Jürgen Stark: Adjusting monetary policy in a challenging environment

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the "ECB and its Watchers XIII" conference, Frankfurt am Main, 10 June 2011.

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1. Introduction

Ladies and gentlemen,

It is a great pleasure for me to be here today at the thirteenth in this series of conferences entitled "The ECB and its Watchers".

The theme of this session is the return to normality. It assumes that we know what the "new normal" will look like. What we do know is that it will be different from the "old normal", as the crisis has changed the economic and financial environment in many ways. But it is still too early to characterise what exactly the new normal will look like, also because the crisis is still ongoing.[1] Therefore, rather than talking about going back to normal, I prefer to talk about adjustments to policies.

Indeed, during the period of acute financial stress we have seen many changes in the area of economic and prudential policies. However, this is far less the case for the ECB's monetary policy. Our main objective which is to maintain price stability for the euro area as a whole over the medium term has remained unchanged. Of course, exceptional circumstances have called for extraordinary measures. In response to the crisis, we lowered our key interest rates in an unprecedented manner. We have also introduced a number of non-standard measures to support the transmission of our interest rate decisions to the euro area economy. All these measures have lent considerable support to economic activity, while remaining fully aligned with our deep-rooted aim of maintaining price stability.

Now, economic recovery in the euro area is on a more self-sustained path. Looking ahead, we expect the economy to further benefit from ongoing global growth and the still accommodative monetary policy stance. At the same time, for some months by now, we have been observing relatively high inflation rates and continued upward pressure on prices. Overall, we see risks to price stability on the upside. This calls for strong vigilance. In this respect, we stand ready to further adjust our still very accommodative monetary policy stance. In the same vein, we will act in a timely manner as regards further steps to phase out our non-standard measures. The concrete steps of adjustment will remain guided by our aim of keeping inflation in the euro area below, but close to, 2% over the medium term for the euro area as a whole.

In my contribution today, I will emphasise that the ECB conducts monetary policy "as usual". In particular, after briefly recalling the motives for our April interest rate increase, I shall elaborate on how the ECB deals with the particular challenges prevailing, namely

- inflation pressures stemming from commodity prices
- costs of keeping interest rates low for too long
- the adjustment to the monetary policy stance with some non-standard measures still in place, and
- divergent macroeconomic and financial developments in the countries of the euro area.

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1 Further elaborations on this theme can be found in my intervention "The new normal" at the 13th Euro Finance Week, Frankfurt, 16 November 2010.

Outline

- Commodity prices and the outlook for price stability
- Costs of keeping interest rates low over a long period
- Interest rates and non-standard measures
- Monetary policy and heterogeneity

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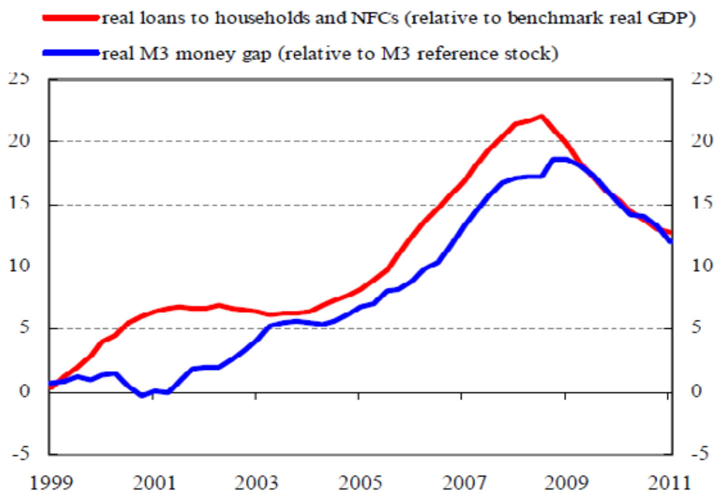
2. Commodity prices and the outlook for price stability

On 7 April we increased our key interest rates by 25 basis points. This decision was the first policy move since May 2009. It was mainly driven by upside risks to price stability, in particular relating to further increases in energy and commodity prices. Continued upward pressure on overall inflation is discernible in the early stages of the production process. It has the potential to translate into inflation expectations, broad based second-round effects in price and wage-setting and inflationary pressures over the medium term.

As mentioned, we continue to see upside risks to price stability. Signals from the monetary analysis indicate that the underlying pace of monetary expansion is gradually recovering. At the same time monetary liquidity remains ample. It could accommodate upward price pressures.

Excess monetary liquidity
(percentage points)



Note: The real money gap is defined as the difference between the actual level of M3 deflated by the HICP and the deflated level of M3 that would have resulted from constant nominal M3 growth at its reference value of 4½% and HICP inflation in line with the ECB's definition of price stability, taking December 1998 as the base period. The level of benchmark real GDP compared to real loans to households and non financial corporations is calculated using a 2% annual growth rate. The calculation takes December 1998 as the base period.
Source: ECB

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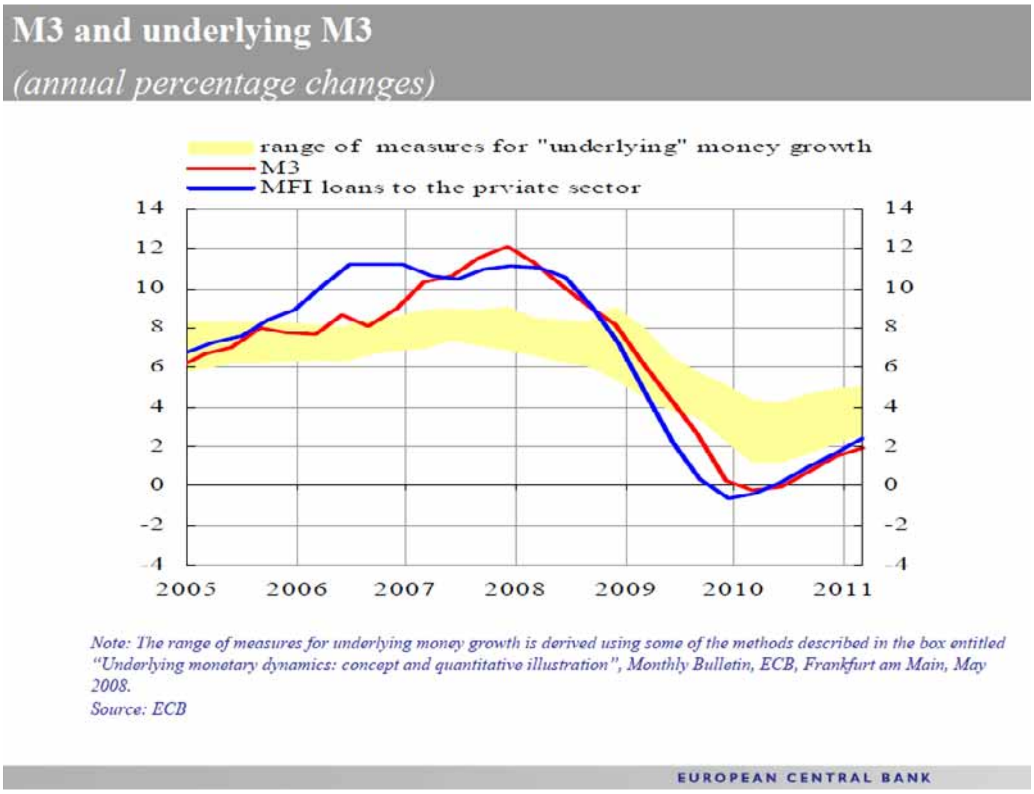
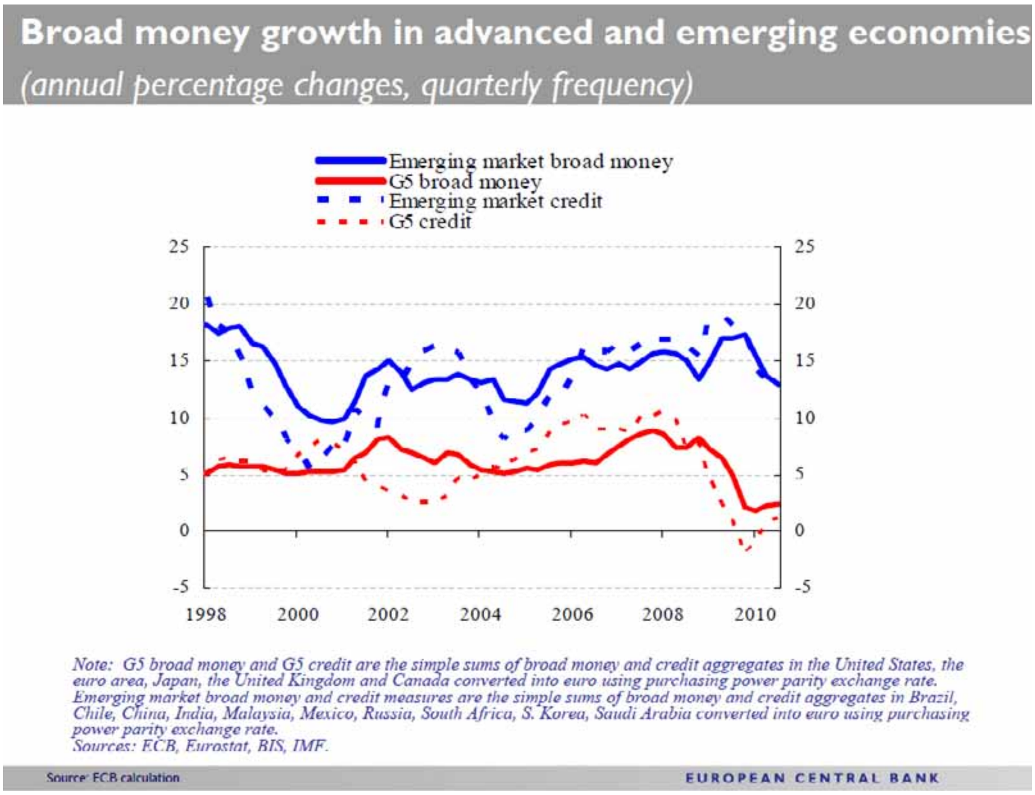


In addition, strong economic growth in emerging markets likely contributes further to commodity price rises. Ample liquidity at the global level could support this development. The monetary policy stance of many central banks around the world also remains very accommodative. This creates an environment which is raising inflationary challenges, in particular for emerging economies that shadow US monetary policy.



Is the fact that inflation is being driven mainly by commodity prices not a reason to be less concerned about inflation in the medium term, as these such developments are usually temporary only? Theoretically, it is possible to look beyond the volatility in inflation triggered by first-round effects of commodity price changes if these are of a purely temporary nature. However, the central bank also needs to consider policy action in case sustained upward trends in commodity prices are seen as a risk to price stability over the medium term. We have already observed in the past that commodity prices tend to follow a secular “trend” reflecting amongst others things the fast growth in emerging economies.

Moreover, if transitory rises in commodity prices ran the risk of triggering second-round effects, they may also have a more lasting impact on consumer price developments and medium-term inflation expectations. Monetary policy then needs to avert temporary inflation increases that lead to second-round effects in wage and price-setting behaviour, for instance due to the indexation of wages and prices to past inflation.

Today’s discussion on how to react to rising commodity prices reminds me of that prevailing in the 1970s. In the aftermath of the oil price shocks of 1973 and 1979, inflation in the OECD countries increased dramatically from already relatively high levels 5.7% in 1971 to double-digit numbers 14.8% in 1980. It seems evident that this evolution, which was later labelled the “Great Inflation”,[2] was mostly driven by increasing oil prices.[3] However, Germany – and also Switzerland – was a notable exception.[4] German inflation rose from 5.2% in 1971 to 5.4% in 1980. The Bundesbank chose to tighten its monetary policy stance. This policy resulted in significantly higher real interest rates in Germany, compared to other OECD countries. This helped the economy to grow in line with its potential. Moreover, on account of the associated appreciation of the D-Mark, the oil price increase had a more limited direct impact on inflation. Overall, the different inflation experiences of the 1970s clearly demonstrate that the “Great Inflation” was not only the result of rising oil prices but to a large extent driven by different monetary policies. Faced today with rising commodity prices we should not forget this lesson, a fortiori in a context of globally loose monetary policies and ample liquidity.

3. Costs of keeping interest rates low over a long period

Maintaining our medium-term focus is particularly important in the current environment. Short-term volatility is extensive and uncertainty remains unusually high. Thus, central banks need to avoid just looking at the short-term consequences of a somewhat tighter monetary policy stance and take a longer-term perspective. This should include the costs and related risks to price stability that may arise if interest rates are kept too low for too long.

The risks associated with keeping interest rates low for too long a period have been clearly exposed and documented in several recent analytical contributions. The period prior to the financial crisis has demonstrated that global policy accommodation for a protracted period of time can inadvertently distort incentives and behaviour in the financial sector. Low interest rates over too long a period foster an under-pricing of risk[5], inducing excessive risk-taking.

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[2] See for instance Meltzer A. (2005), “Origins of the Great Inflation,” Federal Reserve Bank of Saint Louis Review, 87, pp. 145–175.

[3] On this interpretation see for instance Blinder A. (1982), “The Anatomy of Double Digit Inflation in the 1970s,” in Hall, R.E. (ed.), “Inflation: Causes and Effects,” University of Chicago Press for NBER, pp. 261–282, and Bruno M. and J. Sachs (1985), Economics of Worldwide Stagflation, Harvard University Press.

[4] See “The ‘Great Inflation’: Lessons for Monetary Policy,” ECB Monthly Bulletin, May 2010, pp. 99–110.

[5] See for instance Bekaert G., Hoerova M. and M. Lo Duca (2010), “Risk, uncertainty and monetary policy,” NBER Working Paper, No 16397.

And low interest rates delay and ultimately prevent the necessary repair of balance sheets. In the end, this turns low interest rates into a curse. It does not only hinder strong and sustainable economic growth but also compromises price stability over the medium term.

Nonetheless, the current global policy debate seems to favour the same asymmetric approach that characterised the pre-crisis conventional wisdom, the so called Jackson-Hole consensus – to which the ECB never subscribed – and which can be summarised in three elements:

1. aggressive policy easing when financial developments turn sour;
2. postponing the exit from low rates even when conditions improve, for fear of harming the economic recovery;
3. no policy reaction to domestic and global liquidity over and above what is requested by standard inflation forecasts at standard horizons.

Undoubtedly, this asymmetric approach at the global level contributed to the financial crisis.

In contrast to this, the two-pillar strategy of the ECB follows a more structured approach. It currently indicates that improvements in monetary, credit and financial conditions require an adjustment to the monetary policy stance. Empirical evidence shows that, also in the past, monetary policy in the euro area reacted symmetrically to signals coming from monetary and credit conditions.[6] This symmetry has contributed to limiting financial imbalances and will continue to provide a clear medium-term focus.

Does the above imply that the ECB is carefree as regards current economic developments? Of course not. We are aware of the risks surrounding the current pace of economic expansion. But easy money cannot and will not address the root causes of the crisis. Homework needs to be done on the fiscal side. Governments need to strengthen decisively public finances. We need a safer financial system. This requires improving the capital position of banks and tighter regulation. Central banks can not be expected to continuously prolong measures to compensate for lingering risks from the financial system.

4. Interest rates and non-standard measures

Do liquidity support measures constrain the conduct of monetary policy? Decisions on policy interest rates and on non-standard measures are largely separated: as always, we set interest rates to maintain price stability, while our non-standard measures support the transmission of monetary policy.

Nevertheless, to some extent, the two decisions are also interlinked. The fixed-rate full-allotment procedure in all refinancing operations, for instance, created large amounts of excess liquidity, as observed, in particular, over the lifetime of the 1-year LTROs, driven by strong demand from banks, which resulted in short-term money market rates (such as the EONIA) falling below the rate of the main refinancing operations. Movements in the EONIA have further trickled down the EONIA swap curve at different maturities. The money market rate therefore does not unambiguously reflect the stance of monetary policy in the same way as in the past.

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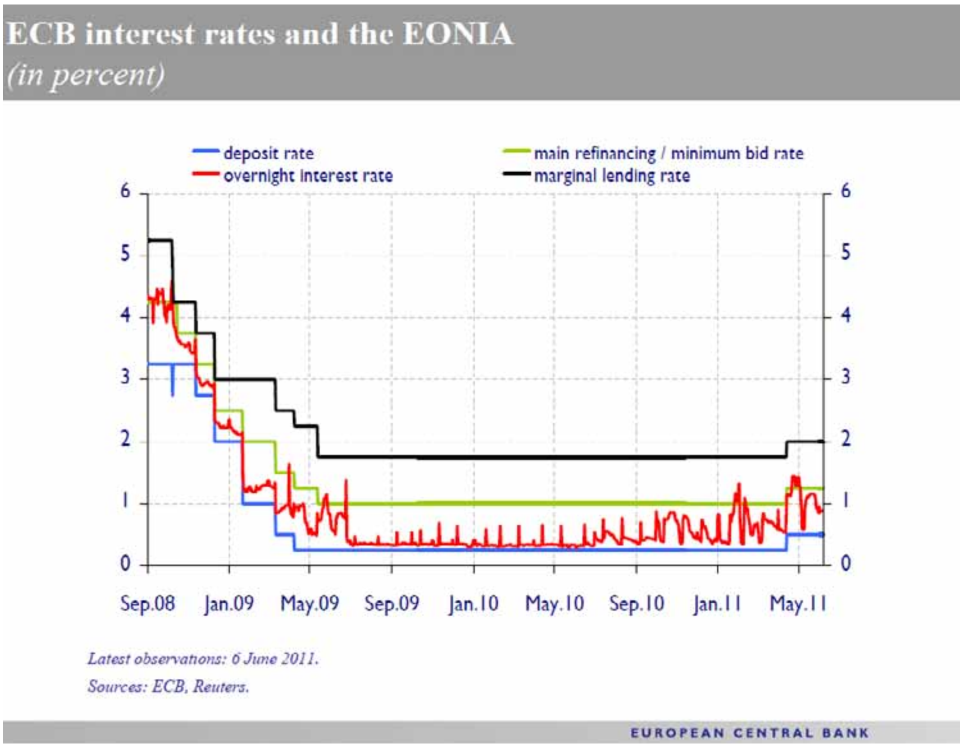
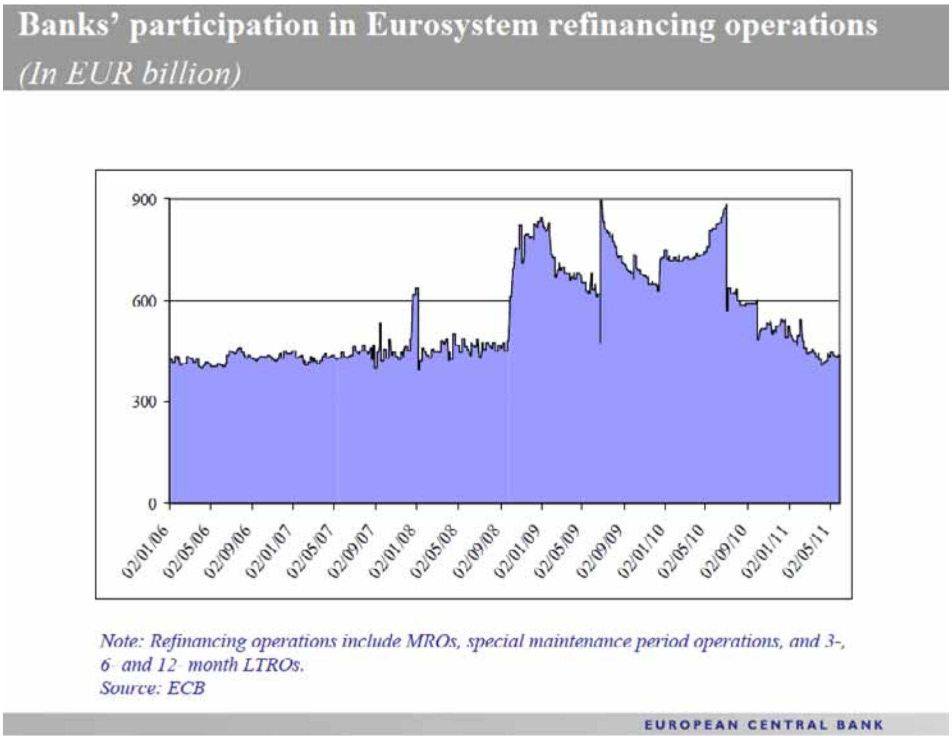
[6] A “thick-modelling” approach can be used to estimate a very large number of monetary policy reaction functions using different indicators for inflation, economic activity and monetary and credit developments is estimated. This approach takes into account the degree of uncertainty stemming from the different signals policymakers receive from the broad range of indicators available before each Governing Council meeting. The average estimated reaction function is: interest $rate_t$ = 0.92 interest $rate_{t-1}$ + 0.08 (0.78 + 1.94 $inflation_t$ + 1.16 $output_t$ + 0.34 $money/credit_t^{strong}$ + 0.37 $money/credit_t^{weak}$). The estimation sample runs from January 1999 to September 2008. See also Blattner T. and E. Margaritov (2010), “Towards a robust monetary policy rule for the euro area,” ECB Working Paper, No 1210.



The MRO rate will become more relevant again in the future, signalling our monetary policy stance. This implies that the overnight rate will be close to the MRO rate. We already see that interbank markets are performing better, as shown for instance by the decreasing dependency of banks on ECB refinancing operations. Recourse to these operations has declined significantly from close to €900 billion in June 2010 to around €430 billion today.



5. Monetary policy and heterogeneity

In public debates, viability of the euro has again been questioned on the ground that the financial crisis has deepened the economic divide across member states. But the ECB's monetary policy continues to be geared towards price stability in the euro area *as a whole*. The single monetary policy of the ECB cannot address different economic growth or inflation across regions of the euro area. Such macroeconomic heterogeneity is a normal feature within a monetary union. Heterogeneity can even be a desirable feature when it reflects the necessary adjustments to macroeconomic imbalances that have built up.

Macroeconomic diversity is an issue that national policy-makers should deal with, not the ECB. Their primary contribution of course would be to avoid building up unsustainable macroeconomic imbalances. Indeed, the bulk of the current imbalances in some euro area countries reflect that countries have insufficiently internalised the participation in a monetary union into domestic policies. To fully realise the benefits of EMU requires national policies to adapt to EMU. This applies to the areas of fiscal policy (including taxation), structural reforms, regulation and banking supervision. Without this, imbalances will inevitably reoccur, challenging the proper functioning of EMU and thus of monetary policy. It is essential to put in place a European framework that is incentive-compatible and credibly enforceable, to avoid the re-emergence of significant imbalances. National policies should be fully guided by the framework.

Does this then imply that monetary policy completely ignores developments in individual euro area countries of the euro area? No, but specific national developments play a role for monetary policy only to the extent that they have an impact on the medium-term outlook and risks for price stability in the euro area as a whole.

Maintaining price stability for the entire euro area is the central contribution the ECB's monetary policy makes with a view to supporting sustainable economic growth, job creation and financial stability. Any other monetary policy would come at the cost of lower medium-term growth, for instance on account of higher longer-term interest rates or reduced confidence on the part of economic agents.

6. Concluding remarks

Let me conclude.

For the main elements of the ECB's monetary policy strategy, there is no need for adjustment as these elements have not changed during the crisis. We will do all that is needed to ensure price stability over the medium term. We will change the monetary policy stance whenever necessary. There is no pre-defined sequence as regards interest rate decisions and the decisions on the phasing-out of non-standard measures.

Monetary policy will continue to be orientated towards the medium term, taking into account macroeconomic effects that take place after the initial effect, including effects on the incentive-structures of economic agents caused by keeping interest rates low over a long period. In this respect, we rely on the structured approach provided by our two-pillar strategy.

Likewise, the ECB's single monetary policy will continue to be geared towards the euro area as a whole, not just a small part of it.

The times of crisis have shown that we in the Governing Council of the ECB are strongly determined to deliver what we are expected to deliver: price stability in the euro area in the medium term. The continuation of well-anchored inflation expectations in the euro area illustrates the credibility we have achieved in reaching our objective. For this objective, and this one alone, the ECB can be held accountable.

For other policy areas, national policy-makers and authorities need to take full responsibility. National authorities need to address outstanding imbalances urgently, by restoring fiscal sustainability and by putting the financial sector on a healthy footing. Embarking on this path would also ensure that the single monetary policy fits all.