Jean-Claude Trichet: The financial crisis and the ECB's response so far

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the Chatham House Global Financial Forum, New York, 27 April 2009.

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Ladies and gentlemen,

Chatham House was established after the First World War to promote understanding of international affairs. My intention today is to promote understanding of the European policy framework and specifically our response to the financial crisis.

Policy-makers around the globe are facing formidable challenges as the crisis, which originated within a few blocks from here, has swept across the globe. Restoring confidence in the global financial system is of paramount importance. The G7 and IMFC meetings last weekend, as well as the G20 meeting four weeks ago, confirmed in my view a strong signal of reform that can provide the basis for a more resilient global economy in the future. In my remarks, I would like to focus mainly on the ECB's response to the crisis. I will also note, *en passant*, how our policy compares with those of other major central banks. Clearly, there are differences in central banks' approaches to managing the crisis. In my view, these reflect profound differences in the economic structures within which central banks operate. But they do not reflect conflicting views on fundamental principles. Central banks around the world are united in purpose.

The ECB's guiding principles are very simple and very clear. Our policy is geared towards preserving price stability over the medium term and, in so doing, supporting the conditions for enduring financial and economic stability. The crisis has not changed this objective. Where we have made changes is in our operational framework and the implementation of an exceptional set of policy tools that is very broad and very deep, as I will explain. This set of policy tools, in combination with the bold action taken by euro area governments over recent months, is essential to revive a resource that has become much too scarce in recent months: *confidence in the future*.

The origins of the financial crisis

To set the scene, let me recall the origins of the current crisis. Over the past ten years, we have witnessed a dramatic shift of focus in the financial sector – away from facilitating trade and real investment towards unfettered speculation and financial gambling. Managing genuine economic risk gradually ceased to be the main concern of international finance. Instead, the creation and assumption of financial risk – the risk involved in arbitrage and deliberate exposure to asset price changes – became the core activity of the financial industry. A point was reached where the main role of the financial system was no longer to hedge existing economic risks and assist trade within and between countries, but increasingly to create and propagate new risks.

To be clear, I do not deny that financial liberalisation and financial innovation over the past two decades have made important contributions to the overall productivity of our economies. For example, the securitisation of assets – the transformation of bilateral loans into tradable credit instruments – had tremendous potential for the diversification and efficient management of economic risk.

But securitisation also meant that banks and non-banks were able to sell loans – or place them off-balance sheet – immediately after they had been extended. This weakened lenders' incentives to conduct prudent screening and constant monitoring. The resulting decline in underwriting standards and lending oversight fuelled excessive credit growth starting in the second half of the 1990s. At the same time, it created the conditions for its reversal.

The credit boom was exacerbated by three multipliers. First, incentives: ill-designed compensation schemes for loan managers and traders reinforced the shortening of their time horizons. Second, complexity: increasingly complicated and opaque financial instruments made it difficult for holders of securities to assess the quality of the underlying investments. And third, global macroeconomic imbalances: a chronic shortage of savings in some industrialised economies was made possible by an excess of savings in other parts of the world, a multiplier that was exacerbated during the years immediately preceding the crisis by the sharply rising prices of oil and other commodities.

From financial turmoil to financial panic

In mid-2007, suddenly though not unexpectedly, the interactions of perverse incentives, excessive complexity and global imbalances threw the credit boom into reverse. The asset cycle turned, and many of the missing links in the financial chain were exposed. Investors suddenly lost confidence. After years of high profits and exceptional risk tolerance, markets became extremely discriminating about financial risk. Funding costs for borrowers increased. The spreads on the debt of financial institutions – seen as being clogged with assets of dubious value – widened considerably. Uncertainty about the extent of credit write-offs and the future earnings capacity of financial institutions took a heavy toll on the valuation of many revered names.

The collapse in mid-September last year of a major financial player, which was directly involved in about 30 large payment and settlement systems worldwide and disposed of a balance sheet of $600 billion, turned a large-scale crisis of confidence into a global financial panic. As the intensity of the crisis became evident, financial intermediaries restored liquidity buffers. While intermediaries were scrambling to economise on capital and to scale down their balance sheets, assets were sold and lending conditions tightened. Banks and other financial institutions dramatically reduced their exposure to the risks that they had imprudently accumulated during the phase of financial euphoria. They reduced illiquid claims and sought refuge in cash-like instruments, such as reserves or short-term government paper. Collectively, they engaged in a large-scale process of “deleveraging”. Banks’ intermediation was reduced in the aggregate, and loans to companies were curtailed. The credit squeeze and the toll on the real economy set in.

Financial/economic structures and monetary policy

So much for the backdrop of events against which our policy actions have been implemented. We at the ECB have moved pre-emptively and forcefully to counter the adverse consequences of the financial crisis. At all times our response has been carefully calibrated to the structure of the euro area economy.

Allow me to elaborate a little on this structure, which differs significantly from the structure of the US economy in several important respects, relating to both the financial system and the real economy.

First, there are profound differences in the financial structures of the euro area and the United States. The United States has a primarily market-based financial system; in contrast, the financial system of the euro area is largely bank-centred. A few numbers illustrate these 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. The corresponding proportion of bank loans to GDP in the United States is only 63%. This means that the banking sector is more than twice as important in the euro area as it is in the United States. It also means that to be effective, ECB policy must focus first and foremost on the banking sector.

Similarly, direct debt securities account for 81% of GDP in the euro area. The corresponding proportion in the United States is 168%. This means that market-based financing plays a much smaller role in the euro area and is only half as relevant as in the United States. Therefore, the structures of private credit outstanding in the euro area and the United States are almost mirror images: recourse to banks on our side of the Atlantic makes up two-thirds of non-equity external finance. On this side, the equivalent proportion is only around 30%. Against this background, it is natural that the Federal Reserve's "credit easing" policies mainly target markets for debt securities, whereas our policies of "enhanced credit support" focus on banks.

There are also many profound differences in our respective economic structures, which of course are also reflected in financial structures. For the sake of brevity, I will single out three characteristics of the euro area economy that our policies have to take into account in order to be effective.

The first characteristic is the very important role that small and medium-sized enterprises (SMEs) play for the euro area economy. These SMEs in general cannot tap credit markets directly. Guaranteeing continued access to bank credit is vital for SMEs to be able to finance their activities.

The second characteristic is the role of the housing market in the crisis. In the United States, the housing market is at the epicentre of the crisis. This is not true for the euro area. Nevertheless, the euro area is indirectly affected as banks there hold toxic assets partly backed by mortgage loans originated in the United States. Forcefully addressing the toxic asset problem is a precondition for reviving credit on both sides of the Atlantic. I should add that addressing this problem clearly falls into the realm of fiscal policy, not monetary policy.

The third characteristic is the flexibility of the economy. Goods and services prices and wages are more sluggish in the euro area than in the United States. This sluggishness, on the one hand, has drawbacks as it slows down the adjustment of the euro area economy to adverse shocks. At the same time it offers some protection against very bad outcomes, provided that the policy framework provides a solid anchor for private sector expectations. In the euro area, the institutional framework provides such an anchor through the medium-term stability orientation of fiscal policies and monetary policy geared towards fiscal sustainability and price stability. In this environment, overly activist policies risk destabilising expectations and, thus, being counterproductive.

In technical terms, I would say that acknowledging the existence of structural differences between the euro area and the United States is crucial for understanding the mechanisms behind the policy models and concepts that we use in our decision-making processes. Structural differences imply that the policy response has to be calibrated to the structure of the economy.

The financial and economic structures I have just described provide the background for our policies. These policies are guided by our monetary policy strategy, a key element of which is the quantitative definition of price stability. We aim at an inflation rate of below, but close to, 2% over the medium term. The precise quantification of our policy objective has proved an invaluable asset, a fail-safe mechanism against excessive swings in inflation expectations, downwards as much as upwards. Long-term inflation expectations in the euro area, whether based on surveys or extracted from financial indicators, have thus far been exceptionally resistant to sudden short-term price changes. We will ensure that inflation expectations remain impervious to short-term changes in inflation, even in the face of sharply falling inflation.

The ECB's response to the financial crisis

Against the background of the economic and financial structures I have just described, you will see that the ECB's responses to the financial crisis are in line both with these structures and with our medium-term objective. Our actions have been different from those taken by other central banks, reflecting differences in economic and financial structures. Indeed, given the different economic structures, they *need* to be different to achieve the same objective.

Interest rates

Before explaining in detail the core elements of ECB policy since August 2007 and in particular since last September, I would like to talk briefly about interest rates – the conventional indicators of monetary policy. Some observers tend to reduce monetary policy to the level of the key policy rate. Monetary policy is the more effective in response to a downturn, the argument goes, the lower the policy rate. This view is too simplistic. Comparing only the levels of policy rates without consideration of the resulting market rates and other economic variables is looking at just one part of a far broader canvas.

Let me give you a concrete example. At 1.25% at the moment, our rate on refinancing operations is higher than the federal funds rate target range of 0-0.25%. But owing in particular to the very low rate on our deposit facility of 0.25%, this difference in policy rates does not translate into equivalent differences in money market rates.

In the euro area, six-month and twelve-month euro interbank offered rates are important benchmarks, which are widely used by banks to set floating rate loans to households and companies, for example, for setting mortgage rates in countries such as Spain. These six- and twelve-month rates are actually slightly lower in euros than the corresponding rates for contracts denominated in US dollars. In a similar vein, the benchmark ten-year government bond yield in the euro area – the German bund yield – is broadly comparable to the yield on the ten-year Treasury note. This shows that in the current circumstances, international comparisons of policy rates provide limited information about the effective credit conditions prevailing in individual markets. One key reason for lower market rates is the fact that spreads are lower in the euro area, a positive interpretation of which would point to somewhat lower credit and liquidity risk premia.

Non-standard measures

Let me now turn to the exceptional policy actions that we have taken in response to the crisis – the so-called “non-standard” measures. As you will recall, when the very significant stress in interbank markets first manifested itself in August 2007, the ECB immediately stepped into the breach and accommodated the temporarily elevated liquidity demand from the banks through a fixed rate operation with full allotment, providing €95 billion to the market within a few hours. Overnight lending of the same kind continued to be provided albeit with lower volumes during the following three days. So we can say that the ECB was the *first* central bank in the turmoil to engage in non-standard measures.

When in mid-September 2008 interbank trading came to a virtual halt, the ECB had to engage in a new mode of liquidity provision. We started to provide refinancing well above the levels that banks had absorbed to fulfil their reserve requirements in normal times.

Let me explain to you how and why we did this. There are three main building blocks to our new approach.

1) Our primary concern was to maintain the availability of credit for households and companies at accessible rates. We significantly adapted our regular operations in the crisis. Since then, we have followed a new “fixed rate full allotment” tender procedure and we have significantly expanded the maturity of our operations. This means that banks have been granted access to essentially unlimited liquidity at our policy interest rate at maturities of up to six months. To appreciate fully what this means, let us step back for a moment and look at what we do in normal times. In normal times, we auction a given amount of central bank credit, mainly in refinancing operations with a one-week maturity, and let competition among bidders determine the interest rate at which that credit will become available to the banking system as a whole. This means

that the liquidity injection is restrained by a policy decision. Last autumn, we changed that. As the demand for liquidity by individual institutions expanded abnormally and markets dramatically ceased to allocate liquidity, we have turned that practice around. We have been determining the lending rate – at a very low level – *and* we stand ready to fill *any shortage* of liquidity that might occur at that interest rate for maturities of up to six months. This means that we currently act as a surrogate for the market in terms of both liquidity allocation and price-setting.

2) The second building block of our new approach is our large list of assets that we take as collateral. This list was already very large before the crisis, but we have enlarged it even further and now accept an even wider range of securities as collateral. Government securities account for only 44% of the nominal value of securities on the list. The rest are private securities. In contrast to many other central banks, the ECB already intermediated private paper before the crisis and we have even strengthened this aspect in the crisis by accepting an even wider range of private paper.

   The total value of these securities, which are 45,000 in number, is currently €12.2 trillion. This amounts to 86% of all debt securities issued in euros and to 130% of GDP in the euro area. This very ample eligibility of collateral has dramatically eased banks' liquidity constraints during the crisis and, ultimately, it has encouraged them to extend new credit or continue rolling over maturing loans.

3) The first two building blocks offer unlimited refinancing against a very wide range of collateral. But they can only reach the financial system if they are coupled with the third building block, namely the very large number of counterparties that have always been able to take part in our refinancing operations. Even before the crisis, 1,700 counterparties fulfilled all relevant criteria. This number was higher at the time than for the other major central banks. Following the changes to our operational framework in October 2008, this number rose further. Currently 2,200 credit institutions in the euro area have the opportunity to refinance themselves with us, and for most of the remaining 4,300 credit institutions it would not be a problematic to become eligible. For example, in March 2009, 750 counterparties actually made use of this opportunity, compared with 450 in July 2007.

This structural feature of our operational framework has been instrumental since the first stages of the crisis in ensuring widespread confidence that all relevant intermediaries can access liquidity. It may be useful, by way of comparison, to note that whereas we had about 450 active counterparties before the crisis, the Federal Reserve had about 20. These facts may demonstrate to you the dimension of our outreach to the financial system in the euro area and its effectiveness in insuring against a systemic liquidity threat.

Our measures to safeguard the banking system's access to liquidity have resulted in a considerable expansion of the Eurosystem's balance sheet, which reached a peak of 19% of GDP at the height of the crisis around the turn of the year. Since then, we have seen liquidity flows moving back from our balance sheet to the money market. This is a sign of improving confidence and more favourable conditions. We therefore see some indication that the functioning of the money market is improving.

How does the ECB's non-standard policy compare with the approaches taken by other central banks also grappling with the turmoil in financial markets? Since mid-September 2008, the Federal Reserve has embarked on a policy of direct "credit easing". This policy involves, first, the provision of liquidity directly to borrowers and investors in key credit markets and, second, the purchase of debt instruments such as commercial paper or asset-backed securities. These measures are targeted at directly addressing instability or declining credit availability in critical non-bank channels of intermediation.

Clearly, while sharing a common purpose, the ECB and the Federal Reserve have relied on different channels of transmission. And as I explained earlier, this is justified by the profound differences in the financial and economic structures of the euro area and the United States.

In the context of the euro area, guaranteeing steady access to credit for households and companies largely means preserving the viability of the banking system. Banks play such a dominant role in our economy that it was appropriate until now for our non-standard measures to be implemented through the intervention in and with the active participation of the banks.

As for possible additional non-standard measures in the future, I will stick to what I said at my last press conference: the Governing Council will take any new decision on 7 May. At this stage we have agreed not to give any further indications but will, on that day, provide all the necessary information on anything that is decided.

Conclusions

I have spoken about differences in the approaches to crisis management of major central banks, which are related to differences in the structure of their economies. But let me reiterate that we are all united in purpose. The overarching aim is to restore confidence, to take measures that will solidly anchor the expectations of households and companies, and to lay the groundwork for a return to sustainable prosperity.

I have also strongly stressed that the scarcest resource we have right now is confidence in the future. That is why in the present, very demanding, circumstances our primary goal should be to strengthen confidence at all levels. The global economy was hit in mid-September 2008 by an unprecedented and abrupt loss of confidence. It was perhaps the first time in economic history that a single event was able within just a few days to have a simultaneously negative effect on all households and companies in both the industrialised and emerging economies. We are in uncharted waters, and there are still risks of a sudden emergence of unexpected financial turbulence.

My personal conclusion of the G7, the G20 and the IFMC meeting in Washington is that public authorities, executive branches and central banks must do everything they can to restore, preserve and foster confidence so as to pave the way for sustainable prosperity.

This calls for a bold yet solidly anchored response. 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 term.

Confidence also calls for ensuring a global level playing field. It is essential that all economies of the world apply the same rules, respect the same principles as regards financial regulation, and display the results of their corporate businesses along the same accounting rules. Regulatory arbitrage across countries and across continents would be a recipe for catastrophes.

Confidence calls for resolutely combating protectionism and particularly financial protectionism which could delay the recovery and considerably dampen the future growth of the global economy.

Confidence calls now for an effective, efficient, convincing, as well as a quick implementation of the decisions which have been recommended by the Financial Stability Board, the IMF and the World Bank and approved by the G20. In crisis periods time is of the essence. At this stage we do not need new decisions from executive branches, but resolute and rapid implementation.

The ECB for its part will do all that is necessary to continue to be a very solid and reliable anchor of stability and confidence in these challenging times.

I thank you for your attention.