Andreas Dombret: Challenges for financial stability – policy and academic aspects

Dinner speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Joint Conference of the Deutsche Bundesbank, the Technical University Dresden and the Journal of Financial Stability, Dresden, 17 January 2013.

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2012: An "annus horribilis" or an "annus mirabilis" or neither?

Your Magnificence Professor Müller-Steinhagen,

Mister State Minister Doctor Beermann,

Ladies and Gentlemen:

The turn of the year gives me the chance to relate my discussion of some of the future challenges for financial stability to a résumé of the previous year. Please allow me to do this from a European perspective and let me start with a seemingly innocent question: Will 2012 go down in history as an "annus horribilis" or rather as an "annus mirabilis", or neither?

The answer to this question is less trivial than it appears at first. Let's look to the origins of the words "annus horribilis" and "annus mirabilis". To see this please note that the originator of the "annus horribilis", Queen Elizabeth, used it to describe her feelings about the year 1992.

At the time, her Majesty was talking about, among others, the fire at Windsor Castle, but one might also read it as a comment about what happened in the financial sector in 1992 when the markets forced the UK to leave the European Exchange Rate Mechanism. More recently, the Queen's remarks sound as a comment about the financial and economic development of 2012. Please also note that many people use the metaphor of a large-scale fire to explain the economic term of a "systemic" event.

Thus her Majesty is worth quoting in more length: "1992 is not a year on which I shall look with undiluted pleasure. In the words of one of my more sympathetic commentators it has turned to be an 'annus horribilis'. I suspect that I am not alone in thinking it so. Indeed I suspect that there are very few people or institutions unaffected by the last months of worldwide turmoil and uncertainty."

According to various measures 2012 was a year of considerable systemic tensions. Indeed, the indicators were approaching – but did not quite reach – the sad levels seen in the second half of 2008 and in the first half of 2009 – which was without doubts a very difficult period in the financial and economic history. Therefore, one might be tempted to classify 2012 as an "annus horribilis".

I wish to challenge this view. Will 2012, with hindsight, possibly go down in history as an "annus mirabilis"? Absurd, you may think. But on second thought this notion seems less absurd than it first appears.

Let us not forget that the famous poem of John Dryden entitled "annus mirabilis" was inspired from major events in the year 1666. A very difficult year, to put it mildly, a year in which the Great Fire destroyed 80% of the city of London. The fire spread so rapidly due to the city's narrow streets and the "interconnectedness" of houses.

The battle to stop the fire was considered to have been won by two factors: the strong east winds died down, and the Tower of London garrison used gunpowder to create effective firebreaks to stop the fire from spreading further eastwards. Dryden's view was that God had performed miracles for England. The King promised to improve the streets.

Well, some may say, so it is in 2012. The fire in the financial markets was stopped by the ECB, by the two firewalls EFSF and ESM as well as by the governments announcing that they would improve the financial system. Thus 2012 is an "annus mirabilis".

But as you know, miracles need to be acknowledged either by the pope or by the scientific community. So let us check whether a miracle was at work in 1666. And what I am going to say now about 1666 can be understood as a metaphorical warning about what could happen if we do not draw the right policy conclusion from the events of 2012.

Despite numerous radical proposals, London was rebuilt using essentially the same street plan which was in use before the fire. So the miracle is that nothing similar to the Great Fire has happened in the following years.

The lesson of this story is quite clear. The financial system needs better rules than in the years preceding the crisis.

We need a resilient financial system. We need a strong supervision. We need effective macroprudential instruments. We need to know how these instruments will work, which is a challenge for the scientific community as well as for macroprudential policy makers. Otherwise, we would be putting our trust in a miracle.

And we need to understand the complicated interactions between the financial and the real economy, which is the topic of your conference.

Links between the financial system and the real economy

Take, for example, the LTROs which provided banks with liquidity for a period of three years. These LTROs have made the links between the public and the banking sector in some countries closer, not wider meaning that the system is even more vulnerable to systemic contagion than before.

Another example is the issue of deleveraging and forbearance.

In Europe, many banks' balance sheets are too large. Most of you probably agree that it is necessary for these banks to shrink their balance sheets. At the same time, some fear that deleveraging cuts off corporations from their financing sources.

From a theoretical viewpoint, however, a distinction needs to be made between good and bad deleveraging. Good deleveraging, for instance, means scaling back the exposure to other financial intermediaries whereas bad deleveraging means that lending to the real economy is being reduced.

The problem with this view is that, in practice, the distinction is not at all so clear-cut. The issue becomes even more complicated, when we additionally introduce the concept of forbearance, i.e. postponing the act of declaring a doubtful loan to be a doubtful loan.

What is the best response to this issue? The first answer is transparency. At this point, transparency is more easily said than done. But we need it, particularly in the context of a banking union and possible bank recapitalisations. And transparency is especially important with a view to legacy assets and forbearance of the problem banks.

How do we proceed further? Repairing the banks' balances sheets and injecting capital is one answer. However, some fear that repairing balance sheets has procyclical effects and could damage the availability of credit for the real economy. In my view, however, repairing balance sheets will have a long-term positive impact on potential output growth more than offsetting the possible short-term cyclical effects.

The limits of state interventions

I often hear that the banks were responsible for the crisis. But can governments do better?

As you know, one reason for the financial crisis was the use of risk models based on assumptions, which concentrated on expected values rather than tails. Peter Bernstein, the financial historian from the US, illustrated this point by citing the anecdote of a Moscovite professor of statistics, who refused to go to the air-raid shelter during World War II bomb attacks. The professor argued: “See, Moscow has seven million inhabitants. Why should I expect to be one who will be hit?” His neighbours were astonished, when he came back to the shelter the next night. Now the professor’s argumentation was: “Moscow has seven million inhabitants and one elephant. Last night the elephant was hit.”

If regulators and banks essentially use the same models for their risk management, why should we expect a better financial stability outcome? Of course, one solution is to improve our models. But I do not think that this is the end of the story.

I rather believe that regulators can do better if they acknowledge their own limitations. Regulators should employ the market mechanism to find the best risk management tools. In an ideal world the market is a discovery process. First, each individual agent knows better what is good for him. But at the end of the discovery process – in theory – we will get the best risk management tools, if – and this “if” is the decisive word here – if banks with weak risk management processes are allowed to fail, having to leave the market. This is one reason why resolving the “too-big-to-fail”-problem needs to be a top priority on the regulatory agenda.

As far as I can judge, we are only beginning to understand how well-established instruments like the capital ratio work and what effect they have on the banks’ behaviour. And there are other new macroprudential instruments where our knowledge is even more limited.

Take the counter-cyclical buffer. The idea is simple and compelling. When the regulators identify a bubble developing, this buffer is activated, thereby leading banks to reduce their lending. If all works well, this buffer prevents the exuberances altogether, or at least mitigates it.

However, it is not clear how the buffers should be calibrated in order to achieve better financial stability. Moreover, not much is known about possible time lags. In the worst situation, these buffer effects are not counter- but pro-cyclical. Things become even more complicated if different instruments are applied at the same time. As you can easily see, there are many questions waiting to be answered, many problems waiting to be resolved.

When I think about what we know how macroprudential instruments work, traffic lights come to my mind. To prevent pedestrians from crossing the street when the traffic light is red the authorities actually installed buttons that pedestrians could press to shorten the red phase. And it turned out to be a success: fewer pedestrians crossed the street when the lights were red.

However, what the pedestrians did not know was that pushing the buttons had no effect on the duration of the red phase.

Please do not misunderstand me: I do not believe that macroprudential instruments are useless. Quite the contrary is true. What I want to highlight is that we cannot expect to prevent all future crises from happening. It is an illusion to believe that we can finetune our instruments such that they have exactly the effect we want them to have. Recently, Otmar Issing wrote in the Frankfurter Allgemeine Zeitung: “The attempt to prevent each kind of crisis is just as hopeless as harmful. … The guiding principle of the market paradigm of action and liability for the consequences (of these actions) should be valid without exemption.” Taking this into consideration, the effects and the interdependence of macroprudential instruments may turn out to be a very fruitful research area.

To sum up, every intervention in the market needs to be justified by market failures, something that, unfortunately, is not hard to find in many areas of the financial system. There is no guarantee, however, that governments can do a better job. But at least the state has an incentive taking into account the negative externalities of banks’ decisions and thus to minimise tax payers’ losses. When the state is aware of its own limitations there is a good chance that the outcome will be better than one in which the financial system is left to its own devices.

Newton's "annus mirabilis"

There was one famous scientist for whom 1666 was indeed an "annus mirabilis". Isaac Newton made revolutionary inventions and discoveries in calculus, motion, optics and gravitation. As such, 1666 was later referred to Isaac Newton's "annus mirabilis". It is the year when Isaac Newton was said to have observed an apple falling from a tree and hit upon gravitation. He afforded the time to work on his theories due to the closure of Cambridge University. In his own words: "All this was in the two years 1665 and 1666, for in those days I was in the prime of my age of invention, and minded mathematics and philosophy more than at any time since."

Nowadays, Newton's experience might inspire you to invent and discover macroprudential mechanisms which policy makers could put to appropriate use in practice. Then the year 2012 might, in hindsight, turn out to have been a genuine "annus mirabilis".

I wish you all a very successful conference. Thank you for your attention.