Introductory Statement by Mr Vitor Constâncio candidate for VicePresident of the ECB, to the the Economic and Monetary Affairs Committee of the European Parliament

Brussels, 14 January 2010

I am honoured to appear before your Committee for an exchange of views related to my candidature for the Vice-Presidency of the ECB. I trust you have read my CV and had the occasion to note my commitment and involvement with the European project and also my professional experience as a central banker. I particularly wish to underline my almost ten years of service as an active member of the Governing Council of the ECB. I am proud of the quality of the monetary policy we have been able to deliver with positive results, as reflected in an average inflation of just 2 % since the beginning of monetary union and the firm anchoring of inflation expectations, a fundamental criterion of a good monetary policy.

That is what I wanted to remind you about my record and I will devote the rest of this statement to a presentation of my views about the mandate and the role of the ECB, explaining in the process my position on some sensitive monetary policy issues.

I think that Otmar Issing got it right when in his recent book he summed up the basic principles of our monetary union: «In legal terms, the monetary policy of the ECB rests on three pillars: prohibition of monetary financing; central bank independence; primacy of price stability» [1] This last principle implies, as is well known, that the Treaty establishes a clear hierarchical mandate defining as secondary and subordinated the objective of supporting « the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in article 3…» [2]. The meaning and operational consequences of this secondary objective have been much discussed. There is general agreement that in the long run there is no trade-off between inflation and growth or, to put it better, the best way for monetary policy to support the long-run growth rate is to maintain price stability, as this promotes efficiency in a decentralized market economy. The situation is different in the short term, a fact which is clear when there is a supply or cost-push shock to which monetary policy should not respond immediately in spite of the temporary increase in headline inflation. That is what we did when we didn't respond, in the absence of second round effects, to the oil price increases of 2000/1, and even reduced interest rates in May of that year, when headline inflation was 3.2% . More generally, even if one accepts the notion that the economy has a spontaneous tendency to go back to its long-term path, there is a short term trade-off because macroeconomic policy affects the speed of that convergence and may avoid higher output volatility, thus increasing the general welfare. Nonetheless, it is difficult to exploit this trade-off in a hierarchical mandate.

I take seriously the secondary objective defined by the Treaty, which becomes operational when price stability is clearly assured. In a way that is what we have been doing in the present crisis. When, after the failure of Lehman, we saw that inflation was no longer a risk, we acted forcefully to avoid the collapse of the banking system and to prevent its recessionary and deflationary consequences.

In what regards our *monetary policy strategy*, I attach great importance to the clarifying statement we issued in May 2003 after having deeply analyzed the functioning of our monetary framework, an endeavour in which I actively participated. I want to stress five points of that statement. First, the new quantified objective for price stability, defined as inflation «below but close to 2%». The reasons for this new way of defining the objective are well spelled out in the statement itself: «to provide a sufficient safety margin to guard against the risks of deflation. It also addresses the issue of the possible presence of a measurement bias in the HICP and the implications of inflation differentials within the euro area.» All three reasons are important, particularly the first one in the present situation of very low inflation, which has recently led the Eurosystem staff to forecast inflation rates well below 2% for this year and the next. The commitment to keep inflation, on a medium-term basis, below but close to 2% is what provides the most solid structure for our monetary strategy. It is our compass, as President Trichet likes to point out.

The second point is related to the clear assignment of different time frames to the previous two pillars and to deal first in our communication with the economic analysis that is very relevant for the operational horizon of policy. The third aspect points to monetary analysis being very relevant for medium to long-term trends in inflation, specifically mentioning that «monetary analysis mainly serves as a means of cross-checking, from a

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[1] Issing, Otmar (2008) «*The birth of the Euro*»

[2] Previous Article 2

medium to long-term perspective, the short to medium-term indications coming from economic analysis». The fourth item results from the intention of underlying the medium to long-term horizon of monetary analysis and led us to decide that we would « no longer conduct a review of the reference value on an annual basis». Finally, the last point relates to the concept that « monetary analysis will take into account developments in a wide range of monetary indicators including M3, its components and counterparts, notably credit». If carefully reflected upon, these several points should have been sufficient to put into proper perspective the role of the different aspects of the comprehensive, full information analysis that we apply to assessing inflation risks.

The point about the use of credit aggregates allows me to address another issue regarding the relation of monetary policy to other goals. This time, what is at stake is the important issue of financial stability. «There is some ambiguity about the definition of financial stability but two main meanings stand out. One, more fundamental, follows Mishkin (1991) [3] and defines financial stability as a situation where the financial system is able to ensure in a lasting way, and without major disruptions, an efficient allocation of savings to investment opportunities. In another sense, financial stability refers to the absence of a major misalignment of asset prices that can threaten future disruption of markets and the real economy. Both meanings are of course connected as they point to the same notion of smooth functioning of financial institutions and markets.» [4]

Naturally, the instruments of regulation and prudential supervision are prominent to deal with issues related to financial stability. However, it is well known that the evolution of credit aggregates in particular is associated with periods of asset price booms and crashes. In view of the severe disruption caused by asset price crashes, as we have seen in the present crisis, the debate about the inclusion of asset prices in the objective function of monetary policy has been reignited. Traditional thinking maintains that it is not feasible and it is not even necessary because price stability in the market of goods and services also creates the stability environment that ensures financial stability. However, this view has been invalidated by the events of the past few years that show a succession of bubbles in asset prices coexisting with a climate of low inflation. This means, for instance, that the fact of our framework comprising monetary analysis, including credit aggregates, does not necessarily imply that monetary policy orientated to price stability will automatically cater for financial stability. This would not be the case even if we increased the horizon of our operational decision-making because asset prices do not always move together with prices of goods and services.

There is a trivial sense that implies that all central banks consider the indications of asset prices in thinking about monetary policy. For instance, the wealth effects stemming from asset appreciations will always have to be considered as they influence global demand, putting pressure on inflation. Beyond this role, there are several arguments against a tighter integration of asset prices in monetary policy objectives but those arguments also have good rebuttals. A point of general agreement is that no precise targets concerning asset prices could ever be defined as a concrete goal for monetary policy. On the other hand, though, monetary policy is not an exact science and economists and central bankers should not fall into the mistake of certain theoreticians stigmatized by Keynes as people who «prefer to be rigorously wrong rather than approximately right». After all, financial market disruptions can create episodes of unstable prices, in either direction, and central banks should not assume the asymmetric position that they only intervene to avoid the consequences of crashes in financial markets and do nothing when price booms or bubbles are developing. With the additional caution that using monetary policy to help contain incipient bubbles should not go to the point of creating unnecessary recessions, the attitude of «leaning against the wind» may have to be considered, especially after the experience of the present crisis.

A more general question relates to the inclusion of financial factors in the economic analysis undertaken by central banks, in particular in the current state-of-the-art macroeconomic models. A full-fledged inclusion of these factors would undoubtedly enrich our analysis of issues related to asset prices and financial stability. Valuable work aiming to bridge these dimensions is currently being undertaken at central banks and universities, but clearly further research is still needed on this dimension.

Regarding the instruments of regulation and prudential supervision, the work already done and the measures already announced in the wake of the financial crisis go a long way to address the problems and will

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[3] Mishkin, Frederic S. (1991) "Anatomy of financial crisis" NBER Working Paper n. 3934

[4] Vítor Constâncio (2006) «Finance and Regulation» Meeting of the European Association for Banking and Financial History, Lisbon 26-27 May 2006 (available in http://www.bportugal.pt)

contribute to avoiding future crises of the same type. I find particularly relevant the following measures; (i) the redefinition of the regulated perimeter of the financial system to eliminate the «shadow banking system»; (ii) the correction of the prociclicality of existent capital regulation with dynamic provision; (iii) the increase in the requirements for more and better capital; (iv) the introduction of a leverage ratio that will put a brake on institutions' excesses; (v) the introduction of concrete liquidity regulations; (vi) the corrections to consolidation rules and to fair value accounting when markets are under stress. Nevertheless, there are aspects that, in my view, still require further work: the monitoring of rating agencies; the crisis resolution of cross-border institutions in Europe; and the problem of «too big to fail» institutions. A positive development is the institutional reform of regulation in the European Union with the creation of the ESAs and the ESRB.

The other aspect of financial stability that I mentioned before – the need to avoid disruption to the proper functioning of the financial system – also confronts monetary policy. It is a problem that cannot be ignored by central banks as financial institutions are essential for the economy and for the transmission of monetary policy itself. What is at stake here is especially the provision of liquidity in difficult situations. What makes less problematic this possible conflict with monetary policy main priority, is that providing temporary liquidity, and even easing interest rates, in such situations of grave danger for the financial sector, will not compromise the primary objective of keeping price stability. This compatibility of objectives was clearly obvious in the present crisis, especially after the failure of Lehman Brothers. Since the beginning of the crisis, in August 2007, we have been more forthcoming than others in providing liquidity. But until October 2008, when inflation was going up as a result of commodity price hikes, we provided abundant liquidity to the financial system even while keeping interest rates basically unchanged. We only started to reduce rates after the panic created by the Lehman case made the risks of inflation disappear in the wake of the ensuing recession. Also, and most important for the functioning of the financial system, we decided to change the provision of liquidity by increasing the maturity of monetary operations and, especially, by guaranteeing full allotment of the liquidity demanded by the banks. With this measure, we allowed for the overnight interbank market rate (EONIA) to become lower than the monetary rate and for the whole spectrum of Euribor rates until 12 months to come down. As a result of all this, the balance sheet size of the Eurosystem increased substantially and the monetary base went up by about 40%. The same, or even more, was also done by other major central banks, which led some analysts to start fearing future inflation. In fact those fears are misplaced. As a consequence of the recession, the demand for credit and money decelerated a great deal and the banks became more restrictive in supplying credit all of which led to a collapse of the multiplier and to the recent absolute reduction in nominal terms of both credit and money – M3 decreased for the first time in decades. This means that the money supply at large has in fact not increased. Recognising this, however, some do not put to rest their concern because they fear that the high level of central bank money in the system could lead the banks at a future date to suddenly start over-expanding credit again. This is of course unlikely because the recovery will be very moderate, especially in Europe, as everyone predicts. Headline inflation and core inflation are at the lowest point since the inception of the euro and all forecasts for the next two years point to figures well below 2%. The only significant upside risk to inflation comes from a possible jump in commodity prices. If, however, the landscape changes and the recovery proves to be much stronger and inflation risks start to gradually emerge, we would change the monetary policy stance very quickly and keep inflation under control. Reducing central bank money is fairly easy in our case because the increase was mostly done through normal open market operations with the banks. We have even started to announce the gradual withdrawal of some of those operations, paving the way for a gradual exit strategy. All these reminders mean that I firmly belief that we are in a position to fulfil our mandate by keeping inflation low, thus creating the conditions for long-term healthy growth and defending the purchasing power of European citizens.