Jürgen Stark: The ECB's monetary policy – preserving price stability in times of financial distress

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the conference “The ECB and Its Watchers XI”, Frankfurt am Main, 4 September 2009.

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Ladies and gentlemen,

Last year at this conference, on 5 September 2008, I said that the previous 13 months had been the most challenging in the ECB’s history. The 12 months since then have been even more difficult. We have no reason to believe that the period ahead will be much easier, but there are at least indications that the challenges will be of a different nature.

We increasingly see signs that the massive response from governments and central banks has been effective and that the global recession is bottoming out. Uncertainty is still high, but one of the main challenges to the maintenance of price stability is likely to be the phasing-out of the extraordinary and unprecedented measures we have taken.

The President has just outlined the ECB’s exit strategy. I will add to his comments by considering how our monetary policy framework – which has served us well – will be of great help in timing the exit correctly. I will also offer some thoughts on fiscal policy.

Recognising turning points

The principles that guide our decisions are quite clear. Our mandate is to maintain price stability over the medium term. As soon as upside risks to price stability emerge in a context of an improving macroeconomic environment, it will be time to withdraw the policy stimulus. Furthermore, our independence guarantees that we will take the steps necessary to fulfill our mandate.

A key issue will therefore be to correctly identify the turning point in macroeconomic prospects and the emergence of upside risks to price stability. This is in general a very difficult task, but it is even more demanding now, mainly because of the increased uncertainty about the sustainability of the economic recovery and the growth potential of the euro area economy.

The decade that preceded the crisis was an exceptionally long period of strong growth in the world economy. The high levels of growth were however based on large and growing imbalances, reflected in asset price and credit bubbles as well as global current account imbalances, which ultimately proved to be unsustainable.

This means that some of the growth we experienced in the past was probably above potential, both in the euro area and elsewhere. Under these circumstances, elusive estimates of the scale of economic slack are even less reliable as a guide for monetary policy makers.

Fortunately, the ECB’s monetary policy strategy is well-suited to guide monetary policy in the current situation. At a time when academics are reconsidering the mandates and strategies of central banks, it is important to stress that our strategy is comprehensive and robust. All of you are aware of the main elements of our strategy:

- The quantitative definition of price stability
- The medium-term orientation
- The two pillar-based assessment of risks to price stability

I would in particular like to highlight that the high priority we attach to the monetary analysis offsets any over-dependence on single, potentially flawed indicators and concepts, such as the output gap.

To illustrate this, let me go back to 2005. In that year, the signals from the economic analysis remained rather mixed and our monetary analysis was indicating upward risks to price stability. This led us to increase interest rates in December 2005 – a move widely criticised, also by a number of ECB watchers. In retrospect, however, the strength of the economic recovery from 2006 and onwards showed that our decision was well-timed. Moreover, tightening monetary policy at an early stage may have been one important reason why financial imbalances in the euro area could be kept relatively contained, compared with those in some other regions.

There are few historical precedents for steering monetary policy back to a "normal" path after a prolonged period of a very accommodative policy. But one unambiguous lesson from the past is that an over-reliance on real-time assessments of the state of the economy and a neglect or even misinterpretation of monetary developments can contribute significantly to policy mistakes.

The textbook example of a premature tightening is the increase in reserve requirements in the US after the Great Depression. To counter the potential inflationary consequences of excess reserves in the banking sector, central bank reserve requirements were increased in 1936. In 1937/38, the US economy entered a new recession, which was partly blamed on the monetary tightening brought about by the higher reserve requirements. Fiscal policy was also tightened. With hindsight, one can say that it was a failure to appreciate the fragility of the recovery and a misinterpretation of the inflationary consequences of the monetary developments that led to a too early exit. In addition, the statistical base on which monetary authorities had to base their assessment of the state of the economy at that time was thin.

Examples of tardy exits from monetary accommodation can be found more easily and in more recent times. I will refer to two notable cases. The first case is the "Great Inflation" of the 1970s. After the recessions following the first oil price shock, the potential output levels were assessed too positively, leading countries to maintain expansionary monetary policy stances for too long. Ultimately, this gave rise to a massive acceleration of inflation. Only a few countries managed to avoid the "Great Inflation". The monetary policy strategies of these countries did not rely excessively on Phillips curve-type inflation models but rather took the medium-term link between monetary trends and inflation into account.

The second case concerns the period between the stock market crash in 2000 and the outbreak of the global financial crisis in 2007. After the early-millennium recession that followed the bursting of the dot-com bubble, many central banks around the world lowered interest rates and kept them at very low levels for a protracted period of time – in the end for too long. It was probably a misperception of the size of the output gap after the "New Economy" boom and of the risks to financial stability that were building up with the rapid expansion of credit during this period that induced this late exit. Today, it is widely assumed that the monetary easing during this period exacerbated the imbalances building up in housing and credit markets that ultimately triggered the crisis.

The current outlook

Where do we stand today? There are no deflationary risks. For the moment, both pillars in our analytical framework point to low inflationary pressures. This is why the Governing Council assesses that current rates as appropriate and why the policy rates were left unchanged yesterday. We also agreed that the 12-month refinancing operation at the end of this month will be conducted without a spread over the rate at the main refinancing operations at the time.

Annual HICP inflation in August was less negative than in July. We expect inflation rates to move into positive territory within the coming months, mainly driven by past developments in energy prices. But following the increase this autumn, inflation rates are projected to remain at relatively subdued levels in 2010. This reflects the gradual economic recovery we expect to see in the course of next year. Both the ECB staff projections for inflation and growth have been revised slightly upwards since June. However, uncertainty remains high. The improvements we have seen over the past few months have in part been driven by the fiscal stimulus. The still strained financial markets are a further source of uncertainty. The risk of deflation in the euro area, which was never substantial, has however clearly receded since earlier this year and has now virtually disappeared.

The monetary data for July showed an ongoing parallel decrease in monetary and credit annual growth. This supports our assessment of low inflationary pressures. At the same time, the latest month-on-month growth rates of M3 did not, on balance, point to a further deceleration in monetary growth.

While developments in M3 contain relevant information about future inflation over medium to long-term horizons, developments in M1 typically have good leading indicator properties for turning points in real GDP growth in the euro area. But in times of financial turmoil and strong policy responses, monetary aggregates may be volatile and should be assessed with caution. In this respect, the recent buoyancy of M1 growth also reflects portfolio considerations to hold liquid funds in a period of low opportunity costs and therefore does not automatically point to an equally strong upturn in the economic cycle. The information content of M1 has however proved to be relatively robust in the past for identifying turning points. At the same time, the subdued M3 growth may increasingly reflect more profitable investments in longer-term assets due to the emergence of a relatively steep yield curve.

Overall, the monetary and the economic analysis indicate at present that inflationary pressure is low. This means that the time for exit has not yet come. But we will continue to monitor very closely all developments over the period ahead. Once the macroeconomic environment improves, we will make sure that the measures taken are unwound in a timely fashion and the liquidity provided is absorbed in order to counter effectively any threat to price stability over the medium to longer term.

The phasing-out of non-standard measures

When we consider the phasing-out of the non-standard measures, it is important to keep in mind why they were introduced in the first place. The financial turmoil caused disruption on the money markets, in particular after the collapse of Lehman Brothers last autumn. Because the changes in our key policy rates affect the broader economy initially via money markets, we had to take a number of steps to ensure that our policy changes were transmitted properly to the rest of the economy. Overall, we refer to the set of non-standard measures which we employed as our policy of “enhanced credit support”.

Let me first take stock of the effectiveness of our non-standard measures so far. Overall, it is difficult to separate the effects of the ECB’s measures from the effects of other factors. Spreads in the money market have come down significantly since last autumn and, together with the policy rate cuts, have brought about a substantial decline in lending rates to households and firms.

There has been much focus on the subdued developments in lending in recent months, especially as our measures have been designed to support lending activity. These developments should however be assessed in light of their consistency with stylised facts of the business cycle, which in fact indicate that the recent credit developments appear to be broadly in line with the currently projected path for real GDP growth. Furthermore, based on the past regularities, the current levelling-off of household loans would normally be associated with a further contraction in loans to corporations until at least early 2010. This

contraction will presumably be stronger than that for loans to households, as troughs in loan growth to non-financial corporations are usually deeper than those for household loans.

To shed some more light on this finding, let me first mention that the historical evidence suggests that real loans to households tend to lead real GDP growth by about a quarter, while loans to non-financial corporations lag real GDP developments by around three quarters. Loans to households are mainly driven by housing market developments, and both house prices and interest rates tend to be low during downturns, which increases the attractiveness of borrowing.

By contrast, the cash flows of firms usually improve in an economic upturn, which may lead them to their own funds first and only turn to external financing later. Moreover, banks may prefer to expand lending earlier in the cycle to households than to firms because household loans are generally better collateralised.

It is obvious that we cannot maintain the current degree of policy accommodation and enhanced credit support indefinitely. As the President mentioned, the feasibility of a timely and orderly exit was one of the guiding principles when the non-standard measures were chosen and designed. Except for the purchases of covered bonds, the rest of our non-standard measures have built-in and self-correcting mechanisms that help to reabsorb liquidity and allow for the normalization of the policy stance once this is justified.

Let me just elaborate on how and when to phase them out.

Our operational framework worked well until the financial turmoil escalated in September last year, and from an operational point of view, our principal goal will therefore be to re-establish the key features of this framework, in particular to revert to a situation where the one-week main refinancing operation is the main tool for steering money market rates and where we are “rate-takers” in the longer-term money market.

There are no impediments which may lead to delay when the time of exit is ripe. We are well equipped to properly identify the time of exit, and our independence, as it is enshrined in the Treaty, ensures that we can take the necessary steps in a timely fashion. Our actions will be guided by our mandate to maintain price stability, but the specific steps we take to re-establish the main features of our operational framework will also depend on the state of the money market. It is impossible to forecast these developments with any certainty. But let me just briefly flesh out two highly stylised scenarios.

One scenario would be that the problems in money markets disappear before any upside risks to price stability emerge. This means that the non-standard measures could be unwound before rates are raised, and the withdrawal of the measures would not be expected to have much impact.

But what if, under an alternative scenario, upside risks to price stability emerge while the problems in money markets persist? In this case, we may have to maintain parts of the enhanced credit support while rates are raised in order to counter upside risks to price stability and at the same time ensure that the monetary policy transmission mechanism functions properly.

This situation is more complicated. In particular, we cannot accept a situation in which excess liquidity constrains our ability to steer money market rates to higher levels. Under these conditions, it would be crucial to re-assess the sources of funding constraints for banks. We would have to judge whether these funding constraints are a result of dysfunctional markets or whether they only exist at the individual bank level. In the latter case, it is obvious that any funding support from the Eurosystem would have to be carefully assessed as our operational framework serves the implementation of monetary policy.

In any case, our operational framework is sufficiently flexible to deal with any such scenario effectively. We are well prepared to phase out non-standard measures in a timely fashion and withdraw policy accommodation to counter any threats to price stability.

The fiscal factor

A discussion of the unwinding of the measures implemented during this crisis would not be complete without a few words on fiscal policy. Unsustainable fiscal policies are an upside risk to price stability in a number of countries because we cannot rule out that debt-burdened governments may in the end resort to monetary financing. This is not an option for governments in the euro area, but high inflation in other countries will also make it more difficult to preserve price stability here.

The financial crisis has illustrated clearly that capital markets are wary of countries' fiscal imbalances and that concerns about fiscal sustainability lead to higher risk premia on sovereign debt. Spreads have recently narrowed somewhat, but there is no room for complacency.

Exit strategies from high fiscal deficits need to be developed and consistently implemented in order to contain moral hazard, to forestall a rise in long-term real interest rates and crowding-out effects, and to ensure the sustainability of public finances. Bringing sovereign debt ratios onto a sustainable, downward path represents a key priority for fiscal policy-makers. In this respect, the Stability and Growth Pact provides a sound and flexible framework to steer the timing and speed of fiscal consolidation.

Conclusion

Let me conclude. In response to the crisis, governments and central banks across the globe have taken immediate and unprecedented measures. Governments have taken measures to rescue the banking sector and stimulate the economy. Central banks have lowered rates to very low levels and provided ample liquidity. The key question is when and how to phase out these measures.

This is a challenging task both for governments and central banks, but ex-ante co-ordination between fiscal and monetary authorities, as some voices have called for, is not an option. This would undermine our independence and therefore violate our mandate. As in the past, our policy decisions will exclusively be based on our assessments of risks to price stability.

I am confident that the ECB's broad-based monetary policy strategy, which has shown itself to be robust, will continue to serve us well in handling these challenges. The fact that our risk assessment is rooted both in the economic and monetary analysis ensures that all relevant information is taken into account. In particular, the monetary pillar has a disciplinary effect: it reminds us not to ignore risks to price stability stemming from imbalances in money and credit developments.

The time for exit has not yet come. Both the monetary and the economic analysis give us this message at the moment. But I can assure you that we will continue to monitor very closely all developments in the period ahead, in order to continue to deliver on our task of maintaining price stability over the medium term.