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A changing role for central banks?

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Introduction

The economic cost of financial crises is enormous. The recent crisis highlighted the extent of systemic risk and thus the overriding importance of a stable financial system. It also demonstrated the inadequacy of the instruments and measures used until now to ensure financial stability. More effective measures are needed to check and prevent systemic risk. The key question is how should – or can – this be achieved in the future?

In my talk today I would like to address this question by focusing on the role of central banks. Specifically, I will endeavour to answer the following question: To what extent will the lessons learned from this crisis affect or even alter the future role and tasks of central banks? I intend to examine this from three perspectives:

In the first part of my talk, I will examine the extent to which central banks need to undertake a fundamental review of their instruments and objectives in the light of recent events. In particular, there is a need to analyse the effectiveness of the monetary policy strategies and instruments used to date, especially in periods of crisis.

In my view, monetary policy measures and instruments alone are inadequate for the task of effectively checking and preventing systemic crises. In the second part of my talk, I shall therefore focus on the regulatory response to deal with potential instabilities within the financial system. One possible response to the inadequacies highlighted by the crisis would be to strengthen macroprudential supervision and regulation. In this case, the interaction between these measures and monetary policy would have to be borne in mind.

Thirdly, institutional aspects play a key role in the restructuring of the regulatory environment. I will outline these briefly in the final part of my talk.

Monetary policy after the crisis

Let me start by reviewing the objectives and instruments of central banks in the light of recent events. Comparing today's world with the situation a few decades ago, it becomes evident that much has changed. Deregulation of the financial markets has increased and globalisation has progressed extremely fast – in the real economy as well. The brisk level of trading made a significant contribution to the long-lasting worldwide upswing in recent years. This was supported by the credible policies pursued by central banks, which increasingly prioritised the goal of price stability, thus contributing to a global reduction in the level and volatility of inflation. The battle against high inflation appeared to have been

won. Overall, this led to firm expectations of low inflation and a dramatic drop in risk premia in virtually all areas of the financial markets.

However, the successful battle against inflation and the related reduction in macroeconomic volatility – also known as the 'Great Moderation' – were not able to prevent serious instabilities within the globalised financial system.

Alongside its evident benefits, the 'Great Moderation' thus seems to have produced a number of damaging by-products. In combination with low real interest rates, financial innovations and liberalised capital markets provided enormous credit-creation potential. Together with a reduced perception of risk, this fostered a rapid rise in asset prices which ultimately led to excesses and imbalances in some markets. Through contagion effects, the bursting of a credit and asset price bubble can bring the entire global financial system to the brink of collapse within a very short period of time. In view of the interaction with the real economy, this also has serious implications for the world economy and global growth.

This raises a number of questions about the future role of central banks. Can and should monetary policy be used to actively counter the development of imbalances or financial bubbles? Does it make sense to use monetary policy instruments for this? Will the new instruments used during the crisis also play a more important role in monetary policy in the future?

To answer these questions, I would like to look specifically at two aspects. First, I will examine the measures used by central banks during the crisis and briefly outline the possibilities and limitations on their future use in monetary policy. Then I will consider whether monetary policy should step up its focus on the goal of financial stability.

With regard to measures taken during the crisis, I can say straight away that the effectiveness of monetary policy instruments was clearly demonstrated. We were able to safeguard price stability and cushion the negative impact on the real economy. However, vigorous interest rate cuts were not sufficient on their own – neither in Switzerland nor in other countries. The liquidity situation on the money markets initially remained extremely tense. In many cases, interest rates rapidly dropped to zero. The chief monetary policy instrument could thus no longer be used. Central banks around the world therefore adopted so-called unconventional measures. These included direct intervention in the financial markets by buying assets, such as long-dated government bonds, debt securities issued by private bor-

rowers and foreign exchange. Another measure was the temporary expansion of liquidity provision to banks beyond the 'normal' level – for example, through repo transactions with unusually long maturities of up to one year.

These measures were taken for two reasons. First, they permit further monetary easing if the desired stabilisation of prices and the economy cannot be achieved through cutting interest rates alone. Second, unconventional measures can be justified by the central banks' role as lender of last resort. Its role, in other words, of providing emergency funding for financial institutions that are facing short-term liquidity bottlenecks. The aim of these unconventional measures is to restore the functioning of market forces as quickly as possible and ultimately to restore market confidence in the financial system.

Two main lessons can be learnt from the vigorous response by central banks. It showed that zero interest rates on no account mean that central banks have exhausted their set of monetary policy instruments. Through quantitative and credit easing measures, the central banks have effective instruments that can be used to reduce risk premia, alleviate liquidity bottlenecks and prevent deflation. Moreover, their role as lender of last resort has taken on a new dimension. Previously, this role was confined to providing funds to bridge temporary liquidity bottlenecks at a particular bank. At the height of the crisis, however, the priority was to secure the liquidity of entire markets. The central banks demonstrated that they can fulfil this function to a previously unforeseen extent. In short, they demonstrated their ability to respond to a systemic crisis.

Nevertheless, we need to be cautious when considering whether such measures should be included in a central bank's conventional set of instruments in the future. These unconventional measures proved useful for direct crisis management. However, so far we have little practical experience of monetary policy management at zero interest rates, especially over a prolonged period of time. It is clear that the instruments used come at a price. In the longer term, for instance, they could create new instabilities and distortions on the financial markets. Similarly, such an enormous increase in liquidity could lead to a build-up of significant inflationary potential. So it is too early to conclusively assess the impact of the measures taken. In general, though, they should be reserved principally for crisis management.

Looking beyond the reactive crisis management, the aftermath of the crisis has brought an old question back into the limelight: To what extent should central banks proactively hinder the development of imbalances on the financial markets, rather than simply adopting an ex post 'mopping up' role. More specifically: should central banks try to counter market excesses by steering interest rates in order to prevent a potential collapse of the financial system and the resultant costly implications for the real economy?

This is a complex issue and answering it would go well beyond the scope of this talk. However, it is very topical and tends to recur constantly in the public policy debate. I would therefore like to give you my view on this issue.

For a long time now, central bankers and economists have been examining the extent to which changes in asset prices should be taken into account in monetary policy. For example, this could mean that the central bank would raise interest rates if there was a risk that an emerging credit bubble could destabilise the system. The debate is fraught with difficulties, and though it started some time ago, research is still in its infancy. I will therefore merely outline the possible problems and challenges that could arise.

To make my position clear: I am convinced that a strategy geared to medium and long-term price stability is vital for effective implementation of monetary policy. After all, the economic benefits of stable prices are undisputed. High and volatile inflation rates are detrimental to productivity and growth. Uncertainty about future price trends leads to inefficient investment and consumer spending decisions. That does not mean, however, that financial stability should be ignored completely in monetary policy considerations. Nevertheless, taking greater account of financial imbalances presents a number of practical difficulties.

An initial problem is that a *single* instrument – namely the interest rate – would be expected to achieve *two* objectives simultaneously: price stability *and* financial stability. That does not seem to be a problem at first sight, because usually the two support each other, especially when taking a long-term view. Credible action to ensure price stability fosters a sense of security and market confidence, which in turn play a key role in ensuring financial stability. Similarly, a stable financial system is a key prerequisite for price stability. The recent financial crisis provided impressive negative evidence to confirm this rule. The bursting of a financial bubble can easily trigger a deflationary trend.

So far, so good. However, a second glance reveals potential conflicts between these two objectives in certain situations. For example, a positive supply shock – as a result of technological progress, for instance – could keep inflationary pressure low for a prolonged period. Expansionary monetary policy conditions could therefore be maintained. But if we look at financial stability, this situation entails the risk of a boom-bust cycle, which would require a tightening of monetary policy. A similar problem is conceivable if the economic outlook is so poor that raising interest rates would be inappropriate because of the risk of deflation. However, maintaining low interest rates would pave the way for potential imbalances, which – from the point of view of financial stability – would actually have to be countered by raising interest rates. Such situations make it clear that a *single* instrument cannot simultaneously achieve *two* objectives

A further problem is that a bubble is not easy to identify. Expecting us to be able to tell in advance whether damaging price imbalances are building up within certain asset classes is not realistic. First, that would require us to be better than market forces in assessing the fundamentally justified value of a specific asset. Second, it is not easy to clearly identify which variables are to be used as indicators of imbalances.

A third problem is that we do not yet have any sound knowledge of the timing, effectiveness and required scope of the monetary policy response that would be necessary to counter financial imbalances. Since asset prices are typically far more volatile than real economic variables and general price levels, substantial changes in interest rates could be required to check financial imbalances, and this could have serious side-effects on the goal of maintaining price stability.

As you can see, there are many questions that have not yet been clarified. The problems I have mentioned make it clear that central banks would rapidly reach their limits if they were simply to add a further goal alongside price stability without new instruments to deal with it. The more objectives an instrument is expected to achieve, the greater the risk of wrong decisions and conflicting objectives.

However, as I have already said, these problems do not mean that financial stability should be ignored completely in monetary policy decisions. Asset prices and other variables such as credit growth must be included as indicators when assessing the situation and the outlook for inflation. They are already included in the practical implementation of today's monetary policy strategy. Yet care must be taken when interpreting such 'instability variables' because they provide only limited information about future economic trends.

To sum up, monetary policy can make an important contribution to financial stability. However, the set of monetary policy instruments is unsuitable for excluding all imbalances in all circumstances. Accordingly, instruments that have a direct effect are needed to counter the emergence of (global) financial instabilities. A key lesson of the crisis is that there is scope to strengthen what is known as macroprudential supervision and regulation. This should be seen as complementary to monetary policy, to aid attainment of the twin goals of price stability and financial stability. Allow me to explain this in more detail.

A framework for macroprudential supervision and regulation

Put simply, macroprudential supervision and regulation is concerned with the stability of the entire financial system, rather than that of individual institutions, which is the domain of microprudential supervision and regulation.

Macroprudential supervision and regulation involves examining systemic risks that arise from the interaction between individual banks or the risk that the default of a *single* bank – because of its size or market share – could jeopardise certain functions that are vital for the economy, such as payment transactions or lending business. For example, one solution that could significantly reduce such problems would be progressive capital adequacy requirements. In other words, the greater a bank's systemic importance, the more equity it would be required to hold. If capital adequacy requirements rise in step with systemic importance, banks have an incentive to stay smaller and thus less systemically important. Capital reserves for systemically important banks in excess of a minimum level could also act as a kind of 'automatic stabiliser'. Reserves built up in 'good times' allow banks to absorb losses in 'bad times' without having to cease normal business operations.

Another central aspect of macroprudential supervision and regulation takes account of the build-up of systemic risks *over time*, and especially the procyclical effects in the financial sector. Discretionary action could be taken to cushion the growth of such risks over time –

for instance, by imposing an obligation to build up additional capital in phases of excessive credit growth, in other words a countercyclical capital buffer. A key aspect here is that such measures help prevent possible imbalances within the financial system. Another way of achieving the required countercyclical effect is, for example, imposing direct restrictions on loan-to-value ratios if there are signs that a bubble could be forming in certain markets, such as the mortgage market.

The difficulties of applying macroprudential supervision and regulation should not be underestimated, however. First and foremost, experience of discretionary instruments is still fairly limited. For example, there is not yet any conclusive research showing which indicators could be used to reliably identify systemic risks. Moreover, it is not easy to assess the point beyond which credit growth should be regarded as excessive. Furthermore, the interaction between macroprudential and monetary policy instruments could make implementation more difficult. In particular, monetary policy transmission channels could be affected. The impact of a change in interest rates on lending could vary depending on the level of a bank's capital buffer. Therefore, in order to develop reliable indicators for systemic risk, to analyse the interaction and feedback between macroprudential and monetary policy instruments, and to carefully evaluate the effective measures, we need clear mandates, enough time and additional expertise.

So what is the role of central banks in establishing such a macroprudential framework? Generally speaking, the traditional tasks of central banks are closely linked to various aspects of systemic stability. A stable financial system is very important for the effective implementation of monetary policy. But also in active crisis management, central banks bear a major responsibility, as the recent financial crisis clearly demonstrated. The contribution of central banks is therefore of great relevance in the analysis and regulation of systemic risk.

In particular, central banks will have a key role to play in macroprudential supervision and regulation for the following reasons: Developing and structuring macroprudential measures requires reliable analytical and forecasting skills – for instance, with regard to the overall economy or specific market segments, such as real estate. Central banks have extensive and soundly based knowledge of these fields. Moreover – as I have already pointed out – macroprudential policy interacts closely with monetary policy. This implies that the information advantage of central banks could be important in shaping macroprudential measures. Cen-

tral banks will therefore almost certainly have to play a major role in implementing such instruments.

At the same time, the risks involved in overemphasising the role of central banks in connection with such supervision and regulation also have to be borne in mind. Central banks could find themselves facing increased political pressure that could jeopardise their independence. If their credibility with regard to maintaining price stability were undermined, this could have devastating implications for the effective implementation of monetary policy.

Institutional aspects

And now, in the final part of my speech, I would like to look at some institutional aspects. To allow a more detailed analysis of systemic risks and how to keep them in check, we need a macroprudential framework in which various instruments can be combined to optimal effect. What is the best way of achieving this? Firstly, it is essential to recognise that ensuring financial stability as a whole is generally dependent on the decisions made by a range of different bodies. These need to act together in order to ensure financial stability. To create the necessary basis for a functioning macroprudential framework, the exact institutional set-up of the regulatory authorities is of the utmost importance.

First and foremost, objectives, mandates and responsibilities need to be clearly defined. In Switzerland, for instance, FINMA – the Financial Market Supervisory Authority – is responsible for the regulation and supervision of individual banks. The SNB, on the other hand, is required to contribute to financial stability. With regard to Switzerland's two big banks, there is a clear overlap between institutional and systemic risks. In this context, an exact definition of the responsibilities of the SNB and FINMA is of central importance for optimal macroprudential supervision and regulation. The revised Memorandum of Understanding between the SNB and FINMA is an important step in this direction.

Secondly, to ensure that the institutions involved can optimally carry out the roles assigned to them, it is also important to give them the right tools. In concrete terms, this means that the SNB would, for example, need to have more extensive information about the stability of financial institutions – regarding their risk exposure, interdependences, etc. – or it would require specific instruments enabling it to take the right decisions when implementing macroprudential policy.

Thirdly, the crisis made it clear that closer international cooperation between regulatory authorities is vital. Functioning international coordination mechanisms are required to counter future crises earlier and more effectively. International cooperation is the only way to check undesirable developments on the globalised financial markets.

Conclusion

Ladies and gentlemen, the stable economic growth and low inflation of the last two decades could not prevent the emergence of vast imbalances in the global financial system, as the financial and economic crisis clearly showed. Such massive economic shocks are bound to have an impact on how central banks work. Nevertheless, ensuring price stability remains our top priority.

The crisis made it evident that central banks have an effective set of instruments that can be used to mitigate the negative impact of financial crises. The unconventional measures used in this regard also proved to be effective. Yet despite these measures, the cost of the crisis remains enormous. One central conclusion, therefore, is that more attention needs to be paid to crisis prevention in order to improve the stability of financial systems. However, monetary policy instruments are only suitable up to a point in countering the emergence of financial imbalances. Hence, a different approach is needed. Strengthening macroprudential supervision and regulation is one plausible option. Macroprudential policy takes account of systemic risks in the financial sector through action geared to reducing such risks. As yet, however, we have little experience of this type of supervision and regulation. It is therefore vital that we act prudently and gradually when implementing any new measures, and that we give ourselves adequate time. The first step is to define clear and realistic mandates and objectives and to evaluate possible instruments. Collaboration between the various authorities involved – both nationally and internationally – is also of crucial importance.

Overall, we need to create conditions that allow the timely application of suitable instruments to counter emergent financial instabilities. These instruments would essentially supplement our set of existing monetary policy instruments. Within such a framework, the SNB would be able to make an optimum contribution to both objectives – price stability *and* financial stability.