Nout Wellink: Crisis intervention and policies – effectiveness and the need for coordinated action

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at the ELEC (European League for Economic Cooperation) event, Amsterdam, 6 March 2009.

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I am not telling you anything new if I say that the global financial system is ill, severely ill. Being ill is a concern, but in itself no cause for alarm. This time, however, there is something special about the state of the global financial community. Bank by bank, sector by sector, and country by country have been infected. The current financial crisis is much like a flu epidemic. A flu epidemic is by definition drastic and difficult to fight. Sometimes, the only option is to let the epidemic rage and focus on damage control, through intense coordination between the different emergency services.

Damage control and the need for joint action also apply to this financial crisis. Despite extraordinary measures taken by authorities, the engine of the global financial system is not working properly. Market conditions are still fragile and banks' access to key markets remains problematic. Banks face ongoing pressure to deleverage by shrinking their balance sheet and reducing credit supply. The financial system has great difficulties in fulfilling its role as intermediator. Banks' own crisis management focuses on reducing exposure to risky assets, securing more stable funding and increasing capital. That is important, but insufficient to tackle the crisis. In the meantime, more and more economies are in recession. So the challenge to recover from the most serious financial crisis since the 1930s is immense. In this setting, I will discuss the recent interventions and their effectiveness, and the shortcomings in cross-border coordination.

Most authorities have taken a host of measures to prevent the financial system from breaking down. We can distinguish four categories of support measures: 1) expansion of retail deposit insurance, 2) guarantees for bank liabilities other than deposits, 3) capital injections, and 4) purchases or guarantees of assets held by banks. These measures have been complemented by generous central bank liquidity provisions and policy rate cuts.

To date, Australia, Germany, Spain, the United Kingdom and the United States and also the Netherlands have carried out all four measures. More than a dozen countries have adopted at least three of these measures. It is striking that most authorities prefer the same measure. In the Western world, three quarters of the countries have expanded their deposit insurance scheme and introduced guarantees for bank liabilities and capital injection programmes. Asset purchases were not very popular until recently, but have now been arranged by a number of countries.

More recently, many countries have concluded that bank rescue measures alone will not be sufficient to address the financial crisis and hence should be complemented by fiscal stimulus packages. So far, fifteen countries have announced such packages in the order of 1-5% of GDP and China even announced a package of more than 10% of GDP.

Despite the strong interventions, recovery of the banking system seems a long way off. So how effective are the interventions? Rather than risking a judgement while the crisis is still unfolding, I would like to stress that the resolution of the crisis is being complicated by its unique, international and complex nature.

The crisis is unique in that it has presented new challenges to policymakers, such as the drying-up of securitisation markets, the simultaneous deterioration in banks' ability to sell or fund assets, and the wave of involuntary re-intermediation of credits on banks balance sheets. The key challenge is that the unknown is by definition difficult to address and resolve.

The crisis is international as it has a cross-border impact and affects all aspects of both the financial and the real economy. The right answer to this crisis is necessarily a global solution. But recent experiences have shown that the coordination of national responses to cross-border crises is problematic for at least three reasons. Burden sharing is politically extremely difficult. The mandates and objectives of authorities are still mainly organized along national lines and may conflict. And thirdly, there are potential conflicts between national resolution regimes. Complexity and interdependencies within cross-border groups aggravate this.

The crisis is complex because it was triggered by innovative and intransparent products and markets. The lack of adequate information has raised uncertainty and complicated crisis resolution. The crisis has become a fast moving target, especially since it is increasingly interacting with an economic recession.

Due to the unique, international and complex nature of the crisis, its resolution has been a continuous learning process for policymakers. Over the past 22 months, traditional crisis resolution frameworks have been only partially effective, and the crisis has uncovered some fundamental weaknesses. We need to be critical about the effectiveness of measures, to show flexibility amid changing circumstances, and continue to learn along the way. Let me illustrate this with three examples of advancing insights and lessons learned that have led to adjustments to, and extensions of, existing measures.

Initially, authorities addressed the crisis with tailor-made rescue plans for troubled institutions. However, this piecemeal support failed to prevent a rapid erosion of market confidence, especially after the Lehman failure. Authorities reacted by adopting more systemic approaches to prevent bank failures. One example is the Troubled Asset Relief Program in the United States. Another is the common rescue framework adopted by EU-countries in October 2008. Under this framework, the EU countries committed themselves to fight the crisis through explicit government guarantees on retail deposits, guarantees for bank liabilities and capital injections. These programmes succeeded in halting the deterioration of confidence in the banking sector: bank CDS spreads narrowed across the board and reached a permanently lower level from the middle of October onwards. The lesson learned is that system-wide stress demands a systemic approach to reducing the risk of bank defaults.

The learning effect is also true of government capital injections into banks. These measures have been much needed to avoid a collapse of the banking system. However, many of the capital injections have been eroded by rising losses on toxic assets. This has prompted a number of governments to announce asset purchase or guarantee programmes. Recapitalisation of troubled institutions is not sufficient unless authorities tackle the asset problem on banks' balance sheets simultaneously.

Central bank measures to address funding pressures by banks have also benefited from advancing insights. Initially, the ECB and other central banks resorted to existing tools to stabilize overnight interbank rates. But the need for longer-term funding operations to address bank's general unwillingness to lend in term interbank markets quickly emerged. While central banks supported the money markets, the situation in the wholesale and debt funding markets became critical. Lending by non-bank financial institutions and across currencies also started to dry up. This prompted the introduction of new lending facilities, arrange currency swap lines between central banks and widen the range of counterparties beyond conventional frameworks. The lessons from this are twofold. First, during a prolonged liquidity crisis, central banks might need to shift their focus more towards non-traditional bank funding rather than just the money market. And second, when central banks are confronted with setbacks, they need to be pro-active to overcome those challenges.

As I said, authorities implemented a number of policies to fight the pandemic. Some of those worked, others didn't. However, each of the measures has its merits, and I would like to stress that their success or failure are a matter of hindsight. I believe authorities did their utmost in their response to the crisis at the beginning, given the challenges at that point in time. But it got worse, far worse, and new, more drastic measures were needed. That doesn't prove that initial policies and measures were wrong. Rather, it illustrates the determination of authorities to fight this crisis.

But it also shows something else, that fighting this crisis demands international coordination. At best, uncoordinated nationally implemented measures may be effective in solving national problems. But a number of those measures unintentionally triggered problems in other countries. The chain effect of raising the deposit guarantee scheme protection is a clear example. The introduction of higher levels of depositor protection triggered a flow of savings out of other countries, forcing other governments to implement similar policies. Coordination could have prevented negative side effects.

Many of the policies implemented to fight this crisis carry the risk of economic nationalism. Uncoordinated national policies fail to take into account the complexity of the financial system. The interconnectedness of the financial world should have made it utterly unthinkable to act unilaterally. This does not just apply to measures targeting the soundness of financial institutions. In our integrated world any uncoordinated policy aiming to boost the economy, might cause negative externalities. However unintentionally, uncoordinated measures could spark a period of real protectionism. The net effect of such "beggar-thy-neighbour" policies is a deepening crisis. Supranational authorities could and should play a bigger role.

Enhanced coordination is not limited to governments, regulators or supervisors. During the financial crisis we saw several cases, most notably the collapse of Lehman Brothers in September 2008, which had a truly systemic impact. These events have demonstrated that the distinction between macro- and microprudential stability is hypothetical in practice. Both are necessary. Therefore there is an urgent need for close and continuous cooperation between macroprudential supervisors – central banks – and microprudential supervisors.

To be frank, I don't think the crisis is anywhere near its end. But I do think it is time to consider what shape an end to the crisis would take. Fighting this crisis has been tough. Reversing the implemented measures will require exactly the same coordination and determination.

And reversing those policies isn't going to be easy. The same national interests that drove the uncoordinated remedies to fight this crisis are at stake. At the end of the crisis, when it is economically justified to downsize those measures, economic nationalism will be lurking again, albeit unintended. At the end of the crisis we may enter a period in which governments cannot sell their stakes in banks or downsize the coverage of the insurances schemes, without the risk of putting their institutions at a comparative disadvantage to their protected peers abroad. It's time to start thinking about a credible exit strategy.

Again, coordination and timing are important. Selling or reducing stakes in banks too early could reduce investors' and depositors' faith in those banks. Getting out too late would cause a prolonged period of market disruption as institutions (partially) owned by governments are at a competitive advantage over privately owned banks. Prolonged government intervention hampers the healthy effects of competition. Normalization of the markets is far more difficult under those circumstances.

Even if unintended and socially justifiable, substantial state interests in financial institutions is effectively protectionism. Guarantee schemes are a powerful tool to create confidence in banks and protect depositors, but the downside is that they stand in the way of market normalization. And the threat is not just that some governments may choose to maintain their policies longer than others. The terms and conditions of state withdrawal will materially affect a bank's competitiveness vis-à-vis its peers. In other words, the level playing field is at risk.

Everyone can rationally envision the problems of downsizing crisis policies, and the subsequent reluctance of governments to reverse nationally orientated measures. Especially if this puts their financial institutions at a comparative disadvantage. Since all governments are going to face this dilemma, the only way out is coordinated action. If we fail to coordinate towards the end of the crisis, distortions will emerge and some governments will keep substantial stakes in credit institutions for a long time. While I don't say governments shouldn't hold stakes in financial institutions, I think it is time to discuss the terms and conditions, including the exit strategy.

Fighting this crisis has been a learning process. And I guess we are still on the steep part of the learning curve. We have definitely experienced that it can always get worse, and to be prepared for that. We have seen that measures labelled as "too drastic" may at some point become the appropriate response. And we have learned that you can't fight a crisis like this on your own.

By many standards this crisis has been, and still is, an extraordinary series of events. Its systemic and complex nature has revealed fundamental weaknesses in the crisis management of financial institutions, policymakers and supervisors alike. It is as if a new aggressive variety of the flu virus has suddenly emerged and is threatening our very existence. So, in the face of this pandemic, it is no surprise that we all had to improvise and to learn as we went along.

Authorities have been creative in their responses and have shown great commitment in adjusting to new challenges. In the past few months national governments have acted to protect the interest of depositors of individual financial institutions. Regrettably, but understandably, they did so in a largely uncoordinated way. The crisis has shown that cross-border coordination remains problematic. While governments have emphasized the importance of joint action, initiatives to bring it about are lacking so far. International cooperation well beyond the current level is imperative if we are to put an end to this crisis.