José De Gregorio: Financial stability, monetary policy and central banking

Introductory speech by Mr José De Gregorio, Governor of the Central Bank of Chile, to the 12th annual conference of the Central Bank of Chile “Financial stability, monetary policy and central banking”, Santiago, 6 November 2008.

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Welcome to this 12th Conference of the Central Bank of Chile, entitled *Financial Stability, Monetary Policy and Central Banking*, which will gather a select group of central bankers, experts and academics today and tomorrow.

I cannot open this conference without sending my most heartfelt condolences to Klaus Schmidt-Hebbel, our former director of Economic Research and creator of this series of conferences, and to all his family, on behalf of the Central Bank of Chile and myself, for the terrible loss of his beloved son Diego. To him we dedicate these two days' work.

Like every year since 1997, we are looking forward to two days of intensive work with discussions of the highest technical level, which usually have opened areas for us to develop our research agenda with rigor and relevance, in an ever more complex world.

This version of our Annual Conference finds us in the midst of severe global financial crisis. After the Asian crisis, many of us wondered about where the next blow would come from and what shape it would take.

The academic literature has analyzed foreign exchange and financial crises in small, open economies. First there were the first-generation fiscal and currency crises, which gave way to second-generation crises such as the one endured by the European monetary system in the early 1990s, and finally to third-generation ones occurring in Asia. All of them featured a variety of origins and transmission mechanisms.

Now we are facing an international financial episode that many concur in labeling as the worst since the Great Depression, which originated in the developed economies, particularly the United States. Its initial symptoms are known: rapid financial innovation, credit expansion and asset price bubble. Its progression and repercussions, however, are unprecedented.

On the other hand, our better understanding of the distortions that bad macroeconomic and financial policies can trigger, has made emerging economies in general, and Chile in particular, build a strong position to deal with a very weak international scenario. There is no better moment than this to get together and exchange our visions and opinions, and draw the first lessons from the events unfolding in the world economy.

I want to begin with some comments on the present crisis. This episode has several unprecedented aspects stemming mainly from the complexity and sophistication of financial institutions and instruments, in a context of high financial and trade globalization.

Of course, some elements have been observed before, such as the loss of confidence in key financial institutions by investors and the general public, and the uncertainty regarding its duration.

As we all know, this crisis started little over a year ago, with the end of the real estate boom in developed economies, which would end up exposing both the weakness and the excesses of the subprime mortgage loans. However, and as was apparent in the subsequent developments, the problem went far beyond lending to agents with low payment capacity. Overall, an asset price bubble, particularly in the housing sector, fueled by an accelerated credit expansion has proven to be a dreadful combination. Maybe bubbles cannot be made to disappear, but the integrity of the financial system must be preserved and requires continuous monitoring.

The collapse of Lehman Brothers can be considered a landmark event that took the financial markets from a period of turmoil to a major crisis. In fact, after the downfall of this investment bank, commercial banks in developed economies, regardless of size, began fearing that their counterparts might go broke and stopped lending to each other, which nearly dried up an already precarious interbank market. Every fragility indicator in this market, and stock exchanges around the world, reflected the onset of a confidence crisis.

Whether or not it was a prudent decision to let Lehman Brothers go bust will be argued over for years to come, an institution whose fragility was common knowledge since early this year. Probably some bet on a Bear-Sterns-type rescue, a clear example of moral hazard. Maybe it should have been intervened months ago. But anyway, had Lehman been salvaged, one cannot be sure that other systemically important institutions would not have followed. Would a 750 billion dollar package been approved without the collapse of Lehman? If Lehman had been thrown the lifeboat, would such a large package have been necessary? There will be plenty time to discuss this and other issues. However, there is a very straightforward conclusion, which is that policymakers should have been aware of the magnitude and consequences of the downfall of a major financial institution. This is at the core of this conference: evaluating systemic risks in a very complex world. Such a complexity offers big benefits, but also poses enormous challenges in regulation, monitoring and risk assessment.

In the future, it will also be necessary to discuss what to do about weak institutions. As has happened in Chile in the past and is now happening in developed economies, in my opinion the balance is tilted towards allocating the losses to shareholders and executives, intervening institutions to ensure good use of public funds and preserving financial discipline.

In the past few years we have accumulated a lot of experience, which permits us to be certain that asset price drops and credit market difficulties can impose a large burden on the economy if ignored. Investors have lost confidence in the ability of certain firms to meet their obligations, complicating access to the capital market and short-term financing, and thus accelerating the fall in those firms' stock prices. Here, the role of central banks as liquidity provider is essential to ensure the proper functioning of the financial system, and this is one of the main lessons we learned from the mistakes made during the Great Depression that wrecked havoc in the real sector, which could have been substantially reduced.

We have also learned that sound regulations designed for normal times and as crisis preventing mechanisms are not necessarily the best for moments of great stress or turmoil, including mark-to-market practices in some segments of the financial industry.

It would be premature to draw definitive lessons from the present crisis that is still in the making and going through the damage-control phase. A new wave of discussions on the international financial architecture will come. And although this happens every time there is a world crisis, progress to date has been rather timid.

Nonetheless, the potential liquidity constraints that economies outside the epicenter of the crises may suffer, may add an unnecessary burden to countries that had little or nothing to do with today's events and at the same time are the basis to sustain growth in the world. In synchrony with this, the new liquidity swap facility that is being offered by the IMF is very appropriate. It should be disbursed quickly as current conditions require. In the present circumstances, countries that have saved their terms-of-trade windfalls and enjoy a solid international liquidity position, as is the case of our country, should not have the need to apply for these facilities.

Once the emergency is over, the present international financial architecture will have to be examined carefully, in terms of its extreme dependence on the decisions of more advanced countries, its governance and its surveillance role, particularly in the financial system. The IMF has made great progress with the *World Economic Outlook*, which had already warned about the real-estate bubble and global imbalances, and the *Global Financial Stability Report*. These efforts must now be redoubled.

From the standpoint of central banks, recent events have underscored not only their role in monetary policy, but also their important function in the stability of the financial system. In this context, research on issues related with financial stability has been dramatically intensified. Clearly, there are varied degrees of consensus regarding how to characterize a good financial policy framework, how to measure it, achieve it and preserve it, as well as its possible tradeoffs with monetary policy.

This conference seeks to contribute the study and analysis of these topics, as well as cooperating in our management, as policymakers, of financial stability and associated macro-financial risk.

Today, our work will focus on defining the concepts of financial stability and systemic risk, and on understanding the conceptual frameworks that support their evaluation and the links with and feedback from monetary policy.

Garry Schinasi will open the day, introducing what we must understand by financial stability and examining the implications and challenges of understanding systemic risk. Claudio Borio will explore the operational aspects and the precautions we must take regarding the methodologies we use to measure systemic risk. Dale Gray will handle the third presentation, integrating the idea of financial risk – by using options – with macroeconomic models focusing on monetary policy analysis, then applying the tools to the particular case of Chile based on his joint research with Leonardo Luna and Jorge Restrepo. Johan Molin will share with us the experience of the Sveriges Riksbank, which has led financial stability analysis since the problems it endured in the early 1990s.

This afternoon, Francis Diebold will analyze, for the financial markets of the United States and four Latin American economies, stock returns and volatilities to look for evidence of contagion and its characteristics. Charles Goodhart, Dimitrios Tsomocos and Alexandros Vardoulakis will present us the study of a heterogeneous agent model with a real-estate sector and financial fragility. Later on, Ethan Cohen-Cole and Enrique Martínez-García will present their research on the interaction of financial intermediation and banking system regulations and its effect on the optimal monetary policy response.

Tomorrow will begin with the presentation of Jaime Ruiz Tagle and Marcelo Fuenzalida, who will examine, for the case of Chile, the systemic risk of household debt. Miguel Segoviano will follow, with a review of systemic risk and banking stability from a macroeconomic perspective.

Then comes a presentation by Jaime Caruana, who will draw some lessons from the recent crisis and the international financial integration. In the afternoon we will feature Sujit Kapadia and Prasanna Gai with an analysis of financial contagion using a network model. In addition, there will be two panels that will review financial risk management with two important nuances: its incidence in emerging economies on one hand, and on systemically significant financial institutions, on the other. The economists invited to these panels include Michael Bordo, Paul McCulley, Martín Redrado, José Darío Uribe, Martin Wolf and Roberto Zahler. Finally, Charles Calomiris will share with us his vision on the current crisis and the implications of the works presented in this conference.

Two intense days that hold in store enormous technical content that, without any doubt, will make a fundamental contribution to our future view of macroeconomic and financial phenomena.

I want to finish by thanking Rodrigo Alfaro, Dale Gray and Jorge Selaive for their work in putting together this conference. Also Mauricio Calani, Mónica Correa and Soledad Gallardo, and our Institutional Affairs Management for their help in organizing this event.

I also want to thank the many authors and discussants of the papers for their dedication to preparing their valuable presentations. To all of you, dear participants, I wish you two days of fruitful discussion. Thank you.