Lorenzo Bini Smaghi: Presentation of the book entitled "L'acqua e la spugna" by Franco Bruni

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the Center for American Studies, Rome, 24 June 2009.

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Above all, I should like to thank the Center for American Studies for inviting me to present this book by Franco Bruni; a book which is a real pleasure to present because it actually shows to be untrue what many have claimed recently, namely that the economists did not foresee the crisis and that they did not send out the alarm signals. Some economists, such as Franco Bruni, had been pointing out the imbalances accumulating on the financial markets for a long time, and, whilst they may not have anticipated the full extent of the crisis, they did, for sure, signal the risks.

Franco Bruni's book is a book well worth reading, because it helps us understand how the science of economics, is, at the end of the day, linked to common sense, and also that the "new paradigms", which are increasingly cited to justify events that cannot be easily explained, should be questioned. If you base your own judgements on sound analytical grounds, albeit unsophisticated – and the book has the great advantage of also being accessible to non-specialists in economics – you can get to grips with the general trends, at least in the medium term. In this context, the conflicting schools of thought, for example, the Keynesian and monetarists, serve no purpose. Those who did not understand the crisis were those who, in some way or another, were trapped in simplified models without understanding that these models are the starting and not the finishing points of an analytical path aimed at understanding reality.

On the one hand, those who have made the neo-Keynesian models extreme, excluding money and the financial markets, have made the search for model elegance an end in itself, without understanding that it does not actually help to explain reality.

This may seem absurd nowadays, but at a conference organised by the European Central Bank, in the autumn of 2006, to explain its own monetary policy strategy – a strategy in which money and the financial markets play an important role – the majority of academics, above all on the other side of the Atlantic, played down the usefulness of taking money and financial markets into account in economic models. In the more sophisticated neo-Keynesian models, they managed to completely get rid of money! Consequently, monetary policy could also get rid of money, and focus only on the interest rate as the variable representative of the equilibrium on the money and financial markets.

With such models, it was sufficient to align the interest rate with the equilibrium level, or the so-called "neutral" level, in order to ensure a monetary policy in line with the general equilibrium. No one, however, asked, in a world of uncertainty, how to measure the "neutral" level of the interest rate. That was assumed as a given. This is the theoretical basis of the so-called Taylor rule.

Nor was the crisis understood by those who continued to assume that financial markets were perfect, without frictions, in which the inflating and bursting of speculative bubbles is part of a moving equilibrium condition, in which economic policy should not intervene.

In accordance with this approach, monetary policy, or the prudential supervision system, should not intervene in order to avert erratic market behaviour, which causes excessive flows of indebtedness and unstable dynamics in financial activities, but rather intervenes ex post, in order to reinflate the bubble when it bursts. Doing it that way, by reinflating it, the bubble has finally burst with detrimental effects on the world economy.

Franco Bruni's book demonstrates that the excessively accommodative monetary policy following the dot-com bubble and 11 September fuelled the subsequent speculative bubble, which then burst in the summer of 2007. He himself acknowledges that the main responsibilities probably do not lie with monetary policy, but rather with the absence of regulation of new financial instruments, which permitted institutions to increase their leverage capacity and favoured the indebtedness of households and firms.

However, monetary policy contributed to the build-up of imbalances by keeping interest rates very low, above all, during the period when the US economy was starting to pick up again. I believe that by now there is a broad consensus on this theory. Alan Greenspan's counter-argument that US monetary policy was not responsible for low interest rates, but rather the inflow of capital from China, is not convincing.

Even if there were any truth in Greenspan's theory, the lesson that should have been learnt was that the short-term interest rates were too low and should have been increased.

It was decided not to do so for fear of the US economy falling into deflation and it was, therefore, preferable to "err" in the direction of excessive monetary growth, in order to avoid the risk of deflation, despite the low probability of this occurring, rather than to err in the opposite direction.

This fear was evidently well founded. And, as such, the mistake developed into an excessively expansive policy, which led to the subsequent bubble. This experience demonstrates that the monetary policy approach in terms of "risk management", as defined by Greenspan, which does not take into account the medium-term probability of events, but rather the extreme risks, does not account for the errors that the statisticians call "second type", which is to give too much importance to a hypothesis which does not actually materialise. This is interesting because, generally, it is academics who underestimate this type of error and attach greater importance to the first type of error. Empirical research tends to be taken note of when it demonstrates the significance of a statistical relationship, not its insignificance. In 2003 heavy emphasis was placed on evaluating the significance of the hypothesis of deflation, not its absence, nor the probability of future inflation.

Franco Bruni does not assign to the ECB the same level of responsibility, given that it kept its rates higher than those in the United States. He is not one of the many who belatedly reconverted to monetary rigour ex post, forgetting what was written at the time. On 2 December 2005, Franco Bruni wrote: "The small ECB rate increase was announced. It is a logical increase (which in fact comes a little late) for various reasons. The starting point is very low…".[1] And yet Bruni seems ungenerous. First of all, the European economy grew at a rate of 1.5% over the three-year period 2003-05, below potential and even lower than the US rate (3%). Moreover, in this period, the effective exchange rate of the euro appreciated, by slightly less than 10%, signalling a relative tightening of monetary conditions. I would like to recall that at the time there were many, both in academia and in politics, who argued that the ECB should tie its monetary policy to that of the United States and fix the exchange rate to the dollar. Just imagine how much more liquidity would have been provided to the market in those years and how much more devastating the effects of the bursting of the bubble would have been now!

Indeed, at that time, the ECB was subject above all to criticism contrary to that levelled by Franco Bruni. At least three European heads of state, and many ministries of finance, not to mention business people, trade unionists, journalists, politicians and commentators, exerted public pressure on the ECB to finally cut rates. And when, at the end of 2005, the ECB decided (rather late, in Bruni's opinion) to increase them, many of those persons lined up, together with renowned international institutions, to severely censure the decision, because

[1] La Stampa, 2 December 2005.

they felt it would have cut off the legs of the recovery. The ECB is independent, fortunately, and cannot dump on others the responsibilities of its own choices. But what we should not forget is the context in which it operates, largely influenced, also in the countries of continental Europe, by an "activist" vision of monetary policy with an Anglo-Saxon inspiration.

It is also surprising how the teachings taken from that period of monetary policy are quickly put aside when you go from the historical analysis to that of the economic juncture, in particular the current economic situation. If the experience of the first half of this decade teaches us that monetary policy should have a medium-term orientation, should take into due consideration the developments in the financial markets and should avoid focusing on extreme events that are unlikely to take place, and should be put into effect by an independent central bank, with a clear mandate that favours price stability – in line with the analysis contained in Franco Bruni's book – the assessments of the present frequently continue to be contingent on opposed preconceptions. In the current circumstances, the actions of the central bank, especially those of the ECB, continue to be assessed in terms of a comparison with the United States and in terms of quantity rather than results. There's a tendency to look above all at the number of rate cuts and points cuts and the scale of the refinancing operations, rather than looking at the results in terms of the sustainability of a certain policy over time. As I have had an opportunity to explain, a policy that quickly brings rates down to zero but cannot generate expectations of stable rates at those levels, can end up being less effective than a policy which maintains rates slightly higher but has stable expectations, allowing a flatter yield curve to be maintained.[2] If you look today at the results obtained in terms of the yield curve and inflation expectations, you can appreciate the strategy followed by the ECB in the rate-cutting phase.

One point on which I don't agree with Franco Bruni's analysis concerns his judgement on changing the objective of monetary policy after the failure of Lehman Brothers on 15 September 2008. Bruni writes: "…the objective became only that of saving the credit system from the collapse. This last change of objective is of great conceptual and political importance, it has a significance that could prove to be, so to speak, historic. And yet it has never been officially declared, particularly by the ECB". The proof that he provides for the above remarks is the decision to reduce interest rates from 2% to 1.5% in March this year, a step which, in his opinion, was not justified by the trend of the economy, but by the problems facing Europe's banking system.

There is a misunderstanding here that needs to be quickly clarified, also in view of the ensuing discussion on macro-prudential supervision and on the powers of the central banks in question. From the outset of the crisis in August 2007, the ECB has pursued a policy of separation between, on the one hand, the interest rate decisions, based solely on the priority objective of price stability and, on the other hand, the decisions concerning the instruments used to pump liquidity into the system in order to tackle the difficulties being encountered by the market.

The most obvious example of the separation is precisely the one which occurred on 9 August 2007, when amid market tensions, it was decided both to maintain the rates unchanged *and* to intervene on a substantial scale to satisfy the banks' demand for liquidity, with a €90 billion operation. And the same separation has been continued in all the months since then.

That the decision to reduce interest rates in March to 1.5% was justified is, I believe, evident from the growth and inflation estimates published at that time. I remember the ECB staff projections were pointing to euro area GDP growth for 2009 and 2010 being equal to -2.7% and 0.0% and inflation of 0.5% and 1.1% respectively. Also taking into account the relevant horizon for monetary policy, between one and two years ahead, an interest rate of 2%

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[2] "Three questions on monetary policy easing", University of Ancona, 6 March 2009 (available at www.ecb.europa.eu).

seemed excessive, also considering the downside risks to growth that the ECB's Governing Council had signalled and that they duly manifested themselves. Indeed, the projections were again revised in early June, and the cut in the official interest rate to 1% decided in May is consistent with that revision.

The objective of the decisions to supply liquidity to the banking system was not to "rescue the banks" but to ensure the continued functioning of the financial market, starting with its base, i.e. the money market. The ECB's entire range of instruments, characterised by a wide corridor between the interest rate on the marginal lending facility and the rate on the deposit facility, weekly repurchase agreements, the acceptance of a large number of counterparties and a wide range of collateral, is based on the money market functioning. If the money market doesn't work, the mechanism for transmitting monetary policy doesn't work. The only solution remaining for a central bank at this point is to stand in for the market and perform the role of the banks, even by lending directly to the private sector. Maybe this solution is the most preferable? I don't believe so. In my opinion, the functioning of the market is a statutory objective for a central bank. It should therefore intervene to guarantee the liquidity of the market. It should be remembered that every injection of liquidity is guaranteed by the collateral deposited by the counterparty banks. This means that banks' assets are made liquid. It's obvious that without such a liquidity intervention, the market would collapse, taking the banking system with it. This is always true for last-resort interventions whose objective is to keep a solvent but illiquid system alive. It is at the heart of the role of central banking, particularly in times of systemic crisis. There can be no doubt that the ECB had to take on this role and I believe it has done so in an appropriate way.

However, the point is not to intervene to remedy problems of solvency resulting from wrong decisions regarding investment or resulting from insufficient capital. In this regard, a central bank is not in a position to deal with these problems, nor is it its job to. This is the responsibility of the political authorities. Following the collapse of Lehman Brothers, this has become clear in Europe. Only the heads of state and government, in their meeting in Paris prompted by President Sarkozy, were able to commit public funds to avoid several banks going under. The programme aimed at supporting banks' capital and at guaranteeing bonds was a government initiative, even if the ECB made a technical contribution. And this is exactly how it should be.

If something can be said to have gone wrong, it was with the implementation of the measures, not with the decision itself. The ECB has repeated its invitation to financial institutions many times to make full use of the state measures for increasing capitalisation in the banking system.

If this doesn't happen, there is a risk that the retroactive effect of the current recession on banks' accounts will cause the banks ultimately to reduce their financing of the real sector, thereby further exacerbating the economic crisis. Evidently, there is not enough incentive for bank shareholders and bank managers to make use of such instruments, the shareholders out of fear that their shares will drop in value, and the managers for fear of operational and pay structure constraints. This poses a problem in terms of coordinating behaviour, which has to be resolved by policy-makers. However, time constraints prevent us from exploring this matter any further today.

I would like to conclude by looking to the future. I agree with Franco Bruni's analysis and recommendations.

This crisis affirms the need for fully independent central banks in which the appointment of Executive Board members is not linked to electoral cycles, and where such members have long-term mandates. It also confirms how important it is for price stability to be the primary objective of monetary policy. This experience has shown that having more objectives than this does not make the task any easier, neither in terms of preventing a crisis, nor resolving it. Given the objective of price stability, central banks should also aim to contribute to financial stability but they should also have instruments at their disposal to achieve this.

Finally, whenever central banks are given specific powers, they are also expected – and rightly so – to exercise accountability. Franco Bruni is no exception, but in this regard he cannot be distinguished from a certain trend which erroneously considers the ECB to be less accountable than the Federal Reserve, particularly with regard to parliament. The appendix gives details about the methods of reporting to the respective parliaments, in terms of reporting, hearings and responses to questions posed by the parliament. It can be confirmed from this that the ECB reports with the same intensity and frequency as the US central bank. This does not mean that the quality of interaction cannot be improved, but this depends, to a large extent, on the European Parliament.