Jean-Claude Trichet: Reforming EMU – time for bold decisions

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference of the Group of the Progressive Alliance of Socialists and Democrats in the European Parliament "What future for the euro?", Frankfurt, 18 March 2011.

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Ladies and gentlemen,

honourable members of the European Parliament,

It is a pleasure to have the opportunity to speak at your conference this afternoon.

We meet at a time of multiple challenges for our world. For more than three and a half years now, we have been focused on the challenges to our economies and our societies by the unfolding financial crisis. But the tragic events in Japan over the past week remind us of even greater threats.

The potential impact of the earthquake and its aftermath on both the Japanese economy and the world economy is something we will be thinking about deeply in the coming days and discussing with our friends at the Bank of Japan. For the moment, my heartfelt thoughts are with the people of Japan, whose lives and whose livelihoods have seen such havoc.

Your conference today asks "what future for the euro?" In addressing that question, I would first like to speak about the achievements of the past, before focusing on the challenges ahead for Europe's economic and monetary union (EMU).

I would like to reiterate and explain the need for what I have called a "quantum leap" in the economic governance of Europe. And I would like to outline what that means in practice and what more needs to be done to make that quantum leap a reality.

1. Achievements of the euro

First, let me take a brief look back at the history of the euro. Having had the privilege of serving as a member of the European Central Bank's (ECB) Governing Council since the launch of the euro and as the ECB's President for the past seven years, I can report that we have achieved a great deal. All Europeans should take pride in these achievements.

The key to understanding the current challenges is to recall that the specific construction of our modern economic and monetary union rests on two separate economic and monetary pillars. Under the monetary pillar, there is only Europe: the single currency, the single monetary policy and the single central banking system – with the ECB at its core.

The economic pillar is decentralised, with responsibility for fiscal and economic policies in the hands of individual countries. These policies should be steered by overall rules and coordinated to ensure that national economic policies are fully compatible with the fact that we have a single currency without being part of a political federation.

When it is working properly, this structure balances the independence of nations and their economic interdependence that is at the heart of EMU.

It should represent an approach where sovereignty is shared, meaning that it is neither exclusively national nor exclusively European.

When EMU was first established, many people asked how monetary union could function effectively in a Europe of sovereign states.

The answer is that it can function effectively with an appropriate economic union.

2. The "M" in EMU

Let me discuss the two pillars in a little more detail, first the "M" in EMU. In monetary policy terms, the ECB has a clear assignment: to deliver price stability.

According to our primary mandate, our definition of price stability means an inflation rate below but close to 2% over the medium term. And over the 12 years since the launch of EMU, the average annual inflation rate in the euro area has been 1.97%.

This is the best result of a major central bank in the euro area over the last 50 years.

For Germany, the inflation rate has been even lower than the average since the euro was launched. From 1999 to 2010, inflation averaged 1.5% per year.

And we achieved this during challenging times, not just in the period since August 2007. Over the years, we have had to cope with the bursting of the *dot com* bubble, the aftermath of the events of 11 September 2001, the jump in oil prices to $145 per barrel, rising prices of food and commodities, and then of course the worst financial crisis since the Great Depression.

Yet throughout these very different economic shocks – which could have been either inflationary or deflationary – citizens in the euro area have remained confident in our commitment. Proof of this is that medium- to long-term inflation expectations have been firmly anchored in line with the ECB's definition of price stability.

Observers and financial markets are also expecting in the years to come that price stability will be maintained. For the next five years, professional forecasters currently foresee an inflation of precisely 2%.

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 about 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.

3. The "E" in EMU

Let me turn to the economic pillar, the E of EMU.

Here, we need fundamental reforms.

Economic union is a fundamental counterpart to monetary union.

A single market with a single currency calls for a very solid framework for handling the collegial governance of national fiscal policies and macroeconomic policies.

I recall the 1989 Delors report that stated: "an Economic and Monetary Union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries. (…) Uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the community."

The need for better coordination is recognised by the citizens of Europe, particularly those in the euro area. The recent Eurobarometer survey has shown that, on average, more than four out of five euro area citizens are in favour of greater policy coordination between countries to overcome the crisis.

This is very important: citizens want a stronger coordination of economic and fiscal policies among the countries of the euro area. European integration has led the people of Europe to appreciate the value of cooperation, especially in difficult times.

So what does more coordination require? At its core, it means strengthening the economic governance of Europe, a project to which I know that the European Parliament is fully committed.

Let me share with you our view at the ECB on what progress has been made and what remains to be done.

4. The ECB's position on reforming economic governance

The ECB has recently published its legal opinion on the economic governance proposals. In a separate publication on our website, we have highlighted 10 points where we have called for more ambitious steps. We believe that we must draw not just some, but all appropriate lessons from the crisis.

In essence, the thrust of our message is as follows.

More automatic and speedy procedures, a broader range of enforcement tools and more ambitious policy requirements are all urgently required at euro area level. But these will not be sufficient if they are not solidly anchored at national level: the gap between the EU and national level must be closed. An effective way of achieving this would be to swiftly implement strong national budgetary frameworks in the Member States.

Earlier this week, the Ecofin Council took some steps forward. In particular, the Council accepted the introduction of an annual fiscal expenditure benchmark and a numerical benchmark (the 1/20th rule) for debt reduction.

The fact that the Council "expects to, as a rule, follow the recommendations of the Commission, or explain its position in writing" – is a step in the right direction. It would be a big step if there were assurances that it would be implemented in a strict and rules-based manner.

As regards the anchoring of the objectives of EU fiscal coordination in national budgetary frameworks, it is of the essence that the directive is transposed into national law as faithfully as possible, and no later than by the end of 2012. It would be helpful if the Eurogroup could issue a formal statement to that effect.

The Ecofin Council also agrees with a framework for the prevention and correction of excessive macroeconomic imbalances, including an early warning mechanism and eventual sanctions in the case of euro area countries. The ECB welcomes the intention to channel any fines collected to the crisis resolution fund.

Nevertheless, in our view, still more ambition on governance is warranted.

5. The need for greater ambition in governance reform

Let me briefly highlight the main points and explain why we find them so important. You will see that my remarks are very specific. This is because we are at a point where it is time for decisions, and the matter before us is complex. Parliament has received about 2000 amendments on the six legal texts. Therefore, specificity in recommendations is essential.

Let me summarise them under four headings.

First, all surveillance procedures have to be faster and more automatic, including the new macroeconomic surveillance framework.

We have seen more than ever the importance of a timely correction of fiscal imbalances. Therefore, we cannot wait months or even a year until policies are corrected. In the meantime, spillovers would hurt other Member States.

In the past, the Council has often suspended the procedures of the Stability and Growth Pact, thereby weakening its credibility. This must not happen again. The newly agreed "comply or explain" principle under fiscal surveillance still leaves too much room for discretion. Moreover, it does not cover the new macroeconomic surveillance framework.

Beyond this, the ECB believes that the use of reverse majority voting could be extended further across the various surveillance provisions – not just the two regulations on financial sanctions for euro area countries.

Second, the enforcement tools also need to be more effective. For example, the new macroeconomic surveillance framework needs to provide clear incentives by envisaging financial sanctions already after the first instance of non-compliance. Discretion to reduce or suspend financial sanctions – either on grounds of exceptional economic circumstances or in response to a reasoned request by a Member State – strongly reduces the effectiveness and sets the wrong incentives. This should not be permitted: it will help nobody.

Third, the policy requirements should be more ambitious to match the current reality of the euro area. The new macroeconomic surveillance framework, as amended by the Council, does not yet provide a clear focus on the euro area countries with large current account deficits, significant losses of competitiveness and high levels of public and private debt, as well as any other vulnerabilities challenging our economic and monetary union.

As regards fiscal surveillance, ambitious benchmarks are needed when establishing an excessive deficit. The scope for considering "any relevant factors" in case of an excessive deficit should be clearly reduced.

The adjustment path towards a country's medium-term budgetary objective also needs more ambition. In this context, the annual improvement in the structural balance should be significantly higher than 0.5% of GDP when a country's government debt exceeds the reference value of 60% of GDP, otherwise there are fiscal sustainability risks.

Fourth and finally, it is also crucial to guarantee the quality and independence of fiscal and economic analysis. We propose the establishment of an EU advisory body of recognised competence. It goes without saying that remaining weaknesses in the collection and reporting of data have to be addressed immediately and rigorously.

These are my main areas of recommendation.

It is clear that implementation of the new governance framework will have a significant impact on national policies, which will call for enhanced democratic legitimacy. A key issue will be to anchor the forthcoming reforms firmly at national level by means of strong budgetary frameworks.

For euro area countries, independent national fiscal policy institutions should be mandatory. Clear borrowing frameworks should also be considered.

I welcome the euro area countries' commitment of 11 March to transpose the EU fiscal rules into national legislation and including for sub-national levels.

The ECB and, I believe, also the citizens of Europe count on the European Parliament to drive these changes forward. We are mandated as European institutions to take a broader perspective. We are independent of specific national circumstances. And we are here to think long-term, as do our citizens.

Let me borrow the words of Willy Brandt, speaking as the first Head of Government of a member state of the European Communities to address the plenary of the European Parliamentary Assembly, back in 1973. "This is where the political will should, at long last, carry the day over the many national administrative egoisms, which may be justified individually, but all in all can no longer be tolerated. Having gone so much astray in the past years, we must now achieve a better harmonization of our economic policies. New decisions are needed which place more precise obligation on us, and bind Member States more closely."

6. The quantum leap

If the European Parliament were to go further in this direction, it would provide a true "quantum leap" in the rules that regulate how countries make their national economic policies. Countries need clear rules to guide policy-making, and sanctions if they stray from a sustainable path.

For those still hesitating whether to go that far, let me recall what happened some years ago: after a period generally acknowledged as a period of economic fair weather, governments decided to weaken the Stability and Growth Pact in 2004 and 2005.

This initiative was led by the euro area's largest economies. The ECB voiced its "grave concerns" at the time. Governments had not used the more benign years to put their fiscal houses in order. I now see that many acknowledge that the weakening of the Pact was a serious misjudgement.

The crisis has given us an opportunity. It has made plain the flaws in the Stability and Growth Pact that allowed countries' fiscal policies to become a problem – not just for themselves, but for everyone else within the monetary union.

We now have an obligation to fix the flaws. All of them.

We now have to lay the ground for policies towards sustainable and balanced growth. It is only such growth that will contribute to lasting job creation and social harmony.

7. Conclusion

Let me draw to a conclusion. As I have indicated, the history of the euro is something in which all Europeans can take pride. I have every confidence that the future of the euro will be one in which we can equally take pride. But to get to that point, several improvements need to be made to our economic union.

As I have indicated, progress is being made. Yet we need to draw all the lessons from the current situation to complete the work on Europe's economic and monetary union.

We must ensure that the well-functioning monetary union is complemented by an equally well-functioning economic union.

All of this should be done to achieve the common goal: a union of individual freedom and collective respect; a union of responsibility and cooperation; and a union of stability and prosperity.

Thank you for your attention.