Ewald Nowotny: "Central bank policies – past challenges and future perspectives" – Session 1

Speech by Prof Dr Ewald Nowotny, Governor of the Central Bank of the Republic of Austria, at the ceremony to mark the 200th anniversary of the Central Bank of the Republic of Austria, Vienna, 2 June 2016.

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Mr. President of the Republic Heinz Fischer,

Prime Minister Christian Kern,

Dear President Mario Draghi,

Ladies and gentlemen,

It's a great pleasure for me to welcome you today to the commemoration of the 200th anniversary of the Oesterreichische Nationalbank and we are very grateful and proud that such an eminent audience has followed our invitation to this celebratory event.

In the two hundred years of its existence, the fate of the Nationalbank has always been closely entwined with the fate of Austria, for better and for worse. It is not by accident, that it was Schumpeter, the great economist and short-term finance minister of the Republic of Austria, who said that the condition of the monetary system of a nation is a symptom of all its conditions, or in German, "Der Zustand des Geldwesens eines Volkes ist ein Symptom aller seiner Zustände."

If there is one lesson to be drawn from the eventful monetary history of Austria, then it is that the greatest threat to financial and monetary stability has been, and continues to be, war. In fact, it was also war, which triggered the foundation of the Nationalbank in 1816. When on June 1, 1816, Emperor Francis I signed the decrees establishing the privilegirte oesterreichische National-Bank, he did so almost exactly one year after the conclusion of the Congress of Vienna, which marked the end of more than twenty years of war in Europe. Ultimately, the Austrian Empire emerged as one of the victorious powers, but the price of victory had been steep. A significant part of the war effort had been financed by issuing paper money, which resulted in high inflation. In addition, the Austrian state had to declare default on its debt in 1811. As is always the case in periods of high inflation, the consequences for the population were disastrous.

The agenda for the new bank can thus be summarized quite briefly: get the monetary system back in order. The most important ingredient for stability was the reestablishment of trust. The Austrian people had lost their faith in the Austrian currency because of inflation and state bankruptcy; now a way had to be found to regain public confidence. The solution was to create the new issuing bank as an institution held by private shareholders. This arrangement was not uncommon at the time. The Bank of England, which dates back to 1694, as well as the Banque de France and De Nederlandsche Bank, which had both been founded only a couple of years before the Oesterreichische Nationalbank, had been set up as privately held joint stock corporations. The advantage of this arrangement was two-fold. On the one hand, the shareholders contributed capital, which was the foundation of the financial strength of the new institution and which the Austrian government itself would have found difficult to raise. On the other hand, private shareholders' participation in the management of the bank was thought to pose limits on the government and prevent government from intervening in a way that might prove harmful to monetary stability. Thus, the new institution would find it easier to obtain confidence and trust. The shares of the bank were subscribed by a rather broad group of people. Indeed, we find many entries with just one or two shares in the list of shareholders. One of many medium-sized investors was the composer Ludwig van Beethoven. In our museum you can have a look at a share made out to his name. By the way, this was quite a good investment: Between 1818 and 1827, when Beethoven died, he earned something between 15% and 20% per year on his investment.

The Nationalbank was not only financially successful for its shareholders; it also succeeded in stabilizing the value of the Austrian florin in terms of silver. The period of calm lasted until 1848, when the people of the Empire toppled Metternich's repressive regime. The bank, which was perceived as quite close to the state, faced a run – everybody tried to convert his banknotes into silver coins. In response, the Nationalbank resorted to a measure that was a small revolution in itself. To restore confidence, the governing board decided to start publishing end-of-month financial statements. Before 1848 nobody apart from a handful of bank officials and civil servants at the ministry of finance had known about the true state of the bank, notably the amount of banknotes in circulation and silver reserves held. Now this information was made public. In the following years, the bank never returned to its former secrecy, but recognized the importance of transparency for the confidence in the quality of the money. Transparency and accountability are also key elements in how we think about policy in the Eurosystem today.

In the 19th century, the privileged Austrian central bank evolved from a bank that mainly financed the government to a central bank of the banking system of the monarchy. In 1847, the bank had opened its first branch office in Prague. By 1913, the network comprised some 100 offices all over the monarchy. These branch offices were not only useful when it came to stemming local banking crises, they also helped facilitate the flow of capital within the monarchy, thus forging together this vast, yet highly heterogeneous economy. This way, the bank – which had for its first forty years been mainly active in Vienna – became a truly "national" bank, in the original sense of encompassing all the people of the Empire.

By that time, however, "national" already referred to a rather exclusive concept, which opposed rather than united different groups of the population. The bank could not escape the national struggles that marked the Habsburg monarchy during the last decades of its existence. In 1867, Hungary obtained a significant degree of independence within the Empire, now renamed Austria-Hungary. As a consequence of this "compromise," most competences of the central government were devolved to the levels of the Austrian and the Hungarian parliaments and governments, respectively, notably fiscal policy. Only few areas of policy continued to be run jointly: including foreign policy, the army, the navy, foreign trade and – last but not least – the common currency. The bank faced an environment that had fundamentally changed. Before 1867, the bank had negotiated with just one counterparty, the Imperial government, about its statutes, which had to be renewed at regular intervals, and all other laws pertaining to the monetary system. Now, the bank faced two interlocutors, which more often than not found it difficult to agree. The Austrian central bank was renamed the Austro-Hungarian bank, Budapest was promoted to become the second head office equal to Vienna and a common, but independent decision-making process was installed. In the following years, the relationship between Austria and Hungary was not always harmonious, to put it mildly. More often than not, important decisions were blocked. Within this difficult setting, the bank operated quite successfully. In the 1890s, after almost 50 years of floating exchange rates, Austria-Hungary succeeded in pegging its currency to gold, then seen as the seal of prudent policy. As it turned out, being an independently run, supranational institution, the bank was well placed to take decisions swiftly, when the political process was fraught with difficulties. Here, all of you probably see some similarity to the role of the Eurosystem during the recent crisis. Quite often the Eurosystem had to take the lead, e.g. with the SMP or OMT, until the governments managed to agree on long-run arrangements like the ESM or banking union.

That war is the greatest threat to financial and monetary stability became again painfully clear when the First World War broke out in 1914. The four years of war proved catastrophic, for the population, which suffered death and hunger, for the monarchy, which fell apart after centuries of existence, and for the currency, which by November 1918 had lost 95% of its pre-war value. But worse was to come. The new Republic of Austria, found itself in a horrendously difficult position. In the post-war chaos, Austria was cut off from the supply of food and coal and its traditional markets. The only way to finance the burgeoning government expenses was to print money. It is therefore not surprising that those parts of the monarchy, like Czechoslovakia, that found themselves in a better economic and political condition created their own currencies. Czechoslovakia, i.e. today's Czech Republic, by the way, is the only part of the former Empire that to this day uses the name "Crown" for its currency, the name introduced by the Austro-Hungarian central bank in 1892. By 1919, the monetary area governed by the Austro-Hungarian bank for more than hundred years did no longer exist.

In the meantime, Austria faced the worst inflation in its history that could only be stopped when the newly founded League of Nations arranged a loan for Austria in 1922. The League loan, which was the first international support scheme of its kind, came with severe conditions attached. For several years, Austrian fiscal policy was under direct supervision of League commissioners. In 1923, the Oesterreichische Nationalbank was resurrected from the ashes of the defunct Austro-Hungarian bank. Here again, a representative of the League sat on the board. The stabilization succeeded and the republican Schilling replaced the crown of the old monarchy. The new bank, however, soon had to face a banking system that was weakened by hyperinflation and the need to shrink after the old markets of the monarchy were lost. A number of banks failed in the 1920s. The long-drawn-out crisis culminated in the failure of Creditanstalt in 1931. The Creditanstalt crisis marked the beginning of a series of banking and currency crises worldwide, first in Germany, which then led to the exit of the United Kingdom from the gold standard. For Austria the failure of its largest bank proved dramatic. If an example of a systemically important, too big to fail institution were needed, the Creditanstalt would fit perfectly. Ultimately, the bank was reconstructed by using taxpayer money and significant resources provided by the Nationalbank. In the face of a deep economic slump, record unemployment and increasing political conflicts ultimately leading to a brief episode of civil war, however, the Nationalbank like many other central banks at this time followed a very conservative line of monetary policy, which aggravated the economic and social problems of Austria.

Thus, political unrest and unemployment made Austria an easy target for populist-nationalist Nazi propaganda. Austria was attractive for the German rulers. By 1936, due to massive re-armament, Germany's economy was running at full capacity, and foreign exchange reserves, which were needed for imports, were low. When German troops marched into Austria on March 12, 1938, one of the first targets were the substantial gold reserves of the Nationalbank, which were quickly shipped to Berlin. The bank itself became part of the Reichsbank.

After seven long years, Austria was liberated in 1945. Even before the war officially ended on May 8, the Nationalbank started to operate again on April 14 on the basis of the pre-1938 law. The argument was made that the Nationalbank had in fact never ceased to exist but had only been prevented from operating because of German occupation. The challenges in 1945 were quite similar to those in 1918. Austria needed to be carved out of a larger, disintegrating monetary area, then the crown, now the Reichsmark. In a second step, money supply had to be brought into a reasonable relationship to the amount of goods available. While the setting was similar, this time – unlike after 1918 – the government and the Nationalbank together succeeded in managing the transition without hyperinflation. A monetary reform in 1947 reduced the money supply dramatically, while negotiations between employer and worker representatives allowed for a gradually engineered increase in the price level. Finally, the Marshall plan proved crucial, first, to receive food aid, and later, to receive necessary raw products and machinery. The following years saw a fantastic economic recovery, a veritable "Wirtschaftswunder."

In 1955, the Nationalbank received new statutes. The objective set in the law was no longer a gold standard but to keep both the internal and external value of the schilling stable. When President Nixon closed the gold window in 1971 and the system of Bretton Woods disintegrated, Austria rather quickly opted for a peg to the German mark. After 1945 and until the early 1970s, foreign exchange policy had mainly served to encourage exports and keep the current account balanced. Now, foreign exchange policy became the tool of choice to control domestic inflation. The peg was successful and could be kept until Austria adopted the euro in 1999. It thus became one of the longest stable pegs on record internationally. Sustaining the peg required careful policies. Austria's policy was built on a broad consensus between the two main political parties, the social partners and the Nationalbank. The social partners also sat in the General Council of the Nationalbank, which allowed coordinating general economic policies and monetary policy to achieve the overarching objective of low inflation and a stable exchange rate.

In 1995, the Austrian people voted with an overwhelming majority of two-thirds to join the European Community, soon to become the European Union. Membership of the European Union meant that Austria was also to be among the first round of countries to introduce the common currency, the euro, in 1999, followed by the introduction of banknotes and coins in 2002. Austria was now part of a large economic area dedicated to maintaining monetary stability. In this sense, joining the euro area was the logical final step and the crowning moment of the policies Austria had pursued over the previous quarter century.

At the same time, joining the Eurosystem brought significant changes to the role of the Nationalbank. Monetary policy in the Eurosystem is jointly decided by the presidents/governors of all member central banks. We are glad to bring in our expertise, both in general – and specifically also for the region of central Europe – to the work of the ECB. Furthermore, in Austria the Nationalbank is responsible for monetary policy operations, we manage the foreign reserve assets of our country, ensure the smooth operation of cashless payments, provide businesses and the general population with high-quality secure banknotes and collect and provide crucial financial statistics. A relatively new task, which is also jointly operated with European institutions, is the supervision of banks. Last but not least, the Nationalbank serves as a link between the European level and the Austrian public, ensuring the legitimacy of the Eurosystem and our common monetary policy.

Looking back at two hundred years of central banking in Austria, it seems that few countries – and their central banks – have lived through as many exceptional and difficult experiences. But then Austria and the Nationalbank have also lived through some happy and peaceful years: in particular the past seventy years, which brought economic growth, high employment and stable prices. Yet, irrespective of the challenges the Nationalbank faced at different moments of its 200-year history, the overarching principles of its policy were always the same: the quest for stability, built on trust in the Nationalbank, which in turn is fundamentally linked to its independence.

It is these same principles of stability and independence which still guide our policy today as well as the policy of the European Central Bank and the other national central banks united in the Eurosystem. I am therefore extremely glad that the OeNB has had the privilege to host the June meeting of the Governing Council of the ECB in Vienna this morning and that I can welcome so many dear colleagues and friends to the commemoration of our bank's bicentennial today.

In particular I am very happy to be able to now welcome the President of the ECB, Mario Draghi.