Central banking in Turbulent Times

Les Banques et Système Financier: Quelle régulation?

Francesco Papadia

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

A five minutes summary

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- 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

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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 A and Ω 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

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- 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

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- 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

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- 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

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- 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)

Struck by multiple hits during the Great Recession II

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- 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

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- 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

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- 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

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Struck by multiple hits during the Great Recession VI

- 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

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- 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

Struck by multiple hits during the Great Recession VII

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- 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 IIX

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A hesitant forward look I

- 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

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- 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

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A hesitant forward look II

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

A hesitant forward look III

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A hesitant forward look IV

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.

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- 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

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A hesitant forward look V

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**

A hesitant forward look VI

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- **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

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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

A hesitant forward look IIX

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