Jean-Claude Trichet: Hearing at the Economic and Monetary Affairs Committee of the European Parliament

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, at a hearing at the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 21 June 2010.

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Dear Madam Chair,

Dear Honourable Members,

Since our last meeting on 22 March, the euro area has faced one of the most challenging periods since the beginning of Economic and Monetary Union. To address the unprecedented pressures in financial markets, public authorities in the European Union, including the European Central Bank, have taken bold and courageous steps.

Die wichtigen Entscheidungen, die in jüngster Zeit getroffen wurden, erfordern fundierte Erklärungen und Antworten auf Fragen, die sicherlich auch in diesem Hohen Hause gestellt werden. Daher begrüße ich die Möglichkeit zum Austausch anläßlich der heutigen Anhörung ganz besonders.

Je commencerai donc mon intervention par une évaluation de la situation économique. Je reviendrai ensuite sur la décision annoncée le 10 mai dernier de procéder à des interventions sur les marchés obligataires de la zone euro. Dans une troisième partie, je me pencherai sur les mécanismes de coordination économique de la zone euro et les changements que la situation actuelle appelle.

I. Economic and monetary developments

Since the previous hearing in March, incoming data have confirmed a continuing recovery in the euro area in the first half of 2010. According to the latest estimates, the economy grew by 0.2% quarter on quarter in the first three months of this year. Looking ahead, our earlier expectations that the euro area economy would expand at a moderate rate this year and next have been confirmed.

The latest projections by Eurosystem staff are broadly in line with this assessment. In our view, the risks to this outlook are broadly balanced. Nevertheless, the recovery is likely to remain uneven over time and across economies and sectors, in an environment of continued uncertainty and with tensions in some segments of the financial markets.

The annual rate of inflation in the euro area stood at 1.6% in May, up slightly from 1.5% in April, mostly because of higher energy prices. We may see some further slight increases in inflation in the second half of this year. Looking further ahead, we continue to expect price developments to remain moderate over the policy relevant medium-term horizon.

Our monetary analysis confirms that inflationary pressures over the medium term should be well contained. This is reflected in particular in the overall weak growth of money and credit. The annual growth rate of loans to households is continuing to strengthen, but the growth rate of loans to enterprises has remained negative, as expected in the current phase of the cycle. Suggestions that inflation might be unanchored are entirely unfounded. On the contrary, euro area inflation expectations appear to be remarkably well anchored, in line with our definition of price stability.

Given the outlook for price stability and the solid anchoring of longer-term inflation expectations, the Governing Council regards our monetary policy stance and the current level of key ECB interest rates as appropriate. In order to cope with tensions on the money markets, the Governing Council has decided to reintroduce some of our previous non-standard measures. In particular, we have gone back to full allotment in 3-month and 6-month operations, so as to facilitate the liquidity planning of banks. And we have reactivated operations that provide liquidity in US dollars, in coordination with the Federal Reserve and a number of other central banks, to prevent possible liquidity tensions.

II. The ECB's securities markets programme

Let me now turn to the Governing Council's decision to intervene in euro area debt securities markets, announced on 10 May following abrupt and very severe increases in financial market tensions throughout the world, but especially in Europe. Those tensions were spreading to a wide range of financial market segments, including the stock market, the interbank market and the foreign exchange market. It was observed that the epicentre of these tensions lay in European debt markets, in particular those for government debt.

Although the composition of the shocks that triggered the intensification of those tensions was different from that observed in October 2008 after the collapse of Lehman Brothers in the United States, this situation was comparable in terms of the suddenness of the change in sentiment and the abruptness of the flight to safety by international investors.

Overall volatility in markets increased sharply and liquidity conditions deteriorated significantly, not only in sovereign bond markets, but also to a critical degree in the money markets. Transactions within the interbank market declined rapidly and uncertainty among banks about counterparties' creditworthiness increased.

There was therefore a risk that the normal functioning of markets and the first link in the transmission mechanism of monetary policy between the central bank and credit institutions could become impaired. This would have meant that the ability of banks, which are the primary source of financing in the euro area, to provide credit to the real economy could have been seriously harmed.

It is against this background that the ECB announced on 10 May not only the reactivation of previous non-standard measures, as well as the reactivation of the swap agreements with the Federal Reserve, but also its intervention in debt markets with the launch of the Securities Markets Programme. The single reason for acting is that it is crucial for the effective conduct of monetary policy that government bond markets function as properly as possible.

The government bond markets are very important for three reasons.

1. First, interest rates on government bonds usually set a floor for the interest rates that firms and banks have to pay when issuing their bonds. In circumstances of highly disrupted bond markets, the short-term interest rates of the central bank would no longer be passed on to households and firms, and thereby to prices, to the appropriate degree. This is what we call the price channel.
2. Second, sharply lower bond prices implied by the much higher interest rates associated with disrupted bond markets would cause significant losses in the portfolios of financial and non-financial sectors; for banks, this would reduce their ability to provide loans to the economy. This is what we call the balance sheet channel.
3. Third, abnormally low liquidity for government bonds would reduce their role as collateral in refinancing operations, thereby also hindering banks' supply of loans. This is what we call the liquidity channel.

The decision to start intervening in bond markets was therefore taken in order to help maintain the appropriate transmission of monetary policy to the real economy in the euro area by addressing the malfunctioning of some segments of the securities markets.

As the aim of the programme is not to inject additional liquidity into the banking system, we fully neutralise the bond purchases by means of specific reabsorption operations. As a result, the prevailing level of liquidity and the money market rates are not affected by the programme. In other words, our monetary policy stance is not affected, and there are no inflationary risks related to this programme.

Let me emphasise that we took the decision to introduce the Securities Markets Programme fully in line with the provisions of the Treaty, only operating in the secondary markets for government bonds. We also took the decision in complete independence.

We were aware of the commitments made by euro area governments prior to that weekend, on the evening of Friday 7 May. In particular, the Governing Council took note of the statement by euro area governments that they "will take all measures needed to meet [their] fiscal targets this year and the years ahead in line with excessive deficit procedures" and of the "precise additional commitments taken by some euro area governments to accelerate fiscal consolidation and ensure the sustainability of their public finances". (Quotes from statement by euro area Heads of State or Government, Brussels, 7 May 2010)

This brings me to the third issue I would like to discuss.

III. Economic governance at a crossroads

You have asked me to speak about enhanced economic coordination and surveillance in the euro area.

The ECB believes that a true quantum leap is needed in the framework for surveillance and adjustment of fiscal policies, as well as broader macroeconomic policies concerned with Europe's competitiveness.

"*La solidarité de fait*" that Robert Schuman called for 60 years ago is reflected in the degree of economic integration and interdependence already achieved in Monetary Union. But solidarity is a two-way street. The benefits and protection that are derived from membership of Monetary Union bring with them responsibilities and obligations. This is the fundamental contract which forms the basis for our currency. We now have to turn it into a more effective structure for fiscal and macroeconomic surveillance and adjustment.

In line with the topics addressed by the task force chaired by European Council President van Rompuy, let me focus here on two main areas of reform. A third area, a crisis management framework, is still to be examined at the level of the task force.

First, it is of the essence that the surveillance of budgetary policies be strengthened. I am pleased to note that the European Council confirmed this assessment at its meeting last Thursday.

At the level of the EU27, and in particular within the euro area, we must have effective instruments to prevent – and, where necessary, correct – excessive deficits and debt levels. A more stringent implementation of rules and procedures is essential, among other things by increasing the automaticity and speed of procedural steps. The initiation of sanctions also needs to be quasi-automatic.

Fiscal surveillance must be more direct and effective. It must also be based on more independent monitoring and assessment. We may need a differentiated approach to surveillance depending on the fiscal performance of countries. The Commission should have greater responsibility by making proposals, which can only be modified with unanimity in the Council, rather than mere recommendations under the Stability and Growth Pact.

In the event of non-compliance, sanctions need to be applied much earlier and to be broader in scope. They should not only address excessive debt ratios, but also apply when countries are not making sufficient progress towards medium-term budgetary objectives. A wider spectrum of financial sanctions needs to be considered, along with non-financial and procedural sanctions, such as more stringent reporting requirements or even a limitation or suspension of voting rights.

The second area may appear more novel, both at the level of the European Union and at the level of the euro area, but the ECB has in fact been stressing it in the Eurogroup since at least 2005: the surveillance of policies to maintain Europe's internal and external competitiveness – policies to raise productivity, to enhance people's skills and to improve firms' competitiveness. These policies go well beyond the tradable sector. They must also encompass the non-tradable sector, including the public sector, since it too is decisive for the competitiveness of an economy as a whole.

Conscious management of wages and costs in order to maintain a healthy position for the economy within a competitive environment – this should be the core focus of such broader macroeconomic surveillance. The reason why competitiveness should be the main focus is not that countries should pursue export-oriented policies or boost international market share. The reason is that within a monetary union, the relative competitiveness of economies captures very well the sustainability of price and cost developments.

I am pleased that last Thursday's European Council confirmed the need for an effective surveillance framework in this area. Experience has shown that persistent divergence in this regard is detrimental both for Member States and for Monetary Union as a whole.

As with fiscal surveillance, this framework needs to allow for targeted and differentiated surveillance and follow-up measures. For countries that experience significant losses of competitiveness, surveillance should become increasingly deep and detailed. More ad hoc reporting and dedicated country missions, policy recommendations, compliance requirements, public peer pressure and gradual financial steps to encourage compliance could all be part of that process.

For this to work, we need a transparent and effective trigger mechanism to determine the intensity of vulnerabilities and surveillance. This should be based on close monitoring and reporting by both the Commission and the ECB. Experts are currently developing ways to best capture the complexity of the issue, as well as procedures by which indicators could be used in a surveillance and adjustment framework.

If we can put in place effective surveillance and adjustment frameworks for both fiscal and competitiveness policies – and if we can ensure through appropriate regulation that our financial system serves the real economy and not the other way around – our European Union and our Economic and Monetary Union will exit this crisis much stronger than before and will be very well placed in the global economy.

IV. Conclusion

Honourable Members,

Let me conclude by saying that as we steer a course through these difficult times, we must clearly all work hard, but we must also maintain our ambition. This means that decisions need to be proportional to the importance of the Union.

A single market of 500 million citizens and an Economic and Monetary Union of 330 million citizens – which are among the largest and most advanced economies in the world and which are built on solid foundations in terms of human and social capital – cannot and should not be measured according to the strengths or weaknesses of their individual components alone. Particularly as regards Economic and Monetary Union, policy-makers need to internalise what it means to be part of a monetary union, in words and in deeds.

I therefore very much welcome the calls by this Parliament for ambitious reforms. The reaction of Europe in times of crisis has always been to strengthen European cohesion. I would like to urge you, as Members of the European Parliament, as the representatives of Europe's citizens, to continue to give your support to that course of action.

Thank you for your attention.