Luis M Linde: Monetary policy in the advanced economies

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the Nueva Economía Fórum, Madrid, 8 July 2014.

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Let me first thank the Nueva Economía Fórum for their kind invitation to participate in today's event.

I shall briefly be discussing the monetary policies currently being implemented by the main advanced economies. The similarities and differences between such policies are not always readily understandable and they add complexity to the current economic circumstances.

After a brief overview of the role monetary policies are playing in managing the international crisis, I shall specifically refer to the cases of the United States, the United Kingdom and Japan, and then focus in greater detail on the European Central Bank's approach and on the measures it has recently adopted.

The role of monetary policies in managing the international crisis

Unlike in the Great Depression, and largely as a result of the lessons learned from it, the economic authorities responded swiftly, robustly and in a relatively coordinated fashion internationally when the crisis in the advanced economies broke. This response took the form of a raft of measures to support financial systems and the application of a series of expansionary demand-side policies.

The measures set in train were aimed firstly at heading off a potential global liquidity crisis, which would have seen the functioning of financial systems and, therefore, of economies themselves collapse. Massive injections and the enabling of mechanisms to supply liquidity in different currencies were pivotal in containing the risk of such collapse.

These measures were accompanied by official interest rate cuts that contributed to generating the necessary demand stimuli to counter, as far as possible, the adverse effects of the crisis on activity and employment.

In the initial stages of the crisis, the measures of the Federal Reserve, the Bank of England, the Bank of Japan and the European Central Bank essentially followed a common pattern. The differences between them had, above all, to do with the singular characteristics of their respective operational frameworks.

Subsequently, differences have become apparent between the paths pursued. While cyclical positions continued relatively to coincide, the emerging divergences were linked to the specific structural features of the different economies, such as, for instance, the different weights of banks and capital markets in the intermediation of financial flows. Later, however, differentiation was increasingly more related to the differing pace of exit from the crisis in each economic and monetary area.

The monetary policy of the US Federal Reserve

Since the start of the crisis, the US Federal Reserve has been pursuing a strongly expansionary monetary policy. In this connection it has resorted to a wide array of both conventional and less conventional measures.

The Federal Reserve cut its official interest rates successively until placing them at their natural lower bound, i.e. close to zero, and it embarked on massive securities purchase programmes that substantially expanded its balance sheet. It also pursued a forward guidance strategy, aimed at conveying its intention to maintain monetary expansion for a prolonged period.

In May last year, given the evident improvement in the economic situation, the Federal Reserve communicated its intention to begin *tapering*, or gradually reducing the intensity of its expansionary impulses through cutting its monthly volumes of securities purchases. Following a period of some confusion around the month of May 2013 (which impacted the markets to some extent), this strategy has progressively taken root.

The challenge the Federal Reserve faces in these circumstances is no longer that of a change in monetary tack, but how to trim its expansionary monetary stance, in line with the improvement in the economy's cyclical position, without endangering economic recovery, which is still not perceived as sufficiently firm. This is a complex challenge that fuels market uncertainty and affects the margin for manoeuvre of other central banks.

The monetary policy of the Bank of England

The situation of the Bank of England is somewhat different. Like the Federal Reserve, it also exhausted its scope for conventional measures and likewise resorted intensely to securities purchase programmes and to forward guidance. Furthermore, the Bank of England pioneered the implementation of measures aimed directly at boosting lending to specific sectors through its Funding for Lending programme. In short, this programme enabled the institutions most active in specific credit market segments to obtain financing at the central bank at a lower cost.

The pick-up in economic activity in the United Kingdom has been sharper than in the United States and, according to most analysts, it appears to be underpinned by sounder foundations. Inflation is holding on a path consistent with the target of 2% and it should also be borne in mind that the prices of certain assets, housing in particular, have been moving on a rising trend and have reignited debate on the role the central bank and its monetary policy should play in preventing potential bubbles.

Here, although the Bank of England has not yet modified its accommodative monetary policy stance either, the prevailing expectations are already discounting a more or less immediate change. The latest messages from the Bank of England suggest, in any event, that when rates begin to rise they will do so very gradually, remaining below historical values for a lengthy period.

The monetary policy of the Bank of Japan

The differences are even more marked in the case of the Bank of Japan. Nor can we forget that, prior to the international crisis, the Japanese economy had not overcome the effects of its own domestic crisis which began in the 1990s following a substantial credit boom and a burgeoning real estate bubble. The various economic programmes implemented since have not managed to put the Japanese economy back on a stable growth path, illustrating the difficulty involved in restoring normality when an economy enters a perverse cycle of deflation and contraction of activity.

The latest programme – introduced and promoted by Prime Minister Abe – included among its three pillars an ambitious monetary expansion plan which, with official interest rates close to zero, is being implemented through growth of the monetary base.

Although the latest data show an incipient return to positive rates of growth and inflation, evidently monetary policy in Japan is still far removed from the threshold marking not only a change of cycle, but also a move towards a less expansionary stance, in contrast to the cases of the Federal Reserve and the Bank of England.

The monetary policy of the European Central Bank

The specific characteristics of current euro area monetary circumstances stem from the complexity and depth of the crisis and the slow pace at which the euro area is emerging from the crisis in comparison with other areas. Following the negative data of 2012 and 2013, the projections published by the ECB last June indicate that the euro area will not recoup pre-crisis levels of GDP until the end of next year. However, the recovery in employment in the euro area as a whole will not be completed in 2015.

Since end-2011 the inflation rate has moved on a declining trend. It stands at an all-time low and the available projections indicate that it will remain, for the foreseeable time horizon, far from the benchmark of 2% which, in the medium term, marks the price stability target governing the ECB's actions.

The scenario I described above was that encountered by the Governing Council of the ECB at its meeting in the first week of June and required resolute and more expansionary monetary policy action. Such action was required because, although available indicators still pointed to medium-term inflation expectations remaining anchored at levels compatible with the definition of price stability, if inflation becomes entrenched at excessively low levels for an extended period, there is a significant risk that these expectations will ultimately be for deflation and a long period of low growth. And we know from Japan's experience that once this disanchoring has taken place, it is very difficult to return to normal.

Before June, the ECB had already reduced its policy interest rates to very low levels on several occasions. The rate on the main refinancing operations stood at 0.25% and that on the deposit facility at zero. The ECB had also embraced the policy of forward guidance, both in the area of liquidity, by announcing in advance that it would extend the fixed-rate tender procedures with full allotment, and in the area of interest rates. Here, forward guidance was introduced in July last year when the uncertainty surrounding the Federal Reserve's intentions led many investors and analysts to anticipate a change in monetary policy stance not only in the United States but also in the euro area – a change evidently not on the ECB's agenda.

The ECB had also resorted to assets purchases before June. The programmes adopted, however, were not directed at providing economic stimulus by expanding the ECB's balance sheet. The purchases were aimed at repairing the monetary policy transmission mechanism, which was damaged by the crisis, and redressing the fragmentation of the euro area's financial markets.

Against this background, the ECB's response to the challenges posed by the complex situation in early June consisted of the activation of an extensive package of conventional and non-conventional measures.

First, the key interest rates were trimmed further. The rate on the main refinancing operations was cut to 0.15% and, for practical purposes, it can now be considered to have reached its lower bound. The interest rate on the deposit facility, i.e. the remuneration received by banks on the funds they place with the central bank, was set at negative values (–0.10%) for the first time in the history of the Eurosystem. Finally, the interest rate on the marginal lending facility was likewise reduced to 0.40%.

As regards forward guidance, it was decided to extend the duration of the fixed-rate tender procedure with full allotment for such time as may be deemed necessary and at least until December 2016. Also, it was reiterated that, given the current inflation outlook, key interest rates would remain at their current level for a long time.

Finally, the package of measures was supplemented by two further initiatives directly designed to promote lending to firms and households.

First, a new longer-term refinancing operations programme, with special characteristics expressly geared to boosting the growth of credit to the private sector, was implemented.

These operations, which will begin in September this year and will be repeated quarterly until June 2016, will mature in September 2018. This loan term of up to four years for the first loans requested by banks clearly exceeds the usual time horizons in liquidity management and is much closer to those seen in the extension of credit to the private sector.

The cost of funds for banks will be highly competitive because their interest rate has been set at the level for the main refinancing operations (currently at 0.15%, as noted above) plus a small fixed spread of 10 basis points.

The amounts banks may apply for under this programme will be set on the basis, first, of their current level of lending (strictly credit to the non-financial private sector, excluding that for house purchase) and, second, of their performance over the coming two years. Banks that are more willing to grant credit will have access to a larger volume of funds.

To ensure that funds are effectively used for financing the expenses of households and firms, the measure includes a mechanism whereby any banks failing to show lending levels above certain minima (set on the basis of their track record in the twelve months before the Governing Council's decision) will have to return the funds they borrowed from the central bank.

The second credit-related measure adopted was to step up the work currently under way to design a programme for the purchase of asset-backed securities. This market was heavily affected by the crisis, and its underdevelopment in Europe is constraining the greater diversification of sources of corporate finance, particularly for SMEs. Initiatives such as this may stimulate the deepening of this market, although they are unlikely to be decisive if not accompanied by further action in equally important areas, such as that of regulation.

To sum up, the situation of the euro area justifies the differing conduct of its monetary policy which, as I have attempted to explain, is still at the stage of scaling up its expansionary action, in contrast to the likely winding-down of stimuli prevalent in other advanced economies. This adds complexity and uncertainty to the exceptional situation of abundant liquidity and low interest rates prevailing in the markets.

Thank you.