Peter Praet: Speech on the occasion of the “Annual Danish Top Executive Summit 2013”

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the “Annual Danish Top Executive Summit 2013”, Copenhagen, 29 January 2013.

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Introduction

It is a real pleasure for me to share some thoughts today with such a distinguished group of business leaders.[1] It may strike you as somewhat paradoxical for a central banker to address such an audience in a conference where the main theme is innovative thinking. After all, central bankers have traditionally been stereotyped as conservative and, well, rather dull.

I firmly believe, though, that in a constantly changing world, decision-makers need to develop and maintain a healthy degree of scepticism around whether their current strategies and practices remain fit-for-purpose. This holds for decision-makers in business as well as in the public policy domain. And it is particularly relevant for central bankers, who have shouldered large part of the responsibility to navigate the economy through a once-in-a-generation financial and economic crisis.

In the first part of my remarks today I will contour some salient features of central banks’ response to the crisis. But I am sure that everyone here today is more interested in the future than pondering on what has been done so far. Indeed, as the macroeconomic and business environment remains challenging, the calls for a rethinking of business models and strategic orientations become more forceful. This is also the case in the monetary policy-making arena, where new strategic aspects are being promoted and debated around the globe. In the second and main part of my remarks I would, therefore, like to focus on two examples of such “innovative” strategic thinking for monetary policy, assessing them from a euro area perspective. The first example concerns the objective of monetary policy. The second one refers to how policy is conducted to deliver the assigned objective.

Addressing the global financial crisis: a delicate balancing act requiring strength, control, horizon and courage

Prompted by the crisis, central bankers globally have thought openly and creatively. They designed and deployed a host of measures that went well beyond their traditional *modus operandi*. This reaction of central banks has clear parallels to the way business leaders confront challenges. To illustrate this, let me briefly outline how features of central banking practices correspond to the four themes that the organisers of this conference have laid out as relevant for addressing challenges in the corporate world.

The first theme is *strength*. Central banks typically rely on financial markets to transmit their monetary policy intentions to the real economy. During the crisis, dysfunctional segments of financial markets threatened to weaken or completely suppress this process. Central banks addressed these market dislocations in a resolute way, thereby showcasing the strength of the instruments that are at their disposal.

Second comes *control*. Ensuring that the expectations of firms and households regarding future inflation remain well-anchored is of the essence for keeping inflation in check. During the crisis, through words and deeds, central banks have strived to maintain these expectations under *control*.

[1] I would like to thank Thomas Vlassopoulos for his contribution to the preparation of this speech.

The third theme is *horizon*. The most obvious concept of horizon in the context of central banking is that of time-horizon. Both in normal times and in times of crisis, central bankers seek to maintain a medium-term horizon and thus avoid being overwhelmed by short-term considerations. At the same time, central banks have demonstrated a capacity to deploy crisis management measures within a very short time span, when this was necessary.

The fourth and final theme of the conference was *courage*. Again this may sound paradoxical. Central bankers are proverbially prudent and risk averse. But there is a particular type of courage that they need to exhibit: the courage and firm character to stay the course and unwaveringly pursue the assigned mandate, when calls to serve other objectives can be increasingly loud.

At the ECB, in particular, our response to the crisis has been two-pronged. The first element has been the swift reduction of our key policy rates to historically low levels in response to the emergence of downside risks to price stability. This is what is considered "standard" monetary policy action. The second element has entailed a host of measures to address dislocations in financial markets that were preventing the permissive monetary policy interest rates to be fully and evenly reflected in the lending conditions faced by households and firms across the euro area. These measures are typically referred to as "non-standard" and were intended to relieve liquidity and funding constraints in the banking sector, as well as unwarranted tail risks. This set of measures, therefore, serves to improve financing conditions over and above what can be achieved through reductions in the key ECB interest rates.

In addressing the crisis we have been acutely aware of the need to strike a delicate balance between two sets of competing considerations. On the one hand, central banks were faced with the risk of a financial meltdown, which would have had profound implications for the real economy and which posed a serious threat to price stability. On the other hand, the resolute response of the central bank to the financial crisis relieves the pressure from other actors in the economy to measure up to their own responsibilities, correct the past unsustainable economic course and unwind excesses. This refers not only to governments but also to the private sector. In the past year we have seen significant progress in the European economic governance framework. These changes to the institutional architecture of the EU have been of great importance for restoring the appropriate incentives of the actors involved.

Increasing the numerical definition of price stability

Let me now turn to the discussion of "innovative" ideas on strategic aspects of monetary policy. Since the early 1980s, a broad consensus has emerged across advanced economies which has elevated price stability to the main – although not always the sole – objective of monetary policy. Indeed, through the fixed-exchange-rate policy for the krone vis-à-vis the euro, Danmarks Nationalbank is effectively also among the central banks aiming at maintaining price stability.[2] In most cases, the mandate for pursuing price stability has been operationalised by defining a numerical value for inflation that the central bank should aim to deliver. In advanced economies this value is low, typically within a narrow range around 2%.

In the wake of the crisis, however, a number of pundits have called for an increase in the inflation rate that central banks should aim for. These calls have originated from diverse sources spanning academia, policy circles and financial markets.[3] Proponents of this

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[2] Danmarks Nationalbank, *Monetary Policy in Denmark*, 3rd edition, Danmarks Nationalbank, Copenhagen, 2009.

[3] In academia the recommendation for a higher inflation rate objective in a low nominal interest rate environment predates the current crisis, see P. Krugman, "It's Baaack: Japan's Slump and the Return of the Liquidity Trap", Brookings Papers on Economic Activity, 2, 1998, reformulated more recently in G. Eggertsson and P. Krugman, "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach", *Quarterly*

approach argue that this is a way to provide more monetary policy stimulus to the economy when nominal short-term interest rates – the instrument typically employed by central banks – cannot be reduced further because they are at zero, or close to zero.

The rationale is that a higher inflation objective, if credible, would prompt firms and households to revise their expectations regarding future inflation upwards. By doing so, it would reduce further down real interest rates, which are not necessarily constrained by zero. As real – rather than nominal – interest rates matter for economic decisions such as investment and consumption, this change should promote economic activity. It is therefore argued that switching to a higher numerical aim for inflation will bring about a one-off accommodative effect when it is adopted. Moreover, it is claimed that it will also make it less likely in the future that nominal rates will become constrained by their lower bound.

It may not surprise you to hear that I am very sceptical about this proposal, both in general terms and in the euro area context in particular. To explain my concerns, I shall step back for a moment and clarify an aspect of the ECB's monetary policy framework that is subtle, but in my view important. By contrast to many central banks around the world, the ECB does not practice inflation targeting. The ECB has been mandated by the Treaty (Treaty on the Functioning of the European Union) to maintain price stability over the medium term. The mandate itself does not entail a precise definition of what price stability means in practice. The Governing Council, therefore, decided to identify inflation values consistent with conditions of price stability.

Price stability conditions do not necessarily entail stable prices, that is to say zero inflation. Inflation levels which are sufficiently contained to not interfere with economic choices are to be considered indicative of a stable monetary environment, and therefore of price stability. Inflation impinges on a large array of economic activities.[4] For instance, it has an important effect on the way people take decisions about how to allocate resources across time. For example, a household's decision to consume today or instead save and consume in the future; a worker's decision to supply labour; or a firm's decision to invest. Moreover, inflation – especially if it is volatile – creates distortions in the information content of relative prices in the economy. This can lead to incorrect economic decisions if, for instance, firms wrongly interpret a general price increase as a signal of increased demand for their product. It also affects the frequency of changes in businesses' price tags and menus. Importantly, these effects lead to dead-weight losses and distortions in the allocation of resources and, therefore, to socially sub-optimal economic outcomes.

The upshot is that the rate of inflation, above which distortions of economic decision-making start becoming material, is not a matter of policy preference, like an inflation target. Instead, it is a structural feature of the economy. It is linked to aspects such as contract and commercial pricing technologies; the tax and welfare system; and the demographic structure of the population, to name but a few. While these structural features of course can and indeed do change, they do so only very gradually and infrequently. Moreover, the direction and size of the effect of any such changes on the non-distortive inflation rate is not *a priori* clear. It needs to be thoroughly examined and conclusively proven.

Journal of Economics, vol. 127 (3), 2012, pp. 1469–1513. A similar recommendation has been put forward by IMF staff, see O. Blanchard, G. Dell' Ariccia and P. Mauro, "Rethinking Macroeconomic Policy", *IMF Staff Position Note*, SPN/10/03, 2010. An example of an endorsement of this proposal by financial market participants is provided in M. Pradhan, *The Global Monetary Analyst: Debt Dominance, Mandates and the Impossible Puzzle*, Morgan Stanley Research, 31 October 2012.

[4] For surveys of the literature on the costs of inflation, see O. Issing, "Why price stability?", in: A.G. Herrero, V. Gaspar, L. Hoogduin, J. Morgan and B. Winkler (eds.), *Why price stability*?, First ECB Central Banking Conference, European Central Bank, Frankfurt am Main, 2001 and G. Camba-Mendez, J.A. Garcia and D. Rodriguez Palenzuela, "Relevant economic issues concerning the optimal rate of inflation", in O. Issing (ed.), *Background studies for the ECB's Evaluation of its Monetary Policy Strategy*, European Central Bank, Frankfurt am Main, 2003.

Where does this leave us on the proposal to increase the numerical objective pursued by monetary policy? An inflation target can be changed to reflect shifting policy tastes and moving priorities. But a quantitative definition of price stability is a range of inflation values that can be qualified as unproblematic for economic decision-making. And this qualification is a factual statement, not a matter of tactical choice. Changing it on tactical grounds would be opportunistic and would harm the credibility of the central bank. For a central bank like the ECB, wedded to a range of inflation values that can be characterised as indicative of stable prices, a change to this range – and notably to its upper quantitative limit – is not conceivable barring analysis that convincingly argues for a wider range and larger values. A change not justified on these bases would create permanent damage to our ability to steer inflation expectations and contain inflation volatility.

A loss of credibility can lead to an overshooting of inflation expectations. This would require a disproportionate withdrawal of monetary policy accommodation in the future to rein in inflation. Any initial boost to economic activity will therefore ultimately be more than reversed. Additional and unnecessary volatility in real activity would be the price to pay.

In any case, it seems to me that the trade-off implied by this proposal is rather lopsided. Even if the central bank is successful in engineering precisely the intended permissive conditions as measured by a real interest rate decline, it is far from clear that this would indeed generate real effects even in the short-term. If, for instance, there are quantitative constraints in the availability of credit at play in the economy, the lower short-term real rates will fail to stimulate aggregate demand. Overall, therefore, one risks trading very uncertain gains – in terms of immediate policy accommodation – against rather certain costs – in terms of higher inflation, possibly for an indefinite period. Such risk-payoff structures are perfectly acceptable in the business world. Indeed taking calculated risks is often the mark of a successful business leader. For public policy, however, this strikes me as a deal that should not be made.

But for some of the proponents of increasing the central bank's inflation objective this proposal is not motivated by a perceived need to stimulate aggregate demand when nominal interest rates are at zero or close to zero. Instead, they focus on another feature of the crisis: balance sheet adjustment in order to address the over-indebtedness problem. According to this argument, a higher inflation objective makes it less likely that the economy may get trapped in a destructive debt-deflation spiral of the type described by Irving Fisher. In the midst of the Great Depression, Fisher put forward a theory of economic crises that centred on the mutually reinforcing effects between over-indebtedness and deflation.[5] According to this view, over-indebtedness beyond some point triggers distressed asset sales as debt is called in. This leads to abrupt deleveraging and a contraction of the amount of money in circulation. The destruction of money precipitates a fall in the general price level. Deflation in turn causes the real debt and interest burden to go up, thereby triggering a new bout of distressed asset sales and deleveraging and trapping the economy in a vicious circle.

Deflation poses risks to the economy that – in some respects – are even more intractable than inflation. It is for this reason that the Governing Council's definition of price stability rules out negative inflation values. Moreover, the Governing Council's policy aim (within the range of positive inflation rates that are consistent with price stability) is sufficiently close to the upper bound of the range to stave off the risk that negative price shocks may unleash a self-reinforcing downward inflation spiral. But engineering financial repression in order to facilitate balance sheet adjustment would clearly violate the mandate to maintain price stability as a primary objective conferred upon the ECB by the Treaty.

Earlier in my remarks I referred to the central bank's steering of inflation expectations as an illustration of the notion of *control*. Moreover, I mentioned that the steadfast pursuit of the

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[5] Fisher, "The Debt-Deflation Theory of Great Depressions", *Econometrica*, vol. 1(4), 1933, pp. 337–357.

central bank's mandate exemplifies the notion of *courage*. I am very sceptical whether increasing the numerical definition of price stability helps in either of these dimensions.

Engaging in communication regarding the future path of policy rates

Let me now turn to the second example of an innovative proposal for monetary policy that I would like to discuss today. Unlike the previous proposal, this one does not relate to the objective of the central bank. Instead, it focuses on how the central bank can actually achieve its assigned objective, when the chances that the objective will be hit diminish.

As I already mentioned, central banks typically conduct monetary policy by steering nominal short-term interest rates. These are the rates over which they can exert significant influence through the monopoly supply of central bank reserves. It is, however, widely accepted that it is primarily long-term interest rates that matter for the main economic decisions that the central bank wants to influence.

How is it then that monetary policy can have an impact on the economy? Well, one can think of long-term interest rates as comprising two elements: expectations regarding the future evolution of short-term rates; and premia. Premia relate to the compensation investors demand for holding on to an asset for a specific period of time (the term premium). Moreover, they relate to the compensation for risks, such as the possibility of incurring capital losses due to difficulties they may encounter when selling the asset back to the market before maturity and at short notice (the liquidity premium). Changes in the current policy rate are typically interpreted by markets to also signal changes for short-term rates in the future. That is, they affect market expectations for future short-term rates and therefore, long-term rates.

In normal times, this signalling channel works well and market expectations tend to be in line with monetary policy makers' intended long-term rates. When, however, short-term nominal rates are at zero or close to zero, this signalling channel loses its potency. The risk is that long-term rates may drift away from the central bank's intended path, in which case financing conditions in the economy will not properly reflect the stance of monetary policy. Some academic economists have advocated that, particularly in such a situation, the central bank should engage in active communication regarding the future path of policy rates.[6] This communication would serve as a commitment device for the central bank to follow in the future the announced path of short-term rates, possibly conditional on actual developments in the economy.[7] If this commitment is sufficiently credible, it will be effective in steering expectations regarding future interest rates and so influence the first component of long-term interest rates to which I was referring before. This is turn, will allow the central bank to deliver accommodative financing conditions in the economy over a certain horizon. A number of central banks around the world – most recently including the US Federal Reserve – have adopted some version of this approach.

But the decomposition of long-term rates I mentioned a few moments ago suggests that there is also another possible way for the central bank to deliver appropriate financing conditions in the economy. This second approach is to exert influence on the premia, to the extent that they are unwarranted and reflect dislocations in markets. I would argue that the

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6 The argument was originally made in P. Krugman, op. cit. It was presented in a more formal way in G. Eggertsson and M. Woodford, "The Zero Bound on Interest Rates and Optimal Monetary Policy", *Brookings Papers on Economic Activity*, 1, 2003, pp. 139–233 and, more recently, in M. Woodford, "Methods of Policy Accommodation at the Interest-Rate Lower Bound", paper presented at the Jackson Hole Economic Policy Symposium of the Federal Reserve Bank of Kansas City, "The Changing Policy Landscape", August 31 – September 1, 2012.

7 The commitment mechanism is necessary due to the time-inconsistency problem inherent in such a situation, i.e. the incentive for the central bank to ex post renege on this promise. See F. Kydland and E. Prescott, "Rules Rather than Discretion: The Inconsistency of Optimal Plans", *Journal of Political Economy*, vol. 85(3), 1977, pp. 473–492.

assessment regarding which approach is more appropriate depends on the particular situation each monetary policy maker faces.

The approach focusing on communication regarding the future path of short-term interest rates is in principle applicable to a situation where there is a need to provide general, across the board, stimulus to the economy. Moreover, it applies in currency areas where financing conditions are more or less homogeneous throughout segments of the financial market and of the currency space. By this I mean a situation in which following a reduction in the array of risk-free interest rates, firms or households with comparable characteristics experience a broadly similar decrease in the borrowing rates they are charged for finance.

Despite the notable improvements recently, this by and large is not the situation we are facing in the euro area. Domestic financial conditions across euro area countries remain fragmented. The spreads that lenders apply over benchmark rates are very uneven and, in some countries, abnormally high, reflecting dysfunctional market dynamics. Moreover, there is no uncontroversial way to define the term structure of the risk-free rate in the euro area. Unlike economies with a single fiscal authority or with a fully-fledged federal structure, the euro area comprises multiple sovereign states. The debt of each of these states has different liquidity and risk characteristics. Under these circumstances, it strikes me as far more appropriate to encourage conditions for a more even distribution of the very permissive liquidity provision that is in place. Engaging in promises regarding the future monetary policy stance would not be the most effective instrument for achieving this. Instead, we need to continue addressing the part of the premia in long-term rates in the euro area that is not warranted. But let me be clear, this does not mean that monetary policy instruments should be used to reduce credit spreads that reflect well-founded concerns regarding long-term debt sustainability and competitiveness.

Is this alternative approach effective? In a nutshell I would say that the arsenal of the ECB's instruments for monetary policy implementation continues to be able to induce relaxation of conditions in term borrowing, when this is deemed necessary. In particular, the very long tenor of some of our refinancing operations combined with the full accommodation of banks' demand for such refinancing at the prevailing rate has proven to be very powerful. Indeed, this has been effective in lowering rates along the yield curve, without having to engage in commitments on the future stance of monetary policy to steer expectations. By providing security to our bank counterparties that central bank credit will remain in place for a sufficiently long horizon, we have acted on the liquidity premium component of term interest rates: the spread that remunerates banks lending in the inter-bank market for the risk that their borrowing counterpart may become illiquid and unable to honour the inter-bank credit contract at maturity. This added degree of comfort has encouraged market activity at decreasing term lending rates.

But I do not want to imply that the approach that the ECB has followed thus far is free of pitfalls. For instance, the use of refinancing operations with a very long maturity results in an immediate expansion of the balance sheet when implemented. Such an expansion is not without challenges for central bank communication and for managing inflation expectations. Moreover, it has the unintended side-effect that it increases the encumbrance of banks' balance sheets. That is, it increases the share of bank assets that are already pledged as collateral, and thus unavailable to support the borrower's standing in additional credit operations. The share of bank assets that would be available to cover the claims of unsecured creditors in case of a default shrinks. This, in turn, amplifies the perceived loss given default of additional claimants and makes it more difficult for banks to access the unsecured money markets, which in normal times is the main market for marginal bank funding. We are fully aware of this risk and this is part of the reason that we have allowed for early repayment of our 3-year long-term refinancing operations. This way, when a counterparty judges that its chances of accessing market funding are being constrained by its use of ECB 3-year long-term refinancing operations, it can repay all or part of the amount borrowed earlier than its original maturity. In fact, tomorrow is the first opportunity to make

use of the early repayment option. Euro area banks have taken this opportunity and have informed us that they will repay €137 billion of the slightly more than €1 trillion outstanding in such long-term operations.

We will exert vigilance to ensure that – notwithstanding the legitimate decisions of individual banks to reduce their liabilities to the central bank – the overall liquidity conditions prevailing in the money market will remain consistent with the degree of accommodation that the current outlook for prices and real activity warrant.

Whichever of the two approaches a central bank decides to use, it needs to be well appreciated that there are limits to what monetary policy alone can achieve. Delivering accommodative financing conditions and ample liquidity to the banking system has been necessary to avoid an abrupt deleveraging that could tip the economy into a destructive deflationary spiral. But parts of the banking system remain overstretched and this needs to be addressed in order to move decisively out of the crisis. Similarly, structural reforms need to be undertaken in order to restore the competitiveness of euro area economies. Only such reforms can deliver a lasting reversal of the fragmentation phenomena that the euro area has witnessed. And clearly neither of these tasks can be taken up by monetary policy.

Conclusion

Let me conclude with a cautionary tale. Innovation is the quintessence of entrepreneurship and a cornerstone for economic growth and prosperity in market-based economies. But there can be innovations that create more problems than the ones they were originally conceived to address.

I am reminded of the two mortal sins of economic policy-making that clearly transpire when reading Carmen Reinhart and Kenneth Rogoff's excellent book on financial crises: arrogance and ignorance.[8] Transposing this insight to the discussion on monetary policy frameworks, I would say that it is dangerously arrogant to believe that one's current approach to monetary policy is perfect and no improvements or changes will ever be needed. Certainly, before the crisis, a certain degree of academic group thinking and central bank professional hubris bred a sense of accomplishment that proved exceedingly complacent and ultimately self-defeating. Looking forward, we should temper a tendency to self-complacency – if not arrogance – with the strength of thought and the courage of vision.

But courage and vision should not entice us into hazardous experimentations. We should not be ignorant of the lessons that history has taught. And history has shown that inflation was permanently brought under control when the public's inflation expectations became safely anchored. This in turn occurred when central banks gained credibility regarding their determination to stabilise inflation. This credibility was hard-earned but can be eroded easily. It would be irresponsible to jeopardise it.

As regards the ECB in particular, I am convinced that our existing monetary policy framework provides enough scope for instruments to continue addressing the crisis in a decisive and effective way. We remain attentive to possible shortcomings in our policy framework and to changes in the structure of the economy that would warrant revisiting aspects of this framework. At present, however, I see no compelling case for change.

Thank you very much for your attention.

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[8] C. Reinhart and K. Rogoff, *This time is different: Eight centuries of financial folly*, Princeton University Press, Princeton and Oxford, 2009.