Thomas Jordan: A new role for central banks?

Speech by Mr Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank, at the Zürcher Volkswirtschaftliche Gesellschaft, Zurich, 16 January 2014.

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Ladies and gentlemen

A country's prosperity largely depends on how the different agents perceive their role and their responsibility. This is true for both private agents and government institutions.

Within the regulatory framework, private agents must continuously reappraise their role and their business model and make adjustments so they can compete in the marketplace in the long term. This is the only way for them to create and secure jobs and income for the population. Given the dramatic changes both in the regulatory framework and in the economic environment in the past few years, this is no easy task.

Today, however, I am not going to speak about the future role of others and the challenges they face, but rather look into the mirror, as it were. Should central banks not also have to fundamentally rethink and perhaps redefine their role after the financial and debt crisis? Unlike other private agents in an economy, central banks are obviously bound to their legal mandate. In most countries, however, this mandate is purposely defined in comparatively loose terms, with the main focus on ensuring price stability.

As has become evident in the past few years, central banks have considerable room for manoeuvre in implementing this mandate. In response to the crisis, they first lowered interest rates to zero and subsequently eased monetary policy further using new kinds of instruments. At the same time, central banks had to provide the banking system with large-scale liquidity assistance to ensure financial stability. As a consequence, central banks' balance sheets have now reached levels beyond all previous imagination. In addition, many central banks have been given additional responsibilities and have taken on new tasks, in particular in the area of financial stability.

The shocks triggered by the global financial crisis did not leave Switzerland unscathed either. The Swiss National Bank (SNB), therefore, had no choice but to move into uncharted waters. During the crisis, maintaining a functioning Swiss franc money market and subsequently stabilising our country's largest bank were the first priorities. At a later stage, the massive appreciation of the Swiss franc threatened the economy at its core, creating a risk of deflation. The SNB came to the rescue by injecting liquidity into the market, setting up the StabFund, intervening in the foreign exchange market and introducing the minimum exchange rate. Our balance sheet is a reliable indicator of just how intense these interventions were. Prior to the outbreak of the crisis at the end of 2006, the balance sheet total was just over CHF 100 billion. Today, it amounts to nearly CHF 500 billion. In the area of financial stability, the SNB, too, was entrusted with some new tasks, especially with regard to macroprudential measures. The countercyclical capital buffer as well as the designation of systemically important banks and their functions are probably the most well-known of these measures.

On the whole, central banks around the world have thus far been successful in their role as firefighters. They managed to prevent the global economy from falling into a depression and to ensure price stability. In addition, in many countries, they worked side by side with their governments to shore up the banking system. This has bought some time – time that in numerous places should be used to solve the underlying problems. In many countries, measures that should be undertaken to achieve this include well-designed structural reforms of the economy and comprehensive restructuring of government finances.

The downside of the central banks' success is that it could give the impression that treating the root of the structural problems is not necessary at all. To put it somewhat bluntly, this fallacy can be described as follows: Now that the central banks have done so much to save the economy and the financial system from collapsing, they should be permanently in charge of ensuring sound economic growth, high employment, low interest rates and a healthy real estate market.

Such extremely high expectations are exceedingly dangerous. Central banks would be forced into a role in which they had to fulfil tasks for which they neither have the requisite responsibilities nor the appropriate instruments. As a result, other agents could be induced to neglect their responsibilities. While the crisis might be delayed, it most certainly would not be overcome. It may appear politically opportune to put problems on the back burner, rather than working out solutions. In the long term, however, the cost to the economy and to society would be horrendous.

What can central banks do to counter such unrealistic expectations? They can, for instance, communicate clearly and emphatically what their role is and where their limits are. With this in mind, I invite you to join me on a brief tour d'horizon.

I would like to start by examining a few selected aspects of monetary policy, focusing on long-term effects. I will then look at the area of financial stability. Finally, I would like to use the insights gained in this brief overview to answer the question posed in the title of this presentation about the role of central banks. Since every country has its own set of idiosyncrasies, I can obviously not speak for all central banks. I will therefore focus on Switzerland and the SNB. As in other areas of the economy, however, developments abroad affect Switzerland and thus the SNB via the global financial markets. This just goes to show how important it is for us that the right direction for central banks is also set abroad.

Role of monetary policy largely unchanged

I would now like to say a few words about the central banks' role in monetary policy. In my opinion, the core mandate should remain unchanged. The SNB's monetary policy is still credible. The SNB must, as an independent central bank, ensure price stability while taking due account of economic developments. The National Bank Act grants us substantial flexibility in implementing this mandate, and this has made a major contribution to retaining our freedom of action, even under extreme conditions. When the zero bound was reached, we were able to use new instruments swiftly and rigorously even though this was associated with considerable balance sheet risks. As a result, we successfully fulfilled our mandate and ensured price stability. How else, for instance, could we have credibly set and enforced the minimum exchange rate, if the law had imposed restrictions on the SNB with regard to its balance sheet?

The key importance of price stability was uncontested for a long time. Now, however, the relatively old discussion about the optimal goal of monetary policy has been fuelled by the crisis.

First, the question is being raised as to whether price stability should not be interpreted more broadly and should include asset prices in addition to consumer prices, in order to prevent future financial crises. In my view, this would be the wrong conclusion. Although it is correct that central banks cannot and may not neglect the movements of asset prices, and, in particular, those of real estate prices, they should not attempt to stabilise asset prices with the aid of the interest rate tool, if this would lead to a conflict of goals with respect to price stability. Macroprudential tools are therefore needed in such a case, in order to counter imbalances on the real estate markets. I will return to this point in my comments on the role of central banks in financial stability.

Second, the question is raised as to whether the inflation targets set by most central banks might not be too low. The argument is that, in normal times, higher inflation targets would lead to higher nominal interest rates. This would open up the freedom of action for conventional monetary policy because the zero bound for interest rate policy would not be reached so quickly. This reasoning does not seem conclusive to me either. For instance, given the history of the struggle against inflation, it is rather bold to assume that well-anchored inflation expectations can simply be released and then immediately locked in at a desired higher level. As a rule, higher inflation is also associated with greater fluctuations in inflation. The costs of higher and strongly fluctuating inflation would have to be set against the alleged benefits, which, in fact, are likely to be minimal. The zero bound for interest rate policy has not proved to be an insurmountable obstacle for monetary policy. Moreover, it is questionable whether an additional one to two percentage points of nominal interest rates would have provided sufficient freedom of action to avoid the zero bound in the crisis.

Third, it is suggested that further criteria be added to price stability – relating to employment and growth, for instance. Growth and employment are, of course, essential economic parameters. Our mandate takes them into account with its reference to the development of the economy. However, specific requirements with regard to growth and employment would, once again, raise expectations which the SNB could not meet in the long term. Instead, the goal of monetary policy with respect to the economy must be to reduce larger risks and alleviate extreme situations. A clear example of this was the massive appreciation of the Swiss franc in the summer months of 2011, to which, as you will know, we responded with the minimum exchange rate.

Monetary policy is not suited to fine-tuning the economy, however. In practice, we have learned that it is impossible to conduct a monetary policy which responds immediately and in a differentiated manner to all kinds of business cycle fluctuation. Neither can monetary policy replace a sustainable growth policy, a well-balanced fiscal policy, a well-functioning labour market or an open world trade regime. It is important to avoid any illusions in this respect. Monetary policy cannot assume responsibility for everything.

Deeds needed, not just words

Alongside the discussions about the right goal of monetary policy, the crisis has also prompted a debate about the best way of communicating this policy. There is general agreement on one point, which is that, in principle, the more unconventional the monetary policy measures, the greater the public's entitlement to be informed. The distribution effects of unconventional measures differ, potentially, from those of monetary policy using a conventional toolkit. Accordingly, a central bank using these resources must clearly explain why they are absolutely necessary for fulfilling its mandate.

The explanation of monetary policy decisions, and the reasons provided, must be as transparent as possible. Monetary policy must be comprehensible for markets, politicians and economic agents. The SNB attaches great importance to this; we therefore endeavour to provide detailed explanations of the reasons for our monetary policy decisions and enter into extensive public dialogue on the topic. Yet for transparency, it is also true that more is not necessarily better in every case. Sometimes transparency can be counterproductive.

One example of this is the publication of the minutes of SNB Governing Board discussions on monetary policy decisions. In this respect, it is important to take account of Switzerland's special situation. By international standards, the Governing Board is a very small decision-making body made up of just three people. Also, it traditionally reaches its decisions by a process of consensus. If the minutes of its meetings were to be published, discussions within the body would probably become less candid and open and – ultimately – the quality of decision-making would suffer as a result. Moreover, it is unlikely that publishing the minutes would in fact lead to better public understanding of monetary policy within Switzerland. That is why, in view of these special Swiss features, we have decided not to release the minutes of our meetings.

An additional way of increasing the transparency of monetary policy, and thus its effectiveness, could be the provision of information on the future path of reference interest rates. “Forward guidance” of this kind may be useful for many central banks. However, there are pitfalls and this could easily lead to confusion in the market, especially if the guidance is attached to too many conditions. However, I would not want you to misunderstand me. It is absolutely right that central banks should explain to the general public how monetary policy would react to certain developments. This is nothing new. In the case of the SNB, for instance, the conditional inflation forecast – our main interest rate indicator and an important element in our communications – already provides certain information about the future path of interest rates. In addition, we are currently emphasising the fact that, as a result of the low rate of inflation and the risk of appreciation, the minimum exchange rate will be the focus of monetary policy implementation for the foreseeable future.

So you see, the SNB is carefully monitoring international debates about the right objective and the best way of communicating monetary policy. Nevertheless, no central bank should simply jump on the latest monetary policy bandwagon without careful consideration. On the contrary. Changes must be undertaken with great caution and care. Our monetary policy strategy worked well during the crisis, so there is no reason for us to abandon it. This also applies to the way we communicate, where – obviously – the demands are particularly great in times of crisis, and it is necessary to focus more than ever on the key messages. To avoid any misunderstanding, these messages must be simple and absolutely clear. Nevertheless, words alone are not always sufficient. A central bank must be prepared to back up its words by deeds. A good example of this was the situation in early summer 2012. With the European debt crisis escalating and, as a result, extreme upward pressure on the Swiss franc in the currency market, we rigorously enforced the minimum exchange rate through extensive foreign currency purchases.

I would like to make a final point on monetary policy. During the crisis, central banks worked particularly closely together at the international level. For instance, in 2008, the SNB was involved in a coordinated reduction of interest rates, it concluded swap lines with the aim of alleviating tensions in money markets, and it remained in close consultation with other central banks. However, the principle that the SNB conducts an independent monetary policy for its own currency area remains completely unaffected by these activities. Cooperation and independence are not irreconcilable. On the contrary. Good cooperation promotes and reinforces the effectiveness of monetary policy decisions which have been taken independently. Perhaps this can be illustrated, once again, by using the example of the minimum exchange rate, which enjoys a high level of international acceptance – not least as a result of our excellent dialogue with other central banks. Neither are independence and the minimum exchange rate irreconcilable. The minimum exchange rate does not restrict our monetary policy independence, as some observers wrongly claim. Rather, it is a genuine expression of our monetary policy independence. The minimum exchange rate is not a move towards the euro and most certainly not any tie to the European currency. What it in fact does is to ensure appropriate monetary conditions for our country in an economic environment which remains extremely difficult. Meanwhile, the value of the Swiss franc is still high.

In the long run, a central bank can only pursue an autonomous monetary policy in line with the needs of its country if it is independent. Independence is therefore a further condition for ensuring that a central bank retains its freedom of action at all times. Independence is more than an abstract construct. It gives the central bank the freedom to act swiftly, resolutely and credibly, if needed. What independence also means, however, is the responsibility to use this freedom strictly within the meaning of the statutory mandate, no matter what the prevailing political climate may be. Independence cannot be taken for granted, it is a privilege. It was granted to us under the Constitution in order that we could achieve the goal of price stability in the long term. As a counterweight to its independence, the SNB has a duty of accountability and information with respect to parliament and the public. The SNB is thus firmly anchored in our constitutional democracy. In a free society, an authority with a complete free hand would be a foreign body.

Favourable environment created by Confederation and cantons

Yet independence must also be lived. The SNB may not accept instructions from political authorities; neither can it allow itself to be put under pressure by public opinion. It must conduct a monetary policy that serves the interests of the country as a whole, to the best of its ability, and in accordance with its mandate. It is only natural that our monetary policy cannot please everyone at all times. However, an independent central bank must not be put off by this.

The relevant legislation contains a number of mechanisms designed to ensure the SNB's independence. One of these is our distribution practice, which has been developed on the basis of the provisions of the National Bank Act (NBA). We are happy to make distributions to the Confederation and the cantons; we can only do so, however, where the balance sheet and annual results allow for this. As we announced some days ago, this will unfortunately not be the case for the 2013 business year – the first time since we began our profit distributions in the current form, over 20 years ago. Thus the provisions regarding profit distribution clearly set out in the NBA have come into effect. This ruling takes automatic account of the fact that the risks in our balance sheet have increased as a result of combating the crisis. According to the legislative authority, a strong SNB balance sheet is more important than distributions to shareholders or to the Confederation and the cantons. It therefore supports the SNB in its conduct of an independent monetary policy, something which is particularly valuable in difficult times. Nevertheless, I am conscious that the lack of a distribution can be very distressing for the Confederation and the cantons, in particular, and will be a challenge. However, distributions will not be assured in the future either, since our results will continue to be subject to considerable fluctuations.

However, there is another area in which the Confederation and cantons have made an even more important contribution to the independence of monetary policy. They put the favourable years before the crisis to good use by making their public finances pretty weatherproof. As a result, Switzerland was one of the few countries where government finances did not deteriorate substantially in the crisis. Sound government finances are essential not only for the competitive strength of an economy but also for safeguarding social security institutions – and thus for social cohesion. In the long term, excessive government indebtedness can also endanger price stability and the independence of monetary policy; one reason for this is that it increases the temptation to keep interest rates very low for longer than necessary.

At this point, I would like to draw a preliminary conclusion with regard to the SNB's role in monetary policy. I am firmly convinced that no change is needed in the SNB's current mandate and therefore with regard to its fundamental role in monetary policy. Our job is to ensure price stability while taking due account of economic developments. This is a sensible and credible mandate. Our clear definition of price stability has also stood the test of time. The SNB equates price stability with a rise in the national consumer price index of less than 2% a year. Deflation – in other words, a protracted decline in the price level – also breaches the goal of price stability. However, we do not react automatically to inflationary developments. What is also important is our high degree of flexibility in the use of instruments and lengthening of the balance sheet. These two facilities allow us to combat major economic disruptions rapidly and effectively, as shown so impressively in the crisis. New monetary policy instruments merely serve to fulfil our mandate in a transformed environment.

What also appears important to me is that central banks do not take on tasks that they cannot tackle with their existing instruments, thereby awakening false expectations and hopes. To ensure that monetary policy remains effective, it is important that central banks do not depart from their mandate of price stability. If expectations are too high, central banks are bound to disappoint them in the long run. This will cause them to lose credibility in their core area, and this could lead to politicians becoming involved. In this situation, central banks' independence would be at stake. Caution is to be recommended with respect to monetary policy trends. Certainly, the SNB will not simply go with the general flow, but will instead pursue its own path tailored to the needs of our country.

Extended role and new financial stability approach

I will now say a few words about financial stability. Financial stability means that financial system participants are able to carry out their functions and are resilient to disruptions. It is an important prerequisite for economic development and effective monetary policy implementation. Consequently, it is clear – and well-established historically – that central banks make an important contribution to financial stability. In fact, several central banks were founded specifically for this purpose. The idea was that the central bank should serve as the lender of last resort, thereby protecting the banking system from collapse.

In Switzerland, the SNB has always been the lender of last resort. In the revision of the NBA carried out ten years ago, the SNB received for the first time an explicit mandate to contribute to financial stability. The term "contribute" expresses the fact that other state institutions also have an influence on financial stability and that, in addition, this stability can never be absolutely guaranteed.

Until recently, the SNB had two options for its contribution to financial stability, in addition to the monetary policy toolkit, which was mainly based on interest rates. The first was to rely on the persuasive power of its sound arguments and hope that banks and other financial market participants would draw the right conclusions from these, so that a crisis did not arise. The most important example for a persuasive approach is our annual *Financial Stability Report.* Since 2003, this report has conducted an assessment of the stability of the banking industry, highlighted tensions and imbalances, and made recommendations. The second option was for the SNB to provide a bank facing a crisis with emergency liquidity assistance, if this was necessary for the functioning of the financial system. An example of emergency liquidity assistance of this kind was the support provided to UBS in 2008.

Prevention is better than cure

The crisis showed, first, that it is not easy for central banks to identify all of the risks in advance. Second, it became clear that when central banks talk about specific risks, their warnings often go unheeded. The crisis also showed that policies limited to clearing up once a situation is out of control can be extremely costly. Moreover, there are contexts in which, for monetary policy reasons, the interest rate tool cannot be used for financial stability purposes. This situation has been only too familiar to us in Switzerland for some years now. Imbalances are developing on the mortgage and real estate markets, thereby posing a risk to financial stability. In principle, this risk could be combated by higher interest rates. However, the higher ranking monetary policy goal of price stability does not allow for any increase in interest rates in the foreseeable future.

Thus monetary policy instruments, rhetoric and emergency assistance alone are not enough to make an effective contribution to financial stability. That is why new tools – the new macroprudential measures – have been developed internationally in accordance with the principle that prevention is better than cure. Their aim is to strengthen the resilience of the financial system as a whole and to prevent the build-up of such excesses on the asset and credit markets.

Yet the concerns which used to be expressed about preventive approaches are not entirely without foundation. It is not usually possible for central banks to fully measure the build-up of excesses on financial and asset markets in real time, to intervene at exactly the right time and thus put a stop to dangerous bubble formations at precisely the right moment. However, the current macroprudential toolkit neither claims nor intends to do this. Just as monetary policy is unsuited to fine-tuning the economy, macroprudential measures are also little suited to fine-tuning asset and credit markets. Instead, what is involved are relatively limited interventions in order to prevent foreseeable larger imbalances that might possibly endanger financial stability at a later stage.

While there is broad international consensus that the new instruments make sense, there is a wide difference of opinion about how the institutions that use them should be organised. In some cases, new bodies have been created to examine the use of these instruments, while in other cases responsibility has been placed fully in the hands of the central bank. A number of countries have gone even further by handing over the traditional area of individual banking supervision to central banks as well. Similarly, it is equally impossible to use a one-size-fits-all approach for all the measures and instruments introduced in different countries. A priori, there is no right or wrong approach here, since the design and character of the macroprudential instruments chosen must take account of the special features of the banking system in the individual country in question.

What approach has Switzerland chosen? In the area of financial stability, it has opted for an approach in which responsibilities are clearly allocated to existing institutions. The principle adopted in the case of the structures and tools is "as much as needed but as little as possible". In my view, this regulation approach is well suited to our country. Concentrations of power are not in line with the culture of balance and limitation of powers which is fostered in our country – a culture which has served it well. Thus, contrary to the international trend, microprudential banking supervision here has not been transferred to the central bank, remaining the responsibility of the Swiss Financial Market Supervisory Authority, FINMA.

A lean approach was also chosen for the macroprudential area, with the new responsibilities clearly divided between the two institutions. FINMA is responsible for measures of a more structural nature, such as the increased capital requirements which systemically important financial institutions are required to meet in order to alleviate the "too big to fail" issue. The aim of these instruments is to improve regulation of and incentives for individual institutions. Consequently, it makes sense that FINMA, which is experienced in supervising institutions, is responsible for this area. Conversely, the SNB takes on a key role when it comes to cyclical measures. The thinking behind this division is that measures of this kind require comprehensive economic analyses, with which we are familiar. An excellent example of a cyclical measure is the countercyclical capital buffer. The Federal Council decides on the activation of this tool at the request of the SNB. In the designation of systemically important banks and functions, the SNB also has a comparative advantage because its approach is geared to the financial system as a whole.

Although powers and responsibility for specific macroprudential measures are clearly allocated to one authority, overlapping and mutual dependencies can always occur. Consequently, it is very useful for the institutions to work together closely and engage in a certain amount of coordination. That is why the Swiss authorities have clearly specified how they will differentiate their tasks and work together.

From a purely theoretical point of view, a strategy where one institution bears sole responsibility for financial stability might be more appealing. However, experience from the financial crisis does not provide any evidence that the one-authority-for-all model is superior – in systematic terms – to other organisational forms. On the contrary. In this country, the UBS case clearly showed that it is very possible, in an emergency situation, to carefully and discretely draw up a bundle of comprehensive measures in support of financial stability, and to implement these in good time, even where various institutions are involved.

Exercising care and caution in uncharted macroprudential waters

The authorities are sailing in uncharted waters when it comes to macroprudential measures. The complex interrelationships between monetary policy, traditional banking supervision and the macroprudential toolkit are difficult to assess. Consequently, we do not always know exactly how the different measures will work. The need for analysis and research in this field is correspondingly great.

However, to be realistic, we will never have all the answers or be able to dispel all uncertainties, as – incidentally – is always the case in monetary policy. But this should not stop us using these instruments when we judge it to be necessary. In doing so, we endeavour to exercise the requisite care and caution. Consequently, we undertake comprehensive investigations, evaluate the results carefully and systematically, and carry out our measures based on criteria which have been specified in advance. As in the case of monetary policy, if decision-making is as free as possible from political influence and manipulation attempts, its quality will be improved.

Following these thoughts, I would like to return to my initial question concerning the SNB's role in financial stability, as a kind of interim conclusion. Central banks have always had an important role in financial stability. However, the crisis has shown that the traditional approach, which relies exclusively on the power of persuasion and the extinguishing of fires, can be very expensive. Consequently, it makes sense, in principle, for central banks to take on macroprudential tasks as part of their contribution to financial stability. However, because the situation can vary depending on the individual country, there is no consensus about either the extent of these measures or the institutional responsibilities. Switzerland has limited its macroprudential arsenal to what is absolutely necessary and has clearly allocated responsibilities to the different authorities. In this respect, the relevant legislation has extended the SNB's role in financial stability in some areas but not completely changed it. I am fully convinced that this cautious approach with clear allocation of responsibilities makes sense. We are doing everything we can to fulfil this extended role as best we can, in the interests of our country; in doing so we can draw on our wealth of experience in "traditional" financial stability.

Concluding remarks

Ladies and gentlemen, we have reached the end of our perusal of monetary policy and financial stability. I particularly wanted to show you which roles can and cannot be assumed by central banks and especially the SNB.

As regards monetary policy, our role has not changed, even if the use and the extent of monetary policy instruments have taken on new dimensions since the beginning of the crisis. In the case of financial stability, our role was extended as a result of the experiences gained in the financial crisis, although the adjustments have been much less extensive than in some other countries.

The SNB is not closing itself off to changes that will be necessary over the course of time. However, it is worth recalling here that central banks are not all-powerful. What remains decisive for us is that our mandate for monetary policy and financial stability is formulated in a sensible manner and can be fulfilled. However, the SNB must also have the necessary instruments and be in a position to use them flexibly. In addition, it is essential that it can act independently when fulfilling its mandate. It can only take responsibility for its mandate under these conditions. This is another important reason why we are generally reserved when confronted with new tasks.

A central bank which is guided by this model when fulfilling its mandate and consistently discourages excessive expectations makes the biggest contribution towards a prosperous development of the economy, thereby serving the overall interests of the country in the best manner. By fulfilling its price and financial stability mandate steadily and reliably over a longer period, a central bank builds up confidence in the general public and on the markets – confidence which is extremely important for the development of the economy. If I have succeeded in persuading you to share this conviction with me, or strengthened your belief in it, my talk this evening has achieved its purpose.