Jean-Claude Trichet: What lessons can be learned from the economic and financial crisis?

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the "5e Rencontres de l'Entreprise Européenne", organised by La Tribune, Roland Berger and HEC, Paris, 17 March 2009.

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Monsieur le Président,
Mesdames et Messieurs,

The "Rencontres de l'Entreprise Européenne" were established – if I may interpret your mission – as a tribute to entrepreneurship, *the* engine of growth in Europe and, more broadly, in the global economy.

Looking around this room, I see myself surrounded by many entrepreneurial people who create the conditions for sustainable growth, who invest in both physical capital and human capital, and who are patient enough to wait for deferred payoffs. As a central banker, I very much appreciate the medium-term orientation of business. The current crisis has exposed a different and less far-sighted kind of investment attitude. I want to draw some parallels, and make some distinctions, between the two forms of economic activity and the lessons to be learned from them.

Tonight, I would like to examine the roots of the current crisis and the policy responses, which are taken to address it and to inspire a new sense of direction. I will also explain what I see as the main factors that can provide the basis for a resurgence of growth in the not so distant future. A future that will see companies and their employees in the real economy return to the forefront of economic activity.

Throughout, I will take inspiration from the words of Jean Monnet: "To abandon a project because it meets too many obstacles is often a grave mistake: the obstacles themselves provide the friction to make movement possible." (Jean Monnet, *Mémoires*, 1976).

Financial excesses

In the last ten years, we saw a dramatic shift in influence away from entrepreneurship in the real economy to speculation and gambling in the financial sector. The assumption and the hedging of genuine *economic risk* gradually ceased to be the main concern of international finance. This is the risk that companies face when introducing innovative new products and new processes. Over time, the creation and assumption of *financial risk* became the core activity of the financial industry. This is the risk inherent in arbitrage and deliberate exposure to asset price changes. At some point, the financial system seemed to be no longer there primarily to hedge existing economic risks, but more and more to create and propagate risks on its own.

In the past two decades, financial innovation and liberalisation made important contributions to the overall productivity of our economies. But as the demand for finance increased throughout the 1990s, intermediaries had growing incentives to develop innovative funding techniques. The securitisation of assets, for example – the transformation of bilateral loans into tradable credit instruments – had tremendous potential to facilitate the diversification and efficient management of risk. As such, it was a powerful and useful tool.

But securitisation also meant that banks and non-banks were able to sell credit – or place it off-balance sheet – immediately after it had been extended. This alchemy enabled lenders to expand the volume of their operations and conserve on capital. Fatally, the same mechanism weakened lenders' incentives for prudent screening and steady monitoring. The resulting declines in underwriting standards and lending oversight was one of the main sources of the excessive credit boom.

The credit boom had three multipliers. First, ill-designed compensation schemes for loan managers reinforced the shortening of lenders' horizons. In the eyes of many loan managers, the short-run gains from an expansion of credit obscured the need for any consideration of the potential losses that their institution could incur over the longer term.

Second, the complex structure of securitised products made it difficult for the ultimate holders to assess the quality of the underlying investment. This perpetuated the boom, as it took time for investors to discover and reassess the underlying risks.

Third, international imbalances and their potential to encourage liquidity creation on a global scale acted as the macroeconomic – and perhaps most powerful – multiplier. A chronic shortage of savings in some of the world's advanced economies was funded by an excess of savings in other parts of the world. These global macroeconomic imbalances contributed to the creation of international liquidity and therefore further fuelled credit and debt accumulation. In the period before the start of the crisis, the oil and commodity price shock augmented the savings glut even further.

The policy response

The interplay of the forces that I have described went into reverse – suddenly, although not unexpectedly – sometime in the middle of 2007. Liquidity dried up, and the entire financial sector was put under severe strain. The collapse of a major and highly interconnected financial player in mid-September of last year then turned the crisis of confidence into full-blown distress. This development also triggered the economic downturn that we are currently facing, and that has created a need to restore confidence throughout the global economy.

The European Central Bank moved pre-emptively. It ensured the continued functioning of the money market at the very first signs of the turbulences in August 2007. We have not shied away from action at any time since then. Our actions have been early, resolute and broadly based.

What did the ECB do and why? And how did these actions support the financial sector and the real economy? In times of distress, banks and other financial intermediaries instinctively reduce their exposure to risks. Individually, they try to change the composition of their assets; they reduce illiquid investments and increase liquidity. Collectively, this process leads to what is known as "deleveraging". Banks' intermediation is reduced in the aggregate, and loans to companies are curtailed. If this process unfolds in a disorderly manner, it can cause severe damage for borrowers and for the broader economy.

At the first signs of liquidity hoarding by banks in August 2007, the ECB took several measures to protect against a disorderly correction in credit. Banks were not only concerned about the *volume* of liquidity that they could secure, but also about the *horizon* over which liquidity was expected to remain available to them. Therefore, we provided liquidity with long maturities, as a way to insure banks against future liquidity shortfalls. This helped bolster public confidence that banks would continue to be able to meet their obligations. At the same time, it encouraged banks – which, as you know, are so central to Europe's financial architecture – not to discontinue lending relationships with their customers.

Since the intensification of the crisis in September and October 2008, the ECB has – under profoundly changed global conditions, falling commodity prices and rapidly receding inflationary pressures – stepped up its crisis resolution measures, including through non-standard means, to protect the viability of our financial system. Again, our primary concern in the area of support to the financial sector has been to preserve the availability of credit for companies and households at accessible rates. One can therefore describe our policies as enhanced credit support. Under our generalised "fixed-rate full-allotment" procedure, in place since October, eligible euro area banks have been granted access to unlimited liquidity from one week to six months' duration at our main policy interest rate. Another non-standard measure has been the considerable expansion of the list of eligible assets that banks can pledge as collateral. This has eased banks' balance sheet constraints, and encouraged them to extend new credit or continue rolling over maturing loans to firms.

As the inflationary pressures that we were still observing until last summer, receded rapidly, we have also been able to grant unlimited access to central bank credit *at a sharply decreasing cost*. Our key policy rate has been reduced by 275 basis points since the crisis worsened in the autumn. At present, the Eurosystem is providing unlimited refinancing at a rate of 1.5%. And sound and creditworthy banks can secure overnight credit at an interest rate which is in between the main policy rate, namely 1.5%, and the deposit rate, namely 0.5%. At present the overnight rate is at a level unseen in the entire post-war history of European monetary affairs. Being able to borrow at such low costs, banks can grant credit to other banks and to their non-bank customers at conditions that are very accommodative by historical and international standards. Thanks, in particular, to smaller spreads between the interbank money market rates and the OIS rates, the 6-month and 12-month EURIBOR rates are lower than the corresponding LIBOR rates for contracts denominated in US dollars.

Enhanced credit support has also meant a considerable expansion of the Eurosystem's balance sheet. The size of our balance sheet is currently around €600 billion above its pre-crisis volume. This measures the size of the additional intermediation we are undertaking – substituting for the market. The size of our balance sheet represents today around 16% of euro area GDP compared with 10% before the crisis; the Federal Reserve System's balance sheet is around 13% of US GDP. The additional intermediation has prevented a seizing up of the whole credit market. Short-term interest rates on loans to households and businesses have declined. The pass-through of the ECB interest rates to the economy has proceeded in accordance with past regularities.

How does this policy course of enhanced credit support compare with the approaches of some other central banks grappling with tumult in financial markets? Since mid-September 2008 the Federal Reserve has pursued a policy of direct "credit easing". These measures are targeted at directly addressing instability or declining credit availability in critical non-bank channels of intermediation.

The euro area and the United States have significantly different financial structures. While the United States has a primarily market-based financial system, the euro area is largely bank-centred. A few illustrative figures give an idea of the differences. At the end of 2007, the stock of outstanding bank loans to the private sector amounted to around 145% of GDP in the euro area, but only 63% in the United States. Correspondingly, the incidence of direct debt securities was 81% of GDP in the euro area and 168 % in the United States. The structures of private credit outstanding in the euro area and the United States are almost mirror images: the recourse to banks on this side of the Atlantic makes up two-thirds of non-equity external finance. On the other side, the equivalent proportion is only around 30%.

This has important explanatory power for interpreting the approaches that we have taken in the euro area and in the United States. In the context of the euro area, guaranteeing firms and households a steady access to credit largely means ensuring the banking system has appropriate liquidity. In the euro area, it is natural for "credit easing" to be implemented primarily through the participation of banks.

As regards non-conventional measures, let me recall the following. We have already decided upon a number of them, including the non-standard commitment decided at our last meeting to prolong the unlimited supply of liquidity at fixed rates as long as needed, and in any case beyond the end of 2009. Moreover, as I said in my press conference of 5 March, we are in an ongoing process of studying further measures and assessing the possible need for them.

Reviewing our actions over the past few months, there is one further point that I wish to highlight: the central bank was not alone in tackling this financial and economic crisis. I have been deeply impressed by the action plan drawn up by euro area governments and the European Commission since last October within an extremely short period of time. In the past, some outside observers have questioned the euro area's ability to act in a timely fashion in the event of a major economic emergency. Last October euro area governments and the European Commission demonstrated their strength and unity of purpose. Governments' coordinated bank recapitalisation and guarantee schemes proved vital for preserving the viability of the euro area financial system in extremely tense conditions.

The way forward

Looking ahead to the resolution of this crisis, the following is a good starting point: we should start by distinguishing carefully between the many things that were wrong and need to change, and the many other things that were right and that we can continue to count on. A number of "monuments" and "totems" of the pre-crisis economic universe have now lost most of their value. From this standpoint, the reforms proposed by the Financial Stability Forum and currently considered by the G20 should be implemented with vigour. At the same time, other elements have maintained their worth. It is on these elements that we should build the future of this continent. I will mention three assets on which we can count in this effort.

The first asset is our single currency. The euro has certainly proven its worth during the crisis. If the countries of Europe that now make up the euro area had been forced to withstand the financial turmoil alone, with their floating currencies, currency crises would have been likely. The crisis in the European Monetary System in 1992 and 1993 naturally comes to my mind. With the benefit of hindsight, we can see the introduction of the euro ten years ago as a forward-looking response to the challenges of today. And let us not forget that the process leading to the introduction of the euro owes a great deal to the prescience of President Valéry Giscard d'Estaing and Chancellor Helmut Schmidt, who in the late 1970s conceived the European Monetary System and the precursor to the euro, the ECU.

A second lasting resource for Europe is a macroeconomic policy framework oriented towards the medium term. With hindsight observers now acknowledge that macroeconomic policies in some economies have in the past been insufficiently focused on medium-term stability and sustainability. In the euro area policy commitments to price stability over the medium term and to the long-run sustainability of public finances helped, by and large, to contain the size of macroeconomic imbalances. This has contributed to job creation. In the past ten years, the euro area created more than 2 million jobs in excess of the number created over the same period in the US economy.

The third asset is a group of factors that have made our real economies in Europe successful in recent years: our openness to trade; our balanced and dynamic business structures; our talented and well-trained workforces.

None of these factors is single-faceted. It is well known that international comparisons of productivity growth started to paint a bleak picture of the euro area countries in the middle of the 1990s. While the measured pace of growth of output per hour worked halved after 1995 in our economies, it almost doubled in the United States. In trying to understand the causes of that poor performance we discovered that the share of the population in tertiary education was almost two-thirds higher in the United States than in the European Union and that US and Japanese performance was superior in terms of patents granted. But we also discovered that the EU, and the euro area in particular, was home to at least two of the world's innovation leaders – Germany and Finland – and that this country, France, together with Belgium is on a par with the United States in terms of the structural conditions required for innovation, investment in research and development, and the successful application of know-how. Furthermore, we learned that the financial sector, a principal user of information and communications technologies, was the main source of the greater dynamism in the United States. Conversely, a smaller share of that sector in total value added was seen as the main obstacle to the diffusion of such technologies, and thus a drag on overall productivity, in the euro area economies. Today, this much smaller share of financial services in the euro area economy can probably act as a partial protection against the recessionary forces that the downsizing of those activities is exerting on many of our international partners.

The openness of our economies, too, has been seen as a major challenge, not an opportunity. Certainly, greater openness has meant that our economies have been more exposed to the international crisis. But the trend towards global trade integration has resulted in a major adjustment of production patterns in the euro area. Many countries have profoundly adjusted their export portfolios according to their technological advantages and towards products that are more skill-intensive and more capital-intensive. This upgrade of our production structure will make European firms better prepared to withstand a decline in trade volumes.

From an economic perspective, resilience is a virtue, protectionism is a sin. Fiscal and monetary authorities constantly endeavour to shield their jurisdictions from shocks and disturbances that can destabilise economic behaviour and expectations, and thus damage aggregate incomes and collective welfare. But this must be done without building walls and fortresses around the economy. Open markets are the valuable result of a long and painful process of trade liberalisation that has lasted over 60 years. This process has dismantled barriers between countries and has included an expanding share of the world population in a network of exchange and growing economic prosperity. And we know from past experience in the 20th Century that protectionism would be a recipe for economic disaster.

Conclusions

More than ever, in the present very demanding circumstances, confidence is key. The global economy was hit in mid-September 2008 by an unprecedented abrupt loss of confidence. It was perhaps the first time in economic history that a single negative event was able, within a few days, to have a simultaneous and negative effect on all private economic agents in every economy, industrialised and emerging. This is why we are presently in uncharted waters, and the risk of abrupt economic and financial phenomena and unprecedented behaviour on the part of economic agents remains.

Public authorities, executive branches, and central banks must do all they can to regain, preserve and foster confidence among households and corporations to pave the way for sustainable prosperity. This calls for actions to be measured. We must maintain the appropriate balance between the need to take immediate action commensurate with the gravity of today's situation and the equally undeniable obligation to return to a path that is sustainable in the medium to long term. *Confidence* of households and corporations today depends crucially on their trust in the capacity of authorities to preserve the soundness and sustainability of fiscal positions in the years to come. *Confidence* of economic agents today depends equally on their trust in the determination of central banks to preserve price stability – in Europe less than 2% but close to 2% - in the medium and long run.

It is essential to achieve this balance between the measured audacity of today's non-conventional decisions and the credible determination to ensure a path that is sustainable in the medium and long term. Exaggerated swings without perspective would delay the return of sustainable prosperity, because they would undermine confidence, which is the most precious ingredient in the present circumstances.

Europe can count on the ECB to continue to strike the right balance between audacity and wisdom, in line with its mandate. In acting in this way, the ECB will continue to offer a solid anchor of stability and confidence.

Thank you for your attention.