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Speech by the Governor of the Banco de España at the 2017 CUNEF graduation ceremony

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Governor

It is an honour to be here with you today, to celebrate the CUNEF University 2017 graduation ceremony for graduates and postgraduates.

Allow me to congratulate all those who are graduating today, and to express my gratitude for the invitation to preside over this ceremony, which it has been a great pleasure to accept.

Since its foundation more than 40 years ago, CUNEF University has played a very important role in the education of banking and finance professionals in Spain. CUNEF graduates occupy important positions not only in the private sector but also in the public sector, including in the institution that I represent. And I am sure that the students graduating today will maintain the tradition of professional excellence built by this university.

I would like to focus today on what is, without a doubt, the key function of central banks: monetary policy. I will start with a brief historical outline of how the functions of central banks have changed from when they were first established up until the present day, and I will then describe the current framework for monetary policy implementation, concluding with some reflections on the main challenges we face following the economic and financial crisis that broke ten years ago this year.

The evolving role of central banks

Central banks are offspring of the Enlightenment. The first two central banks, the Sveriges Riksbank and the Bank of England, were founded in the second half of the seventeenth century. The Banco Nacional de San Carlos, the first forerunner of the Banco de España, was founded during the reign of Charles III, the Enlightened, in 1782, and the Banque de France opened its doors in the year 1800, shortly after the coup of 18 Brumaire, which brought Napoleon to power.

Central banks were initially set up to satisfy European states' demand for funds, to pay for their increasingly costly armies. The banknote issuance monopoly, which most central banks enjoyed from their foundation, was the main feature that distinguished them from commercial banks.

Until the First World War, the operations of central banks were linked to the gold standard.

The interwar period was marked by a number of economic disasters, such as the hyperinflation in Germany and the Great Depression in the United States, partly associated with the attempt to adapt the role of central banks to the new political realities.

The post-war world was marked by the Bretton Woods agreements, which are named after the location (well chosen, it is really a beautiful place that I would recommend you to visit when you get the chance), in the US state of New Hampshire, where there was then, and there still remains today the hotel at which an international conference was held in July 1944. This conference, attended by Keynes, among others, saw the signing of the agreements to set up the International Monetary Fund and the new exchange-rate system, which remained in force until the beginning of the 1970s.

The system to which the Bretton Woods agreements gave birth replaced gold with the US dollar, insofar as exchange rates were fixed in relation to the dollar rather than to gold, although an indirect link to gold was maintained through the dollar/gold parity. It was agreed at Bretton Woods to set up the institution charged with oversight of the stability of the international system of exchange rates, namely the International Monetary Fund.

The “dollar standard” set the tone for the post-Second World War period. This era of relative stability and widespread prosperity ended in the early 1970s, when the US government suspended the convertibility of the dollar into gold, one of the pillars of the Bretton Woods agreements. This occurred when the markets came to believe that the dollar/gold parity overvalued the former, in a context of the economic and financial disruption that followed the oil market crisis in 1973. The system of fixed but adjustable exchange rates was abandoned and replaced by a floating exchange rate system, and at the same time all the rules relating to the convertibility of the various currencies into gold were also abandoned. Since then, the system of floating or variable exchange rates has been the mainstay of the international currency market.

The 1970s and 1980s were characterised by the attempt of central banks to find a new model for the design and implementation of monetary policy. Many central banks were then subject, in one way or another, to government control, which led to an excessively accommodative monetary policy. The result was the emergence of high rates of inflation accompanied by poor economic growth and sharp increases in unemployment. This prompted the rethinking of the role that central banks ought to play in the economy and of how they should act when performing this role.

The current framework for the conduct of monetary policy

The experience of the 1970s highlighted the importance of giving central banks a clear and credible mandate based on control of inflation and the achievement of price stability, as the basic objective to support growth and macroeconomic stability in the medium term.

With this objective, since the 1990s central banks have been accorded an extensive degree of autonomy to isolate their decisions from political considerations that might interfere with their central mission of ensuring a moderate level of inflation. The Law of Autonomy of the Banco de España of 1994 was approved in this context. Likewise, the treaties establishing the European Central Bank are clear as regards its independence and main objective, namely the maintenance of price stability within the euro area. In the case of the European Central Bank, its objective is to maintain inflation rates below, but close to 2% over the medium term.

What is the conceptual framework for the performance of central bank functions today? That is to say, how do they decide on their monetary policy stance given the economic situation?

Although there are differences between central banks, I believe it is possible to generalise by saying that the prevailing framework is based on the idea that, as a result of various economic frictions, including notably price and wage rigidities, the economy may deviate from full employment and stable prices. The central bank is capable of influencing the state of the economy through changes in the nominal interest rate. These changes affect in turn the real interest rate, i.e. the interest rate adjusted for inflation, which is the relevant one for the investment and consumption decisions of firms and households.

Thus, by indirectly affecting the spending of economic agents, the central bank exerts influence over inflation, attempting to stabilise it at moderate levels. With this objective, the central bank attempts to ensure that the real interest rate is as close as possible to the economy's "natural" interest rate, i.e. the rate that would prevail if the economy did not suffer from the frictions that I mentioned. The natural rate, which in recent years has given rise to endless debate among economists, depends on structural parameters, including most notably demographic developments and technological innovation.

If the actual interest rate is above the natural rate, the monetary policy stance is contractionary, leading to an excessive decline in prices and economic activity. If, on the other hand, the real interest rate is below the natural rate, the monetary policy stance is expansionary, which may lead to the generation of inflationary pressures and, normally, for a time, higher economic growth than the economy can sustain without the emergence of imbalances.

The intrinsic difficulty of this conceptual framework is that its central feature, the economy's natural rate of interest, cannot be observed in reality, but only, in the best of cases, estimated indirectly. Accordingly, the central bank needs to analyse a broad range of indicators in order to infer the state of the economy, so as to be able to determine the appropriate monetary policy stance.

This conceptual framework worked satisfactorily during the 1990s and the early years of the current century, a period known as the "Great Moderation", characterised by stable growth in the advanced economies and relatively low levels of inflation. However, the economic and financial crisis that began in 2007-2008 forced central banks to adopt innovative policies and, on occasion, to navigate "uncharted waters". This is the subject I wish to talk about in the final part of my speech.

The monetary policy challenges arising from the crisis

The magnitude of the crisis that began in 2007-2008 led the central banks of the main developed economies to design and implement expansionary monetary policies of unprecedented magnitude and scope.

The crisis had a significant effect on banks and other financial intermediaries, leading to a contraction in credit and, therefore, in economic activity. This led the main central banks to introduce various measures to provide liquidity to their banking systems at times of market malfunctioning. In addition, asset purchase and medium and long-term financing programmes were launched that avoided a systemic crisis which would have led to the failure of a large number of banks and, undoubtedly, to an enormous crisis in the real economy, as during the "Great Depression" in the 1930s.

Even so, the severity of the recession led to a very sharp contraction in demand, and ultimately to inflation rates that were too low and incompatible with the mandate of the central banks of the main advanced economies. This situation forced them to reduce the interest rates determined by monetary authorities to historic lows. Some central banks, such as the ECB and those of Japan, Sweden, Denmark and Switzerland, reduced rates to negative levels.

In fact, one of the factors that has influenced the actions of central banks most in recent years has been the difficulty of reducing interest rates when they are already at very low levels. Interest rates that are too low may mean that there is no incentive for financial intermediation, since, for example, it is more profitable to store money in cash than to deposit it in the banking system.

What should we do then when rates are very low and the economy still requires greater monetary stimulus? Central banks have made two main proposals in this respect.

First, quantitative easing, through the purchase of public and private debt, seeks to extend the effects of low short-term interest rates to the rest of the yield curve, including to long-term rates, over which monetary policy normally has no direct influence. To do this, the central bank purchases assets with long-term maturities, generating an increase in their price, or, tantamount to this, a reduction in their yields. These lower yields on the assets acquired by the central bank are in turn partly passed through to the yields on assets with a similar duration, such as the interest rates on bank loans, which tend to be the most relevant ones for the saving and investment decisions of households and firms, thus stimulating demand and price rises.

Second, forward guidance seeks to transmit to private agents the central bank's commitment to maintaining an expansionary monetary policy throughout the early stages of the recovery, in order to avoid the deanchoring of inflation expectations.

These programmes, whose application has involved major challenges for central banks given the lack of any similar experience in the past, seem to be working acceptably well, assisting the economic recovery and avoiding the emergence of crisis-induced deflationary pressures. According to analysis carried out by the Banco de España, ECB action can explain around half of the nominal GDP growth in the euro area over the period 2015-2017.

That said, it is important to stress that central banks cannot take sole responsibility for the recovery. A greater degree of cooperation is required from governments in the area of reforms and budgetary policies, to encourage growth and reinforce the monetary stimulus.

Conclusions

I shall now conclude.

Central banks have played a fundamental role in the economic policies launched to combat the crisis, especially in the most developed economies, namely the United States, the European Union, Japan and the United Kingdom. This response has been based on very loose monetary policies, which have led to growth in central bank balance sheets to unprecedented volumes and, although at different tempos, has helped to contain and reverse the negative demand and employment dynamics.

In the context of the European Union, the role of the ECB has, of course, been extremely important, and the attention aroused by its measures, initiatives and announcements is therefore entirely understandable.

I said at the start that central banks are offspring of the Enlightenment. As heirs to this tradition we should all aspire to ensure that pursuit of the common good and reason continue to be the main driving forces guiding these institutions.

Thank you very much for your attention, and my congratulations to all this year's CUNEF graduates