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Central Banks Are Never "Out of Ammunition"

Timothy B. Lee | May 31, 2012

Evan Soltas tells the tale of an effort by the Swiss central bank (SNB) to prevent the Swiss franc from becoming more valuable against the euro. As the future of the euro—and with it, the EU economy—has been looking increasingly dire, many people had been trading in their euros for Swiss francs, which have a reputation as a particularly stable currency. This has caused the franc to appreciate rapidly, which the Swiss central bank worried would harm the competitiveness of Swiss exports and push Switzerland into a recession.

Soltas tells what happened next:

> The SNB made a bold surprise promise: we will not let the swiss franc appreciate any more; we will hold the exchange rate at 1.2 CHF to 1 euro. And, in short, it worked. The appreciation of the swiss franc came to an immediate halt. The CHF-EUR exchange rate stabilized at 1.2. Even during this current turmoil in the Eurozone — which one might think would lead the currency to appreciate as capital flowed into Switzerland's financial safe haven assets — the Swiss central bank has kept the exchange rate steady, fulfilling its promise.
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> Switzerland has the ability to stabilize its currency from upward pressure because its monetary policy tool is unlimited — it could always print out more swiss franc to satisfy market demand. This is, in other words, the opposite of trying to prop up a currency, which strains the foreign currency reserves of the central bank. The result is that the Swiss intervention is entirely credible.

So far this is obvious: an institution with the ability to create an infinite number of Swiss francs can always reduce the value of Swiss francs if it wants to. But the more subtle lesson of the episode is what happened next:

> The SNB has stopped having to buy up foreign currencies with new swiss franc, which it did in earnest to prove its commitment in 2011, increasing its foreign exchange reserves by 177 billion from July to September. It hasn't had to defend at all the value of its currency against appreciation since September, despite what should be enormous pressures.

As long as there was uncertainty about the long-term value of the Swiss franc, speculators who thought the currency undervalued had an incentive to buy francs in order to profit from the appreciation, pushing the price up in the process. But once speculators became convinced that the SNB would prevent the franc from appreciating, there was no longer any opportunity for speculation, so speculation stopped. The SNB's credible commitment to prevent the franc's appreciation prevented the franc from appreciating*without the SNB actually doing anything*.
In contrast, if the Swiss bank *hadn't* publicly announced its target, speculation would have continued for much longer and the SNB would have had to continue intervening. In other words, the public announcement of the target is the most important step for hitting the target.

The same point applies to the Federal Reserve. We tend to say that the Fed "sets interest rates," but what it really does is announce a rate target and then buy or sell assets until the interest rate hits the Fed's desired target. And in practice, the Fed doesn't actually have to do much buying or selling, because as soon as the Fed announces a new target, the market immediately starts moving toward the new target. (Why borrow at 2 percent if the Fed just announced it was going to push rates down to 1.5 percent?)

In monetary policy debates, it's common to hear people claim that the Fed is "out of ammunition," meaning that with interest rates already close to zero, there's no room for further monetary easing. But this confuses the Fed's mechanism (buying assets with printed money) with its target (interest rates).

Obviously, if the Fed targets interest rates, then 0 percent is a lower bound. But the Fed doesn't have to target interest rates. For example, the Fed could publicly announce that its new target was a 20 percent

inflation rate, and that it would print as much money as it took to hit this target. If the Fed did that, and the market believed the announcement, prices would start rising even before the Fed printed its first new dollar. The Fed might still need to print some money, but much less than would be required if it tried to raise the inflation rate *without* announcing an explicit target.

To be clear, I'm not saying that a 20 percent interest rate is a good idea. But the point is that what the Fed *says* can be more important than what it does. When a central bank sets a clear and credible target, markets do most of the central bank's work for it, reducing the need for actual intervention. On the other hand, if the Fed fails to announce a clear and credible target, then the Fed will have to do a lot of work to achieve whatever unannounced policy goals it might have.

As I've written before, I agree with Scott Sumner and Bill Niskanen that the Fed ought to set a nominal-income-based target. In his 2008 chapter in the Cato Handbook on Policy, Niskanen noted that the Fed's policy between 1983 and 2007 effectively stabilized the growth rate of nominal incomes at around 5.5 percent per year. But the fact that the Fed failed to announce nominal income growth as its official target (focusing instead on interest and inflation rates) made it more difficult for the Fed to keep the economy on this pathduring the financial crisis. If the Fed had a standing, credible commitment to keeping nominal incomes growing at 5.5 percent in 2008-2010, speculators would have effectively helped the Fed achieve its goal by buying up assets before they fell too far, in expectation that future Fed intervention would cause those asset values to rise again. And that would have saved the Fed from actually needing to intervene very much to offset the economic contraction. Market forces would have helped the target become a self-fulfilling prophesy.