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

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, 11 September 2007.

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Madame la Présidente, Mesdames et Messieurs les membres de la Commission Economique et Monétaire,

La crise du marché américain des prêts immobiliers subprime et son impact potentiel sur l'Europe ont suscité beaucoup d'intérêt au cours des dernières semaines. Je souhaiterais tout d'abord vous fournir de plus amples informations sur les interventions de la BCE en réaction à la forte volatilité enregistrée sur les marchés financiers. En second lieu, j'évoquerai brièvement la situation économique et monétaire et reviendrai plus en détail sur les raisons sous-jacentes à nos récentes décisions de taux. Zum Abschluss möchte ich einige vorläufige Schlussfolgerungen aus Sicht der Finanzmarktstabilität ziehen.

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Let me begin by providing you some further information about the recent events in financial markets and the ECB's interventions. In July and early August, the crisis in the so-called US sub-prime mortgage market intensified and appetite of global investors for risky assets declined. Market volatility increased in all asset classes. Stock prices declined and government bonds benefited from safe-haven investment flows. In this context, several investment funds holding asset-backed securities suspended withdrawals. A number of European banks admitted direct or indirect exposures to the US mortgage market. Yet it is important to remark that the credit losses were not significant enough to materially impact the soundness of core financial institutions.

Initially, the impact was felt in the US dollar money market, where domestic and international banks were raising short-term liquidity in order to cope with the liquidity needs of a number of "special vehicles" or "conduits" that had difficulty to refinance themselves on the commercial paper market. On Thursday morning 9th of August, the tensions also spread to the euro money market. These unprecedented circumstances called for commensurate actions. Therefore, the ECB injected additional liquidity in the money market in order to restore orderly conditions.

Let me briefly describe our operations in more detail. Our first operation was carried out on 9 August and matured the following day. It was a non-regular overnight operation where the ECB provided liquidity to banks at a fixed rate of 4.00 percent, which is the level of our key policy rate. This liquidity was provided through so-called reverse repurchase agreements. These are transactions whereby the ECB purchases a given amount of eligible assets on the understanding that these will be repurchased by the counterparty at a given price the following day. We pre-announced that we would fulfil 100 percent of the bids submitted by banks. This allowed us to gauge the amount of exceptional liquidity needs in the banking system as a whole and to contribute to calming down the overnight money market under these circumstances. As a result of this operation, the calm on the very short-term money markets was restored for the rest of the day.

During the following three business days, the ECB conducted similar overnight liquidity-providing operations through variable rate tenders with a minimum bid rate of 4.00 percent. In the case of variable rate tenders, counterparties are asked to indicate both the desired amount of money and the interest rate at which they wish to obtain it. The Eurosystem then satisfies first the bids with the highest interest rates. The use of a variable rate in these subsequent overnight liquidity-providing operations was in line with our usual practice. Thanks to these operations, on each day from 9 to 14 August the ECB provided additional euro liquidity above what is needed by the banking system under normal circumstance. It rolled over a progressively smaller amount on each day, as the rates and amounts bid by banks in our tenders became progressively lower.

On 14 August, the first Tuesday following the start of the tensions in the money market, the ECB resorted to its standard instrument for market operations, namely its one-week main refinancing operation which is usually allotted on Tuesdays. With a view to ensuring orderly conditions in the money markets, the ECB allotted significantly larger amounts of liquidity than it would have under normal circumstances. The same approach was adopted in the subsequent one-week main refinancing operations on 21 and 28 August and 4 September. Thanks to this relatively generous allotment, money market rates with maturities up to one week were brought back to usual levels.

However, tensions remained in money market rates for maturities above one week. In order to support a normalisation in this money market segment, the ECB decided to implement two supplementary longer-term refinancing operations, the first decision being taken on 21 August and the second on 6 September, both with the usual maturity of three months.

In preparing and deciding upon the various operations, the Eurosystem remained, as usual, in close contact with other central banks, including in particular, but not exclusively, the Federal Reserve, the Bank of Japan, the Bank of England, the Bank of Canada and the Swiss National Bank. These other central banks also took steps, each within the parameters of their own operational framework. When comparing the steps taken by the various central banks, it is important to take account of these differences in operational frameworks.

In any case, it is important to stress that the Eurosystem has shown its capacity to react both promptly and effectively to these challenges. I am convinced that, given the circumstances, we did the right thing at the right level at the right time.

Monetary policy stance

Through these liquidity operations, the ECB fulfilled one of its key responsibilities, namely to ensure an orderly functioning money market. I will now turn to our primary objective, namely that of delivering price stability over the medium term and be credible in the delivery of price stability over the medium and long term. I would like to emphasize that our primary mandate calls for our monetary policy stance to deliver price stability in the medium term. Once the level of interest rates is decided we have the responsibility to ensure the smooth functioning of the segment of the money market that we influence. The two responsibilities are clearly separated and should not be mixed.

On 6 September the Governing Council decided to leave the key ECB interest rates unchanged. The incoming macroeconomic data confirmed that risks to price stability remain on the upside over the medium term, as identified by both our economic and monetary analysis. The incoming macroeconomic data also again confirmed the strong fundamentals of the euro area economy and support a favourable medium-term outlook for real GDP growth. Data on activity in the third quarter – from various confidence surveys and indicator-based estimates – remain overall favourable. The latest data on unemployment indicate improving labour market conditions and the global economic activity is expected to remain robust, as the likely slowdown in the United States is expected to be largely offset by the continued strong growth in emerging markets. This outlook is also reflected in the September 2007 ECB staff macroeconomic projections for the euro area, which foresee average annual real GDP growth in a range between 2.2% and 2.8% in 2007, and between 1.8% and 2.8% in 2008.

The monetary analysis confirms the prevailing upside risks to price stability at medium to longer-term horizons. On the basis of the latest available data, covering the period to the end of July, the underlying rate of monetary and credit expansion remains strong. This is reflected in the rapid growth of the broad monetary aggregate, M3 and the strength of MFI loans to the private sector, which continue to increase at double-digit rates on an annual basis.

Against this background, our monetary policy stance is still on the accommodative side with, inter alia, money and credit growth vigorous in the euro area. At the same time, the financial market volatility and reappraisal of risk of recent weeks have led to an increase in uncertainty. Given the current high level of uncertainty, the Governing Council has deemed it appropriate to gather additional information and carefully examine all new data, before drawing further monetary policy conclusions. Accordingly, the Governing Council will monitor very closely all developments. On the basis of our assessment, by acting in a firm and timely manner, we will ensure that risks to price stability over the medium term do not materialise and that inflation expectations are firmly anchored in line with price stability, which is even more important in the current context of financial market volatility and increased uncertainty. In this respect, the Governing Council will continue to pay great attention to future financial market developments.

Financial stability

I would like to conclude my introductory remarks by drawing some tentative lessons for financial stability and supervision of this episode.

Let me first qualify how we see the current situation. We are experiencing a market correction with a significant reappraisal of risk, the possibility of which we had been warning about for quite some time. I can recall that in my appearances before you and elsewhere, I had said that we were diagnosing a level of risk appreciation in global financial markets that was signalling an under-appreciation of risks in general. This was illustrated in particular, but not exclusively, by the relatively low level of spreads, the low level of risk premia and the low level of volatility across a wide range of financial markets. In the very first issue of the ECB Financial Stability Review published in December 2004 we had said that a high level of risk appetite was encouraging a search for yield among investors across a wide range of markets and asset classes. This phenomenon went on for several years together with a very significant degree of innovation and creativity in global financial markets which was improving financial efficiency but also creating new sources of risk.

As I just said we are now in a correction phase which can, as frequently observed in such situations, comprehend episodes of hectic behaviour, a high level of market volatility and elements of over-shooting.

We had seen a distinct possibility that the ongoing deterioration of the creditworthiness of borrowers in the US sub-prime mortgage market could be a trigger for more broad-based market correction. We had said this in our Financial Stability Review published as recently as last June. The most important channel for the propagation of the correction turned out to be the maturity mismatch and, therefore, the strains placed on the balance sheets of special purpose vehicles and conduits which had funded medium-term positions in asset backed securities – where sub-prime mortgages were an important element – with short-term financing commercial papers. It was the difficulties these vehicles faced in rolling over their short-term funding which created much of the strains we saw in money markets.

Now, I know that you are particularly interested in the lessons we can draw from the present episode. As we are not yet at the end of it, I would say that at this stage we must be prudent in drawing definitive conclusions. That said, I believe there are a number of areas where we know lessons will have to be drawn by the international community and where orientations for appropriate improvements can be seen.

First, over the past decade, we have experienced a tremendous increase in the sophistication of financial instruments. While the positive effect of these innovations has been to allow market participants to better share risk, some negative aspects have clearly been highlighted by the ongoing episode. In particular, the degree of complexity of some products that are designed for the purposes of re-packaging and selling debt instruments has become overwhelming. Although I would be very hesitant to impose limitations on the creativity of market participants in their pursuit of innovation and enhanced efficiency of the financial markets, in my view, instruments and structures that cannot be fully understood even by those who bear the ultimate responsibility of the level of risk taken by financial institutions should not be acquired or set up by banks and investors who are lacking sufficient sophistication in the management of the risks. At the same time, the responsibility of those originating such new products should not be understated either, as the current episode has demonstrated that the underlying assumptions in the pricing models for complex instruments are not always robust to changing financial market conditions. Investment banks have become very active in this area and a part of the dramatic increase in derivatives markets and financial leverage that we have witnessed has been favoured by the underpricing of risk, of which the ECB has repeatedly warned about in the recent past.

Second, much attention has been focused on the role played by rating agencies prior to the current market correction. It is true that the very small number of large global rating agencies is a real issue for the present functioning of global finance. Potential conflicts of interest, where they exist, would have to be dealt with and possible benchmarks for improved behaviour could be worked out. In any case an important lesson of the current risk re-pricing is that investors must never take the opinion of rating agencies as a substitute for their own credit analysis and due diligence.

Third, the current events highlight the importance of further improving financial sector surveillance activity by financial regulators and the risk management practices of financial institutions. The new Basel II capital accord, which is currently being implemented, will bring substantial benefits in this sense. Indeed, Basel II strongly relies on significantly improved risk management in determining the appropriate capital buffers for banks. Despite these improvements, the degree of sophistication of financial markets calls for constant investment in stress-testing practices in order to ensure that banks are aware of the potential losses they might accrue even in highly unlikely scenarios. The Basel Committee for Banking Supervision, where the relevant authorities are represented, is playing a very important role in this field. Another area where progress could and should be made is the area of liquidity. Appropriate harmonisation of the various national rules and requirements appears to be particularly opportune in the light of the recent events.

Fourth, we have to continue reflecting on how to deal with all non-regulated entities. The main channels of propagation of the present turbulences have been the non-regulated constituency of so-called conduits and special investment vehicles and not the highly leveraged non-regulated institutions like hedge funds and private equity funds. I would say at this stage that we should implement rapidly what is already crystallized in international consensus on hedge funds, namely the recommendations of the Financial Stability Forum. And we have to improve very substantially our handling of conduits and special vehicles.

Looking forward, some tentative policy implications can be identified from a financial stability perspective. First, we need to restore confidence as we have a paradox that there is a large number of high quality assets which investors are currently treating as if they were not creditworthy. Now, it seems to me that the one important reason why we observe such a lack of confidence is because we do not have sufficient transparency. This is an area that we need to look at very carefully, to see which measures should be taken to improve transparency. Let me remind you that after the Asian crisis we drew that conclusion: the absence of sufficient transparency had driven a number of investors and market participants to consider that each particular issuer in Asia was to be treated with great caution and fear, because they were not sure of the accuracy of the information and data which were displayed. The international community drew the conclusion that it was necessary to increase transparency in particular as regards monetary policy, fiscal policy and the level of reserve assets in these emerging markets. And it worked, in my opinion, pretty efficiently. So again, it is a lesson that we learnt in the past.

I am now at your disposal for questions.