

Ewald Nowotny: Combating the crisis – the role of central banks

Opening remarks by Mr Ewald Nowotny, Governor of the Austrian National Bank, at the 37th Economics Conference of the Austrian National Bank, Vienna, 14 May 2009.

* * *

Dear Chancellor Faymann,

Ladies and gentlemen:

I am very pleased to welcome you to the 37th Economics Conference of the Oesterreichische Nationalbank here in Vienna.

We are honored that Werner Faymann, Austria's Federal Chancellor, has found the time to address the participants of this year's Economics Conference, despite his packed schedule. He will be our first speaker today.

Let me also say a few words of welcome to this morning's other high-level speakers: Arnout Wellink, President of De Nederlandsche Bank and Chairman of the Basel Committee on Banking Supervision; and Lucas Papademos, Vice President of the European Central Bank. Thank you very much for coming to Vienna – we are delighted to have you here.

Let me add that I am very pleased to see that so many delegates have joined us today. In this year of all years, I find it particularly important to get together with you all to exchange views and to seek out the opinions of renowned national and international experts, of whom we have been able to win an impressive mix for this conference. We have designed our conference to look "Beyond the Crisis"; today and tomorrow, we will thus discuss the challenges of making "Economic Policy in a New Macroeconomic Environment." While the general public has, quite understandably, been focusing on the immediate impact of crisis, we wish to refocus the debate by discussing above all the medium- and long-term perspectives that arise for economic policymaking.

Let me thank all speakers and panel discussion participants in advance for the contributions they are going to make, as well as our staff members for the efforts they have put into organizing this event.

Ladies and gentlemen,

We are currently finding ourselves in a very special constellation: On the one hand we are faced with growth projections that are severely dampened by the crisis – a fact we need to take very seriously. After all, euro area GDP growth is forecast to shrink by 4% in 2009, and output growth in Germany by 6%. On the other hand, signs of stabilization are beginning to emerge, especially in the financial sector. As a case in point, the iTraxx credit derivatives index for Europe – a prominent risk measure – sank by 19% in April compared with March, while the U.S. iTraxx went down by 16%. Corresponding risk measures for the Republic of Austria have also improved substantially. In Europe, the issuing volume of corporate bonds was roughly four times as high in the first four months of 2009 as in the first four months of 2008; and other indicators, too, for instance order intake figures, point toward recovery. At the recent IMF Spring Meeting there was, incidentally, a buzz about the emergence of "green shoots" of economic recovery. And at the BIS meeting this week there was even talk of a "forest of green shoots" sprouting in China.

Current economic conditions around the world, which are characterized by problems in the global banking sector and a sharp global economic contraction, have created tremendous challenges for policymakers. A major challenge is, of course, the dimension the current financial crisis has reached. Another challenge is how to ensure the effectiveness of the economic policy response.

With regard to the dimension of the crisis, there is a broad consensus among economic policymakers and economists today – unlike at the time of the crisis in the 1930s – that it takes strategically coordinated macroeconomic policies to respond to a situation in which the tensions in financial markets and the contraction of the real economy are mutually reinforcing. The underlying rationale of measures – and thus, the consensus – must be to boost aggregate demand, strengthen bank balance sheets and revive and sustain the flow of credit. The key to effectively counteracting the economic contraction triggered by the crisis is to find the right mix of expansionary monetary and fiscal policies. Central banks, thus, play a pivotal role in this process.

Last year, above all in the period following the collapse of Lehman Brothers in September, central banks around the globe moved to take a number of nonstandard measures in implementing monetary policy; they also used new instruments, on top of the traditional framework, to provide liquidity to the banking system. You will all remember the headlines the sheer dimension of these measures made. Against this backdrop it makes sense to revisit the fundamentals of monetary policy.

Modern central banks are economic policy institutions with a clearly defined target, namely the primary goal of maintaining price stability. As you all know, the Eurosystem has defined price stability as an increase of the Harmonised Index of Consumer Prices of close to, but below 2% in the euro area over the medium term. Modern central banks enjoy a high degree of independence from political influence, which supports them in reaching the goal of maintaining price stability. Their main policy instrument is the key interest rate or, in other words, the rate at which credit institutions may borrow from them.

In addition, central banks are responsible for safeguarding the stability of the financial system. The key channel for meeting this responsibility is the provision of liquidity to the banking sector. Central banks stand ready to use both types of instruments in times of crisis.

In response to the current crisis, the traditional monetary policy instruments have, indeed, been used widely. Since last October, the ECB has lowered its key interest rate by a total of 325 basis points. At the same time, the Eurosystem has also widely used its framework of liquidity-providing instruments. Moreover, this framework has been expanded to include instruments that would not be typically used under normal circumstances, such as the provision of liquidity with a maturity of up to one year, or the provision of liquidity in foreign currency (such as U.S. dollar and Swiss franc) in the form of swaps with the Federal Reserve System and other central banks.

Both measures – interest rate policy measures and liquidity-providing measures – have helped ease tensions in the interbank lending market and have been instrumental in meeting the challenge of safeguarding the stability of the financial system. At the same time, I would like to stress that both types of measures are compatible with the ECB's price stability objective, as both inflationary pressures and inflation risks have decreased substantially in the course of the crisis. Any concerns that the current monetary policy stance may push up inflation in the time ahead are, therefore, unfounded. Neither short-term inflation expectations nor forecasts of the degree of capacity utilization (output gaps) in the real economy, and neither credit growth figures nor money supply measures are, at present, signaling inflation risks. It goes without saying that we are closely monitoring developments to be able to take action fast, if need be. In the near term, we see some signs that price levels might go down in individual euro area countries, which we interpret as an unwinding of increases seen last year in an environment of soaring energy prices. The producer price index for the euro area, in fact, dropped by 3.1% from March 2008 to March 2009. Let me stress, however, that over the medium term I see neither the risk of deflation, nor the risk of inflation.

In times of crisis it may happen that the traditional instruments of monetary policy don't suffice, or that they become blunt. This is particularly true of the key interest rate, which may eventually approach the lower boundary of zero. Yet, in such a situation, there are still other measures to which central banks may turn.

One possibility would be to widen money supply and to use the additional funds to purchase assets such as government bonds, but also commercial bonds, instruments issued by other banks or other financial assets. The Governing Council of the ECB, for instance, most recently – in its meeting on May 7, 2009 – created the possibility for the Eurosystem to buy euro-denominated covered bonds issued in the euro area, and made the EIB an eligible counterparty to the Eurosystem's monetary policy operations.

Yet, while central banks play a key role in providing economic policy responses to the current financial crisis, it takes a wider strategic framework to stage an effective overall response – it also takes expansionary fiscal policies to fight the crisis effectively. It is important for the public sector to counteract developments rather than exacerbate conditions through restrictive fiscal policies in a situation in which all components of aggregate demand – consumption, investment and exports – are contracting.

At the same time, it is important to agree in advance on an exit strategy from expansionary fiscal policies, to readjust those policies and redirect them toward a clearly defined fiscal consolidation path as soon as the economy starts to recover on a sustainable basis. There is broad consensus among economists on the need to adopt an exit strategy – also among policymakers in Austria, I presume.

Ladies and gentlemen,

Up to now, I have outlined why central banks play a key role in economic policymaking during the current crisis. To do their job, they may use a range of instruments, provided the outcome is compatible with the price stability goal. So far I have focused on central bank policy in general, and on the policy of the ECB and the Eurosystem in particular.

I would now like to focus even more specifically on the OeNB, which – being a Eurosystem central bank – naturally plays a special role in this context. After all, it fulfills a broad range of tasks that are crucial both in implementing the Eurosystem's monetary policy and in managing the crisis at the national level.

All departments of the OeNB play a role in combating the crisis, either directly or indirectly. The OeNB is responsible for implementing the Eurosystem's monetary policy operations in Austria, and for providing emergency liquidity assistance to banks based in Austria. As an expert organization, it provides a high degree of know-how, comprehensive analyses and high-quality data for the ECB and for the OeNB's partner organizations in Austria. In addition, the OeNB plays a direct role in safeguarding financial stability in its capacity as the national banking supervisor.

The know-how of the ECB and of the national central banks of the Eurosystem and their capacity to act are crucial for the smooth functioning of the money and financial system. This is even more true in crisis situations, such as we witness at present.

The instruments of central banks are the more effective the better they are integrated in a comprehensive macroeconomic strategy, alongside fiscal policy measures. Using those instruments to take concrete economic and monetary policy action presupposes the existence of strong institutions with a pronounced capacity to act, which the OeNB has got. In times like these, the OeNB's capacity and know-how are of particular importance, and we are well aware that we have a big responsibility to meet.

Ladies and gentlemen,

Allow me to draw a simile to conclude: To excel in central banking, we need to have the courage to rush in like firefighters, and we need to be as vigilant as policemen. Right now we are busy fighting a large fire that has spread across the world; and I would say we have been doing a good job in getting the fire under control. At the same time I can assure you that we have seen to it that money and lending market operations continue to run smoothly, and that we promote the resumption of sustainable growth and preserve price stability.

This brings me to the end of my introductory remarks. To conclude, I look forward to having a day and a half with you to discuss these critical and timely issues of economic policy from a multitude of perspectives. I hope you will find our Economics Conference a useful and an insightful event.