Economic prospects and the role of monetary policy in the current situation

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Ladies and Gentlemen,

Since the second half of 2008, we have witnessed the deepest economic downturn since World War II and the fastest deceleration in inflation since the launch of the euro. We have confronted this situation with unprecedented decisions. Unprecedented has been the magnitude and size of interest rate cuts. Since October 2008, we have reduced key ECB interest rates by 275 basis points. Unprecedented has been the scope of liquidity support we offer to the financial system. But central banks alone are not in a position to resolve the current financial crisis. Policy makers need to prevent a further deterioration in economic and financial conditions. To this end, resolute action is needed to restructure, recapitalise and consolidate the banking system.

To be realistic, the year 2009 will be a very difficult year. 2009 will be the year of adjustments in the balance sheets of banks, firms and private households. These adjustments should lay the foundations for economic conditions to eventually stabilise and improve.

Let me now elaborate in greater detail on where we stand in terms of economic and monetary developments in the euro area and how this has affected the conduct of monetary policy. I will subsequently talk about how we have adjusted our refinancing operations in response to the financial crisis. Finally, I will briefly discuss challenges in the resolution of the crisis.

Economic prospects

a. Global economic situation

Let me start with the economic outlook. The world economy is currently undergoing its deepest downturn since the second World War. The crisis started in summer 2007, as losses in the US sub-prime mortgage market, a relatively small segment of the US housing markets, triggered the ongoing financial turmoil. However, its impact on the global economy remained relatively limited until the summer of 2008.

However, after the collapse of Lehman Brothers last September, the tensions in global financial markets escalated to a full-blown financial crisis and thereafter turned into a global economic crisis. The severe global economic downturn has now become more synchronised. The collapse in global trade has amplified the adverse impact from the financial turmoil and caused emerging market prospects to deteriorate drastically. In advanced economies, falling house prices, tumbling financial markets, collapsed household and business confidence, and the resulting need to restructure consumers' and firms' balance sheets have been curbing private consumption and investment. In emerging economies, nosediving global trade and the unwinding of both internal and external imbalances accrued in past years have led to a sharp decline or even negative GDP growth rates.

According to most economic forecasts, the weak growth period is expected to last for some time. For example, the IMF [1] projects that the world GDP growth would decelerate to only ½ % in 2009 measured in terms of purchasing power parity and even to turn negative when measured in terms of market exchange rates. For advanced countries this means a negative annual growth rate of -2% in 2009. For emerging economies the growth is projected to remain positive, although the 3.3% growth projection is just half of the pace recorded in 2008.

While it is expected that the world economy will recover in 2010, risks surrounding the outlook are on the downside as the depth and length of the global economic downturn will crucially depend on the evolution of the financial crisis.

The inflation outlook has also changed significantly. Global inflationary pressures are quickly diminishing . In the short term, this is mainly due to effects from lower commodity prices, but over time, weaker labour market conditions and sluggish global demand increasingly play a role.

b. Euro area activity

Let me now come to the euro area. Economic activity has not been sheltered from the negative impact of the global financial crisis . We had seen already a moderation in the underlying momentum of euro area economic growth before the crisis got worse. This slowdown reflected the dampening effects from sharp increases in commodity prices before the summer 2008 and the ongoing correction in the housing market in some euro area countries.

As a result of all these factors, euro area activity declined markedly in the second half of 2008. After falling moderately in the second and third quarters of 2008, euro area GDP growth contracted very sharply in the fourth quarter of the year, decreasing 1.5% quarter on quarter. This reflected not only a decrease in foreign demand for euro area exports but domestic demand was also adversely affected by domestic factors, notably very low confidence and tight financing conditions. Annual growth in 2008, at 0.8%, was the weakest rate since the early 1990s.

Indicators for the first months of this year suggest a further large contraction in activity in early 2009. Consumer and business sentiment worsened further, falling to new all-time lows in February. Moreover, labour markets have deteriorated which does not bode well for consumer spending. In this context, let me stress that we in the ECB Governing Council anticipated in our interest rate decisions that there will be bad news to come for the first quarter of 2009, as we take our decisions in a forward looking manner. Once these expectations of further weakness in growth are confirmed by official data, we will not to take it into account again – there is no double counting!

Looking ahead, we expect a protracted period of further weakness in euro area activity. We have to face the truth that 2009 will be a very difficult year. It will be a year of balance sheet adjustments across banks, non-financial companies and private households. This could be a further drag on investment and consumer spending, already negatively affected by very low global demand, tight financing conditions and, in the case of private consumption, a further deterioration in labour markets. However, these corrections are inevitable as they lay the foundation of the gradual recovery. This is also reflected in the March 2009 ECB staff macroeconomic projections. The expected negative or very low annual GDP growth in 2009 and 2010 somehow masks these developments as it is affected by negative carry-over effects of the previous year. Looking beyond the annual growth numbers, the underlying quarterly profile embodies expectations of increasingly positive quarterly rates of growth in real GDP over the course of 2010.

Underlying this outlook is the expectation of a gradual improvement of the external environment and a normalisation in financial markets, reflecting the extensive policy measures that have been introduced to restore the functioning of the financial system, both inside and outside the euro area. This together with low inflation rates which strengthen real incomes and the strong fiscal and monetary stimulus should support the gradual recovery in euro area activity.

In our view, the economic outlook remains surrounded by uncertainty. The risks to economic growth appear now to be more balanced. On the one hand, there may be stronger than anticipated positive effects, also on confidence, stemming from the extensive macroeconomic stimulus under way and reflecting other policy measures taken. On the other hand, concerns relate mainly to the potential for the turmoil in financial markets to have a stronger impact on the real economy, as well as to the emergence and intensification of protectionist pressures and to possible adverse developments in the world economy stemming from a disorderly correction of global imbalances.

c. Euro area price developments

Let me turn to price developments. Inflation in the euro area has declined rapidly since it reached its highest level in over a decade in the summer of last year. According to Eurostat's flash estimate, euro area annual HICP inflation was 1.2% in February 2009, well below the rate of 4.0% registered in July 2008. This decline primarily reflects the marked fall in global commodity prices, and in particular oil prices, over this period, owing mainly to weak global demand. The fall in commodity prices has also contributed to a significant diminishing of supply chain pressures from very high levels as signalled by strong falls in survey measures on price setting indicators of companies and substantial declines in producer prices at early production stages.

Looking ahead, HICP inflation is expected to fall further in the coming months. This mainly reflects a rather technical effect which is called "base effect". Base effects are important when looking at developments in annual inflation rates, i.e. comparing the price level now with the one registered a year ago. The increases in energy and food prices, which led to the extended inflation hump until mid-last year, will subsequently drop out of the year-on-year comparison in the coming months. These base effects will exert significant downward pressure on overall inflation and there is a high likelihood that in this process of ongoing disinflation annual HICP inflation in the euro area will temporarily turn negative in the middle of 2009. It also cannot be excluded that we will see in some euro area countries negative inflation rates for a more extended period of time.

However, this will mark most probably only a trough in inflation. The same factors pushing down inflation in the first half of 2009, namely base effects related to volatile oil and food prices, will subsequently unwind and actually put upward pressure on prices, contributing to rising inflation rates over the course of the second half of 2009. Overall, the ongoing disinflation process in the euro area is expected to imply sharp fluctuations in HICP inflation rates during 2009 as also foreseen by the ECB staff projections. For 2010, the ECB staff project HICP inflation at moderate rates.

Let me emphasise that sharp fluctuations in annual inflation rates or the temporary emergence of negative inflation rates is a normal concomitant of any disinflation process, which by its very nature is temporary and thus should not be confused with another "d"-word, namely deflation. From a conceptual point of view, deflation is a completely different state. A deflationary process is a persistent, broad-based and self-sustaining decline in the overall price level. It is reinforced by the anticipation that prices will decline further in the future. As a consequence, inflation expectations become unanchored and negative, with adverse effects on investment and consumption.

By contrast, disinflation, which is linked to transitory movements in relative prices, is per se a welcome development because it helps sustain real incomes, provided that medium-term inflation expectations remain well anchored at levels consistent with price stability. To the extent that this is the case, short-term volatility in annual inflation rates, including negative inflation rates, is not relevant from the medium-term perspective of monetary policy. We expect that price stability is maintained at the medium-term. Moreover, available information indicates that medium-term inflation expectations in the euro area are solidly anchored at levels consistent with the aim of the Governing Council of keeping inflation at rate of below, but close to, 2% over the medium term. Such a firm

anchoring represents the strongest and most reassuring safeguard against any risk of a downward spiral of inflation and inflation expectations. The fact that we have a clear mandate and a clear definition of price stability is helpful in anchoring inflation expectations.

As in the case of growth, a considerable degree of uncertainty surrounds the inflation projections of the ECB staff. Risks to these projections are broadly balanced. They relate in particular to the risks to the outlook for economic activity as well as to risks to commodity prices .

d. Monetary and financing conditions

Latest money and credit data support the view that inflationary pressures have been diminishing. Broad money growth decelerated in 2008, increasingly so at the turn of the year. In particular, it brought headline M3 growth back to levels that reflect the underlying monetary dynamics, which also decelerated.

The financial turmoil and its intensification in September 2008 had a substantial impact on the behaviour of market participants and affected money and credit dynamics, leading to higher volatility in money and credit aggregates. On the money side, this relates in particular to marketable instruments, but also to the significant substitution that is taking place between different categories of deposits included in M3. On the credit side, the flow of bank loans to the private sector around the turn of the year was also rather volatile, partly reflecting a possible turn-of-the year effect. But discounting this effect, latest credit developments confirms the decline in the growth of bank credit to households and firms observed during 2008.

This shows how important it is to look through short-term developments when assessing the underlying pace of monetary expansion and the associated indication for risks to price stability.

Let me turn to the financing conditions in the euro area which have deteriorated further since September 2008. With plummeting equity valuations and soaring credit spreads, the overall cost of financing for euro area non-financial corporations has edged upwards. At the same time, bank lending rates have declined. In fact, it seems that the substantial past reduction in the key ECB interest rates is increasingly being passed through to bank lending rates, indicating that, despite the tensions in financial markets, the transmission mechanism of monetary policy is not significantly impaired in the euro area.

Monetary policy

Let me now turn to the second part of my speech, namely the role of monetary policy in the current situation.

The financial crisis has contributed to a pace in disinflation and economic deceleration which has been unprecedented. This has required us taking unprecedented decisions to contain adverse spillover effects of financial market tensions on the real economy and thereby to maintain inflation over the medium term in line with price stability.

In a coordinated move, the ECB and other major central banks announced reductions in their policy interest rates on 8 October 2008. Overall, since October 2008, we lowered the key ECB interest rates by 275 basis points. The overnight money market rates fell even more steeply over this period, as the ECB significantly enlarged its liquidity provision to euro area banks. Since October last year we have provided the banking sector with unlimited funds at maturities up to six months, against an expanded range of eligible collateral. These decisions have been taken in a timely and decisive manner, in a context characterised by an exceptionally high level of uncertainty.

To better understand the scale of our interventions in the interbank money market, one needs to appreciate its importance in the implementation and transmission of monetary policy. Money market interest rates, especially of short maturities mark the starting point in the transmission of monetary policy. They determine the marginal costs of refinancing of the banking sector and thereby act through the bank lending channel. Money market interest rates are a key factor in determining the entire yield curve and thereby are crucial for the expectations channel of monetary transmission. Of course, longer-term interest rates and bank lending rates cannot be directly controlled by the central bank, but expectations of short-term money market rates are key in determining them.

Contributing to the functioning of the money market and preventing a liquidity crunch therefore has been crucial to forestall a breakdown of the transmission of monetary policy and a systemic crisis. As a consequence of our measures, the Eurosystem's consolidated balance sheet has grown by two thirds from summer 2007 until most recently, or by 6% of euro area nominal GDP. To put these numbers into perspective, the size of our balance sheet has grown from 13% of euro area nominal GDP in 2007 to over 20% most recently. By providing unlimited funds in our refinancing operations we have ensured that banks facing difficulties raising funds in the market are always able to fulfil their liquidity needs.

But we need to be realistic about what we, as a central bank, can achieve. In my view, we cannot expect to see the money market functioning the way it did before August 2007. What is certainly encouraging is that recently the volumes allotted in our refinancing operations have come down slightly. The same is true for the number of banks participating in these operations. Spreads between secured and unsecured interest rates at term maturity have gone down somewhat. But they have remained high. The turnover in unsecured interbank lending, especially at longer maturities, still remains low. To be clear: The problem is not a lack of liquidity in the market. It is the lack of trust among the banks themselves. Unless trust in the solvency of banks is re-established, there is hardly any chance that conditions in the money market will normalise.

As already mentioned, financing conditions have not eased exactly in line with key ECB interest rates. So will key ECB interest rates have to be cut to even lower levels? In principle, even after last Thursday's decision the ECB could still contribute to easing credit conditions by cutting its key interest rates further. But this will not fundamentally solve the problems that have caused the financial crisis. The contrary could be the case. If maintained for an extended period of time, too low or very low interest rates might in fact aggravate them. They have the potential to weaken the incentives for banks to clean up their balance sheet of troubled assets and monitor their credit risk carefully. This in turn may reinforce the very problems that currently impair the functioning of the financial system. Too low interest rates tend to foster lending to unprofitable business. This would

harm the growth potential of the economy and thereby prepare the ground for anaemic growth. Or, as in the past, it could lay the foundations for another asset price bubble. Finally, very low interest rates hamper the functioning of the money market: The lower interest rates in the money market, the lower the incentive of banks to trade funds in the market rather than depositing them safely, at the same low return, with the central bank.

So, as we have started to operate at very low interest rates, are we running out of ammunition to ease monetary conditions further if warranted? Do we need to take more non-standard measures?

Let me emphasise that what we have implemented so far has already been rather unconventional. But in considering any additional action to improve the functioning of the financial system and transmission of monetary policy we need to be mindful of our responsibilities and our mandate – i.e. to be conscious of what monetary policy can do and, even more importantly, what it cannot, and consequently should not do.

Central bank measures aimed at easing credit conditions have not been met with undivided enthusiasm. Commentators have worried about a host of issues. Will the expansion of central bank balance sheets ultimately lead to inflation? As central banks are seen as switching attention from implementing monetary policy by steering short-term interest rates to targeting the composition and size of their balance sheets, have they lost their instrument? Have they become intransparent and unpredictable? With the measures put in place, how are central banks going to preserve their financial and political independence which has been so hard to earn? Under what conditions and when are central banks going to unwind these measures?

I can assure you, we have not lost sight of the principles that have successfully guided us in the past. The measures that we have taken and any additional measures we might implement remain strictly consistent with our responsibilities. Accordingly they meet a whole range of criteria and they will continue to do so.

Any additional measures need to be consistent with our mandate and our principles. Consequently, they can only be taken with the view to pursue price stability and to contribute to the preservation of financial stability. Pursuant to this objective and the Treaty requirements the measures must be compliant with the prohibition of monetary financing. In addition, the scope of such measures is limited by the need to contain the Eurosystems risk exposure so as to safeguard its financial independence, as otherwise the ECB will end up jeopardising its credibility. Furthermore, as conditions in the financial system will eventually improve and in line with our assessment of risks to price stability these measures will be unwound. Accordingly, and finally, bearing also in mind that the health of the financial system cannot be made the ECB's responsibility, one needs to be careful not to blur the responsibility of monetary and fiscal authorities in the euro area.

Of course, we will do whatever we judge to be necessary and appropriate to maintain price stability and contribute to the preservation of financial stability. But we will strictly adhere to these principles.

In considering further easing measures, these principles have obvious implications. Central banks can alleviate liquidity risks. But they cannot address the perceived solvency problems that impair the financial system. One could conceive measures to

ease credit conditions by taking over some of the credit risk on commercial paper that banks currently hold. The ECB has already been accepting corporate loans as part of collateral in its regular liquidity operations. By operating through the banking sector, this has significantly contributed to providing funding to non-financial corporations – and thereby an easing of credit conditions. Buying corporate debt outright would circumvent the banking sector.

We have a responsibility to keep the Eurosystem financially sound. This concern puts a break on how much further we can expand our balance sheet.

How to solve the crisis?

Clearly, the challenges for resolving the current crisis remain tremendous. There is no panacea. We have made our contribution by making sure that longer-term inflation expectations have remained anchored in line with price stability and by preventing a liquidity crunch. It remains our responsibility to continue to do so. But one cannot rely solely on central bank policies to address all the consequences of the financial crisis and its fall-out on the economy.

Resolute action is needed to restructure, consolidate and recapitalise the banking system. Specifically, action is needed to help banks support their balance sheet so as to sustain an adequate flow of credit to the non-financial sector.

Since last autumn, governments have provided or pledged a substantial amount in guarantees for new debt issuance by banks. In addition, they have recapitalised a number of financial institutions. The commitments to provide support are already substantial. But it will take time for the measures to be completely implemented and to show their full effects. In case these measures prove to be insufficient, they need to be complemented by further actions to address problems on the asset side of banks' balance sheets.

To be successful in resolving the financial crisis the asset support schemes need to meet a whole range of objectives. From the central bank perspective the overwhelming objective is to safeguard financial stability and restore the flow of credit from banks to the private sector. In addition, the measures taken will need to be implemented in a way so as to maintain a level playing field in the EU financial market and minimising the burden to public finances.

In line with these objectives, the Eurosystem has issued a set of guiding principles for the design and implementation of asset support schemes to address the most critical issues. Apart from guidance on the types of assets and institutions that would be eligible to support, these guiding principles call for an adequate degree of risk sharing as a necessary element to limit the cost to the government, to provide the right incentives to the participating institutions and to maintain a level playing field across these institutions. They also mention that schemes with well-defined exit strategies should be favoured and that conditionality may be attached to such schemes.

Conclusion

Let me conclude. We face unprecedented challenges. At the ECB we have demonstrated a willingness and capacity to react rapidly to exceptional circumstances. We have cut interest rates sharply to forestall the emergence of downside risks to price stability. We have provided unlimited liquidity support to the banking system so as ensure that liquidity risk does not lead to a systemic crisis. But, ultimately, we alone as central bankers cannot resolve the current financial crisis. The onus is now on governments, supervisory and regulatory authorities, and the financial industry itself, to cooperate to act resolutely to restructure, recapitalise and consolidate the banking system. Such government measures are under way. On our side we will continue to do whatever we judge to be necessary and appropriate to maintain price stability and contribute to financial stability. And in doing so we will stick to the principles that have served us well in the pursuit of price stability. We will safeguard our financial independence. We will be transparent and accountable for our actions. Most importantly, we will remain faithful to our mandate and provide an anchor of confidence and stability in difficult times.

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[1] IMF WEO Update, 28 January 2009.

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