

Towards better management, supervision and transparency

Keynote speech: **Reflections on the Financial Markets Correction**

Wednesday morning, 4 June 2008

Moderator: **Françoise Crouigneau**, Chief International Editor, *Les Echos*, France
Jean-Claude Trichet, President, European Central Bank (Speech available)

As a long-standing friend of Jean-Claude Trichet, **Angel Gurría** introduced this keynote session by remarking that the ECB president had successfully navigated many a headwind, and the present financial turbulence was the latest one.

Mr Trichet recalled the first rumbles of the present financial crisis in early 2007, when the European Central Bank warned against the vulnerabilities created through the underpricing of financial risks on a global scale. The harrowing speed at which the US subprime crisis from August infected other market segments revealed how inadequate our understanding of the complexity of the financial mechanisms was.

Mr Trichet identified **three general factors** that stirred up this turbulence: the excess of savings compared to investment, which finally led to a desperate “hunt for yield”; the interdependence of financial systems driven by complex financial instruments whose functioning is often obscure; and the tendency of financial actors to favour short-term profits, fees, and arbitrated regulations over the management, underwriting and trading of claims on future cash flows. Together these factors created a spiral of asset prices, leveraging, complexity, and reduced transparency.

But the rough weather was not a complete surprise. Mr Trichet pointed out that previous downturns were foreshadowed by a similar recognition that underlying credits were worsening. The difference was that the various amplifiers used modern financial systems heightened the uncertainty—in particular, the originate-to-distribute model.

Abundant liquidity, coupled with financial complexity, was responsible for the leveraging, as well as its eventual unwinding. The mechanics of this unwinding are now well understood. Ignorance of the magnitude and distribution of risk among financial instruments made it difficult to adjust risk positions. This led to evaporating liquidity, and more uncertainty.

The response of the European Central Bank was guided by the distinction it draws between setting monetary policy to maintain price stability and its liquidity decisions under this policy. The volatility of the last ten months has not changed this stance. The primary aim of the euro system is to keep the overnight rate as close as possible to the minimum bid rate. When financial institutions had trouble assessing liquidity on the interbank market, prompting a mercurial and often unpredictable demand for liquidity, a supply was made available early on to provide a reserve for credit institutions. This

“frontloading” differs from the even supply of liquidity throughout a maintenance period in that the amounts disbursed diminish over time. The ECB also fine-tuned operations to keep short-term interest rates close to the minimum bid, in spite of unpredictable liquidity demands, and significantly increased longer-term refinancing, which may have tamed interest rates by easing the future liquidity needs of banks.

Mr Trichet said that the lessons learned were many. He reminded the audience that financial complexity reflects a complex global economy and requires a system of checks and balances to prevent another leveraging spiral. He also stressed the need for transparency, and **in response to a question from the floor**, referred to the Asian crisis of a few years ago, in which the absence of transparency seeded mistrust among investors when a country released inaccurate or false data. The consequence was that *no* figures were judged trustworthy. Transparency also provides for the just allocation of resources.

He said that an internationally accepted methodology was needed to identify future market turbulences. Moreover, financial institutions should promptly disclose their risk exposure, and strengthen risk-management practices. In general, accounting and disclosure standards need to be improved. These recommendations, he added, should be implemented rapidly.

When asked by **Françoise Crouïgneau** whether, in light of recent events, he favoured tighter regulation in the euro area, Mr Trichet answered that he preferred to give decentralisation a chance, leaving it to the private sector to set the various bench marks for best practice, but that if it proved incapable of doing so, only then should authorities intervene. Mr Trichet recommended better management, supervision and transparency to weather any future storms.

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