Conference in memory of Tommaso Padoa-Schioppa

Presentation by Charles Wyplosz
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Tommaso Padoa-Schioppa

I first met Tommaso in the 1980s when he was Director General for Economic and Monetary Affairs at the European Commission. He had assembled a group of economists whom he asked to look at important issues faced by the European Community, as the EU was then called. This group, the CEPS group, brought together some very senior economists and some junior ones, like me. This was in line with Tommaso's natural inclination to shun pecking orders. For me, it was my first encounter with policymakers, a sudden confrontation with reality, straight from academia and theories learnt in Graduate School. It was a life-changing event, a taste of the challenges of actual policy-making and the starting point of an enduring search for the relevance of principles that achieve useful practical results. Since then, I had the good fortune to frequently see Tommaso at conferences, meetings and working groups. Later on, Tommaso gracefully accepted my invitation to serve as Chairman of the International Center for Monetary Banking Studies, which I direct in Geneva. For that, and for the many enriching encounters that I have had with him, I am enormously grateful.

As I was preparing to travel to Rome for today's conference, I wondered about why Tommaso had been so popular. Of course, he was highly congenial. He was engaging people with a mix of energy and sympathy that was irresistible. It was remarkable how willing he was to engage into debates. Many people in high position do not debate, they just make assertions. Tommaso always gave the impression that he was willing to learn. That does not mean that he was easy to convince, and much that he was willing to concede. But he was willing to argue and to listen. As an academic, I was seduced by his eagerness to couch his views in theoretical terms to which we can easily relate. Sometimes he was lyrical as well, which I found both charming and destabilizing¨. Most remarkable is that, when faced with arguments that he did not like, he did not use "political imperatives" to express his disagreements. Rather, he would invoke theoretical reasons, occasionally bending theory a bit!

When the euro was launched, I felt that some injustice – and historical mistake – was made by not turning to him to lead the ECB. He had all the required credentials but not the right passport. I have often thought that he would have been a great Chairman. But a wrong has now been righted: the passport is no longer an impediment to hold the job.

Payment systems

The organizers of the conference have asked us to talk about payment systems. I have long thought that this is a boring and useless issue, once that was not worth Tommaso's time. I was always surprised to hear talk about payment systems with enthusiast and I had concluded that he must be right for some strange reason. When the crisis came, I suddenly realized how deeply right and foresighted he had been. We have all been lucky that he had worked on that issue: without his successful efforts, we would now be in an even worse situation than we are. This being said, I still do not know much about that topic and I will now shift to two other suggested issues that are close to my own interests.

Economic models

It has been half a century since Jim Tobin called upon the profession to bridge the deep gap between macroeconomics and finance. He identified this as a weak spot in both fields. The crisis has reminded us of the urgency of the task. Yet, I do not think that we are getting closer to that goal. Finance has refined its analyses and invented ever more complex instruments, still assuming away macroeconomic factors. The rediscovery of systemic risk, really the link between macroeconomics and finance, may lead to a new effort to meet Tobin's challenge but this will require major changes in macroeconomics. The currently fashionable DSGE models have attracted considerable interest in central banks. I can see their theoretical elegance, but I don't see how they can be relevant; the single representative agent eliminates nearly everything that is of interest. I suspect that Tommaso has long concluded that the dream of achieving a complete model is just that, a dream.

In fact, since the beginning of the crisis, I have been struck by how easy it has proven to understand the unfolding events when using the many partial models that we have at our disposables. Let me mention just two of them, because they are crucial to design the policies that stand to bring the euro area crisis. The first model is portfolio balance. Beyond the details and the limits of this model, lies a deep fundamental truth: financial market equilibrium only concerns stocks, not flows. Stabilizing financial markets is about ensuring that existing stocks of assets are willingly held by investors, no matter whether it was right or wrong to issue them. Today, this concerns public bonds. The current policy strategy is failing because it aims at financing the upcoming flow of new bond issues. The crisis will stop when policy-makers shift their focus on the accumulated stocks of public debts, and stop complaining that these stocks are too large. I will soon come back to that issue.

The second class of models that has proven enormously helpful are those that allow for multiple equilibria and their consequence, self-fulfilling prophecies. Where markets wrong in not imposing spreads on Greek bonds before the crisis? Maybe but there is another more convincing story. We can see endless debates about whether this or that country is solvent. For that to be the case, it must be that the present discounted value of future tax earnings is at least as large as the current (net) debt plus the present discounted value of future government spending. Since a country is expected to exist forever, the future here is truly infinite. Is the Italian government solvent? It is just completely impossible to answer this question. Yet, the financial markets that hold billions of public debts do not have the luxury of being theoretically pure. They must make a guess, a very wild guess, and a deeply uninformed guess, for what can they know about Italian public spending and taxes in 2111? So, until July 2011, they mostly concluded that Italy was solvent. Then they changed their mind, for whatever reason. As they did, spreads abruptly rose and the Italian government now must pay a huge interest on its new borrowing. At such interest rates, the debt to GDP ratio is bound to rise fast. Soon Italy may lose access to markets altogether. Whether it is solvent or not, the Italian government will be unable to carry on. Markets do not really evaluate solvency, but they determine market access. It is perfectly useless to debate whether the markets are wrong or right for two reasons. First, because we will never know the answer. Second because losing access is a self-fulfilling tragedy, a shift from a good to a bad equilibrium. Once it happens, policymakers must deal with the painful consequences, rather than complain about markets' wickedness.[1]

The ECB's mandate and objectives

Tommaso was keenly aware of Knightian uncertainty, the fact that there is an infinity of possible events that we cannot imagine. What happened since 2007 is, alas, a spectacular example of Knightian uncertainty. This phenomenon has profound implications for the mandate of the ECB.

Legislation rests on principles that are meant to guide those who apply the law when new events occur. But some events are so unpredictable that they cannot be dealt with existing legal principles. When such events occur, they elicit two types of reactions. Conservatives fight to defend old laws and legal principles, often these are real guard battles. An extreme example is insane people that were branded as sorcerers and witches and routinely burnt. Psychiatric advances have shown that these people were not inhabited by the devil and they are no longer burnt. On the other hand, visionaries are sometimes emboldened to challenge the law. Another extreme example is Galileo whose unexpected discovery brought considerable hardship upon him.

The objective of price stability is a very fine principle. Tommaso fully recognized its importance, but he also recognized the fiscal stability is important and may take precedence over price stability. This quasi-theological debate today threatens the very existence of the euro.

Bond markets are currently highly unstable. The stock of euro area public debt is close to €9000 billion. Stabilizing the bond markets require dealing with this stock. Everyday, the markets set interest rate spreads that are required to convince investors to hold the stock. If investors grow too suspicious – the markets switch to the worst equilibrium – there may be no spread large enough to balance stock supply and demand. At that stage, either the stock must be reduced through default or someone must guarantee the value of bonds.

Currently the ECB occasionally buys limited amounts of the most distressed bonds. This has a temporarily beneficiary impact on the market because it affects both demand and anticipations. Bond purchases have a tactical impact because they tend to raise the price of bonds; investors react by delaying sales. They also wonder whether further large-scale purchases are strategic, designed to significantly change the balance of demand and supply. But the ECB's insistence that these purchases are once off and fundamentally limited completely undermines the anticipation effect. It limits the role of purchases to their tactical aspect, which results in short-term effect that vanish pretty quickly. Solving the debt crisis requires strategic action that concerns the whole stock – or the stocks of distressed and potentially distressed bonds.

One solution is deep restructuring that wipes out significant amounts of existing

[1] Of course, not all governments stand to face an abrupt switch to a bad equilibrium. Having a low debt makes such an event less likely.

debts. Another solution is a guarantee, which is more efficient that large scale purchases. Who can offer such a guarantee – or undertake large-scale purchases, keeping in mind that the stock is € 9000 billion? Not the EFSF, whose firing power is currently limited at some € 250 billion and unlikely to be significantly “leveraged”? Not its successor the ESM, whose resources will be similarly limited. Not the IMF whose lending power is about € 400 billion and not fully available for Europe. Not Germany whose GDP is of about € 2000 billion. The only place were such an amount of money is available is the ECB.

Opposition to such an ECB intervention is based on three arguments. The first one is that debt monetization is inflationary. This is a misreading of both theory and practice. Base money creation by a central bank is inflationary when it leads to increases in wider money aggregates through an expansion of bank credit. At this stage, bank credit is contracting. It will rise after the crisis, which leaves ample time for the ECB to reabsorb the liquidity; this is precisely what the US Fed and the Bank of England are planning to do after their massive increases of base money. Historically, the German hyperinflation followed from continuous financing of on going budget deficits, with no monetization of the debt stock (whose real value collapsed as the result of inflation).

The second argument is that a debt guarantee is a source of moral hazard. This is certainly correct. The solution, however, is not to let the crisis fester and the recession deepen with catastrophic economic, financial, social and political consequences. Instead, we must use another instrument to eliminate the moral hazard. We must eliminate future fiscal indiscipline by adopting specifically designed arrangements – one instrument per objective in the Tinbergen tradition. The predicted failure of the Stability and Growth Pact originates into its incompatibility with sovereignty in budgetary matters. Removing this sovereignty would be a possible solution if it were politically plausible that fiscal policy sovereignty would be abandoned. This is most likely, and not necessary. Better solutions exist. In contrast with the German federal model, the US model rests on decentralized fiscal discipline enforced at the state level, with full sovereignty. This model is arguably better suited to Europe. Balanced budget rules that allow for countercyclical policies exist, such that the Swiss debt brake, adopted in Germany in 2009 to fully come into effect in 2016.

The third argument is that the ECB is not legally allowed to undertake large-scale guarantees. This is where Knightian uncertainty comes into play. The Founding Fathers of the Maastricht Treaty did not envision the crisis that is now unfolding. As a result, the mandate and objectives of the ECB are completely ill adapted to the current situation. Modern-day conservatives insist on upholding arrangements that have failed us repeatedly. The survival of the euro requires a modern-day Galileo.