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Presentation of the Papeles de Economía issue: "Monetary policy following the Great Recession"

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Let me first thank FUNCAS for their kind invitation to inaugurate this presentation of the issue of the review *Papeles de Economía Española* dedicated to "Monetary policy after the Great Recession".

In my address I will briefly review the predominant view before the crisis. I will then discuss how the crisis has affected this consensus. Finally, I shall conclude with some thoughts on two changes which, as a result of the foregoing, are already taking place in monetary policy conduct: how to structure its interaction with macro-prudential policy and the role of unconventional monetary tools.

Before the crisis

Before the crisis, low inflation, low price volatility and the high degree of economic stability attained in the advanced economies enabled a certain consensus to be forged on what the essential components of a successful monetary policy should be.

Monetary policy would be delegated to an independent central bank whose remit saw the maintenance of price stability as its main objective. This objective, in turn, could be translated into a more explicit goal in terms of inflation targets.

To fulfil its mandate, the central bank would confine itself to controlling the short-term interest rate. Its interventions would be transmitted to the real economy through three main channels: the long-term interest rate, inflation expectations and financial asset prices.

The credit channel played a secondary role. Indeed, in most of the macroeconomic models used by central banks, the private banking sector would play a marginal role, if any at all. The assumption of financial market efficiency and self-regulation meant that credit was not a central variable.

The consensus then prevailing also had it that, in order to ensure financial stability, it sufficed to supplement price stability with regulatory and micro-prudential supervisory policy action geared to ensuring the strength of individual credit institutions.

In step with this concept, the role of monetary policy in the face of potential risks to financial stability would be confined to cleaning up or repairing damage when such risks ultimately materialised. The Federal Reserve's measures following the bursting of the "dot.com" bubble illustrate this type of conduct.

The crisis

From the summer of 2007 and, above all, following the Lehman brothers debacle in September 2008, a crisis broke that generated the most severe global economic contraction

since the Great Depression. Among other side-effects, this crisis obliged us to revise much of the previous consensus on monetary policy.

It would however be unfair to ignore the fact that, in the specific monetary policy realm, discordant voices had some years back raised objections to the predominant model. In particular, the Bank for International Settlements had maintained since the early 2000s that, in specific circumstances, central bank conduct in the face of severe risks to financial stability would have to be pre-emptive and not only reactive. Simply put, the damage wielded by a financial crisis might be so great that some price stability slippage in the present would be warranted in exchange for preventing a future, more serious deviation that might prove more difficult and costly to reverse.

The Bank for International Settlements also asserted that the combination of a price stability-oriented monetary policy and a merely micro-prudential supervisory policy did not ensure the stability of the financial system as a whole. In this connection a third tool was needed: a macro-prudential supervisory policy.

While it is still too early to draw all the economic policy lessons arising from our experience of this crisis, I believe certain necessary changes can be discerned. Among these, the need to pursue macro-prudential policies is one of the most evident implications.

Macro-prudential policy

The crisis has demonstrated that the previous combination of monetary policy and micro-prudential policy is insufficient both for shoring up the stability of the financial system as a whole and for ensuring, in the event of crisis, that the impact on the real economy is limited. To achieve these goals a macro-prudential policy is also needed, and it must be equipped with new objectives and instruments.

There is already some agreement on the need to have this new macro-prudential policy rest on two levels or dimensions.

First, a cross-sectional dimension, focused on controlling the distribution of risks within the financial system at each point in time. This requires analysis of how institutions interact and what are the consequences of these interactions for the system as a whole. The aim should be to identify those interactions of most global systemic significance in order to subject them, logically, to more demanding soundness requirements.

Further, macro-prudential policy should also heed the time dimension, which analyses how aggregate risk evolves and how it interacts with the normal functioning of the real economy. This is the perspective needed in order to design, for example, measures to temper the procyclical tendencies inherent in the financial system. As is known, the Banco de España

was a pioneer in this field when, in 2000, it introduced dynamic provisioning. In the initial stages of the crisis the potential of such a tool was evident; however, the subsequent heightening of the crisis also showed its limitations.

The interactions between monetary and macro-prudential policy will pose complex challenges to central banks. Theoretically, monetary policy should continue focusing on maintaining price stability; and macro-prudential policy, on ensuring financial stability. In practice, however, action by each of them will inevitably exert a strong influence on the objectives of the other, and that has implications for the institutional design of the macro-prudential authority.

The advantages arising from coordination between both policies would suggest assigning the central bank with a pivotal role in the pursuit of macro-prudential policies. This has been the path followed to date in most cases. Thus, for instance, in the United Kingdom a sister committee has been set up within the Bank of England and alongside the Monetary Policy Committee, namely the Financial Policy Committee. Italy, Belgium and Ireland have followed similar arrangements. In other countries such as France and Germany, committees have been set up with the participation of other economic authorities, but the central bank plays a very important role in them, and actually wields veto powers over the decisions of the macro-prudential body relating to or affecting the field of competence of the national central bank or of the Eurosystem.

Nonetheless, concentrating different and occasionally conflicting economic policy objectives within a single institution no doubt makes accountability more complicated and may make the institution's mandate more ambiguous. This is indeed one of the reasons why in other instances, such as the United States, the option chosen was to create institutions in which responsibilities are distributed more symmetrically between the central bank and the other economic authorities.

This is no doubt a complex debate with unquestionable political connotations. I see more advantages than drawbacks in the European approach, since I believe that to achieve good coordination between monetary and macro-prudential policies and ensure sufficient capacity and speed of response, the central bank should play an important role in the design and management of the new macro-prudential instruments and measures.

The use of unconventional measures in monetary policy implementation

The second change I wish to discuss regarding monetary policy management is the role of what are dubbed unconventional measures.

As you will recall, central banks' immediate reaction to the first signs of the crisis was to deploy all available conventional instruments. Firstly, faced with clogged-up interbank markets, central banks had to directly assume the task of liquidity re-distribution among banks.

Also under the heading of conventional measures, most central banks aggressively cut official interest rates to prevent an abrupt and deep decline in activity from triggering a deflationary process. This policy ultimately took intervention interest rates to very low levels. Accordingly, when the worsening of the crisis made it necessary to relax the monetary policy stance even further, most central banks had to look to unconventional instruments.

Unconventional measures can be grouped into three major blocks: forward guidance; measures aimed at expanding the central bank balance sheet, and changes in the composition of this balance sheet.

The use of forward guidance to steer inflation expectations and interest rates has spread among the main central banks. The ECB resorted to this last summer to anchor interest rate expectations. The Federal Reserve and, to a lesser extent, the Bank of England have also used this instrument to signal their intention to provide a greater stimulus to the economy.

Unconventional measures affecting the size and composition of the central bank's balance sheet are also being extensively used. In the euro area, in October 2008, the ECB changed its liquidity management policy, implementing its main refinancing operations at a fixed rate with full allotment. In May 2009 it lengthened the average maturity period of monetary policy operations and set in train a purchase programme for covered bonds and other similar assets to reactivate this market segment. One year later, faced with the qualitative leap that the euro area sovereign debt crisis entailed, it introduced the Securities Market Programme. Under this programme it purchased, always on the secondary market, public debt of the countries where the tensions were disproportionately restricting the funding of their economies. Finally, when doubts over the viability of the euro reached critical levels in summer 2012, the ECB responded with an announcement that it would, within its mandate, do whatever was needed to save the euro. It designed a new securities purchase programme – the Outright Monetary Transactions Programme – which, though its use has not been necessary, has been instrumental in changing expectations in a favourable direction for market stability and normalisation.

Conversely, in the United States, the changes in the Federal Reserve balance sheet have been linked to massive asset purchases as part of a standard quantitative easing programme. These purchases, far higher than those in Europe, have been conducted with the express purpose of contributing to easing monetary and financial conditions. The Bank of England has, in this respect, been closer to the Federal Reserve than to the ECB.

There have therefore been notable divergences in the use of unconventional instruments between the ECB, on one side, and the Federal Reserve and the Bank of England on the other.

These divergences reflect the characteristics of the respective financial systems, in particular the predominant role of banks in the euro area compared with the greater significance of capital markets in the United States and the United Kingdom.

However, they also respond to a different perception of the risks that a central bank can and should assume in terms of its credibility and reputation. Widespread opinion has it that the Fed's strategy has involved some blurring of the boundaries between monetary, fiscal and financial stability policies. The ECB, on the other hand, has kept a greater distance from these boundaries because the joint existence of a single central bank with the fiscal and financial authorities of 17 independent countries (18 as of today and, possibly, 19 as from January) poses particular challenges and difficulties.

In sum, I have focused on structural aspects of monetary policy. I believe, nonetheless, that some brief thoughts on the monetary policy decisions adopted by the ECB governing Council last week would not go amiss.

As you know, a broad raft of measures was agreed last Thursday covering the three main spheres of action of the ECB throughout this crisis. The conventional monetary policy stance was additionally eased with a further cut in official rates which, for practical purposes, have now reached their lower bound. The horizon for the policy of generous liquidity provision was extended once more to 2016. And, lastly, a further step was taken in respect of unconventional measures with the launch of a new, four-year, long-term refinancing operation aimed and designed at promoting greater credit flow.

As we know, neither the ECB nor monetary policy alone can resolve the problems at the root of the crisis still besetting the euro area. But decisions such as those last Thursday no doubt contribute to facilitating the action of other economic policy tools which, by their nature, may have a more powerful and lasting effect on growth and employment.

Thank you.