Jean-Claude Trichet: Lessons from the crisis and steps towards economic stability

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank (ECB), at the 9th Munich Economic Summit, Munich, 29 April 2010.

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Sehr geehrter Herr Bundespräsident, lieber Horst Köhler,
Sehr geehrter Herr Chrobog, sehr geehrter Professor Sinn,
Meine sehr verehrten Damen und Herren,

ich danke den Veranstaltern dieser Konferenz recht herzlich für die Einladung. Besonders dankbar bin ich für die Gelegenheit, im Anschluss an meinen langjährigen Freund Horst Köhler sprechen zu dürfen. Wir sind uns über einen langen Zeitraum hinweg in verschiedenen Positionen immer wieder begegnet und haben oft sehr eng zusammengearbeitet.

It has always been an enormous pleasure to talk with him and to work with him. Both of us were engaged in the negotiations of the Maastricht Treaty. That is where we met nearly twenty years ago.

We were also heavily involved with the handling of the European Monetary System crisis in 1992/93. I remember that episode very well. It was a defining moment not only for the monetary integration of Europe. It remains in our memories as a vivid example of what close and friendly cooperation can do in very exceptional and demanding circumstances.

In my remarks today I would first like to reflect on the lessons that I believe we can draw from today's financial and economic crisis. In the second part, I will touch on the current situation, and describe the three key steps that I believe we need to take to return to the path of economic stability.

Lessons of the financial crisis

The financial crisis has taught us painful lessons. It has revealed fundamental weaknesses in our global financial system. In the years that led up to the crisis, the European Central Bank was among those institutions that warned against the under-pricing of risk in financial markets. But the growing complexity of the global financial system and specifically its international linkages made it difficult to predict how and when developments would turn.

With hindsight we know a great deal about the causes of the crisis. Financial innovation led to the development of new instruments that were intended to expand the diversification of risk for savers and investors. In retrospect, we know that instead they contributed to a common exposure to systemic risk.

Gradually, the focus of finance shifted in the recent past. From its traditional role of helping the real economy to cope with economic risk, finance became a self-referential activity. The notion of "financial engineering" is a striking illustration of the shift of attitudes that spearheaded the changing focus of finance. When I started my professional career, no one would have used this expression. Engineering is about building tangible structures that support human endeavours. Some of the structures that were invented in finance turned out to be neither tangible nor helpful to society.

Nevertheless, the vast expansion of the financial sector would not have been possible without both supportive macroeconomic conditions and inadequate prudential regulation. Global current account imbalances have generated large financial flows, as large developed countries sucked in massive capital flows from oil exporting and emerging economies.

Seemingly bright macroeconomic prospects combined with deregulation and global conditions of over-extended credit.

The crisis has shown that deregulation does not always pave the way for greater efficiency and greater prosperity. Rather we have rediscovered the value of properly functioning regulatory and supervisory institutions. And we have also rediscovered the value of medium-term orientation, sustainability and stability.

Consequences of the financial crisis

The consequences to be drawn to minimise the risk of a comparable crisis in the future are numerous and wide-ranging.

First, comprehensive regulatory reforms of the financial system have to be implemented with top priority. While some progress has been already made, major challenges lie ahead. Most importantly, the pro-cyclicality of the financial system must be mitigated. It is essential to change regulatory and accounting rules that tend to amplify the natural cyclical swings of our economies.

Second, we have to enhance the transparency of financial structures. That concerns rules of disclosure as well as market infrastructure. In particular, derivative market instruments need to be subject to greater transparency. But, beyond changes in financial governance, there needs to be a deeper economic assessment of the benefits of these structures to society.

Third, incentives should be aligned. Remuneration schemes, for example, should support sustainable business rather than myopic trading.

There is one over-arching issue that I would like to highlight: the financial industry has to reconsider its role in the economy. Returning to a role of serving the real economy would be desirable. “Financial engineers” may prefer to create ever more “sophisticated” financial products. But finance has to come back to the basics. Among the basic tasks of the financial industry is the supply of credit to the real economy. This too is a profitable business, the profits from which are justified because they are mirrored by the social value of the intermediation function. Businesses and individuals depend in particular on the steady supply of credit by banks.

The ECB and the national central banks of the euro area have taken comprehensive measures during the crisis to help commercial banks and other financial institutions. When the turbulence started in August 2007, the ECB was the first central bank to step in by frontloading liquidity.

After the intensification of the crisis in the autumn of 2008, we tackled the paralysis of inter-bank transactions in the money market. In addition to a swift and substantial reduction of our policy rate, in line with our primary objective of maintaining price stability over the medium term, we decided to implement a set of non-standard measures, which we collectively refer to as “enhanced credit support”. I explained these measures in detail here in Munich in a speech last July.

These measures have significantly helped to maintain banks’ liquidity. But we did not pursue this policy with the ultimate goal of reconstructing banks’ profitability. Rather, the purpose of our enhanced credit support has been to ensure the transmission of monetary policy transactions to the broader economy.

Global economic governance

The crisis has important implications for economic governance, and here remarkable efforts have been made or are under way. On the global level, the G20 has become the main forum for international cooperation, and a strong consensus has emerged within this group not only about the causes of the crisis but also about the appropriate policy responses. The G20 has been highly effective in addressing the global crisis.

The more technical questions concerning regulation and financial stability are mainly delegated to the Financial Stability Board (FSB). The extension of both the membership and the range of tasks of the previous Financial Stability Forum have pushed the Financial Stability Board into a leading role when it comes to coordinating the reform of financial regulation.

The European regulatory response to the crisis will include a new body that will provide macroprudential oversight and focus on the avoidance of systemic risk in the financial system of the European Union as a whole. This is the European Systemic Risk Board (ESRB), the establishment of which intends to make macro-prudential oversight operational at the European level.

While the ECB and the national central banks of the European Union will be heavily involved in the ESRB framework, it is essential to make a clear separation between macro-prudential oversight and monetary policy. The primary objective of euro area monetary policy will remain the maintenance of price stability.

Financial stability lays the conditions for the central bank to pursue its task of maintaining stable prices. It is also the outcome of an environment of steady macroeconomic prospects and confidence, which only stable prices can ensure.

Current challenges for European integration

Ladies and gentlemen, although the financial crisis did not originate here, it has profoundly challenged the European economy – and it is continuing to do so.

Economic and Monetary Union – in short: EMU – is a union based on two foundations: economic and monetary. These are two foundations that reinforce one another.

Responsibility for the "M" is centralised and assigned to the Eurosystem with the ECB at its core, aiming to ensure price stability in the euro area over the medium term. We have defined price stability as an average annual inflation rate below but close to 2% over the medium term.

How have we performed against this objective since the introduction of the euro? Based on current staff projections for this year, by the end of 2010, the average inflation rate in the euro area since the introduction of the euro is estimated to be around 1.95%. Beyond the ups and downs of the economic cycle since 1999, despite the swings in the international prices of raw materials, monetary policy has managed to keep its inflation record faithful to its strategic aim. I am satisfied that we have fulfilled our mandate.

Speaking in Germany, I would like to recall that the average annual inflation rate in this country in the 1990s was 2.2%, and in the 1980s it was 2.9%.

Given the initial promise made to all people of Europe that the euro would be as credible, reliable and as good a store of value as were the best of the national currencies. On these figures, I can say that with an estimated average annual inflation rate of 1.95% for the first twelve years, the euro is in terms of safeguarding purchasing power "stark wie die D-Mark".

In a nutshell, the "M" has done its part. The main current challenges for our union originate in the "E". Economic union is based on responsible national policies: fiscal policies, wage policies, structural policies. At the core of the economic union is the Stability and Growth Pact.

The crisis has revealed some of the shortcomings of national policies to comply with the requirements of an economic union. In particular, in a number of cases, national policies that are responsible for domestic public finances and for the competitiveness of member economies have not achieved their objectives.

But the crisis has also revealed weaknesses in the peer surveillance process and in the implementation of the Stability and Growth Pact. Thus another major lesson of the crisis is the need to strengthen the institutional framework of the economic union.

Of course, the deterioration of public budgets has partly been due to a “migration” of risk from the financial sector to the public sector. Public budgets have been called on to absorb the excessive risk that the financial industry had been creating during the booming years that led up to the crisis.

Partly, however, the deterioration of public budgets is also due to some short-sighted fiscal and economic decisions in the brighter times that preceded the crisis. Before the crisis, weak public finances had combined in some countries with inattention to domestic competitiveness and a lack of long-term strategies to prepare national economies for competing successfully in the challenging – but rewarding – environment of the internal market.

In Greece, in particular, past fiscal irresponsibility and inattentiveness to domestic competitiveness made the national economy extraordinarily vulnerable to a sudden turn in confidence.

As I have implied, after the crisis, the main players in the world economy will be judged by a new yardstick. Private players will be held accountable to new and stricter standards of economic integrity and prudent management. And governments, the world over – and in Europe in particular – will have to show self-discipline and trustworthiness to gain respect and preserve confidence.

That is why financial reform will have to go hand in hand with fiscal reform. Fiscal reform will reinforce confidence. In the current situation, we have to – and we do – stand firm on these principles.

Speculation on more and more elevated sovereign risk has been one factor behind spreads being driven to very high levels. This is why it was very important that the heads of state and government declared on 11 February 2010 that they were ready to “take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole”. I said, on behalf of the ECB, that I approved of this important statement.

In this respect let me stress the following: Loans are not transfers, and loans come at a cost. They come not only at a financial cost; they also come with a strict conditionality. This conditionality needs to give assurance to lenders, not only that they will be repaid but also that the borrower will be able to stand on its own feet over a multi-year horizon. In the case of Greece, this will require courageous, recognisable and specific actions by the Greek government that will lastingly and credibly consolidate the public budget.

Other countries in the Union and elsewhere have gone through times that were no less difficult, and they have emerged from a determined adjustment stronger and more competitive than in the past. These countries have demonstrated that a clear U-turn in national policy governance is achievable. After making the turn, they have reaped large payoffs.

I will not comment on the negotiations that are currently taking place in Athens. They have to be concluded by a courageous, comprehensive and convincing multi-year programme. And I am confident as regards the results of these discussions between the Greek government, the European Commission, the ECB and the International Monetary Fund.

Let me add a word about Germany and the current public debate here. I very much appreciated the invitation by Finance Minister Schäuble yesterday to speak with the floor leaders of all political parties represented in the Bundestag. I said yesterday in Berlin that I had found this meeting – in which Jürgen Stark and I could respond to all questions of our interlocutors – extremely important. My main message was that a fast parliamentary procedure was highly recommended in the present circumstances.

What we need most at this time is a strong sense of direction. We need a sense of direction that can guide us on how we can emerge from these turbulent events and how we can return to the path of economic stability.

In my view, this sense of direction can be provided in three steps: first, in the case of Greece, a strong and credible programme, negotiated between the Commission, the ECB, IMF and the Greek government. Second, the support I have mentioned that will avoid the materialisation of financial risks for the euro area as a whole. And third, a giant step forward in our own framework of surveillance, peer pressure and policy adjustment within the monetary union.

Speaking in the presence of Federal President Köhler, who played such a decisive role in creating monetary union and in the presence of the former Finance Minister Theo Waigel, the father of the Stability and Growth Pact, I must say that I count on the contribution of Germany with regard to the third step – the leap forward in policy surveillance and policy adjustment.

Fiscal adjustment alone will not be sufficient to ensure sustainability. Structural reforms that will lead to more balanced growth are also vital to rebuild the resilience of our economies.

The result must therefore be a renewal of the Stability and Growth Pact and the incorporation of a framework of surveillance for national policies of competitiveness. I hope that considerable energy will be devoted to this area in this country, so that a central outcome of the present demanding episode will be to strengthen the foundations of our monetary union.

Conclusion

Ladies and gentlemen,

Europe has reacted with speed, energy and determination in the financial crisis. We have to stay on this path. We continue to need wise and sound, rapid and determined action by all countries.

We need to resolutely improve the effectiveness of the peers' surveillance of fiscal and economic policies. The weak points of past multilateral surveillance will be corrected, and the Stability and Growth Pact will be reinforced and rigorously applied in its letter and in its spirit. It has to spot at an early stage and to correct deviant behaviours. The overall scope of peers' surveillance should be resolutely broadened to include the competitiveness as well as structural reforms of individual countries, so as to maintain healthy and sustainable growth as the ECB has constantly asked for during the past year.

In doing so we will pave the way for a European economy which will have a higher level of growth potential, and which will be prosperous, stable and resilient.

The introduction of the single currency represents the greatest achievement to date in the history of European integration – a process that has ensured six decades of peace and prosperity in Europe.

Countries that share a common currency share a common destiny.

Thank you for your attention.