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Dinner Speech by

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It’s a pleasure to be here with you tonight, in my native town - Florence - and would like to thank Jefferies for this invitation.

This is supposed to be – according to the title - a central bank conference, so I thus would like to talk tonight mainly about monetary policy and the challenge for central banks in this very special period we are living in.

If you ask me - straight away - what is, and what has been, the biggest challenge for central banks during the crisis, I would no doubt answer that it is the dealing with a very special type of risk – which is difficult to measure, difficult to forecast, difficult to assess but inevitably affects us – i.e. political risk.

By political risk I mean the uncertainty which surrounds the actions of the political authorities, which relates not only to the contents of the decisions and their timing but also their effective implementation.

Central banks do not act in a vacuum. There are other players – millions of players – which influence the way in which the measures decided by the central bank affects the environment. One player is particularly important, especially when it introduces additional uncertainty into the system: the Government.

This is particularly relevant in the European context, because there are 17 Governments, which meet in the context of the Eurogroup for Finance ministers, or of the European council for the Heads of State or Government.

But it’s not an issue for Europeans only. Think about the Federal reserve having to deal with the uncertainties surrounding the political decision-making process in the fiscal sphere. Think about the political environment which surrounds the decision of the Swiss national bank to peg its currency to the Swiss Franc.

Political risk has become particularly important during this crisis, especially in Europe, because some of the solutions to the crisis require changes to the institutional set up or special measures which can be adopted only by the political authorities.

In Europe, in particular, some of the measures which are needed to overcome the crisis, which require the pooling of sovereignty – think about the establishment of the EFSF or the move to a banking union - cannot be decided by a federal institution which already exists, but by the 17 or 27 member states which have to agree to such a measure, through their own procedures which involve the respective Governments, Parliaments and sometimes Constitutional courts.

Central banks have to deal with the political risk. This has been one of the most difficult issue during my term at the ECB.

I will elaborate on this issue tonight.

There are two main ways to deal with political risk.

The first one is to consider it exogenous. In this case the central bank can try to make an assessment about such a risk, attributing probabilities to an event rather than another one, and taking decisions on the basis of its best judgment.

This is the traditional (Anglo-Saxon) approach, applied for instance to the way in which forecasts about fiscal policy are incorporated in the macroeconomic projections of the central bank. These projections are then used as a basis for the decision making. In such a system the central bank does not enter the field of fiscal policy, nor engages in debates or discussions with the political authorities to try to influence the fiscal outcome. Fiscal policy, and any risk surrounding it is taken as being entirely exogenous by the central bank.

This system has certain advantages.

It may in particular avoid that the central bank enters into discussions with the government or other political authorities on issues which are not within its primary responsibility. This allows it in turn to better protect its own responsibilities, concerning monetary policy. Politicians tend to resent when central banks express opinions on fiscal issues without being able to reciprocate as any discussion about monetary policy is considered to be an undue interference and a breach of independence.

Central banks may better preserve their independence if they stick to their own mandate and do not step into the shoes of other policy makers.

This approach is certainly preferable when fiscal policy is implemented within a clear set-up and a predictable medium term framework. At times of crisis however, when monetary and fiscal policy tend to complement each other, it becomes more difficult to consider the latter as being totally exogenous.

One issue to take into account is that the interaction between monetary and fiscal policy is not a one-off event but a repeated game, in which the two actors take each other's decision, and potential decisions, into account when setting up their own policies. In such a context, fiscal policy cannot be considered as being entirely exogenous by the central bank if the fiscal authorities take their own decisions on the basis of what the central bank will do. In other words, if the fiscal authorities take decisions on the basis of what the central bank will do, the central bank has to incorporate this reaction function in its own decision making process. If the central bank does not behave accordingly, the fiscal authorities may act in a time inconsistent manner. The outcome may turn out to be suboptimal.

We can find examples of this perverse behavior on both sides of the Atlantic.

In the US, the Federal reserve's unconditional commitment to do "whatever it takes" to bring the unemployment rate down, independently of what the fiscal authorities intend to do, might actually reduce the incentive of the Administration and Congress to agree on a credible fiscal adjustment path. The issue is relevant because, as most analysts would concur, the biggest obstacle to a stronger recovery in the US, in particular with respect to business investment, is represented by the uncertainties surrounding the fiscal situation over the next few years, in particular with respect to how the fiscal cliff will be resolved. This effect may actually outweigh any beneficial impact that further doses of monetary easing can provide on the economy.

The question that needs to be asked is whether a different combination of fiscal and monetary policies, conditional one on the other may obtain a better outcome than the current one. The next question is how to achieve this result within the prevailing institutional context. In other words, can the central bank enter into a dialogue with the fiscal authorities and, without losing independence, can it aim at achieving a better combination of policies and a better outcome.

We can find examples of perverse incentives also in the euro area. For instance, at the end of 2012 the decision to implement two 3year LTRO at fixed rate full allotment has substantially improved the liquidity conditions of banks. At the same time it may have created the incentive for national supervisors to delay or minimize the recapitalization process for ailing banks. This is clear in particular in Spain where the amount of additional capital required was underestimated and too long a time was given to banks to obtain the funding. Market confidence was undermined and the credibility of the LTRO vanished.

So how can a central bank deal with the risk that the inability of the political authorities to follow up on their decisions actually jeopardize also the effectiveness of the monetary policy itself?

The issue is not simple at all because policy authorities may not only delay their decisions but also renege their own decisions.

I would like to comment on what happened over the summer, from the end-June European Council to the 6 September decision by the ECB, and what followed thereafter, to assess the complexities of the interaction between monetary and fiscal policy in the euro area going forward.

Before doing that let me recapitulate a few precedents of such an interaction, which related in particular to the decisions of the ECB to intervene in the Government bonds market. These past episodes will help understand what was decided, and why, and the potential problems over the next few months.

I will consider two main episodes.

The first is the decision of 10 May 2010 to start the SMP.

As some of you may remember, markets where experiencing extreme volatility after the first Greek package. The main reason was that the way in which the package was designed, after months of negotiations and hesitations, was too complex to be repeated to other potential applicants. A more structured solution was required. However, this would require time. In the face of the increasing tensions, only the action of the central bank would be capable of restoring stability. Pressures were mounting for the ECB to act.

However, the ECB knew that if it acted, in particular by stabilizing the Government bonds markets of the countries under pressure, the 17 Governments would have very little incentive to speed up the process for establishing a more permanent safety net, capable of deciding speedily an adjustment program in favor of a country under pressure. Had the ECB decided, in the first week of May 2010, to intervene by purchasing Government bonds of Greece, Ireland and Portugal, it would have become "the only game in town", and would have remained so for a long time. This would have delayed adjustment and led de facto the central bank to finance ailing Governments.

This is the reason why on 6 May 2010, at the Press conference in Lisbon, where the ECB Governing Council was meeting, President Trichet answered to the question of whether the ECB was going to intervene in the markets, that we had not discussed it.

Markets reacted very negatively. In fact the ECB was considering the possibility to act, but only to provide a bridge for the fiscal authorities of the 17 euro member states to create a permanent safety net. This was clearly communicated to the Heads of Government of the 17 states, which ultimately blinked and charged their finance ministers to meet over the week end to agree on such a safety net, the EFSF. Only after the creation of the EFSF was announced, early in the morning of 10 May, the ECB announced the SMP and started to intervene.

With the benefit of hindsight, the decision of the ECB to wait for the action of the politicians was risky but well-founded. The euro area is more protected with the EFS than with the ECB alone, which could not have provided unlimited financing to the weakening countries.

The problems unfortunately did not end with the announcement of the decision to create the EFSF.

The ratification process of the EFSF took a very long time, and markets started doubting the will of some countries. The existence of the EFSF did not encourage the countries experiencing difficulties, like Ireland and Portugal, to request assistance and the adjustment process was delayed. Last but not least, the discussion on the permanent version of the EFSF, the ESM, introduced the concept of Private sector involvement, with automatic debt restructuring clauses which scared financial markets and frustrated most of the actions conducted by the ECB.

The ECB had ultimately to phase out the SMP as its effectiveness was being undermined by the excessive political risk which was affecting the integrity of the euro area.

The second precedent that I would like to mention is the decision of 7 August 2011 to reactivate the SMP to purchase Italian and Spanish Government bonds.

The previous experience had thought that even when the safety net is available, under the form of the EFSF, the incentive for countries to apply to it is reduced. The renewed tensions in the euro area, after the Greek debt restructuring achieved in June 2011, had pushed Italian and Spanish bond yield to levels close to being unsustainable. Unless some action was undertaken, the situation could rapidly turn into a self-fulfilling crisis.

The crisis seemed clearly one of contagion. Application for a program to the EFSF by the two countries was considered potentially risky, in light of the reaction which had occurred after Ireland and Portugal had applied, with huge increase in spreads. Furthermore, the amounts available in the EFSF were probably not sufficient to take the two countries out of the market for a sufficiently long period of time.

However, an intervention with no conditionality attached would probably reduce the pressure on the two countries to continue the adjustment.

The decision was made by the ECB to enter into direct dialogue with the two countries, asking them to adopt specific measures. The two countries agreed and the ECB decided to intervene in the secondary markets, thus reactivating the SMP.

The initial result was quite strong, as spreads came down substantially. However, as soon as the markets improved, the pressure on the countries to stick to their commitments eased. The Italian Government even started to re-discuss some of the measures, creating uncertainty in the markets.

Spreads started to rise again, undermining the effectiveness of the SMP. The credibility of the ECB's action was seriously undermined.

The lesson from this episode is that the ECB cannot enter into a bilateral relationship with the member states aimed at establishing the conditions for its interventions, and avoid that they turn out providing an explicit subsidy to the Government. The ECB does not have a sufficiently binding contractual relationship it can offer to the member states as pre-condition for its actions. The cost for Governments of reneging or delaying action is smaller than the reputational cost for the central bank.

Let's come to the latest episode.

In June 2012 the European Council agreed that it needed to ring-fence the euro area against possible catastrophic events, such as the unforeseen exit of one of its members. Increasing the size of the ESM was difficult in the current circumstances, as it would have increased the burden on the sounder countries and thus weaken their rating. A banking license was considered not in line with the statutory prohibition to finance Governments. Resort to central bank support, against conditionality was then the only possible way forward, together with other measures aimed at strengthening the institutional framework underlying the euro, such as the banking union.

Markets tested the understanding of the decisions taken. This was clarified when the ECB spelled out the conditions in order to implement "whatever it takes" to avoid a collapse of the euro.

On the basis of the previous two experiences, the OMT could only be decided conditional on the countries having implemented an adjustment program, according to the various options available. This was necessary in order to outsource the negotiation and monitoring of the program to other institutions. The ECB did not want any more to be the arbiter of the situation and decide which countries should benefit from its interventions.

In other words, the ECB has left it to the political authorities to decide whether countries abide to the conditions for eliminating the "convertibility risk", by setting the requirement that the countries needing support have to adopt a program.

Has this decision solved all problems?

The answer is no, unfortunately. Several risks remain.

The first risk is that countries delay the request for support, because of the political stigma attached to the request of a program. This may lead countries to ask for the request under the pressure of the markets, when spreads have risen again. This creates the worse of all environments for the ECB's intervention to operate.

The second risk is that the implementation of the program is not smooth and may at some time derail. This may raise a series of issues. The first is whether the Eurogroup will have sufficient strength to constrain the deviating country to get back on track. The second is whether the ECB should continue to support the country, even if it became evident that the country was off track although the Eurogroup was not fully recognizing it. In other words, does the ECB have an exit strategy in case of underperformance?

The third risk is that in spite of the interventions the convergence of the underlying fundamentals, in particular competitiveness takes more time, requiring further financing.

The fourth risk is that the process of European integration slows down, failing to provide the underpinning for the ECB's action. For instance, the discussions on the banking union seem to have become more complicated than expected and there are several uncertainties concerning the timing, scope and effectiveness of the new regulatory regime.

The fifth risk is that in the face of all the previous risk, some fatigue may arise in the ECB to implement a policy which entails certain risks, in particular to the balance sheet. If the cohesion within the ECB was externally perceived to weaken, speculations about possible limits to the ECB's willingness to implement the policy in an unlimited way would be disruptive.

In my view these risks, which are more of a political nature, are much more relevant than other practical risks entailed with the OMT which have been mentioned recently.

The risk of exiting too late, or to incur losses, is in my view rather contained, in light of the experience that the ECB has acquired over the last couple of years. Dealing with political risk is instead more complex, not only for the ECB but for the markets at large.

Thank you for your attention.