Lars Nyberg: Challenges following the current crisis

Keynote address by Mr Lars Nyberg, Deputy Governor of the Sveriges Riksbank, at 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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In the last couple of months we have seen authorities all around the globe taking massive actions to deal with the current financial crisis. Few countries are spared as the crisis spreads over the world, not even those that have not been directly exposed to the problems that initially triggered the crisis. Never before has a crisis had such a widespread global impact as the one we are now witnessing. This obviously puts governments, central banks and supervisors in a somewhat new position as they have to deal with the challenges that financial globalisation entails.

Needless to say, these challenges are huge. Today I will only be able to address some of the issues that we will have to deal with when the crisis is eventually over. I will also try to give my views on what the lessons from the crisis imply for the central banks' work on analysing financial stability and systemic risks. However, let me first say a few words about the context of the crisis.

Context of the crisis

When the crisis was triggered it happened in a quite traditional way. As in the case of many historic crises, the underlying problem was that credit losses in the financial sector turned out to be much larger than anticipated. However, as the crisis has evolved over the last one and half years, the problems have come to be less about credit risks and more about the adverse consequences of a global financial industry experiencing a quite substantial deleveraging process.

The huge credit expansion and financial asset growth that preceded the crisis was facilitated by that many financial institutions were assuming high levels of debt, in many cases obviously at unsustainable levels. These institutions are now trying to decrease their leverage either by injecting more capital – or if that is not possible – by shrinking in size.

To shrink institutions simply must sell off assets. This is currently being done on a huge scale by institutions all over the world and explains why financial markets are so strained at the moment. On the supply side there are a lot of sellers trying to get rid of assets, but on the demand side – due to low credit supply and high risk aversion – there are hardly any buyers. As a result, pricing is disrupted and liquidity drastically decreased, which in turn implies falling asset values and further losses in the financial industry.

The fact that the problems to a large extent have been driven by financial markets breaking down, rather than by individual institutions credit risk exposures, explains the unprecedented international impact of the crisis. Globally interconnected markets have resulted in a situation in which financial institutions everywhere have been hit, even if not exposed to the institutions or assets at the core of the crisis. My home country Sweden is a good example of this.

What we have witnessed in recent months, since the default of Lehman Brothers, is the acute phase of a global financial crisis. To respond, authorities have taken action to prevent a systemic break down of the financial system. Both the US and the EU have delivered financial support plans committing governments and central banks to providing the necessary support to the financial industry.

These plans are now being implemented and we cannot yet be certain of their success. However, in my view, the support plans contain the necessary measures to solve the most critical issue right now, namely to restore market confidence by providing guarantees to creditors that their money will be repaid. Therefore, the prospects for restoring financial stability and enhancing the availability of credit for firms and households should be good. That the support plans also provide measures for government capital injections and takeovers is obviously good, but for the purpose of getting markets to function properly ownership issues really are of secondary importance. After all, what creditors are looking for is to get their money back. To them it should not really matter from where or from whom that money comes.

Even if it is too early to tell, we can see that the financial support plans have contributed to a certain degree of recovery in the markets. Interbank rates are falling, credit spreads are narrowing and liquidity is returning in some markets. However, most of the content of the support plans is directed at handling the most pressing problems in the financial system. In the longer term other measures will be needed, and this is what I will discuss now.

What are the future challenges?

Let me first say that we need to realise that times of financial turbulence are unavoidable and something that we have to learn to live with. What is important is that we learn from previous experiences and use this knowledge to lower the probability of future crises occurring, and when they actually do happen, to mitigate their costs.

We also need to realise that despite the many similarities between various crises they are never exactly the same. Therefore, flexibility is needed in the policy frameworks aimed at preventing and managing financial crisis.

If I may start on the *prevention* side, it is hard – given the present circumstances – not to get in to a discussion of what role monetary policy can play in preventing the build up of economic imbalances.

Crisis prevention – the role of monetary policy…

In recent years, perhaps the most influential view of how monetary policy should respond to a rapid increase in the price of an asset, and a possible associated credit expansion, can be described as follows. Let us, for simplicity, say that we are talking about an increase in house prices that has gone hand in hand with a substantial increase in household indebtedness. Monetary policy should only respond to a rapid increase in house prices and borrowing if the central bank's forecasts indicate that it will lead to problems such as overheating and excessively high inflation. If this is not the case, the central bank should wait and see, but be prepared to quickly ease monetary policy if the housing market were to collapse and demand in the economy were to fall drastically. The main argument for such an "asymmetric" response would be that central banks are not especially good judges of whether there actually is an asset bubble or not.

The fact that bubbles are difficult to identify is of course true. Nevertheless, house prices and borrowing can in some cases rise so quickly and by so much that it is difficult for policymakers to remain entirely passive – even if it is not possible to ascertain that there is a bubble building up. If a severe downward adjustment in house prices were to occur later on, it is probable that monetary policy would receive much of the blame for having been too passive earlier.

Essentially, it all comes down to a choice between two alternatives. On the one hand, central banks can try to slow down a worryingly rapid price rise in the housing market by keeping interest rates higher than they otherwise would have been. The obvious risk is that if increasing prices actually are driven by fundamentals, then an incorrect assessment has been made and demand in the economy will be subdued unnecessarily. But if the assessment was correct, a rapid downward correction in house prices may be avoided, or at least mitigated, as well as a subsequent fall in demand.

On the other hand, central banks can disregard the fears and refrain from raising the interest rate. If price increases in this case are due to fundamentals a needless slow down in demand will be avoided. But if prices are due, for instance, to over-optimism among households and lenders, then severe problems may occur in the future when there is a rapid downward adjustment of house prices and a subsequent fall in demand and inflation.

Which of the two alternatives is preferable can always be discussed, and may quite likely vary from case to case. However, it is far from obvious that the best choice is always to wait and see when facing a rapid increase in the price of houses or some other asset. In fact, many observers argue that an important factor behind the current financial crisis was that interest rates were being kept too low for too long. Hence, the approach of "wait and see" and "clean up the mess afterwards" is increasingly being called into question, not least because "the mess afterwards" might be quite severe if the central banks have been passive during the build-up phase. This holds especially true if the price bubble has been associated with an expansion of credit. In most cases it is credit – not asset prices as such – that is the main worry

Having said that, I want to emphasise that monetary policy is perhaps not the most efficient instrument for preventing crises from happening. Even though a too loose monetary policy may *contribute* to the build-up of a bubble, it is less clear to what extent monetary policy can *prevent* such a build-up. It is quite likely that substantial interest rate increases, that central banks would find it hard to implement, would be required to achieve this. More moderate rate increases may of course still have an effect at the margin, not least as a signal from the central bank that there are certain concerns linked to prevailing developments. But a more capable line of defence to prevent financial crises is to have proper rules and effective supervision in place.

…and regulation and supervision

However, both the present and previous crises tell us stories about ineffective and misdirected regulation, as well as insufficient supervision. My point of view is that the need for policy response is not so much about imposing more and heavier regulations, but instead about improving and developing existing ones. When doing so, two conditions must be met: first, some kind of market failure has to be proven, and second, the benefits of imposing new rules must exceed the economic costs.

Given recent events, there are numerous regulatory issues to discuss within this context. In many cases work has already started. For example, how to achieve better management and supervision of liquidity risk as well as greater transparency in the financial sector are important matters currently under review. Further issues include regulatory treatment of the originate-and-distribute model and off-balance sheet entities, as well as procyclical elements in regulation.

Of particular interest is the issue of clearing and settlement arrangements in the unregulated credit derivative markets. One partial explanation of the uncertainty that has prevailed in the financial system recently is the absence of a resilient infrastructure for these markets. No central counterparties have existed and there has been no common market place for exchanging these instruments. As a result, trading has been fragmented and opaque, which in turn has implied that nobody has really known where the credit risks are and few have realised that these risks – directly or indirectly – actually have remained on the banks' balance sheets.

Clearly, there are many issues on the agenda and the course of events over the past year has underscored the need to get to work. But let me stress one thing very clearly: it is important that we get neither too zealous nor to indulgent about regulation. In times such as these, it is easy for opportunism to gain the upper hand, resulting in regulations that do more harm than good. For example, I am a little bit worried about where the discussion on procyclicality is heading. Suggestions have been made that both Basel-rules and fair value accounting standards should be relaxed to cut the banks some slack under stressed circumstances. In my opinion, this seems like a very hazardous way forward.

I am also worried about what I in some instances have seen being proposed with regard to the regulation of credit rating agencies. In can agree that in certain aspects regulation in this area could be considered, for instance in relation to the use of credit ratings for regulatory purposes and also concerning some governance issues. But for me, it is quite hard to see how a more general regulatory intervention in this particular area could be justified. There seems to be neither any proof of an existing market failure, nor any convincing assessments on the benefits of imposing rules. On the contrary, as the credit rating business strongly builds on the confidence of those using the ratings, market mechanisms should be quite enough to provide an efficient output. If agencies cannot deliver qualitative and reliable credit assessments they will soon go out of business. Therefore, the agencies' incentives to do a proper job should be quite enough without regulation.

Crisis management – preparedness needs to be strengthened

Another issue that I believe needs particular attention is how to achieve better crisis preparedness, which means that I am now switching to talk about crisis management issues.

As on numerous occasions in the past, many countries were ill prepared for this crisis and had to rely on ad-hoc solutions for handling it. In the case of the EU, member states quickly had to reach an improvised agreement on a co-ordinated and comprehensive financial support plan. We have had the same situation in Sweden, both when we had a crisis in the early 90s and, more surprisingly, even now. Despite the quite recent experience of a systemic crisis, legislators had not been able to get a proper framework for the management and closure of distressed banks in place. Thus, also this time we had to rely on improvised solutions.

Even if these ad-hoc measures often seem to work out pretty well there is no guarantee that they will do so consistently. To let financial system stability become the hostage of improvised political processes is obviously not an optimal order. Experience from previous crises also shows that improvised crisis management measures often come too late, are inadequate, and ultimately turn out to be more costly then they would have needed to be. I would say that British Northern Rock is the perfect example of all this.

So, what is it that we need in order to achieve better crisis preparedness?

As I just indicated, one important requirement is to have in place solid frameworks for the management and closure of distressed banks. Such frameworks include several different aspects, everything from deposit guarantee schemes to insolvency procedures. Basically, it is a quite technical mix of legal and financial measures which can look rather different from country to country. However, the basic concept applies to all. Frameworks should facilitate the quick and efficient closure of banks at a low cost to the deposit guarantee system, while making shareholders and uninsured creditors bear the responsibility for their investment decisions. It must also allow for special measures to be taken in the exceptional situation where the failure of a bank risks destabilising the financial system as a whole. Also in such situations, the government needs to have a strong negotiating position relative to the shareholders. Necessary ingredients for achieving all this are to allow distressed banks to be put under special receivership and to enable governments to issue guarantees and make capital injections. As a countermeasure the government obviously needs to have far-reaching authority to take control of the institution, for example by requiring the compulsory sale of shares.

With regard to central banks there is also reason to contemplate how crisis preparedness can be improved. For example, we need to consider how appropriate flexibility is achieved in the central banks' operational frameworks to deal with extraordinary situations. Having said that, I would like to add that central banks have managed quite well to quickly adapt to the unprecedented circumstances in markets. Still, deeper thought has to be dedicated to these issues when time eventually allows.

As a final remark on preparedness I would like to stress the importance of practice. No matter how sophisticated crisis management arrangements are, they have to be deployed properly by the authorities using them. However, since financial crises thankfully are pretty rare events, people working in these authorities probably are not going to be particularly used to doing that. But with appropriate practice, crisis management skills can be substantially improved. In my own organisation we regularly perform crisis exercises, both on our own and in cooperation with other relevant authorities and countries. These exercises have not only helped to improve the staffs' skills significantly, they have also provided important lessons on how different crisis management practices could be improved.

One such lesson has been that a higher degree of international coordination and harmonisation is needed, a lesson that has certainly been confirmed by the current crisis.

International co-operation and harmonisation is needed

The need for greater cross-border cooperation pretty much applies to all of the issues I have touched upon so far, both regarding the prevention and the management of financial crises.

Taking Europe as an example, it has become quite obvious in the last year that the diverging national structures of frameworks for regulation, supervision and crisis management have complicated the management of the current crisis. The existing voluntary agreements for crisis management in the EU have proven not to be extremely helpful. Concrete and binding arrangements are instead needed in order to achieve better preparedness and co-ordinated crisis responses. Luckily, this time policymakers around Europe eventually realised that a coordinated crisis response was a necessity.

Partly because of this experience, the EU has initiated work to review how the EU's supervisory framework can be reformed to better cope with the financial market integration. Exactly what this work will include is still unclear, but it is highly welcome that the issue has been placed on the agenda. However, I would like to add that – because of the close interaction between crisis prevention and management issues – it will not be sufficient to deal only with supervisory issues. Arrangements for deposit guarantee schemes and other crisis management tools need to be considered within the same international context. Of particular interest is the sensitive issue of how to distribute the burdens associated with managing cross-border crises, which will inevitably be brought to the table if proposals for supranational supervision enter the debate. After all, who would like to share crisis management responsibilities without getting any supervisory powers in return?

Implications for the central banks' work on analysing financial stability and systemic risks

I will now say a few words about the central banks' work on analysing financial stability and systemic risks. Given the current conditions one may ask if such analysis is at all meaningful. Even if many central banks prior to the crisis pointed at single factors as potential threats to financial system stability, no one really managed to anticipate the situation now at hand. But does this really mean that all work on analysing financial stability and systemic risks is in vain? Obviously, my answer to that question is no. I would rather say that the work in this area is more important than ever. However, as we gain new insights from the current crisis, we have to consider how the analysis could be developed. The obvious conclusion is that the analysis has to be broadened in order to cover all the relevant parts of the financial system and how they interact. I will try to give you some of my thoughts on how this can be achieved.

First, and perhaps most important, one lesson from the current crisis is that the traditional approach to analysing institutions, markets and infrastructure separately is no longer sufficient. Recent experience shows that in the new global financial landscape the importance of markets for system stability has increased dramatically. The financial contagion we have seen is largely a result of certain markets deteriorating and subsequently affecting institutions and markets far from where the problems first emerged. To analyse and understand the interplay between institutions, markets and infrastructure and the potential contagion channels between them is a key factor for successful systemic risk analyses.

The banks' increased dependency on financial markets to fund their operations also creates a need to keep an even closer eye on certain markets, and in particular the credit markets, which banks not only use for their funding needs but also to manage risks.

The greater market dependency also entails the need to apply a greater international outlook in our analysis. Even if a country's financial system is dominated by a few domestic institutions with limited operations abroad, they can evidently still suffer from the breakdown of institutions and markets elsewhere. However, a wider geographical focus is not only justified by the growing importance of markets. Over the last decade, institutions have also become more international. In Europe, for example, we now have a few truly pan-European banks and even more that operate across borders on a regional basis.

Furthermore, in the last year we have seen that not only deposit-taking commercial banks can pose threats to financial system stability. Events in the US tell us that a broad array of other financial institutions, such as investment banks, monolines and the banks' various kinds of special purpose vehicles have contributed to the build up of imbalances. Therefore, analytical focus is needed not only on commercial banks but also on their different counterparties.

Another lesson for central banks I would say is to use their expertise to work more proactively on financial stability policy issues. The current crisis – as well as most historic ones – can partly be explained by regulatory failures. Central banks have a big responsibility to make sure that such failures are avoided. For example, we should promote regulation that favours efficiency and counters undue risk-taking. We should also try to make sure that regulation is designed in such a way that there is no scope for circumventing regulation in order to avoid costs or administrative burdens.

Last but not least, greater international co-operation and harmonisation is desirable also in the analytical field, as this would help to provide a more comprehensive global surveillance of financial stability and facilitate coordinated policy responses to financial turbulence. To this end, it is very welcome that the Financial Stability Forum and the IMF will intensify their co-operation in order to develop the assessments of financial stability risks on a global scale.

Within the European Union, successful efforts have been made to establish a common framework for assessing the systemic implications of cross-border crises. The main purpose of this framework is to serve as a common language between authorities and countries for discussing the systemic impact of a financial crisis, thereby enabling them to reach a common view on the economic impacts of any particular crisis.

This framework is still quite fresh and has not yet been implemented in most EU countries. Therefore, its use has been limited in the current crisis. However, when it is eventually implemented I am convinced that it will contribute significantly to the common understanding of the dynamics and implications of financial crises. I would therefore like to encourage more countries to follow the initiative taken by the EU countries.

Concluding remark

Let me now conclude.

The crisis we have seen over the last one and a half years will most likely redraw the global financial landscape in various ways. And even if the recent measures taken by governments and central banks have improved market conditions somewhat, it is far from certain that the crisis will be over any time soon. What will come out at the other end of the crisis is also still much too early to tell.

Today, I have given you my views on some of the issues that need to be dealt with in the aftermath of this crisis. It all adds up to a quite significant to-do list, including various aspects of regulation, crisis preparedness, central bank policy and assessment and so on and so forth. It will most certainly take time before we can put an end to these discussions.

In the meantime, the financial industry and the responsible authorities have to make certain that the costs of the prevailing financial turbulence are kept as low as possible. For me, as a central banker, this task translates into standing by the commitment to provide key markets and sound institutions with the liquidity needed to ensure that the financial system can function properly.

Thank you!