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Discussing the Financial Crisis

*Interview with Massimo Giannini, La Repubblica,
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1. *Some compare it to the Great Depression of '29, others talk about a crisis unlike any other in history. What type of crisis are we experiencing? Is it a cyclical crisis (perhaps sharper and more unusual than the others, but still temporary), or is it a structural crisis (which will completely change the global financial system?)*

This is not a cyclical crisis even though all crises pass eventually. However, the question we should ask is a different one: after the crisis will the world be the same, as was the case after the '82, '87, '94 and '98 crises? The answer is no. This time, the 'before' and the 'after' will not be the same. This crisis marks a structural change. It is a change that concerns economic ideology, the US growth model, financial methods and practices, attitudes of the authorities, balance between economic and political power, relationships between large geographical areas and the role of politics.

2. *Is this really what Tom Wolfe called the Bonfire of Vanities? In other words: is this really the end of capitalism as we knew it, and as such the end of an era, which Minister Tremonti would call "mercatismo" (literally: market-ism)?*

I would use the market economy concept rather than the ambiguous word capitalism. And I think we are not witnessing the fall of the market economy in a way that could be compared to the fall of the centrally planned economy which marked the end of the Soviet system. What we observe now are the consequences of an ideology and an economic policy which believed in a market without rules. Like the democratic system in the field of politics, the market system is a device that enables to *rectify* mistakes, it is not a device that *prevents* the mistakes. Both systems are effective only if they follow strict rules because they cannot exert self-control. Both systems contain the germ of self-destruction, but if they produce enough anti-bodies they are able not only to rectify isolated mistakes (e.g. an incorrect investment, an unfit ruler) and even to reorganize as a system. The crisis here was due to the infringement of elementary rules of caution and correctness, which the public supervisory system failed to enforce.

3. *Can all of this be linked to the dangers of globalisation announced by Ulrich Beck (sooner or later we will have to pay the globalisation's bill)?*

When we come unprepared to the rendezvous it has set for us, history inflicts us lessons. Here, we are not being penalised for having allowed globalisation, we are being penalised for having managed it too weakly. Globalisation was not something that could be rejected: it is the direct result of technology and of human impulses that cannot be removed – they can only be governed. India and China cannot be blamed for pursuing their desire to come out of poverty.

4. *"Save the people, don't save the banks", we hear from the American demonstrators who are trying to protect their savings. Is it true that so far, both in the US and in Europe all the attention was devoted to the market's interests rather than to the people's interests?*

The American demonstrators are correct only in part. They should talk about not saving the bank 'managers' and the bank 'shareholders'. Not saving the banks would actually punish the people: small savers, workers, families who have a mortgage etc.

5. *The US authorities have been accused of 'doping' the economy in the last decades. According to some we are paying the Greenspan put. What do you think?*

We did not need this crisis to see the dangers of overabundant liquidity which for many years have characterised the world's economies, and especially the US. Too much money was once believed to result, sooner or later, in inflation of consumer prices. However, for 15-20 years prices of consumer goods were kept at bay by wage moderation and also by the injection of goods produced in Asia, where the workforce is both specialised and low-paid. This is why the warning bell of inflation failed to ring. In the meantime, overflowing liquidity was being invested in capital goods, boosting their prices much over their real value: securities in developing countries, high tech shares, real estate. These were market bubbles, but they were perceived as increases of real wealth.

6. You became the chairman of the Foundation that sets International Accounting Standards when Paul Volcker stepped down from this position. Do you think that the 'mark to market' rule, which dictates that balance sheet assets should be valued at market prices is responsible for the bubble? Would it be better to change the rule?

Changing the rule in the middle of the crisis would be a mistake because it would increase pessimism and mistrust in a market that is already too scared. However, in due time, a re-examination of the issue and a few rectifications will be advisable. This is so because undeniably the crisis stems from the inability of the market to make, day by day, 'fair' evaluations.

7. *The US is also being criticised for the origin and the management of this crisis. Regarding the origin: was the supervisory system over investment banks, derivatives, the so-called "toxic titles" too lax? Regarding the management: was saving Freddie & Fannie and letting Lehman Brothers go bankrupt the right thing to do?*

Regarding the management of the crisis it is difficult to judge when you are not in the surgery room; moreover, the surgery is not over yet. Regarding the origin of the crisis, however, there were other factors in addition to the overabundant liquidity: the excessive trust in the self-regulatory ability of the market, and the attitude of the authorities, too reluctant to displease banks and businesses. Supervisory authorities should be independent not only from politics, but also from market participants. In broader terms, the crisis stems from the short-sightedness, the so-called 'short-termism' that unfortunately characterised not only market participants, but also public authorities. One of the key tasks of economic policy is to be more far sighted than private agents.

8. *What do you think about Paulson's rescue Plan and about the Congress vote?*

An emergency intervention was essential. Paulson's Plan had some shortcomings which have been largely corrected during Congress discussion. Not intervening would have been irresponsible.

9. *In your opinion is the US banking and insurance system hiding further developments?*

No one is in a position to know, and there is a reason for it. We might say that we moved from a 'bubble' to a 'black hole', which is a sort of 'negative bubble': we moved from a phase when the market was creating fake values to a phase where it is destroying real values. In a market where there are no rules, no financial institution could bear a downward pressure as strong as the one which is currently possible in the financial world. In some cases also extraordinary State interventions are appropriate.

10. *In this scenery of what Trichet called "absolute unpredictability", some fear the fall of the US dollar, which would produce even worse effects for the economy. In your opinion is this a true danger?*

I don't know. But I know that the foreign exchange market moves in long-lasting and far-reaching cycles of undervaluation and overvaluation of the 'real' values. And the strength it has acquired, even in our mindset, is disproportionate to its wisdom. True, in the long term the market corrects its mistakes; but in the short and medium term (which may last years) it lives from its mistakes. The world economy may be seriously damaged by this. Indeed, we have to remember that the world economy has always had an objective and almost universal monetary standard, and that the more

it integrates the more it needs such a standard. The dollar has continued to be the global currency even after, having disconnected itself from gold, it freed itself from any commitment vis-à-vis the world. I don't think that in today's global economy, where the big players are more than one (US, Europe, China, India, etc.) the currency of one country, governed only by national needs, can be the currency of all.

11. *Regarding Europe, what are the risks? What are the differences between Europe and the US?*

The world's economy, especially finance, is a single system; nobody is sheltered. Europe has some advantages over the US: households do save and are less indebted; the business of *investment banking* is done by institutions that operate and are supervised as banks; the attitude towards the market, albeit positive, is less prone to ideological excesses. Against these advantages, however, there are the drawbacks of a still fragmented supervisory system and the limited capacity to act in case of a crisis.

12. *You were the first to warn Ecofin that a harmonisation of banking supervision criteria was necessary on a European scale. At the time your proposal did not receive the support it deserved. Do you think that the harmonisation has become urgent now, in view of the fact that the central banks of the member states still operate using different criteria and without cross-communication?*

If after a crisis of a major European bank an independent ex-post inquiry was made of how the supervision mechanisms worked in the Euro zone, the verdict on the behaviour of the authorities would be quite severe. The European directives are the same for all member state, but in practice they have produced widely different rules in different countries, which means that a multinational banking group (such as Deutsche Bank, BNP-Paribas or Unicredito) is unable to operate under the same rules everywhere. Also, the information on these groups is not shared between national authorities: each retains the information regarding its own country. We like to say that the banks of a currency zone constitute a system and talk about 'systemic' risk. Yet, in Europe 'system supervision' either does not exist, or travels with its headlights turned off.

13. *What do you think of a European intervention fund?*

As there is occasionally a need for a *lender of last resort*, so a *shareholder of last resort* may become temporarily necessary when in the market a collapse of confidence risks transforming the economy into a black hole. The 'last resort' is public by definition and uses public money coming from taxpayers. But this money is not thrown out of the window: it is invested well and temporarily, until trust is rebuilt. The essential point, here, one which has not been accepted yet, is that in this case the public entity in question should be Europe, or failing this it should be the Euro zone, or failing this, it should be at least a group of countries that understand the high risks of managing the crisis at the national level, an approach which would be almost inevitably of a conflictual nature.

14. *What should be the role of ECB in this scenario? Would it not be better to modify the Maastricht Treaty so that ECB could also be supervising banks in addition to conducting monetary policy? What are the obstacles? Political resistance? If so, according to your experience as a Finance minister, which countries are resisting?*

The political resistance comes from the supervisory authorities, a resistance which only the Ministers would be in a position to overcome, if they acted firmly. The ECB should be the natural supervisory body for Europe, but unfortunately on this issue central bank governors sitting in the ECB Governing Council think 'national', not 'European'. Changing the Treaty would take years, while it is necessary to act now. Yet, even with the current Treaty, immediate action would be possible, if there was the will.

15. *Do you agree with the criticism made to the ECB inflexible approach to interest rates? Why no positive sign was given to the markets last week?*

I do not know how I would have voted on October 2 had I been still part of the ECB Executive Board. But I do know that the ECB cannot give ground to any doubt about its commitment to price stability.

16. *Regarding Italy, what are the risks? Are there banks that could suffer real consequences from the crisis? What will be the impact of the credit crunch and the financial crisis on our real economy?*

Italy has a more robust system because, unlike other countries, it followed a cautious traditional approach and went into the adventure of ultra-modern finance less than many others.

17. *Being a small marginal country has always been considered one of Italy's shortcomings. Given the circumstances, could it become an advantage because Italy would be more protected against a global tsunami?*

If the European economy slows down, it will be impossible for Italy to be isolated from the consequences. For years Italy has been the least dynamic European economy, but we can and must change this situation despite the circumstances around us.

18. *Another worrying aspect for Italy is the dramatic change in the ratio between Italian government bonds (Btps) and the German bonds (Bund) – which means that the public deficit is increasing very quickly one more time. Do you see an "Italian risk" for public finances?*

In Italy we should never forget our enormous public debt. If we prove our determination to decrease it, we have nothing to fear.

19. *There is a debate on the role of politics regarding the global crisis and the public interventions that it has made necessary. The State is no longer the 'problem', and in many cases it becomes the 'solution'. Is this the time to go back to Keynes's theories, after years of liberism?*

During the 70's we have witnessed the pendulum of keynesian policies swing to absurd extremes, which generated inflation and public debt. Now we are witnessing the extremes of Thatcher-Reagan's revolutions started thirty years ago: too much liberalism produces statalism. The economy should be the field of pragmatism, not of ideology. The state and politics have a fundamental role to play, which cannot be surrogated: the fact that they can make mistakes does not make them useless; even private entities make mistakes, as we have seen.

20. *Is this a danger for the future of free trade, which enabled the largest development in the century?*

This is indeed the time to defend the market from those who try to demonise it. But economic policy should not be the slave of the market. The market is not a value or an idol to be honoured with sacrifices; it is a useful tool if it is governed and used correctly.

21. *You and many other forefathers of the Maastricht Treaty have warned us that when the economy flourishes and politics does not follow it, the legitimacy of the ruling class may be undermined to the point that politicians are wiped out by the people. Is this what is happening in the US and in Europe?*

In the early days of the Euro, I pointed my finger on the dangers of a 'currency without a State'. Clearly we needed more European state, rather than less European currency: without the Euro Europe would be living catastrophic days now. One of the reasons why national politicians suffer a loss of credibility lies in the fact that they keep deluding ourselves that individual national governments can separately solve problems (energy, climate, finance, security, immigration, resources) which are not national, but continental and global.