EUROPEAN CENTRAL BANK

EUROSYSTEM

The financial crisis and the response of the ECB

Speech by Jean-Claude Trichet, President of the ECB at the Ceremony conferring the honorary title of Doctor Honoris Causa at the University of National and World Economy, Bulgaria in Sofia on 12 June 2009

Ladies and gentlemen,

It is a great privilege for me to be here in Sofia today to accept an honorary doctorate from the distinguished University of National and World Economy (UNWE), Bulgaria's most respected economics institute.

To properly mark the occasion, I would like to talk about the global financial crisis and its roots, and the ECB's response to the crisis.

The global financial crisis and its roots

Let me start by briefly highlighting the origins and evolution of the current crisis. Imagine a neutral observer who looked at the financial sector about a decade ago and then didn't look at it again until the eve of the current financial crisis. He would have found a completely different financial industry, one which over the past decade has undergone a dramatic shift of focus. He would have discovered a financial system that had moved away from its traditional role of supporting trade and real investment. He would have found a financial system in which speculation and financial gambling had run rife. He would have encountered a system transformed – a system no longer managing genuine economic risks but one actually creating and assuming financial risks – risks resulting from arbitrage and intentional exposure to asset price changes.

That same observer would have realised that financial liberalisation and innovation had made our economies more productive. The securitisation of assets, for example, had great potential to diversify economic risks and to manage them efficiently. But it also meant that financial institutions were able to sell loans or take them off the balance sheet, which weakened lenders' incentives to conduct prudent screening and constant monitoring of credit risk. So underwriting standards and lending oversight declined, and contributed to the excessive credit growth in the second half of the 1990s.

In sum, the observer would have concluded that the factors that fuelled the credit and asset price boom of the past decade also created the conditions for a bust.

In mid-2007 we started to see the backlash. The start of the financial turmoil was sudden but not unexpected. The financial system as it worked over the past decade – with its flawed incentives and its overly complex products and with global imbalances as its macroeconomic backdrop – was no longer sustainable. The asset cycle turned, the weaknesses were exposed and investors suddenly lost confidence. After years of exceptional risk appetite and high profits, the pendulum swung in the opposite direction, as markets became extremely sensitive to financial risk.

In September last year, the crisis escalated sharply, turning a large-scale crisis of confidence into a global financial panic. Financial intermediaries restored liquidity buffers, tried to economise on capital and to scale down their balance sheets. They sold assets and tightened lending conditions. Banks and other financial institutions drastically reduced their exposure to the risks that they had imprudently accumulated during the phase of financial euphoria. Financial intermediation and loans to companies were curtailed in the wake of a forceful process of "deleveraging".

This was the point when important spillovers of the financial crisis set in. We saw the almost immediate spillover from the financial sector to the real economy. The credit squeeze and loss of confidence started to take a toll on the real economy, and a negative feedback developed between the financial sector and the real economy, and has since become a major feature of economic and financial developments. Almost simultaneously, the crisis that originated in the advanced economies spilled over to the emerging market economies. Since the fourth quarter of 2008, virtually all economies – both those of the industrialised countries and the emerging markets – have faced synchronised business cycles in may parts of the world.

The ECB's response to the financial crisis

Since the start of the financial turmoil, central banks around the globe face unprecedented challenges. We at the ECB and other central banks have reacted swiftly, flexibly and decisively. The ECB took the lead with some exceptional decisions as early as 9 August 2007. We have, since then, modified our operational framework and used an exceptional set of non-standard policy tools. These tools, combined with the bold action taken by euro area governments over recent months, have played an essential role in preventing a collapse of the financial system and in bolstering confidence.

I would like to emphasise that despite this upheaval and our exceptional measures, our objective remains unchanged: to preserve price stability over the medium term, and that's what guides our policy. In so doing, we support the conditions for financial and economic stability. The crisis has not changed this objective.

Interest rates

As regards interest rates, the ECB's Governing Council has reacted promptly and decisively to the intensification and broadening of the global financial turbulence. We have lowered our key interest rate by 325 basis points since October 2008. This is the largest cut ever decided over such a short period in Europe. These moves were fully in line with our strategy. The upside risks to price stability have indeed receded considerably over that period due to the sharp fall in oil and other commodity prices, and the abrupt slowdown in economic activity. As price stability is the needle in our compass, we took account of the easing of inflationary pressures and lowered interest rates.

In this context, I would like to underline that since the introduction of the euro in 1999, the ECB's quantitative definition of price stability – an inflation rate of below, but close to, 2% in the euro area, over the medium term – has proved to be an invaluable asset. It has guarded against undesirably high inflation and against deflation. Long-term inflation expectations in the euro area, whether based on surveys or extracted from financial indicators, have been and continue to be firmly anchored at levels consistent with our definition of price stability. Inflation expectations have been exceptionally resistant to sudden upward short-term price changes, and we have ensured that is also the case with sharply falling inflation.

Non-standard measures

In addition to reducing interest rates, we have taken exceptional policy actions in response to the crisis – 'non-standard' measures related to liquidity management. At the very start of the money market stress in August 2007, the ECB reacted within a few hours and temporarily provided additional liquidity to banks with immediate liquidity needs. We were in fact the first central bank to take non-standard measures.

When in mid-September 2008 the crisis intensified and interbank trading came to a virtual halt, the ECB engaged in a new mode of liquidity provision. We started to provide refinancing well above the levels that banks had absorbed to fulfil their reserve requirements in normal times. Our approach comprises three main 'building blocks'.

- We significantly adapted our regular refinancing operations. We now follow a 'fixed rate full allotment' tender procedure and have significantly expanded the maturity of our operations. Banks have been granted access to essentially unlimited liquidity at our policy interest rate at maturities of, initially, up to six months. This is an exceptional mode of operation. In normal times we auction a given amount of central bank credit and let competition between the bidders determine the interest rate. This unusual mode of operation implies that we currently act as a surrogate for the market in terms of both liquidity allocation and price-setting.

- Our second building block is the long list of assets that we take as collateral. This list was already very long before the crisis, but we have extended it even further and now accept an even wider range of securities as collateral.
- The first two building blocks offer unlimited refinancing against a very wide range of collateral. But they can only reach the financial system if they are coupled with the third building block, namely the very large number of counterparties that have always been able to take part in our refinancing operations. Even before the financial crisis, this number was higher than for the other major central banks. Following the changes to our operational framework in October last year, this number rose further.

All these non-standard measures were supplemented by further exceptional steps that the ECB's Governing Council decided in early May and June this year.

- We now conduct liquidity-providing longer-term refinancing operations with a maturity of 12 months. This will further lengthen the maturity at which we provide banks with liquidity at fixed rates and full allotment. This move is consistent with the operations we have undertaken since October 2008 and it recognises the central role played by the banking system in the euro area economy.
- The European Investment Bank (EIB) is becoming an eligible counterparty in the Eurosystem's monetary policy operations. Access to the Eurosystem's liquidity is a natural complement to the EIB's financing initiatives and it will facilitate the accommodation by the EIB of additional demand for its lending programme.
- Furthermore, the Eurosystem will purchase euro-denominated covered bonds issued in the euro area of about €60 billion. These purchases will target an important segment of the private securities market, which has been particularly affected by the financial market turbulence. We have outlined the specific modalities of implementation last week.

Our primary concern when taking these decisions in recent months was to maintain the availability of credit for households and companies at accessible rates. I have described that as 'enhanced credit support'. Furthermore, our very flexible liquidity management ensured that solvent banks did not get into difficulties because of liquidity constraints.

Our response to the crisis has been carefully calibrated to the financial and economic structures of the euro area. In particular, we needed to bear in mind that the euro area's financial system is predominantly bank-based. Take the structures of private credit outstanding as an example: recourse to banks makes up more than 70% of non-equity external finance in the euro area. By comparison, in the US the equivalent proportion is only around 30%. This reflects the fact that the US financial system is primarily market-based. In the euro area, guaranteeing steady access to credit for households and companies largely means preserving the viability of the banking system. Banks play such a dominant role in our economy that it was appropriate to focus our non-standard measures on the banking sector.

Conclusion

To conclude, I would like to call your attention to the following points.

To start with, we are, for the first time, putting to the test the soundness and resilience of the globalised economy, which has become increasingly integrated over the past fifteen years. We now have to draw, systematically and without complacency, the lessons of the global crisis that we are fighting against.

Secondly, we have a duty. Our duty is to considerably reinforce the resilience of the global financial system and the soundness of the real global economy. We should not allow that, a few years from now, a new crisis would emerge that would be similar to the current one. That would be unforgivable.

Thirdly, the international community has engaged in drawing all lessons from the crisis. We agree on the method, on the role of the G20, on the role of the Financial Stability Board, and on the role of international financial institutions, in particular the crucial role of the International Monetary Fund, and also of the Bank for International Settlements, which during the past years has shown remarkable lucidity in its analysis. As regards the global financial sector, we agree on the broad orientations to follow: to reduce procyclicality, to fight short-termism, and to impose transparency.

Fourthly, we are still today in a very difficult and very unpredictable environment. We permanently need to remain alert, and there is no place for complacency. I would have two main messages in that regard. As concerns direct government support to the financial sector, today's priority is "rapidity of execution." Decisions that have already been taken should be implemented swiftly. This holds true, in particular, for recapitalisation, as currently only about 55% of funds earmarked for recapitalisation have been used in the euro area. In crisis times, rapid implementation is crucial. As concerns global governance, I insist on the absolute necessity to reinforce macroeconomic policy surveillance of systematically important countries and economies. The IMF has to play a fundamental role in such monitoring, coupled with responsible and active peer surveillance.

Finally, central banks have a fundamental role in ensuring monetary and financial stability from a long-term perspective. The world economy can count on central banks to continue to act as anchors of stability, which are more needed than ever. The European Central Bank, for its part, will continue to be an anchor of stability and confidence.

Thank you for your attention.

European Central Bank

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