José Manuel González-Páramo: The response of the Eurosystem to the financial crisis

Keynote speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the European Parliament's Special Committee on the Financial, Economic and Social Crisis (CRIS), Brussels, 10 November 2009.

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Introduction

I am happy to have the opportunity to speak in front of the European Parliament's Special Committee on the Financial, Economic and Social Crisis on the Eurosystem's various measures to address the crisis.

The financial crisis created great uncertainty and presented a number of challenges from the policy-making perspective. It is generally recognised that from the start of the tensions, the Eurosystem's response to the crisis has been effective. Indeed, when widespread tensions severely impaired the functioning of the money market in early August 2007, the Eurosystem rapidly reacted by injecting €95 billion into the banking sector in an overnight operation, followed by various additional liquidity injecting operations. When the crisis intensified again in September 2008, the Eurosystem swiftly reacted by announcing further exceptional measures to enhance the provision of liquidity to banks. Similarly, the rapid and pronounced cuts in interest rates after October 2008 represented a timely response to contain the spreading of the turmoil from the financial sector to the real economy, with significant risks to the outlook for price stability.

In my speech today, I will first review the main steps taken by the Eurosystem in response to the crisis. Next I will elaborate on the effects that these non-standard measures had on the Eurosystem's balance sheet and on the provision of liquidity to the financial sector. Finally, I will report on our current thinking about the phasing out of some of these measures.

The Eurosystem's monetary policy response

Central banks around the world reacted to the financial crisis by both cutting policy interest rates and engaging in so-called "non-standard" measures of monetary policy. These are called "non-standard" because they go beyond changes in the interest rate, which represents the traditional tool with which central banks steer monetary conditions in the economy.

Between October 2008 and May 2009, the Eurosystem's key policy rate – the interest rate on the main refinancing operations – was lowered by a cumulative 325 basis points. The speed and extent of the monetary loosening experienced over this period are without precedent since the Eurosystem took responsibility for the conduct of monetary policy in the euro area. This is of course a rather short period, just over a decade. However, changes in interest rate of this magnitude remain exceptional even if we look at the much longer historical experience of the Deutsche Bundesbank and other major central banks in Europe.

The unconventional policy taken, for which we also coined the term "enhanced credit support", consisted of four main types of measures:

1. *Full allotment and increased maturity of the Eurosystem's refinancing operations*. Already in 2007, the number and allotment volumes of 3 month operations were increased, compared to the weekly main refinancing operations. In April 2008, we conducted for the first time 6 month operations. In October 2008, the Eurosystem switched in all its refinancing operations to the so-called "fixed rate with full allotment" modality, thereby fully accommodating private banks' demand for central bank liquidity at the central policy rate. In addition, in May 2009, an announcement was

made to conduct three 12-month operations at fixed rate with full allotment. The first such operation was allotted in June 2009 with an amount of €442 billion. The third 12-month operation will be allotted in December 2009.

2. *Provision of liquidity in foreign currencies*. In December 2007, the Eurosystem started to provide US dollar against our standard euro collateral set. In October 2008, the Eurosystem expanded the provision of liquidity in selected foreign currencies, by offering in principle full allotment. In addition, we started to provide our counterparties with Swiss franc denominated liquidity. The provision of foreign currency was refinanced through FX swap agreements between the major central banks. Again, this appears to be unprecedented in central banking history and illustrates the very effective co-operation between major central banks over the past two years as well as the willingness to enter new modes of liquidity support to banks.

3. *The expansion of the list of assets eligible as collateral*. The Eurosystem expanded in October 2008 its already broad list of eligible collateral, against which counterparties are able to obtain liquidity in central bank refinancing operations. Ample availability of collateral is important in a financial crisis, as counterparties can only obtain liquidity in refinancing operations to the extent that they hold eligible collateral. It may be noted that other central banks widened the eligible collateral set much earlier during the turmoil. This however did not reflect a lack of pro-activeness of the Eurosystem, but the fact that it had always accepted a broad range of collateral. The steps taken by other central banks during the first year of the financial crisis can therefore be considered as convergence of collateral sets in the direction of the Eurosystem's framework.

4. *Outright purchases of covered bonds*. The covered bond market, which has historically been an important source of funding for banks in large parts of the euro area, had suffered from the financial crisis, both in terms of primary and secondary market activity. The total sum allocated to the purchase programme – €60 billion, representing about 5% of the outstanding eligible covered bonds – is deemed sufficient to significantly support activity in this important market, ensuring that the ECB acts as a catalyst for re-activating this market rather than as a market maker of last resort. During the first four months, the Eurosystem bought over €20 billion worth of covered bonds, with the total of up to €60 billion being targeted for June 2010.

Compared with measures taken by other central banks, the measures implemented by the Eurosystem were specifically targeted at the banking sector. The reason for concentrating on the banking sector stems from structural features of the euro area's economy, particularly the fact that its financial system is predominantly bank-based. Indeed, bank loans account for a much larger share of financing to households and firms in the euro area than in the United Kingdom or in the United States, where non-bank financial institutions and capital markets provide important alternative sources of funds. For instance in 2007, the ratio of bank lending to the private sector relative to GDP amounted in the euro area to about 1.5, compared with a ratio of 2/3 in the United States. At the same time, the ratio of outstanding debt securities issued by the euro area private sector relative to GDP was just over 3/4 in the euro area, while it was above 1.5 in the United States.

Accordingly, the set of measures implemented by the Eurosystem – our enhanced credit support programme – were designed with the objective of providing support to the banking sector by: (a) helping the functioning of the money market, (b) easing funding conditions for banks, and (c) improving market liquidity in segments of the private debt securities market (specifically, the market for covered bonds) that represent an important source of funding for euro area banks. Through these measures, the ECB aimed to mitigate the risk of systemic illiquidity in the euro area banking sector and to guarantee a steady flow of banking credit to euro area households and firms.

Impact of measures implemented by the ECB

Let me start with the impact of our measures on the *Eurosystem balance sheet*.

As in the case of other central banks, the size and complexity of the Eurosystem balance sheet has significantly increased. In June 2007, just before the start of the crisis, total assets of the Eurosystem amounted to around 10% of area-wide GDP (€913 billion). By January 2009, the size of the balance sheet had almost doubled, reaching 19% of GDP (€1,763 billion). Subsequent improvements in money market conditions have led to a reduction in the amount of total assets, but they remain at a higher level (16% of GDP, or €1,454 billion) than in the pre-crisis period.

The expansion of the Eurosystem balance sheet was driven both by changes in the so-called autonomous factors, as well as by the introduction of non-standard measures. On the liability side, banknotes and government deposits have steadily increased during the past two years: banknotes changed from around €600 billion at the beginning of 2007 to €768 billion at the end of October 2009, while government deposits over the same time period went from around €50 billion to €140 billion.

On the asset side, three factors may be distinguished, reflecting the non-standard measures. First, the banking system as a whole tended to demand more euro liquidity through refinancing operations with full allotment than actually needed to fulfil reserve requirements and liquidity needs from autonomous factors, and hence deposited the excess amounts back into the deposit facility of the Eurosystem. Second, the composition of the Eurosystem balance sheet is affected by the covered bond purchase programme, whereby the purchases mainly imply a substitution effect, as they are likely to lead over time to a corresponding reduction of Eurosystem refinancing operations. The importance of these two factors for the overall expansion of the Eurosystem balance sheet can be measured very simply in the form of the recourse to the deposit facility. The daily recourse to the deposit facility peaked on 3 July 2009 with €316 billion, reflecting the high demand in the first 12 month long-term refinancing operation (LTRO) in June 2009. Recourse to the deposit facility stood at €106 billion on average during the last maintenance period ending on 13 October 2009. The third factor lengthening the balance sheet was the provision of liquidity in foreign currency, either via collateralised lending or via swaps.

Let me also mention briefly the impact of the change of allotment procedure and increase of maturity on our open market operations volume. The outstanding amount of long-term refinancing operations, i.e. operations with a maturity of between 1 and 6 months, increased from €150 billion in June 2007 to over €600 billion at the end of 2008. Over the same period the total amount of outstanding refinancing operations has almost doubled, peaking at €850 billion on 2 January 2009, and currently standing at €672 billion. The January 2009 figure represented more than 9% of euro area GDP. The 12 month operations conducted in June 2009 was with its €442 billion euro the largest single refinancing operations ever conducted by a central bank. It attracted a widespread participation of counterparties, namely 1,100 financial institutions, which may also have been a historical record.

Turning to the impact of our measures on *financial markets and the real economy* at large, there are some clear signs that the measures are having positive effects. In particular, the spreads between unsecured term interest rates and overnight interest rate swaps in the money market have declined significantly since last autumn and are now back at levels last seen before the bankruptcy of Lehman Brothers. Related to that, and in conjunction with policy rate cuts, interest rates on loans to households and firms have declined substantially.

At the same time, recent data indicates that growth in aggregate lending has not turned around. Although there have been signs that the slowdown in lending to households has come to a halt, the growth rate of loans to non-financial corporations has continued to moderate. Seen in context, the recent developments in loans to firms appear to be broadly in line with past regularities in bank lending behaviour, particularly at turning-points in the business cycle. Indeed, loans to firms tend to lag GDP growth by about three quarters. This may be related to the fact that non-financial corporations usually see their cash flows improve early in an economic upturn and thus tend to finance working capital and fixed investment with internal funds first, and only later with external financing. In addition, when macroeconomic conditions are weak, the dynamics of bank loans are affected by demand-side factors. Having said this, it is important to closely monitor developments in credit in order to assess to what extent supply-side constraints may play a role in limiting credit availability.

Recent data suggests that the global economic slowdown may be bottoming out, and the freefall in economic activity has come to an end. Concomitant positive signs are the improvements in the funding situation of banks, the continued decline in lending rates and increasing indications of a turning point in bank lending conditions. However, uncertainty still remains high and the economic data remain volatile. In addition, we should acknowledge that the future, the evolution of lending will, most likely, depend more than in past episodes, on adjustments taking place within the banking sector.

Preparation for phasing-out from non-standard measures

Although the financial crisis is not yet over, we have carefully and thoroughly developed the set of principles and contingent courses of action that will govern the progressive exit from the set of non-standard measures currently in place. The ECB's monetary policy continues to provide substantial support to the availability of liquidity and the recovery of the euro area economy. Looking ahead, as conditions in the financial markets normalise further, not all our liquidity measures will be needed to the same extent as in the past. Accordingly, the Governing Council will make sure that the extraordinary liquidity measures taken are phased out in a timely and gradual fashion, and that the liquidity is absorbed in order to counter effectively any threat to price stability over the medium to longer term.

In so doing, the stance of monetary policy could be normalised through the change of key policy rates as well as through the gradual withdrawal of our enhanced credit support measures, or through a combination of both. The precise sequencing will depend on the circumstances prevailing at the time.

With regard to the non-standard measures, it is useful to distinguish again between the four different types of measures.

First, for the non-standard refinancing operations, there is an obvious built-in mechanism that facilitates their removal, as the operations mature at pre-specified dates and can then be replaced by conventional refinancing operations, if needed.

Second, as with non-standard euro refinancing operations, the provision of foreign currency liquidity does not need to be renewed when it is considered that it is no longer warranted. In this context, let me remind you that the exit from this specific measure has already started: owing to lack of demand, we have already discontinued foreign currency-providing operations with longer maturities.

Third, it has been made clear that the widening of the collateral framework is temporary. More precisely, its remaining into effect is linked to the conduct of the 12 month LTRO in December 2009. Hence, the widening of the collateral framework will be naturally phased out in December 2010, unless otherwise decided.

Finally, in relation to the covered bond portfolio, there is no particular need to dispose of the purchased bonds at any future moment in time, as it does not interfere with monetary policy implementation. We could therefore decide to hold the portfolio until maturity and let it gradually shrink over time as a result of redemptions. Alternatively, the portfolio could be disposed of in a gradual way that would make it possible to avoid market distortions. In any case, the alternative options can be considered again once the entire portfolio has been established.

Regardless of the specific modalities adopted for the exit strategy, let me stress again that the key principles to phase out existing measures should in any case be timeliness and gradualism. Indeed, the stance of monetary policy should be normalised and the non-standard measures withdrawn in parallel with the gradual improvement in economic and financial conditions.

Let me also stress that there are no technical obstacles to the implementation of our exit strategy. In any case, we have the instruments to allow us to actively withdraw liquidity. Longer-term liquidity-absorbing operations could be envisaged in a scenario where it is clear that the need to absorb persists for a certain period of time, and where a significant tightening in monetary policy is needed. In this case, long-term liquidity absorption could be used to quickly restore a deficit situation along with an increase in interest rates.

In this context, let me mention that, when assessing whether or not the non-conventional liquidity measures have achieved their objectives, we need to be aware that such measures have been introduced for systemic purposes and not to address problems at individual institutions, which fall within the sphere of competence of national governments. Therefore, concerns about the costs or difficulties faced by individual institutions, once the exceptional provision of liquidity is discontinued, should not act as a constraint on the timely implementation of an exit strategy from non-conventional monetary policy.

A final point must be made: the specific operational steps of an exit should not be interpreted as signalling imminent changes to key policy rates. The exit strategy will take place in an orderly fashion with a well-designed and clearly communicated exit framework. The long-term success of non-standard measures is conditional upon achieving both an appropriate stimulus to the economy in the short-term in conjunction with keeping long-term private sector inflation expectations firmly anchored.

Conclusion

The financial crisis has presented exceptional challenges to central banks to support the functioning of money markets and the funding liquidity of banks, to stabilise economic activity and to preserve price stability. The ECB responded swiftly to these challenges by engaging in non-standard monetary policy and aggressively cutting policy interest rates.

While the current economic environment continues to pose challenges, we have a strategy that will govern the progressive exit from the set of non-conventional measures currently in place. Our preparations for a gradual exit from these measures, however, do not suggest that fundamental change in policy is imminent. Rather, the development, communication and eventual timely implementation of a well-designed exit strategy are vital in terms of the preservation of the macroeconomic and financial stability gains derived from the non-conventional measures.