Christian Noyer: The power of monetary policy

Speech by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Paris Europlace Financial Forum, Tokyo, 25 November 2014.

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Two weeks ago, I had the privilege to chair in Paris our triennial Banque de France Symposium. Governor Kuroda made us the great favor to participate. At that Symposium, one speaker remarked that, during the financial crisis, Central Banks in most countries had been (quote) "the only game in town" (end quote). And he went on wondering whether this would still be the case in the future. This observation captures the essence of my remarks today. I would like to talk about the power of monetary policy in the current – low inflation – environment.

Central Banks have been all powerful and decisive in fighting off the biggest financial crisis of the last 70 years. And they succeeded in avoiding a prolonged recession and the collapse of our financial system. Today, however, they are facing a different challenge. Growth has been disappointing in many parts of the world and forecasts have been constantly revised downward. Even more worrisome for central banks, inflation has persistently undershot our definition of price stability. For the euro area, it has declined from 2.5% in 2012 to 0.3% in annual terms, as of last September. This drop in inflation has occurred despite the most accommodating monetary conditions ever witnessed in Europe. So one may ask whether monetary policy will be as successful in the post crisis era as it has been during the crisis; and whether it will manage to avoid the perils of persistently low inflation.

I will concentrate my remarks on the euro area, taking advantage of being in Tokyo to draw some lessons from the Japanese experience, and, I should say in the presence of Deputy Governor Nakaso, from the deep expertise of the Bank of Japan.

One may harbor doubts about the power of monetary policy for two reasons. The transmission mechanism may be impaired; and the equilibrium interest rate may be so low (or even negative) that it becomes impossible to reach.

The first point speaks for itself. The Eurozone has suffered from acute segmentation and severe impairment in its money and credit markets. Those failures have been addressed aggressively through a set of measures I will detail in a moment. Results have been significant. The so-called Target 2 balances have been reduced by half, which means that banks across the Euro area do not rely, to the same extent, on the network of central banks to intermediate their operations. We have now completed with success and credibility the first Asset Quality Review in our banking system, and the new Single Supervisory Mechanism has been made operational last week. Those measures will be essential in restoring a well functioning credit channel and eliminating the remaining differences in financial conditions across the Eurozone.

Let me now come to the second point: the equilibrium interest rate and why it matters for monetary policy.

The concept is familiar to economists since the great Knut Wicksell. The "natural" or equilibrium interest rate is expressed in real terms. It equals savings and investment at full employment and price stability. It provides a central guidepost for assessing the monetary stance. For instance, if the market rate is above the equilibrium rate, there is excess saving, as well as insufficient consumption and investment. As a consequence, inflation falls.

The equilibrium interest rate is not stable. It has fallen significantly since the financial crisis, possibly to negative levels. To maintain price stability and avoid persistently low inflation, market rates must be reduced as well. In normal circumstances, this can be achieved by lowering the policy rate, with subsequent effects on the yield curve. However, when the

policy rates get to zero – the so-called zero lower bound – this “conventional” approach to monetary policy is not available anymore. To avoid an involuntary tightening of monetary policy, central banks must resort to unconventional measures. As I will describe in a moment, a wide array of such unconventional tools have been deployed in the Euro area.

Low equilibrium interest rates can be temporary or permanent. In truth, we don’t really know. We do know, however, that very low inflation, if allowed to persist, can only aggravate the situation, because, everything else being equal, low inflation increases the real interest rate. In turn, higher real interest rates tend to depress economic activity and bring even lower inflation. This is the kind of spiral, possibly leading to deflation that monetary policy must seek to control and avoid.

The process may become even more self-sustaining if it negatively affects inflation expectations. Over the last months, inflation expectations in the euro area have dropped to 1.2% at a one-year horizon and 1.5% at a two-year horizon. More worrisome, long-term expectations – up to now extremely well-anchored around 2% – have been drifting downward. Markets currently expect an inflation rate of 1.8% on average between 2019 and 2024 in the Eurozone.

Monetary policy therefore must aim at influencing both nominal interest rates and inflation expectations. This is exactly what we are currently doing in the Eurosystem. Let me explain how.

First, on nominal interest rates:

Policy rates are now close to zero (%). Negative interest rates have been imposed on the deposit facility. Forward guidance has been used to signal that rates will stay at those levels for a very lengthy period of time. A new liquidity facility, the “targeted very long term refinancing operation (TLTRO)” has been created, with a four-year maturity and, for the first time, a guaranteed fixed rate. Basically, banks are able to get a four-year funding for a 0.15% fixed interest rate. Most recently, the ECB Governing Council has decided a program of private asset purchases, for both covered bonds and ABS. Those purchases will have two positive effects on interest rates and credit: they will further ease banks’ funding conditions; and they will bring down risk premia on private assets.

Those measures have been extremely effective. Our overnight interbank rate, the EONIA, has durably settled in negative territory. The yield curve has shifted downward, both at the short and long ends. Spreads on sovereigns have dropped: Spain today issues debt at a lower rate than the US. Expectations for future overnight rate (the so called OIS) are flat and close to zero for the next three years.

So, our action on nominal interest rates has been strong and efficient. What about inflation expectations?

It would be very dangerous in the current juncture if the Central Bank was perceived as being more tolerant towards low inflation than towards too high inflation. Such an asymmetrical approach to price stability would “validate” falling inflation expectations. And the economy would durably settle into low inflation equilibrium where any negative shock could push it into outright deflation.

To protect ourselves against such misperception, our Governing Council has unanimously stated that, should it become necessary to combat persistently low inflation, it is committed to using additional unconventional instruments within its mandate.

The Eurosystem has also started to communicate on the size of its balance sheet, a topic that has recently attracted a lot of attention. The Governing Council has indicated that it now expects its balance sheet to get back towards the size it had in early 2012. That would imply an increase of around 1 trillion euros. There is considerable debate amongst economists and market participants as to whether the size of a central bank’s balance sheet is a relevant

parameter; and, above all, whether it has an impact on inflation expectations. Let me give you my take on this.

The statement by the Governing Council is not formulated as a firm commitment but as an expectation. Nevertheless, it is very significant. It should certainly be seen as a clear indication that further policy action, if necessary, will not be inhibited by any overall quantitative restraint or limit. This is all the more important that the Eurosystem balance sheet will be expanding whereas balance sheets of other central banks are bound to contract. Communication on the size gives a very concrete signal and content about future policy intentions. As such, it can only help in bringing expectations more in line with our definition of price stability.

I will end up with two remarks on the relationship between monetary and other policies.

First, when inflation is low, it matters whether nominal wages are rigid or flexible. Japan benefits from a high degree of wage flexibility. That is favorable to competitiveness, but may increase the economy's vulnerability to deflationary pressures. By contrast, in Europe, and especially in France, nominal wages are fairly rigid and keep growing, even in the current context, at a robust 1.1% annual rate. While this may be negative for profits and competitiveness, it currently provides a buffer and protection against any deflation risk.

Second, on fiscal policy: If, following Milton Friedman's famous statement, "inflation is always and everywhere a monetary phenomenon", central banks should be able to control inflation in all circumstances. I believe this is fundamentally true. Recent experience has shown, however, that monetary policy is most efficient when operated in a supporting environment, especially as regards fiscal policy. This is often presented as a case for "cooperation" between fiscal and monetary authorities. I am not fully comfortable with this concept, as I don't see how it fits with central banks' independence. However, there is no denying that fiscal and monetary policies interact, more or less harmoniously. Following the crisis, concerns have been expressed on the risk of "fiscal dominance" as major central banks were engaged into large purchases of Government bonds. In the current low inflation environment, the issue is different. Depending on how they are conducted, fiscal policies can either increase or decrease the overall economic uncertainty. More uncertainty means more savings and even lower equilibrium interest rates. Through this channel, fiscal policies have the capacity to complicate the conduct of monetary policies, or, on the contrary, to make it easier. This is especially true in the Euro area, where the single monetary policy interacts with 18 (soon to be 19) national fiscal policies. There are rules and frameworks in place to reduce the uncertainty associated with this interaction. Whether they are, or not, correctly implemented will make a big difference in our capacity to quickly return to price stability.