Jean-Claude Trichet: Key lessons from the crisis

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the "Annual conference 2009", organised by the Asociación de Mercados Financieros, Madrid, 23 November 2009.

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Ladies and Gentlemen,

First of all let me thank the Asociación de Mercados Financieros for inviting me to its Annual conference. It is a special honour for me to speak directly to so many active participants in Spain's financial sector and beyond. Your association provides an important platform for market participants to reflect and address the challenges and opportunities for the sector in a rapidly changing environment.

The financial industry is a key part of the service sector, the infrastructure that makes businesses efficient and a source of value for the economy.

We all have been witnessing the formidable change and progress of the Spanish economy since its accession to the European Community in 1986. Today, and despite the crisis, the Spanish economy is close to the highest standard of economic and social progress available worldwide. The 1990s and the early years of this century have inspired perceptions that a renewed siglo de oro had started.

But the crisis has not spared this country. Spain's unemployment rate is once again edging above euro area averages, with impacts on private consumption and capacity utilisation. Looking forward, Spain's convergence to a balanced growth pattern will require a more balanced progression of income components. Consumption needs to be less dependent on perceived wealth gains, and investment to be more diversified, well beyond the construction sector. This will make participation rates more sustained.

For what concerns the Spanish financial sector, it has long been a source of strength and national pride for this country. In many respects, Spain can be a leading example for global financial reform. I will say more on this later in my talk. Spain's financial system has proved resilient to the shock in the early stage of the crisis. Supported by prudent regulation and supervision, the banking system in this country has built dynamic provisioning cushions during good times. And the traditional role of banking, founded on long-term relationships with customers, has largely been preserved. Looking forward, this is an important asset.

But a solid future calls for some areas of adjustment in the way the financial industry behaves. The exceptional support of public policies will, at some point, have to be withdrawn. Private sector confidence in the future will need to replace policy intervention as the main spur of growth.

The Asociación de Mercados Financieros and its members are an important link in the chain through which confidence will build and transmit to your customers. The obvious prescription for a sustainable return to stability is for many of you to simply look back at your past of prudent and sound management.

Today, I will mainly focus on what we have done at the ECB to deal with the crisis and to support the euro area economy and its banking sector. In particular, I would like to explain the policy that the ECB has adopted to support credit flows in the current environment. This policy has provided a tangible support to households' disposable incomes and firms' credit conditions in all member countries. The people of Spain – a country where a large share of the outstanding mortgages have adjustable rates – have benefited from this policy considerably.

I will draw some key lessons for the stability, resilience and health of the financial system, the global economy and the individual economies more specifically.

Structural reforms in Spain – as in other euro area countries – cannot be avoided or postponed. But in facing these challenges, Spain can build on its past of consistent progress and success since its entry into the European Union, on a young and well-educated labour force and on solid institutions.

I. The ECB's response to the crisis

As you all know, the start of the turbulences began on 9 August 2007. The interactions of very bad risk management and wrong incentives in the financial industry, excessive complexity in financial products and underlying global imbalances were responsible for the previous credit boom and the ensuing bust. The asset cycle turned, and many of the missing links in the financial chain were exposed.

Then, the collapse of a major financial player mid-September 2008 transformed a large-scale crisis of confidence into a global financial panic. Financial intermediaries scrambled to restore liquidity buffers, shed risk and tightened lending conditions. Collectively, they engaged in a large-scale process of "deleveraging". Credit spreads surged and trading activity in a large number of markets collapsed.

In these unprecedented circumstances, the ECB's primary mission was to preserve price stability, in line with our definition – below 2% but close to 2% – and therefore contribute to financial stability. As the inflationary pressures seen over the summer of 2008 receded, we swiftly reduced our policy interest rate in a tight series of steps down to 1%. This interest rate level has not been experienced in the countries of the euro area at any time in recent history.

In parallel, we had to tackle the paralysis of inter-bank transactions in the money market. As you know, 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 made our policy action ineffective. It could have turned the financial crisis into a profound depression.

This is what motivated the second tier of our approach to crisis management: what we refer to as our policy of "enhanced credit support". These "non-standard" measures started in October 2008 and were designed to ensure that our monetary policy intentions were transmitted to the broader economy, despite the problems in the financial sector. The aim has been to enable banks to continue their lending to households and firms.

What have we done specifically? Since October 2008 we have been supplying liquidity in unlimited amounts at the policy rate to the banks demanding refinancing. At the same time, we expanded the list of eligible assets to allow banks to refinance with us a larger share of their balance sheet. This made it possible for many banks to protect their loan and securities portfolios from forced liquidation. Otherwise they could have triggered an avalanche of fire sales in the open market. The interruption of loan contracts would have taken a high toll on the real economy.

We also wanted to support banks in maintaining longer-term credit commitments. Therefore, we have provided liquidity for longer periods. In June this year, we conducted the first operation for one year. We allotted more than €440 billion in this operation. In the second operation, in late September, we supplied banks with €75 billion, and a third operation of one year is scheduled for December.

The crisis also exposed the severity of currency mismatches in banks' balance. To help alleviate those problems, we have provided liquidity in foreign currencies, most notably in US dollars, backed by a swap facility with the Federal Reserve System. Thanks to our policy, banks could count on an ongoing access to foreign currency balances.

These measures can all be seen as an expansion of our regular open market operations with banks. In consonance with this tradition, our non-standard policy was first and foremost aimed at expanding that form of credit in volume and maturity. In July this year, we started to purchase securities outright as a vehicle for introducing further credit support. We intervened directly in the longer-maturity segments of financial markets by buying covered bonds issued by banks. When presenting this decision, I stressed that we were very much in the continuity of our open market operations, because we still had in front of us both the signature of the commercial bank issuing the bonds and the underlying asset itself.

Let me focus more closely on covered bonds for a moment, as they are important for the euro area – and for Spain.

Covered bonds are an attractive source of funding for banks because they have long-term maturities. They help control and rebalance the maturity mismatch between assets and liabilities in banks' balance sheets.

But they are attractive instruments of finance for investors as well. Unlike asset-backed securities, covered bonds do not involve a transfer of credit risk from the issuer to the investor. Credit risk stays with the originator, preserving the incentives for prudent evaluation and monitoring.

From the point of view of the Eurosystem, this was a very important attribute, on top of the fact that covered bonds are akin to our traditional repurchase operations.

Since the announcement in May there has been a wave of new issuances. As Spanish banks have traditionally been significant issuers of this type of securities, developments in Spain are representative.

The issuance volume of Spanish banks between the time of the announcement and the end of October has reached 16 billion euro. It is now around 20% of the total euro area issuance. Spreads have declined in tandem. In Spain they are now more than 100 basis points lower than the level they reached at their peak. Liquidity has returned to the market, with tangible reductions in bid-ask spreads in secondary transactions.

We interpret these developments as a confirmation that our purchase programme, although measured in size, has been effective in bringing new life to an important segment of the European financial market. Overall, we are very satisfied with the effectiveness of this programme.

II. Lessons: present and future

What lessons can we draw from the financial crisis that has occupied all of us for more the last two years?

The crisis has exposed the fundamental fragility of the international financial system. No segment of the market or category of players has been spared.

Therefore, we have to re-consider all aspects of finance as a precondition to reform. Macro-economic policies in some areas have also shown deficiencies, in particular when they lacked a medium-term orientation towards sustainability.

Looking ahead, we need to refine and broaden their oversight of the nexus between financial markets and the macro-economy. Financial risks and the increasing potential for these risks to become contagious and escalate to systemic proportions need to be better identified.

At the level of national economies, efforts should be reinforced by measures to strengthen the structural engines of their economic systems. Far from putting off the agenda for structural reforms, the crisis has made them more urgent.

I want to share with you my thoughts on reform along each of these three dimensions: the financial sphere, global governance, and the structural set-up of local economies.

Financial reform

The ultimate goal of financial reform is clear: the financial sector will have to return to its role of providing the best possible service to the real economy. The fundamental role of financial markets is the intermediation of funds between savers and investors.

During the recent past, this function has been expanded by increasing possibilities for diversification: diversification of risks for savers; diversification of funding sources for investors. For a long time, the demand for hedging against economic risk among entrepreneurs has grown in tandem with the growing supply of new and innovative financial techniques. But at some point supply outgrew demand. Financial innovation ceased to facilitate trade and real investment opportunities and started to become self-sustaining. This weakened incentives to conduct prudent screening and a thorough monitoring of loan quality. Credit became plentiful and market liquidity expanded at a pace that could ultimately no longer be justified.

Looking ahead, three steps will be required to a more resilient system.

- First, the tendency for finance to become pro-cyclical even at a system-wide level needs to be strongly mitigated. The quality and quantity of bank capital and their liquidity buffers have to be improved in good times to provide a sufficient buffer for bank equity 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. Informed decisions by market agents are a key element of market economies. Lack of transparency of financial products masked abuse and led to disaster. Looking into the future, all institutions, instruments and markets of any relevance for systemic stability need to enhance risk disclosure.
- Third, once more, incentives need to be aligned. 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 has resulted in excessive risk taking. A reform of the executive compensation schemes and practices is an essential part of our effort to secure financial stability.

At the financial level, reform in Europe will follow a two-pronged approach. First, it will be centred around the European System of Financial Supervisors. The establishment of this System will permit better coordination among national authorities responsible for financial regulation. If one lesson can be learnt from the crisis, it is that the reach of financial supervision and regulation needs to be extended to better monitor those financial institutions, including highly leveraged, which can arbitrage across national borders and across oversight jurisdictions.

The European Systemic Risk Board (ESRB) will be the other dimension of the European approach to financial reform. This new body will 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. The crisis has displayed the phase transition that risk can undergo almost overnight: a mutation from localised liquidity risk to a generalised solvency threat attacking the whole system of financial interconnections. The ESRB will have to oversee the likelihood and measure the severity of these reactions and instant transmissions. The ECB and the National Central Banks in the EU will fully contribute to this new institutional framework.

Global governance

The underlying approach to reforms should be holistic. The global proportions of the crisis call for a rethinking of the links between financial behaviour and macroeconomic policies, as they interact in a global scene.

The G 20 has made a quantum leap in creating the new premier global economic group. The aspect that impresses me most about this group is the virtually universal consensus on global economic issues. There is a broad consensus at the level of the G 20 on the diagnosis of the crisis. There is a broad consensus on the appropriate response to the crisis. And there is a broad consensus on the direction of financial sector reform, along with the main ideas that I described a moment ago.

There is agreement that macroeconomic policies at the domestic level need to be consistent with the objective of global financial and economic stability. Medium-term and long-term sustainability in domestic macroeconomic policies will have to prevail. A renewed medium-term perspective should guide macro-economic policies from now on. Like financial regulation, policies should not amplify economic fluctuations.

Structural reform

As I said, structural reform is ultimately the responsibility of individual economies. The crisis has reduced some of the imbalances almost automatically. In the euro area, economies with wide current account imbalances – including Spain – have suffered relatively more than others. As a consequence, output and employment losses in these countries are acting as potent stabilisers to re-absorb long-standing gaps between domestic savings and domestic investment. As Miguel Fernández-Ordóñez has said, some structural weaknesses have been revealed even more clearly and call for appropriate reforms.

Spain was on a pattern of growth in the run-up to the crisis that was not sustainable. Before the decline, the housing market had seen an important boom fuelled by expected future higher earnings, an important inflow of migrants and low financing costs. The buoyancy of aggregate demand, in turn, supported a wage-setting environment that did not correspond to the underlying gains in productivity.

In the future, changes in labour market institutions to make wages adjust to productivity are essential to repairing past cumulative misalignments. There is a need for moderation in wage claims to regain competitiveness. This window of opportunity cannot be missed in those countries where substantial increases of production costs have been one of the causes for widening imbalances in current accounts, and Spain is one of them. In this country, the burden of the crisis has fallen disproportionately on temporary workers. Compensation for those employed on a permanent basis has seen only minor adjustments. Looking into the future, wage flexibility will need to be made more widespread.

At the same time the main asset for growth and development in our societies is human capital. Incentives need to be shaped to maintain and develop knowledge by each individual and – collectively – by companies and institutions. This includes training and investment into the workforce, supported by well-designed employment contracts. Reforms in services, can further support the recovery and contain price increases once private expenditure recovers. In the end, these reforms, by increasing productivity and competitiveness help rebalance the external accounts on a permanent basis and reduce the reliance on external financing.

Needless to say, the complexity of the international financial crisis and the synchronised weakening of the real economy have put banks in a complex and exceptional position. In the short-term, with the economic slump and the high levels of unemployment, non-performing loans will be on the rise. And pressure on banks' balance sheets will keep increasing. The business model will have to adapt to the new competitive reality and the international conditions. This may translate into stricter cost management and the use of new technologies. One of the most important tasks will be to embark on a profound restructuring of a number of medium-sized institutions. Restructuring processes ought to aim at tighter synergies and economies of scale. The effort that needed is formidable, but Spain has witnessed numerous processes of this type in the past, which have resulted in highly successful business models.

III. On the way to normal times

As you know, in its last meeting the Governing Council of the ECB has judged the present level of our policy rates as appropriate. As regards our non standard measures, as the situation returns to more normal times, the focus on the medium term calls for a gradual and timely phasing out of these measures.

A number of measures – think of our refinancing operations – will phase out naturally by design. As of today, it is still premature to declare the financial crisis over. But when the appropriate time comes, there should be no concern about the ECB's determination and ability to exit. 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.

On the institutional side, the Governing Council has the unfettered capability to decide and institute appropriate policies whenever circumstances warrant.

Fiscal authorities, too, need an exit strategy. Their response was instrumental in avoiding a collapse of the financial system. It helped to halt the sharp decline in economic activity and build general confidence. But that response also entailed significant fiscal costs. Only the additional fiscal burden that is associated with the workings of automatic stabilisers will reverse by design once economic conditions improve. Discretionary interventions will need discretionary action to unwind. In any case, the additional fiscal costs that governments have shouldered will be carried forward in terms of higher debt for years to come. This is why there is an increasingly pressing need for ambitious and realistic fiscal exit strategies and for fiscal consolidation. Some countries are in a relatively favourable position because their past management was wise and prudent, while others are already very close to losing credibility. Spain – where fiscal consolidation had progressed more than elsewhere – will have to make sure that it keeps its fiscal credibility in the years to come in strictly meeting the requirements of the Stability and Growth Pact.

A clear plan for a medium-term fiscal correction becomes even more pressing for rapidly ageing societies like ours, as an increasing numbers of pensioners will mean mounting claims on public transfers.

IV. Conclusion

More than one year after the dramatic deepening of the financial crisis in September 2008, we can spot a number of signs of economic stabilisation in the euro area. We have halted the freefall in economic activity that we witnessed over a period lasting more than six months after the intensification of the crisis in mid-September 2008.

But the crisis has debilitated the real economy. As I said, the crisis has proved so deep because it has deprived our citizens of confidence. Every business activity is by its very nature an act of trust, an expression of confidence. As regards bankers, by granting loans more actively to entrepreneurs they can contribute to transmitting and inspiring confidence to the economy at large.

Being part of the euro area and the European Union will help in this process.

For what concerns the ECB and the entire Eurosystem team, with Banco de España as a very active member of the team, our 330 million fellow citizens in the euro area ask that we continue to deliver price stability over the medium term, in line with our definition – less than 2% but close to 2%. Our determination to anchor solidly inflation expectations has served us well since the introduction of the euro, including in the recent period of crisis, by helping to avoid the materialisation of the risk of deflation.

The euro area can count on us to continue to be a solid anchor of stability and confidence in these challenging times.

Thank you for your attention.