Jean-Claude Trichet: Today's financial institutions and tomorrow's monetary order

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 19th Frankfurt European Banking Congress: "After the Crisis", Frankfurt am Main, 20 November 2009.

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Ladies and Gentlemen,

It is always a pleasure to join you at the annual Frankfurt European Banking Congress.

I noted that the organisers have chosen as title: "After the crisis".

I understand that the mood in the financial system is one of relief.

But as of today, it is too early to declare the crisis over.

Recent financial developments have been more benign, it is true. However a significant volume of official support underlies these developments. Nobody knows this better than financial institutions and markets themselves.

The total amount of outstanding ECB refinancing is around 60% larger than it was before the financial market turmoil. This reflects also the need for the ECB to "intermediate" parts of the money market.

Euro area governments for their part have committed 26% of GDP to supporting the financial sector. This assistance has come in the form of guarantees, capital injections and asset support.

The magnitude of support is without precedent, and all participants in financial markets should be conscious of that. It has been extended on behalf of the general public, and for the benefit of the overall economy.

Banks are an important part of the economy. The support has been given for their role in the economy, not for the banks by themselves.

We also have to understand the concern of our democracies as regards compensation and bonuses. Principles have been agreed upon at the level of the international community. They were worked out by the Financial Stability Board and approved by the G20. Let us apply rigorously those principles, under the control of the banking supervisory authorities. The wrong incentives to embark in absurd risks and dangerous short-term ventures have to be eliminated.

Challenges to guard against excesses are as old as mankind. I quote Frankfurt's most famous son:

"Die Hauptsache ist, daß man lerne, sich selbst zu beherrschen. Wollte ich mich ungehindert gehen lassen, so läge es wohl in mir, mich selbst und meine Umgebung zugrunde zu richten."

One could translate this as follows. "The most important issue is to learn self-restraint. If I wanted to lavishly let myself go, I could well destroy myself and my environment."

Goethe made this remark in 1830. I am sure he would have repeated it today.

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Three points appear essential regarding the banking sector.

First, banks need to strengthen their balance sheets. They need to become self-reliant and be able to stand on their own two feet.

The authorities can – and have – provided considerable temporary support, but in a market economy we cannot manage the financial sector or provide exceptional support indefinitely.

Banks must rebuild their capital base. There are many ways to do so. The improved capital markets offer opportunities to raise funds including equity. Profits earned should be used – as priority – to build capital and reserves, rather than to be paid out as dividends or undue compensation.

Second, banks should lend, because the magnitude of public support has been provided for this purpose, and the strengthened balance sheets will allow them to lend. Banks should strive to maintain their supply of loans. Most recently, in the third quarter of this year, the annual growth of loans to non-financial corporations continued to decline, while the annual growth of loans to households remained broadly unchanged.

This pattern of loan dynamics is broadly in line with past regularities around business cycle turning points. But the latest ECB bank lending survey suggests that, while the peak in the tightening of banks' credit standards is behind us, credit standards remain considerably tighter than prior to the turmoil. It will be particularly important that banks intensify their efforts to expand their supply of loans once loan demand picks up in the recovery.

Third, compensation and bonuses must remain contained. Otherwise, we would take risks that Goethe already described.

When necessary, banks should take advantage of the available government support to achieve these goals.

From this perspective, I will interpret the conference theme – “After the crisis” – as an appeal to look forward and draw lessons for the future from our experience of the past two years.

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I would like to outline now what measures we, as the central bank of the world’s second-largest economy, have taken in the crisis, and how and why we have designed these measures.

To illustrate, I would like to draw on a medical analogy, identifying three lessons for how we should collectively care for the health of the financial system going forward.

First, once a patient falls seriously ill, emergency medication is required. Strong and invasive painkillers may have to be administered. Contagion must be avoided.

Similarly, a global financial crisis of first magnitude requires prompt and decisive policy action, possibly of an unprecedented nature.

When this crisis began, the European Central Bank was in the vanguard of the policy response, taking early and bold action to address financial turmoil. During the crisis, our exceptional measures – the ECB’s “enhanced credit support” – served to prevent a systemic liquidity crisis, enabled banks to continue functioning and helped to restore confidence.

Second, medical experience tells us that, over time, the continued administration of strong painkillers can be harmful. They can create dependence – r even addiction – or the recipients. Such medicine cannot be a permanent solution. It would eventually create new problems.

By analogy, the exceptional support provided by central banks to the private sector must not degenerate into long-term dependence of the private sector on such support. For that reason, the current non-standard monetary policy measures will have to be progressively phased out. Enhanced credit support is not for eternity. Financial institutions must prepare themselves for an eventual withdrawal, which, as I have said on behalf of the Governing Council, will be timely and gradual.

Third, looking forward, we know that “prevention is better than cure”. “Preventive medicine” reduces the risk of future recurrence of the illness.

Recent experience has offered important insights into how public policies and private incentives can be improved so as to reduce the chances of recurrence. Through preventive medicine, we must develop a fitter and healthier financial system.

So let me describe in more detail: how we have administered the "central bank medicine" to the financial system; how we envisage continuing the treatment going forward; and what lessons we are drawing for the future design of a preventive framework.

Emergency medicine: crisis management and "enhanced credit support"

It is natural to start with the "emergency treatment" that we have provided to the financial system throughout the financial crisis.

The alertness of the ECB was reflected in its actions from the very moment that financial tension first emerged. In August 2007 the ECB was the first central bank to respond, acting within hours. In the ensuing months, we changed the timing and maturity of our liquidity provision, so as to support the functioning of the money market. In addition, we offered foreign currency liquidity to our counterparties.

The intensification of the crisis in mid-September 2008 brought soaring credit spreads, dramatic declines in trading and a spike in volatility. In short, the global financial system came close to seizing up.

Central banks stepped into the breach, addressing this unprecedented market failure. The ECB was in the vanguard, acting to contain these tensions through both standard and non-standard policy measures

In full consistency with our mandate to maintain price stability, the Governing Council reduced the ECB's key interest rates rapidly. The current very low level of interest rates is unprecedented throughout the euro area. Together with our credible anchoring of inflation expectations, these policy actions have resulted in a considerable easing of nominal and real monetary conditions in the euro area.

Moreover, we have gone beyond standard interest rate cuts by adopting several "non-standard" monetary policy measures.

As I have described in the past, collectively these measures embody our policy of "enhanced credit support": fixed-rate full allotment; expansion of collateral; lengthening maturities of operations; liquidity provision in foreign currencies; and financial market support through a measured but significant covered bonds purchase programme.

This policy has been designed to support the flow of credit over and above what could be achieved through interest rate cuts alone.

Avoiding dependence and addiction: exit strategies

Emergency treatment and strong medicines are sometimes necessary. But, if their use is prolonged, they can lead to dependence and even addiction. Eventually, the administration of painkillers must be stopped if patients are to get back on their own two feet.

This brings me to the exit from our non-standard monetary policy measures. The rationale for exit from these measures is the inverse of the rationale for their implementation. We have introduced exceptional measures under exceptional circumstances. These measures will have to be unwound when the situation normalises and the rationale for the measures fades away.

The cornerstone of our exit strategy is its link to our primary objective of price stability. Our actions throughout the crisis have been taken resolutely with this primary objective in mind. Thus, any non-standard measure whose continuation would pose a threat to the achievement of price stability must be undone promptly and unequivocally.

As I said on behalf of the Governing Council, looking ahead, not all our liquidity measures will be needed to the same extent as in the past. Accordingly, we will make sure that the extraordinary liquidity measures taken are phased out in a timely and gradual fashion and that the liquidity provided is absorbed in order to counter effectively any threat to price stability over the medium to longer term. By so doing, we will continue to ensure a firm anchoring of medium-term inflation expectations. Such anchoring is indispensable to supporting sustainable growth and employment and contributing to financial stability.

The financial system and individual institutions within it must act now to ensure that a future removal of central bank support can be managed without painful “withdrawal symptoms”.

Preventive care: lessons from the crisis

The overriding objective of someone recovering from a severe illness is not to suffer a relapse. Unfortunately, there is no way of guaranteeing the avoidance of illness. But “preventive medicine” is crucial in reducing the risk of recurrence.

We have to develop a new preventive framework to minimise the risk of recurrence. This framework will have both monetary policy and regulatory dimensions.

“Leaning against the wind” in monetary policy

Recent experience has reopened the debate about whether central banks should use interest rates to “lean against the wind” of asset price surges.

Prior to the crisis, conventional wisdom was sceptical about such an approach for three main reasons: asset price misalignments or “bubbles” were seen as difficult to identify in real time; it was doubted that interest rate increases of a plausible magnitude could contain surging asset prices once these have achieved a momentum of their own; and third, it has been argued that any damage to the economy stemming from an asset price correction can be contained by prompt and aggressive monetary policy easing.

With these considerations in mind, a “wait-and-see” approach was seen as preferable when addressing asset price surges.

Having spoken on these issues in the past, I do not wish to enter into a detailed discussion of these arguments today. I only want to emphasise that recent experience has demonstrated the limitations of a wait-and-see approach. Unprecedented policy action in response to the financial crisis could not prevent a sharp fall in economic activity, with all the consequences for the labour market, public finances and the society as a whole.

Moreover, a wait-and-see approach risks creating moral hazard. What is required is a more symmetric approach: one that leans against the emergence of asset price booms as well as dealing with the consequences of asset price busts. By encouraging more responsible behaviour on the part of investors, such an approach should make such cycles of boom-bust less likely.

But substantial practical questions remain. Clearly, central banks should not target, nor react mechanically to, asset prices. Judgement is necessary in addressing asset price dynamics within an overall framework geared to price stability.

At the ECB, our monetary policy strategy – with its medium-term orientation and focus on monetary and credit developments – offers such a framework. It ensures that we consider the implications for price developments at longer horizons of financial imbalances and asset price misalignments, which may cumulate slowly.

Therefore, while vindication is a strong word, we feel encouraged as regards our monetary policy strategy, whose underlying analysis we continuously deepen.

Concluding remarks

Let me mention that a number of institutional reforms to the supervisory framework within the European Union are currently being finalised. We welcome the new macro-prudential aspects of this framework. They will take concrete form in the creation of the European Systemic Risk Board. The ECB and the EU national central banks stand ready to provide the risk board with their full support.

The Systemic Risk Board will endeavour to provide early warnings and issue recommendations that will help to prevent a renewed build-up of excessive risk in the financial system as a whole. Such warnings would have been useful in the past: they represent a crucial part of the preventive framework for the future.

While financial liberalisation, deregulation and innovation all have the potential to make our economies more productive and more resilient, the financial sector must not forget that it is to serve the real economy, not the other way around.

This, above all, requires a change in mentality within the financial industry itself.

Specifically, the financial industry has to increase transparency, strengthen its management of liquidity and risk, and make its business models more robust. As I mentioned, while maintaining the flow of finance to the real economy, financial institutions must continue to strengthen their balance sheets, by improving their capital and funding positions.

The future will no doubt bring further challenges. As concerns the authorities, we will continue to be alert and vigilant, as in the past. And our 330 million fellow citizens in the euro area will surely not tolerate a relapse into excessive risk-taking at the taxpayer’s expense. Therefore, the financial sector has to secure its future in a responsible and sustainable way.

Thank you very much for your attention.