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“Central banks’ new challenges”. Intervention of José Luis Malo de Molina at the policy conference on “Central Bank (R)evolutions.

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Introduction

- I would like to start this panel on the challenges that this long-lasting crisis is posing to central banks, by frontloading my views that i) the crisis asks for central banking evolution, not revolution; ii) central banks in the main advanced economies have reacted to the crisis in quite similar a way, which reflects evolution, not revolution; and iii) the only case where I think that the crisis actually asks for a revolution concerns the euro area, but the revolution needed barely affects monetary policy but some other realms of economic policy. Let me now elaborate on this position.

Central banking evolution, not revolution

- I would like to start with a shot list of the main consequences or challenges the crisis has entailed for central banks. I'll focus during my intervention only on the case of the advanced economies.

- Back in 2008, the crisis erupted itself in the form first of a big liquidity shock.

- Later on, the financial crisis evolved into a real sector crisis, which posed downside risks to price stability and even deflation risk in some constituencies, like in the US.

- The third element to be highlighted in this list relates to monetary policy implementation. To implement the expansionary stance that the situation required, central banks have been faced to the problem of how to ease monetary policy when the official interest rate is close to zero.

- And last but not least, the crisis has revealed also the need to fill in a loophole in economic policy making, namely macroprudential supervision, and central banks have been assigned a central role in this new area.

- Well, I'm sure we agree that dealing with liquidity shocks and implementing an expansionary monetary policy in the presence of a zero-lower-bound constrain do not look as the sort of fresh problems that would immediately require a revolution in monetary policy. Admittedly, the liquidity shock may have been larger and more widespread this time, and the zero lower bound may have been perhaps a bit more binding due to the crisis duration. But those are anyway standard problems for monetary policy makers. Their gravity may deserve some fine tuning of the toolkit, but hardly a change of the paradigm.

- As to the "macroprudential supervision shock", the nexus between monetary policy and financial stability and its consequences has been on the agenda of central banks since quite before the crisis. In this regard, let me say that I do not share the view of those who put the bulk of the blame of the crisis on too-loose-for-too-long monetary policies. I'll go back to this issue later on in the context of the crisis of the euro.

- Also, I see no reason why the coordination problems that may emerge between monetary policy and macroprudential supervision when the central bank plays a pivotal role in the later need to be larger than those between monetary policy and microprudential supervision under similar setups.

Central banks' reactions

- I find these views reinforced by a review –brief, of course- of the main decisions made by central banks in advanced economies since the crisis started.

- Their focus was first on dealing with liquidity problems. Without going to the nitty-gritty, let me say that depending on their respective operational frameworks, central banks made a number of changes in their counterparty and collateral policies, and agreed and implemented also swap lines to provide liquidity in different currencies. In addition, the maturity of the monetary policy loans was also expanded.

- In most cases, however, these changes just entailed an approach to other central banks' frameworks. Just to give you an example, the changes in the collateral and counterparty policies implemented by the Fed reflected to a large extent a sort of convergence towards the policies that, for historical and age reasons, were already part of the ECB operational framework.

- There were innovations, of course. The implementation by the ECB of refinancing operations at a 3 year horizon is a good example. There is a consensus in the profession that 2 years is the standard horizon for monetary policy action and effectiveness so moving beyond that threshold was not a minor change. But it is worth noting in this regard that the 3 year horizon came in a smooth way that included, in this order, a change in the effective maturity of refinancing operations towards the upper limit of 3 months, an expansion of that limit from 3 to 6 months thanks to the creation of a new refinancing operation at that horizon, and a new extension of the limit to 1 year thanks to a further fresh operation. I think the term evolution fits much better here than revolution.

- Let's look now at the problem of how to ease the monetary policy stance when the intervention rate is too close to the zero lower bound.

- Well-known monetary theory teaches us that when the intervention rate reaches the zero bound but further easing is needed monetary policy has to act on the longer term of the yield curve. The two standard ways of so doing are i) expanding and changing the composition of the central bank balance sheet by buying long term assets -usually although not necessarily sovereign bonds- that is, quantitative easing and ii) trying to directly steer market expectations on future short-term interest rate moves through forward guidance devices.

- The Fed, the Bank of Japan and the Bank of England have embarked on quantitative easing policies that have had a clear expansionary effect on their respective balance sheets. They have also made use of forward guidance mainly by conveying the message that monetary policy would remain expansionary "for as long as needed". Later on, the Fed took a step forward by materializing the imprecise expression “for as long as needed” into something more concrete: the behavior of unemployment. The singularity of the Fed’s mandate has probably paved the way for this movement.

- Was the ECB different? Well, it was to some extent. Certainly, the euro area didn’t face the deflationary risks seen in the US, for instance. Also, differences in their economic cycles explain that the crisis reached Europe when the official rates were higher, so it has taken longer for the ECB to feel the zero-lower-bound constrain. Regardless of these considerations, the point I would like to make here is that if the ECB followed the textbook recommendation for quantitative easing that would definitely deserve the usage of the term revolution. Let me briefly explain why.

- Contrary to any other constituency, in this unique case there is single central bank that coexists not with one but with 17 different and independent domestic fiscal policy makers. Under this very singular setup, any purchase of a sovereign bond as part of a standard quantitative easing policy entails a component of cross-country income distribution that is absent in other areas. Having a central bank playing a role in cross-country income distribution within a monetary union is what I would definitely call a revolution.

- It is true that the ECB has implemented a number of asset purchase programs, including one for sovereign bonds: the SMP. And it is true as well that the announcement of the OMTs, another program that contemplates the ECB buying sovereign bonds, was instrumental to overcome the worst of the crisis last summer. So, did the central bank revolution happen after all? The answer is no and I’ll spend the rest of my intervention elaborating a bit on this answer.

The crisis of the euro and implications for the ECB

- To understand these and other ECB non-standard measures it is important to have first a clear diagnosis of the ultimate causes of the euro crisis. In my view, the global crisis triggered but didn't cause the euro crisis.

- The root of the euro crisis is in my view twofold. First, in too many euro area countries domestic policy makers did not pursue the domestic policies required to guarantee macroeconomic stability within a monetary union. Financial markets failed to penalize -and then to discipline- those wrong policies and thus imbalances accumulated and erupted abruptly when the global crisis put an end to the buoyant economic growth figures that had helped until then to conceal the underlying problems.

- At the same time, the euro area crisis has resulted too from a number of weaknesses in the institutional design of the euro agreed in Maastricht. The setup included, as you know, a single monetary policy. But the degree of coordination and peer monitoring in the other realms of the economic policy was much looser. The Stability and Growth Pact, to start with, proved non operational in practice. And the instruments to coordinate and monitor structural and financial policies were even weaker. As a matter of fact, the disequilibria that erupted with the crisis speak by themselves about the relevance of these problems. Another relevant shortcoming also revealed by at the earliest stages of the crisis in Europe was the absence of any mechanism to manage a systemic crisis within the euro area. It was not possible to act in a timely manner. All in all, the Economic and Monetary Union designed in Maastricht was certainly monetary but it was barely economic.

- Against this backdrop, a vicious circle was put into motion where poor macroeconomic outlook, financial risks and sovereign risks fed each other, also across countries with little capacity of reaction by the European authorities. The spiral reached a point where many saw the own survival of the euro at risk.

- That spiral was fortunately stopped thanks to action in a triple front. To invert the spiral however a revolution is required in one of these fronts.

- Starting with the actions that helped to overcome the critical point of the tensions, domestic governments accelerated the adjustment of the disequilibria and the structural reforms needed in their economies. Let's think, for instance, of the calming effects that the Troika's endorsement of the progresses in the Greek program had on the markets.

- The second front where action was crucial to overcome the worst of the euro area confidence crisis has been that of monetary policy. Beyond keeping an expansionary stance and a very generous liquidity provision policy since the very beginning of the crisis, the announcement of the Outright Monetary Transactions, a program of conditional public debt purchases, was instrumental in reducing the reversibility risk premia in sovereign markets.

- It goes without saying that in view of the nature of the actual problems that underlie the euro crisis, there is little the monetary policy can do to combat its ultimate causes. It can however buy time for others' measures to bear fruit. And this is what the ECB did with the OMTs. The OMTs, as the SMP before, are not QE devices. Don't forget, for instance, that SMP purchases were sterilized to prevent a balance-sheet expansion. Rather, these measures have to be seen as backstops to hedge the euro against tail risks linked to speculation about a euro area breakup.

- In this regard, what the ECB is doing is to preserve the integrity of the monetary policy transmission mechanism. One of the consequences of the euro confidence crisis has been the fragmentation of the financial markets in the area. When markets are fragmented within a monetary union, the monetary impulses are not passed through in a homogeneous way across the member countries. This requires central bank action. The CBPPs are a clear example of that sort of action. Measures aimed at curtailing the reversibility risks that explain part of the fragmentation are examples too. Measures to reduce the still too high fragmentation of, for instance, the market of bank loans to SMEs, as those under study at the ECB and the EIB also pertain to this domain. But I wouldn't call these measures revolutionary.

- Where a revolution is however needed is in the third and final front of action: that of the measures taken by the European bodies at the euro area level. So far, we have witnessed a deep overhaul of the economic governance of the euro, including new tools like the Macroeconomic Imbalances Procedure and new structures, like the ESM. While that is needed to stabilize the euro, I don't think it is enough to preserve it. Rather, a decisive move from the purely monetary union designed in Maastricht towards a genuine economic union is needed. As you know, there is already a precise proposal in this regard, including a roadmap with four milestones, endorsed by the European Council: a banking union, an economic union, a fiscal union and a reinforcement of the democratic legitimacy of the whole process, that is, a sort of political union. Of course, the ECB will have to evolve to adapt to this fresh setup. Its pivotal role within the Single Supervisory Mechanism that is about to be approved offers a good example.
- But this is a different issue to be dealt with by other people in this panel so let me just thank you for your attention.