

# **Discurso de Jean-Claude Trichet, presidente del BCE, en el Foro de la Nueva Economía**

**Madrid, 22 June 2009**

Ladies and gentlemen,

I would like to thank the organisers for inviting me today to talk about the ECB's policy actions in these times of truly unprecedented challenges – for our financial system, for the businesses large and small that drive our economy and for the citizens of Spain, the euro area and beyond.

As some of you might remember, I was here in Madrid five years ago to give a speech on “The challenges for the European economy in 2004”. At that time one important issue was whether the economic recovery that had become apparent in the second half of 2003 would gather momentum. Another important issue was the need for economic policies that would make the euro area economy more resilient to sudden and sometimes unexpected events and to foster its potential for sustainable long term growth.

Needless to say, the challenges the euro area currently faces are of a different order of magnitude than in 2004. Yet, at a fundamental level, the key issues are similar, namely how to pave the way for a robust recovery and how to increase the long term growth potential in a sustainable manner. In my view these two questions – the cyclical and the structural – are closely entwined. To restore confidence in the near-term and the long-term future, policymakers in the euro area and elsewhere must maintain an appropriate balance between bold short-term action and the return to a path that is sustainable in the medium term.

As I will explain, the ECB's policy actions since the onset of the financial crisis have been at the same time very bold and strongly anchored in the medium-term framework of our monetary policy strategy. We were the first to act when signs of financial stress emerged back in August 2007. We stepped forcefully into the breach when the collapse of a major financial player abroad threatened global financial stability last autumn, embarking in a full allotment mode with fixed rates for the supply of liquidity. And in recent months, we have further deepened the set of measures that we call our policy of “enhanced credit support”.

All the measures we are using share two crucial features: first, they are designed to be effective in preserving the functioning of the money market, the appropriate financing of the economy and taking into account the very significant rebalancing of inflationary risks; second, they can be easily unwound once the financial crisis attenuates and when we see any risks of a future rise in inflation. These two features ensure that all measures taken are fully consistent with the ECB's primary objective, which is to preserve price stability in the euro area over the medium term.

Beyond monetary policy, I see two policy priorities going forward. First, governments need to spell out how they envisage unwinding the crisis-related fiscal stimulus measures to return to sustainable fiscal positions in the medium term. This is particularly important as substantial support for the financial sector might still be needed. While this support often does not directly affect fiscal balances, it creates contingent liabilities that may have to be catered for. Second, the urgent need for reform of the global financial architecture should not distract from the need for further progress with labor and product market reform in the euro area. Rigorous implementation of the Lisbon reform agenda remains as pressing as ever, as increased productivity and efficiency will not only foster the development of the private sector, but also facilitate the return to sustainable fiscal positions.

In my remarks today, I would like first to recall the origins of the crisis. I will then explain in detail the various actions the ECB has taken to support the euro area economy and the financial system. Before concluding, I will also say a few words on the specific challenges currently facing the Spanish economy.

## **The roots of the financial crisis and its propagation**

Over the past ten years, we have witnessed a dramatic shift of focus in large parts of the financial sector – away from facilitating trade and real investment towards unfettered speculation and financial gambling. To be clear, I do not deny that financial liberalisation and financial innovation over the past two decades have made important contributions to the overall productivity of our economies. For example, the securitisation of assets – the transformation of bilateral loans into tradable credit instruments – had tremendous potential for the diversification and efficient management of economic risk.

But the way securitisation was implemented also meant that banks and non-banks were able not only to sell loans, but also often to place them fully off-balance sheet immediately after they had been extended. This weakened their incentives to conduct prudent screening and constant monitoring of loans. This is true only for the most recent product innovations in the field of securitisation. It is not true for a financial innovation that is more than two hundred years old: covered bonds. I will return to this asset class and give you a detailed assessment when I describe the ECB's recent policy actions.

The credit boom was exacerbated by three multipliers. First, incentives: ill-designed compensation schemes for loan managers and traders reinforced the shortening of their time horizons. Second, complexity: increasingly complicated and opaque financial instruments made it difficult for holders of securities to assess the quality of the underlying investments. And third, global macroeconomic imbalances: a chronic shortage of savings in some industrialised economies was made possible by an excess of savings in other parts of the world. This acted as a multiplier that was exacerbated during the years immediately preceding the crisis by the sharply rising prices of oil and other commodities.

In mid-2007, suddenly though not unexpectedly, the interactions of perverse incentives, excessive complexity and global imbalances threw the credit boom into reverse. The asset cycle turned, and many of the missing links in the financial chain were exposed. The collapse in mid-September last year of a major financial player, turned a large-scale

crisis of confidence into a global financial panic. As the intensity of the crisis became evident, financial intermediaries restored liquidity buffers, scaled down their balance sheets and tightened lending conditions. Financial institutions dramatically reduced their exposure to the risks that they had imprudently accumulated during the phase of financial euphoria. Collectively, they engaged in a large-scale process of “deleveraging”. Banks’ intermediation was reduced in the aggregate, and loans to companies were curtailed. The credit squeeze and the toll on the real economy set in.

## **ECB policy actions in the financial crisis**

As I have said, the ECB has taken swift and forceful action to mitigate the effects of the crisis as events have unfolded. We were the first to act back in August 2007, temporarily providing on day 1 of the turmoil unlimited liquidity to preserve as normal as possible the functioning of the money market.

Allow me to stress that our measures together with the support measures of euro area governments have yielded one very important result that sometimes seems to be overlooked: there has not been a single failure of a systematically relevant financial institution in the euro area. This is an achievement whose importance cannot be overstated.

The ECB’s policy actions have at all times been carefully calibrated to the structure of the euro area economy. This relates in particular to its financial structure, which differs profoundly from that of the United States, for example.

The euro area has a largely bank-centred financial system, whereas that of the United States is primarily market-based. A few numbers illustrate these differences. At the end of 2007, the stock of outstanding bank loans to the private sector amounted to around 145% of GDP in the euro area. The corresponding proportion of bank loans to GDP in the United States was only 63%. This means that the banking sector is more than twice as important in the euro area as it is in the United States. It also means that to be effective, ECB policy must focus first and foremost on the banking sector.

The euro area financial structure I have just described provides the background for our policies. These policies are guided by our monetary policy strategy, a key element of which is the quantitative definition of price stability. We aim at an inflation rate of below, but close to, 2% over the medium term. The precise quantification of our policy objective has proved an invaluable asset, a fail-safe mechanism against excessive swings in inflation expectations, downwards as much as upwards. Long-term inflation expectations in the euro area, whether based on surveys or extracted from financial indicators, have been exceptionally resistant to sudden short-term price changes. We will ensure that inflation expectations remain impervious to short-term changes in inflation, even in the face of sharply falling inflation.

The ECB’s responses to the financial crisis are in line both with the euro area financial structure and with our medium-term objective. Since the intensification of the financial crisis in September of last year – and against the background of rapidly receding inflationary pressures –, we have taken monetary policy measures that are unprecedented in nature, scope and magnitude. These measures fall in two categories: first, conventional measures in the form of interest rate changes; second, what have

become known as ‘non-standard’ measures. The latter measures taken together constitute what we call the ECB’s policy of enhanced credit support. These are specific actions we have taken to sustain the flow of credit above and beyond what could be achieved through interest rate reductions alone.

## **Interest rate action**

Before explaining in detail the core elements of our policy of enhanced credit support, I would like to talk briefly about interest rates – the conventional indicators of monetary policy. Since October of last year we have cut our key policy rate by a total of 325 basis points. It now stands at 1%, a historical low not only for the ECB but also for the national central banks that were its predecessors.

Money market yields at longer than overnight maturity have fallen even more strongly than the policy rate. This is important because it means that a crucial element of the monetary policy transmission mechanism is intact. Borrowers in the euro area directly benefit from the low level of six-month and twelve-month money market rates because these are widely used by banks to set floating rate loans to households and companies. This is particularly true for Spain where floating rate loans are widespread, for example with respect to mortgage loans.

## **Enhanced credit support**

Let me now turn to the exceptional policy actions that we have taken in response to the crisis – the so-called “non-standard” measures. As already mentioned, when the very significant stress in interbank markets first manifested itself in August 2007, the ECB immediately stepped into the breach and accommodated the temporarily elevated liquidity demand from the banks through a fixed rate operation with full allotment, providing €95 billion to the market within a few hours. Overnight lending of the same kind continued to be provided albeit with lower volumes during the following three days. So we can say that the ECB was the first central bank in the crisis to engage in non-standard measures.

## **Liquidity management measures**

When in mid-September 2008 interbank trading came to a virtual halt, the ECB had to engage 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.

Let me explain to you how and why we did this. There are three main building blocks to our new liquidity management approach.

- 1) Our primary concern was to maintain the availability of credit for households and companies at accessible rates. We significantly adapted our regular operations in the crisis. Since then, we have followed a new “fixed rate full allotment” tender procedure and we 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 up to six months. On 7 May we decided to lengthen further the maturity of our

refinancing operations, introducing a new one-year operation, the first of which will take place the day after tomorrow.

To appreciate fully what these changes mean, let us step back for a moment and look at what we do in normal times. In normal times, we auction a given amount of central bank credit, mainly in refinancing operations with a one-week maturity, and let competition among bidders determine the interest rate at which that credit will become available to the banking system as a whole. This means that the liquidity injection is restrained by a policy decision. Last autumn, we changed that. As the demand for liquidity by individual institutions expanded abnormally and markets dramatically ceased to allocate liquidity, we have turned that practice around. We have been determining the lending rate – at a very low level – and we stand ready to fill any shortage of liquidity that might occur at that interest rate for maturities of up to six months. This means that we currently act as a surrogate for the market in terms of both liquidity allocation and price-setting.

2) The second building block of our new liquidity management approach is the list of assets that we take as collateral. This list was already very large before the crisis, but we have enlarged it even further and now accept an even wider range of securities as collateral. Government securities account for only 44% of the nominal value of securities on the list. The rest are private securities. In contrast to many other central banks, the ECB already intermediated private paper before the crisis and we have even strengthened this aspect in the crisis by accepting an even wider range of private paper.

The total value of these eligible securities is currently €12.2 trillion, equivalent to 130% of GDP in the euro area. This very ample eligibility of collateral has dramatically eased banks' liquidity constraints during the crisis and, ultimately, it has encouraged them to extend new credit or continue rolling over maturing loans.

3) 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 crisis, 1,700 counterparties fulfilled all relevant criteria. This number was higher at the time than for the other major central banks. Following the changes to our operational framework in October 2008, this number rose even further.

Our measures to safeguard the banking system's access to liquidity have resulted in a considerable expansion of the Eurosystem's balance sheet, which reached a peak of 19% of GDP at the height of the crisis around the turn of the year. Since then, we have seen liquidity flows moving back from our balance sheet to the money market. This is a sign of improving confidence and more favourable conditions. We therefore see some indication that the functioning of the money market is improving.

### **Covered bond purchases**

Another unconventional element was added in May: outright purchases of covered bonds. This measure complements the liquidity management measures I have just described. Covered bonds are debt securities issued by banks, which give them access to

funding of a longer-term nature than the ECB's refinancing operations. Covered bonds thus allow banks to manage the maturity mismatch between their assets and liabilities.

Why did we decide to engage in purchases in this particular asset class? Several reasons guided our decision.

First, as I have already stressed, in the euro area measures to support the flow of credit to the non-financial sector need to operate first and foremost through banks. Covered bonds were a major source of funds for banks in the euro area before the intensification of the financial crisis last autumn, when the covered bonds market virtually shut down. The Governing Council came to the conclusion that the Eurosystem could help in reviving this market, in terms of liquidity, issuance and spreads, by engaging in outright purchases of covered bonds. Already after the announcement of 7 May, and before we carried out any purchase, there has been a wave of new issuances of covered bonds and a degree of compression of spreads. This is true in particular for Spanish banks, which traditionally have been significant issuers, but also for banks from countries where covered bonds were much less widespread. The effects on liquidity are expected to take place when the actual program will be conducted. Let me stress that our purchases – like all our other policies – target the euro area as a whole and not any particular country. Our purchases will benefit not only banks that issue covered bonds but also banks that are holding these assets. More importantly, beyond banks, our purchases will benefit the real economy, which obtains funds through the banks.

Second, covered bonds are different in nature from the variety of asset-backed securities that had become so popular before turning sour with the financial crisis. Importantly, covered bonds do not involve a transfer of the credit risk of the underlying assets from the issuer to the investor. The credit risk stays with the originator, preserving the incentives for prudent credit risk evaluation and monitoring. We could thus say that covered bonds are incentive compatible while many asset-backed securities were not, at least in the way the concept was implemented before the crisis. In the years preceding the crisis, banks tended to favour the issuance of asset-backed securities over the issuance of covered bonds, because this form of finance appeared cheaper in an environment characterised by heavy underpricing of credit risk. Given that the financial crisis clearly exposed the dire consequences of this underpricing, the usefulness of more conservative asset classes such as covered bonds, which have proved to be safe assets over time is obvious. I believe that covered bonds and asset-backed securities will both contribute to a thriving capital market, each catering for a different set of investors and issuers.

Last but not least, the ECB's measures for enhanced credit support were designed in full respect of the euro area macroeconomic framework, which is founded on a clear division of tasks and policy responsibilities between the ECB and the national authorities. Financial support measures potentially involving a significant transfer of credit risk from financial institutions to the taxpayer clearly fall into the realm of fiscal policy. The decided outright purchases of covered bonds are fully consistent with this fundamental principle. While they are expected to be effective in supporting credit, these purchases do not burden the Eurosystem with excessive credit risk and therefore do not limit our flexibility in the conduct of monetary policy.

Before concluding, allow me a few words on the challenges facing the Spanish economy. Over the last decade the Spanish economy has shown a very strong performance in terms of output and in particular employment growth. Spain disposes of some world-class companies in important sectors including energy, communications and banking. Spain has been hard hit by the reassessment of risks in the financial sector and the overall change in economic sentiment since the intensification of the global crisis last autumn. The Spanish economy also faces some specific challenges, stemming in part from macroeconomic imbalances which have developed over many years and the related sharp reversal of the housing and construction boom. For many years strong growth in domestic demand led to relatively high inflation. The persistent inflation and labour cost differential with the average of the euro area during the expansion has hampered competitiveness which will have to be regained. The present situation suggests a need for labour market reform and wage moderation in particular by discontinuing wage indexation. Appropriate structural reforms will support a sustainable economic upswing and also the consolidation of public finances, which will be crucial not only in Spain but in the entire euro area, for confidence to be restored.

## **Conclusions**

As I noted at the beginning of this speech, the current environment is clearly much more challenging than it was five years ago. At that time the question was whether economic recovery in the euro area was sufficiently robust. Currently, we are still in the downturn phase – a downturn that globally is proving to be the deepest since the Second World War. While there are first signs that the pace of economic weakening is decelerating, we must remain alert. We are in uncharted waters, and there are still risks of a sudden emergence of unexpected financial turbulence.

This being said, the overarching aim must be to restore confidence, to take measures that will solidly anchor the expectations of households and companies, and to lay the groundwork for a return to sustainable prosperity.

This calls for a bold yet solidly grounded response. We must maintain the balance between the need to take immediate action commensurate with the gravity of today's situation, and the equally undeniable obligation to return to a path that is sustainable in the medium term.

The ECB for its part will do all that is necessary to continue to be a very solid and reliable anchor of stability and confidence in these challenging times.

I thank you for your attention.