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Neel Kashkari: Why I Dissented a Third Time

Essay by Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, published on the website of the Federal Reserve Bank of Minneapolis, 18 December 2017

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Last week, the Federal Open Market Committee raised interest rates for the third time this year and, also for the third time this year, I voted against that increase. I initially dissented in March because I didn't see much evidence that inflation was climbing toward the Fed's 2 percent target and there still seemed to be slack in the labor market. I didn't see the need to tighten monetary policy. Since then, instead of rising, inflation has actually fallen to 1.6 percent. Now a new concern is emerging: In response to our rate hikes, the yield curve has flattened significantly, potentially signaling an increasing risk of a recession. Together, these factors make a compelling case that the FOMC should not increase rates further until we are much more confident that inflation is returning to our target.

Congress has given the Fed its dual mandate of price stability, which we define as 2 percent inflation, and maximum employment, which essentially means that as many Americans who want to work are able to find jobs. Typically, we believe those two goals are linked through wages: As the job market gets stronger, businesses compete to find workers, driving wages higher, which then drives up inflation. When inflation climbs above the Fed's target, the FOMC raises interest rates, which slows economic activity, wage growth and inflation. We cut rates to do the opposite. At least that how it's supposed to work.

The past couple of years have been perplexing for the Fed because even though the job market has strengthened a lot, with the headline unemployment rate falling from a peak of 10 percent in 2009 to 4.1 percent today, wage growth and inflation have been muted. Why aren't wages picking up?

In my view, the two most likely explanations are that the job market is not as tight as the 4.1 percent unemployment rate suggests and that people's expectations for future inflation have fallen, which can become self-fulfilling.

The headline unemployment rate includes only people who are actively looking for work. While 4.1 percent is low by historical standards, the Great Recession pushed many people out of the labor force, some of whom are only slowly reentering. One measure of the labor force—the participation rate for workers between 25 and 54 years old, typically called “prime age”—suggests that there could be more than a million workers still on the sidelines. We don't know how many will return, but with wage growth still well below its precrisis pace, it's easy to argue that we might not really be at full employment. If wage growth climbs, I expect to see more people come into the labor force.

Turning to expectations, people's beliefs about future inflation are enormously important to where inflation is actually headed. If workers believe inflation will be low in the future, they demand smaller wage increases from their employers. Japan has shown us that when low

inflation expectations become embedded in a society, they can be very hard to raise. While high inflation is clearly bad for society, excessively low inflation can limit the Fed's ability to respond to future recessions, potentially making them longer and more damaging. Market-based measures suggest that U.S. inflation expectations have fallen well below precrisis levels.

These arguments drove me to vote against rate increases in March and June, and the data since those votes have only heightened my concerns. What is new is the flattening yield curve, the difference between 10-year and 2-year Treasury yields, which has fallen from around 1.45 percent before the FOMC started raising rates in late 2015, to approximately 0.51 percent today. An inverted yield curve, where short rates are above long rates, is one of the best signals we have of elevated recession risk and has preceded every single recession in the past 50 years. While the yield curve has not yet inverted, the bond market is telling us that the odds of a recession are increasing and that inflation and interest rates will likely be low in the future. These signals should caution the FOMC against further rate increases until it becomes clear that inflation is actually picking up.

These trends suggest that monetary policy is entering a delicate phase. We all want the economic expansion to continue. However, continuing to raise rates in the absence of increasing inflation could needlessly hold down wage growth while potentially increasing the chance of a recession.

My Analysis (An Update to the Framework First Published in February 2017)

Let me acknowledge up front that the analysis that follows is somewhat detailed and complex; yet it is still not comprehensive. FOMC participants look at a wider range of data than I detail here. I am focusing only on the data that I find most important to determining the appropriate stance of monetary policy.

As I have done previously, let me begin my analysis by assessing our progress in meeting the dual mandate Congress has given us: price stability and maximum employment.

Price Stability

The FOMC has defined its price stability mandate as inflation of 2 percent, using the personal consumption expenditures (PCE) measurement. Importantly, we have said that 2 percent is a target, not a ceiling, so if we are under or over 2 percent, it should be of equal concern. We look at where inflation is heading, not just where it has been. Core inflation, which excludes volatile food and energy prices, is one of the best predictors we have of future headline inflation, our ultimate goal. For that reason, I pay attention to the current readings of core inflation.

Chart 1 shows both headline and core inflation since 2010. The rebound in energy prices lifted headline inflation earlier this year, but it has since moved back down below 2 percent. You can see that both inflation measures have been below our 2 percent target for several years. Twelve-month core inflation has fallen below 1.5 percent in recent months and shows

no sign of consistently trending upward. It is still below target and, importantly, even if it met or exceeded our target, 2.6 percent should not be of any more concern than the current reading of 1.4 percent, because our target is symmetric. Since the June FOMC meeting, when the Committee last raised the target range for the federal funds rate, both headline and core inflation have declined further below 2 percent. Headline inflation has fallen from 1.7 percent to 1.6 percent, while core inflation has dropped from 1.6 percent to 1.4 percent. This is concerning. Some have attributed the low core inflation readings to transitory factors such as a drop in cell phone service prices. That is possible, but I need to see more data before I am convinced that inflation declines are only transitory.

Next let's look at inflation expectations—or where consumers and investors think inflation is likely headed (Chart 2). Inflation expectations are important drivers of future inflation, so it is critical that they remain anchored at our 2 percent target. Here the data are mixed. Survey measures of long-term inflation expectations are flat or trending downward. (Note that the Michigan survey, the black line, is consistently elevated relative to our 2 percent target. What is important is the trend, rather than the absolute level.) The Michigan survey has found inflation expectations trending downward over the past few years, and they remain near their lowest-ever reading. In contrast, professional forecasters seem to remain confident that inflation will average 2 percent. While the professional forecast ticked upward slightly earlier this year, those readings have ticked back down again since the June FOMC meeting.

Market-based measures of long-term inflation expectations jumped a bit immediately after the 2016 presidential election. The markets' inflation forecasts moved back down earlier this year and have edged up slightly since the June meeting. As Chart 3 indicates, market-based expectations remain at the low end of their historical range.

But perhaps inflationary pressures are building that we aren't yet seeing in the data. I look at wages and costs of labor as potentially early warning signs of inflation around the corner. [1] If employers have to pay more to retain or hire workers, eventually they will have to pass those costs on to their customers. Ultimately, those costs must show up as inflation. But we aren't seeing a lot of movement in these data. The red line in Chart 4 is the employment cost index, a measure of compensation that includes benefits and is adjusted for employment shifts among occupations and industries. The blue line is the average hourly earnings for employees. Both lines have moved little since the June FOMC meeting, and each stands at 2.5 percent; both remain low relative to the precrisis period. In short, the cost of labor isn't showing signs of building inflationary pressures that are ready to take off and push inflation above the Fed's target.

Now let's look around the world. Most major advanced economies have been suffering from low inflation since the global financial crisis. It seems unlikely that the United States will experience a surge of inflation while the rest of the developed world suffers from low inflation. Since the June FOMC meeting, headline inflation has increased in the United Kingdom due to last year's sterling depreciation resulting from Brexit, but headline inflation has been roughly flat in other advanced economies. As you can see in Chart 5, with the

exception of the U.K., core inflation rates in advanced economies continue to come in below their target rates.

In summary, inflation has moved further below our target, and market-based measures of inflation expectations remain at low levels. Some argue that the decline in inflation this year is transitory, but we don't know that for certain, and the longer it persists, the more tenuous the transitory factors story becomes.

Maximum Employment

Next let's look at our maximum employment mandate. One of the big questions I continue to wrestle with is whether the labor market has fully recovered or if there is still some slack in it. Over the past few years, some people repeatedly declared that we had reached maximum employment and that no further gains were possible without triggering higher inflation. And, repeatedly, the labor market proved otherwise. Chart 6 shows that the headline unemployment rate has fallen from a peak of 10 percent to 4.1 percent, below its precrisis level. We also look at a broader measure of unemployment, what we call the U-6 measure, which includes people who have given up looking for a job or are involuntarily stuck in a part-time job. The U-6 measure peaked at 17.1 percent in 2010 and has fallen to 8.0 percent today, also below its precrisis level. But these measures still leave out a large number of people who might prefer to work if better job opportunities were available to them.

The employment-to-population ratio and the labor force participation rate capture the percentage of adults working or actively looking for work. We know these are trending downward over time due to the aging of our society (as more people retire, a smaller share of adults are in the labor force). To adjust for those trends, I prefer to look at these measures by focusing on prime working-age adults. Chart 7 shows that, even with the strong job gains in recent years and the decline in unemployment rates, the labor market still shows more slack than before the crisis.

The bottom line is that the job market has improved substantially, and we are getting closer to maximum employment. But we still aren't sure if we have yet reached it. In 2012, the midpoint estimate among FOMC participants for the long-term unemployment rate was 5.6 percent—the FOMC's best estimate for maximum employment. We now know that was too conservative—many more Americans wanted to work than we had expected. If the FOMC had declared victory when we reached 5.6 percent unemployment, many more workers would have been left on the sidelines. Since the June FOMC meeting, the headline unemployment rate has fallen from 4.3 percent to 4.1 percent. The labor force participation rate for prime working-age adults increased from 81.5 percent to 81.8 percent, while the prime-age employment-population ratio increased notably from 78.4 to 79.0 percent.

We also know that the aggregate national averages don't highlight the serious challenges individual communities are experiencing. For example, while the headline unemployment rate today for all Americans is 4.1 percent, it is still 7.3 percent for African Americans and 4.7 percent for Hispanics. The broader U-6 measure, mentioned above, is roughly double the headline rate for each group.

Current Rate Environment

OK, so we are still coming up short on our inflation mandate, and we are closer to reaching maximum employment. Let's have a look at where we are now: Is current monetary policy accommodative, neutral or tight?

I look at a variety of measures, including rules of thumb such as the Taylor rule, to determine whether we are accommodative or not. There are many versions of such rules, and none are perfect.

One concept I find useful, although it requires a lot of judgment, is the notion of a neutral real interest rate, sometimes referred to as R^* , which is the rate that neither stimulates nor restrains the economy. Many economists believe the neutral rate is not static, but rises and falls over time as a result of broader macroeconomic forces, such as population growth, demographics, technology development and trade, among others.

There are a range of estimates for the current neutral real rate. Having looked at them, I tend to think it is around zero today, or perhaps slightly negative. The FOMC raised rates by 0.25 percent in June, moving the target range for the nominal federal funds rate to between 1.00 percent and 1.25 percent. With core inflation around 1.5 percent, the real federal funds rate was between -0.50 percent and -0.25 percent. Combined with a neutral rate of zero, that means monetary policy was only about 25 to 50 basis points, or 0.25 percent to .50 percent, accommodative going into last week's FOMC meeting. Monetary policy has been at least this accommodative for several years, including the effects of the Federal Reserve's expanded balance sheet, without triggering increasing inflation. This further confirms my view that monetary policy has been only moderately accommodative over this period.

Financial Stability Concerns

Please see my essay on how I think about monetary policy and financial stability. [2] In short, while some asset prices appear elevated, I don't see a correction as being likely to trigger financial instability. Investors would face losses from a stock market correction, but it's not the Fed's job to protect investors from losses. Our jobs are to achieve our dual mandate and to promote financial stability.

Fiscal Outlook

I had not factored major fiscal policy changes into my economic and policy forecasts because there was too much uncertainty as to whether, when and how large any fiscal changes would be. But given that the House and Senate have both passed major pieces of tax legislation, I have now incorporated the tax package into my economic forecast. The expected effects on supply and demand do not appear large enough at this point to change my expected path for monetary policy. If the economic effects end up larger than expected, I will adjust my policy forecast when that becomes clear.

Global Environment

The world is large and complex. There is always something distressing going on somewhere. But, overall, global economic and geopolitical risks do not seem more elevated than they have been in recent years. In fact, some global risks appear to have diminished, and the outlook for global growth is somewhat stronger than it was earlier in the year. The world economy is expected to grow at 3.6 percent in 2017 and 3.7 percent in 2018. Developing economies are expected to grow at 4.6 percent and 4.9 percent, respectively, while advanced economies increase at 2.2 and 2.0 percent rates. [3] Overall, the global environment doesn't seem to be sending a strong signal for a change in U.S. interest rates.

Flattening Yield Curve

The yield curve term spread, the difference between 10-year and 2-year Treasury yields, has fallen from around 1.45 percent before the FOMC started raising rates in late 2015, to approximately 0.51 percent today (Chart 8). This flattening of the yield curve is an important new development this year. An inverted yield curve, where short rates are above long rates, is one of the best signals we have of elevated recession risk and has preceded every single recession in the past 50 years.

I believe the FOMC's rate increases are directly affecting the yield curve: As the FOMC has raised rates, the front end of the curve is moving up with our policy moves, which is to be expected. But because the Committee has been raising rates in a low inflation environment, we are sending a hawkish signal, which is likely holding down the long end of the curve by depressing inflation expectations.

The yield curve may also be reflecting the market pricing in a lower long-term neutral rate (R^*) environment. Whether the markets are signaling a lower R^* or lower long-term inflation expectations, these signals should offer caution about future federal funds rate increases, unless inflation picks up.

Policy Tools

The FOMC announced its plan to begin rolling off its balance sheet in the September meeting, which actually went into effect in October. That roll-off plan is operating as expected, in the background. I supported taking that action.

What Might Be Wrong?

What might my analysis be missing? Some economic or financial shock could hit us, from within the U.S. economy or from outside. That is always true, and we need to be ready to respond if necessary. In addition, if we are surprised by higher inflation than we currently expect, we might need to raise rates more aggressively. Some argue that gradual rate increases are better than waiting and having to move aggressively. It isn't clear to me that one path is obviously better than the other.

Conclusion

The labor market has tightened since we raised rates in June, but inflation is not rising. It doesn't appear that we are sustainably moving closer to our inflation target. Inflation expectations are low and may have already fallen. Monetary policy is currently only somewhat accommodative. There don't appear to be urgent financial stability risks at the moment. The global environment seems to have a fairly typical level of risk. One new development is the flattening yield curve, which is also urging caution. From a risk management perspective, we have stronger tools to deal with high inflation than low inflation. Looking at all of these factors together led me to vote against a rate increase.

[1] The truth is there is not much of a correlation between high wage growth and future inflation but, intuitively, they must be linked.

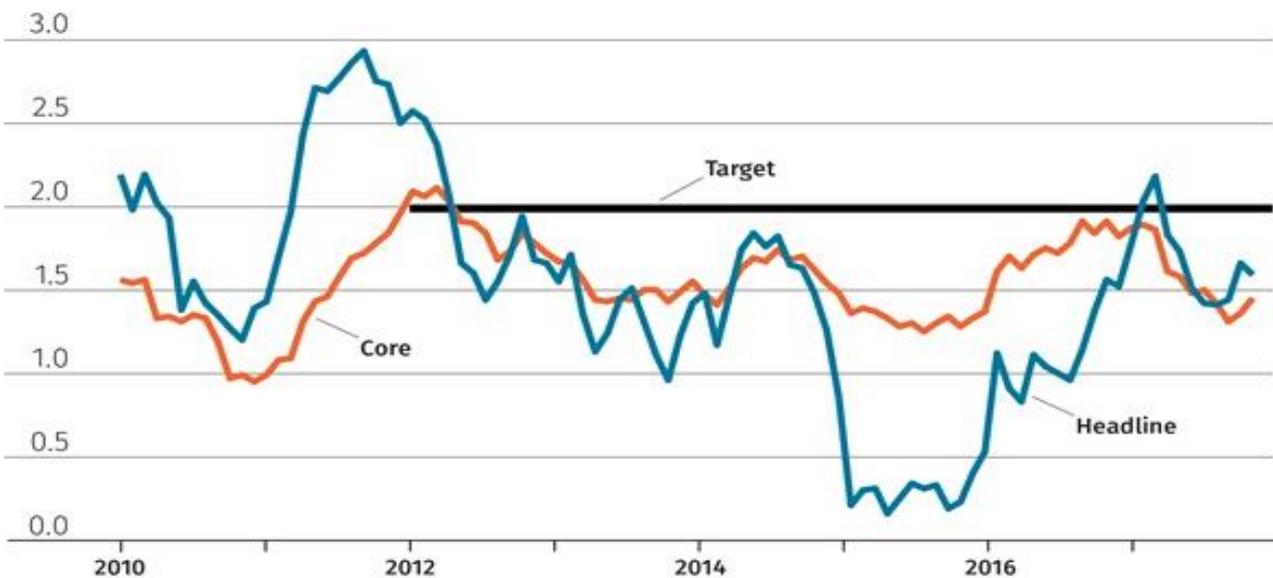
[2] See Monetary Policy and Bubbles.

[3] See the International Monetary Fund's October 2017 World Economic Outlook.

PCE Inflation

1

12-month percent change



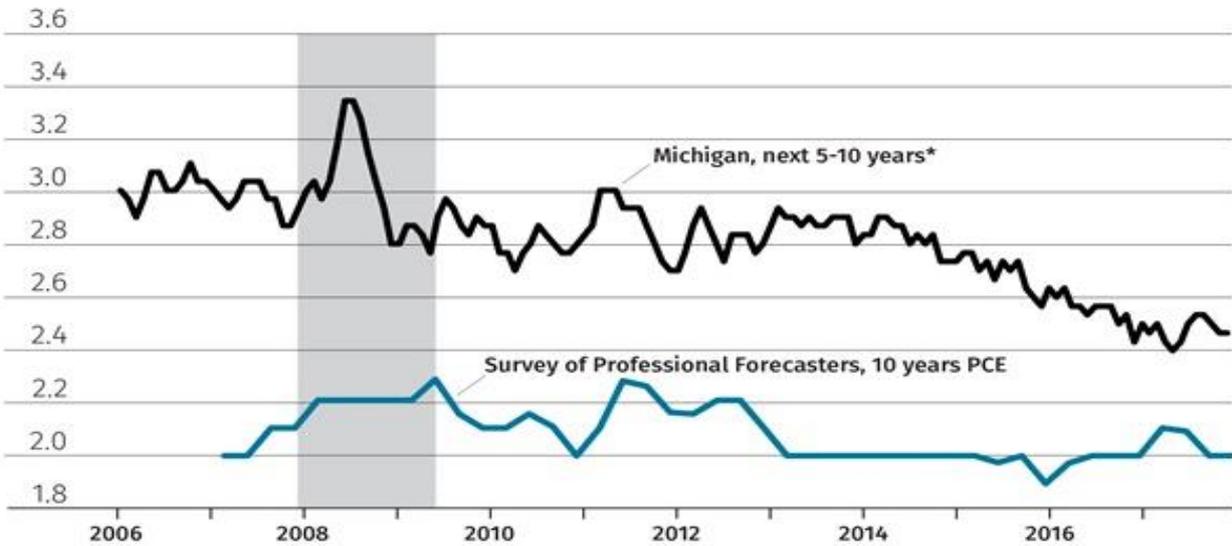
Source: Bureau of Economic Analysis

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Survey-Based Inflation Expectations

2

percent



*3-month moving average

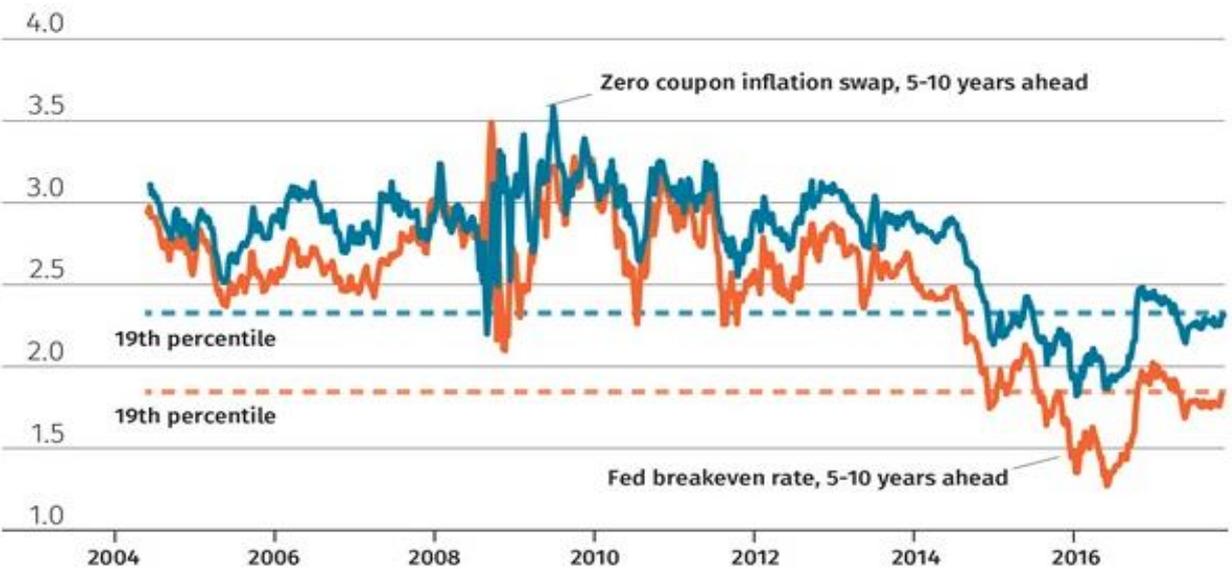
Sources: Survey of Consumers, University of Michigan; Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK of MINNEAPOLIS

Market-Based Inflation Expectations

3

weekly averages, percent



Sources: Bloomberg, Federal Reserve Board of Governors

FEDERAL RESERVE BANK of MINNEAPOLIS

Labor Costs

4

12-month percent change



Source: Bureau of Labor Statistics

FEDERAL RESERVE BANK OF MINNEAPOLIS

Inflation in Advanced Economies

5

12-month percent change in core CPI



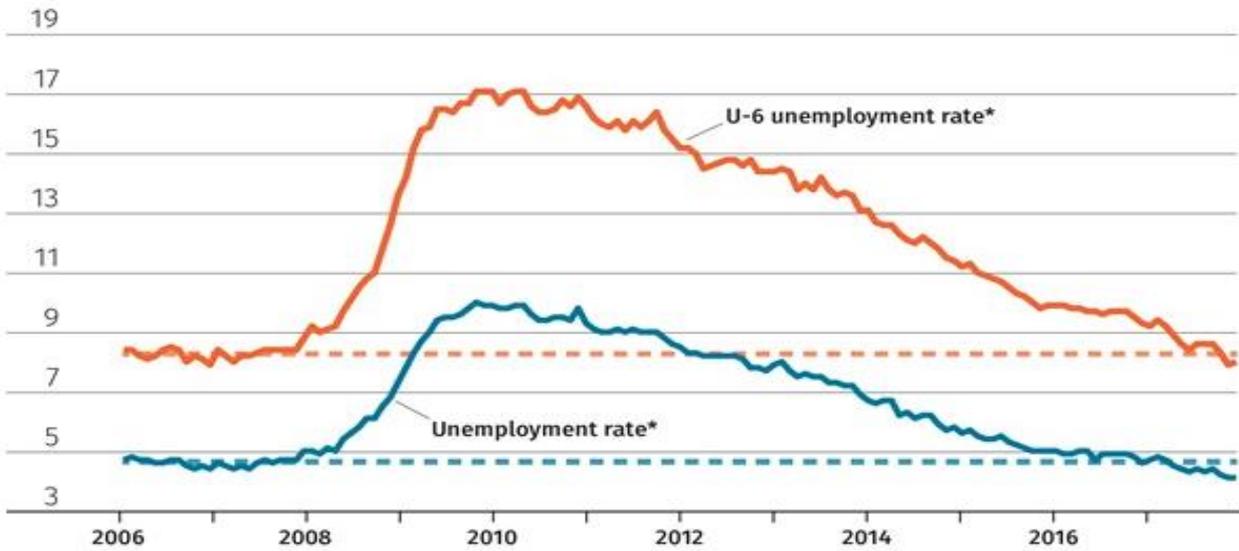
Sources: Statistical Office of the European Communities (Euro area), Ministry of Internal Affairs and Communications (Japan), Office for National Statistics (U.K.)

FEDERAL RESERVE BANK OF MINNEAPOLIS

Unemployment Rate

6

percent



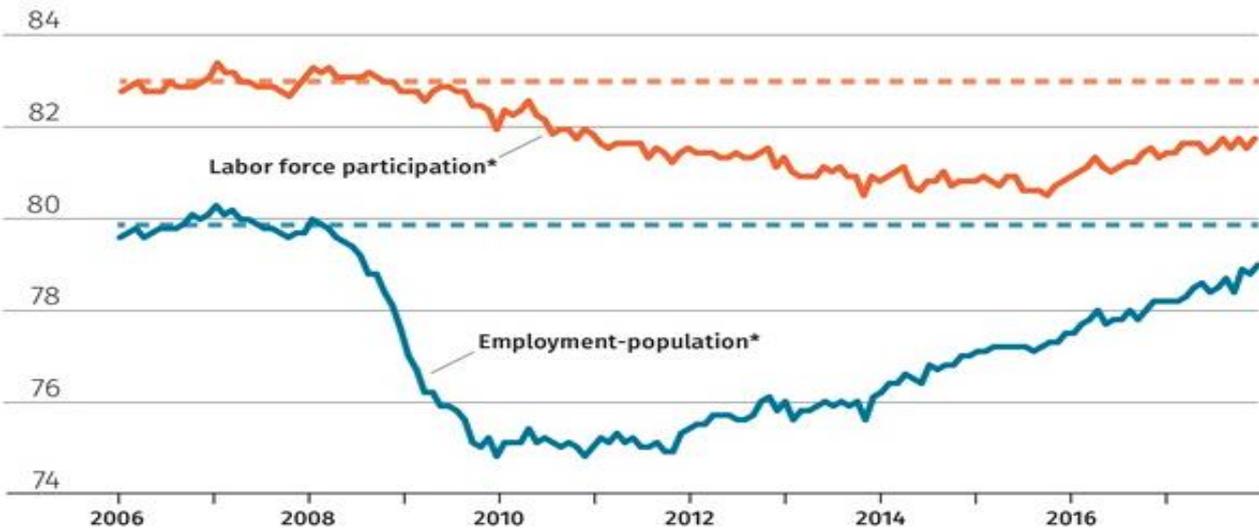
*Dashed lines indicate 2006-2007 average.
Source: Bureau of Labor Statistics

FEDERAL RESERVE BANK of MINNEAPOLIS

Employment-Population and Labor Force Participation Ratios

7

Ages 25-54, percent

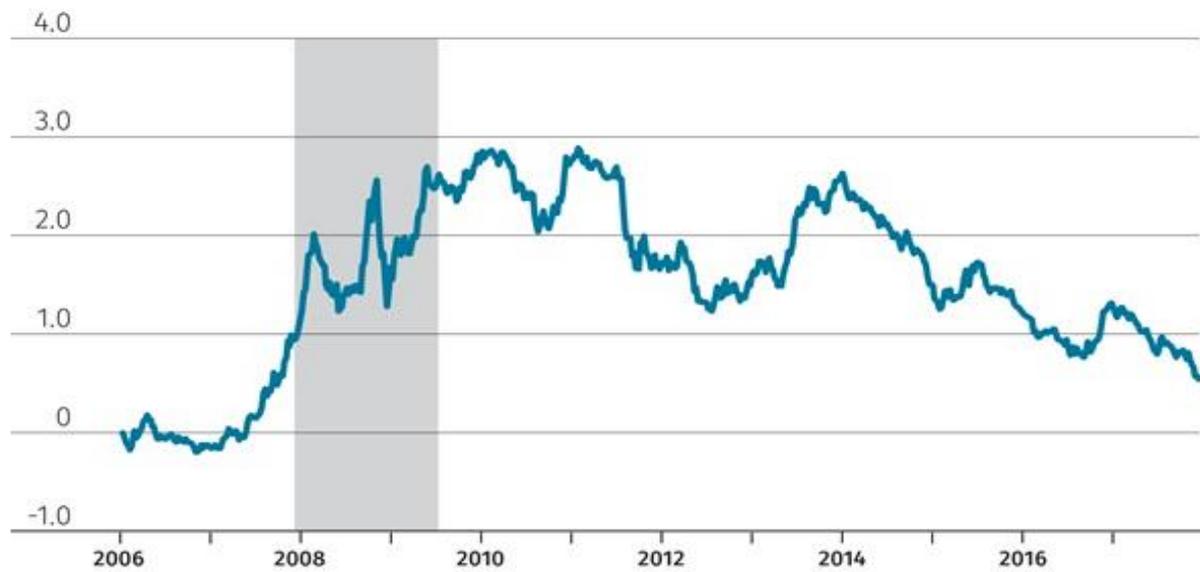


*Dashed lines indicate 2006-2007 average.
Source: Bureau of Labor Statistics

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Treasury Yield Term Spread

10-year minus 2-year Treasury yields



Source: Federal Reserve Board of Governors

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Fonte: Federal Reserve Bank of Minneapolis

<https://www.minneapolisfed.org/news-and-events/messages>

Benoît Cœuré: Central banks as risk managers

Speech by Benoît Cœuré, Member of the Executive Board of the ECB, at the 53rd SEACEN Governors' Conference/ High-Level Seminar and the 37th Meeting of the SEACEN Board of Governors, Bangkok, 16 December 2017

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It is a great pleasure for me to be here today.

Before I comment on this panel's topic, let me express my gratitude and satisfaction with the strategic partnership between the ECB and SEACEN, which got off to a successful start this year. Many cooperation activities, ranging from seminars on macroprudential analysis to central bank governance, have already been launched and more is being planned for 2018. I look forward to strengthening our cooperation over the coming years.

The topic of this panel deals with the implications of political risks for central banks. Given the independence of central banks and their legal separation from the political dimension, this is obviously a complex issue – and one where monetary policymakers need to tread very carefully.

For this reason, I would first like to spell out how the ECB generally incorporates different kinds of risk into its monetary policy strategy, and how this has influenced our actions over the last few years. I will argue that every central bank is to a considerable extent a risk manager, reflecting the forward-looking nature of monetary policy.

I will then explain why political risks cannot be addressed in the same way as economic risks. Central banks should not prejudge political outcomes through their actions. Rather, they should address their effects if and when they become visible in the economic and financial data that are relevant for their price stability mandates.

Monetary policy and risk management

My starting point is that monetary policy works with long and variable lags.

In the euro area, for example, the full transmission of interest rate decisions to output has been estimated to be between one and two years, and even longer for inflation. [1] So, if we were to decide policy on the basis of past outcomes, we would always be behind the curve. Monetary policymakers therefore have to look at the economy in a forward-looking way.

To do this, we produce forecasts, on a regular basis, that indicate our central expectations for the economy – the baseline. In principle, this should be enough to form a view on how policy should be designed today. But we all know that this would be a bad idea. Policymakers are typically poor forecasters, and central bankers are no exception. [2] This is nothing to be ashamed of. It merely testifies to the fact that the past is often a poor predictor of the future.

You can see this quite clearly for the euro area on my first slide. We call it the “spaghetti chart”. It shows the repeated inflation forecast misses over the past few years. On each and every occasion there were good reasons to assume the economy would go the predicted way. But on each and every occasion unpredictable shocks hit our economy that made our central forecast redundant. [3]

The implication is that we would likely have made severe policy mistakes if we had based our policy decisions entirely on our baseline.

And bear in mind that the economy can be more or less elastic to different types of shock. A tail risk, if it materialises, may cause the economy to react in a non-linear and potentially disruptive way – hyperinflation and deflation being typical examples of risks central banks want to avoid.

For all these reasons, central banks usually augment their forecasts with an assessment of the risks surrounding them. This comprises a *distribution* of risks – the range of possible outcomes and the likelihood of their happening – which, in turn, allows us to form a view on the *balance* of risks, i.e. whether they are overall tilted to the upside or downside, and on the probability of tail events.

Such risk assessments are not an exact science and there is no automatic link between them and policy decisions. But we do at times apply what Alan Greenspan famously called a “risk management” approach to monetary policy. [4] If the balance of risks is tilted very strongly in one direction, or if the distribution of risks is especially wide, there might be a case for us to act.

For example, we might need to provide forward guidance, i.e. specifying how we would react to particular risks. Alternatively, we might need to change our policy stance pre-emptively, especially in situations where tail risks are material and it becomes cost-efficient to truncate that part of the distribution.

The ECB’s monetary policy since mid-2014 illustrates these two aspects well.

Around that time, we saw the balance of risks to the inflation outlook shift decisively downwards, while the distribution of risks widened to encompass outright deflation, as you can see by comparing the blue and red lines on my second slide. If they had materialised, those risks would have fundamentally compromised medium-term price stability, and so our strategy required us to respond – even though our central forecast at that time was for a low but positive rate of inflation in the years ahead.

We responded in two main ways.

First, we clarified our reaction function to the main risks we saw and the instruments we would use if each of those risks materialised. [5] This sent a clear signal to observers that we were ready to respond in the case of adverse contingencies.

Then, when those contingencies arose, we followed through with our forward guidance and introduced a set of policy measures that was designed to cover the full downside distribution of risks – that is, a very accommodative policy stance to combat disinflationary forces, and an option to be even more accommodative if the situation deteriorated into outright deflation.

Thanks to these policy interventions, the distribution of risks has narrowed considerably over time – as you can see from the yellow line – and we no longer see a meaningful probability of deflation. The balance of risks has also shifted upwards as the economic recovery has gathered steam. The current economic expansion in the euro area is stronger than it has been for a decade and broader than for two decades.

This improving picture is the main reason for our recent decision to recalibrate our policy by reducing the pace of our monthly asset purchases from €60 billion to €30 billion, starting in January.

Of course, risks emanate not only from our own jurisdiction, the euro area, where we can respond with our monetary policy, but also from the rest of the world. Indeed, while the ECB's Governing Council currently sees the risks surrounding the euro area's growth outlook as broadly balanced, it sees downside risks relating primarily to global factors.

But here too we can manage risks effectively by cooperating closely with other central banks. [6] This does not mean that we decide jointly on policy actions. It rather means that through our regular bilateral contacts, and dialogues in multilateral fora such as the IMF, the BIS and the G20, we can achieve a better understanding of global risks and their channels of propagation. And when risks do turn into shocks, this cooperation allows us to build up readiness and have the tools in place to react.

Perhaps most importantly, since 2011, the ECB has operated a permanent network of swap lines with the Bank of England, the Bank of Japan, the Federal Reserve and others, allowing all participating central banks to obtain foreign currency in the event of a liquidity squeeze. In 2013, the ECB also established a swap agreement with the People's Bank of China in recognition of its growing systemic importance as well as the rapidly growing bilateral trade and investment between the euro area and China. [7]

Factoring in political risks

So how do we factor political risks into our decision-making?

I would argue that central banks cannot process political risks in the same way as economic risks, for two reasons.

The first relates to the degree of uncertainty that surrounds political risks.

Here it is useful to recall Frank Knight's classic distinction between risk and uncertainty. [8] Risk is present when future events occur with measurable probability. Uncertainty arises when the likelihood of future events is indefinite or incalculable. In conditions of uncertainty,

it is not possible to manage risk in the sense of quantifying a range of outcomes. Decision-making then depends on qualitative judgement.

To be sure, this is sometimes the situation central banks find themselves in when surveying the economic outlook. The economy is always characterised by both risk and uncertainty, and there are certain situations – for instance, financial crises – in which models fail and uncertainty prevails. In these cases, central banks still have to take decisions and judgement is the only basis we have.

Yet, I would venture that economic risks are, on the whole, more quantifiable than political ones, and hence more conducive to active risk management. This is because we have workable models of the economy with broadly established parameters and regularities. And even when the parameters of those models appear to change – like the Phillips curve today – they still provide us with a framework to think about those deviations and attempt to explain what we are seeing.

For politics, however, we rarely have such tools.

We may be able to gauge from opinion polls the likelihood of a political change of course happening. We may even be able to weigh up political parties' manifestos and estimate some of the economic consequences of their coming to power.

But fundamentally, we know little about how consumers and firms will react to political developments, and especially to the types of seismic political change that are macroeconomically relevant. Indeed, for such events to be considered a risk they are usually unprecedented.

This means that if we were to engage in managing political risks *ex ante*, most of the time we would be operating in uncertain circumstances and making judgement calls. I would question whether this could really be called risk management at all. Worse still, it would project us into the political domain on very shaky analytical foundations.

This brings me to the second reason why economic and political risks have to be treated separately, and it relates to the endogeneity between monetary policy and risks. In the economic realm, such endogeneity has been recognised as desirable and is a key reason why central banks have become much more transparent over the past two decades or so.

A clear understanding by the public of how the central bank will react to economic risks automatically reduces the likelihood of such risks materialising. For instance, if markets expect central banks to react to adverse shocks by providing monetary accommodation, easier financial conditions will immediately follow. Such anticipation effects can increase the effectiveness of monetary policy.

For political risks, however, establishing such expectations would not be desirable. If we were to communicate that we will take decision “X” in response to political outcome “Y”, financial conditions would move as the probability of that outcome rose, and this would

potentially prejudice the result. That would be controversial in the case of global political risks. For domestic ones, it would be unacceptable.

Even if the central bank had perfect foresight of the economic consequences, such a reaction function would be seen as undue interference in the political process and it could undermine the effectiveness of monetary policy, instead of increasing it.

And since our assessment would be largely based on judgement not analysis – for the reasons I mentioned – we would find ourselves being accused of political meddling. This is a position that no independent central bank would want to be in.

So when it comes to political risks, we have to be data-driven. We do not prejudge political outcomes. And we do not try to risk-manage their effects on the economy, since we can rarely predict those effects accurately – and worse, we may end up influencing political developments and thereby compromising our independence.

The only way in which we can include political risks in our policy framework is by responding to their visible impact on economic and financial conditions. This does not mean being complacent: we can and must plan for all eventualities. But we react to data, not to political events themselves.

In some ways, this is analogous to the debate about “leaning versus cleaning” of financial bubbles: faced with so much uncertainty about what constitutes a bubble, most of the time it is more efficient for central banks to use macroprudential tools to prick bubbles, or to ease policy after they burst, rather than to try and identify bubbles in advance and deflate them by hiking rates. The risk of false positives is just too high.

Two episodes in the recent history of Europe illustrate our data-dependent reaction function: the threat of a break-up of the euro area in 2012; and the threat of a country leaving the European Union in 2016, namely the United Kingdom.

In the first case, we had plenty of data showing that political risks were spilling over dangerously into the economy and financial system. Markets began pricing in redenomination risk. Financial conditions tightened significantly in some Member States. Bank lending contracted and the euro area entered a second recession. Uncertainty in the euro area, as measured by the VStoxx [9], was on the rise – as the grey shaded area on my third slide shows.

Although at this point inflation was still being buoyed up by energy prices and indirect taxes, it was plain to see that political risks had become economic ones, and were in turn endangering the medium-term outlook for price stability. We therefore responded by launching a new monetary policy programme – Outright Monetary Transactions (OMTs) – which brought this episode of market turmoil to an end.

We did this, however, in a way that did not pre-empt political decisions. We took stock of the clear commitment of European leaders to hold our monetary union together and make it

more solid by establishing a banking union. And we made the OMT programme conditional on countries participating in an assistance programme with the European Stability Mechanism.

In the case of the UK's vote to leave the EU, the situation was different, however. Various forecasts predicted severe market turbulence and macroeconomic fallout, so we had contingency plans in place for a range of outcomes. But as the slide illustrates, there were few signs of uncertainty in euro area financial markets in the run-up to the vote or after it. And, so far, there turned out to be no economic consequences with medium-term impact.

So our policy stance remained consistent with the data: unchanged. And the same logic, incidentally, can be applied to the recent political crisis in Catalonia. Though we monitored the situation very closely, we saw no changes in financial conditions or the economy that would have warranted a monetary policy shift.

Conclusion

Let me conclude.

Monetary policy is a forward-looking enterprise and policymakers always have to think in terms of risks. On several occasions in recent years the ECB has changed its monetary policy in response to emerging tail risks, even when our central forecasts for inflation painted a less alarming picture.

This can be seen as applying a risk management approach to monetary policy, in which we prioritised truncating the most dangerous tails of the distribution rather than targeting our policy at the modal point. The frequent central forecast misses we experienced suggest we were right to do so and we avoided much worse outcomes as a result.

When it comes to political risks, however, central banks cannot be risk managers, since this would bring us too close to being political actors. We can monitor political risks, and we can put in place plans for responding to them – but we can only act when the data justify such a step, and in a way that does not pre-empt political decisions.

Our actions during the crisis clearly demonstrated this reaction function.

Thank you.

[1] ECB (2010), "Monetary policy transmission in the euro area, a decade after the introduction of the euro", Monthly Bulletin, May.

[2] For an evaluation of past Eurosystem forecasts, see ECB (2013), "An assessment of Eurosystem staff macroeconomic projections", Monthly Bulletin, May.

[3] See e.g. Draghi, M. (2014), "Monetary policy in a prolonged period of low inflation", speech at the ECB Forum on Central Banking, Sintra, 26 May.

[4] See Greenspan, A. (2004), “Risk and Uncertainty in Monetary Policy”, speech at the Meetings of the American Economic Association, San Diego, California, 3 January.

[5] See Draghi, M. (2014), “Monetary policy communication in turbulent times”, speech at the Conference De Nederlandsche Bank 200 years: Central banking in the next two decades, Amsterdam, 24 April.

[6] For more on the pros and cons of policy coordination among central banks, see Cœuré, B. (2014), “Policy coordination in a multipolar world”, speech at the 5th annual Cusco conference organised by the Central Reserve Bank of Peru and the Reinventing Bretton Woods Committee: “70 years after Bretton Woods: Managing the interconnectedness of the world economy”, Cusco, 22 July.

[7] See <https://www.ecb.europa.eu/press/pr/date/2013/html/pr131010.en.html>.

[8] See Knight, F. (1921), “Risk, Uncertainty, and Profit”, Mifflin, Boston, New York.

[9] Dow Jones EURO STOXX 50 Volatility Index.

Fonte: European Central Bank

<https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp171216.en.html>