Session III: Introductory remarks

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In these introductory remarks, I would like to emphasize two considerations regarding macro aspects of financial stability, which is the main theme of this session. First, while the overarching theme of this discussion is financial sector regulation, improved regulation is only one aspect of financial sector reform. Moreover, improving regulation includes strengthening the effectiveness of existing regulations, but also redefining the perimeter of regulation. One of the key conclusions from the 2008-09 crisis was that some systemically important institutions and markets fell outside the perimeter of regulation, and that some of these were a source of significant financial instability. In recognition of this factor, proposed reforms have encompassed bringing off-balance sheet items – specifically, OTC derivatives and the shadow banking system – within the perimeter of regulation. Of course, regulatory reform also encompasses issues of capital adequacy – such as the work on SIFIs in general, and especially global SIFIS. The challenge of reducing pro-cyclicality also falls within the category of regulatory reform.

But there are other aspects of financial sector reform that are as important as regulatory reform, such as the quality and effectiveness of supervision. We in the IMF have concluded that weakness in supervision was every bit as important as flaws in regulation in creating the 2008/2009 market instability. Thus, failure to strengthen the effectiveness of supervision would seriously weaken the effectiveness of the efforts on regulatory reform. Moreover, the "Too Big to Fail" issue reflects the lack of resolution mechanisms for systemic institutions – both those operating within national boundaries, but especially for institutions that operate in multiple jurisdictions – as well as issues regarding capital adequacy. The impact of the absence of an effective resolution mechanism for failing institutions was demonstrated vividly by the Lehman Brothers' case. More recently, the failure of MF Global will leave many of that firm's clients at the mercy of lengthy and costly legal processes. Without a doubt, making significant progress in developing resolution mechanisms for cross-border institutions is going to be the most difficult and complex of all the reform challenges, but that doesn't reduce its importance or the need for serious effort.

Alongside regulatory reform, supervisory reform and the bolstering of resolution mechanisms, the fourth area of importance in financial sector reform is the assessment of the actual implementation of planned reform measures. In fact, this is one area where there has been concrete progress. The formation of the Financial Stability Board in 2009, at the behest of G-20 Leaders, led to the formalization of a peer review process under the auspices of the FSB. This is highly valuable, but has the inevitable limitations of any peer review process. Hence, the existence of a rigorous and effective independent assessment process represents an important impetus for an effective peer review, as well as possessing intrinsic value. The independent assessment in this case is provided through the Financial Sector Assessment Programs (FSAPs) conducted jointly by the IMF and the World Bank. IMF members agreed that all countries with systemically important financial sectors will undertake an FSAP update at least every five years, and all G20 members agreed the same. Of course, there is a very significant overlap between the counties included under each of these categories.

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The second theme of my introductory remarks is to remind that macro aspects form only one component of financial stability. Financial stability goals certainly involve macroeconomic policies – including conventional monetary and fiscal policies, as well as structural policies. At the same time, micro-prudential policies also expert an important influence on financial stability. In this context, I highly recommend the report on financial stability issues in emerging and developing economies prepared jointly by the FSB, World Bank and the IMF for the G-20's Cannes Summit (available on the imf.org website).

This Report highlights five key issues regarding micro prudential policies, viewed in the context of their contribution to financial stability. These include; First, the application of international standards; Second, cross border supervisory co-operation; Third, the definition of the perimeter of regulation in EMEs; Fourth, the treatment of foreign exchange risks; and Fifth, the development of domestic capital markets. The report states that there is no "One-Size-Fits-All" recipe for promoting financial stability. It also point out that there are important structural linkages among all five issues. Nonetheless, these issues – together with financial market development – represent the key elements of any effort to promote financial stability through micro prudential measures.

Looking forward, there are two intellectual challenges that need to be met successfully in the interest of bolstering financial stability. First is to gain more complete and useful understanding of macro-financial linkages. This means tracing in much greater detail the two-way linkages between financial market developments and the macro economy. Examination of the macroeconomic models currently in use reveals the rudimentary way that those interactions are being captured. But it is these models that are being used to gauge – among other things – the potential impact of financial reform measures on macro-economic performance. Thus, progress in this area would be an important contribution to the preservation of financial stability.

The second challenge is to deepen our understanding about the effective use of Macro-Prudential policy. The IMF has been working very actively on this issue. In April, the Fund published an overview paper titled "Macro-Prudential Policy: An Organizing Framework". The September 2011 edition of the Fund's Global Financial Stability Report (GFSR) included a chapter on macro-prudential issues. I highly recommend both of these publications, and both are available the Fund's website (www.imf.org). A report titled "Macro-Prudential Policy Tools and Frameworks: A Report to the G20" was prepared jointly by the BIS, FSB and IMF. and was delivered to G20 members last August. Two other papers of a more technical nature also were published in August by Fund staff, including "Towards Effective Macro-Prudential Frameworks – An Assessment of Stylized Institutional Models" and "Macro-Prudential Policy: What Instruments and How To Use Them? Lessons from Country Experience". These papers also are available on www.imf.org.

But what needs to be done in order to address the issue of using macro-prudential tools to bolster financial stability? The key tasks in this regard include:

1. Identifying and monitoring systemic financial risk. After all, you can only manage that which can be measured.

2. Specifying and calibrating the potential instruments of macro-prudential policy, which by nature are prudential and macroeconomic, not microeconomic and/or regulatory.

3. Creating the specific instruments and specifying their governance. Governance will have to reflect the need for co-ordination of prudential tools used for financial stabilization with traditional macroeconomic policies like monetary and budget policies.

These issues will be explored by Philip Turner in the main presentation in this section of the seminar that follows directly.