José Manuel González-Páramo: The ECB's monetary policy during the crisis

Closing speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Tenth Economic Policy Conference, Málaga, 21 October 2011.

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Introduction

Ladies and Gentlemen,

It is a great pleasure for me to be here and to discuss with you the ECB's monetary policy during the crisis. I wish I could talk about the financial crisis in the past tense. The last time I had the opportunity to talk about these issues in Malaga was, when I had the honour of receiving the title of Doctor Honoris Causa from this prestigious university in June. Unfortunately, since then, the sovereign debt crisis has reached a new intensity. As you may know, this has led the Governing Council of the ECB, in its recent meeting on 6th October, to adopt additional monetary policy measures in the form of a commitment to continue the fixed-rate full allotment policy at least until the middle of 2012, the allotment of two long-term refinancing operations of approximately 12 and 13-months maturity, as well as a second Covered Bond Purchase Programme. These measures complement the active implementation of the Securities Markets Programme which the Governing Council decided upon at the beginning of August in response to the intensification of the sovereign debt crisis. Apart from these non-standard measures, the Governing Council, however, also decided to leave the interest rate applied in our main refinancing operations unchanged.

I would thus like to use the opportunity of delivering the closing speech to this conference, to reflect on our monetary policy objectives, the challenges posed by the on-going financial and economic crisis for monetary policy, as well as the different standard and non-standard measures we have adopted; and how they relate to each other.

Monetary policy objectives

Price stability

As regards objectives for monetary policy, for the ECB there is one which trumps all others: ***price-stability***. This is the primary objective which euro area governments have delegated to the ECB as an independent central bank, and which is enshrined in the Treaty on the Functioning of the EU. The achievement of price stability is thus what we are accountable for, before anything else.

While the ECB is bound to the primary objective of price-stability, it was left to the ECB to define price stability. Since the start of the euro in 1999, we have defined price stability as a level of inflation of below but close to 2% over the medium-term.

What we have achieved, from the first of January 1999 until the end of this September, is an average inflation rate of around 2.0%. Let me emphasise that this period includes the financial crisis which started in the summer of 2007, which has already entered its fifth year. Despite these challenging times, the record in delivering price-stability is outstanding and stronger than that of any of the national predecessors of the ECB. An average inflation rate of around 2.0% testifies as much to the success of the euro as a currency, as to the ECB as its central bank.

The monetary policy transmission mechanism

The pursuit of price-stability requires an effective ***monetary policy transmission mechanism***. When the monetary policy transmission mechanism functions, then decisions on the official interest rate, in the case of the ECB the minimum bid rate in main refinancing operations, appropriately affect inflation and economic activity through various channels, in line with the established standard empirical relationships.

The starting point of the monetary policy transmission mechanism is the overnight interbank market. From there, interest rates are transmitted along the yield curve, also through the formation of expectations, to longer-term interest rates. Furthermore, banks and other financial market participants, pass on money market interest rates to households and businesses, thereby affecting economic activity.

In what follows, let me focus on three market segments which, in the euro area, are particularly relevant for the monetary policy transmission mechanism. These segments have been specially important during the financial crisis and this is why our monetary policy measures have focused on them: first, the interbank market; second, the covered bond market; third the sovereign debt market.

The interbank market

Let me start with the ***interbank market***. In normal times, the Eurosystem calibrates the amount of central bank liquidity it provides to banks in its refinancing operations in order to meet the liquidity needs of the system as a whole. The aim of this calibration is to equalise the probability of banks being either short or long in central bank liquidity on the last day of the reserve maintenance period. If that is achieved, the price for central bank liquidity in the interbank market should lie half-way between the marginal lending and the deposit facility rate: in other words it should be similar to the MRO rate. Intertemporal arbitrage assures that also in previous days of the maintenance period, the overnight rate equals the MRO rate.

A key pre-condition for interbank markets to work smoothly is, however, that banks lend to each other and that liquidity flows smoothly between market participants. Central bank liquidity provision is based on banks' aggregate liquidity needs. If liquidity does not circulate, then the appropriate liquidity supply is very difficult to calibrate. More than that, if some banks' access to the interbank market is impaired, these may have to pay very high rates. As a result money market rates may rise significantly above the MRO rate, thereby impairing the starting point of the monetary policy transmission mechanism.

Covered bonds

Well-functioning securities markets more generally play a crucial role in the monetary transmission mechanism. The second market I would like to discuss is the most important privately issued bond segment in euro area capital markets, namely ***covered bonds***. Covered bonds represent a central funding source for euro area banks and, as you may know, in contrast to other currency areas, banks are the main source of credit in the euro area. As a result, conditions in the covered bond markets are an important determinant of banks' ability to extend credit to their own customers.

Sovereign bonds

With regard to the third market segment which I would like to discuss, ***sovereign bonds****,* we can distinguish at least three ways in which they affect monetary policy transmission. First, the *price channel*: As a "risk-free rate", sovereign bonds have traditionally served as a benchmark, indeed a floor, for the interest rates banks charged for loans, and for the pricing of other financial contracts and securities. Indeed, due to their supposed "risk-free" property, the holding of government bonds as liquid assets is generally rather encouraged by

regulators. This is especially true also for the new liquidity risk regulation proposed as part of Basel III. Second, the *balance sheet channel*: changes in prices of government bonds affect the balance sheet value of securities held for trading, or for sale. Finally, there is the *liquidity channel,* through which government bonds have become the prime source of collateral in interbank lending.

Other objectives?

Beyond price-stability and the maintenance of the transmission mechanism, can the ECB pursue monetary policy ***objectives other than price-stability***? While the Treaty of the EU establishes price stability as the primary and overriding objective of monetary policy, it also states that *without prejudice to price stability*, the ECB shall "support the general economic policies of the Community" and "act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources". The Treaty also mentions that the ECB shall "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system."

At various points of the financial crisis, including the present juncture, financial stability has been at risk. What does this mean for the ECB in practice? As laid down by the Treaty, there is a lexicographic ordering of objectives: price stability comes first: if this is granted, then the ECB may *contribute* to financial stability. Therefore, there can be no question of trading off price stability against financial stability. Indeed, price stability is a necessary condition for financial stability and thus the best contribution monetary policy can make to financial stability.

Note, however, that even with price-stability guaranteed, the ECB should only *contribute* to the smooth functioning of the financial system. Financial stability is a *responsibility* of governments, while our *responsibility* is price-stability. Indeed, if governments respond appropriately to risks to financial stability and banks reinforce and efficiently restructure their balance sheets, the ECB may have to be less concerned with non-standard measures to restore the monetary policy transmission mechanism.

Against the background of our objectives of price-stability and the monetary policy transmission mechanism, let me now turn to the origins of the financial crisis.

The financial crisis and monetary policy measures

We can distinguish two major episodes in the current crisis, first the sub-prime crisis, magnified by the collapse of Lehman Brothers, and, second, the sovereign debt crisis in whose thrall we still find ourselves.

Mispricing of risk

The two episodes share some common causes. During the so-called "great moderation" – growth was steady, inflation low, and the slicing, dicing and distributing of risk had supposedly made financial markets more efficient and resilient – but what had in fact occurred was that risk had been mispriced. The risk of sub-prime mortgages and the financial products built around them was grossly underestimated. The same occurred with sovereign bond markets, as only small differences in risk premia could be observed in the euro area, despite significantly diverging debt and deficit dynamics in the different member states.

Subsequently, both in sub-prime and sovereign debt markets risks became over-priced with markets quickly becoming one-sided as a result of contagion and extreme risk aversion. Underlying the crisis is thus a significant fragility of security markets, which calls into question the efficiency of financial markets more generally.

From the sub-prime to the sovereign debt crisis

At least three aspects of the sub-prime crisis contributed also to the current sovereign debt crisis. First, the sub-prime crisis weakened banks' balance sheets, which were still under repair when the sovereign debt crisis came to a head in May 2010. Second, the fiscal support given to banking systems and significant spending packages worsened public debts and deficits. Third, the Lehman bankruptcy left confidence in the robustness of the financial system severely dented.

The root cause of the current crisis, however, lies within the shores of the euro area. Nonetheless, with the internal and external value of the euro holding up well, this is certainly not a crisis of the euro but a sovereign debt crisis focused on some euro area sovereigns.

Two things, however, have gone wrong: First, some countries have accumulated debts and deficits, which at a minimum make them vulnerable to self-fulfilling unsustainable dynamics.

Second, the Stability and Growth Pact was effectively suspended when France and Germany escaped sanctions for breaching the debt and deficit criteria in 2003. More generally and at a deeper level, the governance of the economic union, which should complement the monetary union, has been insufficiently articulated since the outset of EMU.

The standard tool: the official interest rate

What has been the role of monetary policy in this context of economic and financial crisis? Let's start by first looking at what is often referred to as conventional monetary policy. The standard and most important tool of monetary policy is the ***official interest rate***, in the case of the Eurosystem the minimum bid rate in the weekly main refinancing operations. Although we characterise this tool as "standard", the financial crisis did require significant and aggressive cuts in interest rates: following the collapse of Lehman Brothers the ECB lowered, within a period of seven months, the refinancing rate by 325 basis points from 4.25% to a historic low of 1%. The rate was kept at this historically low level until April 2011 when the Governing Council decided to increase the rate by 25 basis points. This was complemented by another rate increase to the current level of 1.5%, which the Governing Council decided to maintain at its last meeting of 6th October.

The financial crisis has required the ECB to go beyond the standard interest rate policy. Let me now turn to the three market segments, I have mentioned earlier: the interbank market; the covered bond market and the sovereign debt market.

Interbank market

The sub-prime crisis made itself felt in interbank markets at the beginning of August 2007 when overnight rates started trading at unusually high spreads to the MRO rate. This reflected some banks' perceived need to hedge against adverse liquidity risk. The collapse of Lehman then transformed the ***money market tensions*** into a full-blown crisis as a vicious circle of increased liquidity and credit risk brought interbank trading to a virtual halt. Money markets meanwhile became extremely segmented according to specific bank names: the uncertainty surrounding holdings and values of mortgage-related financial products shut specific counterparties out of the interbank market.

In the sovereign crisis, ***segmentation*** is arguably an even more significant problem, as it occurs normally by jurisdiction. Banks generally exhibit home bias in their public debt holding: as a result, counterparties' ability to trade cross-border in the interbank market becomes increasingly correlated with the perceived riskiness of their sovereign.

In response to the segmentation of interbank markets, the ECB adopted several measures which essentially replace the missing intermediation in the interbank market by increasing ***intermediation through the central bank***: first, the fixed-rate full allotment policy; second,

LTROs with 6-month and 12-month maturity; third: foreign currency operations; fourth: a further broadening of the collateral framework. Let me take them in turn.

While the money market tensions in August 2007 were addressed with a few fixed-rate full allotment tenders with overnight maturity, with effect from 15 October 2008, we introduced the ***fixed-rate full allotment policy*** in all our refinancing operations for the different maturities. Under fixed rate full allotment counterparties have their bids fully satisfied, against adequate collateral, and on the condition of financial soundness. The fixed rate full allotment policy has proven a very efficient way of offsetting liquidity risk in the market by ensuring banks' continued access to liquidity. It is also a very flexible tool, as counterparties can themselves control the amount of liquidity they demand. Thus, a falling demand for liquidity can be seen as a sign of normalisation.

The fixed-rate full allotment policy is probably the most significant non-standard measure the ECB is implementing. At its latest meeting on 6th October the Governing Council, in response to a worsening of liquidity tensions in the market, has committed to maintaining the fixed-rate full allotment policy until the middle of July 2012.

The fixed-rate full allotment policy has been complemented by ***6-month and 12-month operations***. These operations serve to further reduce the funding risk faced by the banking system over a longer time horizon. They were an important tool following the Lehman collapse. Whilst in late 2009 it had been decided to phase them out, in August of this year the Governing Council decided to re-introduce such operations by conducting one 6-month operation and more recently to allot one operation of approximately 12-months and one of approximately 13-months which will reach the beginning of 2013.

As a third element of our non-standard measures, the ***international cooperation*** of the major central banks has been crucial: especially the swap arrangements with the US Federal Reserve which have allowed us to conduct fixed-rate full allotment tenders in US dollars which are aimed at repairing impaired money markets in foreign currency. These operations have been instrumental following the collapse of Lehman, while during the course of 2010 demand in these operations petered out. As a precautionary measure, the ECB has nonetheless recently decided to re-establish 84-day fixed-rate full allotment tenders in US dollar, in addition to the 7-days tenders.

Finally, our response to the crisis has included an extension of our eligible collateral list. The main aspects of the Eurosystem's ***collateral framework*** are the following: that we accept a very broad range of eligible assets; that a broad range of counterparties can participate in our refinancing operations; that the same type of collateral is accepted in all refinancing operations; and that we have common eligibility criteria across the euro area, with loss-sharing in case of a counterparty default.

Having a framework that already accepted a wide range of collateral before the crisis, which in the case of the euro area is due to the original need to accommodate a very diverse financial system, has served as a key crisis-mitigation tool. Especially important is the possibility to increase the liquidity of assets and counterparties in times of stress. It is worth noting that the financial crisis led other major central banks to significantly broaden the collateral framework for their open market operations.

By contrast, the Eurosystem only had to make relatively minor adjustments to its collateral framework. Let me give you two examples: in October 2008, we started to accept some foreign-currency ABS against euro area collateral. Furthermore, credit thresholds on marketable assets (except ABS) were lowered from A– to BBB.

A further response to the sovereign debt crisis relating to changes in our collateral framework has been to suspend the application of the minimum credit rating threshold for outstanding and new marketable debt instruments issued or guaranteed by the Greek, Irish and Portuguese governments, all of which are implementing EU and IMF programmes.

It should be emphasised, however, that our collateral framework is flexible. As part of our traditionally conservative risk management approach, we have also tightened some requirements in the course of the crisis. For instance, the eligibility of foreign-currency ABS was revoked on the first of January of this year and ABS rating requirements have been tightened more generally. For example, we now require newly issued ABS to have at least two AAA ratings, when they are issued, in order to be eligible in our operations.

Central bank intermediation as automatic stabiliser

Both our fixed-rate full allotment policy and our broad collateral framework have the properties of ***automatic stabilisers*** with regards to financial market turbulences. The term "Automatic stabiliser" is usually applied to features of tax and transfer systems which tend to offset fluctuations in economic activity without the need for discretionary fiscal interventions by policymakers. However, both our fixed-rate full allotment policy and our collateral framework smooth out the demand for liquidity in a similar automatic way.

Consider fixed-rate full allotment against broad collateral: If demand is high, liquidity provision is high and within the bound of the standing facilities corridor, money market rates fall, reducing tensions. By contrast, if demand for liquidity declines, money market rates rise again towards the MRO rate and become less accommodative. In addition, if financial market tensions have a negative effect on certain market segments, like the covered bond and ABS markets, our collateral framework can help improve the liquidity conditions for these securities by accepting them as eligible collateral.

Moving on from interbank markets let me now turn to the covered and sovereign bond markets.

Covered Bond Purchase Programme

One of the innovative responses of our operational framework was the launch of our first ***Covered Bond Purchase Programme (CBPP1)*** in July 2009. This initiative had four objectives: first, reducing money market term rates; second, easing funding conditions for credit institutions and enterprises; third, encouraging credit institutions to maintain or expand their lending to households and enterprises; and, fourth, improving market liquidity in important segments of private debt securities markets.

The CBPP was announced in May 2009 and € 60 billion of covered bonds were purchased from July 2009 to July 2010. The programme was successful in restarting activity in primary covered bond markets. However, with the recent intensification of the sovereign debt crisis, covered bond markets have again come under significant pressure. At its meeting of 6th October, the Governing Council therefore decided to announce a second covered-bond purchase programme, CBPP2, within which €40 billion will be bought within the year starting November 2011. CBPP2 shares with CBPP1 the objective of easing funding conditions and encouraging institutions to maintain or expand lending, as well as supporting market liquidity in private debt security markets.

Securities Markets Programme

The fact that ***sovereign bond markets*** in some euro area jurisdictions were becoming increasingly dysfunctional by May 2010, and considerations over the crucial role that this segment plays as a basic pillar of our financial system, motivated the launch of one of our most important non-conventional monetary policies to date: the Securities Markets Programme (SMP). The main purpose of this programme is maintaining a functioning monetary policy transmission mechanism by promoting the functioning of certain key government and private bond segments.

Impairment of the monetary policy transmission mechanism caused by tensions in government bond markets can be significant. This can happen, firstly, via the *price channel,* as the role of the "risk-free rate" as a pricing benchmark is distorted. Falling values of sovereign bond portfolios also affect banks' *balance sheets*, and reduce, through the *liquidity channel* the value of government bonds as collateral. In addition to this, excessive volatility of bond prices can also force investors to sell-off their bond holdings and make it more difficult for market makers to do their job. All these channels affect banks' and other participants' ability to play their role in transmitting our interest rate policy because they negatively affect their intermediation role and can cause a contraction in the supply of credit.

The SMP should, of course, be clearly distinguished from the policy of quantitative easing. While the objective of the SMP is to repair the transmission mechanism, quantitative easing aims at injecting additional central bank liquidity in order to stimulate the economy. As a result, quantitative easing, as for instance with the Bank of England, comes with precise quantitative targets. By contrast, the size of SMP purchases is driven by an intervention strategy which seeks to improve market functioning. Let me stress that the liquidity injected through SMP purchases is re-absorbed on a weekly basis so as to specifically neutralise the programme's liquidity impact.

It is important to note that with its contribution to the monetary policy transmission mechanism, the SMP, in conjunction with the SMP-liquidity absorbing operations, is oriented towards price-stability. Thus, the SMP is very much an innovative tool with an orthodox stability-oriented purpose.

Standard and non-standard measures: complementary or independent of each other?

How can we best characterise the ***relation between standard and non-standard measures***? In terms of our ***decision-making*** we follow a ***separation principle***. This means that there is no pre-determined sequence of standard and non-standard measures. For instance, in April 2011 the Governing Council raised the MRO rate before having phased-out all the non-standard measures. Similarly, at its most recent meeting the Governing Council decided to keep the main refinancing rate unchanged, while, firstly, expanding our non-standard measures by re-introducing LTROs with 12-months and now even 13-months maturity, and, secondly, announcing a second covered bond purchase programme.

As the discussion of non-standard measures has shown, these measures are not, however, necessarily separate from the standard interest rate policy, but rather complement it. While the ***monetary stance*** is signalled through the ***main refinancing rate***, and ***non-standard measures*** are directed towards maintaining the ***monetary policy transmission mechanism***, ***standard and non-standard measures complement each other*** in the pursuit of price-stability , which is the mandate that our fellow European citizens entrusted us with in the EU Treaty.

Concluding remarks

Let me briefly conclude by highlighting that the segmentation of interbank markets is a reflection of the segmentation of sovereign bond markets and of the debt crisis which afflicts some euro area jurisdictions. Our most significant non-standard measure is without doubt the fixed-rate full allotment policy, which provides central bank intermediation where the interbank market fails and which operates in a very quiet manner. Although this policy can moderate the symptoms of the crisis, it cannot provide the lasting solution to this crisis. This solution will require the decoupling of banks' fortunes from the funding situation of their sovereign. In light of recent developments, swift recapitalisations of banks in a coordinated fashion will prove crucial. A lasting solution to the sovereign debt crisis must tackle its root causes. To this end, the affected countries must improve their fiscal adjustments and implement structural measures aimed at promoting growth. In addition to this, the euro area

will also need to develop economic governance which is effective. More generally, governments also have to step up more decisively to preserve financial stability, which is their responsibility.

If banks', following appropriate policy actions on the above mentioned fronts, are no longer mistrusted because of their holdings of sovereign debt, the segmentation of money markets will decrease significantly. Then the need for adopting non-standard measures would disappear. And I would need to steal less of your time to discuss the monetary policy of the ECB. Time is certainly not something we have in plentiful supply, given the immense economic policy challenges that countries like ours have ahead of them on their way out of the crisis.