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**Book Discussion**

# CENTRAL BANKING IN TURBULENT TIMES: A BOOK DISCUSSION WITH FRANCESCO PAPADIA

**Francesco Papadia**, Bruegel and former Director General, ECB
**William C. Dudley**, former President, New York Fed
**Jens Nordvig**, CEO, Exante Data
**Brian P. Sack,** Chief Economist, D.E. Shaw

Please join us for a discussion of the extraordinary policy actions by central banks, particularly the ECB, during the last decade. Author Francesco Papadia, Senior Fellow at Bruegel, will be joined by Bill Dudley, recently retired New York Fed President, Jens Nordvig, CEO ExAnte Data and Brian Sack, D.W. Shaw. *Central Banking in Turbulent* Times was written in cooperation with Tuomas Valimaki.

**Thursday, September 27| 1:00PM – 2:30PM**
1501 International Affairs Building
420 West 118$^{th}$ Street, New York

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**Book Discussion**
**Central Banking in Turbulent Times**
Francesco Papadia with Tuomas Välimäki

With William C. Dudley, Former President, New York Fed. Jens Nordvig, CEO Exante Data. Brian P. Sack, Director of Global Economics, The D. E. Shaw Group and Francesco Papadia, Bruegel Fellow and Former Director General for Market Operations at the European Central Bank.

Patricia Mosser moderated.

The full video is on Youtube:
https://www.youtube.com/results?search_query=central+banking+in+turbulent+times

Patricia Mosser welcomed participants and introduced the discussion, stressing how central banks found themselves in the front line during the Great Recession. Trish then noted that the book rightly addresses both price and financial stability issues. Finally, Patricia introduced the discussants, which will speak first, followed by Francesco who will address the issues they will have raised.

Bill Dudley, who was Francesco's counterpart as Director of the Markets Group of the New York Fed before becoming its President, started his intervention by noting a general agreement with the book's tenets, in particular with the observation that the financial stability objective was neglected before the crisis, including by central banks. While the objective of financial stability acquired renewed importance with the crisis, it is not clear that even now we have a good model to deal with it. In particular it is not clear that the macro-prudential set-up in the US could deliver swift action when required. Bill did not see, however, unlike Francesco in the book, a potential conflict between price and financial stability: both are necessary for the central bank to achieve its objectives.

On the framework of monetary policy implementation, Bill stressed that, while the Fed has not finally chosen which approach it will use when its balance sheet will have normalized, the "floor system" for controlling interest rates, characterized by very abundant bank reserves, presents significant advantages, in particular from a financial stability point of view. The reassurance to economic agents that they have large liquidity available from the central bank will favour their activity. The so called "corridor approach" made it instead difficult in the initial phase of the Great Recession to provide the required amount of liquidity, as this interfered with the control of the interest rate. Allowing the Fed to pay interest on reserves was the decisive change that made it possible to move to the floor approach. Bill added that he does not really see the economic usefulness of the interbank money market: the economic system can be equally efficient without the need to spend resources in maintaining an active interbank money market.

Bill further observed that, while the paradigm of the multiple equilibrium is useful in explaining the Great Recession, the book underestimates the importance of prudential regulation and, in general, supervision. The prompt, swift and, if necessary, forced recapitalization of American banks after the Lehman shock was critical for them to recover fully and promptly their intermediation capacity. The later and blander action in Europe bore instead responsibility for the longer lasting weakness of European banks. Left to themselves, banks are likely to just hope that times will remain easy and stay undercapitalized and with excessive maturity mismatch, but, Bill said, "if nobody plans for the worst, you make the worst more likely".

While the importance of regulation is belittled in the book, the problem of moral hazard receives too much prominence, according to Bill. In a crisis the main objective is to surpass it and the fear of engendering moral hazard should not hinder swift and decisive action: when the house is on fire you first extinguish it and then think about apportioning responsibility and finding ways to avoid future fires. Moral hazard has to be limited by preventive action rather than during a crisis.

Looking forward, Bill noted that the US is in a much better situation now than before the Great Recession, in particular in the banking sector. Shadow banks, however, are still not properly regulated. In addition, the Fed is confronted with the enhanced responsibility of issuing a, indeed the, prominent, global currency. In Europe, the task of rehabilitating the banking system has not been fully achieved as yet and the pace of further integration is too slow: it is in particular disappointing that Banking Union is still incomplete.

Brian Sack started by recalling the frequent interactions with Francesco over the years, both when they were responsible for market operations at their respective central banks and afterwards. He also recalled the useful meetings that were held at the BIS, where market and policy issues were discussed.

Brian concentrated his remarks on the monetary policy challenges that emerged during the Great Recession and that Francesco illustrated in the book.

The first such challenge was the control of the interest rate by the central bank: this was very precise before the crisis in both jurisdictions, but became much more difficult in the initial phase of the crisis, because of the need to provide abundant liquidity, as recalled already by Bill. What proved critical was the ability to separate the control of the interest rate from the control of the central bank balance sheet, in particular the supply of reserve. The payment of interest on bank reserves and the move to the floor approach to control interest rates was decisive in this respect as it allowed to fully regain control of the short term rate while providing as much liquidity as was needed to deal with the crisis. Until this was possible, effects on the interest rate hindered liquidity provision.

The second challenge was that the control of the spreads between the overnight rate, which the central bank aim at precisely controlling, and rates that are more important for the economy became more difficult. The book insists in qualifying the transmission mechanism during the crisis as "impaired" or "clogged", which could lead one to a passive attitude. Instead it should be recognized that, albeit in new forms, monetary policy was working also during the Great Recession and its forceful exercise was needed to confront the tsunami that was hitting the economy. Indeed action had to be even stronger during the crisis just because the shock was so large.

The third challenge was the inability to further ease monetary policy when the lower bound of interest rates, be it at zero or somewhat below, was reached. Fed staff analysis in 2009 indicated that it would have been appropriate to bring the federal funds rate to something like minus 6.5 per cent at the through of the crisis. As this was obviously impossible, recourse was made to a complementary tool like the management of the central bank balance sheet. However this was still insufficient. The risk of not having enough room to reduce interest rates, because of the lower bound, is still with us today. The natural rate of interest is still very low and the prospects are that it will remain low on a persistent basis: central banks should be aware that they could repeatedly bump into the lower bound. Bringing interest rates into the negative domain may help but, given the limited range of negative values that is attainable, it could be not enough. Central banks should be ready to use again their balance sheet as well as forward guidance as additional monetary policy tools, while being aware that they are less powerful than interest rate changes.

Jens Nordvig started with an appreciation of the very long time series presented by Francesco in the book, which are necessary to capture events that have very low frequencies. He also noted that the balanced and pragmatic character of Francesco emerges from reading the book.

Jens announced he would cover five points in his intervention.

The first one is about inflation targeting, which is the dominant monetary policy strategy, but appears in different versions in different countries. Sweden, for instance, has a very, indeed too, precise form of targeting. In fact, while actual inflation is now really close to the target and the economy is growing at a quite strong rate, the Riksbank is insisting with its negative rates to reach the last decimal in inflation still missing with respect to the 2 per cent target.

The second point also has to do with inflation. Although it may be difficult to pinpoint exactly the forces at stake, there is a strong suspicion that there are structural, non-monetary forces that keep inflation down. Demographics comes to the mind in this respect. The clearest case in this respect is Japan. Confronted with these forces one wonders whether one should remain so attached to the 2 per cent target pursued by most countries in advanced economies.

The third point, which is again well illustrated by the case of Japan, is that there are costs in pursuing aggressive monetary policies to reach the inflation objective. Indeed the Bank of Japan has been forced to look closely at the damage that its negative interest rate policy is causing to bank profitability and is cautiously tweaking its Yield Curve Control policy.

The fourth and the fifth points have to do with exchange rates, the main area of work for Jens.

There is the risk that, in the pursuit of their inflation target, countries may resort to foreign exchange interventions. While this is more of an issue in emerging rather than in advanced economies, countries over emphasising the precise achievement of their inflation objectives, like Sweden, have put on the table the possibility to have recourse to foreign exchange interventions, thus going against the consensus view prevailing among advanced economies that this tool is to be used only in extreme circumstances.

The final point raised by Jens echoes one of the issues mentioned in the book, namely about central bank independence. This is less a foregone conclusion than in the past because of the populist wave, the risk of currency wars, the unusual statements of the US president about interest rates and the value of the dollar, to the point of raising even the prospect of foreign intervention by the United States, which are decided by the Treasury but are executed by the Fed.

Francesco started his intervention thanking Bill, Brian and Jens for their comments and, half jokingly, said to Patricia that not only the sequence of interventions at the presentation should be inverted, with the discussants speaking first and the author second, but a further inversion would have been useful, with the book being only written after the presentation, so that the authors could have benefitted from the comments. Francesco also thanked Patricia for having organized the event and for having helped with useful material in the preparation of the text. Finally Francesco thanked Debbie Perelmuter for having helped him filling some knowledge gaps about the Fed.

He then picked up some of the issues raised by the discussants.

On the issue of the possible dilemma between the pursuit of financial or price stability by the central bank interest rate policy, he clarified that this dilemma is a risk, not a necessary outcome. In fact during the Great Recession there was no dilemma, as the measures needed to regain price stability were the same as those needed to regain financial stability. The dilemma may raise, however, in the future. One could hope that macroprudential measures could assure financial stability, but this is by no means certain. Should a dilemma appear, the central bank should , in Francesco's view, ask from its principal, say Parliament, whether to give priority to financial or price stability and pursue the selected objective until when the dilemma would have not disappeared.

On moral hazard, Francesco recognized that this cannot be eliminated, but should just be managed. This could be done, following the example of insurance companies, by not covering the entire risk, leaving part of the risk on the insured agent, by means of deductibles. The pricing of the swaps between the Fed and the ECB followed this principle, which Francesco dubs as the Diamond Dybvig pricing of central bank facilities, which only are attractive for banks in stressed (bad equilibrium) conditions.

Francesco agreed on the point raised by Brian that there may not be room enough to reduce interest rates on the occasion of the next recession and that there may be a need to have recourse again to quantitative easing. The risk of a blurring between fiscal and monetary policy, due to the very large role of the central bank in the market for government securities, may thus persist over time. To attenuate the negative consequences of this lack of clarity, Francesco proposes qualified majorities when the central bank would want to use its balance sheet as an additional monetary policy tool.

On the point raised by Jens, which could be dubbed as obstination in pursuing the inflation target, Francesco admitted that there is no fundamental reason to prefer a rate of inflation precisely at 2 per cent rather than some contiguous rate. He stressed, however, that 2 per cent has become a strong convention, held by nearly a billion people in advanced economies, and that moving away from it would carry substantial costs.

The initial interventions were followed by a lively question and answer session that gave a chance to the three discussants, the moderator and the author to cover some additional issues:

- How deep should the reduction of interest rates be to counter a recession,
- Which degree of transparency should central bank pursue,
- What are the merits and drawbacks of the "narrow bank" that has recently been proposed in the US,

- What would be the future of Freddie and Fannie,
- The set up for Emergency Liquidity Assistance at the European Central Bank,
- The role of the interbank money market and the usefulness of abundant reserves in non-stressed periods,
- The reported view of Claudio Borio that the aftermath of Quantitative Easing would be very difficult to manage for emerging economies.