

Jean-Claude Trichet: Economic and Monetary Union – what we have achieved and what we must do next

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Klausurtagung der CSU Landesgruppe, Wildbad Kreuth, Germany, 7 January 2011.

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Note for the readers: The speech begins with a summary in German. The full text in English starts on page 2.

Sehr geehrte Damen und Herren,

ich danke Ihnen sehr herzlich für die Einladung zu Ihrer Klausurtagung in Wildbad Kreuth. Ich wünsche Ihnen und Ihren Angehörigen ein gesundes und friedvolles Jahr 2011.

Das vergangene Jahr hat uns alle vor besondere Herausforderungen gestellt, und ich freue mich, mit Ihnen über die Herausforderungen im laufenden Jahr zu sprechen.

Lassen Sie mich vorab meine zentrale Botschaft wie folgt zusammenfassen. Wir haben in der EU eine Wirtschafts- *und* Währungsunion. Wie dieser Name besagt, beruht die Union auf zwei Säulen: einer wirtschaftspolitischen Säule und einer währungspolitischen Säule.

Für die währungspolitische Säule stehen die Europäische Zentralbank, ihre Unabhängigkeit und ihre eindeutige Ausrichtung auf Preisstabilität. Preisstabilität im Sinne einer durchschnittlichen jährlichen Inflationsrate auf mittlere Frist von knapp unter 2% ist gewährleistet.

Der Euro ist eine stabile Währung, so stabil wie seine stabilsten Vorgängerwährungen, einschließlich der D-Mark. Und dies gilt für ein Währungsgebiet, das nunmehr 331 Millionen Menschen umfasst. Preisstabilität für diesen großen Währungsraum gesichert zu haben, und sie allen Indikatoren entsprechend auch für die absehbare Zukunft gesichert zu wissen – das ist die entscheidende Errungenschaft der währungspolitischen Säule in der Wirtschafts- und Währungsunion.

Die zweite Säule ist die Wirtschaftspolitik. Für diese Säule stehen der Stabilitäts- und Wachstumspakt, die Ausrichtung der allgemeinen Wirtschaftspolitik und die effektive gegenseitige Überwachung der Finanz- und Wirtschaftspolitik.

Leider hat diese zweite Säule erhebliche Defizite offenbart. Der Stabilitäts- und Wachstumspakt ist zunächst aufgeweicht und dann verletzt worden, die allgemeine Wirtschaftspolitik ist nicht in allen Ländern auf Stabilität ausgerichtet gewesen, und die gegenseitige Überwachung war oftmals nicht effektiv.

Die Entwicklungen im letzten Jahr sind eng mit den Schwachstellen der wirtschaftspolitischen Säule verzahnt. Daher ist die grundlegende Herausforderung für dieses Jahr, die wirtschafts- und finanzpolitische Säule so zu stärken, dass sie trägt. Dies erfordert einen Quantensprung in der Gestaltung und Implementierung des Stabilitäts- und Wachstumspakts, und eine stabilitätsorientierte allgemeine Wirtschaftspolitik aller Länder. Wirtschaftliche Schwächen und Wettbewerbsverluste müssen rechtzeitig korrigiert werden.

Dazu müssen die Mitgliedstaaten erkennen, dass der Euro nicht nur eine gemeinsame Geldpolitik bedeutet, sondern auch eine stabilitätsorientierte Ausrichtung der jeweiligen, nationalen Finanz- und Wirtschaftspolitik erfordert. Diese Erkenntnis muss konsequent in der Praxis umgesetzt werden. Die derzeitigen Vorschläge dazu gehen nach Auffassung der EZB nicht weit genug und ein ambitionierteres Vorgehen ist hier angemessen.

Soweit die Zusammenfassung meiner Botschaft heute.

Ich bitte Sie, mir zu gestatten in Englisch fortzufahren.

Behind us lies a year of remarkable changes, but also remarkable achievements. After the worst recession in decades, economic growth has resumed in Europe. The German economy, in particular, has fared much better than many had anticipated. And with more than 60% of German exports staying within the EU, rising demand from other European countries has made a significant contribution to that recovery.

But 2010 was also a year of great challenges. The euro area economy was severely tested by developments related to the weakened standing of several sovereigns. In response, Europe's leaders chose to take some tough and courageous decisions. None were easy, but they were necessary and they are beginning to pay off.

In 2011 we must strengthen our efforts even more. We need to see further significant progress on the reduction of excessive fiscal deficits. And we have to build and implement an effective rigorous framework for economic governance in the euro area.

Current proposals go some way towards repairing the institutional shortcomings that the recent past has exposed. Vulnerabilities will be detected and made public earlier. There will be less discretion in applying and enforcing macroeconomic and fiscal discipline in Member States.

But Europe cannot afford to rest halfway – we need to be more ambitious. The proposals that we have seen in Brussels do not go far enough in the ECB's view. As I have said before, we need to make a quantum leap in our economic governance. We must achieve a framework where each and every country respects the principle that a successful economic and monetary union is based on sound macro policies. There must be a binding code of conduct for all parties concerned.

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Today I would like to share with you my views on how, together, we can fulfil that duty, building on the notable achievements and stable foundations of our single monetary policy.

The credibility of the ECB rests on its independence, the transparency of its strategy and the consistency of its words and actions. I will also argue that the euro area's new surveillance framework should be built on these three principles – of independence, transparency and consistency of words and deeds.

The achievement of price stability in the euro area

The Treaty assigns to the European Central Bank (ECB) the single objective of price stability. The ECB has provided a clear definition of this objective, as annual inflation in the euro area of below 2%, but close to 2%, over the medium term.

Since its establishment in the summer of 1998 the ECB has worked hard to fulfil this objective. The results are very clear. We have seen 12 years of low inflation and low interest rates. The average annual inflation rate in the euro area has been 1.97%. It is the best result in terms of price stability for any large euro area country over the past 50 years.

So the ECB has performed its duty. As a result, millions of European citizens have seen their purchasing power and the value of their savings preserved.

Speaking before the *CSU*, I would like to recall the concern expressed by Franz-Josef Strauss back in 1978. In connection with the establishment of a European Monetary System, he had warned *“Europa darf keine Inflationsgemeinschaft werden!”* Ich sage Ihnen heute: Europa ist keine Inflationsgemeinschaft geworden. Und wird es nicht werden.

Indeed, in Germany, the inflation rate has been even lower than the euro area average over the past 12 years: 1.5% per year on average between 1999 and 2010. By comparison, the average annual rate of inflation in Germany in the 1990s prior to the introduction of the euro was 2.2%. In the 1980s, it was 2.8% and in the 1970s, 4.9%.

The steady course of monetary policy in the euro area has also contributed substantially to stabilising medium to long-term inflation expectations at a level consistent with price stability. This is a remarkable accomplishment, especially given the numerous economic and financial shocks we have had to face since the ECB came into being.

These achievements have not come at the expense of employment. On the contrary, since Economic and Monetary Union began, employment in the euro area has risen by over 14 million, compared with close to 8 million in the United States. And these achievements have not come at the expense of growth either. Adjusted for population growth differences, growth in the euro area has been almost the same as in the United States over the past decade, at about 1% per year in terms of GDP per capita growth.

The euro is now well established as a credible currency, of which citizens can be proud. This is important for all the Member States of our union, both individually and collectively, as we together face the challenges of the global economy.

Responding to the crisis: bold actions in line with steadfast policy orientation

None of these achievements happened by accident. They were only possible because our actions were enshrined in our medium-term oriented monetary policy strategy.

The financial crisis has changed neither our strategy, nor our objective. The ECB's response to the crisis has always been in line with both our strategy and our medium-term objective of price stability.

But we did broaden the range of our tools to adapt monetary policy to the challenges of the crisis. What we did was to insure euro area banks against present and future liquidity shortfalls. Banks are the backbone of our financial system. 70% of firms' external financing comes from banks. They finance a very large share of the investments made in Europe. Jeopardising banks' ability to lend to companies would have meant jeopardising the jobs of millions of Europeans.

Because of the crucial role of banks in the real economy, we decided to provide liquidity in unlimited volumes and with longer maturities to banks. In parallel, we reduced the interest rate at which they can borrow to a historical low of 1%.

And we launched a programme to purchase euro-denominated covered bonds, i.e. Pfandbriefe, issued in the euro area. The aim was to jump-start this market, which had suffered considerably in the crisis and which is so important for Europe. Overall, the Eurosystem – the ECB and the national central banks – purchased EUR 60 billion of Pfandbriefe across the euro area. This has provided an important contribution to revitalising this market after the crisis. We will hold the bonds to maturity and the profits will be distributed to our shareholders.

Because of these and a number of other important steps, fears of a "Kreditklemme" have not materialised. Our bank lending surveys show that lending in the euro area – even in the middle of the crisis – was not significantly constrained by supply-side factors.

That being said, monetary policy responsibility can not substitute for government irresponsibility. Excessive government borrowing by some Member States led to a seizing-up of the market for government paper. This market plays a central role in our financial system and constitutes a crucial element in the transmission of monetary policy to the real economy. Fire sales of government bonds imply a sharp deterioration in banks' funding conditions.

Confronted with a serious dysfunction in important segments of financial markets, the Governing Council of the ECB decided to intervene. The reason for the decision was certainly not to finance debt-laden Member States, but to address some severe malfunctioning of markets, so as to help ensure a better functioning of the transmission of

monetary policy to all euro area economies. Let me stress solemnly that our monetary policy stance is itself designed to deliver price stability over the medium term.

In any case, we told all governments that they had to correct drastically their fiscal policies. This was not new. It has been our constant message to executive branches: governments must restore fiscal sustainability without delay. This brings me to the second part of my remarks.

Sound fiscal policies: a pre-condition for monetary union

After one of the most difficult years for our still young common currency, it is time to turn the page. It is time for each and every Member State to live up to its responsibilities. And it is time to strengthen the code of conduct for national governments, notably the Stability and Growth Pact, of which I will not hesitate to say that Theo Waigel is the founding father.

We know that for several years fiscal policies in some countries have breached both the letter and the spirit of the Pact. The problems that hit some European bond markets last year were a visible and tangible testimony of fiscal misconduct.

The watering-down of the Pact in 2004 and 2005 by Europe's largest economies was a quieter event, but it was no less grave. In that period, Member States chose to change the rules rather than their policies. The ECB voiced its "grave concerns" at the time.

Today, governments have no choice but to change their policies. And they must substantially reinforce the Stability and Growth Pact.

And it is not only fiscal policies that need to be brought back onto the path of virtue. In several countries, macroeconomic policies more generally need to be aligned with best practice.

Germany went through some painful years of macroeconomic adjustment. Not so long ago it was called the sick man of Europe. Since then, relative unit labour costs have been improved, labour market barriers have been lowered and employment has risen.

Today, the German economy is highly competitive with increasing domestic demand. But because some economies were less courageous in pushing forward necessary structural reforms, the competitive gap between countries in the euro area has widened.

The primary symptoms of a widening competitive gap are unit labour costs, inflation differentials and mounting current account imbalances. Their long-term damage could take the form of persistent differentials in output growth, income and welfare.

We can see the primary symptoms. We are now poised to avert the long-term damage and ensure a smooth long-term functioning of the euro area.

The need for a rigorous and credible surveillance framework

So the period ahead is about two things: fiscal consolidation and measures to strengthen the growth potential of our economies. Both must be monitored by a rigorous and credible surveillance framework.

Currently there is an open and frank exchange of views about the concrete design of the new surveillance framework.

Let me give you a little more detail about the ECB's views on such a framework.

For fiscal policies three elements are indispensable:

- shorter deadlines under excessive deficit procedures;
- quasi-automatic application of sanctions;

- and ambitious targets for the reduction of public debt towards the 60% of GDP ceiling.

The severity of the breach should determine the severity of the sanction. Country missions, fines, reduced access to EU funds, and other pecuniary consequences are necessary.

We should be inflexible in applying sanctions if rules are breached. In limiting the power of discretion, we will strengthen the power of the Pact. Decisions are what we need for sanctions to be credible. Only then will they give national policy-makers the right incentives. This is why we are calling for quasi-automaticity.

There should be greater focus than before on government debt levels, more automaticity, along with improved national fiscal rules and better statistical data.

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 it is a union of monetary stability. Therefore, national price and cost developments that are significantly higher than the union average entail significant losses over time in competitiveness.

Competitiveness losses cannot be sustained forever, and 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.

For monitoring *macroeconomic* policies we have to build a new framework from scratch. Here is what we propose:

- a limited number of clearly defined quantitative indicators to identify undesirable developments;
- transparency about the procedures and the sanctions;
- and a set of reliable statistical data, interpreted and acted on by independent arbiters.

We have advocated that a specific scoreboard should be designed for euro area countries. A detailed and self-contained scoreboard offers a concrete basis for assessment.

Credibility of our analysis is key. But credibility is not a right, it has to be earned.

The credibility of the ECB rests on our independence, the transparency of our strategy and the consistency of our words and deeds. Likewise, Europe's new surveillance framework should be built on these three principles – of independence in the assessment of the fiscal situation as well as of the soundness of macroeconomic policies; transparency of the procedures; and consistency of words and deeds.

Conclusions

Let me draw to a close with a few words on the ECB's role in the crisis. As I have explained, the institutional model of the ECB has proved its worth by delivering price stability over the first 12 years of the euro's existence. This is fully in line with our primary mandate according to the Maastricht Treaty.

As I frequently said, all institutions, whether European or national, must be up to their responsibilities. The ECB is responsible for monetary union, in full independence. The national governments, individually and collectively, duly enlightened by the Commission, are responsible for the Economic Union. The European governments have to fulfil their duties in full. They must face up with the present difficulties by implementing rigorously their national adjustment programmes and by considerably reinforcing their collective governance of Economic Union. We all have to be guided by a clear sense of direction towards the consolidation of EMU and the strengthening of European unity. In an international

environment which comprehends so many hard challenges and so many opportunities Europe must be ahead of the curve and not behind the curve.

Europa heute steht für Frieden, Freiheit und Wohlstand. Die Gründerväter der Europäischen Union wären zu Recht stolz auf die Errungenschaften, die gemeinsam in den vergangenen 60 Jahren erreicht worden sind. Lassen Sie uns auf diesen Errungenschaften aufbauen.

Ich danke Ihnen für Ihre Aufmerksamkeit.

Thank you for your attention.