Jean-Claude Trichet: Restoring confidence in the global financial system

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the annual meeting of the Research Institute of Japan, Tokyo, 17 April 2009.

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Ladies and Gentlemen,

I am honoured to be invited to address the Naigai Josei Chousa Kai.

Today I would like to share with you my views on the roots of the current financial crisis, and the policy responses which aim to address it and to inspire a new sense of direction. The G-20, at its meeting a fortnight ago, sent a strong signal of reform that can provide the basis for a more resilient and stable global economy, in the period to come. Swift implementation of this important agenda will be key.

I will explain the ECB's response to the financial crisis. I will also note, *en passant*, how our policy compares with those of other major central banks. In my view, differences in crisis management approaches between major central banks reflect differences in economic structures rather than conflicting views on fundamental principles. The ECB's guiding principles are very simple and very clear. In the medium term, the ECB's policy is geared towards preserving price stability in line with our objective and in so doing, creating the conditions for enduring financial stability. This policy is essential to revive a resource that has become much too scarce over recent months: confidence in the future.

Financial excesses – at the root of the financial crisis

In the last ten years finance has seen a dramatic shift of focus away from facilitating trade and real investment to unfettered speculation and financial gambling. The assumption and hedging of genuine *economic risk* – the risk that companies face when engaged in product and process innovation – gradually ceased to be the main concern of international finance. Over time, the creation and assumption of *financial risk* became the core activity of the financial industry. This is the risk posed by arbitrage and deliberate exposure to asset price changes. It reached a point where it seemed that the financial system no longer existed primarily to hedge existing economic risks, but, increasingly, to create and propagate new risks on its own.

In the past two decades financial innovation and liberalisation have made important contributions to the overall productivity of our economies. But, as the demand for finance increased throughout the 1990s, intermediaries had growing incentives to develop innovative funding techniques. The securitisation of assets, for example – the transformation of bilateral loans into tradable credit instruments – had tremendous ability to facilitate the diversification and efficient management of risk. As such, it was a powerful and useful tool.

But securitisation also meant that banks and non-banks were able to sell loans – or place them off-balance sheet – immediately after they had been extended. This alchemy enabled lenders to expand the volume of their operations and conserve on capital. Fatally, the same mechanism weakened lenders' incentives for prudent screening and constant monitoring. The resulting decline in underwriting standards and lending oversight was one of the main reasons for the excessive credit growth.

The credit boom was exacerbated by three factors. First, ill-designed compensation schemes for loan managers reinforced the shortening of lenders' horizons. In the eyes of many loan managers, the short-run gains from an expansion of credit outweighed the need to consider the potential losses that their institutions could incur over the longer term.

Second, the complex structures of securitised products made it difficult for holders to assess the quality of the underlying investments. This perpetuated the boom, as it took time for investors to discover and assess the underlying risks.

Third, international macroeconomic imbalances reflected a chronic shortage of savings in some of the world's advanced economies, made possible by a glut of savings in other parts of the world. These imbalances resulted from unbalanced international macroeconomic policies pursuing an inconsistent set of goals. These imbalances also contributed to the augmentation of global liquidity, further fuelling credit and debt accumulation. In the period before the start of the crisis, the oil and commodity price boom further fuelled the international savings glut and aggravated major imbalances.

The global response to the financial crisis

The interplay of the forces and the facilitating factors that I have described so far went into reverse in the middle of 2007. This reversal was sudden, but not unexpected. When the asset cycle turned, and many of the missing links in the financial chain were finally exposed, investors lost confidence. After years of high profits and exceptional risk tolerance, markets became extremely discriminating with regard to financial risks. Funding costs for borrowers increased. The spreads on the debt of financial companies – seen as being clogged with assets of dubious value – widened considerably. Uncertainty over the extent of credit write-offs and the future earnings capacity of financial institutions took a heavy toll on the valuation of many revered names.

Central banks around the globe had to spring into action in the summer of 2007 when there were signs of what appeared at the time to be a liquidity crisis. You might remember that the ECB was the first central bank to embark on exceptional decisions as early as 9 August 2007. The collapse of a major, highly interconnected financial player in mid-September 2008 eventually turned a very large-scale financial market's correction into a financial panic. Throughout the difficult months that followed, central banks and governments around the globe took unprecedented and bold steps. These steps were aimed at restoring financial market functioning and the flow of credit, and at ensuring that our banks have the capital and the liquidity necessary to discharge their critical function even in an acute economic downturn.

Before going into detail, allow me to say that the crisis has brought out the best in terms of international cooperation. Leading central banks around the globe, including the Bank of Japan and the ECB, have cooperated intimately to alleviate financing strains in interbank markets. Governor Shirakawa and I had numerous useful exchanges of views on the sidelines of our regular meetings at the G-7, G-20 levels and, more importantly, in the occasion of the global economy meeting of central bank governors which takes place every two months in Basel. In the language of game theory, one could say that major central banks are closely cooperating to deliver the best possible outcome for the global economy.

Similarly, the outcome of the G-20 meeting a fortnight ago has confirmed that governments can agree on a future course for policy that is based on unity of purpose and shared principles of action. Decisive and immediate action is still required. In my view, progress on three fronts will be critical to restore confidence. Two are geared to the medium term; one is geared to the short term.

First, we need a quantum leap in the breadth and authority of international financial supervision and regulation. Any viable and effective solution will necessarily require broadening the focus and overcoming the fragmentation of domestic oversight arrangements. Second, lasting confidence can only be restored if the commitment to near-term fiscal and monetary stimulus is backed by an equally strong and credible commitment to fiscal sustainability and price stability. The importance of this point cannot be overstated. Third, governments need to swiftly implement the far-reaching set of measures, designed to support the financial system. With fellow governors, Governor Shirakawa has convincingly argued that resolute action to put commercial banks in a healthy situation was absolutely indispensable in the experience of Japan at the beginning of the millennium. In the absence of such action, there is a risk that fiscal stimulus packages will simply trickle away, leaving us burdened with the full load of outsized fiscal liabilities and with no prospect of a sustained economic recovery.

How far has Europe advanced on these issues? With regard to financial supervision and regulation, the European Union is currently preparing important decisions along the lines recommended by the De Larosière report. Among other things, this report proposes a new system for macro-prudential supervision in which the General Council of the ECB would play an important role. There was certainly no lack of warnings – from many quarters – before the crisis. But no mechanism or institution existed to ensure that admonitions were followed by decisive and swift action. The new European system would assign the task of pre-emptive analysis and grant the necessary authority to put risk mitigation measures into practice.

With regard to the appropriate balance between near-term stimulus and medium-term stability, the euro area clearly benefits from its medium-term stability-oriented framework. It is an invaluable anchor for private sector expectations, regarding both fiscal sustainability and price stability. Having proved its value in times of crisis, this framework has emerged even stronger than before. With regard to the overall support to the financial sector, I have been deeply impressed by the action plan drawn up by euro area governments and the European Commission within a short period of time. This action plan and its swift implementation has confounded the sceptics who had questioned the ability of euro area governments to act in a timely fashion in the event of a major economic crisis. Nevertheless, more action is urgently needed to entirely resolve the toxic asset problem.

The ECB's response to the financial crisis

Let me now turn in more detail to the ECB's management of the financial crisis. When the first signs of liquidity hoarding by banks appeared in August 2007, the ECB took several measures to protect against a disorderly correction in credit. Banks were not only concerned about the *volume* of liquidity that they could secure at present, but also about the *horizon* at which liquidity was expected to remain available to them. So the first thing we did was to provide banks with an insurance against future liquidity shortfalls. We lengthened the liquidity horizon for banks by expanding the share of refinancing that was granted at maturities longer than two weeks. This "insurance scheme" encouraged banks to maintain those lending relations with their clients that are central to Europe's financial architecture. At the same time, it helped bolster public confidence that banks would remain solvent.

The financial panic that developed in mid-September 2008 marked a dramatic turning point. Interbank trading in the euro area and elsewhere came to a virtual halt. As cash-rich banks were unwilling or unable to lend to cash-deficient institutions, the ECB had to substitute for the missing interbank trading. We started to provide credit well above the levels that banks had absorbed to fulfil their reserve requirements in normal times.

Since October, against a background of a drastic deterioration in global conditions, falling commodity prices and rapidly receding inflationary pressures, the ECB has stepped up its crisis resolution measures in an extraordinary effort to protect the functioning of our financial system and the stability of our economies.

Again, our primary concern was to preserve the availability of credit for households and companies at accessible rates. Under our new "fixed-rate full allotment" tender procedure, banks have been granted access to essentially unlimited liquidity at our policy interest rate. To fully appreciate what this means, one should note that in normal times we auction a given amount of central bank credit and let competition among bidders determine the interest rate at which that credit will become available to the banking system as a whole. But, as the demand for liquidity by individual institutions has expended abnormally and markets have ceased to perform their allocative function, we have turned that practice around. We now determine the lending rate and we stand ready to fill any shortage of liquidity that might occur at that interest rate. We currently surrogate the market in both its allocative and price discovery functions.

We have also considerably lengthened the list of eligible assets that banks can pledge as collateral, so as to ease banks' balance sheet constraints and facilitate the liquefaction of bank assets for which markets could find no price. The intention was to encourage banks to extend new credit or continue rolling over maturing loans.

Traditionally, the number of counterparties that are eligible to take part in our refinancing operations – both ordinary and long-term – has been the largest among the major central banks that are most directly comparable to the Eurosystem. This structural feature of our operational framework has been instrumental in the first stages of the crisis in ensuring that all relevant intermediaries could be granted easy access to liquidity. The recent changes to our operational framework have expanded the number further. Between July 2007 and March 2009, counterparties have increased from 1676 to 2136.

We have granted unlimited access to central bank credit at a *decreasing* cost. Our key policy rate has been reduced by 300 basis points since the exacerbation of the crisis in the autumn of last year. As I speak, the Eurosystem provides refinancing to all commercial banks that present eligible collateral at a rate of 1.25%. Sound and creditworthy banks can secure overnight credit at an interest rate that is significantly lower, today 0.8%, something never seen before in the entire post-war history of European monetary affairs. Being able to borrow at such low costs, banks can grant credit to other banks and to non-bank borrowers at conditions that are very favourable by historical and international standards. For example, the 6-month and 12-month euro interbank offered rate – benchmarks that euro area banks widely use to reset floating-rate loans to households and firms – have reached levels that are lower than the corresponding rates for contracts denominated in dollar and British pounds. This underscores that in current circumstances international comparisons of policy rates alone do not provide all the pertinent information about the effective credit conditions prevailing in single markets.

Our measures to support credit have resulted in a sharp expansion of the Eurosystem's balance sheet. As banks' usage of central bank credit soared at the height of the crisis late last year, the value of our operations grew quickly. Between June 2007 and March 2009 the size of our balance sheet increased by close to €600 billion. Since the end of September 2008 the growth in the overall size of our operations has been 40%. These measures have likely prevented the whole credit market from seizing up. Since then, the volume has declined somewhat, as banks have been more conservative in bidding for central bank credit and strains in the money market have eased to a certain extent.

The ECB has so far concentrated its non-standard measures on commercial banks' refinancing, mainly because of the nature of the euro area financial structures. As compared to the United States, which have primarily a market-based financial system, the euro area is very largely bank-centred. Accordingly, in a euro area context, guaranteeing firms and households steady access to credit largely means preserving the functioning of the banking system. In our economy, banks play such a dominant role that non-standard measures need to be implemented – first and foremost – through the intervention and with the active participation of banks. This is why I have sometimes referred to our non-standard measures as those of enhanced credit support. They aim at supporting banks in providing credit to firms and households on an ongoing basis.

This goes a long way towards explaining events in the past. As regards the possible further additional non-standard measures, I have been very clear. On behalf of the Governing Council, during my last press conference in Frankfurt: We will decide in our next monetary policy decision Governing Council meeting on 7 May. And it is on 7 May that I will make public the decision of the Governing Council. At this stage, as a *porte-parole* of the Governing Council, I think it is important not to create or encourage expectations. Be sure that what we will decide will fully take into account the financing structure of the euro area economy and will be fully in line with our medium term strategy.

When taking all our decisions, we are inspired by our remit to provide a solid nominal anchor for the economic system. As you know, the ECB's quantitative definition of price stability is a key element of its monetary policy strategy. We define price stability as a year-on-year increase in consumer prices of below 2% over the medium term. In 2003 the ECB's Governing Council clarified that, within its definition, it aims to keep the inflation rate close to 2% over the medium term. This clarification was aimed at confirming the robust anchor for long-term inflation expectations that the ECB had provided since the setting up of the euro.

In the first ten years since the introduction of the euro, the ECB's quantitative definition of price stability has proved to be an invaluable asset, guarding against undesirably high inflation and against deflation. Long-term inflation expectations in the euro area, whether based on surveys or extracted from financial indicators, have been and continue to be firmly anchored at levels consistent with our definition of price stability.

Conclusions

More than ever, in the present very demanding circumstances, confidence is key. The global economy was hit in mid-September 2008 by an unprecedented sudden loss of confidence. It was perhaps the first time in economic history that a single adverse event was able, in just a few days, to have a simultaneous adverse effect on all private economic agents in every economy, industrialised and emerging. We are in uncharted waters, and the risk of the sudden emergence of economic and financial phenomena and unprecedented behaviour on the part of economic agents remains.

Public authorities, executive branches, and central banks must do all they can to restore, preserve and foster confidence among households and corporations in order to pave the way for sustainable prosperity. This calls for a measured response to changing conditions. We must maintain the appropriate balance between the need to take immediate action that is commensurate with the gravity of today's situation, and the equally essential obligation to return to a path that is sustainable in the medium to long term. Confidence today relies equally upon the audacity of our immediate decision and upon the soundness and credibility of our exit strategies. Any ambiguity in our medium term policy direction would delay the return of sustainable prosperity, because they would undermine confidence, which is the most precious ingredient in the present circumstances. We will continue serve our 329 million fellow citizens as a solid anchor of stability and confidence.