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The ECB's Response to the Recent Tensions in Financial Markets

Meine sehr verehrten Damen und Herren,
ich danke den Veranstaltern dieser Konferenz recht herzlich für die Einladung zur 38. Volkswirtschaftlichen Tagung der Oesterreichischen Nationalbank.

I would like to use the occasion of today's conference to recall how the European Central Bank has reacted to the crisis and, in particular, put our most recent actions into this context.

As I am sure you all appreciate, there is a single thread running through all of these actions, namely to ensure that we deliver on what we are expected to deliver: price stability across the euro area over the medium term.

To those observers who have recently asked whether we have changed our orientation, I can only assure them that, on the contrary, it is the circumstances that have demanded special actions, and our orientation remains the same.

As we all know, these are challenging times for Europe and for the ECB. We are confronted with tensions in financial markets, a difficult fiscal situation in some parts of the euro area and an associated adverse impact on the effective functioning of monetary policy.

The current tensions are the most recent repercussions of the financial crisis of 2007 and 2008, which culminated by the failure of Lehman Brothers in September 2008. After that, we saw a sharp fall in global economic activity, hitting the euro area and other advanced economies hard. In the fourth quarter of 2008 and the first quarter of 2009, global trade volumes fell by 18%, the GDP of the euro area fell by altogether almost 4.5% and unemployment rose by 1.4 percentage points in just six months.

The ECB acted quickly and decisively in response to these circumstances. We reduced our key interest rates to unprecedented low levels and introduced a series of non-standard measures to support credit provision by banks to the euro area economy. This was essential at a time when the financial crisis had led to a virtual "free fall" in economic activity and severe problems in the money market were hampering the transmission of lower key ECB interest rates to money market and bank lending rates.

Our non-standard measures, which we refer to as "enhanced credit support", aimed to sustain financing conditions and credit flows above and beyond what could be achieved through reductions in key ECB interest rates

alone. They included lengthening of the maximum maturity of refinancing operations, extension of the eligible collateral list, provision of liquidity in foreign currencies, covered bond purchases, and, above all, provision of unlimited liquidity in all refinancing operations at a fixed rate.

Enhanced credit support fostered a considerable improvement in market liquidity and helped to alleviate funding risks. The measures also protected us

against any possible deflationary situation and helped focus on medium-term price stability.

Earlier this month, at a time when we had already exited from some of our enhanced credit support measures, we were suddenly faced with renewed market tensions. This time, they erupted in a number of segments of the euro area's debt securities markets. After very careful consideration of all implications of acting, as well as of those of not acting, we decided to intervene

in these markets starting on 10 May by launching our Securities Markets Programme. Along with cuts in our interest rates back in 2008 and early 2009, and measures of enhanced credit support, this programme constitutes the third element of our response to the financial crisis.

In my remarks today, I would like to give you some further details about this third element: Why we have introduced it, how it is designed to operate and why it is in line with the key principles of our monetary policy-making. And I would like to place our actions in the context of the broader challenges for economic policy-makers and private sector decision-makers, in our collective pursuit of return to financial stability and ensuring a sustainable economic recovery.

The Fundamental Importance of a Functioning Transmission Mechanism of Monetary Policy

Like all other non-standard measures we have taken, the Securities Markets Programme is time-bound in nature. It aims to ensure the proper transmission of monetary policy impulses to the wider economy and, ultimately, to the general price level. To achieve our primary goal of ensuring price stability, monetary policy-making needs to be effective. In this respect, well-functioning securities markets are indispensable.

Let me briefly describe why this is the case. We implement monetary policy by setting our key policy rates. Through this, we directly influence short-term interest rates in the money market. Financial markets transmit this impulse along the maturity spectrum, since term rates reflect current and expected future short-term rates as well as risk premia.

These rates, in turn, affect the costs of funding for households, for firms, and for governments. The resulting financing conditions affect economic activity and, in the end, prices.

The functioning of the market for government bonds is central to the transmission of the ECB's policy rates. This is because of several channels.

Via the *price channel*, interest rates on government bonds influence financing conditions within the economy. For example, they are often used as a reference rate when a bank prices a loan for a customer, or when a company borrows money by issuing a bond. Sovereign financing conditions, under normally functioning bond markets, often

provide a floor for the funding conditions of the private sector.

Interest rates on government bonds always include add-ons to compensate for liquidity risk and credit risk. But these risk premia should not become so large that they dominate the signal from the key policy rates to a point where it is no longer distinguishable and does not reach the real economy. This can happen when markets no longer function properly.

Closely related is the *liquidity channel*, which comes into play at the start of the transmission mechanism, influencing short-term interest rates beyond the conditions set by policy rates. Government bonds are often used as collateral for banks' refinancing operations. In fact, government bonds are the primary collateral used in the secured interbank market.

If government bond markets are disrupted, this hampers the functioning of the interbank market and reduces liquidity in this market. The consequences are increased money market rates due to premia for liquidity risk. As a result, the capacity of banks to issue loans and refinance the real economy suffers.

A third channel, the *balance sheet channel* , is indirect: Lower government bond prices, which correspond to higher bond yields, imply valuation losses in the assets held by the financial and non-financial sectors. For banks, the lower capital base may mean that they can supply fewer loans to the economy. For borrowers, their creditworthiness is reduced, and this affects their capacity to borrow.

Because of these channels, severe tensions in the bond market hamper the monetary policy transmission mechanism. The relation between our key interest rates and the rates applicable in the real economy gets out of order, and our main tool for influencing refinancing conditions in the real economy does not work the way it should.

This is the situation that threatened us at the beginning of this month, so we saw the need to act quickly to re-establish a more normal functioning of our monetary policy transmission mechanism. The very rapid consolidation of that situation depends crucially on the effective implementation of the fiscal retrenchment programmes that have been decided in a number of countries.

How the Securities Markets Programme Works

Let me now explain how the Securities Markets Programme works. The programme consists of interventions in the euro area's public and private debt securities markets. In order to sterilise the impact of these interventions on the liquidity conditions in the banking system, we re-absorb the liquidity injected. Thus, these measures do not influence our monetary policy stance.

More specifically, the programme focuses on these securities markets that have been affected by severe disruptions recently.

These tensions did not come out of the blue. The sky had darkened since the end of last year, when difficulties with public finances in some euro area countries came into the focus of financial market participants. Following prolonged discussions about the possibility of a loan support facility for Greece, tensions rose further towards the end of April and the beginning of May.

On 6 and 7 May, on Thursday afternoon and throughout Friday, we observed a further deterioration in financial market conditions, both in Europe and, as a consequence, at the global level. On Friday 7 May, spreads on sov-

ereign bonds in Europe, CDS spreads and indices of volatility and stress in the interbank market were signalling the spreading of severe tensions.

Bond spreads for several euro area countries widened beyond any reasonable level. Liquidity in government bond markets of some euro area countries almost dried up. And the tensions in the sovereign bond markets spilled over to other market segments, such as the foreign exchange market and equity markets, where trading volumes and liquidity became erratic, and volatility spiked.

In view of these exceptional circumstances prevailing in the financial markets, we decided that exceptional intervention was necessary.

The Securities Markets Programme and the Principles of Monetary Policy-Making

As always, our actions have been guided by our principles. In this respect, let me focus on three aspects that are key for the credible conduct of monetary policy: price stability, central bank independence and the prohibition of monetary financing.

First, price stability, which is our primary objective. The latest measures address a malfunctioning of certain market segments. Without such measures, the market problems could have created risks to the favourable outlook for price stability. However, we have not gone beyond the goal of re-establishing a more correct transmission of our monetary policy. We have not changed our monetary policy stance: we have maintained the present level of interest rates which is, in our view, appropriate; and we have not embarked on more ample liquidity conditions.

Precisely in order to guarantee that the stance remains unaffected, we sterilise our interventions, as I have explained. The Securities Markets Programme should not be confused with quantitative easing. In simple words: We are not printing money. This confirms and underpins our commitment to price stability.

Credibility is crucial for ensuring price stability. As long as inflation expectations remain well-anchored in line with our definition of price stability, long-term interest rates do not need to reflect the risks stemming from an uncertain inflationary process. In an environment in which the central bank fully preserves its credibility, economic agents do not need to try to anticipate uncertain inflationary developments, thus potentially fuelling inflationary pressures.

In this respect, let me highlight that inflation expectations in the euro area have remained well-anchored in line with the Governing Council's definition of price stability throughout the financial crisis. This is evidenced by a range of indicators. For example, in the Survey of Professional Forecasters, inflation five years ahead is continuously expected to stand either at 1.9% or 2.0% since the beginning of 2002.

A *second key principle* guiding our action is central bank independence. We were fully independent in our decision to act as we have done. We have never hesitated to take the decisions needed to ensure price stability. And we will continue to act accordingly.

Let me recall that in December 2005, we increased rates against the publicly expressed sentiment of the governments. In 2008 we did not hesitate to raise interest rates, even in a period of financial turbulence. We took this decision to prevent broadly based second-round effects at that time, with a view to counteracting increasing upside risks to price stability over the medium term.

We always act fully in line with our own responsibilities. And that is the reason why we have been delivering price stability.

Third, our actions are in full compliance with the prohibition of monetary financing and thus with our financial independence. The Treaty prohibits the direct purchase by the ECB of debt instruments from governments. We are buying bonds on the secondary market only, and we stick to the principles of the Treaty, which are price stability, our primary mandate, and central bank independence. Since our inception, we have always called upon governments to respect budgetary discipline. We had a lot of difficulty with several governments during the last ten years, both as regards their own national responsibilities and as regards their collegial responsibilities of peer surveillance in the Eurogroup. This period is over. We expect from governments strict respect for the principle of budgetary discipline and effective mutual surveillance.

The purchases made on the secondary market cannot be used to circumvent the fundamental principle of budgetary discipline. The Securities Markets Programme strictly aims at correcting malfunctioning of markets.

The prohibition of monetary financing underlines precisely the fact that budgetary discipline is of the utmost importance. We have taken note of the commitments of euro area governments to take all measures needed to meet their fiscal targets. We have also taken note of the precise additional commitments taken by some euro area governments to accelerate fiscal consolidation and to ensure the sustainability of their public finances.

It is crucial that governments implement rigorously the measures needed to ensure fiscal sustainability. It is in the context of these commitments only that we have embarked on an intervention programme in the securities markets.

The Securities Market Programme is an extraordinary action, which was undertaken in the situation of severe tensions in financial markets. I would like to stress that the rigorous application of the adjustment programmes by governments is essential to guarantee the progressive return to a more normal functioning of financial markets.

Conclusion

Let me conclude.

Recent experience, since 2007, has demonstrated how important it is for all decision-makers to analyse lucidly the unexpected situations that they are facing and to act in a timely manner when needed. As soon as it became clear that the intensity of recent market disruptions could have implied very serious consequences for price stability in the euro area, we took firm action. As I have said time and again: we are permanently alert and always prepared to act when necessary.

Price stability is the central contribution, which monetary policy makes to economic growth, to job creation and to financial stability. Our success-

ful track record since the inception of the euro – both in terms of low inflation rates and well-anchored inflation expectations – is remarkable. Since the inception of the euro, more than 11 years ago until April this year, the average annual inflation in the euro area was 1.98%. This is exactly in line with our definition of price stability and it is better than the achievement of any major central bank over a period of many decades, including the Bundesbank.

But the ECB's measures cannot substitute for the actions required to address more deep-seated and fundamental problems. It remains for others – national governments, regulators and supervisors, and the private sector and financial industry – to proceed with the difficult, but vital, measures required to re-establish the trust on which a well-functioning market economy relies.

Cohesive action at a European level is essential to alleviate the current tensions. Such action will also support a sound, longer-term economic recovery in the euro area and beyond. This will benefit all of us who live and work in Europe.

I call on euro area governments to work together. Looking ahead, countries have to take up their responsibilities. Major improvements need to be made to prevent bad fiscal behaviour, ensure effective implementation of the recommendations made by partners and enforce real and effective sanctions in case of breaches. It is equally decisive for the European Commission and the Eurogroup to engage in an effective control of the evolution of relative competitiveness inside the euro area, including of the evolution of unit labour costs. And the implementation of structural reforms, under the surveillance of the peers, is of the essence to elevate the growth potential in Europe.

I call on euro area governments in particular to work actively together to reach agreement on a quantum leap of the effectiveness of their collegial surveillance.

Thank you for your attention.

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