G20 Conference on "Financial Systemic Risk"

September 27-28, Istanbul, Turkey

Opening Remarks by Deputy Governor Manuel Ramos-Francia

Governor Başçı,

Deputy Prime Minister Babacan,

Distinguished Guests,

First of all, allow me to thank the Central Bank of Turkey for organizing this very relevant seminar in such a wonderful city. I am certain that the discussions we will hold in these couple of days will be fruitful and enlightening. This Seminar is part of the work of the G20 for 2012 and I am looking forward to listening to the presentations of the distinguished guests.

The past few years have put the word "systemic" in the minds and lips of most policymakers, analysts, and the media. Indeed, the financial crisis that started since 2007 evidenced the deep interconnections between financial systems, and between financial systems and economies across the world.

The complexity of the financial instruments *multiplied* the links between various holders of these securities far and beyond national boundaries. Even countries whose financial systems did not incur in the excesses that were evident in some other countries became vulnerable to sudden stops and liquidity squeezes. No matter how sound the practices were in some domestic financial systems, and how prudent the regulation, the magnitude of the crisis affected everyone (though, it must be said, in different degrees).

In this environment, authorities around the world and in the G20 in particular, began to think much harder about the origins of risk, the *channels* through which it spreads, the consequences of tail events, and ways to minimize the losses that could arise when these risks actually materialize.

In this sense, financial systemic risk is at the core of current discussions at the G20. Indeed, many of our efforts like *enhancing surveillance*, engaging in *spillover reports*, *mutual assessment* of economic policies, and the *identification* of areas of opportunity, all aim at identifying risks, including financial systemic risk.

Financial stability is a strategic front because of its important role in the recovery of the economy and therefore, it is not surprising that we have had a multidimensional approach to this issue. In fact, the structure of this Conference is a very appropriate illustration of the many fronts we have to delve into in order to tackle this complex issue.

Indeed, the outline of the conference has a correspondence to many of the topics and preoccupations we have been dealing with at the G20.

In this regard, one of the main aspects of the G20 process is that of the Framework for a Strong, Sustainable and Balanced Growth. This framework, in turn, has several components, including a regular practice of a mutual assessment of policies and the evaluation by international financial institutions. In this last aspect, we have made significant progress in making this analysis more efficient and timely and in addressing not only the internal consistency of policies, but also the mutual consistency of policies across countries with the purpose of identifying risks to growth. The current crisis in Europe illustrates painfully well how the adverse feedback loop between financial vulnerabilities has reduced economic activity and sovereign debt sustainability remains one of the key risks to the global economic outlook.

As I said before, under the present context of a fragile global economy, the analysis of financial systemic risk has a strategic relevance. For instance, the potential impacts of the current process of banks' deleveraging on financial systemic risk are uncertain.

Another important aspect of our work has been the strengthening of the international financial architecture. In this area, we have looked at the characteristics of the International Monetary System and how, under certain circumstances, shocks can spread around the world, for instance through volatile capital flows and droughts in global liquidity. We have recognized the importance of global financial safety nets that function as a backstop to prevent or reduce contagion. During the Mexican Presidency of the G20 we have been able to reinforce these global financial safety nets through a significant collaborative effort of several countries, both G20 and non-G20. At the end of the day, both the strengthening of surveillance and of the global financial firewalls aim at dealing with systemic risks in a preemptive way. The challenge for the future lies in setting up the architecture that will allow us to focus on crises prevention rather than on crises resolution.

One other issue at the core of the work of the G20, in particular under the G20 Mexican Presidency, is financial regulation. This subject is, obviously, the most direct way of approaching the issue of financial systemic risk and we have been looking at it from several directions.

The big leap in modern science was launched by measurement. Economics is not the exception, and successful efforts, such as the Cowles Foundation, embraced its importance with the motto "Science is measurement," and later "Theory and measurement."

One aspect that corresponds to Session 1 of this Conference is related to the efforts to bridge data gaps.

Let me say something, in more detail, about the issue of the measurement of systemic risk. There is no doubt that in order to have useful indicators we need sufficient and reliable data. In this respect, the G20 made an early start soon after the crisis by creating the DATA GAPS initiative.

During the crisis it was clear that the lack of accurate and consistent information proved to have a very high cost. Also, for our efforts to result in a more efficient supervisory framework we need better information than we had prior to the crisis. This would allow for the timely identification of the build-up of systemic risk.

In particular, the G20 Data Gaps Initiative aims at improving the early identification of risks and vulnerabilities in the financial sector, gathering information in a structured manner to better understand the interconnections in a "bottom up" approach. This means looking at a wide array of domestic indicators trying to find weak spots and potential sources of vulnerabilities. By taking a comprehensive look at these indicators at the international level, we could also identify potential transmission channels of shocks. The objective is to create the infrastructure to be able to monitor global flows and positions in a timely and active manner. We have to remember that in today's international financial system, the resilience of the whole system is as strong as its weakest link. Therefore, the goal is to strengthen each and every one of its components.

We cannot minimize the importance of macroprudential policies and the regulatory agenda as key elements for mitigating financial systemic risks. As expressed by G20 leaders, our objective is to develop macroprudential policy frameworks and tools to limit the build-up of risks in the financial sector, building on the ongoing work of the FSB-BIS-IMF on this subject. In particular, the G20 has been calling for international bodies to take into account emerging market and developing economies' specific circumstances and concerns in designing new international financial standards and policies. And here, let me emphasize that we need to maintain momentum on the financial sector institutional reforms in order to safeguard the financial systems over the medium term, while taking appropriate actions in the short term to protect credit channels and the integrity of global payments and settlements systems.

Notwithstanding all the work that has been done, it is evident that there still is significant value added to be obtained from including a more thorough assessment of financial systemic risk in our policy discussions. In fact, a first step in this regard can be to explicitly connect our technical discussions regarding financial regulation and measurement of systemic risk to the global outlook assessment.

Strong macroprudential policies are one way to avoid systemic risks, but we are far from having a clear analysis of how these policies can work in the most effective manner alongside with monetary policy. We still have a lot of work to do in order to understand how monetary policy interacts with banks' risk-taking under the new regulatory framework. This is, clearly, a very important consideration for the way in which we should assess risks going forward. In addition, we have to be careful not to put under the umbrella of the macroprudential framework every possible policy measure; including protectionist ones. At the end of the day, we should strive to have a thorough analysis of these policies to evaluate their effectiveness with respect to the understanding and identification of the accumulation of systemic risk. Let me finish with the following thoughts and a word of caution:

Back in 2003, one of the most renowned macroeconomists stated, and I ***quote***:

> Macroeconomics was born as a distinct field in the 1940s, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades. […] ***End of quote***. (That was Lucas in 2003).

Clearly, this reflected the state of overconfidence at the time and, perhaps, gave a false sense of security to the profession and the general public. Very few were the dissenting voices that warned us of the incoming peril. It took, since then, less than a lustrum for another economic disaster to ensue.

As I have commented, and all of you have seen, the policy response to the crisis has been unprecedented, both at the domestic and the international levels. Accordingly, after the crisis, research done in policy institutions, think tanks, and universities on financial systemic risk has been commensurate. Nonetheless hitherto, as I have also mentioned, we are far from a consensus on financial systemic risk and, albeit some common themes are emerging, much remains to be done.

Having said that, it is useful to remember the following:

First, as emphasized by Reinhart and Rogoff (2009), financial crises have been part of history, or more generally, risk is a fact of life. In effect, there is a given level of risk in the economy that is impossible to eliminate, it is essentially non-diversifiable, call it macroeconomic or systematic risk.

In this context, while there is an unavoidable level of risk, above and beyond this level, there can easily be more risk. Evidently, *broadly speaking*, we should procure to be at the lowest level of risk possible, subject to the restrictions we face (*prevention*).

In addition, given that some level of risk is inevitable, we need contingency plans in case a crisis follows. In particular, we need ex-ante risk-sharing mechanisms (*mitigation*).[1]

Second, there is a *trade-off* between economic growth and risk. There is a point in which ensuring less risk necessarily entails less economic growth. It seems that we are nowadays unconditionally embracing risk regulation without carefully considering what it could imply for economic growth or other potential consequences in the long run. Indeed, there could be pernicious incentives to overregulate.

In this context, we need to do at least two things:

To *quantify* this growth-risk trade-off (which is a *technological issue*); and,

Decide, to the extent possible, upon its magnitude (which is a *preferences* issue).

Needless to say, these basic finance principles, apply also to systemic risk. Of course, this seminar is directed towards making progress on all of this.

Once again, I thank the Central Bank of Turkey, Governor Başçı, and the Turkish financial authorities, Minister Babacan, for welcoming us in Istanbul and I look forward to the fruitful discussions that lie ahead.

Thank you very much.

[1] Ex post adjustment mechanisms, although sometimes used, are negotiated or imposed and thus are typically not conducive to a swift recovery.

References

Lucas, R.E. (2003). "Macroeconomic Priorities." American Economic Review. Volume 93(1), pages 1-14, March.

Reinhart, C. and K.S. Rogoff (2009). “This Time is Different: Eight Centuries of Financial Folly.” Princeton University Press.