

## Jean-Claude Trichet: 18th Frankfurt European Banking Congress

Statement by Mr Jean-Claude Trichet, President of the ECB, at the 18th Frankfurt European Banking Congress, Frankfurt am Main, 21 November 2008.

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Ladies and gentlemen,

This year's European Banking Congress takes place at a very challenging point in time. Today's event is therefore a particularly important one. It is a pleasure to be here amid so many distinguished participants and to be joined on this panel by my central bank colleagues from Brazil and the United Arab Emirates.

We are at a critical juncture as far as the set-up and functioning of the international financial system is concerned. The current financial crisis was triggered by a widespread and substantial undervaluation of risk. When the crisis erupted in August 2007, it was at first a systemic threat to the liquidity of the financial system, which mainly affected advanced economies. In mid-September of this year the crisis deteriorated very significantly and turned into a systemic threat to the solvency of important parts of the global financial system. It is no longer limited to advanced economies and is instead also affecting emerging economies. In addition, it has spilled over from the financial sphere to the real economy.

Global challenges call for global responses. Policy-makers across the globe have responded and are taking appropriate action to contain and alleviate the crisis. Central banks are playing a pivotal role in this regard, providing the necessary liquidity – sometimes in ways that were scarcely imaginable up until a few months ago – in order to ensure that financial markets and institutions can continue to function. As far as the ECB is concerned, I would like to point out once again that we have acted decisively from the very beginning of the turmoil in August of last year. At that time, when the threat to the liquidity of the financial system first emerged, we provided the system with no less than EUR 95 billion of liquidity within a few hours. Later that year, the ECB also began to supply liquidity to European counterparties in US dollars through swap arrangements which we established with the Federal Reserve. Since October of this year, we have been granting full allotments in our monetary operations. These are only some of the key measures taken by the ECB in order to support financial markets, and you see from the design of these measures that some of them are literally without precedent.

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At the same time as we are dealing with the current crisis, we also need to look ahead and strengthen the functioning and resilience of the international financial system. A reform agenda for this system will need to comprise many elements. I would like to reiterate three principal elements that I consider fundamental.

- First, **short-termism** – that is to say, the excessive focus on short-term returns – has to be addressed. As we have seen, modern financial systems have shown a particular preference for instruments and intermediaries that have promised significant returns in the short term. Short-termism can lead to the misjudgement of underlying risk. It can also encourage excessive risk-taking on the basis of relatively small amounts of capital. It is therefore essential to establish the right incentives for market participants, including the use of appropriate internal compensation schemes.
- Second, it is essential that **transparency** be increased in various components of the global financial system – for financial instruments, markets and institutions. Transparency is a key prerequisite for the efficient functioning of markets, and one that prevents markets from overreacting, both on the upside and on the downside. It

can thereby help to reduce the scope for “herding behaviour” and contagion. To give two examples, regulators need to tighten up disclosure requirements for markets in which structured financial products are traded and strengthen reporting requirements for unregulated institutions which are relevant for systemic stability.

- Third, it is important to reduce the **pro-cyclicality** of the financial system, namely its potential to amplify business cycle fluctuations and trigger financial instability. Drivers of pro-cyclical behaviour need to be addressed, to restrain financial institutions’ excessive risk-taking in upturns and to discourage their excessive conservatism when credit to companies and households is most needed. Elements of financial regulation, such as capital requirements, provisioning rules and valuation standards, can act as contributing factors in this regard. A considerable amount of work is under way with a view to addressing the issue of pro-cyclicality, with the Basel Committee on Banking Supervision having primary competence in this field and the Financial Stability Forum playing an important coordinating role.

These three reform elements are of particular relevance to the functioning and resilience of the international financial system. Taken together, these changes will foster greater “discipline” in the system. Greater discipline means a reduced likelihood of unwarranted fluctuations, a more appropriate assessment of risks and a better balance between short and long-term investment horizons. In my view, the meetings preparatory to the G20 – in particular the meeting at the level of Ministers and Governors in São Paulo – and the G20 summit itself have brought us a step closer in this regard, as these elements and many further important measures are reflected in the communiqué and the action plan.

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But changes to the financial system itself are only one side of the coin as regards the measures that need to be taken in order to prevent a crisis like this from happening again. The other side of the coin relates to macroeconomic policies – another issue discussed at the G20 summit. Specifically, we also need to foster greater **discipline in the macroeconomic policy-making** of all participants in the global economy. Large domestic and external imbalances have to be reduced in systemically important economies, as their build-up and unwinding can ultimately trigger spill-over effects in the global economy as a whole. Hence, countries should pursue policies that are stability-oriented and sustainable over the medium and long term. One vital element in order to foster such policies is effective surveillance by the IMF.

This brings me to the **organisation and functioning of international institutions and fora**, which are key actors in the global financial architecture. It is important to have in place a well-functioning surveillance framework which identifies imbalances in a timely fashion and encourages the implementation of corrective measures. The current crisis highlights the fact that the IMF needs to gain more traction as regards systemically important countries. This will not be straightforward, but the IMF’s Multilateral Consultations, which foresee a direct exchange between key members of the global economy, represent a process that should be vigorously developed for this purpose.

In terms of governance, there is merit in the international community engaging with emerging market economies in a way that reflects their systemic relevance, thereby making the key international financial institutions and fora more inclusive.

So far, I have focused primarily on the tasks that policy-makers are confronted with. But the **financial industry** also has a very important role to play. As regards the very short term, let me refer to the interbank market. Indeed, it is of paramount importance that the banking sector as a whole takes advantage of the efforts made by central banks and governments and contributes to the normalisation of market conditions. This could be achieved by committing to reigniting the interbank money market and resuming the intermediation function.

In conclusion, while the challenges we are currently facing are truly formidable, central banks in general, and the ECB in particular, are doing everything they can to support the functioning of the financial system. Moreover, market participants and other actors should be assured that the cooperation within the global network of central banks has been excellent and highly conducive to addressing the ongoing challenges.

Thank you for your attention.