Jean-Claude Trichet: The crisis and beyond

Ceremonial address by Mr Jean-Claude Trichet, President of the European Central Bank, at "100 Years of Confindustria", Parma, 10 April 2010.

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Signor Presidente del Consiglio dei Ministri,
Signor Presidente della Regione Emilia-Romagna,
Signora Marcegaglia,
Autorità,
Signore e Signori,

Ho dinanzi a me "l'Italia che lavora e che produce", come ebbe a scrivere Luigi Einaudi, salutando il primo embrione di Confindustria. [TRANSLATION: I have in front of me "all of Italy who work and produce", as Luigi Einaudi wrote to greet the first embryo of Confindustria. *This refers to an article written by L. Einaudi (one of the fathers of the public finance literature, later governor of the Bank of Italy, and first President of the Italian Republic between 1948 and 1955), published by Corriere della Sera on 5 May 1910.*]

I cannot deny that I go back to those early days of the past century with some pride. As you know, a Frenchman, Louis Bonnefon, christened your centenary Association in 1910, as he became its first Chairman.

He had descended the Alps from Lyon to neighbouring *Piémont* – not a long journey, geographically or culturally. He had become a respected entrepreneur in the textile industry. In that region, he had encountered a brewing *milieu* of industrialists, ready to go from craftsmanship to a new, modern, model of industrial organisation. He found that this new generation of industrialists was inspired by a deep sense of pragmatism. They had a strong talent for a scientific organisation of labour and capital, an acute taste for innovation. They were highly appreciative of technical education – in a country in which *"la formazione umanistica"* was considered the most dignified level of knowledge. They found personal fulfilment in collective progress.

These people were the first affiliates of Confindustria, when Confindustria was founded in the wake of the global financial panic of 1907. At the time – with a sharp contraction in the volume of bank credit – it was necessary for the nascent industrial *milieu* in northern Italy to establish a common strategy. Italy, where equity capital traditionally had been scarce, was highly dependent on bank loans for investment. But banks had been hit by the international crisis and were retrenching. So, in 1910 Confindustria was designed to inspire and promote an *"alleanza tra i produttori"* which could strengthen existing enterprises and multiply their number. Indeed this strategy reinforced the industrial sector and prepared the ground for its incredible success. From an agrarian society, with large pockets of poverty, Italy raised to the position of a leading industrial power.

The 2008 financial panic was no less dramatic than the 1907 crash. As we enter the second quarter of 2010, the global economy has just begun to emerge from a prolonged period of economic turmoil. In the euro area, we expect a moderate recovery in the current year.

But the recent decline in international trade has been sharp, rapid and exceptionally synchronised. This means that the recovery in Europe – a trade superpower – is likely to be surrounded by uncertainty. Also, given the diverse pattern of country specialisations within the European Union, the recovery will probably be uneven across regions and sectors, and over time.

Like in the few years that followed the 1907 crisis – today Italy has been hit hard. As a prime exporter of equipment and machinery, this country has particularly suffered from the lopsided composition of the shortfalls in international trade.

But, many times – in the 100 years spanned by Confindustria – after a profound crisis, Italy has gradually moved back to the forefront of innovation and economic excellence. I am sure Confindustria will be part of this come-back.

This morning I should share with you my thoughts on the nature of the crisis and on the strategy that I see as an effective tool for a new start, both in Italy and in Europe more broadly. I will conclude that being able to rely on a solid real economy is an exceptionally valuable asset. The euro and the European Central Bank will accompany and help this process. You, entrepreneurs, will be decisive actors.

Financial excesses

Let me start with a short overview of the nature of the crisis. Here, it is critical to draw a distinction between *economic risk* and *financial risk*.

You know what economic risk is: the risk that your companies face when they introduce new products and new processes. Investment consumes resources in the present, and its future payoffs are uncertain in time and magnitude. This is economic risk.

Historically, the financial industry has been at the forefront of economic progress, because of its ability to offer funding to those who take on economic risk.

But in the recent past the focus of finance has gradually shifted. From helping the real economy hedge economic risk, the focus of finance has quietly moved toward the creation of *financial risk*. Financial risk is different from economic risk. It is deliberate exposure to asset price changes.

Building an exposure to a change in the value of an asset is not bad *per se*. But we have to distinguish between arbitrage and directional positioning. Arbitrage is an essential market force. Indirectly, it helps production and trade. Directional positioning, instead, can amplify and even creates gaps in asset prices. It does so by acting on expectations of future price changes. Unlike in the case of arbitrage, these price gaps are notional – indeed, "speculative". They are often large only because they are not suitably discounted for risk.

When perceived market risk is moderate, failing to discount for risk is not a severe omission. Indeed, in the ten years that led up to the crisis, financial risk was thought to be low and declining.

But, the notion that risk was low and declining was largely an illusion. Individually, diversified financial strategies looked all as rational attempts to unload risk to those parties in the system which were more willing to bear it. In the aggregate, however, diversification was subject to a sort of fallacy of composition.

Individual strategies were diversified. But the aggregation of a complex web of identical strategies – all designed to shed risk individually – generated a lack of diversity for the financial system as a whole. In the end, it turned out that the system could not diversify risk away. Furthermore, the complexity of the financial web made this fact more difficult to identify.

A C.E.O. of an important bank had a terrible image to describe the euphoric state of the markets, only few weeks before the crisis started. He said that: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing". The "dancing" in the metaphor was an irresponsible credit boom, where banks scrambled for borrowers, and the borrowers could dictate the conditions for credit.

Confronted with a similar landscape of market euphoria and industrial hardships in the 1920s, Churchill said: "*I would rather see finance less proud and industry more content*".

Between, say, 2005 and much of 2007 the system was quietly sliding into a state of meta-stability. A system is meta-stable when any external shock – even a trivial disturbance – can tip the balance of stability and trigger an avalanche. When, on 15 September 2008, Lehman Brothers filed for bankruptcy, the turmoil that had started a year earlier turned into an avalanche. The system moved into a chaotic state, mathematically and metaphorically.

The crash

In times of financial panic, banks and other financial intermediaries have an instinct to change the composition of their assets. They shed risky and illiquid investments and rush to liquidity. In the process, banks' intermediation is reduced, and loans to companies are curtailed. If the process is let unfold in a disorderly manner, it can create severe damage for borrowers and for the broader economy.

After the demise of Lehman, liquidity hoarding was so intense that we feared bank intermediation would suffer a complete and lasting collapse.

The ECB was the first central bank in the world – a whole year before the Lehman crisis – to recognise the severity of the situation. As the failure of Lehman precipitated the crisis, the ECB took several measures to protect against a disorderly correction in credit and liquidity conditions.

The ECB provided liquidity in unlimited volumes and with longer maturities. We insured banks against present and future liquidity shortfalls.

You know that the flow of credit is primarily channelled through banks in the euro area. A complete breakdown in the funding relationships that constitute the inter-bank market for liquidity would have derailed the bank lending channel altogether. The interruption of the bank lending channel would have turned the financial crisis into a profound depression. By granting unlimited access to central bank liquidity we put banks in a position to maintain their crucial role in the financing of the real economy. By reducing the interest rate at which banks can borrow liquidity from us we facilitated the transmission of our credit support to the economy.

As I speak, the funding ability of banks appears no longer to be a restraining factor for bank lending. Since the second half of last year, easy funding conditions have been supporting banks' core business: making loans. We still see – in our Bank Lending Survey – a residual slight prevalence of banks declaring a tightening in their credit standards for loans to enterprises. But this is now entirely due to macroeconomic uncertainty. A number of banks are still hesitant because the conditions of their borrowers are still fragile. But in several euro area countries, and Italy is one of them, overall credit standards for corporate loans have already started to ease.

Three ways forward

The crisis, no doubt, has changed our world. I see three ways forward.

Macroeconomic policies

Macroeconomic policies should concentrate on medium-term objectives. This is the perspective entrepreneurs take when deciding on the scale of activities, on investment in plant capacity, on hiring and downsizing labour. Entrepreneurs do not think of today or tomorrow. Entrepreneurs think over the medium to long term. This is the perspective that should guide macroeconomic authorities.

Let me mention that a similar medium-term perspective has guided fiscal policy in Italy throughout the crisis. The fiscal authority has resisted pressures to introduce fiscal stimulus over and above the loosening of the fiscal stance coming from the operation of the automatic stabilisers that are built into the fiscal code. This is an appropriate strategy, given Italy's public debt burden and the prospects for its evolution in the long run.

For what the ECB is concerned, a medium term perspective is what motivates the gradual phasing-out of our extraordinary credit support measures.

The logic which guides our policy is simple. We have granted banks privileged access to credit, when a tightening of their funding conditions would have meant a break-down in the entire chain of intermediation. Now, we have to guard against the possibility that an excess of credit support might become a subsidy to unproductive activities.

If excess credit allows banks to reap excessive returns from directional positioning, they might loose an incentive to expand their lending to the economy. In the end, they might become too dependent on central bank credit. It is possible that credit flows might be diverted away from the funding of productive activities – your businesses – and toward financial arbitrage. You see: underwriting and servicing a loan to a company is resource intensive for a bank. Maintaining an active trading book is less so, particularly if risks are incorrectly priced.

We have decided that we will gradually return to normal procedures for granting liquidity to banks. This will cure opportunistic bidding behaviour and discourage unproductive arbitrage across assets.

Financial reform

The second way forward is financial reform. This needs to be global in scope and surgical in its focus. No segment of the market or category of players has been immune to the crisis. We need to immunise the financial system against its intrinsic tendency to complacency. Three intrinsic weaknesses need correction.

- First, the *transparency* of the financial structures needs to be enhanced. Financial innovation cannot be built upon – and exploit – gaps in investor information and lack of financial literacy. All institutions, instruments and markets of any relevance for systemic stability need to enhance risk disclosure.
- Second, *short-termism* in the design of financial contracts. Market participants were given strong economic incentives to focus on short-term profits. "Due diligence" was not a concern in the pre-crisis world. Collectively, this has resulted in excessive risk taking.
- Third, and perhaps foremost, the *pro-cyclicality* of the financial system needs to be 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 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.

These three points – and others – are now in the mission of the G-20, the new prime forum of international cooperation. The G20 has entrusted many of these tasks to the Financial Stability Board – headed by Mario Draghi.

The business activities that you represent here should benefit from financial reform. Lenders will be made more attentive to the real economic prospects of their borrowers. Long-term value creation will – once again – be the criterion for granting credit to the economy.

Structural change

Entrepreneurs will be important actors of structural change, my third way forward.

Here we can build on assets that have made our real economies in the Continent successful: our openness to trade; our balanced and dynamic business structures; our talented and well-trained workforces.

None of these factors is single-faced. I mentioned already that the openness of our economies has been seen as a major challenge. Greater openness has meant that our economies have been more exposed to the international crisis. But the past trend to global trade integration has already called for a major adjustment in the euro area production patterns. Many countries in the European Union have adjusted their export portfolios according to the technological advantages of advanced economies. In Italy, about half of the firms with 20 or more employees are engaged in restructuring. Many of them are consolidating their technological edge and diversifying their markets. They have moved towards products that are more skill-intensive and more capital-intensive. This upgrade of our production structure will make European – and Italian – firms better prepared for international markets.

We already see signs of improvements. Extra-euro area export volumes have rebounded markedly over the last few months. This rebound has been broad-based, but particularly pronounced for capital goods and intermediate goods, where Europe and Italy are important suppliers. The geographical composition of foreign demand will also be a supporting factor. It is relatively strong for Eastern European countries which do not belong to the Union, for OPEC members, as well as for Latin America and Africa. All these regions account for almost a quarter of euro area exports.

At the same time, a self-sustaining recovery cannot abstract from intra-Union trade and domestic investment in plant capacity, technologies and human capital.

Here, many members of the European Union – and this country in particular – need to advance farther. The lack of investment in capital and skills erodes competitiveness. Lack of long-term economic competitiveness, in turn, can sap confidence and undermine the Union's internal cohesion.

Economies, such as Italy, that in the aggregate have observed a decrease in their market shares need to launch a new long-term competitiveness strategy to harness domestic manpower, skills and capital to the best of their potential.

Structural reforms are critical to this process. And I would like to refer here to the constant messages of Banca d'Italia on reforms in the markets of goods and services, in the labour market and in the domain of pensions. I would also mention three points: an upgrade of high-level education is the top one; regulatory simplification and the reduction of bureaucratic costs for business activity – in particular for business start-ups; and the dismantling of rent-seeking positions – which tax disposable incomes and the economic potential. In Italy, in particular, the pricing chain – notably in the service sector – would benefit from be streamlined to increase the flexibility of goods prices.

None of these avenues will be possible without a critical commitment on the side of the public authority.

But in the end, as I said, you entrepreneurs are very important actors of structural change.

Concluding remarks

You have a sound platform on which you can build your future.

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

Second, the euro has shielded your economy from the worst consequences of a financial fright of historical proportions. You know that the people of Europe can count on us, the ECB and the Eurosystem, to continue to be a solid anchor of stability and confidence.

Third, and no less important, you have a strong tradition. Remember that Italy's manufacturing sector withstood many challenges in recent history.

As in the past, the real economy of production and innovation which you represent here today will return back to the front line where it has belonged since the end of the War. For all of us in Europe, the force to boot-strap ourselves out of the present hardships will come from inside. And we know that technological progress will continue unabated in Europe.

Thank you.