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"Exiting unconventional monetary policies in an uncertain world"

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Ladies and Gentlemen,

Bienvenue à Paris. It is a pleasure to welcome you to the Banque de France for this conference on “exiting unconventional monetary policies”. I must say that you have picked the right moment for such a discussion: I have just returned from Frankfurt, where the Governing council of the ECB held a monetary meeting. Like other central banks, we are now pursuing a course of gradual normalisation in an uncertain world. Allow me to begin by giving some highlights on our **domestic strategy** for the euro area, before elaborating on the challenges that we collectively face at the **global level**.

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1. Monetary policy in the euro area: where are we heading?

The euro area is experiencing a **broad-based economic expansion**. Q2 2018 was the 21st successive quarter of economic growth. 9.2 million jobs have been created since 2013 and the unemployment rate has fallen from 12.1% to 8.1%, although this figure is still too high. The output gap was probably closed by the end of last year. Recent survey data on the growth outlook have been somewhat weaker, although less so in France.

But our outlook for inflation is still firming. There are increasing signs that the labour market is tightening and nominal wage growth is picking up: the Phillips curve is back to work, albeit a bit later than expected; and this should pass through to core inflation which has been lagging behind due to the temporary effects of the appreciating terms of trade and declining corporate margins. We at the Governing Council are thus increasingly confident in the sustained adjustment in inflation back to our objective, with our forecast for 1.7% in each of 2018, 2019 and 2020, vindicating our unanimous decisions in June.

Alongside these positive developments, there are, however, growing uncertainties: protectionism – I will come back to this later; rising oil prices; the US policy-mix – a warranted monetary policy normalisation and a less warranted fiscal stimulus – with which many EMEs are struggling; and equity

market valuations, that may appear more in line with economic fundamentals and corporates earnings after the latest correction, but remain volatile in part due to geopolitical risks as well. Within Europe, Italian fiscal policy is under investor scrutiny. And there is Brexit, although its direct effect on the euro area macroeconomy is likely to be small.

How should we, as euro area central bankers, respond to this economic environment? By combining two apparently contradictory aims: clarity and flexibility.

As regards **clarity**, our first duty as policymakers is to provide markers to help guide economic actors and financial markets in the increasing fog of uncertainties. For our guidance to be reliable, we need to be as clear, credible and consistent as possible. We cannot be clear like a train timetable but more like how a captain sets a course and adapts to the wind and the waves.

So our sequence of steps for policy normalisation is very predictable:

- First, we halved our net asset purchases to 15 billion this month and will very probably end them in December;
- Second, we set down a guide post with our long-dated forward guidance: we will maintain interest rates at current levels until at least through the summer of 2019;
- And third, we will retain our stock of assets for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Let me insist on this: the end of the net asset purchases will not be the end of our monetary stimulus, far from it.

Moreover, this sequence doesn't depend on the fiscal uncertainties that can appear in member states. The Governing Council is clear about the fact that there is no fiscal dominance in the euro area and no influence of any national fiscal policy on our common monetary policy.

In addition, our past consistency forges our credibility for the future. Since March 2016, we took decisions on the evolution of our net asset purchases at

intervals of approximately 9 months. Each time, we gave visibility over the next twelve months; and we stuck to the provisional indicative timetable that we set without extending the time limits.

I turn now to **flexibility**. Our sequence is clear but the details of implementation are flexible and state-dependent. We have included several options, such as the precise timing of the first increase in interest rates and the path of policy rates thereafter, or the pace of our reinvestments. There is much speculation for instance on the future trajectory of our interest rates; but at this stage, I don't see any value in trading off our flexibility tomorrow against more clarity today. Beyond that, as Mario Draghi mentioned today, the question of TLTROs will need to be considered.

In the face of uncertainty, one often hears reference to the celebrated Brainard[i] 'conservatism principle' (as reinterpreted by Alan Blinder[ii]). This is not, as the impression is sometimes given, a general warning to move cautiously when the world is uncertain. The Brainard 'conservatism principle' says only that you should move cautiously if you are uncertain about the effect of your policy instrument on your objective. But we should go beyond a static view of Brainard's principle (which focuses on one single small step): a dynamic view would include the time dimension and consider how to manage and communicate a sequence of incremental steps.

2. <u>How can we collectively respond to global tensions?</u>

There are increasing tensions in the global environment, starting with **protectionism**. Beyond the direct trade policy shock resulting from a rise in import tariffs, two factors at least may amplify the decline in global GDP: a decline in investment demand caused by firms' falling business confidence due to uncertainty, and a rise in the financing cost of capital due to an increase in actual or perceived borrower risk. According to Banque de France model estimates, the negative impact on GDP of higher import tariffs is 2 to 3 times larger when we account for these indirect channels. And this increase in

uncertainty can produce front-loaded negative effects, even before the effective implementation of protectionist measures. That said, protectionism is first and foremost a negative supply-shock, with stagflationary effects. As such, the adverse effects of protectionism cannot and should not be accommodated by monetary policy.

In spite of protectionist threats, the global economy continues to expand strongly, at 3.7% this year. We have used a lot in our latest IMF meetings, the nice French word « plateau » to describe global growth. But this "plateau" is not even: the strong acceleration in the US, even if it is temporary and fragile, is offset by a moderation elsewhere. In short, we are moving from synchronized growth to **economic divergence**.

Consequently, countries might be suffering from the ongoing rise in US interest rates. Helene Rey's famous paper in 2013[iii] argued that floating exchange rates are not sufficient to give countries independence from US monetary policy if they have an open capital account. If the trilemma is in fact a dilemma, then countries will have to choose between monetary independence and closing their capital accounts.

I would question the generality or starkness of this dilemma. For example, I do think that the euro area can determine its own course. Our asset purchase programme has contributed to a spread exceeding 250 basis points between the 10 year yields in the US and in Germany. Likewise, the gap between policy rates in the US and the euro-area is the widest since 2009. More technically, an estimated Taylor rule for the euro area that includes US monetary policy as one of the explanatory factors finds only a very modest co-movement between the two.

What is more, countries seem to be arranged along a continuum, with some exhibiting total independence at one end to those with exchange rates pegged to the US dollar at the other. So they don't have to choose one of the two polar positions but can pick an intermediate position. For example, putting some

temporary restrictions on cross-border movement of capital could give some but not complete independence of monetary policy.

But is there more that central bankers can do to manage the tensions created by this economic divergence? Put another way, how do we reconcile yet another paradoxical couple: **independence** and **co-operation**? In my view, we can and should act to enhance co-operation between central banks, based on four building blocks:

- Mutual predictability of policy making. We will achieve the closest to a co-operative solution if we avoid large surprises between policy makers. While trade multilateralism is at risk, monetary and financial multilateralism stands fast, fortunately. This means continuing to favor dialogue and exchange of information among central banks, and to be very clear about our monetary policy regime choice. We should cherish the "great convergence" of policy objectives of the last fifteen years. Among major advanced economies, we now have domestic inflation targeting around a 2% medium-term objective.
- We are ruling out any currency war, as clearly stated in the unanimous communiqué of our Bali meeting earlier this month: "We will not target our exchange rates for competitive purposes".
- On capital flow management (CFM) measures, we should support the ongoing reflections undertaken within the relevant international bodies and give priority to practical and pragmatic solutions – IMF type – rather than dogmatic purity.
- Last, as the G20 Eminent Persons Group (EPG), led by Tharman Shanmugaratnam, rightly stressed in its recent report, we need to put in place a reliable Global Financial Safety Net before the next crisis and co-ordinate its different layers. This should include an "IMF standing liquidity facility". The global financial safety net is the best insurance we can get against the risks created by economic divergence and it comes at a limited cost.

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Let me conclude by quoting Voltaire, who wrote in 1770: "Doubt is an uncomfortable condition, but certainty is a ridiculous one."[iv] In these times of doubt, we as central bankers should be predictable without being pre-committed – or, as Voltaire would say, we should give clarity without pretending to certainty. This is precisely the objective of Governing Council of the ECB: we are committed to give as much clarity as possible; clarity, not certainty, which is neither possible nor desirable. Thank you for your attention.

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[i] Brainard, W. (1967), « Uncertainty and the effectiveness of policy » the American Economic Review, Vol. 57, No. 2, Papers and Proceedings of the Seventy-ninth Annual Meeting of the American Economic Association, May, pp. 411-425.

[ii] Blinder, A. (1999), Central Banking in Theory and Practice, the Lionel Robbins lectures, MIT Press, Cambridge Massachusetts.

[iii] Rey, H. (2013) "Dilemma not Trilemma: The global financial cycle and monetary policy independence", Jackson Hole conference proceedings, Kansas City Fed.

[iv] Letter to Frederick William, Prince of Prussia (28 November 1770).