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Opening Remarks

Ladies and gentlemen,
I would like to welcome all of you to the 41st Economics Conference of the Oesterreichische Nationalbank here in Vienna.

My warmest regards to State Secretary of Finance Andreas Schieder, and our keynote speakers, Benoît Coeuré, Member of the ECB Executive Board, and Harold James, Professor at Princeton University.

I am delighted and honored to welcome very prestigious speakers among us today, who will enrich this conference with their insightful ideas and novel research.

The OeNB's Economics Conference traditionally brings together leading policymakers, central bankers and academic economists from all over Europe, as well as representatives of civil society, the private sector, and the media. With its focus on issues that are relevant and inspiring to policymakers, academics and the general public alike, the conference offers a valuable platform for discussion that is widely appreciated.

A *Changing Role for Central Banks?* is the question addressed at this year's conference. Our aim is to discuss different perspectives on central banking – its responsibilities, goals and instruments – and to offer a forum for thoughts on how to deal with current and future challenges.

I am looking forward to the interesting and stimulating discussions that we will have on these issues over the next two days.

Let me begin with some brief remarks on the historical roots of central banks. Central banks vary in terms of their founding years, with a first wave of formal institutionalization starting in the 17th century[1] and a second wave in the 19th and early 20th century.[2] They quite often have diverse backgrounds and developments across different countries.

One common denominator for central banks is that monetary coordination emerged as a response to crisis situations and the collapse of financial mechanisms. As an example, I would like to mention the shattered financial systems across Europe in the 19th century, which were a direct consequence of the Napoleonic Wars. To control the impacts of profound hyperinflation, the Oesterreichische Nationalbank was founded in 1816 – an event we will proudly commemorate in 2016.

If we look at the history of central banking and compare the early institutions with their contemporary successors, two features stand out that have

undergone considerable changes over the decades. The first is related to the objectives central banks have been given; the second concerns the interplay between fiscal policy and central banking.

[1] *E.g. 1668 Swedish Riksbank, 1694 Bank of England.*

[2] *E.g. 1800 Banque de France, 1913 Federal Reserve System.*

As far as central bank objectives are concerned, one can observe that the responsibilities of central banks have gone through different phases of transformation. The early central banks were predominantly focused on financial stability. They helped to stabilize currencies and fund government debt, but also facilitated bank transactions, provided repositories and ultimately served as a lender of last resort.

In the postwar era following World War II central banks focused on classical macroeconomic stability, when global monetary turbulences centered on exchange rate regimes. Nowadays the momentum is redirected again toward more financial stability. The evolution of these responsibilities has been similar, though not identical, across most industrialized countries.

This brings me to the second aspect that has considerably changed: the relation between central banks and governments. During the 19th century, central banks were very closely interlinked with national governments. Only in the late 20th century did we observe a shift in emphasis toward the institutional autonomy of central banks. One can safely say that the status, reputation and self-image of central banks have considerably improved over the years. Today, central banks alongside parliaments, governments and judiciary are among the pillars of modern democratic nations.

At our conference we will discuss what kind of pillar of the democratic system a central bank *is* or *should be*. In my short introduction, I want to emphasize two relevant and interconnected issues that are relevant to this discussion:

1. The role of a central bank in the general context of economic policy, and
2. The concept of central bank independence.

In the period after the *Great Depression* of the 1930s and in the first decades after World War II, the mandate of central banks usually reflected the traumatic experiences both of high inflation and mass unemployment. This is e.g. reflected in the broader mandate of the U.S. Fed and also applied to the mandate of Austria's central bank before Austria joined EMU.

In the period following the oil price shocks and up to the *Great Recession*, the economic crisis we have been experiencing for five years now, the role of central banks seemed to be clear cut: central banks should focus on price stability, should operate mainly with one instrument – the policy rate – and should be independent in their actions. This was also the leading perspective when laying the foundation of the European Central Bank – the Maastricht Treaty in 1992. It reflected a strong position of economic theories based on a firm belief in perfectly functioning markets, and was supported by empirical evidence such as a situation of strong – or at least adequate – economic growth and at the same time full price stability. A happy historical episode that would later on become known as the *Great Moderation*.

Unfortunately, we now know that the optimism of this period had not been well founded in many respects. It was based on very specific circumstances: The low inflation rates were to a large extent caused by special globalization effects, such as rapidly rising cheap imports from Asia. In important but poorly regulated markets, financial and real estate bubbles developed. In Europe, current account disequilibria – and to a lesser extent fiscal disequilibria – were growing.

We all know what happened later. Indeed, there have been critical moments when the financial system of the advanced economies, maybe the whole world, was threatened with meltdown. In this situation central banks reacted fast and forcefully by using conventional and unconventional instruments. With regard to the financial system, a fair amount of stabilization has been achieved. But we still see major challenges for the banking sector, and – especially in Europe – we still see a struggling real economy and overstretched public finances. This is why an accommodative monetary policy stance is still needed.

One has to be aware, of course, that this kind of monetary policy, like any policy measure, may also have problematic side effects. These potential side effects have led to a number of critical reflections, especially in the German-speaking countries. In my view, central banks have to take side effects into account and have to be cautious about them. But central banks also have to have a clear view of priorities and of the potential macroeconomic costs of moving away from the present monetary policy stance.

The limits of monetary policy with regard to overcoming a deep and long-lasting crisis of the real economy have become very obvious in the recent past. There is a large variety of problems that are at the core of this crisis, ranging from political to structural problems, but also including demand aspects.

From the point of view of macroeconomic theory it should come as no surprise that economic dynamics – and especially investments – are influenced by both supply-side and demand-side factors. Both sides are affected by fiscal and monetary policy measures alike, and therefore there is a clear interconnectedness between fiscal and monetary policy.

There are two diametrically opposed theoretical positions on how to deal with this interconnectedness. In the aftermath of the Keynesian revolution, economists like Abba Lerner (1943) developed the concept of *functional finance*. This means that fiscal and monetary policy should be seen as comparable and interchangeable tools for demand management. At the other end of the spectrum, there is the position that monetary policy completely ignores general macroeconomic circumstances and only follows a goal of narrowly defined price stability.

What we see in practice today is a clear division of institutional responsibility for fiscal policy, on the one hand, and monetary policy, on the other. At the same time, it is acknowledged that under specific circumstances, coordination between fiscal policy and monetary policy institutions may be necessary. This is also reflected in the legal mandate of the European Central Bank, which states:[3]

In accordance with Article 127(1) and Article 282(2) of the Treaty on the Functioning of the European Union, the primary objective of the ESCB shall be to

[3] *See "On The Statute of the European System of Central Banks and of the European Central Bank", retrieved on June 13, 2013: www.ecb.int/ecb/legal/pdf/en_statute_from_c_11520080509en02010328.pdf.*

maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union.

These objectives of the Union as laid down in Article 3 of the Treaty include especially the goal of full employment and adequate economic growth. So the mandate of the ECB sets clear priorities, but it does not ignore macroeconomic perspectives.

Given the experience of the last years, we now again see a far-ranging discussion on monetary policy frameworks and especially monetary policy targets. For the specific aspects of monetary policy it is important to specify a target that serves as a nominal anchor for the ecnonomy, but it is obvious that no single economic indicator or variable can provide complete guidance to monetary policy. The ECB, which follows a primary goal of price stability, has defined price stability as a rate of inflation below, but close to, 2%. That means that the primary task of monetary policy is to prevent inflation, but also deflation. This is to be seen in the context of *flexible inflation targeting,* which must be understood as a goal to be achieved over the medium run – allowing the ECB to pursue a steady hand strategy to stabilize expectations.

An important contribution to the role of central banks nowadays is their increasing involvement in financial sector stability and banking supervision. One of the lessons of the big economic crisis of the 1930s had been that price stability and also stability of the real economy cannot be achieved without stability of the financial sector of an economy. In the golden days of the *Great Moderation* this lesson seems to have been lost to a large extent; there was a tendency to separate the role of central banks and of financial market agencies. Today, in the context of the recent crisis, we again observe a tendency toward a stronger role of central banks with regard to microprudential – and especially macroprudential – supervision. A specific example is the new supervisory role of the ECB in the context of the great project of a European Banking Union, especially the European Single Supervisory Mechanism (SSM).

As a central banker, I am fully aware that banking supervision is one of the most risky tasks in economic governance, especially with regard to reputational risks. No central banker with a healthy survival instinct will therefore actively try to obtain an encompassing mandate for banking supervision. On the other hand, given the huge potential for market failures in this field – like different forms of asymmetric information and problematic incentive structures – there is a clear need for public intervention; and somebody has to do it.

After a period of *de*-regulation we are now in a period of *re*-regulation. Maybe we will see the usual oscillation from one end of the spectrum to the other, meaning that after too much deregulation we now may see too much re-regulation, especially too much of uncoordinated regulation. But in any case, effective regulation needs effective supervision and there are valid economic arguments in favor of independent central banks taking on a larger role in banking supervision. In my view, this also holds for the specific case of the ECB assuming greater responsibilities for banking supervision. One has to be aware, however, that we have to deal with a very specific case with regard to institutional, economic and legal set-up. To mention just a few aspects: the ECB would act as a bank supervisor not only for banks of the euro area, but of all countries joining the SSM. It is well known that effective banking supervision also requires clarity with regard to bank resolution and eventually fiscal backstops. Right now, we do not have this clarity in Europe. On the contrary: we have, for instance, no coordination between potentially necessary state intervention and European competition policy. In the USA there had been the Troubled Asset Relief Program (TARP), which can be seen as an example of a successful structural program for the banking sector. It did not involve lengthy procedures and a great part of its success was that it was able to work fast.

I do not want to get into further details, but for me the message for the ECB is rather clear: Taking up such a huge responsibility for European banking supervision needs careful preparation, quality being at least as important as speed. This is recognized by the existing road map insofar as not all European banks will be subject to ECB supervision. But anyhow, it is expected that the roughly 130 banks participating in the SSM will cover more than 80% or more than EUR 25 trillion of the euro area's banking assets. It may make sense to follow the advice of some of our German colleagues to start with a smaller number of the major European banks to allow for a staggered approach.

Ladies and Gentleman,

Let me finally share with you some short comments on the independence of central banks and the connected issue of democratic accountability. For a long period of time, central bank independence was not such a clear-cut concept as it seems to be today. Both orthodox Keynesians and orthodox Monetarists see no economic reason for central bank independence and many of you may know the famous dictum by Milton Friedman (1962, p. 51) "Money is much too serious a matter to be left to the Central Bankers".

At the European level, central bank independence was mainly strengthened by the example of the Deutsche Bundesbank, and it was a key element in the Delors report in preparation for the institutional set-up of the ECB. The importance of central bank independence is also stressed in the recently published book *Making the European Monetary Union* by our keynote speaker Harold James. In his book he explores the historical developments in the institutional architecture of Economic and Monetary Union in Europe.

Today, it can be said that the ECB is probably the most independent central bank of the world because its independence is enshrined in the European Treaties, and any changes to these Treaty provisions would be extremely difficult and are thus unlikely. In most

other countries, central bank independence is a matter of national law – and as we have seen, there may always be attempts to change such laws.

The traditional legitimation for central bank independence is the purpose of shielding central banks against government intervention and short-term political cycles. And indeed, I think that this is a very important element of central bank independence. But today, I think it is important to see independence in a wider context: Central banks are macroeconomic policy institutions; they have to follow the policy goals embodied in their democratically given mandate. That means, they not only need to be independent from short-term political influences, but they also have to be independent from all other sorts of special interests. This includes the special interests of the banking sector in an enonomy. In the context of a general macroeconomic policy, central banks must have an interest in a well-functioning banking sector – and they need to fulfil efficient technical and supervisory tasks vis-à-vis the financial sector of an economy. But like any public institution, central banks have to be careful not to be captured by any special interest group. An independent central bank must act as a macroeconomic institution and not as a lobbyist.

In this macroeconomic context, I see the specific task of an independent central bank to act as an expert and also as an advocate for the long-term perspectives and interests of an economy and a society in general. The privilege of being shielded from short-term political cycles should be used for serving as an objective and long-term oriented institution in the field of economic policy. If central banks are able to build up and maintain this kind of reputation they will continue to play a clear and valuable role also in the future.

Ladies and Gentlemen,

During this conference we will have the opportunity to hear different points of views evaluate arguments and gain insights in the roles and responsibilities of central banks.

I wish all of you two very fruitful days with lively discussions inside and outside of the presentation rooms.

References

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