Lucas Papademos: Opening address at the Fifth ECB Central Banking Conference

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the Fifth ECB Central Banking Conference "The Euro at Ten: Lessons and Challenges", Frankfurt am Main, 13 November 2008.

*   *   *

I. Introduction

On behalf of the Executive Board, I would like to welcome you to the Fifth ECB Central Banking Conference, taking place in the tenth year of the ECB's establishment. We are delighted that this year's conference has attracted many distinguished participants from academia, central banks, governments, international institutions and the financial sector. Your contributions will ensure that this conference will provide insightful and thought-provoking analysis and generate debate on many policy issues of relevance to central banking.

As we will be celebrating the 10th anniversary of the introduction of the single European currency in a few weeks' time, the theme of this conference is, of course, focused on *"The Euro at ten: lessons and challenges"*. The introduction of the euro was a historic milestone in the process of European monetary, economic and political integration, with wide-ranging implications for the European and global economies. Accordingly, this conference will concentrate on several issues of relevance to the performance of the euro area economy and financial system and on the challenges for the conduct of monetary policy and the performance of other central banking tasks in an increasingly integrated global economy.

II. The euro: economic performance and policy challenges

The first session will examine the macroeconomic performance of Economic and Monetary Union, its achievements and challenges, over the past ten years. There are several key questions to be addressed. First, has the euro and the single monetary policy established a zone of monetary stability as envisaged, with all the direct and indirect benefits this entails for the 320 million citizens of the euro area? The evidence unambiguously provides a positive answer. The euro has been a resounding success: it has established itself as a stable and credible currency, which has become the second most important currency in the world after the US dollar. A deeper analysis, however, should reveal the contribution of monetary policy, and of other factors, to this achievement and the challenges that lie ahead and must be effectively addressed in order to ensure the preservation of price stability in the years to come.

A second key question is whether – or to what extent – the euro has contributed to boosting the trend growth of the euro area economy by strengthening competition, enhancing market efficiency, raising productivity growth and increasing labour utilisation. The answer to this question if less straightforward and the evidence seems, at first sight, to be rather mixed. On the one hand, average annual economic growth in the euro area has remained virtually the same (2.18%) over the ten years following the introduction of the euro (1999-2007) as in the two preceding decades (2.14% (1990-1999) and 2.27% (1980-1989)). On the other hand, employment grew impressively, namely by 18.67 million, or 1.36% per annum, over the past ten years, compared with 5.99 million, or 0.49% per annum, in the previous decade. A deeper analysis could reveal how the euro has contributed to strengthening the performance of the real economy, but also how other factors constrained and partly offset its positive impact, and it will also point to important challenges ahead, parts of which stem from the divergences in the performance in terms of growth and competitiveness across the member countries in the euro area. We are looking forward to the paper by Wyplosz and Mongelli, and to the discussion that will follow, for answers to these and other relevant questions.

Another important set of issues, which will be addressed in the second session, concerns the role of the euro in fostering the integration of financial markets in Europe and in promoting the efficiency and stability of the European financial system – and through it – of the broader economy in the euro area. Assessing the impact of the euro on the integration, efficiency and stability of the European financial system requires careful analysis in order to disentangle its contribution from the influence of other factors that have simultaneously affected the development and functioning of the financial system.

Indeed, the globalisation of financial markets and institutions, which was fostered by financial innovation and technological advances, has played a key role in shaping the overall environment and influencing the processes that determine financial market efficiency and stability. Moreover, the increasing interconnectedness and interdependence of our economies and financial systems have important implications both for the conduct of monetary policy and for the performance of the central banking task of safeguarding financial stability. These implications – and there are many – will be examined and assessed in the third session on the basis of the paper by Kashyap, Rajan and Stein and in the concluding policy panel. And, in between, two other panels will address – from both an analytic and a policy point of view – other important challenges confronting the euro area, in particular those stemming from its future enlargement and its evolution towards an optimal currency area.

III. The ongoing financial crisis: lessons and challenges for central banks

Over the past ten years, the ECB has performed its tasks in an often difficult economic and financial environment that was adversely affected by sizeable and persistent shocks; and it has had to face some extraordinary challenges. The first was the unique, historically unprecedented challenge of conducting the single monetary policy successfully so as to preserve price stability in a newly established monetary union of politically independent, though economically well-integrated, member countries. The other major and exceptional challenge is the one we are still facing today: the preservation of price stability and the safeguarding of financial stability in the euro area during the worst financial crisis in decades.

The ongoing financial crisis which is, in many respects, unprecedented in intensity, scope and complexity has highlighted the role of the ECB in safeguarding financial stability. The events of the past year allow us to draw a number of conclusions concerning the responsibilities and actions of central banks in general, and of the ECB in particular, in contributing to preserving price stability through both crisis management and crisis prevention. And they have also shown how the conduct of a monetary policy aimed at the preservation of price stability and the performance of tasks aimed at safeguarding financial stability require the appropriate use of available policy instruments. Let me briefly elaborate on a number of pertinent lessons learnt and on the challenges to be faced.

It is by now widely accepted that a main underlying cause of the current global financial crisis was the same one that had fuelled similar episodes in earlier times: the excessive growth of credit globally over a long period of time and the associated high leverage in the financial system and in the non-financial sectors of some countries. Central banks, through their monitoring and analysis of monetary and credit developments, can provide early warning signals about the building-up of financial imbalances that may lead to excesses in the financial markets – through various channels involving an under-pricing of risk and an increase in market liquidity that can fuel asset price bubbles which will eventually be followed by market corrections. And such corrections will be the more severe, the higher the degree of leverage and the more prolonged the period of excessive credit growth. There is substantial empirical evidence across countries and over different periods in support of this proposition. The ECB's monetary policy strategy, which includes a comprehensive analysis of developments in money and credit, is well-suited to provide useful information about monetary risks to financial stability that can have longer-term implications for price stability and output volatility.

A second related policy issue is whether – or to what extent – central banks should "lean against the wind" of financial market excesses that can be expected to turn into a financial storm and whether they can do this both in a manner that is consistent with the preservation of price stability and by effectively using the single policy instrument at their disposal, the interest rate. In principle, this can be done, and should be done, under certain circumstances. This would require the monetary policy stance to be tightened in periods of booming financial markets, so as to contain the risk of instability to the price level over a longer-term horizon (when the boom could turn into a bust); in other words, in order to buy insurance against the risk of a financial crisis in which financial intermediation could grind to a halt. Such a policy could also help address the problem of moral hazard that may be created by policies that aim only to mitigate the impact of adverse shocks to financial stability, and thus treat asset booms and busts asymmetrically. In practice, however, a policy of "leaning against the wind" is not always feasible; it may by itself not be an effective means to contain unsustainable asset price bubbles in the presence of exuberant expectations and it may not be compatible with the maintenance of price stability over the medium term.[1]

Consequently, the single instrument of monetary policy – the central bank interest rate – cannot always be used, cannot be used systematically, to simultaneously achieve the price stability objective (over the medium and longer term) and effectively safeguard financial stability. Clearly, additional tools must be employed to this end. Central banks can further strengthen their analytical tools and methodologies that can help identify risks and vulnerabilities in the financial system and provide early warning signals of emerging imbalances and potential instabilities. And central banks – via their financial stability reviews and other means – have done so fairly successfully. But the recent experience has also shown that, despite the communication of such early warnings, the financial markets did not hear, or did not *want* to hear them for several reasons, including the influence of inappropriate incentive structures at different stages of the financial intermediation and securitisation chain. What is, therefore, needed is a more effective use of regulatory policy instruments by supervisory authorities that can help contain procyclicality in risk assessment and the increase in leverage that is characteristic of asset market booms. Pre-provisioning measures during the upswing phase of the cycle and more effective and longer-term oriented risk management can contribute to this end.

More generally, and this a third important lesson learnt from the ongoing financial crisis, the effective safeguarding of financial stability – both in preventing and in managing a financial crisis – requires parallel and complementary action by central banks and supervisors, and an enhanced cooperation and exchange of information between them. It is evident that this can be achieved most effectively and efficiently when central banks are responsible for banking supervision, or are actively involved in the performance of supervisory tasks – as well as have access to pertinent information – in collaboration with a separate supervisory authority. However, irrespective of the organisational structure and the institutional responsibility, effectively reducing the likelihood of a recurrence of financial crises affecting markets and institutions requires the fruitful cooperation of the central banks and supervisory functions.

Let me now conclude by briefly pointing to two other important lessons and associated challenges that have been highlighted by the ongoing financial crisis: the first concerns the

---

1 An overvaluation of asset prices can occur – and has occurred – in an environment of relatively stable consumer prices. In such an environment, a significant change in the policy interest rate to contain credit growth and asset price dynamics could be inconsistent with the preservation of consumer price stability over the medium term. An alternative means of containing bank credit expansion by reducing the rate of growth of central bank money – at a given policy interest rate – would effectively entail a rise in market interest rates and could pose similar problems of potential inconsistency.

role and actions of central banks in mitigating the impact of financial turbulence on the financial system and the broader economy; the second is related to the need to strengthen the cross-border financial stability arrangements globally and in Europe.

The recent experience has demonstrated the crucial role of central banks in crisis management through the provision and management of liquidity in the money markets and, in exceptional cases, by providing emergency liquidity assistance to individual institutions. Since the eruption of the market turmoil, central banks in advanced economies have used various policy instruments to limit its effects. The ECB's operations in the money markets have been based on a fundamental principle: the separation of the monetary policy stance from liquidity management. The monetary policy stance is defined by the level of the key ECB interest rates and is determined with a view to achieving the primary objective of preserving price stability over the medium term. Liquidity management aims at ensuring the orderly functioning of money markets and at mitigating financial stability risks.

The provision and management of liquidity by central banks has alleviated pressures in the money markets and has kept spill-over effects on the credit markets and the real economy contained. In particular, the provision of unlimited liquidity by the ECB to the euro area banking system against an expanded list of eligible collateral since mid-October should effectively eliminate concerns about liquidity risk and further reduce pressures in the term money market. Central banks, however, cannot address some of the underlying causes of money market tensions, such as concerns about counterparty credit risk and the continuing uncertainty regarding banks' other funding sources and capital positions. The measures being taken by governments should address these problems over time.

The separation principle that guides the conduct of monetary policy and the management of liquidity during a financial market correction implies that the policy interest rate is not employed to alleviate stresses in the financial system if upside risks to price stability prevail. Only if the preservation of price stability is secured over the medium term, and will not be jeopardised by a change in the monetary policy stance, can the policy interest rate be employed to mitigate the impact of financial market stresses in the economy, including their potential effects on medium-term price developments.

Finally, I would like to stress that the financial crisis has underscored the importance of international cooperation and concerted action in addressing the liquidity needs of cross-border financial institutions and ensuring the efficient distribution of liquidity at a global level. In particular, the Federal Reserve, the ECB and other major central banks cooperated closely and their concerted liquidity provision enhanced the effectiveness of liquidity management globally. There is an emerging consensus on the need to strengthen cooperation between the supervisory authorities responsible for major cross-border institutions and to promote a more convergent and consistent application of regulations. In the European Union, the implementation of measures to improve supervisory cooperation, and to accelerate the convergence of supervisory rules and practices, has gained momentum. And there is a growing understanding of the need to strengthen the pan-European character of financial stability arrangements for crisis prevention and crisis management. Regardless of the institutional framework that may be adopted, what is essential is to ensure the effective cooperation and the sharing of relevant information between central banks and supervisors in a timely and efficient manner.

IV. Concluding remarks

Over the past ten years, the euro has established itself as a stable and credible currency and the single European monetary policy has preserved price stability, and thus the purchasing power of the euro, in the euro area. In addition, the euro has played an important role in insulating euro countries from other adverse effects that the financial crisis could have had on their economies, via the foreign exchange markets and other channels, if the euro had not existed. And some Member States that have not yet adopted the euro as their currency have indeed experienced such effects. Therefore, the euro and the liquidity management of the ECB have also played an important role in safeguarding financial stability in the euro area.

With these thoughts on some lessons that could be learnt from our experience with the euro, from the ongoing financial crisis and from the contribution of the ECB and central banks to the preservation of financial stability, I wish us all a fruitful and enriching conference.

Thank you for your attention.