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PRESS RELEASE

Endogenous Financial Risk: the Seventh International Conference of the NBB

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Systemic risk has been at the core of economists' concerns since the outbreak of the crisis. Systemic financial crises are a dramatic example of a market failure where the rational behaviour of individual agents ends up in the accumulation of imbalances over time; eventually the system breaks down, leading to significant levels of uncertainty, instability and costs at the macro-level. In developed economies, endogenous risk-taking behaviour by financial institutions affects other - interconnected - institutions with the effect that seemingly idiosyncratic risk can ultimately be a source of systemic risk. Market failure at the financial market level spills over to the real economy through a drastic drying up of investment sources, causing large decreases in output, employment and welfare.

Such costs appear to have been insufficiently taken into account in the pre-crisis regulatory and supervision framework for financial institutions, which was primarily focused on the micro-level. New policy proposals now aim to internalise the costs caused by such systemic externalities. These proposals, as set out in the Basel III regulation, for example, aim to regulate financial institutions at the broader macro-level. This new regulatory framework for macro-prudential policy comes with new challenges for policymakers. The National Bank of Belgium aimed to contribute to the discussions surrounding these challenges by organising its seventh biennial conference around the theme "Endogenous Financial Risk", held in Brussels on October 11 and 12, 2012.

A first challenge for policymakers involves detecting potential risks of future systemic instability. This requires knowledge about the nature of systemic risk and how to best measure it. The first session, with the keynote speech by Geert Bekaert (Columbia Business School), and two papers from the second session of the conference dealt particularly with this concern regarding measurement of systemic risk. However, policy makers also need to gain insight into the effectiveness of the tools used to address it. A contribution to the second session focusing on the Spanish dynamic provisioning experiments addressed this second challenge by offering an empirical analysis on the potential role of capital-based macroprudential policy. A third challenge is of an analytical nature: most macroeconomic models attribute only a minor role to financial frictions, and even then, they miss the non-linearities involved by risks to systemic stability. The keynote speeches by Frank Smets (BCE) and Yuliy Sannikov (Princeton University) and the papers presented in the third session of the conference addressed some aspects of these modelling challenges. A final challenge faced by policymakers concerns the desirability and the degree of coordination between macroprudential supervision and monetary and fiscal policy. Monetary policy can potentially play a role to safeguard financial stability, while macroprudential policy is affected by fiscal policies conducted in national economies and vice versa. The discussion during the panel session that closed the conference was based on some of these operational and institutional implications.