Luis M Linde: Brief comments on the interactions between monetary policy and macroeconomic adjustments

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the XXXI Conferencia del Círculo de Economía, Sitges, 30 May 2015.

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Let me first thank Antón Costas, President of Círculo de Economía, for his invitation to participate in this final session of the XXXI Conference, which is a classic on our schedule of economic meetings and conferences. Many thanks, too, to Andreu Mas-Colell for accompanying us in this session, where we are joined by the Vice President of the ECB, Vitor Constancio, to whom it will be an honour for me to give the floor immediately after my address.

First, by way of introduction, I should like to make some brief comments on the interactions between monetary policy and macroeconomic adjustments, one of the major matters raised in the euro area monetary policy framework in recent years.

Long periods of very low inflation pose risks to medium-term price stability, to economic activity and to financial stability.

The first of these risks is the de-anchoring of inflation expectations from levels consistent with price stability which, as we know, the ECB defines as an expected inflation rate below but close to 2% in the medium term. Being in the proximity of a deflation dynamic may encourage the postponement of spending decisions by households and firms. Moreover, although nominal interest rates may be at very low levels, if inflation continues falling, real interest rates will trend upwards, contributing to reducing consumption and investment.

Secondly, in economies posting a high level of public or private debt, or both, very high or rising real interest rates may exacerbate the difficulties of bringing about a reduction in household, corporate and public-sector debt, the reason being that the stock of debt, though it holds constant in nominal terms, will rise in real terms. The macro adjustment of a highly indebted economy in an environment of very low inflation or, indeed, deflation, thus becomes difficult and complex.

And, thirdly, in relation to financial stability, the events we have seen in recent years indicate that asset price bubbles and the misallocation of financial resources may coexist alongside low inflation. If the situation of low inflation extends over time and draws close to deflation, we will arrive at very low or even negative interest rates, and that will entail additional risks for institutional investors, for the allocation of resources and for the sound functioning of the financial system.

This was what we experienced in the euro area in the second half of last year. What role can monetary policy play in such a scenario? In September 2014, the ECB decided to expand the tools available to monetary policy by adding a private asset purchase programme followed, in January this year, by public-sector and public debt purchases. ECB policy interest rates were already then at their lower bound, at practically zero, with negative rates on the deposit facility. At the same time, liquidity provision by the ECB through its regular open market operations and its longer-term operations followed an on-demand principle, granting all the liquidity requested by banks; indeed, for several years a policy has been pursued under which, at the interest-rate marked for monetary policy operations, the ECB has not rationed the volume of liquidity provided to banks.

After a few months' experience, we can state that asset purchases have clearly contributed to re-anchoring inflation expectations, in line with the medium-term objective and, most importantly, they have checked and reversed the rise in real interest rates. Their effects have also been manifest in portfolio re-balancing, encouraging investors to shift holdings from riskfree or very low-risk securities to riskier ones, thereby reducing the cost of financing for consumers and investors.

The second aspect I would like to mention is the role of economic policies in countries that have had to set about correcting the deep-seated imbalances built up in the expansion that ended with the onset of the crisis in 2007–2008. I would refer to policies aimed at improving competitiveness in goods markets and at reducing labour market inefficiencies, which are most significant in countries with high unemployment, in particular in those cases in which high indebtness is a constraint on the possibility of implementing demand-boosting policies.

Reforms are conducive to wage moderation and to the containment of the inflation rate, with the potential to initially dampen domestic demand owing to lower wages, the increase in the real value of debt and, in some cases, the increase in real interest rates. However, these initial adverse effects could be offset and, as experience shows, exceeded by gains in competitiveness, increases in exports and gains in confidence that positively affect consumption and investment decisions and generate employment and growth.

Another matter to be highlighted is that of the synergies between structural reforms and monetary policy. The Spanish economy is a good example of a positive interaction and of the fact that, at least occasionally, reforms and policy are mutually reinforcing.

After a period in the euro area with considerable stress combined with very marked segmentation in the credit markets, despite the ECB's increasingly loose monetary policy, this interaction between structural reforms and a strongly expansionary monetary policy finally began to be felt in late 2013 and, naturally, in 2014, in any event in Spain. Unquestionably, some of the reforms launched in 2012–2013 contributed to relieving stress on the financial markets owing, above all, to their contribution to improving confidence. The improvement in public finances governance in the euro area no doubt played a key role in enhancing confidence.

Naturally, we may well ask what happens under this scenario to those economies that have witnessed a loss in competitiveness compared with those countries that have implemented reforms, for example those affecting the labour market and those which have provided, along with other factors, for the so-called internal devaluation. In this case, the relative loss of competitiveness has been offset by the monetary policy stimulus and its impact on national demand and on the external sector.

The depreciation of the euro accompanying this policy which has, no doubt, partly been one of its consequences, has improved the competitiveness of the area as a whole, stimulating exports and overall activity. Here we should recall that the euro area as a whole runs a most significant surplus on its transactions with non-euro countries. Both excessive deficits and large surpluses entail risks and costs. Accordingly, we believe there is justification behind the calls from several international institutions for those euro area countries that have the leeway to do so to implement policies conducive to the expansion of their domestic demand.

I shall sum up with two ideas. First, that the de-anchoring of medium-term inflation expectations entails serious risks to financial stability and growth, risks that may be exacerbated in countries that have to follow a process of macroeconomic adjustment and deleveraging. Second, that monetary policy and structural reforms, when simultaneously applied, may lead to highly positive synergies.

And now a few words to make way for the address by my much-respected and dear friend Vitor Constancio.

As well as having pursued a brilliant academic career, Vitor Constancio has been at the commanding heights of Portuguese politics and economic government.

Constancio has been a Member of Parliament, Minister of Economy and Finance, Governor of the Banco de Portugal on two occasions, the second from 2000 to 2009, a member of the

Council of State and a professor at various Portuguese university institutions. In 2010 he was appointed Vice President of the ECB.

Given his position, and also in light of his personality and experience, Constancio plays a very important role in steering and designing the ECB's policies. He is a representative of what I would define as "flexible orthodoxy", i.e. a rigorous point of view on ECB's tasks and priorities, but one which flees from rigidity and never forgets common sense when it comes to the complex and often difficult decisions, in both the technical and political sense, that the ECB has to adopt.

I give the floor to Vitor Constancio.