Christian Noyer: Monetary policy and banks, and the rise of global protectionism

Introduction 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 GIC (Global Interdependence Center) central banking series "Monetary policy and banks, and the rise of global protectionism", Paris, 10 March 2014.

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These are challenging times for economic policy making. As was apparent at the G20 meeting in Sydney, the performance of the world economy is contrasted and uncertain. A central question is whether monetary policy has a role to play to improve the situation.

To me, the answer is unambiguously "yes". Monetary policy should remain active because persistently low inflation threatens the achievement of price stability as commonly defined by all major central banks today. Not all central banks are the same and there is some diversity in their objectives, mandates and, of course, the situations they are facing. Remarkably, however, all advanced economies have converged – in recent years – towards the same definition of price stability, first adopted by the Eurosystem in 2003: an inflation rate "close to 2%" (and in our case: below but close to 2%).

I will focus my introductory remarks on two issues related to this challenging objective: the low inflation level and the forward guidance strategies.

I'll start with low inflation.

Inflation has been falling recently in all advanced (although not emerging) economies. Its behavior has been atypical compared to previous episodes following a recession. This fall was especially marked in the euro area, from 2.7% in 2011 to 0.8% in December 2013. Recently, developments in the euro area have started to diverge downward from some other advanced economies such as United States and Canada.

The sources and reasons for such a low inflation are complex and multiple. There are many uncertainties. Temporary and global factors may be at play in the euro area with import prices going down. I also think there are more permanent and deep forces pushing inflation down both at the euro area and global level.

Besides there is still an important unused capacity – commonly labeled as "slack" -in most advanced economies, as demand has not yet caught up with its pre-recession levels and firms, as a consequence, have not recovered their pricing power.

Commodity price inflation has been trending down recently. This is true both for energy and food prices. Commodity prices have a global impact and react very amply to small changes in supply and demand equilibrium. They act as amplifiers and transmitters of disinflationary pressures.

Powerful headwinds – and disinflationary forces- are coming from the deleveraging process especially in the euro area, due to the importance of the banking sector and the amplitude of its balance sheet adjustment. We are working very hard to repair the bank-lending channel in the euro area. We have achieved a lot by creating the banking union and the SSM in less than two years – which is unprecedented in European history. Also, the process of balance sheet repair for banks is well underway in the euro area And we will make sure that the forthcoming asset quality review removes any doubt as to the sustainability of the euro banking sector.

Furthermore, for the euro area, there is the exchange rate question. As you all know, from a monetary policy perspective, the exchange rate is not a policy variable, let alone a target. But

it is obviously a very important input when considering overall monetary and financial conditions. The recent appreciation of the euro has had a strong disinflationary impact.

We could discuss further the different causes of low inflation in the debate, but let me make some remarks on this crucial matter for us central bankers.

First, low inflation is not deflation. As many analysts and observers are today alarmed about deflation in the euro area, it is useful to understand the difference. Deflation is a permanent and cumulative process of decrease in the overall price index, fuelled by negative expectations. Deflation is a pernicious spiral. Because consumers expect prices to decrease continuously, they tend to defer purchases, thereby further fuelling the deflation process.

Deflation increases the real burden of debt and creates an incentive to defer investment. Deflation is especially dangerous because, as the experience of Japan has shown, once it becomes entrenched, it is very difficult to stop. From this perspective, there is no deflation today in the euro area. Prices are still increasing and, most important, so are nominal wages. And, as I said, inflation expectations remain firmly anchored in positive territory, even in the short run.

Second, low inflation provides economic stimulus by boosting real income. In most parts of the euro area, nominal wages are downward rigid. Every time inflation “surprises” on the downside, it creates an unexpected increase in real wages and purchasing power. I believe this mechanism is playing some role by improving economic sentiment and supporting consumption as we have seen in the euro area over the past months.

That said, when inflation is too low, it carries very significant dangers and risks.

First, it makes real adjustment more complicated. With low inflation, there is smaller scope for downward adjustment in relative prices and real wages. As you know, the euro area strongly needs such adjustments in order for some countries, including France, to regain competitiveness. This would no doubt be made easier if the overall euro inflation rate stays closer to our definition of price stability.

Second, low inflation makes it difficult to attain low, or negative, real interest rates, that are necessary in all advanced economies at the current juncture.

Finally, low inflation increases the risk that the economy could fall into outright deflation if and when it is hit by a negative shock. The 2% target is meant to act as a cushion against that risk. That cushion is not available at the moment in the euro area. If this situation persists, it could prove dangerous in a very uncertain economic environment.

To sum up, the situation today calls for a very careful assessment in the balance of risks. Precisely because deflation is hard to reverse, even small probabilities should not be neglected and they should be fully factored into policymaking.

Let me now turn to one of the tools recently used by many central banks in the world to respond to very low inflation: forward guidance.

Central banks have been communicating for a long time about their vision for the future as well as their concerns and intentions. Forward guidance, however, brings something more. First, it implies some degree of commitment on the course of future actions. And, second, it broadens the scope of communication. Central banks try and specify how they will behave in the future, – what is called in the jargon their “reaction function”. The presumption is that this reaction will be different from that which could be expected when looking at their past behaviour or commonly accepted (Taylor) rules.

Forward guidance raises several questions.

First, how specific should it be? There is an obvious dilemma. If the commitment is unconditional, it will be very efficient in influencing short-term future expected rates, hence the shape of the yield curve, and, ultimately, long-term rates. But this carries risks to central bank credibility if circumstances change and no longer warrant sticking to the commitment.

On the other hand, if guidance is conditional, it will have less impact and introduce volatility as markets permanently reassess the economic situation and assess the probability that the central bank will change its policy.

Second, if central banks opt for conditional forward guidance, should it be "time contingent" – with time or dates references for future actions – or "state contingent" – dependent on the situation of the economy?

Time contingent forward guidance runs the risk of being undermined by changes in the economic situation. "State contingent" forward guidance may appear better. Experience shows, however, that it is also more complex to manage especially when choosing the "triggers" or "thresholds" attached to commitments for the future. Partly as a result of the crisis, major structural changes are taking place in most advanced economies. Overall, the relationship between major macroeconomic variables are becoming unstable which makes it difficult to calibrate monetary policy on a limited number of parameters, such as, for instance, the unemployment rate. Nowhere are these changes more profound than in the euro area, where structural change is taking place at an accelerated pace as a result of the crisis and adjustment policies undertaken in Member States.

We have taken stock of all these experiences and lessons in devising our approach to forward guidance in the euro area. The Governing Council has made explicit in its communication that we expect the key ECB interest rates to remain at current or lower levels for an extended period of time. We have chosen not to be specific either about the date or the conditions. The euro area is composed of diverse and somewhat heterogeneous economies, as shown by the very different unemployment rates. And as I said, it is undergoing a phase of rapid structural change. The relationships between major economic variables are therefore very complex and uncertain and it may have been very confusing to tie monetary policy moves to any set of pre-specified dates or parameters. As it stands, forward guidance has been quite successful in stabilising the short-term part of the yield curve, thus bringing significant monetary accommodation.

Some concluding remarks

Let me end with two general remarks on the future and limitations of monetary policy.

In the future, after many years of implementing non-conventional policies, one may wonder whether central banks will ever return to their pre-crisis framework. Is inflation targeting dead and non-conventional the "new normal"? I can only offer some conjectures.

While the pre-crisis framework has been transformed, maybe irreversibly it has, in some aspects, also been strengthened: all central banks have now adopted a quantification of their price stability objective; everyone is aware that symmetry in implementing their mandate is crucial; everyone is putting increased emphasis on communication to impact monetary and financial conditions.

What may have changed forever is the way monetary policy operates through a diversity of tools. It is very unlikely that central banks will, in the future, rely solely upon one single instrument: the short-term interest rate. Financial frictions will have to be taken into account, especially when looking at the transmission mechanism. Furthermore, we now know that the zero lower bound is not simply an intellectual curiosity and may effectively constrain policy making. That means that several instruments, including in the macroprudential field may have to be used simultaneously. Liquidity provision will likely play a central role in policymaking in the Eurosystem for some time to come.

Second, I have made the case for an active monetary policy when inflation has reached dangerously low levels. But there is always a risk of expecting too much and "overburdening" monetary policy. It should be recalled that monetary policy cannot by itself increase growth. It also, faces "diminishing returns". The longer interest rates are kept at low levels, the greater the risks for financial stability.

Current easy monetary conditions should be used to create environment conducive to long-term growth. There is a clear message coming out from the last G20 meeting. Economic policy should aim at raising the equilibrium interest rate by fostering opportunities for productive investment, modernising infrastructures and improving the quality of public spending. That can only be achieved through broad-based reform in both goods and labour markets. Ultimately, only strong and determined action can restore durable growth. The opportunity is there and should not be missed.