Guy Quaden: Crisis management at cross-roads

Closing speech by Mr Guy Quaden, Governor of the National Bank of Belgium, at the joint Société Universitaire Européenne de Recherches Financières (SUERF), Centre for European Policy Studies (CEPS) and Belgian Financial Forum Conference, Brussels, 16 November 2009.

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Ladies and Gentlemen,

More than two years after the US subprime crisis triggered world-wide financial turbulence and one year after the collapse of Lehman Brothers exacerbated the crisis dramatically, the title of this conference rightly suggests that crisis management is at a crossroads. Indeed, the exceptional measures taken by central banks and governments do appear to be achieving their objectives. It seems now that the most severe financial crisis since the 1930s, which provoked a free fall in world trade and industrial production over two quarters, will not develop into another Great Depression, even if its toll in terms of subdued economic activity and higher unemployment is not yet over. Crisis prevention will soon have to take over from crisis management. This will require both a timely exit from the exceptional measures taken to stabilise the financial system and the economy, and the implementation of fundamental reforms to remedy the structural defects exposed by the crisis.

1. Timely exit

Let me turn firstly to the issue of a timely exit. The policy reaction to the financial crisis was very decisive. Central banks were the first to react in August 2007, by providing ample liquidity. After the sudden aggravation of the crisis in September 2008, they reduced interest rates to unprecedentedly low levels and took some non-conventional measures to support bank lending and the financial markets. Governments rescued systemically important financial institutions, through capital injections and asset purchases, and supported bank funding, through guarantees. They also launched fiscal stimulus packages. In order to consolidate the recovery, to avoid nurturing the seeds of future crises and to promote sustainable development, these short-term measures have to be unwound at the right time and pace.

The effectiveness of fiscal policy depends on the confidence in its sustainability, and it is important to avoid the private debt crisis being followed by a public debt crisis. The burden of fiscal consolidation should not be passed on to the next generations. Credible fiscal consolidation programmes have to be set up, and the current outlook should allow the first steps to be taken next year.

But let me focus on the Eurosystem's monetary policy. Too early an exit from the current very accommodative monetary policy stance would entail the risk of a relapse: renewed negative interactions between financial sector problems and the real economy, along with a possible threat of deflation. Too late an exit would sow the seeds for new financial excesses, with a risk of inflation. Obviously, the assessment of risks to medium-term price stability must remain the fundamental criterion. Moreover, I expect gradualism to be a key feature of the exit. Certainly, our toolkit would allow us to react swiftly to any abrupt change in inflation expectations. However, economic and financial conditions are likely to gradually return to normal and, consequently, the upward shift in the balance of risks to price stability will probably be gradual. In fact, gradualism is most appropriate in uncertain times as it dampens the risk of disruptions in financial markets. The sequencing of the exit is not pre-defined, nor is its end point, and will depend on developments in financial markets and in the real economy. For example, the Governing Council of the ECB could change interest rates while keeping some non-standard measures in place, if required by a dysfunctioning of the money market – and you may remember that this kind of separation of monetary policy and liquidity management measures was quite common in the first phase of the crisis, from August 2007 to September 2008. Conversely, and this is may be more obvious, some non-standard monetary policy measures are likely to be withdrawn before raising interest rates.

So, where do we stand now? Even though they are not yet back up to their pre-crisis levels, most financial market indicators have improved considerably. Since the spring of this year, there have been signs of a nascent recovery, the “green shoots”, mainly thanks to the policy reactions around the world and especially to a rebound in Asia. However, the economic recovery is still fragile and reliant, in no small measures, on expansionary monetary and fiscal policies. Moreover, commercial banks still have to repair their balance sheets and reinforce their capital base. The current slack in the economy is dampening price developments, an assessment which is confirmed by the monetary analysis. Consequently, the Governing Council believes that current interest rates remain appropriate.

At the same time, the situation is not quite as dire as it was a few months ago, especially in terms of financial market functioning. Therefore, the first steps of a gradual phasing-out of non-standard measures can be envisaged, like a discontinuation of 1-year refinancing operations or a lower frequency for 3-month and 6-month refinancing operations. They should not be seen as the start of a tightening cycle, but rather as an incentive for banks to restructure their portfolios and to resume their market-based funding activities, as a long period of cocooning in the banking sector has microeconomic drawbacks too.

Looking further ahead, the Governing Council will continue to set the monetary policy stance by assessing the appropriateness of monetary and financial conditions in view of the risks to price stability. One of the lessons of this crisis is that central bankers should not be guided by excessively narrow inflation targeting but should pay attention to the build-up of financial imbalances, which may not immediately exert pressure on prices, but an abrupt correction of which may put price stability at risk. The Governing Council can claim that the medium-term orientation of its strategy and its monetary analysis are assets in this respect. A few years ago, at a previous SUERF conference, I announced that M3 might abandon us. And indeed, the long-run relationship between M3 and prices proved to show signs of instability. At the same time, I pointed out that monetary analysis was much richer than monitoring M3 only. We now monitor credit developments closely. Research at the BIS, the IMF and within the Eurosystem is exploring the leading indicator properties of money and credit aggregates which may be useful in the identification of detrimental asset price bubbles. Further research is still needed in order to reach definite conclusions. While monetary policy should play a role in “leaning against the wind” of over-optimism in financial markets, it should however not be over-burdened. Interest rate policy on its own cannot guarantee both price stability and financial stability, and should therefore be backed up by prudential policies.

2. Fundamental reforms

This leads me to the second issue, the fundamental reforms which are badly needed. There is a long list of work in the pipeline of international fora. The Financial Stability Board at G20 level as well as Ecofin at EU level have drawn up detailed roadmaps to pave the way for extensive reforms.

The authorities must be determined in their drive for better regulation and supervision. As explicitly noted by the Basel Committee, “*the banking sector entered the crisis with an insufficient level and quality of capital, inadequate provisions, imprudent valuations, insufficient liquidity buffers, compensation polices that encouraged excessive leverage and risk taking and excessive concentration of exposures among major financial institutions*”. The insistence on the words “insufficient”, “inadequate” and “excessive” shows that, in particular, more and better buffers are expected.

The crisis has given rise to a unique momentum for profound reform of the financial sector. We should not let this momentum slip away. I know full well that the return to more simplicity will be anything but simple. Of course, I realise that a lot of technical issues have still to be resolved. And I admit that it will be important to introduce the new regulations in a timely manner so as not to repress the smooth flow of credit which will be required to support the nascent recovery. In fact, while there is much discussion at the moment on the design of the exit strategy from the public support measures, we should be equally aware of the need for an entry strategy for moving over to more comprehensive regulatory requirements.

But all these considerations should not be an excuse for prevarication and delaying the essential decisions to take for the design of a more comprehensive framework.

The crisis has seriously dented belief in the ability of the markets to regulate themselves. While it would be illusory to dispense with the assistance of the market in designing new supervisory and regulatory arrangements, these market consultations have more often that not been used by many financial institutions as a channel to lobby for softer regulation, certainly in the past and probably still today.

The rapid spread of the financial crisis has also served as a lesson for supervisors. It has shown that the root of the problems was not linked to any specific difficulties faced by individual institutions but, rather, to the gradual build-up of common risks within the system. It is now widely acknowledged that such crystallisation of risk, linked to major shifts in the correlation between financial products and markets, requires more systemically-focused oversight and regulation. To use the professional jargon, micro-prudential control, the preserve of the supervisory authorities, must be complemented by macro-prudential oversight, resorting to the expertise of central banks. To improve the symbiosis between these two approaches, a growing number of countries are adopting the so-called “twin peaks model” where the central bank is in charge of the full range of prudential supervision, in both its micro- and macro dimension, leaving the oversight of market integrity and investor protection to a separate institution. Just a few weeks ago, the Belgian authorities, too, decided to introduce this “twin peaks model” here as quickly and smoothly as possible.

Needless to say, I am well aware that the macrodimension does not stop at our country’s frontiers, while the micro-supervision of cross-border groups also requires close multinational coordination. So, I strongly support the recent proposal to set up, at EU level, a European Systemic Risk Board (ESRB) and European System of Financial Supervisors (ESFS), which are called on to cooperate closely in order to bring more comprehensiveness and consistency to national and international supervision.

Macro-prudential analysis must rely on rapid, direct and comprehensive access to data on individual developments liable to affect global financial stability while, in turn, this analysis must feed the micro-prudential control. It would be a pity if our efforts to improve this flow of information in our respective countries were to be impeded by hurdles at the international level.

Ladies and Gentlemen,

Crisis management has been effective: many banks have been rescued, the abrupt rise in risk aversion has been countered and it seems that financial markets are returning to normal and that the fall in trade and output has come to an end. For the emergency measures not to nurture renewed financial excesses, they have to be withdrawn in a timely and gradual way and, above all, backed up by structural reforms. Better regulation and supervision are needed. Great haste in regulating complex matters would probably not be wise, but the political resolve for reforms should not lose momentum.

Thank you for your attention.