# What have we learnt from the recent financial crisis?

## Latest findings from leading researchers, academics and central bankers, discussed at Conference about Developments in Macroeconomics and Financial Markets in Cambridge

**September 2011.** IESEG School of Management and The Centre for International Macroeconomics and Finance (CIMF) from the University of Cambridge reveal main findings from their recently organised academic conference about developments in macroeconomics and financial markets, 1-2 September at Clare College in Cambridge. Around 60 experts from major central banks and the academic world (see list of participants further down) have been participating. The aim of this 2-day conference was to exchange views on possible lessons from the recent financial crises on research in macro-finance. The conference focused in particular on recent advances in both the theoretical and empirical analysis of financial markets, including money and capital markets.

Some of the main findings:

- In all countries or monetary areas, there should be a better coordination between the regulators of the banks and the regulators of the insurance companies or pension funds, in order to take account of systemic risk. Such coordination is essential to allow an optimal allocation of risks in the economy, and to stabilize critical markets like the sovereign bonds market.

- Most experts stress that enhanced transparency in monetary policy is likely to increase its effectiveness. It could be implemented through even greater emphasis on communication (e.g. via a kind of forward guidance policy of central banks) which should allow the market to better anticipate the future path of the policy rate.

- Following the crisis, central banks are now expected to pursue a larger set of objectives than what were the core objectives under explicit or implicit inflation targeting. They have been given a prominent role in addressing systemic risk issues. The question for example arises as to whether central banks should react to bubbles in various markets but perhaps more importantly whether responsibility for financial stability will impede or aid good monetary policy practice.

- Econometric work is not clear whether increases in public debt ratios increase (or decrease)real long term interest rates and steepen (or flatten) the slope of the yield curve. Typically the literature finds opposing results for Europe and the United States, where in the latter case a liquidity effect of an increased stock of issued bonds seems to prevail.

- Financial factors are dominant at high frequency to explain the temporal fluctuations of the yield curve, but macroeconomic factors (including market beliefs from surveys and central bank “talk-talk”) are more dominant at low frequencies.

- The predictive power of term spreads in interest rates (with respect to inflation or economic growth) has been falling over time.

- Concerning the pricing of risk in unsecured funding markets, recent research shows that the implied riskiness of counterparties and the premium placed on safe collateral have been increasing with the intensification of the crisis – which may place increasing pressure on highly leverages institutions with limited sources of funding

- The liquidity effect, or change in the federal funds rate due to changes in reserve balances, has declined with the growing supply of these balances during the crisis.

- The crisis has altered the relationship between the federal funds rate and the Treasury GC repo rate, which moves less in lock-step than it did before, because of limits of cheap arbitrage opportunities and other market factors. Draining balances could restore the relationship between these rates.

The first part of the conference focused more on the factors driving the yield curve and especially the possible determinants of the risk premium in the bond market. The second part mainly discussed the possible influence of central bank's actions on the dynamics of the yield curve. In addition, the role of fiscal shocks and public debt on long-term interest rate dynamics was also addressed in light of the recent sovereign debt crisis in Europe. The compression of financial spreads in the period leading up to the crisis also acted to suppress information about the fundamental vulnerability of many financial institutions and sovereigns. The subsequent escalation of many spreads has forced us to re-evaluate the connection between the probabilities of payoffs in various macroeconomic states and the prices of those payoffs determined in financial markets.

Academics came from IESEG School of Management (France), Cambridge University (UK), universities of Aston, Birmingham, Cardiff, Essex, Kent, Nottingham, York (UK), Cass Business School (UK), Imperial College Business School (UK), National University of Galway (IE), University of Basel (CH), University of Bologna (IT), University of Copenhagen (DK), University of Liège (BE), Pontifical Catholic University of Rio de Janeiro (BR), University of Western Ontario (CA), University of New South Wales AU.

These academics shared their views with central bankers who came from the Federal Reserve (US), the Bank of England, several national central banks of the Eurosystem (Banque de France, Bank of Italy, National Bank of Belgium, Central Bank of Ireland), the Bank of Korea, the Bank of Canada, the Central Bank of Venezuela, and the Bank for International Settlements.

Keynote speakers: Paul Fisher (Executive Director for Markets at the Bank of England) and Philip Turner, Deputy Head Monetary and Economics department at the Bank for International Settlements on the first day and with Glenn Rudebusch (Executive Vice President and Director of Research at the Federal Reserve Bank of San Francisco) and Frank Smets (Director General of the Directorate General Research at the European Central Bank) on the second day of the conference.

The papers will be published in the second volume of the series Modern Macroeconomic Policy Making, Cambridge University Press. However, a preliminary version of most of papers as most presentations are already available at the following conference website's address:

http://international.ieseg.fr/teachers-and-research/ieseg-cambridge-conference/

The first volume can be ordered at:

http://www.cambridge.org/gb/knowledge/series/series_display/item6542715/Macroeconomic-Policy-Making/?site_locale=en_GB

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***About IESEG School of Management***

*Established in 1964, IESEG School of Management is a business schools with campuses located in Paris and Lille (France). The school delivers select master's programmes entirely in English. The research centre of IESEG is part of LEM, a laboratory accredited by CNRS, the French National Centre for Scientific Research. It covers several fields in economics and management. IESEG is an international institution, with 72 percent of tenured faculty coming from outside of France, and a strong network of 161 partner universities in 46 countries around the world.*

***About the Centre for International Macroeconomics and Finance (CIMF) of the University of Cambridge***

*The Faculty of Economics of the University of Cambridge 2008 launched the Centre for International Macroeconomics and Finance (CIMF) this November under the umbrella of Cambridge Finance, a University wide initiative. This new Centre augments the existing centres in the Judge Business School and the Statistical Laboratory, and complements them by focussing on empirical finance with special emphasis on international macroeconomic financial issues such as global economy interactions, financial crisis, contagion, interactive learning, market and credit risk diversification, real time analysis and signal extraction.*