

Remarks by Mervyn King, Governor of the Bank of England
Conference in honour of Tommaso Padoa-Schioppa

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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.

Tommaso Padoa-Schioppa wrote that “the role of central banks in financial stability is part of their genetic code” (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 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 macroprudential 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 macroprudential 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:

- 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.

- By anchoring inflation expectations, monetary policy can minimise the risk of a Fisherian-type debt deflation spiral (Papademos, 2009).
- 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 macroprudential 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!

References

Padoa-Schioppa, T. (2004) *Regulating Finance: Balancing Freedom and Risk*, Oxford University Press.

Papademos, L. (2009) 'Financial Stability and macro-prudential supervision: objectives, instruments and the role of the ECB', speech at the conference 'The ECB and its Watchers XI'.