François Villeroy de Galhau: Monetary policy in the present environment - reconciling clarity and flexibility, as well as independence and cooperation

Remarks by Mr François Villeroy de Galhau, Governor of the Bank of France, at the Group of Thirty's annual International Banking Seminar, Bali, Indonesia, 14 October 2018.

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Good morning. Let me begin by thanking the organisers of this seminar for the opportunity to speak on such a distinguished panel.

I'd like to elaborate on two challenges. The first is domestic and concerns how we, as Euro-area central bankers, decide and communicate about the gradual normalisation of our monetary policy in uncertain times. The second challenge is a collective one: how we co-ordinate facing diverging economic paths.

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1. <u>Our domestic challenge in the euro area: combining clarity and flexibility</u>

The Euro-area is experiencing a broad-based economic expansion. Q2 2018 was the 21st successive quarter of economic growth. 9.2 million jobs have been created since 2013 and the unemployment rate has fallen from 12.1% to 8.1%, although this figure is still too high. There are increasing signs that the labour market is tightening and nominal wage growth is picking up: the Phillips curve is back to work, albeit a bit later than expected. The output gap was probably closed by the end of last year. We are increasingly confident in the sustained adjustment in inflation back to our objective, with our forecast for 1.7% in each of 2018, 2019 and 2020, vindicating our unanimous decision in June to pursue a course of gradual normalisation.

There are, however, growing uncertainties: protectionism could weigh on business confidence and investment; many EMEs are struggling with the US policy-mix – a warranted monetary policy normalisation, having to cope with a less warranted fiscal stimulus; and financial market valuations that remain stretched despite the recent correction. Within Europe, Italian fiscal policy is under investor scrutiny. And there is Brexit, although its direct effect on the euro area macroeconomy is likely to be small.

How should we respond to this uncertainty? By combining two apparently contradictory aims, clarity and flexibility:

Clarity – Our first duty as policymakers is to provide markers to help guide economic actors and financial markets in the increasing fog of uncertainties. For our guidance to be reliable, we need to be as clear, credible and consistent as possible. We cannot be clear like a train timetable but more like how a captain sets a course and adapts to the wind and the waves. So our sequence of steps for policy normalisation is very predictable: first, we halved our net asset purchases to 15 billion this month and will very probably end them in December. Second, we set down a guide post with our long-dated forward guidance: we will maintain interest rates at current levels until at least through the summer of 2019. And third, we will retain our stock of assets for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Moreover, this sequence doesn't depend on the fiscal uncertainties that can appear in member states. The Governing Council is clear about the fact that there is no fiscal dominance in the euro area and no influence of any national fiscal policy on our common monetary policy.

Flexibility – Our sequence is clear but the details of implementation are flexible and statedependent. We have included several options to deal with incoming data. Let me illustrate this on two points:

- One frequent focus of speculation is the precise timing of the first increase in interest rates and the path of policy rates thereafter. Obviously, we have to consider here the trade-off between more clarity today and flexibility tomorrow. It is true that forward curves beyond the second half of 2019 are somewhat volatile. But for the time being, this volatility is relatively modest, and certainly so for interest rates that matter for the economic decisions of households and corporates. Therefore the trade-off currently favours keeping our options open. I wouldn't see any value in trading off our flexibility tomorrow against more clarity today but as we approach the summer of 2019, the balance will shift in favour of detailing our forward guidance.
- We also have flexibility over reinvestment. We will soon discuss, as Mario Draghi said, the technicalities of our 2019 reinvestments to ensure market neutrality. But we should keep our options open about the timing of our reinvestment in the following years.

In the face of uncertainty, one often hears reference to the celebrated Brainard[1] 'conservatism principle' (as reinterpreted by Alan Blinder[2]. This is not, as the impression is sometimes given, a general warning to move cautiously when the world is uncertain. The Brainard 'conservatism principle' says only that you should move cautiously if you are uncertain about the effect of your policy instrument on your objective. But we should go beyond a static view of Brainard's principle [which focuses on one single small step] a dynamic view would include the time dimension and consider how to manage and communicate a sequence of incremental steps.

2. Our collective challenge facing divergence: combining independence and co-operation

The global economy continues to expand strongly but we are now seeing a strong divergence in performance. We have used a lot in the latest IMF-WEO forecasts, the nice French word « plateau » to describe global growth. But this "plateau" is not even: a strong acceleration in the US, even if it is temporary and fragile, offset by a moderation in growth in the rest of the G7. Some prominent emerging market economies are either expected to slow down rapidly or record only modest growth. In short we are moving from synchronized growth to economic divergence.

In many cases, this divergence reflects differences in the economic cycle and idiosyncratic shocks. More worryingly, from a systemic point of view, however, is that some countries might be suffering from the ongoing rise in US interest rates. Helene Rey's famous paper in 2013[3] argued that floating exchange rates are not sufficient to give countries independence from US monetary policy if they have an open capital account. If the trilemma is in fact a dilemma, then countries will have to choose between monetary independence and closing their capital accounts.

I would contest the generality or starkness of her dilemma. For example, I think the euro area can determine its own course. Our asset purchase programme has contributed to a spread exceeding 250 basis points between the 10 year yields in the US and in Germany. Likewise, the gap between policy rates in the US and the euro-area is the widest since 2009. More technically, an estimated Taylor rule for the euro area that includes US monetary policy as one of the explanatory factors finds only a very modest co-movement between the two.

Countries instead seem to be arranged along a continuum, with some exhibiting total independence at one end to those with exchange rates pegged to the US dollar at the other. Countries don't have to choose one of the two polar positions but can pick an intermediate position. For example, putting some temporary restrictions on cross-border movement of capital could give some but not complete independence of monetary policy.

But is there more that we can do to manage the tensions created by these economic divergence? Put another way, how do we reconcile yet another paradoxical couple: independence and co-operation?

Obviously the question is not to go back to a world of accords negotiated in hotel suites. But we can and should act to enhance co-operation between central banks. Such co-operation includes four elements:

- Mutual predictability of policy making. We will achieve the closest to a co-operative solution if we avoid large surprises between policy makers. While trade multilateralism is at risk, monetary and financial multilateralism stands fast, fortunately. This means continuing to favor dialogue and exchange of information among central banks, and to be very clear about our monetary policy regime choice. We should cherish the “great convergence” of policy objectives of the last fifteen years. Among major advanced economies, we now have domestic inflation targeting around a 2% medium-term objective.
- We are ruling out any currency war, as clearly stated in our unanimous Bali communiqué: ``We will not target our exchange rates for competitive purposes’’.
- On capital flow management (CFM) measures, we should support the ongoing reflections undertaken within the relevant international bodies and give priority to practical and pragmatic solutions – IMF type – rather than dogmatic purity.
- Last, I can only quote you, Tharman, and your impressive EPG report: “It is critical that we put in place a reliable Global Financial Safety Net before the next crisis” and co-ordinate its different layers. This should include “an IMF standing liquidity facility.’’ The global financial safety net is the best insurance we can get against the risks created by economic divergence and it comes at a limited cost.

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So, in conclusion, we as central bankers should be predictable without being pre-committed. In other words, we should give clarity without pretending to certainty. Voltaire summed this up nicely in 1770: “Doubt is an uncomfortable condition, but certainty is a ridiculous one.”[4] In these times of doubt, the Governing Council of the ECB is committed to give as much clarity as possible; clarity, not certainty, which is neither possible nor desirable. Thank you for your attention.

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1 Brainard, W. (1967), « Uncertainty and the effectiveness of policy » the American Economic Review, Vol. 57, No. 2, Papers and Proceedings of the Seventy-ninth Annual Meeting of the American Economic Association, May, pp. 411–425.

2 Blinder, A. (1999), Central Banking in Theory and Practice, the Lionel Robbins lectures, MIT Press, Cambridge Massachusetts.

3 Rey, H. (2013) “Dilemma not Trilemma: The global financial cycle and monetary policy independence”, Jackson Hole conference proceedings, Kansas City Fed.

4 Letter to Frederick William, Prince of Prussia (28 November 1770).