Thomas Jordan: Monetary policy in the financial crisis – measures, effects, risks

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Swiss Banking Global Symposium, Zurich, 16 November 2012.

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When the Swiss Bankers Association was founded 100 years ago as *Vertreter des schweizerischen Bankgewerbes,* or Representatives of the Swiss Banking Trade, this step was warmly welcomed by the Swiss National Bank (SNB). Surprisingly, perhaps, the senior representatives of the SNB were even members of the Association between 1916 and 1937. Since that time, of course, the role and the tasks of central banks have changed significantly. It would be unthinkable for the SNB nowadays to belong to a private sector interest group. Nevertheless, I am happy to observe today that the relationship between the SNB and the Swiss Bankers Association has remained good and reliable over the years. The Swiss Bankers Association has been a key dialogue partner for the Governing Board on all matters relating to the financial centre, and continues to be so.

My topic today is the monetary policy which central banks have pursued during the past few years to manage the financial and economic crisis. I will discuss the impact of the various conventional and unconventional measures, and I will talk about the risks. Since the beginning of the crisis, the expectations placed in central banks by politicians, media and the general public have increased substantially. Therefore, I will also touch upon the political economy risk with respect to the independence and mandate of central banks. In line with the title of this symposium, I will be extending my view beyond the SNB and Switzerland.

The response of monetary policy from 2008 to 2012

The crisis began in the financial sector, and it was possible to deploy monetary policy rapidly and effectively. As a consequence, central banks were in the front line right from the start. Following the collapse of Lehman Brothers in autumn 2008, they rapidly reduced short-term interest rates: in Switzerland, the US, the UK and Japan to almost zero percent; in the euro area and many other countries to historically low levels slightly above zero. The aim of these interest rate reductions was to stabilise the financial system and mitigate the looming deep recession. They also served to counter deflation expectations and prevent a negative price spiral.

With short-term nominal interest rates close to zero, further interest rate reductions were soon impossible. This meant that conventional monetary policy, in other words, managing the economy via short-term interest rates, was no longer an option. Yet concerns that monetary policy might lack any further instruments were unfounded. The measures that can still be used are often described as unconventional in order to distinguish them from the customary instruments.

Most central banks in advanced economies make use of these unconventional measures. While the Federal Reserve and the Bank of England are chiefly focused on ensuring a more expansionary monetary policy, the goals of the European Central Bank (ECB) and the SNB are somewhat different. In the case of the ECB, its unconventional measures are directed against disruptions in the transmission mechanism of monetary policy arising out of the deterioration in government finances and credit conditions in the single currency area. The SNB, for its part, took a stand against an unwarranted tightening of monetary conditions as a

result of the strength of the Swiss franc – a strength whose origin was to be found in international developments.

Unconventional measures mainly take one of the following three forms – forward guidance regarding the future path of policy interest rates, quantitative easing (QE), or foreign exchange market interventions.[1] What is involved here, and what do we hope to achieve?

In the case of forward guidance, the central bank provides explicit information on the expected movement in short-term interest rates. To a certain extent, central banks had already provided such indications previously. This applies, in particular, to countries that communicate their monetary policy on the basis of an inflation forecast conditioned on a given interest rate path. Even where this interest rate path – as in the case of Switzerland – corresponds to the unchanged current rate of interest, the resulting inflation forecast can provide insights with respect to the interest rate path that may be expected.

What is new is that a number of central banks provide explicit information on the length of time they expect interest rates to remain unchanged. This was done by the Bank of Canada a few years ago and is being carried out at the moment by the Federal Reserve. According to the expectations hypothesis of the term structure of interest rates, long-term interest rates reflect expected future short-term interest rates plus a risk premium. Consequently, if the Federal Reserve indicates – as it did in September 2012 – that it expects to hold short-term interest rates exceptionally low until mid-2015 at least, its objective is to influence long-term interest rates, and ultimately the economy.

Quantitative easing is another unconventional method of stimulating the economy when short-term interest rates are at zero. For many, this is the unconventional instrument per se. The idea is to increase liquidity further in order to reduce long-term interest rates, or more generally, term and risk premia. Quantitative easing is usually associated with the acquisition of medium-term and longer-term securities by the central bank. Examples of this are Federal Reserve purchases of agency mortgage-backed securities, or the programme of lengthening the average maturity of the bonds in its portfolio, referred to by some as "operation twist". These kinds of measures can be effective where they have an impact on expectations relating to the duration of zero interest rate policies, or where the different financial assets in investor portfolios are imperfect substitutes.[2] Apart from the Federal Reserve, both the Bank of England and the Bank of Japan have conducted similar, large-scale securities programmes. With respect to Switzerland, the SNB's extensive repo transactions and foreign exchange swaps, carried out in August 2011, may be viewed as quantitative easing.[3]

An alternative to quantitative easing is intervening on the foreign exchange market. Apart from the SNB, Japan is an example of a country that has made use of this instrument in recent years. It is perhaps useful to recall that, between the early 1980s and 2009, the SNB's interventions on the foreign exchange market were extremely rare. Generally speaking, such actions involved very small amounts as part of coordinated intervention by central banks of the Group of Ten countries. This changed in March 2009, after the short-term interest rate had been reduced to practically zero, when the SNB began purchasing foreign currency to stem the upward pressure on the Swiss franc and to prevent an undesirable tightening of

[1] In order to simplify the breakdown, quantitative easing includes credit easing – an activity which often focuses on individual segments of the bond market. The breakdown could be simplified even further, since currency purchases from foreign exchange interventions may be regarded as a form of quantitative easing.

[2] Cf. speech by Ben S. Bernanke, "Monetary policy since the onset of the crisis", Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming, 31 August 2012.

[3] In a foreign exchange swap, a given amount of foreign currency is purchased and sold simultaneously for two different dates. Consequently, this is a money market transaction that does not involve any exchange rate risk, thus differing from foreign exchange interventions.

monetary conditions. Once the economic recovery had gained hold, the foreign currency purchases were suspended in June 2010.

However, in summer 2011, the situation became so acute that the SNB had to take action again. After having employed the less far-reaching measures which I mentioned before, we set a minimum exchange rate against the euro on September 6, 2011. Since then, the SNB has made it perfectly clear that it is prepared to enforce this minimum rate through unlimited foreign currency purchases, if necessary. In setting a minimum exchange rate against the euro of CHF 1.20, we were reacting to the extreme appreciation in the Swiss franc. As you may recall, the price of the euro temporarily fell to as little as CHF 1.00 and that of the dollar to 70 centimes.

The SNB's aim with the minimum exchange rate is not to fine-tune the economy, but to provide the market with some guidance during a phase of great uncertainty. The objective is to prevent severe damage to the Swiss economy from a very substantial and possibly long-lasting overvaluation of the Swiss franc. Accordingly, the SNB has set the minimum exchange rate at a level where the value of the Swiss franc remains high.

Impact and risks

When evaluating the accommodative monetary policy and unconventional measures, we need to take account of effects as well as risks. What can we say about the effects? The way I read the available data, conventional and unconventional measures taken by central banks have made a decisive contribution to preventing the global economy from drifting into deflation and depression. However, the slow recovery reminds us that monetary policy is not omnipotent and is not in a position to solve all problems. Fiscal consolidation and the structural reforms required for the improvement of growth potential in many countries cannot be replaced by monetary policy measures.

An evaluation of the impact of the individual unconventional measures is more difficult. The simplest to assess is the minimum exchange rate. This instrument has made a decisive contribution to stabilising the Swiss economy. The export industry is gaining ground again, and the deflationary expectations that were threatening to take hold were checked. It is more difficult to assess the impact of forward guidance and quantitative easing. Certainly, long-term interest rates have fallen to record lows this year in some areas. However, it is likely that the deterioration in the economic outlook and the flight to safe investments also played a role in this development. Having said that, it is worth mentioning the results of empirical studies on the effects of the Federal Reserve's first two QE programmes. Overall, they suggest that these programmes led to an economically significant reduction in long-term interest rates. However, the effects of the first QE programme appear to have been greater than the second.

What can we say then about the risks associated with the accommodative monetary policy and unconventional measures?

In public discussion, the focus is often on the risk of inflation. In many countries, the monetary base has grown very substantially. In the opinion of some observers, this will lead to a marked increase in inflation. I would therefore stress that inflation rates in the advanced economies have remained low against the background of capacity underutilisation. The same applies to inflationary expectations obtained from financial market data and surveys of households and companies. It is correct that the monetary base will need to be normalised when the crisis subsides. The challenge will be to determine this moment accurately. Yet this problem is not fundamentally different from the normal task of a central bank, which is to select the appropriate volume of liquidity.

Apart from the risk of inflation in an accommodative monetary policy, another main area of public concern are the risks in central bank balance sheets. These risks have become greater with unconventional monetary policy and the associated lengthening of central bank

balance sheets. In the case of the SNB, foreign currency investments have increased substantially as a result of foreign exchange interventions. This has exposed the SNB to a substantial exchange rate risk, which is a consequence of monetary policy considerations. Consequently, it is one that the SNB must take. We reduce the risks through suitable diversification of our foreign currency investments. However, the primacy of monetary policy means that our scope for diversification is limited.[4]

Additional risks in connection with zero interest rate policies can result from the fact that it has become very difficult for investors to achieve a satisfactory return on bonds. There is a danger that investors seeking an attractive yield will become imprudent and take excessive risks. The longer a low interest rate phase, the greater the danger of unintended consequences in the form of speculative price developments and misallocations. We have been observing a substantial increase in real estate prices in Switzerland for some years now, with strong growth in mortgage loans. The SNB has repeatedly expressed its concern over these developments. Prolonged low-interest phases also present the insurance industry and pension funds with considerable challenges.

It goes without saying that central banks continually evaluate and reassess the effects and risks of monetary policy in the light of the most recent data. This applies in normal times and even more so in exceptional situations such as we have experienced over the past few years. The exceptional nature of the situation can be seen not least from the long duration of interest rates close to zero. Apart from the case of Japan in the 1990s, there has been no other example of this in monetary history. There is certainly no precedent for the extent to which unconventional instruments have been used.

Central bank independence and mandate

Ladies and Gentlemen, I would now like to turn to questions relating to the independence and mandate of central banks. During the crisis, central banks intervened flexibly and on a huge scale, and with success. The downside of this success is that politicians and the general public have higher expectations of central banks when it comes to crisis and economic management. This carries the risk that monetary policy will be overburdened in the long term. In addition, the unconventional measures of the past few years have blurred the boundaries between monetary and fiscal policy in places. This is not without its problems as, ultimately, the central banks have no political authority to make fiscal policy decisions. In its recent *Annual Report*, the Bank for International Settlements issued a stark warning about the political economy risks of unconventional monetary policy. Risks of this nature mainly relate to the potential long-term impact on central bank independence. These warnings should be taken seriously.

As you probably recall, in the 1990s, following the painful inflation experiences of previous decades, a global consensus developed that monetary policy should focus primarily on maintaining price stability over the medium term. In addition, those central banks that were not yet independent were given independence, while their duty of accountability was extended. This consensus with regard to the mandate and constitution of central banks led to a long period of low inflation for the global economy, and at the same time demonstrated that a focus on price stability did not result in greater cyclical fluctuations, as had been feared by some. On the contrary: The low inflation rates were accompanied by a very stable real economy, by historical standards.

The focus on price stability remains essential, even against the background of the experiences of the financial and economic crisis. Central banks could not have implemented

[4] Cf. speech by Fritz Zurbrügg, "Challenges posed by the growth in the SNB's foreign exchange reserves", SNB Money Market Event, Geneva, 8 November 2012.

their unconventional measures for stabilising the economy in the crisis if they had not acquired a high level of credibility in the preceding years. Long-term interest rates can only be influenced by a central bank if market participants are convinced that price stability will prevail in the long term. For monetary policy, it remains essential that price stability be ensured, even – and most particularly – in difficult situations like the one we are experiencing at the moment.

After the beginning of the financial and economic crisis, the question of what central banks could contribute to financial stability became more important. In the previous years, the view had become established that monetary policy served financial stability best by focusing on price stability. This was linked to the widespread opinion that monetary policy should not "lean" against a growing bubble on the equity or real estate markets. It should wait until the bubble had burst before intervening and cleaning up. The "lean or clean" question was reassessed as a result of the financial crisis. It became evident that financial stability was not necessarily guaranteed, even where monetary policy – as measured by the criterion of price stability – was very successful. Moreover, the damage caused when a bubble bursts can be so enormous that it is not easily remedied using monetary policy instruments.

To simplify things somewhat, we can distinguish two ways in which central banks can attempt to make a more substantial contribution to financial stability. The first is to steer monetary policy decisions more strongly in the direction of financial stability. The argument against this is the danger of overburdening monetary policy. One lesson from the years of the Great Inflation was that the overall result is not improved when monetary policy tries to achieve too many goals simultaneously. The credibility and success of monetary policy will inevitably suffer as a result. For this reason, the second option has much in its favour. This is to supplement the central banks' instruments in such a way that – alongside the maintenance of price stability – central banks can also make a greater contribution to financial stability than they have done in the past. The specific tools being referred to here are the macroprudential instruments that have attracted increasing interest in recent years, and that have been introduced in many countries. Such instruments can be used in a supplementary manner, as required.

In the case of Switzerland, the SNB has a statutory mandate to pursue a monetary policy serving the interests of the country as a whole, to ensure price stability and in so doing, to take due account of the development of the economy. Within this primary framework, it also has the task of contributing to the stability of the financial system. There is no contradiction between these tasks if target hierarchy is observed. As far as financial stability is concerned, the SNB works closely together with the Swiss Financial Market Supervisory Authority and the Federal Department of Finance to create a regulatory environment that promotes stability. The SNB concentrates on the macroeconomic and macroprudential aspects of regulation. For the macroprudential tasks, a new instrument was created this year – the countercyclical capital buffer. According to the relevant regulation, this buffer can be activated by the Federal Council following a proposal by the SNB.

The SNB's monetary policy remains focused on the maintenance of price stability in the medium term and, since September 2011, on the enforcement of the minimum exchange rate. Consequently, possible distortions in the growth of credit aggregates that could endanger financial stability should be managed, first and foremost, with the macroprudential toolkit.[5]

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[5] Cf. speech by Jean-Pierre Danthine, "Taming the financial cycle", 30th SUERF colloquium, Zurich, 5 September 2012.

Concluding remarks

In conclusion, I would like to stress that we are living in an exceptional monetary policy situation, and not in a new world. The flexibility shown by central banks in the crisis was necessary to prevent a downward spiral. Apart from the central banks, governments have also taken measures to manage the crisis. Important steps have been taken in the regulation of banks, including the tightening of capital requirements. Measures to bring about a long-term restructuring of public finances, however, remain unsatisfactory in many countries. Monetary policy has opened up a time slot that will enable this to be done. It would be disastrous for the long-term future of the global economy if it were not used. In the countries most concerned, government budgets must be returned to a sustainable path as soon as possible. Moreover, a consolidation of this kind would reduce the risk of overburdening monetary policy.

As far as Switzerland is concerned, the minimum exchange rate against the euro will continue to apply. The reasons behind the setting of the minimum exchange rate in September 2011 retain their validity. The financial problems in many countries continue to provide a basis for potential safe haven capital flows. In addition, at its current rate, the Swiss franc remains high and is weighing on the Swiss economy. Consequently, at its most recent monetary policy assessment in September, the SNB confirmed that it would leave the minimum exchange rate unchanged and continue to enforce it with the utmost determination.