Jan F Qvigstad: What is a useful central bank?

Speech by Mr Jan F Qvigstad, Deputy Governor of Norges Bank (Central Bank of Norway), at Norges Bank's Symposium "What is a useful central bank?", Oslo, 18 November 2010.

* * *

It is a great pleasure for me to welcome you to this symposium. I would like to extend a special welcome to those of you who have travelled a long distance to be here today.

November probably does not do justice to Oslo. To do that, we would have held the symposium in February or March, to show you the winter landscape, or in June or July, so that you might experience light summer nights.

But November it is, and not without reason. You all know that the Governor of Norges Bank, Svein Gjedrem, will soon have served his two terms. The governor will step down at the end of the year.

The Governor has always believed that too much attention is paid to persons and there is too little focus on the position that the person holds. By organising this symposium on a theme of keen interest to the Governor, we have tried to combine the strictly academic with respect for the way the Governor has filled his role.

Our chosen theme is *"What is a useful central bank?"* But before we can answer that question, we need to answer the question, *"What is a central bank?"* This may sound like a naive question, especially coming from someone with twenty-five years' work experience at Norges Bank. In recent years, however, I have begun to reflect on the question of what a central bank *really* is. There are two reasons for this reflection.

First I naturally have an interest in the history of Norges Bank. If we look back in time, for example, to the establishment of Norges Bank in 1816, a central bank was something completely different from what it is today. History shows that over time, central banks' core tasks have changed. Or have they really?

Second, recent years' events in financial markets have shined a spotlight on new central bank tasks. The handling of the financial crisis also demonstrates that the definition of a central bank varies across countries and regions. Or are these tasks really new?

Stefano Ugolini, a central bank historian at the Graduate Institute in Geneva, has taught me that central banks' balance sheets reveal a lot about what a central bank is. Who does the bank trade with? What instruments does it trade? With this as our starting point, I shall take you on a brief journey back in time.

What is a central bank?

After the Napoleonic Wars, Norway gained its independence following a five-hundred-year union with Denmark. The country got its own Constitution on 17 May 1814. According to the Constitution, the Norwegian parliament was "to supervise the monetary affairs".

When the major powers used force to implement the provision of the Treaty of Kiel uniting Norway with Sweden, the Constitution needed to be adapted to the new realpolitik. However, the parliament managed to insert a new article in the November version of the constitution. It established an independent central bank, ensuring that Norway would have its own independent monetary system.

The actual Norges Bank Act was not established until 1816. The first deposits were recorded in the books in 1817. At the time there were no functioning banks in Norway. However, there was manufacturing, consumption, barter, investment and trade. There was also a rudimentary credit market and monetary system. Commercial credit was available, savers met investors and bills of exchange were discounted. But these markets were rather inefficient: their margins were high, the supply of credit meagre and uncertainty high.

Most activities associated nowadays with a monetary system took place in the "unregulated markets," to use the current term. Accounts were kept, but not always in the numéraire we think of today. For example, this is described in the local history of Karlsøy and Helgøy, up in northern Norway, where at that time accounts were sometimes kept in commodities such as cod liver oil, saithe or flour.

However, one of these unregulated markets functioned even more poorly than the others, namely the long-term credit market. For that reason, Norges Bank's initial activity was to enter this market. Norges Bank provided loans secured by real property. At its birth, the Bank was, to use current terminology again, *"market maker of last resort"*.

A private banking system gradually took shape. The first savings bank was founded in 1822 and the first commercial bank in 1848. In 1852 the first state mortgage bank was established. These developments allowed Norges Bank to withdraw from the mortgage market and concentrate instead on providing liquidity to the short-term money market. However, it was not until the 1860s that the Bank's predominant task was supplying short-term liquidity.

Much digging and research remains to answer the question of how Norges Bank dealt with the challenges during the 19th century. So far, scholars have not found that the Bank took emergency action when a financial crisis affected Norway in 1847. But when the crisis hit again ten years later, the Bank sent silver abroad to Hamburg, which was the financial centre of the Norwegian merchants. This support was important to enable Norwegian industry to carry out international payments and have their bills of exchange discounted.

In 1892 a new Act was passed whereby Norges Bank became the bankers' bank. As the Governor mentioned in his speech yesterday, this made Norges Bank a modern central bank in a legal sense.

In 1899, Kristiania (as Oslo was called at the time) experienced dramatic fall in house prices. The financial bubble contained all the classical elements, such as a surging credit growth and house price inflation. Norges Bank had to carry out several rescue operations to save banks that were in trouble. 1899 was probably the first year the Bank functioned as *"lender of last resort"*.

If you take a walk around the neighbourhood, you will see the physical aftermath of this bubble. You will find buildings from the 1890s and from the 1920s onward, but virtually nothing built in the intervening period.

The past years we have again been in troubled waters. In September 2008 the turbulence in financial markets developed into a full-blown global crisis. Money markets seized up. Confidence between banks vanished. Liquidity dried up, interest rates rose sharply and equity prices fell. The long-term lending market dried up.

International developments were also felt in Norway. Up until then we could almost take a well-functioning money market for granted in this country. But in the autumn of 2008 the money market stopped functioning and medium-term funding for banks was problematic. Just as in 1816, Norges Bank acted as *"market maker of last resort".*

And so, the history of my own central bank, expanding the window from 25 years to 200 years, does not provide an unambiguous answer to the question of what defines a central bank.

But even if we look at central banks in other countries, there are no clear answers. The way the financial crisis was handled varied across countries. In many places, for instance, substantial portions of the crisis measures remain on the central bank's balance sheet. Here in Norway, the crisis measures relating to banks' medium-term funding are on the balance sheet of the Ministry of Finance.

The financial crisis also demonstrated the need for macroprudential policies. But who will have responsibility for these policies? The framework for macroprudential policies is likely to differ from one country to another. The Governor touched on these questions in yesterday's speech.

To sum up: Perhaps my question was not so naive after all. The examples above show that there is not an obvious answer to "what defines a central bank". Nevertheless, some key principles may apply, both historically and across national borders:

- As early as 1873 Walter Bagehot[1] formulated the well known general principles for the role of central banks. He said:

  "To avert panic, central banks should lend early and freely (without limit), to solvent firms, against good collateral, and at "high rates"

  The events in 2008 showed us that the lender of last resort function continues to be of the utmost relevance and importance.
- The financial crisis also illustrated that central banks have an important role in creating and providing liquidity.
- In addition, the establishment of Norges Bank in 1816 and the Bank's intervention in the money markets in 2008 show that central banks also have an important role as *"market maker of last resort".*

Searching for answers

Even if we can provide some general answers to the question of what has characterised central banking activities, we must continue to search for answers to what central banks are and what makes them useful.

Norges Bank will celebrate its two hundred year anniversary in 2016. We plan to write three books: *The History of Norges Bank* will be written by historians, and *The Monetary History of Norway* will be written by economists*.* The third book from the project will offer an international, historical perspective on central banking, and has been given the working title *What is a useful central bank?* Norway will only be mentioned in this book if our experiences contribute to the international understanding of the question at hand.

This last question was also the topic of the Governor's speech yesterday and the theme of today's symposium. He pointed out that a useful central bank must have a clear mandate with relevant objectives and instruments. The central bank must also seek to reach these objectives in a manner that ensures confidence.

Arranging this symposium on a theme that interests the Governor is our way of honouring him after having served his two periods.

Today we begin with a historical perspective on central banking. Professor Bordo will offer some long-term perspectives, while professor Toniolo will discuss some experiences from central banks' challenges in the interwar period. Later, Governor Aziz will address current challenges for central banks in emerging market economies. After lunch Philip Turner from BIS and Governor Ingves will share some of their insights from the theory and practice of central banking. The day will conclude with a panel discussion chaired by professor Gerlach, on central banks' future challenges.

We are fortunate to have such prominent speakers here with us today. I hope they inspire our further research on the topic "*What is a useful central bank?"*.

---

[1] Walter Bagehot (1873): *"Lombard Street: A description of the Money Market"*.