José Manuel González-Páramo: Monetary policy in unconventional times

Closing remarks by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the colloquium "Monetary policy in unconventional times", Frankfurt am Main, 16 May 2012.

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1. Introduction

Ladies and Gentlemen,

We are approaching the end of this colloquium on "Monetary policy in unconventional times". We have heard many interesting and stimulating presentations and I would like to heartily thank everybody who participated in our lively and constructive debate. Let me close this event by adding a few personal thoughts on the two key issues that we discussed today: the non-standard monetary policy measures and the interaction between monetary policy, fiscal policy, and financial stability.

2. Non-standard monetary policy measures: what have we learned?

I still have vivid memories about the liquidity-providing fine-tuning operation with full allotment that we conducted on 9 August 2007 to avoid the equivalent of a seizure in the euro interbank money market. After almost five years, we still have this kind of measures in place and the crisis is still on-going. Yet, we can already draw some lessons from our experience with unconventional monetary policy.

When I try to define the general objectives of these measures, I think of two common characteristics:

First, our non-standard measures address market dysfunctions and an impaired monetary policy transmission mechanism. From this perspective, non-standard measures are a complement rather than a substitute of standard monetary policy, as also illustrated by recent academic work.[1]

More specifically, these measures address two types of liquidity problems – market liquidity and funding liquidity – by means of a third kind of liquidity, the one offered by the central bank. In fact, Markus Brunnermeier and his co-authors have impressively shown in a seminal paper that, if left unchecked, a dry-up of market liquidity and funding liquidity can be mutually reinforcing and lead to a hazardous downward spiral.[2] For instance, the Securities Markets Programme and the Covered Bond Purchase Programme have helped to reduce the liquidity risk in the government bond and the covered bond market, respectively. From this viewpoint, one could even argue against the qualifier of "non-standard" for these measures: by implementing them, the central bank acts in its traditional role of liquidity provider, compensating for the sudden dry-up of private liquidity.

Second, non-standard measures "buy time" for the necessary fundamental adjustments. For instance, the SMP has enabled some governments to maintain market access, while implementing the necessary fiscal consolidation and structural reforms. Similarly, the three-year LTROs are helping banks to implement the necessary deleveraging in an orderly fashion, by reducing funding risks and avoiding "fire sales" of banks' assets.

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[1] See, e.g., Cecioni, M., Ferrero, G. and Secchi, A. (2011), "Unconventional Monetary Policy in Theory and in Practice," Questioni di Economia e Finanza 102, Bank of Italy.

[2] Brunnermeier, M. K. and Pedersen, L. H. (2009), "Market Liquidity and Funding Liquidity", Review of Financial Studies, 22(6), pp.2201–2238.

While we conducted our non-standard measures with clear objectives, designing them in "real time" confronted us with challenging tasks. Making an exhaustive list of the issues that have kept us so busy since 2007 would be too long, so let me mention three ***essential challenges***:

First, while non-standard measures address market dysfunctions, they can have undesirable side-effects. Let me give you an example.

In the money market, the ECB had to take a greater role of intermediation as the market became fragmented. One can summarise our actions in this market since 2007 as an attempt to preserve a delicate balance between central bank intermediation and market reactivation. If they are not well calibrated, both in intensity and duration, non-standard measures can prolong market freeze, hurting the objective of restoring the monetary policy transmission mechanism.

The ***second challenge*** that I would like to stress is related to the central bank's communication. The link between price stability, interest rates, and monetary policy implementation is conceptually simple – even if in practice very intricate. With the introduction of non-standard measures in addition to the traditional interest rate tool, things became much more complicated to understand, communicate and assess. As the central bank intervenes in several dysfunctional markets and expands its balance sheet, the public may become concerned about its exact motivations. Ultimately, this may hurt the central bank's credibility and endanger the pursuit of its mandate.

The ***third challenge*** is the moral hazard implied by many, if not most, non-standard measures. Because the central bank may be expected to use its virtually unlimited "firepower", the need for making the painful, but necessary, adjustments may easily be forgotten by the other actors – be they banks or sovereigns.

As there have been ***three challenges*** in implementing non-standard measures, so there are ***three conditions*** to be met for non-standard measures to be effective.

First, non-standard measures should remain temporary. The central bank should outline its strategy for an exit from these measures as soon as economic and market conditions make it possible. Ideally, non-standard measures should include built-in exit mechanisms. For instance, the ability to repay after one year and the fact that the interest rate automatically adjusts alongside the MRO rate are two crucial features of the three-year LTROs.

As a ***second*** condition, the central bank should have a strong and credible communication. There should be no doubt that non-standard measures are no substitute for the necessary fundamental adjustments. Strong incentives should be maintained for an orderly deleveraging of banks and for the sovereigns' fiscal consolidation and structural reforms. Finally there should be no doubt on the central bank's independence.

Third, the central bank should remain alert and flexible in its approach to standard and non-standard monetary policy but inflexible in the pursuit of its mandate of price stability. I am convinced that the ECB has done a good job in maintaining this delicate balance. Our non-standard measures have contributed to maintaining the anchoring of inflation expectations at a level consistent with our medium-term objective.

I also believe that the non-standard measures have strengthened the ECB's credibility as a reactive, effective and flexible central bank with regards to the means it employs to achieve its objective but also as a central bank determined in the pursuit of price stability, which is, of course, its ultimate objective. This is an important legacy, which will help limit the damage of the next liquidity crisis when it occurs.

3. Monetary policy, sovereign debt and financial instability

Let me now come to the second main topic we have been discussing today. Talking about credibility, Matthew Canzoneri pointed out that the 1980s and 1990s may be characterized

as a "war on inflation and inflation credibility". As you all know, central banks in major industrialized countries have eventually succeeded in their quest to bring down inflation to low levels and restore credibility. This experience reinforced two key insights for monetary policy making. First, that price stability is the main contribution of central banks to macro stability and, second, that central bank independence is a prerequisite for credibility.

Given the success in bringing the average and the volatility of inflation down and keeping it low, the period from the late 1980s until 2007 has been commonly coined the "great moderation". Low volatility of inflation went also hand in hand with comparatively low volatility of output and of several financial asset prices.

After several years of low macroeconomic volatility, investors, consumers and policy makers, started to extrapolate those "tranquil developments" into the future. Large macroeconomic or financial shocks were considered unlikely. In line with such a view of the world, risk assessment and risk pricing in financial markets were arguably subdued. This applied also to the pricing of euro area government securities, which was un-differentiated in the years before the crisis: notwithstanding considerably different fiscal positions, government bonds of different issuers displayed only minor differences in yields.

It is interesting to note that already the founding fathers of EMU foresaw that financial markets were unlikely to discipline governments towards sustainable levels of debt and deficits.[3] At the same time, it has always been clear that sound public finances are a pre-requisite for sustainable economic growth and positively interact with stability-oriented monetary policy, and vice versa.[4]

Accordingly, it was agreed in the design phase of EMU that explicit rules would be necessary to avoid high levels of public debt and deficits. This view found its manifestation in the Treaty, in particular through the prohibition of monetary financing and the no-bail-out clause. Moreover, explicit fiscal rules, coupled with the idea of peer surveillance and sanctions, were further fostered by the Stability and Growth Pact.

However, despite these well-intended safeguards, we are facing the most severe sovereign debt crisis since World War II. So, what went wrong? Is the current state of public finances and the extreme levels of government bond yields in some euro area countries a result of irresponsible public spending? Or are they due to the overreaction by financial markets? Or, still, do they stem from the need of governments to deal with the financial crisis and provide support to the financial system?

All of these three factors played a role – although to a different extent and to different degrees when we look across countries.

As regards financial markets, there have in fact been situations of market dislocations as I remarked earlier. However, with sound public debt and deficit levels, such extreme price and yield developments would have been without foundation and could not have persisted for so long. So the main question is: Where do the high deficit and debt levels – which are at the root of the sovereign crisis – come from?

First, national governments responded to the financial crisis with fiscal stimulus, but also with various measures to support the financial sector, including asset guarantees, bank recapitalization and the creation of "bad banks". These measures, in conjunction with the triggering of automatic stabilisers in a contracting economy, brought along with it a rapid rise in government deficits and debt ratios.

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[3] See, e.g., the Delors report (1989).

[4] See, e.g., the article entitled "One monetary policy and many fiscal policies: ensuring a smooth functioning of EMU", Monthly Bulletin, ECB, July 2008.

Second, some countries had clearly pursued imprudent fiscal behaviour over several years and entered into the financial crisis with too high debt and deficit levels – obviously, economic governance had failed to guarantee fiscal discipline. Moreover, some countries experienced the build-up of potentially hazardous private sector imbalances. As the crisis has revealed, such private sector imbalances can quickly lead to a rise in public debt, thus exacerbating government sector imbalances.

Apart from exposing and exacerbating fiscal imbalances, the crisis also highlighted the fact that strained public finances and financial system vulnerabilities can enter into an unsettling interplay: eroding fiscal positions, inducing a re-pricing of sovereign debt, and adversely impacting the financial system via banks' exposure to government bonds; this has negative repercussions for the macroeconomy and can batter public finances and financial markets even further.

All this made clear that restoring sound public finances now and safeguarding them in the future is essential. As you know, steps have been taken in this direction. These include: the six-pack legislation, which reinforces both the preventive and corrective arms of the Stability and Growth Pact; the two-pack proposal for improving budgetary surveillance; and also the "fiscal compact", in which all signatory countries committed themselves to enshrining balanced budget rules and automatic correction mechanisms into national law.

The crisis has also led to a rethinking on best practices for financial regulation and supervision in order to address the threats to financial stability. Indeed financial regulation and supervision are currently seeing a major overhaul. This includes a new institutional framework for micro- and macro-supervisions, and also some first – if still insufficient – steps towards a more European approach on bank deposit insurance and bank resolution.

All these initiatives are eventually expected to not only foster fiscal and financial stability, but also to mitigate the vicious feedback loop that arises when one of the two becomes jeopardised.

Sound public finances and a stable financial system create a favourable background for monetary policy. In fact, the interplay between monetary policy, on one side, and fiscal policy or financial stability issues, on the other side, has since long been identified. The point has been made again today and we will hear further thoughts tonight at the "Armchair debate" on "Financial fragility and the role of the central bank". However, the crisis has underlined that there are not only two axes of interaction – monetary policy vis-à-vis fiscal policy, and monetary policy vis-à-vis financial stability – but that there is a complete interaction triangle, including the fiscal-policy financial-stability nexus as a third important edge. The challenge for policy makers arises as the poles of this triangle are all endogenous to one another.

This brings me back to my initial remarks on monetary policy. Unsound public finances, various forms of financial instability and the hazardous interplay between them can eventually jeopardize the smooth transmission of the monetary policy stance. With our non-standard measures we had – at least in part – to address negative externalities from other policy areas, while remaining faithful to our mandate to safeguard price stability.

Let me stress towards the end of my remarks that the defence of price stability never leaves room for complacency. Borrowing the terminology that Matthew Canzoneri used in his presentation: the war on inflation is essentially never over, but is rather an on-going battle.

I would like to stress in this respect that at the ECB our two-pillar strategy – i.e. the use of economic and monetary analysis – has given us very useful guidance in determining the appropriate monetary policy stance for maintaining stable prices in the euro area. I appreciate that in Markus Brunnermeier's new conceptual framework that he presented today, the monitoring of credit growth and monetary aggregates is identified as an essential ingredient of successful monetary policy making.

A key condition for continued success is that our monetary policy stance effectively reaches the economy. In this regard, the current institutional overhauls aimed at preserving sound

public finances and safeguarding financial stability would also contribute to favouring a smooth functioning of the monetary policy transmission in the euro area.

Finally, for achieving price stability the hard-earned credibility of monetary policy must not be put at risk. Here, any demand on the ECB to address the short-comings of other policy areas by compromising on its mandate or its guiding principles must be clearly rejected.

4. Conclusion

When I joined the Executive Board of the ECB eight years ago, I was of course not expecting that I would have to leave it in the middle of such challenging times. But I am confident that eight years from now, my successor as ECB Board Member will have more pleasant topics to talk about: how Economic and Monetary Union has been renovated, how the financial system has been made more resilient, how sound public finances have been restored or how the euro area economy has returned to stable growth. In the meantime, of course, I am also confident that monetary policy will have continued to maintain price stability in the euro area.

Thank you