Foreword

On 9-10 October 2000, the BIS hosted its annual autumn meeting of central bank economists. The topic of the meeting was "Marrying the macro- and microprudential dimensions of financial stability". With a view to stimulating debate on and study of this important topic, this volume makes available the papers discussed at the meeting. These papers address three broad policy questions:

(i) How do central banks monitor the risk of financial instability?

(ii) What mechanisms amplify or dampen financial cycles?

(iii) How should policymakers respond to developments that pose a threat to the stability of the financial system?

Recent years have seen central banks pay increased attention to monitoring the risk of financial instability. As the papers in this volume illustrate, the approaches adopted by various central banks have much in common, although there are certain important differences. Some central banks rely mainly on aggregate macroeconomic and prudential data, while others make extensive use of supervisory data on *individual* financial institutions. Moreover, some central banks rely heavily on models of the financial sector, while others use a more eclectic approach. Overall, the work on indicators of financial stability has led to a more focussed analysis and a greater understanding of the aggregate risks to the financial system, even if it has not led to the development of a simple indicator of financial stability.

A theme that pervades a number of the papers in the volume is the recurrence of financial cycles. These cycles are often characterised by rapid increases in credit and asset prices, and often end with some form of financial system stress. The papers discuss the factors driving these cycles, including the tendency for assessments of and attitudes to risk to be procyclical, incentive structures that encourage short-termism and the nature of regulatory arrangements. One important issue addressed in some of the papers is the tendency for bank provisioning to be backward looking. This tendency reflects both accounting rules and the methodologies that are used by banks to assess risk. Another important issue is the role of contagion in amplifying the downswing of the financial cycle.

The papers identify a number of policy options for dealing with the build up of systemic risk. The first is public discussion by the official sector of the nature of risks facing the financial system. The second is to use regulatory and supervisory policies in a countercyclical fashion or, less ambitiously, to make the financial system more robust to financial shocks. The third is to use monetary policy in an effort to constrain the development of financial imbalances that have the potential to cause financial and macroeconomic instability. The various papers discuss the advantages and disadvantages of each of these types of policies. One common consideration is the ability of policymakers to identify changes in risk sufficiently well to be able to respond. Another is the possible creation of moral hazard if the authorities systematically respond to changes in risk over time. A third important issue is the need to coordinate policy responses amongst authorities with different responsibilities.