Jürgen Stark: The new normal

Intervention by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the 13th Euro Finance Week, Frankfurt am Main, 16 November 2010.

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In my contribution I will discuss the question of ***"What is the new normal"***, a question, which in light of the latest events, may strike many of you as far-fetched. But it is not, since the day-to-day management of the current sovereign debt crisis, too, requires a sense of direction.

The question is certainly a difficult one. To be sure, crisis times are times of rapid and unpredictable changes. In this sense crisis times are transitory, leading from one "stable" situation to a new one. But can we really say that pre-August 2007 was normal?

Let me recall the key characteristics of that time:

1. Strong growth of the world economy of around 5% per year;
2. strongly increasing foreign exchange reserve accumulation;
3. large and persisting current account deficits, e.g. in the US;
4. strong and persisting house price appreciation in large parts of advanced countries;
5. extremely muted volatility in real economic activity, essentially all variables were trending up;
6. large and persisting profits of financial sector entities; implied probabilities of default of large banks were negligible;
7. measures of relative credit risk at historically low levels: yield compression phenomenon;
8. almost no liquidity risk priced into financial contracts.

If you were a policy maker, would you take this characterisation as a benchmark for the design of post-crisis policies and frameworks?

As the answer is obvious, the pertinent question is rather: What should be expected to be the "new normal"?

What can be said with some certainty is that in the "new normal" financial markets will function more smoothly than today and economic growth will in general be on a sustainable path, reflecting the growth potential of the respective economy. But a number of elements will have changed due to experiences made during the crisis and the policy responses which followed. Specifically, I would expect

1. unsustainable deficit paths to continue no longer;
2. business models in financial markets to come under far closer scrutiny;
3. the valuation of liquidity to increase permanently;
4. new regulation to render financial intermediation more secure, but also more costly.

What does this imply in concrete terms? In my view,

1. Pre-crisis growth paths are unlikely to be reached again.
2. Risk premia will stay elevated, relative to pre-crisis levels.
3. More market players in financial markets will exit as their business models will have become unsustainable.

4. We are likely to experience more volatility in macroeconomic variables than in the pre-crisis period.

5. Central banks are likely to show a stronger tendency of *"leaning against the wind"* if unsustainable asset price developments emerge.

6. Macro-prudential risks will be monitored more closely, as exemplified by the establishment of the ESRB.

ECB Mandate

The mandate of the ECB to deliver price stability is clear and will remain unchanged. It is anchored in the Maastricht Treaty. I am glad that we have this single mandate instead of a dual mandate or even more objectives. Mandates with several goals may overburden monetary policy, given that a central bank has only one instrument: the short-term interest rate. Following Tinbergen and Theil, it has been recognised that a central bank endowed with one policy instrument can only pursue one independent goal.

The unambiguous mandate to deliver price stability is the most prominent element of a set of interrelated principles of sound monetary policy.

Further important and widely accepted principles for the conduct of sound monetary policy are:

1. Credible commitment to the mandate of price stability

This principle is the basis for securely anchoring longer-term inflation expectations consistent with price stability. To achieve it, the central bank must always stand ready – and be perceived as standing ready – to take all necessary actions to deliver on its mandate. The credibility of this commitment requires the central bank to operate under the appropriate institutional set-up, most importantly political independence, and that it develops a track record which signals its willingness and capacity to deliver price stability.

2. Independence from political influence

The importance of this principle has been established in a large body of theoretical and empirical literature. It is laid down in the Maastricht Treaty and has proven elementary during the crisis. Central bank independence is also fully borne out by the strict prohibition of monetary financing.

3. Medium-term orientation

The medium term orientation is based on the well-established fact that long and variable lags characterise the transmission of monetary policy decisions. Monetary policy cannot be used to dampen short-term effects on price developments, and it should avoid fine tuning of demand conditions.

4. Transparency and accountability

Transparency and accountability strengthen the credibility of the central bank's commitment to price stability, by ensuring that the public understands that the motivation behind monetary policy decisions is the pursuit of price stability.

5. *Comprehensive analytical framework*

Monetary policy decisions must be underpinned by a comprehensive analytical framework, which ensures that all relevant and available information support timely and efficient decision making in the conduct of monetary policy.

The ECB's two pillar strategy provides such a framework. It combines the results of the economic analysis with those of the monetary analysis. The experience from the financial crisis has demonstrated very clearly that it is not sufficient for the conduct of sound monetary policy to study short-term cyclical developments in the real economy. Rather, the monetary analysis helps to identify longer term risks to price stability and supports thus the medium term orientation of monetary policy. Monetary analysis can also signal financial imbalances and vulnerabilities. It is an important input in any strategy of "leaning against the wind", as mentioned above.

6. *Separation principle*

Generally, a clear distinction must be maintained between the determination of the monetary policy stance and the provision of liquidity to the market. This "separation principle" ensures that the conduct of liquidity provision is not interpreted by market participants as signalling the future course of monetary policy.

Technically this means that the EONIA is kept very close to the main policy rate in normal times. Through the adoption of fixed-rate full allotment in the longer-term refinancing operations the EONIA has been deviating from the main refinancing rate and has been closer to the deposit rate. With a normalisation in financial markets the demand for excess liquidity is dropping, so that the withdrawal of non-standard measures can proceed. As a result the EONIA will ultimately return to levels around the main refinancing rate. Hence, the separation principle will be fully re-established.

The monetary policy of the ECB is firmly grounded in this set of principles. They are partly embedded in the Maastricht Treaty (in terms of: single mandate, political independence, prohibition of monetary financing) and in our operational framework.

Also in a "new normal" environment we will continue to do everything to deliver what we have delivered so far which is, according to our mandate, price stability over the medium term.

Where does the ECB stand in terms of phasing out non-standard measures?

Using its broad operational framework, the Eurosystem in a context of a severely impaired interbank market was capable to alleviate banks' concerns about access to liquidity and thereby to support the flow of credit to households and corporations and ensure the maintenance of price stability.

All our non-standard measures – enhanced credit support and Securities Market Programme – were exceptional responses to extraordinary circumstances and as such temporary in nature. Specifically, all measures taken during the period of acute financial market tensions are fully in line with our mandate.

- Overall, our non-standard measures have proved effective.
- This contradicts academic literature on the "irrelevance of monetary policy operations".
- However: These measures represent strong medicine.
- We therefore need to constantly assess whether or not it is still warranted.
- The ECB has a strategy in place to phase out the liquidity support measures.
- The process of phasing out started in December 2009: We suspended liquidity provision at maturities of 6-month and 1-year; the covered bond purchase

- By now the following liquidity support measures have remained in place: unlimited liquidity provision in our refinancing operations at a fixed interest rate and the SMP.

How will the phasing out process proceed?

Our decisions will be guided by gradualism and steadiness and will be consistent with improvements in financial market conditions and real activity.

In my view, conditions in both money and financial markets have improved significantly over recent months, notwithstanding the most recent tensions in some segments of the European sovereign debt market.

- Since summer, the amount of liquidity demanded in ECB refinancing operations has declined by about one third (not taking into account the CBPP: from EUR 881 bn on 30 June this year to EUR 510 bn today). As a consequence, excess liquidity has dropped by about 60% (from EUR 220 bn on 30 June to EUR 87 bn). This process has been driven by receding demand on the part of financial market participants.
- Furthermore, we have experienced a re-activation of the interbank money market: The EONIA volume has nearly doubled since summer (from EUR 26.3 bn on 30 June to EUR 45.7 bn yesterday).
- I would take this development as a positive sign that banks trust each other more.

Nevertheless, the question remains whether there is something that has changed in interbank money markets which would lead to lower activity at present and in the future – temporarily or permanently. Furthermore, to what extent does the fixed-rate full allotment and the narrower corridor dampen market activity?

The phasing out of our liquidity support measures will continue after the end of the current quarter. What will this phasing out lead us to?

An important lesson is that the operational framework and the principles underlying its design have served the ECB well both before and during the crisis.

The principles are: operational efficiency, a strong market orientation, simplicity and transparency and equal treatment of counterparties.

The post-crisis operational framework needs to be designed in a way that creates the proper incentives for the banking community to assume its responsibilities and take the appropriate decisions in a timely manner to shape a healthy banking sector at the service of the real economy.

Yet, some future changes may be envisaged due to the "new normal" world. One example may be the impact of the new liquidity regulation. We will carefully monitor and adapt the framework, in line with the principles, if need arises.

Let me sum up.

1. We seem to be in the process of "normalisation" in the sense that we move to a more stable situation. However, the crisis is not over yet and the situation in some financial market segments remains challenging.
2. The "new normal" will be different, but still difficult to characterise. The crisis will have changed the economic and financial environment a lot. Which of these changes will be temporary, which ones more permanent?
   - Most likely we will see lower but more sustainable growth paths.
   - I would expect risks to be priced more appropriately.

– As exemplified by the recent agreement on Basel III at the G20 level, regulation and supervision will be strengthened.

3. The lessons to be learned in central banking are that principles of sound monetary policy need to be safeguarded: a clear mandate, a medium-term and broad-based monetary policy strategy, taking into account information on money and credit, and independence from political influence.

4. Finally I would note that non-standard measures were the exceptional response to exceptional circumstances.