Jean-Claude Trichet: Hearing at the Economic and Monetary Affairs Committee of the European Parliament

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Hearing at the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 21 January 2009.

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Madame la Présidente, Mesdames et Messieurs les membres de la Commission Economique et Monétaire, je me réjouis de ce premier échange de vues avec votre Commission en 2009. Cet échange a lieu quelques jours seulement après la réunion du Conseil des Gouverneurs du 15 janvier consacrée à la politique monétaire. De surcroît, mardi dernier à Strasbourg lors de la session plénière dédiée aux dix ans de l'euro, j'ai été heureux de noter le soutien de votre Parlement à l'euro et à la BCE. Aujourd'hui, comme le veut la tradition, je commencerai mon intervention par une évaluation de la situation économique et monétaire, en expliquant les raisons sous-jacentes de nos récentes décisions relatives aux taux d'intérêt. Im Anschluss daran möchte ich einige Worte zum Preisausblick sagen, wie er sich im Eurogebiet darstellt. Und schließlich werde ich auf Fragen der internationalen Finanzarchitektur eingehen. Dieses Thema wird in den nächsten Monaten gewiss noch weiter an Bedeutung gewinnen.

Economic and monetary developments

Since my previous appearance before the European Parliament on 8 December the economic outlook in the euro area has continued to weaken and inflation has declined further. In December 2008 the inflation rate stood at 1.6%. Moreover, inflationary pressures and inflationary risks have continued to diminish. Looking ahead, with the appropriate medium-term perspective for monetary policy and taking also into account our own policy decisions including the most recent one, we expect euro area inflation to remain in line with our definition of price stability over the policy-relevant horizon. Risks to price stability over the medium term are broadly balanced in the view of the Governing Council of the ECB.

As regards economic developments, since September last year the financial turmoil has intensified and broadened. Tensions have increasingly spilled over from the financial sector into the real economy. Looking ahead, both global demand and euro area demand are likely to remain dampened for a protracted period. At the same time, declining inflation rates should support real disposable income in the period ahead, and the euro area economy should benefit from the broad and far-reaching policy measures that have been decided upon over recent weeks.

However, this outlook remains surrounded by exceptionally high uncertainty. Overall, risks to economic growth remain clearly on the downside. They relate mainly to the potential for a stronger impact of the financial turmoil on the real economy as well as to concerns about the possible emergence and intensification of protectionist pressures and to possible adverse developments in the world economy stemming from a disorderly correction of global imbalances.

To lay sound foundations for sustainable growth, all parties concerned should live up to their responsibilities. In this respect, it is crucial to maintain discipline and a medium-term perspective in macroeconomic policy-making. To pursue a stability-oriented and sustainable policy approach is the best way to preserve and enhance confidence. The significant measures being implemented by governments to address the financial turmoil should support trust in the financial system and ease constraints on credit supply to companies and households.

Monetary trends in the euro area support the view that inflationary pressures are diminishing. Notably, the latest evidence confirms a moderating rate of monetary expansion. The Governing Council has repeated its commitment to keep inflation expectations firmly anchored in line with its definition of price stability of below, but close to, 2%. This supports sustainable growth and employment and contributes to financial stability. It is against this background that the Governing Council decided last week to reduce the interest rate on the main refinancing operations of the Eurosystem by a further 50 basis points to 2%, bringing the total reduction since 8 October 2008 to 225 basis points.

Medium-term price developments and the process of disinflation

Let me now look more closely at the medium-term outlook for price developments in the euro area, and in particular at the process of disinflation we are currently observing. I will thereby address the first topic proposed. It is essential here to draw a clear distinction between disinflation and deflation.

Disinflation is a process of falling inflation rates. This process often stems from cost-saving developments on the supply side or terms of trade improvements. Such developments can sometimes go hand in hand with negative demand shocks as is the case at present. However, they are per se benign in nature. This is because they sustain real incomes. In the current context, we are witnessing a process of disinflation in the euro area, mainly as a result of a sharp fall in oil and commodity prices. To that extent it is therefore a welcome development. The spike in oil and commodity prices that began in 2007 and lasted until mid-2008 was both inflationary and contractionary. In consequence, the recent decline in these prices is both disinflationary and expansionary. By way of example, car fuel prices fell by 15.4% in December 2008 year on year. Their weight of almost 5% in the HICP basket means that this explains a significant part of the recent inflation decline. If such favourable supply-side developments are especially vigorous, disinflation can even temporarily lead to negative inflation rates. It is therefore very important in such circumstances to keep medium-term inflation expectations well-anchored.

A deflationary process, by contrast, is a persistent and self-reinforcing decline in a very broad set of prices. This spiral is propagated by anticipation of prices declining further in the future. Such negative inflation expectations mean that investment and consumer demand is postponed, which would cause a second-round demand shortfall and put further downward pressures on prices.

There is presently no threat of deflation. Indeed, the firm anchoring of inflation expectations – to which we are so fully committed – represents the strongest and most reassuring safeguard against any risk of a downward spiral of inflation and inflation expectations.

From all these considerations you will understand that what we are currently witnessing is a process of disinflation, driven in particular by a sharp decline in commodity prices.

International financial architecture

Let me now turn to the second topic we selected, namely the international financial architecture. I consider that the fragility of the global financial system, by which I mean its lack of sufficient resilience that has been revealed in the course of the present episode of turbulences, is not acceptable. We must draw all the lessons of the crisis, without any complacency, considering that all the elements of the system must be significantly improved: the quality of risk management, liquidity management and the overall resilience of private institutions, the transparency of the financial markets, and the clarity of financial instruments.

As already underlined on the occasion of previous hearings in front of you, this calls first for much more transparency, without any consideration of vested interests; second for much less short-termism in the decision-making processes, contrary to the most recent trends; and third for a systematic elimination of the procyclical aspects of our regulatory, prudential, accounting and taxation rules, which are amplifying considerably the fluctuations that are inherent in the functioning of market economies.

The Financial Stability Forum (FSF) has identified the main avenues for such reforms. What we now need is strategic lucidity and, where appropriate, a great deal of political energy to counter considerable vested interests. The G20 and the IMF are and will be decisive in this respect.

But a much better functioning of the financial sphere does not suffice. We also need sound macroeconomic policies that are sustainable in the medium and long run. In particular, we need to avoid the creation of the large domestic and external imbalances which are very much at the root of the present difficulties. An effective surveillance of macroeconomic policies of the major systemically important economies is of the essence. Only the IMF can perform this decisive function, provided its mandate is strengthened.

In terms of institutional set-up, we need two major improvements:

- First, the international financial architecture requires a strengthening of the informal groupings, in particular the FSF and the G20. The FSF is unique in that it links all the authorities and institutions that have a systemic influence on financial markets, which are very largely decentralised and – for many of them – independent from the political sphere. The necessary enlargement of the FSF is key. Particularly important in a time of global crisis has been the new authority of the G20, which is a truly global informal grouping in comparison with the G7, which itself continues to be useful in a situation where the turbulence comes from the industrialised countries.
- Second, on top of the IMF's strengthened surveillance mandate, the governance of the international financial institutions, particularly the IMF but also the World Bank, should become more effective and representative. In particular, a full representation of emerging market economies, commensurate with their importance in the global economy, is indispensable.

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By way of concluding my introductory remarks, I would like to stress two points.

First, as regards euro area policies, persistent wage growth differentials, induced by structural inefficiencies or misaligned national policies, including wage-setting policies, might have adverse implications for the cost competitiveness of individual countries. National authorities have the responsibility to address competitiveness losses accumulated over recent years by implementing structural reforms and ensuring more moderate price and wage developments. Regarding fiscal policies, we welcome the European Council's reconfirmation of its full commitment to sustainable public finances. The current economic situation calls for prudence with regard to the adoption of extensive fiscal stimulus measures, taking into account the particular fiscal situation in each country. As I have said before, countries can use all the room for manoeuvre provided by the Stability and Growth Pact but only the room for manoeuvre that is in the Pact. The significant fiscal loosening and the implied increase in government debt should in no case risk undermining public confidence in the sustainability of public finances, thereby detracting from the effectiveness of a fiscal stimulus.

Second, I should like to turn briefly to financial supervision issues. The financial crisis has heightened the importance of addressing issues relating to financial supervision in a comprehensive and coordinated manner, both globally and at the European level.

As regards the European level, the crisis has highlighted the need to analyse long-term solutions to the structure of supervision. To that end, the proposals which will be put forward by the High-Level Group chaired by Jacques de Larosière will represent an important contribution to the policy discussions.

Considering the possible options and as underlined in particular by a number of Members of Parliament, Article 105(6) of the Treaty explicitly mentions the possibility for the Member States to decide to confer upon the ECB specific tasks in the domain of financial supervision. Reflections have started on the specific role that could be played by the ECB and its Governing Council should this provision of the Treaty be activated. At this stage the Governing Council has not yet taken a position on this topic. I will not fail to report to you the outcome of these reflections.