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“Monetary policy making under uncertainty”

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Ladies and Gentlemen,

Good morning and welcome to Paris for the 6th joint conference organised by the Deutsche Bundesbank and the Banque de France. I would like to thank the organisers Emmanuel Fahri, Emanuel Moench and Benoit Mojon for assembling such an interesting set of papers. I will return to the topic of the conference later.

I would like to use my opening remarks this morning to discuss a highly topical challenge for monetary policy: how to enhance confidence and how to respond to policy-induced uncertainty. We obviously live in an increasingly uncertain world. The lack of predictability of US trade policy – or worse, its protectionism - and the lack of clarity about Brexit risks reversing many of the gains of a globally integrated economy. The euro area itself is seeing a return of uncertainty. Winston Churchill once famously said: “true genius resides in the capacity for evaluation of uncertain, hazardous and conflicting information”. Obviously we, Central Bankers, do not claim to be geniuses, but our duty as policy makers, is to deal with this uncertainty, while sticking to our mandate.

I. How to enhance confidence?

I don’t need to repeat today the important decisions we announced at our recent Governing Council meeting in Riga. We expressed our confidence in the convergence towards SAPI (a sustained adjustment in the path of inflation). Let me elaborate somewhat on the foundations of this confidence, looking first at economic data and forecasts and second at some principles of our monetary policy.

Data and forecast

In economics, it can be hard to know exactly where you are. Monthly and quarterly data can be quite jumpy and there are often multiple plausible hypotheses to explain them: measurement error; abnormal season effects; one-off effects like strikes or natural disasters; or a genuine change in the underlying economy. What happened to output in Q1 is a case in point. Was the slowdown from 0.7% real GDP growth in Q4 2017 to 0.4% in Q1 2018 mismeasurement errors across quarters? Unusually cold weather or a German influenza outbreak? A sign of concern about a potential trade conflict? Or a warning of a slowdown in underlying economic growth? The Governing Council judged that it was largely a moderation from the exceptionally strong growth of Q4 compounded by some temporary and supply-side factors at both the domestic and the global level, as well as weaker impetus from external trade.

The Euro-system staff projections of economic growth of 2.1% in 2018, 1.9% in 2019 and 1.7% in 2020 remains consistent with an ongoing solid and broad-based recovery; the French economy, which is sometimes considered to be a good proxy for the Euro-area average, is likely to follow a similar growth path with 1.8%, 1.7% and 1.6% in 2020 according to the Banque de France.

On the inflation outlook, as part of the SAPI criteria, recent ECB and Euro-system staff projections have become more and more stable giving us increasing confidence that the improving economic growth we have seen will translate into rising wage and price inflation. In other words, whilst we might be a bit less certain precisely where we are in the cycle, we are more confident that we are heading in the right direction on inflation.

Monetary policy decisions

When would the Governing Council end the net asset purchases? When would it announce this decision? These were questions left hanging and the subject of market speculation before our meeting in Riga. Besides the famous and important three "Ps" – perseverance, patience and prudence - the Governing Council's decisions were also guided by three "Cs": credibility, consistency and clarity. Each element is important.

- **Credibility**: Our actions are credible because they stick to our mandate and our economic forecasts, in particular with respect to the inflation outlook. And we were obviously wise not to change the inflation target of 2 % over recent years despite many different calls to do so.
- **Consistency**: We acted consistently with what we have previously said as was the case in our previous packages of December 2016 and October 2017. This consistency helped to have, at least since March, an "alignment of the planets" between the Governing Council's views and those of outside forecasters, including market expectations. It was important that we announce the end of the net asset purchases as soon as we felt the SAPI criteria would be met.
- **Clarity**: Uncertainty is today the number one enemy of growth and financial stability. By providing clear guidance on the path of asset purchases and interest rates – once more several months in advance - we have done our best to reduce uncertainty about future monetary policy conditions, at least out to the horizon that it is prudent to do so.

The consistency, credibility and clarity of the Riga decisions was reinforced by the fact that they were agreed unanimously, demonstrating strong cohesion within the Governing Council. In this divisive world, in this divisive Europe - unfortunately, on tough issues like migration - this cohesion was our shared responsibility and duty to protect the common good of 340 million Europeans: their currency, the euro. They support it at an overwhelming majority of

74% - confirmed in the Spring 2018 Eurobarometer, with an increasing majority in Italy. This confidence in the euro obliges us to act together.

I would like here to welcome another recent positive commitment from political leaders: the Franco-German agreement in Meseberg. The message is clear and threefold:

i. The Eurozone needs, besides Monetary Union, a strengthening of the Economic Union. If not, monetary policy would remain the only game in town, and be at risk of being overburdened by the next recession.
ii. Economic Union needs public risk sharing – an enhanced ESM and a euro-zone budget – as well as private risk sharing. Let me also stress this one, adding Banking Union – with a fully credible resolution mechanism – and Capital Market Union. CMU – which we strongly advocate with President Jens Weidmann and the whole Governing Council - fortunately is in the Declaration too, with a commitment to realise “decisive progress”.
iii. Europe needs a Franco-German impetus. Both countries took their responsibility, still on time. It is now up to the 19 to elaborate a common and operational package. The Euro-zone should seize this moment: it’s now or never.

II. Policy-induced uncertainty

The global and European economy is confronted by two possible policy shocks: trade and fiscal policy. Since we are currently enjoying the World Cup, it seems appropriate to call these policy-induced own goals.

Rise in protectionism

The first of these is the risk to the global trading system of the **rise in protectionism**. The initial measures announced so far by the United States and then China only cover about 1% of global imports and should have limited *direct* effects on inflation and activity. But they have logically triggered retaliation by other countries or regions and the risk of an escalating and global trade war is no longer unthinkable.

The classical analysis of the macroeconomic impact of higher trade tariffs treats it as a negative supply shock involving a trade-off between lower output and higher prices, at least in the short run. Studies that use this rather mechanical approach tend to find significant but still relatively limited effects. The IMF, for example, has examined the fairly severe scenario of a global rise in tariffs that causes a 10% increase in import prices but conclude that this would only lead to a 15% fall in global trade and a drop of around 2% in world GDP after 3 years.

This type of analysis, in my view, seriously underestimates the possible effects because it ignores the shock to confidence through two channels. Firstly, uncertainty can increase risk aversion in financial markets and reduce the supply of credit. Second, a loss of business confidence can deter investment. Both uncertainty channels would tend to depress demand. What's more, they can be front-loaded and occur before any trade restrictions come into effect. Indeed the damage can be done even if no additional trade restrictions are actually imposed.

A good example of outcomes before the facts is Brexit. For the time being, the UK has conducted a referendum and triggered Article 50 but doesn't leave the European Union until March next year: there are no tariff or trade barriers. Yet the pound fell immediately after the referendum result in anticipation of more difficult external trading conditions in the future; this has substantially hurt the purchasing power of UK households. Business investment slowed down – as apparently it has in Canada due to NAFTA uncertainty. The Bank of England estimates that UK real GDP is already 1¾-2% lower than it otherwise would be as a result of Brexit.

Fiscal policy

Uncertainty about **fiscal policy** in many advanced economies is a second source of policy-induced uncertainty. Public debt has risen significantly since the Great Recession. Average gross government debt in the Euro Area rose from around 65% of GDP in 2007 to peak at over 90% in 2014 and is currently still over 85%, despite the fact that primary balances have improved on average across the Euro Area.

The macroeconomic costs of fiscal uncertainty can be felt even without an actual sovereign debt crisis. Risk premia increase and raise the cost of borrowing but without any risk-adjusted increase in return for savers. The risks of fiscal uncertainty are highly non-linear and one could almost say binary due to the reaction function of financial markets, as we have seen since 2010 in the Euro-zone. Below a certain threshold, fiscal uncertainty has very limited effects on sovereign borrowing spreads or economic activity. But once public debt reaches levels at which its sustainability comes into question, for some financial investors at least, there is the risk of self-fulfilling crisis. This uncertainty can weigh heavily on investment and growth.

III. Monetary policy response to policy-induced uncertainty

How should central banks respond to this policy-induced uncertainty? I would like to return to the three C's I mentioned earlier: credibility, consistency and clarity.

To protect our credibility, we need to stick to our mandate of *price stability*. And in this regard I would say that we are more certain about the path of inflation than we are for growth. A protectionist shock would be undoubtedly bad for growth but the effect on inflation is more ambiguous, at least in the short run. A persistently high oil price would as well be negative for growth but contribute to inflation.

Sticking to our mandate also means *no fiscal dominance*. The relationship between monetary and fiscal policy ultimately depends on who determines the price level. The risk with fiscal dominant regimes is that inflation rises in line with public debt because people expect it to be eventually monetized by the central bank. Modern central banking is unambiguous on this point – we cannot have fiscal dominance and the path of inflation is set by the central bank. Not only are central banks forbidden from monetary financing, the timing of monetary policy decisions is not determined by the fiscal problems of member states.

The second C is consistency. Theoretical models often assume the existence of a central bank reaction function. A well-known reaction function can be a powerful tool in stabilizing output and inflation because yield curves can adjust in anticipation of future policy in line with the evolving outlook for the economy. To return to my football theme, Mervyn King referred to this as the Maradona theory of interest rates. But credible reaction functions don't fall from the sky and need to be earned by communicating and acting consistently through time. We are and will remain predictable for our stakeholders. Through its forward guidance, the Governing Council has also indicated its intention to move gradually and in accordance with the data. Faced with uncertainty about the strength of the transmission mechanism, we should be guided by pragmatism - the level of inflation relative to the medium-term objective - and gradualism.

The final C is for clarity. Central bankers should try to spell out what they will and won't do as much as possible. On the first part, we were clear in Riga; on the second part, let me stress that we cannot fully compensate for the uncertainty created by other policy-makers; nor can we fully offset their effects. We have shown in the past few years that monetary policy is flexible, and we have been willing to use every instrument within our mandate to respond to too low inflation. We have gone well beyond what people thought possible and we will do whatever is necessary to deliver on our price stability mandate - no more and no less.

Thank you for your attention