Klaas Knot: The changing role of central banking

Opening speech by Mr Klaas Knot, President of the Netherlands Bank, at the Conference "De Nederlandsche Bank 200 years: central banking in the next two decades", Amsterdam, 24 April 2014.

* * *

Distinguished speakers, dear colleagues, friends,

I am thrilled to welcome you to our conference.

I'd like to extend a special welcome to the governors of our constituency countries. Over the past fifty years, your history has become increasingly interwoven with ours, and I'm therefore glad that you're all here.

Ladies and gentlemen,

You accepted our invitation to celebrate the bicentennial of De Nederlandsche Bank. And you all cleared your agendas to discuss the future of central banking.

At this festive moment I will tell you more about the history of De Nederlandsche Bank. And against that background, I'd like to address my central question: has the recent financial crisis stirred up the role of central banks, and if so, how? In other words: are we in the midst of a paradigm shift? I do so in light of the theme of this conference: where central banks will be heading over the next two decades.

The point I want to emphasise here today is that our understanding of the role of central banks, has constantly changed over time. Let's begin with the easy stuff: the origins of De Nederlandsche Bank; DNB. If you look at our history, you can see how DNB evolved over time.

We used to be a mainly Amsterdam-oriented credit institution that performed commercial activities. And now we're a truly pan-European institution, with public duties and a centre of gravity in Frankfurt.

How did this come about? Our history starts with King Willem the First's decision to set up a central bank. Two hundred years ago.

At the time, the Netherlands had just been liberated from the Napoleonic days. Our economy was in really bad shape. Not much was left of our Golden Age.

The new King – also known as the King-Merchant – however, was determined [quote] "*to lift up Commerce – the nerve of this State – , from the derelict condition to which past times and circumstances reduced her*". [unquote]

He established De Nederlandsche Bank, to realise his plan for a national circulation bank. DNB had a difficult start in life. As a newcomer it was greeted with distrust. It took quite some time for DNB to evolve into the kind of national bank the King had in mind: a bank granting credit and distributing banknotes throughout the country.

It wasn't until the end of the 19th century that DNB turned from a principal lender to trade and industry into a real lender of last resort. By protecting the Netherlands from several financial crises, DNB gradually became – in the words of my then predecessor Vissering – "*the absolute central institution, around which everything was concentrated*".

In those unsettled times, DNB evolved from "*a sleeping old lady"* into a vibrant institution with a wide range of activities, and increasingly interwoven with society.

We gained prominence as a national monetary institution. And the foundations where laid for the modern, post-war Dutch central bank. DNB was nationalised. And the 1948 Bank Act made DNB responsible for preserving the value of the currency.

From then onwards, DNB was known as the *“Guardian of the guilder.* We were responsible for circulating banknotes and for managing the payment system. And finally, DNB was given the task of supervising all financial institutions.

Around the beginning of this millennium, financial supervision was reorganized along functional lines.

I can be a lot briefer about DNB’s remaining history, given that many of you have shared our various milestones in recent years.

By this, of course, I mean the Treaty of Maastricht, which established the Economic and Monetary Union, and the introduction of the single currency. These major events paved the way for DNB, and 17 other central banks, to become a truly pan-European institution within the European System of Central Banks.

And the most recent milestone, of course, is the European Council’s decision in 2012 to create a European banking union; a project which is still under construction.

In the first few decades after European co-operation got underway, we were able to reach some kind of consensus on the role of central banks. And their relationship with society. This general view was threefold:

one: central banks served society best if they focused primarily on price stability.

two: central banks played a relatively narrow role in financial stability.

Yes, they should be ready to provide emergency liquidity, while promoting the stability of the payment system, but that is where it stopped.

three: central banks should leave micro-prudential supervision and regulation to other, independent parties.

That generally meant outside the central bank! (although there were some exceptions, including DNB).

These were the times that we now sort of nostalgically refer to as the Great Moderation. But then, however, came the Great Financial Crisis. And we moved from the Great Moderation to the Great Recession. And, here in Europe, to the EMU crisis.

These events painfully reminded us that financial instability can indeed severely damage the broader economy. Has the recent crisis altered the general view we held for so long?

This is a relevant question for us, central bankers, given two well-known pitfalls we have to avoid as monetary policy-makers. The ***first*** pitfall is *reacting too late*.

During the interwar years, for instance, central banks in the major economies were “prisoners” of their own economic orthodoxies and so made mistake after mistake.

My institution, too, was dogmatic in believing in the benefits of the gold standard, even in the face of the huge losses due to the devaluation of the British pound.

The ***second*** pitfall is that we’re so afraid of reacting too late, that we *respond too soon.* How can we avoid both these traps?

I believe there are ***two*** preconditions that we must meet.

First, we should protect the independence of central banks in monetary policy matters, in all circumstances. The 19th century economist David Ricardo already explained that governments would almost certainly abuse their power to issue paper money if, for instance, they were forced by war into creating money. He argued that central banks should instead be governed by individuals entirely independent of government.

Central banks should – [quote] “ *never, on any* ***pretence,*** *lend money to the Government, nor be in the slightest degree under its control or influence*”. [unquote]

There are certainly many episodes in our history, when the central bank's relationship with the State has come under pressure. For example, after Belgium – at that time known as the Southern Netherlands –became independent in the 1830s, the Dutch government's deficit soared to unprecedented levels. And when, at that time, DNB was unwilling to provide credit to the State in return for Treasury notes as security, the King sighed that he could expect little help from this institution.

All I'm saying here is that preserving central bank independence is a delicate balancing act, but also one that's vitally important to pursue.

The ***second*** precondition to stay clear off the pitfalls of either reacting *too late* or *too soon*, is that we must never forget that central banks are very exceptional institutions. Because of their ability to lend and so to create liquidity for banks.

In normal times, this may just mean day-to-day management of liquidity in the financial system. But in times of financial stress, as we've seen in recent years, it may mean having to act as lender of last resort.

Being the "bank of banks" means central banks have always been at the heart of the payment and settlement process. But here, too, central banks will continue to face major challenges in keeping up with innovation and technological change.

The difficulty here is that payments systems have characteristics of a *public* service, while most of them are actually operated by *private* agents. Given the overall economy's reliance on the payment system, these private sector activities require a certain degree of public policy guidance.

And they also require an increasing amount of public oversight to make sure they take account of the needs and wants of the public at large.

And so, as well as preserving their independence, central banks also need to continue to support and improve the safety, the reliability and the efficiency of the privately operated payment and settlement systems.

I've tried to shed some light on the history of DNB. And I've tried to point out the two pitfalls we have to avoid at present. Let me now address my central question, which touches upon our future:

Has the recent financial crisis stirred up the role of central banks, and if so, how? In other words: has the financial crisis resulted in a paradigm shift for central banks?

I would say it *has*. Let me explain that by looking with you at three major lessons that the crisis has taught us. Three lessons that have challenged the pre-crisis consensus on what central banking was about.

The first lesson. The crisis has reminded us that price stability alone is not enough to ensure macro-economic and financial stability. By now it's therefore become widely accepted that the pre-crisis view of central banking, which was based on central banks focusing mainly on price stability, was too narrow. Or, to quote Willem Buiter, "*the financial stability role of central banks has returned with a vengeance".*

The second lesson. The crisis has shown us that central banks are on the front line when the financial system comes under stress. This has fed arguments in favour of entrusting central banks with the prudential supervision of financial institutions.

Since central banks are the only parties with enough information to decide whether lending on exceptional terms is reasonable.

The crisis may, therefore, have reversed the pre-crisis tendency to separate micro-prudential supervision and central bank regulation. A clear example of this, close to home, is of course the ECB's preparations for taking on new banking supervision tasks as part of the Single Supervisory Mechanism.

The third lesson. The crisis has also taught us that price stability alone is not enough to ensure financial stability. And that adopting a micro-prudential perspective does not suffice either. We know that the key factors in the crisis were the links between various financial players, and the links between financial institutions and sovereigns. And so we are aware of the need to also have a macro-prudential perspective as well.

This perspective places the financial system as a whole, including its pro-cyclicality, under constant scrutiny. Unfortunately, this scrutiny was clearly lacking in the pre-crisis framework. There is also some acceptance of a key role for central banks *here*, given that monetary and macro-prudential policies are very much interdependent.

Here in the Netherlands, DNB has indeed been entrusted with this role. From 2014 onwards, enhancing financial stability is now also explicitly embedded in DNB's mandate. We're now on the verge of adopting a broader view of what constitutes central banking. The financial crisis has clearly brought the core functions of central banks closer: Monetary and liquidity policy, micro- and macro-prudential regulation and supervision, stability and reliability of payment and settlement systems…. They all complement each other!

So we are gradually beginning to see this broader view taking shape. Yet there are still many operational questions we need to answer.

For instance: What are the implications for monetary policy strategy of incorporating financial stability risks?

How should we deal with the interactions between macro-prudential policy and monetary policy and between monetary policy and supervision of banks?

How can central banks contribute to cross-border payment cooperation and ensure level playing fields without discouraging competition and without creating undue uncertainty about regulations?

And above all, and this is very important in my view, how are we to deal with the major institutional challenges of bringing these core functions of central banks closer together and preserving the synergies between them?

Luckily, these are some of the very questions that you're here to discuss today and tomorrow. But these are also questions that are not easily answered. For there are several concerns that we need to take into account:

– For one, giving central banks a larger role in financial stability may blur the lines between different policies.
– And the fact that financial stability involves so many different actors, makes things even more complicated.
– Also: central banks may end up becoming more political than they were in the decades before the crisis.
– And this, of course, will then give rise to a legitimate concern about a possible democratic deficit.

The all-important question, therefore, is: How we can preserve our independence with regard to price stability, while at the same time broadening our responsibilities?

In my view, it is therefore vital to foster a clear understanding of what central banks can and *cannot* do in each of their responsibilities and in each of their roles. Not until then can we avoid unreasonable expectations about what central banks *can* – and *cannot* – achieve.

One way of improving the understanding of the role of central banks is to find new ways to increase transparency and accountability. After all, independence on the one hand, and transparency and accountability on the other, are two sides of the same coin.

Ladies and gentlemen,

Let me end by returning to the start of our conference. I'm confident that this conference in celebration of our bicentennial is going to give us plenty of food for thought, and will also shed some light on the questions I just identified.

The decades before the crisis were perhaps a period of relative calm. The aftermath of the crisis challenges us to look into the future, into the role of central banks over the next two decades. If only, because we need to bring our core functions more closely together, while preserving our independence where required.

Given our long history as an institution at the heart of society and our continuing dedication, I believe we have proved to be of immense value as a contributor to sustainable prosperity. And I am confident that we will continue to be so.

I thank you for your attention. And I wish you all a fantastic conference.