Christian Noyer: Inflation, financial innovation and monetary policies – some contemporary challenges

Speech by Mr Christian Noyer, Governor of the Bank of France, at the GIC and CEPII Conference, Paris, 13 May 2008.

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Inflation pressures are now at work in most parts of the world. Today, I would like to start with offering some comments on this worrying development and then elaborate on the challenges raised by financial innovation for monetary policies.

The current rise in global inflation appears in stark contrast with the price stability recorded over the past decades.

During the last twenty years, globalisation has made a significant contribution to price stability. With new large players (such as China and India) entering the world economy, cheap imports of manufactured goods have become available to developed countries. The fall in import prices has allowed real consumption wages to grow without impacting real production wages. This, in turn, has lowered the inflation rate for any given level of employment. In parallel, the effects of globalisation have been felt more indirectly through increased competition, both on products and labour markets.

Inflation dynamics have also changed. Maybe the most documented and commented-on of these changes has been the so-called flattening of the Phillips curve. This, in economic jargon, means that domestic inflation has become less sensitive to the domestic output gap, or, alternatively, that it has become more stable during the business cycle.

There are several possible – and not mutually exclusive – explanations for this phenomenon. Expectations may be more solidly anchored, which would lessen the impact of the output gap on current inflation. It is also possible that, as a result of structural reforms, the NAIRU has decreased in many countries in recent years, thus giving the "optical" impression of a horizontal Phillips curve during this period. In a broader sense, globalisation itself may also be responsible for the flattening of the Phillips curve. In an open economy, domestic demand changes can easily be satisfied through increased imports. As a consequence, domestic inflation may become less sensitive to the domestic output gap and more sensitive to global tensions on production capacities.

Overall, these developments have made it easier for central banks to bring down inflation without real costs to the economy.

But it is clear, today, that these effects are being reversed.

The prices of oil, food and other commodities are now increasing fast. There might be three reasons for this rise (the importance of which is currently hotly debated): first a supply-demand imbalance; second, the emergence of commodities as an asset class, attracting substantial flows into commodity funds; and, finally, the use of commodities as a hedge against inflation or dollar depreciation.

In addition, while labour supply in emerging countries will remain abundant, it is not all that clear that it will remain cheap. Indeed, we are currently seeing an increase in export prices in emerging countries, which translates into higher import prices for developed economies.

In short, the world environment has become very inflationary.

And yet, in many parts of the world, monetary policies remain somehow permissive. The reason for this paradox can be found in the dilemma faced by many countries, which maintain some link between their currencies and the US dollar, in order to prevent an unwanted appreciation of their exchange rate. However, according to Mundell's incompatibility triangle, a country cannot tie its currency to another currency and simultaneously conduct an independent monetary policy, when capital flows freely between countries. As a consequence, many emerging economies are currently led to partially "import" the US monetary policy although their situation and position in the economic cycle are fundamentally different.

This situation could be very unstable and dangerous. First, real exchange rate appreciation – which is bound to occur anyway – takes place through increased inflation rather than nominal exchange rate appreciation. Indeed, inflation in many emerging countries is currently accelerating. Second, at the world level, we might be piling up inflationary pressures, which could develop further in 2009-10. There is an explosive mix of rising commodity prices and permissive monetary policies, which could create an ongoing spiral, and, if it were allowed to develop, would specially hurt the poor countries, most of which are net food importers. It is our common and joint responsibility to do everything in our power to avoid such an outcome.

Let me now turn to another major challenge: the impact of financial innovation on the conduct of monetary policy. The current financial turmoil is here to remind us that financial innovation is not a smooth process. An appropriate knowledge of the mechanisms through which monetary policy affects the economy is of crucial importance for central banks. Financial innovation affects these mechanisms by altering the channels through which monetary policy operates. Drawing on some lessons from the current turmoil, I would like to make four points.

First, securitisation has created new uncertainties in the transmission channels of monetary policy. It may have weakened some channels and strengthened some others. At least in normal times, financial innovation significantly weakens the bank-lending channel. Securitisation gives firms broader access to capital markets and, as such, makes them less dependent on bank funding. Similarly, banks may be more able to issue debt securities and less dependent on the constraint of funding themselves with secured deposits. At the same time, however, securitisation strengthens the “direct” transmission channel through which interest rates operate, since a great number of financial intermediaries are more dependent on liquidity and on its price.

Second, financial innovation – to the extent that it makes it easier to take risks and encourages the “search for yield” – may have increased the impact of monetary policy because, in such an environment, risk premia are highly procyclical and move in tandem with interest rates.

Third, this same procyclicality of “risk taking” can lead to booms and busts, when investors’ appetite for risk changes. Another effect of financial innovation is thus to create asymmetries in the reaction of the economy to monetary policy: for example, the slow build-up of bubbles during periods of monetary easing followed by an abrupt retrenchment when monetary policy tightens. Note that there is currently a debate as to whether this inherent procyclicality of financial systems is amplified by our accounting and prudential regimes.

Fourth, it may be that modern financial innovation creates new discontinuities in the financial system and dynamics. When conditions are less benign than usual, the transmission process along the interest rate curve becomes non-linear: a striking feature of this summer’s events was the surge in the short-term money market. Wider and variable spreads between term funding rates (of which many bank loans are priced off) and policy rates may reduce the efficiency of interest rate adjustments when needed. Innovation also reinforces the mechanism of the "financial accelerator", through which the level of asset prices influences credit distribution (through collateral values and, now, its impact on banks tier one ratio), then the real economy; and, in return, the real economy impacts asset prices and values. This spiral can go upwards, or, as we see now, downwards.

Overall, I believe that central banks have coped well with these challenges over the past ten months. The monetary policy response has differed across industrialised countries, as warranted by the differences in economic situations and outlooks. A striking development, however, has been the progressive convergence of liquidity provision frameworks, even if technical modalities remain, and will remain, country-specific. There has been a general move towards a lengthening of maturities, a broader range of collateral and a wider list of counterparties. A clear and strong distinction has been preserved everywhere between liquidity provision, on the one hand, and monetary policy, on the other. In the euro area, the policy rate has been maintained unchanged, even if, at the same time, liquidity has been provided to the interbank market. Indeed, the bulk of liquidity injections since last August has been aimed at aligning the timing and maturity of the liquidity supply with a changing demand within the reserve maintenance periods, in order to stabilise the very short-term interest rate. As I have already pointed out, a standard result in economic theory (William Poole's paper from 1970) states that, when demand for central bank money is uncertain, then it is optimal to stabilise the short-term interest rate, letting money supply adjust endogenously.

We are, by no means, in totally safe territory. The conjunction of inflationary pressures and residual financial instability will prove, in times to come, very challenging for policy-makers. But we can rely on our experience and the lessons learned during the last few months to try and steer the world economy through its current troubles.