Jean-Claude Trichet: Economic and Monetary Union – current situation

Introductory remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the International Club of Economic Journalists, Frankfurt am Main, 13 December 2010.

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Ladies and Gentlemen,

It is a true pleasure for me to participate in the meeting co-organised with the International Club of Frankfurt Economic Journalists. I vividly remember the interesting discussions we had in December 2008. At the time, I took the opportunity to discuss the changes in central banking communication. Today, I would like to focus on the current situation regarding Economic and Monetary Union.

Let me start by quoting from a famous speech that, according to the ancient Greek historian Thucydides, the Athenian statesman and leader Pericles delivered to his fellow citizens during the Peloponnesian War more than 2400 years ago:

> *"Our constitution does not copy the laws of neighbouring states; we are rather a pattern to others than imitators ourselves. Its administration favours the many instead of the few; this is why it is called a democracy."*[1]

As democracy in Periclean Athens 2400 years ago, the construction of Europe does not have established institutional patterns to copy. The European Union and the euro area are shaping new forms of cooperation and integration between sovereign states. The founding fathers of Economic and Monetary Union (EMU) built the European house from its foundations. They could count neither on guidelines nor on predetermined rules. We are still progressing. An ambitious agenda lies in front of the European Leaders. It is a visionary agenda, and despite all the current challenges it is being pursued with determination.

Serious work is currently under way to underpin macroeconomic and financial stability in the euro area. We all know that it calls for determination, resolve and a solid sense of direction.

For what concerns monetary policy, you can rest assured that the European Central Bank will continue to deliver the most efficient policy response and retain the posture of "credible alertness" that was adopted since the outbreak of the financial turmoil back in August 2007. 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.

The ECB's Governing Council has demonstrated a strong ability to preserve price stability during one of the most challenging period of modern monetary history, a period that could have led to a repeat of the Great Depression of the 1930s.

Not surprisingly all advanced economies, being stressed by the worst financial and economic crisis since World War II, are called to reflect on the weaknesses of their economic and financial structures and on the appropriate reforms to redress their medium and long term macroeconomic and macro-financial strategies. This is the case in the United States. This is the case in Japan. It is the case in the European Union and in the Euro area as well.

My plan for tonight is precisely to assess the institutional framework of the Euro area by highlighting the origin of the tensions we are currently experiencing and the plausible solutions that would help to restore market confidence and consolidate the building blocks of EMU.

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[1] Thucydides (431 BC): The History of the Peloponnesian War (translated by Richard Crawley).

As its name suggests, "Economic and Monetary Union" has two attributes: one is "Economic" and one is "Monetary." The Monetary attribute of our Union refers to the ECB, its mandate and its independence. The "Economic" aspect of our Union comprises the fiscal regime enshrined in the Stability and Growth Pact; the national frameworks of economic policy, including macroeconomic policy and financial supervision; and the system of mutual surveillance.

The developments we are currently witnessing in Europe's economy have to do with its "Economic" functions. They have essentially three origins: unsound fiscal policies in a number of member states; inappropriate macroeconomic and supervisory policies in a number of member states; and overall an inadequate system of surveillance. This is the triangle that lies behind the current situation. And let me make this very clear: the triangle does not include monetary policy.

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The "monetary" side: price stability in the euro area

The "M" side of the EMU is relatively straightforward to assess. The Treaty assigns the ECB the primary responsibility for maintaining price stability in the euro area over the medium term. We now have almost 12 years of experience with the euro: this is a sufficiently long span of time to provide an evaluation of how successful the ECB has been in delivering on its mandate.

You all know that from the outset the ECB has set itself a very clear numerical benchmark, which is a public and transparent yardstick. The ECB's Governing Council has defined price stability to be an annual rate of inflation in the euro area of below 2% over the medium terms. The Governing Council has also declared that, in pursuing its mandate, it aims – within that range of values – at an inflation rate over the medium terms close to 2%.

Let me emphasize that the track record is solid. Over the first 12 years of existence of the euro, the average annual inflation rate in the euro area has been 1.97%. This is the best result in the euro area for at least 50 years and despite the number of economic and political shocks we had to face since we began, in 1999, with a new institution, a new currency and a new framework for monetary policy-making. It has been achieved in an environment of positive growth that in per capita terms was virtually the same as in the United States. It has been achieved in an environment of employment growth with employment rising by over 14 million. And it has been achieved for an entire continent of 330 million people.

Furthermore, over the same period, inflation expectations have generally been aligned with our definition of price stability. Even at the height of the financial crisis, in a situation of high uncertainty, inflation expectations have remained anchored. Today, as witnessed by the October reading of the Consensus Forecast, as well as of the Survey of Professional Forecasters and Euro zone Barometer, they remain anchored, with both readings at 1.9% at a 5 years horizon. The more recent Eurosystem staff economic projections – that spans a shorter time horizon – also reflect the stability of inflation looking forward.

Our monetary policy strategy has communicated a clear sense of direction. The sustained anchoring of expectations has made it possible for the ECB to ease its policy stance in response to the crisis without entering pre-commitments about the future path of the policy rate. Our definition of price stability has guided our citizens in their economic decisions and has acted as a built-in stabiliser in the deepest phases of the crisis.

The "economic" side: sound and sustainable fiscal policy

Let me now turn to the main contention of my remarks: the tensions we are experiencing today in the Euro area sovereign debt markets find their deep causes in the countries' policy slippages of the past years. These slippages are all concentrated on the "E" side of EMU. First, fiscal policies in some countries have not been aligned with the requirements laid out in the Stability and Growth Pact. Second macroeconomic policies in some Euro area countries were not fully consistent with the participation in a monetary union that is founded on price stability.

To be sure, looking at the euro area as an aggregate, and comparing the euro area with its major global partners, the fiscal problem appear relatively modest. Next year, the average Euro area budget deficit will be in the order of 4.6%. By 2012 it is expected to decline further to 3.9% (Source EC Autumn 2010 economic forecast). These expected numbers are about half the corresponding expected figures for the US and Japan. The problem, the source of the current tensions clearly reside with national fiscal developments, notably localised in those countries that have not done enough to correct imbalances or to prepare for difficult times, when times were still good.

We know that for several years, fiscal policies in some 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 always 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 important 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 dark moment in the history of European policy decision making.

In 2004 and 2005, the governments of the three largest Member economies coalesced to try and dismantle the Stability and Growth Pact. It was a very fierce battle at the time, and the ECB publicly voiced its grave concerns.

The recent crisis has demonstrated that growing underlying macroeconomic imbalances can also destabilise fiscal policies and place a country on an unsustainable trajectory. A boom-bust cycle can mask a fiscal problem for a long time and suddenly expose the problem when it turns. High fiscal elasticities tend to curb budget deficits – and even produce overall surpluses – when asset price run-ups boost revenues from financial and housing transactions. The same elasticities, however, will send the budget into distress when the boom reverses.

The second area of policy slippage concerns macroeconomic policies. Here what stands clearly in front of the policymakers is the sustained increase in unit labour costs whose growth in some member countries has consistently outpaced both domestic inflation and euro-area average union labour costs. Such competitiveness losses cannot be sustained forever, and catching-up phenomena can only explain a limited part of the process. 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.

Reinforced fiscal surveillance, for all its critical importance, is not enough. We need to scrutinise more closely the macroeconomic policies. We need reinforced macroeconomic surveillance. You know that the monitoring of fiscal and macroeconomic policies in the European Union and the Euro area is performed by peer group fora: the Eurogroup and Ecofin meetings of finance ministers. The European Commission typically supports the activity of these fora. 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.

Europe's economy: the current challenges and the way ahead

Let me come to the third part of my remarks: what is expected of national governments and of European Union institutions?

Starting from fiscal policies, in some countries there remain significant concerns about the sustainability of their own fiscal positions. It is not possible to procrastinate further the solution to these problems and fiscal authorities need to act in order to strengthen public confidence in sound public finances, thereby reducing risk premia in interest rates and supporting sustainable growth over the medium term. More generally, all euro area governments should step up consolidation efforts in a way that is credible and lays the foundation for sustainable long-term growth. 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. In their 2011 budgets, countries need to specify the necessary fiscal adjustment measures in detail, while standing ready to correct any slippages from the fiscal objectives announced.

In this context, let me express the appreciation of the Governing Council for the economic and financial adjustment programme which was recently agreed by the Irish government with the European Commission, in liaison with the ECB, and the International Monetary Fund. I am sure that the programme is suited to bring about a sustainable stabilisation of the Irish economy and sooth the tensions in financial markets that are associated with the Irish fiscal problems and the reorganisation of its banking sector. Furthermore, by addressing in a decisive manner the economic and financial causes underlying current market concerns the programme will also contribute to restoring confidence and safeguarding financial stability in the euro area as a whole.

Equally important is that structural reforms are rapidly implemented that enhance the prospects for higher sustainable growth especially in those countries that have accumulated over the past years significant loss of competitiveness or are suffering from high fiscal and external deficits. Removing labour market rigidities and increasing product market competition – particularly in the services sectors – would further support the adjustment process of these economies. Measures working in this direction will also facilitate the restructuring of the economy and foster innovation, productivity growth, which ultimately leads to sustainable long-term economic growth. At the current stage it cannot be stresses enough how important it is that the banking sector of the euro area be appropriately restructured. By repairing their own balance sheets, implementing sound and effective risk management strategies the banks in the euro area will increase their resilience to domestic and external shocks, which would allow them to make their contribution to sustainable growth and financial stability.

Finally, let me state clearly – also on behalf of the Governing Council of the ECB – that we are not completely satisfied of the proposals put forward by the Commission and the European Council Task Force that should aim at strengthening the system of economic governance in Europe. These proposals in our view do not yet represent the quantum leap in economic governance that is needed to be fully commensurate with the monetary union we have created.

Most important, we need to strengthen in particular two areas of the economic and financial structure in the EU. The first area is the surveillance on domestic fiscal policies with a view to preventing excessive deficits and unsustainable public debt. The second one is the adoption of a mutual surveillance framework on macroeconomic policies in the euro area focussing on those countries which experience sustained losses of competitiveness and large current account deficits as these countries face the greatest sustainability challenges.

To be specific, I think that for these two broad areas, one can highlight six main lines of reform that the ECB deems it is necessary to purse further. Starting from the fiscal policy side, I am convinced that, as far as the euro area is concerned, one should:

1. The deadlines for action on the side of governments under excessive deficit procedures should be shortened, and the system of sanctions should operate much

earlier in the EDP process. In the past lenient applications of the rules were exploited by short-sighted policymakers for irresponsible delays in adjustments and laid the premises for the current situation.

2. Sanctions should be applied in a way that is quasi-automatic and based on clearly defined criteria and with less discretion over outcomes. This will mean, first to diversify the spectrum of possible financial and non-financial enforcement mechanisms. Among the financial mechanisms, I include fines, deposits and reduced access to EU funds. Under the non-financial mechanisms, I include country missions, recommended adjustment programmes, possible limitations of voting rights for Member State in persistence violation. Quasi-automaticity will also imply the limitation of the scope for discretional intervention at the political level, for example by implementing to the maximum possible extent the "reversal of voting majorities" at the European Council.

3. Place more ambitious targets for the reduction of public debt towards the 60% ceiling. We should assign the debt criterion the importance it is given in the Treaty by combining a clear and sufficiently ambitious rule on public debt reduction with the prescriptions on deficit developments that are typically the exclusive focus of EDP procedures.

For what concerns the mutual surveillance framework, three other main lines of reform are necessary in our opinion:

1. The design of a transparent procedure that clearly specifies the sanctions in case of breach of sustainability rules. Identification of Member States with vulnerabilities should be done on the basis of clear and undisputable quantitative indicators which should not be left to the sole discretion of the Commission. We have advocated that a specific scoreboard should be designed for euro area Member States which would trigger a quasi-automatic in-depth analysis and reinforced monitoring. A detailed and self-contained scoreboard offers a concrete basis for assessment. Furthermore, it restricts the scope open to countries to arbitrage across indicators and monitoring dimensions.

2. The procedure should be transparent in order to give the possibility to the general public and to market participants to appreciate the evolution of the process, from the stage at which macroeconomic imbalances are detected and assessed, to the stage at which recommendations for corrective actions are issued. Transparency in this case reinforces – rather than weakens – the teeth of the procedures.

3. The increase in the quality and independence of the economic analysis that underpins the surveillance exercises. It is important that the Commission is permitted to assess not only national budgets, but also the individual budgetary measures taken by Member States and have the right – in liaison with the ECB – to carry out missions to Member States in order to assess the budgetary situation. Ancillary to this last point, we need to bring the reliability of statistical data to the highest possible level.

It is my opinion that in order to pursue these lines of reform we need to give the Commissioner himself and the Commission services charged with conducting macroeconomic and fiscal surveillance for the euro area the highest degree of independence possible within the Commission, ideally supported by a body of "wise persons" providing external assessments.

Let me conclude with an example that demonstrates that in Europe policymakers can make bold steps when and where necessary. I am referring to the recent decisions of the European Council and the European Parliament to create 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 will be a landmark event in how Europe deals preventively with systemic risk. It will complete the European construction in the direction of adding safeguards that will stabilise the financial system and make Europe's economy more stable and resilient in the medium terms. Furthermore, it will facilitate multilateral dialogue and cooperation in the field of macro prudential oversight with similar institutions in other countries, including the US and the newly created Financial Stability Oversight Council (FSOC).

Conclusion

The ECB has, I trust, been living up to its responsibility and delivered what had been promised to our people: a stable currency that has promoted economic growth and job creation. This has not been an easy journey and we had to drive on rocky roads and absorb various shocks, including food and oil price gyrations as well as the consequences of the terrible terrorist attacks in the US. Over these years, the euro has always been a force for stability and it remains so also in what is now a more than three-year period of economic and financial instability.

In Europe, as in all other major advanced economies, we are now called to react to the challenges posed by the crisis. Changes are needed in the euro area involving both our economic models and surveillance frameworks. Taking into account the lessons to be drawn from the global crisis in terms of functioning of the Economic Union, it appears of the essence to pursue greater cooperation and greater cohesion through a economic governance that will be considerably reinforced. We must keep our sense of direction: towards more European unity and more responsible European unity.

Thank you for your attention.