

Closing remarks by Lucrezia Reichlin, Director General Research of the European Central Bank, to the Fourth Joint Central Bank Research Conference on “Risk Measurement and Systemic Risk” (Frankfurt, 9 November 2005)

Ladies and Gentlemen,

It is my great pleasure to address you after two intense conference days here at the ECB.

I know that after two days of a very intense conference you must be exhausted by now, so I will be very brief.

I will organize my remarks in three parts.

In the first part, I would like to review a little bit the history and tradition of this conference.

In the second part I will discuss some issues in areas that are a little bit closer to my own current research interests, namely issues relevant for monetary policy and macroeconomics.

And last, I would like to look ahead a bit and see what comes next.

1. The tradition of the “Risk Measurement and Systemic Risk” conference

The Joint Central Bank Research Conference on “Risk Measurement and Systemic Risk” (RMSR) under the auspices of the G-10 Committee on the Global Financial System, the former Euro-currency Standing Committee, has now a decade of history.

The “first edition” was hosted in 1995 by the Federal Reserve Board in Washington, DC. It featured papers on credit risk, market volatility and co-movements, trading techniques, market risk management models and systemic risk in the banking sector.

At the time, Federal Reserve Chairman Alan Greenspan deplored the widespread use of thin-tailed distributions in the measurement of portfolio risk and in the assessment of overall banking system risk. He said that “improving the characterization of the distribution of extreme values is of paramount concern”. I am happy to say that not only we here in DG Research of the ECB, but also other researchers and policy institutions have made progress in using extreme-value theory to analyse the events we care most about from the perspective of financial stability. More generally, it seems that the themes of “RMSR 1” have remained important over the years and they still constitute core areas of interest in the later “editions” of the conference.

In 1998 the Bank of Japan hosted “Risk Measurement and Systemic Risk” in Tokyo. This was actually the first time that “we”, which meant at the time staff of the European Monetary Institute (the “predecessor” of the ECB), actively participated in it. This “second edition” focused very much on systemic risk in banking and payment systems, stress scenarios in financial markets – memories of LTCM must have been fresh at the time –, market microstructure studies of financial instability and central bank policy responses to systemic risk.

“Issue 3” took place in 2002 at the Bank for International Settlements in Basel. It was the first time that the ECB acted as a co-organiser of “RMSR”, only three years after the introduction of the euro and immediately after the circulation of euro banknotes and coins in the euro area.

At the time liquidity was very high on the research agenda. At the conference it was particularly debated whether liquidity dries up during financial crises, making them deeper and more widespread, and through which mechanisms that could happen. Clearly, this phenomenon is a major concern also today. For example, on the days after the terrorist attack of 11 September 2001 it was of crucial importance that the Eurosystem was able to provide US dollar liquidity to European banks with the help of a swap arrangement with the Federal Reserve Bank of New York.

We at the ECB here are very pleased to have been able to host the “fourth edition” of the conference now. Collaborating with the Federal Reserve Board, the Bank of Japan and the CGFS Secretariat we have tried to stick to its tradition, while gearing the program towards research and policy issues of highest relevance at the present time.

We identified the pricing, trading and transfer of credit risk, particularly through so-called structured products, as an area that deserves particular attention. It is more for you than for me to judge whether the conference has been successful in providing you with new and interesting insights in this regard.

2. Financial stability, monetary policy and the macroeconomy

This brings me to the second part of my remarks, which will refer to the last session we saw today. It is the session that is closest to the question how monetary policy and financial stability interact. I firmly believe that this is a key issue, but we are still in a learning process to understand very basic questions in this regard. We in the ECB pay increasing attention to financial sector issues in general and the link of financial stability and monetary policy in particular. And if I may say, Otmar Issing and Lucas Papademos who addressed you before are certainly key drivers of this process.

The paper by Bill Nelson and Roberto Perli on “Selected Indicators of Financial Stability” presents a number of key market-based indicators of financial stability that need to be monitored closely, both for the purposes of maintaining price and financial stability.

This is a good illustration of what central banks should look at when monitoring financial systems. Given the new developments in financial markets that this conference has discussed, central banks will be well advised in deriving also new indicators for monitoring financial systems. These could provide useful information in addition to the one contained in traditional bank credit and monetary indicators.

Market participants closely monitor these measures as well. Following the evolution of these measures, therefore, helps to understand how large institutional investors assess financial risks. This may also help policy makers in communicating with market participants.

I have been particularly struck by the finding that almost a fifth of the downward trend in US ten-year government yields can be explained by hedging strategies of large players in the mortgage-backed securities (MBS) market.

The presence of spillovers is a feature that has received some attention, but this is indeed a high figure!

In general, what are spillovers telling us about monetary policy? How much do they explain of the break in the relationship between short and long term interest rates, which has been called by the Federal Reserve Chairman the interest rate conundrum? As it has been stressed by the work of Hyun Shin and others, in standard models for monetary policy financial markets play a passive role. They are far-sighted but essentially passive. This might not be a good representation of the world, and I am definitely more convinced of this after two days at this Conference. Is the break in the term structure a symptom of financial market activism and what does this tell us about the effectiveness of monetary policy? Food for thought for research and for another conference!

The other two papers of the Section focus on the relation between credit risk and macroeconomic variables. This is a more standard subject for monetary policy, but the papers bring interesting insights which lead to new questions.

The paper by Mathias Drehmann, Andrew Patton and Steffen Sorensen on “Corporate Defaults and Large Macroeconomic Shocks” puts the emphasis on non-linearities and large monetary policy shocks. The main point of the paper is that standard linear macro models tend to over-estimate the impact of small monetary policy shocks on credit risk and under-estimate the effect of large shocks.

This result provides a new perspective on the recent monetary policy debate on the value of “gradual” policies and interest rate smoothing. Small gradual changes in policy may be less destabilising. Distinguishing between “standard” and “extreme” shocks is a very useful idea and I hope that future research on other countries will shed further light on these asymmetric effects.

In “Exploring Interactions between Real Activity and the Financial Stance” Tor Jacobson, Jesper Linde and Kaspar Rozbach study interaction and feedbacks between firms’ balance sheets and the

macroeconomy. This is a nice paper, which exploits information from a rich panel data set that covers firm balance-sheets for almost all Swedish incorporated companies. The paper makes points which are important both for understanding the role of the credit channel in monetary policy and the interaction between financial stability and monetary policy.

Their findings suggest that the response to a given monetary policy shock depends on the portfolio structure of firms and that monetary policy is more effective during recessions than during booms.

Here I have some questions and suggestions for further research. The credit channel for monetary policy identified by this paper would suggest that the effect of monetary policy is amplified with respect to the conventional interest rate effect. This points to greater effectiveness of monetary policy, whereas the observation I made before on the weakened link between short and long rates suggests lack of effectiveness via the term structure channel. How do we quantify the relative importance of these different effects? This is a key question for the understanding of the monetary transmission mechanism.

According to the authors, the amplification of monetary policy is at work especially during recessions. Since there is only one in their sample this conjecture requires further empirical research with longer data series.

I would encourage research that uses event study methodologies to analyse what happens during recessions. Recessions are indeed very informative events to understand the role of large shocks for both financial fragility and the propagation of monetary policy. “Unfortunately,” there are only few of them! (I am of course joking here.)

Let me now get to the third part of my remarks.

3. Next steps

What are the next steps?

Let me emphasise again that research on “Risk Measurement and Systemic Risk” remains important for central banks. Central banks manage risks on their balance sheets from foreign exchange portfolios as well as domestic assets and liabilities. Even when they have no direct supervisory responsibility, as the case here at the European Central Bank, they have to have a good understanding of risks in financial institutions, which include the reliability of their risk management practices.

More generally, central banks need to have a deep understanding of vulnerabilities in banking, in particular credit risk, and other parts of the financial system that could lead to a systemic crisis. The ECB’s Financial Stability Review, whose second edition will come out next month, is an important tool

in this context. Last, as I was trying to argue in the previous part of my remarks, central bankers need to know how monetary policy interacts with financial stability.

This is why we in the ECB will continue conducting research on “Risk Measurement and Systemic Risk” in order to support financial stability monitoring and effective policies. This is also why I very much hope that in three years from now we will see a “fifth edition” of “RMSR” and that it will raise as much interest as the one held here in Frankfurt, as suggested by the 170 participants who attended over the last two days.

My last remark relates to another good tradition of “RMSR”. In all previous “editions” a little volume has been produced displaying or summarising the conference contributions. The organisers from the Fed, the BoJ, the CGFS secretariat and the ECB will contact all authors in the next few weeks to explore whether and in which format this tradition should be continued. Meanwhile, all papers will be available on the internet.

So, let me thank you all again for participating and actively contributing to this exciting conference. Good bye and have a safe trip home.