Jean-Claude Trichet: The crisis and its lessons

Lecture by Mr Jean-Claude Trichet, President of the European Central Bank, at the University of Venice, Venice, 9 October 2009.

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I. Introduction

Ladies and gentlemen,

It is a great pleasure for me to be at the University of Venice. Ca' Foscari is one of the most prominent and vibrant universities in Italy. I know it is also one of the universities that is most open to international exchanges. Its blend of research excellence and cultural diversity makes it close to the ECB in spirit. The ECB is perhaps the most diverse central bank in the world in terms of its staff composition: more than 27 countries are represented in our ranks. And our economic departments constitute a relevant centre of economic analysis in Europe.

As a central bank, we are prime consumers of economic research. For this reason, we maintain very close interactions with the academic world. We import tools and ideas and are eager to employ excellent economists from centres of advanced economic studies such as Ca' Foscari. At the same time, the ECB is an active source of cutting edge economic thinking. I was very happy to see that last year our electronic Working Papers Series – posted on our web-site – attracted some 4 million downloads. A number of those articles have made significant contributions to macroeconomic research.

I am also most delighted to be in Venice. This city talks both to the artist and to the economist. I have discovered that its name can be construed to signify its charm. As you will know, Francesco Sansovino, for example, claims that: *"[i]t is held by some that this word VENETIA signifies VENI ETIAM, that is, come again, and again, for however often you come, you will always see new things, and new beauties".*[1]

But, for all its beauty, Venice was never a place of idle contemplation for its citizens. My countryman and great scholar of European civilizations, Fernand Braudel, chronicles that wealthy Venetian merchants in the early 1500s used to instruct their agents to "never leave '*li danari mortti*', money lying dead." "Sell quickly, even at a lower price, in order to '*venier presto sul danaro per un altro viaggio.*'"[2] It would be nearly impossible to find a more fitting description of the inner force that moves a market economy. In a vibrant market economy, money does not rest and is used to serve the creativity and the effort of undertaking enterprises.

II. The financial crisis

Let me start my remarks by recalling the origins of the crisis as I see them.

Over past decades, our economies have greatly benefited from the effects of financial liberalisation and financial innovation. For example, the securitisation of assets has played a role in facilitating an efficient allocation of economic risks. It allowed the financial sector to offer credit for productive purposes, at more favourable conditions than was possible in the repressed credit systems of the past.

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1 Francesco Sansovino, Venetia città nobilissima et singolare, Venice, 1581.

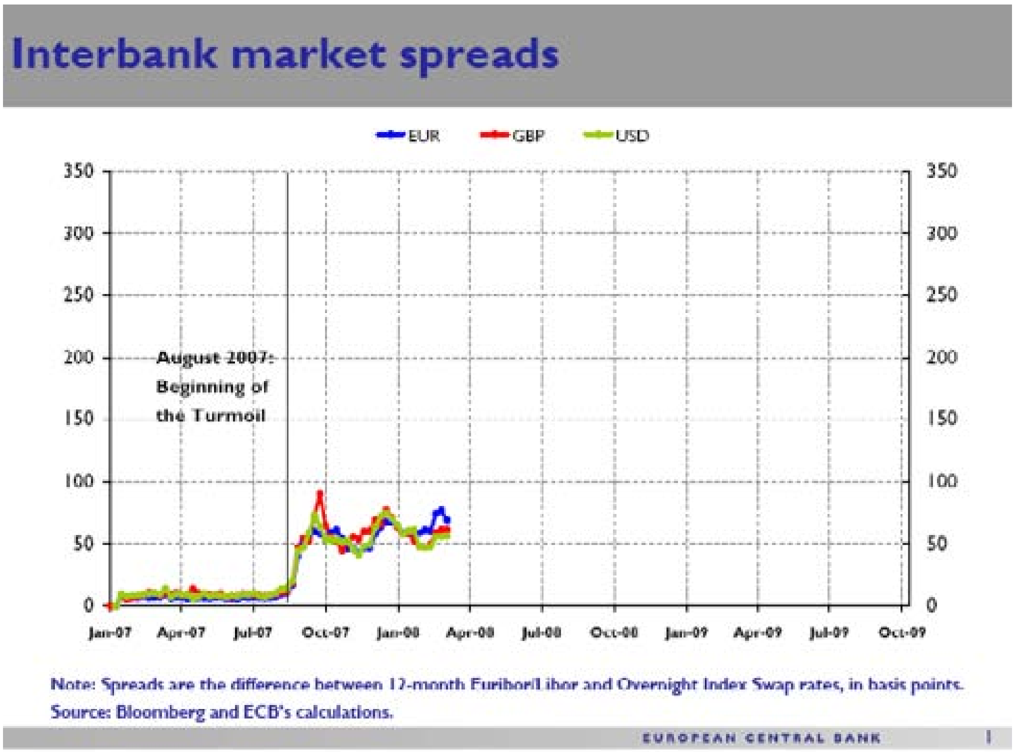
2 Cited in F. Braudel, "*Civilization and Capitalism, 15th-18th Century: The Wheels of Commerce*" University of California Press, 1992.

More recently, however, managing genuine *economic* risk gradually ceased to be the main concern of international finance. Instead, the creation and assumption of *financial* risk became the core activity of the financial industry. The decoupling of financial positions from the underlying flows of goods and services gradually created the conditions for a credit boom. The credit boom was reinforced by an asset price boom, which credit itself was partly sustaining. Both the credit and the asset price expansion found formidable amplifiers in the microeconomics of the financial markets and in global imbalances.

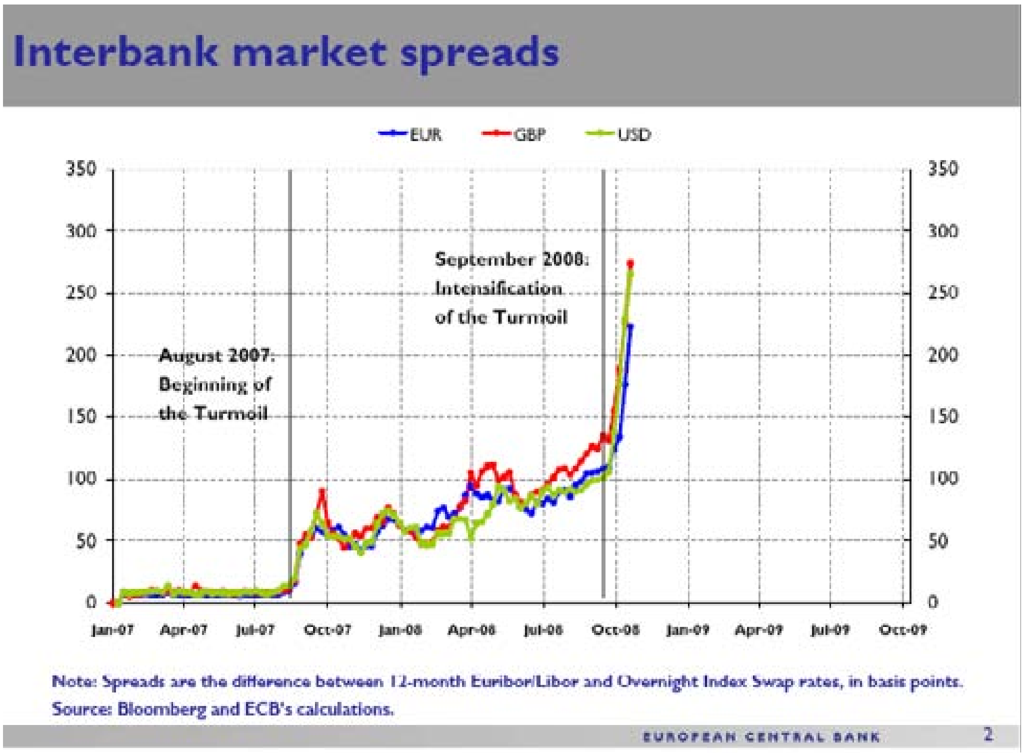
In the financial market, compensation schemes for bank loan managers weakened their incentive to conduct a prudent screening of loans. Executive pay was a function of overall volumes, which encouraged turn-over and the origination of loans. At the same time, risks could be shed – or so it seemed – by selling off the loan to other investors in the secondary market. As for these investors, increasingly complicated financial structures made it difficult for them to assess the quality of the assets that they were acquiring. They had to trust the originators. More than in the past, the viability of the financial system came to depend critically on trust and confidence.

On a global scale, a chronic shortage of savings in some industrialised economies had to be financed out of an excess of savings in other parts of the world. So, international intermediation provided a potent fuel to the expansion of finance.

In August 2007 – suddenly but not unexpectedly – trust and confidence started evaporating. The circular interactions between asset price appreciation, biased incentives, excessive complexity and global imbalances went into reverse. Market liquidity became scarce and investors extremely afraid of the risks that they had been exposing themselves to for so long. Finally, mid-September 2008, the collapse of a major financial player turned the re-pricing of risk into major financial panic. The chart of money market spreads tells this tale clearly.



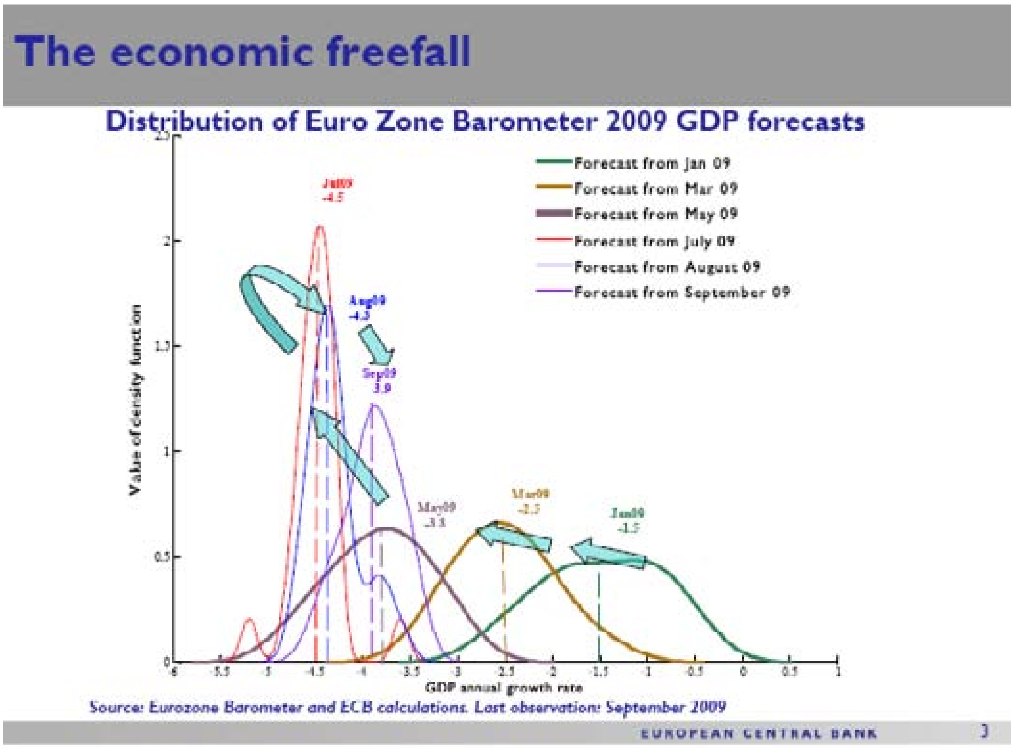
As the collapse of confidence became evident, financial intermediaries made every possible attempt to restore liquidity buffers. Credit spreads soared. Financial market activity fell dramatically, and the global financial system came close to seizing up.



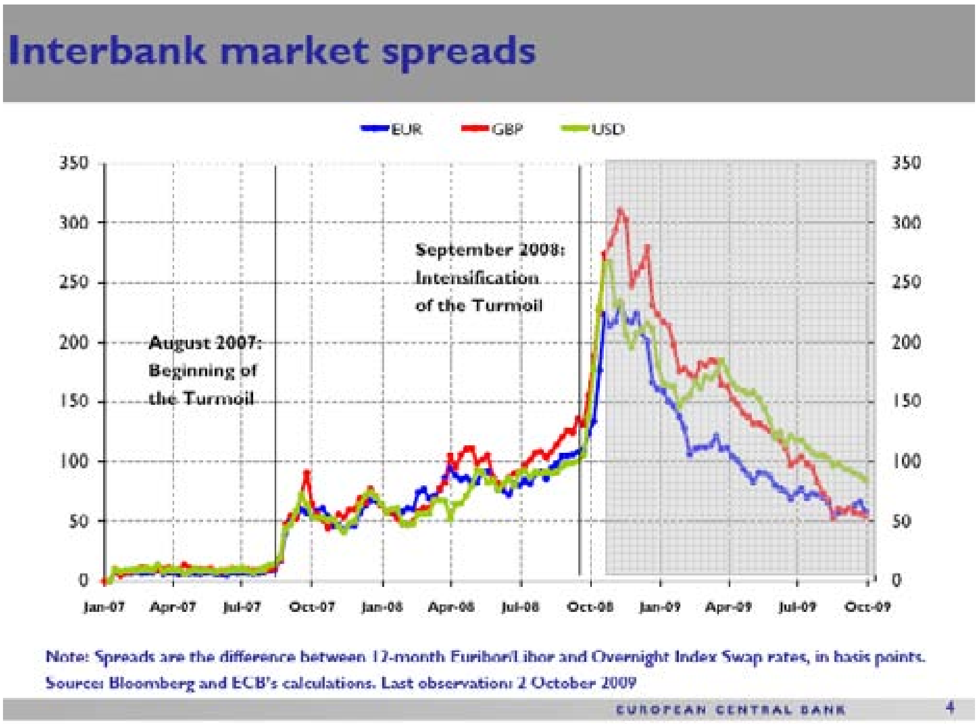
The crisis triggered a freefall in economic activity.

Within a few months, from January to July 2009, the distribution of GDP projections for the current year shifted to the left, increasingly into negative territory. To fully appreciate the massive change in perspective that this brought for all of us, compare the range of outcomes that were considered likely in successive rounds of forecast updates.

In January, forecasters predicted on average a decline of 1.5% for this year. In March, they had become even more pessimistic, and they provided a decline of 2.5%. The uncertainty surrounding these forecasts was high, but even in March a decline of 4.5% was not seen as possible. This figure was outside the range of all forecasts and was a zero-probability event. Four months later, in July 2009, it became the central forecast. This shows the rapid and dramatic free-fall in economic activity. By now, in September, there has been a slight improvement, to a 3.9% contraction for this year.



Faced with such unprecedented challenges, central banks around the globe demonstrated a remarkable unity of purpose. Different economies, different channels of transmission called for different responses.



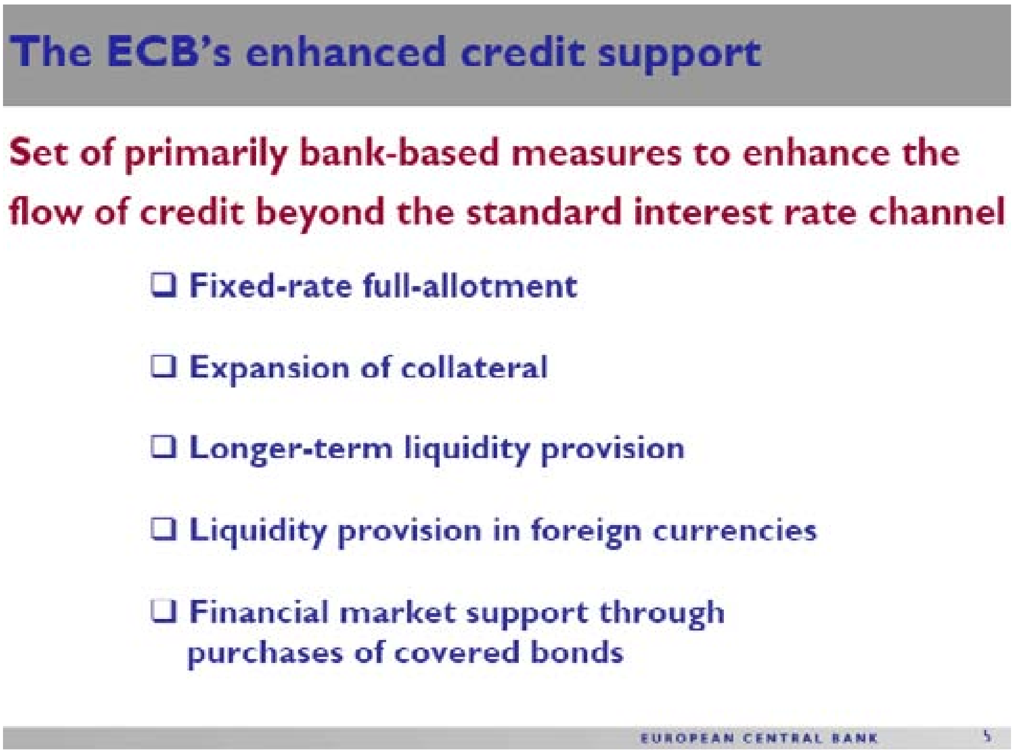
In the end, the action taken by the leading central banks paid off. If I can return to my first picture, money market spreads – a symptom of the lack of trust that had gripped financial transactions in the early autumn – retreated from their peaks. They are now back at levels that were prevalent before the intensification of the crisis.

III. The ECB's response to the crisis

How did the ECB meet the challenge? The turmoil started on 9 August 2009. The ECB was in the vanguard among major central banks. It was first in identifying the severity of market distress, and the first to act on the very same day. As the financial debacle finally materialised, in the autumn 2008, the ECB's approach to crisis management was diversified but consistent.

We activated both conventional and non-conventional instruments of policy. We cut our key policy interest rate by 325 basis points, bringing it to a level that has no historical precedent in post-World War Europe. In parallel, we adopted a wide spectrum of "non-standard" measures. They were designed to ensure that the reductions in our policy instrument were transmitted to the broader credit market and the economy at large.

These non-standard measures are part of what we collectively define as our policy of "enhanced credit support".



This policy comprises five building blocks:

1. First, full accommodation of banks' demand for central bank liquidity at fixed interest rates in our refinancing operations.
2. Second, a further expansion in the list of assets eligible for use as collateral in our refinancing operations.
3. Third, a further extension of the range of maturities at which liquidity is made available to banks in our refinancing operations. The longest maturity is now one year.
4. Fourth, provision of liquidity in foreign currencies, notably US dollars.
5. Fifth and finally, a direct covered bank bond purchase programme aimed at reviving a segment of the financial market that is important in Europe.

Let me emphasise only a few selective aspects of this policy. First, our primary mission is to preserve price stability. It implies that the transmission of monetary policy impulses is functioning correctly and that the money market is not disrupted. In this new unexpected situation we had to tackle the paralysis of inter-bank transactions in the money market. The money market is where banks can refinance their assets as a precondition for rolling over their loans to the economy. The flow of credit is primarily channelled by banks in the euro area. A complete breakdown in the funding relationships that constitute the money market would have derailed the bank lending channel altogether. The interruption of the bank lending channel would have turned the financial crisis into a very profound depression. By granting unlimited access to central bank liquidity – the "fixed-rate full-allotment" tender procedures – we put banks in a position to maintain their crucial role in the financing of the real economy. By expanding the list of eligible collateral, we ensured that banks could refinance that large proportion of their assets that had become less liquid in the crisis. By extending the maturity of their liquidity provisions, we gave banks a more medium-term perspective in their liquidity planning. This measure greatly attenuated the maturity mismatch between assets and liabilities in banks' books, which would otherwise have further deterred bank lending activity.

We have also been providing foreign exchange liquidity. This primarily took the form of US dollar liquidity backed by a swap facility with the US Federal Reserve System. The malfunctioning of the foreign exchange swap market had made the currency mismatch in banks' balance sheets extremely severe. Thanks to our policy, they could count on ongoing access to foreign currency balances. This policy was made possible by the very close cooperation between central banks in the crisis.

Finally, the Governing Council's decision to intervene directly in the financial market by purchasing covered bonds was meant to re-ignite activity in a market segment that is particularly important as a source of funding for banks.

IV. Liquidity and exit considerations

Our enhanced credit support policies have boosted market liquidity. Through that channel – as I showed a few minutes ago – the reductions in our policy instrument could be transmitted to a whole spectrum of interest rates that are used as re-setting benchmarks for adjustable-rate loan contracts. This has greatly benefited households and firms. But what is the link between liquidity and price stability? Will enhanced liquidity provision trigger inflation sometime in the less proximate future? In this respect, let me emphasise two important aspects of our exceptional policies.

The first aspect is related to the definition of liquidity. Our non-standard measures have increased central bank liquidity – cash reserves that the Eurosystem makes available to banks in refinancing operations. But this has not led to an increase in broader monetary aggregates. In fact, broad measures of money growth are decelerating in the euro area. In normal times, banks would use an increase in our liquidity provision to expand credit to households and enterprises. In current conditions, however, liquidity primarily takes the form of precautionary balances that certain banks are deliberately holding with the Eurosystem. As long as central bank liquidity serves at least in part banks' precautionary motives, this extra liquidity will not result in higher inflation in the future.

These considerations bring me to the second aspect of our non-standard policies: the conditions for their unwinding. Exceptional times have called for exceptional measures. But we will need to phase out these measures once the rationale for their adoption fades away and the situation normalises.

The Governing Council believes that it would be premature today to think that the crisis has been overcome and conquered in a sustainable manner. So, it is not the time to exit yet. Our future decisions on the phasing-out of non-standard measures will be guided by a transparent exit strategy. This exit strategy has been designed around four cornerstones.

First, it will be linked *to our primary objective and thus to our monetary policy strategy*. The crisis has not changed the ECB’s primary objective. This means that any non-standard measure whose continuation would compromise the maintenance of price stability at any time in the future will be undone promptly and unequivocally.

Second, the *forward-looking initial design of the measures* will help us wind them down when the time is ripe. The ECB’s non-standard measures were designed with exit considerations in mind. A number of measures – think of our refinancing operations – will phase out naturally by design. At the same time, the size and scope of the outright purchases have been calibrated so that they would not interfere with the implementation of appropriate liquidity conditions in a phase of interest rate increases.

Third, the ECB has the *technical and institutional capability to act*. The operational framework of the ECB proved very resilient at the start of the turmoil. It is also sufficiently flexible and reliable to fit all possible situations which could realistically arise in the future. On the institutional side, the Governing Council has the unfettered capacity to decide and institute appropriate policies whenever circumstances warrant this. The ECB rests on a strong institutional platform, with a clear dividing line between what pertains to the central bank and what belongs to the fiscal sphere of responsibility.

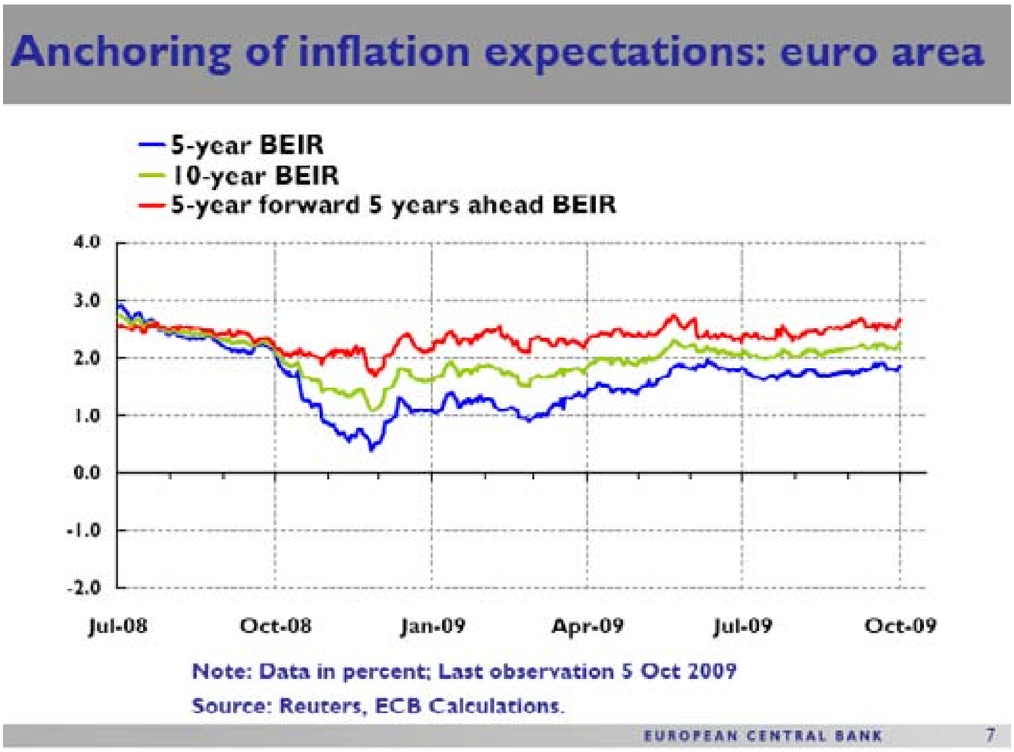
Fourth, the Governing Council can mobilise its *reputation for swift and decisive action whenever that reputation will be required to support the credibility of its policies*. Over the past decade, our institution has established a clear track record of steady-handedness. This is also because market participants know that we are permanently alert and that we act decisively and in a timely fashion when conditions so demand.

V. The current situation

The ECB's "steady-handed approach" to conventional monetary policy action has not impeded, in fact it has strengthened, a swift transmission of policy changes to market rates and to credit conditions more broadly. This was possible for two reasons. First, steady-handedness makes policy changes more powerful. Private sector expectations regarding future interest rates adjust and move in a manner consistent with policy-makers' intentions at all maturities. Second, interest rate reductions have been reinforced by our non-standard monetary policy measures. These policies have made financial intermediaries less reluctant to pass on the degree of credit easing that the ECB wanted to implement.

All in all, there are encouraging signs that the substantial stimulus introduced is gradually bearing fruit. The negative inflationary readings over the summer have been due to large declines in the price of crude oil in relation to the previous year. In this sense, the fall in inflation – by boosting the purchasing power of our citizens – has acted as an automatic stabiliser at a time in which the economic conditions were deteriorating.

Inflation expectations are a good measure of the degree to which the free fall in the economy and the dis-inflationary process could come to feed upon itself. They have remained stable around levels consistent with our definition of price stability.



The economy, too, is showing signs of stabilisation. After the strongly negative readings recorded earlier this year, economic activity in the second quarter is estimated to have declined by 0.2% relative to the previous quarter. In the period ahead, we expect to see a very gradual recovery. While the statistical risks to this outlook remain broadly balanced, there is no room for complacency and we are, as always, alert to any unexpected developments. On the upside, the impact of the macroeconomic stimulus packages and other policy measures may prove to be stronger than currently foreseen. On the downside, the negative feedback between the real economy and the still strained financial sector may prove more protracted than expected.

VI. Lessons to be learnt

What lessons can we learn from the financial crisis that has shaken our world so profoundly? The crisis has exposed the fundamental fragility of the international financial system. I had mentioned that the macroeconomic situation shows signs of stabilisation. We expect a very gradual recovery ahead, but substantial risks remain.

We have to consider all aspects of finance very seriously. The financial system needs to be as immunised as possible against its intrinsic tendency towards complacency, irresponsibility and self-destruction. Three intrinsic weaknesses need correction.

- First, the *pro-cyclicality* of the financial system needs to be mitigated by mechanisms that can provide built-in stabilisers. The quality and quantity of bank capital and banks' liquidity buffers have to be improved in good times to provide a sufficient buffer for bank equity to withstand the inevitable increase in credit risk when the cycle turns. The cyclicality of market economies is inevitable. But the financial system should not be allowed to amplify swings.
- Second, the *transparency* of the financial structures needs to be enhanced. Financial innovation cannot be built upon – and exploit – gaps in investor information and a lack of financial literacy. Well-informed decisions by market agents are a key element of any functioning market economy. All institutions, instruments and markets that are of any relevance for systemic stability need to enhance their risk disclosure. The reach of financial regulation needs to be extended to better reflect the role of highly leveraged institutions and prevent abuse in the derivatives markets.
- Third, *short-termism* in the design of financial contracts needs to be corrected. Market participants – traders, loan managers, risk committees and boards of directors – were given strong economic incentives to focus on short-term profits. Long-term value creation was not a concern in the pre-crisis world. Collectively, this resulted in excessive risk taking. In tune with the last G-20 pledge, a reform of the executive compensation schemes and practices is an essential part of our effort to secure financial stability.

Far from putting off the agenda for structural reforms, the crisis has made them more urgent. No segment of the market or category of players has been immune to the crisis. The list of areas that proved dysfunctional can be extended to include the risk management and credit assessment of banks, accounting standards, audit quality, supervision, and many more elements. No market segment or financial actor should escape profound rethinking. This rethinking should have the scope and ambition of a paradigm change. The new paradigm should be based on three notions.

First, medium-term and long-term sustainability in macroeconomic policies and financial strategies should replace the myopic perspective that is always a temptation. Herd behaviour in the financial markets might have two parallels in the macroeconomic sphere. These are: profligate fiscal policies in times of boom and over-accommodating monetary policy in downturns. A new medium-term perspective should concentrate policies on medium-term objectives. Like financial contracts, policies should not amplify economic fluctuations.

Second, authorities and major players in the financial scene should immunize themselves against complacency. The crisis has proved that unpredictable shocks, however unlikely, can compound in the aggregate. In these conditions, historical correlations of risks become an insufficient instrument to check the resilience of an institution or the system as a whole. A constant monitoring of resilience should become part of the new regime.

Third, the approach should be holistic. The global proportions of the crisis call for a rethinking of the links between financial behaviour and macroeconomic policies. This has two implications. The first concerns *domestic governance*. Major economies need to complement their micro-prudential apparatus with a new macro-prudential function. Macroeconomic resilience calls for a systemic analysis of risk. Macro-prudential supervision offers this type of analysis and can act as a countervailing force to the tendency of the financial system to amplify economic swings. A far-reaching reform in this direction is underway in the EU. A new European Systemic Risk Board (ESRB) will be created which will detect risks to the EU financial system and issue warnings and recommendations to national supervisors.

The second implication concerns *international macro-governance*. Over the last year, efforts to find new fora in which risks to the global economic order can be identified, discussed and addressed have intensified. Throughout the turbulent times, coordinated guidelines have been put forward at the European and international levels by the Financial Stability Forum, the Eurogroup and the European Council. They were reflected in the declarations of the G-20 summits. The G-20 itself has emerged as the *premier forum* for international economic dialogue.

Within the G-20, I find it encouraging that there is now a broad consensus between the emerging market economies and the industrialised countries on the principal directions of financial reform. In this field, I see a very strong consensus in the global community of central banks. As first signs of recovery can be observed and as banks are returning to profitability, it is important to keep up momentum and to proceed with the further steps that are necessary to ensure that events of such intensity do not recur in the future.

Yet, in the new economic order that will emerge these fora – and each single macroeconomic authority that is represented at the table – will share a precisely defined responsibility: the correction of global imbalances. Trade and financial imbalances were a major source of instability in the pre-crisis world. Now, it is the precise mandate of the world economic leaders to identify a pattern of growth across countries that is more sustainable and balanced. They need to evaluate whether the macroeconomic policies that are enacted domestically by the major economic players are collectively consistent with more sustainable and balanced growth worldwide.

For this process to be effective, peer pressure needs to be made more compelling than it was in the past.

Let me say a few words on Italy.

The Italian economy is undergoing an unprecedented adjustment, as are virtually all developed countries throughout the world. Many Italian enterprises, in particular small and medium-sized ones, are currently dealing with very challenging times. I am confident that they will emerge from present hardships with leaner cost structures and a more efficient organisation of production processes. In the end, the entrepreneurial spirit that is in the genes of this nation will prevail.

The financial crisis, the macroeconomic response to it and the lessons that we need to learn have been the themes of my talk today. My main message is that despite all the difficulties, the crisis is an opportunity for this continent and for this country in particular. Italy is a country that has traditionally gained confidence in the severest of circumstances. I therefore hope that reflections on the causes and lessons of the crisis can contribute to economic reform that can bring a new era of progress for Italy.

First of all, the crisis has shown the health of private finance in Italy. Italy never indulged in the financial excesses of the recent past. It remains an economy, where finance is first and foremost support for real economic production. Strong saving propensities and prudent banking represent a platform of security from which the economy can restart.

But economic reforms cannot be delayed. The crisis can be the trigger for an ambitious plan to modernise the Italian economy and to make it more dynamic. Labour market institutions need to be overhauled to make labour compensation better reflect individual effort and firm-level excellence. The pricing chain – notably in the service sector – needs to be streamlined to increase the flexibility of prices. Welfare-enhancing positions that are a drain on disposable incomes and the economic potential of the country need to be discarded.

I would like to encourage policy makers to tackle these issues.

VII. Concluding remarks

Bold efforts by central banks and governments around the world have been effective in containing the propagation of a formidable shock. But short-term steps to alleviate the crisis need to be reinforced by longer-term reforms that can inhibit the development of bubbles, stabilise financial markets and provide greater financial security to households and businesses.

A number of elements and – one might even say “totems and taboos” – of the pre-crisis economic universe have now lost most of their value. This applies to individual financial players and business models alike. Other elements, however, have maintained their worth. It is on these latter elements that we should build the future of this continent.

The euro – the single currency – and the macroeconomic framework of the Union have certainly proved their strength in the last 12 months. The countries of Europe were not left to weather the storm alone. The financial maelstrom has not turned into any national debacle. A medium-term-oriented macroeconomic framework had helped – before the crisis – to put Europe on a solid ground. Those solid foundations have enabled it to withstand the onslaught.

In the end, the strength to overcome the present hardships will come from the inside. Our openness to trade, our balanced and dynamic business structures, our talented and well-trained workforces are part of our future. We know that technological progress will continue unabated in Europe. Companies and people will continue to prove their entrepreneurial spirit in large and small organisations. Reflection and endurance will be rewarded by a sense of personal fulfilment and by collective progress. Private thrift and a sense of prudent housekeeping are Europe’s primary safeguards against the risk of developing into a bubble economy.

All this will be the engine that will steer the economy towards tomorrow’s recovery.

Thank you for your attention.