Klaas Knot: Monetary policy and the Great Financial Crisis

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the Third Annual Nyenrode Finance Day, Breukelen, 28 October 2011.

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The past four years have been tumultuous for the global financial system and the global economy in an unprecedented way for all of us. The eruption of a systemic financial crisis of quite unusual intensity and international reach has been compared to the widespread shut-down of international capital markets on the eve of the First World War. The violent unraveling of events has shaken many beliefs in the economics profession. And the threat of a collapse of the world economy similar to the Great Depression has prompted unprecedented policy responses. Monetary policy makers reacted to the crisis by deploying both conventional and unconventional tools.

In this speech, I want to discuss how the conduct of monetary policy in the euro area has evolved during the different stages of the crisis and the challenges it is currently facing.

To put this discussion in perspective, let me start by recalling the ECB's mandate to deliver price stability, as is anchored in the Maastricht Treaty. Pursuing this mandate requires that a number of elements are in place.

First, there has to be a *credible commitment to price stability* as a primary goal of monetary policy. A credible commitment implies that the public's long-run expectations about inflation are anchored by the ECB's definition of price stability – HICP inflation below but close to 2%.

Second, monetary policy has to be *transparent* and monetary authorities must be *accountable* for their decisions. This implies a need for *clear and effective communication*.

Third, monetary policy decisions have to be taken in *full independence* from political influence. This principle is laid down in the Maastricht Treaty. It implies the strict prohibition of monetary financing.

Fourth, monetary policy has a *medium-term orientation*, given the long and variable lags of the monetary transmission mechanism.

Fifth, monetary policy is underpinned by a comprehensive *analytical framework*, which rests on two pillars: the economic analysis and the monetary analysis. I should note that the crisis has shown how the monetary analysis can play an important role in signalling financial imbalances and vulnerabilities. It is an important input in a strategy of "leaning against the wind".

Finally, monetary policy follows a so-called *"Separation principle"*, which distinguishes decisions about the monetary stance aimed at achieving price stability from tools directed at implementing monetary policy decisions through liquidity management.

With these principles in mind, let me turn to the monetary policy responses to the crisis. At a very general level, the ECB used conventional tools – an aggressive easing of the policy rate – to counter deflationary pressures and unconventional tools, which aimed at restoring a well-functioning transmission mechanism. These policies were pursued in four phases.

1. *Between July 2007 and the fall of 2008*, the ECB responded to disruption in interbank markets by expanding its liquidity provision to commercial banks.
2. *Between the fall of 2008 and end-2009*, as the financial crisis escalated and turned from a liquidity crisis into a solvency crisis, the ECB lowered its policy rate in quick steps to an unprecedentedly low level. In addition, it also employed a range of unconventional tools – such as fixed-rate full-allotment at the weekly tenders, longer-term refinancing operations.

3. The third phase extends *from end-2009 to mid-2011*. As the macroeconomy rebounded and financial market conditions improved in late 2009, the ECB started a gradual exit from its unconventional measures. When the sovereign crisis hit euro area bond markets in the early months of 2010, the Eurosystem responded to an increasingly dysfunctional monetary transmission mechanism, by activating a Special Markets Program (SMP).
4. When the sovereign crisis intensified in *August 2011*, the gradual exit from unconventional was stalled. Also, additional unconventional measures were taken to support the monetary transmission mechanism.

These policy responses went a long way in supporting the ECB's goal of price stability, and to address problems in the monetary transmission mechanism.

At the same time, these measures – and the SMP in particular – entailed a number of *risks*. As I mentioned in earlier speeches and interviews, I see four main risks.

First, these measures tended to reduce pressure that markets exerted on governments to pursue *fiscal discipline*.

Second, treading further along the path of interventions in government bond markets implies increasing risks of *monetary financing* of fiscal debt.

Third, purchases of assets in markets under stress implies a *financial risk* for the Eurosystem's balance sheet, which may eventually lead to fiscal transfers.

Fourth, there is a risk that the Eurosystem will enter *political waters*, which will make the conduct of monetary policy more difficult.

With our experience during the crisis and the connected risks in mind, we need to rethink the role and set-up of monetary policy after the crisis. Where are we headed? And how do we get there?

I see three main elements of monetary policy after the crisis. For the *monetary policy framework*, the crisis has shown that the monetary analysis can play an important role in signaling financial imbalances and vulnerabilities. It is an important input in a strategy of "leaning against the wind".

For the *operational framework* for monetary policy, it is crucial that after the crisis we will return to the principles that guided the framework before the crisis. In particular, we need to return to a clear and transparent separation principle between monetary policy stance, on the one hand, and liquidity management, on the other hand.

Finally, there is a clear need for a sustainable *institutional framework* for the euro area. This framework will need to center on budgetary discipline and sound economic governance. *In the long-run, as a closing piece*, I see joint financing through euro bonds as the only sustainable solution to self-fulfilling liquidity/solvency problems in individual member states and domino-effects/contagion between euro area member states.

How do we get there? In a transition to a post-crisis monetary policy, it is important to exit *gradually* from unconventional and conventional instruments that are being used during the crisis. In this phase, *communication* will play a very important role. And *fiscal and prudential policies* need to play a primary role in addressing problems that originate in the fiscal and financial spheres.

Let me conclude. As Stan Fischer said in a recent Tinbergen Lecture in Utrecht, the big question monetary authorities face in these times is – what do you do if policymakers that should tackle problems do not act sufficiently? My answer is that monetary policy cannot solve the crisis, since it is rooted in fiscal policy and the vulnerability of the banking system. All monetary policy can do is to buy time, at the cost of stretching its mandate to the limit, if not beyond.