Yves Mersch: The financial crisis – challenges and new ideas

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the Luxembourg School of Finance, Luxembourg, 28 January 2010.

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I am very pleased to be here tonight and wish to thank the Luxembourg School of Finance for providing me with this opportunity to speak on the recent financial crisis, the policy response, and the challenges ahead.

The run-up to the crisis was driven by animal spirits, which encouraged excessive risk-taking by investors and a significant increase in financial sector leverage. Asset price declines triggered an unexpected departure from the normal functioning of the financial system, plunging agents into unquantifiable "Knightian" uncertainty. This unleashed panic, characterised by a "flight to safety" and fire sales of financial assets that amplified the crisis. The risk to systemic stability required intervention by the authorities that was unprecedented both in its extent and in its form.

It is important to recall that we have very limited knowledge of many aspects of the crisis. All financial crises share certain phases of market behaviour, but they are all different. In recent years some warnings highlighted existing imbalances and vulnerabilities, but nobody predicted the timing and nature of such a sudden break in market behaviour. As the crisis unfolded, authorities had to take policy decisions rapidly although their effects had become uncertain, as normal market functioning could no longer be expected.

What was most surprising in the recent crisis was the role played by liquidity. In retrospect, it is easy to conclude that it should have been monitored more closely and that pro-cyclical behaviour needed to be mitigated more effectively. However, these suggestions only represent "preventative care". The implementation of such measures could reduce the likelihood, or at least the extent, of future crises. Once a crisis hits, it is too late for "preventative care" and the authorities have to implement "emergency interventions". These carry significant costs for the taxpayer, so it is natural to ask how the private sector can help share this burden.

In my remarks, I will begin with the recent past, reviewing the crisis and the policy responses of both central banks and governments. Then I will turn to the lessons of the crisis and the challenges both in the immediate future and at a longer horizon. I wish to focus on the need to reform the current financial architecture. This process is already underway at the global level as the April meeting of the G20 endorsed Financial Stability Board proposals in this domain. One important objective is to re-align incentives in the financial sector from an excessive focus on short-term profits towards more "socially useful" activities that include reducing systemic risk and encouraging the creation of long-term wealth. Finally, I will comment on some "new ideas" that may contribute to this aim.

1. The policy response to the crisis

In the financial crisis, monetary authorities intervened to address liquidity issues and government authorities intervened to address solvency concerns. These complementary roles were clearly established long ago. However, it is generally agreed that the recent crisis somewhat blurred this distinction in practice. As a central banker, I will begin by reviewing the response of the monetary authorities.

1.1 Central bank policy response

The financial crisis initially appeared in August 2007 as a sudden shortage of liquidity in the money market. Traditionally, central banks monitor the functioning of this market very carefully, because it is here that monetary policy is implemented through regular refinancing operations. This is why the Eurosystem was the first to respond with massive liquidity injections.

The decline of asset prices reduced the value of complex structured finance products, which were widely disseminated across the banking sector. It suddenly became difficult to find a buyer for these instruments. As trading volumes collapsed, it also became difficult to value these assets accurately because prices were no longer observed on the market. Uncertainty increased dramatically and banks began to view each other with suspicion as they realised that individual exposures were not transparent.

As the inter-bank market dried up, banks found themselves hoarding cash to rebuild their liquidity buffers. This induced them to tighten credit standards, posing the risk that they might cut back loans to firms and households, transmitting the financial crisis to the real economy. In mid-September 2008 the collapse of a major financial player set off a global financial panic. Given the severe downturn in the euro area economy and receding inflationary pressures, the Governing Council of the European Central Bank responded by rapidly lowering interest rates to 1%, a historical low for the euro area countries in the post-war period.

In addition to standard monetary policy measures, the Eurosystem introduced a policy of "enhanced credit support" intended to limit the role of liquidity in the propagation of the crisis, to maintain the transmission of interest rate decisions, and to enhance the flow of credit to the real economy.

These extraordinary measures lead to a doubling of the central bank balance sheet in the euro area and an even greater expansion in the US. In effect, the money market ceased to exist and the central bank took over its intermediation role. This emergency intervention contributed to a broad-based improvement in financial markets and a return to a more normal functioning of the money market. According to the most recent figures, the Eurosystem's balance sheet has already shrunk by 11% from its peak in December 2008, while in the US it has remained stable. Overall, central banks appear to have successfully performed their function as "lender-of-last-resort".

1.2 Government policy response

Turning to the government policy response, this took three forms: (i) the fiscal stimulus, (ii) asset support and (iii) capital injections and guarantees.

In October 2008 the intensification of the financial crisis began to affect the real economy and the need for a *fiscal stimulus* became apparent. In April 2009 the G20 summit in London signed a global plan for recovery and reform. Although justified by the extent of the crisis and varied in extent across countries, this fiscal stimulus caused a substantial deterioration of public deficits and debt-to-GDP ratios.

In addition to asset support, governments also intervened on the liabilities side of bank balance sheets, with direct capital injections and with state guarantees. Since these measures are the subject of tonight's conference, I will discuss them in more detail in the second part of my speech.

For now, let me just recall that so far euro area governments have committed 26% of GDP to supporting the financial sector (although the sum actually drawn is only about 10% of GDP). This support was necessary, not for the banks' sake, but for the sake of the central role they play in the market economy. This is particularly true in the euro area, where banks are firms' main source of external funding, as opposed to other economies whose financial system is sometimes considered more "market based". These differences across economies also determined different policy responses. The US and the UK initially focussed on asset support that was intended to return markets to proper functioning. Eventually, they turned to their second line of defence, with direct capital injections to support the banks. In the euro area, this order was reversed, with authorities more focussed on the banking sector and turning to asset support as a second line of defence.

2. Preparing for the future

Having described the recent policy response to the crisis, I turn now to the challenges that remain for the future.

I will divide my remarks in three parts. First, the immediate challenge is to implement *exit strategies* from the current extraordinary monetary and fiscal measures. Second, a longer term challenge is to design and implement *financial reform* that effectively mitigates systemic risk. Finally, I will discuss some *new ideas* advanced within this process of reform.

2.1 Immediate challenge: monetary and fiscal exit strategies

First, let me consider the exit strategy from current extraordinary monetary measures. As I mentioned before, there are signs of substantial improvement both in financial markets and in the real economy. These suggest that the Eurosystem extraordinary liquidity measures are not all needed to the same extent as in the past. However, unwinding of enhanced credit support must be both timely and gradual. It must be timely because there are risks associated with acting either too early or too late and it must be gradual because the situation is only improving progressively. The process of withdrawal is facilitated by the fact that many of the non-standard measures were designed to phase out naturally over time unless renewed by explicit policy decisions. For other measures, the situation has improved sufficiently for Governing Council to initiate the gradual process of withdrawal.

The cornerstone of the exit strategy is the ECB primary objective of price stability in the medium term. This has guided the introduction of enhanced credit support and will govern the process of withdrawal. As with the monetary policy strategy, the exit strategy cannot precommit Governing Council to a given timing or sequence of actions. These must be decided with reference to changing economic and financial circumstances.

Now I wish to briefly address the exit strategy from the current *fiscal stimulus*. In addition to government measures supporting the financial sector, the extraordinary fiscal stimulus and the so-called automatic stabilisers have substantially deteriorated public finances during the current economic crisis. According to autumn 2009 forecast of the European Commission, the deficit ratio in the euro area should reach 6.9% of GDP in 2010, while government debt is expected to reach 84% of GDP in 2010. These significant fiscal imbalances undermine public confidence in the sustainability of public finances, which may place an additional burden on monetary policy in maintaining price stability.

As stressed by the ECB Governing Council, national governments must abide with the EcoFin Council agreement to communicate timely, ambitious and credible fiscal exit strategies as soon as possible. The fiscal consolidation process should be transparent and should be guided by the rules of the Stability and Growth Pact (SGP). Current government commitments to start consolidation in 2011 at the latest represent a minimum requirement for all euro area countries. Furthermore, given the future challenges raised by ageing populations, fiscal consolidation efforts should provide a strong focus on expenditure reforms. Developing and communicating fiscal exit strategies is an urgent policy priority.

2.2 Financial reform process to mitigate systemic risk

Beyond the immediate challenges, I wish to focus on the ongoing programme of wide-ranging financial reform. The objective of this process is to counter systemic risk and enhance the future resilience of the financial system.

The recent crisis provided us with three important lessons that could guide this process of financial reform

- First, systemic risk needs to be monitored by an operational macro-prudential framework, extending the perimeter of regulation and mitigating the pro-cyclicality of the financial system
- Second, incentives need to be aligned on creating long-term value and not short-term profits
- Third, cooperation in surveillance and oversight needs to be improved

Let me expand on the first lesson, the need for an operational *macro-prudential framework*. The analysis and control of systemic risk was a key missing ingredient in the run-up to the crisis. The problem is that although banks may seem resilient when considered individually, the banking system as a whole may still be vulnerable. This paradox can be explained through the two key dimensions of the macro-prudential framework. First, the cross-sectional dimension focuses on the risk of joint failures that reflects similar exposures or interconnectedness. Second, the time dimension focuses on interactions within the financial system, as well as feedback between the financial system and the real economy. These links account for the pro-cyclical behaviour of the financial system, which can aggravate systemic risk by amplifying the effects of the business cycle.

The Basel Committee on Banking Supervision has already agreed on a set of proposals aimed at improving the resilience of the system. These focus on raising the quality and quantity of bank capital in order to better absorb future shocks. They also suggest introducing a bank leverage ratio, although this will have different effects in the US and the EU unless there is convergence in accounting standards. More generally, there is agreement on the need to require banks to build-up countercyclical buffers in good times that can be drawn down during bad times. In addition, the Basel Committee and the CEBS (Committee of European Banking Supervisors) are developing new standards for liquidity. The European Union has also enhanced its macro-prudential framework by creating the European Systemic Risk Board, with responsibility for issuing early warnings and recommendations.

The second lesson was that *incentives* need to be aligned on creating long-term value rather than short-term profits.

The final lesson of the crisis was that it clearly revealed the need to improve cooperation in surveillance and oversight. This requires better links between the two pillars of financial supervision: the micro approach, which focuses on individual institutions, and the macro approach, which focuses on systemic risk.

2.3 New ideas to prepare for the future

I have described the immediate challenges linked to exit strategies and the longer-term process of financial reform that is already underway. Let me now comment on some new ideas advanced in the wake of the crisis to prepare for the future.

In a Financial Times column entitled “how to save banks without using taxpayers’ money” Professors Wolff and Vermaelen describe a financial instrument called Contingent Convertibles (also known as CoCo bonds). In the recent crisis, these could have helped distressed institutions to convert debt to equity, reducing the need for capital injections from the state. The advantage of Contingent Convertibles is that they would not require a negotiated decision by the firm or an intervention by the authorities, but would convert debt to equity automatically when the value of equity falls below a level specified in advance. The process appears to be transparent, predictable and dictated by market developments. Professors Wolff and Vermaelen add a twist by providing the original shareholders with a call option to buy back the converted debt. This serves to smooth the conversion process and avoids an incentive problem that can create so-called “death spirals.” I expect Professor Vermaelen, who will speak next, will provide more details.

Turning to other “new ideas,” the “Tobin” tax on financial transactions reappeared in the recent policy debate to finance the cost of future bailouts. This is an old idea dressed up in new clothes. The Tobin Tax appears to be a solution in search of a problem, as it has already been suggested to finance developing countries, offset the cost of global warming, prepare for population ageing, etc. Even in the present case, a transaction tax would still not address the underlying problem. In fact, it may actually aggravate it, acting as an additional source of moral hazard. By raising costs, this tax could actually encourage higher risk taking, preparing the ground for the next systemic crisis.

The Jackson Hole Conferences in 2008 and 2009, in which I participated, presented several additional “new ideas” in this context. Most recently the discussion focussed on Ricardo Caballero’s analysis of the “surprising” nature of the recent crisis. He stressed that the “surprise” was not the decline in property prices, but the repercussions this had in the financial sector. The unexpected departure from the normal functioning of the financial system plunged agents into unquantifiable uncertainty. This unleashed panic, characterised by a “flight to safety” and fire asset sales that amplified the crisis. At this point, the role of the authorities is to fight the panic, which involves providing some form of insurance. In the 2008 Conference, Anil Kashyap and his co-authors suggested that capital insurance could be provided by the private sector, while in 2009 Caballero argued that only the state can insure against systemic risk.

Necessarily, any insurance arrangement is contingent, so it may share some of the features of Contingent Convertible bonds. However, if all banks were required to contribute to a common insurance pool, the risk coverage would be spread more broadly than if the scheme is limited to the “too-big-to-fail” banks. Caballero proposed Tradable Insurance Credits (TICs) that institutions could attach to individual assets or liabilities on their balance sheets. Since TICs could be traded between banks, they would allow insurance coverage to flow to where it is needed in a crisis, without the authorities needing to specify in advance the nature of the contingent event to be covered. Banks that find themselves less exposed in a crisis could choose to sell their insurance to distressed banks at a premium, a reward for prudence that most insurance schemes do not offer.

I find some of these features attractive, but any insurance scheme is also subject to important limitations. Private insurance schemes require freezing huge amounts of resources to cover the insurance promises. The failure of some mono-line insurers in the recent crisis indicates that private sector resources can turn out to be insufficient, aggravating financial instability. On the other hand, public sector insurance schemes jeopardise the sustainability of public finances as they transfer the risks to the taxpayer and distort incentives as mentioned above.

3. Conclusion

Let me conclude.

Financial crises are an inevitable part of the business cycle. It would be misguided to expect to eliminate them completely. However, we *do* have a responsibility to learn from them in order to reduce the inefficiencies in the financial system and improve its resilience in future episodes of turbulence.

I wish to stress that there is no “silver bullet” solution just as there was no single error behind the financial crisis. If we are to improve on the current situation, there are *many* changes that need to be implemented.

Some critics have argued that the response of governments and central banks raised moral hazard problems that sow the seeds of the next crisis. However, it is important to recognise that moral hazard also appears *within* the crisis. This was spread over many months, allowing agents to adapt their short-term behaviour to authorities’ decision whether or not to intervene. The policy response had to simultaneously stabilise the short-term situation while accounting for long-term costs.

Today it is generally accepted that the extraordinary policy measures taken were necessary to prevent a collapse of the financial system with even worse economic consequences. Let us hope that the ongoing process of financial reform will enhance the resilience of the financial system, reducing the need for extraordinary interventions in the future and their associated costs.