# Jean-Claude Trichet: Lessons from the crisis

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the European American Press Club, Paris, 3 December 2010.

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Ladies and Gentlemen,

I would like to start by thanking the organisers for inviting me to share with you my thoughts on the economic and financial crisis. The crisis is not yet over, but we should certainly start drawing lessons and we should certainly start implementing them.

Times are challenging, and Europe's citizens expect all policy-makers to be up to the responsibilities of fulfilling their respective mandates.

As far as the European Central Bank (ECB) is concerned, I recall that we were among the first central banks in the world to react to the outbreak of the financial turmoil back in August 2007. Since then, we have continued to act with a posture that I have called "credible alertness". This posture includes both standard monetary policy, which is implemented through interest rate changes, and non-standard policies, which are implemented, in essence, through special liquidity operations and interventions in some bond markets including covered bonds.

It is my opinion that the ECB's Governing Council has demonstrated a strong ability to keep the European monetary vessel on course through the waves of a financial storm that has often been defined as the most serious since the Great Depression. Throughout the global crisis, resolute action by policy-makers has helped to avoid a repeat of the economic policy disasters of the 1930s – and to foster close cooperation around the world, including among central banks.

But recent developments in European sovereign debt markets remind us that the crisis is not yet over. They also remind us that Economic and Monetary Union rests on two pillars: an "Economic" pillar and a "Monetary" pillar.

The "Monetary" pillar obviously refers to the ECB, its mandate and its independence. The "Economic" pillar comprises the fiscal regime enshrined in the Stability and Growth Pact; the national frameworks of economic policy; and the system of mutual surveillance.

It is very important to understand – and it has perhaps not yet been sufficiently understood – that the developments we are currently witnessing in Europe's economy have to do with the "Economic" functions of Economic and Monetary Union. They have essentially three origins: unsound fiscal policies in a number of Member States; inappropriate macroeconomic policies in a number of Member States; and overall an inadequate system of surveillance by all Member States.

This is the triangle that provides the perimeter of the current situation.

The solution to these three elements involves both the responsibility of national fiscal authorities in ensuring sound fiscal policies in each and every member state and the ability of Europe's policy-makers to design and implement a truly effective system of macroeconomic and fiscal surveillance.

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Today I would like to start by discussing the two pillars of Economic and Monetary Union. Then I will briefly describe how the ECB has responded to the crisis. And finally, I will touch on the current economic situation and conclude with the key challenges that lie ahead of us in achieving effective economic governance in Europe.

## The "monetary" pillar: price stability in the euro area

The Treaty assigns to the ECB direct responsibility for maintaining price stability. From the outset the ECB has set itself a very clear numerical benchmark, which is a public and transparent measure. The ECB's Governing Council has defined price stability to be an annual rate of inflation in the euro area of below 2%, but close to 2%, over the medium term.

We now have almost 12 years of experience with the euro – enough time to judge whether the ECB has been successful in delivering its mandate. Over these 12 years, the average annual inflation rate in the euro area has been 1.97%. We have achieved price stability in the euro area over what has already been quite a long horizon. It is the best result of any of the larger countries in the euro area for at least 50 years.

The conditions for achieving price stability have not always been easy, and the ECB's Governing Council has had to face a number of economic and political shocks since we began, in 1999, with a new institution, a new currency and a new framework for monetary policy-making.

Over the years we have had to cope with highly volatile developments in many components of the consumption basket – including oil prices in the vicinity of $150 per barrel – considerable variations in exchange rates, the bursting of the internet bubble and the fallout of the terrorist attacks on the US, to name but a few. Hence, the track record, with 12 years of price stability, is worthy of note.

For France, the inflation rate has been even lower than the average in the euro area over the past 12 years: 1.8% per year on average from 1999 to October 2010. This is even slightly lower than, but very close to, the average rate of inflation in France in the 1990s prior to the introduction of the euro, which was 2.0%. In the 1980s, it was 7.4% and in the 1970s 8.8%.

The credibility of the euro, as measured by its ability to preserve purchasing power, is better than its legacy currencies have been over the last 50 years.

## The "economic" pillar: sound and sustainable fiscal policy

The "Economic" pillar of Economic and Monetary Union rests on two ideas. First, fiscal policies must align with the requirements laid out in the Stability and Growth Pact. Second macroeconomic policies must be aligned with the general rules governing the participation in a monetary union that is based on price stability.

I want to be candid with you today. The roots of the sovereign debt tensions we face today lie in the neglect of the rules for fiscal discipline that the founding fathers of Economic and Monetary Union laid out in the Maastricht Treaty.

We know that for several years, fiscal policies in many European countries have breached both the letter and the spirit of the Stability and Growth Pact. The Pact calls for budgets that are close to balance or in surplus over the cycle, deficits below 3% of GDP and a public debt level of below 60% of GDP. When a few years ago it became clear that in some countries fiscal policies would not be able to meet the rules of the Stability and Growth Pact, it was not the policies that were changed but the Pact. This was clearly a mistake.

In 2004 and 2005, several governments, including the government of the larger Member States, were actively trying to dismantle the Stability and Growth Pact. It was a very fierce battle at the time, and the ECB publicly voiced its grave concerns.

The second area of policy slippage concerns macroeconomic policies. In a monetary union, national developments in prices and costs have to take account of the fact that the union is a union of monetary stability. Therefore, national price and costs developments significantly higher than the union average entail significant losses over time in competitiveness. Competitiveness losses cannot be sustained forever, and sooner or later adjustments in unsustainable economic policies have to be made. Fiscal and structural policies need to keep domestic demand in line with rates of sustainable growth and price stability. Otherwise, booms and busts may prevail.

Both fiscal and macroeconomic policies are monitored by the peers, supported mainly by the European Commission. The Eurogroup and Ecofin meetings of finance ministers are the fora for such peer monitoring. Of course, effective monitoring requires adherence by members to the policy framework, it requires peer pressure and consequences to deal with deviant behaviour, and it requires reliable statistics.

Reinforcing economic governance is essential. Fiscal and macroeconomic surveillance have fallen short of the requirements of a monetary union. Fiscal policy conduct has quite often not been in line with the Pact, macroeconomic policies have been too loose, and peer pressure has overall been weak. These problems were visible well before the financial crisis, but the crisis has certainly taught us that there is no excuse for those that have not lived up fully to their responsibilities.

I will come back the institutional remedies the ECB thinks are necessary to deal with these issues in a moment. But first let me turn directly to the crisis and illustrate how the ECB operational framework helped us in tackling the challenges that the financial turmoil posed for monetary policy.

**The financial crisis and the policy responses**

It is fair to say that more than three years since the crisis began in the summer of 2007, there is a broad agreement on the role of imprudent practices in the financial sector. Over the few years preceding the crisis, the focus of finance moved towards the *creation* of financial risk, and away from the sound management and insurance of economic risks, typically borne by entrepreneurs that are willing to take risk and need financing.

Financial risk is different from economic risk. It entails a deliberate exposure to expected asset price changes. Inasmuch as it supports price discovery, financial risk-taking contributes to efficient allocation of resources in market economies. It can at times become toxic when it is based on wrong perceptions of risk.

The events that unfolded after 15 September 2008, when Lehman Brothers filed for bankruptcy, threatened to create severe damages for borrowers and for the broader economy. Banks and other financial intermediaries shed risky and illiquid investments and rushed to liquidity, banks' intermediation was reduced and loans to companies were curtailed. If not tackled promptly, such developments could eventually have led to financial meltdown.

As I mentioned, the ECB was among the first central banks to recognise the severity of the situation as early as August 2007, when the turmoil began and prompted our first reaction to the lack of liquidity in the money market. As the failure of Lehman precipitated the acute phase of the crisis, the ECB acted decisively again, taking several measures to protect against a disorderly correction in credit and liquidity conditions for the euro area. Our approach of enhanced credit support helped restoring a more normal transmission of our monetary policy stance and ensuring that banks could maintain their crucial role in financing the real economy. The ECB also engaged in a covered bond purchase programme worth €60 billion throughout the euro area. The covered bond market is important in our economy and it was vital to re-start and support its functioning.

In May 2010 increasing market concerns about the sustainability of public finances led to severe tensions in certain market segments, which were hampering the transmission mechanism of monetary policy and thereby the effective conduct of our efforts to maintain price stability. Once more the ECB decided on appropriate measures.

Private financial intermediation was again threatened. With the rapid increase in secured interbank lending in the euro area in recent years, the impact on money markets of developments in government bond markets has grown substantially. Government bonds have traditionally been an important element in the monetary policy transmission process because they serve as a benchmark for the pricing of other financial contracts and fixed-income securities.

They have also emerged as a prime source of collateral in interbank lending. As a result abrupt changes in the value or availability of these securities can imply a sharp deterioration in banks' funding conditions – with adverse effects on both the supply of bank loans to the real economy and their prices.

All our non-standard measures help to restore a more normal monetary policy transmission mechanism, which is necessary to fulfil our primary mandate of maintaining price stability in the medium term.

In recent weeks, the tensions associated with the Irish fiscal problems and the reorganisation of its banking sector have led to renewed bouts of high volatility in financial markets. More than ever it is important that governments step up consolidation in way that is credible and lays the foundation for sustainable long-term growth. There is a clear need to strengthen public confidence in the capacity of governments to return to sustainable public finances and thus support sustainable growth over the medium term. To this end, it is essential that countries pursue credible multi-year consolidation plans and fully implement the planned consolidation measures. Positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected economic environment, should be exploited to make faster progress with fiscal consolidation.

## Europe's economy: the current situation and the challenges ahead

Let me come to the third and final part of my remarks: what are the lessons we have learned from these events?

First, our monetary policy strategy has proved to be effective. The quantitative definition of price stability and the medium-term orientation significantly reduce the likelihood of either deflation or inflation scares. The firm anchoring of inflation expectations – throughout a time of crisis – meant that we could maintain the rate on our refinancing operations at positive levels without having the materialisation of a deflationary risk or of an inflationary threat.

Europe's leaders should recognise that our economic model is in need of a considerable strengthening, especially our system of economic governance. In this respect, the Governing Council of the ECB considers that the proposals put forward by the Commission and the European Council Task Force do not yet represent the quantum leap in economic governance that is needed to be fully commensurate with the monetary union we have created.

In particular, we need to strengthen the surveillance of fiscal policies to prevent excessive deficits and unsustainable public debt with three main elements: shorter deadlines under excessive deficit procedures; quasi-automaticity in the application of sanctions, based on clearly defined criteria and with less discretion over outcomes; and ambitious targets for the reduction of public debt towards the 60% ceiling.

As regards the surveillance of macroeconomic policies in the euro area we need a new system of mutual surveillance, concentrating firmly on countries experiencing sustained losses of competitiveness and large current account deficits as these countries face the greatest sustainability challenges. It should be determined by transparent and effective trigger mechanisms and specify clearly the sanctions in case of breach. And we need transparency. The assessments of macroeconomic imbalances and recommendations for corrective action should be given appropriate publicity at all stages of the surveillance process.

The effectiveness of these enhancements to the governance framework will in part be determined by the quality and independence of the economic analysis that underpins them. Without reliable statistical data we cannot be certain that the governance framework will provide the quantum leap forward that is necessary. It is therefore extremely important that the Commission services charged with conducting macroeconomic and fiscal surveillance for the euro area be sufficiently independent, ideally supported by a body of “wise persons” providing external assessments.

To be sure, the EU has already responded to one particular issue raised by the crisis, namely the need to co-ordinate macro-prudential oversight. You are all aware that the European Council and the European Parliament have recently finalised the decisions regarding the creation of the European Systemic Risk Board or ESRB, which I shall have the honour to chair.

This new European body will be part of the new European System of Financial Supervision and its function will be to provide macro-prudential oversight of the EU financial system. It will bring together the governors of the national central banks, the new European Supervisory Agencies, the Commission and the national supervisory authorities of all 27 member states.

The establishment of the ESRB was first recommended in February 2009 in the report of a high-level group chaired by Jacques de Larosière. The new institution is backed by a remarkably strong consensus between the Commission, the Council and the Parliament.

The ECB will contribute to establishing the ESRB as a credible and effective body. Concretely, the ECB will host the Secretariat of the ESRB, thereby making it operational and providing analytical, statistical, logistical and administrative support.

While the ESRB Secretariat will be located at the ECB, the ESRB will be a separate body, distinct from the ECB. The establishment of the ESRB will not affect the mandate and the functioning of the ECB’s statutory role in monetary policy.

The establishment of the ESRB will be a landmark event in how Europe deals preventively with systemic risk. It forms part of wider developments across the globe, including in the US with the newly created Financial Stability Oversight Council (FSOC). Very much like the ESRB, this council is a collaborative body bringing together the relevant US authorities with the aim of identifying systemic risk and responding to threats. We will aim for close cooperation with the FSOC and other authorities for macro-prudential oversight.

## Conclusion

Let me draw to a close. The past 12 years have been very challenging. The ECB has, I trust, lived up to its responsibility and delivered what had been promised to our people: a stable currency, as credible and as inspiring of confidence as the best of the legacy currencies. The euro has also been a force for stability in what is now a more than three-year period of economic and financial instability.

As in all major advanced economies, which, without exception, have had to review their economic models and surveillance frameworks, changes are needed in the euro area. These are not the kind of changes that push us towards more unilateral action, with the implicit dangers of lack of cooperation. Rather they are changes towards greater cooperation and greater cohesion through a strengthened framework of economic governance. We must keep our sense of direction: towards more European unity and more responsible European unity.

Thank you for your attention.