Luncheon intervention
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The global financial crisis – Central bank responses in the western Hemisphere

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(The views expressed are personal and do not necessarily correspond to those of the ECB)

Introduction

- I had prepared a technical presentation on liquidity management at the ECB during the financial turmoil, and I have it here with me, but I thought instead that I would take the opportunity of this luncheon speech to share some thoughts on some more general considerations raised by the crisis. In so doing, I will freely use ideas from some of the few papers that the hectic times have allowed me to read, including a paper by Tommaso Padoa Schioppa, one by Carmen Reinhart and Kenneth Rogoff, the recent Geneva report on the Fundamental principles of Financial regulation and the equally recent G30 report on Financial reform.

- There are two preliminary considerations which I would like to take as points of departure of my talk.

- The first consideration is really a confession: I did not understand what was coming. Indeed I remember numerous conversations I had with the President of the ECB, before August 2007, in which I tried to convince him, without much success I must say, that the very favourable situation in both the financial market and the real economy which was prevailing at the time was basically justified, even if I was ready to admit that there were some aspects of it which were not entirely clear. On the real side, my argument went, the fact that billions of workers, particularly in India and China, had become relevant for the world economy caused a positive supply shock, which brought about, in turn, low inflation and high growth. On the financial side, technological innovation, and in particular the great advances in risk transfers, also because of the development of derivatives, were behind the low volatilities, the low spreads and high returns. Of course, with hindsight, my financial argument was basically wrong, and this explains much of my wrong assessment. I would still contend, instead, that the real argument was and still is right, swamped as it is now by the serious recession we are going through.

- The second preliminary consideration has a psychological origin. In the middle of the very bad news which continuously pop out of our Reuters and Bloomberg screens, I am looking for a silver lining to share with you. In all the doom and gloom, the only possible silver lining, beyond the hope that the extraordinary policy moves that are enacted will eventually prevail over demand retrenchment, is that the extreme configurations of events which is taking place can teach us some lessons which we can use to improve the performance of the global economy. The lessons I want to draw from the mistakes we have evidently committed are more in the financial sphere than in the real one, but this is more due to professional bias than to any fundamental reason. In summary, an Italian proverb can summarise the silver lining I want to present to you: “Sbagliando s’impara”, which the Spanish speakers may understand but loosely translated could sound as “Mistakes are a source of knowledge”. The proverb has a particular meaning when applied to the situation we are in: it basically means that we should not try to blindly go back to the situation which was prevailing before August of 2007: having learnt the lessons from the mistakes we made, we must change some important aspects of the economic model which was prevailing until then.

Lessons learned

The first lesson taught, or rather taught again, by the crisis is that the market economy is a wonderful but delicate machine. The machine is wonderful because it can, alone among the economic models we know, basically free man from poverty, with the accompanying ills of premature mortality, analphabetism, malnutrition, pervasive sickness and, overall, a miserable and short life. However, over the centuries, the market economy has shown also its serious, if amendable, vulnerabilities. Markets do not remain competitive unless they are tended to by tough competition authorities, nor are they capable of producing in sufficient quantity public goods. In addition a market economy tends to produce, if left to function totally on its own, income inequalities that many societies are not willing to accept. The crisis we are going through forcefully reminds us of another problematic aspect of the market economy: its recurrent bouts of instability. In a wonderfully simple paper, Carmen Reinhart and Kenneth Rogoff compare the current crisis to a host of past crises. The fact itself that one can build a full sample of crises shows that what we are going through is by no means an isolated case. It is true that, in the long period of the so called great moderation, we had come to believe that the technological innovation consisting of establishing independent central banks devoted to the maintenance of price stability had substantially reduced macro instability. This conclusion is shaken by the severity of the current recession, but I believe that the invention of independent central banks is serving us well also now that the main problem of maintaining price stability is the risk of deflation more than that of inflation. In particular, I think it is crucial that an independent central bank establishes not only the amount and the duration of the monetary easing, but also its nature, now that central banks all over the world are embarking into non-standard measures, whether they are called credit or quantitative easing.

I do not resist at this point making a little detour on the issue of credit or quantitative easing.

When I think of how to classify the actions that a central bank can carry out when fulfilling its responsibility to manage monetary policy, I find the distinction of four categories useful:

1. the first category covers the standard task of managing the **net** amount of liquidity needed to keep interest rates where they should to be to reach the macro objective attributed to the central bank, nowadays generally identified in price stability;
2. then come, so to say, non standard tasks, the first of which is the management of **gross** flows of liquidity to intermediate between banks which have become unwilling to do so; it is with this category that the size of the balance sheet of the central bank becomes more relevant from a monetary policy point of view;
3. another, non standard task is the management of gross flows of liquidity to intermediate funds towards the real sector, to remediate the limitations of an impaired banking-financial system;
4. finally, we have quantitative easing, meant as actions leading to an expansion of the money supply over and above what is implied by the prevailing, very low or even zero, level of interest rates.

To give some practical content to my four categories, let me tell you that the first category, managing net liquidity to maintain the desired level of interest rates, is what central banks did until the 9th of August of 2007. The second category, intermediating **within** the banking sector, is what the ECB started doing, and kept doing with increasing determination, since that fateful day, followed by many other central banks. The third category, intermediating **beyond** the banking sector, is what the FED is doing in a particularly forceful way, followed more recently by the Bank of Japan and the Bank of England with its purchase of commercial paper. The fourth category, quantitative easing, is what the Bank of Japan did in the nineties and what the Bank of England has started doing with its recently announced program of purchase of 75 billion sterling of securities, mostly gilts.

The four categories are very different one from the other. The first one considers quantities just as an instrument without any particular value per se: provided the desired level of interest rates is reached a level x or a level twice x of liquidity is indifferent. In addition, only the **net** amount of liquidity is relevant for controlling rates. The second and the third category have in common that they give importance to the quantity of **gross credit** provided by the central bank and that they concentrate on the asset side of the balance sheet of the central bank. They differ, however, because one does not bring the central bank in contact with entities outside the banking ambit while the essence of the other is just that. The fourth category also gives importance to gross flows, but this time on the liabilities side of the central bank balance sheet. If you are inclined to see things in an academic light, you could say that quantitative easing is inspired by monetarism while the credit easing approach, both in the version limited to banks and in the version which goes beyond them, is inspired by Keynesianism.

As it is often the case, categorising things is the easier part, choosing which category is appropriate to what circumstances is, instead, the complicated thing, over which the best minds, at least among those employed in central banks, are currently pondering. We may discuss on this issue in a questions and answers session, but let me leave it at that for the moment.

The second lesson learned is that globalizing governance is needed for a globalizing market. I am a bit pedantic here, I did **not** say that we need a **global** governance for a **global** market, because this would definitely be an exaggeration, the market is globalizing, not yet global. But this is quite enough to create a large gap between the ambit of the market and the ambit of governance, as Tommaso Padoa Schioppa forcefully remarked and as Charles Kindleberger noted already many years ago. A powerful, but delicate, market economy, which is globalizing more quickly than public action creates problems of governance. I advance, here, however the hypothesis that the gap is larger in the case of governments than in the case of central banks.

Let me cover first the point about governments.

We read in newspapers of the difficulty of governments to pull their action together. Indeed, there is increasing, and ominous, talk of financial protectionism, as if we felt the compulsion to replicate in the financial area the mistake we made in the commercial area in the thirties. The explanation, not the justification, for financial protectionism is that huge amounts of taxpayer money are being used to try to stem the crisis in the banking and financial sector and taxpayers may, very reluctantly indeed, spend these large sums of money to repair the broken national financial system but are not willing to help “foreigners”. The problem with this attitude is that in a globalizing world the very content of the word “foreigners” has lost much of its significance. Was Fortis a Dutch or a Belgian bancassurance company? Were the consequences of the failure of Lehman limited to the United States? Is Dexia a French, a Belgian or a US bank? And is City really an American bank? Outside the financial sector, is Opel a German or an American car manufacturer? Tax payers have all the right to ask that their money is wisely spent, but insisting that it be spent along national lines is no wisdom. The avoidance of protectionism, in the financial as well as in the real economy, is the minimum to be asked in terms of globalising governance in a globalizing world, but this is the minimum minimorum, a passive approach, one that avoids mistakes more than doing something positively right. More is needed in terms of dealing with a cross border approach with problems which are inherently cross border, like the supervision of multinational banks.

Before telling you why I believe central banks have made more progress in answering the governance needs of a globalizing world, let me say something about that interesting experiment of supranational governance which is the European Union. An example may be the most intuitive way to present the basic idea behind the European Union, that is the idea that the European Union allows to raise to the appropriate level the production of a public good. My example is about anti pollution action. Some anti pollution policies, such as for instance, garbage collection, have to be conducted at local level. Some others, say transport policies, have to be conducted at national level. Still others, for example sea pollution, have to be carried out at regional, meaning multinational, level, while still others, such as global warming, must necessarily have a global dimension. The European Union, in essence, is filling the regional government level, producing those public goods which are best produced at that specific level. In this perspective, money, in the euro area, is a public good that the constituency of initially 11 and now 16 countries have decided is better produced at regional rather than national level.

The European Union is not immune from nationalist tendencies, the difference is that it has created a system of political and legal institutions which control them. In addition, in its 50 years of existence it has shown a distinct ability to surpass difficulties by moving forward rather than backwards. This is also my firm expectation as regards the economic difficulties that some countries are experiencing now, within and outside the Euro area, even if it does make a difference whether a country has adopted the euro or not. In the euro area, if the need would appear, the difficulties of one or the other country will be dealt with internally, in a spirit of solidarity which, at the same time, will reinforce the internal rules which assure a sound conduct of budgetary policies. The ECB, on its side, continues to conduct a monetary policy oriented to the whole area and targeting price stability. The countries **in** the European Union but **outside** the euro area may need, as it has already happened with Hungary and Latvia, the assistance of the International Monetary Fund, but the European Union has also contributed to the packages. Also the ECB, in its specific area of competence, will contribute, as it has already done extending a repo agreement with Hungary and Poland.

Let me now come to my point about central banks and let me explain why I believe they are further progressed on the path of integrating an international dimension in their national responsibilities, in line with a globalizing world.

The most visible aspect of this general phenomenon is the net of swaps which central banks have established among themselves to deal with the liquidity problem, which is an important part of the economic crisis we are undergoing. Let me concentrate on the case of the FED, which is, of course, the most important, but let me mention that also the ECB and the Swiss National Bank have made their currencies available to some other central banks to deal with illiquidity problems that had emerged in their jurisdictions. I do not need to go through the facts: early in the crisis the FED, the ECB and the Swiss National Bank ascertained that the supply of dollars in Europe had become impaired by the general unwillingness of banks to lend to each other, also in the usually safe way of currency swaps. The remedy to this impairment was the creation of a sort of “by-pass” whereby the liquidity, which was flowing with much more difficulty through its traditional conduit, would now flow through a new, central bank channel. As you know the initial agreement was subsequently increased, up to the point where there is now a swap of unlimited size between the ECB and the FED, and extended to many more countries, both advanced and emerging.

If you think of it, this is absolutely extraordinary: issuing base money is the sancta sanctorum of central banks, in a way this is their quintessential function: a central bank is exactly that, central, because it issues that particular financial product which is base money. Now, the central bank issuing the most important currency in the world allows another central bank to issue base money for it in unlimited amounts, as it recognizes that this is necessary to absolve its responsibilities. Before the net of swaps was enlarged, spoiling my joke, I used to say that the ECB had become the thirteenth district of the Federal Reserve and the Swiss National Bank the fourteenth.

The operational collaboration carried out in the swap program is the most visible aspect of the collaboration among central banks in their action to limit the damages and shorten the duration of the crisis but it is not the only one. The continuous exchange of information, assessment, plans, analyses, on a bilateral and multilateral level is also crucial. At the Bank for International Settlement, in bilateral conversations, in the framework of the IMF there is a continuous exchange and learning from the experience of other central banks is an essential component to identify at any point in time the best course of action. Just a few days ago my counterparty at the Bank of England, at the time when they were announcing their program of outright purchases, offered to share the problems they had gone through in establishing their program so that we could do our own mistakes and not repeat those through which they had already gone. In a way “sbagliando s’impara”, learning by mistake, has acquired a cross section and not only a time series dimension, you may learn from the mistakes of others, not only from your own past mistakes.

Of course, collaboration and exchange of experiences will normally not lead to all central banks doing the same things: economic conditions are different, mandates have some different nuances, even if it easy to exaggerate their importance, responsibilities, at the end, are towards the constituency to which one central bank belongs. But pursuing national responsibilities after a deep exchange of assessments and in a spirit of collaboration which takes fully into account the interactions between different countries, is very different than an isolated pursuit of a myopic national interest.

The third lesson is that we should have more trust in fundamental economic principles and be ready to act on their basis. Well before August 2007, many papers had shown that the economic configuration of a lack of saving in the US, mirrored by an excess of saving in some emerging countries, and particularly China, was unsustainable. Clever stories were put forward to demonstrate the contrary, but however clever the stories were they could not hide the fact that the most important economy in the world was financing its consumption by borrowing huge amounts of money from the rest of the world. Neither could it be hidden that this resulted in a configuration of current accounts, and therefore capital flows, which was the contrary of what any model based on relative factor endowment showed: the country with a high capital labour ratio was importing huge amount of capital from countries with a low ratio.

The economic oddities which have become evident after last summer, but which were not sufficiently clear to many, me included I must admit, were not only the savings imbalances between the US and some emerging economies but also the unsustainable increase of house prices in the US and the even less sustainable expectation that house prices would go up for ever, thus financing a sort of macro Ponzi scheme, or may be, given the levels to which the game has been brought, a sort of macro Maddoff scheme. I do not enter here into the vexed question whether monetary policy should have addressed asset prices and whether controlling good price inflation is enough or not, as Bill White, the former economic advisor of the BIS has argued. The topic would deserve a treatment on its own. Neither do I want to enter into a discussion of what should have been the role of the dollar in remedying the current account deficit of the US, generated by the lack of domestic saving and the huge import of foreign saving. I tend to think that calibration of domestic demand, in both the surplus and the deficit country would have been, and in some way still is, a more natural way to correct savings disequilibria, but again this is a discussion we can not have today. The fact remains that if the intellectual resources which went into justifying what experience has shown could not be justified had instead been used to find out what had to be done to get out of that unsustainable situation and if we would have had the courage to follow our basic reasoning we may have avoided at least part of the havoc we are going through. I read somewhat similar conclusions in a recent speech of the President of the Federal Reserve.

The fourth lesson is that the way we supervise and regulate finance should be thoroughly reformed and, in different ways, this applies on both sides of the Atlantic and, may be being in Lima, on both sides of the Pacific as well. If we are still discussing what we should have done differently in macroeconomic terms, there is not much discussion that the supervisory system was severely flawed and allowed things to happen that should have never happened. We are appalled at the incredible scandals which have taken place but, beyond them, something much more systematic and dangerous took place. Liquidity was assumed to be for ever abundant and cheap, care and responsibility in lending were forgotten, the necessary link between risk taking and capital was swept aside, non regulated, often non capitalized or poorly capitalized, institutions took intermediating functions which they were in no way able to sustain except in the most, artificially, favourable circumstances. In a recent report of the International Center for Monetary and Banking Studies and the CEPR, 29 recommendations were listed, practically covering all aspects of regulation. The Group of 30 report has 18 of them. Chairman Bernanke in a recent speech addressed four broad issues in the area of supervision which need to be thoroughly reformed. In the European Union a group, led by the former IMF managing director, De Larosiere, has produced a report proposing some sweeping innovations in the way supervision should be conducted in the European Union.

I have no pretence to give as comprehensive and deep a treatment as any of the analyses I quoted. What I want to do is to give my own view of the main fault lines around which the problems emerged and which are to be corrected.

One first problem is that the same intermediating function has been regulated in a different way, depending from which type of institution carried it out. Regulatory arbitrage has been rampant in the run up to the crisis, regulated institutions have had recourse to “tricks” of different kind to park outside of the regulated ambit operations which would have required capital if conducted in the appropriate way. Non regulated institutions, on the other hand, carried out functions which were proper of regulated institutions.

A second issue is that liquidity risk has been practically ignored by regulators as well as by the financial firms. Liquidity regulations have been only applied to banks in some jurisdictions and with very disparate approaches, often rudimentary ones. Overall, financial firms, as I said, practically assumed away the problem, taking it for granted that it would never arise.

A third problem is that multinational financial institutions have not been subject to proper consolidated supervision, not even in a setting like the European Union. More generally, supervision has been balkanised by national borders and by institutional differences which had lost practical importance.

A fourth issue is that brilliant ideas of financial innovations like securitisation and new risk transfer tools have been damaged, to near fatal point, by an extremely opaque and baroque implementation.

A fifth issue is that supervision has been micro oriented: the question was basically what has to be done for an individual institution to remain sound in a sound environment, the macro side of prudential supervision was, basically, ignored, with the consequences that we see right now. And the difference between a macro and a micro prudential approach are crucial: what makes a lot of sense from a micro point of view can be totally counterproductive from a macro point of view, as we see now when ferocious deleveraging is feeding on itself aggravating the illiquidity situation.

A fifth issue is the one of prociclicality: current supervision gets more lenient in fair weather conditions and stricter when bad weather prevails, exactly the opposite of what is needed.

A sixth and final issue, which is inevitably aggravated by what is being done right now, is that bigger and bigger financial institutions are created, which it is very difficult to let fail, as a proper market mechanism requires.

I see the new supervision set-up which will prevail after the crisis as one in which a strong macro perspective will complement the micro one, in which liquidity will get as much attention as solvency, in which a function rather than the specific form of an institution will be regulated, in which balkanisation will give way to a consolidated approach, in which ways will be found to automatically make rules stricter when things go well to become more generous when the going gets tougher, in which opacity will be appropriately countered and financial institutions, however big, will not feel free of the risk of failure. I see in this new set-up an increased role for central banks: after all there is no other institution which has so clear a responsibility and competence when it comes to liquidity, a macro perspective and the economic cycle. I do not believe this means that central banks should be leading in the supervision task, but their role will definitely be more important than it is now.

Conclusions

I am not sure you share my view of which are the lessons we should draw from the current crisis and I am very interested to hear your opinions on this. In these dire moments, let’s assume that things develop as favourably as they can: we agree on the lessons, we act upon this agreement and remedy the fault lines which the crisis has made evident. The world will then be better organised and we will be ready to go through a different crisis and learn some different lessons, and so on….. Sbagliando s’impara.