

## Jean-Pierre Danthine: Are central banks doing too much?

Translation of a speech given in French by Mr Jean-Pierre Danthine, Vice Chairman of the Governing Board of the Swiss National Bank, at the Foire du Valais, Martigny, 9 October 2014.

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### Introduction

In recent years, central banks have been active in their attempts to mitigate the financial crisis and its aftermath, and they have also assumed a more prominent role in the regulatory efforts to prevent similar crises in the future. This has led many commentators to ask the question I raised in the title of this speech: are central banks doing too much?

The short answer to the question – you may not be surprised – is “no”. The measures which central banks have taken since the beginning of the financial crisis in 2007 are a direct consequence of the severity of the crisis itself. First, conventional central bank measures – cutting interest rates, providing liquidity and acting as lender of last resort – were required to prevent the collapse of the financial system. Second, the use of various unconventional measures was a responsible step to support weak recoveries, given the shortage of available alternatives. And third, a reinterpretation of central banks’ financial stability mandate towards a more active role in crisis prevention is necessary to reduce the need for another round of extensive crisis management in the future.

This, in a nutshell, is the main argument of my speech today. In what follows, I will elaborate on the rationale behind the conventional and unconventional measures that central banks have adopted to mitigate the crisis, and explain why central banks need to play an active role in the new regulatory framework which is being implemented in response to the crisis.

Central banks may not exactly have a reputation for being big innovators. But just as the *Foire du Valais* has developed into French-speaking Switzerland’s pre-eminent fair over the past 50 years by successfully combining innovation with its core strengths, central banks have evolved over the past few decades by remaining focused on their core mandate – price stability – while adapting to a changing environment and being open to learn new lessons when they present themselves. The financial crisis was such a moment, and a reinterpretation of central banks’ financial stability mandate is an important lesson to take away from it.

### Preventing the collapse: conventional monetary policy

The economist John Kenneth Galbraith quipped that financial memory is brief and that “there can be few fields of human endeavor in which history counts for so little as in the world of finance”.<sup>1</sup> Given that the sixth anniversary of the collapse of Lehman Brothers passed just a few weeks ago, let me briefly remind you of the hectic events that gave rise to the policy actions of the past few years.

The bankruptcy of Lehman Brothers on 15 September 2008 turned what had previously been a crunch in the interbank market into an outright financial panic. In the weeks and months after the collapse of Lehman, the prospect of a second Great Depression was real. In fact, key economic indicators showed worrying parallels in the early stages of the two crises; by

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<sup>1</sup> Galbraith (1990).

January 2009 global industrial output had dropped by more than 10%, global trade by almost 20%, and the global stock market had lost about half of its value.<sup>2</sup> In the 1930s, all three of these indicators continued to fall for another two years, eventually leading to record unemployment of 25% in the United States and around 30% in the United Kingdom and Germany, the second and third largest economies at the time.

This, at the end of 2008, was the environment in which policymakers found themselves and the prospect that they were trying to avoid. So how did they react? Almost immediately after the collapse of Lehman Brothers central banks, including the SNB, began to lower interest rates to almost zero. Over the following months, they also injected liquidity into markets that were on the verge of drying up, and acted as lenders of last resort by providing liquidity to distressed financial institutions.<sup>3</sup>

The importance of providing liquidity and acting as lenders of last resort is the main lesson which central banks took away from the experience of the Great Depression, and it has been seen as their main role in times of financial distress ever since.<sup>4</sup>

Thus, as regards central banks' reaction in the early days of the crisis, what we saw was not them doing too much – it was them doing their job. For most, certainly for the SNB, they were doing what their mandates required them to do. Collectively, they helped stabilise economies and financial markets that were in danger of collapsing. Many challenges remain, to be sure, but avoiding a rerun of the 1930s does constitute a success.

### **Supporting the weak recovery: unconventional monetary policy**

Once central banks had lowered nominal short-term interest rates all the way to zero, they hit a natural limit at which conventional monetary policy becomes powerless. Their decisive reaction, together with fiscal policy measures by governments, had succeeded in stopping the free-fall, but economies were still weak, unemployment rates high, and recoveries feeble.

More action was clearly required. Conventional economic wisdom asserts that at the zero lower bound fiscal policy is the most effective lever on which to act. Unfortunately, most governments perceived themselves unable to do more for a variety of reasons. Most importantly, many governments entered the crisis with high levels of public debt and, with the crisis already putting pressure on their budgets, they were reluctant to spend yet more.

So even after having exhausted their conventional policy tools, central banks found that they were the only ones left to support weak recoveries. With many of them mandated to react to below-potential output, they turned to unconventional policies.<sup>5</sup>

While their motives were somewhat different, all the major central banks resorted to either one or both of two measures: quantitative easing – the large-scale purchase of long-term securities, and forward guidance – the commitment to keep short-term interest rates low for a

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<sup>2</sup> Eichengreen and O'Rourke (2010).

<sup>3</sup> Liquidity provision to distressed financial institutions typically occurred in the context of state intervention and state capital injections to ensure the solvency of these institutions. In Switzerland, the SNB acted as lender of last resort by providing liquidity assistance to UBS in October 2008, once the bank's solvency was guaranteed by a capital injection from the Swiss government.

<sup>4</sup> Friedman and Schwartz (1963) argue convincingly that it was the reduction in the money supply that caused the large drops in output and prices between 1929 and 1933, and that this drop in the money supply was amplified by the large-scale bank failures in that period, which the Fed did not prevent through lender of last resort action.

<sup>5</sup> The path was not entirely untrodden: in the 1990s, Japan was facing weak growth and the threat of deflation in the wake of its asset price crash, even though the Bank of Japan (BoJ) had slashed rates to zero. The BoJ thus started to experiment with unconventional monetary policy measures.

certain period of time. Both of these tools are intended to lower long-term borrowing rates and, through that channel, to stimulate economic activity.

The SNB is a bit of a special case. In summer 2011, Switzerland was confronted with an excessive appreciation of the Swiss franc as a result of the euro area crisis, an appreciation that continued to the point where it posed a serious threat to price stability. As a result, we resorted to a range of unconventional tools to increase Swiss franc liquidity and – eventually – introduced an exchange rate floor of 1.20 Swiss franc per euro in September 2011.

So, are central banks doing too much in terms of unconventional policy? The answer is – again – “no”, but less categorically than in the case of conventional policies.

On the one hand, being the only ones left to react to weak economies and high unemployment forced many central banks to take further action – action that was justified by their mandates.

On the other hand, the jury is still out on the overall assessment of unconventional policies. For one thing, while evidence suggests that quantitative easing in particular succeeded in lowering long-term borrowing rates, its effect on the real economy is less certain.<sup>6</sup> For another thing, such policies may have important side-effects: they may lead to additional risk-taking in financial markets and thus contribute to financial instability,<sup>7</sup> and they can create spillover effects to the rest of the world – notably emerging markets, where capital flows in search of higher yield can fuel asset prices and currency movements.<sup>8</sup> A complete assessment of the positive and negative effects of these measures will thus have to wait until we have data on the full experience, that is, until the complete exit from these policies.

An assessment of the effectiveness of the SNB’s minimum exchange rate is clearer: this measure has played a decisive role in addressing the imminent risk of deflationary developments and has thus been successful. Given the still weak economic environment, it remains the central tool to ensure that monetary conditions are appropriate and that the SNB’s primary objective of price stability is fulfilled.

The period since the collapse of Lehman Brothers has also underlined the value of central banks being able to respond flexibly to unexpected circumstances. On 30 November, the Swiss electorate will vote on the so-called “gold initiative” (“Save our Swiss gold”, in full), which, paradoxically, would severely constrain the SNB’s room for manoeuvre in a future crisis. Let me digress for a few minutes to explain why the SNB is opposed to this initiative.

The initiative is calling for three things: first, the SNB should hold at least 20% of its assets in gold; second, it should no longer be allowed to sell any gold at any time; and third, all of its gold reserves should be stored in Switzerland.

Let me address the last point first. Today, 70% of our gold reserves are stored in Switzerland, 20% are held at the Bank of England and 10% at the Bank of Canada. As you know, a country’s gold reserves usually have the function of an asset to be used only in emergencies. For that reason, it makes sense to diversify the storage locations. In addition, it makes sense to choose locations where gold is traded, so that it can be sold faster and at lower transaction costs. The UK and Canada both meet that criterion. In addition, they both have a strong and reliable legal system and we have every assurance that our gold is safe there.

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<sup>6</sup> Christensen and Krogstrup (2014), Filardo and Hofmann (2014), Stein (2012), Williams (2013) and references therein.

<sup>7</sup> Chodorow-Reich (2014), IMF (2013).

<sup>8</sup> Rajan (2013).

The initiative's demand to hold at least 20% of our assets in gold would severely restrict the conduct of monetary policy. Monetary policy transactions directly change our balance sheet. Restrictions on the composition of the balance sheet therefore restrict our monetary policy options. A telling example is our decision to implement the exchange rate floor vis-à-vis the euro that I mentioned above: with the initiative's legal limitation in place, we would have been forced during our defence of the minimum exchange rate not only to buy euros, but also to buy gold in large quantities. Our defence of the minimum exchange rate would thus have involved huge costs, which would almost certainly have caused foreign exchange markets to doubt our resolve to enforce the rate by all means.

Even worse consequences would result from the initiative's proposal to prohibit the sale of gold at any time. An increase in gold holdings could not be reversed, even if necessary from a monetary policy perspective. In combination with the obligation to hold at least 20% of total assets in gold, this could gradually lead the SNB into a situation where its assets would mainly consist of gold: each extension of the balance sheet for monetary policy reasons would necessitate gold purchases, but whenever the balance sheet needed to be reduced again for the same reasons, we would not be able to resell our gold holdings. This would severely restrict our room for manoeuvre.

Furthermore, because gold pays no interest or dividends, the SNB's ability to generate profits and distribute them to the Confederation and the Cantons would be impaired.

As a final point, note that currency reserves which cannot be sold are not truly reserves. It does not make sense to call for an increase in emergency reserves – gold holdings – and simultaneously prohibit the use of these reserves even in emergencies.

The SNB's overriding objection to the gold initiative stems from the danger it poses to the conduct of a successful monetary policy. It would severely impair the SNB's ability to fulfil its constitutional and legal mandate to ensure price stability while taking due account of economic developments, in the interests of the country as a whole.

### **Drawing the lessons: reinterpreting the financial stability mandate**

Let me close this digression and return to my main theme. Once the initial shock of the crisis waned, policymakers began to address the root causes. The crisis has revealed two deficiencies of the existing regulatory framework. And because central banks are well placed to address these deficiencies, it has led to a reinterpretation of their financial stability mandate away from managing financial crises and towards preventing them.

In this final section of my speech, I will explain in more detail what the deficiencies of the pre-crisis regulatory framework were, and why central banks are well placed to address them.

The first deficiency of the framework was the focus on crisis management. Before the crisis, it was thought best for central banks to act decisively once financial crises had occurred, rather than to try and prevent these crises from happening. The large cost of the recent crisis in terms of social welfare has made it clear that more effort needs to be invested in preventing such events altogether.

The framework's second deficiency was that it missed out an important dimension of risk. Because it focused on preventing distress at individual financial institutions (microprudential regulation), the framework failed to capture the build-up of financial-system-wide risk. This "systemic risk" can arise from two sources. One is financial institutions that are either so large (think UBS or AIG) or so interconnected (think Lehman Brothers or Bear Stearns) that their failure would threaten the stability of the entire financial system. In this regard, the failure of Lehman Brothers has demonstrated just how real the problem is. The other source from which systemic risk can arise is small financial firms who, by acting together and procyclically, amplify booms and busts in financial markets.

Addressing systemic risk directly requires a specific set of instruments, so-called macroprudential tools, which were first discussed more than a decade ago.<sup>9</sup> In terms of systemic risk, these tools fall into two broad categories. The first category is tools which aim to strengthen institutions that are systemically important because of either their size or their interconnectedness. An example is the Swiss ‘too big to fail’ legislation. The second category of tools aims to enhance the resilience of the financial system and to limit the procyclicality of financial institutions’ collective behaviour. The countercyclical capital buffer, which is currently activated in Switzerland, is an example of such a tool.

In short: we have learned that system-wide financial crises can be very costly, and that we should focus on preventing rather than managing them. There is also a broad consensus that we require macroprudential tools to address systemic risk directly.

One last question remains: why should central banks play an important role in implementing these tools? There are four main reasons.

First, as lenders of last resort, central banks are the ultimate providers of liquidity to the economy in times of financial stress, and thus play an important role in managing crises. But these operations are not without risks, so that central banks have a particular stake in preventing such situations. To do that, they need the appropriate tools.

Second, financial stability is a critical precondition for central banks’ ability to fulfil their primary mandate of ensuring price stability. Financial instability can distort prices directly, and it can impair the proper functioning of monetary policy transmission mechanisms.

Third, macroprudential and monetary policy tools interact, in the sense that the use of one may have an effect on the use of the other – for example when low policy interest rates not only stimulate economic activity (as they should), but also translate into an excessive reach for higher yields in financial markets, thereby contributing to the build-up of systemic risk, which in turn justifies the tightening of a macroprudential tool. In such a case, the chances of achieving the best policy mix are higher when macroprudential and monetary policy tools are well coordinated, which is considerably easier if they are both managed by the central bank.

Finally, analysing and monitoring systemic risk and the impact of macroprudential instruments requires competences akin to those that are traditionally assembled within central banks, where having a macro perspective on the economy and an understanding of financial markets is paramount for the fulfilment of the price stability mandate.

In sum, then, there is a compelling rationale for giving central banks a prominent role in the fight against systemic risk, in the design of macroprudential policy and in the management of macroprudential instruments. Uniting the responsibilities for monetary and macroprudential policy within the same institution is sure to improve information sharing and policy coordination.

For many central banks, and certainly for the SNB, the responsibility for macroprudential policy and the shift in focus from crisis management to a more active role in crisis prevention constitute a reinterpretation of our financial stability mandate. For the SNB, it brings new competences on two levels: first, the SNB is endowed both with the responsibility for identifying financial institutions that are systemically important and with the authority to designate them as such. And second, it is responsible for monitoring cyclical risks and, to that end, for proposing to the federal government the activation and the level of the countercyclical capital buffer.

So, the answer to the question whether central banks have too prominent a role in the new regulatory framework is once again “no”. Given our recent experience, it would be negligent not to address systemic risk directly in order to prevent system-wide crises in the future, and

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<sup>9</sup> Crockett (2000).

because addressing these risks involves a set of tools and competences that naturally belong to the domain of central banks, their prominent role in this task is a direct consequence. It is also important to bear in mind that the expanded efforts to prevent future crises will, if they succeed, reduce the need for extensive crisis management in the future.

## Conclusion

History is a great teacher. And central banks must learn from its critical episodes. The recent crisis is such an episode and is thus an exceptional learning opportunity.

Central banks were active in managing the crisis with both conventional and unconventional tools. Their efforts played a major role in preventing the collapse of the financial system in the early days of the crisis, and have contributed to mitigating the economic damage of the aftermath. These actions were only possible because central banks, including the SNB, were able to act flexibly in exceptional circumstances – a flexibility which the gold initiative would severely constrain.

But the social costs of the crisis were – and still are – enormous, and the main lesson that central banks need to take away from it is the necessity of reinterpreting their financial stability mandate, away from managing crises and towards a more prominent role in preventing them.

This means that systemic risk has to be addressed directly and effectively, a job for which central banks are well placed. If we succeed, the need for extensive crisis management measures will be reduced. In other words, one should expect to see more of central banks on one front so as to see less of them on another.

Let me conclude by reiterating the answer I gave right at the very beginning: in responding to the crisis and in implementing new regulatory measures to prevent another one, central banks did not do too much; they did what was and is necessary.

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