

20120207 Bank of Portugal: Systemic Risk - Too-Important-to-Ignore (Speech by Governor Carlos da Silva Costa)

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Address by Governor Carlos da Silva Costa at the Portuguese Banking Association Conference "Systemic Risk - Too-Important-to-Ignore" - Opening session Lisbon, 3 February 2012

Ladies and gentlemen, good morning. It is a pleasure to be here.

Let me start by congratulating the Portuguese Banking Association for bringing together such an impressive panel of speakers and for having selected the most topical of all themes.

Systemic risk has been brought to the spotlight as the international financial crisis unfolded, and is currently one of the buzzwords in the financial industry and regulatory community.

What exactly is systemic risk?

It's a complex concept which is still evolving, as you will understand after the presentations from the eminent experts who will be speaking to you today.

Just to give a flavour of what is at stake, I will say that, in the context of the economic environment, systemic risk is the threat that certain developments may disrupt the functioning of the financial system, impairing its ability to perform its basic functions, and thereby triggering losses in economic activity.

To make it easier to understand the concept, let me recall an analogy that has been used to illustrate the notion of systemic risk.

Let us suppose the financial system is a forest, populated with many different kinds of plants, be it large oaks or small bushes. If we want to preserve the integrity of this eco-system and prevent it from being destroyed by fire, it is essential to monitor the risk of a fire starting. If a fire should start, it will inevitably destroy a certain part of the forest and some trees will be lost. In that case, what is absolutely crucial is to prevent the fire from spreading, or else the whole forest would be at risk, causing serious damage to the community which depends on its resources for survival.

The financial crisis has made it clear that vulnerabilities may develop in the financial system even if individual players or instruments appear sound. Indeed, huge risks may emerge from the complex interactions between the individual players and instruments, the institutional framework and the broader macroeconomic environment. Detecting this type of underlying vulnerability requires a 'top-down' approach to complement the 'bottom-up' supervision of the financial system's individual components. This is the focus of 'macro-prudential supervision' as it is known. To quote Jose Viñals, who is speaking later this morning, what is needed is "to see both the forest and the trees". Europe has been the epicentre of the crisis in the past two years. Three European Union Member States - Greece, Ireland and Portugal - lost access to market financing, and had to negotiate financial assistance packages with the European Union and the International Monetary Fund. In recent months, the interplay between public finance and financial sector fragilities intensified and contagion spread to other euro area economies.

The systemic crisis affecting the euro area is threatening one of Europe's greatest achievements - the single currency. Market pressure is no longer about unsound policies, or unsustainable debt paths. Taken together, the fundamentals of the euro area are stronger than those of the US or Japan. However, the crisis has brought to the forefront severe inconsistencies in the governance model, internal organisation and instruments available to manage the single currency.

The initial response of European leaders has been slow and hesitant, but in the past few months, important steps have been taken towards a more balanced EMU governance model and effective 'firewalls'. Decisive implementation of the new procedures and mechanisms is still necessary to reassure markets on the irreversibility of the euro. Failure is not an option: we would risk irreversible damage to the foundations of the European Union itself, with unpredictable geopolitical consequences.

My intention is not to look into the past, and discuss how we got here. The root causes of the

global crisis, the euro crisis and the Portuguese crisis have been discussed at length, and I believe the diagnosis is now widely shared. What I would like to do today is two things:

First, I would like to present and explain the Banco de Portugal strategy to secure financial stability in the context of the Portuguese economy's adjustment and the euro area systemic crisis.

Secondly, I would like to comment briefly on how the Portuguese banking system is responding to the new environment.

To read the full speech click [here](#).

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