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Central Bank Governance in the New International Financial Architecture:

What have we learned so far?

by

Jean-Pierre Roth

Chairman of the Governing Board

Swiss National Bank

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It is a great pleasure and a great honour for me to participate in this conference on the occasion of the 50th anniversary of Bank Negara Malaysia. Down the years, Bank Negara has established itself as a modern central bank, respected by the markets and a guardian of stability. The Swiss National Bank extends its best wishes for the next fifty years.

The events of the last eighteen months have called many principles into question for all the central banks. Who could have imagined in 2007 that central banks would be obliged to inject so much cash into the economy? Or acquire securities which had until then been ineligible? Or remove risks from the banks' balance sheets and add them to their own?

What lessons can we learn from these events in terms of good central bank practice?

1. The central banks' dual mandate must be clear

Whereas until now it was believed that a central bank should intervene as a lender of last resort only to assist a specific institution, the crisis has shown that support for financial stability could assume a global dimension. It is no longer a case of saving a bank but of safeguarding the functioning of the markets. Moreover, as the financial crisis has brought a troubled credit market in its wake, making credit harder to come by and also more expensive, monetary policy has had to be reoriented in order to protect the real economy from the effects of the financial market crisis. Since 2004, the Swiss National Bank has had the dual mandate of preserving price stability and, insofar as possible, contributing to financial stability. It is on this basis that it has been able to take measures aimed at maintaining the country's monetary stability as well as measures aimed at consolidating the banking system. The fact that it has not been necessary to consult parliament in advance has simplified the procedures.

Lesson learnt: Monetary policy and policies aimed at preserving financial stability are policies which are both interlinked and holistic. These two mandates should be clearly specified in the central bank's articles of association.

2. Defining central banks' operating scope as broadly as possible

The financial crisis has had a multitude of effects: strangling the interbank market, making good quality collateral a rarity, increasing spreads, disrupting the balanced distribution of liquidity, and generally increasing the volume of cash in circulation. In order to counter these various problems, the central banks have had to deploy new instruments or modify the conditions of the instruments used until now. The SNB has started to grant loans in dollars, to have the ECB distribute Swiss francs, to inject liquidity by means of swaps in exchange for foreign currency and to extend payment periods for its repos. It has taken over a significant portfolio of UBS's illiquid assets. The SNB was able to decide on all these measures without needing to resort to new laws, which has considerably speeded up its actions.

Lesson learnt: Give the central bank the legal framework that ensures it the broadest possible operational room for manoeuvre.

3. A major financial crisis is necessarily global

Due to the interconnection of markets and the presence of global financial players, a national financial crisis is likely to spread abroad rapidly. Exemplary in this regard was the fact that regional banks in Europe were affected by the American sub-prime crisis or the fact that all international banks were confronted by the same problems of investment in illiquid assets. The response to these global problems was global too: the central banks coordinated their actions to ensure that they would be as effective as possible. The SNB thus distributed dollars in Europe on behalf of the Fed and the ECB conducted Swiss franc auctions on behalf of the SNB. Numerous other monetary policy decisions have been coordinated to strengthen their impact on the markets. This cooperation would not have been possible if the central banks had had to consult with their governments before being able to make their decisions.

Lesson learnt: The independence of action of a central bank is even more precious in the event of a crisis.

4. The central bank must have significant resources available to it

The way the crisis has played out has sprung a number of surprises on us: an American real estate problem has been transformed into an international financial crisis; banking institutions have been affected to various degrees and in various forms; markets have simply ceased to function under the influence of the contagion. The central banks have had to intervene rapidly and in an ad hoc manner to support institutions in difficulty. In Switzerland, the SNB has initiated a large-scale operation to consolidate the UBS situation. This operation has led it to absorb assets into its balance sheet at considerable risk. It could not have done this if it did not have its own reserves. The Swiss Constitution permits the SNB to retain a proportion of its profits. Thanks to this accumulated capital, which represented 50% of its balance sheet total at the end of 2007, it was able to act rapidly to defend the country's financial stability.

Lesson learnt: Enable the central bank to have its own reserves so that it can take risks if necessary.

Four principles of governance taught to us by the financial crisis

1. The central bank's mandate must extend to monetary and financial stability.
2. The central bank must have free access to the widest possible range of instruments.
3. The central bank must be able to act rapidly and independently.
4. The central bank must have reserves enabling it to take risks.