François Villeroy de Galhau: What can monetary policy do?

Speech by Mr François Villeroy de Galhau, Governor of the Bank of France, at the House of Finance Days of Paris-Dauphine University, Paris, 14 March 2016.

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Ladies and gentlemen,

It is a great pleasure for me to participate in this first edition of the *House of Finance Days* of Paris-Dauphine University. In order to "[imagine] the finance of tomorrow" – to quote the theme of this event – it is essential to understand all facets, and in particular to be able to decipher the prevailing environment. Through its three main tasks, the Banque de France plays a key role as, firstly, it implements **monetary strategy**, as a member of the Eurosystem alongside the European Central Bank in Frankfurt; secondly, it ensures **financial stability**, by supervising the banks, insurance firms and, more generally, the **financial system**; and, lastly, it provides an economic service to households and SMEs/VSEs.

Today I will focus on the monetary policy that we conduct in the framework of the Eurosystem. Monetary policy has long been considered a technical or even an austere subject. But, since 2008, it has been far more widely discussed: central banks in different countries have played a major role, and a role largely hailed as positive, in exiting the crisis. Today, however, their actions to address the persistence of very low inflation are subject to debate. I would first like to talk about our objective, then our instruments and their effectiveness.

First, the question of the objectives.

This question, which really covers two questions, has generated much thought and debate. Indeed, central banks examine their actions, with a lot more modesty than is often credited:

1. What is the objective, the "mandate", of the central bank?
2. What are, with regard to this objective, the current challenges?

1) Let us start by the mandate.

a) In the United States, the Federal Reserve has a dual mandate of price stability and full employment. In the euro area, under the Maastricht Treaty – approved democratically in each country, and in France by referendum in September 1992– the objectives are clearly set out in a hierarchical order: **the Eurosystem is dedicated to price stability, which is its primary objective**; ensuring a high level of employment and sustainable growth is secondary to its price stability objective. This difference has often been discussed; with hindsight, it does not seem that important. When the ECB fights too low inflation, this also contributes to supporting activity. And among the indicators that we monitor, the output gap- the difference between the actual output of an economy and its potential output, still negative in France and the euro area – is a key element.

b) In concrete terms, our primary objective – maintaining price stability – means achieving **inflation rates below, but close to, 2% over the medium term.** Most central banks in advanced economies share this medium-term 2% objective, including the United States and Japan. This has been the ECB's objective since 2003, when it was proposed by the German former chief economist, Otmar Issing. It may appear paradoxical that price stability is not zero, but there are good reasons for this. First, the "Boskin effect", named after the US commission that showed in 1996 that the price indices used to measure inflation tended to overstate inflation, by underestimating the substitution towards products whose prices increase less quickly, and product innovation. Therefore, the inflation objective can never be too strictly observed since it is necessary to keep enough leeway to ensure that the economy doesn't sink into deflation in the event of negative shocks. Also, low inflation facilitates structural adjustments in an economy where there are downward nominal rigidities of certain prices, in particular wages.

c) In the euro area, however, like in most advanced economies, **inflation remains too low,** despite the historically low interest rates: the harmonised index of consumer prices (HICP) indeed returned to negative territory, standing at -0.2% in February 2016, and underlying inflation, i.e. excluding energy and food, is only 0.7%. Does this mean the Eurosystem can no longer achieve its price stability mandate, or will have to change its objective? I don't think so. Current challenges do not call into question our mandate, but they change the way in which we fulfil it. For the credibility of monetary policy, this objective must be maintained: this 2% target is a medium-term "anchor", at a time when there is so much volatility and short-termism affecting the economy.

2) What are, with regard to this objective, the challenges central banks are facing?

Today, the Eurosystem is faced with two main challenges: deflationary pressures on the one hand, and the risk of an unanchoring of expectations, on the other.

a) First, a certain number of factors are currently contributing to low inflation. Primarily, the euro area is faced with deflationary pressures associated with a series of economic shocks: firstly, the fall in oil prices, from over EUR 80 per barrel in mid-2014 to EUR 34 in early March 2016, or more than 2.5 times lower, as well as the decline in commodity prices; secondly, the slowdown in growth in emerging economies and chiefly China; and, lastly, inadequate growth in the euro area with persistently high unemployment, which curbs wage rises and weakens demand and price growth. Moreover, structural factors, such as the ageing population, are likely to exert downward pressure on the "natural" interest rate, a term coined by the Swedish economist Knut Wicksell over a century ago. This rate can be defined as the interest rate consistent with the full employment of the factors of production. In this case, in order to achieve the right balance between savings and investment, markets rates must come down too.

In normal times, central banks cut their key rates, and this passes through to the yield curve. However, in order to deal with the financial crisis, the ECB like other central banks have brought their key interest rates to very low levels, around zero. This means that our traditional monetary policy tools had to be supplemented by other instruments, known as non-standard instruments, in order to reach our prices stability objective. I will return to this point later.

b) The second challenge, which stems from the first, is the risk of an unanchoring of expectations, which would make it harder for us to achieve our 2% target again**.** Indeed, if inflation stayed too low for too long, economic agents may revise downwards their inflation expectations, which would create second round effects. Lower inflation expectations influence economic agents' price- and wage-setting behaviour, which in turn keeps inflation low. It can even raise the risk of deflation, defined as a cumulative process of falling prices, including those of assets, or even wages and production, as the world economy experienced in the 1930s or Japan partially underwent in the 1990s. Such deflationary dynamics are not at play today; but that is why our inflation target is symmetrical. We consider too low inflation to be just as costly as too high inflation. And, therefore, it is more risky for central banks to act too late than too early. Since the start of the year, we have observed that market-based measures of inflation expectations have fallen. Nevertheless, the latest forecasts provided by the ECB last Thursday continue to point to a gradual rise in inflation over the coming years: 0.1% in 2016, 1.3% in 2017 and 1.6% in 2018.

II. This brings me to my second point: how effective are our non-standard measures?

1) **Since the summer of 2014, we have implemented a series of monetary policy measures, dubbed “non-standard”, to complement cuts to key interest rates,** which now stand at 0.00% for main refinancing operations and-0.40% for the deposit facility. These measures include:
2) Targeted longer-term refinancing operations, conditional on the provision of bank lending to the real economy. The new series of TLTROs that we decided to launch on 10 March - TLTRO 2 - will allow banks to borrow at highly favourable rates, depending on the amount of new credit they provide;
3) Purchases of private and public sector securities, to further ease monetary and financial conditions in the euro area. The Eurosystem buys asset-backed securities, covered bonds and investment grade bonds issued by euro area sovereigns, agencies and institutions. On 10 March we decided to expand this programme further by including corporate bonds among eligible assets, and increasing the amount of monthly purchases to EUR 80 billion from EUR 60 billion previously;
4) Indications on the future path of key interest rates – or “forward guidance” – in order to influence agents’ expectations. On 10 March, we gave the following indications: “key ECB interest rates [will] remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases”, which means extending well beyond March 2017.

Turning now to the comprehensive package that has just been introduced, it sends out two clear messages:

a) Our decisions are guided by our mandate which is to bring inflation back towards our target of 2% over the medium term. We are firmly set on this objective, and have a broad range of instruments with which to achieve it. In addition to negative interest rates, which naturally have their limits, we are also acting both on bank lending – via credit easing with the new TLTRO – and on market financing - via the extended QE asset purchase programme – and are guaranteeing that we shall continue to do so for as long as necessary - via forward guidance.

b) Our priority is to promote the financing of the real economy. The goal of TLTRO 2 is not, as some have claimed, to offset the impact of negative rates on banks. It is to encourage banks to lend to corporations, SMEs and households alike; similarly, extending the asset purchase programme to corporate bonds will be of particular benefit to large French corporations. In other words, we are securing the provision of credit to businesses and households, and protecting it from tensions linked to market volatility.

2) These non-standard measures have been effective.

They have translated into a substantial easing in borrowing conditions for euro area companies. Since June 2014, the cost of borrowing for businesses has fallen by 80 basis points. Without non-standard measures, we estimate that we would have had to lower key rates by around 100 basis points in June 2014 to achieve a similar effect on bank interest rates. This has also helped to stimulate lending to the real economy: in the euro area, outstanding loans to businesses have gone from a contraction of -2.5% in June 2014 to growth of 0.6% in January 2016. The impact is even more marked in France, where outstanding business lending grew by 4.8% year-on-year in the first month of 2016 - the highest pace of growth in the euro area and, what’s more, with the lowest rates of interest. Convergent estimates from the ECB and the Eurosystem indicate that, all other things being equal, the measures introduced since June 2014 should add 1 percentage point to inflation over the period 2015-2017, with a similar impact on growth. In France, they helped to boost 2015 growth by 0.3 percentage point, and estimates from INSEE even put the impact slightly higher at +0.4 pp. That represents about 80,000 additional jobs for the economy - although only structural reforms can generate lasting gains for a country's growth and employment. To conclude on this estimate of effectiveness, the IMF – regarded as an objective judge of the relevance of economic policies – was unequivocal in its assessment at the last G20 meeting in Shanghai at the end of February, saying, "The ECB's asset purchase programme has supported the recovery by improving confidence and financial conditions [and] monetary policy should remain accommodative".

3) What about the risks?

I talked earlier about the risks of doing nothing: we need to take action in order to bring inflation back up towards 2%. That said, we also need to keep a close eye out for any possible negative **side-effects of our monetary policy, notably for financial stability.** We are actively monitoring the financial cycle, including in France where the task falls to the Haut Conseil de Stabilité Financière (High Council for Financial Stability), set up in 2013: I will be taking part in its 8th meeting at the Finance Ministry tomorrow. For the time being, there are no signs of any bubbles forming in the main financing markets: on the whole, developments in the equity markets appear in line with corporate profit forecasts, while evolutions in bond yields also seem consistent with the outlook for inflation and growth. Nor are there any signs of excessive credit growth in the financial system. Nevertheless, we remain vigilant over all aspects of the current macroeconomic and financial environment. In the last HCSF communiqué in December 2015, for example, we indicated, on the subject of the property market, that "the price adjustment in the residential market since 2012 appears appropriate, whereas commercial real estate prices remain high". We are ready, when needed, to take action with macroprudential measures, to prevent and mitigate any systemic risks that might arise.

Monetary policy is thus doing a great deal to counter weak inflation and support economic activity – it is our duty and we will continue to do so with steadfast resolve: we are consistent in our objective, ready to act with the right instruments, and alert to any possible risks. However, I would also like to stress that **"monetary policy cannot be the only game in town"**. Other economic policies also have a role to play. This is precisely what the members of the G20 reiterated in Shanghai on 27 February: "Monetary policies will continue to support economic activity and ensure price stability, consistent with central banks' mandates, but monetary policy alone cannot lead to balanced growth". Where there is sufficient margin to do so, fiscal policy must support demand – this is not currently the case in France, but it is in other countries in Europe. Moreover, structural reforms remain absolutely vital in France, to encourage creations of jobs and of businesses and thus bring the economy back to full potential. Our country can't wait any longer; its unemployed, its young people – such as yourselves – can't wait any longer. At European level, we need to move finally towards a true economic union, in addition to the monetary union embodied in the Eurosystem.

Only by optimising the governance of the euro area can we optimise growth. The current extremely accommodative monetary policy stance creates the ideal conditions for carrying out much-needed reforms. It should not be used instead as an excuse for putting them off: Europe and France urgently need to make the most of this opportunity, right now.

Thank you for your attention.