Mr Liebscher wonders whether financial crises are really here to stay

Luncheon speech delivered by Dr Klaus Liebscher, Governor of the Oesterreichische Nationalbank, at the Ost-West Konferenz of the Oesterreichische Nationalbank on the theme of "Financial crisis - a never ending story?", held in Wien on 23 November 1999.

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Ladies and Gentlemen,

I have my doubts whether financial crisis is a topic that lends itself well to a luncheon speech, since part of what I am going to say may sound like the analysis of a nutrition expert who warns about bad eating and drinking habits which are not conducive to health and fitness. So when I talk about too much appetite for risk and unsound financial systems and so on, this will hopefully not spoil your appetite for lunch. If it does, I apologize in advance.

What I am going to serve you is not a light dessert but a rather heavy main dish with the following ingredients:

- First, a reminder of some features of the financial market trends, including the lessons to be drawn for economic policy;
- second, a brief note on recent work in official international fora on financial stability;
- third, an assessment of the relationship between public policy and markets;
- fourth, an outlook on the course policymakers should pursue in the future;
- and fifth, some reasons why financial stability issues are of concern to central bankers.

1.

With the new millenium approaching, we clearly have not reached the end of history as one author suggested several years ago. We are rather in the process of transforming our economies, and financial markets have become a driving force behind this transformation, mostly supporting it, but capable of seriously disrupting it at times. Global finance, driven itself by technology and liberalization, has brought continents closer to each other and thus increased spillover effects. The trend towards disintermediated finance is going on and financial instruments are becoming yet more sophisticated. Financial capital is becoming less complacent vis-à-vis policy errors and more demanding as far as the required return is concerned. The recent crises have shown that policy mistakes tend to be sanctioned drastically by financial markets, and the longer the sanction is delayed the harder it turns out to be. What has further become clear is that stability is a prerequisite for long-term efficiency and sustainable growth - a lesson that appears to be easily forgotten as long as everything goes well. But when things take a bad turn, it becomes obvious that financial crises tend to be costly not only for creditors and banks but also for the economy as a whole. This is not to say, though, that stability is an excuse for financial repression which distorts economic decisions. If the financial market doesn't work like a market any more, the backlash can be strong. After the crumbling of central planning, stability was in a way discredited, and financial speculation developed against the backdrop of insufficiently regulated and supervised financial institutions with only a limited capacity to serve the needs of the real economy.

2.

Public policy is actively addressing the issues posed by the trends and changes I have just mentioned. During the last months a lot has been achieved: IMF and World Bank have increased the transparency of their policies and thus helped financial markets to make better decisions.

At the BIS the Basle Committee worked out a consultative paper on capital requirements, whose main thrust is a pronounced individualization of supervision, designed to give banks a more adequate supervisory treatment. Generally, awareness has been created and agreement on principles has been achieved. These principles must now be implemented, which will be the most arduous part.

In response to the recurrent crises in recent years the Financial Stability Forum has been set up. It is a platform of collaboration between international supervisory authorities and the Bretton Woods institutions; a platform that opens up the opportunity to detect crises at an early stage and to strengthen global cooperation.

Finally, the European System of Central Banks has specified its role in financial supervision on the basis of the allocation of competencies set out in the Treaty.

3.

The process of change in the financial landscape - with change sometimes evolving smoothly, and sometimes less so - is also a process of interaction between public policy and financial markets: financial markets influence policy, but policy influences financial markets as well. It is fair that market participants should be informed well in advance about the framework conditions for doing business. Policymakers, likewise, need to know the views of financial market participants. The dialogue between policy and markets is therefore important. It must be clear, however, that policy has to fulfil its role by setting the rules for efficiently functioning markets. Adequate prudential regulations and oversight mechanisms are essential in this respect. One crucial question we must tackle in the future is: how far can we go in letting the markets regulate themselves? How far can private entities be a substitute for public commitment? As we saw during the Asian crisis, rating agencies can get it wrong, in some instances confirming only the new direction the market itself has already taken. While the primary responsibility for the overall soundness of the financial system lies with policy, market forces should be used as an indispensible complementary tool to exert discipline. This requires policymakers to be aware of the mechanisms according to which markets work, and sometimes fail to work. Eventually, behind the seemingly anonymous markets there are human beings trying to maximize their individual well-being according to the incentives which they are given. By contrast, public policy needs to have in mind what is optimal for society as a whole.

4.

I would like to point out three broad avenues that public policy should take in the future.

First, make the market function more efficiently so that risk is priced correctly. If market failures occur and consequently the price mechanism doesn't work, public policy should look into the incentives existing for financial market participants and - if need may be - adapt the framework. Too big an appetite for risk is at the heart of subsequent financial crises. It is encouraged by explicit or implicit guarantees which weaken the hard budget constraint that ought to characterize any efficient economic system. To avoid moral hazard, public policy should dissipate a false sense of security which might arise because financial markets feel the "too big to fail" doctrine or the "too complex to fail" doctrine will be applied anyway. Constructive ambiguity - based on knowledge of the facts and the risks - might help to make operators more cautious. What we have learned during the Asian crisis is that "ambiguity" sometimes is not only appropriate when dealing with possible financial support but also in exchange rate policies. When there is a lack of fundamental convergence in the medium term, exchange rate pegs can invite short-term speculative capital movements and unsustainable investment and consumption patterns.

This brings me to macroeconomic policies in general, the *second* big avenue, the importance of which I would like to stress. The globalization of finance has put a premium on good policies. Public authorities are thus well advised to pursue policies which do not lead to macroeconomic imbalances that threaten price stability and long-term growth. Furthermore, if such imbalances arise policies must adjust quickly. Finally, countries need to be transparent so that there will be an additional incentive to identify the build-up of macroeconomic imbalances at an early stage and to take adequate action. The highly valuable ongoing efforts to increase the functioning of the international financial system would be wasted if they cannot build on the preparedness of any country in the world to keep its own house in order. If this effort is pursued collectively, for example on a regional level, a higher leverage can be achieved. Monetary and fiscal discipline in the euro area and structural reforms making the economy more flexible will both make the euro area less prone to originate shocks but also less vulnerable to outside shocks.

The *third* avenue public policy should take is to give more attention to the legal infrastructure of financial markets, covering both bankruptcy procedures and effective corporate governance. This could also be a standard feature of international surveillance. "Ordnungspolitik" thus has to get prominence in the design of worldwide integration and liberalization strategies. The liberalization of capital movements, as desirable as it is, must go hand in hand with the establishment of sound and efficiently supervised financial systems; otherwise not only the countries which liberalize prematurely would suffer from a potential sudden reversal of capital flows and the ensuing exchange rate and economic crisis, but also the world economy as a whole would be hit. Let me just mention that - due to the Asian and Russian crises - some regions of the euro area will experience substantially lower growth this year than last year, and for the same reasons real growth in the euro area as a whole dropped from around 3% in 1998 to an estimated 2.1% this year.

To sum up, public policy in general and financial supervision in particular thus have an important role to play. They have to keep the long-term stability and health of the financial system in mind, correcting for the - very often - rather short-term orientation of financial markets. Public policies should be designed to avoid the headache after the party, by moderating exuberance and exaggeration. This is certainly more easily said than done and probably not always popular. But are watchdogs there to be popular?

5.

Let me now turn to the question of why financial stability issues are of concern to central banks.

First, central banks must nowadays even more than in the past know what is going on in financial markets. They need to be in a position to assess how the transmission mechanism is influenced by changing financial market conditions. Moreover, monetary policy must have an interest in the smooth functioning of the financial system. As the Japanese example shows, monetary policy may become ineffective when there is a liquidity trap or when bank lending is restrained by the need to rebuild capital in the aftermath of a financial crisis. A lowering of the policy interest rate would - under such conditions - provide no stimulus to the economy.

Second, as one of the classical functions of a central bank is to extend emergency liquidity assistance, central banks need adequate information not only on financial markets in general but also on individual institutions. As monetary stability might be affected when a big player gets into difficulties, central banks should be in a position to form a view if a certain institution is illiquid or insolvent, and if the latter is the case, whether this institution is of systemic importance or not. An additional challenge here is that institutions outside the supervisory umbrella - such as hedge funds - tend to grow significantly. Moreover, the growth of financial markets in general and the growing importance of financial conglomerates in particular go hand in hand with a greater opaqueness of the size and distribution of risks. This puts additional demands on the analytical capacity of those concerned with financial stability.

Third, with financial liberalization, asset price and credit cycles may have become more prominent and suggestions have been made that monetary authorities should react to this cycle, for instance by raising interest rates when stock markets are clearly overvalued. Central banks may thus have an interest to contribute to the discussion of prudential rules, which could contribute to a dampening of the asset cycle. Prudential rules, and not interest rate changes, are there to safeguard financial stability. This is not to deny a role for asset prices in the monetary policy strategy. In the context of the ECB's monetary strategy they are monitored to draw conclusions about future price developments, but there is no reaction to movements on financial markets as such. As the priorities within the Eurosystem are clear there is no risk that the central bank loses sight of its primary goal of price stability for fear of a negative reaction of the stock market.

Ladies and Gentlemen,

To shield the real economy as far as possible from financial instability and prevent instability in the first place, continued adaptation of public policy to the changing financial landscape is required. To keep monetary policy effective, a smooth functioning of a diversified financial system is also in the interest of central banks. Monetary policy can contribute to financial stability by keeping expectations about future inflation as low as possible and thus reducing inflation risk premia to a minimum. Even when monetary policy cannot eliminate excessive risk-taking and speculation it can at least try to avoid fueling it. Let me conclude by saying that we must never lose sight of why we need both monetary and financial stability. They are not an end in themselves but contribute to long-term growth and raising of living standards.