Mugur Isărescu: Nine lessons from the current financial crisis

Speech by Dr Mugur Isărescu, Governor of the National Bank of Romania and Member of the Romanian Academy, during the session titled “What lessons can be learned from the current economic crisis?”, organised by the Economics, Legal and Sociology Department within the Romanian Academy, in co-operation with "Costin C. Kiritescu" National Institute of Economic Research and the ”ESEN Reflection Group” Romanian National Committee, Romanian Academy, Bucharest, 14 April 2009.

*   *   *

Your Excellency, Mr. President of the Romanian Academy,
Dear colleagues,
Ladies and gentlemen,

I have recently talked about the causes of the current financial crisis and the manner in which it affects the Romanian economy at Babeş Bolyai University in Cluj-Napoca and Transilvania University in Braşov. Let me just recall here that the current crisis on the US subprime mortgage market was only the trigger of the global financial crisis. Its root causes were both macroeconomic and microeconomic in nature. Plentiful liquidity was the catalyst for the merging of multiple microeconomic causes such as securitisation, financial deleveraging, rifts in the business model of rating agencies and excessive deregulation, which resulted in today's financial crisis.

World economies are hit by this crisis to various extents, depending on the vulnerabilities of each and their exposure to toxic assets. The response to the crisis is contingent upon the fundamental principles we believe in, the available resources, the institutions and the instruments we can make use of.

A short list of the lessons should reflect all these aspects: what we have learned or think we have learned about the causes of the crisis; about the efficiency of the institutional texture and the array of instruments at hand; and, last but not least, about the most appropriate positioning in the event of a crisis. With these criteria in mind, I will refer to nine lessons, of which seven are universally valid and two hold particularly true for emerging economies, such as Romania.

In order to root out any possible confusion, I would like to point out from the very beginning what these lessons do NOT deal with. First, they do not address the issue of shorter or longer economic cycles and do not suggest that a crisis means the end of an economic cycle. Second, the lessons do not provide an answer to the question whether we could ever avoid a financial crisis.

1. Low inflation is not a sufficient condition for ensuring financial stability in the long run.

Past experience appeared to have confirmed the opinion that inflation is the major source of financial instability. High inflation episodes were usually accompanied by pronounced financial instability and banking sector crises or were followed by recession after the authorities took inadequate measures to curb inflation.

The current global financial crisis became manifest after nearly two decades of relatively low, stable inflation. A number of factors caused low inflation to coexist with ample liquidity. The latter, along with the overly high level of savings, helped keep interest rates and volatility at bay. All this translated into a new financial texture, in which the bank intermediation model shifted away from "originate and hold" to "originate and distribute". The new products and institutions that changed the fabric the financial system was made of until three decades ago led to the outbreak of the current financial crisis. The financial crisis was triggered by the developments in the US subprime mortgage market, as I have mentioned earlier. In turn, it broke out due to the fact that the Federal Reserve System, given the above-mentioned conditions, had no other option but to increase interest rates with a view to maintaining low inflation. With the new financial texture however, rate hikes brought about the emergence of the financial crisis.

In view of the above, my opinion is that ample liquidity changed the financial system to the point where monetary policy found itself trapped. Inaction would have resulted in higher inflation. The actions taken brought about financial instability. If regulation and supervision had prevented the excessive build-up of risks by investors, interest rate hikes could not have prompted financial instability. Such developments point to the need of efficient cooperation between monetary policy, on the one hand, and regulation and supervision, on the other, a fact that failed to materialise over the past years in some of the world's leading economies. Monetary policy was sometimes overly loose, also in regard to the regulatory and supervisory framework in place.

2. Regulation and supervision trail behind the markets at intervals.

Markets always find a way to innovate because of the ongoing competition among economic agents to meet real needs. Innovations enhance the efficiency whereby such needs are met and that is why the innovation process will never cease. Even if confronted with administrative barriers, markets will still identify solutions to meet demand.

A clear example in this respect was the NBR's attempt at slowing down the frantic pace of forex-denominated loans. We resorted to administrative barriers, yet their efficiency was subdued and we realised that side effects outweighed benefits. Hence we removed those barriers relatively quickly.

The innovation process can be so dynamic and sophisticated that market regulators or supervisors may lag behind. A statement in the G20 London Summit Communiqué of 2 April is particularly relevant in this respect: "Regulators and supervisors must (...) support competition and dynamism, and keep pace with innovation in the marketplace". One of my advisors said this is a recognition of the fact that the current financial crisis is not due to market failure, but rather to regulatory and supervisory institutions' inability to adapt to market realities. I would like to add that it is, at the same time, a guideline on how to keep the pace with market innovations. It is important to strike a balance between the two by enhancing regulatory and supervisory structures, as this process should by no means result in stymieing competition or economic agents' creative energies.

3. The EU lacks certain institutions.

This is clearly pointed out in the De Larosière Report. The chapter focusing on EU supervisory repair proposes a structural reform targeting two areas, namely micro-prudential and macro-prudential supervision. The Report recommends the establishment of the European Systemic Risk Council (ESRC), which should pool and analyse information pertaining to macro-prudential risks and vulnerabilities across all EU financial sectors. The ESRC shall issue risk warnings and shall adopt economic policy recommendations.

Another institution proposed in the Report is the European System of Financial Supervision (ESFS), within which the level 3 committees (CEBS, CEIOPS, CESR) will be transformed into three new European Authorities: the European Banking Authority, the European Securities Authority and the European Insurance Authority. These three entities will have wider powers in the licensing and supervision of some specific EU-wide institutions, but it is the strong coordinating role of the ESFS that I want to stress.

The fact that the European Systemic Risk Council would be set up under the auspices of the ECB and of the European System of Central Banks would allow it to benefit from the analytical capabilities and technical infrastructures developed by central banks in their own monetary and financial stability analyses. This also implies a strong cooperation between the ESFS and the ESRC. Thus, both the ECB and the European System of Central Banks should have access to relevant information from supervisors.

We trust that this new structure, which is in charge of macro- and micro-supervision, will be able to help achieve the timely identification of behaviours likely to generate financial crises. But, as the ECB President Jean-Claude Trichet also pointed out, for the proposed macro-prudential framework to function as intended, it is crucial that the risk warnings and economic policy recommendations issued by the ESRC be translated into policy action as effectively as possible. That is why I believe that these warnings and recommendations should be reported to the ECOFIN Council, while also providing an appropriate institutional basis that might vest the ECB and the other central banks, as advocated by President Trichet, with the necessary authority, accountability and legal capabilities in relation to the new macro-prudential tasks.

4. Wage incentives in private companies are not adequately correlated with risk management.

The link between incentives for managers and risk management is not always obvious. In recent years, financial innovations and products, as well as institutions subject to inadequate regulation and supervision has allowed for building up huge profits in the near run at the price of taking very high risks. There were no incentives to link wages and bonuses to medium- and long-term profits. Thus, managers were encouraged to take risks which they either failed to understand or ignored in order to increase the profitability bonuses were linked to.

Now it is better understood that compensation and internal risk management policies can be decorrelated. The De Larosière Report holds that compensation incentives should be better aligned with shareholders' interests and long-term, firm-wide profitability. In particular, the assessment of bonuses should be set within a multi-year framework, allowing their actual payment to be spread out through the cycle. The De Larosière Report contains the proposal that supervisors should oversee the adequacy of financial institutions' compensation policy and enforce changes or additional capital requirements within pillar 2 of the Basel 2 framework unless corrective measures are implemented. My belief is that such a measure is in line with the principle of spurring competition and progress and is thus welcomed.

5. In good times, people forget about the crises and ignore designing crisis management mechanisms.

Significant financial strains and all the more so financial crises are seldom occurring events. We are therefore lucky, but rare occurrence comes at a cost. The crisis management mechanisms in place at the time such events emerged may be inadequate. There may be legal provisions hampering quick actions, or the set of instruments and procedures may differ across countries thereby hindering cooperation, etc. The lesson to be learned is that crisis management mechanisms should be updated on a regular basis.

Establishing a clear and transparent single crisis management framework based on the recommendations of the De Larosière Report would benefit the UE in particular. Moreover, this framework should be flexible enough to allow countries to give a response according to the features of the crisis specific to the respective country. Anyway, clear principles for preventing legal bottlenecks and the cross-country spillover of negative effects should be put in place, and countries should share the fiscal burden of a cross-border crisis in line with those principles.

6. The IMF strengthened its role after being criticised for not having foreseen the Asian crisis.

A few years ago, many economists expected a sharp decline in the IMF's role in the current economic context. Against the background of the current crisis, the world seems to rediscover the role of the IMF. The institution's funds have recently been increased in order to meet the requests of different countries for financial and technical assistance. The statements of the G20 leaders are indicative of the fact that the IMF will assess regularly the measures taken and the global actions necessary to be initiated. Furthermore, a close cooperation between the IMF and the Financial Stability Board (FSB), which will include all G20 countries, members of the Financial Stability Forum, Spain and the European Commission is envisaged. Together, the IMF and the FSB will convey early warnings on macroeconomic and financial risks and will indicate the necessary actions to address such risks.

My opinion is that the current financial crisis highlights the fact that in such difficult times, an institution having an image of each economy in the global context is required. The IMF has an experience of at least 5 decades in analysing the economies of its members, 185 countries at present, and such a capacity is rather difficult to build.

7. Expansionary measures should be accompanied by exit strategies from the very beginning.

History has shown that expansionary measures taken in order to exit an economic crisis do have side effects in terms of inflation. The lesson learned from the '70s is that protracted expansionary policies resulted in high levels of inflation and public debt, the reduction of which called for tight monetary policies, which resulted in relatively low average economic growth. This lesson, along with that learned from other episodes which were addressed similarly, shows that the measures to weather the crisis should be based on the objective of ensuring medium- and long-term fiscal sustainability and price stability. In practice, this means that anti-crisis measures should be accompanied by credible exit strategies from the measures that are now necessary to support the financial sector and provide renewed impetus to global demand.

From this perspective, the recent meeting of the G20 leaders is encouraging. On the one hand, there were discussions regarding expansionary fiscal and monetary policies, including the use of unconventional monetary instruments, and, on the other hand, the objectives of ensuring medium- and long-term fiscal sustainability and price stability, with a special emphasis on drawing up credible exit strategies from the measures that are now necessary to underpin the financial sector and give a new impetus to global demand.

8. It is important that macroeconomic imbalances should be avoided and that a critical mass of structural reforms should support a sustainable growth path.

This lesson holds particularly true for the emerging economies. Over the past several years, I have repeatedly pointed out in my speeches that convergence with the EU along with maintaining macroeconomic stability is the major challenge facing Romania. In recent years, fast-track economic growth drew on external saving. Banks became dependent on external financing and the current account deficit exceeded the sustainability limits, which caused the Romanian economy to grow vulnerable.

The global crisis fostered this vulnerability which translated into a marked economic slowdown. Today it has become clear that the natural bias towards speeding up real convergence needs to be balanced by the need to ensure a sustainable convergence process. The NBR has repeatedly warned against the pro-cyclical nature of the fiscal policy, which added to excess demand. We should learn the lesson that allowing wide budget deficits while the economy is expanding ends in failure. It would have been much easier today for us to find the means to weather the crisis if our budget had been on a surplus over a two-year period prior to the unleashing of the crisis.

9. The adoption of the euro cannot be a substitute for the need of domestic policy adjustment.

This lesson became clearer at the moment emerging economies were hit by the economic crisis. While the leu was strengthening, up until the summer of 2007, the issue of adopting the euro was not on the agenda of economic agents. The crisis highlighted the fact that the leu was overappreciated and the market made the necessary correction. Over a relatively short period – from July 2007 to date – the leu weakened by around 35 percent. Over the same period, the prospects of economic growth changed dramatically: from an almost 9.4 percent growth rate in 2008 Q3 to a most likely significant decline in 2009 Q1. The monetary and fiscal policies will be resorted to with a view to adjusting to the new environment.

In face of the crisis, the relatively large stock of private foreign debt and the increased market volatility made some economic agents believe that the early adoption of the euro could supersede the need for economic policy adjustments. Yet this is not a viable option, as adopting the euro prior to having achieved the main stages of convergence with the EU might pose serious threats in the future. The adoption of the euro today would mean to relinquish monetary policy before having ensured convergence sustainability, namely before removing all the imbalances we are facing today. The outcome would consist in monetary policy being designed by the European Central Bank (ECB). But the ECB policy might prove inadequate from the standpoint of the specific problems facing the Romanian economy. The risk might occur that, in face of relatively high volatility of output and inflation, we run out of instruments to tackle the issue. I consider this as a strong enough reason not to adopt the euro prior to eliminating all major imbalances in the economy and before having made enough progress on the path to achieving convergence.

We stand committed to implement the pre-announced calendar of the euro adoption. We intend to join ERM II on 1 January 2012. After the minimum two-year stay in this mechanism, the joint decision on entering the euro area will be made in 2014 and (likely to) become effective as of 1 January 2015. Mention should be made that this is the calendar considered by most rating agencies and foreign investors, hence any large deviation (postponement) from this calendar would be negatively perceived and penalised accordingly.

* * *

I believe there will also be other lessons for countries to learn from the current financial crisis. They will learn the manner in which a banking system can be restructured so as to cope with a global financial crisis, particularly what is the impact of a so-called "bad bank" on real life. I trust countries will learn that central banks' resort to unconventional instruments bears certain costs. **Yet, regardless of the number of lessons learned, the experience of financial crises indicates that the social memory of crises is of short duration and that the possibility of repeating the same mistakes should never be ruled out.**

Let me conclude my speech with the words of Ivy Baker Priest, former Treasurer of the United States between January 1953 and January 1961.

"The world is round and the place which may seem like the end may also be only the beginning", Ms. Priest said. The idea of this quotation may appear as a truism but it is relevant for today's state of the financial system.

It may prove to be the key lesson to learn from "today's" crisis unless it may have been the lesson that mankind thought it had already learned every time a crisis occurred.

References:

1. *The High-Level Group on Financial Supervision in the EU report,* chaired by Jacques de Larosière, Brussels, 25 February 2009.
2. *London Summit – Leaders' Statement,* 2 April 2009.
3. Jean-Claude Trichet, President of the ECB, *Introductory remarks,* Brussels, 30 March 2009 (Hearing before the Economic and Monetary Affairs Committee of the European Parliament).
4. Mugur Isărescu, *Criza financiară internațională şi provocări pentru politica monetară din România,* Cluj-Napoca, 26 February 2009.
5. Mugur Isărescu, *Criza financiar-bancară şi economică: strategii, programe şi măsuri anticriză. Implicațiile şi perspectivele unei agende naționale,* Braşov, 6 March 2009.