# Gertrude Tumpel-Gugerell: Monetary policy challenges in light of the current financial market developments

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at Alpbach Talks, Vienna, 15 June 2009.

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## Introduction

Ten years ago, on 1 January 1999, the euro was introduced as the common currency of 11 Member States of the European Union. Today, the euro is used by around 330 million citizens in 16 countries and it has established itself as a stable currency, accepted in financial markets worldwide. Looking at the inflation performance over the first decade of Monetary Union with inflation averaging slightly more than 2% during this period, the ECB has fulfilled its mandate under the Maastricht Treaty, which is to maintain price stability for the euro area as a whole.

Nonetheless, undoubtfully, we are currently facing the biggest challenge so far: The world is hit by a severe economic and financial downturn, the deepest since the beginning of the Great Depression in 1929. It poses grave challenges to the financial industry and central bank community, as well as to supervisory and regulatory authorities and national governments and to the citizens at large.

## The key challenges arising from the current financial market turbulence

Since August 2007 the global financial markets have experienced extensive corrective realignments. The repercussions of the turbulence were initially visible in the financial market in the form of dramatic increases in risk premia and increased volatility in interest rate movements.

The outbreak of the financial market turbulence was not entirely unexpected, however. Both the ECB and other institutions had warned of macroeconomic imbalances and systematic undervaluation of risks in the years leading up to the crisis.

Those years were characterised by an extended period of low interest rates, low inflation and sustained economic growth, both globally and within the euro area. At the same time, liquidity was abundant and default risks were considered by many to be very low. This environment strengthened investors' risk appetite. In particular, with financial market participants expecting this environment to continue for quite some time, risks were systematically underestimated and the search for ever higher yields intensified. As a result, commercial banks readily granted credit for house purchases to households that otherwise could not have afforded it, and without adequately assessing their creditworthiness or credit default risk. At the same time, in an attempt to achieve higher yields, a number of innovative and increasingly complex financial products were offered, particularly in the United States. One prominent example of this was the bundling of mortgages in new and highly complex financial products and their resale as new securities to third parties via global financial markets.

It eventually became evident that this practice was viable only as long as house prices in the United States continued to increase. When the many years of increases in house prices came to an end and house prices started to fall, problems soon emerged, including in the euro area, as banks here were among the buyers of these securities. Investors suddenly began to doubt the quality of their assets. This led to a sharp correction in prices on the financial markets, accompanied by a withdrawal of funds from the markets, leading to corresponding liquidity shortages for banks, particularly in the money market.

### *Response to the crisis*

From the very beginning of the crisis, the ECB has acted in a decisive manner. It has taken a number of measures unprecedented in nature, scope and timing. The ECB has provided large amounts of liquidity support to banks. By making changes to its operational framework, the ECB made sure that all solvent banks would have sufficient access to funding. When the crisis intensified in September last year, we introduced a number of new measures. Most importantly, we provided banks with unlimited access to liquidity at fixed rates for up to six months. The ECB also expanded its list of assets eligible for use as collateral in the Eurosystem's credit operations. Moreover, we recently announced further measures, namely to provide longer term refinancing up to one year and to purchase covered bonds of up to EUR 60 bn.

As a result of these new measures, the size of the Eurosystem's balance sheet has expanded by a substantial EUR 600 billion and now stands at 16% of GDP, compared with 10% in mid-2007. The measures taken by the ECB have eased banks' balance sheet constraints and thereby certainly helped to avoid a sudden collapse in the supply of credit and the emergence of a systemic crisis.

Moreover, in line with the substantial weakening of global demand and economic activity, inflationary pressures and risks have been diminishing. As a result, the ECB's policy rates have been cut by 3.25 percentage points since the intensification of the crisis last October. These rate reductions, together with the liquidity management measures, have had a significant impact on money market interest rates. Since last October overnight money market rates have fallen even more steeply than the ECB's policy rates. Money market rates in the euro area have now reached very low levels by international standards. Lower money market rates have also led to lower interest rates for private households and firms, although the decline in money market rates has so far been greater than the decline in interest rates on credit for households and firms.

The fiscal authorities in the euro area have also demonstrated their capacity to react rapidly to exceptional circumstances. In a coordinated effort, the national governments of the euro area have provided support to the banking system, most notably through recapitalisation and guarantees for liabilities and assets. The funds provided under the package announced to stabilise the financial sector through these types of measure amount to 23% of the euro area's GDP. The overall fiscal stimulus – through discretionary policy measures and the effect of automatic stabilisers – amounts to 3.6 percentage points of GDP for 2009 and 2010.

Overall, during the ongoing financial market turbulence, the euro area and the EU as a whole have proved their capacity to act decisively and promptly under difficult circumstances.

### *Lessons from the crisis*

The current financial crisis has pointed to a number of weaknesses that need to be addressed if we are to avoid a similar crisis in the future. Some weaknesses are rooted in the current design of the international financial system. This is particularly true with regard to the lack of transparency and accountability within the financial system. In this respect, much relies on financial players themselves taking responsibility for evaluating risk more effectively and increasing transparency as regards risk. In addition, various initiatives at national, European and international level aim, in particular, to improve the robustness of the financial system

I would like to highlight three areas where I think change is necessary: there needs to be an increase in transparency, a dampening of pro-cyclicality and an improvement in institutional design in the field of financial supervision and regulation.

First, we need to undergo global regulatory and supervisory repair. The Basel Committee has already set some milestones in this regard including the publication of the principles for sound liquidity risk management and supervision and its current work on strengthening the

Basel II capital framework. Work is also underway concerning the development of measures to mitigate pro-cyclicality stemming from the regulatory frameworks, namely by building buffers in good times that can be withdrawn in less benign conditions. In this context, let me recall that the G20 Leaders approved the recommendations by the FSB to address procyclicality, which are to be implemented by the end of this year. To this aim, the Basel Committee is developing proposals for countercyclical buffers and ways to promote provisioning over the cycle, with the aim to come up with concrete proposals by year-end.

Second, regulatory gaps need to be closed. In that respect, the G20 Leaders endorsed last April the extension of the regulatory net to all systemically important institutions, markets and instruments. These include systemically important hedge funds, credit rating agencies and Over-The-Counter (OTC) derivatives markets. With the aim of preventing regulatory arbitrage, the IMF together with the FSB, have been requested to develop, by autumn, guidelines to assess systemic importance.

And third, macro-prudential supervision has to be strengthened. This includes in particular the global monitoring of systemic stability and the supervision of systemically important cross-border institutions, while properly addressing interlinkages among themselves, with other financial and non-financial institutions and markets. In this context, I fully support the broadened mandate and stronger institutional basis given to the Financial Stability Board (FSB). The G20 Leaders called on the re-established FSB to develop macro-prudential tools, together with the Bank for International Settlements (BIS), to identify and take account of macro-prudential risks across the financial system and limit the build up of systemic risk for regulated entities. Moreover, the envisaged cooperation between the IMF and the FSB for the conduct of Early Warning Exercises will be crucial for the success of the global monitoring of systemic risks.

At the European level, the proposal of the De Larosière group to establish a European Systemic Risk Council should substantially improve the assessment of risks to financial stability at the EU level. In order for the new Council to perform its tasks in an optimal manner – in my view – three requirements must be fulfilled. First, the ECB must have timely access to the relevant information, including information concerning individual institutions. Second, risk warnings from the new Council should be translated into effective policy action. And third, for the new Council to be independent and effective in its decision-making, it is essential that it have a solid institutional and legal basis.

I also think the current crisis holds some lessons for monetary policy. The crisis has shown us that a stable financial system is a prerequisite for price stability. Monetary policy-makers should try to mitigate the risk of the build-up of financial bubbles by being aware of the effects their policy decisions can have on the financial system. Therefore, one could argue that asset prices should play a greater role in monetary policy considerations. As the build-up of an asset price bubble might have severe economic consequences in the longer term, central banks should try to deal with the bubble pre-emptively.

Nonetheless, the interrelation of financial stability goes beyond the pure consideration of asset prices. Analysing developments in borrowing and lending, particularly loans to the private sector, is helpful in extracting the relevant signals from monetary developments on potential financial imbalances. Consideration of these aspects must become more extensive and systematic in the future.

Strengthening the ECB's role in financial supervision should contribute to ensuring that proper consideration is given to the possible build-up of financial imbalances when making monetary policy decisions. The current crisis has clearly demonstrated that risks to financial stability are accompanied by risks to price stability. Central banks must give even greater consideration to these risks in their analyses.

### The benefits of the euro in the current crisis

As mentioned, the current crisis represents the greatest challenge for the euro so far. 2009 will be a very difficult year. According to the most recent macroeconomic projections by ECB staff, published in June of this year, the euro area economy is expected to contract by between 4.1% and 5.1% in 2009. This means, among other things, fewer jobs, higher unemployment, less investment and less exports.

That said, we should not forget how Europe would look today without the euro. In addition to the financial market turbulence, the problems in the financial sector and the economic downturn, we would be facing potentially large fluctuations between Europe's national currencies. In fact, the currencies of some of the countries outside the euro area have experienced considerable fluctuations during the current crisis. This is an additional source of uncertainty for these countries. Therefore, the turmoil has confirmed one clear advantage of the euro, namely that, in stormy seas, it is better to be aboard a large ship than a small boat.

This seems to be also reflected in the fact that many central and eastern European countries have expressed the wish to join the euro area as quickly as possible. This is no surprise, given that many countries have already made progress towards adopting the euro. Nevertheless, all countries must first fulfil all of the relevant criteria before joining the euro area.

Still, I would like to emphasise that the euro area is not a closed shop. Five new countries have joined since the start of Monetary Union in January 1999, with Slovakia becoming the newest member of the euro area in January of this year. The door is open to all those that meet the clearly stated and predefined criteria for membership of the Economic and Monetary Union.

### Conclusion

Joseph Schumpeter coined the expression of the creative destruction to bring about entrepreneurial innovation and progress. Schumpeter certainly did not have in mind an economic and financial crisis of the severity and extent we are experiencing today. But having the concept of Schumpeter in mind, the current crisis also created a window of opportunity for change and reform. This window, however, will not remain open forever. Therefore, we have to act now in bringing forward the necessary reforms in the international financial system to strengthen the supervisory architecture. The ECB stands ready to take up its part on macroprudential supervision.