

## One money and one central bank: how many monetary policies?

Giacomo Vaciago

Tommaso Padoa-Schioppa spent the whole of his professional life seeking always to be a “practical economist”: when there is a problem – and we have never been short of problems over the years – you seek the best answer. He knew this and he stated it explicitly in these terms: “The considerations that follow are those of a person who is accustomed to thinking of problems from the viewpoint of action and of “what to do”, which I would call a professional approach. I ask those who might feel that this vision of the world is over optimistic to understand that every practical effort made must be based not only on a realistic analysis of the facts and the circumstances, but also on the conviction that reality can change as a result of human actions.”<sup>1</sup>

A practical economist is therefore one who above all continues to learn from events (practicing not just “learning by doing”, but having first of all ... learnt to learn!); and who also for this reason is able to find practical answers to improve the otherwise predictable reality. A second characteristic of his was also evident: the great importance he attached to the need to always have to convince public opinion, aware of the costs and benefits of taking political decisions to change the course of events.<sup>2</sup>

---

<sup>1</sup> See Tommaso Padoa-Schioppa, *Europa, forza gentile*, Il Mulino, Bologna, 2001, pp. 12-13. The reference is to what the *European adventure* (in the sense of a journey from which to learn) taught us.

<sup>2</sup> Hence his continuous verbal and written communication of which we have ample record. A very active member of the “il Mulino” Association since 1<sup>st</sup> February 1997, he had already been helping

He believed – and I would say this is still important and very relevant today – that the task of government authorities is always first and foremost that of explaining and not just of doing. Hence also his regret<sup>3</sup> for an undesired consequence of the increased independence of central banks from politics, which therefore “lost their role as privileged advisors of governments: they won their independence at the cost of their influence”. Is this also something that we have seen over the last year?

Let us now consider the topics of this first session, which is on the subject of monetary policies. As we will see, it is not difficult to make use of TPS’s ideas to judge events in 2011. It has been a difficult year, difficult to understand, let alone to govern. I will try to examine three issues which have been at the centre of our concerns this year. The crucial issue is obviously that of the effectiveness of the central bank’s action, given the two largest obstacles it may run into: a lack of *fiscal discipline* and the possibility of a *financial crisis*.

The difficulties of 2011 (but the predicament is not over yet) are precisely the result of all three of those problems occurring together: how to pursue effective monetary policies, in the presence of growing uncertainty, originating from fragile financial conditions, attributable above all to conditions of poor (and mostly very varied) fiscal discipline. It is difficult to compare the problems which the ECB has had to face this year with those already experienced by other central banks in the past, mainly because a similar past has never occurred. Consequently there is no “handbook” to refer to with all the answers ready to follow. And nor is there even a “rule”, simple enough to be relevant and useful, which the ECB could easily follow. I feel we can say as a consequence that all these circumstances reinforce the validity of an opinion expressed many times by TPS<sup>4</sup> in favour not of set rules, but of institutions able to exercise a certain degree of discretionary

---

this publishing house with its editorial selections since the end of the 1980s, having published at least one article every year in the journal “il Mulino” since the beginning of the 1990s.

<sup>3</sup> Tommaso Padoa-Schioppa, *La veduta corta*, Il Mulino, Bologna, 2009, p. 21.

<sup>4</sup> See for example Tommaso Padoa-Schioppa, *La lunga via per l’euro*, Il Mulino, Bologna, 2004, p. 153.

power, institutions which learn from events and are therefore able to predict developments and steer them back on course.

From this viewpoint what Keynes posed in Chapter XV of his *General Theory* as a condition for the effectiveness of monetary policies in the presence of a changing “preference for liquidity”, is still very relevant today. In order to be successful in influencing the long-term interest rate, monetary policies should:

- “i) appeal to public opinion as being reasonable and practicable and in the public interest,
- ii) be rooted in strong conviction,
- iii) and promoted by an authority unlikely to be superseded.”

According to TPS<sup>5</sup>, the progress that has been made in the development of central banking is all contained in the statute of the latest central bank to be founded, that of the European Central Bank located in Frankfurt, and it constitutes a fairly good match with Keynes’ original concept. However, 2011 also confirmed that it is not always easy to influence the long term interest rate in the European adventure still in progress. We should first decide what is *the* relevant long term rate and how much the ECB is able to control *it today*.

I will try to recount on this subject how I explain these problems – with due account taken of TPS’s teachings – to my students<sup>6</sup>. Firstly, today’s financial crisis is in part a reaction to the prevalent “market fundamentalism” of the past, i.e. that ideological vision according to which financial markets were capable of self governance, almost as if they were able to produce results that could not be improved upon, even in the absence of rules and public policies<sup>7</sup>. This reaction, predictable and predicted, led from the euphoria of the past to the panic of today and this has determined increasingly greater differences between long term rates in different

---

<sup>5</sup> See Tommaso Padoa-Schioppa, *Europa, forza gentile, cit*, p. 27.

<sup>6</sup> On the course that I teach at the Catholic University of Milan, together with my colleague Marco Lossani, which is entitled: “Political Economy of the European Union”.

<sup>7</sup> Tommaso Padoa-Schioppa discusses it at length both in *La veduta corta* and in *Regole e Finanza*, Il Mulino, Bologna, last edition updated in 2010.

countries in the eurozone. The long term interest rate – a transmission objective of the ECB's monetary policy – measured as the weighted average of the long term interest rates of the 17 countries, therefore increased, indicating an increase in the degree of monetary tightening during the year. The ECB limited its action and only partially corrected this, with the recent half a percentage point cut in its rate and with purchases of some countries' government securities, which were modest and in any event "sterilised" to have no effect on liquidity. Is it possible that a *de facto* tighter monetary policy than that planned resulted from that increase in the "preference for liquidity", which was not promptly recognised by the central bank and which, as such, was satisfied?

A definite answer is obviously not easy, for two partly connected reasons. Firstly, because that increase in the spreads between the long term rates of different countries in the eurozone – some rates of the core countries with Germany at their heart, having fallen until December while others of peripheral eurozone countries increased (primarily for Italy and Spain in 2011) – was attributed above all to a crisis of confidence in countries with excessive debt.

People have spoken of a "sovereign debt crisis", which is obviously an oxymoron when used for countries which have given up their "monetary sovereignty". They haven't issued any sovereign debt for many years now. In other words, since governments have been deprived of their ability to issue debt that was always risk-free, it is as if their debt is seen from this viewpoint as if it had become private debt. Since the only risk-free debt for the eurozone as a whole would be that represented by an alternative which remains sovereign, and that is an instrument like those issued by the US Treasury, it is also quite clear why the correct measure of Europe's monetary policy stance must, if anything, be measured on foreign exchange markets, i.e. by monitoring and controlling the dollar-euro exchange rate. From this viewpoint too, the relative strength of the euro over the last year would suggest that ECB monetary policy has been moderately tight.

It should be underlined that events in 2011 have confirmed what TPS said as far back as the time (1989) of the Delors Report, which has been recalled many times since<sup>8</sup>:

1) the probability that enlarged financial markets would initially facilitate the financing of excessive government debt; 2) the subsequent high probability not so much of a gradual adjustment of the costs of financing that debt, but of a sudden deterioration in market opinion to extreme points where financing would become impossible; 3) the conviction that the degree of discipline inflicted by yield spreads could nevertheless not be a substitute for the effect resulting from the independence of the central bank and from the rule which forbids it from becoming involved in the problems of single countries.

This last aspect, which TPS had repeatedly underlined<sup>9</sup>, is what we forgot in the summer of 2011, when another very different interpretation prevailed of how the central bank transmitted its monetary policy to the different countries which each formed a different “region” of a single monetary area. Since the different long term interest rates reflected the “sustainability” of the participation of each country in the common currency, i.e. its costs in terms of reduced monetary sovereignty, that would justify even massive and basically unlimited intervention by the ECB on the securities market. This would be true, except that at this point, an opportunity for an alternative strategy would open up for the central bank itself with regard to the single “divergent” countries. These would thus be subject to the “costs” of their divergence in terms of the sustainability of their public debt, with doses of crowding out induced by higher interest rates and therefore the imposition of a diffuse and general “penalty” on their economies. The two letters which Frankfurt sent to Madrid and Rome at the beginning of August of this year belong to this strategy, which is new for the European Monetary Union, but is to be found in many episodes in the history of central banking and in relations between monetary discipline and fiscal

---

<sup>8</sup> See Tommaso Padoa-Schioppa, *La lunga via per l'Euro*, Il Mulino, Bologna, 2004, pp. 174-179. This was a paper presented at a conference held at Tel Aviv in January 1990!

<sup>9</sup> In addition to the previous citation, see also pp. 191-2.

discipline. As in many other “strategic games” between independent powers, it is not obvious that the result will always be the best: the risk exists that financial markets will want to “see” if and which of the two players is in reality bluffing . And consequently the worst possible outcome may be that which then actually occurs. It is an occurrence which that incorrigible optimist TPS excluded, by underlining that the capacity of the central bank to intervene in emergency conditions was in any case without limits and that is how it should remain, without announcing either the rules or the conduct to follow in advance. Because on the one hand that would encourage *moral hazard* and on the other it could be simply dangerous: the good thing about financial crises is that they are never ever predicted in full detail, while intervention in an emergency means diverging from the rules almost by definition<sup>10</sup>.

The different possible measures of the monetary policies actually implemented by the ECB this year, help us to fully understand the complexity of its transmission mechanism in the presence of heightened uncertainty over the outcomes of relations between *monetary discipline* and *fiscal discipline*, since the relative structural conditions are still endogenous – i.e. destined to change partly due to the pressures of events.

---

<sup>10</sup> Tommaso Padoa-Schioppa, *Regole e finanza, cit.*, pp. 173-187.