9/23/10 – Dinner & Keynote Speech: Tommaso Padoa-Schioppa

TOMMASO PADOA-SCHIOPPA: Good evening. Thank you for these kind words. I realize that according to the original plan these remarks have to be delivered to an audience already benefiting from (inaudible 1:49), from Emile, and ready to sleep. I will try to contribute to the same evolution of your state by my remarks, but I will try to keep them short.

I am very pleased to be here. This conference of the Federal Reserve Bank of Chicago has been a myth for me for many years. It is the first time that I have attended it and I am particularly happy to be given this opportunity. I will, with my remarks, try to put the debate on micro-prudential regulation in perspective. And the perspective will be: One, provided by the long-term evolution of central banking, the way I see it, or to put differently, the evolution of the constitution of money.

It is an evolution that I reconstruct on the basis of my personal service of many years in central banking and in some ways it goes from the central banking as I discovered it when I joined the profession, to the one I observe today. In summary, my remarks will say the following:

Among the determinants of the present crisis, I think that the relevant place and one that is for the moment insufficient to recognize is taken by flows in the constitution of money that have taken shape over the last 30 or 40 years.

Research efforts and policy initiatives in the field of macroprudential regulation in my view are steps towards the correction of those flows. However, the construction of the viable and sustainable constitution of money consistent with a financial system which is highly sophisticated and with globalization requires probably further and more radical steps than the one that our goal today under the name of macroprudential regulation.

This is a summary and I will develop my argument by first describing what I would call the old concept of central banking, then describe what I could name as the deconstruction of that concept. Third, I will briefly lead that through the crisis and finally say something about possible reconstruction.

So the elements of the old construct, the key elements are the following: First, central banks had a three-fold or triadic mandate which can be related to the three classic functions of money. They have a mandate in the field of price ability through the conduct of monetary policy and this can be related to the numeral function of money. They have paid a function in the field of financial stability, supervision of banks and these can be related to the store value of money, and they had a function in the payment system and this, of course, relates to the medium of the exchange function of money.

The essence of money is to perform these three functions which are inseparable and in my view equally inseparable where the three functions in the institution of central banks. A second element was the existence of an international anchor or a super-national anchor which put limits to the extent which money could be manipulated. That anchor was a commodity, it was gold; but conceptually, it could also be a different type of anchor. The essence is it was an international one that went beyond the sphere of exclusive influence of nation states.

The third element was the definition of the mandate of central banks in rather loose terms. If you read the statutes of the legislation of central banks prior to the wave of reforms of the last 30 years, the mandate of the central bank was tainted in very generic terms like looking after the currency, having some currency, safeguard the currency, notions like this. And the fourth element, the last was what I could call a single jurisdiction or mono-line jurisdiction. I mean by this that in that old construct the debtor, the creditor, the intermediary, the currency, the legislation, the central bank all were belonging to the same, within the same perimeter of the nation state.

It took about a century for this construct to take shape. It began with the event of paper currency. It went on with the event of commercial bank money. It originates from the medium of exchange function of money with new ways to organize monetary exchanges. It developed into a banking supervision function, not on the basis of any specific mandate, but simply on the basis of a 'know your client/know your customer' type of need for the central bank, which was the bank operating with other banks and needed to know how sound their clients were.

When I entered the profession of central banking about 40 years or a little more ago, this construct was still alive. It was not taught in universities. I discovered the payment system function when I started operating in a central bank. University teaching was focusing essentially on monetary policy which of the three functions I have described was the late comer, was the last, and certainly central banks were not created to conduct the monetary policy in the way we mean monetary policy today.

So I have learned, formed in my own mind, this kind of description of central banking by experience rather than by university education. Deconstruction, I said when I joined central banking, this concept was still alive, but it had already -- deconstruction had already gone a rather long, long way. The key moment however in deconstruction was August '79. It was the cutting of the last link between money and gold which meant design current -- currency from one of the two anchors that had operated for maybe a millennium, certainly for centuries with the two anchors being a commodity and being sovereign.

The commodity anchor was definitely cut in August '79 and the anchoring to the sovereign became correspondingly stronger and the sovereign being the nation state what we have observed as a consequence of the August '79 event was a strong move towards monetary nationalism. This was the defining moment, but there were other elements in the deconstruction. There was a sort of fund bonding of the triadic function of central banking as I have described. There was an increasing sharpening in the definition of the mandate and an increasing focus on the monetary policy mandate.

There was a stronger acquisition of a start of independence by the central bank. The central bank became a much more narrowly focused, independent, possibly isolated, institution compared to the old construct. So the other elements of the deconstructive model were a shift from discretion to rules. A disconnection of financial stability and banking stability, the responsibilities from the central bank; when I became a central banker, I have no memory of any country where the supervisor was an entity other than the central bank. You know how this situation is today.

Another element of this legal structure was the gradual fading away of the notion of financial stability as the responsibility of the central bank. The strong reluctance to make room for judgment and discretion, this was part -- this last element was partly related to a need for stronger accountability, but also for stronger accountability to an academic profession that had become increasingly demanding in terms of formalization of the policy conduct.

Why do I call this deconstruct to contrast it with the construct? It may seem unfair to use this expression and it seems to not be doing justice to the certainly very remarkable process of formalization, intellectual sharpening and sophistication in the definition of the functions for the central bank and also the institutional evolution. Still I think that the word 'deconstruct' is not a simple provocation, which is what the keynote speech at this hour should offer. It also refers to the fact that some elements that deeply constitute a consistent set of characteristics were loosened and in some way lost their unity.

There was a degree of unbundling of the triad that I have described. There was a loosening of the international consistency of the monetary ordering. There was a complete unbundling of what I call the single jurisdiction. And I think there was also a certain loss, at least in my view, of the wisdom that was embodied in the generic formulation of the mandate of the central bank. There was wisdom in saying that the central bank has to look after the currency without being much more specific than this.

So the crisis came and on the crisis I would like to make quickly three points. First, to say that to some extent it is not caused by deconstruct; but it is a product, an event that could take place against the background of what I call the deconstructive model. Second, that the crisis itself has partially provoked a reconstruction, a rebundling of some of the functions that had been dispersed. And third, I would like to say that this temporary and partial reconstruction is not yet what we need to have a satisfactory monetary constitution.

The way to see why the deconstructive model has contributed to the crisis is to consider that one keen element of the crisis was the position of the dollar and the way in which it has been possible for very long to protract a non-sustainable course of events without any signaling or any disciplinary mechanism as being set in motion of the kind of those that should normally operate.

The extreme bundle creation of liquidity did not create inflation; it created asset inflation, but not consumer price inflation. And this was largely related to the fact, to the dampening effect that cheap imports from manufacturing countries where labor costs were much lower than the United States kept or contributed to keep inflation under control. So that when it is said that price stability is a necessary but not sufficient condition for financial stability, we say something that is certainly true, but there may be something misleading in the degree of price ability that was experienced in the years before the crisis.

And there is an international element in which the monetary secting contributed to the crisis. Remember that the crisis is due to the fact that an unsustainable course was sustained for too long and because it was sustained for too long, the correction was so dramatic. Had it been sustained for much less, had the corrective mechanism operated much earlier, it would have been normal physiology of the way in which economic and financial systems operate. The domestic monetary element is the one I have described a moment ago. The international monetary element is the fact that the external deficits of the United States could be easily financed by the accumulation of dollar reserves from the exporting countries.

So we cannot say that the deconstruct is the cause of the crisis but we can say it was consistent with the crisis or that the crisis could develop against that particular background. In the meantime the crisis has produced a departure from the deconstructive model. It has brought again to the forefront, the primacy of the payment, the functioning of the payment system. It has obliged central banks, even those which are not mandated to pursue financial stability to put financial stability as a top priority.

It as recomposed the triadic nature of central banks and it has recreated the need to exert judgment and discretion. And yet, this is my third point on the crisis, it is not yet a reconstruction of an (inaudible 21:12) monetary constitution. We have seen, indeed, creative and innovative crisis management. We have not yet seen the reconstruction of a system that is more equipped to avoid a crisis rather than to simply manage one when it comes.

Here is where macroprudential regulation comes in. Macroprudential regulation is clearly an important correction of some of the flows I have described. I will not expand on this point. It is clear there is an effort. This conference is a remarkable respect to the fine framework for macroprudential regulation to identify the relevant concepts, the objectives, the tools to move towards the creation of a framework that one day may be compatible to what we have for monetary policy.

But my sense is that this effort is made under a sort of a (inaudible 22:30) assumption as if all the rest of the model could stay the way it is and simply could be complimented with this new element that is macroprudential regulation. The macroprudential regulation formula, there are two words that are possibly which are: One is 'prudential' and the other is 'regulation'. Prudential, of course, proven is one of the classic virtues from theologies for centuries, but it leaves me somehow -- the two words I am missing are 'stability' or 'financial stability' and 'policy'.

Regulation refers to a particular instrument of policy, which means stating rules and macroprudential is almost a contradiction of terms. After all, prudence is a virtue of the individual. It is not the virtue of a crowd. I understand, of course, why this jargon has developed. It has developed because the need to be precise has led to narrow the broader notion of what this financial stability should have in the policy of central bank which is in my view the right way to state the issue into something much more limited which is in what ways prudential regulation should incorporate macroeconomic considerations which is absolutely necessary. It is a big step forward, but it does not exhaust, in my view, the issue.

If we really want to construct a system that regains some of what was lost from the old construct, I am not speaking of going back to that old construct but to find an advanced way to satisfy those same needs, I think we need to regain a degree of international discipline. We need to rediscover the inseparatability of the three components of the functions of money and the need to have an institution that is responsible for the three functions and not just the one. And we need probably to recognize that the room for discretion cannot be reduced to too little as I think the intellectual trend and the combination of being demanding on analytical grounds and being demanding on accountability and political grounds has produced over the years.

But if these elements are considered as a necessary part of reconstruction, then one can wonder whether what we have can stay unchanged. Is it possible to reconstruct an international monetary system when all the apparatus of monetary policy is fundamentally rooted in a national setting? It is based on the monetary policies which should be exclusively focusing on the objective of a single nation with the illusion that the outside either does not exist or can be taken care of by letting exchange rates flow.

There is no acceptance of exchange rate discipline. There is no acceptance of the international coordination or cooperation in this field. It is the purity of the mandate of the exclusive focus on domestic price ability, which has misled monetary policy in the most important context of the world. One where the crisis has originated, I don’t think can survive a reconstruction as ambitious as the one I have just sketched.

So I stop here. The conclusion is that macro-prudential regulation is a fundamental innovation, extremely positive, maybe it is the most significant brick that has been so far brought to the task of reconstructing a more viable system, but it is just one brick and not the reconstruction. Thank you.

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