Peter Praet: Have unconventional policies overstretched central bank independence? Challenges for accountability and transparency in the wake of the crisis

Keynote address by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the "Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States", Frankfurt am Main, 29 March 2017.

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Evolution in consensus on the role of central banks and central bank independence

In the course of monetary history, consensus on the role of monetary policy and on the appropriate degree of independence of the central bank has fluctuated considerably. During major crises, the pendulum has tended to swing from one extreme to the other.

In the heyday of the gold standard, i.e. the decades preceding World War I, there was a commonly accepted understanding of how to preserve monetary and financial stability. The gold standard provided what we call a "nominal anchor". It effectively ensured central bank independence from other public policies by subjecting monetary policy to an automatic rule.[1] At the same time, there was a clear understanding of the role of central banks as a lender of last resort. Under that regime, central banks enjoyed sufficient discretion to take effective action in the event of banking panics. Adherence to the oft-quoted Bagehot principle ("lend freely at a high rate against good collateral" to solvent, but illiquid institutions[2]) ensured that lender of last resort activities did not threaten monetary stability.

The pendulum began to swing away from this pre-war consensus when World War I prompted many countries to subordinate monetary policy to financing war and to suspend the gold standard. Countries returning to the gold standard after World War I, however, turned to overly rigid management of monetary affairs. Lacking the necessary discretion, following the Wall Street crash and the global recession in 1929, and the subsequent banking crisis, monetary policy prompted a precipitous collapse in money and prices.[3] This spawned the greatest loss in jobs and output on record in what came to be remembered as the Great Depression.

In a fateful irony of monetary history, the role of monetary policy in precipitating these calamitous events did not usher in monetary reform. On the contrary, notions hardened that monetary policy was powerless and that macroeconomic stability needed to be safeguarded through other policies.[4] This shift in emphasis culminated in fiscal dominance, which contributed to the monetary mismanagement of the 1960s and 70s, paving the way for the "Great Inflation". Only a few countries that preserved central bank independence, such as Germany, were able to maintain low inflation rates throughout these years.

The Great Inflation was eventually overcome as monetary policy once again gained centre stage and was recognised as a powerful factor in macroeconomic stability. Economists, irrespective of their scholarly persuasion, and policymakers alike became convinced of Milton Friedman's famous dictum that "inflation is always and everywhere a monetary phenomenon".[5] This return to old wisdom helped to rebuild a consensus that central banks need to be granted sufficient independence to pursue monetary stability without political interference. The pendulum had swung back, and central bank independence became the mainstay of inflation targeting frameworks. In the European Union, the independence granted to the ECB for the pursuit of price stability is a central plank of the Treaty on the Functioning of the EU and has thereby attained a unique institutional and legal status.

Challenges for central bank communication and accountability in times of crisis

We have been going through the biggest financial crisis in two generations, which has now lasted nearly a decade. Prior to it, monetary policy operated predominantly through adjustments to short-term interest rates. But the crisis has upended traditional patterns in finance and economics, and monetary policy is no exception. In its response to the crisis, the ECB has deployed a novel and complex range of instruments. The novelty and complexity of these unconventional measures have created challenges for accountability and transparency.

The financial crisis has evolved in three main phases, each of which has required different monetary policy responses and has brought about particular challenges for central bank communication and accountability.

The first phase was the abrupt liquidity crisis triggered by the turning of the global financial cycle and the subsequent collapse of Lehman Brothers. It provoked a systemic failure of funding markets and prompted global central banks to step in with forceful and coordinated interventions to provide essential liquidity to the banking sector. Without this response, the financial system would have collapsed and a far deeper recession would have ensued.

Owing to the funding freeze, the classical interest rate instrument ceased to be the main signalling device of the monetary policy stance. The deployment of the central bank balance sheet as a stabilising instrument was a novelty, and immediately met substantial scepticism. First, there were concerns about moral hazard, given the unprecedented expansion of ECB credit to banks at a time when banks were under scrutiny for their mismanagement of risk in the pre-crisis period and for having precipitated the crisis in the first place. Second, there were also concerns about these liquidity injections paving the way for inflation.

Owing to the incompleteness of the institutional structure of Economic and Monetary Union (EMU), the profound effects of the banking crisis were not addressed as swiftly in the euro area as in other jurisdictions. This paved the way for the second phase of the crisis, the sovereign debt crisis, which was amplified by the fact that banks predominantly hold debt securities of their own national governments. As the cost of borrowing increased for certain governments, banks with exposures to this debt came under intense market pressure, ultimately leading to entire national banking systems losing market access. This in turn resulted in financial fragmentation and a serious disruption of the monetary policy transmission mechanism. As a consequence, cuts in key ECB interest rates were not being passed on to firms and households to the same extent in every euro area country.

To arrest and reverse this development, two policies were introduced. First, to ensure banks could rely on longer-term funding, central bank liquidity was made available for up to three years, and the collateral that could be used to access central bank money was expanded. Second, the announcement of Outright Monetary Transactions (OMTs) in 2012 removed the euro area break-up risk that was being priced into government borrowing costs.

Notwithstanding the success of OMTs in alleviating redenomination risk, the sovereign debt crisis set back the recovery and laid the ground for the third phase of the crisis. Banks in large parts of the euro area became less willing and less capable of keeping credit flowing to the real economy, producing a vicious circle of contracting credit growth and weak demand dynamics. Accordingly, headline inflation began to drift downwards, owing both to global energy and commodity price developments and to ongoing weakness in the core components.

In June 2014 monetary policy in the euro area embarked on a phase of renewed expansion, aimed both at enhancing monetary policy transmission, in a context of continued bank deleveraging, and increasing policy accommodation in view of persistently weak inflation. Having limited room for manoeuvre on the main refinancing rate, the ECB initiated a series of new unconventional measures. These consisted of our targeted longer-term refinancing operations

(TLTROs), our asset purchase programme for public and private sector securities (APP), and our policy of charging a zero interest rate on main refinancing operations and a negative rate on excess reserves. As the floor of our monetary policy corridor – which by then had become the key instrument steering monetary conditions in the money market – was reduced to negative levels, other short to medium-term market yields dipped below the zero line as well.

Given the novelty, scope and size of the measures taken, and given their potential interaction with other public policies, communication of these measures proved to be much more difficult than before the crisis, when we only had to explain how changes in the main policy interest rates affect the economy and ultimately the price level.

Likewise, holding the ECB accountable for its monetary policy has also become more difficult. Let me illustrate this difficulty by considering how observers have been using Taylor rules to compare our policy interest rates with rule-based benchmarks. In a Taylor rule, such benchmarks are pinned down mainly by the deviation of inflation from target and by a measure of economic slack. On this basis, observers held central banks accountable for monetary policy decisions, as the relation between policy objective and instrument is transparent and not equivocal. In a nutshell, empirical regularities lay the ground for a prescriptive monetary policy rule – even though oversimplified – against which central bank actions can be evaluated.

In crisis times, it turned out to be nearly impossible to track the monetary policy stance using a Taylor rule. First, with the interest rate having ceased to be the main instrument, incorporating balance sheet measures into the rule is not straightforward at all.. Second, as the transmission of policy interest rates to the economy has been impaired, their comparison with Taylor rule benchmarks has become much less informative. Third, in view of persistently weak and low inflation and a high degree of economic slack, Taylor rules might well prescribe the setting of interest rates below their effective lower bound, wrongly indicating a tight policy stance, as the easing effects of unconventional measures cannot be accounted for. Developing other comparatively simple monitoring tools has not been possible. Overall, the ability of observers to use policy rules to hold the ECB accountable has been severely hindered.

How can we then be sure that the measures taken fall within the ECB's narrowly defined price stability mandate?

The precise scope of our price stability mandate has been the subject of some debate in recent times.[6] Some have argued that central banks, by engaging in a systematic expansion of their balance sheets, are in effect venturing into the realm of fiscal policy. Such views could be paving the way for another turnaround in the public perception and institutional status of central banks, which could result in less financial and, ultimately, less statutory independence. This threat may be even more pronounced in a world in which, virtually everywhere, public debt has surged to high levels, making political pressure on central banks to alleviate debt servicing costs through higher inflation more likely.[7] Another swing of the pendulum?

Central banks are ultimately judged on their success or failure in ensuring low and stable inflation. Central bank independence gives them the freedom to pursue their mandate. Independence does not mean that they can act in a completely unfettered way. In modern democratic societies, independent institutions are accountable. They need to explain the reasons for their actions and why these are appropriate for fulfilling the mandate that has been assigned to them as the result of a democratic process. For central banks, one of the challenges is to communicate their internal deliberations in a transparent manner to their external stakeholders.

Safeguarding accountability

The Treaty sets out an accountability framework for the ECB, which requires regular appearances by ECB officials before the European Parliament and the publishing of the Annual

Report. Let me remind you that the ECB was the first major central bank to hold press conferences on its monetary policy decisions. The Economic Bulletin provides a comprehensive account of the economic and monetary analyses supporting the Governing Council's assessments. In 2015, we took another important step: we started publishing accounts of the monetary policy meetings of the Governing Council, as an additional means to explain the deliberation process that leads to our actions.

Overall, the steps that the ECB took to enhance transparency have been acknowledged in a report released this week by Transparency International EU.[8] Concerning monetary policy communication, it notably commends our decision to publish regular accounts of the Governing Council's monetary policy discussions. By explaining the rationale behind our policy decisions, the accounts also show how the measures we take are aligned with our mandate of maintaining price stability. This is important, because some unconventional monetary policy measures have been challenged on the grounds that they could be serving other policy objectives.

To elaborate further on this, I will take a few examples of monetary policy measures that some have perceived to be fiscal or quasi-fiscal measures. It is imperative to be fully transparent on such measures and dispel any doubts about their motivation and their effect on price stability. Safeguards against encroachment on the area of fiscal responsibilities are extremely important. Conflicts with the price stability objective could emerge from monetary operations that support unsustainable government finances or insolvent financial institutions.

There is no doubt that monetary policy has had beneficial effects on government finances; monetary policy has unavoidable implications for public budgets. The same kind of indirect support occurred during the easing cycle in the early 2000s, when our main refinancing rate was reduced to 2% – a very low level at the time – and was maintained at that level for more than two years. The fiscal ramifications of monetary policy that we see today (and in the early 2000s), however, differ fundamentally from the deliberately coordinated strategy of monetary financing that we observed in some countries in the 1970s. Today the use of any central bank instrument has to be justified solely on the basis of the central bank's narrow price stability objective, and not on any fiscal consequences thereof.

Borrowing from the theory of monetary regimes, it is the dominance of the central bank mandate over the objective governing fiscal conduct that differentiates the setting of monetary policy today from anything we saw prior to monetary union. The ECB continues to have the necessary institutional independence, the financial resources and operational capacity to take all appropriate measures, if and when needed, to counter upside or downside risks to price stability in a truly symmetric fashion.

It could be argued that there are multiple channels through which the central bank could take on tasks and obligations that pertain to the fiscal authority, and some of these channels are both more subtle and less apparent than outright financing of public deficits. Extending liquidity support to insolvent banks is a case in point.

But, even in this admittedly fuzzier terrain that separates liquidity provision from solvency support, the ECB operates in a sound framework that has passed multiple resilience tests in recent years. In the case of Greece, for instance, the choices of the Governing Council were another example of strict adherence to this framework. In keeping with Article 123 of the Treaty, which prohibits the ECB from monetary financing, the Governing Council imposed strict limits on the use of government securities as collateral for loans that the Greek banks received from the ECB.

We nevertheless continued to supply the necessary liquidity so as to ensure the functioning of the Greek banking system and the continuation of lending to businesses and households. This was in line with the principle by which the Eurosystem may lend to banks which are solvent and have sufficient collateral. To sum up, the balance we achieved with our interventions during the

Greek crisis was fully within our mandate; it respected the political commitment to the single currency contained in the Treaty, but at the same time we implemented that commitment within the limits of our Statute.

The Treaty prohibition of monetary financing has been a key element in preserving the monetary policy nature of OMTs and the public sector purchase programme (PSPP). The technical features of OMTs imply that they would only be considered if warranted from a monetary policy perspective. Moreover, the extra exposure to any single country that the Eurosystem might acquire as a consequence of OMT activation would be secured by the country's strict obligations arising from the European Stability Mechanism (ESM) macroeconomic adjustment programme to which the country would have to submit as a precondition. It is worth noting that in June 2015 the European Court of Justice ruled that, given the strict modalities for activation, OMTs fall within the scope of the ECB's mandate and include sufficient safeguards to avoid monetary financing.

A number of safeguards apply to public sector bond purchases under the PSPP too. Such purchases have a monetary policy purpose which is different from the one that applies to OMTs and are specifically aimed at bringing inflation back to our medium-term objective in a situation in which our key interest rates are at levels that can hardly be reduced much further. The modalities are exclusively governed by the primary objective of price stability and are decided in full independence, irrespective of developments in other policy areas.

The size and duration of the PSPP are calculated to achieve progress towards the ECB's inflation objective. The effectiveness of the tool is rooted in two important features of the financial system. First, government bond yields are the benchmark indicator for pricing a large set of private debt instruments. Second, government bond markets are deep and liquid. Interventions in these markets can initiate a process of portfolio rebalancing with significant secondary effects on broad financing conditions. Several safeguards are in place to minimise potential distortive effects on market functioning and price formation (such as the issuer limit and the issue share limit of 33%).

There has been a prominent financial stability dimension in all unconventional measures taken, but the existing institutional framework ensures that monetary policy is the *last* line of defence with respect to preserving financial stability. The establishment of the European banking union, in particular the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), has taken monetary policy one step further away from financial stability issues. Progress has been made to ensure that regulatory capture and forbearance are minimised and that shareholders bear responsibility and face the consequences of failure. But we are not there yet. These mechanisms need to be complemented by a common system of deposit protection, which would further bolster financial stability by reducing the risk of bank runs in crisis times.

Conclusion

To conclude, unconventional policies have been complicated to implement and to communicate. But they have been effective in enhancing our ability to deliver on our mandate in a medium-term perspective. Our measures have been designed to complement each other and have proved adaptable to and effective against the series of shocks which have buffeted the euro area economy. The complex nature of unconventional measures has repercussions for the transparency and accountability dimension of central bank independence. But they were a *sine qua non* for our mandate to be respected. The challenge from the monetary policy consequences of the financial crisis has placed a particularly heavy responsibility on the ECB to explain how the measures taken fall within the ambit of its price stability mandate.

Non-standard measures have been designed in such a way that they cannot compensate for failures in other policy areas. The evolving institutional structure of EMU is further contributing to ensuring that, if at any critical juncture in future the macroeconomy faces risks, monetary policy will be able to concentrate solely on preserving price stability.

[1] As described in Barry Eichengreen (1992), *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939*, Oxford University Press, pp. 29–66, the credibility of the pre-World War I gold standard rested on international cooperation, with Britain at the centre, enjoying considerable leeway in observing the rules of the game, and France, Germany, and others willing to support sterling's stability. The United States, at the time an agricultural exporter and a foreign borrower, with the Federal Reserve System not yet operating, faced more binding constraints. Seasonal swings in the demand for money, for example, triggered gold flows which could not be absorbed, thereby causing periods of deflation.

[2] For a critical appraisal, see Charles Goodhart (1999), "Myths about the Lender of Last Resort", *International Finance*, Vol. 2(3).

[3] Barry Eichengreen, op. cit.; Milton Friedman and Anna J. Schwartz (1963), *A Monetary History of the United States, 1867–1960*, Princeton University Press; and Ben Bernanke (2004), *Essays on the Great Depression*, Princeton University Press.

[4] Robert L. Hetzel (2008), *The Monetary Policy of the Federal Reserve: A History*, Cambridge University Press.

[5] Milton Friedman (1963), *Inflation: Causes and Consequences*, Asian Publishing House.

[6] Willem Buiter (2016), "Dysfunctional Central Banking; The End of Independent Central Banks or a Return to 'Narrow Central Banking' – or Both?", *Global Economics View*, Citi Research, 21 December; Otmar Issing (2016), "Central Banks – From Overburdening to Decline?", *SAFE White Paper Series*, No 42.

[7] Jakob de Haan and Sylvester C.W. Eijffinger (2017), "Central bank independence under threat?", *CEPR Policy Insight*, No 87.

[8] Transparency International EU (2017), Two sides of the same coin – Independence and accountability of the European Central Bank, transparency.eu/wp-content/uploads/2017/03/TI-EU_ECB_Report_DIGITAL.pdf.