



LSE public lecture

Banking on the Future: The Fall and Rise of Central Banking

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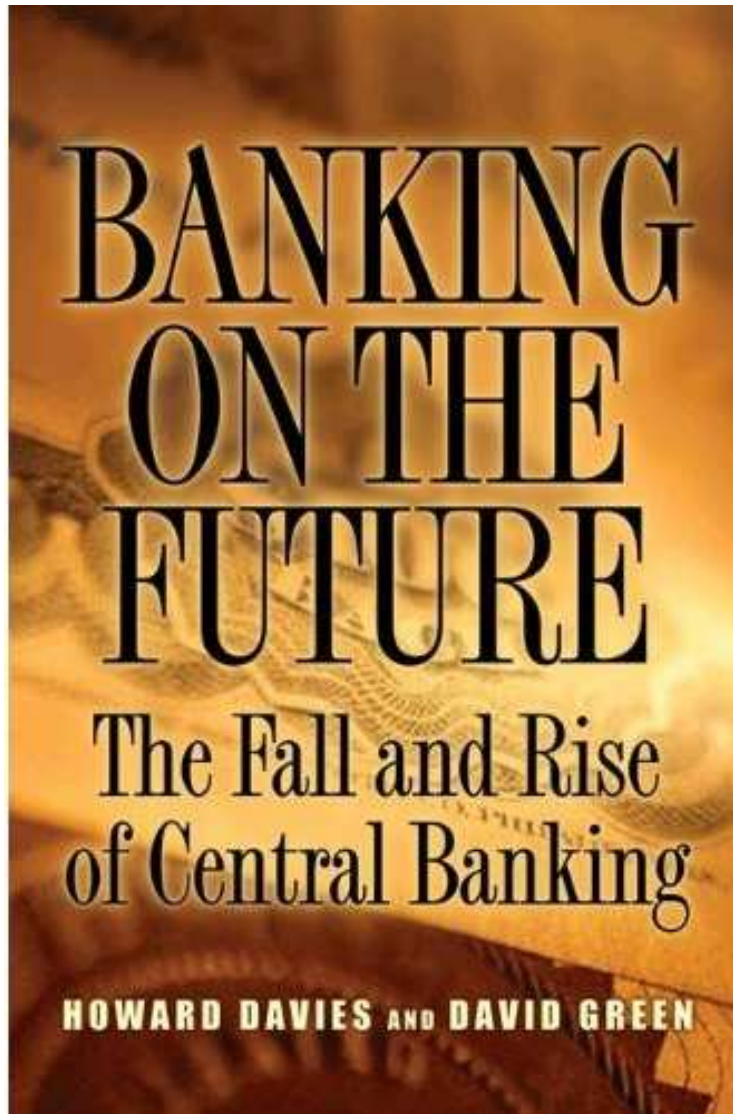
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Central Banking in Europe: Unfinished Business

LSE

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Creation of monetary union is the most ambitious central banking project ever



Recent events have exposed in stark form many of the key issues in central banking today

- Whether inflation is more important than stability of the financial system
- Whether monetary policy can be conducted independently of fiscal policy
- What role a central bank should have in supervision

How did we get here?

**Why did something have to
give?**

Where are we now?

What does it mean?

Many minor institutional details resolved, though at the cost of major inefficiencies



In a monetary union of sovereign states

- Which responsibilities should be merged and which not
- What should be identical across jurisdictions and what not
- How much power should be at the centre and how much with national central banks

The big issues never addressed (1)



Some of the key decision-makers never understood them

- Political motives and superficial economic attractions paramount
- Marriage without option of divorce believed to minimize risk of armed or commercial conflict
- Not understood that there would be a single interest rate

The big issues never addressed (2)



- Not understood that a government could run out of cash without its own central bank to print it or reduce its debt burden though the option of devaluation
- Not believed that fiscal discipline was a necessary, not just a desirable requirement for euro area members

Now the fault lines have split open



“EMU is unfinished business”

Commissioner Almunia, October 2008

Always known that with a single interest rate and no option to change the exchange rate real competitiveness was critical



For a decade

- Single interest rate meant that credit could expand extravagantly at a national level
- Risks masked by the global Great Moderation AND by cross-border funding of deficits

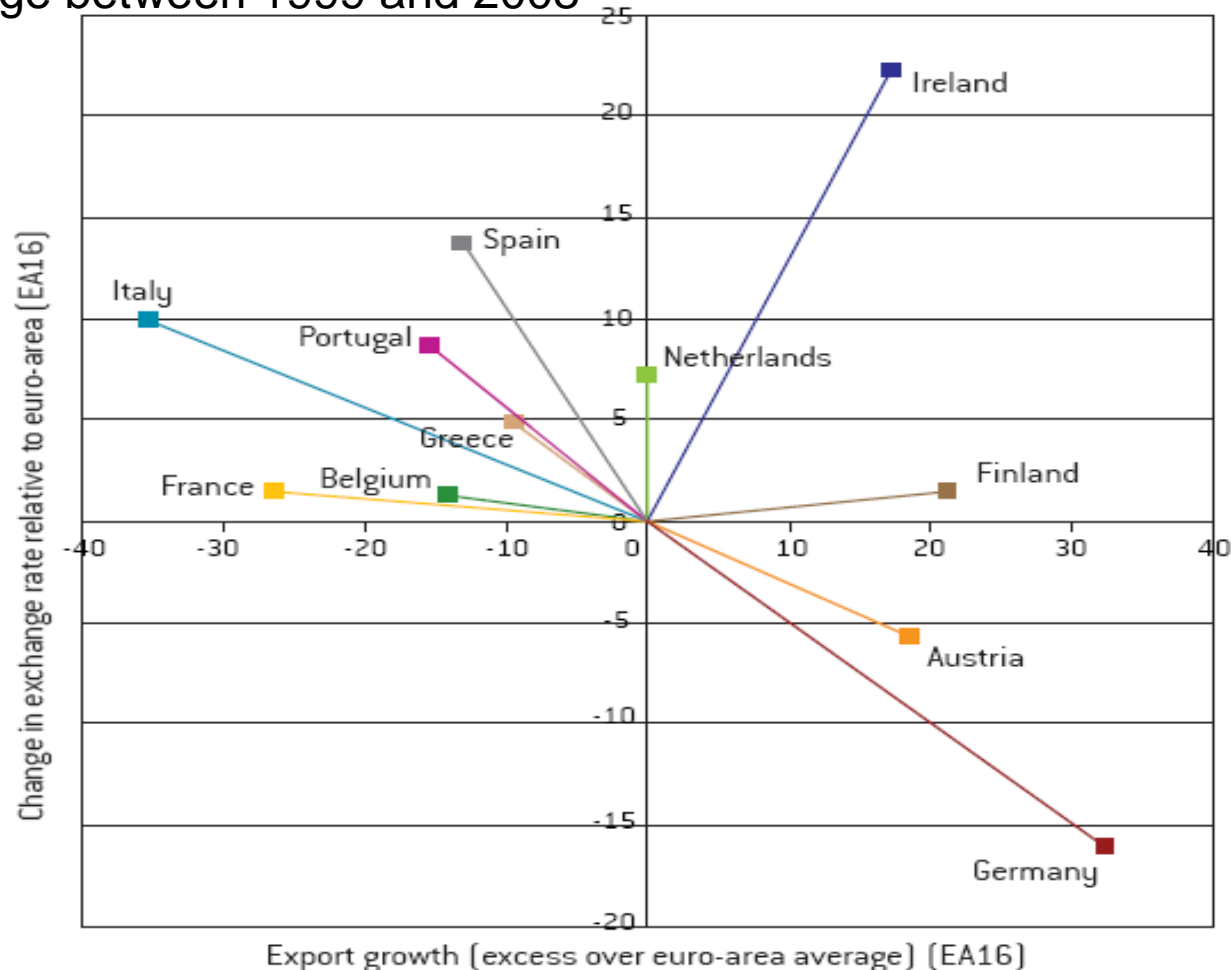
And then

- Mervyn King's NICE decade – non-inflationary and consistently expansionary – came to an end
- Lending halted abruptly by prospect of sovereign insolvency

There has been a remarkable divergence in competitiveness

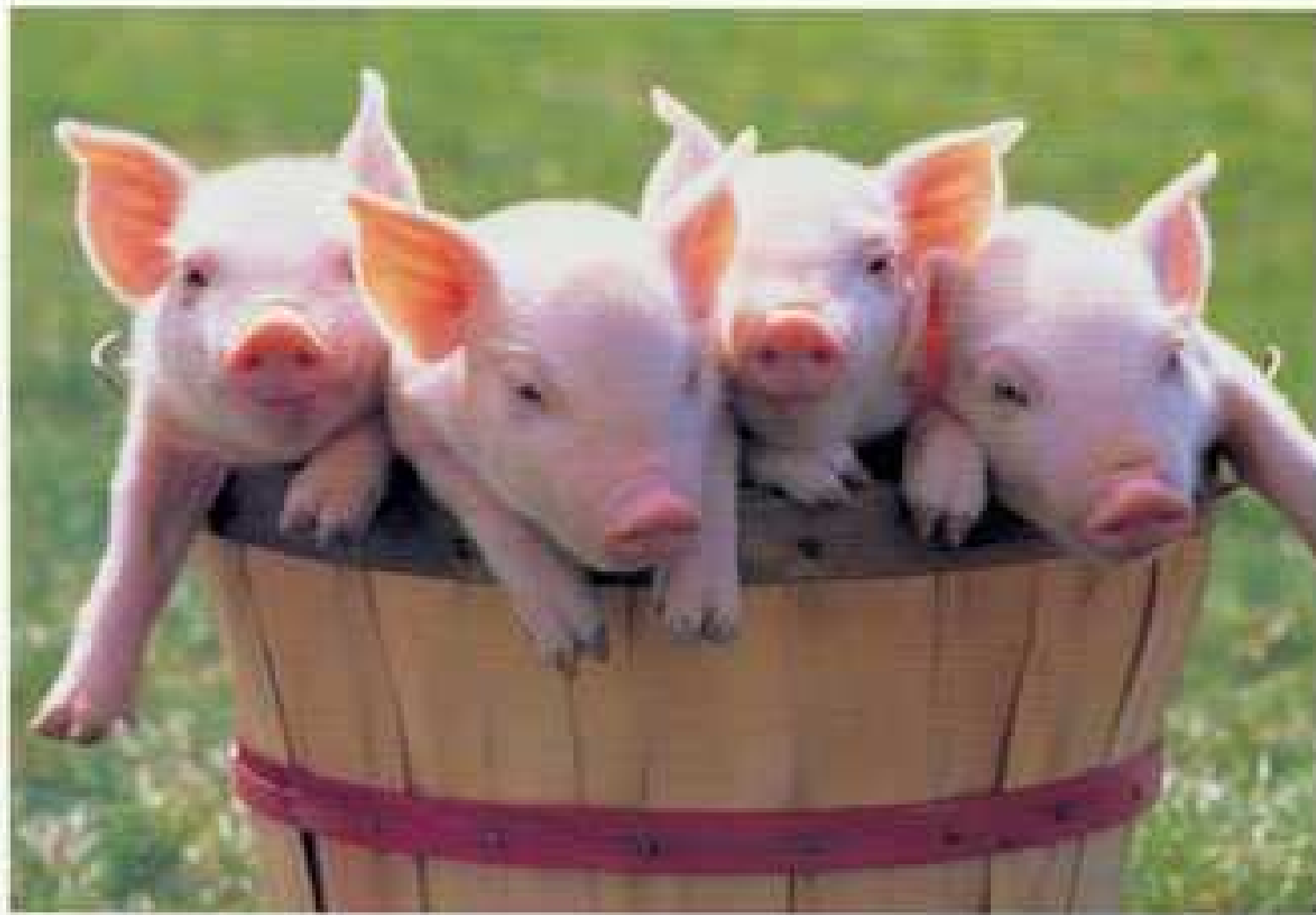


Real exchange rate* and relative export performance, cumulative change between 1999 and 2008



*Real exchange rates are based on unit labour costs.

Source: Bruegel Policy Brief, March 2010.



Greece is the frontrunner as the most vulnerable country of the euro area



Vulnerability index

	Gross debt (% GDP)	Fiscal balance (% GDP)	Nominal unit labour cost	Current account (% GDP)	Net National Savings (% national income)	Vulnerability index
Greece	1.9	-1.8	0.7	-1.2	-1.1	6.7
Portugal	0.4	-0.3	0.6	-1.6	-1.9	5.0
Ireland	0.4	-2.5	0.4	-0.1	-0.3	3.7
Italy	1.6	0.6	1.0	-0.1	-0.4	2.6
Spain	-0.2	-1.0	0.6	-0.6	-0.3	2.3
France	0.4	-0.4	-0.7	-0.1	0.0	0.2
Belgium	1.0	0.4	-0.4	0.5	0.5	-0.6
Netherlands	-0.2	0.3	0.7	0.9	0.4	-1.1
Finland	-0.9	0.8	0.1	0.5	0.2	-2.2
Austria	0.1	0.5	-0.7	0.5	0.7	-2.4
Germany	0.2	0.7	-2.4	1.0	0.5	-4.5

Source: CEPS Policy Brief, No. 202, February 2010.

Monetary policy tools could do little



- Like all central banks ECB has nothing but its own balance sheet and the power of persuasion
- Pressure for it to stop telling finance ministers what to do and instead use its balance sheet by printing money

Monetary policy easing not enough – only governments could do what was necessary



- Direct inter- country loans ?
- Multilateral loans ?
 - International Monetary Fund
 - European Monetary Fund
- Gifts ?

Financial fragility and supervision of the European banking system

- Crisis in the financial system
- De Larosière reforms
 - Role of ECB and European Systemic Risk Board
- Exposure of European banks to PIGS
fresh reminder of existing challenge
- ECB purchases of euro area government bonds
- Provision of dollars to banks

Functioning of Eurosystem



- Challenges for ECB bound to come
- Lack of transparency
- One vote per country – but hitherto always consensus
- Ratio of centre to regional vote
- Could strength become a weakness ?

So where are we now ? (1)



- The common fiscal arrangements seen as needed to finish the “unfinished business” are almost in place
- Monetary policy will focus on the financial system rather than inflation or exchange rate
- Votes will matter in the ECB
- The ECB is bound to become more closely involved with supervision

So where are we now ? (2)

- The UK ?
- The Eurogroup of finance ministers has been confirmed as a major decision-making body
- The UK's position in Europe has changed – and so has the Bank of England's

The background of the book cover is a warm, golden-brown color with a textured, slightly grainy appearance. It features faint, overlapping images of currency notes, including what appears to be a US dollar bill, which adds a financial theme to the design.

BANKING ON THE FUTURE

The Fall and Rise
of Central Banking

HOWARD DAVIES AND DAVID GREEN