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Financial markets, economic forecast and monetary policy

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1 Introduction

Ladies and gentlemen

Last week, the Bank of England cut its official Bank Rate by 25 basis points to 5.0%. We at the ECB's Governing Council decided to leave the key ECB interest rate of 4.0% unchanged, but to continue to monitor very closely all developments over the coming weeks. In the UK as well as in the euro area, monetary policy decisions were taken against a backdrop in which global headwinds play a crucial role. I would therefore like to use this opportunity to discuss the economic outlook for the euro area in general and Germany in particular as well as the Eurosystem's monetary policy stance.

Let me start, however, with the ongoing financial market turmoil, as it is arguably the global risk factor that is attracting the most attention at the moment. As for the other global headwinds, in particular energy and food prices and a global rebalancing, I can assure you that they will get a mention later on.

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2 Recent financial market developments

Over the past few months, practically all financial markets have been experiencing considerable tensions. Indeed, what began as a fairly contained deterioration in the (relatively small) US subprime market has rapidly developed into a severe test of the stability of the global financial system.

The unfolding of the global financial market turmoil is often broken down into various waves. In August 2007, the first wave hit the markets for securitised and structured financial products as well as the interbank money markets. The predominant feeling was one of general mistrust among market participants in terms of the extent and the distribution of subprime-related losses. The second wave reached global financial markets in November 2007. Once the banks had published their quarterly reports, it became evident that losses incurred by globally active financial institutions were not confined to transactions related to residential mortgage markets and far exceeded expectations. Hence, the focus shifted from liquidity issues to concerns about market participants' solvency. The third wave, which we have been witnessing since February/March, consists of a massive deleveraging in the global financial system.

Incoming data support the view that adjustment processes in global financial markets are far from over and that they will continue to be painful. But some positive signs are also emerging now indicating that the worst may be behind us. This leads us to the question about the origins of the current financial market turmoil, which is at once the first turmoil in the market for securitised products. Contrary to what Ulrich Cartellieri, at the time a board member of Deutsche Bank, once conjectured, namely that "banks are the steel industry of the 1990s", meaning that banking would lose much of its importance in a world

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moving towards capital-based financial systems, the current turbulence clearly demonstrates that the securitisation of credit risk has by no means reduced the leading role banks play within the financial industry. On the contrary, commercial and investment banks initially benefited from the rapid development of structured financial instruments such as residential mortgage-backed securities (RMBS), credit default swaps (CDSs) and collateralised debt obligations (CDOs) by actively managing their own credit portfolios, earning fees from originating, structuring and distributing these instruments and earning revenue from market-making and trading.

Despite such profits, the originate-and-distribute model, that is the ability to distribute credit risk away from one's own balance sheet – through the use of structured products – to investors with an appetite for it, is at the heart of today's financial market tensions. The ongoing tensions have revealed serious vulnerabilities that had long been masked by the fast pace of growth in credit risk transfer markets. First, the originate-and-distribute model induced investment banks as well as other, often unregulated financial institutions such as hedge funds and special purpose vehicles to take on large holdings of credit risk with a high degree of leverage. Second, securitisation exacerbated the information asymmetries that are inherent in credit markets. In particular, there is uncertainty about the distribution of credit risk among global market participants and, consequently, transparency about exposures is limited. Third, some market participants' risk management standards have not kept pace with developments. This cocktail of vulnerabilities may explain the surprising speed with which mistrust among market participants spread around the world, causing several financial market segments to dry up temporarily.

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However, there is more to the present financial market turmoil than meets the eye of the casual observer. When comparing the ongoing financial market turmoil with similar episodes in the past, it becomes evident that a process is at work in which macroeconomic and financial factors reinforce each other. This is particularly true and visible in the USA. Let me exemplify this interplay using the present financial market developments. Against the benign and prolonged backdrop of robust global economic growth, low inflation, a low level of interest rates, low default rates and rising asset prices in many countries, not just in the USA, lending experienced rapid growth. Credit transactions were also supported by the originate-and-distribute model and by the strong demand for securitised products owing to a global search for yield. These processes were mutually reinforcing until the credit cycle finally turned and set in motion a deleveraging in the financial system, which has in turn put pressure on financial market prices, thereby raising financial institutions' capital requirements.

The extent to which a global downturn in the credit cycle affects the real economies in different parts of the world obviously varies according to a country's direct and indirect exposure, the degree of overvaluation in housing and mortgage markets, the structure of its banking system, its macroeconomic imbalances and other factors. As for the euro area and Germany, the economic outlook is still favourable, a point I will elaborate on shortly.

In times of sizable money market tensions, restoring confidence among financial market participants is of the utmost importance. For a transitional period, central banks have therefore been acting as market makers of last resort on interbank markets. The Eurosystem in particular has used its

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standard refinancing operations in order to stabilise the euro area overnight rate around the minimum bid rate of currently 4%. We will continue this policy as long as tensions persist in order to ensure the orderly functioning of the euro area money market. However, it is important to bear in mind that we in the Eurosystem strictly separate our management of aggregate liquidity conditions from the determination of our monetary policy stance. This implies that when deciding on key interest rates, the primary objective of the Governing Council has been (and will continue to be) price stability, which is in accordance with our mandate.

But what about the fundamental problems facing the financial markets – how are they to be solved? Various groups at a European and international level, especially the Financial Stability Forum (FSF), are busy finding ways to overcome the apparent vulnerabilities of the global financial system. Last weekend, the FSF presented its detailed recommendations for enhancing the resilience of the global financial system. The recommended actions are in five areas:

- Strengthened prudential oversight of capital, liquidity and risk management
- Enhancing transparency and valuation
- Changes in the role and uses of credit ratings
- Strengthening the authorities' responsiveness to risks
- Robust arrangements for dealing with stress in the financial system

These measures are a first step to a regulatory response which aims at tackling those weaknesses of the global financial system that caused the

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current and severe financial stress. In our G-7 meeting last weekend in Washington, we endorsed the FSF's report. It is now essential that these recommendations are implemented effectively. Rapid implementation will help to restore confidence in the soundness of markets and financial institutions.

The FSF has not yet made recommendations about the forces that contribute to procyclicality, as this is an issue that requires further study. Procyclicality is inherent in financial transactions and means that the monitoring, measuring and pricing of financial and credit risks typically tend to be too optimistic in an economic upturn and are often too pessimistic in an economic downturn. It is well understood that the financial and regulatory infrastructure should not add to or exacerbate the procyclicality of credit and financial transactions. We therefore need to study carefully how the resilience of the global financial system with respect to procyclicality can be enhanced further.

3 Economic outlook for the euro area and Germany

After four to five years of buoyant growth, the global economy now faces a new setting: On the one hand, the US subprime crisis and its repercussions in various financial markets have had a dampening effect not only on the US, but also on the global economy. On the other hand, inflationary pressures, which mainly stem from sharply rising energy and food prices, are increasing on a worldwide scale. They pose a particular challenge to some developing countries, but also give rise to concern in industrialised countries.

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Against this backdrop, the US housing market, and with it the US economy as a whole, has deteriorated further over the past few months. Consequently, economists and financial market participants alike are – once again – asking themselves if Europe will be able to decouple now that the US outlook has substantially deteriorated.

Arguably, in today's globalised world where domestic markets for goods and services, as well as labour and capital markets, are becoming increasingly interlinked, Europe is unlikely to succeed in isolating itself from the development in one of the world's major economies. And indeed, in the UK, after a decade or more of a *n*on-*i*nflationary *c*onsistently *e*xpansionary economy (a time dubbed "nice" by Mervyn King, the Governor of the Bank of England), output growth is expected to moderate and inflation to rise further this year. In the euro area, too, the weakening global expansion, stronger pressure from commodity prices and the impact of financial market developments have set the stage for a more cautious, though still robust economic outlook. As a consequence, in March, the ECB staff slightly adjusted downwards its macroeconomic projections on economic growth in the euro area. Average annual real GDP growth is now projected to be between 1.3% and 2.1% (average: 1.7%) in 2008 and between 1.3% and 2.3% (average: 1.8%) in 2009, which reflects moderate but ongoing economic activity.

Hence, exaggerated growth pessimism is the wrong attitude at the current juncture. Instead, it is important to keep in mind that even if a full decoupling of the euro area economy from the US economy does not seem plausible for the time being, structural shifts in the world economy have taken place that support the view that a US slowdown will have less of an impact in Europe than in the

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past. This hope is further justified by the euro area's sound economic fundamentals and its likely good performance in the first quarter of 2008.

To elaborate further on the decoupling issue, let me turn my attention to Germany. German real GDP has grown strongly by 2.7% on average over the past two years in price-adjusted terms. Despite mounting global headwinds, the German economy has started into 2008 on a positive note, which is reflected in substantial increases in both industrial activity and construction output in the first quarter of this year. We expect German GDP growth in the first quarter to be around ¾ %. Moreover, business sentiment has not deteriorated so far. Labour market conditions remain favourable, with the number of unemployed at its lowest level in 15 years, down almost 1.5 million unemployed within the last two years. However, consumer spending remains lacklustre. As for its future path, we expect private consumption to benefit from the sustained improvement on the domestic labour market. But there is the high risk that consumer spending will prove sensitive to the elevated levels of consumer price inflation and thus display protracted weakness.

All things considered, however, the German economy has weathered the global headwinds remarkably well. Indeed, the conditions required for a continuation of the economic upturn in Germany are still very much in place even though downside risks persist. We still expect the German economy to grow roughly in line with potential in 2008 and see no need to substantially change our December 2007 projection. There are three main factors that support this favourable outlook.

1) The remarkable efforts made by German companies, wage bargainers and politicians over the past few years, namely restructuring measures, wage

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moderation and labour market reforms, have strengthened corporate balance sheets and boosted the price competitiveness of German firms. It is worth recalling that these efforts were the outcome of a painful learning process resulting from years of stubbornly high unemployment and competitiveness problems for major German industrial sectors. Now that these efforts are starting to bear fruit, it is essential that all parties concerned do not abandon them for short-time vested interests and thereby jeopardise the sustainability of economic growth.

2) The second reason for German firms' relatively good position is external demand. In this context, fears are frequently voiced that the strong euro and the slowdown of the global economy could prove a drag on German export performance. To date, these fears have not been realised. First, the major share (that is more than 40%) of German exports goes to the euro area and is therefore not affected by exchange rate movements – at least not directly. In addition, total German exports include an increasing percentage of capital goods (such as machines and technical equipment), for which global demand is less price-responsive. Second, a considerable portion of Germany's exports goes to new and faster-growing markets, such as Asia and the new EU member states, which have so far proved fairly resilient to the slowdown in the US economy. Third, the euro's appreciation should not only be viewed from the perspective of external demand. A strong euro simultaneously dampens the prices of import goods. This helps to curb the inflationary pressures resulting from strong rises in energy and food prices and thus has a stabilising effect.

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3) The third factor in favour of a fairly optimistic economic outlook for Germany is that the ongoing financial market turmoil has so far had no discernible impact on the German economy. In particular, credit growth is still robust, the German housing market is not overstretched, corporate balance sheets remain strong and consumers are not excessively leveraged. So far, the German banking system has proven sound. Admittedly, the ongoing adjustments in the global financial markets will be associated with a number of further challenges for banks both nationally and internationally. However, from the current perspective, the risk of a credit crunch in Germany is fairly remote.

In summary, the driving forces behind the current upswing of the German economy remain fundamentally intact. As a consequence, I see no compelling reason to paint a bleak growth scenario for the German economy in the ongoing year.

4 The Eurosystem's monetary policy stance

Strong upward pressure on global inflation can, to a large extent, be explained by sharp hikes in energy and food prices. A combination of protracted and robust global economic growth and increasing capacity constraints drove commodity prices to new record highs. Consequently, inflation has increased markedly all over the world, a development which, in industrialised countries, has been particularly pronounced since the second half of 2007.

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This is also true of the euro area. The annual Harmonised Index of Consumer Prices (HICP) rose to a worrying 3.6% in March. This is the highest rate since the euro's launch in 1999 and well above the Eurosystem's definition of price stability – inflation rates of below 2% in the medium term. Looking ahead, energy and food prices are likely to keep the eurozone's inflation rate at elevated levels for longer than initially expected. Hence, we will witness temporarily high inflation rates for a more protracted period than previously anticipated, though rates will eventually decline towards 2%.

What does such an outlook mean for the Eurosystem's monetary policy stance? To put the issue into a broader perspective, let me note that a central bank cannot adequately react to the (temporary) first-round effects stemming from increases in oil and food prices, indirect taxes and the like. Nor should it attempt to do so, since a change in monetary policy impacts on the price level only with a considerable time lag of several quarters. Consequently, a central bank reacting mechanically to first-round effects would be likely to do more harm than good.

In the medium run, however, the persistence of high energy and food price inflation is cause for serious concern. Protracted relative price changes may translate into medium to longer-term inflation expectations becoming less well anchored and drifting slowly over and above a central bank's price stability threshold. Elevated inflation expectations could give rise to a damaging wage-price spiral, thereby generating the so-called "second-round effects". Given the costs of curbing such inflation dynamics once they have started, the stability-oriented Eurosystem has to fight the risk of broad-based second-round effects decisively and proactively. The recent rounds of wage settlement in the euro

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area have not contributed to curbing inflation pressures. On the contrary, recent wage dynamics in conjuncture with elevated and persistent energy and food price pressures have increased the risk of a prolonged period of intolerably high inflation.

At our last meeting of the ECB Governing Council, we have emphasised that given the uncertainty about the economic outlook and the downside risks associated with the tensions in global financial markets, the continued vigorous expansion of money and credit and the strong upside risks to price stability the current Eurosystem monetary policy stance will contribute to the anchoring of medium to longer-term inflation expectations at a level consistent with price stability. At the same time, the ECB's Governing Council has promised to do what is needed to ensure that inflation expectations will continue to remain firmly anchored at low levels.

Against this background, we will have to continuously monitor closely all incoming data and evaluate whether the current level of interest rates in fact ensures to achieving our objective. After all, the best contribution the Eurosystem can make to sustainable growth in the euro area is to safeguard price stability in the medium to long term – and not to be forgotten: A reliable monetary policy in combination with a commitment to provide liquidity to ease market tensions also helps to reduce uncertainty in times of the ongoing financial market turmoil.

Thank you for your attention.

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