Commentary: Evaluating Monetary Policy Operational Frameworks

Jean-Pierre Danthine

I. A Paper with Two Faces

This is a very interesting, complete and timely update on monetary policy frameworks. It touches on many issues which I cannot do justice to in the allotted space. I will be selective in my discussion. The first reading of the paper presented to me the image of Janus, the Greek god of gates and doors, characterized by his two faces, one that looks behind, the other one that looks ahead. Like Janus, the present paper has two very distinctive faces. The first one is the expected discourse on classical "back office" concerns of central banking. It is the looking behind face since it is mostly pre-crisis and in fact the description of the pre-crisis consensus is fully concentrated on these issues. The second face draws the lessons from the crisis and not surprisingly, it is dominated by the lender of last resort (LOLR) elements of the operational framework (OF) and their financial stability implications (but it also discusses the optimal size of the central bank's balance sheet). The parallelism with the similar re-emphasizing of financial stability concerns that took place on the front office side of a central bank's operations is interesting, if not surprising. The looking behind face focuses on the control of the operational target (Section IV). It is precise and technical—as one would expect from one of the leading specialists in the field—and it gets to specific conclusions

(notably summarized in conclusions 4 to 11 of Section VII). The forward looking face, on the other hand, is almost fully open-ended; it organizes the questioning on these issues without proposing specific answers. The reason for this is that it is very much encumbered by unresolved front office issues. Here the preliminary warning of the author that "the aim of deriving universal principles for OF design is regularly confronted with limits relating to fundamentally different philosophies of central banks" fully applies.

The distinction between the two faces is not made as clear-cut as I am making it. In my view it would gain in being more so. An example of the ambiguity that results is that some of the early discussion around the guiding principles of OF design clearly applies to the first face of Janus but not the second. E.g., one may claim that the specifics of the mechanism for controlling the overnight rate have a "relative" character, i.e., the optimal OF is not universal but depends on circumstances. One may even argue for irrelevance—"OF design does not really matter." It is hard, however, to imagine anyone making such claims for those OF elements related to the LOLR.

I will not say much about the classical OF design part (Section IV). First, because I am far from being an expert. More interestingly, because as a post-2010 central banker, I have not been confronted with any of these issues. There is simply no overlap between the questions we asked ourselves during my tenure at the Swiss National Bank (SNB) and the issues raised in Section IV. The main reason is, of course, that there was so much else to worry about. But this is also a reflection of the fact that there was no sense of discomfort about the pre-crisis performance of SNB's OF or that no significant gaps had been identified that should have led us to give any priority to a rethinking of our OF. This is so despite the fact that the SNB OF deviates in significant ways from what is described in the paper as the pre-crisis consensus and from some of the prescriptive conclusions—notably the Swiss OF makes use of minimal reserve requirements and builds on the three-month Libor instead of an ON rate as the operational target. This could be interpreted as supporting, if not the irrelevance claim, at least the relativist view: the best OF really depends on the environment. In the meantime, of course a key element

of the Swiss OF design is ready for questioning. It is not because of a fundamental dissatisfaction with the set-up, but because one of the key element, the three-month LIBOR, has been shown to be deficient and has a doubtful future. Some rethinking may indeed be needed and the discussion in Section IV of the paper will no doubt prove very useful in this instance.

II. Balance Sheet Size—A Swiss View

As one of the nonclassical topics inspired by post-crisis central bank activity, Ulrich Bindseil takes up the issue of the size of the central banks' balance sheet and he advocates a return to a lean balance sheet as this would "suggest that the central bank focuses on the core of its mandate." Greenwood, Hanson and Stein (2016) take another view guided by financial stability concerns. Worth noticing from a Swiss perspective is the fact that this discussion can be dissociated to such an extent from the question of the appropriate stance of monetary policy. The SNB has a very large balance sheet as a result of its foreign exchange interventions over the last eight years, interventions aiming at keeping the Swiss franc appreciation within limits bearable to the real economy. This is a case where returning to the status quo ante requires not only putting an end to the expansionary policies that cause the balance sheet expansion but actually reverting them. That is, the classical question on the stance of monetary policy and the optimal mix of the two determinants of monetary conditions in a small open economy—the interest rate and the exchange rate—will remain by far the dominant considerations. And there is no guarantee that future economic conditions will permit adopting a monetary strategy consistent with a significant decrease of the SNB's balance sheet, at least in the near or medium term, even if this was unanimously desired.

The question raised in the second part of this section is all the more relevant: what to do with the "not policy constrained" part of central bank assets? This is a good concept and a good question. Bindseil suggests a central bank is justified to hold long duration and low liquidity assets, thus contributing to the maturity and liquidity transformation services provided by the financial system. While I agree in principle, I would like to point out that the term spreads

and the liquidity premia will add not only to the average size of the profit transfers to society—a point made by Bindseil—but also to their volatility. How much volatility in these transfers, and in the valuation of the central bank balance sheet, the public is willing to swallow is very much in question in a transparent democratic context (like the Swiss). As with an increasing number of issues related to central bank policies, there is here an important question of democratic acceptance, with potential implications for the discussion on central bank independence. This is because an independent technocratic institution is not ideally placed to decide on behalf of society how much risk the latter should be ready to assume.

III. Financial Stability

One could take the stand that getting into financial stability issues unduly expands the notion of the OF. But Bindseil argues that one of the lessons of the crisis is that we need to have OFs "supporting the ability to address possible future crises forcefully and quickly" while, simultaneously, OF design must be such as to "avoid contributing to the build-up of future financial crises." I fully agree with this view and with the two dimensions—ex post and ex ante—of the brief.

The fact that the brief has to be spelled in two parts clearly hints at the central concern, which is moral hazard. Tackling this critical issue from the perspective of the OF is illuminating. The crux of the matter is that it is nearly impossible—certainly so under the rule of honesty proposed by the author as a guiding principle—to separate, on the one hand, the OF design and the degree of technical preparedness it implies with, on the other hand, the message sent on the readiness and willingness to help banks with liquidity problems. That is, the doctrine of constructive ambiguity and the honesty principle of OF design enter very much in conflict. This section of the paper shows that there are many issues, delicate trade-offs and loose concepts to address them, such as "being harsh ex ante but soft ex post" and taking a position of "tough regulation and liberal LOLR." Rather than relying on such loose concepts, the paper hints that "if central banks are worried about moral hazard, they could adjust the pricing of their LOLR services." And it proposes a step in that direction by promoting the advantages of an over-proportional framework. But this is a

very timid step. It helps eliminating an excessive degree of "regular" reliance on central bank credit. In my view, a more systematic pricing approach is worth thinking through. As Bindseil argues, the issue is critical. The readiness of the central bank to act as LOLR affects the ability of the financial system to provide maturity and liquidity transformation services to society and concretely the intermediation spreads and the profitability of banks.

One could start with the observation that central banks can provide liquidity at zero cost if solvency is assured and that pre-pledged collateral with adequate "worst case" haircuts can insure the latter. One could then think of integrating into OFs facilities where commercial banks would insure themselves access to central bank liquidity at a price, which could take the form of pre-committing collateral. Interestingly the liquidity-shortage financing facility known as EFF (Engpassfinanzierungsfazilität) of the SNB is an already effective tool that functions under this principle. The prerequisites for using such facility are the granting of a limit by the SNB and the provision of collateral that must be deposited at all times. The limit determines the maximum amount of liquidity that a counterparty may obtain. Today this facility is modest in size but, forgetting all pretense of ambiguity, it could be expanded in terms of volume, type of acceptable collateral and haircuts (today it is limited to collateral eligible for SNB repos and the haircut takes the form of a 110 percent coverage of the accepted limit). Going all the way and imposing that all liquidity and maturity transformation services are offered under such an insurance scheme, one obtains King's "Pawnbroker for all Seasons" (2016). One may question whether this would be unduly expensive and whether one could do with less than full insurance. But the goal should be to get to a situation where the amount of maturity transformation would be the result of the decisions of private bankers informed by correct prices, with the associated risks being appropriately insured and any contribution by the taxpayer excluded.

IV. A Modest OF Design Add-On to Push the Effective Lower Bound

To conclude, let me come back to one of the lessons of the crisis drawn by the author but to which he does not return later in the

paper. Reviewing the recent experience with negative rates and the prospect of their prevalence in the future, Bindseil argues: "the question arises whether in the context of the OF design, the ability to go slightly negative can be supported." Since no answer to this question is provided in the paper, let me suggest one drawn from the Swiss experience (for an elaboration, see Danthine 2016). I start from the observation that commercial banks have universally been very reluctant to pass on negative rates to their retail clients. This reluctance can be understood as the result of two facts. First, retail clients have been forever the prime source of low-cost funding for banks and thus key to the profitability of their maturity transformation operations. Second and importantly, negative interest rates are very unpopular. They are counterintuitive for the man in the street and generally seen as a measure of financial repression. In this context, bankers are understandably fearful that imposing negative rates at the retail levels will lead to the permanent loss of their prized retail clientele. And it is a fact that retail depositors have not been affected by this monetary policy measure (except in the form of higher banking fees) in any of the five economic areas with negative policy rates. With this configuration, paper currency hoarding by the general population is not a threat and preventing hoarding at the wholesale level should be enough to permit a significant lowering of the effective lower bound (ELB). To achieve that outcome, a modest design add-on should do: the ability to impose a fee on paper currency withdrawal at the wholesale level. The fee structure should be independent of handling costs so that it can be tailored to the depth of negative rates and the anticipated duration of such a regime. It would be exclusively preventive with the goal of making paper currency hoarding unprofitable (thus the fee would never be levied). It is true that, the lower the rate, the larger the pressure on the profitability of the banking system given the fact that market rates *are* affected by the policy measure. To a large extent this pressure can be alleviated by an OF innovation mentioned by Bindseil, the excess reserves tiering systems, by which the bulk of excess reserves is exempted from the application of negative rates. The Swiss experience is conclusive on this score: bank profitability has been maintained in 2015 (it has actually improved) despite the introduction of negative rates in mid-January. This is not

to say that the current environment is not challenging for banks (or for that matter other financial institutions such as pension funds and wealth managers) but this has more to do with low rates on all assets than with negative rates on cash per se. This "minimal" way of lowering the ELB has one big advantage: with the retail depositors not affected by the negative rates, public acceptance of the policy stands a much better chance (even if it is not straightforward). It also has its drawback, in particular, it will not be effective if the objective of the policy is to provide a "classical" monetary stimulus in a bank dominated financial system. In Switzerland, bank lending rates have been only marginally affected by the negative rate policy and mortgage rates have actually increased after the introduction of negative rates. For a small open economy in search of an appropriate interest rate differential to moderate the strength of its currency, however, the exclusive transmission of negative rates to market instruments is sufficient and such a way of lowering the ELB would be of great help.

References

Danthine, J.P. 2016. "The Interest Rate Unbound," Hutchins Center WP19, *http://www.brookings.edu/research/papers/2016/06/22-the-interest-rate-unbound.*

Greenwood, R., S. Hanson and J.C. Stein. 2016. "Central Bank Balance Sheets and Financial Stability," in *Designing Resilient Monetary Policy Frameworks for the Future*, Federal Reserve Bank of Kansas City, Jackson Hole Economic Policy Symposium, Aug. 25-27.

King M. 2016. *The End of Alchemy, Money, Banking and the Future of the Global Economy*, W.W. Norton & Co., New York-London.