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“OUR FINANCIAL WORLD: LESSONS TO BE LEARNED FROM FABRIZIO SACCOMANNI”

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ABSTRACT

This is the speech given by Mr. Jacques de Larosière during the VILLA VIGNONI Euro-Workshop on 16 September 2021.

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I have known – and worked with – Fabrizio for the last thirty years or so. He was an influential member of the Banca d’Italia when he became Director General from 2006 to 2013. After, he was appointed Minister of Economy and Finance in the Letta Government.

He participated - in the footsteps of the great international expert, Rinaldo Ossola - in the successive negotiations on what was called the “monetary architecture”: he had been, in the early 90’s, the personal assistant of my colleague Carlo Ciampi.

I would like to remember the magical musical evening we had in my home in Picardy in October 1990 where Luciana and Fabrizio were present.

My collaboration with Fabrizio developed into a close friendship. His untimely passing away in 2019 left us all deeply saddened and distressed.

To prepare this speech, I have read, once again, his lucid books and, in particular, “Managing international Financial Instability” (2008) and “Crepe nel sistema: the crumbling of the Global Economy” (2018).

All his life, Fabrizio Saccomanni has studied the financial global system, the magnitude and rapidity of capital flows, as well as the market innovations and vulnerabilities that have resulted in so many crises over the years.

In a nutshell, one can say that Fabrizio focused his attention on the shortfalls of the global financial system.

If, in the older days, the cycles were mainly of an economic nature (succession of periods of high and low demand), the modern cycles are set in motion by the monetary impulses of major industrial countries and are amplified through the operation of the global financial markets.

Given this fundamental change, his thesis is the following:

a) National authorities should – while formulating their monetary policy strategy – give a high priority to the objective of financial stability.
b) But he adds that the stabilization of the global financial system requires, in turn, a multilateral framework to deal with global current account imbalances and exchange rate misalignments.

Let me deal with these two intertwined aspects of Fabrizio's thinking:

I – The need for a financial stabilization effort.

1. The author has studied in detail **the functioning of financial markets** and has clearly perceived their weakness.

   I will mention a few of them:

   - Financial globalization accelerated in the early 1980's.

     The process was associated with financial innovation: securitization, expansion of derivatives, growing importance of non-banking intermediation, international consolidation of the banking and financial sector, revolution in information technologies, ….

   - Fabrizio showed that financial globalization was much more than a purely geographical phenomenon: global players are simultaneously present in all countries but also in all markets.
   - Given that competition tends to reduce yields on less risky investments, the pursuit of higher yields and spreads necessarily involves the financing of clients carrying

a higher risk and having limited access to the market and therefore willing to pay higher interest rates. The appetite showed by the market to finance these "subprime" clients weakens the global quality of credit.

- Operations of a speculative nature occupy an especially important place in global finance: hedge funds have developed a free range of speculative investment strategies.

2. Fabrizio stresses the "**global consensus**" on main principles (like the "Washington consensus" in the early 1990's). This adds to the strength and to the herd reactions of markets: all players share the same fundamental views. Therefore, it is not possible for a State or a private borrower to escape the market verdict.

   Turning to global market failures in the 90's, Fabrizio notes:

   "The single biggest dysfunction was the tendency of intermediaries to underestimate credit risk and overvalue the degree of liquidity of the market". These shortfalls were even more dangerous now that markets had massively increased in size and reach.

3. Concerning the succession of crises of global finance, Fabrizio provides a vivid "catalogo" like the one presented by Don Giovanni to Madamina in Mozart's Opera.

In doing this, he relies on Hyman Minsky and Charles Kindleberger to explain the origin of the crises (often triggered by an external « displaced » event).

Fabrizio analyses a few key factors that have led to recent crises:

- Excess leverage,
- The US balance of payments deficit,
- The debt problems of emerging countries (all of them were preceded by massive capital inflows),
- Illiquidity episodes on markets,
- Exchange rate misalignments (the US dollar overvaluation in 1983-1985, the Yen misalignment 1994-1995 …),
- Asset price and housing bubbles fostered by expansionary monetary policies, ….

Despite the special nature of the above individual factors, it remains that "globalization can create conditions and promote behavioural patterns that allow the virus of instability to grow and spread".

II – The need for a proper multilateral framework.

Fabrizio Saccomanni has always been looking for an appropriate substitute to the Bretton Woods system.

He recognized that a return to a fixed exchange rate regime was incompatible with present global conditions and with the sheer size and freedom of capital movements (although he never shared the blind endorsement of "free capital" of the Washington consensus).

1. He was deeply concerned by the way the "non-system" had evolved since 1973: letting countries free to "manage" their floating exchange rate to protect the competitiveness and strength of their exports.

Fabrizio stated in this regard: "I do not believe that it is good policy to allow individual countries to pursue fiscal and monetary policies promoting their domestic economy while leaving the exchange market to deal with the inconsistencies generated by this nationalistic stance"[1]. I could not agree more.
Therefore, he advocated: "the only conceivable alternative to manage international financial instability is **international cooperation**"[2].

2. In his view, an enhanced "cooperation should go beyond the kind of informal arrangements practiced in the G7 which tend to be enacted sporadically and only when there is unanimous agreement that the coordinated action is in the interest of each participant. The way forward must be through '**institutionalized cooperation**'" (2).

3. "Although the authority of the IMF has been weakened by the fall of Bretton Woods and by the advent of financial globalization and floating exchange rates, it retains sufficient legal powers to formulate and implement a procedure for the multilateral surveillance of the monetary and exchange rate policies pursued by the major countries" (2).

4. "Ideally such an enhanced surveillance procedure should enable the IMF to operate both **as a forum** for cooperation between systemically important countries and **as a channel of communication** with financial markets participants".

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1 *See: "Crepe nel systema" page 82.*

2 *See: "Managing Internaitonal Fianancial Instability".*

This proposal makes, in my view, a lot of sense. Since monetary policy decided by major countries has an immediate impact on the financial cycles, it is essential to include such policies in the surveillance procedure.

Of course, Fabrizio was not naïve. He asked – and discussed – the question: “Can sovereign nations cooperate?”.

Normally, historians teach us that cooperation is only possible if led by a hegemonic but benevolent power (see Kindleberger).

But in a more multipolar world (like the one that is shaping up with the ascent of China), others (Robert Keohane) claim that cooperation is possible even in the absence of a leading power.

Be it as it may, Fabrizio notes « his growing concern that the inability of major countries to cooperate, in the end threatens the survival of globalization ».

The remarks above are directly inspired by Fabrizio’s writings.

They show how lucid and perceptive he was and how his vision - based on factual observations - and recommendations are valid today.

To sum up, I think we can synthetize as follows the main “lessons” to be drawn from his analyses.

a) The financial cycle has become **the** main determinant of the global macro-economic environment. But the consequences of any significant move or disturbance or dysfunction of such a huge capital and debt overhang have become more and more problematic. Therefore, the urgent need to “tame” the “market tigers” as suggested by the sub-title of his book: “National Tamers versus Global Tigers”.

b) In this respect, international cooperation is a must.

Without a form of “institutionalized” multilateral surveillance, national temptations to optimize growth and exports will prevail and exacerbate the risks of a demise of the global system itself.

Let me conclude with a quote[3] from his last book which sounds pretty relevant in our present monetary environment:

"Economic policy cannot discard the need for a balanced recourse to discretion. Discretionary measures allow us to react swiftly to urgent situations. Rules can play a useful role to support economic policies, but not to replace them".

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[3] *"Crepe nel Sistema" page 178.*