Gertrude Tumpel-Gugerell: The financial crisis – looking back and the way forward

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the conference "Rien ne va plus? Ways to rebuild the European Social Market Economy", organised by the European Economic and Social Committee and European Trade Union Confederation, Brussels, 22 January 2009.

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Ladies and Gentlemen,[1]

It is a great pleasure for me to speak here in Brussels at the European Economic and Social Committee conference. I would like to thank the organisers for their invitation and the opportunity to share with you some remarks on the current developments in financial markets and the response of the public authorities.

We are facing a severe financial crisis. While the full economic consequences are still unknown, the declining pace of economic activity in the second half of 2008 and data from the labour market show that the real economy in the euro area as well as abroad is deeply affected.

In the middle of this stormy and challenging situation there is still reason to be confident. The euro is now 10 years old. And it has shown to be a great success! Since its introduction on 1 January 1999, the common currency has succeeded in maintaining price stability in the euro area. And most recently, it also had the chance to prove itself as a strong anchor, able to weather even the severe financial turbulence that we are experiencing. For example, by joining the euro area, its member countries eliminated the risk of exchange rate volatility between each other. And the stability of the euro area in this crisis seems to have attracted more support for euro area membership in European countries that have not adopted the euro yet. Even if the current situation is far from benign, I believe it would have been more difficult without the euro.

But let me now take a closer look at the developments in financial markets over the last months. I will then turn to the various ways in which we have addressed the challenges arising from the crisis. Before I conclude, I will also explain to you what I think needs to be done in the coming months.

1. Developments in financial markets

The combined strength of the various shocks which have affected the global financial system since the outbreak of the financial turmoil in the summer of 2007 has been broadly unexpected. However, the crisis as such cannot be regarded as a complete surprise. It did not build up overnight but instead has developed gradually over several years.

But what factors lie behind the current turmoil? The pre-crisis global macroeconomic environment was characterised by low interest rates, low inflation and sustained economic growth. This strengthened investors' risk appetite and contributed to the underestimation and under-pricing of risk. The intensified search for yield fostered the proliferation of innovative financial instruments such as structured finance products. Rising leverage and excessive credit growth increased the vulnerability of the financial system.

[1] I am very grateful to Kevin Koerner and Stephan Sauer for their valuable input.

This fragility set the stage for the turbulence in financial markets which started in summer 2007. With the end of the boom in the US housing market and increasing interest rates on sub-prime mortgages, delinquency rates on mortgage loans rose. The value of mortgage-backed securities dropped heavily. From the sub-prime market segment, the tensions gradually spilled over to most other asset markets, in particular the credit derivatives markets, corporate bond and equity markets, and also to the money markets, not only in the US but also in the euro area and elsewhere. With the bankruptcy of Lehman Brothers on 15 September 2008, the crisis sharply intensified.

Let me now illustrate the developments in financial markets since the beginning of the turbulence with the help of some charts.

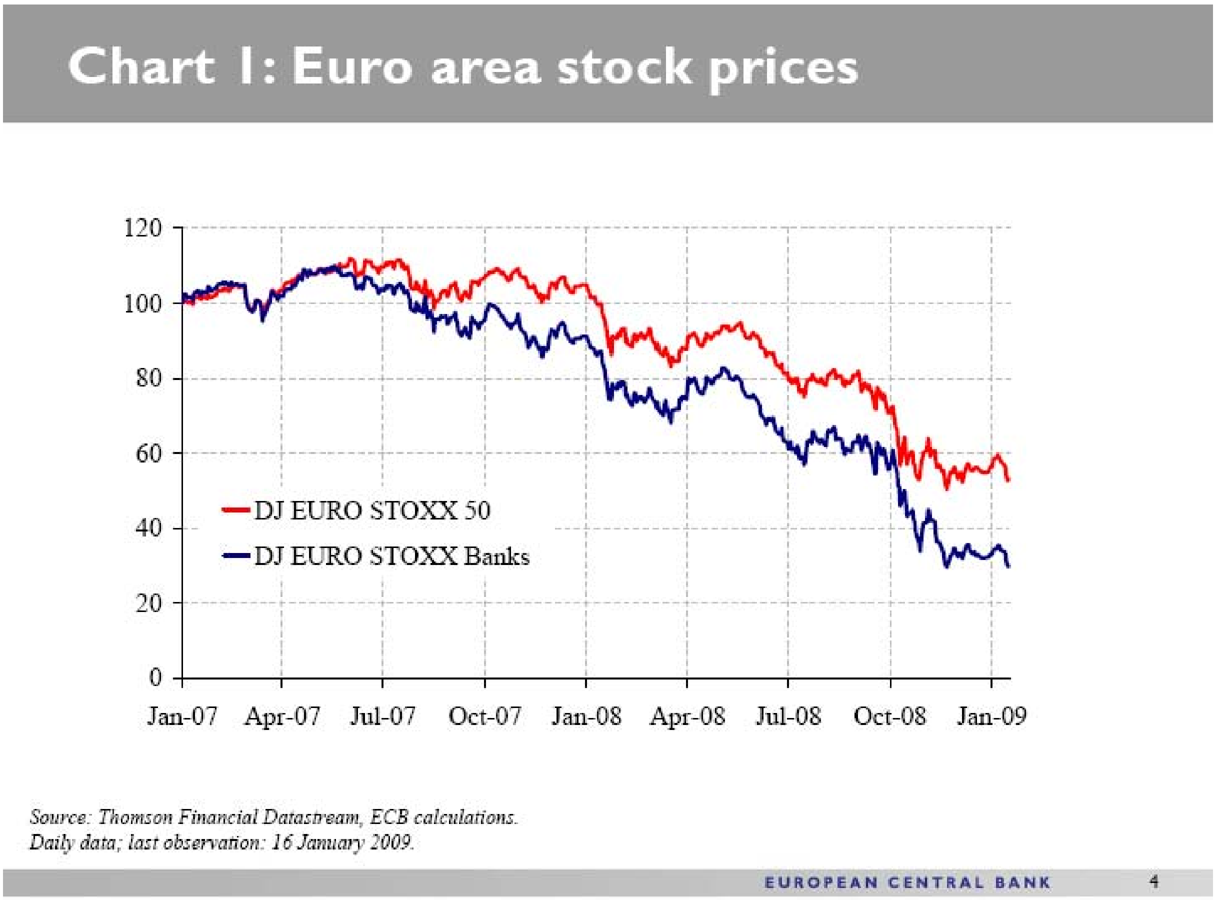

Chart 1 shows the recent movements in euro area stock prices, represented by the Dow Jones Euro Stoxx index. From 15 September 2008 until mid-January 2009, this broad index declined dramatically, losing about 30% of its value. Since July 2008, the index has declined even more, by about 50%. As you can see from the chart, the most severe stock market losses occurred in the banking sector, with a decline of about 50% since mid-September 2008 and about 70% since summer 2007.

Chart 2: Implied stock market volatility

Source: Bloomberg.
Daily data; last observation: 16 January 2009; implied volatilities from stock options on DJ EURO STOXX 50.

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Chart 2 illustrates the exceptionally high level of uncertainty in stock markets, here measured by implied volatility taken from stock options on the Dow Jones Euro Stoxx 50 index. In autumn 2008, implied volatility skyrocketed to new historical highs not only in the euro area but across the globe.

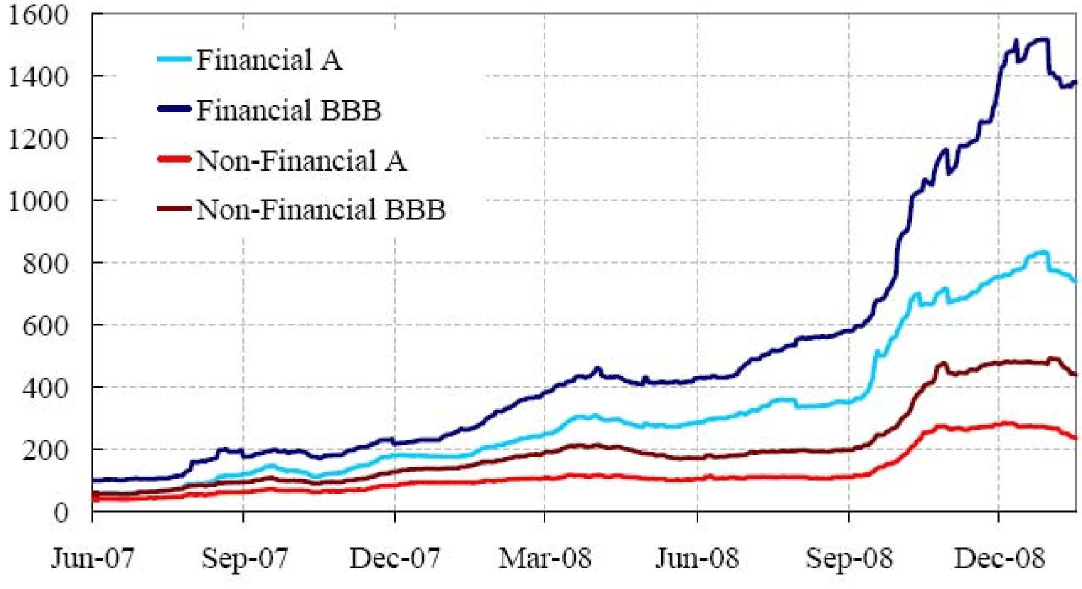
At the heart of the crisis has been a general deterioration of confidence in the health of the banking sector and worries about a weakening economic outlook. This has led to a gradual and global repricing of credit risk.

As shown in **Chart 3**, the yield spread between corporate bonds and government bonds has widened markedly. In particular, lower-grade financial firms have been affected mainly on account of increased credit risk perceptions and a much lower general risk appetite.

Perhaps the most striking indicator of the various stages in the current crisis is the spread between the three-month Euribor, an indicative rate for unsecured lending among banks, and the three-month euro overnight index average (Eonia) swap rate **(Chart 4)**. A strong increase of the spread in summer 2007 and in September 2008 reflects the reluctance of banks to lend to each other, closely related to a general lack of transparency about the risks individual banks have been carrying on their books.

In aggregate terms, credit market-related writedowns of financial institutions amounted worldwide to USD 780 billion in mid-January 2009. For the euro area, losses of USD 134 billion have been realised. These writedowns and declining bank profits have likely contributed to a slowdown in banks' loan supply to the non-financial sector. And the profitability of financial institutions might face further downside risks in the months and quarters ahead. The risks arise from excessive investments in particular in the credit derivatives markets and, most recently, from a dramatic weakening in economic activity, as indicated by the latest survey data for November and December 2008. All this is part of our recent assessment of the outlook for economic growth in the euro area.

Chart 3: Corporate bond yield spreads



Source: Thomson Financial Datastream, ECB calculations.
Daily data; last observation: 16 January 2009.

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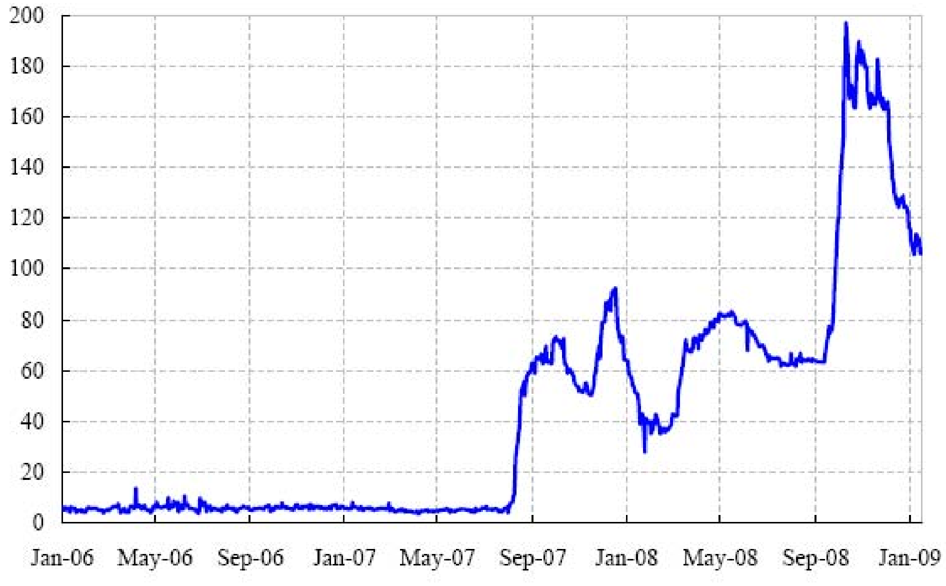
Chart 4: 3-month Euribor/OIS spread



Source: Reuters, ECB calculations.
Daily data; last observation: 16 January 2009.

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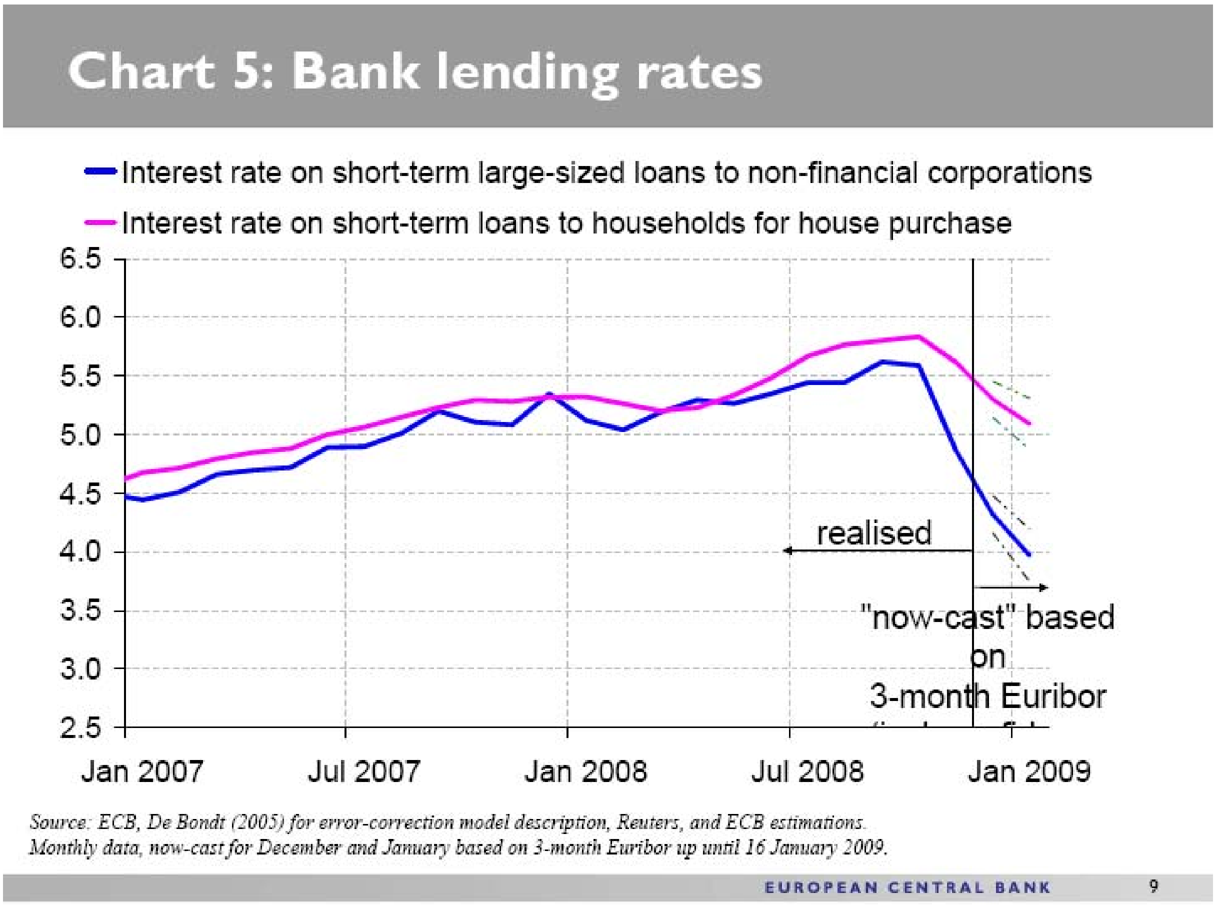
2. Response of the public authorities

How have the public authorities and in particular the Eurosystem reacted to these developments? The Eurosystem has shown a remarkable flexibility in terms of liquidity provision since the start of the crisis in summer 2007. This flexibility was necessary in order to compensate for the shortage of liquidity in the interbank market,, which is very important for the transmission channel of monetary policy. Thereby, our liquidity operations have contributed to avoiding further increases in the funding costs of banks and their customers.

In October 2008, markets entered a downward spiral in which even sound banks were threatened by the possibility of illiquidity which could quickly turn into insolvency. The common European action plan agreed to by the EU and national authorities in October showed the ability of European and national authorities to live up to their responsibilities and to act in a swift and concerted manner. The ECB contributed to the European action plan through a further widening of its liquidity operations as well as by issuing recommendations on recapitalisations and on the pricing of government guarantees. The ECB has swiftly and substantially cut the main refinancing rate – four times since October – by a total of 225 basis points against diminishing inflationary pressures and downward risks to the real economy.

I think the liquidity policy, government measures and interest rate decisions that have been taken were decisive in breaking the downward spiral in the financial sector in October. The first signs of positive effects are visible: spreads in the interbank market have come down from their peaks in October and November last year, although they still stand at historically high levels.



In particular, as **Chart 5** shows, banks have begun to pass on the ECB's interest rate cuts to bank lending rates to non-financial corporations and households. At the same time, the growth rate in the volume of loans to the private sector has fallen. We are aware that the crisis is far from over, we are aware that the effects on the real economy have only started to be felt and we also are aware that there are substantial differences between euro area countries.

Let me also explain why the public authorities have acted the way they did. First of all, rescuing the banking sector is no end in itself. The banking sector is of systemic importance for the whole economy. A breakdown of financial intermediation would severely damage all other sectors in the economy. Historical evidence shows that banking crises can have seriously negative effects on GDP. In Europe, we experienced such effects in Finland and Sweden in the early 1990s.[2]

Hence, we need a financial system that can finance investment, innovation and ideas. All measures taken aim at supporting trust in the financial system and preventing constraints on credit supply.

Nevertheless, I think it is also important to emphasise that there are limits to what policy-makers can achieve. As unsustainable developments in certain market segments and geographical regions have partly caused the crisis, adjustments have been necessary. Monetary and fiscal policies are needed to smoothen out the adjustment process and to prevent negative overshooting. At the same time it is important to maintain the confidence of the public in the long-run sustainability of public finances.

3. The way forward

At the same time, the private sector and public authorities are not helplessly exposed to the forces that caused the crisis. Various initiatives at national, European and international level aim to improve the financial system.

Of these initiatives, I would like to highlight three areas where I think change is particularly needed because they were primary causes of the current financial crisis: first, the internal risk management systems of financial institutions and compensation frameworks in general need to be aligned with requirements for sustainable development. Private sector entities can shape the rules mainly within their own organisations to avoid short-termism. Second, transparency in all respects is necessary in order to make informed investment decisions. For example, the ECB welcomes the initiatives to create central counterparties for credit default swaps and expects to see concrete results. Third, although business cycles are a common characteristic of market economies, public authorities should shape the economic order in ways that limit the probability and extent of future crises.

In this context, regulatory and supervisory bodies have to ensure that their regulations and actions do not amplify business cycles. The current review of capital requirements in the financial sector is an important device for making risk measurement and management more effective and comprehensive. Guidance concerning liquidity risk management has already been published. Moreover, a debate on improvements in accounting rules is ongoing. In this respect, fair-value accounting rules should be changed to reduce a tendency to magnify boom-and-bust cycles. Marking-to-market practices provide timely and relevant information on the state of financial firms under normal market conditions. Yet, they may also trigger negative feedback effects when markets are disrupted, as financial institutions may be required to sell assets into falling markets, exacerbating the asset price decline. Furthermore, accounting rules should support banks in building buffers during good times against future losses.

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[2] See Reinhart and Rogoff (2008, 2009) for a comprehensive overview of financial crises and their impact on real GDP.

Responding to the financial crisis by supporting trust in the financial system, by preventing constraints on credit supply and by addressing the shortcomings in the financial system that I have just mentioned – these are our most immediate concerns. At the same time, we must not forget that the long-term prosperity of the European Union does not only depend on a sound financial system. In order to increase Europe's long-term growth potential, to promote the creation of jobs and to increase the resilience of the economy to shocks, the implementation of the Lisbon strategy for growth and jobs remains of key importance. In particular, investments in innovation, education, qualification of the labor force, and competive markets should become the focus of policies again.

4. Conclusion

Let me summarise the main points: we are experiencing a severe financial crisis that has started to show substantial spillover effects to the real economy in the euro area. We have seen that European policy-makers have lived up to their responsibilities and acted in a swift and concerted manner. At the same time, we have to acknowledge that we are going through a phase of necessary adjustment after a period of excessive risk-taking in the global economy. We have developed a number of initiatives at European and international level to improve upon the existing framework. Once again, history has proven Jean Monnet's wisdom when he said: "People only accept change when they are faced with necessity, and only recognise necessity when a crisis is upon them." It is now time to accept change and implement the proposals. The Eurosystem is ready to actively contribute to the implementation of reforms wherever necessary.

Thank you very much for your attention.

References

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