What can central banks do in a financial crisis?

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Recent experience of financial crises

1980s: Developing countries’ sovereign debt crisis
1992-93: European exchange rate crisis
1994: Mexican crisis
1997-98: Asian crisis
1998: LTCM crisis; Russian crisis
2007-2009: Sub-prime / Lehman / ‘Great recession’ crisis
Exploiting commonalities

• Evolution of financial crises exhibits common features across different episodes

• With hindsight, the belief that “this time is different” is an illusion

• Existence of such commonalities suggests early detection possible

• Need for additional tools and policies, e.g.
  ✓ enhanced monetary analysis;
  ✓ macro-prudential surveillance and policies.
One commonality: *Excess credit leads crises*

Note: The shaded areas denote widespread housing/equity boom episodes. The global credit gap is constructed using data on private credit for a panel of 13 OECD countries. Credit to GDP ratios are computed for each country and then averaged across countries by means of GDP-weights based on PPP exchange rates.

Source: Alessi and Detken (2009) based on BIS and IMF data.
Respecting specificities

- **Triggers and channels of propagation of crises** vary across different episodes.

- **Specificities need to be identified quickly:** timing of policy response crucially important.

- **Current crisis required innovative response,** e.g. *ECB’s enhanced credit support.*
One specificity: Money market turmoil, 2007-10

Spread unsecured 3-month money market rate to 3-month OIS rate

August 2007: beginning of the Turmoil
September 2008: intensification of the Turmoil

Note: Spreads are the difference between 12-month EURIBOR / Libor and Overnight Index Swap rates, in basis points.
Conclusions

1. Prevention is better than cure
2. Guard against complacency
3. Crisis management requires:
   - both: innovation and flexibility
   - and: respect for well-established principles