Jean-Claude Trichet: The ECB's response to the crisis

Statement by Mr Jean-Claude Trichet, President of the European Central Bank, at the European American Press Club, Paris, 20 February 2009.

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Ladies and gentlemen,

Please allow me first of all to thank the European American Press Club for organising this event and giving me the opportunity to share with you some thoughts on the financial turbulence. I will describe, in this context, the steps taken by the European Central Bank.

I had the pleasure of addressing you in January 2005, when I talked about the euro's successes and challenges. Four new countries have since joined the euro area, with the result that 329 million citizens now share the same currency.

The financial turbulence intensified significantly in September of last year and has quickly spread from the financial sector to the real economy. In sharing my thoughts on this subject, I will talk about the role of the operational framework of the Eurosystem, which comprises the European Central Bank and the national central banks of the euro area. I will describe the measures implemented by the European Central Bank in response to this difficult and unprecedented situation, and I will stress the role played by cooperation between central banks at the international level.

The current turbulence poses a serious challenge to the financial system as a whole and to economic policy-makers and regulatory authorities around the world. Since August 2007 central bankers have sought to address the increased volatility and risk in financial markets. This environment deteriorated considerably in September and October of last year, when several market sectors effectively closed and a systemically important financial institution went bankrupt.

The primary objective of the European Central Bank is to maintain price stability (defined as price increases below, but close to, 2%) over the medium term. Achieving this objective involves more than just establishing our monetary policy stance and setting key interest rates. Under our operational framework, we also implement our monetary policy by conducting open market operations with a view to steering short-term interest rates in the interbank money market.

Since the financial market turbulence began in August 2007, the Eurosystem's open market operations have, in addition to steering short-term interest rates, also sought to ensure that solvent banks have continued access to liquidity. Our endeavours in this area have focused on helping to alleviate the tensions hampering the functioning of the money market.

The Eurosystem's "intermediation role" has grown significantly over the last five months. We are now providing – and this is quite exceptional – unlimited refinancing to the banks of the euro area for maturities ranging from one week to six months in exchange for eligible collateral. This measure was necessary in order to counter the increased tensions observed for the shortest maturities in the money market, where a sharp steepening of the yield curve had been observed for unsecured loans. For instance, the spread between the unsecured three-month EURIBOR and the rate on overnight index swaps, which is normally extremely small at around 4-5 basis points, reached a historic 186 basis points in October 2008.

I would now like to describe in detail the means by which the ECB's monetary policy has been implemented during the period of financial market turbulence, as such aspects are of considerable importance in the context of the current crisis.

The role of the Eurosystem's operational framework during the period of financial market turbulence

There is no doubt at all that the current turbulence represents the biggest challenge that the Eurosystem's operational framework has had to face since it was established more than ten years ago. Recent experience has shown that certain structural characteristics of our framework have played a decisive role in the stabilisation of short-term money market rates, thereby contributing to financial stability.

- First, the fact that a large number of counterparties – hundreds of banks throughout the euro area – are eligible for the Eurosystem's refinancing operations and marginal lending facility allows liquidity to be provided to the wide range of banks that need it where the money market fails to function correctly.
- Second, the very large volume of our refinancing operations has allowed the Eurosystem to provide refinancing to eligible counterparties which no longer have normal access to the interbank money market. At the same time, the Eurosystem has continued to steer liquidity in an appropriate manner in the course of reserve maintenance periods.
- Third, the fact that, since the creation of the euro, a wide variety of assets have been accepted as eligible collateral in refinancing operations has allowed banks to obtain refinancing against those assets through the Eurosystem.
- Fourth, the Eurosystem's operational framework has, since the creation of the euro, allowed financing to be provided to banks for several months (three months), which is not generally the case for other central banks.

The European Central Bank's response to the financial crisis

I will now look in greater detail at the various ways in which the European Central Bank has responded to the financial crisis, the rationale underlying those actions and the effects of those measures. I will focus on the means by which the ECB's monetary policy has been implemented, which are of vital importance in the light of the current crisis.

The first phase of the turbulence

During the first phase of the financial market turbulence, which ran from August 2007 to mid-September 2008 and was characterised by a systemic shortage of liquidity, the ECB modified the technical procedures used for the supply of liquidity in normal times, using all of the room for manoeuvre provided by its operational framework for the implementation of monetary policy.

- First, the Eurosystem adjusted the *distribution of liquidity* over the reserve maintenance period, providing liquidity earlier than in normal times. Thus, at the beginning of the reserve maintenance period we systematically allotted *liquidity in excess of the theoretical benchmark amount* in our main refinancing operations, while still aiming for balanced liquidity conditions at the end of the maintenance period. The total amount of liquidity provided in the course of the maintenance period thereby remained unchanged. These measures sought to take account of the changing profile of banks' demand for liquidity.
- Second, the Eurosystem also provided the banking system with liquidity through open market procedures, which had rarely been used – if at all – prior to the turbulence. Particularly in response to banks' increased demand for longer-term financing, the Eurosystem extended very significantly the average maturity of its lending to euro area banks. Consequently, with a view to leaving the total amount of

outstanding refinancing unchanged, the amount of liquidity provided through one-week main refinancing operations was reduced accordingly.

- It is also important to note that international cooperation between central banks was strengthened at a very early stage through increased exchanges of information and the collective monitoring of market developments, and then, in mid-December 2007, through concerted measures in the implementation of monetary policy (which for the ECB meant providing euro area banks with liquidity in US dollars). In the past, cooperation between central banks had traditionally concerned the area of exchange rate policy.

These measures allowed the Eurosystem to manage the tensions observed in short-term interest rates, as well as having a positive effect on conditions in longer-term markets.

The second phase of the turbulence

However, in mid-September 2008 concerns regarding credit risk increased significantly, tensions immediately spread from the United States to the euro area and the money market more or less stopped functioning. At that point, the Eurosystem intensified its actions with a view to allowing solvent banks to carry out their activities. As a result, a number of unprecedented additional steps were taken.

- Thus, in mid-October the ECB took the quite exceptional step of adopting a *fixed rate tender procedure with full allotment* for all of its weekly main refinancing operations and its longer-term refinancing operations with maturities of up to six months. This will remain in place for as long as is necessary given the situation in the markets.
- It also increased the *number and frequency* of longer-term refinancing operations, conducting three additional refinancing operations per month – two with a maturity of three months and one with a maturity of six months – and introducing a special-term refinancing operation with a maturity corresponding to the duration of the reserve maintenance period.
- In parallel, the ECB implemented a new series of exceptional measures seeking to *temporarily extend the list of assets* eligible for use as collateral in Eurosystem credit operations.
- Finally, the ECB increased the *US dollar financing* provided to its counterparties by conducting *fixed rate tender procedures with full allotment* and maturities ranging from one week to three months through swap agreements concluded with the US Federal Reserve System.

These measures, which reflect the very significant strengthening of the Eurosystem's intermediation role during this period of turbulence, have allowed solvent banks continued access to liquidity despite the dysfunctional nature of the money market. They have also helped to alleviate the tensions observed in certain sectors of the money market. For example, the spread between unsecured longer-term EURIBOR rates and the rates on overnight index swaps has declined considerably – although it remains elevated, significantly higher than the levels observed prior to September 2008.

In practice, these measures allow euro area banks to obtain as much euro liquidity as they wish, whether through our weekly operations or our longer-term refinancing operations, using a wide range of assets as collateral. In total, the Eurosystem's balance sheet rose by about EUR 600 billion since end-June 2007 and today, an increase of about 65%; with the assets reflecting the strong increase in the volume of liquidity provided and the liabilities reflecting banks' concomitant recourse to the deposit facility. These measures have proved effective in overcoming the liquidity shortage in the interbank market. However, they cannot eliminate the increased concerns regarding credit risk. In this regard, the conditions in the money market have not yet normalised and remain strongly affected by an elevated degree of risk aversion.

The increase in the Eurosystem's intermediation role has proved necessary in response to the current dysfunctional nature of the money market, but this cannot – and must not – be regarded as anything other than a temporary measure. The Eurosystem wishes, of course, to see a return to interbank lending and traditional intermediation activity by banks. The ECB's recent decision to return to 200 basis points the corridor formed by the interest rates on the standing facilities either side of the rate on the main refinancing operations aims to stimulate interbank activity. In this respect, we are observing a reduction in banks' demand for refinancing in our open market operations and a correlated decline in recourse to the deposit facility. In parallel, we are witnessing an increase in the volumes underlying the calculation of the EONIA.

Cooperation between central banks

Faced with the development of the financial market turbulence, central banks have already taken numerous steps to counter systemic liquidity risk, demonstrating their determination in this regard on numerous occasions.

Since December 2007, the ECB, thanks to a swap agreement with the US Federal Reserve System, has been providing euro area banks with liquidity in US dollars in exchange for eligible collateral.

This exceptional measure seeks to alleviate the tensions observed in short-term funding markets. Since the launch of these operations, the range of maturities covered has grown and the amounts allotted have increased, with financing being allotted by an increasing number of central banks. As regards the Eurosystem, the framework for this facility was extended in October of last year when the ECB decided, in agreement with other central banks, to offer financing in US dollars at various maturities by means of fixed rate tender procedures with full allotment. Since October 2008 the ECB has also provided euro area banks with liquidity in Swiss francs through a swap agreement concluded with the Swiss National Bank.

The financial turbulence has shown that, by stimulating confidence, particularly in periods of considerable uncertainty, cooperation between central banks in various areas can prove an effective response to both national and global challenges.

Conclusion

Ladies and gentlemen, I would like in conclusion to say a few words about a most important question, I mean confidence. The intensification of the financial crisis, which occurred last September, was triggered by an abrupt loss of confidence striking simultaneously the financial system as well as the real economy, the industrialised countries as well as the emerging economies.

Improving confidence is one of the necessary conditions to overcome the present woes. The European Central Bank and its Governing Council do everything which is possible to preserve, enhance, strengthen confidence. More than ever our institution has to be an anchor of stability, therefore an anchor of confidence, in these uncharted and turbulent waters. The euro area and our 329 million fellow citizens can count on the ECB and the Eurosystem to take the necessary decisions whilst having always in mind monetary and financial stability as an aim in the medium and long term.

Thank you for your attention.