Mr Tietmeyer talks about systemic risk and lender of last resort facilities

Speech by the President of the Deutsche Bundesbank, Prof Hans Tietmeyer, at the conference entitled "Systemic Risk and Lender of Last Resort Facilities" organised by the Center for Financial Studies in Frankfurt on 11 June 1999.

I

Thank you very much for the invitation to speak to this distinguished audience. As a financial center, Frankfurt has to be more than a center of commercial and central banking. Undoubtedly, it also needs to be a center of critical scientific analysis. Therefore, I appreciate very much the contribution which the Center for Financial Studies is making to the intellectual capabilities of Frankfurt.

II

The subject of this conference "Systemic risk and Lender of Last Resort Facilities" is likewise both important and tricky. There is no doubt about the fact that recent events have placed questions about the soundness of global financing on the intellectual and political agenda. On the one hand, we have experienced severe financial crises in different regions over the past few years. In terms of their impact, the speed with which the events occurred and the ensuing contagion effects, the crises revealed a new dimension. On the other hand, new games and players have entered global financial markets; for example, highly leveraged activities and institutions. We have learned, in one case in particular, that such institutions can cause serious troubles if their working assumptions on the future development of market prices fail.

So, besides all the old or new-fashioned macroeconomic questions, the discussion on the soundness of appropriate financial and supervisory structures is an important one. And the consideration of systemic risk is part of that discussion. However, we should be careful when using the label "systemic risk".

Firstly, not every financial crisis of a country or an institution necessarily causes a systemic risk. That does not mean that the international community should or could neglect such crisis. But in order to assess which measures are appropriate, the nature of the crisis has to be clear.

And secondly, systemic risk is not a given quantity. To a large extent, it is an endogenous variable which depends on the structures of the financial market, on the supervisory framework at the national and international levels and on the decisions taken by the political and monetary authorities.

Therefore the topic of systemic risk has a lot of different aspects. The aspect on which this conference focuses, namely the lender of last resort, is certainly not the most prominent point.

The first and most fundamental question in that context is how to make a substantial reduction in systemic risk. Or, to be more precise, how to reduce systemic risk without restraining or patronizing financial markets but rather by improving their functioning. A lot of work is under way to find ways of doing this. Improved transparency should foster the self-control and self-discipline of the markets. That includes different aspects such as: more and better data on the debt structure of individual countries, the application of standards for banking supervision, improved disclosure of risk positions of market participants.

Of course, in the case of a national sovereign crisis, financial assistance too might play a role. Therefore, we have agreed to fill up the IMF's reserve tanks. Such assistance, however, has to be bound to conditionality, to an incentive to redeem the official credits and to a fair burden-sharing between official and private sectors. If the talk of a lender of last resort means only that kind of financial assistance, I don’t mind. Even though that expression might not be absolutely accurate. But we should not argue about words.

But if lender of last resort in a broader sense means that draining liquidity and offering generous or even unlimited credit lines should be regarded as main response and that the international community should place its highest priority on such measures, I would be strongly opposed. A lender of last resort of that kind may be of intellectual interest for academic textbooks. In reality, such a role for the IMF or another institution would severely hamper the functioning of the markets.

The main point is: Whatever the international community intends to do, the measure should — as far as possible — avoid creating incentives for moral hazard behaviour. For domestic policy-makers, this means that international assistance must not be seen as insurance either against dangerous exchange rate experiments or against a loss of credibility. For the markets, there should as few incentives as possible to underrate country-specific risks based on the hope of a later bail-out.

So, in the first place, financial crisis and systemic risk do not lead to the question of the lender of last resort. Instead, they lead to the question how to improve the framework. And that was the background to my report I presented to the Group of Seven (G-7) Ministers and Governors at their meeting in Bonn on February 20, 1999. Professor Illing asked me to add some remarks on that report. I will follow that suggestion.

III

As you know, my proposal to the G-7 included convening a Forum of Financial Stability.

What is the philosophy behind that proposal?

Firstly, there is the conviction that sweeping institutional changes are not necessary. Instead, a process to improve coordination between existing national and international authorities and groupings is important for improving the functioning of the market and, in doing so, promoting the stability of the financial system.

Secondly, a permanent body which brings together major experts on supervisory issues, either technical or political representatives, either at the national or at the international level has more potential to be a driving force for practical change than several ad-hoc-groups may have.

How is the Forum composed?

Members of the Forum are: representatives of the IFIs, the BIS and the OECD, representatives of key international regulatory groupings, namely the Basel Committee on Banking Supervision, IOSCO, the International Association of Insurance Supervisors, central bank experts concerned with market infrastructure from the Committee on Payment & Settlement Systems and the Committee on the Global Financial System and — not least — representatives of the national authorities — the ministries of Finance, central banks and senior supervisory authorities — initially of the G-7 countries.

What is the Forum’s field of activity? The G-7 report identifies three areas where improvement is necessary.

The first potential area concerns the assessment of vulnerabilities affecting the global financial system. These kinds of information-pooling-and-processing activity must be clearly separated from normal macro-economic policy assessment. The Forum should obviously not attempt the IMF’s systematic surveillance of individual countries, although cases may arise where financial vulnerabilities in individual counties merit the Forum’s attention.

A second potential area of activity for the Forum is identifying and overseeing actions needed to address the vulnerabilities affecting the global financial system, including encouraging the development or strengthening of international best practice and standards and defining priorities for addressing and implementing them.

A third potential area of activity for the Forum is improving mutual coordination and the exchange of information among the various authorities responsible for financial stability (a sort of permanent round-table). In this respect, the forum should be a vehicle for the regular in-depth exchange of information among the international financial institutions and the international regulatory groupings.

How should the Forum work?

The Forum should not duplicate work being undertaken elsewhere. The Forum should, rather, work through its members, taking due account of their comparative advantages. Specifically, the Forum should bring together information about activities taking place in diverse groupings and coordinate overlapping activities. In addition, the Forum should identify gaps in existing work, and propose appropriate means of filling such gaps. Finally, the Forum should, wherever possible, aim to produce concrete, implementable recommendations, as distinct from analytical reports stating alternative views. And it should monitor the implementation of those recommendations.

IV

Two particular points have to be addressed further.

Firstly, the involvement of the private sector. The Forum is asked to find flexible ways of drawing on private sector expertise. One way is for the Forum to meet with the private sector immediately before or after the meeting. It would also be possible for sub-groups of Forum members to meet the private sectors on other occasions.

Secondly, countries outside the G-7 should be more involved. That can be done either be inviting qualified experts from outside the G-7 to contribute to the activities of the Working Groups. Or by inviting representatives from national authorities as guests in the forthcoming regular meeting of the Forum.

In the meanwhile, the first meeting has taken place. Upon my proposal, the G-7 Ministers and Governors have appointed Andrew Crockett to be the Chairman of the Forum for three years. That guarantees the necessary experience as well as continuity. Three Working Groups have been established:

- The Working Group on Highly Leveraged Activities and Institutions; Howard Davis (UK) has the chair.
- The Working Group on Short-term Capital Flows; Mario Draghi (Italy) has the chair.
- The Working Group on Offshore Centres; John Palmer (Canada) has the chair.

The second meeting is scheduled for mid-September. I am personally following the work of the Forum with great interest, of course, but also at some distance because from September 1st onwards I shall be only an outside observer, but an interested one.

And let me end with the following remark: if the Forum can help to improve the international financial framework, it may make a greater contribute to coping with systemic risk than a lender of last resort ever could.