Jean Claude Trichet: Hearing at the Economic and Monetary Affairs Committee of the European Parliament

Introductory speech by Mr Jean Claude Trichet, President of the European Central Bank, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 7 December 2009.

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Dear Madam Chair,
Dear Members of the Committee on Economic and Monetary Affairs,

This is our first meeting since the entry into force of the Lisbon Treaty. The new Treaty is a reason to celebrate: in Europe generally, here at the European Parliament, but also at the ECB. It will make the Union stronger, more effective and more efficient.

The powers and responsibilities of the European Parliament increase. The ECB formally becomes an institution of the European Union, and all its essential features, above all its independence, are confirmed.

Dans le cadre du nouveau traité, nous nous réjouissons de notre collaboration à venir avec le Parlement. La qualité de cette coopération a été exemplaire à mes yeux au cours de ces dernières années.

Unsere heutige Anhörung ist drei wichtigen Themen gewidmet: erstens, unserer Einschätzung der aktuellen wirtschaftlichen Lage; zweitens, unserer Exit-Strategie zum Auslaufen der außergewöhnlichen geldpolitischen Maßnahmen, die wir in dem Höhepunkt der Krise eingeführt hatten; und drittens, dem Thema der systemischen Risiken im Finanzsystem.

1. Economic and monetary developments

The economic situation and outlook have continued to improve since my previous hearing before this Committee ten weeks ago. The euro area economy shows increasing signs of recovery. Economic activity in the third quarter is estimated to have increased by 0.4% compared with the previous quarter. In 2010 we expect to see a moderate recovery. This is in line with the latest Eurosystem staff projections, which were published last Thursday. However, this expectation remains surrounded by a high level of uncertainty. In the view of the Governing Council, the risks to the outlook remain broadly balanced.

As regards price developments, inflation and inflationary pressures have remained low over recent months. In line with our expectations, inflation rates turned positive again in November, reaching an estimated 0.6%. Looking ahead, we expect inflation to remain moderate over the policy-relevant horizon, in line with a relatively slow recovery in demand. Indicators of inflation expectations over the medium to longer term remain firmly anchored, in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.

Our monetary analysis confirms the assessment of low inflationary pressures over the medium term. In particular, we see that money and credit expansion continues to decelerate. In the case of loans to households, the latest data provide further confirmation of a levelling-off at low rates of growth. The growth of loans to enterprises follows turning-points in the business cycle with some lag. The still subdued levels of production and trade, coupled with broader uncertainty regarding the business outlook, will dampen firms' demand for bank financing also in the coming months, especially for short-term loans. At the same time, overall financing conditions continue to improve, which should support the demand for loans in the period ahead. Thus, at present we see no signs of a credit crunch for the euro area as a whole. We are monitoring developments very closely.

It is against this background that the Governing Council continues to view the current level of key ECB interest rates as appropriate.

2. Phasing-out of non-standard measures

In response to the financial crisis, the Eurosystem has introduced a number of non-standard measures since October 2008.

As I explained to you before, the five key elements of our enhanced credit support have been: fixed rate full allotment; an expansion of the list of collateral; longer maturities for refinancing operations; liquidity provision in foreign currencies; and financial market support through a measured but significant covered bond purchase programme.

These measures have served the economy well in critical times. They have supported the ability of banks to provide credit to the euro area economy, ensuring that money and credit market conditions properly reflect the monetary policy stance decided by the Governing Council.

As you know, all our exceptional measures were designed with the phasing-out in mind. In most cases, the phasing-out occurs naturally, and our operational framework is sufficiently flexible for us to be able to adjust liquidity conditions when warranted. Our institutional independence means that we are unrestricted in our ability to implement the appropriate decisions.

I have always stressed that the phasing-out would be timely and gradual. It must be timely, because one should exit neither too early, nor too late – any ex ante bias is not justified. The phasing-out must be gradual, because the situation is improving only gradually and downside risks remain.

Last Thursday we took a decision to initiate the gradual phasing-out of some of the extraordinary liquidity measures, as they will not be needed to the same extent as in the past. This will avoid distortions associated with maintaining non-standard measures for too long. It is important to avoid a situation in which banks are heavily dependent on exceptional central bank financing. In the context of a stabilisation in the money markets, incentives have to be strengthened for banks to restructure their balance sheets through recapitalisation. In addition, a timely and gradual phasing-out should help activity in the money market and strengthen peer monitoring among banks.

It was against this background that the Governing Council decided to adjust the design of some of our refinancing operations. We will continue to fully accommodate banks' liquidity needs at fixed interest rates in all our main refinancing operations for as long as is needed – and at least until mid-April next year. We thereby continue to provide liquidity support to the euro area banking system so as to facilitate credit provision to the euro area economy. But as regards our one-year operations, we decided to not engage in further one-year operations beyond the December operation that was already announced. The improved conditions in financial markets have indicated that not all our liquidity measures are needed to the same extent as in the past. Similarly, it is our intention to discontinue the 6-months refinancing operations after the last operation at the end of March next year.

Liquidity developments in non-euro area EU countries

Allow me to say a few words on the broader implications of our decisions on non-standard measures, with a particular focus on the EU Member States outside the euro area. Macroeconomic and financial conditions in these countries seem to have stabilised, although there are significant differences across the region. A general "sudden stop" in capital flows to central and eastern Europe has not materialised. The significant presence of foreign banks seems to have had a stabilising effect in this regard, as parent banks have to a large degree been able to maintain their exposures to the region. The ECB’s extensive liquidity provision to parent banks established in the euro area has contributed to this. In addition, the ECB has provided liquidity support to some non-euro area central banks in cases of market malfunctioning or to facilitate the functioning of the international financial system.

Fiscal policies in the euro area

Finally, I should like to add a few comments on fiscal exit strategies. Many euro area governments are faced with high and sharply rising fiscal imbalances, which are not sustainable over the longer term. This could weaken public confidence in the sustainability of public finances, with adverse effects on market sentiment, leading to less favourable medium and long-term interest rates. Unsustainable fiscal positions may also complicate the task of our monetary policy to maintain price stability.

Communicating credible fiscal exit strategies is therefore crucial in order to anchor expectations. Such strategies need include credible measures, notably on the expenditure side. As agreed by the Ecofin Council last week, governments need to set out concrete and quantifiable adjustment measures that will lead to a sustainable correction of fiscal imbalances. Several countries will have to start consolidation in 2010, and all others in 2011 at the latest.

3. Systemic risk

Let me now turn to the last topic we selected, namely the issue of systemic risk in highly interconnected financial systems and ways to address it.

Systemic risk is the risk of a broad-based break-down of the financial system. It results from an impairment of the financial system, generally resulting from the high degree of interplay and interconnectedness within the system. Systemic risk is distinct from the risk that can affect the safety and soundness of individual financial institutions. Furthermore, systemic risk, when it erupts, is to be certain to seriously affect the financial intermediation process to such a degree that there are negative spill-overs to the real economy.

The crisis has illustrated that systemic risk may be triggered by the collective behaviour of institutions and the manner in which they interact in financial markets. It has highlighted the importance of improving our knowledge and assessment of interconnectedness in the financial system, both via the direct links between financial institutions and the indirect ones created in financial markets.

Micro-supervisory assessment, institution by institution, typically investigates the vulnerability of each entity, under various assumptions of stress. In contrast, systemic risk assessment investigates the possibility of the whole system, or significant parts of it, being vulnerable, and considers that major risks may emerge from the financial system itself. Such risks may arise, for example, because large parts of the system might have similar exposures, may rely on the same funding sources, can be exposed to rising financial imbalances, may comprehend large similar currency or maturity mismatches inducing liquidity vulnerabilities, and can be exposed to large scale underassessment and mis-pricing of risks. In the assessment of the systemic risk of the financial system itself, the judgement on the robustness of financial infrastructures is particularly important.

One important issue in assessing systemic risks is to measure the degree of procyclicality which is embedded in the financial system itself, namely the capacity of the system to amplify fluctuations and to produce after a certain period of time, excessive booms and busts starting from relatively modest initial shocks, up or down. This “procyclical systemic instability” of the system is itself a complex concept which calls for analysis of the interplay between diverse phenomena such as: herd behaviour, contagion from common or correlated exposures, counterparty relationships, and undesired procyclical effects of prudential rules, of accounting rules, of behaviour of credit rating agencies, etc.

Another important domain in assessing systemic risk is the analysis of the inter-linkages between the financial sector itself, taken as a whole, and the real economy. Financial imbalances often mirror real-economy imbalances. The adverse feedback loop between a fragile system, prone to procyclicality, and the real economy might be devastating, as has been demonstrated by the recent crisis experience. This means that unsound macro-policies over time, including macro imbalances, can themselves trigger financial imbalances, which in turn would aggravate instability and fragility in the real economy.

Sources of systemic risk are particularly difficult to assess. By definition, they stem from the interrelations between the various elements in the system and are hence inherently complex. We know that the evolution of systems under stress is particularly difficult to capture. Furthermore, the materialisation of a risk is very often a sharp, abrupt and rapid non-linear phenomenon which calls for non-standard analysis. For example, in a very large and highly complex financial system, the channels through which risks are propagated are very difficult to capture comprehensively. A deep understanding of leverage, correlations and concentrations of exposures is key in this respect. But the identification of the different channels of propagation does not suffice. The robust modelling of the system is, in itself, a formidable challenge.

In practice, analysts can rely on early warning indicators and models, indicating when clusters of financial institutions or markets of systemic relevance are approaching "danger zones". In assessing the resilience of the system, macro stress tests have become an important part of the risk assessment tool-kit. They can also help in prioritising the risks identified and are a pertinent tool to support the formulation of policy recommendations.

Central banks and supervisory authorities around the world are working to enhance and develop these tools. In my view, the European Systemic Risk Board (ESRB) can make a significant contribution in fostering systemic risk analysis, coordinating analytical efforts and concentrating central banking and supervisory expertise from all EU countries. I am also confident that the role of the ESRB in translating risk assessments into appropriate risk-prioritisation, early warnings and concrete policy recommendations to mitigate systemic risks will contribute to the much more resilient EU financial system we are all looking forward to.