Peter Praet: Monetary policy and balance sheet adjustment

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the ECB Forum on Central Banking, Sintra, Portugal, 27 May 2014.

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Ladies and Gentlemen

It is a great pleasure to be here on the second day of the ECB forum on Central Banking.

I am pleased to welcome on this panel three outstanding central bankers who have shaped our thinking on monetary policy.

We have tasked our panellists with reflecting on monetary policy and balance sheet adjustment. I very much look forward to hearing their views on this important and complex topic.

But before giving them the floor let me share with you a few thoughts on how the process of balance sheet correction that is taking place in the euro area could influence the shaping of monetary policy in the current conditions.

Balance sheet recessions

One important question raised by the crisis and its aftermath is the following: are "balance sheet" recessions different from "normal" recessions and do they call for a different monetary policy treatment? Put differently: the crisis has left a legacy of cross-sectoral financial exposures that, by and large, need to be run down in the aggregate. Probably, there exists a new financial texture (in terms of cross-sectoral borrowing and lending) that would make the economy more resilient and less conducive to financial shocks. The question is: should that new financial structure become a conditioning variable for monetary policy – possibly, on a par with other and more traditional target variables, such as inflation and macroeconomic stability that one sees in standard central bank reaction functions? And should the planned time to approach that goal determine the horizon for monetary policy?

To preview my conclusions: I have a lot of sympathy for the view that balance sheet recessions are indeed different and may require re-thinking the role of financial imbalances in monetary policy design, starting in the run-up phase. In fact, "rethinking" is not the right word in respect of the ECB. Let me quote from a speech that Otmar delivered almost 12 years ago in Jackson Hole: "…*monetary aggregates and credit developments in situations of financial instability can signal to what extent consumption, investment, labour and price setting decisions are being affected by conditions of financial disorder, excessive euphoria or disillusion*." He went on to draw some strategic conclusions, saying that: "…*we were given two eyes: one to watch money and credit aggregates and one to watch everything else. Ultimately, these two policy perspectives are to be combined in a single strategy which subsumes them both in a unified – albeit complex – and robust framework for action."* This was alien language in the homeland of the "Jackson Hole consensus", which did not envisage a role for monetary analysis or *financial disorder* in monetary policy-making at all. It has become common parlance since, even there.

At the same time, I have questions – many questions – on how best to integrate balance sheet considerations into policy-making in a way that does not undermine the best legacy of the pre-crisis era: our price stability mandate.

Let me elaborate.

Balance sheet restructuring

Previous crises have shown that prompt and decisive balance sheet repair after a period of excessive credit growth is the best way to restore sustainable growth.[1] Post-recession growth may not even be significantly weaker than normal if the overleveraged financial sector aggressively cuts back excess credit in the recovery phase.[2]

Like balance sheet imbalances, structural impediments to growth and to an efficient allocation of resources are generally very relevant for the conduct of monetary policy and need to be tackled decisively. Trying to stimulate growth through standard aggregate demand policies may be ineffective and, under certain circumstances, even counterproductive in balance sheet recessions, when structural breaks on potential growth predominate.[3]

It is for this reason that the changes to euro area and EU governance introduced in response to the crisis are so important and need to be implemented with determination. The reforms undertaken in many stressed countries, especially those benefiting from official external assistance, should eventually lay the foundations for a robust recovery.

Most importantly, the steps being taken to create a banking union should help to address existing balance sheet problems. The initial focus is on banks' balance sheets. The comprehensive assessment of their balance sheets currently being done by the ECB is a critical element. Thousands of supervisors are carefully scrutinising the books of the euro area's largest banks.

At the end of this process, the assets in banks' books should accurately reflect the economic realities. That means that the value of loans to over-indebted firms and households will be adjusted to reflect the actual debt servicing capacity of these debtors. Incentives for evergreening and the associated misallocation of capital will be reduced.[4]

At the same time, banks will be required to take corrective action regarding their own capitalisation levels, if needed. The increased transparency of banks' books brought about by the comprehensive assessment should make it easier to raise additional share capital. This will reduce the need to resort to further shedding of assets with all its negative macroeconomic consequences.

All this will create the necessary preconditions for an eventual more robust and sustainable recovery in the euro area.

Implications for monetary policy

Leaving aside the ECB's newly acquired role as supervisor and its traditional contribution to institutional reforms in Europe, what are the implications of a balance sheet recession for the monetary function narrowly defined? Should the policy rule that traditionally assigns the control of inflation and minimisation of excess macroeconomic volatility to central banks be enriched with further elements which become binding at times of financial adjustment?

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1 For example, the Nordic banking crisis of the 1990s provides a case study of how decisive and well-targeted crisis management can mitigate and shorten the damaging effects of deleveraging stress. For an overview of the Swedish case, see Ingves and Lind (1996).

2 See Takáts and Upper (2013). While in general credit-less recoveries – in which banks delever aggressively – are indeed significantly slower than recoveries with credit growth, the authors find that, during credit-less recoveries following financial crises that were preceded by credit booms, lower bank lending to the private sector does not necessarily slow down economic growth. They find that after such financial crises economic growth and bank credit growth are not correlated in the first two years of recovery.

3 See Bech, Gambacorta and Kharroubi (2012).

4 See Caballero, Hoshi and Kashyap (2008).

This, in my view, is the main area of reflections where a vision for the role of monetary policy in a changing financial landscape should take shape. In fact, how a central bank deals with structural balance sheet imbalances is not a problem confined to the management of recessions. It is a key element of a strategy for handling the business cycle in its entirety. So, it lies at the very heart of monetary policy. But it is an exceptionally difficult problem to solve. It is fraught with a cluster of ancillary questions. Let me list some of these.

As I said, I tend to believe that the objective of repairing prior misallocations of credit and capital across sectors should be incorporated in one way or another as a "high priority" in the policy process.

But we immediately run up against three issues here. The first issue concerns the governance of instrument setting for the central bank. Let us take a very simplified representation of monetary policy-making: a Taylor rule. How would this "high priority" be included in this Taylor-inspired interest-rate-setting process? Would it be an additional objective to be traded off, on a par with inflation and demand conditions, i.e. an additional reaction variable weighted by its own coefficient? Or should it be expressed as a constraint, a knock-out clause, which could become binding only occasionally? And, in the latter case, who should decide when this rebalancing or inversion of policy priorities – from time to time overriding the Taylor prescriptions – should be pursued?

The second issue is one of policy legitimacy. It may be easy to say: the business sector as a whole is over-indebted and we (central banks) need to promote a correction, first and foremost avoiding monetary policies that can induce moral hazard, and thus only obstruct and delay the adjustment that is anyhow inevitable. But it is more difficult to say "within the business sector, this industry deserves less credit relative to that industry" without quickly entering the terrain of allocative policies, which should be alien to our mandate. And I fear rebalancing policies will inevitably have allocative implications.[5]

Finally, the third issue is the one that bothers me most. Let us take it for granted that monetary policy should – at least occasionally – deviate from its stylised Taylor representation and look at and act upon financial imbalances. Let's imagine a post-crisis situation, where various sectors are over-indebted. Let's also assume that a central bank has a clear view about the size of "excess indebtedness" and its concentration across sectors. Third assumption: the central bank is assigned a price stability mandate, which it needs to deliver "over the medium term".

Probably, in this situation, the time horizon for normalising inflation will be the relevant parameter that this central bank will have to select to chart its way out of a deep crisis in a manner that encourages – or at least does not discourage – structural rebalancing in the financial sector. Probably, the central bank will have to be able to choose a longer journey back to its target: it will have to accept more disinflation – and for longer – during the transition than it would tolerate in different balance sheet conditions.

But at this point I start wondering: allowing a central bank a lot of discretion in the choice of the horizon for monetary policy is sometimes almost the same as giving it discretion in its choice of the monetary policy objective. And some memories come back to mind. In the 1970s monetary policy-makers were busy convincing their legislatures that rampant inflation was a temporary phenomenon. Once the various structural forces at play – high pay demanded by unions, high oil prices charged by Middle Eastern countries, high food prices induced by drought – had faded, they claimed, inflation would return to more tolerable levels. Of course those "temporary factors" never reversed and inflation persisted for a decade. Inflation expectations had been fatally affected by a combination of high inflation and policy

[5] On the redistributive properties of monetary policy during the crisis, see Goodfriend (2011).

forbearance, and it took central bank resolve – and a painful global contraction – to break away from that equilibrium.

I tell myself: we could imagine situations in which the same narrative – invoking structural forces to justify a monetary policy stance that tolerates a sustained deviation from the objective for too long – leads to a symmetric, durable scenario of uncomfortably low inflation, which eventually feeds itself.

I do not have definite answers to all these questions. History is still being written as we speak. But let me share a few thoughts on these issues.

What is the role of monetary policy in this process? Maintaining a very accommodative policy stance for too long certainly carries severe risks. Incentives for a timely balance sheet repair may be undermined and new imbalances may ultimately emerge.

Still, central banks will have to remain true to their mandates of ensuring price stability. This mandate should be interpreted as a symmetric mandate. Too low inflation, or even deflation, for a prolonged period of time cannot be seen as consistent with price stability.

The ECB's policy framework

There are clear limits to the leeway that we – central banks – can afford within our mandates. Our medium-term price stability objective implies that we cannot stretch our policy horizon forever – even if the economy is undergoing a lengthy deleveraging process. Monetary policy needs to act forcefully if and when the adjustment process threatens the fulfilment of our mandate.

We should preserve the virtues of *constrained discretion:*[6] a delicate and fragile blend of opposing attributes of monetary policy-making, which central banks acquired in the form of mandates in the 1990s, and which has served us well since then on our long journey back from the inflation years. Let's not forget that – since the early 1990s when the industrial world eradicated inflation – the emphasis in the "constrained discretion" oxymoron has always been on *constrained*.

In the early 1990s rules won a long battle over discretion. And rules meant a numerical definition of the inflation objective and a flexible but certain horizon for accomplishing the objective.

Pushing on a string when the transmission of monetary policy stimulus is impeded by the countervailing forces of deleveraging can be counterproductive. At the same time, accepting low or even negative inflation rates in such a situation may render the balance sheet adjustment more painful and drawn-out.

And it may destabilise inflation expectations. A protracted period of too low inflation, which is typical for episodes of balance sheet repair, might lead to a de-anchoring of inflation expectations, magnifying the risks of a self-fulfilling decline in the general level of prices.[7]

Most of the building blocks monetary policy has put in place in its fruitful interactions between academic theory and central bank practice remain valid. Let me highlight three key elements:

First, central bank independence; second, a clear price stability objective supported by a quantitative definition of price stability. We chose 2 percent as the upper limit of our numerical definition of price stability because above that level inflation starts becoming a conditioning factor in economic choices. It introduces distortions. And there is no reason for

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[6] The term was first used in connection with monetary policy by Bernanke and Mishkin (1997). For an account of the historical debates on rules vs. discretion in monetary policy, see Bernanke (2003).

[7] See Fisher (1933).

the pace at which the nominal scale of a fiat money system drifts over time to be a distorting factor of real economic decisions.

Should this upper limit be made bigger in steady state because that higher level would insure against major macroeconomic crises? I don't think so. Maintaining a high tax almost all the time just for the pleasure of cutting it in a rare occurrence (and even if that rare event is going to bring sufficiently severe consequences) does not seem to pass the test of optimal intertemporal allocation of policy action. The costs of high inflation are high. But the benefits of having high inflation as a hedge against a crisis are small after all, as central banks have learned to do crisis control with unconventional instruments. And these instruments work at any steady state inflation rate.

The third key element is a transparent monetary policy strategy that will ensure central bank accountability and help to anchor inflation expectations at the central bank's objective.

Recent years have shown that such a framework – again bearing the imprint of constrained discretion with a clear emphasis on "constrained" – can notably reduce the risks of deflation – even in the face of the so-called zero lower bound. Long-term inflation expectations in the euro area remained firmly anchored even at the height of the global financial crisis and in the midst of the euro area's sovereign debt crisis. This was a remarkable achievement.

True, the crisis brought back pale memories – confined to books on the Keynes/von Hayek dispute in the 1930s – of what it means for a central bank to be handling an economy which is highly unbalanced.

Central banks should draw on this experience. In an upturn, they should not actively promote financial short-sightedness by ignoring the threat of credit and financial exuberance. In a downturn, or during a painful recovery, they – again – should avoid short-sighted policies that promise to alleviate the side effects of the adjustment but in fact make that adjustment never-ending.

At the same time, we should never forget that price stability needs a quantitative expression – put simply, a number that people can internalise firmly in their decisions – as well as a recognisable horizon.

Thank you.

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