Challenges for Central Banks during the Current Global Crisis

Address by
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Introduction

Ladies and Gentlemen

It is a great pleasure to welcome you to Zurich for the Sixth Annual Seminar organized jointly by the National Bank of Poland and the Swiss National Bank. Today and tomorrow, you will be discussing the challenges for central banks during the current global crisis.

The unprecedented financial crisis, which first emerged in August 2007, turned into a global economic recession since last year. The Swiss economy has been feeling the full impact, like many other countries around the world. In response to the financial crisis, many industrialized countries implemented relief packages for banks and large corporations, while most central banks relaxed their monetary policies and some even put unconventional measures into operation to alleviate the liquidity needs in financial markets for the first time in their history.

In these difficult times, it is of utmost importance for central banks to fully understand the conditions that led to this crisis as well as the effectiveness of the measures they have till now taken. In that respect, your discussions today and tomorrow will be very valuable in broadening our knowledge about the current global crisis and what central banks can – or should – do to achieve financial and macroeconomic stability.

Past history of the Joint Seminar and collaboration with the NBP

Before I talk about this year's conference, let me remind you how the *Joint Seminar* – as we refer to it at the SNB – came into existence.

Exactly five years ago, the National Bank of Poland (NBP) and the SNB collaborated to organize the first *Joint Seminar* on "Exchange Rate Regimes and Monetary Policies" in Warsaw. The main goal of that conference was to bring together academics and central bankers to discuss theoretical and practical aspects of central banking, and to provide an opportunity for sharing experience and expertise.

As the first *Joint Seminar* turned into a success, it was only natural to organize it every year since then, while the location has been alternating between Poland and Switzerland. Over the last five years the conference topics ranged from exchange rate regimes to inflation targeting to financial sector development. And I can gladly say that for all the participating central banks *including* the organizers, the discussions and exchange of ideas at the *Joint Seminar* have continously been fruitful.

I am also very pleased to say that thanks to the *Joint Seminar* our multilateral relations with the central banks of Developing Europe and of the CIS countries as well as with the National Bank of Poland is getting stronger each year.

Pre-crisis conditions

Based on previous years' enriching experience we can expect that this year's *Joint Seminar* will indeed broaden our understanding of the ongoing crisis.

As we all know, the financial market crisis has now evolved into a global economic recession. Before talking about what central banks can do to calm the markets, first we need to understand the circumstances under which the crisis hit our economies. Rapid credit growth and large capital flows were wide spread phenomena before the onset of the crisis. Particularly large external imbalances and foreign currency borrowing raised concerns regarding their sustainability in the long-run and their impact on financial sector stability. Who were indeed these foreign or local currency borrowers? Could they service their debt after unfavourable exchange rate movements or after a slow-down in economic activity?

With banking sectors in developed countries currently experiencing liquidity strains and international investors feeling a home bias again, developing countries may now find themselves in difficulty to refinance their external deficits. Because of these tensions in the financial sector, it is crucial for central banks to understand the linkages between financial sectors across countries as well as the profile of borrowers in each country to assess the risks associated with sharp exchange rate movements and a sudden stop of capital flows.

Accordingly, central banks need to know who the so-called "carry traders" are and which economic agents choose to borrow – in their domestic or in a foreign currency – in order to gauge the impact of the crisis onto their economies. Your discussions this morning will shed light on the characteristics of the households[1] and firms[2] constituting credit growth in

[1] "Borrowing in Foreign Currency: Austrian Households as Carry Traders" by Christian Beer, Steven Ongena and **Marcel Peter**

their respective countries as well as how an economic slow-down can impact their debt servicing[3].

Impact of the crisis on the economy

The crisis has been so severe that it has had ramifications in all sectors of the economy and all markets. Recent research[4] shows that the crisis has been so severe that the strain on money markets forced fundamental arbitrage conditions thought to be pillars of finance to break down. Is there evidence that the crisis left behind riskless and profitable arbitrage opportunities on the table? Possibly. This afternoon, your discussions will clarify our understanding of the effects of liquidity tensions on exchange rates.

Central banks have the same goal, namely achieving price stability. However, central banks around the world have been implementing different monetary operating procedures to achieve that same goal. Till this crisis, it did not seem to matter which operating procedure was used. Current research[5], however, suggests that, what did not matter during "normal" times may have a considerable effect on stability during extraordinary times. In fact, preliminary results suggest that the choice of monetary operating procedure can have significant impact on macroeconomic and financial stability. Your discussions this afternoon on different monetary operating procedures will be essential for all central banks to have a clear picture of the impact of their actions on the economy.

Clearly, the crisis had a varied impact on different economies. By analyzing how individual countries were affected by the credit crunch[6] we can pinpoint particular vulnerabilities in the financial sector and can draw lessons from this crisis in order to avoid future ones. We can also illuminate financial and trade linkages in this global world. As I observed during my trip to Central Asia last month, several countries in the region are experiencing balance of payments problems. For example, in Tajikistan remittances decreased significantly since the beginning of this year. In this regard, I believe it will be very beneficial for all

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[2] "Foreign Currency Borrowing by Small Firms" by Martin Brown, Steven Ongena and **Pinar Yeşin**

[3] "Breeding One's Own Subprime Crisis: The Effects of Labor Market on Financial System Stability" by Tomasz Daras and **Joanna Tyrowicz** (NBP)

[4] "The Covered Interest Parity Condition during the Financial Crisis" by **Tommaso Mancini** and Angelo Ranaldo

[5] "Macroeconomic and interest rate volatility under alternative monetary operating procedures" by Petra Gerlach-Kristen and **Barbara Rudolf**

[6] "Impact of the Credit Crunch on the Polish Economy" by Michal Brzoza-Brzezina and **Krzysztof Makarski** (NBP)

participants of the *Joint Seminar* to hear individual countries' experiences[7] during the crisis and exchange views.

Policy tools during crisis times

As we all witnessed, growing uncertainty about the stability of the financial system gradually paralyzed the money markets. Most industrialized countries implemented relief packages for banks with the aim of improving their refinancing conditions, cleaning up their balance sheets or strengthening their capital base. In fact, the crisis led to an unprecedented level of government intervention. Far reaching guarantees were granted, major corporations were put under state control, and a substantial amount of risk was transferred from the private to the public sector. Central banks around the world took prompt and decisive action in response to the strains in the money markets and substantially relaxed their monetary policies.

Yet the crisis in global financial markets led to a sharp downturn in the world economy since December 2008. Unavoidably, the Swiss economy has been pulled down too. The Swiss National Bank had reacted by considerably relaxing its monetary policy, moving – in effect – to a zero interest rate policy.

In mid-March, as a result of the sharp economic downturn, a further major expansion of monetary policy became necessary in Switzerland. However, the SNB was already operating a de facto zero interest rate policy, and the natural limits of conventional monetary policy had been reached. The SNB therefore took three unconventional measures: increasing the number of transactions in repos with longer terms, purchasing Swiss franc bonds issued by private sector borrowers, and buying foreign currency on the open market.

Your discussions tomorrow morning regarding the role of central banks[8] in the financial system are vital in enriching our understanding of the practical aspects of the measures taken[9][10] by central banks as well as their effectiveness in re-developing a healthy

[7] "Discussion: Impact of the Crisis in Developing Europe and the CIS Countries – Country Experiences: Azerbaijan, Bulgaria, Kyrgyz Republic, Romania, Russia, and Turkey" led by **Pawel Samecki** (NBP)
[8] "Financial Stability in Switzerland: The SNB's Role" by **Signe Krogstrup**
[9] "Tensions in the money market: Measures taken by the SNB" by **Martin Schlegel**
[10] "Measures taken by the NBP" by **Piotr Szpunar** (NBP)

functioning financial sector and how capital flows[11] will impact our economies in the future.

Concluding remarks

Ladies and Gentlemen

As central bankers, our primary task is to maintain price stability. In order to do so, we need to understand how the financial markets function and how central banks can achieve their task in this globalized world – both in normal and extraordinary times.

I hope that this year's *Joint Seminar* provides you with new ideas and further motivation to achieve your goals also during this crisis. I wish you fruitful and dynamic discussions and a successful conference.

[11] "Capital Flows: Build-ups and Let-downs" by **Laura Kodres** (IMF)