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Monetary Policy in Times of Crisis

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Introduction

It is a great pleasure to be back to the Nomura Central Bankers Seminar. Two years ago was in Kyoto, this time it's in Tokyo.

In preparing my speech for today, I was curious to go back and read again what I had said at that time – it was 15 April 2010. I would like to share with you a few sentences that I said two years ago, so that you can judge whether I was right or wrong in assessing the situation.

> *"Last week-end the euro area member states agreed on the procedure, mechanism and financial amount to support Greece in its fiscal adjustment programme, with*

a defined burden sharing mechanism and non-concessional pricing scheme (...) This announcement makes it clear what the euro area authorities have said since many months, i.e. that a scenario of default and exit from the euro area, which some market participants and observers had toyed with, was simply absurd.

If it was so obvious - one might ask - why wasn't the decision by the euro area countries and the Greek government taken earlier(...) The answer has much to do with political process and the length that it sometimes takes in our democracies to take certain decisions (...) (...) European policy makers may have underestimated the self-reinforcing nature of market trends. If a speculative strategy based on a certain hypothesis, such as the default of Greece, delivers capital gains over time – as has been the case since the fall of 2009 – it is bound to attract an increasing number of investors. As a result, the market pressure increases, making the hypothesis more realistic. The action needed to convince market participants that the hypothesis is unrealistic and to stop the mounting speculative wave has to be firm. Vague statements that some event, such as a default, will not occur, are not sufficient to calm the markets. Concrete *actions are needed. This was not fully understood over the last few months. (...)*

The agreement reached over the last week-end is very important and marks a key turning point in the crisis. But this experience should now be used to create a more efficient decision making process within the euro area aimed in particular at preventing similar situation from occurring in the future and eventually at solving them more efficiently."

With the benefit of hindsight, I was probably right on the diagnose but wrong on the expectation that policy-makers would learn from past mistakes to improve their decision-making. The process has been lousy - to say the least - and the last two years have been quite painful as the crisis has worsened instead of appeasing.

The crisis worsened only three weeks after the Kyoto conference and the European Central Bank was confronted with a series of difficult decisions. I will not recall all the decisions, but in less than two years the ECB decided in particular to:

- relax the collateral requirements for countries which had entered an adjustment programme with the EU/IMF;
- intervene in the Government bonds market with the Securities Market Programme;

- extend Emergency Liquidity Assistance to some banks, to raise interest rates;
- intervene in the securities markets of non-programme countries;
- re-start the 1 year Long Term Refinancing Operations;
- extend these operations to 3 years and
- cut rates.

This is just a short summary of the many decisions that were taken during these two years of crisis.

I would like to address a few issues that help understand how central banks take decisions in time of crisis. They are not presented in any specific order, but I would like to address mainly 6 issues.

Identification

The first important issue is to recognize the nature of the crisis. Crises take different forms and are triggered by different factors, not all of which require central bank action.

Central bank action is needed to address disruption in the economic and financial system which may result from the malfunctioning of markets, especially those markets which are very close to the transmission of monetary policy to the rest of the economy, such as the payment system or money markets. Indeed, the mispricing of certain assets can impair the conduct of monetary policy. Contagion to other markets might also be relevant for monetary policy, to the extent that they can affect the core of the financial system and impair the achievement of price stability.

It is not easy to identify crisis situations which clearly require central banks to take the lead in order to solve the problem. Indeed, most crises have several origins, which are mixed with each other.

To give an example, the malfunctioning of the money market which we are currently experiencing, and which is very close to central bank responsibility, would probably not have occurred without the Sovereign crisis and the associated banking difficulties in several countries. To be sure, the responsibility of solving the sovereign and banking crises is not with monetary policy. On the other hand, even if these problems are addressed forcefully, it is unlikely that markets will start functioning again as they did before the crisis. Indeed, markets tend to overshoot – in both direction – and it may take a long time before confidence between participants is restored. Multiple equilibria may arise, which may be destabilizing and delay the adjustment.

In such a situation, the primary responsibility is not with the central bank. However, without accompanying central bank action there is little chance of success. The central bank has thus to make a fine balance between avoiding to act too forcefully, which would take away responsibility from the other decision makers, and providing sufficient support to the latter to ensure that the adjustment is successful.

Making such an assessment is not easy. It ultimately relies on the distinction between solvency and liquidity problems, of a bank or of a Government. Even in case in which the problem is of a solvency nature, and is being addressed with concrete measure, markets may take time before recognizing that the problem is in the process of being solved and thus provide financing at adequate terms. If markets take time before starting to work again properly, a liquidity problem may arise which, if not solved, may create again a solvency issue.

The decision on whether the central bank should act, and support the adjustment process, ultimately depends on an assessment of whether markets function properly or not. If at a given point in time markets are considered not to function properly, the central bank has to take a view about the action that would be commensurate to achieving a sustainable equilibrium.

We know that markets are not always right, and can make huge mistakes. But we also know that it is very difficult to replace the markets, especially when actions can create distortions in the allocation of resources between the various market participants.

Central banks cannot escape from this dilemma and ultimately have to take responsibility for their decisions.

Accountability

The tasks of central banks in modern times is complicated by the fact that they have to justify their actions, ex ante and ex post. This is not easy because stakeholders do not have necessarily the same expertise as central banks to assess the situation and understand the scope of action of the central bank. A further complication, in the euro area, may come from the fact that economic conditions may be quite different in different parts of the area and, as a result, generate different perceptions about the need for central bank action.

It's clear that as the crisis started in Greece and spread to other parts of the periphery, the awareness of its gravity, and of the need for action was much deeper in these countries, compared to those where financial market conditions were more benign. In Germany for instance, where the economy proved to be relatively resilient even during periods of acute financial tensions, the latter were perceived as being rather remote and not necessarily requiring action by European authorities. They were considered as being mainly the responsibility for the national authorities (especially the authorities of the crises countries), and prompt action by the latter was considered to be sufficient to restore stability.

Contagion was perceived more directly by the countries next in the line affected by financial instability, while those at the end considered it with some distance.

One example of this different perception was the joint hearing by Jean Claude Trichet and Dominique Strauss Kahn at the German Bundestag in May 2010 to explain the causes of the crisis and the need for action by European institutions.

Accountability has to be exercised also ex post. In this respect, central banks know that it is generally very difficult to justify ex post an action which fails to achieve its objective in full.

This brings me to the third issue, of effectiveness of central bank action.

Effectiveness

At times of crises central banks must act in a way that catalyses market forces and achieves success rapidly. If success is not achieved, it becomes very difficult to justify a given action.

There are of course many factors which affect the effectiveness of central bank action, especially when the latter tries to influence the direction of the markets. An important factor – in this respect - is resoluteness. The central bank must show determination in achieving the objective which it has set for its own action. This means in particular that it should stand ready to do what it needs to make markets adjust to its own objectives, even at the price of inferring losses to those who do not follow.

In a fiat money system, the credibility of the currency depends entirely on the willingness of the central bank to stand behind the value of its currency, which implies also the possibility to accommodate any portfolio shift by market participant, towards the most liquid assets like banknotes. For instance, if markets expected that a central bank had put a limit to the amount of banknotes that it was willing to issue, for whatever (strange) reason, they would immediately raise the fear that bank accounts would not be convertible and thus fuel a bank run.

Central bank action is effective if it is aimed at a clear objective, and is implemented with determination. A good example is last year's decision by the Swiss National bank to stand ready to intervene for unlimited amounts if the Swiss franc were to appreciate above 1.20 francs per euro. The decision was well prepared and announced, to the extent that the SNB did not have to intervene so far to achieve the result.

To be effective, actions has to be implemented in a way which clearly shows the determination of the central bank to achieve the objective. The central bank has to show resoluteness and unity of intent. In this respect, the actions by the ECB over the last two years have suffered from the expression of public dissent by one or a few members. Even if this was a minority, it injected in the markets doubts about the willingness of the ECB to "go all the way", if needed, and to implement the policy in a way which would be most efficient.

The dissent expressed (by one member) on the activation of the SMP, in May 2010, has in my view undermined its effectiveness. Furthermore, the weekly publication of the amounts of the intervention has enabled the markets to interpret the intentions of the ECB and it degree of resoluteness. This is a case when too much transparency in the short term is damaging for society as a whole.

In the most recent case, of the 3-years LTRO, the discussions which have taken place recently, notably about the risks deriving from the unprecedented size of the Eurosystem's balance sheet, and the undesirability to have a third operation if needed at a later stage, are again undermining the effectiveness of central bank action.

In my experience, the decision making process of the central banks, in particular that of the ECB, allows for all views to be duly expressed, debated and incorporated. Thorough discussions about the pros and cons of any decision need to be duly weighted. However, once a decision is taken, communication should be aimed at presenting a united view. This is particularly important at times of crisis.

Moral Hazard

Let me move to a fourth issue, which constrains central banks in their policy decisions. Their actions should not become a substitute for the actions of other institutions, such as the fiscal authorities or bank regulators.

Let me make again an example to clarify the issue. In the first week of May 2010, as market participants were getting increasingly worried about the Greek situation, turbulence spread to the other segments of the financial market and beyond Europe. Volatility and correlations reached a peak. The concern was that unless a well-defined safety net was put in place to support the adjustment of countries which had lost market access, a run on the euro would spread, affecting all markets, in particular Government bonds markets.

The responsibility for finding an adequate solution to such a problem was in the hands of the euro area countries. However, it was quite evident that even if the Governments agreed, on that famous first week end of May, on establishing a European Financial Stability Facility, it would take time to implement it. Markets had in the meantime deteriorated so much as to become illiquid and dysfunctional. Without central bank intervention, confidence would not be restored over time. On the other hand, the central bank had to be aware that by intervening to stabilize financial markets, it could relieve the pressure on Governments to do their own part.

The instruments that central banks have at their disposal can be so powerful as to solve many problems, including those that are not under their direct responsibility. If this happens, the other policy makers loose the incentive to do their own part, in the expectation that the central bank will always solve all problems.

Coming back to the May 2010 example, the objective of the ECB was to make sure that Governments would agree, in the upcoming week end meeting, to a sufficiently large safety net, which would be capable of addressing potential problems and thus calm the markets. The ECB knew that this decision would probably not be sufficient to calm the markets, and that it would have had to intervene, in some form or another, to make sure that markets found the new equilibrium. On the other hand, had the ECB made known that it would have been ready to intervene before the Governments have agreed on the safety net, the latter would have had much less pressure to take the decision on time. This is the reason why, at the ECB press conference of 6 May 2010 in Lisbon, President Trichet answered the question about possible interventions by the ECB in the bonds markets with the words "*we did not discuss it*". The intention was to avoid giving the Governments the impression that the ECB would have taken the burden away from them, and unconditionally assumed the responsibility for supporting fiscal policies. Markets reacted negatively to the Trichet statement, but a different answer would have generated moral hazard.

During the whole week-end, as Heads of State and Government and Finance Ministers of the euro area met to discuss how to tackle the situation, the ECB had to hide its cards to avoid taking away the pressure from the Governments to take their own decisions. This was ultimately done, at the last minute, on Sunday night, just before the opening of the Japanese markets – with the announcement of the creation of the EFSF.

We experienced moral hazard in several other occasions over the last two years. One instance was when the provision of Emergency Liquidity assistance to Irish banks, in the Summer and Fall of 2010, released the pressure on the Irish authorities to act decisively to restructure the Irish banking system and to adopt swift budgetary actions aimed at avoid the deterioration of the debt.

Another example of moral hazard was experienced in the Summer of 2011. As Government bond markets started to deteriorate across the board, the ECB decided to extend the SMP to Spain and Italy. It did so, however, based on a judgment about the policy actions that the two countries announced, aimed both at reducing the budget deficit and at implementing structural reforms which would stimulate growth potential and thus alleviate the adjustment cost. The ECB's interventions contributed to reduce sharply the spreads between the bond yields of the peripheral and the core countries. However, as soon as this result was achieved, the pressure to implement the agreed measures was relieved and the Italian Government started to re-discuss some of the measures, which led again to a widening of the spreads. This vanished the effectiveness of the central bank action.

Defining the limits of central bank action is not easy. It certainly requires self-restraint, keeping in mind the final objective of monetary policy, and a complex interaction with the other policy authorities. Let me address these two further issues in turn.

Clear objective

A clear guidepost for defining the boundaries of central bank action is the consistency with the primary objective of monetary policy, which is price stability. This is now widely recognized, including for the Fed as a result of the changes which have been recently adopted.

Central bank interventions at times of crises are much more easy to defend when there are no upside risks to price stability, or if there are risks of deflation. It's clear that price stability cannot be achieved if the financial system collapses, which does not mean – as I just said - that it's only the task of the central bank to intervene in order to stabilize markets. Providing unlimited liquidity to the banking system at times of falling inflation, as it happened after Lehman brothers' failure, is much easier to justify than intervening when inflation rises and monetary policy is tightened, as in the first half of 2011. This is a reason why the interventions conducted by the ECB through the SMP were always sterilized, to make sure that they did not impact the ability of the central bank to control the overall amount of liquidity.

There have been many discussions recently about providing the ECB with a dual mandate, like the Fed, with financial stability being added to price stability.

This would in my view weaken the ability of the ECB to act swiftly and in a credible manner to ensure both goals. It would also put pressure on the ECB to address issues, like those of solvency of financial institutions and Sovereign, which are not of its own competence. By putting price stability as the primary goal – without forgetting all the others which have to be pursued conditional on the former – the ECB has a clear instrument to discriminate between those actions contributing to financial stability which it can pursue and those that it shouldn't.

To sum up, I do think that a clear mandate, expressed in terms of price stability, has a double advantage. First, it protects the central bank from conducting policies which are in the realm of other institutions. Second, it provides a justification for using all the non-standard tools to contribute to financial stability. The best response that the ECB can give to those who criticize the excessive use of non-standard measures and the widening of its balance sheet is the record it has achieved with respect to its primary mandate, which is price stability.

Interference

This brings me to the other issue, the relationship with the other institutions, in particular Governments. The latter have learned that it is not useful to put pressure on the ECB to achieve a different monetary policy than the one it wishes to pursue. Too many times in the past public requests to change interest rates in the direction of a looser monetary policy have been turned down. More recently, even in the most difficult moments of the crisis, there have been no request to change monetary policy.

However, Governments have seen how powerful central banks can be in influencing financial markets at critical times. Calls for the ECB to act as lender of last resort of the Governments have been made occasionally, not only by authorities but also by academics.

One of the pillars of monetary union has been that the central bank should not be the lender of last resort of Governments. And Financial markets actually seem to believe it. They expect that in case a euro area country loses its access to financial markets, the central bank will not be the residual buyer of its debt. This is the reason for markets pricing in different credit risk across countries.

The separation between the fiscal and monetary authorities protects the central bank from interferences in its monetary policy. There is a risk, however, that at times of crisis the central bank is seen as being too powerful and taking positions that go beyond its mandate.

This risk may arise when Governments delay action, especially concerning budgetary adjustment, until they feel the pressure of the markets. This seems to be a common feature in our democracies, where it is difficult to create consensus around difficult budgetary and structural measures without some form of outside pressure.

This is what happened in Greece and in other countries of the euro area over the last two years.

The problem with such a feature is that when markets lose confidence in the ability of Governments to adjust their budgets, they tend to overreact and generate self-fulfilling expectations which can produce lasting market disruption. In order to regain market confidence, under these circumstances, the budgetary authorities have themselves to over-react, putting in place tight budgetary measures aimed at proving to the markets that they are determined in their endeavour. These measures, however, tend to produce recessionary effects. They may generate perverse effects which delay the stabilization of the debt.

Part of these effects could be avoided if markets started to function properly again and regained confidence more quickly. The central bank can help to restore a better functioning of financial markets, and thus a quicker regain of confidence in the Government. But in doing so, the central bank faces a dilemma similar to the one I mentioned previously. If it acts too forcefully in stabilizing markets, it may reduce the incentive of the Government to implement the adjustment in a decisive way and may even encourage the postponement of tough decisions. If it acts too hesitantly, it imposes a high an excessive burden on the economy resulting from the fiscal adjustment alone and the excessively long time needed for markets to regain confidence.

To calibrate its actions appropriately, and without generating moral hazard, the central bank has to define the boundaries of its actions, taking into account the actions of the Government. This implies that the central bank has de fact to indicate to the Government what are the conditions for supporting its actions and contribute to improving market conditions if the latter are enacted. Incidentally, these measures are not necessarily limited to the budget domain, but can have a broader scope. In particular they can relate to structural measures aimed at increasing growth potential, with a view to alleviate the impact of restrictive budget measures.

This has been the case in the euro area. When the central bank intervened in the Government bond markets, it had to spell out the conditions that the latter had to meet, either through the adjustment programme negotiated by the Troika (of which the ECB is part) or through bilateral discussions. De facto, this has involved the central bank into discussions with the member states' Governments on the fiscal policy measures necessary to ensure that the solvency issue would be dealt by the sovereign, thereby clarifying the scope for the liquidity measures.

Last Summer, when the ECB also decided to intervene in the Government bonds market of non-programme countries like Italy and Spain, it wrote letters to the two Governments indicating the policies it considered necessary for confidence to be restored in a lasting way.

De facto, these were pre-conditions for the central bank to act in a way which would reduce the burden of the fiscal adjustment.

A similar interaction has taken place with the national authorities in charge of prudential supervision. Precise measures aimed at the restructuring of the banking system, negotiated by the Troika with the authorities of Greece, Ireland and Portugal, were the precondition for providing Emergency Liquidity Assistance to the banks of these countries.

Another example is the provision of long term liquidity to banks which experience some difficulty in accessing market financing. There is a risk that cheap central bank financing may create disincentives for banks to restructure and strengthen their balance sheets in order to regain market access as soon as possible. This is one of the potential downsize of the recent LTROs.

In the euro area it is the task of the national supervisors to put pressure on the domestic banks not to get too addicted to central bank financing, and to pursue the restructuring of their balance sheet.

The interactions with the other institutions de facto gives the central bank new responsibilities and tasks, which go beyond its domain. It may create risks for its independence.

The central bank not only has to assess whether markets function properly, and whether they are distorted by general instability. It has to indicate to Governments the measures, budgetary and structural, which are necessary to regain market access in a sustainable way and are a pre-condition for the central bank to accompany with additional actions aimed at smoothening the adjustment.

Given that these measures may be harsh, and politically unpalatable, central banks may be blamed for forcing Governments to take so-called unpopular decisions. Although the ultimate responsibility is of the Governments, which have postponed the adjustment until they were under the pressure of the markets, thus requiring much tougher measures to regain confidence, it is in the interest of elected policy makers to blame others, in order to be re-elected.

Central banks have to avoid getting trapped in the game of scapegoating, being blamed for dictating the conditions to restore market access. This requires that they become more vociferous in good time, and warn of the risks of relying too much on market discipline in good times, because markets can turn around very quickly if Governments wait for market pressure in order to start the adjustment.

Conclusions

Textbook analysis of the interaction between fiscal and monetary policy are based on the usual assumption that markets work efficiently. Under these circumstances it is desirable that monetary policy supports the attempt to correct excessive budgetary imbalances through low interest rates aimed at reducing the recessionary impact, which puts downward pressure on prices.

Reality is different. Fiscal adjustment tends to be delayed until Governments start facing adverse financing conditions. At that point the fiscal adjustment needed to restore adequate market conditions is much higher and risks creating a vicious circle of low growth and increasing debt.

Monetary policy may contribute to improve market conditions and put the country in a virtuous path. In doing so, however, it may create the incentive to delay fiscal action and structural adjustment. To avoid such a perverse incentive, the central bank has to dictate precise conditions and boundaries for its actions. In doing so, the central bank enters domains which are beyond its mandate and within the realm of other policy authorities. It may become subject to scapegoating and criticism, which ultimately may undermine its independence.

To avoid this, central banks have to start playing a more vociferous voice in good times, pointing to the risks that too benevolent markets may hide the build-up of imbalances in the public and private sectors, including the banking system. This will protect them in bad times, when they may have to interfere with other policies.

Central banks still have to take away the punch bowl before the party gets too exciting. They have also to start telling the partygoers that too much punch is bad for their health.

Thank you for your attention.