Ignazio Visco: Money and monetary institutions after the crisis

Opening remarks by Mr Ignazio Visco, Governor of the Bank of Italy, at the Conference on "Money and monetary institutions after the crisis", in memory of Curzio Giannini, Bank of Italy, Rome, 10 December 2013.

* * *

It is my pleasure to welcome you all here today at this conference on *Money and monetary institutions after the crisis*. Key aspects of the evolution of money and monetary institutions had been identified more than ten years ago by Curzio Giannini, a brilliant Banca d'Italia economist who was a dedicated scholar of central banking and died in July 2003 at the age of 45, in a book on *The age of central banks*.[1] This conference is held in his memory. In the final pages of his contribution he wrote:

> In the years to come, the most interesting developments will probably be precisely in the sphere of supervision and regulation. […] Whatever its detractors may say, the central bank has no need to move into new lines of business. Capitalism generated the central bank and capitalism will come to it again, even if the current infatuation with the financial markets' self-regulating capacity were to endure.

Indeed, the financial crisis has led to a generalized collapse in the confidence of such self-regulating capacity. Central banks have had to profoundly innovate their instruments of intervention by introducing liquidity-providing operations of unlimited quantity, unusually long maturity and at exceptionally low interest rates, also through currency swaps and with respect to non-bank counterparties; they also engaged in large purchases of public and private securities. The domestic and supranational institutional frameworks have been greatly modified. The crisis has prompted several relevant changes in the IMF lending framework in terms of additional financial resources, new financing facilities and cooperation with euro-area institutions; its surveillance is conducted within an enhanced legal framework and has become more attentive to international spillovers; ongoing governance reforms are further strengthening its legitimacy and effectiveness. In many jurisdictions central banks have been given stronger supervisory powers and new bodies in charge of macro-prudential supervision have been created. The most profound wave of institutional innovation took place in Europe, where the sovereign debt crisis generated a leap forward in the process of unification.

I am convinced that Curzio Giannini's analyses can facilitate the interpretation of the problems that we are facing today and can offer guidance to frame our discussions on the institutional evolution of central banking in rigorous terms. This is indeed one of the main reasons why we decided to organize this conference. One of Curzio's distinctive qualities was the ability to grasp the essence of the issues he dealt with, among which the complex relationship between the evolution of central banks as institutions and as economic, historical, social and political developments. This was the result of his passion for research, his intellectual brilliance, the multidisciplinary nature of his interests. During the years he worked at the Research Department of Banca d'Italia, he dealt with the reforms of Italy's monetary institutions in the 1980s and 1990s, European monetary integration, financial market regulation. He was involved in a number of initiatives concerning payment system issues, which helped him greatly to forge his ideas about central banking, and paid great attention to international relations, in particular to the role and functioning of the International Monetary Fund.

---

[1] C. Giannini, *L'età delle banche centrali*, Bologna, Il Mulino, 2004. English translation, *The age of central banks*, Edward Elgar, Cheltenham, UK, 2011, p. 255 and pp. 258–59.

Giannini's basic thesis is that central banks are the outcome of a gradual institutional evolution, the rationale of which resides in money's distinctive features compared with other goods and services. This evolution is not deterministic but path-dependent, correlated with the historical evolution of our political, social and economic systems. It depends largely on the fact that if money is to survive and perform its functions in economic transactions effectively in space and time, it must instil and maintain a sufficient degree of confidence in its acceptability and future value. The role and the powers of central banks – indeed their very existence – derive from the ultimate purpose of sustaining that confidence. Interestingly, Giannini is convinced that innovation in central banking is prompted more by deflationary than by inflationary pressures and by the need to cope with financial stability problems.

This approach allowed him to foresee key issues, strictly related to the themes that will be covered in the four sessions of this conference: the relation between price stability and financial stability and the interaction between monetary policy and macro- and micro-prudential policies; central bank independence and the changing relationship with government, in light of the recent massive expansion of central banks' balance sheets; the evolution of money and payment systems, and whether we are witnessing a new phase of changes in the forms and the use of money; supranational money management issues and the problems related to the international lender of last resort function.

For each of these themes, Giannini's works provide a great deal of evidence of his extraordinary foresight. For instance in the early 2000s he had already clearly anticipated the risk that too narrow a focus on price stability could deflect economists' and policymakers' attention from the importance of the banking system as the transmission belt of monetary policy. He was also aware of the difficulty in replicating typical central banking functions, such as lending of last resort, at an international level (e.g. the International Monetary Fund) and with respect to sovereign borrowers. Or that a monetary union also requires a banking union, and this in turn calls for a greater degree of political integration. Or that an area that was often neglected, that of an international framework for debt restructurings, would soon need to be addressed.

°°°

Today, discussing the role of central banks, their independence, and their relationships with other economic and financial authorities has again become an issue of the utmost importance. The idea that the central bank's role must encompass a plurality of functions related to one another, at the core of many of Curzio Giannini's analyses, has gained growing consent: not only in the field of monetary policy and the management of the payments system, but also for macro- and micro-prudential supervision. This coexistence of tasks has historically characterized the Bank of Italy, and since the onset of the crisis it is becoming more and more of a feature for many central banks worldwide.

Central banks conduct monetary policy to achieve the objective of price stability – in most cases their primary goal – which in turn fosters broader macroeconomic stability. But central banks also have responsibilities in the area of financial stability: this is indeed a key precondition for price stability. Following the crisis, greater attention is being devoted to the interactions and possible conflicts between policies addressed to maintain, respectively, price and financial stability. For example, in the current crisis, "unconventional" measures have been used to address dysfunctional liquidity markets and banks' reluctance to lend. In many cases, central banks had no choice but to move into unchartered waters, so as to limit the consequences of inadequate institutional or regulatory frameworks, imprudent behaviour in the private sector or national governments' flawed fiscal policies. Only institutional reforms and fiscal policy adjustments can avoid overburdening central banks with an excessive workload.

The sovereign debt crisis in the euro area is a clear example of a situation in which disentangling price and financial stability issues became virtually impossible, and in which the role of the central bank as a guardian of trust was crucial. The unconventional measures adopted by the Governing Council of the European Central Bank were actually aimed at countering distortions in financial markets and self-fulfilling debt runs which threatened the correct transmission of the Eurosystem monetary policy and, ultimately, its ability to pursue the primary objective of price stability.

The need for these measures arose, to a large extent, from fundamental weaknesses in the European institutional design and from delays or mistakes in the response to the crisis. The announcement of the involvement of private investors in the restructuring of the Greek debt in the summer of 2011 made financial markets fully aware of the implications of the prohibition to intervene to rescue member states under the Treaty on the Functioning of the European Union. This triggered a further worsening of sovereign risk assessments and led to a very serious crisis of confidence in the ability of the single currency to survive. The crisis became systemic; the yield spreads between the government bonds of the countries under stress and German bonds rose dramatically. On this, again, Curzio's foresight is most remarkable: ten years before the sovereign debt crisis he had identified several of the key features that have characterized the situation as it actually unfolded:[2]

> The inevitable complexities of political decision making create the possibility of a self-fulfilling debt run, while the fundamental information asymmetry between national authorities, on the one hand, and multilateral organizations and private creditors, on the other, works against the creation of a climate of trust once a crisis emerges, and might even stand in the way of mobilizing public support for the government's program.

The European institutional weaknesses were clearly reflected in financial markets' risk assessment. The sovereign spreads came to be determined by two factors, one national and one European, linked respectively to the flaws of certain countries' economies and public finances (sustainability risk), and to the incompleteness of European construction and the attendant fears of a break-up of the monetary union (redenomination risk). In July 2012 the yield differential between the 10-year Italian BTPs and the equivalent German Bunds was again just over 500 bps, compared with a value of about 200 bps estimated to be consistent with Italian and German economic fundamentals.

The response to the sovereign debt crisis has thus been two-pronged: individual countries have pledged to adopt prudent budgetary policies and structural reforms to support competitiveness; a far-reaching reform of EU economic governance has been undertaken, backed by political commitment to strengthen the Union. But the time needed to implement Europe's complex strategy to counter the economic crisis will necessarily be long. Distortions and fragmentation in financial markets can in the meantime undermine the transmission of monetary policy and jeopardize the entire process. This has led to the ECB stepping in with emergency unconventional measures, thus providing a "bridge".

The ECB Governing Council's decision to announce the Outright Monetary Transactions in the summer of 2012 was a response to these dangers. The announcement, an unmistakeable signal of the determination to preserve the euro, reversed the spiral of pessimism at a crucial juncture. By restoring confidence, it produced immediate benefits: as a result of a sharp reduction in the redenomination risks, medium and long-term yields in the countries under pressure decreased and the fragmentation of markets along national borders was attenuated. In the presence of a credible and firm action to restore market confidence, there is no need to actually use the new instrument. But the complete elimination of the redenomination risk can only be achieved if sustained progress is made in the euro-area's economic fundamentals and in the process towards a fully fledged European Union. Discussion on budgetary and political union must be followed by concrete action.

---

2 Curzio Giannini, *Pitfalls in international crisis lending*, in Charles Goodhart and Gerhard Illing (eds.), *Financial crises, contagion and the lender of last resort: A reader*, Oxford University Press, 2002, p. 521.

The recourse to unconventional measures by major central banks and the expansion of their balance sheets have been justified by the severity of the crisis. Central banks' unprecedented activism has raised new issues, giving rise to a debate that not only encompasses technical aspects, notably how to exit these measures and normalize monetary policy, but at times touches upon key institutional aspects such as independence of central banks. For example, it has been argued that central bank independence in the pursuit of price stability may be incompatible with an active use of unconventional measures in response to the financial and sovereign debt crisis. It is also feared that an active use of central banks' balance sheets would blur the boundaries between monetary and fiscal policies. The new challenges to central bank independence arise as a consequence of prolonged monetary policy accommodation: at the current juncture central banks could be unduly constrained in their choices about the timing and pace of policy normalization by pressure arising both from financial markets that have become overly dependent on their support and from unrealistic expectations about what central banks can deliver. On these issues, the jury is still out.

More in general, the crisis has raised the question of whether central banks should revise their objectives or strategies. In my view there is no need to question the current objectives of monetary policy; in the case of the Eurosystem, that of preserving (medium term) price stability. I do not believe that there is a particular need for financial stability to become an explicit objective of monetary policy on a par with price stability. Indeed, the benefits of our monetary framework have become more, not less, evident during the crisis, with inflation expectations remaining well-anchored throughout. Also, assigning financial stability as an explicit additional objective to monetary policy could risk blurring responsibilities and creating potential conflicts. However, I believe that there is no question that preserving financial stability is a crucial albeit not exclusive responsibility of central banks. Indeed, the crisis has not put into question the idea that over longer horizons there is no trade-off between price stability and financial stability objectives – rather, there are synergies.

°°°

The crisis has thus rekindled the long-standing debate on whether central banks should act pre-emptively against signs of financial instability that can morph into systemic risks. A broad consensus has indeed emerged on the idea that macro-prudential policies should be adopted to limit these risks. These policies would address both the cross-sectional dimension of the financial system, with the aim of strengthening its resilience to adverse real or financial shocks, and its temporal dimension, to contain the accumulation of risk over the business or financial cycle. Furthermore, countercyclical macro-prudential policies moderating the financial cycle would support monetary policy in the stabilisation of the economy and, by adding a systemic perspective, they would complement micro-prudential policies directed at preserving the stability of individual financial intermediaries.

However, a potential for conflicts, or what economists usually refer to as tradeoffs, may arise between monetary, macro- and micro-prudential policies. It could, for instance, materialise during downturns, when the macro-prudential regulator may want to release equity buffers in order to avoid a credit crunch, whereas the micro-prudential regulator may be reluctant to let that happen owing to the need to preserve the safety and soundness of individual institutions.

Different institutional settings can be envisaged to solve these conflicts. Some have argued that the best way would be to allocate different policies to different authorities. However, given the strict complementarities between monetary, macro- and micro-prudential policies, a view is emerging – which I share – that central banks are best positioned to offer effective solutions. Conversely, there is broad agreement that resolution mechanisms to resolve financial intermediaries must be located outside central banks, most notably because resolution decisions may involve the use of public money. Even if it would be appropriate for resolution and supervision to be separated, close cooperation and information sharing should be obviously in place, not the least to better identify proper forms of recovery, as in several cases the issue is not just one of outright bank liquidation. In any event, the broadening of central banks' tasks requires that their independence in the pursuing of financial stability is ensured to the same extent as for the conduct of monetary policy.

All this is particularly clear in a currency union, where distinctive challenges come from the involvement of a plurality of institutions. In the euro area, price stability is an area-wide objective targeted by the Eurosystem's single monetary policy. However, financial imbalances can take on a country-specific dimension, so that macro-and micro-prudential policies can be adopted by national authorities. Tradeoffs may arise and therefore there is a need for the coordination of national policies when financial instability gives rise to area-wide (systemic) risks. The recognition and understanding of these interactions and tradeoffs help in driving decisions about the institutional setting for policy-making.

The Regulation establishing the Single Supervisory Mechanism, also involving the National Competent Authorities, assigns to the ECB not only micro-prudential tasks but also specific roles for macro-prudential policy, notably the implementation of macro-prudential measures set out in EU legislation. The ECB thus provides a concrete case of an institutional setting aimed at best exploiting the complementarities between monetary, macro-prudential and micro-prudential policies while addressing possible interactions and tradeoffs; at the same time care will be taken to ensure a clear functional and operational separation of these policies within the institution and the system. The setting should also ensure the much-needed euro area-wide coordination in the application of these policies, so as to adequately address potential spill-over effects.

°°°

In the euro area the institutional changes resulting from the crisis are exerting a major impact on both the ECB and the national central banks, whose scope is no less important than the one arising from the introduction of the euro. Regardless of the specific innovations in their institutional settings, operations and tools, ultimately the main task of central banks is to produce trust. This consideration comes from the heart of Curzio Giannini's work, the final sentences of which are indeed very telling:

> The central bank produces an intangible but essential good – trust – of which capitalism (based as it is on a pyramid of paper if not mere electronic signals) has an immense need. We must not forget that trust, or its synonym "confidence", derives from the Latin *fides*, meaning faith, which cannot be produced simply by contract. In fact the legitimacy of central banks does not lie in their policy activism, or the ability to generate income, or even, save in a highly indirect sense, their efficiency. Rather, […] it derives from competence, moderation, the long-term approach, and the refusal to take any tasks beyond their primary role. If, as I am sure, there is another phase in the development of central banking, it will spring from these values.