Christian Noyer: Re-examining central bank orthodoxy for un-orthodox times

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 conference of the Global Interdependence Center/Bank of France, Paris, 26 March 2012.

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The unconventional policies implemented during the crisis have transformed the face of central banking. But will these changes prove permanent and will "the unconventional become the new normal?" There is not yet definitive answer to this question. We may not, as easily as we would like, be able to revert exactly to the *status quo ante*. However, I strongly believe we must make sure that the gains from the pre-crisis period, in terms of monetary and price stability, are not compromised in the process.

Prior to the crisis, a description of central banks would have centred on four characteristics:

They were *focused* with price stability being their primary or key objective, and no responsibility was sought or given for financial stability;

They were of *limited size* with very small balance sheets and interest rates as their only policy instrument;

They were *independent*, a condition recognised as necessary to anchor inflation expectations, and embodied in very strong institutional frameworks;

And they were *successful:* the "Great moderation", a period of exceptional low volatility in output and inflation, was widely seen as a product of efficient and wise monetary policies.

There was a happy feeling that, at last, a perennial monetary regime had been found, well-tailored to the characteristics of a modern market economy. Financial markets were efficient and the zero lower bound and liquidity trap appeared to be no more than historical curiosities.

With hindsight, of course, we can see now that this "ideal" economy may never have existed. The Great Moderation was as much a product of "good luck" (brought by disinflationary effects of globalisation) than good policy. Monetary stability is a necessary but not a sufficient condition of financial stability, because capital markets are not always and necessarily efficient. And downward financial spirals may quickly bring our economies to the point where interest rates can no longer be used as effective tools.

Therefore, as the crisis unfolded, central banks responded by taking unprecedented measures and, in the process, underwent three major changes

A diversification of their interventions. In order to both:

Unclog financial markets (both private and public). This involved exceptional liquidity provision to banks as well as temporary purchases of assets, both private and public.

Circumvent the zero lower bound and bring down real long-term interest rates through purchases of government bonds, and/ or interest rate guidance.

As a consequence, central banks' balance sheets expanded by a factor of three, dramatically increasing their role in financial intermediation and sometimes raising concerns, at least in some quarters, about the possible inflationary impactTogether, this diversification and the increase in size have *created more complex interactions with fiscal policies.* Specifically, asset purchases are sometimes seen as "quasi fiscal policies" both on the asset side (due to the potential risks attached) and the liability side (when they contribute significantly to meeting the funding needs of the sovereigns).

At the time they were decided, those exceptional interventions were absolutely necessary. Although it had been forgotten, central banks were initially created to protect the economy from excessive financial disturbances. This was, historically, their "*raison d'être*". As ultimate and unique providers of liquidity, they cannot escape this responsibility and let the financial system and the economy collapse.

At the same time, by doing so, central banks have exposed themselves to a number of risks

First, there are risks linked to balance sheet expansion. They cannot be ignored, although all central banks have been extremely careful in valuing the assets purchased or taken as collateral.

Second, they run the risk of blurring the lines between fiscal and monetary responsibilities. A dynamic use of their balance sheets by central banks has effects on the allocation and distribution of resources in the economy. They may favour or penalise some types of collateral or certain borrowers. If central banks take on additional responsibilities in the area of financial stability, they will have to do so in close cooperation with fiscal authorities, thus exposing themselves to possible interferences with monetary policy.

The major risk, however, is the risk of confusion. A multiplicity of interventions could be interpreted as a relative dilution of objectives. There is a tendency by market participants and some policymakers to consider central banks to be "universal problem solvers" whose balance sheets can be used, without cost, for all purposes. There is also a doubt, at least an ambiguity, in the minds of some analysts, about the true purpose of government bond purchases. Central banks' activism may create doubts as to their ability to stick to their core mandate – price stability – in the face of increasing pressures and constraints.

Overall, the euro area is well protected against all of these risks thanks to the robustness of its institutional framework

Price stability is unambiguously the priority objective of monetary policy

Monetary financing of governments is strictly prohibited

The Eurosystem (the ECB and National Central Banks) is extremely well capitalised, which protects its independence.

This has allowed the Eurosystem to implement nonstandard measures on a large scale without endangering its credibility.

Of course, we do not control fiscal policy. We will never accept a situation where fiscal imbalances could constrain monetary policy. It is very important, therefore, that credible fiscal consolidation takes place across the euro area. This will make it easier for the Eurosystem to be active in protecting financial stability. On the contrary, doubts over governments' resolve to ensure the sustainability of public finances would make us powerless to fight instability and expose the euro area to great dangers.

Now for the more normative aspects. We may have to live with nonstandard measures for a long time. Indeed, some central banks have adopted interest rate guidance announcements covering the next two years. It is likely that monetary policy will, for some time, make use of a diversity of instruments. Macro-prudential measures will interact with monetary policies in a complex way.

In that context, it is therefore all the more important to keep clarity of purpose and stick to two crucial features inherited from the pre-crisis consensus: the focus on price stability and, its corollary, central bank independence.

There should be no ambiguity about what central banks are trying to achieve. The more non-conventional their actions, the less obscurity there should be as to their ultimate purpose. Non-conventional measures, like any others, can only achieve their objectives if inflation expectations are solidly and clearly anchored. From that point of view, calls by some economists and market participants for a temporary relaxation of price stability objectives

are, in my view, totally misguided. I find it significant, on the contrary, that two major central banks have recently decided to quantify their price stability objectives and enhance their communication accordingly.