Luc Coene: Challenges for euro area monetary policy going forward

Keynote speech by Mr Luc Coene, Governor of the National Bank of Belgium, at the 29th SUERF Colloquium, Brussels, 10 May 2011.

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Ladies and Gentlemen

This week marks the ***first "anniversary" – if I may say so – of the sovereign debt cri*sis**. Indeed, the first week of May last year was characterised by extreme turmoil on financial markets and on the markets for public debt of some European countries in particular. That forced the Eurosystem to announce a set of measures on Monday 10th of May 2010, including a programme to intervene on markets for debt instruments. One year after that very turbulent period, I think it is a good time to take a look at what challenges are ahead of us. I will focus my remarks on monetary policy in the euro area, and in particular on the challenges posed by the current macroeconomic outlook and how the sovereign debt turmoil has an impact on euro area monetary policy decisions.

Let's first go back to the early days of ***May 2010***. What we witnessed those days, was a full-blown panic on financial markets after tensions on some government debt markets had been mounting since the fall of 2009 as investors increasingly cast doubts on the capacity of Greece to repay its public debts. The turmoil in May not only led to very high spreads on Greek paper, but also affected other countries' sovereign debt markets, led to extremely volatile equity and foreign exchange markets and brought about a new freeze in interbank trading as banks again became reluctant to lend each other in a context of uncertainties regarding exposure to the countries concerned. Therefore, the Governing Council of the Eurosystem decided on a ***package of measures***. First, a programme to intervene on the secondary markets for private and public debt securities was set up in order to restore the smooth functioning of securities markets, a key link in the monetary transmission chain. Second, it was decided to organise again all Eurosystem liquidity providing operations as fixed-rate full allotment tenders, which allows banks to obtain all liquidity they need at a fixed rate, of course against the pledge of appropriate collateral. Finally, banks could again obtain US dollar liquidity through a swap line with the US Federal Reserve.

Since these early May days one year ago, the ***economic outlook has improved***, both on the global level and at the euro area level. Yet, in my view, the economic environment is characterised by some ***divergences***. I see two types of divergences. At the ***global level***, we currently experience what the IMF in its latest World Economic Outlook calls a two-speed recovery. Indeed, the recovery is led in particular by the emerging market economies while the advanced economies are still characterised by rather low growth and excess capacity. The resource-intensive growth of the emerging economies does put severe upward pressure on commodity prices, which are now standing at levels close to those seen before the financial crisis erupted in 2008. Of course, not only the fast economic growth in emerging economies pushed up commodity prices, also tensions in the Middle East and North Africa and the Japanese disaster led to higher prices. At the ***euro area level*** too, we see divergences. The rather solid recovery for the euro area as a whole does, indeed, hide significant heterogeneity as the so-called "core countries" are posting nice growth numbers while the countries most affected by the sovereign and banking crisis are lagging behind.

This all means that, when doing our job – which is to maintain price stability –, the ***Governing Council faces a number of challenges***. First and foremost, the Governing Council identifies clear ***upside risks to price stability*** which do require close monitoring. At the same time, I must admit that the ***sovereign debt crisis*** and – in some cases mutually related to that – the still ***fragile euro area banking sector*** do complicate the Governing

Council's task as it threatens the good functioning of the monetary transmission mechanism. I will look at each challenge in turn.

Risks to the inflation outlook have shifted to the upside: the euro area recovery is now gaining a good footing and commodity prices have posted large gains. These higher prices push up inflation: according to Eurostat's flash estimate, headline inflation stood at 2.8% in April, clearly above the ECB's quantitative definition of price stability. On top, we see a lot of price pressures in the pipeline which implies that the risk of second-round effects is non-negligible today, in the context of a continuing recovery and given the likely persistent nature of the raw materials price increases. Therefore, the Governing Council decided to ***raise the key ECB interest rate in April to 1.25%***, up from the 1%-level at which it stood since May 2009. That interest rate rise – which was widely anticipated by financial markets – indeed aims at avoiding that the first-round effects of higher commodity prices which we see in today's inflation figures translate into second-round effects and would hence entail a prolonged period of high inflation. The higher commodity prices – which, as I said earlier, mainly reflect the good performance of emerging economies and are therefore, at least in that sense, a blessing – are a *real* impoverishment for the euro area economy which cannot be avoided. Higher wage claims or price increases seeking compensation for such a deterioration in the terms of trade only postpone necessary adjustments and only lead to a longer period of higher inflation without any longer-run *real* benefits. Therefore, a solid anchoring of inflation expectations is essential and the Governing Council will do whatever is necessary to maintain price stability over the medium term.

The Governing Council acknowledged that the current monetary policy stance does remain accommodative. "***Is this increase the first in a series of interest rate rises?***", is therefore a question which observers have often raised over the past month. As you all know, the Governing Council never pre-commits but at the same time, I think our strategy is very clear and markets and observers alike do realise that we will do whatever is necessary to ensure price stability will be maintained. Markets currently anticipate a *gradual* withdrawal of monetary accommodation and I personally think that is no unreasonable assumption, given the clear upside risks to price stability I mentioned earlier. Needless to say, it is incoming data and our assessment of the economic outlook that will ultimately determine our course of action and the pace at which monetary accommodation will be withdrawn.

Another question people often raise is how such an increase in interest rates squares to the ***ongoing sovereign debt turmoil***, which brings me the second challenge I want to discuss. I see two ways in which the sovereign debt turmoil enters our discussion. First, the turmoil does have important bearings on *the* ***transmission of monetary policy***. Indeed, that was the very motivation for setting-up the Securities Market Programme in May 2010 and for re-introducing the regime of fixed-rate full allotment for longer-term operations, which is still in place at the current juncture. It will be maintained for as long as necessary, and at least until July 2011. That should avoid that banks in need of short-term funds are being cut-off from liquidity in case banks with excess funds are no longer willing to lend to them because of uncertainty on counterparties' exposure to sovereign debt.

At the current juncture, ***we deem these non-standard measures an essential part of our monetary policy toolkit as they help to maintain financial stability and hence a good functioning of the monetary transmission mechanism, an essential condition for being able to deliver price stability***. At the same time, I would like to stress that these measures are temporary in nature. Indeed, they are not without drawbacks. The regime of fixed-rate full allotment discourages interbank trading because the Eurosystem in fact puts itself between banks with excess liquidity and those in need of liquidity. That is not a sustainable situation and it does not fit in the ECB's view of a market-oriented implementation of monetary policy. Moreover, the non-standard measures may lessen the incentive for banks to regain access to market funding, for instance through recapitalisation – possibly with the help of public funds –, balance sheet restructuring or a change in their business model. These are the only structural and long-run solutions for the banks concerned. The current non-standard measures – which will be phased-out when appropriate – help to make the transition as smooth as possible but are no substitute for concrete actions on the part of the banks.

Another way through which the ***sovereign debt problems*** enter our discussion is through their ***impact on the economic outlook and the outlook for price stability in particular***. The considerable fiscal consolidation efforts already undertaken and those still to come, are of course indispensable to secure sustainable public finances over the longer term, but they do weigh on domestic demand in the short-run. Moreover, we continue to see the sovereign debt turmoil and its possible fall-out to the financial sector and the real economy as a downside risk to the economic outlook. These developments are therefore duly taken into account when deciding on monetary policy in the months ahead.

To conclude, I would like to touch upon two issues which often raise questions with observers. The first concerns the role of heterogeneity in the euro area and the second concerns today's policy constellation in which we raise interest rates but maintain very flexible liquidity provision policies.

As regards ***heterogeneity across euro area countries***, I do not consider this as such a phenomenon which greatly complicates our task. It is the outlook for the euro area as a whole that determines the course of our actions: there simply is no other option with a single monetary policy. Moreover, I tend to see the current heterogeneity as being part of a necessary – but, admittedly, painful – process of adjustment through which some countries have to go in order to regain competitiveness and to repair their balance sheets. Besides, being part of a monetary union will help them – rather than make it more difficult – to do so, because the greater trade links they have, allow them to benefit from faster growth in well performing member countries. Although monetary policy cannot be tailored towards the needs of specific countries or regions, national developments are to some extent taken into account when deciding on monetary policy measures. That is, for instance, the case when the Governing Council decides on its non-standard measures. Indeed, the monetary transmission impairments we observe are located mostly in those countries most affected by the sovereign and banking crisis. It is therefore no coincidence that we kept these measures in place, although we raised interest rates.

In that respect, some people ask me ***whether I see any conflict between raising interest rates and maintaining such flexibility in liquidity allotment modes***. The answer is "No": both conceptually and technically, I see no problems in raising rates while at the same continuing to provide banks with unlimited liquidity.

From a conceptual point of view I want to underscore that these ***two types of measures are geared towards different, but complementary, goals****.* The monetary policy stance is signaled by our key interest rates and is set as a function of the outlook for price stability. The non-standard measures, in contrast, are designed to ensure that the transmission of the monetary policy stance to the rest of the economy happens as smooth as possible, which should in turn allow the Governing Council to deliver price stability over the medium term. Hence, these measures are complementary to each other, rather than conflicting.

Let me ***conclude***. The Governing Council has shown it will do whatever is necessary to deliver price stability, which means taking the necessary measures to avoid a "Great Depression"-scenario as we did in 2008, but also to raise interest rates if upside risks to price stability threaten to materialise. We do have the will and the tools – including non-standard ones – to cope with the challenges in front of us. The flexibility of our framework should, however, be no excuse to postpone necessary adjustments, both in the financial and non-financial sector. And although we see encouraging signs – for instance in terms of competitive adjustment in some countries –, I think there is still a lot of work to do.

Thank you for your attention.