DEUTSCHE BUNDESBANK
EUROSYSTEM

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Dinner Speech

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1 Introduction

Ladies and Gentlemen,

I warmly welcome you to this dinner on the occasion of the joint Bundesbank-Banque de France conference here in Gouvieux. The regal ambience of this castle may help us to momentarily forget our everyday events and concerns; however, this will certainly not last.

The global financial crisis has been keeping the world on edge for nearly two years now. The turbulence in the international financial markets that erupted in August 2007 developed into a full-blown global financial crisis in September 2008 with the collapse of US investment bank Lehman Brothers. The deterioration of the situation in the financial market caused the decline in global economic output, which was already starting to take hold, to take a dramatic turn for the worse. Industrial and emerging economies underwent a nearly completely synchronised sharp economic downturn in the last two quarters.

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Despite growing signs that the intensity of the downturn is subsiding, past experience has shown that the economy is generally very slow to recover from recessions that are associated with real estate and financial crises. Although the forecast uncertainty is currently particularly high, the crisis is likely to put a strain on global financial markets and the real sector for some time to come.

To quote the opening lines to the Tolstoy novel Anna Karenina: “Happy families are all alike; every unhappy family is unhappy in its own way.” This pearl of wisdom is also relevant in times of financial crisis. Although virtually the entire world was bowled over by the sheer force of events, it is small details that set the individual transmission channels apart.

Allow me to briefly cite Germany as a case in point. In August 2007, right at the beginning of the financial crisis, Germany was the first country to see two banks encounter difficulties, even though we had not had any local asset price bubbles. Since the financial crisis is clearly a global problem, the risk-bearing capacity of many internationally active financial institutions has now been affected severely on a worldwide scale.

Turning to developments in the real sector, it is striking that Germany saw a particularly sharp drop in overall economic activity relative to the rest of the world. Germany’s GDP fell by 3.8% in the first quarter of this year, and the Bundesbank predicts a fall of 6.2% for the year 2009 as a whole, making Germany one of the industrial countries currently being affected particularly seriously by the crisis.

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The reasons are not hard to find. Germany has an extremely open economy and is accordingly heavily dependent on exports. In addition, the range of German exports contains a large share of capital goods, that is to say goods for which global demand has slumped particularly distinctly on account of the crisis. The German example therefore demonstrates that the growing export specialisation of an economy is associated with stronger swings in the business cycle – at least in those cases in which the world economy is hit by a common global shock. To complete the picture, though, it needs to be noted that the German economy has benefited very strongly in the past few years from the cyclical stimuli emitted by exporters and their downstream industries. Diversifying the export portfolio by region or product, however, ultimately will not protect an open economy such as Germany's from veritable global shocks.

Let me finally add with a view to the German banking system that lending by banks in Germany to German non-banks grew with an annual rate of merely 0.8% on average in pre-crisis years (ie 2004 to 2006). Hence, during that time, German banks profited strongly from portfolio investments in structured financial products and booming real estate markets abroad.

2 Financial crisis and economic research

Let us return to the global view of the financial crisis. There is no disputing the fact that a whole cocktail of micro and macro-level factors caused the global financial crisis. The variety of causes leading to the current crisis is also reflected in this conference's programme.

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This is already the second research conference jointly organised by the Bundesbank and the Banque de France. You will certainly be aware that research plays an important role in central banks. Joint projects, conferences and discussions between researchers both within and outside the world of central banking have contributed time and again to further expanding and improving the theoretical foundations of economics and to backing them up empirically.

The financial crisis has once again underlined clearly that, in this context, the interests of researchers and central bankers are very closely related, and not just in the area of monetary policy. A by-product of the crisis, so to speak, is that it has provided numerous ideas for the advancement of research in this area. It presents an opportunity to rethink, and examine with scepticism, some of the assumptions found in theoretical models. One example that comes to mind is modelling how economic agents form expectations, or the degree of sophistication with which the financial system can be integrated into macro models.

There is another quite interesting question from the empirical side. How can the available data in the area of the financial world be better used to identify systemic risks – or do they need to be supplemented by certain additional data? Some of the papers presented at this conference have found very promising approaches.

Answers to these and similar questions will amplify the meaningfulness and practical relevance of future research findings. This is of great interest to

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central banks, not least because we use the knowledge gained from research as an input in our monetary policy decisions. Allow me to discuss two relevant cases in which current events have stimulated research.

2.1 Segmentation in the money market

One concerns the question of how central banks can most effectively supply the financial system with liquidity. After the US investment bank Lehman Brothers had filed for insolvency, the ability of whole financial market segments to function was severely constrained, requiring central banks around the world to inject a massive volume of liquidity into the money markets.

Against this background, a Deutsche Bundesbank study[1] identified segmentation in the German money market. For the behaviour of German banks in the money market, the study finds signs that the size of a bank has a systematic effect on the price of liquidity. Taking a number of other factors into account, larger banks end up paying less for liquidity than smaller banks. This effect is even more pronounced when there is an increase in the imbalance of the liquidity positions.

Thanks to its very broad range of counterparties, the Eurosystem was able to ensure that all banks active in the euro area, whether large or small, were given equal access to the ample supply of central bank liquidity from the beginning of the financial crisis onwards. In addition, over a year ago the

[1] F. Fecht, K. Nyborg, J. Rocholl (2008): The price of liquidity: bank characteristics and market conditions, Deutsche Bundesbank Discussion Paper, Series 1, No 30/2008.

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Eurosystem had already expanded the range of maturities of its refinancing operations and now provides liquidity in the form of a fixed-rate tender with full allotment with a maturity ranging from one week to 12 months.

As is borne out by the results of our study, these measures are likely to have made it easier, particularly for the smaller institutions that are less active in the money market, to obtain access to liquidity in these turbulent times. The Eurosystem has thus made a decisive contribution to stabilising the European money market, including the longer-term maturity segment.

2.2 Monetary policy issues

Moreover, the financial crisis has pushed the interplay between monetary policy and financial market developments back into the centre of attention. In the past, research was often focused on how central banks dealt with growing asset price bubbles. However, reality indicates that this focus was too narrow. After all, maintaining an overly expansionary monetary policy for too long in some currency areas was probably one of the framework conditions that contributed to the emergence of the global financial crisis.

Boom-bust cycles in financial markets cannot develop completely independently of monetary policy. One of the good things a stability-oriented monetary policy can do is to monitor such movements in the financial sector and – where possible and consistent with the price stability mandate – to dampen them. This requires a more symmetrical monetary policy that already

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recognises growing risks in times when monetary and credit aggregates are growing dynamically, asset prices are skyrocketing and market participants' perception of risk is decreasing.

I think the Eurosystem is well equipped for this task. First, our (often-criticised) monetary analysis is a valuable analytical tool that forces us to include the medium and long-term development of monetary and credit aggregates in our monetary policy decision-making process. Second, the liquidity policy crisis measures taken thus far still enable us to exit from the policy of ample liquidity injection quite easily. Should the overall economic picture improve, the Eurosystem will absorb the extra liquidity provided as quickly as possible. In this manner, we will counter potential risks to price stability early on and, at the same time, make a contribution to avoiding future financial crises.

3 Conclusion

Ladies and gentlemen, this conference will be dealing with a host of other issues I could discuss at great length. However, allow me to follow a particularly useful suggestion to dinner speakers: "Start at the beginning. And when you get to the end, stop." And this is where I have arrived. I thank you for your attention and wish everyone "bon appétit".

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