# Foreword

Erdem Basçi[1]

There are two major types of problems in the area of finance. These are "I don't know" type of problems and "I don't care" type of problems. The former perhaps can be addressed by "financial education." But the latter is better addressed by "financial regulation."

Economic agents cannot easily assess the results of their financial activities. The main reason behind the "I don't know" type of problem is the difficulty in handling dynamic optimization. This difficulty exists even in fully deterministic dynamic optimization problems. The degree of difficulty is more pronounced for dynamic stochastic optimization problems. It is much more pronounced for problems that involve further complications, such as presence of an unusually high degree of uncertainty or uncertainty arising from interactive decision making and, perhaps, multiple equilibria.

To mitigate this first type of problem, financial education would be useful. For example, Bernheim et al (2001)[2] and Lusardi (2008)[3] show that financial education leads to increase in saving rates and asset accumulation via better informed decisions.

The second type of problem – "I don't care," – arises from the insensitivity of agents to the results of their financial decisions on the well-being of others. Well-known examples are the so-called agency problems, such as moral hazard and adverse selection. These two problems arise when the flow of information is asymmetric between a principal and its agent. Such informational asymmetries are pervasive in financial decision-making. A banker is much better informed than the depositor and the shareholder. A debtor typically is much better informed than the creditor. Financial regulation is typically introduced to mitigate this type of problem. "Microprudential regulation" is the typical term used for such financial precautionary policies.

If the negative externalities of our actions are rather indirect and hence are less visible, then a "I don't care" problem of a different nature arises. Some examples of terminology, also used frequently in this volume, are: systemic risks; risks in the financial system as a whole; aggregate demand externalities; and macro-financial linkages. The mitigation of problems of such nature are considered under the heading of "macroprudential regulation" or "macroprudential policy."

The Central Bank of Republic of Turkey (CBRT) recently placed more emphasis on financial education and its relation to financial stability. The organization of the "International Conference on Financial Education and Financial Awareness: Challenges, Opportunities and Strategies" on 9-11 March 2011 in Istanbul jointly with the Capital Markets Board of Turkey and the publication of the booklet "Access to

1 Former Governor, Central Bank of Republic of Turkey.

2 Bernheim, B D, J Skinner and S Weinberg (2001): "What accounts for the variation in retirement wealth among US households", *American Economic Review*, vol 91, September, pp 832–857.

3 Lusardi, A (2008): "Financial literacy: an essential tool for informal consumer choice?", Dartmouth College, mimeo.

Financial Services and Financial Education in the World and Turkey", were two steps to contribute financial education in Turkey.

The emphasis on macroprudential policy is also rather new. The global approach to the financial system before the global financial crisis of 2008 can perhaps be summarized in one word: "deregulation." The trend at that time was towards less and less government intervention, including financial markets and institutions. This led to a concentration of a significant amount systemic risk in an under-regulated financial system. The result was an unstable and fragile global economy.

"Reregulation" of the financial sector has then become a keyword. It has been repeated many times at national and international forums after the global financial crisis. While the Basel I and Basel II frameworks were mainly microprudential frameworks, the Financial Stability Board came up with proposals including macroprudential policy measures to contain the risk of contagion. The G20 leaders called on the FSB, IMF and BIS to focus on macroprudential policy framework in their Seoul Summit in November 2010. A joint FSB/IMF/BIS Conference on macroprudential policy framework was held in 2011. The three organisations responded to this call with a progress report which set out a comprehensive framework for discussion. This was an important call to the authorities and to academia to do work further on macroprudential policies.

After the global financial crisis, the awareness of the need to use macroprudential policies increased dramatically because of two reasons. Firstly, macroprudential policy tools were deemed necessary to mitigate macro-financial externalities, like pecuniary externalities related to real exchange rates or aggregate demand externalities related to leverage or liquidity.

Secondly, price stability and financial stability trade-offs became more evident. Using the short-term interest rate as the only monetary policy tool was clearly not the optimal solution to deal with such trade-offs. Moreover, short-term interest rates proved to be too blunt for specific financial stability purposes. In this respect, both advanced and developing country central banks employed very diverse sets of macroprudential tools and policies.

Research shows that monetary policy rules that feature responses to financial variables such as credit spreads and the real exchange rate produce better results in coping with external financial shocks. These benefits, however, might be reaped at the expense of sacrificing price stability. Furthermore, using solely short-term policy rates might be counterproductive if hitting multiple targets necessitates different trajectories for the single policy tool. Overall, it seems that macroprudential policies are better suited for the financial stability purposes and their effective use may provide enough room for interest rate policy to target price stability more effectively. Nonetheless, these areas are still open for discussion. More research is needed and a consensus is yet to emerge.

The CBRT/BIS/IMF Joint Conference on "Macroprudential Policy: Effectiveness and Implementation Challenges" which was held on 26-27 October 2015 in Istanbul was a successful event and a good opportunity to discuss and exchange opinions. This volume is a collection of research and speeches presented at the conference. It contributes to the literature and to the better understanding of the issue not only by academicians but also by decision-makers. I therefore would like express my gratitude to all the participants of this conference and to all the contributors to this useful volume.