

Jean-Claude Trichet: Toward the first decade of Economic and Monetary Union – experiences and perspectives

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 36th Economics Conference of the Austrian National Bank, on “Toward the First Decade of Economic and Monetary Union – Experiences and Perspectives”, Vienna, 28 April 2008.

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Verehrter Herr Bundeskanzler,
Ministers, Excellencies,
Dear Klaus,
Sehr geehrte Kollegen der Oesterreichischen Nationalbank,
Dear colleagues of the Eurosystem,
Ladies and gentlemen,

I would first like to thank very warmly the Oesterreichische Nationalbank for inviting me to speak here today on the occasion of the forthcoming 10th anniversary of the Eurosystem. It is both a privilege and a pleasure for me to be here today and to share with such a distinguished audience my views on the track record of the Eurosystem and the challenges that lie ahead of us.

Not too long ago, many prominent commentators thought a single currency in Europe was unfathomable. Many amongst those adept to the politics and sociology of European integration made the point that national banknotes were more than just a means of payment or the embodiment of a unit of exchange for the citizens of Europe. National banknotes communicated national icons that resonated deeply with homeland feelings. The national central banks themselves were by and large seen as monuments to territorial sovereignty.

Sceptics were numerous among economists. Experts in international macro-economics feared that a single monetary policy would not suit a group of countries deemed diverse in many respects. A single currency would be a hindrance for growth stars – which would suffer from chronic overheating – and laggards – no longer able to devalue their currency – alike. Scholars of political economy found the coexistence of sovereign national fiscal policies and a single monetary policy a precarious combination. A (sub-)optimal currency area would not work in the face of widening economic gaps, free-riding policies and cross-national resentment.

Close to completing its first decade of operations, the euro symbol appears as an icon of the decade-long quest for continental reconciliation. Sceptics of all persuasions and disciplines have been confounded by the determination and ability of the governments of Europe to launch a new single currency. Far from suppressing growth and entrenching divergences, the euro has spurred a spectacular drive of job creation virtually everywhere in the Union – a trend to which I shall return later in my remarks. By fostering a long-due redressing of economic priorities and processes, the euro has helped rejuvenating some economies that had been written off as too ossified and self-complacent to successfully compete in a monetary union. We see signs that this restructuring is spreading to other parts of the Union that have been less successful so far in taking up the challenge.

Well-designed institutions and a strong sense of shared responsibility are the foundations of good collective performance. So, our institutional framework and the inner workings of the Eurosystem will be my principal theme. Examples will include the successful transition to the euro, both at the outset of monetary union – our first operational challenge – and as part of an ongoing process of continental integration and inclusion which the European System of Central bank has taken upon itself as a mission. I will then proceed to the impact that the euro is exercising on the deep economic structure of Europe. Finally, I will outline the ECB's conduct of monetary policy through difficult and sometimes agitated events. The recent

turbulences in global financial markets will offer the background against which our strategy can be recognised and understood. A strategy that reconciles flexibility of action and a firm, fundamental, concentration on our primary responsibilities.

The ECB itself has very rapidly become a mature institution. Collegial thinking in monetary policy deliberations has instilled a shared strategic view and common goals. The transformation was quick. Almost instantly, the Governing Council of the ECB shaped into a truly collegial body, a “team”, rather than a collection of individuals. Not only has this transformation preserved the Governing Council from the emergence of national biases. It also has inspired in its members a profound sense of common ownership of decisions. This has been decisive for the critical task of active representation that Governors have: the task of expounding the rationale for our common policy course, and explaining our single monetary policy before the various national constituencies in their own languages. And I would like here to pay homage to my dear friend Klaus Liebscher, Gouverneur of the Oesterreichische Nationalbank, who is a fantastic member of our monetary team and whose wisdom has been and is priceless in the Governing Council.

Interactions across staff at the ESCB level have also intensified virtually from day zero. In fulfilling our mandate we rely heavily on the close cooperation between ECB and NCB staff that meet regularly in various technical committees. The existence in the Eurosystem of these technical bodies offers an important first platform in the way toward the achievement of shared decisions. For example, the Monetary Policy Committee is in charge of the Eurosystem staff macroeconomic projections, which represent an important input for the monetary policy deliberations of the Governing Council. The discussions that take place in this committee in preparation of the Eurosystem staff macroeconomic projections provide a forum where differences of assessment across the NCBs can be identified and reconciled into a common picture at an early stage. More generally, the Eurosystem’s culture of very close and intimate cooperation at all levels of staff in the context of committees, working groups and taskforces support decision making in the Governing Council.

The successful transition to the euro

Cooperation and a sense of camaraderie were critical in preparing for our big-bang. In spite of the extraordinary operational hazards involved, the euro changeover in January 1999 passed without any incident affecting the orderly conditions of the monetary system. Large-value payment systems and billions of electronic records were adjusted to function in the new currency. At the same time, a new infrastructure for payments and securities settlement was launched. Three years later, the euro became a tangible reality and the euro banknotes and coins became the legal tender for, at that time, more than 300 million citizens. The smooth introduction of the euro in 1999 and the success of the cash changeover in 2002 were the result of years of thorough preparatory work involving the ECB, the NCBs and a large number of public and private institutions which represent the core of the financial sector in the euro area. This has been reflected in the open and positive way in which the general public and financial markets have received the euro.

No doubt the introduction of the euro and the realisation of stage three of European Economic and Monetary Union (EMU) was a milestone in the long and multifaceted process of European integration. A completely new monetary policy framework was introduced in Europe, with the ECB conducting a single monetary policy for the entire euro area consisting of eleven and soon twelve countries. But despite the uncertainty surrounding the transition to the new regime, the ECB and the euro have been credible from day one. Market interest rates at all maturities converged to the *lowest* – not the average – interest rates prevailing prior to the euro. This caught by surprise those observers who had long anticipated that the yield curve after aggregation would translate into a sort of arithmetic average of the curves defined on the legacy currencies, rather than into the benchmark set by the most credible previous national currencies. In parallel, long-term inflation expectations aligned with the low

levels of the best performing economies that were merged into the euro. As a result, in some euro area countries, short-, medium- and long-term market interest rates fell to levels that had not been seen since the long-gone days of the gold standard. They have remained at those levels ever since.

How can a new currency with no historical credentials secure such trust and confidence? Preconditions were sound institutions, and the Community's determination to lay the monetary union on the steady foundations provided by the most credible national central banks and the best public policy available in Europe. In two words: strong monetary and strong fiscal institutions.

The new single monetary authority was to be indisputably devoted to the maintenance of price stability in the euro area. Safeguarding stable prices is a necessary condition for serving the other Community objectives, such as non-inflationary economic growth, job creation and social cohesion. In order to accomplish this goal, the new central bank was to be guaranteed full independence, in close continuity with its forebears, in an international Treaty.

While the Treaty was very explicit about the primary objective of the new monetary authority, it was left to the Governing Council of the ECB to define and announce the strategy that would support price stability. But at the time of our institutional design it could not be taken for granted that previously established economic relationships and regularities would continue to hold after the transition to monetary union. This placed a premium on choosing a strategic framework that would prove robust to changing circumstances and would continue to stand the test of time in the face of new challenges. To devise the best possible monetary policy for the new currency, we built on the wisdom and the wealth of experience that had been accumulated in the preceding decades by central banks and the academia.

By formulating and publishing the definition of price stability, the overriding objective of monetary policy, in quantitative terms, in total continuity with the definition existing, before the euro, in the countries of the core currencies, namely less than 2 %, the ECB has provided the basis for market participants to form expectations efficiently and to reduce the sensitivity of inflation expectations to short-term shocks. Without firm guidance on the strategy and the objective of monetary policy, a central bank risks that temporary adverse price shocks result in a reappraisal of the expected inflation rate by the public. Disorientation about the true intentions and determination of the monetary authorities can force upon the central bank an overly aggressive pattern of reaction to inflationary risks in order to state its intentions by the force of facts. This, in turn, can lead to unnecessary volatility in both output and inflation. We thought that this pattern could be avoided if the potential disconnect between expectations formation and central bank priorities was addressed and solved in the founding act of our central bank, the act that defined its mission and the strategic means to accomplish its mission.

A transparent monetary policy framework, comprising of a quantitative definition of price stability, and of a candid display of our strategy based upon two pillars, an economic analysis and a monetary analysis, provide a strong anchor for inflation expectations and facilitates markets' understanding of the systematic responses of monetary policy to the evolution of macroeconomic conditions. There is compelling empirical evidence that the ECB's open and timely communication on its objectives, strategy and assessment of the economic outlook has been reflected in a high level of predictability for its monetary policy decisions. Reduced market volatility in recent years also supports the view that the understanding of the ECB's monetary policy framework and its communication has improved over time. At the same time, the ECB's quantitative definition of price stability provides a clear yardstick against which the public and its elected representatives can hold the ECB accountable.

Moreover, research has shown that the inflation process becomes less persistent and more forward-looking when the economy internalises the central bank's objective firmly. In fact, this is what we observe in the euro area. The influence of the ECB's quantified inflation

objective on the evolution of inflation is an important factor that expedites the process by which the economy absorbs shocks that, otherwise, could have long-lasting implications for inflation. In a sense, the forward-lookingness that our quantitative definition of price stability introduces in price and wage setting makes the inflation process less inertial – that is, more *forgetful* of past adverse innovations – than it would be otherwise, if expectations internalised our objective less firmly and past inflation were the only guide in price setting. This is an important factor which, in Europe, helps compensate for the added inflation inertia that stems from more rigid production and distribution systems. And when I say “more rigid” I mean relative to the United States where the frequency of price changes is almost twice as high as in the euro area.

Nevertheless, it is not the stability-oriented monetary policy framework of the ECB alone that has made the successful transition to the euro possible. As I said earlier, monetary responsibility is difficult to exercise if economic institutions tolerate unbridled government borrowing. In the end, absent fiscal restraint, hard choices will be forced upon responsible monetary authorities. Over time, the risk that the central bank periodically might be forced to clamp down in the attempt to ensure price stability is capitalised in higher financing costs, making the job of the central bank in controlling inflation all the more difficult. Without the clear directions and the constructive goals offered by the Stability and Growth Pact, the inbuilt bias in favour of budget deficits could undermine a stable monetary constitution, elevate real interest rates, crowd out capital spending and lower productivity growth.

The ECB’s past track record

Let me now turn to the ECB’s past track record. Guiding inflation and interest rate expectations requires not only precise and consistent communication of the central bank’s ultimate objective and the strategy, but also consistency between words and deeds. In the end, only a track record of monetary policy decisions can support the central bank’s credibility. Looking back in time, the ECB is also gradually building up its own track record – something which, as a new institution, simply did not exist when we started operations.

Since its inception, the Eurosystem has been tested by a series of events and challenges, some of which we shared with the other major economic areas in the world, and some which were characteristic of our European environment. Thanks to a well-defined institutional framework laying down the conditions for a sustainable convergence process, the progressive integration of a number of catching-up economies is an enterprise, a mission, which the euro area – unique among the great economic powers in the world – has set for itself and to which it has successfully worked. Euro adoption by Greece, Slovenia, Cyprus and Malta was smooth and technically flawless, despite the potential challenges that each enlargement round implicates in both operational and economic terms. Some of these events are charged with formidable symbolic implications. For example, Slovenia’s accession and rise to the Union’s presidency has been only the most recent and vivid testimony to the notion that the trauma of the iron curtain – once gripping Europe – is definitely behind us.

Some facts which punctuated our short history were less joyful events. My memory goes to the bursting of the dot-com bubble, the aftermath of the tragic terrorist attacks on 9/11, the persistence of sizeable global imbalances, the surge in global commodity and energy prices and, more recently, the surge of food prices and the financial turbulences that originated from the sub-prime crisis. These shocks were very significant and quite persistent, but the ECB has not hesitated to take firm and timely actions to pursue a monetary policy that best serves the ultimate objective of maintaining price stability, while at the same time trying to minimise unnecessary macroeconomic disruptions.

As a result, over the past ten years, the inflation rate in the euro area has remained on average in a tight vicinity of 2%, although it has occasionally risen above levels that the ECB considers consistent with conditions of price stability. It is remarkable that even amidst such adverse and potentially unsettling disturbances, financial markets and the public at large

have not lost faith that, in line with our strategy, we would reaffirm price stability over the medium term. Amidst turbulent circumstances, the ECB has purposely chosen to communicate and enact a sense of direction. Adjustments to its policy stance were intended to preserve medium- and long term price stability in an environment of high uncertainty. A steady monetary policy course has substantially contributed to stabilising medium to long-term inflation expectations at a level consistent with our definition of price stability, while, at the same time, protecting our economy from the corrosive influence of policy-induced volatility.

As I mentioned earlier, growth and employment were undeterred by this. The euro and our monetary policy are providing a positive impetus for the euro area economy, vindicating the soundness of the institutional setting of EMU. Since the launch of the euro, most euro area countries enjoy much more favourable financing conditions than in the 1990s, supporting private and public investment as well as fiscal consolidation. Real gross capital formation in the euro area in the nine years after the introduction of the euro grew on average by 2.9% per year, as compared to only 1.7% during the nine-year period prior to the euro. A particularly noteworthy development is the marked improvement in the performance of the euro area labour markets. Since the start of EMU, around 15.7 million people have been added to the number of employees in the euro area, in comparison to approximately 5.5 million in the nine preceding years. At the same time, the euro area unemployment rate has fallen to its lowest level since the early 1980s. These are encouraging developments, which show that the structural reforms and the degree of wage moderation necessitated by the new economic environment have helped to overcome some of the constraints on growth stemming, in particular, from still rigid and over-regulated markets in a number of economies.

The euro is also supporting the deepening of trade and financial linkages across euro area countries. There is clear evidence that the introduction of the single currency and the associated increase in price and cost transparency have promoted both intra- and extra-euro area trade in goods and services. Exports and imports of goods and services *within the euro area* rose from about 31% of GDP in 1998 to around 40% in 2007. The completion of a single market for services will further facilitate trade in services. The rate of increase in *extra-euro area* exports and imports of goods and services even exceeded that in intra-euro area trade, rising from about 32% of GDP in 1998 to almost 44% in 2007. Extra-euro area trade has, of course, also benefited from a period of strong external demand and increasing integration at a global and European level. All in all, this also proves that we did not build a fortress Europe and that regional integration can go hand in hand with increased openness and globalisation.

Finally, the euro is acting as a catalyst towards a single market in financial services as evidenced by a number of indicators. For instance, euro area cross border holdings of long-term debt securities have risen markedly since the launch of the euro from around 10% in 1997 to approximately “60%” in 2005. In a similar vein, between 1997 and 2005 euro area residents *doubled* their holdings of equity issued in another euro area country, while, at the same time, the share of euro area equity assets held outside the euro area remained much lower and increased only slightly. Expanding cross-border investment opportunities enhances the allocation of resources to their best uses. Also, the diversification of national income sources will improve the opportunities for smoothing consumption in the face of localised shocks.

But complacency would be off mark. The European leaders’ March 2000 meeting in Lisbon recognised that the European economic model was in need of a competitive fix. They launched what came to be known as the Lisbon Agenda, which set a fully innovative and competitive Europe as a ten-year goal. To date, progress has been uneven. Regulatory inhibitions in many respects still hold back Europe’s growth potential. Long-standing structural rigidities are, in my view, the major cause of the remaining difference in growth potential in Europe as compared to the best advanced industrialised economies. Reforms are essential in order to raise factor productivity and potential output, to create new jobs, to

achieve lower prices and higher real incomes, and to increase the resilience and flexibility of the economy. When pushed to the edge, we know, Europeans seem to regroup and productively engage the global community. A major catch-up on the Lisbon Agenda will be our next frontier.

The ECB's policy response to the tensions in financial markets

I left the recent financial turbulence as my last point. Well before the financial turmoil erupted in August last year, the ECB, as well as other central banks and institutions, have pointed out regularly in their communications that there was a significant underpricing of risks in a large array of markets. On the basis of our diagnosis, we explicitly and publicly called for institutions and markets to prepare themselves for a correction that was unavoidable and necessary to consolidate a smooth return to a normal assessment of risks in markets. When these risks materialised last summer and threatened to impair the orderly functioning of the euro money market, the ECB reacted immediately and provided overnight liquidity to the interbank money markets in a sequence of fine-tuning operations. Subsequent measures that were launched since August 2007 were designed to ensure that very short-term money market rates remained close to the ECB's policy rate and to contain spreads in the longer-term segment of the money market. During this turbulent period, the Eurosystem remained, as usual, in close contact with other major central banks and joined a concerted liquidity providing measure in December 2007. Overall, the ECB's timely liquidity operations have contributed to ensure a smooth functioning of the short end of the money market without – of course – eliminating the causes of the tensions, originating outside the money market.

In this context, it is imperative to stress that the ECB conducted these money market operations without changing its monetary policy stance, which the Governing Council determines on the basis of its economic and monetary analysis and in full accordance with the ECB's primary objective of maintaining price stability over the medium term. In view of safeguarding its credibility and firmly anchoring long-term inflation expectations, it is crucial that the Governing Council sets the appropriate monetary policy stance on the basis of no other considerations than the delivery of price stability in the medium term. Once the appropriate level of the key ECB interest rates has been set, the Executive Board of the ECB implements monetary policy so that the effects of its interest rate decisions are transmitted to the financial markets and the real economy effectively. In this sense, the ECB had to act swiftly and decisively to deviations of money market rates from its policy rate to support its monetary policy objective and to avoid that tensions in the money market would spill-over to other markets and adversely affect the real economy.

But central banks' liquidity operations cannot address the underlying causes of the financial turmoil. Careful reflection has taken place at the European and global level with regard to the policy lessons that need to be drawn on a co-ordinated basis by public authorities with regard to the measures necessary to avoid the recurrence of such major turbulent episodes in the future. In this respect the recent report released by the Financial Stability Forum embodies the consensus of the international community on the recommendations that we consider among the immediate priorities for addressing the underlying causes of the financial turmoil.

Let me briefly stress the essence of the diagnosis that has inspired the G7 recommendations of the Financial Stability Forum: first, and most importantly, financial markets are currently marked by a lack of transparency. The absence of full information on both financial instruments and institutions is a trigger to contagion and herd behaviour at times of financial distress. High levels of transparency are an important feature of a healthy global financial architecture and make markets more efficient by reducing irrational behaviour. Financial institutions should fully and promptly disclose their risk exposures, write-downs and fair value estimates for all instruments. Second, there is a large element of pro-cyclicality present in numerous rules, regulations and procedures that govern global financial markets. These elements tend to amplify the booms as well as the busts and encourage imprudent

behaviour. A careful reduction – without any prejudices – of the pro-cyclical components present in the global financial system is therefore warranted.

I kept the turmoil for my conclusions because it crystallises two principal tenets, two leading principles behind our strategy: flexible action guided by a steady and unwavering compass. We sprung into action as the seriousness of the hardships in markets and the need for the central bank support became evident. It did not take long – a few hours – for us to identify the degree of stress that was gripping the markets and to clearly state that the ECB intended to remain in command of the shortest-term interest rates in the money markets, close to our policy rate.

We did not let our medium-term perspective dwindle. We remained committed to a sober evaluation of the underlying factors that – beyond market jitters – impact economic decisions and price setting behaviour in the economy. We drew a clear line between the considerations that pertain to the right calibration of the monetary policy stance and actions that belong to the monetary policy implementation sphere. Liquidity interventions aimed at restoring orderly trade conditions in money markets and maintaining short-term interest rates close to our policy rate were not compromising in any respect the longer-term achievement of the price stability or being complacent with imprudent behaviour by market participants. This distinction is particularly important at the current juncture taking into account the upside risks to price stability over the medium term and observing that the adjustment of financial markets is an ongoing phenomenon.

I trust that in all circumstances, but even more particularly in times of heightened uncertainty in global financial markets, our strong commitment to preserve price stability over the medium term is of the essence. In preserving a solid anchoring of medium- to long-term inflation expectations at levels consistent with our definition of price stability, it contributes to appeasing tensions and volatility in the financial markets whilst paving the way for future sustainable growth and job creation in Europe.

Concluding remarks

Let me conclude. The past ten years have been very challenging and demanding for all of us, and for the euro and the Eurosystem in particular. When the euro was set up back in 1999, it was born as a credible currency thanks to the provisions governing the ECB's mandate and its full independence as laid down in the Maastricht Treaty as well as the wisdom and credibility of the ECB's monetary policy framework. Thanks to the joint effort of all institutions forming the Eurosystem, we have lived up to our responsibility and delivered what we promised to deliver: a stable currency as credible and confidence-inspiring as the best previous national currencies. At the same time, the euro has contributed to a further integration of Europe's economies and it protects our economies more effectively from external shocks as ever before. Yet, there is no reason to be complacent: the present circumstances continue to be very demanding. I am confident that the Eurosystem, through its stability-oriented monetary policy strategy, will stand up to these challenges and be successful in maintaining price stability in the euro area. As I have said on behalf of the Governing Council of the ECB, we believe that the current monetary policy stance will contribute to achieving our objective of price stability in the medium term and of firm anchoring of medium- to long-term inflation expectations. I thank you for your attention.