Jean-Claude Trichet: The financial turbulence – where do we stand?

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Economic Club of New York, New York, 14 October 2008.

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Introduction

Ladies and Gentlemen,

It is a great honor and a pleasure for me to be invited to speak at the Economic Club of New York in these very challenging times for banking supervisors and central bankers.

The changing nature of the turbulence over recent months, together with the new developments over the past few weeks, have meant that the turmoil is an enormous challenge for the financial system at large, as well as for policy makers and regulators around the globe. Since August 2007 central bankers have been busy managing increasing volatility and risks in financial markets. The primary goal of a central banker and certainly of the ECB is to maintain price stability over the medium term and be credible in delivering price stability, which is a necessary condition for financial stability, if not a sufficient condition. To achieve this, we not only have to define the monetary policy stance and set policy rates, but we also have to implement our monetary policy. This is done by conducting open market operations with the aim of steering short-term interest rates on the interbank money market – and in particular the overnight rate – close to our main policy rate, i.e. the minimum bid rate in the main refinancing operations of the Eurosystem. In doing so we steer the shortest end of the yield curve, which is the starting point of the transmission process of monetary policy, ultimately reaching the real economy in order to achieve price stability.

I would like to commence by describing how the ECB has implemented monetary policy during the financial market turbulence, which started in August last year. In this context, I shall describe how the Eurosystem took action through its liquidity provision to the euro money market in order to ease tensions. I shall then turn to the coordinated action taken by central banks, and how important it was for them to address effectively tensions in global financial markets.

In the second part of my intervention, I will discuss the measures put in place by the international financial community to restore market functioning and to ensure that the weaknesses highlighted by the current market correction do not recur in the future. In this regard, I will cover the progress made on the implementation of the priority recommendations of the Financial Stability Forum (FSF), as well as policy areas in which work is currently underway, including risk management of financial institutions, procyclicality and cooperation between central banks, supervisors and regulators. I will conclude with the most recent “action plan” that was adopted by the G7 in Washington and on the “concerted European action plan of the euro area countries”, which was just agreed last Sunday in Paris.

1. The responses of central banks to the financial turmoil

Over the past four weeks – in particular following the collapse of Lehman Brothers – credit risk concerns have intensified and have led to additional disruptions in the functioning of money markets, not only in the United States, but also in the euro area and Europe in general.

Central banks are taking all the necessary steps to stop the downward spiral, and recent actions have once again demonstrated their determination in this respect.

In both “normal” and “turbulent” times, the primary objective of the Eurosystem’s open market operations is to keep the shorter rates, in particular, the overnight rate, as close as possible to the minimum bid rate. However, during the recent period of turbulence, open market operations have also aimed at ensuring the continued access of solvent banks to liquidity, notably by contributing to easing the impaired functioning of the money market. The Eurosystem intends to continue to follow this approach as long as necessary.

From the first day of the financial market turbulence on 9 August 2007, in an environment of increased liquidity risk and in response to banks' changed liquidity demand pattern, the ECB has achieved these objectives through making technical changes to the way in which it supplies liquidity in normal times, while also utilising the full latitude of its framework for monetary policy implementation.

First, the Eurosystem has adjusted the distribution of liquidity supplied over the course of the reserve maintenance period by frontloading, relative to normal times, the supply of liquidity at the beginning of the maintenance period and reducing it later. In this way, the total supply of liquidity over the entire maintenance period remained unchanged and, at the same time, the changed pattern in banks' liquidity demand was satisfied without putting pressure on short-term interest rates. In addition, last month the ECB enlarged the provision of liquidity at its regular weekly main refinancing operations, well above the amount normally envisaged by the frontloading approach, with the aim of further strengthening its liquidity intermediation at a time of significant rigidity in the euro money market. The ECB then reabsorbed the resulting excess of liquidity on a daily basis through overnight fine-tuning operations, and continued to rebalance the liquidity conditions towards the end of the reserve maintenance period.

Second, the Eurosystem has supplied liquidity to the banking system by using open market procedures, which were very rarely, if at all, used before the start of the turbulence.

1. The use of fine-tuning operations has been much more frequent than in "normal times" because of the volatility in banks' liquidity demand and the difficulty of producing a reliable ex-ante estimate of the overall liquidity conditions. In particular, I would like to mention that the ECB made recourse to these operations repeatedly in August 2007 and again in September this year to provide overnight liquidity in addition to the liquidity provided at its weekly main refinancing operations. In addition, as already mentioned, in the past two weeks, overnight fine tuning operations have been used regularly to re-absorb the excess liquidity provided to the euro money market.

2. The Eurosystem has very significantly increased the average maturity of its lending to euro area banks. The outstanding amount of refinancing provided via longer-term refinancing operations has increased by around €270 billion since 2007. The latest measure in this respect consists of a series of special term refinancing operations with a maturity of six weeks, which were launched in September 2008 and will be continued until at least beyond the end of the year. Consequently, and in order to keep the total amount of outstanding refinancing unchanged, the amount of liquidity provided via the one-week main refinancing operations has been reduced correspondingly.

3. On 8 October, due to intensified tensions in the financial market, the ECB took the absolutely exceptional decision to adopt a fixed rate tender procedure with full allotment for all its weekly main refinancing operations as long as market conditions dictate.

Third, in October 2008 the ECB reduced the corridor of the standing facilities around the interest rate on the main refinancing operations was reduced from 200 basis points to 100 basis points.

These measures, which reflect the increasing intermediation role assumed by the Eurosystem during this period of turbulence, have contributed to the stabilisation of conditions in the euro money market, to containing the volatility in the very short-term rates, especially in the overnight rate as measured through the so-called EONIA, and to limiting somewhat the volatility in the three-month Euribor, even if the behaviour of the money market remained extremely tense, as was also the case in New York.

Cooperation between central banks in the field of monetary policy

It is important to recall that as the financial market turbulence developed , central banks strengthened the already remarkable levels of cooperation, first, through enhanced information exchange and collective monitoring of market developments and, later on, through coordinated steps to provide liquidity. Since December 2007, the ECB, in cooperation with the US Federal Reserve System and the Swiss National Bank, has been conducting term auction facilities – so-called TAF operations – in which it provides USD liquidity on behalf of the US Fed to euro area banks against ECB eligible collateral. These operations do not have a direct impact on euro liquidity conditions and are aimed at improving global funding conditions.

In this respect I would like to stress that to my knowledge this was the first joint action of that kind ever taken by central banks to relieve pressures in the short term funding markets.

Yesterday at 8 a.m. Central European Time and 2 a.m. in New York, the ECB announced, together with the Bank of England and the Swiss National Bank, that – thanks to a swap agreement with the Federal Reserve System – we will conduct tenders of US dollars funding at 7-day, 28-day and 84-day maturities at fixed interest rates for full allotment. Counterparties in these operations will be able to borrow any amount they wish against the appropriate collateral in each jurisdiction. This is a “world premiere” in exceptionally confident cooperation between central banks.

Another exceptional “first” at global level was the coordinated reduction in policy rates by the same amount of 50 basis points, which was decided by a large number of central banks from the G10 countries. It was justified by the fact that the intensification of the financial crisis had further diminished the upside risks to price stability and that central banks were considered to have regained control of inflation expectations.

The role of the Eurosystem operational framework during the financial market turbulence

The current financial market turbulence has certainly provided the biggest challenge to the operational framework of the Eurosystem since its inception more than ten years ago. The recent experience has so far proved that some of the structural features of our framework have had an important role in stabilising short-term money market rates, signalling the monetary policy stance and contributing to financial stability.

More precisely, the Eurosystem’s operational framework is characterised, first, by a large number of counterparties eligible for refinancing operations and marginal lending facility. This facilitates the direct provision of liquidity to a large number of banks in need of it, at a time when the money market is working imperfectly.

Second, the Eurosystem accepts a wide range of collateral eligible for its refinancing operations. This has facilitated the raising of liquidity via the Eurosystem for banks with reduced access to the interbank market, at the same time economising through their operations with the Eurosystem on those few types of assets that have continued to be tradable throughout the turbulence, such as government bonds. In this respect, the framework may have also supported the continued functioning of capital markets.

Third, the large size of its refinancing operations (around one third of total assets in the Eurosystem balance sheet – or €450 billion) has allowed the Eurosystem to provide longer term refinancing to banks at a large scale, and at the same time to continue to adequately steer liquidity in the course of the maintenance period.

2. Implications for central banks, financial regulators and supervisors

At the level of the international community, we have adopted a methodology for responding to the present turmoil and working out what lessons can be drawn from the crisis: the FSF, created after the Asian crisis, coordinates global efforts towards creating a more resilient financial system. By April 2008, the FSF had reached consensus on a set of 67 policy recommendations aimed at addressing the vulnerabilities identified in the global financial system. Some of these recommendations concern structural changes and thus can only be implemented over the medium term. However, a number of priority areas calling for immediate action were identified and the relevant recommendations are already being implemented by the competent authorities and the industry. In this respect, a major priority area involves the disclosure of financial institutions' structured finance-related exposures and their valuation practices. Many large global banks have already applied the methodology set out in the FSF report to their holdings of complex and illiquid instruments in their mid-year financial reports. By doing so, they have demonstrated the willingness of the private sector to contribute to strengthening market confidence by increasing transparency. I strongly support this development and believe that the example set by these banks should be followed by a wider range of institutions.

Furthermore, guidance on transparency has been provided and is being further developed by the Basel Committee on Banking Supervision and public sector initiatives, such as the European and the American Securitisation Fora. In the same vein, the International Accounting Standards Board is intensifying its work to enhance the accounting and disclosure standards for off-balance sheet entities and to develop guidance for valuation in illiquid markets. The ECB is monitoring developments in this area, and I believe that providing clear guidance on this issue is pivotal to improving the confidence in and the comparability of banks' financial statements.

Finally, another area where good progress has been made under the impulse of the FSF concerns the role of credit rating agencies, which is being clarified thanks to new regulation by the SEC and the revision of the IOSCO Code of Conduct. At the same time, in Europe, the European Commission will engage in regulatory initiatives for the credit rating agencies' authorisation and supervision.

Let me now focus on three issues which I believe are especially important in the current context and for which transatlantic cooperation between central banks and financial regulators is warranted, namely risk management, procyclicality and financial stability arrangements.

With regard to risk management, it has become clear that the current situation in the financial markets originated for the large part in excessive risk-taking and leverage by financial institutions. A key explanation for this behaviour lies in banks' risk management systems, which did not appropriately price risks, resulting in the creation of capital and liquidity buffers that (in many cases) proved insufficient to insulate them from the dislocation in the financial markets. Furthermore, liquidity risk did not receive enough attention in banks' overall risk management.

Strengthening risk management techniques and procedures is key in the current context. Public authorities have a clear role in this respect, and the Basel Committee on Banking Supervision is a major player in this field at the global level. I fully endorse the work done by the Basel Committee to review banks' risk management practices, as well as the Guidance on Sound Liquidity Risk Management and Supervision, which was recently published and constitutes a benchmark for the practices of financial institutions.

The European Central Bank, as the ultimate provider of liquidity in the euro area, has a particular interest in issues relating to liquidity risk management. Against this background, our work on liquidity stress testing and contingency funding plans has highlighted the importance of both banking supervisors and central banks having access to the results of liquidity stress tests carried out by banks so that they can better assess the potential systemic impact of a liquidity shock. The ECB supports the idea of organising common liquidity stress tests, for which participating banks would use their own stress tests based on a joint scenario.

Furthermore, the contingency funding plans of large banks should be shared not only with banking supervisors but also with central banks, as also recommended by the FSF.

Having said that, I would like to stress that financial institutions are ultimately responsible for ensuring that all relevant risks, including liquidity risk, are properly integrated into their overall risk management. In this vein, the full and timely implementation of the principles and best practice recommendations developed by both the public authorities and the industry, as well as a regular assessment of this implementation process, are of utmost importance.

The second issue that I would like mention is that of **procyclicality**, and in particular the extent to which the current regulatory framework could encourage the procyclical behaviour of financial institutions. This is a complex issue as procyclicality depends on many factors. Although the way in which financial institutions manage their risk is regarded by many as the main determinant of procyclicality, other elements such as capital requirements, accounting standards or banks' compensation schemes can act as contributing factors. In terms of policy action in this field, in the short term, regulators are determined to avoid measures aimed at tightening capital requirements, as these could impinge on the financial standing of banks and negatively impact the supply of credit and, in turn, the whole economy. At the same time, the contributing factors to procyclicality must be looked at from a longer-term perspective.

Finally, I would like to address the importance of **cross-border cooperation between central banks, supervisors and regulators** in the current context. Indeed, the significant impact of the crisis in the US sub-prime market on other parts of the world highlights the importance of improving cooperation between national authorities, both for preventing and for resolving shocks. On the crisis prevention side, it has now been agreed that there is a need to reinforce multilateral surveillance at the global level. To this end, the FSF and the IMF will intensify their cooperation with a view to enhancing the assessment of financial stability risks on a global scale as well as to coordinating possible policy responses. This endeavour should be mirrored at the national and the regional level by heightening the level of cooperation and exchange of information between central banks and supervisory authorities to establish an overall better monitoring and assessment of the risks to the financial system.

On the crisis management side, the ECB focuses on central bank operations and on cross-border arrangements between financial authorities. With regard to central bank operations, I would underline that we need to ensure that central banks' operational frameworks are flexible enough to deal with extraordinary situations. In this respect, the Eurosystem's framework is very flexible. In terms of cross-border arrangements between financial authorities, I would stress the urgent need for enhancing cross-border arrangements between banking supervisors for dealing with weak banks. In fact, the global nature of financial markets and the increasing interlinkages between markets and institutions mean that the systemic impact of a financial crisis can only be properly assessed if supervisory authorities share information on the risk exposures of large institutions and on the impact of shocks in their jurisdiction. In addition, supervisory cooperation should be intensified on a cross-sector basis. Indeed, all financial sectors are impacted by market developments as the boundaries between financial activities are becoming increasingly blurred. More broadly, all competent financial authorities, central banks, supervisors and ministries of finance should strengthen their coordination mechanisms for managing a crisis impacting cross-border financial institutions. In Europe, an important step has been taken in this direction with the Memorandum of Understanding signed by the financial authorities of all EU Member States in June 2008, which established common principles, procedures and terminology to be used by all parties involved in a cross-border crisis.

Conclusion

We are experiencing a very challenging and demanding episode of the market correction which started more than a year ago and was due to a significant underassessment and underpricing of risks in global finance. This fostered extremely high risk–taking behaviour, excessive leverage and a widespread use of toxic, obscure and abnormally sophisticated financial instruments. In this regard, global finance was potentially unstable before the start of the turbulence and this was mentioned publicly, particularly in 2006 and the first part of 2007, by a number of speakers, including myself. The sub-prime mortgage crisis has therefore played the role of a trigger but there was a good deal of explosive around.

My experience of previous crises is that it is extremely important to analyse situations very carefully and lucidly and never to underestimate its gravity. Since 9 August 2007, we at the ECB realised that we were facing a very serious situation and drew all the lessons for such events not to be repeated.

The same experiences lead me to think that crisis management is essential and that it requires a lucid diagnosis as well as the ability to act not only wisely and decisively but also in a quick fashion whenever and wherever it is necessary.

These are times where quick decisions are indispensable because the adverse consequences of a delayed – albeit right – decision may be considerable. Central banks, on both sides of the Atlantic, have in my opinion been lucid in their judgement of the situation, bold in their decisions and quick to take these audacious actions. Let me only mention yesterday's decision to provide broad access to liquidity and funding in dollars.

We are doing – and will continue to do – everything that is necessary to supply the requisite liquidity while preserving the solid anchoring of inflation expectations. However, we cannot, and should not, assume the role of executive branches. It is time for all of us to take action – private sector as well as public authorities – at the global level.

From this standpoint, I am impressed by the concision of the Plan of Action that I signed, together with Ben Bernanke, Ministers and Governors of the G7 in Washington last Friday. This unusually concise five point plan shows that this is time for immediate action and not for eloquent rhetoric.

It is such action, called for at the level of the international community three days ago in Washington by the G7, the IMFC and the G20, that the Europeans considered indispensable, particularly in the euro area last Sunday, with the adoption of a concerted European action plan.

This plan has six dimensions: ensuring appropriate liquidity; facilitating the funding of banks through various means (guarantee, insurance or similar arrangements for new medium-term – up to five years – bank senior debt issuance); providing additional capital resources to financial institutions; recapitalisation of distressed banks; ensuring appropriate implementation of accounting rules; and enhancing cooperation among European countries.

The very day after the meeting, namely yesterday, a large number of euro area countries displayed their implementation of the Eurogroup commitments at the level of the Heads of State and Government.

I will not hide the fact that I am impressed by the degree of responsibility and decisiveness that was demonstrated last Sunday and this week in the euro area. I am impressed by the will of the countries that share the single currency not only to work together, but also very closely with the United Kingdom and all EU Member States. And I see that the new decisions taken in the United States are further reinforcing this very impressive implementation of the plan that has been approved by the international community.

This is no time for complacency. Central banks will remain solid anchors of stability and confidence. Public authorities must be alert, decisive and effective at a global level: this is not a problem of the industrialised countries alone; this is a global issue that has to be addressed with the full participation of the emerging countries. At the same time, private financial institutions and market participants must behave wisely, prudently and with a solid sense of responsibility. It is time to keep our composure.

I thank you for your attention.