EUROPEAN CENTRAL BANK

EUROSYSTEM

Laudatio for Professor Kenneth Rogoff, recipient of the 2011 Deutsche Bank Prize in Financial Economics

Speech by Vítor Constâncio, Vice-President of the ECB, Frankfurt am Main, 22 September 2011

Ladies and Gentlemen,

It is a great pleasure to address a few words to mark the awarding of the 2011 Deutsche Bank Prize in Financial Economics to Professor Kenneth Rogoff of Harvard University.

I will recall some of Professor Rogoff's outstanding contributions to economics and financial economics, and I will also comment on some of his research in the context of the responses to the current crisis.

Let me first emphasise that research plays a crucial role for the Eurosystem – just as it does for other central banks. Indeed, research has provided an essential input to the definition of the ECB's price-stability monetary policy strategy. I would thus like to express my appreciation to Professor Rogoff for the influential contributions he has made in many fields of special relevance to central bank policymakers, ranging from monetary policy to international finance and financial crises. He merits particular praise for helping us to improve our understanding of some of the main causes and mechanisms behind the links between financial crises and sovereign debt crises.

Early in his career Professor Rogoff worked as a central banker in the International Finance Division at the Board of Governors of the Federal Reserve System. In this period, he wrote two of the most celebrated papers in monetary economics and international finance. One, which appeared in 1985 in the *Quarterly Journal of Economics* under the title " *The optimal degree of commitment to an intermediate monetary target*," is especially cherished among central bankers (and still his most cited contribution according to Google Scholar with over 2,100 citations). It forcefully laid out the rationale for the delegation of monetary policy to an independent central bank with an explicit price stability objective, a fundamental principle obviously enshrined in the ECB mandate.

The second contribution, co-authored with Richard Meese, appeared in 1983 in the *Journal of International Economics* under the title " *Empirical exchange rate models of the seventies: Do they fit out of sample?*" and is one of the most cited papers in international finance. It established key empirical regularities about major currencies exchange rates. The implication that nominal exchange rates are best modelled as unpredictable "random walks" is still the basis of the best practice followed by many institutions. This paper marked the beginning of Professor Rogoff's long-standing prominence in the field of international finance and was followed by a steady flow of equally distinguished contributions, in some instances literally re-writing history. This was the case with " *The Modern History of Exchange Rate Arrangements: A Reinterpretation*" co-authored with Carmen Reinhart and published in the *Quarterly Journal of Economics* in 2004.

Professor Rogoff has also been at the forefront of modelling efforts in the field of International macroeconomics, particularly with a view to replacing the Mundell-Fleming-Dornbusch open economy model, previously the workhorse of virtually all policy analysis in international economics both inside and outside central banks. This ground-breaking effort, reflected in the work written jointly with Maurice Obstfeld entitled

"Foundations of International Macroeconomics", gave birth to a new field in "new open economy macroeconomics" and spurred a vast and ever-growing literature. This new approach has allowed both researchers and policymakers to analyse substantive issues, such as current account and fiscal imbalances, and to provide a welfare-theoretic perspective on global macroeconomic policy. As the IMF's chief economist between 2001 and 2003, Professor Rogoff launched the development of a large-scale version of his model with Maurice Obstfeld, the Global Economy Model (GEM), one of the first fully-fledged Dynamic Stochastic General Equilibrium (DSGE) models to be used for policy analysis.

More recently, he has offered us invaluable insights into financial crises. His 2009 best-selling book with Carmen Reinhart, *This Time Is Different,* is a landmark work. This tour-de-force, drawing on data for 70 countries over 800 years, provides evidence that financial crises are far more universal, and that there are far more quantitative similarities in their aftermath, than previously believed. The "this-time-is-different-syndrome" is a powerful reminder of the dangers of complacency. One key observation is that financial crises are followed by unusually prolonged recessions in economic activity. Another valuable insight is that the fiscal and financial dimensions are closely interconnected. Fiscal imbalances can undermine the financial sector; financial sector imbalances can weigh down on the credibility of the sovereign; both can spillover into the real sector, and vice versa. The book foresaw that the massive implicit liabilities towards the financial sector accumulated by governments could result in unsustainable levels of sovereign debt.

Despite the important theoretical and empirical advances to which Professor Rogoff has contributed substantially, there is still much to be learnt about the root causes, the triggers and the propagation mechanisms of crises. The major challenges for policymakers posed by the existing knowledge gaps are reflected in the very controversial debates about the optimal responses to mitigate and resolve the current crisis and to prevent future crises. In this context, since his time at the IMF, Professor Rogoff has featured prominently in global policy debates, producing analyses and making recommendations on how to contain the current crisis and restore overall macroeconomic stability in the euro area.

On that very subject, as we all know, conditions in financial markets have taken a turn for the worse since the second half of July and early August. In the euro area, the renewed intensification of financial market turbulence is leading to very high interest rates in some countries, to potentially damaging volatility, and to very low trading volumes in some government bond markets that at times cease to function appropriately. The tensions to some extent resemble those of May 2010, but in some respects they are more broad-based than what we saw at that time. It is clear that sovereign debt challenges in individual euro area countries – no matter their size – can undermine the stability of the euro area as a whole.

In view of these developments, the authorities in the euro area have taken a multi-pronged approach to address the concerns about sovereign risk and its impact on the financial sector. Regarding fiscal support for crisis countries, euro area governments announced on 21 July a second support package for Greece and the introduction of additional flexibility for the European Financial Stability Facility and the future European Stability Mechanism. In this respect, the full and timely implementation of the 21 July agreement between heads of state or government is crucial. A renewed commitment by all euro area governments to the agreed fiscal targets is of course equally essential.

The ECB has also stepped up its responses, reflecting its full commitment to ensuring a continuing smooth functioning of the key euro area market segments, a necessary prerequisite to achieve price stability in the euro area. First, it decided to continue to support ample liquidity conditions by conducting its refinancing operations as fixed-rate tender procedures with full allotment, at least until mid-January 2012. Let me point out that the outstanding Eurosystem credit in our refinancing operations currently amounts to about €530 billion and has come down since last year. The total value of marketable securities already presented and approved for Eurosystem credit operations amounts to €1.7 trillion and our counterparties have at their disposal almost €4 trillion out of the overall total of existing eligible securities of about €14 trillion. Therefore, this confirms that there is no liquidity or collateral shortage for the euro area banking system.

Second, the ECB resumed its government bond market interventions under its Securities Markets Programme

(SMP) in August. Via these interventions, the ECB Governing Council aims to help restore a more appropriate transmission of its monetary policy stance in an environment in which key market segments, such as those for government paper, are dysfunctional. The interventions do not influence our monetary policy stance. In order to sterilise the impact of these interventions on the liquidity conditions in the banking system, we re-absorb the liquidity injected.

Let me underline that the secondary market purchases are not, and cannot be used to circumvent the principle of budgetary discipline as a pillar of Economic and Monetary Union. Sustained buying of government paper by the central bank would only postpone problems and delay the necessary fiscal adjustments, ultimately resulting in a build-up of inflationary pressures. The ECB has never hesitated to reaffirm and remind all Member States, in very concrete terms, that compliance with the principles of budgetary discipline is absolutely fundamental.

Naturally, since member states do not control their currency alone, they are vulnerable to liquidity episodes and multiple equilibria. Creditors' assessments can change, e.g. via contagion effects, even when the fundamentals would not justify it. The high degree of financial integration within EMU means that, if left unchecked, contagion in the banking sector can spread rapidly via cross-border holdings of sovereign debt. For the sovereigns themselves, sudden shifts in market re-pricing of risk can lead to unexpected liquidity challenges. These dynamics underscore the importance of strengthening the mechanisms that prevent such risks – the SGP, surveillance of broader macroeconomic imbalances and stronger financial supervision. However, the liquidity dry-ups and the contagion risks also call for stronger backstop mechanisms, to provide significant, albeit temporary, liquidity assistance.

The SMP aims to create a better functioning transmission mechanism of monetary policy to all parts of the monetary union and is therefore in full compliance with the prohibition of monetary financing. Also, we sterilise the impact of the SMP on our total liquidity provision. The relative size of the programme, representing just 1.6% of the euro area GDP against 13.7% of GDP that has been bought by the Bank of England or the 11.4% purchased by the Federal Reserve, makes it easier to implement. The ECB continues to comply strictly to its mandate to ensure price stability and does not allow inflation to increase as a way of easing the burden of the debt. On this point we disagree with some of the suggestions made recently by Professor Rogoff. The inflation tax is a blunt tool whose accidental effects would reflect mainly ex-ante institutional features (such as the degree of indexation or the maturity structure of liabilities) rather than the actual necessity to adjust. More importantly, Professor Rogoff has said himself, inflating the debt away would unduly jeopardise the most precious capital of the ECB and of any independent central bank, namely its credibility. The ECB will never debase the currency, as our record shows: we have remarkably preserved both internal and external value of the euro by keeping inflation low and inflation expectations well-anchored. As we have learnt and repeatedly experienced, credibility and in particular the ability to anchor inflation expectations are crucial for the smooth functioning of monetary policy. Their key role has been highlighted again and again during the financial crisis, particularly in preventing the danger of an entrenchment of deflationary expectations.

The euro area is a highly integrated economic and financial area which needs to be managed through common decisions. However, aside from monetary policy, it lacks powerful decision-making institutions. This means that rules-based frameworks must act a substitute for centralised authority. For fiscal and economic issues, a unitary state would have a finance ministry which both defines and vetoes fiscal and broader economic policies. EMU must achieve the same effect through its economic governance framework. We know from research, including some by Professor Rogoff, also corroborated by experience, that soft-rules will not achieve the desired outcome. Strengthening the rules governing fiscal and broader macroeconomic policies is thus essential.

The Stability and Growth Pact (SGP), which was created to discipline fiscal policy, has not worked well and is now being strengthened and complemented by a macroeconomic imbalances procedure. Greater automaticity in the implementation of the SGP is needed when unsustainable policies put the stability of the euro area as a whole at risk. Credible economic governance needs to be consistent and predictable. It also needs to be backed by timely, tough sanctions to encourage compliance. Fiscal surveillance should set ambitious benchmarks for excessive deficit and for setting the adjustment path towards a country's medium-term budgetary objective. The liquidity dry-ups and contagion risks also call for stronger backstop mechanisms, to provide significant, albeit temporary, liquidity assistance. Stronger financial supervision at euro area level is also essential. Finally, national authorities need to take ownership of their European commitments. This means anchoring EU rules in their national legislation and making them mandatory and being held to account by domestic parliaments.

Economic governance is not only about preventing crises, but also about creating the conditions for economic growth. At present, this is a major challenge requiring greater coordination across the euro area. Projections of the euro area's long-term growth prospects remain weak, depressed by the fiscal burden of age-related expenditure, slow productivity growth, and on going debt sustainability challenges. I agree with recent comments by Professor Rogoff that Europe needs to do more to reverse this trend. It is essential to give renewed impetus to a comprehensive and ambitious programme of growth-enhancing structural reforms supported by intensive monitoring and follow-up.

Let me conclude. It is precisely against the backdrop of the challenges stemming from the current crisis that we can fully appreciate the invaluable contributions of scholars like Kenneth Rogoff. I extend my sincerest congratulations to him as he receives the 2011 Deutsche Bank Prize in Financial Economics, a well-deserved recognition for his work.

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