
**Conference on Public Debt and Monetary policy
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Introductory statement of Francesco Papadia.

The European Central Bank has stated that it is prepared under certain conditions to buy unlimited amounts of short term public bonds in secondary markets when conducting monetary policy. This approach has implications both for the ability of debtor countries to issue bonds and for their prices. What are the risks and the longer-term monetary and budgetary consequences of the role played by the ECB? For example, will its independence be impaired by its purchase programme of public debt?

I will cover three topics [slide 2]

I. Regaining control of interest rates in the €-area. [slide 3]

I would like to start by offering a different perspective to what the ECB is doing, arguing that it has engaged into a set of actions to regain control of interest rates.

Transmission mechanism

[slide 4] The predominant view in academia and in policy circles is that the transmission mechanism should be seen in a Wicksellian, or Neo-Wicksellian approach, in which the rate of interest fixed by the central bank has to be compared with the “natural rate of interest”, which one can assimilate to the marginal productivity of capital. Different formulations of the Taylor rule are ways to translate the Wicksellian approach into something closer to policy implementation. The failure of the Friedmanian-quantitative model to the transmission mechanism (monetary base-money multiplier-money aggregate-money demand-aggregate demand-inflation) to explain economic developments during the crisis (and before?) contributed to the consolidation of the Wicksellian-Taylor approach to monetary policy. (Background slides).

When moving the Wicksellian-Taylor approach closer to policy implementation, one has to recognise that the rate fixed by the central bank has hardly any relevance for firms, households and the real sector, i.e for the real economy. The central bank rate, however, is the hinge of two yield curves, one over a time dimension and one over a risk dimension, over which are placed the rates which are indeed relevant for the real economy. In normal times, by moving the hinge, the central bank moves the entire curves and thus influences the real economy and controls inflation.

Non-Standard actions

This state of affairs was deeply disturbed during the crisis by three developments:

1. The control by the central bank of the money market rate became less precise,
2. The two yield curves got very irregular, with very high and volatile spreads over the central bank rate of the rates relevant for the real economy,
3. The approaching to the lower bound of interest rates at 0.

Non standard actions were the tool central banks created to obviate the problems created by these three developments.

Let me indulge in some vanity in reporting the initial sentences of my recent Policy Contribution for Bruegel to illustrate the dramatic change in central bank actions to answer to the crisis:

“Central banks normally provide liquidity:

- 1. In carefully controlled quantities and*
- 2. Only in national currency to national banks.*

During the Great Recession however central banks provided liquidity in unlimited amounts, also in foreign currency and to foreign banks.”

With these drastic changes central banks aimed at

1. Re-establishing their control of money market rates,
2. Bring some order in the spreads that had gone beyond any reasonable level and become very volatile,
3. Loosen monetary policy further when the 0 bound was approached.

The results of these drastic changes were similar, from a quantitative point of view, for a number of central banks in advanced economies.

Balance sheet differences ECB-FED, BOE, SNB, BoJ [slide 5]

There was, however, a significant difference between the ECB, on one hand, and the FED, the BoE, and the SNB in the way the central bank balance sheet expanded on the asset side. The balance sheet of the ECB grew predominantly because of temporary operations (basically first the one year LTRO and then the 2 three year LTROs) [slide 6]. The balance sheet of the 3 other central banks grew, after a first phase in which it was also swollen by temporary operations, by outright operations, consisting in purchases of Treasuries and MBS securities in the US, Gilts in the UK and foreign exchange (€) in the case of the SNB [slide 7].

Endogenous tightening

The apparent technical difference between the ECB and the other central banks in the composition of their balance sheet raises an important policy point: in the €-area liquidity is controlled by banks in their aggregate behaviour while bidding for liquidity in central bank operations, in the other countries liquidity is controlled by the central bank.

This obviously has implications for the market rate. Currently the overnight market rate is compressed by the large amount of excess liquidity close to 0, i.e. the rate on the deposit facility. [slide 8] As can be seen from the scatter diagram between excess liquidity and the spread between the ECB policy rate (MRO) and EONIA, this situation would prevail until excess liquidity would move towards 100 billion and then would steeply increase. There is indeed the potential for this to happen as banks are gradually returning to the ECB the liquidity that they borrowed under the 2 three year LTROs, of which they have returned already more than 300(?) billion.

This can be seen positively, as a kind of homeostatic mechanism: as the situation improves banks return the borrowed liquidity and rates increase. This can also be seen as something undesirable, however, as the central bank may consider the increase of rates not appropriate based on its understanding of the state of the economy: the potential for a rate increase in current conditions is two 25 bp steps, is this what the €-economy needs? At the end, whether this is a negative or a positive phenomenon depends on who has better information about the state of the economy: the central bank or the aggregate banking system? My CV gives me a penchant for the former, but the issue is not an easy one to settle.

But there is another, even more important factor outside of the control of the ECB.

The magnetic power of government bonds

Currently the **push/pull attraction** from government yields in the different jurisdictions on bank funding costs disturb the relationship between the rate the central bank controls and those relevant for the real economy. The attraction derives from the fact that the yield on government securities acts as a magnet for interest rates in the entire jurisdiction, in particular a bank can not normally fund itself cheaper than the sovereign and will only lend with a mark-up on its cost of funding. The desire and the need to weaken the link between bank funding cost and the yield on government securities is at the basis of the drive towards banking union, but this result is not there as yet and therefore the effect is still very strong. [slide 9] The **pull/push** factor is, quantitatively, the most important for funding rates prevailing in individual countries, as the spread between core and periphery bonds, which is still of the order of 200 basis points for the two year maturity in Spain and Italy, is of course, much more important than the 25 basis point reduction of the repo rate recently enacted and larger of any possible conceivable further reduction of the official rates by the ECB and also larger than the potential

“endogenous tightening” estimated above. [slide 10] This explains, for example, why German banks can fund themselves much more cheaply than Spanish banks (with a spread of 250 basis point). Prospectively, the core-periphery spread will move following the waves of tension/calm in the euro area and does not depend only on the ECB.

Given the risk of endogenous tightening and the push-pull attraction of government bond yields, the ECB is trying to regain control.

Regaining control: lower MRO, OMT

The ECB is of course aware of the fact that the potential endogenous tightening and the magnetic power of government bonds is affecting its ability to steer the economy towards its price stability objective and has taken measures to counter these difficulties.

A step in this direction was the reduction of the official rate. This had two effects. First it reduced the potential for additional tightening: if before the cut there was a potential for three 25 bps increase up to the MRO rate of 75 bp, after the cut this potential was reduced to only two 25 bps increase. Second it gave incentives to commercial banks to maintain a larger amount of excess liquidity as this became cheaper. Indeed after the reduction of the MRO rate the pace of reduction of excess liquidity slowed down significantly, assuring a longer period of rates close to zero.

Another step in the same direction was the announcement of the OMT as the spread between core and periphery bonds came down sharply since the announcement of the Outright Monetary Transaction program last July. However, the spreads are still quite large and this explains, for example, why German banks can fund themselves much more cheaply than Spanish banks (with a spread of 250 basis point). Prospectively, the core-periphery spread will move following the waves of tension/calm in the euro area and does not depend only on the ECB.

So, in conclusion, the ECB regained a degree of control on money market rates, through the reduction of the MRO rate, and on the bank funding rate, indirectly by reducing the yield on government securities. Of course, the degree of control is far from perfect, especially when it comes to the cost of bank lending, which is the one directly important for the real economy. Still a substantial improvement was achieved.

Lorenzo asked Hans-Helmut and me to take either a Wiedmanian or an Anglo-Saxon perspective in our introductory statements and I volunteered for the first one. I realize, however, that I did not say much of Wiedmanian so far. So let me try and remedy now talking about risks, covering them in increasing order of gravity.

II. The risks from non standard measures for central banks. [slide 11]

In increasing order of gravity:

Financial risk

Much is made of the increase of financial risk for the balance sheet of the Eurosystem. Of course there is more financial risk on the balance sheet of the Eurosystem now than before the crisis. This is obvious given that the balance sheet of the Eurosystem is about 3 times as large as before the crisis, given that the financial soundness of the banks to which it lends is significantly weaker, given, finally, that the collateral that it takes as guarantee of its lending has also become riskier. There are, however, two reasons to put this risk first in a rank from the less to the more grave.

The first reason is of an institutional kind and that is that central banks were just invented to absorb risk in a crisis. Indeed Bagehot turns this conclusion on its head by writing: “..making no loans as we have seen will ruin it [Bank of England]; making large loans and stopping, as we have also seen, will ruin it. The only safe plan for the Bank is the brave plan, to lend in a panic on every kind of current security, or every sort on which money is ordinarily and usually lent. This policy may not save the Bank; but if it does not, nothing will save it.” So, he says, apparently taking more risk (lending freely and bravely) is the way to take less risk. Applied to the current

situation, what would have happened to the balance sheet of the Eurosystem if it had not had recourse to its non standard measures?

The second reason is of a financial nature: the ECB has been endowed with large “equity” buffers (about half a trillion adding up capital, reserves and provisions) which can protect it should things turn sour. [slide 12] It should be noted, however, that the Eurosystem has so far made money from its interventions, on foreign exchange, on covered bonds and on government securities. On the latter, in particular, I have recently estimated that it made marking to market gains of the order of 14 billion euro.

Inflation risk (short term)

Short term inflation risk is my second least relevant risk. The reason for this is that even if inflation risk is the ultimate risk for the central bank, as price stability is its dominant objective, it is difficult to find any evidence that there is a risk of inflation over the foreseeable future. Inflationary expectations (however measured) are well behaved, being anchored close to the 2.00 % limit, both when measured from the price of financial assets or from expert forecasts. For 2014, specifically, the forecasts range between 1.2 % for the OECD to 1.5% for the European Commission, if anything raising worries of too much of a distance from 2.00%.

This is not surprising taking into account the impeccable control of inflation by the ECB since being responsible for monetary policy in the €-area. [slides 13 and 14]

Risk of fiscal dominance [slide 15]

With the risk of fiscal dominance we enter into more treacherous ground. Historically very large central bank balance sheets tend to prevail during periods of fiscal dominance, when monetary policy is subjugated to the funding needs of the government. This was, for instance, the case of Italy before the Banca d'Italia and the Treasury signed the so-called “divorce” in 1981 or the case of the United States before the so called Accord, which freed the FED from the burden of keeping the yield on government securities at a low, fixed level. This correlation raises the worry that again fiscal dominance may accompany very large central bank balance sheets. There is nothing mechanical here and, as is well known, correlation does not mean causation. The risk, however, exists that a Treasury that has seen its funding helped by large central bank purchases would get addicted to them and insist for these to continue also when any monetary justification for that would have disappeared. The protection against this risk must be found in institutions and behaviour. In terms of institutions, an independent central bank is the first line of defence. A solid fiscal framework avoiding excessive deficits complements on the institutional side the protection against fiscal dominance. In terms of behaviour, the central bank needs the determination to exit from the extraordinary measures as soon as they would no longer be needed for monetary policy purposes.

Risk of overburdening of monetary policy

The risk of fiscal dominance borders that of overburdening monetary policy. Again to indulge in self quotation: *“Overall, the prescription not to overburden monetary policy holds at international as well as at domestic level. This prescription is particularly important after central banks have shown during the crisis their ability to do things that nobody thought they were capable of doing: providing liquidity beyond their borders and in a foreign currency and expanding, over a short period, their balance sheets by a factor of three or four. Demonstrating unexpected abilities should not feed illusions that central banks can do more than they actually can.”*

The risk overburdening of monetary policy takes a specific form in current conditions in the €-area. The ECB, the governments of stressed jurisdictions and the governments of the stronger €-area countries are engaged since the beginning of the crisis in a three-sided chicken game: each player wants to extract as many concessions as possible from the other players while, of course, avoiding the risk of a crash. Governments, impressed by the central bank ability to deliver, may insist in asking from it more than what it can deliver: capital for banks that need it, growth that can only come in a durable basis from increased productivity, low

interest rates, that are fostered by an appropriate fiscal behaviour.

Inflation risk (long term)

There is no way to forecast inflation over the long term. We have indirect indication that this is expected to be well behaved in the €-area by the fact that very long term bonds are issued at rates which do not incorporate a significant inflation premium, but this is no assurance that there will be permanently no inflation risks. The huge balance sheets, the very low interest rates that have avoided even more damage to the real economy and caused no inflation while, on the contrary, protecting from the risk of deflation, could in different circumstance engender inflationary risks. And this is the biggest risk of all. Again the issue of the exit from the non standard measures is essential. Particularly the timing is essential: too early would cause damages to the economy, too late could endanger inflationary risks.

III. Conclusions [slide 16]

Central banks were created to absorb risk during a crisis

And doing this they have avoided even more serious damages to the real economy.

The risk benefit balance

has been so far, in my view, definitely favourable. The Great Recession had the potential to become a repeat of the Great Depression of the end of the twenties. It was the determined action of policy makers, with monetary policy, fiscal, structural and institutional tools that fended this risk off.

Utmost care is however needed to maintain the balance between risks and benefit under close control and exit before the former will exceed the latter. From this point of view, the recent announcement of the FED that it is considering a gradual and cautious exit from its extraordinary measures is welcome. The conditions are not right quite now for the ECB to announce its exit, but the hope is that this time will not be too far in the future, as the situation in the €-area improves.