for businesses has fallen by 80 basis points. Without non-standard measures, we estimate that we would have had to lower key rates by around 100 basis points in June 2014 to achieve a similar effect on bank interest rates. This has also helped to stimulate lending to the real economy: in the euro area, outstanding loans to businesses have gone from a contraction of –2.5% in June 2014 to growth of 0.6% in January 2016. The impact is even more marked in France, where outstanding business lending grew by 4.8% year-on-year in the first month of 2016 – the highest pace of growth in the euro area and, what's more, with the lowest rates of interest. Convergent estimates from the ECB and the Eurosystem indicate that, all other things being equal, the measures introduced since June 2014 should add 1 percentage point to inflation over the period 2015–2017, with a similar impact on growth. In France, they helped to boost 2015 growth by 0.3 percentage point, and estimates from INSEE even put the impact slightly higher at +0.4 pp. That represents about 80,000 additional jobs for the economy – although only structural reforms can generate lasting gains for a country's growth and employment. To conclude on this estimate of effectiveness, the IMF – regarded as an objective judge of the relevance of economic policies – was unequivocal in its assessment at the last G20 meeting in Shanghai at the end of February, saying, "The ECB's asset purchase programme has supported the recovery by improving confidence and financial conditions [and] monetary policy should remain accommodative".

b) Why have we decided to do more on 10 March? The comprehensive package that has been introduced by the ECB sends out two clear messages:

First, our decisions are guided by our mandate which is to bring inflation back towards our target of 2% over the medium term. ***We are firmly set on this objective, and we have a broad range of instruments with which to achieve it***. In addition to interest rates, we are also acting both on: bank credit easing with the new series of targeted longer-term refinancing operations (TLTRO 2); and on market financing via the extended QE asset purchase programme, to 80 billion EUR per month including corporate bonds. On top of that, we are guaranteeing that we shall continue to do so for as long as necessary – via forward guidance. So, negative interest rates are only part of a much more comprehensive package. We think that they have been effective, but they naturally have their limits. Furthermore, the Governing Council gave a strong signal of its will towards an internationally cooperative attitude, as it decided not to opt for a tiering system exempting banks from negative rates.

Second message: ***our priority is to promote the financing of the real economy***. The goal of TLTRO 2 is not, as some have claimed, to offset the impact of negative rates on banks. It is to encourage banks to lend to corporations, SMEs and households alike; similarly, extending the asset purchase programme to corporate bonds will be of particular benefit to large French corporations. In other words, we are securing the provision of credit to businesses and households, and protecting it from tensions linked to market volatility.

c) Now, ***what about the risks?*** I talked earlier about the risks of doing nothing: we need to take action in order to bring inflation back up towards 2%. That said, we also need to keep a close eye out for any possible negative side-effects of our monetary policy, notably for financial stability. We are actively monitoring the financial cycle, including in France where the task falls to the High Council for Financial Stability set up in 2013. I took part in its 8th meeting at the Finance Ministry last week. For the time being, there are no signs of bubbles forming in our main financing markets: on the whole, developments in the equity markets appear in line with corporate profit forecasts, while evolutions in bond yields also seem consistent with the outlook for inflation and growth. Nor are there any signs of excessive credit growth in the financial system. Nevertheless, we remain vigilant over all aspects of the current macroeconomic and financial environment. Last week the High Council for Financial Stability alerted on potential risks associated with commercial real estate, especially: "the sharp rise in demand by investors on certain market segments and a high level of prices, in particular office prices in the Paris area". The HCSF's assessment will be released for public consultation in the coming weeks. We are ready, when needed, to take action with macroprudential measures, to prevent and mitigate any systemic risks that might arise.

In sum, monetary policy is doing a great deal to counter weak inflation and support economic activity – it is our duty and we will continue to do so with steadfast resolve: we are consistent in our objective, ready to act with the right instruments, and alert to any possible risks. However, I would like to stress again that "monetary policy cannot be the only game in town". Other economic policies also have a crucial role to play. This is precisely what the members of the G20 reiterated in Shanghai on 27 February: "Monetary policies will continue to support economic activity and ensure price stability, consistent with central banks' mandates, but monetary policy alone cannot lead to balanced growth". Where there is sufficient margin to do so, fiscal policy must support demand – this is not currently the case in France, but it is in other countries in Europe. Moreover, structural reforms remain absolutely vital in France, to encourage creations of jobs and of businesses and thus bring the economy back to full potential. At European level, we need to move finally towards a true economic union, in addition to the monetary union embodied in the Eurosystem. Only by optimising the governance of the euro area can we optimise growth. The current extremely accommodative monetary policy stance creates the ideal conditions for carrying out much-needed reforms. It should not be used instead as an excuse for putting them off: Europe and France urgently need to make the most of this opportunity, right now.

Thank you for your attention.