Remarks at the Eighth Annual BIS Conference

Introduction

We are facing a crisis of historic proportions. Numerous comparisons to earlier crisis episodes have been made, but it is safe to say that the global dimension and the negative spiral between the financial sector and the real economy are unprecedented. This raises many questions related to the causes and the policy cures. I will highlight some of them during my intervention, without pretending to have all the answers. First, I will discuss the resilience of the financial system. Next, I will raise some issues regarding macroprudential analysis. Third, I will touch upon the translation of analyses into policy actions and, finally, I will talk about several key policy initiatives, including those being pursued by the Basel Committee.

Where did we go wrong?

The financial system has proven to be less resilient than most of us assumed not too long ago. Until recently, it was common wisdom that the financial system had improved substantially over the past decades: financial services had become more accessible to broad categories of firms and households, the possibilities to spread and manage risks had increased, and the financial system was capable of absorbing shocks, including the burst of the dotcom bubble, the September 11 attacks and rising geopolitical tensions. In sum, it seemed that the financial system had become more efficient and stable, allowing more transactions at a higher speed. While I was a little sceptical about the birth of a new financial era at the time, I still believe that many of the improvements we saw are real. But somehow the system has turned out to be prone to large accidents, as the current crisis illustrates. This raises an important question: how is it possible that a system that seemed to have evolved for the better in so many ways, collapsed while taking the real economy down with it? And, related to this, how could a problem in the relatively small US subprime market result in a global crisis?

We all know that a small snowball can create an avalanche of devastating proportions. But for this to happen, the snow on the slope of the hill has to be footloose at the outset. So the key question is: what characteristic of the financial system created the risk of such an avalanche? Part of the answer lies in the fact that financial markets have become increasingly interwoven. Currently, local financial markets hardly exist anymore. By implication, we have become less vulnerable to small shocks, but more to occasional large ones. We are now facing a global financial market in which the higher speed of transactions implies that not only gains, but also losses are transmitted quick and far, hardly hampered by time or distance. In addition to this interconnectedness, risks were vastly under-priced in the years before the crisis, creating avalanche prone circumstances.

The need for an improved toolkit

This experience has underscored that a financial system is more than the sum of its parts because of the interlinkages between financial institutions, contagion and reputation effects. By implication, we need a macro prudential approach, a framework that maps out how risks spread through the system, especially during episodes of systemic stress. Also, more attention should be paid to micro-macro linkages which have become increasingly relevant in today's market-oriented financial system. Wrong incentives at the micro level have resulted in excessive risk taking, such as the supply of subprime mortgages to households that cannot afford them. At the macro level, the size and distribution of such risks is blurred by complex financial instruments and risk transfer mechanisms.

One instrument to improve our insight into financial resilience is stress testing. These tests should play an increasingly important role in our overall assessment of financial stability. At my central bank, DNB, we have conducted macro stress-tests on a regular basis in the context of its responsibility for prudential supervision and financial stability. An important question is how we should treat the results of these tests. We perceive the tests as one of the instruments in our supervisory toolkit, and the outcomes are considered in conjunction with other supervisory assessments. Our main aim is to inform regular monitoring and to assess the financial sector's resilience to potential stress in the economy and the financial markets. A related question is if the results of the stress tests should be published. I would argue that outcomes should generally be published on an aggregate level in for instance financial stability reviews, as part of the overall financial stability assessment. In our specific case, we do not use uniform criteria to assess the stress-test outcomes (e.g. capital targets), but applied a tailor made approach instead. Therefore, we do not publish the individual firm stress test results. In my view these tools are an indispensable part of the overall macroprudential framework.

Translating analyses into policy actions

That being said about the need for further analyses, the bridge between risk identification and risk mitigation is still under construction, as somehow the warnings we did receive failed to make their way into policymaking. A key question is: how can we translate these analytical insights into better policymaking? This raises a host of complex issues.

In the first place, the development of early warning indicators and early warning exercises has risen to the top of the policy agenda. And rightfully so. However, in practice our early warning systems are generally late warning systems instead, only providing warnings when large imbalances have already been built up. In such circumstances it is difficult to find the right policy as most measures risk deepening the downturn. Related to this, how transparent can we be regarding imbalances and risks without creating a self-fulfilling prophecy? In other words, how do you communicate about risks without precipitating the crisis? We were confronted with these questions

when the imbalances in Iceland became apparent. Warning against the instability of that country and its banks, would undoubtedly have prompted a bank run.

Second, how can we assure that policy adjustments are implemented on time? The IMF has extensive experience with policy recommendations that are not lived up to. How do we ensure that recommendations have more bite and that countries take more account of the cross-border effects of their policies?

And finally, how do we know if we got the diagnosis right? This question is critical as a biased diagnosis results in the prescription of the wrong medicine which may worsen the illness, or even create a new one.

No regret policies

Notwithstanding the difficulties surrounding the identification of risks and the implementation of policy actions, there are remedies which I would call 'no regret policies'. These are policy measures that we are confident we should implement. Examples that speak for themselves are policies relating to more robust accounting and transparency standards, balanced remuneration schemes, more forward looking ratings, and more decisive crisis management instruments. The Basel Committee has also done extensive work on policy initiatives in this category. I will highlight two of them.

First, the crisis has reaffirmed that a strong capital base is critical to bank resilience and broader financial stability. We all agree that both the amount and the quality of regulatory capital should be increased. But not just yet. If we strive for higher capital requirements now, we risk accentuating the downturn. Thus, a key challenge is to build countercyclical buffers into capital frameworks and provisioning practices. This will help ensure that reserves are built up during periods of earnings growth, and that they can be drawn down during periods of stress. One approach to achieve this, which is being explored by the Basel Committee, is to complement strict minimum requirements that always hold with a long-term target capital level to be achieved in good times. Moving between the two levels introduces a countercyclical element. Such an adjustment mechanism can be readily designed in a way that is compatible with banks' own incentives, for instance by limiting dividends, share buy-backs and other distributions to shareowners as long as capital coverage is below the target level.

Second, of similar importance is a strong liquidity base. During this crisis, many banks have found themselves in a liquidity squeeze even though they had adequate capital levels. Therefore, liquidity needs to be managed in a more prudent manner. In this context, the Basel Committee has published *Principles of Sound Risk Management and Supervision*. Going forward, we should closely monitor the implementation of these principles. Benchmarks, tools and metrics to do this are currently under construction.

In Conclusion

A last thought to conclude. It took us about 60 years to gain a true understanding of the causes and dynamics of the great depression. When it comes to this crisis, there is yet a long way to go. Our insights in financial transmission mechanisms are partial at best. Although extreme times call for extreme measures, a crucial question is: how do we know whether our unconventional measures are the right ones? Unfortunately, the answer probably is that we do not know for certain. This means that we should be extra careful in implementing these measures. In practical terms: we should already be pondering our exit policies. In times of strain, policymaking is like tightrope walking. The Japan crisis has taught us that delaying interventions can deepen a crisis. But we should not forget that excessive policies measures will likely do more harm than good, creating new vulnerabilities. In short, we need to strike a fine balance.