

Speech for Benoît's colloquium

It is a pleasure to be back here this morning to celebrate Benoît's contribution to the ECB over the past eight years.

The theme of this colloquium – “monetary policy: the challenges ahead” – leads our eyes not only to the past. Fitting Benoît's personality and celebrating his insights, it asks questions about the many challenges that lie on the horizon.

My remarks today are primarily in praise of, and friendship for, Benoît. But precisely because Benoît is a person of substance over form, it is not possible to praise him without being drawn into the substance of the policy to which he has devoted his mandate.

Benoît's time as a Board member was one of change and innovation in many areas. The issues facing monetary policy over his tenure at the ECB, however, can be broadly divided into **two questions**:

First, whether the central bank can control financing conditions in the economy.

And second, crucially, whether those financing conditions impact on real behaviour – investment, consumption, saving – in the way desired by the central bank.

1. Central banks and financing conditions

Before we get into the **first question**, let me make clear that the primary subject central banks look at when making their decisions is the real economy. Once this is absolutely clear, we can consider other issues such as the relationship between the central bank and the market – which is the topic of the first panel today.

How central banks and markets interact – and critically, who leads whom – is an important topic. Benoît reflected on a great deal during his time as a Board member.

From a policy perspective, however, any framing of the issue that pits the central bank and the market against one other is not especially fruitful. Ultimately, the central bank must make the market work alongside it.

Jeremy Stein in previous work used a particularly evocative image to convey this notion: he said that central banks “recruit” banks and other financial intermediaries to transmit their policy impulses to the broader economy.

This is because many channels of monetary transmission operate through financial markets, and first among them is the bond market. Market prices reflect expectations of central bank policy and how its reaction function is understood. They transmit its policies into financing conditions for the real economy. And they reveal the degree of confidence in the effects of monetary policy on output and inflation.

Market prices, in other words, are a mirror of the policy stance, a channel of transmission and a barometer of central bank effectiveness. However intensively a central bank deploys its instruments, it can only succeed if it recruits the market to extend its reach.

So the most important policy question is: what is the best way for central banks to ensure that the market is working with them to achieve their goals?

Central banks first have to be clear about their assessment of the economy and, second, to be prepared to deploy the necessary tools, within their mandate, so as to steer the economy in the direction that is most consistent with attaining their mandate.

If these two conditions are met, then the market will follow and be a key ally, helping the central bank deliver its intended policy stance.

Indeed, my view is that monetary policy is fundamentally guided by an assessment of the economy. And it is only when the central bank shares that assessment with the market, and convinces the market that it is ready to do what is necessary within its mandate to achieve its objective, that the market will be recruited to its side.

We saw this during the crisis. Before the crisis, it was generally thought that the capacity of monetary policy to steer financing conditions would diminish as interest rates approached zero. But major central banks showed this was not a foregone conclusion.

By explaining why unconventional policies were needed given the state of the economy, and by showing their commitment to using them, they were able to continue easing financing conditions even as rates hit zero – be it by breaking through the zero line, and/or by using asset purchases to lower term premia further out the yield curve.

In the ECB's case, successive policy packages were able to lower the whole matrix of interest rates – across the maturity spectrum and asset classes – to levels that could spur the recovery and inflation normalisation. That process was so powerful that monetary policy became the main driver of the economic recovery after 2014.

And, once the market understood how and why these policies worked, it opened up another possibility, which was for a more transparent disclosure of the reaction function that reinforced the stabilisation capacity of monetary policy.

Forward guidance is an example of this. In the case of the ECB, it now means that the start of rate lift-off, the end of net asset purchases and the end reinvestments are all automatically revised by markets in line with the latest data releases. That in turn leads to rate expectations and term premia adjusting in the direction desired by policy.

So this illustrates how, with the right tools and communication, markets can “fight alongside” the central bank – but with policy leading and prices following.

That said, central to the effectiveness of this mechanism is confidence that the central bank is institutionally empowered to use all the instruments it needs to fulfil its mandate.

Post-2008, the ECB faced an exceptionally complex environment where, for some time, the irrevocability of the euro was not taken for granted; where monetary policy was complicated by fiscal policies and sometimes financial sector policies acting pro-cyclically; and where the ability of the ECB to act to secure price stability was challenged in court.

This meant that the ECB had to restore policy transmission not only by adjusting the parameters of policy, but also by dismantling false conceptions about its willingness and capacity to act. This was also reinforced by the rulings of the European Court of Justice.

So, I am confident that those exceptional circumstances are now consigned to the past.

Throughout this period, Benoît contributed greatly to the success of the ECB's actions, in particular as the board member in charge of markets. That gave him a key role in the design of the Outright Monetary Transactions programme and in the execution of the asset purchase programme.

But Benoît also helped turn financial markets into an ally in a more indirect, but equally powerful way: he convinced through the strength of argument.

Indeed, central bankers can influence markets not just by expressing their views about the state of the economy, calibrating their tools or defining their reaction functions. They can also do so by leading the debate in economic and policy circles about the tools that are needed in any specific circumstance and how they work to achieve their goals.

That is why we make so many speeches, and Benoît himself has made around 175 as a Board member. But remarkably, he has rarely ever repeated himself.

Rather, he shed light on many critical issues for the ECB and, in doing so, shaped public opinion and built confidence – a confidence that was crucial when we were introducing measures for which there was no prior precedent.

2. Financing conditions and real activity

Still, even if central banks are successful in making the market work with them, the **second question** remains: how accommodative financing conditions affect the real economy.

There is ample evidence that easier financing conditions lead to higher consumption and investment. We have seen all of the main transmission channels at work in the euro area over the last 5 years: intertemporal substitution through credit, wealth effects and income effects.

Importantly – and contrary to a common narrative – monetary policy exerts some its strongest effects via those at the bottom of the income scale. These people are typically net debtors, and so experience a positive income effect from lower interest payments. They also benefit disproportionately from the employment gains created by expansionary policy.

And, since these households have a higher marginal propensity to consume than those higher up the income scale, the subsequent effects on consumption are significant.

But that being said, one can also envisage situations where the causality from easier financing conditions to stronger demand might become looser.

One example is when there are high levels of macroeconomic uncertainty, which can affect private sector transmission, in particular via business investment.

Another example is when there is institutional uncertainty, which can lead to precautionary saving as countries are forced to self-insure. President Lagarde recently talked about how insufficient risk sharing within EMU can create a “paradox of thrift” in this regard.

A third example is the question surrounding the “reversal rate”, and how close policy rates are to a point where they might hamper monetary policy transmission and/or trigger mass retrenchment from credit creation.

Whether we are close to the reversal rate is an empirical question. But, insofar as these various effects are plausible, they call for independent central bankers to reflect. They imply a need to think beyond their sole field of action and to understand interactions between policies.

For example, if macroeconomic uncertainty is constraining the private sector transmission of monetary policy, the public sector transmission channel becomes more important as a counterweight. So monetary-fiscal interactions become more relevant.

Likewise, if the slow pace of institutional deepening is producing precautionary saving, a commitment to move faster can raise confidence and provide a demand stimulus. So monetary policy and EMU reform become part of the same policy mix.

In other words, one can conceive of situations where the classic interpretation of the Tinbergen principle – where single tools are assigned to single objectives – becomes less useful, because it is in fact multiple policies working together than can best deliver those objectives.

Independence and democratic accountability require central bankers to fulfil their mandates even when policy areas do not contribute enough. Of course, they should act carefully under uncertainty and be aware of the financial stability risks that their actions might entail.

But one question that is rarely asked is whether these risks would be lower in the absence of the monetary policy that is required by their mandate.

At the same time, central banks cannot compel other policy areas to act alongside them. Instead, they have to explain to others what is needed to deliver price stability most efficiently, and to convince them of why it is necessary.

And since this is in the service of price stability, it is not contrary to the principle of “monetary dominance”. It is rather its natural extension in new economic times. “Monetary dominance” means that alignment between policies must serve the central bank’s objectives and never detract from them.

This brings me back to Benoît. Few have done so much to explain – and so convincingly – why other policy areas need to play their role in a well-functioning monetary union.

He has explained the interactions between monetary policy and structural policies. He has set out how a euro area fiscal capacity could be constructed while avoiding moral hazard.

And in his role in charge of International and European relations, he has led debates on the institutional reform of EMU and its link to the transmission of monetary policy.

I hope that, in a future where policy coordination becomes more salient, the world will continue to heed what Benoît has to say from his new position in Basel.

So let me conclude by saying: thank you Benoît. Thank you for everything you did. And thank you in advance for everything you will continue to do.