

## **Jean-Pierre Danthine: Monetary policy is not almighty**

Speech by Mr Jean-Pierre Danthine, Vice Chairman of the Governing Board of the Swiss National Bank, at the *Journée Solutions Bancaires*, Geneva, 31 May 2012.

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Ladies and gentlemen,

It is a great pleasure for me to be here with you all today. At the outset, please allow me to thank the organisers at Unicore for having invited me to speak at the 14th *Journée Solutions Bancaires* to be held here in Geneva.

Today, I will reflect on what monetary policy can and cannot do. I would like to emphasise where central banks' powers and responsibilities end and where those of fiscal policy and the private sector begin. "Why is he focusing on this now?" I hear you ask. "We are in the midst of a crisis. Shouldn't he be emphasising what central banks can do, instead of what they cannot?" My answer to you is this: while the monetary policy measures taken in recent years have had a stabilising effect, today, monetary policy has acquired a degree of prominence that could lead to its powers and its reach being overestimated. Central banks are far from almighty and, in efforts to emphasise this, I will review the various policy options at the zero lower bound and the risks associated with the measures currently in place. I will first examine the issue in universal terms, before concentrating on the very unusual case of Switzerland.

### **Conventional policy options at the zero lower bound**

Conventional macroeconomic theory states that, when interest rates are at the zero lower bound, monetary policy becomes ineffective and economic policy action should concentrate on fiscal measures. In slide 1, the depiction of the economy using the standard IS/LM model summarises this point of view. As you can see, the economic situation is represented in terms of two key variables, the interest rate and output (or GDP). Economic equilibrium is represented by the intersection of the IS and LM curves. The first corresponds to the interest rate and GDP levels that balance savings and investment and the second represents the combinations of these two variables, which equilibrate the demand and supply of money.

Expansionary monetary policy corresponds to pulling the LM curve to the right. When interest rates are at the lower bound, however, the LM curve is horizontal. At this point, pulling a horizontal to the right has absolutely no impact on the intersection of the IS and LM curves, and therefore on the equilibrium level of output. Conventional monetary policy hence becomes ineffective. Intuitively, if interest rates are at the zero lower bound they cannot be lowered further, yet it is precisely by lowering interest rates that monetary policy can stabilise the real economy.

By contrast, it is at the zero lower bound that the potential benefits of fiscal policy are most significant. As the same diagram suggests, it is precisely when the LM curve is flat that it becomes most appealing to use fiscal policy. This is because a fiscal stimulus is not counteracted by an increase in interest rates – that would lead to a what is known as a "crowding out" of private investment – and thus fully translates into increased output (slide 2).

### **The challenges associated with fiscal imbalances**

Of course, the functioning of a IS/LM model is simpler than that of the real economy. In practice, the effectiveness of fiscal policy, even at the zero lower bound, is more ambiguous. There are several reasons for this. Governments' decision-making processes can be

laborious, for example, so fiscal stimulus may not be implemented when it is most needed.<sup>1</sup> Similarly, it may take time for fiscal stimulus to take effect or, in the case of a small open economy, it may simply evaporate in the form of increased imports. Whatever the case may be, the root of the current challenges is different. It resides in the fact that many countries now have very little leeway with which to undertake fiscal policy manoeuvres. As a result, it is becoming increasingly difficult, sometimes impossible, for public authorities to use fiscal policy to support the recovery, even when this may seem appropriate.

Most mature economies would have been in a better position to address the current situation if their fiscal reserves had been more significant at the onset of the crisis. In several cases, public debt-to-GDP ratios were already around 60% or even above. Yet, since 2008, many governments have actively used fiscal policy to combat the effects of the crisis and to refinance the banks. As a result, the debt-to-GDP ratios of G7 countries, for example, have increased by an unweighted average of almost 30 percentage points (slide 3). As a consequence, today, the option of implementing new fiscal stimuli has been virtually ruled out.

### **Monetary policy: in the frontline once again**

When it comes to economic policy matters, central banks have, therefore, returned to the limelight somewhat by default.

In the current crisis, monetary policy has proved more effective than the IS/LM model might suggest. This is essentially because central banks have resorted to using various combinations of conventional and unconventional measures to help provide conditions conducive to economic growth in a context of deflationary risks. Here, the aim has often been to impact long rates directly, given that it was no longer possible to influence short-term rates. Several central banks have therefore purchased assets to put pressure on their longer-term yields (quantitative easing). To the same end, some have extended the maturity of the assets on their balance sheets, while others have purchased private sector assets to contribute to the easing of market conditions (credit easing). Meanwhile, others have conducted foreign exchange interventions to reduce pressure on the export sector and to ease monetary conditions. Many have also made implicit or explicit long-term commitments to foster expectations of future low rates.

The scale of central bank intervention has been significant, as indicated by the combined balance sheets of central banks in the US, the UK, the euro area, Japan, China and Switzerland, for example. The total now amounts to some USD14 trillion (slide 4), i.e. over 30% of GDP in these currency areas. These exceptional monetary policy measures do, indeed, appear to have exerted downward pressure on interest rates, thus sustaining the real economy in the spirit of the IS/LM model.

### **What are the risks associated with these policies?**

Despite these positive (short-term) effects, I would first like to argue that the general message of the IS-LM diagram has not been invalidated by recent central bank actions. That is to say, when interest rates are close to zero, it is most appropriate to resort to fiscal policy and monetary policy becomes less effective.

Moreover, the current policy-mix can entail risks, to which I would now like to draw your attention. My greatest concern is that the general public could come to overestimate the impact of central banks' actions and the suitability of their intervention in each and every

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<sup>1</sup> For a discussion of the impact of fiscal measures in Switzerland between 2008 and 2010, see, "Die Konjunkturmassnahmen des Bundes 2008–2010: Evaluation der Konzeption und Umsetzung der Stabilisierungsmassnahmen," Swiss Federal Audit Office, May 2012.

economic situation that is deemed “unsatisfactory”. This could result in central banks being perceived as all-powerful, though such expectations are far from realistic. Troubled financial markets and dangerous economic circumstances required the implementation of exceptional measures. Even if these measures have a welcome impact in the short term, central banks must remain focused on their core mission, which is to ensure price stability. This is their long-run contribution to economic well-being. Monetary policy does not create wealth in and of itself. It is the innovative and entrepreneurial strengths of the private sector, not short-term monetary policy measures, that are the engines of real sustainable growth.

Could the short-term liquidity-creating measures pose a risk for price stability? This risk is often alluded to, and central banks are acutely aware that any measures must be rigorously and repeatedly assessed to prevent any mid-term resurgence of inflation. In any case, there are well-identified means of quickly reversing the effects of an abundance of liquidity, though it is true that the timing of such “exit” measures is a matter of delicate monetary policy assessment.

Today, however, abundant liquidity and extended periods of low interest rates are recognised as posing a risk to financial stability. One of the lessons of the recent crisis is that price stability is not sufficient for financial stability. Many central banks are therefore placing greater weight on financial stability concerns in their decision-making processes. To this end, several now envisage the use of specific new (“macroprudential”) instruments to directly address the risks to financial stability.

It is also worth considering whether central banks’ recent activism could undermine their independence. Several critics claim that, by implementing measures such as quantitative and credit easing, central banks have, at times, adopted “quasi-fiscal” policies and that the boundaries between fiscal and monetary policy were, thus, blurred. Yet, central bank independence is a delicate democratic concept. Its objective is to prevent temporal inconsistencies in the policies pursued from leading to results that could harm the economy as a whole. In other words, independence enables central banks to focus on price stability in the long-term interests of a country, as opposed to prioritising the short-term demands of specific political or economic interest groups. At present, the use of unconventional measures is largely motivated by the fact that monetary policy is at the zero lower bound and fiscal policy options are very limited. These are exceptional responses to exceptional circumstances and should remain so.

Finally, it is important to acknowledge that, by expanding their balance sheets, central banks have had to assume increased financial risks. Many central banks have purchased bonds when interest rates were very low. They are therefore exposed to considerable interest rate risks, which could lead to significant balance sheet losses and even to negative equity positions. In the short term, this is not a problem as it does not affect a central bank’s capacity to fulfil its mandate. After all, as a central bank has banknote-issuing privileges, it cannot become illiquid. Moreover, it is normally in a position to rebuild its equity in the longer term. Nevertheless, it is not desirable, even for a central bank, to experience a long period of negative equity as this could generate doubts about its credibility.<sup>2</sup>

### **Switzerland: a very special case**

Although the recent crises have been global in nature, every country has had to define policy in response to the specific circumstances that affect it. The Swiss case is very special as our country still has the leeway to undertake fiscal manoeuvres. Instead, we are confronted by another major challenge, the exceptional power of our currency. As we all know, the increased uncertainty and extreme risk aversion, which arose as a result, drove the Swiss

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<sup>2</sup> Cf. Jordan (2011) for more details on this topic.

franc to an all-time high in early August of 2011, posing a threat to the economy and carrying the risk of severe deflationary developments. As I already mentioned, fiscal policy remained a conceivable means of addressing this problem as our country's debt-to-GDP ratio is less than 40% and its public sector budget has been in surplus for the last six years. It was not, however, as the massively overvalued Swiss franc first threatened demand for Swiss exports and Switzerland is, of course, not in a position to stimulate the entire world economy. In this particular case, it was inappropriate to resort to fiscal policy. It was therefore up to the SNB to take action. It implemented measures aimed at a substantial and sustained weakening of the Swiss franc. After provoking an exceptional increase in liquidity in August, on 6 September 2011 the SNB announced that it would no longer tolerate a EUR/CHF exchange rate below CHF 1.20. This measure remains the focal point of Swiss monetary policy. In the current global context, Switzerland's economic situation does not justify any strengthening of monetary conditions and this should remain the case for the foreseeable future. The SNB continues to enforce this minimum rate with the utmost determination and remains prepared to buy foreign currency in unlimited quantities for this purpose.

From a conceptual perspective, the minimum exchange rate is not a quantitative easing measure and most of my generic comments do not strictly apply to the Swiss case. Nevertheless, the risks associated with this measure do, to a certain extent, resemble those I just described. The first of these risks is that the minimum exchange rate may superficially seem like a simple or straight-forward measure, which may in turn give the impression that monetary policy is a catch-all problem-solver, i.e. that it is almighty. This is clearly not the case. Monetary policy has neither the capacity nor the mandate to protect the Swiss economy from all the shocks to which it is subjected. The aim of the minimum exchange rate is to avert the worst possible developments in zero interest rate environment. It is not a response to each and every challenge with which the Swiss economy is faced, nor can it be implemented at any desired level, free of any risk.

The SNB's mandate is still to ensure price stability. The minimum exchange rate has decreased the deflationary and recessionary risks associated with a massively overvalued currency. It is entirely in line with our mandate. Furthermore, there is no risk of inflation in Switzerland for the foreseeable future. However, the SNB does recognise that the long period of low interest rates we are experiencing constitutes a danger to the stability of the financial system. The domestic credit and real estate markets are vibrant and there are concerns about the possible build-up of imbalances, which could eventually lead to price corrections and substantial losses in the Swiss banking sector. There is no doubt, however, that, in the current context of global economic indications of downside risks to the Swiss economy, current interest rate levels and the minimum exchange rate are vital. Any concerns about the housing market must, therefore, be addressed by alternative means. The SNB thus advocates the introduction of a "countercyclical capital buffer", a macroprudential tool targeted at the specific situation we are experiencing. If the SNB's recommendations are implemented, the banks will be legally obliged to meet specific equity capital requirements as soon as certain indicators on the real estate and mortgage markets show signs of unsustainable growth.

The concept of central bank independence is widely recognised in our country. The fact that an independent monetary policy best serves the interests of the country is rarely disputed. In the current exceptional circumstances, the imposition of a minimum exchange rate is a measure that has received strong support from economic and political actors in Switzerland and abroad. Both the IMF and the OECD recently confirmed that this was an appropriate response<sup>3</sup> to the risk of economic contraction and deflation in our country.<sup>4</sup> Given the perfect

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<sup>3</sup> OECD (2012).

<sup>4</sup> IMF (2012).

alignment of this exceptional monetary policy measure with the pursuit of the SNB's price stability mandate, one would imagine that, in the future, the National Bank's independent status will remain as strongly anchored as in the past.

Finally, it is important to consider the risks associated with the SNB's inflated balance sheet. Our balance sheet has become more volatile, principally because it has grown in size – it is four to five times larger than it was in 2007 – but also because of the volatility of the overall environment. In the course of the last two years, risks have manifested themselves both positively and negatively. In 2010, for example, the SNB experienced its biggest ever loss, but in 2011, it also experienced one of its largest gains. The much increased size of our balance sheet, the unavoidable exchange rate risks associated with our foreign exchange reserves and a dependence on developments in the gold and capital markets, mean that the high volatility of the SNB's annual results will be a standard feature of the near future.

In this respect, it is important to emphasise that monetary policy considerations always take precedence over those regarding the SNB's balance sheet risks. It is therefore worth repeating that there is a very high level of uncertainty in the international environment. An appreciation of the Swiss franc would again expose the Swiss economy to considerable risks and, once more, endanger both price stability and economic situation. Given this state of affairs, the SNB will continue to enforce the minimum exchange rate with utmost determination and, should the economic outlook and the threat of deflation require, is prepared to take further measures at any time.

### **Concluding remarks**

In closing, I would like to summarise my message. The unconventional measures the SNB and several other central banks continue to implement are tailored responses to exceptional circumstances. Their impact should nevertheless not be overestimated, and the associated risks must be recognised. Central banks are the guardians of price stability. Taking the broad economic situation into consideration, they can promote conditions that are conducive to growth. But central banks are not almighty. Monetary policy does not create wealth in and of itself, only financial and economic actors can harness the very best of their innovative, technological and creative talents to generate value and promote sustainable growth.

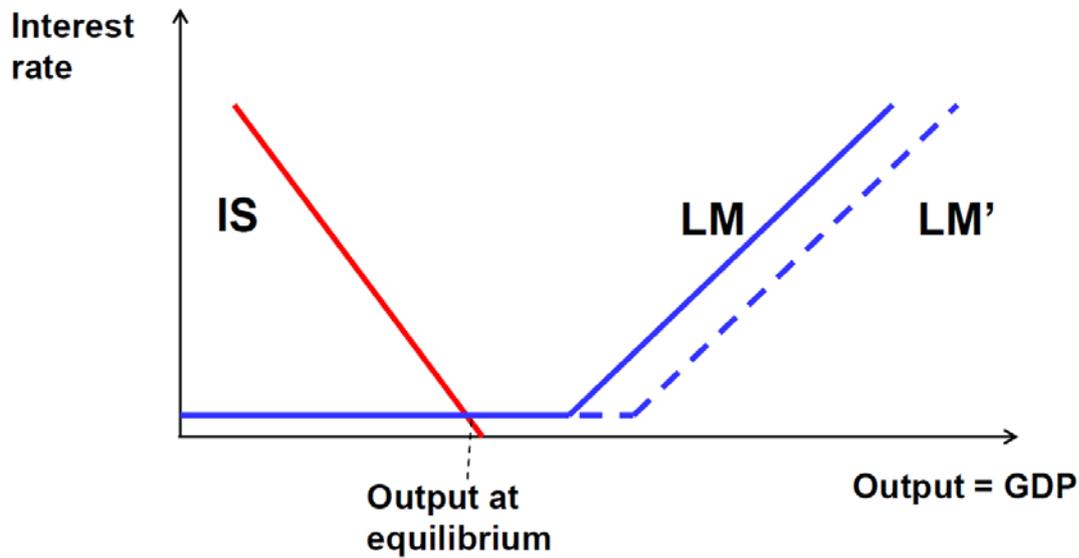
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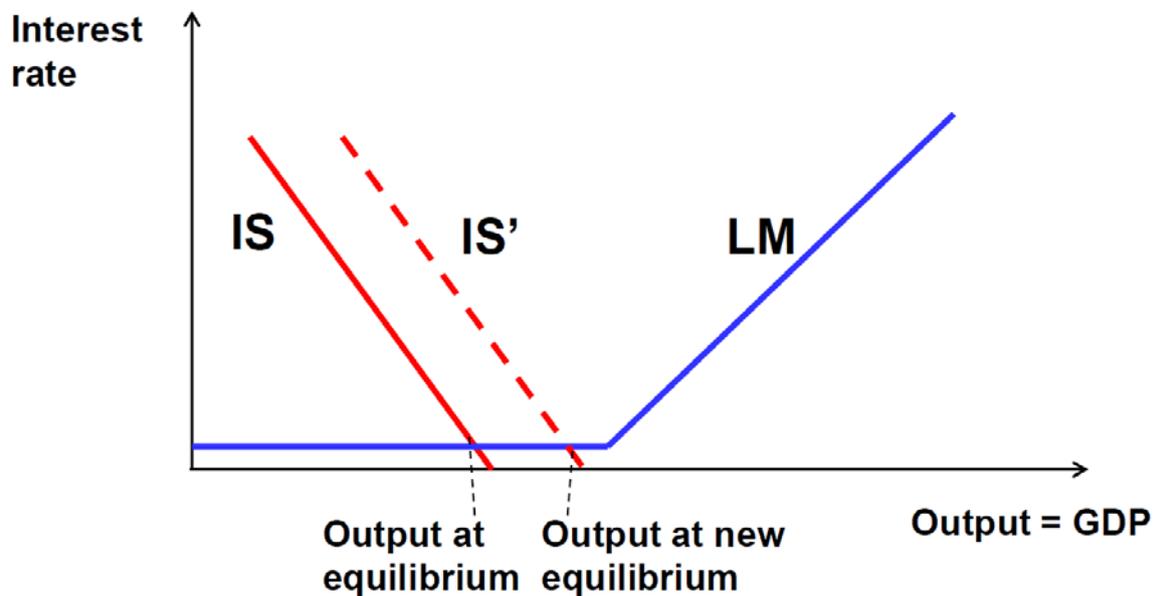
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# Monetary policy at the zero lower bound



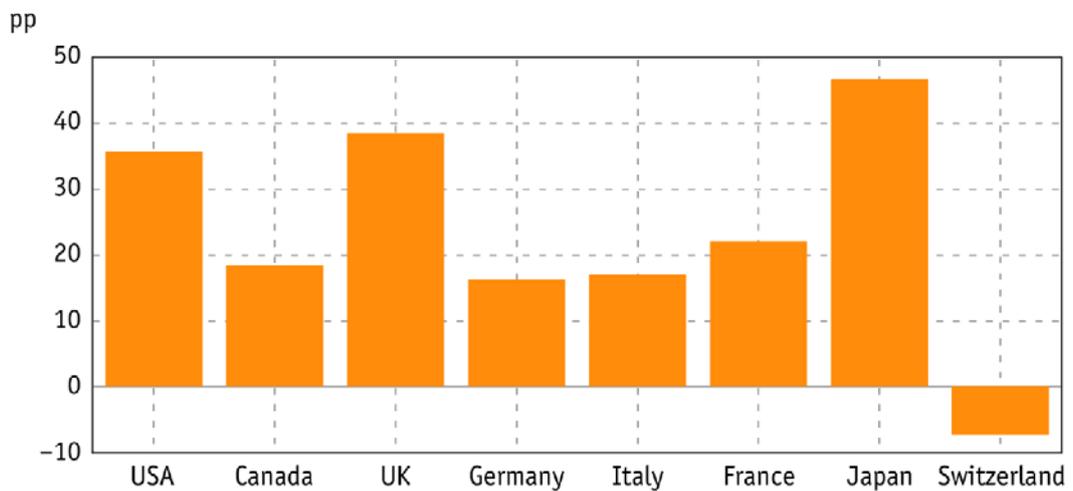
# Fiscal policy at the zero lower bound



# Debt-to-GDP ratios

## Public debt as a % of GDP

Change in percentage points from 2007 to 2011 in G7 countries and Switzerland



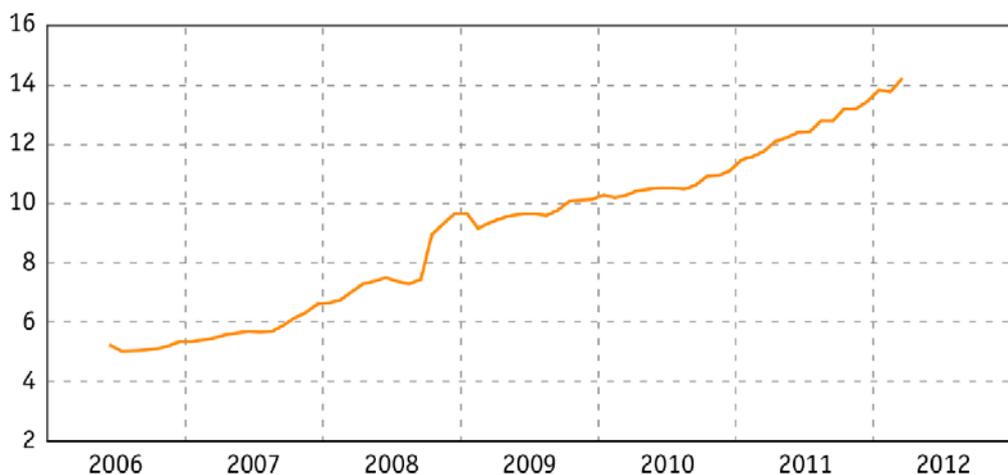
Sources: SNB Markets Analysis Platform, IMF Estimates

# Inflated central bank balance sheets

## Sum of major central bank balance sheets

— FED, BOE, ECB, BOJ, PBC and SNB

USD trillion



Sources: SNB Markets Analysis Platform, Bloomberg & Datastream

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