Christian Noyer: The role of central bankers in today's global capital markets

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the 50th General Assembly and Annual Meeting of the World Federation of Exchanges, Paris, 12 October 2010.

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In May 2009, the ECB initiated a covered bond purchase programme and, in May 2010, it embarked on rounds of interventions in the public and private debt securities markets, actually the sovereign debt market, with a view to, and I quote, "ensure depth and liquidity in those market segments which are dysfunctional".

In fact, since 2008, the active presence of almost all central banks on a wide range of market segments could suggest that direct market intervention has become the general modus operandi of central banks. This is far from being the case and I would like to focus my talk today on the following two ideas:

- Central banks require efficient markets to fulfil their mandates.
- This can lead to massive direct interventions in markets but these interventions must remain exceptional.

In order to examine the role of central banks in markets, we should start off by considering their mandate, which not only covers the tasks themselves but the way in which they are performed, i.e. in keeping with the principle of independence that governs them.

Since this is not the main topic of our discussion today, I will simply give a brief reminder of the facts.

- The role of central banks in markets stems from their objectives, the primary one incontestably being to ensure price stability. But this is not their sole objective. As we know, the Fed operates under a "multiple mandate" that is, and I quote, "to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" whereas most other central banks, and in particular the ECB, have a "hierarchical mandate" that places the price stability objective above all other policy goals. More specifically, the Maastricht Treaty states that "without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community". In that perspective, one of the objectives of the Community that we must support is to "promote solidarity among Member States".
- In order to fulfil its mandate, central banks must be credible and thus independent. If economic agents have the least doubt or the least suspicion that the institution might have an incentive to surprise them by allowing high inflation, they might adjust their behaviour as a precaution and thus "create" higher inflation by increasing their wage claims, thereby triggering a wage-price spiral; or by demanding greater returns on their savings, which pushes up long-term interest rates and weighs on growth. Independence, which is particularly well established among euro area central banks, prevents this problem; as you know, the Treaty specifies that the Eurosystem and the members of its decision-making bodies may not take instructions, in particular from governments of a Member State.

In practice, central banks achieve their objectives through the performance of tasks, notably implementing monetary policy. To do this, we use our main policy instrument, the setting of the key interest rate, which is the very short-term interest rate at which commercial banks obtain refinancing from the central bank. Monetary policy impulses are transmitted to the

economy via the interest rate channel in conjunction with the bank lending channel that is of particular importance in the euro area economies, which have high levels of intermediation.

We know the traditional workings of these transmission channels: the central bank sets the very short-term risk-free rate and then the markets determine, for all maturities and issuers, the value of assets based on their expectations concerning the future path of this interest rate and their assessment of risks: solvency of debtors, liquidity of assets, and uncertainty surrounding all parameters. The markets construct in this way a set of yield curves that establish the supply and demand for financing balance on financial markets and bank lending markets.

In a world in which the credibility of the central bank to keep inflation low is well anchored, the solvency of most agents is taken for granted and markets are well organised and hence liquid, interest rates remain low across the whole maturity spectrum and valuations high; changes in key rates do not affect inflation expectations that remain low and changes in real interest rates allow monetary policy decisions to be effectively transmitted to the economy.

In normal times, interactions between central banks and markets are therefore important but fairly unintrusive:

- Central banks influence markets through changing the level of short-term interest rates; they explain the rationale behind their interest rate decisions in order to improve the quality of economic agents' expectations; they put in place technical mechanisms to promote liquidity on certain key market segments, for example by establishing the list of assets eligible as collateral in their refinancing operations or by setting up a discount window that ensures that banks with unexpected temporary requirements can refinance themselves.
- While markets listen to central banks, central banks also listen to markets since the price formation in markets reflects agents' expectations, in particular concerning inflation, and their assessment of risks; central banks require such information to make their analyses and take their monetary policy decisions.

The smooth functioning of markets and financial stability are therefore essential for the effective transmission of monetary policy.

- If the shape of the yield curve is evolving regardless of monetary policy decisions, if risk premia are uncorrelated with fundamentals, if market liquidity dries up, then the interest rate channel ceases to function.
- When this affects banks' funding, in particular via a freezing of the interbank market, the bank lending channel seizes up.

In such circumstances, central banks must turn to non-standard measures such as direct aggressive interventions to ensure that their monetary policy decisions are effectively transmitted and that markets keep ticking over.

Needless to say, the recent period has seen many such incidents as well as the implementation of many non-standard measures. Among the measures currently in place, some are based on "quantitative easing", which involves the purchasing of securities primarily with a view to generating excess liquidity that in turn moves into all market segments and fosters a better refinancing of the economy; others are based on "credit easing" and aim to restore the functioning of certain particularly disrupted market segments. Seen from another angle, certain policies aim to restore the smooth functioning of the interest rate channel by directly impacting the yield curve, others aim to restore the bank lending channel by ensuring that banks can obtain funding beyond the very short-term maturities to which central banks usually confine themselves. In all events, central banks stand in for failing market participants or markets.

Since 2008, we have seen the Fed come to the rescue of the US commercial paper market and the mortgage backed securities market; we have seen the Bank of England purchase in the space of a few months GBP 200 billion in government securities, representing around 15% of the United Kingdom's GDP; the Eurosystem, for its part, has conducted massive one-year refinancing operations with euro area banks and has kick started the covered bond market, via its EUR 60 billion purchase programme. Next May, it also start intervening in the government securities market. This calls for further clarification in the light of my earlier analysis because its motives are highly illustrative of the interactions between markets and central banks.

What was the situation in May and how has it changed?

- Price stability was not and is still not in question in the euro area; following a period in which prices declined, largely due to developments in energy prices, we are steadily returning to a configuration that is more consistent with our definition of stability, i.e. price increases below, but close to, 2%. However, all indicators have shown continuously, since the beginning of the year, that the upside risks to inflation are very limited. The Commission published for example in early May euro area inflation forecasts of 1.5% for 2010 and 1.7% for 2011. ECB inflation forecasts published in early September project inflation at 1.6% in 2010 and 1.7% in 2011.
- Euro area countries have taken rapid and significant steps to bring their public finances back into balance and going forward to restore the competitiveness of their economies. This is clearly the case for countries whose debt markets have been the most affected over the past months.
- Yet, in May, financial markets started to seize up again, admittedly in a slightly different way than that seen in 2008, but with the same potentially disastrous consequences, that is to say a drying up of financing for the economy. In 2008, the financial system was badly impacted by the subprime crisis and the failure of Lehman Brothers that brought transactions to a standstill as market participants realised that any bank, no matter how big, can fail especially since the exact amount of exposure to subprime risk of all institutions were not fully known. In the May 2010 episode, the same dynamics were at work: the different investors started to believe that euro area countries could default on their debt, and therefore stopped lending to these countries or their banks, or to any banks with possible exposure to these countries and, finally, as a precaution, ceased all lending activity.

This situation called for rapid and decisive action by the ECB because:

- We cannot implement monetary policy in dislocated markets that do not effectively allocate the liquidity that we inject or that radically modify the effects of our monetary policy by offering interest rates that are inconsistent with our key rates.

We therefore took a series of measures aimed at immediately restoring the situation by dealing with all the problems within our sphere of competence and, in particular, we decided to intervene on securities markets whose abnormal functioning was jeopardising the implementation of monetary policy and financial stability. In this case, we targeted sovereign debt markets because they determine the financing conditions of the country's other issuers. When sovereign debt markets cease to function, the financing needs of the country as a whole cannot be met.

This type of intervention is not a quantitative easing operation since no particular amount is set beforehand and all the liquidity provided through the purchase of securities is sterilised in the interbank market via term deposits offered to banks. Neither is it a credit easing operation targeting a particular type of agent ; government securities are not purchased in the primary market and the securities in question may be issued by borrowers such as Greece that has almost stopped issuing debt due to the mechanism in place to ensure its financing by euro

area countries and the IMF. It was simply a measure to restore the monetary policy transmission channels via the debt markets.

I believe that recent episodes clearly highlight what the markets may expect from central banks, that is to say resolute action to deflate positive and negative asset price bubbles if they interfere with monetary policy transmission channels. Each situation may call for an appropriate response and we now know that this includes massive and direct interventions in markets, to some extent similar to foreign exchange interventions. It is plain that this type of action has no constraints in terms of amounts or timeframes; such amounts are unlimited because central banks can absorb the liquidity injected and they inherently have no liquidity problems in their currency. Moreover, I believe that the fact that central banks have shown that they are able to take such action is in itself likely to limit the emergence of asset price disruptions by limiting speculation. Some recent modest purchases under our Securities Market Programme have acted as a strong reminder that we were still monitoring very closely the evolution of key markets.

But this does not mean that markets and market participants should always expect central banks to make such interventions. Similar to its lender of last resort function, the role of buyer of last resort that central banks can take on must not extend to insolvent issuers and must not, at the risk of causing a very dangerous moral hazard, be systematic each time a problem arises. Such interventions must result, as rapidly as possible, in a return to normal market functioning, which is the only way to ensure a truly efficient allocation of capital and which enables us to determine economic agents' expectations.

Thank you very much for your kind attention.