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MONETARY POLICY AT CRISIS TIMES

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1. Introduction[1]

It is a real pleasure for me to share my thoughts before such a distinguished gathering here at the *Centre International d'Etudes Monétaires et Bancaires.*

Advanced economies have all lately witnessed a "sequence" of crises which had a considerable impact on the state of the financial system and the global economy at large. For the euro area, the last few years have been especially turbulent. The sovereign debt situation in some euro area Member States is at the heart of concerns about financial and economic stability in the euro area.

The sovereign debt crisis pointed to an imperfect implementation of economic – but clearly not monetary – governance in the euro area. As a currency, the euro has been a success. At the same time, it has become clear that continued success hinges crucially on overall sound economic and financial policies in the euro area Member States.

With this in mind, I will structure my remarks under two main headings. First, I would like to briefly review some key elements of the institutional framework governing monetary and fiscal policy in European Monetary Union. Thereby, I will point to the root causes of the sovereign debt crisis but also to the considerable progress made more recently in putting fiscal governance on more solid footing.

Second, I will more closely review the role of monetary policy in the mist of what turned out to be the worst crisis since the Great Depression, arguing that the ECB has boldly reacted to it with a series of both standard as well as non standard measures, in full preservation of its medium-term oriented mandate of price-stability.

2. The crisis, institutional framework and policy responses

The crisis has reinforced the insight that monetary union needs to be based on fundamentally solid institutional anchoring. So let me take the occasion to revisit some of the institutional rationale behind the construction of European Monetary Union.

One main anchor of this framework is an independent monetary authority primarily entrusted to deliver price stability. However – as we have witnessed – appropriate monetary policy strategy and actions by the central bank are not necessarily sufficient to maintain macroeconomic stability. Stability also requires appropriate fiscal policy, namely a credible

[1] I would like to thank Marco Catenaro and Wolfgang Lemke for their contributions to the preparation of this keynote speech and Oreste Tristani for his useful comments.

commitment by the government to ensure that any temporary increases in deficit will be eventually offset by corrective measures.[2] Hence, the second anchor of a monetary union is governments that are committed to maintaining solid public finances.

The institutional framework governing EMU reflects these insights. On the central bank side, the maintenance of price stability over the medium-term is the most important contribution that monetary policy can make to sustainable growth, employment, and social cohesion. On the fiscal side, the institutional framework reflects our long-standing experience that sound and sustainable fiscal policies are in turn fundamental to fostering longer-term sustainable economic growth.

Following these principles, monetary and fiscal policies are mutually re-enforcing. Solid fiscal policy is conducive to a macroeconomic environment that facilitates the task of a stability-oriented central bank. At the same time, credible monetary policy contributes to a smooth conduct of fiscal policies by guaranteeing stable inflation expectations and low inflation risk premia, which is in turn beneficial for the level and volatility of long-term government bond yields and therewith sovereign financing costs.

For both policies to successfully do their jobs, a clear assignment of their objectives and reign of action is warranted in a monetary union. While fiscal policy is ideally suited to absorb country-specific shocks, monetary policy safeguards price stability in the monetary union as a whole.

This is what the "founding fathers" of EMU had in mind when they assigned the responsibility for monetary policy to the Eurosystem endowing it with the primary objective of safeguarding price stability across the euro area as a whole. Such assignment was flanked by the provision of a high degree of independence to the ECB – institutional, financial as well as functional.

As a core component of its monetary policy strategy, the ECB has from its start announced a quantitative definition of price stability to be maintained over the medium term. In 2003 the Governing Council has clarified that it aims to keep HICP inflation below, but close to, 2% over the medium term to achieve its objective. This decision was intended to serve also as a hedge against the risk of deflation occurring.

As another component of its strategy, the ECB has announced a clear framework for assessing the risks to price stability. Within its "two-pillar" strategy, the short-to-medium

[2] See e.g. Michael Woodford, 2001, "Fiscal Requirements for Price Stability", Journal of Money, Credit and Banking 33, pp. 669-728.

term indications on inflationary developments stemming from its economic analysis are "cross-checked" with the signals extracted from the monetary analysis.

More than thirteen years after its inception, we can state that the Eurosystem and its monetary policy have delivered upon their responsibilities. The policy measures by the ECB Governing Council have resulted in an inflation rate which is in line with our quantitative definition of price stability.

On the fiscal side, the picture has been less positive, though. The fiscal stimulus measures in response to the financial crisis, large-scale government support programmes for ailing domestic banking systems, the working of automatic stabilizers and eroding tax bases in the face of weakening growth have put government budgets in the euro area countries under intense pressure. However, let me emphasise that for some euro area countries government budgets had already suffered from lax fiscal policy before the crisis. Governments which entered the crisis with significant fiscal imbalances exited the recession with the highest deficit and debt-to-GDP ratios recorded in times of peace. The aggregate fiscal balance of the euro area increased from a close-to-balanced budget in 2007 to a deficit of more than 6% of GDP in 2010, with a debt ratio rising from about 66% in 2007 to more than 85% in 2010 – and still increasing. This already drastic aggravation of public finances in the aggregate masks much more extreme developments for some individual countries.

The sovereign debt crisis has shown that sound public finances are all the more important in a monetary union where a large number of independent fiscal policy-makers share the benefits of a single currency, gaining access to a large pool of savings and being immunized against exchange-rate risk.

Originally, it was expected that financial market pressures as well as Treaty obligations would provide strong disciplining devices for Member States to maintain sound public finances and to engage in structural reforms.

Firstly, financial markets were expected to discriminate between sovereign borrowers, leading to differentiated long-term bond yields across issuers with differing degrees of fiscal soundness.[3]

However, as we have seen during several years before the crisis, markets did not come up with differentiated pricing, but rather with a fairly complacent pricing of risk across the board. In the wake of the financial crisis, these – one might say, "falsely comforting" – steady states have abruptly turned around. On the one hand, the government bond yield increases

[3] See e.g Rudi Dornbusch, 1997, "Fiscal aspects of monetary integration", American Economic Review Papers and Proceedings 87, pp. 221-223.

that we saw over the last years certainly contained episodes of overshooting, not fully reflecting economic fundamentals. On the other hand, the re-pricing served as an important wake-up call that strongly pushed for consolidation of public finances and urged policymakers to re-think fiscal governance in Europe.

Secondly, euro area countries were bound by the "no-bail-out" rule and the Stability and Growth Pact. They were supposed to implement the necessary structural and fiscal policies to ensure sound and sustainable economic positions within EMU.

However, when we look backwards, the joint responsibility for effective surveillance too often took the form of "peer support" instead of "peer pressure". It became also clear – and the ECB had warned several times – that the intended "more intelligent" interpretation of the SGP ultimately failed to produce the desired increase of ownership, which can only be gained if all agents internalise the rationale behind sound, simple and easily monitorable rules. The role of such rules was, and remains, to provide credible incentives for sound fiscal and macroeconomic policies in a monetary union.

In this sense, it is encouraging to see that important steps have recently been taken. One step was the governance reform package (the so-called "six pack"), which came into force in December 2011. It strengthens both the preventive and the corrective arm of the Stability and Growth Pact and establishes minimum requirements for national budgetary frameworks. It was also important that the Heads of State or Government have further agreed on a new "fiscal compact" with a view to achieving a more effective disciplining of fiscal policies. Major elements of the fiscal compact are the strengthening of the role of the balanced budget rule and a further tightening of the excessive deficit procedure. It is of utmost importance, that the rules are now fully implemented in the spirit of this agreement. All these measures aim to ensure that individual countries live up to their responsibilities to bring their public finances in order.

In addition to imbalances in public finances, the crisis has also brought to the fore two additional key issues: first, cross-country differences in competitiveness and economic growth; and second, the importance of interlinkages between banks and sovereigns.

As regards the first issue, in some euro area countries – as I said before – the incentives to engage in structural reforms have been obviously insufficient. For these member states it is now all the more urgent to undertake structural reforms to regain competitiveness, thereby strengthening growth prospects and job creation. This includes fostering competition in product markets, particularly in services sectors, and the reduction of rigidities in labour markets.

As regards the second issue, let me stress the importance of a more sound and resilient financial system. In this respect, recent steps like the Basel III framework mean some good progress in this direction. Nonetheless, further bold policy actions need to be taken. This includes in particular the establishment of effective bank resolution schemes for systemically important financial institutions and an improved supervisory framework with new macro-prudential tools. The establishment of the European Systemic Risk Board and the three European Supervisory Authorities are only first steps.

Finally, while the reforms of economic and financial governance that I mentioned are vital, it is crucial that all these measures are complemented by a set of instruments that can directly address financial market tensions. In other words, we need firewalls that tackle the threats to financial stability and the risk of contagion – both between different sovereign debt markets, but also between sovereign debt markets and other financial market segments. Therefore, the setting up of the European Financial Stability Facility (EFSF) and its successor, the European Stability Mechanism (ESM), represent important additions to the architecture of EMU. In this context, I very much welcome the decision by the Heads of State or Government to let the ESM enter into force already by July 2012, that is, one year earlier than originally planned.

3. Monetary policy at the crisis: framework and recent measures

Having identified the need for reforming the framework for fiscal governance, the question arises whether the institutional framework governing euro area monetary policy would also benefit from some changes or finetunings. My view here is that our framework, with the important institutional elements – that I have mentioned earlier – has in fact served us rather well in conducting monetary policy both in turbulent and more tranquile times.

Nevertheless, recently some calls have been made on euro area monetary policy to adapt its set of rules and to concede to the needs of other policy areas. Before I come back to this, let me take a step back and look at the experience of other central banks, which have – compared to our own relatively young institution – a longer history.

In the period after the Second World War in the United States, the Federal Reserve had to completely accommodate the debt management policies of the Treasury. With inflationary pressures rising, the conflict between the Federal Reserve and the Treasury escalated and ended with the Fed-Treasury Accord of February 1951, which provided to the Federal Reserve the independence to conduct its own interest rate policy. Central bank independence has become a paradigm that is considered an essential element of any stability-oriented monetary policy frameworks until today.[4]

Since the mid-sixties, the professional climate on monetary policy making was gradually changing: monetary policy came to be more and more regarded as ancillary to fiscal policy or was at least urged to coordinate closely with it. Loose policies during downturns failed to be offset by tightened conditions over upswings. The result was a creeping public debt and ratcheting inflation.

This example points to the risk of watering down established principles of monetary policy. The important lesson to draw is that monetary policy makers need to be highly alert when vested interests start to question the central bank's mandates, responsibilities and operating frameworks. This holds in particular around crisis times.

Currently, one of the most pressing challenges is the idea that a central bank – and the ECB in particular – should act as a "lender of last resort". The traditional definition of lender of last resort typically refers to a reserve financial institution, most often the central bank of a country, which directly intervenes in the market or via the extension of credit lines to avoid bankruptcy of banks or other institutions deemed solvent. Provision of funding is therefore direct, albeit temporary in nature.

Different is the notion that the central bank should act as the lender of last resort vis-à-vis sovereigns, as it has recently been advocated. When calls are made for a central bank to play the role of "lender of last resort" in government bond markets, such calls effectively amount to the central bank being asked to directly fund illiquid sovereigns, either via direct interventions on the primary market or by extending direct credit lines. Such activities are not legally within the reach of the ECB, since the Treaty clearly imposes the prohibition of monetary financing (Article 123 TFEU). There must not be any circumvention to this prohibition. Again, this Treaty provision was not chosen arbitrarily. It is based on the experiences in many countries over several decades, which taught us that a central bank that bows to the needs of public finances cannot ultimately be successful towards delivering upon its medium-term oriented price-stability objective. In particular, moral hazard could weaken incentives for governments to pursue fiscal consolidation to safeguard or restore fiscal sustainability. This will ultimately endanger price stability, and macroeconomic stability more generally.

[4] See, e.g., Michael Bordo, "Central Bank Independence and Financial Crises in History", Paper prepared for the Austrian National Bank Conference "Central banking after the crisis: responsibilities, strategies, instruments", Vienna, 2010; and Frederic S. Mishkin, "Will Monetary Policy Become More of a Science?" in Deutsche Bundesbank, ed., Monetary Policy Over Fifty Years: Experiences and Lessons (Routledge: London 2009), pp. 81-107.

As a further complicating factor in the current crisis, the problems of public finances and financial stability are closely intertwined. Here, we have to be especially vigilant to shield monetary policy from attempts to engross it into inappropriate financial stability tasks; for such attempts may turn out to be disguised aspirations to drag the well-established paradigms of monetary dominance towards the realm of fiscal dominance.

Against this background, how should one interpret the ECB's interventions in euro area public debt markets through its Securities Markets Program? As we explained at various occasions, the SMP is purely founded on a monetary policy rationale. When we observed that tension in some euro area sovereign debt markets were threatening a smooth functioning of the transmission of our monetary policy, we set up the SMP in order to support depth and liquidity in those market segments which had become dislocated. This was essential so that we can optimally pursue our task of guaranteeing price stability in the euro area.

Overall, it is essential that the clear demarcation lines provided in the Treaty are not violated or shifted. This would constitute in fact a lasting damage and institutional regress to our well-serving monetary policy framework, which would be intricate or even impossible to reverse.

I will now, in the final part of my speech, conclude with a brief review of the main policy decisions more recently adopted by the ECB in response to the crisis. I will not take you on a full tour through our non-standard monetary policy measures that we started to take with the onset of the financial crisis in 2007. I would rather like to focus on the more recent decisions, addressing what we decided at the Governing Council meetings of last year's December and last week.

An important part of the ECB's response to the crisis comes in the form of our "standard" policy measures. In November 2011 the ECB cut its main policy rates by 25 basis points in response to mounting downside risks to the growth outlook of the euro area and the global economy, ultimately threatening price stability. These downside risks were also related to an intensification of financial market tensions. Additional 25 basis points were cut in December, since intensified financial market tensions continued to dampen economic activity in the euro area. Since then, the rate on the main refinancing operations has been at the historically low 1%.

From the onset of the crisis, the ECB has also embarked in a series of non-standard measures – as they are usually labelled – aimed at preserving the proper transmission of monetary policy.

Among the measures announced in December, I recall that the Governing Council decided upon two very long-term refinancing operations with a maturity of three years, the first of which was already conducted last December. This duration is an innovation in ECB monetary policy operations. It serves to give banks a longer horizon in their liquidity planning. It also helps banks to a balanced and orderly deleveraging over the medium term, thereby avoiding "fire-sales" of their assets and avoiding a downscaling of longer-term lending.

A second measure was to expand the set of available collateral. This allows banks to use certain types of loans as collateral, which was unavailable for banks before. The broadening of collateral standards will ensure that the liquidity provided under the three-year LTRO operations will reach not only the large banks but also small and medium-sized institutes. These tend to finance the small and medium-sized enterprises, which are the backbone of the euro area economy.

The third measure was to reduce the required reserves ratio from 2% to 1%. This measure releases liquidity of the banking sector of about 100 billion euro. In combination with other measures, the reduction in the reserve requirements should likewise help revive money market activity and support lending.

Again, the goal of all these measures is to maintain the appropriate credit supply to households and firms, to ultimately guarantee price stability in line with our mandate.

At our recent meeting in February, the Governing Council decided to keep key interest rates unchanged. According to our assessment, inflation is likely to stay above 2% for several months to come, before declining to below 2%. Regarding economic activity, available survey indicators confirm some tentative signs of a stabilisation at a low level around the turn of the year, but the economic outlook remains subject to high uncertainty and downside risks. For the temporary acceptance of additional credit claims as collateral, upon which the Governing Council had decided last December, it approved specific national eligibility criteria and risk control measures.[5] This measure will facilitate a more uniform transmission of the single monetary policy across the euro area.

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[5] The Governing Council approved a first wave of seven NCBs adopting frameworks for accepting "additional performing credit claims" (ACC) as collateral. A minimum quality threshold should apply to all ACC frameworks. However, each NCB may decide to set a stricter minimum quality threshold.

4. Conclusion

Let me conclude. The sovereign debt crisis has brought to the spotlight the weakness of economic governance in the euro area. Important steps forward have been taken for improving fiscal governance and redressing the public finance situation in several member countries. At the same time, macroeconomic imbalances across the euro area need to be addressed by suitable policies geared towards fostering competitiveness and spurring economic growth. In drawing the right lessons from this recent episode, the euro area has the chance to emerge strengthened from this crisis.

As regards monetary policy, the ECB response to the challenges has been swift and resolute. Besides the reduction in policy rates, the Eurosystem has implemented several non-standard measures that ensure the proper working of monetary policy transmission and the provision of liquidity to the euro area banking system. In particular with its most recent measures since December last year, the Eurosystem has crucially helped maintain the credit flow to the real economy.

At this stage it is essential to counteract any attempts that aim to burden monetary policy with tasks that are beyond its mandate of maintaining price stability or violate the principles enshrined by the Treaty. This is a key condition for monetary policy to remain an anchor of stability in turbulent times.

I thank you for your attention.

See also the Box "Implementation of new collateral rules and reserve requirements" in the February 2012 issue of the ECB Monthly Bulletin.