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Conference in Memory of Tommaso Padoa-Schioppa

Rome, 16 December 2011

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Tommaso Padoa-Schioppa (© ANSA)

Conference in Memory of Tommaso Padoa-Schioppa

Rome, 16 December 2011

Proceedings

edited by Pietro Catte, Carlo Maria Fenu, Sergio Nicoletti Altimari

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Preface

This volume collects the proceedings of a conference organized by the Bank of Italy to honour the memory of Tommaso Padoa-Schioppa, which was held in Rome on 16 December 2011, almost one year after his untimely death. The proceedings had already been published, immediately after the conference, on the Bank's website. Three years later they still remain fresh and highly topical. The decision to collect them in a volume is further recognition of the Bank's deep and lasting gratitude to Tommaso, whose ideas and personality have left an indelible imprint.

The aim of the conference was to gather a group of present and former central bankers, policy-makers and academic economists who had worked with Tommaso during his long and distinguished career in public service, in order to discuss some of the policy issues and themes that had been at the heart of his work up to the very last days of his life. This, we thought, would be the most fitting tribute to his unsparing dedication to public service.

The conference could not have taken place at a more challenging time. More than three years into the global financial crisis, policy-makers and the economics profession were still coming to grips with its broad-ranging implications, which required a profound reworking of

central banking, financial regulation and the international monetary system, as well as of economic theory. In the euro area the sovereign debt crisis was at its height, and a heated debate was under way on the appropriate policy response, encompassing monetary and fiscal policies as well as actions to strengthen European governance and instruments for financial stabilization. All of this lent the discussion at the conference, particularly on European issues, a strong sense of urgency.

While challenging established economic ideas in many areas, both the global and the European crisis have demonstrated the enduring value of many of the theoretical insights developed by Tommaso Padoa-Schioppa over the years. This was stressed repeatedly by the panellists. It also emerges very clearly from the four background notes prepared by Bank of Italy staff and included in this volume, recalling Tommaso's thoughts on each of the main areas covered by the conference: monetary policy and payment systems, financial system regulation and supervision, the process of European integration, and the reform of the international monetary system.

In publishing the proceedings we have chosen to reproduce the participants' contributions in their original form, with only minimal editorial revisions, in order to preserve the authentic feel of the discussion; for this reason the texts have not been updated in the light of subsequent events. We have also decided to reprint, in

the companion volume, a preliminary bibliography of Tommaso Padoa-Schioppa's economic writings edited by Rosanna Visca, Valentina Memoli and Silvia Mussolin, which was distributed to the conference participants and which also testifies to the depth and breadth of his intellectual contribution.

We would like to take this opportunity to express our gratitude to all the participants in the conference, as well as to Alessandra Piccinini, Giorgio De Matteis, and many others who contributed to its organization. Our thanks also go to all the people who helped with the publication of the conference proceedings: the panellists who kindly revised their contributions; Rosanna Visca, Valentina Memoli, Rita Anselmi, Silvia Mussolin and Christine Stone, for their editorial assistance; Roberto Marano, who helped with the charts; Massimo Omiccioli and Livia Cannizzaro, for their valuable advice throughout the project. Finally, a special thought goes to Tommaso Padoa-Schioppa's family, who strongly supported the initiative.

The editors

Pietro Catte, Carlo Maria Fenu
and Sergio Nicoletti Altimari

INTRODUCTORY REMARKS

Ignazio Visco

I am very grateful to all of you for being here today for this conference in memory of Tommaso Padoa-Schioppa. I am glad that we have been able to bring together so many of his colleagues and friends who through the years had the fortune to appreciate his intellectual and human qualities. And I am especially glad that we are gathering here at the Bank of Italy, the institution where he spent a good part of his professional life and the environment in which he first built an international reputation. An institution that, like the others he worked in, he helped to forge and to which he always remained deeply attached.

For many of us Tommaso was more than a colleague; he was also a friend and a mentor. You could always count on his advice, his ability to anticipate and find concrete solutions to problems. Conversation with him was always enlightening; you benefited from having your ideas challenged, you sharpened your reasoning, you learned, from his example, how to deliver results. In the year since his untimely death I have often missed his wisdom and acumen, his lucid vision of the road ahead, and I have often found myself trying to guess what his advice would have been at a time when we face so many difficult challenges in Italy, his native country, and Europe, the ideal to which he devoted much of his life.

Tommaso was devoted to his country and was always conscious of its great potential. But his innate optimism did not blind him to its serious weaknesses or to the troubles that lay ahead. He considered Italy a country suffering from a grave illness: twenty-five years of healthy growth after the Second World War had been followed by two decades of growth achieved with "toxic stimuli": "A combination of inflation and currency devaluation, deficit-financed public expenditure, accumulation of debt and impoverishment of capital" (Padoa-Schioppa, 2007). The result was a country at once heavily indebted and under-capitalized, growing too slowly, where social inequalities were bound to increase. With his writings, speeches and actions, as Minister for the Economy he sought to instil a sense of urgency in an often hostile political environment: it was vital to act immediately and simultaneously for stability, growth and social equity. A sense of urgency, I must say, much vindicated by recent events.

The underlying problem, in his view, was that Italy had lost the ambition to excel. As he put it so vividly, "Italy is like a cyclist who is capable of extraordinary sprints to catch up with the group, but incapable of taking the lead or breaking away. It seems that only the anguish of lagging behind and the nightmare of being excluded enable us to summon up the energy and the will to do our best" (Padoa-Schioppa, 2005).

Well, once again we are at a point where it is imperative to demonstrate our determination to react to an emergency; but it is also time to take, as Tommaso used to say, a longer-

term view of the problems of the Italian economy and to tackle the structural impediments to sustained growth.

With regard to Europe too, in his last years Tommaso saw his fears materialize, with alarm and some bitterness. Although he is rightly considered one of the architects of the euro, he sensed from the very start that the single currency was an unfinished project. He was among the first to warn of the dangers of a "currency without a State". He was deeply dissatisfied with the political inertia that had followed the introduction of the single currency. He clearly perceived the risks posed by inadequate governance in the macroeconomic field, in financial regulation and supervision, and by a union that "failed to satisfy, even for the functions that have been attributed to it, the cardinal principles of western constitutionalism (balance of powers; the democratic vote; the majority principle)" (Padoa-Schioppa, 1998). He pleaded unflaggingly for a closer political Union.

Tommaso was not an academic economist. He had a special gift for using insights from theoretical economics to challenge received ideas and established practices. At the same time, he challenged academic economists to go beyond simplistic behavioural assumptions and to take the role of institutions fully into account.

Institutions and their design indeed constituted a leitmotif in his thinking, whether in connection with central banking, market infrastructures, European integration or global monetary arrangements. He always stressed the need to clearly identify the nature and scope of the public good

that needed to be provided in order to design the most suitable set of rules and institutional framework case by case. At the same time, he had a dynamic view of issues and institutions: only by looking at underlying economic trends could one predict which new demands would drive the evolution of institutions in the future.

Thus, for example, a fundamental insight of his – from early on in his career as an economist and, let me add, as a political scientist – was that growing economic and financial integration and interdependence, both in Europe and at the global level, would inevitably require a profound rethinking not only of how to allocate policy-making responsibilities but of the very concept of national sovereignty. He certainly did not underestimate the difficulty of this process or the resistance it would meet.

Like Jean Monnet, Tommaso was fond of quoting the words of the Swiss philosopher Henri-Frédéric Amiel: "Experience starts over with every individual. Only institutions become wiser, as they accumulate the collective experience". We can only add that institutions lucky enough to have had public servants as clear-minded and far-sighted as Tommaso Padoa-Schioppa really have had a chance to become wiser.

To conclude, Tommaso's example is a constant source of inspiration, a model of the kind described in one of his favourite quotes from Machiavelli: "A wise man ought always to follow the paths beaten by great men, and to

imitate those who have been supreme, so that if his ability does not equal theirs, at least it will savour of it. Let him act like the clever archers who, designing to hit the mark which yet appears too far distant, and knowing the limits to which the strength of their bow attains, take aim much higher than the mark, not to reach by their strength or arrow to so great a height, but to be able with the aid of so high an aim to hit the mark they wish to reach" (Machiavelli, 1908, Ch. 6).

We have decided to commemorate Tommaso by taking his ideas as a starting point to discuss some of the burning economic issues of today's real world, an approach, I believe, he would have appreciated. We have prepared four background notes, one for each session of the conference, to summarize his thoughts and legacy on each of the four themes that were at the centre of his work: monetary policy and payment systems, financial system regulation and supervision, the process of European integration, and the reform of the international monetary system. I think that the notes are ample testimony of the depth and vitality of his contribution.

Before the panel discussions, however, we will have the pleasure of being addressed by Italy's Prime Minister, Professor Mario Monti, whom I thank warmly for confirming his acceptance of our invitation in spite of his many pressing engagements.

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ADDRESS

Mario Monti

Mr Governor, Mr President of the European Central Bank, distinguished guests of the Bank of Italy, members of the Padoa-Schioppa family, ladies and gentlemen,

On behalf of the Italian Government, I wish to congratulate and thank the Bank of Italy and its Governor for having taken this highly significant initiative today of commemorating Tommaso Padoa-Schioppa and of leading us once more to reflect on his unique contribution to economics, to the forging of institutions, to European integration, and to a civil and administrative life centred on integrity and a sense of the common good.

I will recall very briefly a few aspects of Tommaso's personality in a way that partly reflects the opportunities I had of meeting with him, being influenced by him, and working with him. I first met Tommaso Padoa-Schioppa in 1962 when we were both students at Bocconi University in Milan. I saw him for the last time on 13 November 2010 in Paris at the Comité d'orientation of Notre Europe. I will make a brief reference to that below. Between those two dates I had the privilege of frequent contacts with Tommaso, sometimes in the form of close cooperation, often in the pursuit of common battles in the name of a vision – for Italy, for Europe, for

Italy's role in Europe – which was usually shared, but on many occasions definitely tended to be a minority view.

I would like to talk briefly about the very first experience of working together that Tommaso Padoa-Schioppa and I had, along with a few other people I can see in this room, around the mid-70s, when Guido Carli, having left his position as Governor of the Bank of Italy, had become President of the Ente Einaudi and decided, with the agreement of his successor Governor Paolo Baffi, to set up a group to investigate the structural aspects of the Italian banking and credit system. That group was co-chaired by Tommaso Padoa-Schioppa and myself and was composed of a number of young, very young economists from the Bank of Italy and Bocconi University. I recall that for me and for my young colleagues from Bocconi University this was, I hope you realise, the very first opportunity to physically see this institution, the Bank of Italy, where we used to come for those meetings and I believe were unwittingly inspired by the climate there.

Many of those young economists have since had opportunities to work within the Bank of Italy. I never had such an opportunity, although I applied for a scholarship just after my graduation, which I simply did not get. Even those who were not members of the Bank of Italy but worked closely with them and within these rooms really absorbed a climate, an integrity, a sense of public service that was, still is, and always will be the strength of this institution and of its outstanding contribution to Italian public, and I would say moral, life. It was an opportunity that marked me and my colleagues for a

very long time after. At the time it was extremely interesting to follow, sometimes agreeing, sometimes not agreeing, the line taken by Tommaso in his work, for he had, as we all know and as many of us directly experienced, this unique combination of extremely close attention to technical and institutional aspects – which most of us sometimes found very boring but which were not boring to him – with a long-term philosophical, political and cultural vision that enabled him to be normally one step ahead of his interlocutors.

Especially in this last year since he left us I had – before I was temporarily caught up in Italian public life, that is, when I was a free man – many opportunities to take part in events in Europe, in very different circles, where Tommaso has been commemorated. And it was really incredible, not only to me but to every other person present on those occasions, to see how deep an influence on monetary, financial, economic, institutional thinking he had had over the years. We knew, of course, when he left us that he was leaving behind a very powerful legacy, which also became apparent, at least to me, afterwards. Of course, that legacy was not confined to Europe alone, as was made clear at a commemoration ceremony that we held at Bocconi University in Milan by the immediate acceptance and very warm participation of Paul Volcker, who came expressly from the US to commemorate Tommaso.

We have discovered, too, as the economic and financial situation of Europe has deteriorated in the recent period, how much Tommaso had said that was not noticed at the time but would have had a very strong impact; if even closer attention

had been paid to what he wrote or said then, much of the current crisis in Europe, not to say Italy, would have been less severe and would have been tackled more promptly. He has become legendary after he left us for his insistence on the long view as opposed to the short view, and we can say that in the conduct of individual firms, of individual financial institutions, of individual countries, but also of integrated systems of countries, the excessive attention given to the short-term horizon is basically at the root of major policy mistakes.

One could say, and this is also my view, that even in the exercise of discipline, which is a fundamental prerequisite for sound economic policy, one can be subject to an excessively short-termist approach, as we have seen already in a first round of calls for discipline in 1997-1998, at the beginning of the extraordinary experience of forging the euro. This was repeated just a few years later, when a small catastrophe, with a complete loss of credibility for the Stability and Growth Pact, was caused by those very countries that had insisted so much on discipline but were wrapped up in a too short-termist approach. This is why I believe that all the discussions in which we are engaged in Europe at this time and which are meant – an objective totally shared by Italy – to enhance the framework of discipline of the fiscal compact should, as President Draghi rightly says, be embodied in a long-term sustainable approach, and not just be designed to please the short-term hunger for discipline in some countries which could then lead to a lack of discipline in those very countries and others. Therefore, there

is a series of messages from Tommaso's work which I think still have a lot to say today.

Equally, and this will be my last reference, I was very impressed by my last conversation with Tommaso less than one month before his departure, and that was in Paris in November 2010 at the Notre Europe meeting which I have mentioned already. Several of you were present there too, and he concluded the session by chairing a panel on the growth dimension of the European economy. It was very inspiring to see him go back to the notion that he had developed in the last few years about the need for Europe to strengthen the policy apparatus surrounding sound monetary and fiscal policy, but also the need to go beyond mere coordination of policies towards common policies and even unitary policies in the area of growth.

I can say that we all see now that there, too greater attention to his messages would have prevented Europe from making some mistakes. However, what I would like to conclude with in this very sketchy and unsystematic and perhaps a bit too emotional little speech about my friend Tommaso Padoa-Schioppa is that in my present work, which I conduct with a number of people who also had the opportunity to be influenced by Tommaso's work and friendship, there are two elements that strike me as permanent legacies: one is that working for Italy and working for Europe are not really two different things, particularly at a time when Italy has shown some weaknesses both structural but also in policy conduct in the recent past, which have undoubtedly contributed to a crisis not of the euro, which is not a currency in crisis, but

to a fiscal and financial crisis within the Eurozone; the other, however, is that Italy has a message to give to Europe and it needs – this is my commitment – to convey it more strongly, to be more intelligently assertive than has been the case in the past in order to ensure that the European construction evolves in a way which unites, which does not divide.

We cannot and will not allow the crisis within the Eurozone to bring us to what Martin Feldstein described in 1997 in an article – which I considered unrealistic at the time but which risks becoming a prophecy in the light of subsequent circumstances – namely, that the European currency might under certain conditions bring us to conflict more than to deeper integration. This risk of conflict between a virtuous north of Europe and an allegedly vicious south of Europe, of divisions between social classes and between countries, would be a very detrimental side effect of a powerful and magnificent construction, the single currency, which was meant to unite Europeans, as I am sure it will do in the end, not to divide them.

A disciplined Italy has a message to give and a policy contribution to make to Europe. But, of course, a disciplined Italy means an Italy which is more able than in the past to take the long view, as Tommaso would have said. In the present difficult, complicated political and social circumstances this is our engagement and Tommaso's legacy, from Tommaso the intellectual, to Tommaso the Minister for Economy and Finance, a very powerful legacy which we treasure.

[Thank you very much.]

PANEL I

MONETARY POLICY AND PAYMENT SYSTEMS

MONETARY POLICIES AND MACRO-PRUDENTIAL POLICIES

Mervyn King

Introduction

For me, Tommaso was not only a great friend, but also an intellectual sparring partner. Meeting Tommaso would always bring a warm glow of anticipation of conversation in which the past, present and future of Europe would stretch out before us as memories and ideas were exchanged. How could one not savour an evening with Tommaso when, after a good dinner, he would sit back, light a cigar and discuss the world with, in the apposite words of Mario Monti, "the intellectual approach of a philosopher".

Part of the pleasure was that although we agreed on much, we did not agree on everything, particularly concerning Europe. The prospect of recreating the Holy Roman Empire was more attractive to a man who enjoyed the warmth of a summer evening outdoors in Rome, than to a man who grew up at its rainy and windy outer extremities. Tommaso understood only too well why his vision of Europe was unlikely to include either the Ancient or the Modern Britons. But that did *not* stop us working constructively together on European questions for over 25 years, beginning with the

Group which Tommaso chaired on the single market, and of which I was a member.

I shall treasure the memory of a balmy evening in Rome over four years ago when he and I, and our two Barbaras, dined in one of his favourite restaurants in the Piazza Farnese. The cigars were lit. The talk flowed. He revealed the loneliness of being Italian Finance Minister. In his eyes shone his vision of Europe. A year after his death, it is hard to believe that such evenings will be no more.

Tommaso held an array of top international jobs in Italy and at European level for over three decades. He would have been in his element dealing with the current systemic financial crisis, and his calm wisdom is sorely missed.

Central banks' role in financial stability

Tommaso had a distinguished career as an economist with over one hundred publications. One focus of his work was the gap between monetary policy and prudential supervision, and central banks' role in filling this gap. His concern for this topic was prescient in the light of recent events. He wrote that "the role of central banks in financial stability is part of their genetic code" (Padoa-Schioppa, 2004). Central banks are bound to be involved in financial stability, not least because of their role as lender of last resort.

Superficially it may appear that central banks need to become intimately involved in issues of financial stability only during a crisis. As Walter Bagehot remarked: "In

ordinary times the Bank [of England] is only one of many lenders, whereas in a panic it is the sole lender". But in the UK we learned, to our cost, that to be able to operate effectively in a crisis, we need to be more active in promoting financial stability in 'normal' times as well. And that requires an authority with the tools and mandate to look across the financial system as a whole.

We have been forcefully reminded that it is central banks that are best suited to macro-prudential supervision because of their expertise in monetary and financial stability analysis and their proximity to financial markets. None of this would have been news to Tommaso.

The complementarity of monetary and macro-prudential policy

Tommaso believed that price stability is a necessary but not a sufficient condition for economic and financial stability. Events have proven him to be right. For example, between 2000 and 2007 inflation in the UK averaged 1.5%, and in the euro area 2.2%. Despite this, credit expanded considerably. Over the same period, the ratio of private credit to GDP grew by around 45% in the UK, and by around 30% in the euro area. In addition, major UK banks' balance sheets roughly trebled in size and their leverage ratios increased from 21 to 35, and, in some cases, around 50.

Monetary policy is naturally well suited to tackling inflation. But it is less well suited to dealing with other distortions in the economy – for example, financial

imbalances which can build up while inflation remains low and stable. A policymaker with one instrument (interest rates) and two targets (monetary and financial stability) faces a trade-off. The addition of a macro-prudential policy toolkit, focussed more directly on the underlying source of the exuberance, should alleviate this trade-off, thereby improving outcomes. The two instruments (interest rates and macro-prudential tools) may exhibit spillovers because the level of interest rates affects risk taking, through credit conditions and asset prices, while the strength of lending affects aggregate demand.

But both objectives can be pursued at the same time as, although they work through some of the same channels, the transmission mechanism of monetary policy is clearly not perfectly overlapping with that of macro-prudential tools.

In fact monetary and macro-prudential policy should be mutually reinforcing:

a) price inflation can cause misperceptions about the future state of the economy, making it more difficult for lenders to assess the quality of borrowers and projects;

b) by anchoring inflation expectations, monetary policy can minimise the risk of a Fisherian-type debt deflation spiral (Papademos, 2009);

c) monetary policy requires a stable financial system for the transmission of policy.

Co-ordination and communication challenges

The two policies may at times act in different directions (one tightening, one loosening). Some people worry that this is problematic. In fact though, this is an indication that the second instrument is required, and is performing a useful function. The UK experience provides a case in point. As I have already described, before the crisis inflation was close to target but credit and leverage grew rapidly.

In retrospect, macro-prudential tools might have been useful to lean against the increase in leverage and indebtedness. However, all other things being equal, this would have required a loosening of monetary policy to prevent inflation falling below target. So, moving these policies in opposite directions may at times be optimal. Nevertheless, it is important that decisions for each policy tool take into account the setting of the other. And it is essential that this interdependence of policy be communicated effectively.

That raises a question about whether monetary policy and financial stability policy decisions should be taken by the same group of people. Of course, similar issues arise between monetary and fiscal policy. I personally think that this coordination issue is of second order importance. The more fundamental point is to recognise the need for a second instrument directed at macro-prudential policy.

The UK's new framework

Let me conclude with a few words about the new UK institutional arrangements. Responsibility for macro-prudential policy will sit with the Bank of England. A new Financial Policy Committee (FPC) has been set up within the Bank which will eventually have statutory powers to implement macro-prudential policy. The Monetary Policy Committee and the Financial Policy Committee have overlapping membership and a common Chairman to facilitate the effective coordination of policy decisions.

The FPC has recently been discussing the risks around central counterparties (CCPs), a subject which overlaps with Tommaso's interest in payment systems. Although central counterparties can help to enhance systemic resilience, it is critically important that they manage risk effectively. CCPs continue to grow in importance – for example around half of interest rate swaps are now centrally cleared, and notional outstanding interest swap positions on CCPs total over $100 trillion. A big concern is that CCPs may become "too important to fail", and therefore implicitly guaranteed by governments. We have seen how costly this can be in the case of banks. To guard against this risk, it is vitally important that CCPs can if necessary be resolved quickly should they fail. Work on a cross-border resolution regime for banks is underway already. This will need to be matched by one for CCPs.

Like the Monetary Policy Committee, the Financial Policy Committee has four external members – Don Kohn, sitting next to me, is one of them. How wonderful it would have been if Tommaso could have joined him: for Tommaso we would surely have relaxed our rule on no smoking, at least after dinner!

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DESIGNING UNCONVENTIONAL MONETARY POLICIES: PRINCIPLES AND CHALLENGES

Donald Kohn

I am honored to be asked to participate in this conference. Tommaso was a role model for me as a central banker. He was a public servant who served his country and the global financial system in many different capacities. To each he brought a deep intellect, broad interests, wide knowledge, curiosity, and recognition that policy takes effect through the real world of payments systems, imperfectly formed expectations, and constraints on policymakers. But at the same time, he insisted that policy must take account of how decisions are shaped by economic principles and how those decisions have to be made in the context of a longer-term perspective. It's a world in which there's no substitute for policymaker judgment. Tommaso had no peer in exercising that judgment.

Nowhere is the need for judgment so evident as in the challenges that have faced central banks in the ongoing economic and financial crisis. We have seen unprecedented shocks to the economic and financial systems. No rule book guides the responses and there is little relevant experience to bring to bear. In these circumstances, distinctions that seem so clear in models and sometimes on op-ed pages of newspapers become very blurred – e.g. the distinctions between liquidity

and solvency and between fiscal and monetary policy. Inspired by Tommaso, I will draw on three plus years of experience central banks have had dealing with this crisis to outline some general principles and challenges in designing unconventional policies in these extraordinary times.

Principles

The first principle is that such policies are best if designed and explained as natural extensions of more normal policy tools – rather than as something completely different, exotic, and revolutionary, exploiting heretofore undisclosed and untested authorities and channels. Central banks are not grabbing new powers, but instead have been forced by circumstances to exercise old powers in new ways.

With respect to liquidity operations, perhaps the most basic and time-tested function of a central bank is to supply liquidity to banks and other intermediaries when funding sources begin to dry up. Supplying liquidity under such circumstances is designed to forestall or limit fire sales, to keep credit flowing to households and businesses, and generally to avoid or limit the adverse feedback loop of constraints on lending and spending. Lending in size to a potentially wider-than-usual range of counterparties against a wider-than-usual range of collateral is completely in keeping with the principles of traditional central banking exercised in an era in which many credit flows bypass banks. Consistent with Bagehot, it is critical that central bank rates and collateral requirements be both a little tighter than market rates and valuations in

normal times, but not chase the market spiral of higher rates and reduced collateral values in a panic. If the parameters are set to the conservative side of normal, unusual borrowing will wind down when market functioning is restored.

Many central banks have also been required to seek additional monetary policy accommodation when short-term policy rates are already at the zero lower bound. In these circumstances, acting on intermediate and longer-term interest rates by shaping market expectations about future policy or by buying longer-term assets is a natural extension of lowering short-term interest rates in more normal times, which works mainly through its effects on longer-term rates and asset prices.

A second closely related principle is that actions must be related to and explained as furthering the achievement of the long-standing objectives of central banks to promote financial and price stability in the context of sustainable growth and employment. Central banks are not trying to do something new and different; instead, their actions are aimed at legislated or treaty goals in an environment in which traditional tools have not proven effective enough. To the extent they become involved in, say, credit allocation or extra support of government bond markets, that should be explained as necessary and temporary, and not as a permanent addition to the central bank tool kit.

The third principle is that unconventional policy actions heighten the importance of transparency, clarity,

and accountability for the central bank. Much of the opposition to unconventional policies comes from a lack of understanding and from suspicions that central banks have taken on new powers unchecked, that the actions won't be effective and could be counterproductive, that they serve narrow private interests rather than the public interest, and that oversight and accountability are lacking. This sort of reaction is not surprising given the lack of experience with such policies and circumstances. But these reactions also point to a premium on clear explication of the actions – their rationale and expected effects and their costs and benefits. Those explications must include a discussion of uncertainty and associated risks; central banks and the economists who comment on their policies must admit what we don't know.

Clear explanations can be challenging when the policy-makers themselves disagree on effects and channels, but that is a healthy and inherent aspect of operating in these circumstances. And there can be a trade-off between transparency and effectiveness, but central banks need to err on the side of transparency and wherever possible to defuse suspicion and opposition. Clarity, transparency and accountability are necessary to preserve the political backing for independent central banks.

Challenges

Policies based on those principles still face substantial challenges. One such challenge is the calibration of policy. For liquidity operations the central bank should lean on the

side of doing more rather than less; Bagehot said to "lend freely" in a panic. Operationalizing this command may not be straightforward, however. Central banks try to direct their efforts toward solvent institutions, but "solvency" can be difficult to discern in a crisis when the distinction between insolvency and illiquidity may not be clear-cut. The lack of liquidity can result in insolvency as funding becomes more expensive or assets need to be sold at fire sale prices, which argues in favour of a generous supply of liquidity to intermediaries in a panic situation. Central banks need to be conscious of the moral hazard produced by their lending, but not paralyzed by such concerns. The financial system and the economy shouldn't be sacrificed to avoid moral hazard. The moral hazard effects of generous central bank liquidity provision can be addressed with the instruments of regulation and supervision.

The calibration of monetary policy at the zero lower bound through asset purchases and balance sheet expansion is especially difficult. Most central banks have little or no experience with policy of this sort and are learning about its effects as it is implemented. As a consequence it cannot at this point be made rule based. Among other difficulties, its effectiveness depends greatly on the behaviour of banks and on circumstances in particular markets – such as the housing market in the United States – at a time when financial institutions and markets are in uncharted waters.

The quantity of reserves and monetary base created by unconventional policy presents special challenges for

calibration and explanation. Reserves are a product of the asset purchases, but the question is what is driving the effect of the policy actions on the economy – is it the asset or liability sides of the central bank's balance sheet? A popular and strongly held view in some quarters is that it is the liability side – and that "printing money" (central bank liabilities) is inherently inflationary. But, in my view, once interest rates are at zero, added reserves by themselves don't have much effect – they certainly do not automatically feed into money supply and inflation. These relationships are marked by pronounced nonlinearities and there is no necessary feedthrough from the size of a central bank balance sheet to prices – at least while the output gap is very large. Instead the effects of central bank portfolio policies arise primarily from the purchase side through their implications for the prices of bonds and other assets.

A difficult calibration issue arises from the possible spillovers onto other countries. Should policies in each country be recalibrated to take account of their effects on other countries – even beyond the feedback of those effects on the home country? There was much comment from other governments and central banks along these lines after the Federal Reserve undertook its second round of large-scale asset purchases.

Monetary policies do have effects on trading and capital flows with other countries – that's one of the several channels through which monetary policy achieves its goals. A number of commentators seem to believe that unconventional

policies have greater spillovers – though why this should be so is not clear. There's a theoretical possibility that global economic performance can be enhanced when one country sacrifices for the sake of another – runs suboptimal monetary policy from its narrow perspective. But it is quite unclear how those gains are to be redistributed back to the sacrificing country.

Should the economy suffering from high and persistent unemployment and experiencing low inflation sacrifice domestic welfare to help foreign countries restrain inflation? I find this to be a dubious proposition, especially when the foreign countries that suffer from the inflationary impulse of easier policy do so in large part because they are protecting export led growth by holding down exchange rate appreciation. Whatever the theoretical possibilities, in real life can we really improve on the model of each country pursuing price stability at home in a flexible exchange rate environment?

A second set of challenges arises from the potential fiscal policy implications of central bank actions in a crisis. As a general principle, central banks should not be involved in fiscal policy. Only the elected representatives should be deciding how to use taxpayer funds. But the distinction between fiscal and monetary policy is harder to make in a crisis. Some blurring of the boundaries may be a necessary by-product of legitimate central bank actions that follow the general principles outlined above. Those actions can necessarily entail taking added risks onto the central bank

balance sheet. For example, as I noted, collateral valuations behind liquidity facilities should be based on conservative principles in a non-crisis environment. But failures can occur in the middle of crisis and valuations can be slow to return to normal.

Recall also the difficulty of distinguishing liquidity and solvency among borrowing institutions. In some liquidity facilities it established during the crisis, the Federal Reserve took the credit tail risk because we judged that was required to restore market functioning. Monetary policies at the zero lower bound also tend to involve some added fiscal risk. The Federal Reserve, for example, has taken considerable duration risk onto its balance sheet; the Swiss National Bank has assumed foreign exchange risk.

Although central banks may need to assume added fiscal risk in stabilizing the financial system and economy in a crisis, that assumption should be guided by a number of general principles. First, it should be overt, not covert; everyone should understand the risks. Second, it should be minimal and consistent with achieving goals for financial and macroeconomic stability – including price stability. Third, it should be seen as temporary, and planned for unwinding as soon as consistent with economic objectives.

All these principles apply to government bond purchases as well as to other forms of monetary and liquidity policies. These purchases – "monetizing debt" – are sometimes portrayed as inherently inflationary and mixing monetary

and fiscal policy. Also, to the extent that these purchases blunt market signals to political authorities, they can be problematic with respect to incentives to restore healthy long-run fiscal trajectories. Still, in a bad situation such purchases may be necessary to achieve goals. Bond purchases cannot be a substitute for the difficult decisions needed to place budgets on a long-term sustainable basis. But they do not have to result in inflation or feed fiscal profligacy provided the central bank undertakes them in the context of achieving its long-run price stability objective and everyone understands that they will be reversed one day.

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" (Padoa-Schioppa, 2001, pp. 12-13). [1]

A "practical economist" is therefore one who above all continues to learn from events (practising 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. [2]

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 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" (Padoa-Schioppa, 2009, p. 21). 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 Tommaso'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 Tommaso (Padoa-Schioppa, 2004, p. 153) in favour not of set rules, but of institutions able to exercise a certain degree of discretionary 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:

a) appeal to public opinion as being reasonable and practicable and in the public interest;

b) be rooted in strong conviction; and

c) be promoted by an authority unlikely to be superseded.

According to Tommaso (Padoa-Schioppa, 2001, p. 27), 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, 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 Tommaso's teachings – to my students.[3] 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.[4] This reaction, predictable and predicted, led from the euphoria of the past to the panic of today and this has determined increasingly large differences between long-term rates in different 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 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 Tommaso said as far back as the time (1989) of the Delors Report, which has been recalled many times since (Padoa-Schioppa, 2004, pp. 174-179): [5] (a) the probability that enlarged financial markets would initially facilitate the financing of excessive government debt; (b) 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; (c) 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 Tommaso had repeatedly underlined (Padoa-Schioppa, 2004, pp. 191-192), 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 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 Tommaso 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 (Padoa-Schioppa, 2011, pp. 173-187).

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 pressure of events.

NOTES

[1] The reference is to what the *European adventure* (in the sense of a journey from which to learn) taught us.

[2] Hence his continuous verbal and written communication of which we have ample record. A very active member of the Il Mulino Association since 1st February 1997, he had already been helping 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.

[3] 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*.

[4] T. Padoa-Schioppa discusses it at length both in *La veduta corta* (2009) and in *Regole e finanza* (2011).

[5] This was a paper presented at a conference held at Tel Aviv in January 1990.

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THE FINANCIAL CRISIS AND THE ROLE OF THE ECB: WHAT HAVE WE LEARNED?

Charles Wyplosz

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 policy-makers, 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 engaged people with a mix of energy and sympathy that was irresistible. It was remarkable how willing he was to take part in debates. Many people in high positions 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 less 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 disagreement. Rather, he would invoke theoretical reasons, occasionally bending the 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 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: that passport is no longer an impediment to holding 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, one that was not worth Tommaso's time. I was always surprised to hear him talk about payment

systems with enthusiasm 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 closer 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 been to understand the unfolding events when using the many partial models that we have at our disposal. Let me mention just two of them, because they are crucial to design the policies that can bring the euro area crisis to an end.

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. Were 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. Firstly, because we will never know the answer. Secondly, because losing access is a self-fulfilling tragedy, a shift from a good to a bad equilibrium. Once it happens, policy-makers 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 by reference to existing legal principles. When such events occur, they elicit two types of reaction. Conservatives fight to defend old laws and legal principles; often these are rearguard 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 that 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 €9,000 billion. Stabilizing the bond markets requires 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 the bonds.

Currently the ECB occasionally buys limited amounts of the most distressed bonds. This has a temporarily beneficial 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 one-off and fundamentally limited completely undermines the anticipation effect. It limits the role of purchases to their tactical aspect, which results in short-term effects 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 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 €9,000 billion? Not the European Financial Stability Facility (EFSF), whose firing power is currently limited at some €250 billion and unlikely to be significantly "leveraged". Not its successor the

European Stability Mechanism (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 about €2,000 billion. The only place where such an amount of money is available is the ECB.

Opposition to ECB intervention is based on three arguments. The first 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, Germany's hyperinflation followed from continuous financing of ongoing 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

in 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, but unnecessary.

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 as 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.

NOTES

[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.

Background note

T. PADOA SCHIOPPA'S PERSPECTIVE ON MONETARY POLICY AND PAYMENT SYSTEMS

Paolo Angelini and Paolo Del Giovane

Tommaso Padoa-Schioppa was critical of the predominant approach in macroeconomic theory, which gives little if any role to money and credit, and thought that a full and joint analysis of the functions provided by money – means of payment, measure of value, and store of value – is essential to understand its role in the economy. In parallel, he saw monetary policy as inextricably linked to financial stability and to the functioning of the payment system (Bini Smaghi, 2011).

1. *Monetary policy formulation in Italy between the 1970s and early 1980s*

Padoa-Schioppa's contributions to monetary policy thinking span a period of over thirty-six years during which he served at the Bank of Italy (1970-1979 and 1983-1997), the European Commission (1979-1983), the Italian Securities Commission, Consob (1997-1998), and the European Central Bank (1998-2005). His first contributions to monetary policy formulation date back to his early years at the Bank of Italy. After completing his

post-graduate studies at MIT, he arrived at the Research Department as a young economist in 1970, becoming head of the Money Market Division in 1975. Back then, the Italian economy was afflicted by considerable instability, high and volatile inflation rates, large and sudden depreciations of the currency, and strong rigidities, a "100% plus indexed economy", as Padoa-Schioppa and Franco Modigliani labelled it in their 1977-78 essays (Modigliani and Padoa-Schioppa, 1977 and 1978). Financial markets were underdeveloped, public debt management non-existent; the central bank and the banking system played a key role in financing the large and rising budget deficits. In spite of extensive financial repression, elusion or outright evasion of capital controls was common. Furthermore, society was racked by violent terrorism, in a context of social unrest. The challenges faced by policy-makers in that context were enormous.[1]

In those years, due to the lack of well-developed money markets, monetary and credit management took place through a system of administrative controls on quantities (portfolio constraints on banks' bond investment, ceilings on credit expansion), that generated inconsistencies and conflicts. To address this state of affairs, the Bank of Italy began to lay the foundations of a "new system" that would shift over to indirect monetary controls and open market operations.

Padoa-Schioppa's participation in this process was influential. He was the promoter of a reform that led the

Bank of Italy to assume an active role in the auctions of government paper, and to the adoption of variable rate tenders. This reform enhanced the Bank's ability to affect the interest rate on T-bills, then the reference rate for monetary policy. It was the beginning of the road to full independence, achieved in the early 1990s after a long series of gradual steps (including the 1981 "divorce" between the Treasury and the Bank of Italy, whereby the Bank ceased to act as residual buyer at Treasury bill auctions, a milestone in this process). As described by Ciampi (2011) and Micossi (2010), Padoa-Schioppa himself vividly recalled that Baffi (at the time Director General of the Bank) initially opposed the proposal of his young collaborator, but then – after sleeping on it – admitted he had changed his mind at a meeting with Padoa-Schioppa and the Board of the Bank, which approved the proposal.

As Rossi (2011) noted, the analytical foundations of Padoa-Schioppa's important contributions to this reform process (a radical revision of the compulsory reserve regime being another important change in the same years) can be found in studies he made in the mid-1970s (Padoa-Schioppa 1974; Caligiuri, Fazio and Padoa-Schioppa, 1976) and in a wide and enlightening retrospective that he published a decade later (Padoa-Schioppa, 1987b). In this essay Padoa-Schioppa provided a vivid description of monetary policy conduct in Italy and the reforms of those years. He also put forward a number of general ideas which would

remain a yardstick throughout his entire career as an economist and central banker.

One of these ideas concerned the nature and complexity of the monetary authorities' tasks, and the relationship between monetary policy, the structural features of the economy and the areas for reform. In his words, "The monetary authority maximizes its objective function subject to constraints that are of both an institutional and an economic nature, and it responds to factors that make such constraints more binding" (Padoa-Schioppa, 1987b, p. 265). In a period in which the sharp increase in the public sector borrowing requirement was one of the main constraints, a transformation of the financial structure became imperative, and the monetary authority had to play a decisive role in this process: "The importance of the role played by the Bank of Italy in this process has been a distinctive feature of the Italian experience. The resources that the central bank has devoted to it suggest that rather than a 'nuisance', innovation has been an explicit objective" (Padoa-Schioppa, 1987b, p. 266).

Another way in which he expressed this idea was by arguing (along Tinbergen lines) that economic policy had to include, in addition to "quantitative" actions, also "qualitative" actions, designed to change structural characteristics of the economy. In his view the Italian experience in the period under consideration provided ample evidence that this concept "applies forcefully to monetary policy, which normally encompasses both the manipulation of policy variables in a given structure

and deliberate innovative action on the structure itself" (Padoa-Schioppa, 1987b, p. 267).

2. Monetary policy "styles"

Between 1979 and 1983 Padoa-Schioppa served as Director General for Economic and Financial Affairs at the European Commission. After returning to the Bank, he was appointed Deputy Director General in 1984 (a post which he then held for thirteen years). The European Monetary System had been established in 1979; in the second half of the 1980s exchange rate controls were removed and capital movements were completely liberalized. During this period he devoted his energies to the thorough transformation of the Italian financial infrastructure (Visco, 2011).[2] At the same time he concentrated on the exchange rate system and on the process that eventually led to the European Economic and Monetary Union. In this period he put forward the idea that the coexistence in Europe of free trade, full capital mobility, fixed (or managed) exchange rates and national monetary policies would generate an "inconsistent quartet", and that the only solution to the inconsistency would be to complement the common market with a monetary union (Padoa-Schioppa, 1982 and 1987a).[3] As Bini-Smaghi (2011, p. 3) points out, in the early 1980s these ideas were still pioneering and visionary, but they later became extremely influential in shaping the history of Europe, turning vision into reality.

In this period he also put forward his ideas about monetary policy strategy. In a paper published in 1996 he discussed the relative merits of rules versus discretion, and activism versus non-activism, arguing "that the conflict between activism and non-activism is still present, at a deeper level, once one fully acknowledges the implications of uncertainty. Adding uncertainty to a model does not simply involve adding a stochastic term to its equations. What uncertainty really implies is that there are unforeseeable events that cannot be incorporated in a stochastic rule, no matter how sophisticated it may be" (Padoa-Schioppa, 1996, p. 44). These ideas reflected his awareness of the importance of taking into account in the policy-making process the concepts of model uncertainty and robust control, built upon theoretical ideas developed in previous decades (such as "Knightian uncertainty") and later formalized by economists such as Hansen and Sargent. He added that "once the two extreme hypotheses of deterministic rules and arbitrary action are rejected, experience shows that rules, even when provisos are added, must allow for discretionary action by central banks to cope with the complexity of real life, changes of a structural nature and extraordinary events. A strong central bank is an institution which is in the position to act in a discretionary way". At the same time, he was well aware that modern central banks had to balance their growing independence *vis-à-vis* the political sphere with increased accountability for their actions to the government, parliament and the public.

In the same paper, he discussed what he called the possible "styles" of monetary management. He distinguished three styles based on a formal and quantified pre-commitment to a single target variable (the exchange rate, the money supply or the rate of inflation) and a fourth one, which he called the "classic" style, that relied instead on a multiplicity of variables and did not entail a prior commitment by the central bank to react to a specific indicator. He observed that the styles actually implemented by central banks deviated in many instances from those formally announced and that the "classic" style had been, on the whole, the most widely adopted. Based on inflation performance, he also noted that price stability can be achieved through different styles and that a formal pre-commitment to a single target variable may not be as important in practice as it might appear in theory; furthermore, "central banks should be aware that trying to influence market expectations by 'speaking up before' may be useful but that the best way to win credibility is still through the results they achieve and the determination and consistency they show in their behaviour" (Padoa-Schioppa, 1996, p. 40).

This line of thinking explains his scepticism about inflation targeting. Since this was, at the time, a newly emerging style and it was therefore not yet possible to judge its effectiveness empirically, he discussed it *a priori* and concluded that the main merit of inflation targeting, i.e. the focus on price stability, also represents its most serious drawback, because it forces the central bank to make a formal commitment

with respect to an economic variable that is beyond its full and direct control, especially in the short time horizon used for judging monetary policy actions. His preference went to the classic style. To critics who lamented the lack of transparency of this style, Padoa-Schioppa answered that "transparency should not be reduced to announcements. Central banks adopting the classic style try to eschew both the gambles and the monistic bias of some recent strands of theory, while incorporating the useful elements that can be distilled from them and from experience inspired by them […]. They are by no means inherently less transparent and accountable than central banks adopting inflation targeting" (Padoa-Schioppa, 1996, p. 63).

In the following years, Padoa-Schioppa's main ideas on monetary policy and the tasks of the central bank did not change substantially. As a member of the Executive Board of the ECB, he again used the four archetypes coined ten years earlier, with the only difference that the classic style was renamed "discretion" (Padoa-Schioppa, 2004, Ch. 4). He saw the ECB approach as choosing none among money targeting, inflation targeting and discretion, while drawing something from each of them; recognizing the merits of the rather eclectic approach prevailing for over a quarter century among leading industrial economies and avoiding tying monetary policy action to a single variable; not seeing inflation expectations as sufficient to depict exhaustively the state of the economy; using a plurality of models, not a single model or paradigm; regarding a margin of flexibility

to cope with exceptional circumstances as desirable; and, all in all, favouring a wide discretion over a simple rule.

He discussed the arguments of the main critics of the ECB strategy (Svensson and Galí are mentioned as the main examples), arguing that, in conclusion, "large part of the dispute over the ECB strategy can be traced to a differing appreciation, of the ECB and of some of its critics, as to whether monetary policy should rely on a diversified, or else a unified, all-encompassing model of the economy. The rationale for a discretionary policy label, such as that widely used in the quarter century before the start of the euro, is not only for a simple desire to be free at the moment of policy decisions, it is also in recognition of the risks associated with an unconditional adoption of a single model without conclusive evidence that it is the best model. Discretion, which implies some eclecticism, in turn confers some robustness to policy-making". He concluded that "A strategy, useful as it is for good decisions, does not yield decisions. Its role is to identify relevant information, help interpret it, and connect it with possible actions, but not to mechanically produce a decision. Ultimately this is due to the fact that a decision is an act of *will*, not an act of *knowledge*" (Padoa-Schioppa, 2004, pp. 76-77).

3. The payment system: thought and action

Until the 1980s, the debate on money did not centre on its role as a means of payment. Most of the analysis focused on the two other functions of money, that of *numéraire* and

that of store of value. Likewise, the particular technology of payments went largely unheeded in those decades. It was generally taken for granted that money was essentially *fiat* money, paper legal tender or cheque. "Technological change set the thinking about money in motion once again. Innovation was brought about by the joint application of electronics and telecommunications. In the payment system, this innovation has determined epochal changes. What started out as a product innovation (electronic money) ended up as a fundamental process innovation (the modification of the circuits for the exchange of money)" (Padoa-Schioppa, 1992, foreword). Perhaps more than any other area over which Padoa-Schioppa exercised his intellect, that of payment systems is the one in which his deeds have been as important as his thinking.

As noted by Visco (2011), it is now natural to think that a smooth, well-functioning and economical payment system is a pre-requisite of a modern financial system. But this is a relatively recent achievement, following the information and communication technology revolution. In the mid-1980s the large value payment system was rather neglected and far from well-organised, not only in Italy. In the 1980s, the gradual spread of new technologies and developments in financial markets fuelled a spectacular growth in the volume of transactions going through large value payments systems – the set of structures and procedures used by financial intermediaries, mainly banks, for payments among themselves. During the decade, volumes went from

35 to 80 times annual nominal GDP in the US; in Japan, over the same period, they went from 20 to 115 times GDP. Until then, banks in the main industrialized countries had exchanged payments largely through net settlement systems, mechanisms that would allow banks to exchange promises of payment during the day and settle the net balance at the end of the day in base money. The exceptional growth in volumes increased the counterparty and credit risks generated by these systems. Central banks gradually became aware of these risks and started to think about ways to curb them. The US Federal Reserve was among the frontrunners in this area. The Fed's own large value payment system, called Fedwire, allowed banks to settle their payments in real time using base money; banks could run uncollateralized overdrafts during the day, free of charge as long as they were paid back by close of business. In practice, the Fed would make good a bank's overdraft, bearing the credit risk until the payer reimbursed it at the end of the day. The risk became painfully clear to the US central bank when in March 1985 the Bank of New York failed to reimburse its daylight overdraft, and the Federal Reserve Bank of New York was forced to extend the bank an overnight credit equal to several times its supervisory capital. While the episode ended well, as the failure turned out to be due to a technical problem, it made the central banking community well aware of the risks created by the staggering growth in payment volumes and by high tech payment system.

At that time the Italian interbank payment system was heavily outdated. The settlement of cheques or the completion of a credit transfer were long and cumbersome processes that involved a fragmented set of bilateral arrangements between banks. Diffidence and competition prevented banks from joining forces and investing in infrastructures that would have benefited all. Padoa-Schioppa saw this, and became convinced that a change was needed. More broadly, he believed that central banks should focus not only on monetary policy, but also on improving the payment system and the other market infrastructures that are essential to a market economy.

He therefore embarked on an effort to improve the Italian payment system. He set up a new coordination structure at the Bank of Italy, the Technical Secretariat for the Payment System, and became its driving force. The Secretariat relied on several departments and encouraged their cooperation, as well as that of Italian commercial banks, helping bridge the gap between Italy and other major economies in this field. Initially the reforms promoted by Padoa-Schioppa involved the clearing system, with the launch of dedicated projects for various payment types (customer paper-based and electronic, inter-bank, foreign exchange, securities trading). He was then instrumental in the realization of a state-of-the-art national real-time gross settlement (RTGS) system which put the Bank of Italy among the frontrunners in this area. By the end of the 1990s RTGS systems had become a worldwide standard.

In these years Padoa-Schioppa was also deeply involved in the process of European monetary unification. He soon realized that the creation of a single currency would have to be accompanied by the institution of a unified mechanism for its circulation throughout the European economy. The euro area real-time gross settlement system, TARGET, was, and still is, the backbone of the monetary policy technical apparatus in the euro area. As it allows banks to exchange funds in real time and therefore to arbitrage away differences in overnight rates across borders, it is a prerequisite for the implementation of the single monetary policy. As pointed out by Visco (2011), a workshop organized by Padoa-Schioppa at the Bank of Italy's conference centre in Perugia (SaDiBa) in November 1991 revealed how fragmented the procedures and mechanisms of the various European countries were and set the agenda for payment system evolution over the following years. From 1991 to 1995 Padoa-Schioppa chaired the Working Group on Payment Systems of the central banks of the European Community. When he joined the Governing Council of the European Central Bank he promoted the move from TARGET to TARGET2, an innovative, highly efficient and secure RTGS created and jointly managed by the Bank of Italy, the Deutsche Bundesbank and the Banque de France on behalf of the entire Eurosystem, which settles interbank payments for each euro area country. Between 2000 and 2005 Padoa-Schioppa served as Chairman of the Basel Committee on Payment and Settlement Systems, an appointment that marked a worldwide recognition of his leadership in this area.

4. Monetary policy and financial stability

Padoa-Schioppa was of the view that, in general, sound monetary and financial stability policies support each other, although they should remain distinct (see in this volume the background note *Financial system regulation and supervision*, by A. De Vincenzo and A. Generale). His criticism of narrowly-defined inflation targeting and his endorsement of the classic approach are consistent with the rethinking on the subject triggered by the financial crisis among leading central bankers and academics. At the same time, he was also aware, at least since the early 2000s, that price stability is certainly not a sufficient condition for financial stability, based on the observation that significant episodes of financial crises in the previous two or three decades had in fact taken place in a context of overall price stability.

He also believed that there could be an occasional trade-off between monetary and financial stability, and that higher inflation in the short term could be accepted in some cases to avoid financial instability: "An important question is: could there be circumstances in which the monetary policy stance required to maintain price stability could harm the stability of the financial system? Theoretically, such situations do have fairly robust underpinnings, although empirically these occasions appear to be quite rare - mainly a result of the strong link between recessions and financial crises. But such situations can arise. If for example, the central bank assigns a relatively high probability to financial instability and assesses that such instability is associated with deflationary

tendencies, it may need to accept higher inflation in the short term" (Padoa-Schioppa, 2003, p. 2). Therefore, monetary policy tools, such as interest rates and market operations, could at times be used to promote financial stability. In the short run, easing monetary conditions may be entirely appropriate for central banks concerned about system-wide financial problems, if there is a risk that they may in turn disturb monetary stability.

NOTES

[1] For a description of the features of the Italian economy in that period and their implications for the conduct of monetary policy, see I. Visco (2011, pp. 1-2).

[2] I. Visco (2011) recalls – among the many transformations carried out in those years – the suppression of direct credit controls, the reform of reserve requirements, the adoption of competitive-bid auctions for Treasury bills, the introduction of longer-term Treasury bonds (with uniform price auctions) and indexed Treasury credit certificates, the establishment of screen-based markets for government securities and for inter-bank deposits.

[3] The idea of an "inconsistent quartet" had previously been set out in the literature as the impossible trinity proposition, according to which a group of countries cannot simultaneously maintain a fixed exchange rate, carry out autonomous monetary policies and retain full capital mobility. Padoa-Schioppa adapted this proposition to the specific European context, including free trade as a fourth element; above all, he saw the adoption of a single monetary policy and a single currency as the most coherent way to reconcile these elements (Bini Smaghi, 2011, pp. 2-3).

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PANEL 2

FINANCIAL SYSTEM REGULATION AND SUPERVISION

REGULATION AND SUPERVISION: BEYOND THE "OWN HOUSE IN ORDER" DOCTRINE

Jaime Caruana

I greatly appreciate the invitation to participate in this conference to commemorate Tommaso. I had the pleasure to work and to discuss with him for many years, and I always admired his capacity to analyse and to think looking forward. He was a man of vision and a friend whose advice we miss.

I would like to make three points in relation to Tommaso's contribution. First, he rejected the "own house in order" doctrine. Second, he stressed the importance of supervision. Finally, he underscored the limitations on our capacity to quantify risks.

In 1994 Tommaso Padoa-Schioppa and Fabrizio Saccomanni described the market-led global financial system as still requiring international cooperation that transcends national sovereignty in three areas: monetary policy; payment systems oversight; and banking supervision. I will structure my remarks around these three headings, with particular emphasis on the third rubric, banking supervision.

I agree with Tommaso's rejection of the "house in order" doctrine, which claims that if each national policy player keeps its house in order, then the world itself would be in

order (Padoa-Schioppa, 2008). In all three areas, we are progressively recognising the need for competence and action that go beyond the self-sufficient Westphalian state, which exercises unchallenged sovereignty within its own territory (Padoa-Schioppa, 2010b).

En passant, I note that Tommaso remained very much the same man as his career spanned these three areas: Deputy Director General of the Bank of Italy and member of the Executive Board of the ECB; Chairman of the Committee on Payment and Settlement Systems; and Chairman of the Basel Committee on Banking Supervision (not to mention securities supervisor, accounting standard setter and finance minister). Tommaso's vision was not bounded by any silo.

Monetary policy

In that spirit, regarding monetary policy, allow me to make three quick points.

First, taking one particular example, global liquidity developments highlight the insufficiency of the "house in order" doctrine in national monetary policy. Major currencies are extensively used outside the home jurisdiction, and so the home authorities have a direct influence on monetary conditions in the rest of the world. [1]

Second, Tommaso's far-sightedness led him to call the euro a "currency without a State",[2] which makes it a post-Westphalian project *par excellence*. He held that "further progress toward the construction of a political union would,

over time, be critical for the potential and ultimate success of the single currency" (Padoa-Schioppa, 2004, p. 36).[3] In my view, at present the euro area states are the sovereigns behind the euro.[4] Thus, further fiscal agreement is a necessary condition for a stable single currency.

Third, Tommaso held that there was a tension between a single monetary policy and national bank supervision. Let me return to this in a moment under the rubric of banking supervision.

Payment systems

Again in the spirit of Tommaso, please permit me to make two quick points about payment systems. First, in the euro area, the TARGET payment system should be recognised as one of the greatest pieces of infrastructure since the Roman aqueducts, lengths of which still stand in Europe. Nowhere else do national borders matter so little for payment flows.[5]

Second, CLS Bank, a result of international cooperation, has done what no single nation could do in taking settlement risk out of the currency market. Now payment against payment for most currency exchanges spans the time zone gaps that are as old as the planet (CPSS, 2008).[6]

Banking supervision

Finally, I turn to my subject proper, banking supervision. Two recent changes in the Basel Committee deserve

attention. The Basel Committee was enlarged in 2009 to recognise the resulting breadth of interest, including the G20 countries. And, more fundamentally, global banking supervision has made additional progress in recognising the limitation of the "own house in order" doctrine.

Regulation and supervision beyond the "own house in order" doctrine

Stefan Ingves, the Basel Committee Chairman, has said that "Setting rules without ensuring their implementation is akin to building a lighthouse without ever switching the light on" (Ingves, 2011). Peer review has become a new additional approach to ensure consistent implementation.

Accordingly, the Basel Committee will monitor the implementation of Basel III. In particular, its Standards Implementation Group will assess members' progress in adopting the Basel standards and draw attention to any lack of progress. In addition, the Committee will assess the consistency of its members' national or regional regulations with the globally agreed Basel III rules, disclosing the results of off-site and on-site assessments. Finally, the Committee will assess whether the rules are delivering comparable outcomes across banks. In particular, the Committee will test whether risk weightings for assets are similar (for similar exposures) in various jurisdictions. In performing reviews of implementation, the Committee is shifting significantly from its previous practice and culture. The Committee will now take its assessments to the doorsteps of banks or supervisors.

In Tommaso's terms, all this carries the practice of banking supervision further away from the Westphalian model of national sovereignty. Precisely because banking strains do not respect borders, banking supervisors must work together across borders. Within Europe, Tommaso argued, and subsequent events have strongly confirmed, the introduction of the euro led to an unsatisfactory mismatch between a single monetary policy and integrated financial markets, on the one hand, and national bank supervision, on the other (Padoa-Schioppa, 2002). I am sure Andrea Enria will address this European perspective.

Importance of supervision in addition to regulation

In his Per Jacobsson Lecture, Tommaso emphasised the importance of supervision in addition to regulation. He said that "Government was captured by the myth that finance can regulate and correct itself spontaneously and hence retreated too much from the regulatory and supervisory role that is necessary to ensure stability. […] Supervision, not regulation, was the main problem. Stronger enforcement of the existing rules [supervision] would have sufficed to avoid the disaster" (Padoa-Schioppa, 2010b, p. 4 and p. 10). It is evident that the same rules produced different results in North America and in Europe, in part owing to differences in supervision. Moreover, the light touch proved not to be the right touch.

The main challenge remains to capture systemic risk and to internalise systemic risk. This goes beyond changes in risk management and regulations – it requires institutional changes in regulatory and supervisory frameworks. At the national and international levels, institutions responsible for macroprudential supervision must be made to work, including the European Systemic Risk Board.

In this domain, central banks have a critical role to play. I remember at a conference at the ECB Tommaso eloquently arguing that work on financial stability is in the genetic code of central banks. Tommaso was also prescient in his forecast on that occasion: "Since the importance of liquidity and contagion risks is increasing, we should expect an increase in the role of central banks in financial stability. Attention should be paid to the risks stemming from non-bank financial activities and financial market price developments. [...] Central banks cannot be indifferent to financial stability; a policy of benign neglect is not an option. The Eurosystem cannot be an exception to this" (Padoa-Schioppa, 2002, pp. 40-41). The role assigned to the ECB in the new European Systemic Risk Board bears out Tommaso's prediction. Access to relevant information, including individual institutions' supervisory information, is critical.

Limitations on risk quantification

Tommaso spoke many times of the need to avoid a false sense of security derived from models of risk. One of the

lessons that we must draw from the financial crisis is that we, the financial industry and supervisors alike, face limits in our capacity to quantify risks, particularly if incentives line up in the wrong direction (Caruana, 2010). We have a modest ability to internalise risks, particularly systemic risks arising from interconnections and procyclicality.

The implications of these limitations are clear. We need larger and better buffers for capital and liquidity. These buffers must be ample enough to be hit in adverse circumstances. In setting them, we must look through the cycle. They need to grow in good times so that they can be drawn down in bad times.

To conclude, in all three dimensions – monetary policy, payment systems oversight and banking supervision – we acknowledge the acuity of Tommaso's insight: there is no alternative to effective, collective and supranational action.

NOTES

[1] The market-led international monetary system undid what Tommaso and Fabrizio called "the territorial correspondence between financial markets and central banks' jurisdiction". See Caruana, 2011. See also Borio, McCauley and McGuire, 2011. Tommaso pushed the argument to conclude that any currency managed along strictly national lines cannot serve as a satisfactory international money – what he called a "generalised Triffin problem". See Padoa-Schioppa, 2010a. See also Palais-Royal Initiative (2011).

[2] First used in Padoa-Schioppa, 2000 and subsequently in Padoa-Schioppa, 2004, p. 35. See also Issing, 2006.

[3] Thus, Tommaso understood the deep historical connection between the state and money, as opposed to the ahistorical view that money developed out of private sector transaction cost minimisation. See Goodhart, 1998.

[4] Taking a different line, Jaap Hoeksma and Dirk Schoenmaker argue that the sovereign behind the euro is the combination of euro area states and the European Union (Hoeksma and Schoenmaker, 2011).

[5] Tommaso was very closely involved in setting up an EU-wide system for making large-value payments, as it was then described. See Padoa-Schioppa, 2004, pp. 130-134.

[6] Admittedly, Tommaso would have preferred a central-bank-run settlement utility; see the central bank "common agent" option as described in the Noël Report (CPSS, 1993, pp. 24–25).

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TOWARDS A MORE STABLE AND EFFICIENT FINANCIAL SYSTEM: KEY CHALLENGES

E. Gerald Corrigan

Good morning ladies and gentlemen. Following the examples of those who have preceded me on today's program, I want to begin with a few observations about Tommaso Padoa-Schioppa. Tommaso and I had a great deal in common. He began his highly distinguished career at the Banca d'Italia in 1968 – the same year I joined the New York Fed. Early on in our careers as central bankers we both developed a passionate curiosity about the workings of payment and settlement systems. Each of us came to view financial stability, alongside price stability, as the inherent goals of central bank monetary policy. Tommaso and I also served as chairs of the Basel Committee on Banking Supervision in the 1990s. Later, we worked together on a number of critical accounting policy issues and their implications for financial stability.

I could go on at great length about Tommaso's legendary achievements as a scholar and economic visionary, but I would rather end these remarks with a few words about the human side of Tommaso. He was truly a kind and gentle man. He cared deeply about the well-being of people – especially the less fortunate among us. He had an engaging and ever present smile and a twinkle in his eye especially

when yet another innovative idea or concept occurred to his always inquisitive mind. For Tommaso, differences of professional judgment among scholars and policy makers were always expressed in cordial, respectful and understated terms. In short, Tommaso's quiet leadership and his sense of what was right and proper for its own sake were the visible traits of a great man and an even greater colleague and friend.

My purpose today is to share with you some thoughts and observations on a profoundly complex and vitally important question; namely, as we look ahead to five years from now and almost ten years after the darkest days of the financial crisis, will the probabilities of major and systemic financial shocks have been dramatically reduced in the context of a more stable and more efficient system of global financial intermediation?

In seeking to answer that question we must keep in mind that the dual goals of greater stability and greater efficiency are a "package deal" in that it is very difficult to imagine how we can achieve either one of them without the other. Indeed, if we fail, the consequences of that failure will almost surely be reflected in adverse prospects for economic growth and employment.

Because so much is on the line, allow me to begin by answering my own question. In short, I believe that the prospects of achieving those dual goals are within reach but such an outcome is far from certain. I say that in part because the goals are so ambitious but also because many countries here in Europe, as well as the United States, are faced with

sub-par economic growth and strong headwinds in the form of outsized budget deficits and high and rising debt ratios. Indeed, in many respects, the sovereign debt crisis in Europe is an extension of the excesses and distortions of the forces that gave rise to the events of 2007 and 2008.

In these circumstances, the premium on national and international efforts to press ahead with well conceived and well executed financial reform assumes enormous importance. The subject matter and the scale of the reform effort are so vast – and have so many moving parts – that I believe we have no realistic choice but to focus particular attention on four high priority reforms, which in my view constitute the necessary conditions for success. In essence, I am suggesting that if we do not get the design and execution of these four priority reforms right, even a high degree of success with the other items on the reform agenda will not be sufficient to achieve the goals of enhanced financial stability and efficiency. In the worst case, failure could actually result in greater instability. The four necessary conditions for success are as follows:

First: strengthened capital and liquidity standards

With regard to capital, the Basel Committee has made substantial progress in framing the Basel III capital standards, including a multi-year plan for the phase-in of the new rules. While some important issues remain unresolved (e.g. the concept of a capital "add on" for so-called systemically important institutions and ensuring

broad consistency in the calculation of risk weighted asset numbers) the market place is already treating the Basel III capital standards as an accomplished fact with here and now focus on how firms' capital positions stand today relative to the future standards.

Most observers – including myself – view the increases in the amount of capital and especially the quality of capital as contemplated by the Basel Committee as an important step in the direction of greater financial stability.

While a cross-border framework for capital adequacy has been a reality since the mid-1980s, international standards for liquidity adequacy are a new – and long overdue – phenomenon. Indeed, the financial crisis forcefully illustrated that impaired liquidity (particularly in the form of an electronic "run on the bank") is almost always the proximate cause of the demise of seriously troubled financial institutions.

It is critically important that the emergence of more rigorous capital and liquidity standards be treated by supervisors and practitioners as a single discipline. Financial history is crystal clear: it is the interplay between capital and liquidity that is at the center of our quest for greater financial stability.

The Basel Committee, the Financial Stability Board and national supervisors have made great progress in designing new capital and liquidity standards but it is still far from clear how the remaining points of controversy regarding

Basel III will be resolved and even less clear how the timing and other details of execution will be sorted out.

Second: managing very low probability contingencies (living wills)

In the aftermath of the crisis there is broad agreement in principle that the authorities – working with the private sector – must find credible approaches to essentially eliminate the "too big to fail" problem. Conceptually, this issue involves the very complex task of how a seriously troubled financial institution and its supervisors will respond to extreme contingencies in order to identify a set of concrete steps that can be taken to either stabilize the troubled institution or wind it down in an orderly fashion.

The term that is widely used to describe this concept is living wills although I, for one, rather dislike that term in this context. Keeping in mind that rarely – if ever – have we witnessed the successful orderly wind-down of a systemically important financial institution – especially one with an international footprint – the design and execution of such policies and practices is, to put it mildly, a very formidable task.

The concept of living wills has been discussed and debated at great length over the past two years. At this juncture, I want to acknowledge that meaningful progress is being made in the design of workable approaches to the concept of living wills.

While acknowledging the progress that is being made, I hasten to add that we still have a long and hard road ahead to design – much less execute – the living will concept. As an example, at systemically important institutions, risk monitoring and management takes place – as it should – largely on a fully consolidated basis. In contrast, for the purposes of living wills, the analysis of alternative contingencies and action steps is often based on legal entities, including legal entities located in multiple jurisdictions worldwide. That being the case, the concept of "ring-fencing" these legal entities has much support in regulatory and political circles. Short of a truly global framework in such areas as bankruptcy laws, I remain uneasy as to whether ring-fencing will help or hinder the goal of orderly wind-downs. As another example, orderly wind-down necessarily implies that at the point of wind-down the troubled institution and its supervisors must have in hand vast amounts of current and accurate information including, but in no way limited to, the following:

- comprehensive and current data on all exposures to all counterparties and estimates of all such exposures from counterparties to the failing institution;
- valuations consistent with prevailing market conditions that are available across a substantially complete range of the firm's asset classes (including derivative and cash positions);
- accurate and comprehensive information on a firm's liquidity and complete maturity profiles of its assets and liabilities;

- fully integrated, comprehensive risk management frameworks capable of assessing the market, credit and liquidity risks associated with the troubled institution;
- legal agreements and transaction documents that are available in an organized, accessible form such that cross default, close out rights, seniority claims, and other critical rights and obligations can be readily discerned;
- comprehensive information on the firm's positions with exchanges, clearing houses, custodians and other institutions that make up the financial system's infrastructure;
- comprehensive information on customer and client account balances held by the failing institution and its affiliates.

As I said earlier, some progress is being made – more than I had anticipated – but this is an area in which we have little or no history or precedent. Thus, the risks of flawed design and execution remain very high.

Third: enhanced resolution authority

In the United States, Title II of the Dodd-Frank legislation provides the high level legal and regulatory road map associated with enhanced resolution authority. For the purposes of this discussion, the most important provisions of Dodd-Frank are those relating to the "orderly liquidation of covered financial companies." In the legislation, a "covered" company is defined as "a systemically important institution."

The trigger which activates Title II is an approval by the Secretary of the Treasury of a written recommendation from the Fed and the FDIC to appoint the FDIC as receiver for a systemically important institution that is in default or danger of default. Once Title II is activated, the FDIC (in consultation with the Fed and the Treasury) is the agency responsible for the wind-down exercise. In discharging these responsibilities, the statute vests the FDIC with an important degree of flexibility including, in certain circumstances, the provision of funding to the failed institution if needed to preserve the continuity of systemically important operations.

While the linkage between living wills and enhanced resolution authority is clear, there is little or no precedent available to help guide the execution of living wills and orderly wind-downs of systemically important institutions with an international footprint. To put this subject in further context, I should quickly add that the progress that has been made over the past two years in these endeavours is substantially greater than I once feared would be the case. However, even while acknowledging that progress, neither the design – much less the execution – of these untested policy tools are close to operational status.

In the meantime, authorities and practitioners will continue to conduct stress tests, scenario analysis, and simulations in order to garner the insights that will help fine-tune planning and execution of enhanced resolution authority. These tools and techniques are helpful but based on my experience they can never capture the tensions

and uncertainties associated with real time wind-downs when material surprises occur suddenly and with alarming frequency. That, of course, is why the success of wind-downs and enhanced resolution authority will always depend not on abstract rules and regulations but on the experience, judgment and steady nerves of those responsible for the execution of these policies.

Fourth: enhanced international coordination and cooperation

The international contagion effects of the crisis have dramatically strengthened the already strong case for enhanced international coordination and cooperation in economic and financial affairs with renewed emphasis on both crisis prevention and crisis management. These efforts are being spearheaded by the G20, the IMF, the Financial Stability Board, the Basel Committee on Banking Supervision and a number of other international institutions.

In recent years, but especially in the immediate aftermath of the crisis, long overdue and largely successful efforts were made to broaden and deepen the range of countries which are engaged with these institutions, particularly at a policy level. While broader participation was necessary, the post-crisis environment has not made it easier to achieve consensus much less agreement on economic, financial and regulatory policies. There are a number of reasons why consensus and agreement are more difficult to achieve, including (a) the subject matter has become more complex; (b) sovereign prerogatives loom more – not less – important; (c) the

large number of people in the room or at the table; and (d) national economic and financial performance – especially in the industrial countries – is, at best, a mixed bag.

The silver linings behind the cloud of obstacles to the international cooperation process are that despite these obstacles (a) the crisis management efforts during 2007 and 2008 were an outstanding success; and (b) the leadership across all of these international institutions clearly recognize and are focused on the right issues and the right questions.

While success in forging financial reforms in these areas is a necessary condition for medium-term gains in financial stability and efficiency, the risk profile of today's economic and financial environment is – in my judgment – every bit as troubling as it was in the fall of 2008. That adverse macro-economic and macro-financial risk profile is largely driven by the European sovereign debt crisis. In recent weeks and months, the authorities in Europe have had a measure of success in framing the broad architecture of a plan to contain and ultimately reverse the debt crisis. While the plan is promising, important details remain vague so that the timing and execution of the plan is not clear. In these circumstances, financial markets remain fragile and the risk of a financial shock with highly complex contagion and systemic elements cannot be taken lightly.

THE NEED FOR EU-WIDE ARRANGEMENTS FOR FINANCIAL REGULATION AND SUPERVISION

Andrea Enria

Before discussing the points that we will address in this roundtable and the seminal contributions of Tommaso Padoa-Schioppa in the field of financial regulation and supervision, I would like to recall together with you what an extraordinary personal experience it has been to work with him. I believe that three words summarise well this experience: *passion*, *analysis* and *civil service*.

Padoa-Schioppa was particularly able to pass on to his younger colleagues the passion he had for his subjects, bringing their productivity to the highest level. He kept at the same time a truly analytical attitude, free of any contamination or pre-judgement, open to debate and challenge, irrespective of the hierarchy. And of course, he involved all of us in a genuine search for the best solutions in the public interest, with the true attitude of a civil servant. The combination of these elements, and his unique human touch, made working with him a real privilege.

I believe my role in this panel is to elaborate on one of the key red threads in Padoa-Schioppa's thinking: the need for EU-wide arrangements for regulation and supervision. I

will focus on three points: the *Single Rulebook*, the need for *coordinated policies in supervision and crisis management*, a *macroprudential framework* at the EU level that can contain procyclicality.

First, the *Single Rulebook*. Padoa-Schioppa pointed out that with the creation of the Single Market the bulk of rules that banks would have to comply with in the EU was stemming from EU Directives. However, he noticed that a good deal of flexibility was left to – and fully exploited by – national authorities in translating these directives into national rulebooks. The consequence of this was that the regulatory environment remained very diverse with (a) ample space for regulatory competition – as we learned only too well in the run up to the crisis – (b) inefficiencies in the compliance process, and (c) grains of sand in the wheel of a smooth supervision of cross-border groups.

The rulebook that counted for banks was the collation of national rulebooks and the EU dimension got lost in implementation. He then proposed, already in the early 2000s, to move to a Single Rulebook, i.e. to adopt key technical rules at the EU level, through EU regulations directly binding in the whole Single Market, without need for national implementation. The idea was finally accepted a few days before Padoa-Schioppa passed away. However, these days several national authorities are having second thoughts on this, as they have lately realised the full extent of this momentous change.

Three main arguments are used against the Single Rulebook. First, it is argued that all we need is minimum harmonisation – after all, what harm can do the decision of a jurisdiction to be tougher on its banks? This argument, however, overlooks that we have already been living in a world of minimum harmonisation and that this has not prevented regulatory competition. Financial regulation is now very complex and apparently higher standards could well turn out to be laxer because of different methodologies in applying the requirements.

Secondly, it is suggested that the Single Rulebook would hamper the operation of macroprudential supervision, which needs flexibility to adapt to the requirements of the specific conditions of markets in each country. But we may well leave room for flexibility in the Single Rulebook, in the same way as single national rules allow the supervisor to change the capital required of a bank, if its specific risk profile requires. This should, however, be done within a common EU framework of constrained discretion, with ex-ante coordination and ex-post review by the European Systemic Risk Board (ESRB), to ensure that the same build-up of systemic risks receives an approximately similar macroprudential response.

Third, it is argued that the Single Rulebook may harm small, local banks, especially cooperative and savings banks. But this can be dealt with through the notion of proportionality, exactly in the same way as it is done at the national level. So my conclusion on this point is that the arguments for the Single Rulebook are stronger than ever

and these first months of work at the European Banking Authority (EBA) have only reinforced the view that we should carry forward this seminal idea of Padoa-Schioppa.

The second point I would like to raise covers the *need for coordinated policy action* at EU level. Padoa-Schioppa has often been portrayed as pushing for centralisation of supervision at the EU – or Euro area – level. As a matter of fact, he always argued that centralisation would have been necessary only if national authorities had failed to give real content to a key building block of the Single Market: supervisory cooperation. He always stressed that there was no need for changing the Treaty, provided national supervisors were able to connect to each other and provide a unified pan-EU response when needed, that is when the risks were European in nature. In a nutshell, this is the ability to join forces and act as a single supervisor when needed.

Are we passing this test? After the default of Lehman there was a political decision that bank rescues were the sole responsibility of national governments. As a result, the market started assessing banks on the basis of the credit quality of the sovereign which was providing their safety net. This has generated the interconnection between banks and their sovereign that we are grappling with in this new phase of the crisis. The reaction of European institutions after the first phase of the crisis was slow but promising.

I remember Padoa-Schioppa calling for a significant strengthening of the institutional framework for regulation

and supervision at an Ecofin meeting at the end of 2007. At the time, all finance Ministers were listening very attentively to his proposals, but while their body language seemed to show that they were sharing the basic points of Padoa-Schioppa's analysis, they eventually voted for maintaining the *status quo*. Finally, two years later the EU institutions acknowledged that a change in the institutional framework was needed and went on to create new European authorities. No more *chacun pour soi* in a crisis, boldly stated the first page of the de Larosière report.

Although it is not up to me to say, I believe that progress has been made, and quite a significant one in these first months of operation of the new institutional framework. But now that we are getting closer to the fire again, unilateral national responses start coming back to the surface. Some national authorities are raising capital requirements for their banks above the benchmarks indicated by the EBA, putting pressure on other authorities and using the regulatory lever to attract funding in their jurisdiction. Some are ring-fencing activities and preventing transfers of assets, or limiting the banks' ability to expand their balance sheet in foreign jurisdictions. All this is segmenting the Single Market across national lines, hampering one of the major conquests of the European "adventure", as Padoa-Schioppa used to refer to it.

Lastly, I do not want to enter into a detailed discussion of Padoa-Schioppa's contribution in the field of *macroprudential supervision*, as Jaime Caruana and Charles Goodhart are addressing this point. However, there is a question that is

particularly important to me at the current juncture: is it right to ask banks to raise their capital levels in the current market situation? Or is it going to be procyclical? I would like to stress the fact that the absence of a macroprudential framework in the run up to the crisis made it unavoidable to then raise buffers during the crisis. It would have certainly been better to have had the buffers already in place and be in a position to release them if the crisis had worsened and losses had started materialising. However, in September both the IMF and the ESRB stressed, from their macroprudential perspective, the need to significantly strengthen the capital buffers of EU banks in front of the systemic risk generated by the sovereign debt crisis in the Euro area.

In the design of our requirements, the EBA has been quite careful to avoid that they create incentives to shrink the amount of credit provided to the real economy and to a fire sale of sovereign bonds. We are well aware that a massive deleveraging process is already under way as a result of the impact the sovereign debt crisis has had on bank funding markets. We are trying to rebalance the process, pushing banks to raise capital instead of simply cutting assets. More generally, however, I would say that the recent experience has made me more sceptical as to the possibility of releasing capital and liquidity buffers during a crisis, especially if this is of a systemic nature.

CAN COUNTERCYCLICAL CAPITAL RATIOS WORK?

Charles A.E. Goodhart

We are all here because we have been friends of Tommaso Padoa-Schioppa. I am proud and privileged to have been his friend for many years. The latest connection I had with him was with respect to his previous role as Chairman of the Basel Committee of Banking Supervision (BCBS), as indeed are also two of the other speakers in this panel. I have had the pleasant job of being historian of the Basel Committee, and in that context I corresponded with him about his time as Chairman of the BCBS.

More generally, my main connections with Tommaso have been that we both had a considerable interest in the process of financial regulation. We provided, in the Financial Markets Group, a financial study group which was founded by Sir Mervyn King and myself just about 25 years ago, a platform where Tommaso could come and give regular presentations, which he did at fairly frequent intervals. After he had been there for his third or fourth time, I suggested that he put these papers together and collect them into a book. Which he did, in his book, *Regulating Finance: Balancing Freedom and Risk* (Padoa-Schioppa, 2004). It is an excellent book; I was delighted to write a foreword for it.

I will now turn to, not exactly a dispute, but an argument that I had with Tommaso, since it bears on what Andrea Enria has just been saying. Tommaso, like Andrea, was a keen exponent of European-wide supervision and crisis management, especially the handling of cross-border European bank resolutions. I said that this was all very well in principle, but it failed at one particular point. Which is, that if you have crisis resolution still being funded by the individual Nation State so that the guarantee, say provided by the Irish government, and the bailout via temporary public ownership is done by the Nation State, so that the Nation State bears the cost of resolution (and there is always likely to be some cost), then that Nation State is going to want to have responsibility for being sure that the supervisory and regulatory process is as it wants. There is a well-known phrase: "He, who pays the piper, calls the tune". So long as there is still national payment for resolution, then the Nation State has a legitimate ground for saying that they have got to have the main say on the supervision of their home-based institutions, cross-border or not.

That leads me on to the view that, whereas I agree that European-wide supervision, crisis resolution and all that is highly desirable, it cannot really happen until everyone moves systemically and systematically into a proper fiscal union. And by fiscal union I do not mean the kind of reinforced stability and growth pact outlined at the October 2011 summit, but a proper fiscal union in which there are certain tax competencies and certain expenditure functions

which are given to the federal center, rather than to the Nation State.

Let me now embark on a brief discussion on Tommaso's views on financial system regulation and supervision, partly illuminated by the excellent note that Alessio De Vincenzo and Andrea Generale have put out in advance on Tommaso's views. I would, in that context, like to congratulate the Banca d'Italia on their advance preparation for this conference, in many ways better than almost any other conference I have ever attended.

What they say in their note, was that Tommaso was very concerned, as indeed he was, with the tendency for both markets and regulation to overshoot and thereby enhance procyclicality. I now hardly need to comment on the overshooting of markets; rather I want to emphasize that there is also an innate tendency for regulation to overshoot. Inevitably, if something goes wrong in the financial stability sphere, that means that in some respects regulation and supervision have been found wanting.

The immediate, and inevitable, response is "That must not happen again". And so what always happens after a crisis is that the authorities (you in this audience) push additional regulations onto a financial system which, by the crisis itself, has been quite severely weakened, often in a context in which raising funds, either in equity or long term debt, will be difficult. So you are imposing much more regulation on a banking system which is much weaker.

And then what happens all the time is that eventually one gets recovery and everything seems to be going all right and everybody notes that these regulations prevent banks doing what otherwise they would like to do, and it does not seem to be particularly disadvantageous to weaken and relax the financial constraints, as the banks naturally want, and so you do it. And so, inevitably, as time passes and nothing goes wrong, the regulations get weakened until the next crisis comes along. And then we start all over again.

Now at last I think that we have recognized that syndrome, but I am concerned that our attempt to counter that by countercyclical adjustments to the capital ratios will not be sufficient. There are a number of headwinds to the effective use of countercyclical measures. First, the 2.5% potential countercyclical adjustment that is allowed by Basel 3 is small compared to the cyclical swings in profit and capital. Think of the difference in the conditions of the financial and banking systems between 2006 and 2011: 2.5% compared to that, you must admit, is tiny.

Second, systemic stability management often requires a granular approach, as Mervyn King was saying, which could conflict with the desire for harmonization and uniformity. I was glad that Andrea Enria said that there was no conflict in principle and I think he is right. If you do this correctly, if you do this properly and if you do it with understanding, then there will be no conflict. The question is, will you do it in the best way?

Now, my next worry is that countercyclical measures only bite during booms because it is the market which is going to constrain the financial system and the banking system during the busts. And booms are very widely popular and their sustainability is by definition uncertain, because if everybody realized that a boom was unsustainable, it would go away instantaneously. The only reason that an asset price boom can continue is because many people think it is going to go on further. I remember a lecture by the then President of the Royal Economic Society to the British Academy in I think it was 2006, saying that there was absolutely nothing wrong with British housing prices, because the relatively low level of British long term real interest rates meant that asset prices should be high relative to incomes. If the President of the Royal Economic Society can say that there is nothing wrong with British housing prices, who are the rest of us to say that it is a bubble?

So you can never be sure what is an "unsustainable bubble" *ex ante*; that means that you have to rely in a difficult way on a number of complex presumptive indicators, to which we did not pay enough attention, such as credit ratios, leverage ratios and so on. We need a number of what I call presumptive indicators to reinforce action. Without some support from some such indicators, you have to be a very brave central banker, like Paul Volcker, to get up and say "Enough is enough, I'm going to cut a lot of people out of the housing market". Such central bankers are not going to be politically popular. Let me note that the best person

working in this field is another Italian, Claudio Borio, who has done better work at the BIS than anyone else in this field. While it may be Bill White and Nouriel Roubini who get praise for having warned about what was going wrong, it was Claudio Borio who has been doing the underlying hard empirical work in this field.

Next, assuming that we can and do use countercyclical capital ratio requirements, raising them during the boom, can we lower them during the crisis and panic? The answer is obvious: No. Because during the crisis and the panic, the banks are all looking weak and therefore dangerous; they are looking risky. Can you lower a required ratio when all your banks are looking as if they may be in danger? The answer is: You cannot. It just does not seem to make any kind of sense.

So, how do we get out of this problem, where a countercyclical adjustment can only be ratcheted up; you can never let it down during the crisis. One of the underlying problems is that we have never really thought through the question of what these capital ratios are actually supposed to be for. One of the key moments in my book on the BCBS is where Peter Cooke, the Chairman at the time, mused about the question of what these capital ratios are supposed to be. Are they supposed to be minima? Are they supposed to be targets? Are they supposed to be standards? What the heck are these ratios supposed to be?

Martin Hellwig, one of the greatest experts in this field, said that the problem is we just pragmatically apply capital

ratios, without realizing that they fulfill differing functions. Martin notes that they are used to provide owners "skin in the game"; they are used as a buffer for a going concern against loss; they are used as a buffer for other creditors when it is a gone concern; and they are used as a trigger for intervention.

The capital ratios that we have got are fairly good, not very good, but fairly good as a buffer for other creditors when the bank is a gone concern, and some work well as a trigger for intervention. But they are not very good as a margin for absorbing loss over the required minimum, because it is a minimum. I think that the way we have been operating capital ratios is wrong.

Instead of having one number, we ought to have two. We ought to have a lower number as a trigger for intervention and maybe taking it over into temporary public ownership, because the bank is too weak to be allowed to continue; such a ratio should relate much more to market equity valuations than to accounting valuations, for the obvious reasons of lags and the ability to manipulate accounting ratios. The second, upper ratio should be at the point where the marginal gain in having additional equity capital matches the marginal cost, whatever such additional cost may be, perhaps somewhere of the order of 20-25%. So then you would have two admittedly rather dodgy numbers.

What you then really need, rather than worrying too much about these exact numbers, since nobody knows

what these numbers should actually be, is then to have an increasing ladder of sanctions between the two, upper and lower, ratios. That ladder could be in terms of constraints on bonuses and dividends, it could be a pecuniary charge, becoming tougher as the bank's position goes down towards the lower ratio. So what you would then do to apply countercyclical measures, is to toughen the ladder extensions during the boom, and ease the ladder extensions during the downturn, so that banks could move further away from the 20-25% fully desirable level without running into severe sanctions.

Let me just finish with an anecdote. When I went up as an undergraduate to Trinity College, Cambridge in 1958, there was someone from America who came over to Trinity and wanted to find an English gentleman. After about a month he said "I have found two examples of an English gentleman, but one of them is a communist – who was actually Maurice Dobb, who was my supervisor at the time – and the other was an Italian, Piero Sraffa." I would like to end by saying that Tommaso represented the ideal that we all would like to think of as an English gentleman. He had all the virtues and all the qualities that we like to think an English gentleman has. It has been a privilege to have known him and a privilege to have worked with him.

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Background note

T. Padoa Schioppa's perspective on financial system regulation and supervision

Alessio De Vincenzo and Andrea Generale

It is almost impossible to try to summarize in a few pages the contribution that Tommaso Padoa-Schioppa has made to the development of the theory and of policy-making in the field of financial regulation and supervision.

However, we can take as our starting point the essays collected in the volume *Regulating Finance*, originally published by Oxford University Press in 2004 and now available in Italian with two very important additional chapters on the causes of the recent financial crisis and on the need to revise Europe's financial architecture (Padoa-Schioppa, 2004c).

Among many issues, five can be selected, since they are of topical interest in the current debate on regulation and supervision: market-friendly vs. intrusive regulation; regulation and supervision; European financial integration and supervision; macro-prudential analysis; and central banks and financial stability. The fact that Padoa-Schioppa developed these views many years ago testifies to his forward-looking thinking.

1. *Market-friendly vs. intrusive regulation*[1]

This issue is constantly present in the works of Padoa-Schioppa and his views have informed the work of the Basel Committee on Banking Supervision (BCBS), which he chaired from 1993 to 1997.

He observed that the mainstream view in the 1980s and 1990s was that the benefits of pervasive regulation were outweighed by the costs to economic agents. In discussing the contribution of the BCBS to this policy issue, he argued that a good example of market-friendly regulation was emerging. Basically, while not leaning towards a *laissez-faire* model, the new regulation that was written in Basel was seen as a balanced solution, respectful of changes in market activity.

As an example of this market-friendly approach, he mentioned the possibility for banks to use their internal models for market risk (and subsequently for credit risk), in recognition of the fact that market participants are sometimes in a better position than the regulator to measure their exposure to risk. He, however, made a clear distinction between the market-friendly approach – which he saw as an inevitable and positive development – and the 'light-touch' approach of some supervisors. Indeed, he claimed that this latter view was too lenient towards a vision of self-correcting markets, a concept that he clearly refused.[2]

This market-friendly approach was criticized. For example, Goodhart, in the foreword to *Regulating finance*,

noted that the use of internal models for credit risk proved to be dauntingly complex (and hence difficult to validate by supervisors) and that there was a risk of reinforcing herding behaviour by banks. Caruana noted that, while it would be wrong to deny the progress that has been made, risk management models failed to account for the real risk, not least because of wrong incentives and poor governance (Caruana, 2010).

Where do we stand now after the overhaul of regulation introduced with Basel III?

The financial crisis showed clearly that the quantification of risk was overly optimistic and that internal models were (partially) inadequate to gauge market developments; the focus on capital was not sufficient to avoid disruptions and liquidity problems were a major driver of the crisis; and the rules in place somewhat increased the natural tendency of financial intermediation to be procyclical.

The new regulatory framework addresses these problems with the introduction of a leverage ratio as a backstop to contain errors in the models; new liquidity rules; and capital buffers to smooth procyclicality.

These are major changes. However, does this mean that the underlying philosophy of market-friendly regulation has been abandoned? Probably not, given that the basic philosophy of previous Basel accords, namely the need to avoid as far as possible direct restrictions to banking activity that can induce distortions and be easily circumvented by

the process of financial innovation has been substantially confirmed. Again, Padoa-Schioppa's thinking is illuminating as is shown by his discussion on narrow-banking proposals: "Paradoxically, adoption of the narrow bank model could lead to a financial environment in which non-bank banks develop even further and uncontrolled and unsupervised risks spread even more" (Padoa-Schioppa, 2004c, Ch. 2).

We think that the main message that comes from Padoa-Schioppa's work in the field of financial regulation is the need to avoid the false sense of security that a certain regulatory framework could give to supervisors. Regulators, then, should keep abreast of market developments, thus confirming their scepticism towards self-correcting markets. Finally, even the best rules are powerless if there is no convinced and uniform enforcement at the international level.

2. *Regulation and supervision*

In 2010 Padoa-Schioppa gave a lecture at the Per Jacobsson Foundation discussing the impact of the financial crisis on markets and governments. He said: "I am one of those who think that supervision, not regulation, was the main problem: stronger enforcement of the existing rules (supervision) would have sufficed to avoid the disaster" (Padoa-Schioppa, 2010).

Indeed, in certain jurisdictions the market-friendly approach was too friendly. At the roots of the financial crisis

lies a misinterpretation of the light-touch approach. While it is indeed true that it was meant to reap the economic benefits of the process of financial innovation, this aim should not be an excuse to allow competition in laxity among different jurisdictions. He also noted, "A policeman has to be friendly and helpful to citizens – just as regulators need to be market-friendly – but a policeman always has to remember who he is" (Padoa-Schioppa, 2002b). This is a useful starting point to evaluate the three main developments that we observed as a reaction to the financial crisis.

First, the new set of rules on systemic institutions introduced after the G20 summit in Cannes complements the Basel III reforms. Specifically, the measures to reduce the probability and impact of the failure of systemically important financial institutions (SIFIs) address one of the worries that Padoa-Schioppa highlighted in his 2010 lecture, namely the fact that after the crisis the financial industry has become more concentrated, with an increase in moral hazard for institutions that are "too big to fail". This implies that the proposals on SIFIs are a correct answer to the problem. However, in this field too, the implementation of the rules should be forceful, effective, and uniform at the international level. This is why the indications coming from the FSB on effective supervision and peer review processes are no less important than the new rules themselves.

Second, Padoa-Schioppa noted that after the financial crisis there was a risk of the market overshooting. He observed that the market had moved from obliviousness to

alarmism over the capital adequacy of financial institutions. This risk is very real today: the push to front-load the new capital rules is very strong and is exacerbated by the increase in sovereign risk. Coupled with a deceleration in economic activity at the global level, this calls for substantially higher capital levels risks being procyclical and depressing economic activity still further. This is a clear example of the overshooting and undershooting phases of the markets that Padoa-Schioppa so lucidly explained. Policy-makers need to react to these tendencies as well.

Third, Padoa-Schioppa thought that the policy failure was due to the fact that the institutional setting at both the global and the European level did not keep pace with the evolution of banking activity. While he considered that the benefits of cross-border diversification of activities were a way of spurring competition and efficiency, at the same time he was well able to see the other side of the coin, i.e. the increased risk of contagion to other countries of a crisis stemming from one jurisdiction (see for example, Padoa-Schioppa, 2004a).

3. *European financial integration and supervision*[3]

As Bini Smaghi puts it, Padoa-Schioppa provided a farsighted and realistic contribution to the design of the architecture for financial supervision in Europe, as he was convinced that in a single market the supervisory framework has to be a common one (Bini Smaghi, 2011). In his preface to the Italian edition of *Regulating Finance*, Enria

observes that a recurrent theme of Padoa-Schioppa was the need to establish truly European (if not global) supervisory frameworks in order to cope with the systemic risks due to the interconnectedness of financial institutions and markets in different jurisdictions (Padoa-Schioppa, 2004c).

Where do we stand on this?

The reform of the European supervisory architecture for financial institutions and markets was completed with the creation of three new micro-prudential authorities (the ESAs, European Supervisory Authority) and one macro-prudential authority (the ESRB, European Systemic Risk Board). This reform marks major progress towards consistent supervisory practices.

Specifically, the European micro-prudential authority for banks (the EBA, European Banking Authority) has the task of implementing the Single Rulebook. Padoa-Schioppa noted that "Strengthening the supervisory structure for multinational financial institutions means achieving two results: a single European rulebook aimed at ensuring equal treatment, low costs of compliance, and the removal of regulatory arbitrage; and an integrated supervision of EU-wide groups, resting on a complete pooling of information and the enhancement of the powers of the colleges of supervisors" (Padoa-Schioppa, 2007). However, supervision of large cross-border banks remains the responsibility of national authorities. As Padoa-Schioppa put it, the exchange

of information among different jurisdictions and the powers of the colleges of supervisors have to be upgraded.

Especially in periods of crisis, such as the one that we have been experiencing since 2008, there is a tendency to retrench behind national borders. Indeed, the increase in sovereign risk and the contagion among various European countries have reinforced the transmission of shocks between banks in different jurisdictions. The new European authorities and the policy-makers have to cope with this further aggravation of the financial crisis and act rapidly to protect the value of financial integration.

How to value the performance of the European micro and macro supervisors?

Progress has been made, but a great deal remains to be done. Much, however, depends on the willingness of European policy-makers to cooperate in order to maintain the benefits of integration while at the same time preserving financial stability.

4. *Macro-prudential analysis*

After the financial crisis there was a flurry of contributions on the topic of macro-prudential analysis. Padoa-Schioppa noted that effective action has to rely on a rich analytical framework.[4] He also observed, and this observation is common to many other contributors to the macro-prudential approach, that differently from the field of monetary policy,

for financial stability there was a lack of a clearly established analytical and operational framework.

He fruitfully contributed to the advances in this field. He proposed his working definition of financial stability, which is "the ability of the system to withstand shocks without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payments in the economy" (Padoa-Schioppa, 2002a). While the focus on system-wide disruptions that can impair the ability of the system to finance the economy is common to the definitions given by other economists and policy-makers, he also stresses the preservation of the integrity of the payment system. This is very important, not only because Padoa-Schioppa's contribution to the definition of payment system oversight policies represented a milestone in this field, but also because it demonstrates his attention to the systemic risks stemming from the interconnectedness of financial institutions – an issue that is at the core of the current phase of the financial crisis.

As regards the analytical framework, while he concurred that the focus of macro-prudential analysis differs from the micro-prudential one, he also underlined the synergies between the two. For example, as regards the analysis, he stressed that a strict separation of the macro-prudential and micro-prudential dimensions is conceptually inappropriate and could even be detrimental. He was firmly convinced that these two dimensions were two sides of the same coin. As regards information, the crisis unveiled the presence of

important data gaps. Indeed, one powerful way of increasing the information set for macro-prudential purposes is to leverage on micro-information: for example, the use of thematic on-site inspections has proved to be a powerful instrument for assessing the importance of common sources of risk and allowed for a homogeneous across-banks assessment of risk. Moreover, tools designed for micro purposes, such as the high frequency monitoring of the liquidity conditions of the main banks, are an important tool to shed light on the interconnectedness of large players.

He stressed the need to have an analytical framework able to provide early warning signals of crises, while at the same time recognizing that it is very difficult to spot in advance the build-up of imbalances. At the national and international level there have been fruitful discussions on the components of an early warning toolkit. If correctly used, stress testing techniques can be useful devices to increase resilience to shocks. It is not by chance, then, that in the European Union both micro-prudential and macro-prudential authorities have started to make extensive use of this tool.

He also stressed the need to have an appropriate communication framework so that the authorities responsible for macro financial supervision could send the right signals to the markets and to other policy-makers. In his view, then, the publication of Financial Stability Reviews was not a mere compilation of interesting facts about the financial system, but a policy tool, that he classified under

the heading "Public comments", i.e. communication with the public.

Finally, he noted that prudential instruments aimed at contrasting systemic imbalances might be very similar to the ones used by the micro-supervisors (e.g. capital requirements, loan-to-value ratios, etc.), but that their concern was to avoid procyclical effects. Here, the subsequent work of the Basel committee on the countercyclical capital buffer has made a major contribution. At the same time, the focus on the cross-sectional dimension of systemic risk, with the work on systemically important financial institutions, also goes in the direction of containing macro-prudential risks. These are promising steps forward; in order to be effective, they have to be implemented consistently at the international level.

5. *Central banks and financial stability*

As a central banker, Padoa-Schioppa delivered numerous speeches on the relationship between monetary policy and financial stability, an issue that has gained a lot of attention in the aftermath of the financial crisis.

First of all, on the role of central banks in financial stability, he frequently recalled his long experience at the Bank of Italy, an institution that has responsibility for both central banking and financial stability. He claimed that "central banking has three major components: monetary policy, the payment system and the stability of the banks".

On the relationship between monetary policy and financial stability, at the basis of his line of reasoning was the conviction that while monetary policy and financial stability measures have to remain distinct, the objective of price stability is not possible without financial stability (Padoa-Schioppa, 2002a). Indeed, the major crises in history are those that hampered the ability of the financial system to finance the economy. At the same time, he also noted that price instability is conducive to huge redistributions of wealth, which are subsequently reflected in financial instability. He also thought that at certain times there can be a trade-off between sound monetary policies and financial stability objectives (see in this volume the background note *Monetary policy and payment systems* by P. Angelini and P. Del Giovane), an issue that is extremely relevant today.

Moreover, he identified specific policy instruments that central bankers could use to address systemic risk. First, he identified an important tool in private and public comments, i.e. the ability of the policy-maker, with his informed judgement, to influence market perceptions in the right way. In doing so, he anticipated one of the roles of the European Systemic Risk Board, for which warnings and recommendations are the main policy tool. He correctly warned that public commenting should be used prudently, in order to avoid undesired consequences and to maintain reputation and credibility, which are essential ingredients of effective policies. Second, he emphasized the operational

standards in the payments system. Payment system functioning and regulation were at the core of his interests: he noted that given the high degree of integration, the malfunctioning of these systems might be one major source of financial instability. Finally, he believed in the importance of liquidity support and the coordination of private sector solutions. While emergency liquidity assistance remains a national responsibility, he forcefully noted that market operations aimed at preserving adequate liquidity conditions remain key among central banks' tools. This observation fits particularly well with the actions of central banks in recent years.

NOTES

[1] See the essays "Market-friendly regulation" and "Licensing banks" in Padoa-Schioppa (2004c).

[2] Padoa-Schioppa (2010). In this lecture he noted that "[The view that] if financial markets are 'always right', they also possess a 'natural stability' […leads to] the unwarranted conclusion that there is little need to subject the financial system to special regulations concerning products, institutions and market structures".

[3] See for example, T. Padoa-Schioppa (2004b).

[4] In Padoa-Schioppa (2010) he noted "Like a vessel, action stands out of the waves only if it is supported by the heavier, albeit invisible, body of an understanding of the forces of history, and of principles and goals helping to manage the opportunities and constraints embedded in the circumstances".

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PANEL 3

EUROPEAN INTEGRATION

THE EUROPEAN CENTRAL BANK: LENDER OF LAST RESORT IN THE GOVERNMENT BOND MARKETS? *

Paul De Grauwe

Introduction

In October 2008 the ECB discovered that there is more to central banking than price stability. This discovery occurred when the ECB was forced to massively increase liquidity to save the banking system. The ECB did not hesitate to exert its function of lender of last resort to the banking system, setting aside all fears of moral hazard and inflation, and concerns about the fiscal implications of its lending.

Things were very different when the sovereign debt crisis erupted in 2010. Then the ECB was gripped by hesitation. A stop-and-go policy ensued in which it provided liquidity in the government bond markets at some moments only to withdraw it at others. When the crisis hit Spain and Italy in July 2011, the ECB was again compelled to provide liquidity in the government bond markets.

Is there a role for the ECB as a lender of last resort in the government bond market? This is the question I want to analyze in this paper.

* This is a slightly modified version of a paper published as CESifo Working Paper, 3569, 2011.

The fragility of a monetary union

It is useful to start by describing the weakness of government bond markets in a monetary union. National governments in a monetary union issue debt in a "foreign" currency, i.e. one over which they have no control. As a result, they cannot guarantee to the bondholders that they will always have the necessary liquidity to pay out the bond at maturity. This contrasts with "stand alone" countries that issue sovereign bonds in their own currencies. This feature allows these countries to guarantee that the cash will always be available to pay out the bondholders. Thus in a stand-alone country there is an implicit guarantee that the central bank is a lender of last resort in the government bond market.

The absence of such a guarantee makes the sovereign bond markets in a monetary union prone to liquidity crises and forces of contagion, very much like banking systems that lack a lender of last resort. In these banking systems, solvency problems in one bank may lead deposit holders of other banks to withdraw their deposits. When everybody does this at the same time the banks will not have enough cash. This sets in motion a liquidity crisis in many sound banks, which degenerates into a solvency crisis as banks try to cash in their assets, thereby pulling down their prices. As asset prices collapse many banks find out that they are insolvent. This banking system instability was solved by mandating the central bank to be a lender of last resort – and the neat thing about this solution is that, when deposit holders are confident that it exists, it rarely has to be used.

The government bond markets in a monetary union have the same structure as the banking system. When solvency problems arise in one country (Greece) bondholders, fearing the worst, sell bonds in other bond markets. This triggers a liquidity crisis in these other markets, only because there is a fear that cash may not be available to pay out bondholders. But this selling activity leads to an increase in government bond rates and turns the liquidity crisis into a solvency crisis. There is a sufficiently high interest rate to make any country insolvent. The characteristic feature of this dynamic is that distrust can push a country in a self-fulfilling way into a bad equilibrium.[1] The latter is characterized by high interest rates, recessionary forces, increasing budgetary problems, and an increased probability of insolvency. In a bad equilibrium it is also likely that domestic banks experience funding problems that can degenerate into solvency problems.

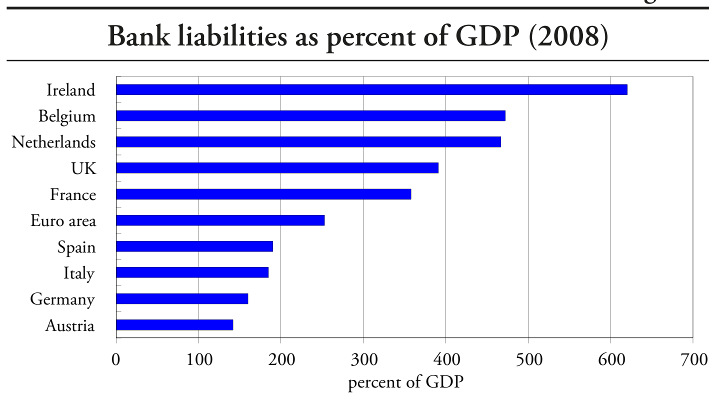
The single most important argument for mandating the ECB to be a lender of last resort in the government bond markets is to prevent countries from being pushed into a bad equilibrium. In a way it can be said that the self-fulfilling nature of expectations creates a coordination failure, i.e. the fear of insufficient liquidity pushes countries into a situation in which there will be insufficient liquidity for both the government and the banking sector. The central bank can solve this coordination failure by providing lending of last resort.

Failure to provide lending of last resort in the government bond markets of the monetary union carries the risk of forcing the central bank into providing lending of last resort to the

banks of the countries hit by a sovereign debt crisis.[2] And this lending of last resort is almost certainly more expensive. The reason is that most often the liabilities of the banking sector of a country are many times larger than the liabilities of the national government. This is shown in Figure 1. We observe that the bank liabilities in the Eurozone represented about 250% of GDP in 2008. This compares to a government debt to GDP ratio in the Eurozone of approximately 80% in the same year.

Figure 1

Bank liabilities as percent of GDP (2008)



Source: IMF, *Global Financial Stability Report*, 2010.

While the argument for mandating the ECB to be a lender of last resort in government bond markets is a strong one, the opposition to giving the ECB this mandate is equally intense. Let me review the main arguments that have been formulated against giving a lender of last resort role to the ECB.

The risk of inflation

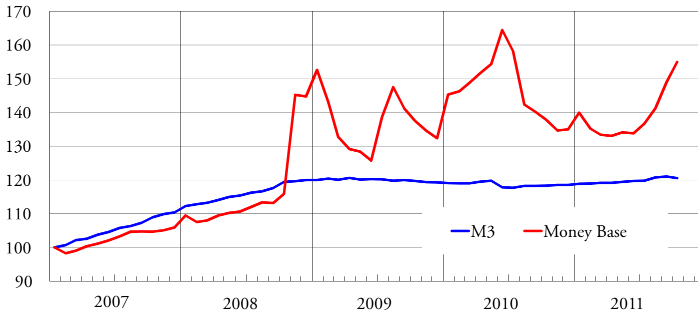
A popular argument against an active role of the ECB as a lender of last resort in the sovereign bond market is that this would lead to inflation. By buying government bonds, it is said, the ECB increases the money stock thereby leading to a risk of inflation. Does an increase in the money stock not always lead to more inflation as Milton Friedman taught us? Two points should be made here.

First, a distinction should be made between the money base and the money stock. When the central bank buys government bonds (or other assets) it increases the money base (currency in circulation and banks' deposits at the central bank). This does not mean that the money stock increases. In fact during periods of financial crises the two monetary aggregates tend to become disconnected. An example of this is shown in Figure 2. One observes that prior to the banking crisis of October 2008 the two aggregates were very much connected. From October 2008 on, however, the disconnect became quite spectacular. In order to save the banking system, the ECB massively piled up assets on its balance sheets, the counterpart of which was a very large increase in the money base. This had no effect on the money stock (M3) (see Figure 2). In fact the latter declined until the end of 2009. The reason why this happened is that banks piled up the liquidity provided by the ECB without using it to extend credit to the non-banking sector. A similar phenomenon has been observed in the US and the UK.

Figure 2

Money base and M3 in the Eurozone

(Index: Jan. 2007=100)



Source*:* ECB, Statistical Data Warehouse.

Another way to understand this phenomenon is to note that when a financial crisis erupts, agents want to hold cash for safety reasons. If the central bank decides not to supply the cash, it turns the financial crisis into an economic recession and possibly a depression, as agents scramble for cash. When instead the central bank exerts its function of lender of last resort and supplies more money base, it stops this deflationary process. That does not allow us to conclude that the central bank is likely to create inflation.

All this was very well understood by Milton Friedman, the father of monetarism who cannot be suspected of favoring inflationary policies. In his classic book co-authored with Anna Schwartz, *A Monetary History of the United States*, he argued that the Great Depression was so

intense because the Federal Reserve failed to perform its role of lender of last resort, and did not increase the US money base sufficiently (Friedman and Schwartz, 1963). In fact, on page 333, Friedman and Schwartz produce a figure that is very similar to Figure 2, showing how during the period 1929-33 the US money stock declined, while the money base ("high powered money") increased. Friedman and Schwartz argued forcefully that the money base should have increased much more and that the way to achieve this was by buying government securities. Much to their chagrin, the Federal Reserve failed to do so. Those who today fear the inflationary risks of lender of last resort operations would do well to read Friedman and Schwartz (1963).

This unfounded fear of inflationary consequences of a lender of last resort activity continues to affect policy-making. For example, when the ECB recently decided to start buying Spanish and Italian government bonds, it announced that it would sterilize the effect these purchases have on the money base by withdrawing liquidity from the market. This was an unfortunate decision. There was absolutely no need for it. Since the start of the banking crisis in October 2008 the yearly growth rate of M3 in the Eurozone has only been 1%, much below the growth rate of 4.5% the ECB has previously announced would stabilize the rate of inflation at 2%. If Friedman were alive today the chances are that he would berate the ECB for making the same mistakes as the US Fed during the Great Depression.

Fiscal consequences

A second criticism is that lender of last resort operations in the government bond markets can have fiscal consequences. The reason is that if governments fail to service their debts, the ECB will make losses. These will have to be borne by taxpayers. Thus, by intervening in the government bond markets, the ECB is committing future taxpayers. The ECB should avoid operations that mix monetary and fiscal policies (Goodfriend, 2011).

All this sounds reasonable. Yet it fails to recognize that all open market operations (including foreign exchange market operations) carry the risk of losses and thus have fiscal implications. When a central bank buys private paper in the context of its open market operations, there is a risk involved, because the issuer of the paper can default. This will then lead to losses for the central bank.[3] These losses are in no way different from the losses the central bank can incur when buying government bonds. Thus, the argument really implies that a central bank should abstain from any open market operations. It should stop being a central bank. The truth is that a central bank should perform (risky) open market operations. The fact that these are potentially loss making should not deter it. Losses can be necessary, even desirable, to guarantee financial stability.

There is another dimension to the problem that follows from the fragility of the government bond markets in a monetary union. I argued earlier that financial markets can

in a self-fulfilling way drive countries into a bad equilibrium, where default becomes inevitable. The use of the lender of last resort can prevent countries from being pushed into such a bad equilibrium. If the intervention by the central banks is successful there will be no losses, and no fiscal consequences.

Moral hazard

As with all insurance mechanisms there is a risk of moral hazard. By providing a lender of last resort insurance the ECB gives an incentive to governments to issue too much debt. This is indeed a serious risk. But this risk of moral hazard is no different from the risk of moral hazard in the banking system. It would be a terrible mistake if the central bank were to abandon its role of lender of last resort in the banking sector because there is a risk of moral hazard. In the same way it is wrong for the ECB to abandon its role of lender of last resort in the government bond market because there is a risk of moral hazard.

The way to deal with moral hazard is to impose rules that will constrain governments in issuing debt, very much like moral hazard in the banking sector is tackled by imposing limits on risk taking by banks. In general, it is better to separate liquidity provision from moral hazard concerns. Liquidity provision should be performed by a central bank; the governance of moral hazard by another institution, i.e. the supervisor. This has been the approach taken in the strategy towards the banking sector: the central bank assumes the responsibility of lender of last resort, thereby guaranteeing

unlimited liquidity provision in times of crisis, irrespective of what this does to moral hazard; the supervisory authority takes over the responsibility of regulating and supervising the banks.

This should also be how governance is designed within the Eurozone. The ECB assumes the responsibility of lender of last resort in the sovereign bond markets. A different and independent authority takes over the responsibility of regulating and supervising the creation of debt by national governments. To use a metaphor, when a house is burning the fire department is responsible for extinguishing the fire. Another department (police and justice) is responsible for investigating wrongdoing and applying punishment if necessary. Both functions should be kept separate. A fire department that is responsible both for fire extinguishing and punishment is unlikely to be a good fire department. The same is true for the ECB. If the latter tries to solve a moral hazard problem, it will fail in its duty to be a lender of last resort.

The Bagehot doctrine

Ideally, the lender of last resort function should only be used when banks (or governments) experience liquidity problems. It should not be used when they are insolvent. This is the doctrine as formulated by Bagehot (1873). It is also very strongly felt by economists in Northern Europe (Plenum der Ökonomen, 2011). The central bank should not bail out banks or governments that are insolvent.

This is certainly correct. The problem with this doctrine, however, is that it is often difficult to distinguish between liquidity and solvency crises. Most economists today would agree that Greece is insolvent and therefore should not be bailed out by the European Central Bank. But what about Spain, Ireland, Portugal, Italy and Belgium? The best and the brightest economists do not agree on the question of whether these countries' governments are just illiquid or whether they suffer from a deep solvency problem. How would the markets know?

As argued earlier, when sovereign debt crises erupt, these are very often a mix of liquidity and solvency problems. Liquidity crises raise the interest rate on the debt issued by governments and therefore quickly degenerate into solvency problems. Solvency problems often lead to liquidity crises that intensify the solvency problem. It is therefore easy to say that the central bank should only provide liquidity to governments or banks that are illiquid but solvent. It is most often very difficult to implement this doctrine.

In fact it is even worse. The doctrine leads to a paradox. If it were easy to separate liquidity from solvency problems, the markets would also find it easy to do so. Thus if a government came under pressure, financial markets would be able to determine whether this government suffered from a liquidity or solvency problem. If they determined it was a liquidity problem, they would be willing to provide credit to the government. The central bank would not have to step in. If they determined it is a solvency problem, they would not

want to provide credit and rightly so. The Bagehot doctrine would come to the same conclusion: the central bank should not bail out the insolvent government. The conclusion is that if solvency and liquidity crises can be separated, there is no need for a lender of last resort. Financial markets would take care of the problem. Who wants to believe this these days?

There is one way in which the Bagehot doctrine could be applied by the ECB. As will be remembered, Bagehot put forward the principle that in times of crisis the central bank should provide unlimited liquidity at a penalty rate. Bagehot saw this as a way of taking care of the moral hazard problem. The ECB could apply this principle by committing itself to provide unlimited liquidity as soon as the government bond rate of country A exceeded the risk free rate (say the German bond rate) by more than, say, 200 basis points (it could also be another number). This could be one way in which the ECB takes care of moral hazard concerns.

Legal objections

It is often said that the ECB's decision to buy government bonds represents a violation of its statute, which, it is claimed, forbids such operations. A careful reading of the Treaty, however, makes clear that this is not the case. Article 18 of the "Protocol on the Statute of the European System of Central Banks and the European Central Bank" is very clear when it states that "the ECB and the national central banks may operate in financial markets by buying and selling [...] claims and marketable instruments". Government bonds are

marketable instruments, and nowhere is it said that the ECB is forbidden to buy and sell these bonds in financial markets.

What is prohibited is spelled out in Article 21: the ECB is not allowed to provide "overdrafts or any other type of credit facilities" to public entities, nor can it purchase directly "debt instruments" from these public entities.

The distinction between these two types of operations is important and often confused. According to its statute the ECB is allowed to buy government bonds in the secondary markets in the context of its open market operations. In doing so, the ECB does not provide credit to governments. What it does is provide liquidity to the holders of these government bonds. These holders are typically financial institutions. In no way can this be interpreted as a monetary financing of government budget deficits.

In contrast the prohibition on buying debt instruments directly from national governments is based on the fact that such an operation provides liquidity to these governments and thus implies a monetary financing of the government budget deficit.

Conclusion

The ECB has been unduly influenced by the theory that inflation should be the only concern of a central bank. Financial stability should also be on the radar screen of a central bank. In fact, most central banks have been created to solve an endemic problem of instability of financial

systems. With their unlimited firing power, central banks are the only institutions capable of stabilizing the financial system. It is time that the ECB recognizes this old truth instead of fleeing from its responsibility.

In order for the ECB to be successful in stabilizing the sovereign bond markets of the Eurozone, it will have to make it clear that it is fully committed to act as lender of last resort. By creating confidence, such a commitment will ensure that the ECB does not have to intervene in the government bond markets most of the time, very much like the commitment to be a lender of last resort in the banking system ensures that the central bank only rarely has to provide lender of last resort support.

While the ECB's lender of last resort support in the sovereign bond markets is a necessary feature of the governance of the Eurozone it is not sufficient. In order to prevent future crises significant steps towards further political unification will be necessary. Some steps in that direction were taken recently when the European Council decided to strengthen the control on national budgetary processes and on national macroeconomic policies. These decisions, however, are insufficient and more fundamental changes in the governance of the Eurozone are called for. These should be such that the central bank can trust that its lender of last resort responsibilities in the government bond markets will not lead to a never-ending dynamic of debt creation.

NOTES

[1] See De Grauwe (2011) where this point is elaborated further. See also Kopf (2011). For formal theoretical models see Calvo (1988) and Gros (2011). This problem also exists with emerging countries that issue debt in a foreign currency. See Eichengreen, Hausmann and Panizza (2005). The problem is also similar to self-fulfilling foreign exchange crises (Obstfeld, 1994).

[2] In fact this happened in December 2011 and February 2012 when the ECB was forced to pour €1 trillion into the banking system that had become infected by the sovereign debt crises.

[3] The same is true of foreign exchange market operations that can lead to large losses as has been shown by the recent Swiss experience.

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MISGUIDED POLICIES RISK BREAKING THE EUROZONE AND THE UNION

Stefano Micossi

I met Tommaso Padoa-Schioppa in the early 1970s as a new young professional in the Research Department of Banca d'Italia, where he was head of the monetary policy unit. Many of us newcomers, fresh from American graduate studies, were appalled by the Bank's monetary approach, replete with quantitative controls and administrative measures to channel funds to an insatiable Treasury.

Tommaso, who already participated in the bank's inner policy-making circle, often countered our fervent criticisms with irony; but it was he who first proposed that the Bank abandon fixed rates in Treasury bill auctions, opening the way to the complete independence of monetary policy that was to come in the 1980s. Those frank exchanges, held in an atmosphere of strong commitment to public service, created solidarities and friendships that have lasted up to today and outlived divergent career paths.

Tommaso's approach to European affairs was a unique combination of vision and realism. An economist by training, over and over again he showed a special ability to rise above the prejudices of his profession and push forward institution-building with feasible arrangements that could muster the necessary political support.

In the last years of his life, like many of us he was deeply concerned about the waning support for the European project. He considered the European construction the most compelling bequest of the 20th century in the domain of political institutions. “Nowadays we know, and we must tell our children and teach in our schools that the will to power of nation states as well as individuals may be channelled through a rule eventually capable of depriving it of its capacity to overwhelm and destroy” (Padoa-Schioppa, 2001, pp. 13-14).

But he saw that the construction of Europe was incomplete and he often repeated, in his later days, that either it would find the compromises necessary to strengthen its institutions – notably in the economic domain – or it would go into reverse and break down. He was also convinced that the time of technocratic and elitist decisions was past and the imbalance between democratic member states and technocratic European institutions had become a straightjacket suffocating further progress.

Unfortunately, he was right and his fears were well founded. Poor leadership has transformed a small debt crisis into a confidence crisis that is threatening the very survival of our monetary union. And, as I will argue, the treaty changes under discussion are mainly motivated by political expediency and cannot tackle the existential problems affecting the Eurozone and the Union. The entire European construction is at risk. Unfortunately, Tommaso is no longer with us to help sort out the incredible mess created by shortsighted political leaders.

Crisis management is failing

Some eighteen months after the first Greek rescue (May 2010), crisis management in the Eurozone has clearly failed to restore confidence. Indeed, following each round of emergency measures matters have taken a turn for the worse (see Figure 1 showing the widening spreads, over the German Bund, for sovereign borrowing in the Eurozone). The solemn decisions of the December 9 Eurosummit already seem in tatters.

Meanwhile, contagion has spread beyond Spain and Italy to the core sovereigns. France is close to losing its Triple A rating and spreads over the Bund have widened for Austria, Belgium, Finland and the Netherlands. Even Germany experienced partial failure in a Bund auction on November 23. The banking system Europe-wide is under increasing strain, with term funding all but closed to any bank with significant exposure to distressed sovereign debtors and the interbank market close to seizing up. Deposit withdrawals have occurred in a number of large banks from the periphery. The euro has started to weaken in foreign exchange markets, eroding the distinction between the Eurozone debt crisis and the euro-currency crisis from which some observers were until recently drawing comfort.

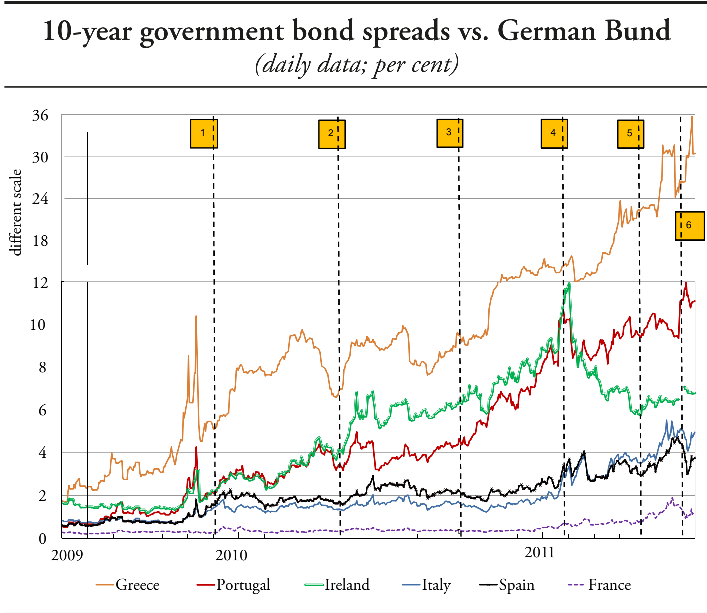
These developments raise once again the fundamental question: what is it that is not working? Why is it that dramatic changes in our policies and institutions within the Eurozone are failing to halt the meltdown of confidence? An

answer is needed, and needed soon, because down this path the breakdown of the Eurozone is a concrete possibility.

Figure 1

10-year government bond spreads vs. German Bund

(daily data; per cent)



Source: *Financial Times* on Thomson Reuters.

Notes: (1) May 2010: Adoption of the first financial assistance package for Greece and establishment of the European Financial Stability Fund. – (2) 18 October 2010: Deauville agreement between France and Germany destabilises financial markets. – (3) 24-25 March 2011: European Council agrees on new economic governance. – (4) 21 July 2011: Eurozone leaders agree on a rescue package for Greece and EU crisis management framework but announce 20% loss on Greek debt for private investors. – (5) 26 October 2011: Eurozone economic governance tightened, liquidity support still weak, losses for private creditors raised to 50%. – (6) 8-9 December 2011: European Council reaches bungled agreement on Treaty reform and financing arrangements that fails to convince markets.

Reform under way in the Eurozone

One important strand of opinion, notably in Germany and other Northern European countries, maintains that the culprit is lax fiscal policies and excessive debt accumulation by some Eurozone member states. Greece, for one, is defaulting on its debt obligations, despite very harsh corrective measures, although its plight has been aggravated by the economy, as a consequence, going into free fall, while its political system is coming under close-to-unbearable strain to keep the austerity course. But the numbers are small and would not endanger the solidity of Europe's banking system even under extreme hypotheses of debt restructuring.

Ireland, Portugal and Spain have adopted public sector consolidation measures and market reforms which have won praise by the Commission, the ECB and the IMF; and indeed their sovereign interest rate spreads over the German Bund were all receding – dramatically so for Ireland – until the latest round of meetings by the Eurosummit at end-October and early December (Figure 1). Last summer sovereign selling pressures extended to Italy, which has a small deficit but a large debt-to-GDP ratio (120%). Eventually, harsh budgetary measures, including a sweeping pension reform, were decided to anticipate budgetary balance to 2013, along with a fresh round of structural reforms and market opening measures. Meanwhile, the economy has been falling into recession and the spread over the Bund remains in the upper 400 basis points region.

In short, budgetary consolidation seems well under way in all the “sinning” countries together with long-awaited structural reforms. Based on IMF forecasts to 2016, after increasing in the aftermath of the 2008-09 financial and economic crisis, sovereign debts are expected to stabilize at manageable ratios to GDP in all of the Eurozone countries except Greece – but not to decline, due to persistently slow growth. And market assessments of their sovereign debts are improving only slightly.

Furthermore, the Eurozone suffers from large competitive imbalances between its members which are reflected in large and growing imbalances in current external payments. In 2011 Germany and the Netherlands are expected to record current external surpluses close to 6% of GDP, with their counterpart largely represented by deficits in the Eurozone periphery – with the exception of Ireland that has a 3% surplus. With the unfolding confidence crisis, the increase in private savings in the periphery has prompted a large widening of public sector deficits, while private capital flows have turned away from the periphery and the financing of external deficits has fallen almost exclusively on official sources – showing up as ECB TARGET balances. This evidence has prompted some authors to read the ongoing crisis in the Eurozone as a balance of payment crisis (Sinn and Wollmershäuser, 2011).

Thus, the Eurozone has turned into a straightjacket where everyone is tightening budgetary policies, growth is faltering and, in addition, the periphery countries must engineer substantial real exchange rate devaluations to regain

competitiveness and reabsorb their external deficits – while the core countries will do nothing to strengthen aggregate demand and relieve pressure on their partners. Thus, if the periphery succeeds, both the core and the periphery will suffer from falling aggregate demand; if it doesn't succeed, either the deficits will continue to be financed, leading to further accumulation of external debt, or the entire Eurozone will fall into depression, with sovereign debtors eventually defaulting on their liabilities (Wolf, 2011).

This unsustainable policy pattern may be at least in part responsible for the crisis of confidence gripping the Eurozone. If this is the case, a lasting solution will have to include credible measures to raise the Eurozone growth rates, a theme that is notably absent so far in the Eurosummit agendas.

Stronger economic governance

Meanwhile, economic governance in the Eurozone has been strengthened to unthinkable heights as regards both substance and enforcement procedures. The Integrated Policy Guidelines of Article 121 of the Treaty on the Functioning of the European Union (TFEU) are now accompanied by legally binding enforcement procedures, while the European Semester ensures ex-ante coordination of economic policies and time-consistent decision-making processes in the member states and the European Council. The Eurosummit has also formalized a new governance structure for the euro area entailing regular meetings of the Heads of State or Government ("at least twice a year") and a permanent presidency; a strengthened role for

the Eurogroup which will set up its own permanent structure in Brussels; and a special monitoring committee comprising the presidents of the Eurosummit, the Commission and the Eurogroup which will meet "at least" once a month.

The excessive deficit procedure has been reinforced in both its preventive and corrective arm, and now includes fresh constraints on the growth of public expenditures and operational criteria for public debt reduction (the "1/20 rule"); there is a new procedure, also legally binding and accompanied by sanctions, for the correction of "excessive economic imbalances", explicitly targeting competitive imbalances and their underlying causes. The Euro-Plus Pact details the enhanced policy commitments of Eurozone members for budgetary stability, structural reforms and market opening.

Eurozone members are also required to strengthen their national budgetary frameworks with the adoption of multi-year planning, top-down decision-making procedures and independent evaluation agencies. Italy and Spain have already decided to insert balanced-budget rules in their constitutions.

The European Commission has been given independent powers to signal emerging deviations from agreed policy guidelines, and make recommendations to the Council on the opening of formal procedures, down to the phase of sanctions, that the Council can only reject or weaken with "reverse" qualified majorities. New proposed Regulations,

now before Council and Parliament for approval, will require Eurozone member states to present their draft budgets at the same time each year and, before national parliaments decide on them, give sufficient time to the Commission to assess them and, if need be, ask for revisions when it considers that the draft budget violates the Stability and Growth Pact. Stronger provisions are envisaged for Eurozone countries in excessive deficit procedure.[1]

Against this background, it is worth dwelling for a moment on the new decisions on economic governance taken by the Eurosummit on December 9. Once again, the failure of the previous Eurosummit, on October 26, to halt financial turmoil raised pressure on Germany to expand liquidity support in Eurozone sovereign debt markets. Once again, half-baked, unconvincing measures to that effect were accompanied by new demands to tighten the governance screws, so as to appease a recalcitrant domestic public. Enter the new “fiscal compact”.[2]

A treaty change will oblige Eurozone members to adopt a balanced-budget rule in their constitutions, and the European Court of Justice will be empowered to verify their correct transposition in national legislations. Members in excessive deficit will submit an “economic partnership” programme detailing the necessary structural reforms to ensure an “effectively durable” correction of their deficits. And a mechanism will be put in place for the ex-ante reporting by member states of their national debt issuance plans. The deficit and debt-reduction obligations under the excessive

deficit procedure will be "enshrined in new provisions", and there will be mechanisms for the automatic correction of any slippages. With national budgetary powers for sinners and potential sinners transferred to a new "compact" governed by Germany and managed on its behalf by a Committee made up by the presidents of the Eurosummit, the Commission and the ECB (with the IMF in attendance).

One wonders whether all this is really feasible, technically and politically. For one thing, economic policy is a fairly complex matter, and past experience may turn out to be a poor guide to future decisions – as was the case with the deficit and debt criteria, which famously failed to detect developing imbalances in the private sector in the Irish and Spanish economies. For another, interactions between the member states would be entirely overlooked, which seems quite odd in a highly integrated area: for instance, would an exogenous increase in the propensity to save in Germany always have to be met by a deflationary adjustment in Italy?

As for the proposed treaty change, for the second time in less than a year[3] a fundamental change in common policies in the Eurozone would be enacted with an intergovernmental treaty outside the Union framework – opening the way for an awkward combination of German direct rule over national fiscal policies under French inter-governmentalism. Thus, the UK veto offered the pretext for a solution that fitted well with Franco-German intentions but is potentially disruptive for the entire Union.

First, there is a need to clarify why, in order to strengthen the legal underpinning of the new governance obligations, the leaders did not consider the possibility of using Article 136 of the TFEU, which empowers the Council to "adopt measures specific to those member states whose currency is the euro". Most, if not all of the measures of strengthened economic governance could be adopted under this legal basis – with the exception perhaps of the balanced budget "golden rule", which is already in the Euro-Plus Pact and could be turned into a political commitment. Incidentally, the Article 136 procedure would allow matters to proceed more speedily, with qualified majority voting of Eurozone members in the Council (unanimity is needed only for provisions relating to the excessive deficit procedure), while the treaty changes envisaged by the Franco-German duo could well require two to three years to come into effect, barring an adverse referendum in some member states (e.g. Ireland).

Second, and more importantly, the treaty may well be revised, but then more fundamental questions concerning the fiscal union would inevitably arise, including issues of explicit centralization of budgetary powers and related legitimizing controls at Eurozone level, as well as the relation to be built between the Union and the Eurozone institutions. More broadly, building up enhanced cooperation for economic policies outside the Union legal framework could over time damage the latter irreparably, owing to the temptation to pick and choose the most convenient legal framework in response to contingent political goals.

The foreign currency syndrome

Far from abating financial turmoil, the announcement of ever harsher governance measures has apparently added fresh fuel to the fire. Either the announcements lack credibility – which does not seem to be the case, with policies on the right track everywhere – or there is something else which is missing in the leaders' policy responses.

For one thing, non-Eurozone countries, such as the US and the UK, not to mention Japan, with its mountainous public debt, have no problems in selling their paper, while within the Eurozone even countries with a smaller debt/GDP ratio than Germany – Austria, Finland and the Netherlands – must pay a positive spread over the Bund on their government issues.

Thus, the Eurozone seemingly suffers from some special disease. That disease is the "foreign currency syndrome" that was brought into full light by Professor Paul De Grauwe (2011). Please note that if Professor De Grauwe is right – as I believe he is – then in all likelihood we are letting financial markets push us onto a path of excessive deflation that may eventually frustrate our efforts at budgetary consolidation – Greece *docet*.

The fundamental difference between a country that is a member of a monetary union and a country that has its own currency is that the former needs the permission of an institution that it does not control to increase liquidity – say to compensate for an outflow of liquidity through the banking

system or stabilize the government bond market – while the latter does not. For each of the monetary union members, to all practical purposes the euro is like a foreign currency, since no one country enjoys access to the euro printing press. As a consequence, Eurozone members are exposed to currency runs. Such a system can switch rapidly from "fair weather", where foreign currency risks are underpriced, to "bad weather", where risks become overpriced. In the second scenario, the explosion of financing costs can make fears of a run self-fulfilling.

The switch from fair weather to bad weather is not an entirely unpredictable event. A further feature of the monetary union is that one monetary policy must fit all – regardless of divergent prices and wages, productivity, market structure, public spending and taxation. When a country with higher inflation and structural rigidities joins a monetary union, initially it typically finds itself awash with liquidity, since the foreign-exchange risk premium disappears, real interest rates turn negative and borrowing becomes an irresistible bargain. Meanwhile, its real exchange rate will appreciate and business competitiveness will suffer, leading to rising unemployment; but abundant credit will encourage the postponement of adjustment and preserve inefficient jobs with public money. Public spending will rise and the public sector deficit will widen, while politicians will thrive on distributing subsidies and protections to broaden electoral consensus.

Lax financing conditions may prevail for quite a long time, but sooner or later they are bound to change, as growing

external and public sector deficits become unsustainable. Till one day, typically as a consequence of some exogenous shock, investors flee, liquidity evaporates and the divergent country finds itself unable to refinance its debts in private markets at acceptable prices – as happened to Greece and Portugal.

A variant of the model is one in which the economy in the divergent country experiences a real estate boom and rapid economic expansion, leading to unsustainable private indebtedness, while the public sector stays in good health thanks to buoyant growth. But again, the real estate boom must come to an end and, when house prices start falling, private debts cannot be serviced and lending financial institutions become insolvent. Governments are then obliged to step in and rescue the banks: this is where unsustainable private indebtedness is turned into large government debt, as happened in Ireland and (to a lesser extent) Spain.

Thus, lax and divergent national policies do bear responsibility for the sudden switch in confidence. When that happens, even countries that did not run divergent policies or, at any rate, maintained manageable exposures in fair weather, may find themselves unable to manage them after the shift to bad weather. With an extra ingredient, which is that national banking systems have in the meantime become highly interconnected – as "core" country banks over-lent to divergent country banks and governments. Thus, any doubts about the sustainability of sovereign obligations in divergent countries are readily transformed

into doubts about the sustainability of the banking system in the core, stable countries.

Confidence in financial markets is a fickle commodity, which may evaporate quite rapidly unless investors can be reassured that a liquidity crisis will not be allowed to develop into a solvency crisis for one member after another of the monetary union. Which is what has happened in the Eurozone since Greece was first bailed out in May 2010.

Liquidity support and debt restructuring

A confidence crisis spreading contagion even to the "sound" part of a monetary union can be stopped by an abundant supply of liquidity from the central bank or by a common fund performing the same service, and subject to appropriate policy conditionality, with resources lent by the central bank or raised in capital markets. In all likelihood both are needed, in some appropriate combination.

Failure by the Eurosummit to agree on a strong and effective rescue fund has stiffened resistance from the ECB, which fears that losses on its distressed sovereign holdings may one day force it to turn to national governments for capital, and thus lose independence.

Two stumbling blocks have so far impeded adequate liquidity support. The first is fear that liquidity will reduce pressure on "sinners" to adjust. All arguments that sinners are now mending their ways, under much strengthened common economic governance arrangements, have so far failed to

convince – even if, as I have recalled, policies have turned in the right direction everywhere. Some will not be satisfied till they see a direct power by the Union to intervene and change national policies, when these deviate from their policy commitments.

However, everyone should be aware that even the best policy course will need time to produce its effects; in the meantime, adequate financing flows must be maintained or adjustment policies will fail to prevent a currency run. The second ingredient in the unfolding drama is the intermingling of liquidity support and fiscal transfers, which inevitably arises if some of the countries on life support become insolvent and thus require debt restructuring. In this regard, Germany is adamant that liquidity support can never entail fiscal transfers – which would breach the no bailout provision of the TFEU (Article 125) – and has on this account maintained strong pressure on the ECB to limit its open market operations in support of distressed sovereigns.

In reality, if adjustment works, there is no reason why liquidity support should be turned into fiscal transfers. To the extent that confidence is hit by fears of insufficient liquidity, the simple act of restoring adequate liquidity would stop the run and make insolvency, and the need for fiscal transfers, unlikely. On the other hand, if there is a collapse of liquidity, fiscal transfers may become inevitable at least to rescue own (German) banks, following the chain-collapse of all other sovereign debtors in the Union.

Germany has also insisted that the private sector should share the burdens of any debt restructuring. As a result of disastrous communication, private sector involvement (PSI) has become a promise of losses on all outstanding Eurozone sovereign exposures, without sufficient differentiation. Thus investors have started to dump most Eurozone sovereigns; even Germany has been affected. A cursory look at Figure 1 will confirm that contagion really started following the Franco-German announcement in Deauville that PSI would be part of any financial assistance programme, in October 2010. Two further jumps in the spreads are clearly associated with the July and October 2011 meetings of the Eurosummit, as the announcement of rising haircuts on Greek debt, combined with inadequate liquidity support for the other distressed debtors, have made private investors in Eurozone sovereigns run for the door.

The disgraceful insistence on private sector participation has now been abandoned, and our wise leaders have reverted to "the well established IMF principles and practices" whereby each case is assessed on its own merits and there is no presumption of losses for private investors in connection with financial assistance programs. Also the European Financial Stability Facility (EFSF), later the European Stability Mechanism (ESM), will be allowed to lever its resources and the unanimity rule in decision making will be substituted by qualified majority voting (with an 85% majority).

In general, recent decisions have once again failed to convince financial markets that the liquidity problem has

been tackled. The ESM has not gained liquidity access to the ECB, as had been envisaged by President van Rompuy in his preparatory note for the summit; the total available resources have been raised, perhaps, but nothing is certain. The Eurogroup is still struggling to make sense of the cumbersome arrangements that have been proposed to lever the EFSF resources. The persistent refusal to back EFSF obligations with the joint and several guarantee of Eurozone members has left financial markets uncertain as to whether individual guarantees will be sufficient, as more and more members are hit by contagion. And everyone is puzzled by the fact that Eurozone members are willing to put up €200 billion in credit lines for the IMF to defend the euro, hoping that more will come from the emerging world, while they are not willing to do it directly with the EFSF and the future ESM.

The only new development was the announcement by the ECB of a new unlimited term-lending facility for banks, whose undeclared but transparent purpose is to encourage banks to buy sovereigns again. The snag in the scheme is that banks are not likely to buy securities that Eurozone governments are collectively unable to support. Continuing to try to circumvent problems, rather than tackling them, will not do.

Thus, it looks like until the next summit we are in for further turmoil, which no doubt will lead to more requests by Germany for stronger economic governance rules. As Albert Einstein once famously remarked: “Folly is doing the same thing again and again, and expecting different results”.

In conclusion

The Eurozone has proven so far collectively unable to develop a convincing economic strategy to revive economic growth, bring excessive public debts back to normal levels, restructure the Greek debt, and raise credible liquidity walls around the other distressed sovereigns. Meanwhile, the costs of adjustment in divergent countries are ballooning thanks to rising interest rates and falling activity, heralding further budgetary cuts and further deflation.

The Eurosummit has to go back to the drawing board and agree on a less unbalanced policy combination between discipline, liquidity support and growth policies. If this cannot be done, the risk that the Eurozone and the Union will break up, with gigantic economic dislocations, will remain high.

As to the proposed new fiscal compact by intergovernmental treaty, it is already clear that it will go nowhere, which is good, since the Union institutions might suffer fundamental damage if they were to go down that road. The alternative is to follow the Article 136 procedure, which allows Eurozone members to insert in the TFEU special provisions applicable only to themselves.

NOTES

[1] Proposal for a Regulation on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the member states in the euro area, COM(2011)821 of 23.11.2011, and a Regulation on the strengthening of economic and budgetary surveillance of member states experiencing or threatened with serious difficulties with respect to their financial stability in the euro area, COM(2011)819 of 23.11.2011.

[2] These requests were anticipated by President Draghi of the ECB in his Statement before the European Parliament on December 1 (2011), where he stated that "I am confident that the new surveillance framework will restore confidence over time. I am also quite sure that countries overall are on the right track. But a credible signal is needed to *give ultimate insurance over the short run*. What I believe our economic and monetary union needs is a new *fiscal compact* – a fundamental restatement of the fiscal rules…" (my italics). Thus, rather than large liquidity supply, the 'big bazooka' to stabilize financial markets in the short term is a new fiscal rule.

[3] The first was the amendment to Article 136 TFEU to set up the ESM.

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THE EUROZONE CRISIS: ROOTS AND POLICY RESPONSES

Klaus Regling

Thank you for inviting me and giving me an opportunity to pay a tribute to our friend Tommaso.

I met him first in 1981 when he was Director General of Economic and Financial Affairs (EcFin) in Brussels, and he left a deep impression on me at that time, like on everybody else. I learned that one could have a national passport but at the same time be very much a good European. I would never have expected then that I would take his job twenty years later. The difference, of course, was that I was 50 when I got the job, while he was 38 when he got the job.

Then I met him on many occasions in subsequent years, of course when he was at the ECB, but particularly important was the time when he was Minister of Finance, because then I saw him every month in the Eurogroup. And he was a very special member of the Eurogroup, the seventeen Finance Ministers of the euro area. He brought strong expertise in Economics and Finance, more than any of the other ministers (this is not a criticism of the others; it is just that his experience was so strong, having been accumulated in important positions). What he did several times in those meetings was to say: "Now I speak as Italian

Finance Minister. These are the Italian national interests". And then after a while he said "And now I change hat: I speak here as a member of the Eurogroup and I will talk about the European interests". And he was really the only one who was able to do that. That's why we are missing him there very much.

Now, let me try to do this impossible task after the two previous speakers, because there's so much I disagree with in what they said that I would need two hours to explain all those points. So I can only make a start. The panel was asked to look at what are the problems in the monetary union: are they being fixed now? That's what I also wanted to do.

At first when Paul started, I thought we would overlap, but then it became clear that we don't. If I understood Paul correctly, the main problem is that there are imbalances, but they will be fixed sometime later. He didn't say when; the time is never right, I guess. He was grateful that there's enough debt, except in Greece. And his main complaint – like Stefano's – is that the ECB does not intervene more. I think that's a bit narrow.

When I look at the problems that led to this crisis, I have a list of seven points that I want to go through, to explain briefly what is being done to address them. And a lot has been done. Stefano, to his credit, also said that "unthinkable progress has been made in governance and in some other areas". So let me go through these seven points. I will also say something about lender of last resort and financing available

and all of that, which is the only thing that markets seem to care about. They don't care about the things that I will be addressing now; they only look at what the ECB is doing: is there enough money? And also Paul took the view that – as I read every day in the *Financial Times* – only the ECB can do it. And if they are not allowed to do it, or if they don't want to do it, then there's no solution to this crisis. I don't share that view. I'll come to that in the end.

My seven points are about the root causes of the crisis.

The first point is that, for a long time, Member States did not accept the constraints that being a member of the monetary union brings with it. They did not accept these constraints and did not do the adjustment on fiscal policy. But the failure to adjust goes much beyond fiscal policy, to include maintaining competitiveness and all the rest. That for me was the first root cause of the crisis. Stefano has talked about it so I don't have to add much. We now have a stronger Stability and Growth Pact. It's all rules-based, but I think in Europe that works well. We have stronger rules on debt reduction. Importantly, we have less political interference, because in the past we had these occasions when the rules of the Pact were not followed. Despite the fact that the Commission made the right recommendations, the Council didn't follow. That will now be almost impossible, because organizing a qualified majority against the proposal of the Commission is almost impossible. As you remember, it was not too difficult in 2003 for Germany and France to prevent a qualified majority in favour of the European Commission.

This is a very important step. I think one can say we are on the way to a fiscal union. It's not glorifying what that means, but we will have tighter rules – that's the European semester – with a stronger role for the European Commission. So this first root cause, I think, is being dealt with.

Second, there was a temporary effect that was very important in some countries. Countries that joined the Monetary Union and used to have higher interest rate levels had to go through a very special adjustment phase, the transition to permanently lower interest rates. Obviously this did not play a role in Germany, the Netherlands or Finland, but in countries where previously interest rates had been higher, like Italy, Spain, Portugal, Greece and some others, this created windfall profits for the budget. Some countries used these windfall profits well, others did not. And in some countries it created huge credit and real estate bubbles, particularly in Spain and Ireland. I think that's a very important second reason, but it was a temporary thing that would not happen again, except for countries that one day may join the monetary union. Some countries went through that adjustment more successfully than others, but in some it was a real problem.

The third reason why things went wrong is that we had not enough focus in our surveillance activities on competitiveness and private debt. The main focus was on the fiscal side. That focus is all right, but it should have been broadened. We now have the excessive imbalance procedure, something that we did not have before the crisis. I could talk

about all the details. I think that's important progress we have there, so this issue has also been addressed.

The fourth point is something that only economists really understand, but there are many of them here. We don't have a good methodology to analyze structural fiscal balances. This sounds harmless, but it is not, because it explains why countries like Spain and Ireland a year before the crisis had a fiscal surplus and thought everything was ok on the fiscal side. The problem was that we had not been able to analyze well that a large share of the revenue was due to the real estate bubbles, and would disappear when growth slowed down. When I was at the Commission we started a project with the OECD to work on this issue, because it is very important for policy-makers to understand where the fiscal situation really is. We have not made much progress on this. So I think one has to mention that this is a continuing problem and I am not sure that it couldn't come back and again create problems in the future.

The fifth point, by contrast, is very simple. We did not have good control of our data, including the fiscal data and the debt data. We all know now that Greece cheated on its data for many years. Eurostat had no power at the time to go to the countries to check the data. The Commission several times made a proposal to give Eurostat that power, but it was rejected by most Member States, including by Germany, as too much interference into national affairs. After the crisis the Commission made the proposal again and everybody agreed immediately, so now Eurostat has this

power to go to the country, check the data and that's what we are doing now. So this problem should also hopefully have been addressed for the future.

The sixth point is that surveillance of financial markets has been too much along national lines, within the limits of national borders, while we know that the major players in financial markets operate cross-border. This has now been addressed to some extent, I don't think fully yet, but with the creation of the three supervisory authorities on banking, insurance and securities markets we have made an important step. There was a real transfer of sovereignty, from the national to the European level. Some argue it is not enough, but it was a transfer of sovereignty. In addition, the European Systemic Risk Board (ESRB) has been created, and I think that's very important, particularly for the monetary union. Macroprudential risks were ignored before the crisis. Other countries have created similar bodies, but I think it's even more important to have such a body in a monetary union. In a monetary union, while obviously monetary policy cannot be used in any country-specific way, on the supervisory side there are instruments that can be used in a country-specific way. The ESRB should be able to guide national supervisors in using the available instruments in that direction, and I expect that they will do so.

Finally, the seventh and last point. We should not forget that this crisis that we have now in Europe would probably have happened one way or another, but was made much worse by the global financial crisis, which did not start in

Europe. For instance, at the Commission, already in 2006 and 2007 we were discussing with Ireland and Spain about their housing bubbles. The adjustment began in 2008, one can see that in the data. But then the global crisis hit, and what was already a problem was made much worse.

To summarize – and I know I differ here from some of the previous speakers – in my view there is real progress. The right issues, which I have underlined, are being tackled. There is more progress than anybody would have thought possible eighteen months ago, and with all these things monetary union will work better in the future than it did in the past. I have no doubt about that. I also know that Tommaso would want to go further than that, because he was always ahead of the rest of the crowd. He wanted more common policies, more moves towards a United States of Europe, but I think our population is not ready for that. It would make life much easier, but I think that's not possible at the moment.

As I said in the beginning, markets do not seem to focus on the progress that has been made. They only focus on one thing: crisis management, not crisis prevention. They say there is not enough money, and only the ECB can provide it. That is what we read every day in the *Financial Times*. So, let me talk about this a little bit and just give you a few numbers to dispel the myth that Europeans are not coming up with anything like a sufficient amount of money in response to this crisis. When I look at what has been done over the last two years or so, and what is still available and not committed, the numbers are quite staggering.

Looking back, let's start with the ECB, which has intervened for about 200 billion euros. Then there are the three programmes that are in place for Greece, Portugal and Ireland. The Greek one was the first programme and those for Portugal and Ireland are ongoing. They are 280 billion already committed. At the European Financial Stability Facility (EFSF) we have unused firepower for 400 billion euros. The IMF has made a political commitment to always come up with about one third of all packages. So, if the EFSF money were used for other programmes, I would expect that the IMF would also participate with another 200 billion. When I add all this up, it is more than one trillion euros. That's more than 10 per cent of the euro area GDP. All this has been either spent or is available, and this does not include all the funds that have been made available at the national level to help the banking systems, which is another more than a quarter of GDP. So, I'm always a bit surprised when I read that the Europeans don't do enough.

Now, looking forward. If we look at what are our possible needs and what are the available means, I think the picture is also much better than what I've heard here today and what I read in the newspapers, particularly in Anglo-Saxon newspapers. As I said, the EFSF has 400 billion of uncommitted resources. We may need around 100 billion of that for the second Greek adjustment program. The numbers are not completely known because the negotiations are still ongoing in Athens, but let's take a rough number. We may have to do some bank recapitalizations, which the

EFSF is now allowed to do even in countries that don't have programs, maybe 50 billion. That would leave 250 billion of uncommitted resources. Now, as you know, we have been working on leveraging these resources, which means finding ways that would enable private investors, but also sovereign wealth funds or central banks of surplus countries, to bring in their capital through some insurance schemes or first loss tranches in investment vehicles. We don't know how much leverage will be possible, but there will be some, and the IMF again will be there if there's a need. This takes me to more than 600 billion available.

Moreover, the last EU summit, a week ago, also said that they would review the amounts available next March, which is in three months (I don't think that was disgraceful, Stefano). So, if most of the money has been used by then – which I don't expect – I'm sure more will be made available. Maybe the process is always rocky and noisy and controversial, but one thing is credible: Europeans and the leaders of the euro area will do what is needed to preserve the euro and financial stability. As I said, 600 billion is available. And when I look at the potential needs, if, in the extreme, Italy and Spain were to ask for support, their gross financing needs in 2012 are less than that, and I don't think that they would need to be taken off the market. So, again, I find a bit surprising what I read everyday and I have also heard today here on the panel, that all these amounts are just not sufficient and that only the ECB could do it.

TOMMASO PADOA-SCHIOPPA AND EUROPEAN INTEGRATION

Niels Thygesen

Over nearly four decades I had the privilege in three periods to work closely with Tommaso Padoa-Schioppa – TPS for short – and, more permanently, to enjoy his friendship and hospitality.

The first period was 1971-72. Banca d'Italia showed the OECD the favor of nominating Antonio Fazio and TPS as members of a Monetary Experts Group (which still meets annually) that I chaired at the OECD to study the transmission mechanism of monetary policy in the largest industrial countries. They added greatly to the study and to the Italian part of it, and I remember with fondness the crash course on the Italian economy I received at Banca d'Italia in the summer of 1972. It helped that we were all three students of Franco Modigliani, but TPS was a particularly judicious guide to the intricacies of Italian monetary policy at the time with its many, now forgotten, instruments.

The second period was 1979-83. Almost on the starting date for the European Monetary System (EMS) in March 1979 TPS became Director-General of what is now DG Economic and Financial Affairs (EcFin) at the European Commission, a nomination applauded not least by his

academic friends. But what looked like the opening of a very promising period became one of some frustration for TPS. The plans of its founders to develop the EMS into a European Monetary Fund were quietly shelved, there were frequent realignments and little effort, at least until 1982-83, to seize these occasions for policy adjustments rather than accommodation of past inflation; and some smaller, more technical, improvements in the functioning of the EMS proved difficult to agree on and generated some unjustified suspicions among German officials as to the motives of TPS.

This did not, however, lead him into passivity; he explored the appropriate future balance between global and regional financing of external deficits, memorably at a conference debate in Geneva with Jacques Polak, then outgoing Director of Research at the IMF, and TPS organized through the Centre of European Policy Studies the CEPS Macroeconomic Policy Group – with his friend the late Rudi Dornbusch as Chair and with then young European macroeconomists based in the US (Olivier Blanchard and Willem Buiter) together with more senior European-based colleagues (initially Giorgio Basevi and Richard Layard, later Herbert Giersch, Jacques Drèze and Mario Monti) as its early members – to offer advice to often reluctant European policy-makers in the Commission or in national governments. One key concept from the Group's contributions was "the two-handed approach" to economic policy: budget consolidation with a growth-friendly investment policy, a theme that TPS saw as more

permanently relevant. He finally established a relationship as trusted interlocutor of Jacques Delors, who had become Finance Minister in France in 1981.

The third period was 1987-89. Two years after Delors had become President of the Commission he called on TPS to chair a working group (with Mervyn King and Lucas Papademos among its other members) which looked at the challenges to the European policy framework. In the group's 1987-report "Efficiency, Stability and Equity", arguing that the stability function was beginning to lag behind the two other policy challenges, particularly as market integration deepened and capital movements were liberalized. With this view gaining ground at the political level in early 1988, Delors wanted TPS to serve as Secretary of the Committee on Economic and Monetary Union which Delors was asked to chair at the Hanover European Council.

The contribution of TPS to the Delors Report was crucial. Although he could not speak in the meeting sessions, he had his say in preparing initial thoughtful questions to address and, decisively, in preparing – with his colleague Gunter Baer – well-balanced early drafts of the chapters in the Report which greatly facilitated agreement in the Committee. But he had an additional role in sustaining the Chair of the Committee after difficult meetings when the prospects of agreement seemed tenuous. TPS could usually see a way forward and he was notably more confident than Delors that the objections raised by one or more of the national central bank governors could be overcome at the

next meeting – and how. As an insider among the central bankers he was obviously respectful of their hesitations, but not intimidated by them. In the end the members signed the Report unanimously.

That central bankers could agree on the outline was not as surprising as the subsequent consensus which developed at the political level. TPS was there, first to see the Report through the scrutiny of the Finance Ministry officials in the group set up by the French EU-Presidency under Élisabeth Guigou, then – as a key Italian negotiator working closely with then Governor Carlo Ciampi – in preparing the Intergovernmental Conference, convened in 1990 in Rome, and in persuading the Italian authorities towards the end of the Maastricht negotiations to push for an element of automaticity in starting the final stage of EMU in 1999, rather than looking every two years to see who was ready to join and whether they constituted a majority of Member States. Without that automaticity provision EMU might never have started. Finally, TPS was active in facilitating the return of the lira to the EMS in late 1996, just in time for Italy to qualify among the first participants in EMU. In June 1998 he began his seven years of service as a Member of the ECB Executive Board.

TPS was not only an inspiration for those policy-makers who saw the potential of EMU; he became a key figure in implementing the vision. In this double role the unique combination of passion and patience which marked his personality came into full play.

In the rest of my comments I want to focus on the issue of governance in the Euro area which remained a major concern for TPS, as evident most clearly in his 2004 book *The Euro and Its Central Bank* (Padoa-Schioppa, 2004); he clearly regarded the framework from Maastricht as work in progress.

The model of governance outlined in the Delors Report and basically accepted at Maastricht is today widely seen as lopsided. Centralizing monetary policy, while leaving other macroeconomic and structural policies largely in national hands, though with budgetary policies subject to constraints on strongly deviant behavior, was 20 years ago the most that could find political support. But it also seemed economically defensible on two assumptions generally accepted at the time: (a) that the budgetary rules would be respected by participating governments and monitored by their partners and the Commission, and (b) that the deeper integration of the markets for goods, services and capital then underway would keep national price and cost trends on broadly parallel tracks. We now know that these two optimistic, but not *a priori* unreasonable, assumptions proved unrealistic – and not only because the group of participants in EMU turned out to be much larger than expected.

In addition, there was an omission in the Maastricht framework, viz. that one could maintain a largely national approach to financial regulation and supervision in a unified currency area. Few officials or academic economists had the imagination to envisage the degree of financial

interdependence that would develop with the introduction of the euro and how it would intensify at a time of crisis. The issue did not receive much attention in the Delors Committee, despite some prodding by TPS and a couple of members, maybe because the central bank governors were not keen to be given any responsibility for financial stability and hence to take on any such role jointly at the EU level.

Only a few central banks had supervisory responsibilities for their banks at the time; most countries were building up unified national Financial Supervisory Authorities for all financial activities. Central bankers feared that responsibility for financial stability would lead to onerous political oversight and hence constitute a threat to autonomy in monetary policy. They struggled to contain such dangers in the set-up of a European Systemic Risk Board which focuses on macroprudential issues, leaving the supervision of individual financial institutions to new European institutions.[1]

The design of the coming European System of Central Banks – the only new and operational policy institution – was marked by a "purist" vision. TPS has in his 2004 book a fine analysis of the long swings in the focus of central banking: towards the end of the two turbulent decades of the 70s and 80s with on average high inflation the focus was firmly on creating the most reassuring framework for a joint monetary policy with medium-term price stability as its primary objective, and pursued by a central bank with a high degree of autonomy from political authorities and

as few distractions from government finances, instabilities in the financial sector and in foreign exchange markets as possible. The prohibition of monetary financing of public sector deficits (and the no-bail-out rule), the absence of responsibility for financial stability and the deliberate impediments to any active exchange rate policy interventions can all be seen as desirable safeguards of the central bank's main and highly autonomous role in monetary policy – and on these safeguards there was agreement between central bankers and the political authorities.

TPS was from the start uneasy with the design and he foresaw the need to eventually develop it further. In his 2004 book he warns against confusing central bank independence with loneliness; if the central bank is effectively alone on the European policy stage, it may end up performing tasks which in a properly functioning system of governance fall to the political authorities. That could pose greater dangers to policy autonomy than those obviated by the safeguards in the purist design of Maastricht.

This central message has become clear over the past two years of severe crisis in the Euro area; the laxity with which national governments have treated the constraints imposed on their budgetary and other policies by EMU is the main cause of the crisis, but the "congenital" weakness of the original purist design has also become visible and in need of repair. TPS only lived to see the first of these two years of crisis, but he left some pointers as to what he saw as desirable improvements in the framework.

Without any doubt, TPS would have regarded the developments in governance in 2010-11 as useful, indeed necessary, but also as inadequate. To begin to take the budgetary rules and their monitoring seriously is indispensable, even if one may question whether the more legalistic provisions for the Euro area participants now under debate in the European Council are strictly necessary on top of what had just been enacted through the so-called "six-pack". In addition to that major updating of the rules, the brutal awakening to new forms of market discipline, and the experience of the countries that have had to borrow from the European institutions and the IMF and to negotiate harsh adjustments, will remain fresh in the minds of policy-makers for a long time. To be "bailed out", officially or privately, is not an attractive option; it has become a powerful deterrent to misbehavior.

However, regardless of whether one regards the possible Treaty changes that emerged from the December 2011 European Council as essential or not, the proposals fall short of major steps towards policy coordination in any real sense. We were too generous at the time of the Delors Report and the Maastricht Treaty in using the latter label for the framework under construction. Guidelines for budgetary behavior are designed to constrain individual country behavior; they can at best promise some indirect coordination.

The recent proposals to reinforce them extend the asymmetry in policy-making in the Euro area, where we have a central bank that addresses only policy issues common

to the whole area, and a Eurogroup which speaks almost exclusively about individual countries without any aggregate view. Jaime Caruana mentioned in his intervention that TPS did not regard a multi-country strategy embodying only the prescription that each participant should "put his own house in order" – even when all participants do so systematically at the same time – as sufficient; the approach should be supplemented by a view of the aggregate, or joint, effort required.

Is there a way of meeting that challenge without simply slowing down the degree of joint austerity currently on the agenda? TPS would hardly have been sympathetic to the calls, primarily from economists in the US or the UK, for expansionary budgetary policies in Germany and other countries in external surplus; after all the German public debt is presently close to the Euro area average of about 85% of GDP, leaving little room for looser policies. He would also have acknowledged that EMU was constructed to facilitate the spreading of the best national policies, rather than to further convergence to an average performance. But even the best-performing economies can do better by pursuing structural reforms and making the joint project of the Single Market advance, not least through better implementation of the Services Directive.

Mario Monti's Report on the subject, delivered in May 2010 to the Commission, offers a number of implementable proposals. Allowing the EU long-term budget to grow modestly beyond its 1% of EU GDP, while recognizing

that even in a pre-federal state it can be more efficient to spend at the EU rather than at the national level, could be a further counterpart to the sole emphasis on joint austerity in the prevention of future crises. In informal conversations at the time of the Delors Committee I recall that our Chair thought that an EU budget in the order of 3%, rather than 1%, of EU GDP would be a natural and likely complement to the joint monetary policy in EMU; TPS shared that evaluation at the time. While still very much at a pre-federal level, such a budget would have permitted the beginnings of the type of stabilization functions which governments in large federations undertake at an early stage.

TPS would also in my view have been likely to ask whether all proposals for Eurobonds/Stability Bonds would have to be deferred until well after the tighter budgetary rules had demonstrated that they work. Various non-governmental sources – Bruegel, the German Council of Economic Experts and the European League for Economic Cooperation – have made proposals that in various ways limit the open-ended joint issues of sovereign bonds that have understandably been rejected by the most creditworthy governments as leading to moral hazard and as requiring major Treaty changes. These ideas are all complex to develop, so debate on them, including systematic comparisons, should not be long delayed.[2]

TPS saw, right from his EMS days in Brussels, the monetary unification of Europe as a process to be driven not only by political decisions, but also by financial markets.

He would have been critical of the schizophrenic attitude of many national policy-makers in Europe towards markets. As long as financial markets supported interest-rate convergence – as they did until 2009 with surprising enthusiasm – that was taken as a great compliment; when markets became increasingly skeptical, and no doubt overreacted to divergences, they were vilified in the political debate. One major challenge for future economic governance in the Euro area is to come to terms with monitoring by both markets and governments, marked by less violent and simultaneous swings in both.[3]

The challenge is extremely difficult, as we have seen well illustrated throughout the crisis. Markets are impatient and look for decisive political moves rather than for a long drawn-out process of gradual progress. And markets look not only for more readily enforceable mechanisms of budgetary discipline, though that is an essential first step. The present crisis is to a large extent, but not exclusively, a budgetary crisis in individual countries. It is also one of severe imbalances between participants, as well recognized in the new procedures for monitoring external imbalances and competitiveness. The evolution of governance will have to address this dimension more explicitly and seek remedies for imbalances to ensure smooth relations with financial markets and, ultimately, with the European electorate. The advice of TPS will be sorely missed in this endeavor.

NOTES

[1] TPS did not live to see the topic of banking union, with the ECB in the central role as single supervisor of individual banks, reach the agenda. That happened only in 2012, well past the conference in honor of TPS. I am not in doubt – on the basis of what he wrote on several occasions, notably in his 2004 book – that he would have welcomed this new role for the ECB, at least with respect to the large banks. He was also well aware of the potential for moving in this direction by means of Art. 127.6 of the Treaty.

[2] The Commission, at the insistence of the European Parliament, in 2013 set up an expert group to report on the feasibility of various proposals for Eurobonds and bills.

[3] The announcement in 2012 by the ECB of possible resort to Outright Monetary Transactions (OMT) has removed so far the fear of a break-up of the Euro area, narrowing spreads between sovereign bond issues by different participants to levels where monitoring by governments and by market monitoring can be exercised jointly in a constructive way.

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Background note

T. PADOA SCHIOPPA'S PERSPECTIVE ON EUROPEAN INTEGRATION

Fabrizio Balassone and Sergio Nicoletti Altimari

Tommaso Padoa-Schioppa's private and professional life was animated by his profound political and civil faith in the potential of a united Europe to ensure the wellbeing of all European nations. When the opportunity came, he skilfully provided practical impetus to the European construction in the run up to EMU. He was sharply aware of the incompleteness of the project and of the limits of a currency without a state. When the financial crisis struck and the shortcomings of European governance became apparent, he saw his concerns become reality. Even then, he never doubted Europe's ability to come through the storm and take a further step towards political union.

1. *A lifetime commitment to the European ideal*

Padoa-Schioppa's vision of a unified Europe was grounded in political passion much more than in economics. He was often explicit on this point. He wholeheartedly embraced the inspiring vision of men such as Jean Monnet, Altiero Spinelli, Jacques Maritain and Luigi Einaudi, and saw the value of a power superior to that of sovereign states

as a means to stop the pendulum of wars and precarious armistices that had marked European history for more than three centuries, until the tragedy of the two world wars. As a child he directly witnessed the great anguish and uncertainty of those years. A unified Europe was necessary not only for the welfare and security of European nations, but also for world peace and order.

"Central banker by profession, supporter of a united Europe by political creed" (Padoa-Schioppa, 2004a), he saw the economic union of Europe as a means to a higher end. The gradual creation of a common European area where goods, capital, services and people could move freely (even more freely than they had been allowed to within the borders of each state) required that individual sovereigns gradually relinquish part of their powers to a higher institution: it was not a European State, but it had the powers of a State. His colleagues and friends were well aware of the strength of his passion. "Europe was Tommaso's strongest ideal, the powerful engine behind his action, his existential mark, even" (Ciampi, 2011).

A defining moment in the professional career and personal development of Tommaso Padoa-Schioppa was his appointment as head of the Directorate General for Economic and Financial Affairs at the European Commission in 1979. There, passion encountered the possibility of concrete action. The opportunity came at a difficult time for the European Community. The European economy was battling stagflation after the oil shocks of the 1970s, while

the European integration process was languishing. It was a period decried as “Eurosclerosis”. But it also came at the moment of the establishment of the European Monetary System.

Padoa-Schioppa’s term at the European Commission centred on the reinforcement of the EMS. He called it the “priority of priorities”. The early 1980s were marred by tensions on the foreign exchange markets. Stabilization of the EMS required convergence of economic policies. Realignments were key in this process as policies became collective decisions rather than unilateral ones. In this respect the realignment of March 1983 was a turning point, with the adoption of a *politique de rigueur* in France marking Mitterand’s “conversion” to the EMS. Padoa-Schioppa contributed significantly to this development, working closely with Commissioner François-Xavier Ortoli, Jacques Delors, the French Finance Minister, and Beniamino Andreatta, the Italian Finance Minister.

He was also very much involved in the second institutional phase of the EMS agreement, concerning the creation of a European Monetary Fund. Negotiations on the subject did not go well and the proposals initially developed by the Commission were put on hold. He responded by setting out to strengthen the EMS, developing a plan that did not involve institutional reforms. There were technical improvements, but also a platform for the full participation of all currencies in the Exchange Rate Mechanism and the issue of an ECU coin. It was around this time that he became

convinced of the impossibility for a group of countries like the EU member states to simultaneously aim at free trade, capital mobility, independent domestic monetary policies, and fixed exchange rates. He called these four goals, each apparently desirable in its own right, "the inconsistent quartet" (Padoa-Schioppa, 1982). So it must have been with great delight that in February 1982 Padoa-Schioppa received the message from Karl Otto Poehl, then president of the Bundesbank, that "if you are proposing a European Central Bank based on a Treaty, then I agree; but I will not allow constraints to be imposed on the Bundesbank without any legal basis" (Padoa-Schioppa, 1998a).

2. *Europe and the euro*

By the late 1980s restrictions on trade and capital movements within Europe had been eliminated and Padoa-Schioppa explicitly advocated that the problem of the inconsistent quartet be solved by creating a single currency and a single European central bank. In this more favourable economic environment, which helped create a more positive political climate, the possibility of making plans for another step towards European integration became reality. At the European Council held in Hannover in June 1988 it was decided to set up a committee to study the feasibility of a European Economic and Monetary Union – the Delors Committee. Padoa-Schioppa was named Joint Secretary to the Committee together with Gunter Baer. As Jacques

Delors himself later observed, the role of Padoa-Schioppa and Baer was decisive (Delors, 2001).

The Delors Report of April 1989 recommended a European Monetary Union (EMU) with a single currency. It assumed a crucial role as a reference and anchor point in further discussions and negotiations on EMU, succeeding where the Werner Report nearly two decades earlier had failed, and becoming the basis for the chapters on EMU in the Maastricht Treaty.

Although the expression EMU dates back to the late 1960s, when it became part of the language of the meetings of EC Heads of State and Government, exactly what was meant by economic and monetary union was not defined even at the Hannover meeting. One of the first steps taken by the Delors Committee was to define the concept. It did so by concluding that it essentially meant three things: the single market; the unification of monetary matters; and some fiscal or budgetary discipline. The first component, the single market, had already been defined and there was no change in the provisions of the Treaty of Rome as amended by the Single European Act. Discussions focused on the other two elements.

According to Padoa-Schioppa, the key to the success of the Delors Report was its assertion that monetary union must be accompanied by a single monetary policy. In his view the essence of a monetary union was institutional, even more than economic: the fact that the responsibility

for monetary decisions was shifted to a single institution instead of being entrusted to a plurality of central banks (Padoa-Schioppa, 2004b).

The inclusion of fiscal discipline in EMU was also decided very early on by the Delors Committee. Padoa-Schioppa thought that on *economic grounds* there was no compelling argument for claiming that a monetary union cannot function without a fiscal union or, more generally, without a form of federal discipline in budgetary matters. However, he felt that on *political grounds* it was indispensable to present monetary union as being based on sound budgetary policies, since consensus on monetary union depended on reassuring public opinion that it would be built on solid fiscal foundations. At the same time, he felt that the excessive deficit procedure was "half-way between expressing a wish and establishing a binding rule […and that...] only time will tell whether it will work or not" (Padoa-Schioppa, 1995).

In Padoa-Schioppa's view, the road to EMU was facilitated in the late 1980s and early 1990s by a number of factors. To some he contributed significantly,[1] while he saw others as "a benevolent historical conspiracy".

To the first category belongs the increasingly widespread recognition of the need to fix the "inconsistent quartet" (which was at the root of the continuous tensions affecting the EMS) and to rebalance the so-called efficiency-equity-stability triangle (the three main objectives of economic policy) at the European level. Of his contribution to

monetary union in particular, as a means to reconcile the "quartet", we have already spoken. Concerning the "triangle", Padoa-Schioppa argued that with the efficiency side being dealt with mainly through the completion of the single market, the European Community left the other two sides (equity and stability) somewhat behind. In his opinion many of the developments of the late 1980s, after the single market process had been launched, can be seen as attempts to rebalance the three sides of the triangle, with monetary union as the ultimate solution for stability and the European social cohesion policy and growth strategy addressing equity concerns (Padoa-Schioppa *et al.*, 1987).

Economic factors in the "benevolent historical conspiracy" included (a) the relatively favourable economic conditions and political stability prevailing from the mid-1980s up to the early 1990s; (b) the increasing popularity of the idea that public intervention in the economy should be reduced and greater scope allowed to the play of market forces; and (c) the growing support for the paradigm according to which monetary policy should be primarily concerned with price stability and central banks made independent. Both the second and the third factor tended to minimize the perceived shift of sovereignty implied by monetary union.

Political factors facilitating the road to the euro were at least as important. First of all, the vision of political leaders: "Like Adenauer, De Gasperi and Schuman in the 1950s, Kohl, Mitterand, Andreotti and Gonzalez in the 1980s knew little about the economic and technical arguments

for or against monetary union. In line with the original motivations of the 1950s they saw the single currency as a further step – and a prerequisite to yet other steps – in the political unification of Europe. In the 1970s they had directly experienced how urgent the need for a tighter union was for their own countries and for Europe as a whole to play a role in the international world. To move forward decisively, they chose the monetary world, sometimes against their own experts" (Padoa-Schioppa, 2004a).

Finally, unusual historical contingencies also played a crucial role: "during the phase in which the blueprint prepared by the Delors Committee was at the junction of being either shelved or becoming a concrete political commitment, the Berlin wall fell (November 1989) and the course of post-World War II European history suddenly changed. The reunification of Germany became possible. Both the hope of closing the last wound of World War II and the fear of a resurrection of German hegemony revived at once. From this situation came a decisive impulse to the implementation of the single currency. By supporting the single currency, the German government gave the clear sign that reunification of the nation and further European integration were two inseparable aspects of one and the same policy" (Padoa-Schioppa, 2004a).

In relation to these facilitating elements, Padoa-Schioppa liked to quote Guicciardini, the Italian political thinker and historian of the sixteenth century, who said that "faith breeds obstinacy" and that "since the things of this world

are subject to a thousand random chances and accidents, unexpected help may appear in many forms in the course of time for those who have obstinately persevered" (Padoa-Schioppa, 1995).

In 1992, following the Intergovernmental Conference, the Maastricht Treaty adopted the recommendations of the Delors Report, including the gradual phasing-in of EMU in three stages. In Padoa-Schioppa's view, the Treaty contained two formulas that represented a major change: the "opt-out clause" for the United Kingdom and Denmark, and the "convergence criteria" to qualify for the final stage of monetary union. Both these formulas allowed Europe to move to the final stage of monetary union without all the Member States having to participate from the start. Convergence criteria also meant accepting the principle that Member States could be excluded from participation in projects on performance grounds. Moreover, the Treaty provided for the decision-making body of the ECB, the Council, to be made up of the members of the Board and the Governors of the national central banks, and the voting rule within the ECB Council to be one head, one vote.

The EMS crisis in 1992-93 appeared to pose a major threat to the goal of the single currency, but it occurred too late to stop the process. Padoa-Schioppa noted how "to some extent independently, the macroeconomic requirements set for joining the single currency acquired a life of their own. They were adopted by markets and observers as a benchmark of good economic policy behaviour, to the

point that complying with them became a central issue in the domestic policy debate of each country" (Padoa-Schioppa, 2004a). As a result the convergence process and the technical preparation for the introduction of the euro proceeded rather smoothly and on 1 January 1999, the euro became the single currency.[2]

3. *An incomplete project*

Padoa-Schioppa considered the introduction of the euro a fundamental step in European history, certainly the most important event he had the fortune to contribute to. However, the sense of incompleteness of the project prevailed in him from the start. According to him the euro was not the product of a technocratic vision or of a bureaucratic process; it was the certification of the deep integration already achieved by European economies and, at the same time, a crucial element of further progress: "the advent of the euro is a quintessentially political event in its genesis, and a profound social and cultural change in its nature" (Padoa-Schioppa, 2004a).

He never joined in what he considered the excessively triumphal attitude that had pervaded many after the adoption of the single currency. He was instead among the first to acknowledge the incompleteness of the European project and the inherent risks generated by politics lagging behind economics in the process of integration.

On 3 May 1998, when Europe was completing the last steps before the adoption of the single currency, he wrote in a column for *Corriere della sera*: "The Union has full competence for *microeconomic* policy (the opening up of borders, the rules on products and services, the safeguarding of competition), but its capability for *macroeconomic* policy is, with the exception of the monetary field, embryonic and unbalanced: it can impede harm (excessive deficits) but it cannot do good (a proper fiscal policy). It is for this reason, in addition to its strong legal status, that the European Central Bank and monetary policy will benefit from unprecedented autonomy. A Union that fails to satisfy, even for the functions that have been attributed to it, the cardinal principles of western constitutionalism (balance of powers; the democratic vote; the majority principle), and does not have real competence for foreign policy and internal and external security, is incomplete and weak. It is thus right not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness" (Padoa-Schioppa, 1998b).

Padoa-Schioppa lamented the lost opportunities for proceeding further with political union: "One week after those elections [of eastern *Länder* representatives to the Bundestag] that marked a great victory for Kohl, in a letter to the Irish President of the Community, Kohl and Mitterand requested that the Council scheduled a few days later decide to proceed towards Monetary Union and Political Union and call two intergovernmental Conferences to stipulate

two consequent Treaties. There is a strict temporal sequence between German reunification and this political indication that the European Council adopted. […] However, we could say that 1989 was a lost opportunity because the Monetary Union was made, but the political Union was not." (Padoa-Schioppa, 2009b).

In his view this lack of political union represented a *vulnus* for the single currency itself. When at the ECB, he often warned policy makers not to confuse the independence of the central bank (something he had fiercely fought for during his career) with its isolation, the lack of a strong political counterpart. To succeed, the central bank cannot operate in a political *vacuum*: "Ultimately, the security on which a sound currency assesses its role cannot be provided exclusively by the central bank. […] History shows that when that order appears to weaken, the currency weakens, regardless of the actions of the central bank. A strong currency requires a strong economy and a strong polity, not only a strong and credible central bank" (Padoa-Schioppa, 2004a).

The lack of a political union meant above all the impossibility of taking effective decisions in many crucial fields of Europe's economic life. Padoa-Schioppa's job as a central banker led him to contribute most in the area of financial stability and supervision, where he lamented the lack of homogeneous rules and pushed for a single rulebook and a centralized supervisory framework for cross-border groups in Europe. At times he did not hesitate to criticize his

fellow central bankers openly, accusing them of "thinking in national, non-European terms" when they resisted proposals to extend the mandate of the ECB to banking supervision. He argued that "immediate action [was] necessary and while changing the Treaty could take years, if the will [was] there it would be possible to act under the current Treaty".[3]

But the consequences of an incomplete Union were particularly severe in the field of economic policies, where he saw basic flaws in the European construction. The essential problem was that an economic governance based "on the mere coordination of national policies was at the same time too weak and too ambitious. Too weak because it is fatally flawed by the fact that the power of coordinating is at the hands of the same ones that are supposed to be submitted to this power. Too ambitious because it grants the EU a power of intrusion in its member States policies that – even in mature federations – the central government normally lacks *vis-à-vis* local governments (be they States, *Länder*, Provinces or Regions)" (Padoa-Schioppa, 2010b).

The reform of the economic governance undertaken in the aftermath of the recent crisis was considered by Padoa-Schioppa as a positive but also as a largely insufficient step because it continued to be based on the very same concept. In his view, the way forward was instead to empower the Union with the means for conducting *common* policies as opposed to *coordinated* policies. This required some very fundamental changes.

First of all, the EU had to be endowed with its own budget in order to develop the policies for which the Treaty assigns "shared responsibility" to the member states and to the EU (in particular in the fields of transportation, research and the environment). He thought that the EU needed a more flexible budget with resources coming directly from the taxpayers (possibly through one or two specific European taxes), and with the ability to use its borrowing capability. With today's arrangements the filter of national budgets has the effect "that member states perceive the resources allocated to the Community as being funds of which national budgets have been deprived" (Padoa-Schioppa, 2010a).

The second profound change he was adamant about was the abandonment of unanimity in deliberations and the expansion of the majority rule. He saw problems lying in particular in the European Council, an institution whose characteristics of intergovernmental composition and unanimity he considered a major impediment to its capacity to take decisions and to act: "Taken together these two characteristics transform the Council into a negotiating table among governments, in the classic way of international relations, not a collegial body of traditional governmental institutions of States. None of the members of the Council that have the power to decide is attributed a European mandate, none of them represents the Union…" (Padoa-Schioppa, 2009a, p. 376).

He saw the lack of majority rule as a key obstacle for the Union to tackle effectively the economic problems that

had emerged with the crisis that started in 2007: “In order to manage the crisis we need measures in the monetary, supervisory and economic policy fields. The Union exists in the first field where decisions are taken according to the majority rule. It does not exist in the other two where, to decide, it is necessary to have unanimity, and if a decision is taken, common and operative means are lacking” (Padoa-Schioppa, 2009d).

Considering the weaknesses in the European construction, he saw the crisis as an opportunity but also as a formidable threat: “Europe as it is now does not have the means to confront the challenges of history, including the current one, which has taken by surprise not only its policies, as has happened in all countries, but also its institutions, something that does not happen in consolidated political unions... Proceeding ‘everyone for himself’ is not only ineffective, it is also dangerous. The crisis will possibly generate the means that are now lacking and get us closer to an accomplished Union; but it could also have disruptive effects” (Padoa-Schioppa , 2009d).

In an interview, he noted that “There is more bitterness than satisfaction in witnessing a prophecy come true. At the beginning of the euro I spoke of the dangers of a ‘currency without a State’. It is clear that we needed more of a European State, not less of a European currency: without the euro, Europe would now be living a catastrophe. One reason for the lack of credibility of national politics is that it keeps on giving people the illusion that national powers are capable of

tackling issues (energy, climate, finance, security, migration, primary goods) which are not national, but continental and global" (Padoa-Schioppa, 2008).

4. *The future*

Padoa-Schioppa thought that "the process of European unification was the strongest positive legacy that the [last] century leaves to humanity in the sphere of political orders. It is the demonstration that human society can, with peaceful means, move from the state of nature to civilization also in an area – relations between sovereign states – where this transition had not yet succeeded" (Padoa-Schioppa, 2001). As such it was not only a great accomplishment, it was also a promise.

But Europe is still in a transitional and unstable phase. Padoa-Schioppa describes the European Union as a mixed model, "an economic and monetary Union that preserves the name of Community, accompanied, in the political sphere, by forms of voluntary and non-binding cooperation" (Padoa-Schioppa, 2006). More than a mere confederation of States but not yet a true federal Union. To complete this transition it was necessary to extend the federal method to properly political fields (foreign policy, security, defence), adopt the majority rule and endow the Union with his own, more flexible budget. The federal method was in his view the way to assign the power at the right level of competence, simultaneously limiting and reinforcing it.

He had little patience with the political inertia that followed the completion of EMU, to the extent of calling for an act of rebellion by the European Parliament.[4] To make concrete steps, groups of countries could decide to advance faster than others, they could decide to reinforce cooperation in some specific fields. He often remarked that the European Union wouldn't have existed unless the countries that wanted to move ahead had decided to proceed, even if alone. On the contrary, he saw one of the signs of the current standstill precisely in the fading of such determination.

In his view, only by completing the road to unification would Europe be able to ensure lasting peace and welfare and to promote them beyond its borders: "A Europe of sovereign States with unlimited power initially dominated other continents and then destroyed itself, drawing the entire world into war. The evils to which Europe fell victim then now threatens world order: the drive for supremacy of the great powers, the fragility of a peace founded on the balance of powers, the pagan illusion of the absolute power of the State. Precisely because it suffered from its own mistakes, Europe took the route of limiting the power of sovereign States. And this is the path that the world will also have to take if it wants to avoid ruin. Europe can help support the global system of States only if it itself proves capable of completing that same journey, until the very end" (Padoa-Schioppa, 2001).

His hope was that the younger generations would continue down this road. On the fiftieth anniversary of the Treaties of Rome, when asked what his dreams and hopes for Europe were, he answered, “My dream is that this journey will be completed before the tragedies that opened our eyes to the necessity of completing it are forgotten. People my age still remember the war and the destroyed cities; people my children’s age do not. At times they even seem to think that Europe is something that has already been accomplished and does not require their participation in order to be completely realized. My dream is that this participation will come to pass and that today’s twenty, thirty or forty years old realize that they must complete the journey.”

NOTES

[1] On Padoa-Schioppa's role as "architect of the euro", see also Visco (2011).

[2] As a member of the ECB's Executive Board Padoa-Schioppa had the opportunity to contribute to the setting up of the new institution and to guide the first steps of the euro. On Padoa-Schioppa's experience at the ECB, see Saccomanni (2011).

[3] Padoa-Schioppa (2008). See also in this volume the background note *T. Padoa-Schioppa's perspective on financial system regulation and supervision* by A. De Vincenzo and A. Generale.

[4] "Consider a dream scenario. Let us imagine that the new European Parliament were to decide that the economic crisis, the disintegration of the single market, the impotence of individual countries and the fragmentation of public spending in fields of common interest, meant a change in direction was required. First, it would claim the right to choose the new president of the Commission (and the Commissioners). [...] Second, the new parliament would call for immediate and radical reform of the European Union's budget and policies. Expenditures would be made flexible and discretionary, not rigidly partitioned by countries. There would be a truly European levy with new resources to implement common policies required by the ruling treaties. The two moves would completely subvert the Union and block its functioning. [...] Eventually, after months of paralysis, national governments and their Council – the coalition of the unwilling, the huge table at which heads of state and prime ministers recite notes drafted by their officials – would understand that the game has changed. A new power would have risen in Europe. Why go to such extremes? Because complete paralysis for a few months is better than the semi-paralysis in which Europe has been languishing for decades" (Padoa-Schioppa, 2009c).

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PANEL 4

THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Lorenzo Bini Smaghi

1. *Introduction*

It is a great pleasure to attend this conference today in honour and memory of Tommaso Padoa-Schioppa and to be a member of the panel discussing the reform of the international monetary system. That was a field Tommaso bore responsibility for at the ECB and which I inherited from him.

I would like to focus my remarks on his main critique – which he shared with Robert Triffin – that the international monetary system remains incapable of imposing an acceptable macroeconomic discipline on the world economy. I also wish to examine the reservations he expressed about international policy cooperation being enough to ensure stability.

I would like to organise my remarks as follows. First, I would like to explore the theoretical underpinnings of international policy collaboration, and explain why in practice it seems to fall short of what is needed in today's global world and why countries remain trapped in short-term policy-making. I will then review some proposals made by Tommaso to correct today's international monetary system, including the provision of an anchor and an exchange rate

mechanism, and consider the consequences of maintaining the *status quo*. In conclusion, I will argue that it is better to prevent volatility than to cure it. The deployment of ever larger official resources to cope with potential crises cannot be the solution – neither conceptually nor practically.

The policy implications are that there are three key areas where preventive action could and should be taken, and which require structural change by major economies: first, financial developments in Emerging Market Economies (EMEs); second, further financial and economic integration in Europe; and third, reforms to ensure that financial markets serve the real economy and support stability.

2. *Analysis*

Let me start with the global financial crisis. There is a broad consensus on some of the main factors underlying the global financial crisis – such as the growing and persistent current account imbalances, inadequacies in financial regulation and supervision, the systemic risk caused by excessive leverage combined with risky financial products, and so on. As Tommaso argued, there is also some lack of recognition of the fundamental flaws in the present monetary arrangements, or rather non-arrangements. Being a policy-maker, he not only identified the flaws, but proposed the essence of a solution to the problem. Greater cooperation between economies was a critical element in a reformed international monetary system.

Let me elaborate on this point. Why would international policy coordination be beneficial in the first place? After all, every country strives to meet its own growth and stability objectives in order to produce a strong and stable economy. Isn't that enough? The message from the crisis, loud and clear, was "no". The problem is that economic policy actions, particularly those of larger countries, create quantitatively significant spillovers, or "externalities", for other countries. Hence, achieving a global optimum means having to take such externalities into account in the decision-making process. Therefore, coordination can be regarded as a mechanism to encourage countries to include the potential spillover effects in their policy considerations, in other words, to "internalise these externalities". Only then is it possible to achieve a Pareto optimal outcome (Sen, 1970).

In practice, even though international coordination is vital to optimise global welfare, it is notoriously difficult to attain the necessary level of sensitivity and commitment from policy-makers. Economic theory provides us with a conceptual framework that helps explain why this is the case. Countries that impose negative externalities on others create a deviation from the global Pareto optimal outcome. But since such countries lack sufficient incentives to pursue the global optimum, the international community faces a prisoner's dilemma in which systemically relevant countries pursue policies that produce mutually reinforcing negative spillovers. This dilemma however becomes smaller if the participants interact with each other continually. To put it

into our context, if countries repeatedly interact with each other, cooperation becomes more beneficial than pursuing self-interest alone, particularly in complex situations when those involved have numerous options for responding to the strategic actions of others (Mailath and Samuelson, 2006).

Countries do in fact interact with each other repeatedly, but achieving effective international cooperation and internalising externalities still appears to be largely elusive. As Tommaso said, "the self-sufficiency of national monetary sovereignty" (Padoa-Schioppa, 2010, p. 4) is a "false idol"; countries tend to pursue policies which generate unsustainable growth *cum* imbalances in the short run, thereby neglecting global spillovers and negative feedback loops that undermine domestic long-run performance and stability. I would even go a step further. I would suggest that economic growth which relies on an unsustainable policy framework might even turn out *ex post* to be an "accounting illusion".

So why is there such short-termism in policy-making that results in unsustainable domestic policy frameworks and global economic and financial instability? Let me offer four thoughts:

- First, there is the primacy of the electoral cycle. Policy-makers tend to maximise utility functions, which incorporate only national objectives over a limited time horizon. In such a context, it is difficult to enforce policies resulting from international commitments that

may, over the short term and particularly in the run-up to an election, be seen to contradict national objectives.

- Second, policy-makers face asymmetric opposition to change. Interest groups that profit from the current system are usually far more organised and vocal in opposing change than the silent majority, both nationally but also internationally, which could potentially benefit from economic reforms.
- Third, and moving away from political economy considerations, it is very difficult to assess equilibrium values for certain key variables. Therefore, fundamentals are often over- or underestimated depending on the country and the point in time. Imbalances are, thus, financed for too long and at too favourable prices, so any eventual corrections turn out to be very sudden and sharp.
- Fourth, there is habit persistence and sluggishness in the adjustment process, as large international players are sometimes trapped in a given policy framework. For example, despite the financial crisis, policy incentives arising from the US's exorbitant privilege remain unchanged in the presence of sizeable and liquid US financial markets and the strong international role of the dollar as a reserve currency. At the same time, in the case of China, the current growth model still delivers acceptable results – even if it is at the expense of some segments of society and, as such, represents an implicit tax on them.

Given that the accumulation of major imbalances in China persists and does not disrupt other aspects of the economy – thanks to financial repression and a closed capital account – the current growth model is perceived as being sustainable. The same could probably be said of other major economies, like the US.

Sooner or later, however, the unsustainability of domestic policies can be expected to materialise in a crisis. This is particularly the case if, as we witnessed prior to 2008, rising imbalances go unchecked because of weaknesses in market discipline and, all the while, negative externalities persist without redress owing to the absence of a collective or higher authority to rein in what Tommaso referred to as "robust political and economic interests". Crises impose potentially severe domestic economic and financial disruptions on an economy and, at best, lead to a more sustainable model of growth, albeit at a very high price. At worst, they condemn a country to protracted low growth. In both cases, global economic performance and stability are undermined to a greater or lesser degree.

3. *Responses*

How should these weaknesses be corrected? Is the answer to be found indeed in international policy cooperation? I tend to share Tommaso's view that soft international cooperation alone, though necessary, would not be sufficient. In his words, "coordination fails precisely when it is most needed, i.e. when policy preferences are most divergent".

My experience confirms that even in the wake of the global financial crisis – which brought home global interdependencies and the porosity of national boundaries for national policies – international cooperation continues to be based on the premise that the pursuit of national interests is the best approximation of the Pareto superior result. It is the philosophy underlying the G20 Mutual Assessment Process, which seeks to achieve strong, sustainable and balanced growth.

Another weakness of the current international monetary system is that in its centre of gravity – the United States – economic and monetary policy are shaped to suit domestic interests. The current system mimics therefore, as I said earlier, a generalised version of the Triffin dilemma. Tommaso recognised it as such and identified some of the elements of a solution.

First, he argued for some sort of "common exchange rate mechanism" which would ensure that every country agrees to shoulder its responsibility for the appropriate valuation of their currency *and* that exchange rates are determined by the interaction between the market and economic policy. He anticipated that this would be well supported by floating regimes for large currencies, while smaller countries may thrive with an intermediate regime consistent with the geographic pattern of their economic and financial linkages, possibly a managed peg to the regionally dominant currency. He observed, for example, the very strong regional interdependencies in East Asia and the momentum these

create for a regional monetary arrangement comparable to those which Europe sought after the Bretton Woods system came to an end.

The distinctions between large and small economies, and floating and managed currencies, are particularly revealing at the present time, when we are seeing a large anomaly. We are currently facing an unprecedented situation in which a once-small economy that pegged its currency to that of a large economy has since grown to become the world's second-largest national economy. The result is a giant economy running a fledgling currency internationally, outsourcing its monetary policy and its international requirements for money (as a medium of exchange, unit of account and store of value) to the globally dominant currency. This has been a major source of imbalances in recent years. The way in which it has been addressed has been unsatisfactory and the effects on the prospects for the global economy are likely to become graver over time.

The major economies, while recognising the domestic impact of the policies of others, have yet to appropriately factor mutual interdependence into their utility functions and policy deliberations. In Europe, we had the luxury of reflecting on European interdependencies in decades of calmer conditions when making successive attempts to produce a stable European monetary order, leading up to European monetary union. And still, we did not learn the lessons well enough and are now having to do so the hard way. There is no alternative but for a stricter supranational

disciplinary element in Europe and, by corollary, at global level. As Tommaso said, it is nonsensical for countries to believe that they can reap the benefits of economic and financial integration without their policies acknowledging the two-way street.

The second issue is the need for an anchor to ensure the stability of a reformed international monetary system. More specifically, the interplay of demand for, and supply of, the reserve currency should be limited to what supports global stability. Just as Triffin saw an unresolvable tension for global stability arising from the subordination of the management of reserve-issuing currencies to domestic policy interests, Tommaso considered that this tension was keeping the disorder alive. In his view, what was needed was a quantum of supranationality that would hold sway over the global monetary policy stance. And here, he thought more could be made of a supranational currency, the Special Drawing Right (SDR). Tommaso recognised the hurdles to the SDR assuming its heralded role as the key reserve asset, in particular, the need for a critical mass of SDRs in both public and private sector circulation.

Although the SDR may have the potential to *reduce* the Triffin dilemma, it cannot *remove* it. As a basket of currencies, it would not reflect the domestic policy interests of the dominant economy, but rather the "average" for the economies of all the currencies in the basket. And in this respect, it would only improve on global stability to the extent that the "average" policy stance was better than the

dominant policy. However, a mere average of policies driven by national objectives is no guarantee for the public good of a stable monetary anchor on a global scale. This would require a policy framework anchoring the global standard to an objective of global stability.

An alternative view is that of a multi-polar currency system. The emergence of such a system would accompany the global rebalancing of economic power that is taking place. It would be a market-driven process rather than requiring an international agreement, framework or mechanism. And to be most conducive to global stability, the shift to a multi-currency system should ideally occur gradually.

Like the SDR, it offers a welcome alternative to the reliance on one dominant national currency for stability, and should have the effect of eroding the exorbitant privilege of the US dollar and increasing the policy discipline on all major, internationally-used currencies. But also like the SDR, stability under a multi-currency system would still ultimately rely on nationally-oriented policies, though in the case of the multi-currency system, market participants would choose directly the sets of national policies they prefer. Would this reduce volatility, or would it be even greater, as players switch among currencies, particularly in the transition phase as the currency composition of reserves is re-weighted?

Of course, a shift to a multi-currency system requires that the privilege of incumbency of the US dollar be removed,

that the sovereign debt weaknesses in the euro area be resolved, and that the renminbi develop its full international potential.

Now the suggested reforms pose many new questions. Let me focus on two in particular. First, what political and institutional conditions are necessary to form the basis of greater supranationality? We have travelled along this path in Europe and made some progress, assisted by the principle of subsidiarity. Federations may find themselves with a conceptual head start, but also highly open, integrated economies have an innate appreciation of the benefits of cooperation. All the same, implementing a shift of authority from the sovereign to super-sovereign level requires finding a way to overcome the perceived democratic deficit. In this respect, Tommaso believed in the cathartic effects of crises – that they exposed flaws in a system and pointed the way forward. The global financial crisis has resulted in the G20 Mutual Assessment Process. Does it go far enough? Might it become a necessary stepping stone to an improved framework for global stability?

This prompts my second question: what kind of world are we heading for in the absence of a mechanism or anchor for global stability? The focus is likely to continue to be on measures to deal with volatility, such as increasing reserve buffers, restricting capital flows and heavily managing currency values. All of these come at a cost: excessive reserves, especially for EMEs, represent a tax on domestic consumption and, if widespread across countries, would

produce a systematic excess of planned savings over planned investment, leading to a deflationary bias:

- capital controls are an understandable, if unfortunate, response to exceptional surges in inflows and outflows, but they produce externalities of their own, including increasing inflow or outflow pressures on other countries; and
- devaluing currencies can trigger beggar-thy-neighbour retaliatory measures that push the global economy into a downward spiral.

Now the failure to properly address these issues in the past has led to the current scramble for financial resources to shore up systemic stability. And the amount of reassurance demanded by markets increasingly exceeds the official resources available by an ever higher margin. National foreign exchange reserves stand again at an all-time high; regional financing arrangements – especially in Europe and Asia – are better endowed and more sophisticated than ever before; and the IMF had its resources trebled in 2009, and will soon reflect yet again upon the adequacy of its resources.

It is clear from this that prevention is always better than cure. Therefore, we must find better ways to reduce financial market volatility. Policy measures to address the problem need to be tailor-made. In emerging markets, where financial sectors are underdeveloped, policy measures need to foster financial development. Domestic savings could

then be more easily channelled into domestic investment, promoting domestic income growth and consumption, and rebalancing economic growth away from exports and reducing the incentive to maintain a low currency value. It would also lower the need for reserves and official outflows to advanced countries, and the excessive demand for US dollar-denominated financial assets. In Europe, especially the euro area, we need deeper financial and economic integration to reduce the uncertainties and inefficiencies in the current institutional framework, so that the region becomes a core area of stability.

Financial markets need reform so that their structure, conduct and performance support stability. This calls for acute risk awareness, responsible risk analysis and appropriate risk pricing. It requires that participants be able to, and do, bear the consequences of their decisions without jeopardising system stability. And achieving these things necessitates an interplay between markets and regulators in such a way that balances dynamism with stability.

Efforts are under way in all these areas, and yet there remains much work to be done. We cannot afford to wait for the cathartic effects of the (next) crisis to improve the functioning of the international financial system.

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UNFINISHED BUSINESS: POST-CRISIS POLICY COOPERATION

John Lipsky

Before anything else, I would like to thank the Banca d'Italia, and in particular the Governor and Deputy Governor – Ignazio and Fabrizio – for organizing this wonderful and much appreciated event. Moreover, I am very pleased and honored to be on a panel with two good friends and one of my heroes.

We heard earlier today that Tommaso tended to be demanding of his staff. This reminded me of a story about Henry Kissinger that I'm told is not apocryphal. Once, when handed a memo by one of his assistants, he returned it the next day, telling the fellow, "Surely you can do better". The staff member went away, worked on it overnight, and submitted it again the following day. Once again, Henry waited a day, and then returned it, saying, "Still not good enough". Having repeated the cycle, the staff member resubmitted it the following day, saying, "Really, there is nothing more I can do to improve this". Henry's reported response was, "All right, now I can read it".

I am sure that all of us have also very much appreciated hearing about Tommaso's wonderful qualities. Happily, I've had the good fortune of being able to bear witness to them. One anecdote sticks in my mind. In the years just prior

to the recent Global Financial Crisis, the world economy seemed to be doing very well. Many observers were raising questions about the IMF's usefulness, as there was almost no demand for new IMF lending. About that time, I happened to be sitting next to Tommaso at a dinner at the Council on Foreign Relations in New York and I was making the case that lending money wasn't the Fund's most important contribution to global governance. Tommaso, after listening to me patiently – and perhaps a bit indulgently – answered: "John, if you're not needed, you won't be heeded". Soon the Global Crisis was under way, the demand for Fund lending reached record levels, and discussion ceased about whether there was a role for the Fund!

We've heard a lot about Tommaso's remarkable qualities and accomplishments, but one aspect of his career hasn't been mentioned so far today – his service as the Chair of the Ministerial-level International Monetary and Financial Committee of the IMF's Board of Governors (usually referred to as the IMFC). I can understand why his service in this position hasn't been mentioned yet today – after all, Tommaso's tenure as IMFC Chair was very brief, lasting only from October 2007 until May 2008, when he served as Finance Minister. Even though the IMFC Chair isn't a position that looms large in public awareness, nonetheless it is a crucial one with regard to forging agreements on substantive changes in the international monetary system, and in the IMF itself.

Despite its brevity, Tommaso's service at the IMFC was remarkably productive. His concrete accomplishments included an agreement on quota reform that had eluded the Fund for thirty years. An agreement was also reached on a new income model for the Fund – better aligning the Fund's financial underpinnings with the interests of its members – an important outcome that had been sought without success for many years. Changes were agreed in the Fund's investment policy. The charges levied on the use of Fund resources by its members were reviewed and refined. The manner of calculating the Fund's need for precautionary balances was modified. A new Triennial Surveillance Review was initiated. This may sound like a purely bureaucratic shift, but in fact it created a new vehicle through which the Fund's members are required to agree on specific instructions to the Fund's staff and management regarding the intended future focus of Fund surveillance of members' economic policies. From the Fund's point of view, this was a highly meaningful innovation.

In fact, the first Triennial Surveillance Review – or TSR, as it is known at the Fund – took place under Tommaso's Chairmanship. The instructions to the Fund staff in this first TSR were notable and prescient: pay more attention to risk assessment; instead of just focusing on the most likely outcome, Fund analysis should focus on alternative fundamental outcomes and their potential policy implications. The staff were also directed to pay more attention to what I would call macro-financial factors – that

is, the interactions between financial markets and the real economy. Fund staff were instructed to make sure that their analysis was more multilateral and less bilateral. And they were told that future policy assessments should pay more attention to exchange rates.

We also were directed by the IMFC to work on a new financial facility that would serve as a crisis prevention instrument, to complement the Fund's traditional crisis resolution facilities. That resulted in a major breakthrough – the quietly revolutionary Short-Term Liquidity Facility, or SLF – a facility requiring no ex-post conditionality. The SLF was soon superseded by a much more powerful precautionary facility, the Flexible Credit Line, or FCL. The FCL soon proved its worth when the Global Financial Crisis was at its most virulent.

Thus, from the point of view of IMF reform and of making the Fund's policy analysis more relevant and effective, what was accomplished under Tommaso's short chairmanship of the IMFC was remarkable, even if it didn't receive all that much public attention. And these advances wouldn't have happened absent Tommaso's exceptional ability to grasp subtleties, to engineer compromises and to forge agreements. So I hope that his exemplary service to the Fund and to its membership will be honored and celebrated, among his many other accomplishments.

For the balance of my remarks I would like to address the broad issue of international economic policy cooperation. As Lorenzo has pointed out, international monetary, financial

and economic developments have not proven to be either self-regulating or self-adjusting in the way that many had hoped. In other words, the system under stress has seemed much less system-like than many had anticipated.

So let's think briefly about four specific failures that led to the current crisis. The first was the persistence in the period preceding the crisis of inconsistent macroeconomic policies, despite clear danger signs. Of course, it is true that from 2003 to 2006, global growth averaged the fastest pace in thirty years. Moreover, the dispersion of growth rates was the lowest in the post-war period. Thus, performance in terms of GDP growth was not only excellent, but appeared to be unusually well-distributed. Nonetheless, there was at the same time a wide divergence among growth rates in domestic demand. That explains why the evenness of overall GDP growth was accompanied by unprecedented current account imbalances. It wasn't that the imbalances themselves were the cause of the problem; it was that the imbalances were a clear signal that underlying policies were inconsistent, and that ultimately they were unsustainable. Yet, little was done in response.

The source of the inaction wasn't that the problem wasn't recognized. The need to correct the underlying policy inconsistencies that gave rise to the imbalances was exactly the premise of the IMF's path-breaking Multilateral Consultations on Global Imbalances that took place in 2006-2007. The history of this effort is one that deserves to be told accurately – sadly, the monographs that have

been produced up to now about the Consultations have been far off the mark – since it is not widely known or even well understood. But the basic problem with the Consultations was that, at the end of the day, the most important participants weren't really interested in utilizing a multilateral format to solve the underlying policy problems. Yet, bilateral approaches were complete failures.

The second set of failures were those of the financial sector. These have been discussed extensively already today, and were fourfold: (a) regulatory; (b) supervisory; (c) the lack of effective resolution mechanisms; and, (d) inadequate assessments of the implementation of financial reforms and of regulatory changes. The third failure was the inadequate recognition and understanding of what can be called macrofinancial linkages – or how financial markets interact with the real economy. This isn't so surprising, as such linkages typically have been completely absent from standard economic modeling. The fourth failure was the lack of effective macro-prudential policies to help limit the inherent tendency of financial markets toward procyclicality.

It is only reasonable to ask whether anything substantial has been done since the crisis to address these failures in policy formulation and coordination? Here is where I would have a different interpretation than Lorenzo, as I think important changes are being implemented. At the same time, I think that this effort is under-recognized and needs to be better understood, because, to put it bluntly, without

any expectation of success there will be no cost associated with failure.

And what has been done is bound up in the crisis-inspired creation of the Group of 20 at the leaders' level. This decision flowed from the recognition that if effective changes were to be made in such important issues of policy cooperation, they needed to be addressed at the level of Heads of State and/or Heads of Government. And the crisis demonstrated definitively that the pre-existing G7 Summit format was too narrow. It can be debated in the future whether the G20 is the best configuration for this purpose, but fast action clearly was needed at the time of its formation.

Let's examine what the G20 has undertaken so far. The November 2008 Washington Summit established the four key G20 agenda items: restore global growth; repair and reform the financial system; prevent new protectionist measures and promote new trade liberalization; reform the International Financial Institutions (IFIs). The April 2009 London Summit established the Financial Stability Board and provided substantial new funding for the IFIs. The September 2009 Pittsburgh Summit established the Framework for Strong, Sustainable and Balanced Growth, to be carried out through a Mutual Assessment Process.

At the June 2010 Toronto Summit, the G20 Leaders endorsed the analysis on macroeconomic policy cooperation, which concluded that if a coherent, alternative set of policies was implemented by the G20, the economic outcomes would be Pareto-superior (everyone better off and no-one

worse off) to the predicted outcomes of the existing policies and the planned changes submitted by the G20 members acting independently.

In other words, the G20 Leaders accepted the claim that policy cooperation was not about some G20 members accepting an inferior outcome if it enhanced the common good. The issue rather was that policy cooperation would produce results that were better for all. Thus, the idea was accepted by the Leaders that an upside scenario was attainable in which all participants benefitted. Of course, if this analysis is accepted, then the incentive to pursue the upside scenario is completely straightforward. In this case, the key questions are: can the policies leading to the upside scenario be defined operationally? And, can the other members be trusted to do what they are supposed to?

The November 2010 Seoul Summit included the presentation of a 49-page Action Plan of specific economic measures that each of the G20 pledged to undertake in support of a better global outcome, as well as an agreement on new IMF voting shares. At the November 2011 Cannes Summit, the economic policy Action Plan was given additional specificity. If you read the Cannes Action Plan documents (something I suspect few did), you will find a relatively coherent, detailed and well-described set of economic policies that each of the G20 members pledged to implement.

At the IMF, the IMFC – under the leadership of its new Chairman, Deputy Prime Minister and Finance

Minister Tharman Shanmugaratnam of Singapore – is hoping to rival the productivity that was established under Tommaso's leadership. Under the current Chair, the Fund has developed a new Comprehensive Multilateral Stability Report, incorporating what are called Spillover Reports on the five systemic economies: the United States, the United Kingdom, the Euro area, Japan and China. The Fund's staff have discussed each of these economies' policies with the other systemic members. Here is what they concluded about each of the five: the United States needs to fix its medium-term fiscal policy; the United Kingdom needs to adjust its financial system regulations to enhance stability and safety; the Euro area needs to deal urgently with its near-term banking crisis; Japan has a long-term fiscal problem; and China needs to rebalance its economy or, to put it in a different way, China's partners want them to seriously pursue the reforms encompassed in the Twelfth Five-Year Plan.

The IMF's staff – in cooperation with the Financial Stability Board – also established an Early Warning Exercise, in essence a semi-annual ministerial-level discussion of risk scenarios. And, in the support of the G20 process, the IMF has produced a series of Sustainability Reports on China, France, Germany, India, Japan, the United Kingdom, and the United States. In addition, the Fund has produced preparatory work leading up to the adoption by the G20 of its *Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences*.

That doesn't sound like nothing is happening, but what matters is this: the most important analytical result – namely, that a coherent set of policies would produce a superior result, and that this set is both feasible and achievable – has been accepted at the level of Heads of State. There is no underlying analytical conflict about what needs to be done. Obviously, the recommended and pledged policy changes differ among advanced and emerging economies, and among surplus and deficit economies. Moreover, there is an issue of implementation, which requires political will, as well as trust in the other G20 partners. But there simply is no underlying conflict regarding what needs to be done.

Two aspects lead me to be optimistic about the eventual prospect for effective policy cooperation: if the near-term challenges – which, as you all know, are particularly acute in Europe – can be overcome (and I can't, for the life of me, imagine that Europe doesn't have the will and the resources to overcome this crisis), then the G20's Action Plan represents an achievable and sensible medium-term policy path, including a cooperative process for review and adjustment. But for this effort to succeed, it will require the active participation and support of the most important G20 members.

Is there any guarantee of the G20's success? Of course not. At the same time, it isn't correct to say that nothing is happening in this regard, even if much of the progress to date has escaped the public's attention and knowledge. In fact, that's my principal complaint about the current situation.

As I said already: if there is little public knowledge about what is being done, and there is no expectation of success, then there's no cost of failure. And, it is only realistic to expect that in each G20 economy there are vested interests that will oppose policy reforms even if they serve the general interests of each constituency, as well as benefitting the G20 economies as a whole.

In conclusion, there is a coherent analysis of the fundamental causes of the crisis, and there's a medium-term plan to remedy them. The time has come to take the near-term actions – even if they are difficult – that are needed to put the crisis behind us, so we can get on with the longer-term task of making the international economy perform better for everyone, and for a long time to come.

THREE EVOLUTIONARY PROPOSALS FOR REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Edwin M. Truman

It is an honor and special personal pleasure to participate in this conference in memory of Tommaso Padoa-Schioppa. On multiple occasions over three and a half decades and with increasing effect, my life was touched by Tommaso Padoa-Schioppa. We first met when he was a visitor in the Division of International Finance at the Federal Reserve Board in the mid-1970s. A few years later, I was first treated to his insightful comments during meetings of Working Party Three at the OECD, which continued for years.

As the Italian G7 deputy in the 1990s, he was an active and imaginative collaborator in shaping short-term and long-term responses to the crises of that period. As chairman of the Basel Committee on Banking Supervision and Regulation, he coaxed and cajoled that group to agree to compile the Core Principles for Effective Banking Supervision, which was something that we at the Federal Reserve favored.

As "Mr. Euro," while on the executive board of the European Central Bank in September 2000, he worked closely with us at the US Treasury on the first coordinated intervention in euro.[1] As a member of the advisory board of the Peterson Institute for International Economics, he graciously spoke

at a conference on International Monetary Fund reform that I organized in September 2005. Finally, Michel Camdessus, Alexandre Lamfalussy, and Tommaso invited me to participate in his final project: the Palais-Royal Initiative, on *Reform of the International Monetary System* (2011). Pietro Catte is right: The report "both in its analysis and its proposals bear the unmistakable mark of his intellectual contribution" (Catte, 2011). We were all very conscious that he was watching over us as we completed that report.

I did not share Tommaso's view that flaws in the international monetary system were a principal source of the global economic and financial crises of the past four years, or that the international role of the US dollar and a lack of discipline on US macro-economic policies were major manifestations of those flaws.[2] However, Tommaso would say, "Let's start from where we are in agreement,"[3] and Tommaso and I agreed on three important points: the international monetary system can be improved; doing so requires a comprehensive vision; and macro-economic discipline is central to its improvement.[4]

In the balance of my remarks, I address three interrelated steps through which the international monetary system can and should be improved: surveillance, adjustment and reserve accumulation, and an institutionalized global swap network. These steps would not take us all the way to a comprehensive vision, but they are a doable evolution of the system. I am quite confident that Tommaso would favor the first two steps. I am less confident about the third, but two out of three is not bad.

Surveillance

Although Tommaso and I did not share the same starting points in discussions within the Palais-Royal Initiative group, he implicitly challenged me to think about a constructive approach to our common concerns about surveillance and policy cooperation. Consequently, at a conference in Paris on December 11, 2010 I suggested a framework for reforming IMF surveillance. Speaking after me, a week before his untimely death, Tommaso indicated that there might be something useful in what I had outlined. His comment encouraged me to write up my thoughts before the end of the year (Truman, 2010b).

For Tommaso, talk was important, but strong institutions are essential. Bini Smaghi implicitly quoted Tommaso quoting Jean Monnet, "Nothing is possible without humans, but nothing is lasting without institutions" (Bini Smaghi, 2011). The IMF is the central institution of international monetary cooperation. For Tommaso the key word for the IMF was "stability" (Padoa-Schioppa, 2006, p. 513). Global stability has been distinctly absent in recent years in part because it requires a sharing of sovereignty. As Tommaso noted, the ironic tragedy is that in recent years "one trend is a significant erosion of the reality of sovereignty" combined with the "hardening of the ideology of sovereignty, a growing nationalism, and a decline in the acceptance that sovereignty has to be shared" (Padoa-Schioppa, 2006, p. 515).

The principal missing element in the framework of IMF surveillance over the international monetary system today is a shared commitment to global economic growth and financial stability. My preferred starting point to approach this problem would be to amend the IMF Articles of Agreement to incorporate a formal obligation on each member to direct its policies toward this objective. The Articles today contain no such obligation; the only obligations are for a member to direct its policies at its own internal and external stability. However, for the moment, my preferred approach is not in the cards.

All is not lost! In Cannes, the G20 expressed their recognition of the need for the better integration of bilateral and multilateral IMF surveillance via a new decision on surveillance – as called for in the recent IMF triennial surveillance review.[5] However, mere recognition that the present IMF surveillance framework is inadequate is not enough. The G20 leaders must throw the full weight of their countries in support of a robust and comprehensive decision to create the strongest possible presumption, if not an obligation, that the policies of countries should be directed at global economic and financial stability as well as their own domestic and external stability. They also should empower the IMF management and staff to call any country to account if they judge that country has not lived up to the established presumption.

On implementation, the IMF in its multilateral surveillance and the G20 under the Mutual Assessment Process (MAP) should move toward the use of a broader set of norms for

use in the assessment of all aspects of members' policies and performance, as I advocated in my comprehensive proposal for strengthening IMF surveillance (Truman, 2010b). In my view surveillance norms should trigger closer examination of whether countries are living up to their obligations. Those norms should cover the full range of each country's policies and performance including current accounts, inflation rates, fiscal positions, reserves, and exchange rates. The G20's MAP now fails to meet this test of transparent completeness. To outsiders, the MAP is a non-transparent black box. It generated very thin gruel in the Cannes Action Plan for Growth and Jobs. The number of new quantified commitments is zero.

In summary, the balance in IMF surveillance must be shifted away from discretion and toward rules. In Paris on December 11, 2010, Tommaso said the system cannot be based on rules alone. What is needed is a better balance between rules and discretion. He added that, in the exercise of discretion, international institutions are important because they help to intermediate political forces.

Adjustment and reserve accumulation

As noted earlier, I did not share Tommaso's diagnosis that the role of the dollar is the central problem in the international monetary system today. On the other hand, I was intrigued, as many others have been, by his airplane and flight analogy: "We can conclusively prove that we need a flying object; inventing an airplane is another matter" (Padoa-Schioppa,

2010). In this spirit, the single largest distortion in the global economic and financial system today is global imbalances that are associated with the outsized increases in international reserves of a growing number of countries.

To address this problem, on an experimental basis, I favor annual Special Drawing Rights (SDR) allocations of, say, $200 billion per year for the next five years – a total of $1 trillion. The experiment should track whether such an approach significantly reduces the demand by countries to build their non-SDR international reserves and is associated with substantially reduced current account surpluses. This would be a low-cost and low-maintenance experiment. In the present global economic and financial environment, I see little danger. The SDR mechanism provides countries with low-cost potential access to international credit. Access to such international credit is restricted. Should such access be used on a large scale, the chances of feeding an acceleration of inflation in the advanced countries are minimal and the net effects on the global economy would almost certainly be positive.

As an integral part of this proposal, and building on what I have proposed about increasing the role of norms on policies and performance in IMF surveillance, presumptive norms should be established for the level and rate of growth of countries' reserves. As a starting point, no country's international reserves should exceed, say, 25% of its three-year average level of GDP. In addition, once a country's reserves have reached that level, the presumption should be that no

country's international reserves should increase annually by more than, say, 10% of its three-year average GDP. Countries exporting substantial amounts of non-renewable resources could be exempted from these presumptions, but only on the basis of a decision by the IMF Executive Board and increased disclosure about their investments.

After five years, if the results of my proposed experiment are positive in terms of reduced global imbalances and lower rates of accumulation of non-SDR reserves, the program should be continued, and the Articles should be amended to redistribute SDR allocations away from members whose rates of reserve accumulation violate the agreed norms toward other members, thereby introducing some incentives into the system.

An Institutionalized global swap network

The international monetary system needs better tools to deal with threats to the globalized financial system. If the option of returning to comprehensive capital controls and other forms of financial repression is rejected, as I think it should be, the need for new tools becomes more pressing. The dominant lesson from the financial crises of the past four years is that the world is more financially integrated than anyone imagined two decades ago. The recent IMF spillover reports clearly demonstrated the importance of financial linkages relative to real linkages, and they underscored the relevance of access to global liquidity.

The phenomenon of global liquidity is poorly understood as we noted in the Palais-Royal Initiative. An excellent report by a group of central bankers chaired by Jean-Pierre Landau was recently released by the Committee on the Global Financial System (2011).[6] The Landau Report substantially clarifies the concepts, measurement, and policy implications of global liquidity. The Report distinguishes between private liquidity, which is primarily a concept associated with market conditions, and official liquidity, which is primarily associated with quantities and the ability of institutions to finance their operations and, in turn, support market liquidity.

The Landau Group addressed policy implications by sketching out three lines of defense: regulatory frameworks, domestic policies, and cooperative multilateral measures. Unfortunately, the recommendations are progressively vaguer with each line of defense. On cooperative, multilateral measures, the report recommends the *status quo*. I disagree. What we need is an institutionalized global swap network.[7]

Some of my former central banker colleagues prefer constructive ambiguity. They argue that permanent arrangements contribute to moral hazard behavior on the part of governments and private sector banks. My view is that the crises over the past four years have demonstrated conclusively the high costs of such ambiguity. Central banks responded eventually but only after a great deal of economic and financial damage had been done. I agree with Obstfeld (2011) that predictability adds to stability and with his

citation of the views of Richard Cooper (1969), writing in a different era, on the interplay between international monetary cooperation and the demand for international liquidity in the form of owned reserves.[8]

A second argument heard from central bankers is that they need to protect their independence and do not want to be drawn into external entanglements. The appropriate response is that in crisis situations, the central banks will have no choice and should prepare in advance as part of their own crisis prevention activities. Central bankers also argue that they do not want to be commanded by the IMF to engage in lending to other central banks because it is an institution largely dominated by finance ministries and, therefore, inherently more political. Here we have unhealthy institutional rivalry.

Bini Smaghi (2011, p. 9) quotes Tommaso on this theme “independence [of central banks] should not mean institutional loneliness.” Later in his essay (Bini Smaghi 2011, p. 12) he describes Tommaso’s view of central banks “as complex and multifaceted institutions pursuing the public good along several interconnected paths.” These comments give me some confidence that Tommaso would not reject out of hand my advocacy of an institutionalized global swap network.

Aside from the demonstrated objective need, I see the situation as follows. First, when a multilateral organization, such as the IMF, declares that the global economic and

financial situation demands global cooperative solutions, a national central bank gains credibility and protection in responding positively to that declaration. Second, it is possible to establish a global swap network that has the capacity to meet the demonstrated need and at the same time meet the concerns of central bankers. The global swap network could have three keys to unlock it.

The first key would be held by the IMF. Based on objective criteria, the IMF would declare a need for global liquidity to support the international financial system and recommend that central banks consider providing liquidity to private financial institutions in other countries via their central banks.

The potential recipient central banks should be limited to those of countries in the top tier of the comprehensive pre-qualification framework that I have proposed should be applied, as part of the Article IV review process, to all IMF members that potentially may need to borrow from the IMF, in other words to countries that potentially qualify for a Flexible Credit Line (FCL). In time, this framework might be extended to countries that potentially qualify for a Precautionary and Liquidity Line (PLL).[9] See Truman (2010a) for more details.[10]

The criteria employed by the IMF should be objective and linked to generalized global conditions, not country-specific circumstances, associated with heightened stress events. The thoughtful discussions in recent IMF documents (2011a,

2011b, 2011d) provide a good start for the development of such criteria.

The second key would be held by the group of central banks that had previously established the global swap network. Participation in the global swap network would be pre-determined by the central banks based, for example, on the independence of the central banks and assessments of the stability of their financial systems. The central banks would meet and, using their own criteria, would agree or not with the IMF that there was a global need for liquidity that could and should be met by activating the network. The criteria used by the central bankers should be transparent, but they might differ from those used by the IMF. For example, they might give greater emphasis to financial conditions and the risk of global inflation.

The third key would be held by each individual central bank (or pair of central banks) deciding to respond to the decisions of the IMF and the central banks as a group with a specific swap operation or sequence of operations. Importantly, no central bank would be required to activate the third key, and central banks would retain the capacity to enter into swap agreements outside of the three-key framework.

Would national central banks come under pressure to use their third key? Certainly, but those pressures are there already. A structured approach, such as the one I have outlined, would establish the global context for activation

of the global swap network and identify those countries that are most deserving of assistance.

In conclusion, I return to the words of Tommaso Padoa-Schioppa (2006, p. 516). Describing the decline in leadership, which has become more acute in the subsequent six years, he said, “When there is a decline in leadership, it is precisely because there is a decline in the readiness to give by those who lead.” He also issued a warning: “To the sirens singing the song of complacency, I would answer that we are in a situation in which the incubation of instability is extremely slow, but the instability that may eventually erupt is extremely large” (p. 518).

We need leadership on reform of the international monetary system, and therefore we miss Tommaso Padoa-Schioppa. The potential adverse consequences of continued glacial action are serious. In the spirit of Tommaso’s enlightened pragmatism, I have outlined three proposals for the evolution of the international monetary system.

NOTES

[1] At the Peterson Institute for International Economics, Tommaso was known by the more all-encompassing title of Foreign Minister of the European Central Bank.

[2] On the last point, I argued with him that the US dollar's position today is far from unique. We already are living in a multicurrency world. At least four other advanced countries have sizable multi-year current account deficits on which the markets have exerted no adjustment pressures: Australia, Canada, New Zealand, and the United Kingdom.

[3] Bini Smaghi (2011) recalled a similar statement: "If people are willing to discuss issues in a rational way and in good faith, I am confident a solution can be found."

[4] On macro-economic discipline, Tommaso writing about the flaws in the international monetary order, stated, "The fundamental flaw in that 'order' […] lay in its failure to meet the global economy's vital need to be grounded in a degree of macro-economic discipline." (Padoa-Schioppa, 2010). I agree.

[5] The triennial surveillance review (IMF, 2011c) recommended "an integrated and balanced approach to global economic and financial stability" via an amendment to the IMF Articles or an "integrated surveillance decision governing both bilateral and multilateral surveillance activities." The IMF Executive Board subsequently, in July 2012, adopted an integrated surveillance decision which became effective in January 2013.

[6] The Landau Group's report responded to suggestion 9 in the Palais-Royal Initiative: "The IMF and the BIS should work together towards a shared analytical approach for better measurement and surveillance of global liquidity" (Palais-Royal Initiative, 2011, p. 11). The central bankers apparently chose not to acknowledge formally that the report of the Palais-Royal Initiative had predated the establishment of the Landau Group.

[7] More elaborate schemes have been put forward. In Truman (2008 and 2010a), I proposed a system of SDR swaps between the IMF and the central banks that issue international currencies with the IMF loaning the currencies to other central banks to support their financial institutions. See Farhi, Gourinchas and Rey (2011), Obstfeld (2011), and Prasad (2011) for

even more elaborate variations on this theme. In the present circumstances, simplicity is a virtue.

[8] The Obstfeld quotation from Cooper (1969, p. 600) is: "The degree of […] international cooperation […] influences the amount of liquidity needed to finance imbalances in the face of temporarily divergent and conflicting national policies. The more cooperation, the more carefully coordinated national policies are in timing and nature, the lower the need for international liquidity to finance imbalances."

[9] Note that it is an open question whether either the United States or any of the countries in the euro area would qualify for an FCL today. This does not prevent their central banks from engaging in swap arrangements.

[10] My proposal for comprehensive pre-qualification implicitly values the virtue of addressing the stigma issue associated with borrowing from the IMF more highly than preserving the IMF's role as a confidential trusted advisor. In today's world, keeping good advice confidential is of questionable benefit. I am not concerned with turning the IMF into a rating agency as some argue.

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THE "SEVEN PILLARS OF TOMMASO'S WISDOM" IN REFORMING THE GOVERNANCE OF THE INTERNATIONAL MONETARY SYSTEM

Michel Camdessus

Thank you for this opportunity to pay tribute to Tommaso Padoa-Schioppa in the way he would have wanted, namely by devoting our thoughts to issues he would have seen as unfinished business for him and for us all. The date the Banca d'Italia has chosen for this celebration is as touching for myself as it is, I presume, for Ted, almost to the day the anniversary of our last meeting in New York just a week before he passed away.

I can tell you that we had a long working weekend in preparation for what finally turned out to be called – as suggested by Paul Volcker – the Palais-Royal Initiative. During those two days Tommaso was at his best, providing superb leadership of our work, constantly attentive, keen to stimulate debate and to underline convergences. Sadly enough, for him this was the end of an initiative in which he took part with youthful enthusiasm, certain as he was that when you bring together 18 individuals with strong experience in the international monetary field, you must almost necessarily produce a set of reflexions that could prove to be very helpful for those who are now in the field.

As we have already received excellent papers, particularly the note by Pietro Catte summarizing the views of Tommaso Padoa-Schioppa on the reform of the international monetary system, I will confine my remarks to the points I identified as central for him during the Spring and Summer of 2010, when we were working together in preparation for that initiative. It was, in fact, a somewhat complicated endeavour at times, as he was in Corsica or travelling around the world while I was more quietly in the French Basque countryside with my grandchildren.

Throughout this period, what most impressed me was his openness to the views of colleagues and keenness to identify grounds for constructive agreements. Let me hasten to add how strong his views were, particularly when derived from his multifaceted experience of international institutional governance. Trying to recap, I see that I end up, like Klaus Regling, with a list of seven points. Let me call them the "Seven Pillars" of Tommaso's wisdom on the governance of the new International Monetary Fund.

Pillar 1 – A strong machinery to enforce global discipline

At the heart of the system we need a strong machinery, with enough recognized authority to influence every member including the major ones and to effectively enforce the strategic orientations of the membership. The need for it and the required deep changes in the governance of the Fund have only been made more pressing by the crisis and

the new responsibilities which could result for the IMF from the ongoing process of reform.

Pillar 2 – A mutually reinforcing relationship between effectiveness and legitimacy

This was a point on which he was in a position to contribute personally during the too short time in which he chaired – as Carlo Ciampi did before him – the International Monetary and Financial Committee (IMFC). He was instrumental in finalizing the agreement of April 2008 for a rebalancing of IMF quotas, important in itself, and in preparing the ground for later ongoing adjustments. This led him to support three other suggestions for change:

- To solve the problem of legitimacy of the G20 itself and to ensure a universal representation at its highest level. This would enhance its legitimacy. A system of regional constituencies, which has served the IMF and the World Bank well, could be adopted for this purpose.
- To distribute clearly the responsibilities between actors by deciding to establish the Council, as envisaged by the Fund's Articles of Agreement, thus inviting ministers and governors to take personal responsibility for the most strategic decisions. This, in my view, would lead to greater participation of the central banks in the decision making process of the IMF at its highest level, something I had always desired during my time in that institution.

- To change the voting rules. The Palais-Royal group favours lowering the voting threshold on most important decisions from 85% to 70-75%, as well as the extension of the double majority to a number of others, thus ensuring that decisions on key aspects of the institution command the support of the majority of members. Lastly, to bring to an end the "European privilege" of choosing the candidate for the position of Managing Director of the IMF.

Pillar 3 – The risks of "non-aggression" pacts

Strong reservations about a phenomenon he analyzed with sharp lucidity: the risk of seeing the peer review process degenerate into pacts of non-aggression. Let me explain, as there is a paradox here. For years I was a player in a variety of peer review processes. As a matter of fact, I owe my admiration for Tommaso and our friendship to one of them. This was at the end of the 1970s or beginning of the 1980s when he was head of the DG2 of the Commission; he was the maestro of the orchestra (or first violin) of uncomplacent assessments in the context of member countries' peer reviews which, with friendly pressure and commitment by all, eventually brought France and Italy into sufficiently good shape to be able to be part of the formidable innovation the euro has been. But when these reviews were undertaken in the framework of the G7 or G8, they frequently degenerated into "non-aggression pacts" among major players, introducing significant distortions

in multilateral surveillance – something, of course, which should no longer be accepted.

Pillar 4 – "M" as the most important letter of the IMF acronym

A crucial point for both of us, reflecting our wish to see the central banks have a stronger role and leadership in the IMF, particularly at a time when the need for stronger monitoring and control of global liquidity appears imperative, especially given the origin of the present crisis. In his view, the establishment of the Council could be a good occasion to rebalance the influences in the Fund between Treasuries and central banks.

Pillar 5 – A single European Chair at the IMF

Subsidiarity, "regionalization", and decentralization as principles for reforming the system (organizing in that way the representation and relations with the ECB, Chiang-Mai and possibly more organizations to be created). In his mind this approach (which was also that of a European federalist), should lead to the Eurozone being represented in the IMF institution – as the US is – by a single Chair (possibly held jointly by the ECB and the Presidency). A long-term vision, perhaps, but one to bear in mind as of now.

Pillar 6 – The need to ensure the prevalence of the "common good" in the system

A very noble and permanent concern, which frequently led him to pinpoint the deplorable consequences of an old-

fashioned concept of national sovereignty prevailing on the concern for the broader perspective on which monetary policies should now concentrate.

Pillar 7 – Establishing a global and independent advisory committee

His recognition of the permanent need, in all institutions, for fresh air and interaction with the broader community, not just with economists but also with intellectuals from throughout the world. This, of course, reflected his own appetite as a man of vast culture for novel and eye-opening contributions, particularly in our rapidly changing world. From there, the idea of establishing a global advisory committee to give a stronger and fully independent voice to the global interest in the system and the pursuit of the global common good, since an overly narrow focus on country-specific issues can hinder the identification of global trends and developments. The existence of such a committee could also help prepare for the orderly transition toward a fully fledged multicurrency system.

One last word: without claiming to be an authorized interpreter of Tommaso's visionary thoughts, I can nevertheless repeat here something I heard him talk about time and again. This was his fervent wish to not see the Palais-Royal Initiative, to which he devoted his last energies, end up on the shelves of our libraries but to see it continue to be discussed and to provide food for thought to all those who in the G20 and elsewhere are working to provide the

world with a reliable, resilient and effective international monetary system.

Let's join forces at least for that; it will be a good way of honouring his memory and of serving the common good. To quote the closing words of Lorenzo's paper: "We cannot afford to wait for the cathartic effect of the next crisis to improve the functioning of the international financial system".

Background note

T. PADOA SCHIOPPA'S PERSPECTIVE ON THE REFORM OF THE INTERNATIONAL MONETARY SYSTEM

Pietro Catte

Tommaso Padoa-Schioppa initially developed his views on economic and monetary relations among countries mainly in the context of his thinking on European integration, but he always drew important insights from the analogies and differences between the policy issues arising in the European and in the global context. He also felt that Europe, having an important stake in global stability, could and should contribute actively to more effective global governance. Particularly in the last years, with the global financial crisis, he was increasingly emphatic in advocating a profound reform of international monetary arrangements.

This note outlines the key themes running through his main writings on international monetary issues, presented in rough chronological order. As will emerge from this brief survey, there is considerable continuity of themes and ideas. One clear *leitmotiv* is the idea that growing economic and financial interdependence needs to be collectively managed, which usually requires a combination of rules and discretion that would be difficult to handle effectively without

supranational institutions. The essays reviewed here are mostly concerned with defining the requirements for such rules and institutions. While there is substantial consistency in his analysis of these requirements, his judgements on how they are met by the existing international bodies (the IMF, the BIS, the G7, the G20) vary somewhat over time.

1. *The "inconsistent quartet" at the global level*

A good starting point is the well-known analysis by Padoa-Schioppa of what he called the "inconsistent quartet", i.e. the impossibility of maintaining simultaneously (a) free trade; (b) full capital mobility; (c) fixed (or managed) exchange rates; and (d) national autonomy in the conduct of monetary policy (Padoa-Schioppa, 1988a). This insight was clearly drawn from the analysis of the demise of the Bretton Woods system, and can also be seen as a corollary of the Mundell-Fleming model. In the mid-1980s Padoa-Schioppa drew the conclusion that the eventual full liberalisation of capital movements in the European Community as part of the single market project would have dramatic implications for the viability of the European Monetary System's adjustable peg regime, and ultimately required a move to monetary union.

Interestingly, while most authors refer to this as the "impossible triad" or "trilemma", Padoa-Schioppa preferred to call it a "quartet", with "free trade" as the fourth element. At first sight this may appear to be a puzzling choice, since from the strictly analytical standpoint the inconsistency

between the other three elements holds regardless of the presence or absence of free trade. But in a deeper economic sense, taking trade into consideration was essential, since the costs and benefits of different positions along that three-way trade-off depend crucially on the degree of trade integration. In fact, Padoa-Schioppa's argument for moving on to monetary union rested on the idea that, in a region as tightly integrated as the European Community, neither restrictions on capital mobility nor floating exchange rates would ultimately be compatible with a fully developed single market. Hence the need to forgo autonomous monetary policies.

Padoa-Schioppa used this same conceptual framework in a 1988 essay on the international monetary system (Padoa-Schioppa, 1988b). "International monetary history in the postwar period can be interpreted in terms of the periodic manifestations of the 'inconsistent quartet' and the ensuing reactions and adaptations. [...] By the early 1970s the system had come full circle. The two functions Bretton Woods had reserved to the authorities, the control of exchange rates and management of international capital flows, had been handed over to the markets. The simple approach of the 1940s to the inconsistent quartet was replaced by a more complex one in which each of the four elements was restrained in some way to make room for the others" (Padoa-Schioppa, 1988b, pp. 17-18).

The hopes that floating exchange rates would ensure smooth external adjustment, reconcile conflicting national

policies and free them from the external constraint were disappointed, however, as in practice exchange rates deviated widely and persistently from fundamentals. The costs of exchange rate misalignments in terms of resource misallocation and strained trade relations having become increasingly apparent, Padoa-Schioppa, writing soon after the Louvre and Plaza accords of 1985-87, noted a gradual return toward a joint official management of exchange rates.

He suggested that the pragmatic, *ad hoc* approach taken by the G7 could evolve into a more structured and formalised system of adjustable "target zones" for the three key reserve currencies of the day, the dollar, the mark and the yen. That would imply accepting some degree of policy coordination, and the attendant discipline on economic policies, in exchange for greater exchange rate stability, given that, in his view, it was neither desirable nor feasible to curb capital mobility in order to reconcile the other components of the quartet.

As an "intermediate solution" between fixed and flexible rates, unlike the two extremes the system of managed "target zones" would not translate into a simple and unambiguous rule, but would require "a combination of rules and discretion, which is, however, difficult to attain". But who would have to exercise such discretion? Padoa-Schioppa's answer was that, since there was no prospect of a single leader country emerging, "it should be exercised by the international community in a cooperative way." And since "in our industrial democracies it would be unrealistic to

expect cooperation to prevail spontaneously when needed… the only option to be considered requires an international institution to play a stronger role". (Padoa-Schioppa, 1988b, pp. 24-25). This institution – he argued at the time – would have to be the International Monetary Fund.

As compared to the European Monetary System, such an arrangement would have to involve less binding constraints on the monetary management of national authorities, since the three currency areas were not only much less integrated economically than EMS participants but also lacked a comparable institutional set-up and underlying political commitment to support the enforcement of cooperation.

2. *The market-led international monetary system and its "institutional gap"*

If in the late 1980s Padoa-Schioppa was fairly optimistic about the prospects for the emergence of a new cooperative international monetary order, by 1994 his views on cooperation and the role of the IMF had become considerably less sanguine. In a joint essay together with Fabrizio Saccomanni for a conference marking the 50th anniversary of Bretton Woods that year (Padoa-Schioppa and Saccomanni, 1994) the two authors noted that, with the end of the Bretton Woods system the world had moved from a government-led international monetary system to a market-led system. The former had been characterised by "built-in asymmetry between an integrating world market for goods and commodities and domestically insulated,

government-regulated financial markets". That system's very success "set the stage for the reawakening of financial markets, and the inability to adapt the management of its rules led to the eventual collapse of the fixed exchange rate regime" (Padoa-Schioppa and Saccomanni, 1994, pp. 264-265). The shift to floating rates was accompanied by a decision to allow the markets to recycle the large petrodollar balances and was followed by further exchange liberalisation and market deregulation. "A true global financial market emerged. And like Aladdin's genie, once out of the bottle it will not go back to rest." The globalisation of financial markets was bound to continue.

But the new market-led system also suffered from an asymmetry of its own, "between the globality of the financial market and the fragmentation of policy institutions, which are based on nation-states – an asymmetry that generates an institutional gap" (Padoa-Schioppa and Saccomanni, 1994, p. 265). This gap would tend to grow over time: "as markets become the unifying factor of the world economy, despite the permanence of sovereign nations, the institutional requirements of the market-led international monetary system will tend to resemble more the framework applying within a single nation-state than the loose arrangements applying today among nation-states" (Padoa-Schioppa and Saccomanni, 1994, p. 262).

Padoa-Schioppa and Saccomanni examined the consequences of this gap and the policy responses in three areas within the domain of central banking: monetary

management, international payments, and banking supervision. They noted that while the policy response had been "surprisingly strong and innovative" in the latter two fields – where common rules and strategies to ensure systemic stability had been defined through informal cooperation among central banks and supervisory institutions – it had been weak in the sphere of monetary and exchange rate policies, even though this was the area in which an institutional framework, centred on the IMF, already existed.

After the "coordination honeymoon" of the Plaza and Louvre, policy cooperation among the G7 on monetary matters was restricted to informal exchanges of views, with only sporadic coordinated actions by central banks. Meanwhile the IMF's influence over the policies of the major industrial countries had gradually diminished, and the Fund had focused chiefly on the countries whose policies it could sway though its conditional lending. The Bretton Woods institutions, originally designed to manage relations among nation states operating in an environment of fragmented markets, had proved inadequate to deal with the market-led system.

This institutional gap produced widespread dissatisfaction with the operation of the system. Writing just after the EMS crisis of 1992-93 and the bond market turmoil of early 1994, Padoa-Schioppa and Saccomanni noted that large international capital movements and sharp portfolio shifts had shown their power to disrupt the conduct of national

monetary policies and to distort global monetary conditions. At the same time, floating rates had proved “incapable not only of insulating countries that are economically and financially interdependent, but also of consistently exerting market discipline over economic policies” (Padoa-Schioppa and Saccomanni, 1994, pp. 246-247).

How can the institutional void be filled? The two authors reasoned that the “institution” (or institutional arrangement) entrusted with the task of managing the market-led international monetary system should be in the nature of a central bank rather than a government, having global jurisdiction but also operating in the market and being able to cover the three areas of monetary management, payment systems and banking supervision. They argued that if the IMF could have evolved in that direction, in practice it had not done so. Therefore, somewhat provocatively, they pointed to the BIS as the institution most closely resembling their description, although the fact that unlike the IMF it is not based on an intergovernmental treaty severely limits its enforcement powers. They suggested that the IMF would still have an important role to play in surveillance, if not in rule-making and policy coordination.

3. *The role of the IMF*

Padoa-Schioppa discussed the role of the IMF again in 2005, shortly after leaving his position on the ECB Executive Board (Padoa-Schioppa, 2006) and would present some of those ideas two years later in his first address as chair of the

International Monetary and Financial Committee (IMFC) (Padoa-Schioppa, 2007). Referring to the taxonomy of economic policy objectives proposed by Musgrave – allocation, stabilization and redistribution[1] – he suggested that the IMF should be in charge of ensuring stability, the other two objectives being the domain of the WTO and the World Bank, respectively. Clearly, in this scheme the Fund was to deal with the threats to stability arising from interdependence and having a systemic dimension, since there were other mechanisms and policies to handle more limited forms of instability. Padoa-Schioppa argued that in today's world, unlike the early post-war period, the main threats to stability came from financial interdependence as a result of the freer allocation of capital and financial services.

In addressing the threats to stability, in practice the IMF had concentrated on financial assistance to countries that faced a temporary shortage of financial resources, originally to defend a fixed exchange rate and later on to deal with capital outflows or meet debt obligations. Writing in the years preceding the global financial crisis, however, Padoa-Schioppa observed that with the development of global financial markets, and particularly in periods of abundant liquidity, scarcity of finance seemed to have become a thing of the past. In addition, the IMF suffered from declining legitimacy in the eyes of emerging countries, whose growing economic weight was inadequately reflected in the Fund's governance structure.[2]

However, Padoa-Schioppa also pointed to some deeper reasons for the IMF's identity crisis, which he saw as a symptom of a more general decline in the spirit of cooperation. One of them was that, while the *reality* of sovereignty had been eroded as a result of growing economic and financial interdependence, there had been "a hardening of the ideology of sovereignty, a growing nationalism, and a decline in the acceptance that sovereignty has to be shared" (Padoa-Schioppa, 2006, p. 515).

Another reason was lack of leadership, which, he argued, cannot be identified with an institution but must function along with it. "Leadership is the ability to look far ahead and to take special responsibility for the future, to make the common interest prevail over narrow self-interest" (Padoa-Schioppa, 2007). The decline in leadership, in his view, consisted in a decline in US and European leadership in particular. Concentrating on Europe, he suggested that the continent would contribute more to successful international cooperation if it improved its own internal functioning.

On Europe's representation in the IMF, he said it should be "obvious to any person using common sense" that there should be a single representation. "After all, 'monetary' is the key word in the very name of the IMF, and the euro is the second currency on the planet." The failure to reflect this reality in the governance of the IMF "reflects the decline in Europe's sense of responsibility and in its ambition to play a meaningful role in the field of international relations" (Padoa-Schioppa, 2006, p. 518).

That remark was in line with Padoa-Schioppa's long-standing view that Europe could and should contribute to better global governance. Also as member of the ECB Executive Board, he advocated an active involvement in international cooperation, convinced as he was that, "as the central bank of an economy roughly the same size as that of the United States, the Eurosystem had to gradually develop its international role and policy: it owed this to its 'domestic constituency' as well as to the global community, in which monetary unification in Europe could play an important role by enhancing global policy cooperation" (Bini Smaghi, 2011).

4. *The need for a global monetary anchor*

As he reflected on the roots of the global financial crisis, Padoa-Schioppa emphasised the importance of monetary factors (Padoa-Schioppa, 2010), noting that the protracted boom in US real estate prices had come in a context of overabundant liquidity supported by an easy monetary stance, encouraged by the fact that the globalisation of the economy had kept domestic inflation low. But he also argued that this process could not have been carried that far, with such an enormous accumulation of private and public debt, if the dollar had not been the main reserve currency and the United States therefore dispensed, *de facto*, from observing any external monetary discipline.

This pointed to the dollar-centred post-Bretton-Woods international monetary system as an important element

in the constellation of factors that had led to the crisis. Its two key features – exchange rates left to the market and the global dollar standard – had not been created by design but had emerged largely by default, all the attempts to rebuild a more consistent system in the 1970s having failed. The fundamental flaw in this "order" lay in its failure to provide some degree of macro-economic discipline. That would have required correction mechanisms triggered by any breach of discipline. Two conditions were essential for such mechanisms to operate correctly – exchange rates in line with fundamentals and a stable anchor for the global monetary policy stance – and Padoa-Schioppa argued that neither was fulfilled by the present system.

On exchange rates, he maintained that neither a return to fixed rates nor universal free floating would be feasible or desirable. In particular, it would be an illusion to think that full exchange rate flexibility could guarantee the adjustment of imbalances and impose policy discipline: markets have proved unreliable in signalling unsustainable positions, and even when they do send the right signals the adjustment is not automatic, since policy changes are required. Equally illusory is the idea that flexible rates can insulate national economies from external shocks. Therefore, an intermediate solution would have to be found, with exchange rates determined jointly by markets and government policies through a mixture of rules and discretion.

On the role of a monetary policy anchor, Padoa-Schioppa suggested that the original Triffin dilemma – the need for

the United States to provide dollar reserves to the world would inevitably undermine confidence in the dollar, as its dollar liabilities would eventually exceed its gold holdings – was just a special case of the more general flaw of any international monetary regime based on a national currency. That is, a US monetary policy conducted pursuing solely domestic objectives could not provide an adequate global anchor, and would ultimately prove inconsistent with the stability requirements of the system as a whole.

A conceivable SDR-centred system – the development of private SDR markets turning special drawing rights into a true reserve asset usable for official intervention and serving as a benchmark for countries' exchange rate policies – might have the advantage of being more symmetrical and therefore subjecting issuers of reserve currencies to greater policy discipline. But it would not truly resolve the inconsistency as long as the SDR remained just a basket and the global monetary stance just the average policy stance of its component currencies. "In the absence of a global policy-maker pursuing 'what is beneficial for the world', a mere average of policies driven by national objectives cannot produce the global public good of a stable monetary anchor on a global scale" (Padoa-Schioppa, 2010, p. 17).

What type of arrangement could play the role of "global policy-maker"? One conceptually viable solution would be a truly global currency – perhaps the SDR itself, if it should morph into a full-fledged currency – managed by a global policy-maker in order to meet the global demand for

reserves, with the policy stance determined by the scarcity of its supply. However, such a solution, reminiscent of Keynes' Bancor, would probably be regarded as far-fetched by many observers. An alternative, at least in theory, would be policy coordination among the main monetary areas, but while some elements of a framework for coordination already exist (the IMF, the BIS, the G7, the G20), Padoa-Schioppa contended that this alternative may be no less far-fetched. "All past and recent experience suggests that, in practice, coordination fails precisely when it is most needed, i.e. when policy preferences are most divergent" (Padoa-Schioppa, 2010, p. 17). In the end, he did not offer a solution: "For the time being, I think we can conclusively prove that we need a flying object; inventing the airplane is a different matter altogether."

5. *The governance of the international monetary system*

Padoa-Schioppa was strongly critical of the thesis that interdependence could be self-regulating, with no need for supranational governance, and identified as one of that view's ideological underpinnings the doctrine of the "house in order". According to that doctrine, if every country pursued sound domestic policies, international order and stability would automatically follow. There would be no need for national authorities to decide anything in common; it would be enough for them to exchange information. Cooperative arrangements could even be dangerous, insofar as they might blur policy

responsibilities and provide an excuse to deviate from sound national policies. Padoa-Schioppa found this notion dangerously misleading.[3] First, while universal adherence to sound policies would obviously help, it cannot be seen as a precondition for cooperation, since a cooperative order is needed precisely to create the proper incentives for good behaviour and to manage the consequences of deviations from it. Second, even if all houses were in order, there would still be "common areas" (trade and financial relations, exchange rates, health, the environment, poverty) where externalities are too important to be ignored and need to be managed in common.

Padoa-Schioppa often deplored the *de facto* shift in international cooperation away from supranational institutions toward inter-governmental *fora* like the G7 and the G20, where decisions require unanimity. In his view, the unwillingness of individual nations to accept limitations to their sovereignty reflected the illusion that sovereignty could stay absolute despite economic interdependence (Padoa-Schioppa, 2009, Ch. IV).

Padoa-Schioppa saw a fatal shortcoming of the intergovernmental approach in the tendency for "peer pressure" – supposedly the mechanism for encouraging countries to put their own houses in order – to turn, in practice, into "peer protection." Citing the implementation of the EU Stability and Growth Pact and earlier attempts at global policy coordination, he pointed out that large players

had often shown a tendency to stipulate “pacts of non-aggression” to the detriment of the global interest.

Having made the case for “the reconstruction of a fully-fledged international monetary order” in his Louvain lecture, in the fall of 2010 Padoa-Schioppa, together with Michel Camdessus and Alexandre Lamfalussy, assembled a group of former high-level policy-makers (the Palais-Royal Initiative) to draft a report on the reform of the international monetary system, to be delivered to the G20 Presidency in early 2011 as an input for the Group’s planned work in that area. In the event, the report was finalised a few weeks after Padoa-Schioppa’s untimely death (Boorman and Icard eds., 2011). Both its analysis and its proposals bear the unmistakable mark of his intellectual contribution.

After outlining the key weaknesses that have plagued the functioning of the international monetary system – ineffective global adjustment, excesses and sharp reversals in liquidity conditions and capital movements, exchange rate volatility and misalignments, excessive reserve accumulation – the Palais-Royal Initiative report describes their fundamental cause as the lack of an effective governance structure to manage economic and financial interdependence. It underscores that while those weaknesses are not new, in today’s increasingly integrated world economy the consequences of failure to address them have become more and more serious.

The report's proposals recommend strengthening multilateral surveillance through (a) stronger obligations, backed by a set of "norms" for key variables (including exchange rates); (b) well-defined assessment procedures triggered by deviations from those norms; and (c) the possibility of using incentives and sanctions to encourage compliance. To underpin stronger surveillance, a new governance architecture is proposed, integrating the G20 within the governance of the IMF (with a redefined and constituency-based grouping of G20 Ministers and Central Bank Governors taking over from the IMFC). The purpose is to give this governance structure legitimacy and make it effective, by combining the universal representation and treaty-based legal powers of the IMF with the high-level political commitment of the G20. The report also called for a "Global Advisory Council", i.e. a panel of eminent independent experts to advise the key organs of the IMF. Its function would be to give a stronger voice to the global interest, making the peer review process more effective and avoiding deadlock on decisions.

NOTES

[1] This taxonomy is also related to the so-called efficiency-equity-stability "triangle" (see in this volume the background note *T. Padoa-Schioppa's perspective on European integration* by F. Balassone and S. Nicoletti Altimari).

[2] As IMFC Chair, Padoa-Schioppa contributed to negotiate an important agreement in April 2008 for the rebalancing of IMF quotas and the reform of IMF governance (F. Saccomanni, 2011).

[3] Padoa-Schioppa (2009). Padoa-Schioppa also articulated this view in a series of lectures held at the European University Institute in 2005 (Padoa-Schioppa, 2005).

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