John Hurley: The economic and financial environment in the Euro area

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the 6th Finance Dublin Securitisation Conference, Dublin, 27 November 2007.

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Introduction

I would like to begin by thanking the organisers of this conference for the invitation to speak to you today. I can see from the programme that the conference is dealing with many of the pressing issues facing financial markets at present and I very much welcome the opportunity to talk to market participants at this time.

As you are well aware, developments in financial markets have been the centre of attention over the past few months and I will begin today by reviewing what has been happening in markets recently, and go on to look at the broader global situation as well as the impact in this country. I will also talk about how central banks and, in particular, the Eurosystem has responded and is responding to these developments. Finally, I will conclude by saying a little about the current economic situation in the euro area and the monetary policy stance.

Recent developments

After a long period during which financial market conditions were extremely buoyant, global markets have experienced considerable volatility in recent months. This follows a prolonged period when, in many parts of the world, asset prices were driven to excessive levels and with undue attention being paid to risk. The unwinding of these excesses has contributed significantly to the recent increased turbulence in financial markets.

The events of recent months are well known and, at this stage, do not require lengthy recall. The catalyst for the sharp move from risk-taking towards deleveraging over the Summer was triggered by escalating concerns about the state of the US subprime mortgage market. While, a priori, the expectation was that these problems would be confined to that market segment, trouble spread rapidly. Significant disruption occurred in the asset-backed commercial paper (ABCP) market and, in turn, moved relatively quickly to the unsecured interbank money market, as concerns escalated about counterparty credit risks. At this point, which was reached in early August, the broad financial system became affected by the turbulence and a wide range of markets were characterised by a significant lack of liquidity and heightened market volatility.

The depth and breadth of the recent turbulence reflects vulnerabilities which have been uncovered about the way risks have come to be assessed, valued and distributed in today's markets. Once unmasked, these vulnerabilities appear to have combined in unforeseen ways to trigger a very severe episode of deleveraging and reintermediation. While the intensity of the problems across various markets has ebbed and flowed since August, it is clear that this process is still very much ongoing and is likely to persist, at least into the early part of 2008. Recent developments in financial markets, such as the temporary closure of the covered bond market, point to a further tightening in liquidity and reinforce the view that there is still some way to go before we see a return to more normal market conditions. Uncertainty is likely to remain high and confidence will only return to markets when the impact on larger institutions and, indeed, their responses, becomes clearer. Until we reach that point markets may continue to remain fragile and vulnerable to bad news.

Money market problems and central bank responses

I would like to turn now and talk about how central banks have reacted to these developments and what impact this has had. Within their sphere of influence, central banks, in general, responded in an unprecedented manner to counteract disorderly conditions in money markets. In particular, the ECB, along with other major central banks moved quickly to meet the increased liquidity needs of the banking system and liquidity management policies since August have been very much focused on, first, restoring, and, then, maintaining calm in money markets.

The ECB has been particularly active since the outbreak of turbulence and has used the full range of operational instruments at its disposal. It has added extra liquidity through special overnight and longer-term refinancing operations, as well as through more sizeable injections of liquidity in its main refinancing operations. There have also been changes to the pattern of liquidity provision within the Eurosystem, with significant front-loading of liquidity needs to accommodate the demand of counterparties to fulfil reserve requirements early in the maintenance period, and changes to the maturity composition, with much larger weight for 3-month refinancing operations relative to 1-week refinancing operations. I would emphasise that these operations were all conducted within the existing operational framework.

In participating in Eurosystem liquidity operations, market participants have been able to use a very wide range of collateral to access funding. Earlier changes to the collateral framework in particular, have helped in supplying the liquidity needs of the euro markets in a timely fashion. This has added significantly to the flexibility of the Eurosystem's operational framework in managing liquidity in the euro area money market in turbulent conditions.

The actions undertaken in recent months have alleviated problems at the very short-end of the interbank market, although spreads between longer-term rates and policy rates remain relatively high. This is partly a reflection of increased uncertainty about the size and distribution of exposures and losses arising from the developments in credit markets. In addition, another influence has been uncertainty on the part of the banks internationally about the likely calls on their own liquidity, which has created a strong preference on their part to retain liquidity and to avoid lending beyond the very short-term.

To try and further calm this segment of the money market, in recent weeks, the ECB signalled that it will rollover the two outstanding supplementary long-term refinancing operations and, last Friday, stated that, at least until after the end of the year, it will reinforce its policy of allocating more liquidity than the benchmark amount in the main refinancing operations. These actions should help considerably to reduce concerns about end-year factors.

In summary, although overall money market liquidity is adequate, the circulation of this liquidity has been disrupted. Activity in the interbank market remains well below normal and is likely to revert to previous levels only when a greater degree of confidence returns to the markets.

Rationale for responding

Given the scale of central banks' responses, it is legitimate to ask about the philosophy underlying these interventions by the Eurosystem. I would emphasise that this was not targeted liquidity assistance aimed at specific institutions. Rather, it was a series of money market stabilisation operations aimed at reducing undesired volatility in short-term interest rates around a given level of official interest rates. I would emphasise that there is a clear distinction between these type of money market operations and monetary policy decisions.

Failure to respond to the interbank liquidity impact of the wider financial market turbulence would have added a serious additional dimension to the problem. For example, financially sound institutions could have found themselves in need of emergency funding simply because they could not access sufficient funds. Not to respond would have impacted on the entire banking system, most of which had little or no involvement in structured credit markets. Irish banks are a case in point.

It is important for me to state again in this forum that the liquidity management operations carried out by the Eurosystem were aimed at reducing the volatility of short-term interest rates around a given level of official interest rates. I would also emphasise that the actions undertaken were not in any way motivated by an attempt to mitigate losses for those who had taken excessive credit market risks. Rather, the substantial injections of liquidity by central banks were intended to contribute to stability in the interbank market at a time of significant strain.

The situation in Ireland

In the recent Financial Stability Report of the Central Bank and Financial Services Authority of Ireland, we have concluded that while the risks to financial stability have increased since last year, the stability and health of the banking system here remain robust when assessed by the usual indicators of financial health such as asset quality, profitability, solvency, liquidity and credit ratings. However, like their international peers, Irish banks have been operating in an environment where liquidity is not as readily available as heretofore. In addition, notwithstanding the fact that the larger institutions have diversified their businesses outside the Irish economy, the banking sector is operating in an economy where growth will be slower by comparison with recent years. Investor sentiment towards the banking sector globally has been negative in recent times and Irish banks have not been immune from this.

However, the current situation and outlook for Irish banks, based on an assessment of developments so far, is positive. Firstly, the sector's shock absorption capacity has been largely unaffected by the turbulence in international financial markets. A survey of the exposures of Irish banks published in the Financial Stability Report shows that the domestic banking system has no significant direct exposures to US sub prime mortgages and essentially negligible exposures through investments and through links with other financial companies or special purpose vehicles. In addition, the exposure of domestic institutions to hedge funds and private equity is very low by international standards. Secondly, given the extent of the disruption to normal market functioning internationally in recent months, it is inevitable that access to liquidity in the interbank market by Irish banks, like all banks, would be affected. However, the comprehensive liquidity framework within the Eurosystem and the significant volumes of collateral held means that Irish banks are well positioned to access Eurosystem liquidity.

Also, a fuller assessment of the funding patterns of Irish banks indicates that there is a significant medium-term element to much of their funding, as well as a relatively wide range of funding options available to them. Finally, our stress-testing of the banking system and our extensive financial stability analysis indicate that Irish banks are solidly profitable and well-capitalised. In this context, it is worth noting that they have one of the lowest rates of non-performing loans among banks in all EU countries.

I would add that we in the Central Bank, along with our colleagues in the Financial Regulator, have been monitoring our domestic situation very closely. From the detailed information we receive through this process and from the ongoing contact that the Bank and the Regulator have had with credit institutions at various levels, including the highest level, it is clear that they are effectively managing their liquidity in this challenging environment.

Outlook and lessons

As the evolution and duration of the current episode is uncertain, one needs to be careful in drawing firm conclusions at this stage. However, one can make a number of observations.

The elements which came together to generate the recent turbulence involved a weakening of credit discipline, a build-up of leverage, with risks transferred in an opaque way through the global financial system. Added to this was a degree of investor complacency, encouraged by benign economic conditions and a long period of low market volatility, all of which together led investors to focus heavily on return while under-weighting risk. While it was largely predictable that these risks would come back to bite, the problem has been the speed and severity with which they have done so and, the fact that strains have arisen in interbank money markets.

With regard to drawing any conclusions, I have indicated in other fora that there needs to be a careful and balanced assessment made of the lessons to be learned from recent events. While matters in relation to the valuation of complex products, transparency and rating agencies all require attention, events since August have also pointed to some issues in relation to the securitised model of capital markets. In particular, the "originate and distribute" model behind securitisation has changed the incentives regarding the management, assessment and monitoring of credit risk and we need to look at the issues this raises. Some features of the securitised model, such as the conjunction of complex instruments and fragile off-balance sheet structures have proved problematic. This underlines the need for greater information and disclosure about where financial risks lie. It also argues for a stronger connection between the location of risk and capital in the system. Addressing these issues could help to create a more robust securitisation model, thereby ensuring that the many important benefits of this model are preserved.

Economic impact

I would like to turn now and talk about how recent events in financial markets may impact on economic developments. The first point to make is that much depends on how market developments and financial conditions evolve from here and for how long the market turbulence continues. For this reason, it is difficult, at this point, to assess the extent to which activity may ultimately be affected. However, recent developments have not been favourable and increase the risk of a more significant spillover from financial markets to broader economic activity.

Looking first at channels of transmission, tighter financial conditions could reduce economic activity in a number of ways: for example, through increased credit spreads and higher term funding rates; through a fall in financial wealth or net worth as a result of the turbulence and, perhaps most importantly, through problems in credit and funding markets impacting on the overall supply of credit.

The recent euro area Bank Lending Survey offers some early evidence on the response of euro area banks to the initial turbulence in credit markets. The results show a net tightening of lending standards which is greatest with respect to loans to enterprises, particularly for the financing of mergers and acquisitions and corporate restructuring. We have also seen signs in euro area retail interest rates of some rise in rates charged for personal consumer loans and also for lending to non-financial corporations.

On the positive side, the resilience of the euro area economy is helped by the fact that it was growing strongly before the recent outbreak of market turbulence. Underlying economic fundamentals remain favourable, with strong employment growth boosting household incomes and corporate balance sheets quite healthy.

Notwithstanding these supports, however, any marked slowdown in US growth would remove some impetus to activity. While US third quarter growth surprised on the upside, the indications for the quarter are not that favourable. The US housing market, which has been at the root of current problems, continues to deteriorate. This has further heightened concerns about the risk of spillovers to US consumer spending, which has been the main engine of growth in the US economy in recent years. There are some signs that this is now beginning to happen and, if this continues, it is difficult to see how overall economic activity in the US will remain unaffected. In the event of a more significant slowdown in the US, the extent to which global economic activity stays decoupled from US developments remains to be seen. The likelihood must be that it could not remain immune from such developments.

More generally, as is the case for the rest of the global economy, the broad repricing of risk and tightening of financial conditions has tilted the balance of risks to euro area growth to the downside. The Governing Council has made it clear that it is determined to ensure that inflation expectations remain firmly anchored. Looking ahead, the Governing Council has signalled that there is a need to gather additional information and assess new data, including the new projections due in early December, before drawing further conclusions for monetary policy.

Concluding remarks

I want to conclude by briefly outlining the evolving economic environment in this country. Ireland's economic fundamentals – as evidenced by a good budgetary position, strong employment growth and an adaptable economy – continue to be sound. The Irish economy has performed solidly this year in circumstances where a rebalancing of economic activity is underway. The contribution of the domestic housing sector to economic growth is declining, though the overall construction sector remains strong. In these circumstances, judging by the overall level of growth, employment, output and exports, the economy has performed well in comparison with others in 2007. We expect the economy to grow next year by some 3 per cent. or so, and this in a situation where the rebalancing of economic activity will continue. Such a performance would undoubtedly be a good performance particularly given the background of heightened uncertainty and serious market turbulence.

Finally, with regard to the broader international picture, the outlook is not without risk. It is heavily dependent on how market developments and financial conditions evolve, and how banks, households and firms respond. The performance to date of the core financial system in the euro area, and here at home, has been encouraging. The euro area operational framework has worked well and, as I have stated, continues to respond flexibly to the evolving situation. However, uncertainty remains high and it is likely to be some time yet before a broad measure of confidence returns to markets.