Contribution at the conference on Welfare effects of financial innovation

Comments by Deputy Governor Jan Qvigstad [1] (Norges Bank) on Frank Smets (ECB) Financial markets: Productivity, procyclicality, and policy.

Thank you for inviting me and giving me the opportunity to comment on Frank's paper. The common starting point of the literature is that the value of financial markets lies in their contribution to real economic growth. This is the perspective we always need to have for any meaningful discussion of the social value of financial markets. A well developed financial market is not a goal in its own right.

During my 30 years of service in the Treasury and the central bank, I have had my fair share of dealings with banking and financial crises. I will draw on some of that experience in my comments today as part of my modest contribution to this distinguished group.

In the aftermath of the Lehman Brothers collapse the funding situation for banks became difficult, also for Norway with its oil-driven economy. Early in 2009 a swap arrangement was introduced to improve the medium-term funding situation for our banks. Government bonds were swapped for covered bonds issued by banks and normal lending activity was restored. However, this was not the first time the Government had used swaps to stimulate the real economy. We did so around 200 years ago...

Chart: The 1819 non-banking transactions

A swap of government bonds for privately issued securities was used already in 1819 when Norway emerged on the scene as a sovereign country after the Napoleonic wars. The 1819-bonds were swapped for bills of exchange issued by farmers and merchants in the domestic market. With these bonds as collateral they managed to raise sufficient credit to import seed to secure important supplies to farmers and merchants in this difficult period in Norwegian economic history. This is a historical example of how financial markets underpin economic growth.

More generally, financial markets contribute to economic growth in three ways:

- They create credit to make it available for real investment.
- They allocate credit to the most profitable investment projects.
- And they improve risk sharing in the economy.

The caveat is that they create the credit volumes that they find privately optimal, and allocate it to the projects that are most profitable to them. Neither the credit volume nor the credit allocation is necessarily socially optimal: this is one basic reason why financial markets are and should be regulated.

The next question is: How strictly should they be regulated? When does regulation severely impair the positive effect from financial markets to economic growth?

Let me again make some observations from my home country:

Figure: The Norwegian banking crisis

Norway had a severe banking crisis around 1990. Three of the four largest banks failed and the direct capital injections required were alone more than 3½ per cent of GDP. Just to put this figure into perspective, the 106 billion euros the European banks need for recapitalisation now is less than 1 per cent of GDP in the euro area.

Ever since the Norwegian banking crisis in the early 1990s, our banking industry has been regulated more strictly than banks in comparable countries.

- For instance, bank capital definitions have been tighter and the financial supervisor has been more actively restricting banking activities.
- Another example is that packaging loans into complex financial instruments was in practice not permitted until 2007 when new regulations provided for the issuance of covered bonds. The complex instruments central in the creation of the subprime crisis were never introduced, and Norwegian banks did not invest in them.

Our GDP growth rates have still been high during the years up to 2008, also outside the petroleum sector. And the downturn we experienced in 2009 was modest in relation to comparable countries.

At the early stage of the banking crisis in the1990s, the Norwegian central bank provided a large liquidity loan to a savings bank. It soon became clear that the loan would not be paid back. A liquidity problem turned into a problem of solvency. This was not the first time! We were again reminded how responsibilities should be shared between the fiscal authorities and the central bank. It is the responsibility of the parliament and the government to spend taxpayers' money. It is not up to an independent central bank to spend their money! We still remembered this principle in late 2008 and early 2009 when the funding of Norwegian banks also dried up. Then we made sure that the Ministry of Finance became the banks' counterparty in the bond swap I mentioned earlier. We thus avoided the discussion we have seen elsewhere about the central bank intruding into the arena of the fiscal authorities.

Chart: Citigroup, Terra Securities and Norwegian municipalities

The financial crisis also hit some very small Norwegian municipalities – far up North close to the coldness of the Barents Sea and others deep into the fjords warmed by the Gulf Stream – that had in fact invested in instruments exposed to the US subprime market. They were told that they could earn a risk-free excess return of 50 basis points. The instruments were in most cases sold to them by their very small local savings banks, which had taken them on from large US investment banks. The savings banks did not understand the risks either! Ignorance combined with greed – a dangerous combination. In 2008 and 2009 the municipalities suffered very large losses; from risks they had not understood. Welfare schemes had to be cut, schools closed and the pupils had to learn to swim in the cold fjords because the swimming pools were closed.

The main argument used in favour of new and complex instruments is that they facilitate risk sharing across economic agents. But risks that are not understood can hardly be shared in any optimal way. It is also important to keep in mind that risk sharing can also be promoted through simpler and more conventional instruments.

Chart: NBIM Instrument Universe – Changes 2008-2011

Our oil fund – managed by Norges Bank and with more than 500 billion dollars under management - set up a special instrument committee after the recent financial crisis. The committee must sanction every financial instrument before it can be used for investments. As a result, the number of instruments available to the Fund's managers has been significantly reduced, in particular fixed-income and derivatives instruments, since the committee was established.

One factor behind the financial crisis was a very important market distortion described by Hyman Minsky: The interaction between asset prices and credit volumes may create a spiral where both asset prices and credit rise to unsustainable levels. The use of financial innovations to create more credit with the result that it fuels such a spiral is clearly not a socially desirable use.

Adair Turner of the British FSA [2] has pointed out that credit and asset bubbles also represent a massive misallocation of capital in the real economy.

Chart: On the sectoral allocation of capital

One key answer to the spiral described by Minsky has been to introduce macroprudential regulation. Instruments such as the countercyclical capital buffer are meant to provide a cushion when the credit cycle turns down. There is also a commonly held view that we need instruments to dampen credit growth during an expansion.

We should probably look broadly at how the Minsky style spirals could be contained. Discretionary policy can be a useful tool, but due weight must be given to building strong automatic stabilisers into the financial system to reduce the risk of future bubbles.

The topic of this conference is financial innovation. Both Adair Turner [3] and Paul Tucker [4] have raised doubts about the social value of some of these new instruments. I quite agree: Restrictive regulation of some of these instruments could contribute to stabilising financial markets.

One could imagine that the regulator should evaluate the pros and cons of allowing any new instrument. At the very least, the regulator should make sure that any instrument traded in significant quantities is sufficiently transparent to be a useful risk shifter.

In short, I agree with Frank that the positive relationship between financial markets and economic growth has its limits.

The difficult question is naturally where these limits are. It will be hard for a regulator to draw the line. But there are few other candidates for doing it.

Footnotes

[1] I would like to thank Birger Vikøren, Sigbjørn Atle Berg and Helle Snellingen for useful comments.

[2] Speech by Adair Tuner on 29 September 2011, *Credit Creation and Social Optimality*.

[3] Speech by Adair Turner on 18 February 2011, *Reforming finance: are we being radical enough?*

[4] Speech by Paul Tucker on 23 May 2011, Building resilient financial systems: macroprudential regimes and securities market regulation