Jens Weidmann: Lessons from the crisis for monetary policy and financial market regulation

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Frankfurt Finance Summit, Frankfurt am Main, 20 March 2012.

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1. Introduction

Dear Professor Franke,

Ladies and gentlemen,

First of all, I would like to thank you for the opportunity to speak here today. Through numerous collaborations, the Bundesbank has developed a close relationship with the House of Finance. The exchange between the two institutions has always proved rewarding; and it is a pleasure for me to follow up on this tradition today at the Frankfurt Finance Summit.

Almost five years have passed since the eruption of the global financial crisis. Global efforts to resolve the crisis and to draw the right consequences have been exceptional in historical comparison, and our perception of the financial sector has changed profoundly. But many of the questions the crisis has raised have not been fully resolved.

Among others, those questions refer to financial developments leading up to the crisis, chains of contagion throughout the crisis, as well as consequences of policy interventions taken.

All of them have in common that they aim at a better understanding of the financial sector and are therefore closely related to its ever-changing economic role as an intermediary.

There is no question that the role of the financial sector has undergone profound changes in the last decades.

This is illustrated by the increase in value added by the financial sector as a percentage of GDP around the globe. In the US, this figure grew by 70% over the last 30 years. In Europe, the development is more heterogeneous: Spain witnessed a 32% growth in value added by the financial sector as a percentage of GDP from 1995–2007, the UK a 46% growth. In contrast to that, Germany registered a drop by 9%. But altogether, the figures point to a general increase of the financial sector's relative weight.

In addition, more and more financial interaction is taking place within the financial sector itself: Financial assets held by the financial sector have increased by more than 100%. In comparison, the growth in total financial assets held by households and non-financial-corporations is significantly lower at around 50% and 70%, respectively.

Two starkly different explanations for this phenomenon are currently being debated. According to the first paradigm, the role of the financial sector as financial intermediary has changed, resulting in additional functions being performed by the financial system for the real economy. The second – and quite popular – explanation argues that the increase in financial activity has merely been an exaggeration, as a consequence of which the financial system has, to a certain degree, uncoupled itself from the real economy and turned to unproductive activities.

Each line of argument obviously has important policy implications – for the scope and intensity of regulation and supervision, but also for other policy areas, including central banks.

Drawing the right lessons from the crisis requires first of all a clear understanding of the role the financial system plays for the real economy. In my short remarks I will therefore take a somewhat more general approach that goes beyond monetary policy issues. I will argue that, firstly, a highly developed and innovative financial system is indispensable for economic growth, but that there is also an inherent risk of exaggerations.

Secondly, regulatory efforts therefore have to strike a delicate balance between constraining such exaggerations without stifling innovation and thereby hampering economic growth.

And finally, given that the crisis has laid bare serious gaps in our understanding of the financial system, I will conclude by outlining some fields of research that, at least from a central bank's viewpoint, are of particular interest.

2. The role of the financial system

The fundamental role of the financial system is to act as intermediary between borrowers and lenders. Services such as the transformation of maturity, denomination and liquidity allow for efficient capital allocation, thereby promoting innovation and growth.

Furthermore, the financial system solves adverse selection and moral hazard problems between lenders and borrowers. This is of crucial importance for financing innovations and therefore for TFP-intensive growth which we depend on in aging highly developed economies.

Throughout history, this role of the financial system has never been static, but has become more and more complex in step with economic progress. In the process, the contemporary structure of the financial system has gradually evolved over the centuries. Banks perform the tasks associated with money and credit, the bond market provides financing for governments and large corporations, the stock market provides equity financing of joint stock companies, venture capital the funding of nascent businesses – and a myriad of financial instruments allow us to trade and redistribute all kinds of risks.

And it is a well-known fact that this process has, through history, been accompanied by the build-up and bursting of bubbles – usually at large, sometimes very large costs. Prominent examples include the Tulip Mania, the South Sea Bubble, the Roaring Twenties Bubble and the Dot-Com Bubble.

Hence there has always been a trade-off. On the one hand, financial innovation was a precondition for rising prosperity and economic development. On the other hand, the fluidity and dynamism of financial transactions make the financial system prone to exaggeration and the emergence of speculative bubbles.

The financial crisis is another illustration of this pattern, but a particularly severe one that has galvanised policy-makers into reforming financial regulation. But what are the lessons we should draw?

3. Lessons for financial regulation

Regulatory reforms aim to improve the resilience of the financial system as a whole against shocks in the form of a default or the burst of a bubble. To achieve this, financial regulation has to prevent market forces from getting out of control. But it must not suppress financial innovation; otherwise we would eliminate its indispensable contribution to economic growth and development.

The European sovereign debt crisis has raised awareness of the importance of financial markets and their disciplining effect. True, bond markets took note of differences in sovereign risks much too late. But did not economic policy perform even weaker in preventing excessive deficits and the emergence of severe macroeconomic divergences?

For this reason, I am sceptical about correcting undesirable results in the financial markets by direct prohibition or by suppressing market activities.

Instead, regulatory reform should reinvigorate the principle that risks and returns have to be closely aligned: Market participants must be held responsible for their actions, the possibility of losses or even default is a constitutive element of any functioning market, and the financial markets are no exception.

The reforms initiated by the G20 reflect this approach. Measures like Basel III and the new macro-prudential framework explicitly take a systemic view of the financial system. The resolution regimes for SIFIs, the measures adopted to increase transparency and to create a global level playing field strive for a closer alignment of risks and returns. The agenda has picked up on important past trends, such as the increasing role of non-bank-sector and the growing interconnectedness of financial markets.

When looking at the experience of the financial crisis and the channels through which the financial system affects economic growth, the case can be made that the two objectives of an efficient and stable financial system are, to a significant degree, complementary. Well designed regulatory reform can make the financial system more stable without cutting into sustainable growth. But the constant evolution of the financial system and the emergence of new instruments and players also imply that the regulatory framework will never be finalised once and for all.

4. Unresolved questions

Prudent regulation and supervision crucially depend on a sound understanding of the financial system. Research efforts of institutions around the globe, including central banks which also have a keen interest in these issues, have been remarkable. However, a deeper understanding is still required of those trends in financial markets that led to financial instability – and monetary policy measures that sometimes took central banks to the limits of their mandate. I do not want to offer a research agenda, but let me pick out some areas that are particularly interesting for central banks:

Securitisation, for example, is not a new technique, but it has experienced an enormous upswing in recent decades. It is intended to disperse credit risk to those who are better able to assume such risks and absorb the corresponding losses, and as such it increases welfare. We know by now that securitisation can also increase risk-taking and thus the fragility of the financial system as a whole. Some elements of regulatory reform already address this problem. But the question remains whether we have done enough to reduce the drawbacks without sacrificing the benefits.

Another important reason for financial instability with potentially serious macroeconomic costs continues to be overextension in balance sheets in boom periods, which is often an indication of excessive risk-taking. We have learned that this can be masked by a vigorous economy. It is therefore vital that we extend our knowledge of how to make disguised risks more transparent.

Turning from the prevention of exaggerations to more direct countermeasures, we still do not know enough about the desirability of different forms of policy interventions. The search for the optimal mix of measures of *ex-post* and *ex-ante* interventions is still ongoing. Further work needs to be done in order to establish whether macro-prudential regulation can solve the time consistency problems associated with *ex-post* interventions.

This is a particularly relevant issue for central banks. Since the crisis began, functions have been added, especially in the field of macro-prudential policy. As you are well aware, the Bundesbank, too, stands ready and looks forward to assuming more responsibilities in this field. The challenge will then be to integrate these new tasks seamlessly with the functions central banks already perform. I think it is right to have central banks closely involved, given their expertise and the close linkages to other central bank functions; but there can be no doubt that the independence of central banks and our prime objective of maintaining price stability must not be compromised.

Additional issues have been raised by the European debt crisis. As regards macro-prudential policy, the distribution of competencies between the European and the national level and the various bodies is currently the subject of heated debate. Contagion effects of financial crises are particularly severe in a monetary union, suggesting a more centralised approach. But national financial systems still differ significantly within the euro area, and member states retain a large degree of autonomy in fiscal and economic policy, which favours the existing decentralised setup.

An important channel of contagion has been the heavy concentration of sovereign debt at the respective national banks. When risk perceptions started to change, banks holding large amounts of distressed sovereign debt became a severe burden on financial stability. We need to know more about how to best address this sovereign bank nexus.

5. Conclusion

Ladies and gentlemen,

let me conclude. The financial system plays an indispensable role in fostering innovation and growth. This role has never been static: it is evolving constantly. And throughout history, this process has been accompanied by exaggerations.

The continuing, never-ending challenge of financial market regulation is to limit the latter without stifling the undeniably beneficial forces at work in the financial system – we have to tame market forces and self-interest, but should not exorcise them.

To do so, we have to expand our understanding of financial markets, which is still limited and lacking in a number of policy-relevant fields. The Bundesbank is closely involved in this endeavour, and fora such as the Frankfurt Finance Summit are an important part of the process.

Thank you for your attention, and I wish you a lively, interesting discussion.