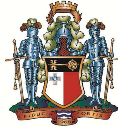

Grant Thornton Europe Regional Meeting

What monetary policy cannot do
Address by Dr Mario Vella, Governor of the Central Bank of Malta
24 May 2017

Almost ten years have passed since the outbreak of the global financial crisis, triggered by the collapse of Lehman Brothers in the autumn of 2008. During this period, central banks have become, according to *The Economist*, "the most powerful financial actors on the planet". Central banks have often been portrayed as the only institutional players with the knowledge and capability to prevent a global financial crisis from turning into a second Great Depression, on par with the one seen in the 1930s.

And yet, despite this aura of power, central banks are both fallible and constrained.

In this address, I would like to touch upon what monetary policy can do and, equally importantly, what monetary policy cannot do. As you know, Malta has formed part of the euro area since January 2008. Therefore, the Central Bank of Malta no longer formulates and executes a monetary policy of its own. Rather, as one of 19 members of the Governing Council of the European Central Bank, the Governor of the Central Bank of Malta takes part in the formulation of monetary policy for the euro area as a whole. At the same time, the Bank is responsible for implementing the Council's monetary policy decisions in Malta.

Monetary policy in the euro area aims at price stability. According to the Treaty this is the primary objective of the European Central Bank. In turn, the Governing Council adopted a more precise, quantitative definition of its objective. It aims for an annual rate of inflation of "below, but close to, 2% over the medium term" as measured for the euro area as a whole. The medium-term orientation of monetary policy is important, because in the short term

actual inflation can fluctuate due to temporary factors, such as spikes in oil prices or changes in indirect taxes. At the same time, it is also worth noting that the focus is on the euro area as a whole, and not on particular member states within it.

But why should monetary policy focus on price stability? In the view of classical economists, money is neutral. On this view, the quantity of money in an economy affects nominal variables, such as the price level, the exchange rate and the nominal interest rate. However, changes in the money supply have no effect on real variables, such as output, incomes or relative prices. Monetary policy has, within this theoretical framework, no effect on the real economy at all.

Today, most economists would consider that the neutrality of money holds only in the long run. In the long run, the economy reaches its steady-state equilibrium, with output at its potential. Any monetary expansion at this point, with the economy operating at full capacity, would merely push up prices. This is evident during episodes of hyperinflation, where rapid increases in the money supply lead to ever-increasing consumer prices.

In the long run, the level of output that an economy can generate depends on the capital stock, the labour supply and the productivity of factors of production. In the steady state, all these factors are outside the scope of monetary policy. Given that monetary policy cannot determine the long-run values of real economic variables then, the argument goes, it is best to let monetary policy focus on what it can really control, namely nominal variables or, in other words, prices.

This brings me to my first proposition: by and large monetary policy cannot affect real economic developments in the long run. The long-run potential output of an economy depends on structural features of the economy, including demographic developments, labour force participation rates, levels of educational attainment and efficiency in product and labour markets. It also depends on the transformation of savings into investment, that is, the proper functioning of banks and financial markets. Success in these domains depends on other

policy makers, notably governments, which can undertake structural reforms and often play a major role in the provision of education.

So what can monetary policy actually do? In the near term, monetary policy nevertheless has a role to play. By influencing aggregate demand, it can cushion the economy from the impact of adverse shocks. In this way, it can limit the volatility of output from its long-run, or potential, level. Moreover, by sustaining demand in the short run, it can prevent a cyclical downswing in the economy from becoming entrenched. If such a downturn were to persist, the economy would risk suffering permanent damage as unemployed workers drop out of the labour force, for example, or as relevant skills are lost. In this sense, monetary policy can safeguard the economy from structural damage and help avoid permanent losses to potential output.

In the euro area, since the onset of the financial crisis, monetary policy has been at the forefront of efforts to sustain a healthy rhythm of economic activity and ensure that the price stability objective is reached. The ECB has used a range of tools in its policy arsenal to support aggregate demand in the euro area and secure price stability.

During this period, paradoxically, the greatest danger that the Governing Council had to confront was not the one that the founders of the single currency had feared. The ECB is institutionally hard-wired to combat inflation. This was the key preoccupation of the architects of the euro, born out of the German experiences with hyperinflation, both during the inter-war years and in the aftermath of the Second World War. From this preoccupation stem essential features of the set-up of the single currency area: a fiercely independent central bank, with a clear mandate to pursue price stability and robust safeguards to stop the ECB from monetising budget deficits, historically the root of runaway inflation.

During the financial crisis, however, the nature of the problem the ECB faced was entirely the opposite. Time and again, the ECB had to act to prevent an unduly sharp fall in economic activity and head off the risk of deflation. Deflation, which is a widespread and ongoing fall in prices, may lead consumers to postpone spending and firms to slash

investment. Both factors lead to a reduction in aggregate demand, lower output, higher unemployment and further downward pressure on prices. This is arguably as dangerous a situation as spiralling inflation.

In late 2008, the ECB faced a situation in which firms, households and governments were carrying excessive debt, at the same time as the banks had to reduce their own leverage. With the collapse of Lehman Brothers, the immediate problem was a shortage of liquidity and the breakdown of the money market. This threatened the health of the euro area economy as a whole, with declining output, rising unemployment and weaker inflationary pressures. In response, between October 2008 and May 2009, the Governing Council lowered key interest rates by 275 basis points, bringing the rate on the main refinancing operations down to 1.0%. Many of these measures were taken in concert with the major central banks around the world.

Under normal economic conditions, such a reduction in short-term interest rates is quickly transmitted to bank lending and deposit rates. In turn, lower interest rates encourage households and firms to consume and invest more, supporting aggregate demand directly. Moreover, lower interest rates on euro-denominated assets lead to a depreciation of the exchange rate of the euro, stimulating exports. This smooth transmission of the impulses from monetary policy to the real economy depends critically on the health of the financial system. In Europe, this primarily means the banks. Since the banks themselves were in trouble, however, the impact of these monetary policy measures was much weaker than it should have otherwise been.

The next wave of the financial crisis in Europe hit in 2010. Financial market tensions rose, resulting from growing market concerns about the sustainability of public finances, especially in Greece. The strong links between banks and their sovereigns led to contagion that eventually also engulfed Ireland, Portugal and Cyprus – all of which needed international rescue programmes. Banking systems in vulnerable countries lost access to funding,

financial intermediaries retreated behind national boundaries and markets began to bet on a breakup of the euro area.

In July 2012, President Draghi announced that the ECB would do “whatever it takes” to preserve the integrity of the euro area. This announcement was followed up in September with the launch of the Outright Monetary Transactions programme, aimed at stabilising jittery sovereign bond markets. One could argue that, in the absence of a robust political response, the ECB stepped beyond the normal remit of monetary policy to counter a threat to the very existence of the euro area itself. Although the programme itself was never activated, the fact that it was in place reduced tensions in financial markets and the risk of a breakup of the single currency area receded.

Economic activity began to recover in mid-2013. Since then, real GDP in the euro area has expanded steadily, if moderately, until by the second half of 2015 it had reached its pre-crisis level. However, the unemployment rate in the euro area remains relatively high, though it has fallen from a peak of above 12% in 2013 to below 10% today.

Against the backdrop of a tentative recovery, and with euro area banks having to clean up their balance sheets and restrict lending, inflation in the euro area began a prolonged downward trend. Inflation in the euro area fell to 0.4% in 2014, zero in 2015 and just 0.2% last year. At these rates, inflation was considerably below the ECB target. Indeed, by mid-2014 disinflationary pressures in the euro area were clear. The concern was that Inflation expectations, which were firmly anchored until then, could lose their moorings. This would lead to a self-sustained deflationary spiral that would further weaken the euro area economy.

At this stage, the conduct of monetary policy ran into another constraint. As we have seen, by May 2009 the Governing Council had cut the main refinancing rate to 1.0%. The main refinancing rate was lowered to 0.25% in November 2013, while the rate on the ECB’s overnight deposit facility was reduced to zero. The Governing Council now faced a dilemma: although the economic situation demanded further monetary stimulus, official interest rates could not fall much further. Nominal interest rates cannot fall far below zero. Otherwise,

households and firms would simply withdraw money from the banking system and hold cash. This 'zero lower bound' is another constraint on monetary policy and one that had not been envisaged when the monetary policy framework for the euro area was designed.

In response, the ECB embarked upon a range of non-standard measures. First, following the example of several other central banks, the Governing Council pushed the overnight deposit rate into negative territory and the rate on the main refinancing operations down to zero. Second, the ECB launched, and then extended, an asset purchase programme, pushing down long-term sovereign bond yields and lowering borrowing costs for the private sector as well. Third, the ECB began offering banks a series of targeted long-term refinancing operations on favourable terms, aimed at prompting them to lend to the private sector. These measures were aimed at stimulating economic activity, staving off the threat of deflation and pushing inflation back up towards its target of below, but close to, 2%.

These unconventional policy measures have been instrumental to provide additional accommodation to the economy and prevent a self-sustaining fall in inflation. However, although economic activity has firmed, inflation still has not converged with the ECB's objective. Underlying inflation pressures remain subdued. The Governing Council continues to hold that such an accommodative monetary policy stance must remain in place until a sustained adjustment in the path of inflation has been achieved. Until now, we do not have sufficient evidence that we have reached this critical point.

This brings me to my second proposition. **Because of the existence of the zero lower bound, it is far easier for monetary policy to fight inflation by raising interest rates than to combat deflation by lowering them**. Although central banks world-wide have used a range of non-standard measures to stimulate economic activity and push inflation up to the target, in practice, this has proven to be extremely difficult.

Moreover, as I pointed out earlier, the institutional set-up of the euro area rules out the easiest policy option to raise inflation, namely the monetisation of budget deficits. Furthermore, in the euro area as a whole, monetary policy was, for a long time, "the only

game in town". With many sovereigns weighed down by excessive debt burdens, there was no space for fiscal policy to play its part in supporting monetary policy in stimulating the economy. Rather, in many countries, the necessary focus on austerity measures meant that monetary policy and fiscal policy were operating at cross-purposes. Unfortunately, those euro area countries with space to manoeuvre chose not to do so.

To sum up, monetary policy can influence nominal economic variables. In the long run, however, it cannot influence real economic variables, which depend on the economy's endowments of factors of production and the efficiency with which they combine to produce output. This highlights the importance of structural reforms to ensure that the economy operates as efficiently as possible.

I have also argued that monetary policy was crucial in preventing the dual shock of the financial crisis and the sovereign debt crisis from having even more negative consequences for the euro area as a whole. The ECB's extremely accommodative monetary policy stance sustained the ongoing economic recovery, while heading off the threat of deflation. I would like to stress, however, it is much harder to sustain economic activity and attain the price stability objective when interest rates reach the zero lower bound. Although the ECB has made ample and imaginative use of non-standard monetary policy measures, inflation in the euro area has not yet risen in a sustained way towards the inflation target.

I would like to conclude with a few words about the Maltese economy. Malta weathered the global financial crisis and the euro area sovereign debt crisis well. Malta has been outpacing other members of the euro area since 2012. We are the fastest-growing economy in the euro area, registering extremely rapid growth rates over the past three years. In part, this was because we avoided the problems that dragged down some euro area member states: the banking system remained liquid and well-capitalised throughout, while fiscal discipline ensured that public debt never rose to unsustainable levels. Malta also benefited, of course, from the accommodative monetary policy stance that I have just described. Crucially, Malta enjoyed the gains from a range of structural reforms that increased labour force participation,

raised efficiency in key economic sectors and led to the diversification of activity into new niche areas, particularly in services.

Monetary policy on its own cannot deliver the full range of desirable economic outcomes. When it is accompanied by complementary and consistent fiscal policy actions, as well as by well-designed structural reforms, then monetary policy can deliver on its primary objective of price stability, while maintaining economic activity and employment close to their potential levels.