



SUERF/Banque de France Conference *The Financial Reconstruction of Europe*

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Main findings from the SUERF/Banque de France Conference commemorating SUERF's 50th Anniversary held at the Banque de France

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(l-r): Natacha Valla (Goldman Sachs and SUERF) presents the 50th Anniversary Volume to Governor Christian Noyer (Banque de France); Huw Pill (Goldman Sachs) and Peter Praet (ECB); Governor Ewald Nowotny (OeNB)

The occasion of SUERF's 50th anniversary provided a fitting occasion for the association to organize a conference jointly with the Banque de France, which has been a staunch supporter of SUERF's activities since the early days of the Association, and in the country where the Association is officially registered. The conference brought together several authors of SUERF's 50th Anniversary Volume, "50 Years of Money and Finance: Lessons and Challenges", which had been specially commissioned for the anniversary, and a number of further high-ranking speakers from around the world, to discuss progress towards, but also unresolved issues crucial for a "financial reconstruction of Europe" after the crisis.

Urs Birchler, President of SUERF, opened the conference with a brief historical perspective about SUERF, and its aim to enable productive dialogue between academics, central bankers and practitioners on European Issues. To commemorate SUERF's 50th Anniversary, the first copy of SUERF's 50th Anniversary Volume was presented to Governor **Christian Noyer**, as a thanks for the Banque de France's long-standing support of SUERF and for hosting the conference.

In his opening speech, **Christian Noyer**, Governor, Banque de France, stressed that since the creation of the SUERF in 1963, the world has witnessed tremendous evolution on economic, political and technological levels. These evolutions have necessitated the call for structural change and in particular for a financial reconstruction of Europe. The first and most essential pillar of this reconstruction should be Banking Union. Banking Union would break the link between banks and sovereigns, while reducing fragmentation in the

euro area and improving the efficiency of monetary policy. Now that the Single Supervisory Mechanism has been established, the next step towards banking union is the creation of the Single Resolution Mechanism to efficiently deal with failing banks at the union level.

Mario Monti, former Italian Prime Minister and former SUERF President (among his many other functions) recalled that his tenure as SUERF President was his first chairmanship as an economist. It represented at that time a unique network on European economic and financial issues. It fostered in-depth cooperation in the academic field. The need to deepen this cooperation on European issues in such a diversified forum is all the more necessary today as Europe is struggling with massive unemployment and a fragile recovery.

Session 1 dealt with "Macroeconomic, Structural and Policy Issues". **Peter Praet**, Member of the Executive Board, European Central Bank, opened the Session with some ideas on the way in which Europe needs to reconstruct its financial system. The EMU project of the European Union was based on the idea to "lock countries into an irrevocable process" and in this way support reforms that were necessary anyway. However, EMU did so far not work out well in rainy days. Cumulative and persistent inflation differentials within the Euro Area turned out to have more severe consequences than initially expected, leading to big gaps in price competition among members. The Euro Area is now at the end of denial and has to address the failures. Problems need to be solved urgently and under pressure. The current prospects for the further development of output fall substantially short of hopes and expectations

prior to 2008. Agents need to adjust their permanent income expectations, including the effects on public finances. But this is not the first time we face such a big adjustment need. Back in the 1960s, the fall in productivity and high nominal wage increases eventually led to a surge in inflation. This time, there is no wage inflation but a build-up of debt. This is why we face a balance sheet recession, which is more deflationary. A common feature across all Euro Area economies is the fall in investment. If we want to unleash investment, we have to address where credit supply restrains investment and reduce economic uncertainty for business. The ECB has contributed to reducing financial uncertainty. While political uncertainty remains high, the ECB has also contributed to assuaging tensions in this field by its unconventional measures in a period of crisis.

Ewald Nowotny, Governor, Oesterreichische Nationalbank, recalled that the concept of a “*financial reconstruction of Europe*” had been coined in the context of the Genoa conference after World War I in 1922. By contrast, the financial reconstruction to be achieved in Europe now is less dramatic, since no production facilities have been destroyed by the crisis, and basically consists in restoring a smooth functioning of the financial system. The circle of countries in the Euro Area and in the single market for financial services is different, which may create certain tensions, as have become obvious in the process of the creation of European Banking Union, including the institutions responsible for running it (European Banking Authority, European Central Bank). Ring-fencing by national supervisors ahead of e.g. the forthcoming stress tests should be avoided. The prospects for the current very low level of long-term interest rates depends on the further development of growth in the Euro Area. If the area remained in stagnation for an extended period of time, then also long-term interest rates may remain very low for very long. This may have serious consequences for institutional investors including life insurances, which entails also consequences for banks (insurances hold large equity holdings in banks) and ultimately also for supervisors. The ECB is currently very active in preparing the Single Supervisory Mechanism. Concerning the 2nd pillar of banking union, the Single Resolution Mechanism, political progress is stalling and the outcome is uncertain. As long there is no Single Resolution Scheme in place, the EU banking market remains fragmented, entailing different lending conditions across Euro Area countries. The link between banking system stability and sovereign debt sustainability is not surprising and in line with historical experiences. The challenge is to cut negative feedback loops as we have experienced them in the crisis. But is there a realistic alternative to banks holding substantial parts of their national sovereign’s debt? Euro Area member states have to be analysed like US states: since they no longer have their own central

bank and monetary policy, they can go insolvent. The alternative to domestic bank holdings of sovereign debt are international holdings, which may bring risks of their own in periods of crises.

Huw Pill, Chief European Economist, Goldman Sachs, opened by recalling that just two years ago, many international investors saw little future for the Euro. Now this is quite different. However, what we have learnt from the theory of Optimal Currency Areas is that the institutional framework created for EMU two decades ago is not fit for crisis situations. EMU requires greater fiscal, financial, real, political and institutional integration. EMU sceptics have concluded that this is not feasible and therefore EMU is not either. EMU supporters, by contrast, conclude that since the euro is desirable, we need deeper EU integration, and the euro is indeed a vehicle towards such integration (“functional approach”). Since full integration – and thus the complete satisfaction of optimal currency criteria – does not seem feasible politically in the foreseeable future, the aim has to be more modest and pragmatic: to achieve a “workable” EMU. How far does integration have to go for this? There are many possible combinations of workable solutions. Elements of integration may be substitutable or complementary to each other - e.g. if financial markets work very smoothly, this substitutes for deeper fiscal union. But for this to happen, we need the necessary institutional arrangements, such as credible backstops, which in turn leads back to complementarity with fiscal union. When there are different workable solutions with different distributional impact, it is very difficult to find solutions between the member countries - e.g. current German opposition to certain aspects of banking union is not a sign of anti-European sentiment, it is just a preference for a different solution with different distributional consequences. As a result, the European integration process is difficult and “chaotic”. This in turn makes it difficult for international investors to buy into the European integration project. Fortunately, international market sentiment has been changing over recent months in favour of EMU: financial markets focus on likely ultimate outcomes, not processes. Markets now price in successful financial integration. The resulting loosening of financial market pressure on fiscal policies brings risks of complacency. Regarding the legacy of public and private debt overhang, Germany for instance argue in favour of non-zero risk weighting of sovereign debt in minimum bank equity regulations. Given large sovereign debt holdings of some banking system, the question arises how to manage the transition to such a new regime. The crisis countries seek support at least during the transition phase. Germany sees risk sharing as the introduction of a fiscal transfer regime in EMU. The core countries want in any case to see reform results first. This leads to a difficult to solve chicken-and-egg problem. Significant adjustment of intra-Euro Area

macroeconomic imbalances has already happened, but the further adjustment of real effective exchange rates required is very large. Substantial and far-reaching structural economic adjustments will be unavoidable.



Session 2. “*Restructuring the Banking Sector and Ensuring the Single Market for Financial Services*” was chaired by **Morten Balling**, Professor Emeritus, Aarhus University and SUERF.

Charles Goodhart, Professor, London School of Economics and author of chapter 7 in the 50th Anniversary Volume gave the first presentation. The speaker described the history of banking and financial regulation in the last 50 years as a journey from national segmentation to globalization. In the 1970s, national separation broke down under the influence of the growing Eurodollar market, cross-border banking, oil price shocks and the growing porosity of exchange control barriers. Banking systems became transformed into a cross-border, global financial system. Regulation also became, to some extent, global under the aegis of the Basle Committee on Banking Supervision (BCBS). Today that global system is under increasing threat. The financial crisis has caused a fragmentation of banking back towards a strong national focus, especially in Europe. Almost all (financial) economists agree that banks in the future should have a much higher equity ratio. The extra benefit in protection against default, contagion and crises would outweigh the relatively minor increase in the cost of intermediation. The problem lies in getting there. Bank boards are not inclined to issue more new equity. Setting a higher capital adequacy ratio will therefore enforce deleveraging of assets. Almost all governments are putting pressure on their own headquartered banks not to cut back on credit creation in their own countries. So, this process strongly reinforces the reverse fragmentation of banking systems away from a global or regional (European) framework back into the segregated national systems from which they emerged in the 1970s and 1980s.

David T. Llewellyn, Professor, Loughborough University and former SUERF President called his presentation “*Pre- and Post-Crisis Bank Business Models*” and referred to his chapter 9 in the 50 Year Anniversary Volume. The speaker distinguished between traditional bank models, models based on securitization, and models applying credit default swaps (CDSs). In the traditional model, financial intermediation is the dominant business of banks which have information,

risk analysis, and monitoring advantages enabling them to solve asymmetric information problems and hence mitigate adverse selection and moral hazard. Banks accept deposits and utilize their comparative advantages to transform them into loans. In this model, the bank carries the credit risk, holds the assets on its own balance sheet, monitors borrowers, and holds appropriate levels of capital to cover unexpected risk. Securitization and credit derivatives are designed to shift credit risk. They also change the nature of risk and, in particular, transform credit risk firstly into liquidity risk (buyers of the securities issued to purchase securitized assets from banks being unable to trade them), then into a funding risk (the securitizing banks being unable to either sell assets at other than fire-sale prices or to roll-over maturing debt), and ultimately into solvency risk. The use of credit-shifting instruments exposed banks to low-probability-high-impact risks in that the reliance on short-term wholesale market funding to finance long-term mortgages meant that some banks became structural dependent on wholesale markets for their funding. Thus, an important element in the financial crisis was that banks stopped behaving like banks. The speaker argued that there is a two-way causation between regulation and bank business models – an endogeneity problem. Business models respond to regulation, which in turn responds to the evolution of new business models. Basel 1 contained incentives to regulatory arbitrage. Banks reacted to these incentives for instance with regard to allocation on assets with different risk weights. Basel 2 draws on the experiences with Basel 1, but created new arbitrage incentives. Now Basel 3 is designed to amend this etc. The speaker observed that regulators will always be behind the decision makers in the financial sector, and that future revisions of banking regulation (“Basel N”) will never be perfect. There are natural limits to what regulatory strategies can reasonably achieve, but the evolution of European banking and its business models over the coming years is likely to be dominated by the legacy of the crisis and the regulatory and supervisory responses to it. There will not be convergence towards a single business model. Diversity among models will remain.

Jean Tirole, Professor, Toulouse School of Economics gave a presentation “*Monitoring banks and states: governance and reforms in Europe*”. There are several motivations for establishing a banking union in Europe. It is difficult for national regulatory authorities in the 27 EU-member countries to possess sufficient expertise to deal with multinational financial institutions. When big financial institutions fail, there are cross-border externalities. Protection of foreign depositors by national deposit insurance becomes an issue. There are also externalities, when bank failures increase government debts. It is difficult for national regulators to avoid home-country bias in the conduct of their

policy. Supervision and regulation at the European level is, however, complicated. To ensure effective supervision, national supervisors must be obliged to provide the European supervisor with sufficient and timely information. When reconstruction of the banking sector implies a need for fiscal support, the absence of a European Treasury becomes a problem. Thus, the structure of the future funding of ESM is important. A European Deposit Guarantee Scheme requires regulation at the European level. There has so far been some progress in banking reforms. Capital requirements have been increased, some countercyclical buffers have been implemented, and there has been some degree of centralization of exchanges. There is, however, much more work to be done. Liquidity regulation, retail-investment bank separation and the future of the right for banks to use internal models are still outstanding issues. Implementation of ring-fencing according to the proposals by Volcker, Vickers and Liikanen is currently under study. Bail-out policy also in relation to investment banks should be consistent. Unregulated shadow banks in difficulties should as a rule not have access to taxpayer money. Under special circumstances, however, bail-outs might be appropriate since some shadow banks can be systemically important. A certain degree of ring-fencing between regulated and unregulated entities can be appropriate. Earmarking of specific assets to specific lenders has always existed in the form of collateral. It is not surprising that in rough times runs for collateralization are observed. Protracted low-interest periods can rescue firms with large maturity mis-matches, but they can also boost asset prices, distort saving decisions and may sow the seeds for the next crisis. It is likely that some sovereign debts will have to be restructured.

Frédéric Visnovsky, Deputy Secretary General, ACPR, Banque de France, started his presentation by looking at the evidence. When data from respectively 2008 and 2012 are compared, it can be observed that the ratio between total domestic banking sector assets and GDP in most Euro area countries has decreased. Banking concentration –measured as the share of the 5 largest credit institutions in total assets – has changed in different directions in the same period. In France, the Netherlands, Belgium and Austria, concentration has declined, while the concentration ratio has increased in Germany, Italy and Spain. A Herfindahl Index for the Euro area as a whole shows an increase from 2009 to 2011 and a decline in 2012. The structure of the banking sector in France is characterized by the universal bank model, very similar to other European banking systems. There is a diversity of legal structures. The universal model has several strengths. Retail banking dominates, proprietary trading does not, while portfolios are diversified and thus able to mitigate negative shocks. Reforms of the framework for banking structures should

not hamper these strengths. Ring-fencing has to be well balanced to avoid excessive associated costs. In July 2013, a French regulatory reform was implemented. It aims to reduce market risks, to protect customer deposits and to enhance prudential supervision of trading activities in credit institutions and investment firms. The reform contains elements of ring-fencing but it preserves some capital market related activities and authorizes deposit collecting institutions to perform certain market making activities. In the ongoing design of a resolution model for Europe, it is important to ensure that costs related to future crises will not be borne by taxpayers, but that risk takers i.e. bank equity holders and subordinated creditors duly take their part in the resolution process.

The Keynote Address¹ was delivered by **Niels Thygesen**, Copenhagen University and former SUERF President, who discussed the various different ways to implement Forward Guidance in light of the possibility that the monetary authority and the private sector could use different models to make forecasts. Non-committal forward guidance announcements are too vague to have substantial impact. Intermediate ones, based on commitment for a definite time horizon or contingent to thresholds, had an impact but raise concerns about the central bank's overconfidence in its model, which can lead to conflicting interpretations. For example, underestimating the recovery in UK implies that the 7% unemployment forward guidance threshold will be reached much earlier than the BoE expects. More radical forward guidance variants, as nominal GDP targeting, may look appealing but they can be hardly implemented.



Session 3 on "Enhancing European Governance" was chaired by **Marc-Olivier Strauss-Kahn**, Director General, Banque de France.

Franco Bruni, Bocconi University and former SUERF president, commented on the role of bilateralism and conditionality, which had been politically essential for gaining approval for the ESM, but which hamper the Mechanism in promoting systemic financial stability. The ESM is prevented from providing quick support for national debt prices when certain global turbulences occur, due to the risk of contagion coupled with any intervention. This is a severe limitation which contradicts the concept of defence against systemic risks and turbulences – the most important lesson learned from the global financial crisis. He also noted that the ECB's Outright Monetary Transactions (OMTs) also cannot be

¹ A full text of Niels Thygesen's Keynote Address appears on pp. 19-22 of this SUERF Newsletter.

enacted without a bilateral and conditional agreement between individual countries and the ESM. The decision to connect OMTs to the ESM aims at separating the systemic, stateless problem of speculative and unjustified conversion risk, from default or liquidity risk premia connected to countries' disequilibria. The connection, however, looks too binding and exceptions should be allowed to allow the ECB to maximize its contribution to save the euro in the event of systemic turbulences.

Esther George, President, Federal Reserve Bank of Kansas City, emphasized that macroprudential supervision and the identification of systemic risk can be most effective when it serves as a complement to a rigorous microprudential regime. Hence she addressed three aspects of a supervisory framework that bring such balance and enhance both firm-level supervision and system-wide assessments. First, such a framework should blend new quantitative macro-supervisory approaches with the qualitative judgments that examiners can contribute at the firm level. Second, it should aim to enhance market discipline by increasing transparency in financial markets. And third, it should rely on cooperation among multiple regulatory agencies in order to be effective.

François Villeroy de Galhau (BNP Paribas) first recalled that markets, rules and institutions have not been functioning well, which harmed European Governance. Banks can partly fix these issues by being responsible. They should aim to restore financial security and to finance the European economy. Anticipating Basel III, many European banks have achieved deleveraging and improved their financial soundness. However credit contraction is still going on in the Eurozone, as opposed to the United States, and one can wonder if it is partly due to a regulatory effect constraining credit supply which amplifies an overall credit demand that is already weak. Hence the right balance between banking soundness and the economy financing can still be improved upon.

Ignazio Visco, Governor, Banca d'Italia) first reminded the audience that the recent sequence of crises led to a crisis of confidence in the euro survival and stressed weaknesses for some countries' economies as well as the incompleteness of the European construction. The reform is part of a process aiming at rebuilding trust among member states. Progress made so far must now be followed by a further, deeper reinforcement of EMU, building on a renovated mutual trust and a longer-term vision. Building an effective Banking Union will be the first test of our resolve but success requires that discussions on fiscal and political union are soon followed by concrete actions.

The conference concluded with Session 4, which addressed the topic of *"Which financial Europe for the future"* and was moderated by **Ernest Gnan**, Secretary General, SUERF.

William White, Chairman, Economic Development and Review Committee, OECD, talked about implications of the euro crisis for the rest of the world. The crisis has emphasized our incomplete understanding of the economy, conventional forecasting models turned out to be useless, global policy makers have retreated into national and conflicting beliefs, and the unprecedented policy experimentation is adding to the uncertainty. The euro area currently faces three scenarios: a) market confidence is maintained, b) market confidence is lost but then regained through policy action; c) market confidence is lost and not regained. White regards the second scenario as most likely: the short term palliatives are still untested, the approach to banking union is "backward", but policy will eventually rise to the challenge. Instability in the euro area would breed instability for the rest of the world due to the euro area's large economic size, its tight trade, FDI, value change and financial links with other countries as well as important confidence spill overs. The rest of the world is vulnerable: US growth is still fragile, Abenomics could backfire, China needs to manage the transition to a different growth model, emerging economies suffer from large imbalances, and in many countries households' debt and house prices are at record highs. The room for global policy responses is very limited, trade integration and international monetary reforms stall. The crisis has political side effects such as the rise of radical governments and a diminished global influence of Europe. All in all, a disorderly euro area development would have huge externalities for the rest of the world; it can and should be avoided but this will take courage and magnanimity from all euro area countries, which non-euro area countries should encourage.

Anne le Lorier, Vice Governor, Banque de France, identified excessive financial leverage as the main reason of financial crises. Leverage-induced crises are particularly severe due to illiquidity feedback loops with non-linear effects and the length required for the recovery, because agents first need to regain a sustainable level of indebtedness. Crisis prevention raises important questions about optimal financial system size and structure and about optimal regulation design. A diversified financial system improves economic efficiency, improves resource allocation and increases long-term growth, and financial innovation improves risk-sharing, while a very large financial sector may encourage excessive risk taking and complexity, thus creating systemic risk. Whether bank-based or capital market-based financial systems are preferable also needs to be seen against the ability to provide funding for SMEs, start-ups and innovation. It seems that prior to the crisis the financial sector had grown excessively and, fuelled by lax US monetary policy, had contributed to real estate and other bubbles. This view is corroborated by huge trading volumes, the spreading of automated



computer trading, excessive wages and bonuses in financial firms and the blooming of offshore financial sectors. Global imbalances may also have supported this trend. Bank based systems seem to be more stable in “normal” recessions, while in financial crises, banks themselves become handicapped, further contributing to the severity of the crisis. While financial supervision has at least implicitly always been within the remit of the central bank, due to their function as lender of last resort and their responsibilities in payment systems oversight, this responsibility is now entrusted on them more and more explicitly, either exclusively or with a leading role. This is also the case for the ECB and national central banks, and brings along big challenges. The experience with macroprudential tools is still very limited, good governance has yet to develop, and interaction with monetary policy may be complex, and interaction with legal systems may vary considerably across countries. Shadow banking remains so far largely exempt from new regulation; this is an area to be addressed in the future.

According to **Catherine Lubochinsky**, Managing Director, Research, Global Risk Institute, derivatives were not the cause of the crisis but they exacerbated it. The history of derivatives was also marked by some infamous accidents. In 2008, the systemic risk component of OTC derivatives was revealed, which in 2009 led to a G20 initiative on derivatives infrastructure, which addressed central clearing, trade repositories, electronic trading and higher capital and margins on non-centrally cleared derivatives. The new initiatives have improved transparency and reduced counterparty risk at the micro level. But Central Counterparties, being systemic nodes of the financial network, may pose important counterparty risk and thus create a new systemic threat. Margin regulations may cause shortage of collateral. Induced rises in repo business, more securities lending and more collateral transformation services may increase interconnectedness. The increased use of securities as collateral may increase elements of pro-cyclicality. The introduction of financial transaction taxes may affect trading volumes. There are still many issues unresolved,

such as the optimal number of Central Counterparties, optimal initial margins, intra-day margin calls, modelling of non-standardized derivatives, or the regime governing a resolution of Central Counterparties.

Frank Lierman, Belfius Bank and SUERF Vice President, identified four strategies pursued by banks as a response to current challenges: first, deleveraging and downsizing, with the asset quality review acting as an accelerator; second, focusing on basic tasks, such as the transformation of deposits into credit, and provision of efficient payment systems, with a clear trend from cash to electronic payments; third, adaption of product mixes towards less sophisticated savings and investment products and more transparency; and, fourth, the end of “free” services: in the future, banks will charge more for payments, investment and credit advice, wealth management etc. Electronic and mobile banking will replace traditional branch banking, banks will also have to put more emphasis on a broad conception of stakeholder value rather than narrow shareholder value. In particular, they need to ensure the financing of the economy. Credit expansion is currently hampered by weak aggregate demand, Basel III/CRD IV capital, as well as by new liquidity and leverage requirements, by higher risk management awareness, and by lower profitability of asset collection, leaving less room for the subsidization of credit. The Bank of England’s Funding for Lending Scheme (FLS), despite its high ambitions, has seen only modest success due to weak credit demand, simultaneous constraints from capital requirements and implicit deleveraging, weak bank balance sheets, and the forthcoming asset quality review, which pushes banks to deleverage. Crowd-funding may provide an alternative source of finance for certain projects but at the same time also brings a number of risks (e.g. fraud, loss of funds, complex ownership models, unclear intellectual rights protection etc.). Governments have also embarked on various alternative forms to bolster credit, such as subsidized forms of credit to SMEs and households in Belgium, EIB facilities, and also the ECB is considering promoting the securitization of credit.



Is Forward Guidance Here To Stay?

Keynote Address delivered at the SUERF/Banque de France Conference
"The Financial Reconstruction of Europe" commemorating SUERF's 50th Anniversary

by Niels C. Thygesen, University of Copenhagen, SUERF President 1988-1991 & SUERF Honorary Member

"Forward Guidance" (FG), or rather guidance about a central bank's future policy actions, has become highly topical over the last year or so. To overcome the constraints on an expansionary monetary policy once the short-term policy rate has approached the lower bound of zero, some major central banks have become more explicit in explaining their future policy actions. At the same time they have bought securities of longer maturities than in the past and stressed their readiness to continue to do so. How should this new activism be viewed? Quite apart from the analysis of the costs and benefits of prolonged use of these unorthodox or extraordinary instruments, are they effective? Do they represent good common sense, extending classical monetary policy, or do they signal central bank hubris?

Quite apart from the topicality of Forward Guidance, I was inspired to take up the subject by an intriguing comment, buried deeply into Bill White's superb survey of the evolution of monetary theory and practice in chapter 3 – "Is Monetary Policy a Science?" - of the SUERF 50th Anniversary volume, where he writes (p. 102):

"Another possibility ... is Forward Guidance about the future stance of monetary policy. Suggestions of this nature seem to assume that central bank statements will have direct effects on private sector behaviour. Fundamentally, this is a variant of the rational expectations hypothesis..."

The core of this hypothesis (REH), first formulated by Muth (1961), is to apply general optimization principles to the efforts of each economic agent to use all information available to forecast the future. While this sounds unobjectionable, the interpretation of what constitutes "all information available" was sharpened by Lucas and his followers in the 1970s; they regarded the common use of the "best" macroeconomic model in forecasting as the optimal strategy for evaluating the future. That assumption greatly simplified macroeconomic models and gave economists confidence not only in teaching, but also in policy advice.

Sargent (2005) gives a striking description of the appeal (and of the central weakness) of the REH approach. Responding to a question on differences in the perceptions of the future by individual agents, he says, Evans and Honkapohja (2005), p.566:

"The fact is that one simply cannot talk about those differences within the typically rational expectations

models. There is a communism of models. All agents inside the model, the econometrician and God share the same model. The powerful and useful implications of rational expectations..derive from that communism of models."

Obviously, and particularly since the outbreak of the financial crisis in 2007-08, such a purist version of REH sits very uneasily with observed behaviour. Economic agents sometimes have great difficulties in evaluating future prospects; there are major observable differences in forecasts, even within policy-making bodies, as we can see from minutes of their meetings. The award of part of the 2013 Nobel Prize in Economics for work to study how large departures from any financial-market equilibrium can build up and lead to major and sudden corrections also serve to remind us of that. Agents continue to learn about the future and revise their forecasting strategies accordingly, so clearly a more search-oriented and gradualist approach to forecasting like the Imperfect Knowledge Economics approach of Frydman and Goldberg (2013), is more appropriate than the communism of models and its abstraction from unpredictable, non-routine structural changes.

One would think that the use of REH-based policy advice had been discredited by recent events, even amongst those who offered it firmly during the pre-crisis years of the "Great Moderation". But there are two reasons why a come-back for the approach is not as implausible as it may seem:

First, from the mid-1970s REH absorbed the idea that announced or perceived changes in the regime for monetary policy was the one element of structural change that agents would wish to take into account, because such a change brings new information also about the future course of monetary policy – the "Lucas Critique".

Second, the central bank will often have a strong claim to be the lead model builder in any country – and it can internalize its own policy reactions into this "best available" model.

These reasons make it worthwhile to reflect a bit further on Bill White's comment.

Is there a pretention in some central banks to have developed the model for their economy? No central bank would find such hubris warranted; since 2008 also central bank models have been unable to avoid gross errors of forecasting in both directions; this applies both

to the detailed macroeconomic model used by the Fed and to the simpler DSGE-models, directly inspired by REH. Most central banks would probably reply, as did Spencer Dale, Chief Economist of the Bank of England, when presenting the November 2013 Inflation Report, by referring to the central bank's informational advantage regarding its own actions, Bank of England (2013):

"...The value of Forward Guidance ... does not come because we think we have some monopoly over forecasting ... the value is helping people to understand how we are likely to behave as the economy changes."

It may be helpful in assessing the motivation, benefits and costs of Forward Guidance to apply the terms "Delphic" and "Odyssean", introduced by Campbell (2012), in analyzing the variants of Forward Guidance observed until now. The Delphic element – no ambiguity implied – is the central bank's forecast, based on all information available to it, including about its own actions, as warranted by the forecast. However, these "warranted" actions will be modified as new economic information accumulates from one policy meeting to the next. By contrast, the Odyssean element contains a commitment to a monetary strategy to remain unrevised for a defined period, or at least until some macroeconomic threshold has been transgressed. Until then the central bank commits to be tied to the mast of its announced strategy – even as new information becomes available.

Let me try to classify the variants of Forward Guidance and relate them to the two grounds for the reappearance of REH: the ability of the central bank to model the economy and the credibility of its declared policy intentions. They correspond broadly to its Delphic and Odyssean credentials. Seven variants have been tried, or are under discussion:

1. Announcing the central bank's path for the future policy rate, warranted by and integrated into the current projection became fashionable in some inflation-targeting central banks (New Zealand, Norway, Sweden) prior to the crisis. The approach is intellectually demanding and hard to agree on in a central bank policy committee; its merits are less than fully convincing. In quiet times the path was not far from the consensus forecast. This Delphic variant – it implied no commitment – may best be seen as perfectionism from pre-crisis times.
2. Announcing monetary ease (or tightening) for some time, but without commitment to a definite horizon, would appear neither Delphic, nor Odyssean. That does not imply that there is no impact on financial markets, though at times it came close to that, as when the Fed announced a tightening "at a measured pace" when exiting from a very accommodating policy in 2004; longer-term rates did not move up

as Chairman Greenspan expected, labelling the experience a "conundrum". A more recent and so far promising example is the ECB's effort to decouple from rising US rates in the summer of 2013, which reminded markets that the US outlook was stronger than that of the Euro area, see e.g. Praet (2013).

3. Announcement of large-scale asset purchases (LSAP) has become a major tool for directly reducing US and UK longer-term rates (and in Japan for two decades). This is a variant of Odyssean commitment to the future use of an important policy tool with limited reliance on modeling. But the commitment has been taken seriously by markets, as the US experience with "tapering" in 2013 illustrates; it temporarily superseded the Fed commitment to very low short rates until 2015 with which it was seen as being in conflict. That surprised the Fed, as markets did not readily accept the Fed view that they should look at the still-growing Fed-portfolio of securities, not at the (slightly) slower inflow announced

While LSAPs in the US and the UK have had a generally expansionary purpose, hence justifying the term "Quantitative Easing", the main rationale for announcing them in the Euro area has been to repair parts of the monetary policy transmission mechanism. The ECB announced purchases of selected sovereign bonds in 2010-11 and a limited covered bond programme, while sterilizing the liquidity impact of these operations. The most spectacular example of a policy announcement was, however, the ECB's Official Monetary Transactions (OMT) of 2012, confirming a readiness to buy sovereign bonds with short remaining maturities, contingent upon the sovereign having negotiated a conditional loan from the European Stability Mechanism (ESM), hence reducing the risk of a Euro-area break-up due to panic-level interest rates ("redenomination risk").

4. Commitment with dates to unchanged policy has been announced on three recent occasions in the US – August 11, February 12 and September 12 – to convey to markets that any rises in the policy rate would come well later than expected by market participants. This primarily Odyssean variant did have a lowering impact on future expected short rates, see i.a. Femia et al. (2013) and Deutsche Bank (2013), though the effects were diminishing with time. Cumulatively, markets became convinced that policy is likely to tighten more slowly than in previous recoveries.
5. Commitment to unchanged policy (at least) until an unemployment threshold is crossed was declared by the Fed in December 2012 and by the Bank of England in August 2013. For the Fed extending the commitment simply to a date which was already

two years ahead might have stretched credibility too far. And for both central banks, linking the initial step(s) away from maximal accommodation to the main macroeconomic indicator, the unemployment rate, was an attempt to clarify their “reaction function” – a step advocated and applauded by leading academics, notably Woodford (2013), as well as by financial sector economists as a significant improvement of strategy.

The flip-side of this advance is, however, to bring differences between the forecast of the central bank and those of others more into focus, testing the authority of the Delphic framework. Both the US and the UK experiences in 2013 have suggested some confusion, as a strategy to delay the beginning of an end to accommodation well into the future was implemented at a time when signs of recovery became more unquestionable. The UK example is the clearest; underestimating the upward momentum finally showing up in the UK economy implies that a 7% unemployment threshold will be reached earlier than anticipated by the Bank of England. In the US, the corresponding unemployment threshold is 6.5%, about one percentage point above the Fed’s estimate of NAIRU, but other forecasters come up with a higher figure, with recent upwards wage trends suggesting that they could be right. So, can tightening wait that much longer?

In both countries many market participants see an upward movement of short-term policy rates coming earlier than the respective central banks have communicated. Reading the tealeaves from minutes of the policy meetings has to some extent substituted for independent thought, to paraphrase Williams (2013). So far, the strategy of the central banks comes close to saying: “We shall tell them until they understand and believe” – and there are many in the markets who want to believe.

To stay in the Odyssean image, there are sirens on both sides of the narrow sailing passage, requiring ever tighter ropes tying Odysseus to his mast, while eroding at the same time some of the policy credibility of the central bank’s Delphic role.

6. Modification of the objective of monetary policy is exemplified by the Bank of Japan’s efforts to raise the inflation target to 2% - and promising to reach it within two years. That would normally qualify as a regime change after two decades of zero (or slightly negative) inflation. Doubts about this more radical variant of Forward Guidance relate to the ability of the Bank of Japan to attain its objective; there are examples in history of breaking high inflation and inflationary expectations fairly rapidly, but hardly any of raising actual and/or expected inflation within a short time horizon.

7. Replacing an inflation by a nominal income objective is seen by some as a variant of Forward Guidance with a particularly strong potential of breaking out of harmfully low inflation, see e.g. Woodford (2012). If the only way out of low activity is to drive short-term interest rates well below zero, a nominal income target – even formulated in levels – might send appropriately aggressive signals. But here again neither the real, nor the nominal component will be easy to move. And the indifference between the two components implicit in this variant seems counterintuitive and destructive of central bank credibility built up over the past three decades, even if it does not bring any inflation rapidly.

CONCLUSIONS

Forward guidance comes in several variants, but all rely, in some combination on the two elements that might be seen to provide their justification: the central bank’s authority as a Delphic forecaster and its Odyssean ability to commit to future policy actions. Those variants that rely only or primarily on the former - (1) and (2) above - may be too vague to have a major impact in both quiet and more turbulent times. (3) is a special case of Forward Guidance by committing an instrument to directly impact the longer-term rate; it appears to have had its major – and important – impact at the announcement stage, both when purchases were to start and when they were to “taper” off. This variant does not build directly as the others on a model, but emphasizes commitment. Intermediate variants – (4) and (5) above – rely on both and have had an impact in lowering long-term interest rates, but they tend to bring the two justifying foundations into conflict, as strong commitment can undermine the careful use of accumulating information, usually associated with central banks. In either the pure time or the threshold variant policy communications will gradually be subjected to suspicions of excessive confidence in messages – hubris and overreliance on REH. This will make it difficult for Forward Guidance to survive into a more normal period where nuanced information accumulates steadily – and may be that is no surprise, as Forward Guidance arose as a response to the extraordinary challenges of the early post-crisis environment.

Precisely for that reason, some central bankers and many academics advocate the more radical variants of Forward Guidance – modifying the inflation objective or replacing it outright, as outlined in variants (6) and (7) above. Logically that sounds appealing, but doubts arise as to the feasibility of implementing the intentions. Can inflation be raised quickly – and could one of these variants stand alone without the qualifications - “knockouts” in the UK terminology - notably referring to the avoidance of financial instability? One major lesson of the crisis of the last few years is that financial stability

can be at risk well before inflation in any broader sense begins to take off. If so, can one avoid raising short-term rates, even when there may be other instruments, notably macroprudential ones, to contain it?

In short, there are major and challenging problems in evaluating Forward Guidance from a policy perspective. There is also a need for measuring more carefully the impact of the several experiences with Forward Guidance in recent years. That is, of course, already high on the agenda of the Fed and of the other central banks concerned, but the methods could be sharpened. It is not

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– or at least not always – optimal to evaluate the impact with an REH framework in mind, where the authority of the central bank as a model builder and acceptance by market participants of its statements on future policy form a powerful combination for shifting market perceptions. Particularly after the crisis the latter cannot be influenced so easily; due account will have to be taken of a more gradual acceptance by economic agents of the central bank’s forecasts and policy commitments.

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Report from the 2013 SUERF General Assembly

This year's SUERF General Assembly was held during the SUERF/DNB/Rabobank Conference in Amsterdam on 4 October 2013. SUERF President **Urs Birchler** opened the meeting and welcomed those attending the General Assembly in SUERF’s 50th Anniversary Year. He gave thanks to **Catherine Lubochinsky** and **Christian Pfister**, who had both stood down from the Council of Management. Their places on the Council of Management have been filled by **Alain Duchâteau** (Banque de France) and **Natacha Valla** (Goldman Sachs), who were formally elected to the Council of Management at the subsequent elections to ensure that SUERF has two French citizens on Council as required under the Association’s Statutes, they having been elected for a three year term retroactively from 1 January 2013. In addition, Urs Birchler’s mandate on Council, was renewed for another three years, effective from the expiry of his present mandate on 1 January 2014.

Since the last General Assembly held in Zürich during the 30th SUERF Colloquium, there had been conferences in Copenhagen, Vienna, Helsinki and Amsterdam, and the programme for the coming year (as listed elsewhere in this Newsletter) was announced, as well as brief information about the 50th Anniversary Volume – launched at the subsequent conference in Paris and details about recent and forthcoming *SUERF Studies*.

Michael Bailey reported on behalf of SUERF’s Honorary Treasurer, **Donato Masciandaro**, that SUERF’s financial position remains sound, thanks to the support of the Association’s membership, in particular Corporate Members and Central Bank Members. Finally thanks were given to the organizations with which SUERF has organized events in 2013 and will organize events with in 2014.

Michael Bailey, Executive Secretary