Highlights

Central Banking after the Crisis: Responsibilities, Strategies, Instruments – Summary of the 38th Economics Conference

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Central banks throughout the world have been playing a pivotal role in combating the economic and financial crisis over the past three years. The crisis has significantly and permanently transformed our understanding of both the importance and responsibilities of central banks and the strategies and instruments they employ. The OeNB's 38th Economics Conference of May 31 and June 1, 2010, explored "Central Banking after the Crisis: Responsibilities, Strategies, Instruments," bringing together distinguished national and international experts as well as practitioners from the world of politics, business, finance and academia to draw some policy lessons for central banks from the crisis.

Conference Teeming with Austria's Top Economic Policymakers

In his opening statement, *OeNB Governor Ewald Nowotny* stressed central banks' enormous responsibility – and challenge – in pursuing a monetary policy geared toward safeguarding both price stability and financial stability. In the new regulatory architecture currently in the making at the European and international levels, central banks are going to assume a decisive role. For central banks, their reputation and thus the foundation of their independence are at stake. Central bank independence has been instrumental for the Eurosystem's success in keeping inflation low and stable since the introduction of the euro 11 years ago. Central bank independence is likewise indispensible for preserving financial stability, especially for the financial system as a whole. Referring to the debate about Eurosystem interventions on the government bond market, Nowotny highlighted that the Eurosystem ensures that temporary volatility and waves of speculation in financial markets do not derail the fiscal consolidation efforts in the euro area. However, it is the governments that have to ensure that their public finances become sustainable again in the long run. The clear assignment of economic policy tasks at the EU level is to be preserved: The Eurosystem's primary objective is to maintain price stability. In the current context of uncertainty, shoring up confidence in the long-run stability of the euro is the best contribution the ECB can make to stabilizing the economy and to supporting economic growth and sustainable public finances. The Eurosystem will continue to adhere to its stability-oriented policy.

Austria's *Federal Chancellor Werner Faymann* talked about the challenges emerging in the aftermath of the crisis. The crisis has shattered our faith in the infallibility of both the markets and the state; in fact, it will be necessary to strike a wise balance between market and government to master the challenges of financial market regulation, socially fair fiscal consolidation, and a new growth and employment strategy. A tighter and better regulation of financial markets is required to preserve public acceptance of the economic and financial system. Serious investors prefer regulated financial markets. More

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specifically, Faymann called for a bank tax and a financial transaction tax, the establishment of an EU rating agency, stronger financial market regulatory and supervisory authorities, tighter rules on securities trading and the prohibition of speculation, legal limits for management salaries, a stricter supervision of hedge funds, improved consumer protection with regard to financial products, and legislation on bank insolvencies. The necessary fiscal consolidation must be carried out in a socially fair manner to preserve purchasing power. Especially in the crisis, it is important to maintain the welfare state. To this end, a growth strategy needs to be put in place that focuses on research, education and training, with cutting-edge climate protection programs holding the promise of providing competitive advantages. The Chancellor explicitly discouraged wage dumping, cuts in social benefits, and tax advantages for large enterprises. Finally, he called for a coordinated European approach in the upcoming budget consolidation efforts to prevent a relapse into recession.

During the Kamingespräch, Austrian *Vice Chancellor and Federal Minister of Finance Josef Pröll* explained his view of current economic and fiscal policies, pointing out that the crisis had highlighted that economic policymaking suffered from a credibility problem. Sound public finances are the best protection against speculation. Moreover, a single currency requires enhanced economic policy coordination. The current problems within the EU primarily stem from unsustainable public finances, Pröll explained, adding that the lack of budgetary discipline of some EU Member States entailed negative contagion effects for other countries. He therefore called for a strengthening of the preventive arm of the Stability and Growth Pact (multi-year budget plans, more rights and more effective control mechanisms for Eurostat) and of its corrective arm (sanctions should take effect earlier on and should indeed be implemented). Although Austria's budgetary situation is less dramatic than that of other countries, determined fiscal consolidation will be inevitable. The Federal Budgetary Framework Act has clearly mapped out the consolidation path to be followed until 2014. Furthermore, the European financial stabilization mechanism should only be used as a measure of last resort. Strict conditionality and adequate financing conditions are to ensure that beneficiaries of the mechanism return to market financing as quickly as possible. Any new financial market rules must be appropriate and reasonable such as not to generate overregulation, which in turn might cause a credit crunch. A financial transaction tax would only make sense if it was internationally coordinated – otherwise, negative implications for Austria as a financial center would be inevitable. Finally, Pröll expressed his support of an independent central bank with clearly defined tasks.

Financial Crisis Management and Central Bank Independence

Session 1 of the conference dealt with the question of whether and how the role of central banks as financial crisis managers is compatible with their independence and what kind of interaction might occur between the two spheres.

For a start, *ECB President Jean-Claude Trichet* explained that the Eurosystem had responded with three types of measures to the financial and economic crisis, namely with massive key interest rate cuts, measures of enhanced credit support and its Securities Markets Programme (SMP). This measure aims to address the severe problems in the markets for European government bonds, which had also spilled over to other markets, and thus to improve monetary policy transmission. The SMP should not be confused with quantitative easing; the purchases are sterilized immediately by liquidity-absorbing operations so that the monetary policy stance remains unchanged. The Eurosystem decided on this measure in complete independence and on the basis of its legal mandate to maintain price stability. Securities purchases under the SMP are made on the secondary market and strictly aim to correct market malfunctioning. The prohibition of direct monetary financing has thus not been violated. Moreover, the market interventions are subject to the requirement that the governments concerned strictly fulfill the budget consolidation plans agreed upon; thus, the interventions strengthen budgetary discipline. Trichet finished by calling on euro area governments to reach agreement on a quantum leap regarding the effectiveness of their peer surveillance to ensure sound public finances.

Economic historian *Michael Bordo (Rutgers University)* explored the interplay between financial and economic crises on the one hand and central bank independence on the other. Using the Bank of England and the Federal Reserve System (Fed) as examples, he showed that central banks slowly developed into lenders of last resort in the course of history, prompted by financial crises and their negative consequences. He showed that again and again, wars prompted direct monetary financing and the loss of central bank independence. Severe monetary policy errors often resulted in lesser central bank independence, and regaining full independence required long struggle. Characterized by the belief in the Phillips curve, the 1960s and 1970s were a time of very low central bank independence. By contrast, the successful anti-inflationary policy of the 1980s as well as the "Great Moderation" period from the mid-1980s to mid-2010 supported central bank independence. The current economic and financial crisis constitutes a considerable threat to central bank independence because the Fed and other central banks have assumed numerous government and fiscal policy functions (credit policy, bailout of non-bank financial institutions, quantitative easing) and (have to) cooperate more closely with the government. Central banks' balance sheets balloon with a number of significantly riskier positions which threaten their financial independence and thus put the credibility of their stability-oriented monetary policy at risk.

During the subsequent panel, chaired by *Ernest Gnan (OeNB), Martin Čihák (IMF)* and *Petra Geraats (University of Cambridge)* explored whether the goals of monetary and financial stability are complementary or might sometimes be contradictory.

Petra Geraats first recalled that while a monetary policy geared toward price stability requires financial stability (i.e. a functioning transmission mechanism), price stability does not automatically ensure financial stability. Recent scientific papers even argue that the high degree of macroeconomic stability that prevailed over the last two decades may have contributed to increasing both financial agents' risk appetite and financial imbalances. Depending on the respective economic shock, it may take more than the central bank's traditional instrument – interest rate policies – to be able to pursue the double objective of price and financial stability; it might also take liquidity policy measures, countercyclical capital requirements or leverage restrictions. At the same time, the separation of monetary and macroprudential policies has its limits, as both share the same tools and appear to have a common cause. By way of illustration, Geraats pointed to the largely parallel development of monetary aggregates and HICP inflation as well as of credit growth and stock prices in the euro area over the last two to three decades. Since both objectives are seen as central bank tasks and central banks are equipped with the sufficient number of tools to systematically pursue them, information synergies can be utilized to achieve both objectives at the same time.

Before the crisis, *Martin Čihák* argued, the dominant view was that when central banks have just one instrument at their disposal (key interest rates), they can pursue only one goal (price stability). Hence the focus on inflation targeting. Financial stability responsibilities were generally considered a source of conflict for monetary policy as well as a risk to central banks' credibility and independence; often, avoiding the concentration of too much power with the central bank was an issue. Only a few central banks had been given the explicit legal mandate to maintain financial stability; in most cases, however, a certain responsibility derived indirectly via other tasks. The crisis raised a number of questions about (narrow) (CPI) inflation targeting. Did this approach neglect credit and asset price developments? And did it neglect synergies with financial stability tasks and deflect due attention from systemic risks? Čihák went on to list a number of reasons why the price and financial stability mandates might be compatible after all in practice. First, credit developments are in any case relevant for monetary policy – supervisory activities also improve the quality of the information monetary policy is based on. Second, their function as lenders of last resort and crisis managers already entails considerable reputational risks for central banks; for this very reason, they would be particularly predisposed to supervising financial stability, given their natural interest in maintaining their reputation. Third, regarding their independence, central banks have always been concerned with financial stability; a formal responsibility would facilitate clearer democratic accountability (which would, however, be limited by the fact that a quantitative definition of financial stability is hardly possible). Fourth, the disadvantage of a concentration of too much power with the central bank would be offset by the advantage of the resulting automatic coordination of monetary and financial stability policies. Over the last 15 years, almost 60 central banks worldwide began to publish financial stability reports; Čihák considered these reports basically useful, pointing out, however, that the transformation of their respective findings into concrete policy action still leaves room for improvement. Also, the reports did not always anticipate crises. Finally, Čihák presented empirical results which showed that increased central bank independence improves the quality of supervision and of financial stability reports and reduces the probability of financial crises. All told, strengthening the central banks' role in the field of financial stability would use synergies and improve supervisory quality; however, such a move would have to be supplemented by adequate measures to ensure transparency and accountability. Moreover, it will be necessary to determine who should bear the ultimate costs incurred by resolving financial crises. Last but not least, the new tasks increase the demands on central bank governance and resources.

Financial Crises, Monetary Policy Strategies and Instruments

OeNB Vice Governor Wolfgang Duchatczek chaired the second session, during which *Stefan Gerlach (University of Frankfurt)* presented his views on the question of whether, and how, central banking will change after the crisis. Before the crisis, improvements in the monetary policy process, a clear focus on price stability, increased transparency and professionalized decision-making procedures and forecasting techniques created the (maybe illusory) impression that monetary policy contributed significantly to the sound macroeconomic performance during the Great Moderation period. For a long time it was overlooked, however, that more stable economic developments and declining risk premia encouraged financial agents to take on greater risks. Should monetary policy strategies and tools be adjusted against this background? Gerlach was skeptical about Blanchard's suggestion to raise the inflation target, particularly because such a move would lead to a loss of credibility. Gerlach expected decision-making on the monetary policy stance to benefit from the inclusion of financial market activities – and the respective forecasts –in the monetary policy evaluation process. However, raising interest rates in response to increasing or increasingly volatile credit and stock prices, in particular over and beyond what they imply for inflation prospects, did not appear to be a very promising measure, since the real economic costs of mitigating bubbles via interest rate policy are very high. Instead, macroprudential regulatory systems should aim at containing the build-up of financial imbalances, if they are not able to prevent them in the first place. Regulatory elements such as procyclical capital requirements and leverage ratios should be applied to all large financial institutions whose operations are based largely on maturity transformation. The respective regulations must be transparent to promote efficiency and must be implemented in coordination with the monetary authorities (establishment of a Macroprudential Policy Committee, analogous to the Monetary Policy Committee). All in all, the environment for monetary policy action will be more difficult after the crisis. Despite the statutory independence of central banks, the implementation of monetary policy will face increased fiscal policy pressure. In view of the strong rise in government debt ratios, the debt dynamics created by interest rate increases should not be underestimated, as they will generate political pressure.

How Much Risk Can a Central Bank Assume?

In the subsequent panel, *Anne C. Sibert (Birkbeck College, University of London)* and *Wolfgang Münchau (Financial Times)* discussed the possibly higher risks nonconventional monetary policy measures might entail for the balance sheets and the profitability of central banks.

Anne C. Sibert raised the question whether the nonconventional crisis measures implemented by the ECB had been legitimate. In particular, she criticized that the ECB's communication on the purchasing procedures for mortgage-backed securities and, as recently announced, Greek government bonds was, if at all existent, intransparent. Information is also lacking on the valuation of these assets and on their expected long-term effects on the risk profile of the ECB's balance sheet. According to Sibert, a critical factor – with regard to legitimacy – is the fact that while the ECB's mandate for maintaining price stability is clearly defined in the EU Treaty, its role in maintaining financial stability is only vaguely described. Legitimacy may be founded on the visible success of the implemented unconventional policy measures in achieving short-term financial market stabilization during the crisis (legitimacy by competence). This, however, does not make up for the legitimacy deficit that currently exists because of a lack of accountability. More transparency and a better review of the performance of the ECB's Governing Council as a whole and of its individual members might be reached by publishing the minutes and voting results of Council meetings.

The contribution by *Wolfgang Münchau* was primarily concerned with the way fiscal policymakers dealt with the Greek debt challenge and with financial markets' speculative attacks. In his view, the primary surplus required to stabilize the debt ratio is so high that a restructuring or a reduction of government debt – while having been postponed through concerted policy action – will be difficult to avoid. It is highly problematic that it is still unclear how a possible bankruptcy of the Greek government might affect the ECB's balance sheet positions of Greek government bonds. Even if sterilized purchases of these bonds are not to be interpreted as monetizing the Greek deficit, they put the ECB's credibility in question. In the field of EU fiscal policy, Münchau considered the latest fiscal measures as being in conflict with the Maastricht Treaty and possibly also with the German constitution. The no-bailout clause in the Maastricht Treaty was circumvented. If Greece were to default, the other Member States would see their government debt ratios increase even more dramatically. A restructuring of Greek government debt at the outset of the crisis combined with a protective shield for Spain and Portugal would have been a clear signal to financial markets, showing political commitment to reestablish long-term stability. A new Stability and Growth Pact with yet another set of nonbinding rules cannot be expected to solve the structural problems.

In a short response, *Gerlach* doubted that the ECB's legitimacy deficit was indeed very large. With respect to accountability, it would have to be evaluated who would be accountable to whom. When it comes to unconventional measures, the European Parliament might not be the appropriate – or only – body the ECB should be accountable to. According to Gerlach, more transparency with respect to ECB Governing Council meetings would reduce the willingness of Council members to discuss matters openly. At the same time, he seconded the call for ex post accountability for the development of balance sheet positions. Finally, he estimated that the financial policy problems in Europe will persist over the next three years and beyond and that the restructuring of Greek debt will become visible in writedowns from ECB balance sheet positions.

Central Banking, Financial Stability and Regulation

The second conference day focused on new financial market issues raised by the crisis. In the first session, chaired by *OeNB Executive Director Andreas Ittner, Giovanni Carosio (Banca d'Italia)* and *Elena Carletti (European University Institute, Florence)* discussed the challenges created by the implementation of a new European macroprudential supervision mechanism.

Giovanni Carosio dealt with the challenges central banks currently face in supervising financial stability. The crisis clearly showed that financial stability supervision will increasingly have to shift its focus from the microprudential to the macroprudential perspective to limit systemic risk. To adequately monitor the stronger financial market interdependencies in Europe, which the crisis unmasked, a new body was established that will systematically exchange and assess information on developments relevant to supervision – the European Systemic Risk Board (ESRB). The composition of the ESRB will imply coordination between the monetary authority, which has the instruments necessary to identify and assess systemic risk, and the supervisory authority, which has the instruments necessary to implement measures. The ESRB will be accountable to the European Parliament. Its work will be based on a system of rules that determine (ex ante) how future crises are to be contained and, if they are inevitable, how they are to be resolved. Early warning signals should serve to localize and contain country-specific systemic risks. While systemic risk is defined relatively clearly, its operationalization is difficult. A number of factors, such as the procyclicality of the financial market, systemic correlation and concentration risks, characterize systemic risk; there may be new variables to be considered, such as mortgage loans, which were considered unproblematic before the crisis, but have recently caused a wave of systemic risk. Since innovation and globalization play a major role in financial market developments, it would be preferable to set up a system of rules by which supervision could flexibly adjust to financial market innovations and expansions and which also allows for resolving crises on a case-by-case basis.

Elena Carletti addressed some aspects of the crisis that have often been neglected. According to Carletti, loose monetary policy over extended periods of time, global financial imbalances and the real estate price bubble were at the root of the financial market crisis; bad incentives in the mortgage industry were but a symptom. However, more restrictive monetary policy might not have prevented the crisis, either. Risks were detected too late because supervision had not paid enough attention to systemic risk. Moreover, the trigger of the crisis was enforced by a major rise in short-term financing and by the accounting practice of marked-to-market prices. Increasing financial stability in the future will require a systemic macroprudential approach to supervision. In the future, global imbalances (i.e. lending levels that, while considered optimal at the individual level, cause negative external effects at the global level) might be contained by an IMF reform, by reserve swaps and the acceptance of new reserve currencies. A reorientation of financial market regulation should also take into consideration the interdependencies within the banking system as well as the correlations between prices and risks. In the end, the crisis has also shown that in their capacity as lenders of last resort, central banks cannot automatically guarantee efficient liquidity distribution. In addition, the credit institutions identified as systemically important (too big to fail) by the central bank are not necessarily too big to liquidate; such liquidation might involve a change in management, the rolling over of pension obligations and orderly resolution. Finally, Carletti called for a coordination of regulatory and competition policies in the financial system. There is evidence that financial institutions' equity holdings, which are kept low by the tax disadvantages for equity financing relative to debt financing, correlate with the respective competitive situation in the credit market. Coordinating regulatory and competition policies might also help contain the size of financial institutions.

How Should We Deal with Large Financial Institutions in a Crisis?

In the final panel chaired by *Peter Mooslechner (OeNB), Urs Birchler (University of Zurich)* and *Alessandro Profumo (UniCredit Group)* discussed the question of how to best deal with very large financial institutions during a crisis.

First of all, *Urs Birchler* pointed out how the relationship between banks and the state has changed over time. While up to 1900, it was the banks that acted as lenders of last resort to the state, the situation has since been reversed; today it is the state that assumes the ultimate responsibility for restructuring insolvent banks that are considered systemically important. A historical comparison illustrated the shift of risk sharing mechanisms to the state. In 1895, JP Morgan refinanced outstanding government debt to the tune of USD 65 million – a volume that was ten times JP Morgan's total assets, corresponding to 0.4% of U.S. GDP. In 2008, the Swiss government decided to refinance UBS, a major bank, with CHF 60 billion – a volume that corresponded to 4% of UBS's total assets or to 13% of Swiss GDP. Birchler considers appropriate the state refinancing and guarantee provisions implemented in many countries to curb the effects of the financial crisis on large banks. In the short run, the economic cost of states refraining from such measures would have exceeded the cost of state intervention by far. However, this consideration neglects the fact that once the state gets involved, it will remain involved. The rescue packages did not cause large financial institutions to shrink, which means that their relevance for the financial system will be even higher in future crisis situations; moreover, future government support measures will be taken for granted and the risk appetite of large banks will not be restrained. This vicious circle would only be broken in the event of sovereign default. The root of the problem is banks' size and their risk appetite (which is rational at the level of the individual institution). In the end, large banks have an interest in maximizing collateral damage to induce the state to act as lender of last resort. Solving the "too big to fail" problem would solve the banking supervision problem, too. According to Birchler, restricting banks' size by breaking them up along business lines, into branches or by implementing bank-specific liquidation rules would be an appropriate measure to reduce the costs of state interventions. Current regulatory measures aimed at preventing bank insolvencies should be complemented not only by the existing regulatory capital requirements, but also by liquidity requirements and possibilities for explicit operational and managerial interventions. In cases where insolvency is inevitable, contingent convertible (CoCo) bonds are an appropriate financing instrument to restore the solvency of the bank in question and minimize the incidence for the tax payers (in case of state participation). The (probably higher) issuing price exposes the bank in question to regulatory market discipline. Birchler named Lloyds TSB and Rabobank as examples for the successful placement of the new CoCo bonds.

Alessandro Profumo attributed the criticism leveled at large banks during the financial crisis regarding their failure to provide a justification for their existence by explaining the value added they provide to the economy. The provision of economies of scale, the creation of value-added for investors and depositors as well as the beneficial effects on risk allocation have not been sufficiently discussed. Given different business models, there is a significant difference between dealing with a large bank like UBS, which is an investment bank, and UniCredit, which has the profile of a private commercial bank. Profumo advocated designing a single European market for banking regulation and supervision – along the lines of the single economic area. He pointed to the risk that country-specific size limits for banks might have negative effects on banking services and, in the end, on the availability of credit in other countries. As an example, he mentioned the large Austrian banks, whose sizeable exposure to Eastern Europe might be considered too large for Austria if a size criterion was introduced. Another problematic issue he mentioned was the fact that governments' future budget consolidation is based on growth, i.e. also on the financial sector's growth contribution. Of the two (extreme) suggestions for crisis prevention and crisis handling, Profumo preferred the approach of coordinating regulation and supervision across the EU to having the banking system alone finance a crisis stabilization fund. He expected a strengthened and more active European supervisory body to contain the moral hazard problem, which is a critical element in any financial market activity. Regulation should prevent liquidity crises in the first place and, if they are inevitable, should provide rules for an orderly insolvency procedure combined with an adequate burden-sharing between shareholders and creditors (in particular institutional creditors). Profumo was critical about a stabilization fund that would be financed entirely by the financial sector itself, since the volume of fund capital, which would depend on the financial system-specific and macroeconomic costs of a systemic crisis, is very difficult to estimate. Moreover, such a fund would provide aid only to solvent banks subject to a change in management or other conditions. The problem of dealing with insolvent banks would again be left to the state. Finally, regarding the current focus on the regulation of equity ratios, Profumo noted that if the banking system is to remain in private hands, banks need to be able to cover the cost of equity – which currently ranges from 9.5% to 12% – in full at any time. Raising equity ratios too much might prompt private investors and creditors to withdraw their investments and might thus increase the urgency of government refinancing. According to Profumo, the financial crisis did not originate from deficient equity ratios but from mismanagement in the balance sheet structure (assets-to-liabilities ratio). Longer-term stability could only be reached by quickly reestablishing confidence in the common European project.

Presentation of the Klaus Liebscher Award

Zeno Enders (University of Bonn), Philipp Jung (University of Mannheim) and *Gernot Müller (University of Bonn)* are the winners of the sixth Klaus Liebscher Award. *OeNB Vice President Max Kothbauer* and *OeNB Governor Ewald Nowotny* commended their joint paper "Has the Euro Changed the Business Cycle?", which studies to what extent monetary union has changed the European business cycle. The authors analyze the business cycle from the perspective of the volatility of fundamental macroeconomic variables and their correlation across individual euro area countries. Their model neatly captures and reproduces the volatility of real exchange rates as it decreased during the implementation of monetary union and the unchanged correlation between macroeconomic fundamentals. Moreover, their analysis shows that the introduction of the euro has caused important changes in the European business cycle: While cross-country spillovers have increased, the effects of domestic shocks relative to those of foreign shocks have weakened.