Mr. Padoa-Schioppa reviews his experience in central banking over the last thirty years Text of the remarks by Dott. Tommaso Padoa-Schioppa, a Deputy Director General of the Bank of Italy, at the Governors' Dinner held in Basle on 7/4/97.

1. To have been invited to attend and address the Governor's dinner is a very great honour for me as I step down from the chair of the Basle Committee and leave the community of central bankers.

When Governor de Larosière proposed my name to succeed Gerry Corrigan, he admitted, so I have been told, that my curriculum vitae was not that of a full-time bank supervisor. Presenting this handicap as an advantage, he suggested that my previous involvement in a variety of central banking activities could be useful because of the growing interaction between monetary policy, payment systems and banking stability. You were generous enough to accept that view. That was an act of confidence. As words like confidence, trust and credibility are the very essence of the vocabulary of banking, I am deeply grateful for the confidence you granted me four years ago.

2. In view of my mixed background, I shall focus on central banking, rather than just banking supervision, and try to sum up what I have learned and what I have witnessed over the last thirty odd years: first about the tasks of central banking and then about the context in which such tasks are performed.

3. A person of my generation is inevitably struck by the difference between what he was taught at university in the sixties and the reality he faced in the two following decades. In the lecture room central banking had just one pole, monetary policy. In the real world I found it was triadic, as monetary policy was combined with involvement in the payment system and banking supervision.

At the Bank of Italy, for instance, more than half the staff of just over 9,000 is devoted to the operation of the payment system (the note issue, clearing systems, Treasury inpayments and outpayments, interbank funds transfers, etc.); around 15 per cent is engaged in banking supervision; less than 5 per cent is concerned with monetary policy. Although not all central banks have primary responsibility for banking supervision, the three tasks are inextricably linked because there is a close relationship between them and the three practically indivisible functions of money as numeraire, means of payment and store of value.

Dealing with the complexities of triadic central banking has been for me both a fascinating professional experience and an intellectual adventure bringing new insights nearly every day.

4. Not only was monetary policy the sole task highlighted when I was a student, but the word "monetary" was overshadowed by the word "policy". Monetary policy had always existed, of course, but the rise of fiat money greatly increased the room for manoeuvre. The central banker came to be seen in the fifties and sixties as a demiurg able to choose between inflation and unemployment, and to do so almost on a quarter-by-quarter basis.

So delicate and powerful was the policy choice entrusted to the central banker that he could not be left to make it alone. Few central banks were truly independent. The intellectual paradigm that followed the demise of the Gold Standard, with its emphasis on discretionary goal setting, implicitly suggested that elected politicians should have the last word. Future historians will perhaps see this view of the role of central banks as having characterized only two or three of the twenty or so decades of their modern history, which began when convertible paper superseded coins as the main means of payment.

5. After a long period of neglect, payment systems have gradually returned to the centre of the stage. When advances in data processing and telecommunications brought a new revolution, we suddenly realized how much our monetary institutions, practices and even theory owed to the previous revolution. Until the eighties the term “payment system” was almost completely absent from central bank reports. Today, there are many who argue that monetary policy functions would not have developed in the way they did without the first revolution in payment technology.

The *raison d’être* for central bank involvement in payment systems is to avoid, or at any rate minimize, systemic risk, while fostering their efficiency through an appropriate blend of cooperation and competition in the industry. Is there also a policy, or even a political, dimension? Perhaps not. The issue of central bank independence would be a much less burning one if only payment system tasks were considered. And systemic risk itself could become much less important in the years to come with the shift from net to gross settlement that new technologies are making possible. It is possible that payment system issues will move to the back of the stage again once appropriate arrangements are in place to cope with the new technological environment.

6. Chronologically, if not logically, the task of supervising banks came after that of running the payment system and before the advent of fiat money and discretionary monetary policy. From a monetary angle, it was the consequence of the spread of deposit banking, which ultimately resulted in bank money accounting for the bulk of the money stock. Runs on deposits can be seen as collapses of confidence about the stability of the rate of exchange between a unit of central bank money and a unit of commercial bank money. Commercial banks had to have sound fundamentals if one-to-one convertibility was to be preserved hence, the need for bank supervision. In the short run interventions, i.e. lending of last resort, could be - and was - used to support the rate. But, as in the more familiar case of foreign exchange interventions, they were no substitute for sound policies; credit provided too easily and too generously could even generate the risk it was meant to avoid; today we call it moral hazard.

The ambivalent relationship between supervising banks and lending to them (surveillance and conditional lending, in IMF language) explains why there is no clear-cut answer to the question whether the central bank or a separate agency should be responsible for supervision. Seven of the twelve Basle Committee countries have a separate agency, as against about 10 per cent of countries in the world as a whole. More importantly, even where this solution has been adopted, the centrality of the banking system, and of its money creation prerogatives, in the monetary policy transmission mechanism means that no central bank disregards the “state of health” of its banks or completely rules out lending of last resort in extreme circumstances.

7. The other, perhaps more important, change concerns the context of central banking. This can be seen in terms of both time and space. I began my career in a world of annual accounts and quarterly or monthly statistics, in which paper was the medium and mail the carrier. For the bulk of financial transactions the two parties, the intermediary, the currency of denomination, the relevant laws and courts, and the central bank all belonged to the same jurisdiction. And that jurisdiction was not only economic, as it included the political jurisdiction from which public

institutions derive their legitimacy through the democratic process. This simple description never fully coincided with the state of the world, of course, but twenty-five years ago it was still a workable approximation. Today, that is no longer true. The advance of data processing and telecommunications technology has been the most powerful single driving force of this change. But the low cost of transportation, the evolution of economic ideas, the desire for closer and more peaceful relationships among nations have also been crucial.

8. The time dimension of our world has shifted from the long and medium waves of the year and the quarter to the short and micro waves of the day and the intra-day. The direct credit controls many of our countries still used ten or fifteen years ago called for compliance at the end of the month, as did most other prudential requirements. Payment finality at the close of the day, achieved through clearing and settlement in central bank money rather than correspondent banking, was considered sufficient. Monthly figures (not monthly averages of daily data) were judged adequate for the purpose of computing compulsory reserves. The exchange rate and other prices were "fixed" once a day.

The reality of the monetary and financial world is becoming that of the intra-day, the micro wave; we are moving towards a continuous-time economy. We do not yet have markets for "one-hour money", real-time accounting and reporting, and other similar devilries. But they will come. The Basle Committee has stated that "although regular reporting will in principle take place only at intervals (in most countries quarterly), banks are expected to manage the market risk in their trading book in such a way that the capital requirements are being met on a continuous basis. i.e., at the close of each business day". Naturally, cost considerations will set a limit to the process, but the effects will be - and to some extent already are - sufficient to upset many of the operational and regulatory instruments on which central bankers rely. Indeed, market players have so far been much more at their ease in the new microcosm than public authorities.

9. As regards the space dimension, markets have grown bigger than jurisdictions. A single transaction is now likely to involve a multiplicity of "nationalities" in terms of currencies, players, authorities and legal systems. We used to regard the "State" as the universal container providing the grounds and the rules for the game played by profit-driven players. Today, we sometimes have the impression that no one is responsible for maintaining the grounds or making the rules and even that central banks are the balls some round, some oval - being hit or kicked around in a free-for-all of baseball, golf, cricket, soccer, rugby and American football.

10. Even the most independent, best equipped and highly reputed national central banks are hard put to perform their triadic task effectively in the new conditions of time and space. The new context has been created by the market, evolves in response to market forces and basically meets the needs of private interests. It is a creature of the market much more than of public authorities.

Partly because of this evolution central banks and governments have become much more respectful of market forces, even humble. They are much more conscious that wealth and welfare are created primarily in and by the market. They know that this is a much more powerful beast than its would-be tamer. The effectiveness of both the instruments on which central bankers rely - banking operations and regulatory provisions - have been eroded by the innovation in market practices and the blurring of national frontiers.

To some extent this is healthy. Market players are not there to serve us, we are here to serve the economy. Yet, this downsizing of our role should not be carried too far. There is still a public interest to be promoted that private actions cannot be counted upon to serve. There are still grounds for being proud to serve the public interest and for claiming that central banks should have the means to achieve their ends. The fact that markets are powerful, global and fast-moving, while central bank operations and regulations are national, intrusive and burdensome, does not mean the monetary system can do without a central bank or a bank regulator.

11. Basle, the BIS, the meetings of the community of central bankers, from the Governors down to junior officials, are where our profession has strived, largely successfully, to maintain the upper hand over the reality that calls for its public function. The task is being performed notwithstanding the wide diversity of national laws, traditions, operational practices and institutional constraints.

I am a convinced institutionalist, because I believe that without a “Rule of Law” liberty and peace - the key prerequisites for economic activity - cannot survive for long. And my basic training, as well as much of my professional experience, have been in the European arena, which is a highly institutionalized cooperative system.

In international monetary cooperation Basle stands at the “soft” end of the spectrum - no legal basis, no written terms of reference, no extensive minutes. Mostly personal contacts and work based on the key words of banking and central banking: confidence, trust, credibility, confidentiality.

12. Although I started to attend BIS meetings well before this tower was constructed (in the old hotel building of the Centralbahnstrasse), it was only when you called me to the Basle Committee that I fully realized how strong this soft approach could be. Lawyers say that the Basle Committee “does not legally exist”. When I was appointed to its chair, my secretary had to take my word for it because she could not find any written evidence of the decision. Yet the Committee rules, once endorsed by you, are adopted by the markets, followed by national legislators and spread to all countries worldwide.

When considering the working methods of the Basle Committee, I have often thought that international cooperation among central banks can be compared to Italo Calvino’s “Nonexistent Knight”. When Charlemagne, reviewing his paladins before the battle against the Infidels, reached the last knight, Agilulf, clad entirely in white armour, the cavalier refused to show his face to the emperor. The explanation he gave was simple: “Sire, because I do not exist”. Charlemagne insisted and when the knight finally raised his visor, the helmet was empty. “Well, well! Who’d have thought it!” exclaimed Charlemagne. “And how do you do your job, then, if you don’t exist?”. “By will power and faith in our holy cause!” said Agilulf. He fought with valour and bravery. His special status assisted him in the accomplishment of his duty and indeed he proved to be one of the best paladins.