Erkki Liikanen: Monetary policy in unconventional times

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at an European Central Bank colloquium in honour of Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, Frankfurt am Main, 16 May 2012.

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Session 1 – Panel discussion on non-standard measures and monetary policy: what have we learned from recent experience?

It is now nearly five years since the start of the financial market turmoil. During these five years, many dimensions of monetary policy have changed. I will touch on three such dimensions. Each of them deals with links between monetary policy in the modern narrow sense and issues that, before the present crisis, were thought to be clearly distinct from it. During the last three or four years we have had to think thoroughly about the following:

- the link between price stability and financial stability,
- the link between monetary policy stance and its implementation, and
- the link between monetary policy and fiscal policy.

Financial stability and price stability

Let me start from the relationship between financial stability and price stability. Here, the crisis has inspired a lot of rethinking. Some commentators, such as Paul DeGrauwe[1], have gone so far as to suggest that the crisis has revealed inflation targeting as a "fallacy". Others, such as Lars Svensson[2] maintain their belief in strict, forecast-based inflation targeting.

It may be useful to think of the relationship between financial stability and price stability as a continuum of views that falls between two extremes:

> At one extreme, financial stability would be elevated to the position of a new, additional objective for monetary policy, alongside with price stability. Monetary policy would be about finding the right balance between financial stability considerations and price stability considerations.
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> The other extreme is what used to be the prevailing view before the crisis; namely, that price stability should remain the single ultimate monetary policy objective, and financial stability should enter monetary policy consideration only indirectly, to the extent it affects price stability.

I don´t think that the price stability objective has failed. If a conflict has emerged between financial stability and some conceptions of inflation targeting, this cannot be held against ECB's monetary policy strategy, which has always taken a medium-term view and takes monetary analysis and credit expansion explicitly into account when setting monetary policy.

This is visible even today. The ECB has repeatedly stressed the importance of preventing a contraction in bank lending, in a situation where inflation has temporarily been higher than we will tolerate in the longer term.

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[1] Paul de Grauwe: "Central banks should prick asset bubbles". Financial Times November 1, 2007.

[2] Lars Svensson: "Inflation Targeting and Financial Stability". Policy lecture at the CEPR/ESI 14th Annual Conference on How Has Our View of Central Banking Changed with the Recent Financial Crisis? hosted by the Central Bank of Turkey, October 28–29, 2010.

So, there is no long-term conflict between financial stability and price stability. It is more a question of time horizon and of the realization that a serious credit crunch can pose the risk of deflation.

We cannot operate on point forecasts. In a recent paper, Michael Woodford has argued that, when thinking about the role of financial stability, central bankers should think less in terms expected outcomes and more in terms of wider probability distributions and risk management.

Woodford does not see the central bank's financial stability task as identifying bubbles and using monetary policy to prick them. This would be difficult; unnecessary even. Instead, he thinks that one of the tasks of the central bank is to monitor the accumulation of systemic risk in the economy and, when necessary, use monetary policy – alongside other policy tools − to counteract excessive increase in tail risks.

What kind of indicators should a central bank then follow in trying to gauge risks to financial stability? There are of course many potential sources of tail risk. It could be financial institutions engaging in increasingly aggressive maturity transformation. Or it could be increasing bank exposures to a particular sector or asset, say the housing market. In general, a necessary condition for severe crisis seems to have been excessive leverage.

For any such potentially risky development, there is typically no shortage of good explanations why everything is, in fact, fundamentally healthy. And obviously, the central bank does not really possess superior knowledge.

What is clear though is that aggressive expansion of credit increases systemic risk and, ultimately, the risk of a breakdown of monetary policy transmission. Hence there has to be a policy response.

Interest rates affect credit expansion, but monetary policy needs also to be supported by more effective macroprudential instruments. Synergies between monetary policy and macroprudential supervision are clear and should be utilized.

Whether the response to emerging problems comes from the monetary policy instruments or from the macroprudential tools – or even the fiscal – side, depends on the situation. The more widespread the symptoms are of excessive risk-taking, the more likely it is that monetary policy needs to carry a substantial part of the responsibility.

The views I have described are by no means novel. In fact, they are not too far off the emerging post-crisis consensus in the central banking community. Over the last few years, "leaning against the wind" has won many hearts and minds among central bankers and academic economists. My reading of the two papers by Brunnermeier and Sannikov[3], distributed for this event, enforce the points made by Woodford: since risk-taking is endogenous, just clearing up the damage in crisis times is not enough, there needs to be some leaning to control the build-up of risks.

I don't think we have yet learnt all there is to be learnt about the role of financial stability in monetary policy making. I do however believe that we have learnt enough to know that we should not return to where we were before the crisis. An increased role for financial stability considerations in monetary policy making is likely to be one of the lasting legacies of the crisis.

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[3] Markus K. Brunnermeier and Yuliy Sannikov: "The I Theory of Money" and "A Macroeconomic Model with a Financial Sector". Manuscripts, 2012.

Monetary policy stance and implementation

Another boundary that has been completely redrawn during the crisis is the one between monetary policy stance and implementation. This is the boundary where Jose-Manuel has been most directly involved during the crisis as the Executive Board member responsible for Market Operations since June 2006.

Before the crisis, monetary policy stance was about setting the key policy rates. Everything else was seen as operational implementation with the focus on money market liquidity management. The ECB even had a name for it: the separation principle. According to this principle, the experts working on implementation issues should be separated from the ones assessing the stance, so that the liquidity conditions and shortest market rates would not convey any signals on forthcoming stances.

The age of innocence came to an end with the return of liquidity and credit risks to the markets' often narrow radar screens. Before the crisis, banks' demand for liquidity was predictable; it was set by reserve requirements. During the turmoil, unpredictable precautionary liquidity hoarding emerged as the dominating factor behind the demand.

There were two important consequences. First, accurate measurement of the neutral level of aggregate liquidity became impossible; and second, the distribution of liquidity between banks started to matter. During the acute phases of the crisis, the interbank market, which used to be extremely efficient in allocating central bank reserves, vanished almost completely.

Suddenly, the ECB and other central banks were forced to worry not only about making sufficient amounts of central bank reserves available to banks, but also about making sure that those that needed the liquidity the most had access to it. A large part of the financial intermediation – previously taken care of by the interbank market – had to be taken over by the central bank balance sheet.

The traditional monetary policy tool, the short term rate, was also used to the full. Once the interest rates were brought to virtually zero, the transformation of monetary policy was complete. Essentially, monetary policy became an exercise in inventing operational tools that would allow liquidity to flow to those parts of the financial system where it was most needed.

Arguably, the operational decisions taken by the ECB during the crisis (such as the shift to fixed-rate full-allotment liquidity auctions, the extension of operation maturities well beyond the money market maturities, and the widening of the set collateral eligible to monetary policy operations) have been every bit as important as its decisions on the level of the short term interest rates. Most of the innovative changes to the ECB's operating procedures have been widely appraised. And no one deserves the praise better than Jose-Manuel as the Executive Board Member responsible for market operations.

Few expect things to revert back where they were before the crisis. Things have changed, and higher risk aversion is likely to stay with us for some time. It is possible that we are not able to return to the conditions where monetary policy stance could be identified with the steering rate, and where collateral and liquidity conditions were regarded as technicalities with little macroeconomic interest. In that sense, central banking, real banking is back in monetary policy.

Monetary domain and fiscal domain

Perhaps the most sensitive of the boundaries that have been tested during the crisis is the boundary between monetary and fiscal policies. The crisis has compelled many central banks to break taboos and to take a more expansive view of their mandate.

But nowhere has drawing the line between the monetary domain and the fiscal domain been as difficult as in the euro area. The ECB is the central bank, not for a single sovereign state,

but for 17 sovereign states. The EU has strictly limited risk sharing arrangements between member states and none between the national banking systems. Now, in the crisis, the divergence of the euro area economies has dramatically increased and the ECB could easily end up becoming such a risk sharing mechanism.

The ECB or the Eurosystem cannot become a mechanism for sharing fiscal risks between the member states. This is because its monetary policy and its independence could be compromised. The risks taken by the Eurosystem must therefore be limited to what is required by monetary policy and by the goal of ensuring the transmission of the monetary policy to all parts of the euro area.

There are very good reasons for not monetizing budget deficits in countries with a national currency. There are even more reasons for not doing so in a monetary union such as the euro area.

Before the crisis, it was too often argued that current account positions between members of a currency union are meaningless, and that there cannot be balance-of-payments crises within a currency union. The last couple of years have proven the fallacy of this view. The sovereign debt crisis carries all the hallmarks of a balance-of-payments crisis. It goes without saying that a central bank whose job it is to equalize monetary conditions between the crisis countries and the safe-haven countries will inevitably face a formidable task. It can only succeed if the imbalances within our currency area are solved, in the medium term, by real adjustments, including budgetary adjustment.

The ECB is protected by its institutional independence. But as the crisis has demonstrated, this independence needs to be complemented by economic policies that avoid the build-up of serious imbalances within the currency area.

All in all, the tradeoffs the ECB has dealt with during the crisis have been difficult. The challenge has been to do what is necessary to maintain a sufficient functioning of monetary policy transmission mechanism for the single monetary policy to operate, while at the same time avoid creating significant moral hazard and AVOID making monetary policy a vehicle of fiscal transfers. The path between the two is narrow, and only time will tell whether we succeeded.

Conclusions

The evolution of economics is driven by crises. The breakdown of the Bretton Woods system and the inflationary years of the 1970s gave impetus to an era of rapid progress of monetary economics. The result was a vast literature on central bank credibility, independence, transparency and price stability mandate. At the beginning of the new millennium, the development of monetary economics reached its culmination. The main challenges of monetary policy were thought to be, by and large, solved.

We know now that this was not so. Monetary economics had failed to incorporate several crucial aspects of real life. The role of the financial sector in monetary transmission, financial fragility, systemic risk, and the role of liquidity, to name just a few, were not sufficiently appreciated.

I still believe that the core insights of the pre-crisis monetary theory will survive this crisis. Monetary stability will still require a credible and independent central bank with clear mandate based on price stability. But the crisis will leave a permanent mark as to how monetary policy is done. We will be thinking more about tail risks. We will have a more expansive view of the central banks' toolbox than we used to have. And we will have to think of ways of redrawing a clear boundary between what belongs to monetary policy and what belongs to fiscal policy.