Presentation of the book "Central Banking in Turbulent Times"
By Francesco Papadia and Tuomas Välimäki
Banque de France-Science Po Seminar
Moderator: Denis Beau, Sous Gouverneur de la Banque de France
Discussant: Jean-Claude Trichet, Former President of the European Central Bank
April 23rd 2018

Denis Beau
The presentation of this book is an occasion to discuss some important topics about central banks after the most acute crisis since the Great Depression in the 1930s.

Introduction by Francesco Papadia
I wish to start expressing my gratitude to Benoit Mojon and his colleagues at Science Po for organizing this event and to Denis Beau for chairing it. It is both very interesting and very pleasant to have the chance to discuss about the future of central banks after the Great Recession in such a distinguished setting. But my greatest gratitude goes to Jean-Claude Trichet, and my gratitude goes well beyond the fact that he accepted to be the discussant in this presentation. Much of the story told in the book I had the privilege to experience under his leadership.

One of development that gets most attention in the book is the use of central bank balance sheet management as a complementary monetary policy tool. This started with Jean-Claude Trichet in August 2007, when the first Fixed Rate Full Allotment (FRFA) operation was decided, and was consolidated in October 2008, when the ECB moved systematically to FRFA, which would remain the auction modality for the following 10 years.

The book has hardly anything in terms of personal memoirs, but if it had a little more of a personal character, the presence of Jean-Claude Trichet would be overwhelming.

A presentation through slides followed the introduction (see slides).

Comments by Jean-Claude Trichet.
The book presents and defends theses, it does not just puts forward facts, but it also provides an interpretation of them. My discussion will be more a complement and a qualification than a rebuttal of the theses in the book.

The current wave of populism was caused by the crisis. We will not be pardoned, and there would be even graver political consequences, if there would be another crisis.

I agree with Francesco that FRFA is part of balance sheet management; indeed it was its first manifestation. And balance sheet management and balance sheet commitment, i.e. the commitment to use the balance sheet to the extent needed to pursue the central bank objective of price stability, are very powerful tools.

I am not sure about the description of the quasi-perfect pre-crisis central bank model for the ECB described in the book. Francesco belittles the importance of the monetary policy component that is the characteristic aspect of the ECB dual pillar approach, distinguishing it from pure inflation targeting. The importance of money and credit developments was vindicated during the crisis, when they provided additional, useful signals to understand what was happening.

Talking about inflation targeting, it is useful to recall that the Fed established its quantitative inflation target very recently, selecting the same 2 per cent traditionally used by the ECB.

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One can interpret the description in the book of the ECB’s independence as being merely technical, while I believe that there is also a political dimension to it, and independence remains essential. Indeed, nobody is challenging the independence of the ECB.

One of the causes of the crisis was massive deregulation in financial markets, which contributed to excessive debt, before and during the crisis. Excessive debt makes us as vulnerable to instability, as we were in 2007-2008. The trust to have tranquil markets in all circumstances was and still is utterly naïve.

In some parts, I find the book’s analysis too constrained by mainstream views. I think there were three components in non-standard, monetary policy measures:

1. Fighting the immediate consequences of the crisis,
2. Acknowledging that private intermediation does not function in all circumstances and one should be very cautious when exiting the non-standard measures,
3. The lower bound for interest rates and, more generally, the difficulty of conducting monetary policy when interest rates are very low.

What I am not sure of is that financial instability alone caused the Great Recession. There were obviously previous macroeconomic mismanagements, signalled by loose economic policies, public and private imbalances and the piling up of public and private debt outstanding that were inevitably asking for corrections. The trigger is often modest in these cases. There was no illusion that Greece would be too small to cause a dramatic sovereign risk crisis. But the system was at stake because at least 4 or 5 other countries were also more or less vulnerable. Lehman Brothers was considered a normal affair by US Treasury, according to the view that failure is a necessary component of a market economy. Subsequent developments showed the fallacy of this view.

I agree with the book’s analysis that the swaps agreements between the Federal Reserve and the ECB, as well as other central banks, avoided higher damages. But we are in a situation in which the explosive is still there.

The book characterizes the equilibrium that prevailed before the crisis as “good”, while emphasising, with the quotation mark around the adjective, that this is used in a particular sense, following the multiple equilibrium model. But the equilibrium was clearly not good in the common sense of the word, without quotation mark, as it nurtured the imbalances that eventually led to the crisis.

I find the influence of mainstream economics also affecting the analysis of the banks situation. The book advances the conclusion that US banks did better than those from the EU. Was this really the case? The financial effort that would have to be done in the EU to rehabilitate banks would have been much larger than in the US, because the banking system is so much larger here. This would have been an additional burden on fiscal balance.

About three of the hits to the pre-crisis central bank model identified in the book:

1. I agree that financial stability has grown in importance for central banks,
2. The book argues that the borders between fiscal and monetary policy may have been blurred, but I agree with its contention that it was not our purpose to help governments, and we did not do what we did because of their pressure. Let me recall that the Securities Market Program was very strongly attacked in Germany.
3. Was salvaging the euro not the task of the ECB? It is surely not the task of the ECB to decide who should be and who should not be member of the euro-area. It was our duty to

carry out monetary policy for the entire euro-area. The fateful stroll on the beach of Deauville between Chancellor Merkel and president Sarkozy, which eventually led to the so-called Private Sector Involvement in Greece, created great market excitement. The ECB had the duty to maintain the euro-area in its entirety.

I would like to add a last point about the « conceptual convergence » which has been observed through the crisis across major central banks: first, it is no more sufficient to look at traditional economic analysis, also credit and monetary developments have to be looked at. Second, it has become the standard view that bank supervisions should be within or very close to central banks. Third, macro-prudential policy is still in its infancy, but the crisis has shown that it should be close to the central bank. Fourth, central bank independence should not and was not put into question. Fifth, last but not least, the four advanced economies central banks which are issuing currencies that are in the SDR basket have now all the same definition of price stability: 2% .

Discussion

A. Giraudo

The world of central banking has completely changed with the crisis, indeed we have a BC (before the crisis) and AC (after the crisis) eras. And it is not clear that we can just go back to BC. Let me point out that there was in history another example of zero nominal rates, but one has to go very far back into the past, to Roman times, under emperor Tiberius, to find it.

Mojon

Which was the greatest challenge during the crisis? Which advice would you give to the young colleagues attending this event?

Trichet

Would it have been possible to do what we did in August 2007 if the ECB had not been independent? We were strongly criticized from London, but we came out of age on that occasion. This was possible because of the functioning techno-structure at the ECB.
For a long while markets underestimated both the Fixed Rate Full Allotment auctions as well as the Securities Market Program.

Papadia

Just one last word answering the question of Benoit Mojon about an advice for the young colleagues attending this event: try, if you can, to work under the leadership of someone like Jean-Claude Trichet!

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