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We turn now to the last but not the least point. We turn our attention away from Europe and look at what the central banks are doing globally and why they are doing it. We could not imagine a better speaker on this than Jacob Frenkel, who is leading our own meditation in our cherished group of 30. You have the floor.

Jacob Frenkel, Chairman of JPMorgan Chase International

Thank you very much. I would like you to imagine, and it will be very easy to do so, the state of mind and physical capabilities of those who have made decisions under fire. Many of you have been here for 11 hours already and your response to me saying we should discuss these things is probably, 'Let us get out of here.' Let me tell you that those central bankers who had to deal with these matters in the height of the crisis had to do so over more than 11 hours and the stress was significantly greater. This was the ambiance.

The subject that was assigned to me was to reflect on so-called "unconventional policy measures". When we speak about unconventional policy measures we presumably have in mind a set of conventional measures which are used as a yardstick to determine that other measures are unconventional. That is a very important point. It means we have as a conceptual anchor the set of conventional measures relative to which we define and analyze the unconventional measures.

Why did policy makers need to resort to unconventional measures if we have that anchor? The answer is that circumstances have been very unconventional and the conventional policy tools were not available. Specifically, budget deficits have already been very large and associated with them public debt has grown significantly, and at the same time interest rates have already been closed to zero thereby constraining the ability of monetary policy to ease further through interest rate reductions. These were the circumstances that necessitated the adoption of unconventional measures. The assumption was that when circumstances become more normal policy makers will result again to conventional measures. This is important because it emphasizes that the dramatic departures from convention was viewed as a temporary measure. It was perceived as a detour rather than as a new paradigm. Of course, the longer that such "temporary detour" lasts, the greater the uncertainty as to whether this is indeed a temporary detour or possibly a new paradigm. As the saying goes "there is nothing more permanent than a temporary measure". In order to convince market that the unconventional measures are temporary it is important that policy makers keep reminding the markets that this is the case and that conventional measures will become again the norm once normalcy returns. This perspective is very important as we discuss the uncertainty prevailing in the global financial system.

Why was there a need for unconventional measures? There were basically two reasons. The first is that other arms of macro-policies, like fiscal policies, were already overstretched. We started the crisis by recognising that the system had excess leverage. That was true of everyone, the corporate sector, the financial sector, the household sector and governments. As a result the freedom to increase further public sector leverage was limited even though governments increased their leverage significantly in order to combat the recessionary tendencies. Thus, the fiscal arm was already stretched. On the monetary side it is enough to recall that before the crisis global interest rates were very different from what they are now. We had interest rates of between 5% and 6% in some countries and between 4% and 5% in other countries. This was the so-called 'normal'. All interest rates today are much closer to zero. The numbers we are talking about are 0.25% in the Eurozone, 0.5% in the UK, 0.1% in Japan 0.1% and 0.25% in the US. Since nominal interest rates cannot be negative, they practically reached the 'zero-bound'. Hence, the channel of stimulating demand through a further reduction in interest rates was not available.

This was the background to the introduction of the unconventional measures for expansionary monetary policy, hence the various QEs, quantitative easing and qualitative easing. The magnitude has been dramatic. If we calibrate the size of the Federal Reserve's balance sheet at 100 in June 2007 then the size of the balance sheet today (December 2013) is 450. That is a dramatic increase which came about through three phases – the first phase, QE2 and QE3 – and most recently QE3 which was very steep.

There is the impression that all central banks have adopted similar expansionary mode. There are however, some nuanced differences among the Central Banks. The European Central Bank (ECB) has also significantly increased the size of its balance sheet, but this expansion has already started to turn around. The ECB's balance sheet has been shrinking for a year or maybe even longer. One of the reasons for this is that the banks that borrowed from the ECB decided to repay some of those loans. If we calibrate the size of the ECB's balance sheet in 2007 to be 100, today the size of the balance sheet is about 190 (compared with 450 for the U.S. Federal Reserve). Japan has also adopted QEs associated with the Abenomics. If we calibrate the balance sheet of the Bank of Japan to be 100 in June 2007, today the size of the balance sheet reached 225.

The Federal Reserve's balance sheet is about 25% of US GDP. The ECB's balance sheet is about 24% of European GDP. The Bank of Japan's balance sheet is already close to 50% of Japan's GDP. All central banks have therefore been engaged in expansion, albeit to different degrees. When we talk about the liquidity of the world, the size of the balance sheet of the US is now about USD 3.9 trillion. The size of the balance sheet of the ECB is about USD 3.1 trillion and that of Japan is USD 2.1 trillion. Put together the size of the balance sheet of these three Central Banks has now reached almost USD 10 trillion. The magnitude of the expansion has been very significant and without precedent.

We focus a lot on the size of the balance sheet, but the drama and the unconventional measures are manifested not only in the size of the balance sheet but also in the composition of the balance sheets. In 2007, before the crisis, 95% of the assets on the Federal Reserve's balance sheet were short-term government Treasury bills. This was the standard of a central bank. These assets are very liquid and are relatively short term. Since the market for short-term Treasury bills is very deep, and since these assets are very liquid, they can be sold rapidly with little drama. The impact of such sale is spread through the entire economic system and is not concentrated in a specific sector. This was the traditional concept of monetary policy: it is an aggregated policy designed to impact on the macro economy rather than have specific sectoral impacts. In this conventional framework sectoral policies were delegated to the tools of fiscal policies. This was the background for the very large proportion of the Fed's assets that were held in Treasury bills in June 2007 (before the crisis). In contrast, as a result of the crisis and the adoption of unconventional policies, the composition of the Federal Reserve's assets has changed dramatically. By June 2010 a snapshot of Federal Reserve's balance sheet shows that about 60% of the assets were mortgage-based securities (MBS). The weight of Treasury bills was reduced to about one-third of the balance sheet.

The Federal Reserve has purchased these securities, some of which were toxic, in order to provide liquidity to the banking system that were holding them. A distinction therefore emerged between two concepts: the price of credit, namely the interest rates, which were already pushed to zero, and the availability of credit. Those are two different concepts. The essence of the QEs was to provide liquidity to the banking system. By now (December 2013) the composition of the Federal Reserve assets exhibits a slight return to normalcy – the weight of Treasury bills has risen to about 50% of the balance sheet and the weight of mortgage-based securities fell to about 40% of the balance sheet. As stated before, the size of the balance sheet however has continued to increase. Thus, there is still a long way before normalcy is restored.

When you look at the composition of the assets of the ECB there is also drama. In 2007 close to 70% of the balance sheet was comprised of short-term refinance bills of short duration (less than one month). In response to the crisis the ECB has increased significantly the duration of its assets. Long-term Refinancing Operations (LTRO) rose to more than 95% of the ECB's balance sheet. In other words, each central bank has changed the size and composition of its balance sheet. This is the most important manifestation of the unconventional measures. In addition to these unconventional measures, the ECB has also lowered the collateral standards necessary to lend, and thereby altered the risk profile of its assets.

In addition, in order to clarify their policy intentions, the monetary authorities have adopted a strategy of forward guidance. This forward guidance was used in order to send a clear message to the markets that the stance of easy monetary policy was not about to be reversed in the near term. Thus, the Bank of England stated that it will not raise interest rates until a certain level of unemployment is reached, and even then rates may not go up. A similar guidance was provided by the Federal Reserve that went further to clarify that even if the unemployment falls to the indicated threshold, it would not mean that the Fed would automatically depart from its exceptionally accommodating stance since they will need to examine the specific causes to the fall in the unemployment rate. Among the factors that will need to be examined, would be changes in labor force participation, the distinction between part-time and full-time employment and the like. In short, while the forward guidance provides a clear direction of the intent of the monetary authority it is not providing a specific date or numerical value of the threshold which will trigger a change in the monetary policy stance.

By now, real interest rates in most of the industrial world have been negative for a relatively long period of time. This must be an aberration since it introduces distortions. Central banks have emphasised time and again that they cannot solve the structural problems of the economy. They are providing oxygen to give time for the other players to do their job regarding the fiscal side, the structural side, improved labour market conditions and so forth. Once the monetary authorities recognize that the financial system is sufficiently robust and recovery takes hold, they would be able to gradually taper off their expansionary mode. This should be viewed by the markets as “good news” since it would demonstrate that the patient can be moved from the intensive care to the rehabilitation center. Once the Fed tapers off its expansionary policies, the implications would be felt all over the world. Should the Federal Reserve take into account the international consequences of its actions and possibly delay policy actions that otherwise would have had to be implemented? As a practical matter it is difficult to assume that the Fed would depart from its mandate in order to take into account explicitly foreign considerations. One of the benefits of the forward guidance that is provided by the Fed is that other countries can anticipate and plan for future Fed actions.

My final remark relates to bank supervision. One of the consequences of the recent crisis has been the recognition that the robustness of the banking system is a critical component of the robustness of the entire economic system, and that bank supervision plays a central role in bringing about such robustness. The institutional setting within which the bank supervision function operates has been a subject of debate. I believe that the recent experience should help in resolving this debate. Specifically, since the Central Bank must have the capabilities to respond very promptly to new developments, and since it must have timely and reliable information about the banking sector, it stands to reason that the responsibility for bank supervision should rest within the Central Bank.