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Macroeconomic policy is essential to stability

*di Jean-Claude Trichet**

The financial market turmoil has been keeping the world on tenterhooks for more than a year now. After a long period of stability, 2007 marked a turning point, with the start of turbulence in financial markets that will be remembered for a long time. Central banks, supervisory authorities and governments worldwide have responded and continue to respond decisively to the emerging vulnerabilities and materialisation of risks, so as to restore stability and conditions conducive to growth as soon as possible.

The root cause of the crisis was a widespread undervaluation of risk. This included an underpricing of the unit of risk and an underassessment of the quantity of risk that financial operators took upon themselves. Several policymakers had indicated during 2006 and early 2007 that market participants needed to prepare for a significant correction. As chairman of the global economy meetings of central bank governors, I myself reported my colleagues' sentiments on this matter. At the same time, several financial stability reports, including from the European Central Bank, the Bank for International Settlements, the Financial Stability Forum and other organisations, had analysed vulnerabilities and warned of the emerging weaknesses.

A number of factors had contributed to the financial environment that prevailed until mid-2007. The spreading of the "originate and distribute" banking model led to a separation of those holding credit risks from those monitoring and managing them. Investors assumed that originators would perform proper risk management, but had no guarantee that this would be the case. They put full faith in the ability of rating agencies to draw up risk assessments for instruments that were new. Moreover, some large financial institutions showed a massive concentration of risk, considering the overall size of their balance sheets and capital. While the extensive spreading of risk is generally a stabilising factor at the system level, in extreme circumstances, such as a global loss of confidence, the impact is by definition systemic. A loss of confidence on precisely that scale occurred in mid-September this year.

While we are managing the current situation, we also have to start designing ways to strengthen the global financial system in a sustainable way The FSF has been drawing lessons from the crisis and its work has been built upon by the international community. In this context, three factors in particular have to be addressed in order to correct the widespread and massive undervaluation of risks: short-termism, lack of transparency and excessive pro-cyclicality.

Modern financial systems have favoured instruments and intermediaries that promise large returns in the short term. Institutions come under pressure to follow the strategies of those able to show high short-term profits. This process tends to lead to herding behaviour, in which risk controls easily become a secondary issue. We need to counter these mechanisms and establish the right incentives for achieving a balance between short-term and long-term investors and intermediaries. Incentives for market participants need to be strengthened in this respect, including through revised internal compensation schemes.

The second point concerns transparency. Despite all regulatory advances and progress in information technology, the financial system has been characterised by a lack of transparency about the ultimate allocation of risks. Two examples are the sheer complexity of structured financial products, which even sophisticated investors are not able to assess properly, and the lack of regulation for certain financial institutions. Regulators therefore need, in particular, to tighten up requirements for markets in which structured financial products are traded and strengthen reporting requirements for formerly unregulated institutions.

Finally, pro-cyclical behaviour is pronounced in financial systems. But in the present global financial system there are mechanisms that intensify fluctuations. The challenge is to preserve an efficient financial system as an engine for economic growth and at the same time ensure its stability. For example, capital regulations and provisioning rules as agreed by the Basel committee on banking supervision, and industry governance structures, especially in the area of risk management, need to restrain excessive risk-taking in upturns and discourage excessive conservatism when credit to companies and households is most needed.

An ambitious and effective reform of the financial system is necessary but not sufficient to restore a stable global economic order. Lasting financial stability also requires macroeconomic policies that have a medium-term orientation and that are stability-oriented and sustainable themselves. This means that large domestic imbalances need to be avoided and that expectations must be solidly anchored towards medium-term sustainability. After all, procyclicality can stem not only from regulatory policies but also from macroeconomic policies, where it is equally undesirable. In a global context, there is hence a need to strengthen significantly IMF surveillance over economies that are systemically relevant.

The IMF's multilateral consultation with key partners is a process that can be built upon. Greater discipline in the global economy is needed to foster stability and help balance short-term and long-term prosperity more appropriately.

**The writer is president of the European Central Bank. This article is based on a speech at the 5th ECB central banking conference on "The euro at ten: lessons and challenges"*