Lucas Papademos: The financial market turmoil, the European economy, and the role of the European Central Bank

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at an event organised by The European Institute, New York, 27 September 2007.

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Ladies and Gentlemen,

I. Introduction

The European Institute in the United States has a long tradition of "fostering transatlantic dialogue". Through a variety of activities, including the publication of its "European Affairs" journal, it succeeds in providing a thorough analysis of and in stimulating a constructive debate on issues pertaining to the European Union and on key aspects of transatlantic cooperation. I like to thank you for the invitation to address some issues of relevance to the economies and public policies on both sides of the Atlantic.

The recent financial market turmoil confirmed how closely integrated our economies have become and, in particular, how events that have a direct impact on financial markets in the United States can have immediate and significant repercussions on European financial markets, which in turn can have feedback effects on American markets. The financial market tensions also underscored the importance of information exchange and cooperation between central banks and other relevant authorities across the Atlantic – cooperation which can reinforce the effectiveness of the policies pursued.

In my remarks I would like to share with you some thoughts on two topics:

- The recent financial market turbulence and its potential impact on the European economy; and
- The role of the European Central Bank in preserving price stability, safeguarding financial stability and fostering economic growth in the euro area.

The ECB and other major central banks have been very much in the news in recent weeks as a result of their money market interventions during the financial market turmoil. Moreover, over the past few months the monetary policy decisions of central banks have been occasionally at the centre of public debate triggered by concerns that interest rate increases might adversely affect economic activity, as well as by more general considerations regarding their policy mandates.

It is said that it is the job of central banks in the economy "to take away the punchbowl just as the party gets going." Looking at the developments in financial markets over the past two months, it looks like the party in some market segments was a rather exuberant affair, characterised by quite a few excesses! And some market participants are feeling the consequences, having woken up with a severe hangover! Which begs a question: what, then, is our role in such a situation? This is precisely one of the issues that I would like to discuss.

II. The financial market turmoil

In early August, before tensions emerged in financial markets, the ECB's diagnosis of the economic situation in the euro area was that the economic environment was positive with conditions in place – both external and internal – for economic activity to continue to expand at a sustained rate, close to potential growth. It was noted, however, that there were downside risks to this favourable outlook for economic growth which included “the possibility of potential abrupt shifts in global financial market sentiment leading to a repricing of risks”.

The month of August was characterised by a substantial increase in financial market volatility and a reappraisal of risk. The financial market turbulence was triggered by a series of events which intensified tensions in the US subprime mortgage market. This resulted in an adjustment of investors’ attitudes towards risk – a diminished appetite for risky assets – and led to an increase in uncertainty about financial market conditions and prospects. Market volatility rose sharply in almost all asset classes. Stock markets tumbled, as investors sold equities and moved funds into safe-haven investments, like government bonds. Several investment funds holding asset-backed securities – with subprime mortgage elements – suspended withdrawals. At roughly the same time, a number of European banks made public their direct and indirect exposures to the US subprime mortgage market. These exposures were sometimes sizeable but were not sufficiently significant to materially impact the soundness of core financial institutions. In addition, several banks, especially in Europe, were subject to rumours about severe losses stemming from exposures to mortgage-backed securities.

What were the factors and the channels that contributed to the propagation of shocks and tensions from one market on one side of the Atlantic to several markets on both sides? The tensions fundamentally reflected increased uncertainty and a loss of confidence in the valuations of structured credit instruments, where the underlying assets are US subprime mortgages. This loss of confidence caused disruption in the asset-backed commercial paper (ABCP) market where “conduits” and structured investment vehicles (SIVs) were borrowing to fund their holdings of asset-backed securities. These financial “conduits” and SIVs faced difficulties to refinance themselves, that is, to roll over maturing ABCP because of concerns about their credit quality. The tensions in the ABCP markets – both in US dollar and euro – spread to the interbank money market on both sides of the Atlantic, as banks began hoarding liquidity to fund their commitments to provide liquidity and credit to these conduits and to put the underlying assets on their balance sheets. Moreover, banks curtailed their lending to other banks because of uncertainty surrounding potential exposures of their counterparties. These developments drove up interest rates for the very short term funds to levels significantly above the ECB’s policy rates.

The actions of the European Central Bank

In this situation of heightened tension and a severe impairment of the functioning of the euro money market, the ECB stepped in and provided overnight liquidity to the interbank money markets in a series of fine-tuning operations. These took the form of reverse repurchase agreement, whereby the ECB lends funds to commercial banks against eligible collateral which are repurchased the next day, at the agreed price, by the counterparty. Initially, the ECB provided such funds at the policy interest rate of 4.00% without limit. Throughout the month of August, the ECB conducted a number of additional fine-tuning operations. It also provided liquidity through its weekly main refinancing operations and two supplementary longer-term refinancing operations with a maturity of 3 months.

The aim of these operations was to ensure orderly conditions in the interbank money markets, to reduce short-term interest rate volatility and to contain the risk that tensions in the financial markets would propagate through the banking system. The ECB conducted the money market operations without changing the overall stance of monetary policy and, needless to say, without aiming to “bail out” any specific financial institution with a special liquidity need. I emphasise this point because there has been a certain degree of confusion about this. It is important to make a clear distinction between two types of key central banking actions. On the one hand, central banks take decisions on monetary policy and official interest rates and these have a clear medium-term orientation geared towards the preservation of price stability and they rest on the macroeconomic assessment of the risks to price stability. On the other hand, central banks may conduct money market operations that provide liquidity to ensure the orderly functioning of the interbank money market. Put simply, monetary policy decisions are about the level of official interest rates, whereas certain central bank operations in the money market aim at the reduction of short-term interest rate volatility around a given level of official interest rates, for the purpose of safeguarding financial stability.

I should also emphasise that throughout this episode and the related money market operations, the ECB and the Eurosystem have been in close contact with other central banks in the world, notably the Federal Reserve System. While each monetary authority took decisions to attain its own objectives and in line with its own assessment and operational framework, it is unquestionable that this liquidity squeeze which had manifestly global dimensions called for a response with commensurately global cooperation.

Did the actions of the ECB and other central banks accomplish what had been intended? For the European side, I can state that the ECB's liquidity-providing operations clearly had a stabilising effect on euro money market rates at the shortest end, and overall, the money markets have recovered somewhat. However, market liquidity remains thin and activity limited in the unsecured inter-bank market, and spreads comparably higher. There are two main reasons for this: first, banks' liquidity needs, especially in US dollar, have risen, because the credit lines extended to the various "conduits" and other financial entities have been largely used. Second, a number of banks are still reluctant to lend to each other, particularly on an uncollateralised basis, in view of perceived counterparty risk. This attitude contributed to reduced interbank activity – and this in spite of the availability of abundant liquidity in the banking system as a whole.

Lessons to be learnt

In the light of these developments we, as policy-makers, need to find answers to two questions: What have been the sources and reasons of what we have witnessed? And what are the lessons to be learnt so as to try to avoid any repetition? It is still too early to make a definitive assessment of the combination of factors that explain what happened – and is still happening – in credit markets and of the consequences of the market liquidity squeeze. However, recent developments have revealed several vulnerabilities in credit markets and allow us to reach some tentative conclusions. I should note that a number of these vulnerabilities and risks had been previously identified by the ECB, in its Financial Stability Review as well as by other central banks and international financial institutions. Some other vulnerabilities or structural weaknesses became visible during the recent developments.

These vulnerabilities relate to features of new financial instruments and markets, new market participants, new business models of credit origination and risk transfer and incentive structures that can affect the behaviour of market participants. In particular, I would like to stress four vulnerabilities that have been exposed and that stem from: (i) the lack of transparency in the broader credit markets, (ii) the valuation of structured credit products which are not traded frequently, (iii) the role of credit rating agencies, and (iv) special-purpose investment vehicles that are highly leveraged.

First, the lack of transparency in credit markets. In recent years, the market of credit risk transfer has facilitated a widespread sharing of credit risk across the financial markets which in general should enhance their efficiency and stability. Nevertheless, the market turbulence confirmed previously expressed concerns about the risks stemming from the lack of transparency as to where credit risks ultimately reside in the financial system, that is, whether they have been acquired by market participants that can manage them properly and how imperfect knowledge of the distribution and concentration of risks can affect participants' behaviour and the liquidity of markets.

Second, structured credit products whose valuations are model-determined. Even if risks are well dispersed across the system, in a crisis situation, a suspicion that some financial institutions could have exposures, event modest, to such assets for which no market value can be computed, can significantly impair the functioning of the market.

Third, the activity of rating agencies has recently come under particular scrutiny. The issues related to the very small number of rating agencies, the possible conflicts of interest and the lack of benchmarks clearly need to be addressed in order to provide optimal conditions for the efficient functioning of the complex and sophisticated global financial markets. What should be clear, however, from the current episode is that financial institutions should not rely exclusively on credit ratings for their risk assessments.

Fourth, special-purpose investment vehicles that are highly leveraged. The financial market turmoil has highlighted the vulnerabilities created by such, off-balance sheet, investment vehicles, namely that such vehicles have proven, in the context of mark-to-market accounting of asset pools, to be prone to liquidity mismatches between their assets and liabilities. These mismatches caused contingent credit (and liquidity) lines to be drawn on banks and resulted in the increased demand for liquidity by banks in the (interbank) money market.

These four issues are only some of the lessons to be learnt from this episode of financial market turmoil; there are others, pertaining, for example, to the liquidity risk management of banks. We need to carefully assess all factors of relevance to the recent financial market developments, and should not be rushed into conclusions without a thorough and comprehensive analysis.

Possible impact on the European financial system

What is the likely overall impact of the recent financial market developments on the European financial institutions? Some institutions have experienced losses from their holdings of asset-backed securities, in particular as a result of both direct and indirect exposures to US sub-prime mortgage securities. Moreover, a number of banks have faced liquidity pressures as credit lines to special-purpose investment vehicles had to be activated to meet commitments to provide liquidity support and as a result of increased uncertainty about counterparty risk. Nevertheless, on the whole, exposures to the US sub-prime mortgage market manageable given the capital buffers. After several years of strong profit growth, including strong profitability in the first half of 2007, and with capital bases in excess of regulatory requirements, the shock-absorbing capacity of the euro area financial system – especially the core financial institutions – has been enhanced. Although the profitability of some European financial institutions is likely to be adversely affected to varying degrees by the recent strains in financial markets, the euro area banking system on the whole should have no major problems in absorbing the impact of recent disturbances.

Looking forward, the most likely scenario is that financial market conditions will normalise progressively over a period of time – which could be protracted depending, among other factors, on the progress made in restoring confidence in the valuation of credit instruments and the creditworthiness of counterparties. However, it cannot be excluded that some low-probability, but plausible and challenging, scenarios for financial stability could be triggered by adverse market disturbances or “credit events” which would further affect global market liquidity conditions. A potential further deterioration in credit quality could lead banks to tighten their lending standards and a less benign scenario could emerge involving a more significant re-pricing of risk and de-leveraging.

Concluding this assessment of some of the underlying causes and the likely consequences of the financial market turmoil, I want to stress the following: The recent market liquidity squeeze originated from a surge in default rates by a subset of borrowers with particularly weak credit histories and economic fundamentals. In other market segments and economic sectors, the fundamentals are broadly strong. In order to contain financial market volatility, it is crucial, at the current juncture, that unanticipated shocks and investor concerns do not lead to unwarranted contagion to markets and sectors where the fundamentals are sound.

III. The outlook for the European economy

Against the background of this assessment of financial market developments, how do we see the outlook for the European economy? To what extent does the recent episode influence real economic activity in the euro area? The overall potential impact on the real economy of increased financial market volatility and the repricing of risk is difficult to gauge. So far, the effects of the market turbulence on the euro area economy have not been significant, despite some tightening of financing conditions. Clearly, the potential effect will depend on future financial market developments. The longer credit market tensions persist, the greater will be their impact on the economy. The most likely scenario – that financial market conditions progressively normalise over a period of time – implies that the effects of the financial market turbulence on bank intermediation and the cost of capital are likely to be contained. Therefore, even if lending standards are somewhat tighter than before and risk premia and the cost of capital increase by a modest amount, their impact on economic activity can be expected to be moderate.

More generally, looking ahead over the policy-relevant medium-term horizon, we should assess the likely effects of all relevant factors – economic, financial and monetary – on the European economy's prospects. The good news is that the fundamentals of the euro area economy remain strong and global economic activity is expected to remain robust. The expected slowdown of the US economy is likely to be largely offset by strong growth in emerging markets. In particular, the fast pace of expansion of economic activity in emerging Asia is expected to contribute to more 50% of the projected rate of growth of global aggregate demand outside the euro area. It will, therefore, continue to provide support to European exports and investment. Moreover, domestic consumption growth should rise gradually over time, as employment conditions are expected to improve further and in line with real disposable income developments.

All in all, the strong economic fundamentals, the expected global robust economic growth in the remaining part of this year and in 2008, and our current assessment of the likely future financial market developments imply that average euro area real GDP growth in 2007 and in 2008 will be negatively affected only slightly by the recent financial market turmoil and euro area economic activity will continue to expand at sustained rates, in line with potential growth. The Eurosystem staff projections published earlier this month foresee average annual real GDP growth in a range between 2.2% and 2.8% in 2007, and between 1.8% and 2.8% in 2008, the same range projected last June. I would like to emphasise, however, that there is considerable uncertainty surrounding the central, or most likely, scenario for future growth and that there are several downside risks. These relate mainly to a potentially broader impact from the ongoing reappraisal of risk in financial markets, global imbalances, protectionist pressures, and further rises in oil and commodity prices.

How about the outlook for and the risks to price stability? The medium-term outlook for price stability remains subject to upside risks. These risks relate to further increases in oil prices and prices for agricultural products, stronger than expected wage developments, and a possible increase in the pricing power in some sectors, and the continued vigour of the underlying monetary and credit expansion, despite some stabilisation in the growth of bank credit to the private sector.

The current assessment, and confirmation of the previous one, that upside risks to price stability remain has implications for the stance of monetary policy. It implies that on the basis of the expected favourable medium-term outlook for real GDP growth, the monetary policy stance is still on the accommodative side and that the ECB should act in a timely and effective manner to ensure that risks to price stability over the medium term do not materialise. At the same time, given the increase in uncertainty surrounding the economic outlook, it is prudent and appropriate to wait and gather additional information before drawing any firm conclusions for monetary policy. I should note that the uncertainty we face is not only related to the likelihood of some specific risks materialising that could affect the financial and product markets, but it also pertains to the ongoing process of adjustment of the attitudes toward risk of financial institutions and other market participants, which could have a bearing on financing conditions. So, we will monitor very closely all developments and continue to pay great attention to financial markets in the coming period. Having said that, I would like to stress that the ECB's monetary policy is firmly geared towards its primary objective of preserving price stability. And especially during a period of increased uncertainty and market volatility, it is important that inflation expectations remain firmly anchored to price stability.

IV. The role of the European Central Bank

Having presented these reflections concerning the financial market turmoil, the current macroeconomic outlook and our monetary policy stance, allow me to conclude by touching upon some broader considerations regarding the role and policies of central banks and, in particular, of the European Central Bank. In this context, it is worth recalling that the ECB's objective, tasks and responsibilities are clearly laid down in the EU Treaty. The primary objective of the ECB – and the Eurosystem as a whole – is to maintain price stability. Furthermore, the ECB is to support the general economic policies of the Union, aiming among other goals at sustainable economic growth, provided that this is possible without prejudice to the objective of price stability. There is, therefore, a clear hierarchy of objectives, and for good reason, as I will explain. The ECB and the Eurosystem are also called upon to "contribute to the smooth conduct of policies pursued by the competent authorities relating to prudential supervision of credit institutions and the stability of the financial system" (Article 105 of the EU Treaty). The objectives of price stability and financial stability are interrelated and mutually reinforcing, in that both serve to create conditions which are a prerequisite for economic growth and prosperity.

Why should the preservation of price stability be the primary, overriding objective of monetary policy? Both theory and history provide strong arguments and evidence to support this assignment. First, monetary policy, with the available instruments at its disposal, can control effectively the price level over the medium and longer run. Second, by contrast, monetary policy cannot influence the level or rate of growth of aggregate output in a permanent manner (or to any significant extent). Third, although in the short term a change in the monetary policy stance could affect economic activity under certain circumstances, such effects are uncertain, cannot be systematically exploited to stabilise the business cycle and there is a risk that a countercyclical monetary policy could be counterproductive and jeopardise the attainment of the price stability goal. Most importantly, by establishing an environment of price stability, a central bank contributes in a fundamental, though indirect way, to sustainable economic growth, since in such an environment reduced inflation uncertainty, inflation expectations anchored to price stability and low levels of long-term interest rates foster sustainable growth. For all these reasons, the mandates of most central banks in the advanced economies give primacy to the price stability objective. It is interesting to note that a major central bank that has a dual mandate has emphasised in its communication some of the messages that I have stressed here, namely that price stability is a necessary precondition for growth. It is, therefore, appropriate not to ignore the conclusions of theory and the lessons of past experience when discussing the objectives of monetary policy.

I explained earlier at length the ECB's monetary policy stance in order to fulfil its objective of preserving price stability. How does the ECB perform its financial stability tasks? First, by monitoring and assessing the outlook for financial stability, and notably by identifying the main sources of risk and vulnerabilities across the three components of the financial system: markets, institutions and infrastructures. To that end, the ECB produces a twice-yearly Financial Stability Review which aims to promote awareness in the financial industry and the public at large of financial stability issues, and, in this way, to play a role in the prevention of financial crises. The second strand of activities with which the ECB and the Eurosystem seek to safeguard financial stability is by providing liquidity to financial markets or institutions in emergency situations, with a view to preventing the propagation of shocks across markets and institutions that might transform a single incident into a wide-spread crisis with systemic repercussions, as I explained earlier.

For a central bank to attain its primary objective and perform its tasks effectively, a number of conditions – institutional, operational, and analytical – must be in place. An essential condition for the effective performance of the central bank's functions is its independence, meaning that it can take decisions on the appropriate policy to achieve its objectives without being subject to any pressure or interference by the government and any other political authorities. There are strong theoretical arguments why the central bank should be independent. But the most convincing reason, which has led many governments to depoliticise monetary policy and grant independence to the central bank, is past experience and the empirical evidence.

Europe's "monetary constitution" enshrines the independence of the ECB and the national central banks in the EU Treaty. But this is not only a case where the law has been made the "guardian of economic wisdom", it also reflects the will of the peoples of Europe, and the value which they attach to price stability. Recent public opinion surveys demonstrate that more than seven out of ten Europeans think that the ECB should be free from influence of politicians in order to pursue its task to preserve price stability. If we, therefore, publicly reiterate the Treaty provisions about central bank independence, we are also lending a voice to this overwhelming majority of European citizens who support our well-established and tried-and-tested institutional framework.

Thank you very much for your attention.