Jean-Claude Trichet: The global dimension of the crisis

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Foreign Correspondents' Club of Japan, Tokyo, 18 April 2009.

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Ladies and gentlemen,

I would like to thank Foreign Correspondents' Club of Japan for inviting me to talk about the global financial and economic situation and outlook. It is for me a great pleasure to be in Japan, and an opportunity to reflect about the financial crisis. Japan is indeed a striking example on how a crisis that started in a segment of the US financial markets eventually spread all over the world: while Japanese financial institutions' limited exposure to the US sub-prime market allowed Japan to relatively withstand the first period of the turmoil, the intensification of the crisis as of September 2008 also impacted significantly the Japanese economy through multiple channels. A broadly similar pattern holds true for the euro area, and ultimately also for the emerging market economies. In my address to you today, I will take a global perspective on the crisis, its root causes and the policy response.

What the crisis has changed and how fast

One striking aspect of the current crisis is how quickly it has reversed some of the features of the global economy that seemed well-performing in recent years, at least to many observers. Let me highlight four areas were we have seen changes as being particularly abrupt. These areas are housing, finance, trade and international capital flows. In all these areas, what looked like an established trend that economic agents relied on has changed very quickly, triggering a chain of reactions that few people had anticipated and leading policy makers to take prompt and decisive action:

- First, the mortgage market meltdown in the United States disproved the previous thesis that house prices would not fall nation-wide. Such belief was widely shared among investors and misled them to lend abundantly to households that did not have sufficient resources. There are of course different ways to compute the change in house prices; according to some measures[1], house prices in the United States nearly doubled in nominal terms between the early 2000 and 2006. The subsequent fall in US house prices (by an estimated 25% in two years) has fuelled delinquencies and foreclosures and led to the dramatic fall in the price of asset backed securities, which, alongside other factors, now plagues the balance sheets of so many financial institutions.
- Second, the major financial shock of mid-September 2008 put the world economy on a completely different path by triggering a broad-based reappraisal of risks and a global fall in confidence. This has led to a strong commitment by all relevant world policy makers to no longer let any systemically relevant financial institution fail.
- Third, international trade flows, which had grown very robustly in recent decades thanks to waves of liberalisation, have suddenly abated towards the end of 2008 and then strongly contracted in some areas, further propagating the effects of the crisis across countries. According to projections by international institutions, world trade is anticipated to shrink in 2009 for the first time since 1945.[2] In the last quarter of 2008,

[1] The so-called Case-Schiller index is a widely used measure.

[2] By 13% in 2009 according to the OECD.

real exports fell by 6.5% in the United States, by 6.7% in the euro area, by 13.8% in Japan and by an estimated 10% in China: these numbers stand in sharp contrast with developments in the past decades. During the 1990s, world trade rose by around 7% on average each year. In addition to the magnitude of the contraction in world trade, its suddenness is also very noticeable as trade fell markedly in the last quarter of 2008, immediately after the intensification of the crisis in mid-September. Related to this, the broad consensus in support of free trade, which has prevailed in past decades, has to be preserved with reinforced determination, whilst risks of protectionist pressures are mounting in many countries. I therefore strongly welcome the commitment taken by the G20 to notify promptly the World Trade Organisation (WTO) of any such measures, with the WTO then reporting publicly on adherence of G20 members to their pledge not to repeat the historic mistakes of protectionism made in previous eras.

- Fourth, another type of international flows that has contracted sharply is financial private flows to emerging economies, leading to balance of payment strains in some of these countries. It is estimated that net private capital flows to emerging and developing economies fell by a factor of 6 between 2007 and 2008. Again, balance of payment strains had by many observers been dismissed as memory of the past. The International Monetary Fund (IMF), which not long ago was facing a problem of falling resources because fewer programs had been launched, has in most recent times been confronted with the opposite problem – an issue also tackled by the G20, who agreed at the London Summit to treble IMF resources.

These examples illustrate how massive the problems were, which were building up under the surface of the global economy. One key word here is synchronisation. I have mentioned how quickly trade and financial flows, which used to act as powerful drivers of globalization, have abated at the end of last year, further propagating the effect of the crisis across borders. What was remarkable in the "boom" period between 2004 and 2007 is not only the fact that a large number of economies was growing very fast, but also the fact that virtually no country was left behind: all systemically important economies registered positive growth rates. Similarly, in this crisis, all regions are affected, albeit, again, to a different extent, and all economies are going through one of their most difficult episodes in decades.

The root causes of the crisis

Let me now turn to the root causes of the crisis. The present crisis cannot be easily explained by one or two factors; rather, a combination of micro and macro factors has been at play.

Micro factors, related to insufficient financial oversight and massive underestimation of risk, are the immediate cause of the financial crisis as I have already stressed on earlier occasions. I will argue, however, that macro factors are important for explaining the emergence of the crisis, as they have created the preconditions for micro factors to unfold.

Structural factors, global imbalances and risk premia

Generally, the macro root causes of the financial crisis can be associated with *two measurable* developments: low risk premia and the accumulation of global imbalances. I will argue that there is an interplay between these two developments that help us to understand the relationship between macro fundamentals and the emergence of the financial crisis.

The first measurable development relates to the price side and is reflected, as I mentioned before, by exceptionally low risk premia **in virtually all markets**. Of course, one could provide specific explanations to any particular market that could rationalize the decline in individual risk premia. **One striking feature has been, however, the persistent and**

synchronized decline in risk premia across all markets. Estimated risk premia in the stock market before the intensification of the crisis in September 2008 were one third and two thirds below their values at the beginning of the 1980s, in the euro area and the US respectively. Term premia in bond markets had lost before the crisis three fourth of their estimated value at the middle of the 1990s. The premium for investments in houses has followed a similar trend in particular in the United States. Finally, the cost of corporate borrowing in excess of a riskless rate, which remunerates credit risk, had also decreased significantly in both economies. *Obviously, we observed the same movements across all markets.*

Facts common to multiple markets suggest the existence of a common factor: one of these common factors, I will argue, was the lack of sufficient medium-term orientation of global macro policies.

A second measurable macro development on the quantity side is the accumulation of “global imbalances”. The expression “global imbalances” refers to saving-investment imbalances within – and external imbalances among – a number of systemically relevant countries, which were unsustainable over a medium- to long-term perspective.

Conceptually, it is helpful to separate the drivers of global imbalances into structural and cyclical components.[3]

Structural issues have been at play in the development of imbalances in advanced economies. While main distortions were to find at the micro level, they had important macroeconomic implications. As argued before, insufficient oversight of financial markets in advanced economies, which ultimately allowed for the originate-and-distribute banking model to develop, led to a separation of those holding credit risks from those monitoring and managing them. The resulting excessive focus on near-term returns led to a misjudgement of the underlying risk, and created wrong incentives for originators. Such an environment created the conditions for the observed herding behaviour, in which risk control easily became a secondary issue. At the same time, rapid financial innovation and the emergence of new, non-standardised structural products made the risk assessment difficult for rating agencies, leading to considerable underpricing of the embedded unit of risk and to biased expectations about the evolution of asset wealth. **Ultimately, at the macro level, this system led to an inefficient allocation of capital and resulted in very low savings rates in some systematically important advanced economies.**

Structural factors have dominated the emergence of excess savings in emerging Asia. The latter happened in a context of quickly rising incomes, growing productivity and commodity prices in emerging economies, and was partly attributable to structural factors such as:

- the propensity of residents to accumulate precautionary savings due to lacking welfare provisions; and
- relative financial underdevelopment.

Recent studies show[4] that the lower degree of financial development in emerging economies, compared with mature economies, has been one important driver of capital flows to mature economies. In fact, the lack of supply in “safe” financial assets in emerging economies can trigger capital flows to regions that are able to produce the desired assets. Evidence indeed confirms the large scope for emerging economies to catch up in financial

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3 Bracke, Bussière, Fidora and Straub (2008): “A Framework Assessing Global Imbalances,” ECB Occasional Paper No.78.

4 Dorrucci, Meyer-Cirkel and Santabárbara (2009): “Domestic financial development in emerging economies: Evidence and implications”, ECB Occasional Paper No. 102 (April).

terms, while at the same time pointing to an accelerating pace of financial development since the late 1990s in most of these countries. In particular, in the past decade the funding of emerging economies in domestic financial markets has been increasing at a much faster pace than in the advanced economies. As a result, in 2007 the funding of emerging economies in domestic markets accounted for about half the ratio observed in the EU, the US, and Japan – compared with less than one third of the ratio in 1998.

Indeed, some of these structural factors can be addressed by proper policies implemented over sufficiently long-term horizons. For instance, the provision of public goods in emerging economies to increase the degree of social security would reduce uncertainty and precautionary savings motives. Similarly, further development of efficient and liquid domestic financial markets would contribute to somewhat lower savings and better channel them to domestic investment.

Globally, very low risk premia coupled with limited volatility created the macro preconditions that encouraged the global "search for yield". Of course, the progressive build-up of systemic risk via a generalised underestimation of the quantity of risk that pushed risk premia to unsustainably low levels was in particular permitted by the inefficiencies in financial market regulations.

The associated "underpricing of the unit of risk" fuelled the overpricing of house and financial assets and encouraged the creation of ill-designed and not transparent structured financial products. More generally, it led to a widespread deterioration in lending standards and credit quality and increasing confidence in leverage activities in several mature economies.

The policy response

How have economic policies responded to the current crisis? The current crisis has shown that there is a need for more rigorous regulation of the global financial system. Such regulation needs to meet two fundamental requirements. First, it needs to prevent the excessive risk taking that we have been observing in financial markets over the past years and that led to the creation of asset price bubbles and large imbalances in the global economy. At the same time, it needs to create an environment that is conducive to sustainable growth for our economies in the long run. In this respect, I should remind that a process of multilateral surveillance of global imbalance had been agreed and put in place under the aegis of the IMF; while a clear diagnosis of the sources of these imbalances and the necessary policy responses emerged among the relevant partners, it is clear that engaging resolutely in the implementation of the pertinent policy prescriptions remained extremely difficult before the crisis erupted.

The international community has swiftly reacted to the need for greater coordination of policies and regulation of international financial markets. In this respect, it is worth coming back to the outcome of the recent meeting of the G20 in London. Governments have agreed to establish a new Financial Stability Board (FSB) with a strengthened mandate and enlarged membership, as a successor to the Financial Stability Forum (FSF). New principles on remuneration will be implemented to guarantee the sustainability of compensation schemes and to prevent the financial market participants from focussing excessively on short term returns. Regulation and oversight will be extended to all systemically important financial institutions, instruments and markets. This will also embrace, for the first time, systemically important hedge funds. The FSB will co-operate with the International Monetary Fund (IMF) to identify systemic economic and financial risks. At the same time, the international community has agreed to triple IMF resources to 750 billion US dollar and to support trade finance for an amount of 250 billion US dollars. The sheer size of these commitments clearly shows that the international community is determined to prevent a retrenchment of global capital and trade flows and to guarantee the stability of the international financial and economic system.

National governments have in addition undertaken an unprecedented concerted fiscal expansion to stimulate demand and foster confidence in our economies. Governments have also decided on a broad set of measures to support the banking sector and strengthen the stability of the international financial system. These measures include the injection of new capital, guarantees on bank debt and deposits, as well as large-scale schemes that aim at coping with the issue of impaired assets. For example, governments in the euro area alone have committed more than 2 trillion euro in the form of capital injections, liability guarantees, impaired asset relief and funding guarantees, which altogether corresponds to around 23% of euro area GDP.

I thank you for your attention.