

The Crisis Management of Central Banks

No. 29 September 2015

By Dennis Flück

The Global Financial Crisis and its impacts on financial markets have presented major challenges to the crisis management of central banks. Ever since the collapse of Lehman Brothers, it became obvious that only comprehensive crisis management can prevent global economic devastation. The concerted efforts of politicians and economic players were required in order to ensure the smooth and orderly functioning of global financial markets and to advance economic recovery. At the onset of the financial crisis, all central banks lowered their key interest rates significantly, eventually reaching the zero lower bound. However, the intensification of the Global Financial Crisis and the ongoing European debt crisis revealed that standard-monetary policy measures were no longer sufficient to effectively counter the financial crisis. As a result, central banks, including the European Central Bank (ECB) have been very creative in adopting new, unconventional monetary policy measures in order to prevent the global economy from drifting into deflation and depression.

Since Japan has struggled with stagnating economic growth and deflation for more than two decades, the Bank of Japan (BoJ) became a pioneer in the adoption of unconventional monetary policy. The BoJ was the first central bank “to set sail in stormy seas without a chart”.¹ In the wake of the financial crisis, the central banks provided funds to a wider range of counterparties and against a much wider range of eligible collateral, expanded the maturities of their operations and agreed on swap arrangements to safeguard liquidity provision in each jurisdiction.

At the beginning of the Global Financial Crisis, the ECB limited its monetary policy measures to the private and banking sector, whereas the Fed’s measures were concentrated on purchasing private-sector bonds. The Bank of England’s (BoE) measures were focused on purchasing public-sector bonds. In contrast, the Swiss National Bank’s (SNB) unconventional monetary policy was coined by strong interventions in the foreign exchange market in order to keep the Swiss franc at an acceptable value.

Following the emergence of the European debt crisis between 2009 and 2011, the ECB started undertaking a number of non-standard monetary policy measures including covered bond purchasing programs and a program of unlimited public-sector bond-buying. Nonetheless, the ECB was the only central bank which did not undertake direct bailouts of financial institutions. However, emergency liquidity assistance (ELA) was provided by the national central banks (NCBs). As a result, any cost of, and the risks resulting from, the provision of ELA lies with the NCBs.² In comparison to the ECB, all other central banks initiated comprehensive rescue packages to recapitalize financial institutions. Apart from adopting unconventional monetary policy measures, the financial crisis has caused major changes to the central banks’ roles in banking supervision. Recently, the authority for banking supervision in the euro area has been shifted to the supranational level. Entrusted with new and exclusive powers, the ECB’s role in the governance of the Eurozone and the nature of the Bank itself have changed remarkably. The ECB now supervises 123 significant banks and plays

a crucial role in the resolution of failing banks through the Single Resolution Mechanism.³ In comparison to the ECB, the SNB and the BoJ have only a complementary role in banking supervision, whereas the Fed shares its supervisory powers with many different supervisory authorities.

The aggravation of the financial crisis has also affected the central banks' degree of independence. The Fed, the BoE and the BoJ were strongly influenced by their governments in their decision-making and could not conduct monetary policy independently from fiscal policy. Due to political pressure from their governments, the central banks were required to adopt comprehensive stabilization measures which were backed by the Treasury. As far as the ECB is concerned, it can be stated that the Bank became more political in the course of the financial crisis, especially with regard to the Greek crisis. At the latest, from the point where the ECB announced it would do "whatever it takes" to preserve the euro as common currency, it should be questioned if the central bank still has the same degree of independence as it had before the crisis. The ECB can be criticized for its purchase of government bonds from Member States that are facing severe financial difficulties because it helps to finance government debt and reduces the governments' incentives to undertake budget reforms. A reason for the ECB's politicization may consist in the fact that it is the only EU institution which can make decisions unilaterally and eventually act rapidly and determinedly.⁴

In conclusion, the intensification of the financial crisis has forced central banks around the world

to adopt unconventional, widely criticized monetary policy measures under qualitative and quantitative easing. Major changes in monetary policy and an increasing role in banking supervision, sometimes at the expense of central bank independence, were necessary to prevent deflation and depression. The European debt crisis has still not been overcome and it remains to be seen to which extent further innovative measures and institutional changes need to be undertaken to free Europe from the fetters of deflation and depression.

Dennis Flück is a ZEI Fellow "Class of 2015"

References:

1. Takahashi, W. (2013). *Japanese Monetary Policy: Experience from the Lost Decades*, *International Journal of Business*, 18(4): 287-306, p303 Osaka 2013, in: <http://www.craig.csufresno.edu/IJB/Volumes/Volume%2018/V184-1.pdf>
2. Alessi C., McBride, J. (2015). *The Role of the European Central Bank*, *Council on Foreign Relations, Washington 2015*, in: <http://www.cfr.org/europe/role-european-central-bank/p28989>
3. De Rynck, S. (2014). *Changing Banking Supervision in the Eurozone: the ECB as a Policy Entrepreneur*, *Bruges Political Research Papers, No 38, College of Europe, European Political and Administrative Studies, Bruges 2014*, in: http://www.euractiv.sk/fileadmin/user_upload/wp38_derynck.pdf
4. *European Union Center of North Carolina. The Politicization of the European Central Bank*, *EU Briefings, European Center of the University of North Carolina, Chapel Hill 2013*, in: <http://europe.unc.edu/wp-content/uploads/2013/12/Brief1312-ecb.pdf>

ZEI Insights are part of the Research Project - Governance and Regulation in the EU: [The Future of Europe](#)

ZEI Insights provide commentary and critical analysis on governance and regulation issues related to the future of the European Union. Authors are responsible for their own views.