Central banking in Turbulent Times

Les Banques et Système Financier: Quelle régulation?
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présentera son livre avec Tuomas Välimäki :
Discussion: Jean-Claude Trichet
Modérateur: Denis Beau, Sous-gouverneur, Banque de France
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• Past: A quasi perfect central bank model
• Present: Struck by multiple hits during the Great Recession
• Future: A hesitant forward look
• With Tuomas Välimäki
• Authors of the boxes (Alessandra Marcelletti, Piero Esposito, Philippine Cour-Thimann, Christophe Beuve, Ariana Gilbert-Mongelli)
• And the comments of many generous readers.

Expanded into 300 pages
A quasi perfect central bank model I

• A secular search for a monetary technology that would manage a fiat currency with price stability
  • Putting price stability on the top rank of objectives of the central bank
  • Granting technical independence to the central bank in the pursuit of price stability
  • The interest rate, a la Wicksell, as $\Lambda$ and $\Omega$ of monetary policy
  • Taylor rules as a specification of a Wicksellian approach
  • Inflation targeting as the framework for monetary policy strategy
  • No intermediate targets (except for small exchange rate targeters)
  • The corridor approach to control interest rates
• Financial stability the neglected child
• Risk of dilemmas in the use of the interest rate swept under the carpet.

A quasi perfect central bank model
II
• The Great Moderation was considered the ultimate validation of the prevailing central bank model
• But macroeconomic, intellectual, regulatory and supervisory failings were feeding imbalances a la Minsky, along the empirical Kindleberger-Aliber, Reinhart-Rogoff pattern.

A quasi perfect central bank model

III
• The Great Recession as a shift from a good to a bad equilibrium, jointly caused by
  • A coordination expectation failure (a lá Diamond-Dybvig)
  • But also dangerous policies that had put banks and sovereigns in vulnerable conditions (low tipping point)

Struck by multiple hits during the Great Recession I
Struck by multiple hits during the Great Recession II

- Monetary policy’s 3 critical, untold assumptions were rejected:
  - Good control of short-term rate
  - Stable relationship between short-term rates and more relevant longer/riskier rates
  - Ability to push down interest rate as much as needed (no-Lower Bound)
• Central bank Balance sheet management as a complementary tool to:
  • Regain control of short-term rates
  • Bring back order in the relationship between short and longer/riskier rates
  • Ease beyond the lower interest rate bound

Struck by multiple hits during the Great Recession III
Central bank action was, overall, successful in the monetary area as

- Interest rate control was regained (mostly moving to a floor modality)
- Spreads were brought to order
- Monetary policy was eased beyond the ZLB
- Price stability was, however, harder to regain
- Central bank collaboration contributed to the favourable results

Struck by multiple hits during the Great Recession IV
• Financial instability came back with a vengeance during the Great Recession
• And the burden fell, by sort of gravity, on central banks shoulders because of two peculiar abilities:
  • Their holistic view of the financial system (ability to assess)
  • The power to move interest rates and provide liquidity (ability to act)

Struck by multiple hits during the Great Recession V
Financial stability issues:
- Limited size of the trigger of the crisis (low tipping point)
- Explosion of financial stress
- Four waves of losses for banks
- Low bank profitability
- Sustained bank disintermediation
- Increased shadow banking
- Disorderly interest rate spreads
- Instability of short term-rates

Struck by multiple hits during the Great Recession VI
Struck by multiple hits during the Great Recession VII

- Overlap between issues relevant for monetary policy and financial stability
- Again consistency with the shift from “good” to “bad” equilibrium (one common cause)
- Dual-purpose (or double edged) measures to deal with monetary policy and financial stability consequences
• Macro-prudential policies more a product of the crisis than a tool to deal with it, but:
  • US Stress Test vs. EU Asset Quality Review
  • US banks recovered much more quickly in the US than in the EU.

Struck by multiple hits during the Great Recession IIIX
Six hits to the pre-crisis central bank model (in decreasing order of importance):

- Renewed responsibilities of central banks for financial stability
- Blurring of the border between monetary and fiscal policy
- Engendering moral hazard
- ECB salvaging the euro
- Participation of the ECB in the troika
- Need to give more weight to global spillovers of central bank action
• Was the pre crisis central bank model jeopardized?
• Have we entered another epoch in central banking?
• Beware before answering positively to these questions

• Are the changes brought about by the Great Recession permanent or transitory?
• Can they be dealt with adaptations or do they require radical changes?
• Operational and institutional aspects

A hesitant forward look II
A hesitant forward look III

Strategic issues:
• Need to review inflation targeting?
  • Price level targeting?
  • A higher inflation target?
  • Nominal GDP Targeting?
• Too early to say, I am inclined to say no
Operational issues:
• Return to a lean balance sheet and balanced liquidity supply? or
• Stay with abundant liquidity and a floor approach?
• In any case much time to accumulate evidence and thoughts before possibly moving away from the floor.
• Institutional issues
  • Financial stability responsibilities
  • Blurred fiscal-monetary policy borders
  • Moral hazard

• The ECB salvaging the euro
• The ECB and the troika
• A more global approach for the Fed and the ECB
Financial stability responsibilities:

- Will macroprudential measures free the central bank from dilemma situations?
- Probably not because of
  - Still unsettled institutional set-up in US and EU
  - Limited empirical and theoretical underpinnings
  - Narrow impact (banks)
  - Circumvention and elusion
• Will a clear separation between fiscal and monetary policy be re-established?
  • This is more a hope than a confident expectation, implying no further need to use the balance sheet as complementary tool
• Will the moral hazard inevitably created during the Great Recession incentivize more risk taking?
  • The pain on banks and sovereign should have taught them a lesson, but…
• Will the ECB need to intervene again to save the euro?
  • Not if the Maastricht design is completed
• Will the ECB need to be part of the troika again
  • Please not!
• Will the Fed and the ECB have problems in taking a more global approach?
  • No, they have learnt their lesson

A hesitant forward look VII
Adaptations to the central banking model:

- No to radical changes
  - Back to dependent central banks (undesirable)
  - Back to narrow central banking (probably impossible)
- Sequential approach to dilemma situations
- Special decision making rules and reporting requirements when using the balance sheet as complementary tool
- Require deductibles when supporting imprudent sovereign or financial institutions (Diamond-Dybvig pricing)
- No support to imprudent sovereigns without conditionality