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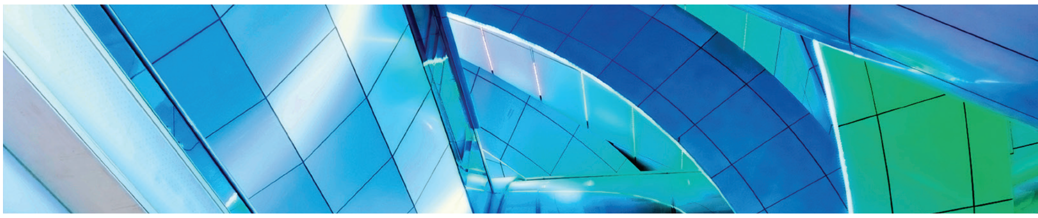

FOCUS

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CENTRAL BANKS: PUSHING THE BOUNDARIES OF MONETARY POLICY

HIGHLIGHTS

Central banks have been at the forefront of economic policies in the aftermath of the Great Financial Crisis. They have pushed back the limits of monetary policy in order to compensate for restrictive fiscal policies and foster nominal economic growth. Contrary to what has often been said, however, they have not yet resorted to actually really print money in outsized scale. But such policies are now seriously considered and could be the next step of the ongoing unprecedented monetary policy experiment

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"Faced with a high-debt and slow-growth environment, central banks have ventured into the unknown in order to spur on final demand. Their journey may not yet be over."

Since the global economic crisis of 2008-2009, central banks have exhibited unprecedented levels of interventionism. With new tools such as large-scale bond purchases, equally large-scale interventions in the foreign exchange market and negative interest rates, monetary policy has gradually become the main driver of economic policy in developed economies. Along the way, central banks have gradually moved beyond their traditional role as managers of the money supply and lenders of last resort. What has prompted them to go to such lengths, barely imaginable just ten years ago? Are central bankers responsible for what a growing number of stakeholders consider to be dangerous excesses? Is current monetary policy a source of risk or stability for the economy and the global financial system? What further developments should we expect after the innovations of recent years? At a time when central banks are more pivotal than ever in the interactions between the economy and the stock market, all of these questions are crucial.

THE MONEY-CREATING MECHANISM

Before describing the traditional role of a central bank, let us begin by giving the lie to a common misconception: most of the money in circulation in an economy is not created by the central bank. The central bank issues only part of the physical currency in circulation (known as 'fiduciary money'), such as banknotes. Issuing coins is the responsibility of the government. And all this fiduciary money accounts for just a fraction of all money in circulation: 8% in Switzerland, and 10% in the eurozone and the United States. The remainder—the vast majority of the money in circulation—is actually dematerialized. It is known as 'bank money' and is made up of sight deposits and short-term deposits in banks. This bank money is created not by the central bank, but by commercial banks.

The central bank does not intervene directly in the creation of bank money by the commercial banks. The commercial banks create 'unlimited' money by electronically crediting the account of an economic operator in exchange for a claim that will be included in the bank's balance-sheet assets (mortgage, commercial loan, etc.). The only constraint on the commercial bank in this process is the capital ratio imposed by its financial regulator, which requires the bank to maintain a certain level of equity capital depending on the size of its assets. The funding for these loans and this money creation comes partly from the banks' equity capital (in accordance with the capital ratio imposed), partly from bank deposits and partly from the financial markets where the banks issue bonds.

THE ROLE OF CENTRAL BANKS

The central bank, however, does have a powerful tool that it uses to guide the behaviour of commercial banks. It sets the overnight interest rate, upon which longer-term interest rates are based. By increasing or decreasing the cost of money, the central bank can discourage or encourage demand for loans and either restrain or stimulate the creation of money by commercial banks. The variations in the commercial banks' funding costs are naturally reflected in the interest rates of the loans they grant.

The central bank uses these levers to reach an objective imposed on it by law. For the big central banks of developed countries (SNB, ECB, Federal Reserve), that objective is to maintain what is known as price stability, meaning an inflation rate that is slightly positive so as to facilitate economic activity but not so high that it erodes the currency's purchasing power.

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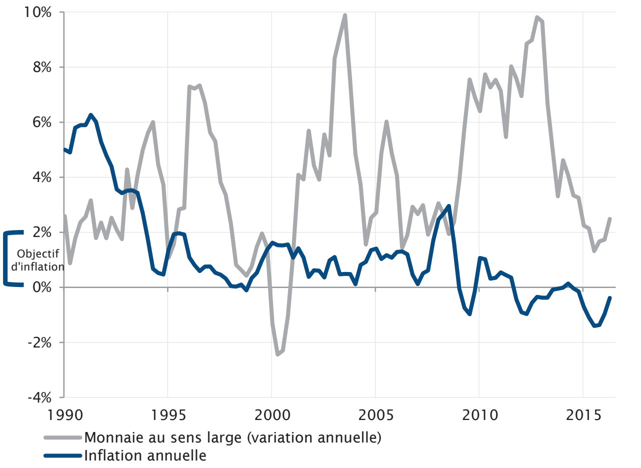
Switzerland: inflation and annual variation of the money in circulation



Source: Datastream

Obtaining a slightly positive inflation rate is seen as the best possible contribution monetary policy can make to general economic activity, as it creates an environment where economic decisions (consumption, investment, etc.) are not influenced by anticipation of variations in the prices of goods and services. To meet this objective and try to regulate the pace of inflation, the central bank uses interest rates to adjust the pace at which credit is distributed by commercial banks. The goal is to ensure that the amount of money in circulation increases at the right rate to achieve the inflation target.

All central banks share this general framework, but the extent and precision of the mandate given to them may vary. Though independent central banks free from government interference have become the norm in developed economies, they remain subject to control by the national parliament, which makes sure that the monetary policy implemented is in line with the defined goal. In addition to deciding monetary policy, the central bank must also ensure the stability of the financial system. It acts as lender of last resort so that, during crises, liquidity shortages don't cause the system to seize up and further exacerbate the situation. This role has been highlighted by the 2009 crisis.

The Swiss National Bank has quite a broad mandate. It entails deciding monetary policy «in the general interests of the country» while prioritizing price stability. Price stability is defined by the SNB as an annual inflation rate that is less than 2% but that does not remain negative for an extended period. Thus, the main determining factor in the SNB's monetary policy is the pace at which consumer prices are rising and projected medium-term trends thereof. This is what led it to intervene in the foreign exchange market in 2011, to place a lower limit on the euro-Swiss franc exchange rate.

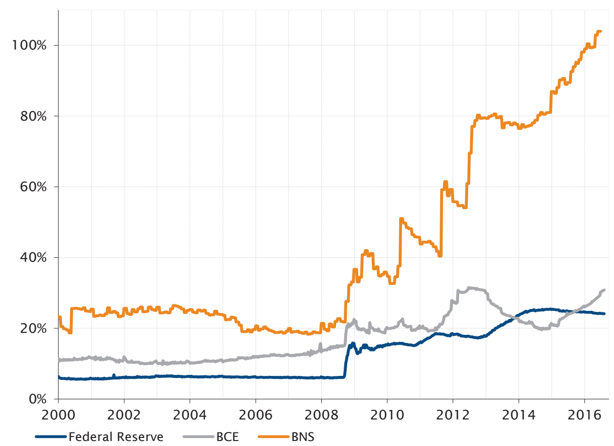
Owing to its negative impact on the international competitiveness of Swiss companies and the downward pressure it exerted on the domestic prices of imported goods, the appreciation of the franc jeopardized compliance with the price stability objective, with inflation expected to drop into negative territory. In another attempt to limit the appreciation of the franc, the exchange-rate floor was abandoned in January 2015 and a negative short-term rate was introduced.

The SNB's independence is assured through its status as a société anonyme [public limited company] whose registered shares are listed on the stock market (most are held by the cantons and the cantonal banks, but not by the Swiss Confederation). The bank's independence and mandate are governed by a special law (Swiss National Bank Act), with an obligation to report to the Swiss Federal Council and the Federal Assembly. The role of the European Central Bank is more narrowly and precisely defined, but is very similar to that of the SNB: to maintain price stability, defined as an inflation rate less than but close to 2%. The US Federal Reserve, for its part, has a twofold objective: to ensure price stability (a long-term inflation rate of 2%) and promote maximum employment. It is therefore more sensitive than the SNB or the ECB to economic growth and to the unemployment rate. In practice, however, the monetary policies decided by these three central banks are quite similar. The main difference probably lies in their capacity to react. Action can be taken more quickly in Switzerland and the United States than in the eurozone, where national sensitivities sometimes slow down the decision-making process.

THE EMERGENCE OF UNCONVENTIONAL MONETARY POLICY

These three central banks have also, in recent years, made use of the same types of policies, all three having been confronted with an environment of excessively low inflation, or even deflation. Having lowered their key interest rate to 0%, they faced a need to further loosen their monetary policy to meet their objective. They duly set about injecting considerable liquidity into the financial system through asset purchases. Be it in Switzerland, with the imposition of the EUR-CHF exchange-rate floor, or in the United States and the eurozone, through domestic bond purchases, central banks have considerably increased the size of their balance sheets by accumulating assets on an unprecedented scale. It is often tricky to judge, in retrospect, whether an economic policy has been a success or a failure, as it is impossible to know what would have happened if it hadn't been implemented. It should be noted, however, that these massive liquidity injections have not had the expected, or feared, effect on inflation. In the United States, Europe and Switzerland, inflation has remained desperately low, even negative at times, and well below the central banks' inflation targets. This illustrates that the use of the term «printing money», in reference to the unbridled creation of money causing it to lose all its value, is ultimately not a fitting description of what central banks have been doing recently. But it could be someday, as we will see shortly.

Size of central bank balance sheets as a % of GDP



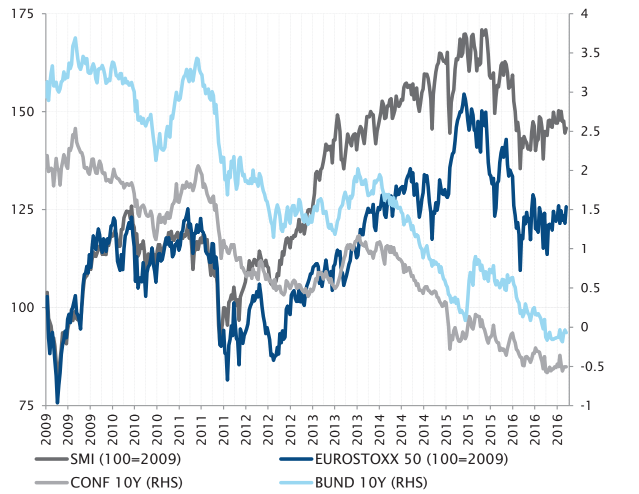
Source: SYZ AM, Fed, ECB, SNB, Datastream, Bloomberg

Although these asset purchases did lead to the creation of money, that money never reached the real economy. The commercial banks have not used the available funds to make loans to households and businesses, preferring instead to leave them in the account they have with the central bank or invest them on the financial markets. Consequently, the money thus created by the central bank has not had any real impact on the level of economic activity or inflation. But why wouldn't a commercial bank use these funds, made available at very low interest rates, to engage in its core activity: granting loans with a margin on the final rate? The answer lies both in low demand and in constraints on supply. Fairly uninspiring growth forecasts are hardly encouraging households and companies to take on debt to invest. Furthermore, higher capital requirements for banks after the 2008 crisis means they have to be more selective when granting loans. Though many feared otherwise, recent experience has shown that simply injecting liquidity into the financial system is not enough for the central bank to increase the amount of money in circulation in the economy.

THE LIMITS OF UNCONVENTIONAL POLICIES

Owing to insufficient demand and a lack of commercial banks capable of lending, this liquidity remained in the financial system, where it has had a considerable impact on asset prices! The combination of very low or negative short-term rates and abundant liquidity is inflating bond and share prices, with investors willing (or forced) to take on greater risk to generate positive yields. The consequences are long-term interest rates at all-time lows in all developed economies, and equity markets that have doubled or more since bottoming out in 2009.

European and Swiss government interest rates and equity markets since 2009



Source: Datastream

In theory, this mechanism is also a transmission channel of monetary policy: lower long-term interest rates improve financing conditions for businesses and households, and the rise in share prices is meant to stimulate household spending through the wealth effect. But it is not in itself enough to reinvigorate economic activity and inflation if the channel for distributing credit through the banks is not functioning correctly. The striking dichotomy between the significant rise in financial asset prices since 2009 and relatively low growth rates, a difference whose starkness varies from region to region, can thus in large part be explained by this imbalance between the transmission channels of monetary policy. The liquidity flows created by central banks essentially concern financial assets, favouring debt for actors who can obtain financing on the markets (large companies, emerging economies, etc.), with very little for bank loans to individuals and small and medium-sized companies. Yet we should not be too hard on central bankers, who are not the only people responsible for the imbalances caused by their monetary policy. At a time of very low growth and inflation, their mandate was (and still is) to try to get things back on the right track, and the only way for a central bank to do that is by loosening its monetary policy. Once short-term rates reached zero (and before resorting to a leap into the unknown territory of negative interest rates), there was no choice but to turn to new policies. The fact that the banking sector has not played its role as a transmission channel as efficiently as it has in the past is not the fault of the central banks. The roots of this dysfunction, particularly in Europe but also in the United States, can be found in the (laudable) tightening of banking regulation after the 2008/09 crisis, which put the brakes on lending. They also lie in the attitude of governments, who have adopted restrictive budgetary policies throughout the period (including in the United States), slowing the recovery and weighing on demand for loans. In fact, with governments having opted to slow or halt rising public debt, central banks and their monetary policy have found themselves alone on the front line in their efforts to kick-start inflation and economic activity in economies plagued by structural problems (high debt, demography, overcapacity) and a difficult context (restrictive budgetary policies). But as central bankers like to say, monetary policy can't solve everything…

TOWARDS REAL MONEY PRINTING?

After several years of unconventional monetary policies, we can now start to assess their effectiveness. In the United States, where seven years of growth, albeit sluggish, have brought about a significant reduction in unemployment, inflation remains below the central bank's target and the Fed has been unable to normalize its policy as it would like.

The considerable increase in domestic and foreign dollar debt (mainly in emerging countries) since 2009 means that even the most modest tightening of lending conditions has immediate negative repercussions on the financial markets and on economic activity. Plus, in a world where other central banks are keeping rates extremely low, raising the dollar rates would inevitably result in an appreciation of the currency, which would itself have negative repercussions on emerging economies, American exporters and domestic inflation at a time when the Fed would like to see it accelerate.

In Switzerland, though inflation seems to be improving, the structural strength of the Swiss franc is like a «sword of Damocles» hanging over the head of the SNB, which cannot afford to normalize its monetary policy as doing so may revive deflationary pressures and cause its currency to appreciate further. In the eurozone, the ECB has had to extend its asset purchase programme to new instruments in an attempt to keep up the fragile recovery in progress.

The Bank of Japan, which was the first to implement all these zero-rate and asset-buying policies in the 2000s, now seems to have reached the limits of what these initially unconventional but now thoroughly mainstream instruments can achieve.

The next stage in experimenting with new instruments could see the use of genuine money printing. Some are already floating the idea of taking banks out of the equation when distributing credit, instead stimulating demand by having central banks create liquidity and distribute it directly to consumers, whether electronically or by directly distributing banknotes. This would ensure that their policy actually stimulates the economy rather than the financial markets!