

# A Changing Role for Central Banks?

Key findings from the 41<sup>st</sup> OeNB Economics Conference,  
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*Central banks worldwide have been playing a vital role in coping with the economic, financial and sovereign debt crisis. The crisis has shifted and has expanded central banks' responsibilities, goals and instruments. Beyond their primary objective of maintaining price stability, central banks are in the process of assuming additional responsibilities in macro- and micro-prudential supervision. While unchanged on paper, monetary policy strategies have been revamped substantially in practice to suit crisis needs. The range of instruments has been widened dramatically; in many cases, unconventional policy tools now predominate or have even nearly completely replaced precrisis modes of monetary policy implementation. While the different goals central banks must now pursue – in particular price stability and macro-prudential stability – are mirrored in theory by a congruent set of instruments, the delineations of goals and of the respective instruments are less clear in practice; experience will result in possible tradeoffs and will bring conflicts to the surface. At an institutional level, the increased range of competences of central banks risk attracting criticism and could ultimately also endanger central banks' hard-won independence. Against this background, the conference sought to discuss what central banks will look like after the crisis. Like previous conferences, the 2013 conference brought together around 350 academics, central bankers, politicians and other interested constituencies to exchange views on these important issues.*

In his *opening remarks*, OeNB Governor *Ewald Nowotny* emphasized that central banks' responsibilities have been transformed to reflect the prevailing historical and economic conditions. Today, central banks alongside parliaments, governments and the judiciary are among the pillars of modern democratic nations. Before World War I, central banks predominantly focused on guarding financial stability and funding government debt. After the Great Depression in the early 1930s up to the era following World War II, the mandate of central banks concentrated on coping with high inflation and mass unemployment. Since then, central banks' foremost aim has been to ensure price stability. Central banks succeeded in achieving their goals quite well by wielding conventional interest rate policy instruments. The financial crisis has entailed additional challenges for central banks. By using conventional as well as unconventional monetary policy

instruments, central banks have reacted fast and forcefully to changed conditions, thus safeguarding financial stability.

An additional challenge for central banks arises from the interconnectedness of fiscal and monetary policy. 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, 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. The mandate of the ECB sets clear priorities without ignoring the larger macroeconomic perspectives. Central banks' increasing involvement in financial sector stability and banking supervision represents an important extension of their role. In the context of the recent crisis, we have observed a tendency for central banks

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to play a stronger role also in microprudential, and especially macroprudential, supervision. Governor Nowotny cited the new supervisory role of the European Central Bank in the context of the project of a European banking union as an example. Banking supervision at the European level is a risky economic governance task requiring reliable and comprehensive preparation.

In his *opening address*, *Andreas Schieder*, State Secretary in the Austrian Federal Ministry of Finance, outlined that GDP growth forecasts for the next two years put Austria in a favorable position compared to other countries such as the Netherlands or France. A balanced growth path is projected for 2016. Still, the economy is suffering from the aftermath of the crisis. Schieder acknowledged the important role of central bank, but also pointed out the limits of a focus on inflation targeting only. He went on to say that the nationalization of some Austrian banks was not only a matter of national interest, but had deeper systemic effects also at the European level. Schieder stressed that a banking union will require coordination and resolution mechanisms. Furthermore, the State Secretary advocated the implementation of a financial transaction tax, which was supported by all Austrian parties.

*Session 1*, entitled “The Mandate of Central Banks,” was chaired by Ewald Nowotny.

The keynote address by *Benôit Coeuré*, Member of the Executive Board of the ECB, focused on the distributional consequences of central bank action. Rising unemployment, lower incomes and reduced household wealth due to decreases in housing prices are a consequence of the financial crisis. Implicitly poorer households were affected disproportionately by the crisis.

Coeuré pointed out that it is not within the central bank’s mandate to address rising inequalities and that any distributional consequences of monetary policy are only temporary in nature. Provided that transmission channels work properly, central banks ensure, by fulfilling the mandate of price stability and contributing to overall economic stability, that distributional effects remain neutral.

But Coeuré observed that the world is fragmenting along three dimensions, which has impaired the potency of monetary policy actions. Each of these dimensions is affected differently by monetary policy: the horizontal dimension, comprising market players with different characteristics; the vertical dimension, comprising investment, consumption and savings decisions over time; and the spatial dimension, comprising different regions and countries. Even though the ultimate objectives of monetary policy are not different during crisis and noncrisis times, the instruments and measures to achieve them may vary. As has been the case for the ECB, during a crisis, the aim of monetary policy should be to repair the transmission channels by reducing such fragmentations and thereby restoring distributional neutrality. Governments alongside central banks need to continue their reforms of the financial sector by stabilizing fiscal imbalances and promoting structural policies.

*Harold James*, Princeton University professor, described the problem of designing an institutional framework in Europe that can deal with financial instabilities. European monetary integration emerged as a response to global currency disorders and current account imbalances. James linked the discussions surrounding the institutional design of the currency union in the 1980s and 1990s to the current debate

on the future evolution of the euro area. He argues that if one regards regulation as the only logical solution to financial instabilities – regulations are designed by national policymakers and as such are implemented within national settings – the consequence will be a fundamental reversal of the historical trend toward integration. In his opinion, the flaw during the introduction of the common currency was that no effective macroprudential supervision mechanism was implemented at the same time. The EU Committee of Central Bank Governors’ draft referred to the possibility that the ECB would be tasked with banking supervision and regulation functions, but by the time this proposal had been included in the Maastricht Treaty provisions on monetary policy, it was accompanied by so many provisos that it looked as if the hurdles to effective European banking supervision could not be set higher. The intrusion of politics had thus resulted in a fundamental flaw in the new European monetary order. James concluded with three recommendations: first, to recognize the need for regionally differentiated monetary policy (e.g. bank collateral requirements); second, to allow for individual transfer systems to guarantee fiscal sustainability at the European level (e.g. the European social security system); third, to increase flexibility regarding sovereign bankruptcy.

*Session 2* on “The Changing Role of Central Banks: A Historical Perspective” was chaired by *Wolfgang Dukatczek*, Vice Governor of the OeNB.

*Forrest Capie*, Cass Business School professor, claimed that central bank independence would not survive the crisis because it is not suitable for all occasions. He illustrates this statement mainly by describing the relationship between the state and the Bank of Eng-

land as one of mutual dependency. During several crises, the government issued rules instructing the bank how to master the respective situation. In the post-World War II period up to 1980, the Bank of England operated under considerable freedom with respect to its principal function of defending the exchange rate. This was complemented by the method of financing the Bank of England through a levy by financial institutions. Capie asserted that during crisis times, ultimately, there could not be an independent central bank because it was impossible to write complete and contingent contracts for central banks. Even the ECB’s behavior is political, as, according to Capie, it switched from controlling inflation by monetary policy to a policy of buying government debt to keep the euro area together at least long enough for further political changes to be implemented in the EU.

*Stefano Ugolini*, assistant professor at the University of Toulouse 1, focused on monetary policymaking from a political economy approach in his contribution. In his view, central banks are the outcome of some form of collective bargaining among different interest groups. Historically, central banks developed along two functional perspectives, namely the microeconomic perspective, e.g. the management of payment systems, and the macroeconomic perspective, e.g. the provision of monetary stability. This interplay determines the complex relationship between monetary and fiscal authorities. The idea that monetary and fiscal authorities can live their lives oblivious of each other is, according to Ugolini, not validated by historical evidence. He therefore advocates a more integrative approach of those two state authorities.

*Session 3* under the header “Central Banking and Macroeconomic Theory”

was chaired by *Martin Summer*, head of division at the OeNB.

*Athanasios Orphanides*, Senior Lecturer at the MIT Sloan School of Management, elaborated on the question of whether full employment was an appropriate monetary policy target. He contrasted the mandate of the Federal Reserve System with its multiple goals with the singular, price stability-focused mandate of the ECB. Citing Paul Volcker, Orphanides claimed that the dual mandate approach was an overburdening and operationally confusing mandate for a central bank. According to Orphanides, the problem lies in the uncertainties involved in constructing real economic targets and in detecting shifts in the natural rates of these real targets. He contended that policymakers could not resolve these issues without acknowledging the dynamics of data revisions. The estimates based on real time data are the ones relevant for policy decisions. Orphanides therefore argued that simple policy rules suggesting good macroeconomic outcomes could be obtained without the need to rely on natural rate estimates. He concluded by stating that full employment was an important public policy objective but not an appropriate monetary policy target.

*Xavier Ragot*, associate professor at the Paris School of Economics, discussed which mandate central banks should pursue after the crisis. The actions of central banks were set to improve transmission channels of monetary policy to restore financial stability. Ragot claimed that the objective should be financial efficiency instead, which is a closer fit to the actual policies pursued by the ECB. He advocated addressing the objective of financial efficiency by financial regulation policies. Furthermore, such an objective was compatible with the notion that mone-

tary policy should not generate redistribution, nor provide too much insurance. Ragot suggested spreads of prices and trading volumes as possible quantifiable measures for the objective of financial efficiency. He advocated reassessing the narrow mandate of the ECB and promoting financial efficiency as a target.

*Session 4* on “The Political Economy of Central Banking in Crisis and Post-Crisis Situations” was chaired by *Peter Mooslechner*, Executive Director at the OeNB.

*Ernst Baltensperger*, University of Bern professor, addressed the issue of “Central Bank Independence in Times of Tranquility and Stress.” Depending on the circumstances, central bank independence is always uncertain and frail: Central bank laws can be reinterpreted, changed or simply ignored. Central bank independence is important nevertheless, as it serves as an obstacle – any change or violation of the principle requires reflection. Central banks’ independence from fiscal decisions is a key element of successful monetary constitutions. In many countries, the debt and banking crises have prompted disregard of this basic insight, and many central banks are now pursuing a dangerous course mixing up monetary and fiscal motives. Monetary dominance in the sense that the central bank uses its instruments solely to pursue its price stability mandate and that the fiscal authority reacts passively, accepting whatever revenue results from the central bank’s action, is the only type of coordination consistent with enduring monetary stability. Whether central banks should be allowed to buy government debt should in theory depend on the underlying motive. In practice, a distinction between fiscal and monetary motives is difficult, and governments’ high debt burdens will

create pressure on central banks to delay exit from these purchases or holdings.

The important lessons from the 1970s and 1980s “Great Inflation” are currently at risk of being forgotten. Two decades of very low inflation have led us to lose sight of the dangers of inflation or have even prompted some observers to call for “some inflation” as a remedy to low growth and high debt burdens. This mood resembles the one of the 1950s and 1960s, and the idea of nominal income targeting is an example of political and intellectual pressure being built up against central banks.

*Laurence Boone*, economist at the Research Division of Bank of America Merrill Lynch, gave a presentation on “One Central Bank, 17 Governments: Avoiding Banking Dominance.” The so far unclear operating framework for the ECB, 17 national supervisors and 17 governments has affected monetary and financial system stability in EMU. The ECB has addressed the risk of fiscal dominance by tying Outright Monetary Transactions (and the preceding Securities Markets Programme) to conditionality. The risk of banking dominance has yet to be resolved. In the current setup, the ECB suffers from information asymmetry. Furthermore, national interests (preserving large national banks regarded as “national champions” and the fear of fiscal and political costs of banking sector restructuring) have delayed necessary reforms and resolutions in the European banking industry in the euro area. European banking union has the potential to redress the situation by correcting for information asymmetries. Furthermore, the ECB’s initial asset quality review will force Member States to proceed with banking sector restructuring and to establish a workable euro area-wide banking resolution frame-

work. To be effective, the asset quality review should be run by the ECB independently of national supervisors. It must be published and must be accompanied by a clear backstop and resolution framework. The crisis has shown that to preserve the ECB’s independence, the central bank has to be responsible both for monetary policy and for financial supervision; however, this needs to be accompanied by full information on banking developments for the ECB, by effective resolution schemes and by a fiscal backstop that allows the central bank to take decisions with complete independence.

The first day of the conference ended with a *Kamingespräch* with *Maria Fekter*, Austrian Federal Minister of Finance. Fekter spoke about public finances and financial stability from an Austrian perspective. The economic recovery is still ongoing; dealing with the aftermath of the crisis has been painful for many countries. Fekter advocated strict fiscal discipline and a common European supervisory mechanism for all European banks, not only those in the euro area. She emphasized the importance of common bankruptcy procedures for banks to determine who should be held liable for a bank’s debt. Fekter called for the creation of a facility to secure deposits of up to EUR 100,000 throughout Europe.

The second day opened with *Session 5* on “Central Banking, Financial Stability and European Banking Union” and was chaired by *Andreas Ittner*, Executive Governor of the OeNB.

*Charles Goodhart*, London School of Economics professor, drew “Lessons for Monetary Policy from the Euro Area Crisis.” He pointed out that the crisis has shown us that price stability is not sufficient to maintain financial stability. Hence, the consensus has emerged that we need countercyclical

macroprudential instruments, which should best be hosted in the central bank. Goodhart asks whether these instruments can work well enough, given incentives among politics to sustain booms, and in the face of regionally strongly differing imbalances and asset price booms and declines. Furthermore, there are important conflicts between micro- and macroprudential considerations: While microprudential regulators also want tighter capital constraints, such restraints can be very detrimental from a macroprudential perspective in a downturn.

Additionally, the risk-weighting approach pursued in Basel II has been shown not to have worked well. But the leverage ratio provided for in Basel III is also far too lax. The crisis has also shown that during crises, funding liquidity through wholesale markets dries up, emphasizing the need for liquidity coverage ratios and net stable funding ratios. When central banks hit the zero lower bound of interest rates, unconventional policies become necessary. The specific crisis in the euro area has also emphasized the need for a banking union. The absence of such a union has been one of the major differences between the U.S. and the euro area crisis experience so far and has promoted “doom loops” between banking and sovereign debt problems in the euro area.

*Dirk Schoenmaker*, dean of the Duisenberg School of Finance in Amsterdam, addressed the issue of “Governance of International Banking.” The crisis has exposed severe coordination failure among national supervisory authorities, given that cross-border externalities of failures of large, internationally operating banks were largely ignored by national supervisors. The “financial trilemma” states that international banking, national financial sta-

bility policies and financial stability are incompatible (much the same as in the “monetary trilemma,” where free capital movements, national monetary policies and exchange rate stability are not compatible). Therefore, international banking is at a crossroads: Either, to preserve international banks, a European banking union with joint supervision and resolution including burden sharing is established, or, if supervision remains a national competence, banking is renationalized with fully independent subsidiaries. These subsidiaries might in the extreme need to have different brand names than the parent institutions to limit spillovers within banking groups.

The national approach comes at substantial costs of inefficiently large necessary local liquidity pools and capital buffers, since they cannot be shared within a group in an emergency. These costs will eventually be passed on in the form of higher lending or lower deposit rates. Given the absence of a European government which could directly collect taxes, the banking union eventually requires burden sharing among governments in the event of bank failures. To facilitate and speed up decision making, voting procedures need to be changed from unanimity to qualified majority voting. In addition to a centralized banking supervision and lender of resort function to be performed by the ECB, a European Deposit Insurance and Resolution Authority as well as an effective fiscal backstop for banks from the ESM are needed.

The conference concluded with *Session 6*, chaired by *Ernest Gnan*, Head of Division at the OeNB, on the topic of “Monetary Policy Crisis Management and Price Stability.”

*Katrin Assenmacher*, deputy director at the Swiss National Bank, gave a presentation on “Monetary Policy since the

Financial Crisis: Why Interest Rates Need to Be Low.” She argued that while central banks worldwide have embarked on highly expansionary conventional and unconventional monetary policy measures, growth remains sluggish and inflation has been slowing. The risks associated with a prolonged period of low interest rates, such as a misallocation of resources, a weakening of fiscal discipline and evergreening of private debt, asset price booms and ensuing financial instability, must be taken seriously. But at the current juncture, stimulating wealth and credit channel effects from higher asset prices as well as investment in riskier assets may buy the time necessary to achieve balance sheet repair. Asset price bubbles pose a risk to financial stability particularly when mostly credit financed, which does not generally seem to be the case now.

The timing of the exit from expansionary monetary policies will be critical. It will also be necessary to get the incentives right to avoid moral hazard. The post-crisis environment for monetary policy will have changed. Central banks should stick to the primary objective of price stability; too many objectives risk overburdening central banks. Regulation should enhance banks’ ability to bear losses. Switzerland performed relatively well throughout the crisis; despite a zero interest rate policy, the Swiss National Bank had to curb the appreciation of the Swiss franc at 1.20 per euro. Strong credit and property price growth prompted the authorities to adopt macroprudential measures in February 2013: Banks will have to hold 1% of additional capital for risk-weighted mortgage loans financing residential property located in Switzerland.

The final paper on “The Short- and Long-Term Effects of Ultra-Easy Mon-

etary Policy” was presented by *William R. White*, Chairman of the Economic Development and Review Committee of the OECD. The crisis has reminded us that economic systems are not machines but highly complex nonlinear systems whose reactions and outcomes are impossible to predict. The current ultra-easy monetary policies are an unprecedented economic experiment; not even during the Great Depression were such policies used. While individual central banks’ measures differ in detail, they share an emphasis on short-run “Keynesian” benefits, ignoring possible long-term costs. Central banks currently face “radical uncertainty.” Their easing cycles since the 1980s have been asymmetrical (more easing than subsequent tightening) and have become more aggressive during each cycle. This “Great Moderation” should rather be understood as a series of booms and busts centered in different markets, and overall aggravating imbalances (artificially low consumer price inflation due to globalization, the collapse of household saving in the U.S.A., housing and other asset price booms, excessive investment in China, a boom of shadow banking, soaring leverage in the face of lax lending standards, exploding current account imbalances) culminating in the current crisis. As a result, policy rates have now hit the zero lower bound, leading to the need for nonconventional easing. Negative medium-term effects include inflation (Wicksell), misallocation of resources (Hayek), malinvestment (Koo), banking sector problems (Minsky), an expansion of shadow banking (Shin).

Ultra-easy monetary policy has so far been quite weak in stimulating aggregate demand, given that uncertainty and long-term perspectives dominate corporate and household spending decisions. Instead, very low rates squeeze

profits of banks and institutional investors, thus tightening credit conditions, boosting some asset prices to unsustainable levels, distorting international capital flows, and leading market dynamics (RORO – risk on-risk off) to dominate economic fundamentals. Ultra-easy monetary policies also impede deleveraging, lead banks to continue lending to unsound firms (which hampers productivity growth in the long run), have substantial effects on distribution, and lead governments to forbear necessary structural, growth-restoring reforms. White called on governments with remaining fiscal scope to use this scope, to encourage private and public investment, to use debt forgiveness and restructuring more aggressively, and to enact more vigorous structural reforms.

The *Klaus Liebscher Award* was created in 2005 on the occasion of the 65<sup>th</sup> birthday of former OeNB Governor Klaus Liebscher in recognition of his services to Austria's participation in the European Economic and Monetary Union and for European integration; it has been awarded annually since then. The Klaus Liebscher Award for 2013 was presented by Claus Raidl and Ewald Nowotny to the authors of two studies of high scientific quality and policy relevance, which were selected from among many high-quality submissions.

In his work on “International Debt Deleveraging,” *Luca Fornaro*, London School of Economics, uses a macroeconomic framework to analyze a monetary union where different countries reduce debt simultaneously. The decline in aggregate demand and interest rates as a consequence of this simultaneous deleveraging cannot be compensated by exchange rate adjustments in the monetary union. He investigates the effects of a systemic recession within such a monetary union and proposes various policy actions that can improve the macroeconomic situation for all countries.

In their joint work “Efficient Fiscal Spending by Supranational Union” *Jenny Simons*, Stockholm Institute of Transition Economics, and *Justin Valasek*, Wissenschaftszentrum Berlin, discuss whether a community of sovereign states with a strong self-interest principle is able to efficiently draw up a joint budget. The authors apply concepts from negotiation theory and show that the bargaining power of the individual states cannot be established from the outset, but rather results in the negotiation process itself. This creates a link between budget contributions and the allocation of these contributions within the community. In this framework, the authors discuss the conditions under which budget preparation and allocation are as efficient as possible.