

Monetary Policy after the Crisis

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The financial crisis which has been keeping the world in suspense since the summer of 2007 continues to worry all of us: banks, politicians, the media, the public at large and, not least, the scientific community. As regards those of us who are dealing professionally with the financial markets and their regulation, we have been awarded with an outright boom: the demand for interviews and lectures underwent a drastic increase. If one considers this to be an advantage or a burdensome side effect - that's a matter of personal taste. Personally, I am somewhat in two minds.

Today, I have no intention to deal with the entirety of the financial crisis. In my opinion, this is too large a subject for this rather short lecture. My topic of this day deals with "Monetary Policy after the Crisis". Consequently, I shall concentrate on the consequences of the crisis regarding monetary policy, as well as on its effects on the price stability, which fall under the responsibility of monetary policy.

"Inflation or deflation?" - this is a question often heard in recent times. What can we expect in the near future? The answer is closely connected with the manner, in which central banks react (and have reacted) to the crisis by means of their monetary policy. In the first part of my speech I will address this question. The answers thereto and the measures taken will be crucial for the development of the financial markets and the global economy during the coming years.

As a matter of principle, one should ask what long-term lessons may be learnt from this crisis for the policies of central banks. Quite often, we hear: "One may learn from crises". I also believe this to be true. But one should learn the correct lessons only. In my opinion, however, there is now a considerable danger that one intentionally prefers incorrect lessons. In the second part of my lecture, I shall address this problem.

Inflation or Deflation, What's in Store for our Future?

Getting out of the crisis by monetary depreciation? That's roughly the topic of our today's conference. "The assessment of the inflation danger divides economists. Some fear hyperinflation, while others consider this as mere scaremongering. There is an ugly dispute among the various factions." (Tagesanzeiger daily of 23 July 2009) This is just an example out of many similar headlines propagated frequently in recent times by the media (which are known to tend toward dramatics and excitement). Or is there even the danger of deflation, as presupposed by others? "Is there the threat of deflation after the debt bubble has blown up and as a consequence of the economic recession, or will the high liquidity created by central banks... along with excessive government spending and the runaway indebtedness of governments entail a violent inflation?" (NZZ daily of 29. Sept. 2009).

But the dispute and the problems are actually not so dramatic. The picture gets more clear by mentioning the time frame in question:

Over the short term, there is hardly any danger of inflation by unanimous consensus of the experts. Overcoming the drastic economic crisis afflicting us now will take considerable time. During that phase, no grave price increase threatens to take place. However, whether the danger of deflation now often conjured up (especially by central banks and politicians) and used to justify the recent expansive monetary and fiscal policy amounts to more than a mere bogeyman is far less clear.

One thing is sure: a temporary dropping of inflation rates down to a level below zero is quite possible (particularly in Switzerland) and has indeed already happened (as of now). But this is by no means a calamity, unless a real deflation *process* ensues, i.e. a long-term trend of steadily decreasing prices of goods, fed by corresponding expectations. But I am experiencing considerable difficulty to discern such a dynamics in view of the immense overexpansion on central banks' balance sheets and the flooding of our economic systems with liquidity. That's why I feel that a deflation is rather unlikely.

On the other hand, a long-term inflationary tendency is undoubtedly quite a realistic perspective due to the expansion of liquidity by the central banks. Most pundits would share this opinion. In Switzerland, the central bank's money supply has more than doubled since the beginning of the financial crisis (even though it decreased somewhat during recent months). *"Liquidity is high, not only in the banking and finance sectors, but also in private households and companies. This is reflected by an increasingly fast growth of aggregate money supply since the beginning of the year" ... "The inflation forecast shows that the expansive monetary policy cannot be continued unrestrictedly without endangering the medium- and long-term price stability."* (Monetary situation analysis by the Swiss central bank SNB of 17 September 2009.) Similar considerations apply to other countries.

In this respect, it is of crucial importance whether the central banks correct their course timely enough and thus siphon off the excessive liquidity created by them in order to overcome the crisis, and additionally whether they will be able to convince the markets that they really wish to do this, upholding thus further a policy of price stability. In principle, central banks are able to do so, and they keep assuring us of their willingness to this effect. But it is less certain whether they will actually adhere to this script. Let me subdivide into four points my reflections about this question, which are subject to some scepticism, as you will see.

- Technically, the central banks are undoubtedly capable of following such a course of action. They are in possession of the necessary instruments, enabling them to reverse the operations for expansion of liquidity in order to siphon off again the excessive liquidity. This applies to "traditional", and conversely in the same way to so-called "unconventional" monetary transactions, which recently have been used by central banks in order to make available liquidity ("monetary easing", "credit easing", i.e. direct purchases of long-term and private/commercial notes and bonds, comprising in Switzerland also purchases made in the currency market). However, as a matter of fact one has to accept that such "reverse operations" may correspondingly affect the pricing at the involved markets, i.e. the interest rate, risk premiums and exchange rates. As a rule, it is precisely in these areas that difficulties do emerge. The renewed placement of previously purchased government bonds as well as commercial paper and notes at the market directly lowers their prices, increasing thereby earnings. If this coincides with a rekindling of long-term inflationary expectations, the resulting upward pressure may indeed be drastic. In such a case, the central bank has the rather unpleasant task of putting off the change of course factually required, or to tolerate a quick and strong increase of long-term interest rates and risk premiums.
- Not to be underestimated is the difficulty in choosing the correct timing. In this respect, central banks are confronted with a kind of tightrope walk. The policy should not be readjusted too early, so as not to choke off at once the initial upturn of the economy. On the other hand, the readjustment should not take place at such a late date when inflation expectations will again be on everybody's mind. Here, there is a considerable risk of errors

to be made. Experience so far made in these instances show that central banks usually tend to take corrective action rather too late. As an example, I would refer to the Swiss monetary policy after the expansion of the money supply in the years 1977/78 in order to combat the huge revaluation of the Swiss Franc. At that time, one had the well-intentioned objective to eliminate later on the excessive liquidity deemed necessary in order to absorb the drastic international increase in the demand for Swiss Francs, hoping to avoid in this way the emergence of inflation. In actual fact, excessive liquidity was siphoned off in 1979 and 1980, but too slowly, which provoked a strong inflationary dynamics during the following years. After the dramatic crisis now experienced by us, the danger looms now very large that the risk of a rising inflation is less feared by public authorities and politicians than the recurrence of an economic downturn due to a premature reversal of the monetary policy. In this respect, I am more optimistic regarding Switzerland and the Euro region than in respect of the U.S. and Great Britain.

- Central banks will undergo strong pressure to delay to the utmost the change of the monetary course (which might then come too late). The change of the monetary policy will entail (possibly fast and strongly) increasing levels of interest rates and again rising risk premiums (spreads). Politicians will not like this, not only with respect to the desired economic upswing, but also based on fiscal policy: high indebtedness of governments and further accruing budget deficits will drastically inflate the debt service bill of many countries. What this means is not sufficiently realized by many people as of now. Governments will find themselves caught in a fiscal strait-jacket: their fiscal room for manoeuvre will be extremely restricted. As regards Switzerland, it will prove to be a big advantage for this country that its leaders did not lose their head even during the crisis, continuing to act responsibly in respect of fiscal policy and public indebtedness. That does far less apply to other countries, in particular the U.S.

Rising interest rates will thus be rather unpopular. Many of those people who now reproach central banks (correctly) for having stuck too long a time to their expansive monetary policy in the years preceding the crisis, while blaming the crisis on the resulting flooding of the global economy with money will now speedily return to their former (erroneous) belief that easy money would be the cure for everything. Every chairman of any central bank will have to stiffen his backbone in such a situation. As a consequence of the crisis, the independent status of central banks is impaired in many countries - not least due to the mixing up of monetary and fiscal measures in order to combat the crisis, coupled with the ensuing right of co-determination claimed by politicians.

- In view of the huge increase of government debt in many countries, in case of the U.S. also its international indebtedness, there additionally exist marked political incentives to reduce indebtedness in real terms via inflation. Naturally, inflation can only disencumber the debtor in real terms if it is not actually anticipated, but appears unexpectedly - otherwise it will manifest itself by way of compensatory increases of nominal interest rates and/or international (nominal) interest differences. But precisely such a situation may provide an incentive to get involved in a fatal *acceleration and intensification* of inflation. History shows that high governmental indebtedness has frequently been eliminated in this way.

Prospects of an international trend towards rising inflation and continuously tight fiscal budgets in many industrialized countries are likely to bring about, in Switzerland too, a difficult situation in terms of monetary policy, even though the country is trying hard to

oppose this tendency based on its preference given to price stability. The Swiss Franc could easily come under strong revaluation pressure, as experienced several times during the past decades. Experience teaches that it is extremely difficult, under these circumstances, to keep a country completely shielded from international inflationary trends. On the other hand, Switzerland will enjoy a strong advantage due to its solid fiscal and indebtedness situation as compared with other countries on international level. It will be able to act and decide regarding its economic projects and policies under considerably less constraint than many other countries.

A new Monetary Policy? Long-term Lessons out of the Crisis for the Policy of Central Banks

A wide-spread notion of our days asserts that, in future, monetary policy should no longer focus predominantly on inflation and price stability, as was the case in the recent past, but that it should instead observe in equal measure the development of asset prices, especially those of real estate and securities, in the aim of preventing the development of new bubbles in these markets. The idea certainly is worth considering as it contains some truth. But it may also entail misunderstandings and is thus problematic. A careful and detailed analysis is necessary.

Moreover, there is at present a tendency to enlarge the part played by central banks in financial market supervision and monitoring as well as the regulation of banks. In the political processes of the U.S., the idea of a broad-ranged assignment given to the Federal Reserve System aimed at ensuring financial stability now enjoys high priority. The same applies to Germany. But this entails a great danger threatening the independence of the central bank and of its policy. Therefore, I feel that such an assignment is very risky. Using the very parlance now favoured by banks, one might speak of a "toxic present" to central banks, or more conventionally of a Greek gift. Let me explain this matter in more detail.

It is certainly correct that in future the central banks have to pay closer attention to the prices of assets. Their low-interest policy, coupled with a craving for yields, lack of risk awareness, insufficient market transparency as well as adverse incentives with respect to the granting and securitization of credits did favour, after 2001, the expansion of national and international "debt pyramids", which would collapse sooner or later. This policy is co-responsible for today's crisis and certainly deserves to be criticized. A closer monitoring of asset prices could assuredly have served as a better early-warning system.

However, we have to ponder very carefully the meaning of this. First of all, we have to realize clearly the true objectives of monetary policy and the parts played by other factors, such as asset prices, information and indicator variables in the monetary process.

The final objectives of monetary policy consist firstly in *price stability* (which is measured at prices of goods, usually consumer goods), and *secondly*, in *a balanced economic situation*. The essential final objectives of central bank policy include also *the stability of the financial sector by ensuring its steady supply with liquidity and by securing a well-functioning payment system*. Central banks have indeed been set up precisely with these aims in mind. Let me add some more details regarding the said final objectives of central bank policy, laid down also in the laws on the Swiss National Bank:

It is well known that *pursuing price stability along with a balanced economic situation* is a rather delicate matter, requiring central banks to perform an outright tight-rope walk in certain

situations. The ranking of these two objectives should therefore first be clarified, as has been done explicitly by the Law on the Swiss National Bank passed in 2004 (and in most comparable foreign assignments imposed recently on central banks). Thereby, the hierarchical order of objectives is also determined. It is both obvious and logical to lay down firmly - as the main task of monetary policy - the long-term price level and thus also safeguarding price stability, which can actually be controlled by the central bank. This is indeed the sole task of the central bank, excluding any other institution involved in economic policy. Ensuring price stability in this manner is the prior key task of monetary policy. Care to maintain a balanced economic situation ranks only subsequently. But avoiding inflation and deflation processes and thus preventing respective expectations affords monetary policy simultaneously a maximum latitude to comply with this additional task.

In the past, central banks (and assignments given to central banks) often pursued multiple objectives, such as price stability, full employment, economic growth, a stable exchange rate as well as an equilibrated balance of payments. In the course of the recent decades, conviction has steadily grown that simultaneous fixing of multiple (and often incompatible) objectives overtaxes the capabilities of monetary policy. The central bank's monetary task is in such a case optional and indefinite. If you saddle the central bank with additional targets involving full employment and output besides price stability, you require it to perform something which it cannot do, preventing it precisely from rendering the performance which truly conforms to its capabilities. The results very often consist in none of the objectives envisaged being attained.

Moreover, it is necessary to describe in precise detail *finance stability* as an objective of the central banks, which bear a clear-cut responsibility for the financial sector's stability. This is precisely one of the main reasons why central banks have been set up by virtually all countries in the second half of the 19th and at the beginning of the 20th century (including also the Swiss National Bank in the year 1907 after decades of discussions). But the central bank's role must be limited to ensuring an adequate supply of liquidity and guaranteeing an efficient and safely functioning payment system.

Fiscal interferences do not belong to its tasks. Bailing out insolvent financial institutions with government funds and by governmental guarantees is of a fiscal nature, forming part of the State's responsibility or of a separate supervisory agency appointed by the State. Analogously, the same applies to measures and regulations of a preventive nature which should avoid the occurrence of such undesired events.

Monetary policy and prices of assets

As regards prices of assets, measured for example at an index of stock prices or real-estate valuations, the same do not and should not belong to monetary policy's final objectives. One might possibly discuss the eventuality to include them as indicators of prices of future products of certain importance in a more comprehensive index of goods' prices. This question has occasionally been discussed in the past, but so far no definite binding answers have been arrived at. However, an equal-ranked co-existence of prices of goods and those of assets does not make sense, and neither would this be the case for self-contained objectives of single components of goods, such as foodstuffs or housing and tenancy costs. In final analysis, prices of asset items are *relative* prices, the control of which cannot be envisaged by monetary policy of central banks. The latter should limit themselves to the long-term control and

safeguarding of purchasing power, i.e. the absolute price level of end products. If this is done successfully, it prevents also basically a mere nominal blowing up of asset valuations.

But asset prices may provide key information variables for monetary policy. Speculative turbulences at stock and real-estate markets are basically possible at any time. They may reveal an erroneously oriented monetary policy, jeopardizing finally the essential objectives of the central bank's policy (price stability and a balanced economic situation, financial stability) - and we have just undergone this distressful experience. If such developments happen, or are with good reason supposed to happen, monetary policy has to react. The emergence of financial market bubbles blowing up sooner or later may serve as a monetary warning signal. On the one hand, it is possible that the excessive liquidity entailing the forming of the bubble will some time or other directly flow into the product markets entailing a sudden increase of product prices. On the other hand, the blowing up of the bubble may unsettle the financial markets, provoke a worsening of banks' balance sheets and threaten the systemic stability. This in turn gives rise to the monetary policy (and the economic policy in general) being narrowly focused on combating the crisis, involving possibly undesired long-term side-effects, discussed by us today in this place.

Therefore, the central bank may and should consider prices of assets as information variables, using them for its decision-making process, in analogous manner as is done with other indicators, such as money supply, inflation rate forecast, exchange rates or the gap in output. It may and should use these indicators to such an extent, as the same may be capable of giving information about a potential threat with respect to the essential final objectives. But these indicators must on no account be ranked as independent final objectives of monetary policy, thus excluding their utilization as objectives of the central bank in the same way as applies to the prices of goods as yardsticks for the general price increase. Even an attempt to stabilize asset prices in the same manner as product prices would be disastrous. It would mean a return to the fatal overtaxing of monetary policy by multiple targets potentially inconsistent among themselves, whose unfavourable consequences are well known to us from past experience (in another context).

As a matter of course, it continues to be difficult for central banks (as well as for other market observers) to correctly interpret the development of asset prices and to diagnose in good time the development of bubbles. But it is equally difficult to interpret correctly other information variables observed and used by the central bank, such as output and production development, interest supply and exchange rates, or the aggregate money supply. Here again, the situation is very similar. Monetary policy has to live with and to meet this challenge, there is no way around it.

A comprehensive assignment of the central bank in respect of financial stability?

Should central banks get a comprehensive assignment for ensuring financial stability and monitoring the protagonists acting in the financial markets? In different countries there are differing modes of regulation in this area regarding the burdening of the responsibility on the central bank on the one hand as well as on another supervisory authority on the other hand (or even several ones, as happens in the U.S.). In Switzerland, these tasks are shared between the Swiss National Bank and the Swiss Financial Supervisory Authority FINMA. During the present-day crisis, the eventuality is being discussed, especially in the U.S., to strongly increase the responsibility of the central bank regarding supervision and monitoring of

financial markets, granting the Federal Reserve System extensive powers in this respect. The FED reacted favourably to this proposal of increased powers (even though it recently lessened somewhat its claims). In Germany, the new partners in the government (CDU and FDP parties) have recently agreed to charge henceforward the Federal Bank (Bundesbank) with the supervision of banks. One may ask whether this is a wise decision.

Undoubtedly, the central bank bears the responsibility of ensuring financial stability. But the latter should, in my opinion, be limited to an adequate supply of liquidity and a well-functioning payment system. This task is imperatively coupled with the regulation of the money in circulation and the monetary policy of the central bank, hence the latter must perforce handle all of this. The central function of the central bank resulting from this role is that of the Lender of Last Resort, i.e. of the authority providing the banking system with money in times of crisis and scarce liquidity, thus ensuring that sufficient means of payment are available to the economy. According to traditional notions, the central bank's liquidity aid should be restricted to (temporarily) insolvent but basically sound institutions.

Admittedly, such a distinction is difficult to make in a case at hand. Illiquidity may entail distress sales, losses and insolvency, while conversely insolvency may quickly undermine credibility as well as bring about refinancing problems and illiquidity. As a matter of principle, the distinction is all the same an extremely significant one, because it implies a reaction on the imperfections of the money and capital markets, and that it cannot be the reason and the purpose of such a rescue to keep artificially afloat institutions which are basically incapable of surviving. Above all, it is evident that the rescue has to be limited to the supply of liquidity. Providing ailing institutions with new equity capital is, however, something quite different. In principle, the central bank may create liquidity at any time to any desired extent (although in the long run there might be negative consequences regarding the price level and inflation). But it cannot itself create equity capital (which applies also to the State) without making use of taxpayers' money.

Consequently, it is necessary to separate clearly from the function as Lender of Last Resort decisions and measures aimed at liquidation, reorganization and restructuring of insolvent or potentially insolvent financial institutions. Bailing out insolvent banks by means of tax money and government guarantees evidently belongs to this sector. It is rather a fiscal operation and falls under the State's responsibility. Likewise, the State answers also for all preventive measures and regulations to avoid the occurrence of such damages, serving also for the necessary containment and limitation of damages. They also form part of the same context. It is certainly advantageous that the State should vest a separate autonomous regulating and supervisory agency with these tasks, which shall then design and implement a long-term optimal supervisory policy.

At least in principle, it is imaginable to vest the central bank by a double assignment with this task, too, in addition to its traditional monetary function. But I feel this would be a dangerous option. The potential fiscal consequences of such decisions and measures would expose the decision-making authority strongly to political pressures and lobbying, even justifying in a certain sense this type of interference. A double assignment given to the central banks would necessarily entail a curtailing of their independence, which has laboriously been acquired and consolidated during the recent decades. This would be a rather bad omen for the monetary policy and the safeguarding of price stability. In the long run, such an accumulation of tasks and responsibilities could be extremely counterproductive.

Let me now add some thoughts regarding the rescue package for bailing out the UBS and the role of the Swiss National Bank in this respect. These measures were absolutely necessary. In contrast to similar operations in many other countries, including the U.S. - the Swiss bailout had been carefully planned and cleverly implemented, thereby assuring a quick success. If no action had been taken, the Swiss and the international financial community would have been severely damaged in view of the national and international importance of UBS. Moreover, I do not criticize in any way the part played by the Swiss National Bank in this operation. The National Bank was indeed compelled to assume this role, because the political sector and the financial supervisory authorities were at that time fully unprepared and not adequately equipped to handle such a huge problem. But it would be wrong to interpret this as a lesson that the Swiss National Bank should continue to be vested with such additional tasks. Quite the contrary: this should remain an exception from the rule. The lesson learnt should require the supervisory authority of the financial sector to undergo an intelligent reform in order to regulate the financial markets on the strength of efficient instruments and means. Thereby, the supervisory authority should be enabled to handle the effects of such disastrous events in an efficient and effective manner as well as to discipline the financial market's protagonists by means of adequate incentives in such a way that the probability of these events to recur will be drastically reduced. However, outlining suitable methods to achieve this result is not the subject of this lecture, but possibly of another one.