Jean-Claude Trichet: An anchor of stability and confidence

Contribution by Mr Jean-Claude Trichet, President of the European Central Bank, to *Frankfurter Allgemeine Zeitung*, Frankfurt am Main, 26 March 2010.

* * *

The public at large generally takes notice of central bank activities mostly when there are special circumstances. The financial crisis and the extraordinary measures taken by central banks across the globe in response to it are an example of such special circumstances. In normal periods, central bank actions in pursuit of price stability are less noticed. This holds all the more true when periods of inflation are long past and memories of the negative consequences of instable currencies have faded away.

Since the introduction of the euro, the phenomena of price instability have not been something that citizens of the euro area have really needed to concern themselves with in their everyday lives. This is to the credit of the European Central Bank (ECB), its Governing Council and the “monetary team” including all national central banks belonging to the Eurosystem. The ECB has kept the promise of the euro’s founding fathers to keep the value of money stable. The average annual rate of inflation for the first 12 years of the euro up to the end of 2010 is expected to be about 1.95%. This is exactly in line with our quantitative objective for price stability, which aims for medium-term growth in the Harmonised Index of Consumer Prices for the euro area to be close to, but below, 2%. By comparison, the average rate of inflation in Germany in the 1990s, i.e. prior to the introduction of the euro, was 2.2%, after 2.9% in the 1980s and 4.9% in the 1970s. In other words, the euro holds its own in the area of stability when compared with the Deutsche Mark. As promised, the euro is at least as strong as the most stable currencies that preceded it, especially it is “mindestens so stark wie die D-Mark”. I could even underline that the German national inflation rate with the euro has been significantly lower than the average in the euro area and, therefore, much lower than at the time of the D-Mark: 1.5% per year, on average from 1999 to 2009.

Given the significant challenges faced by the euro area over recent years, this is a great achievement – especially for a young central bank responsible for a new currency in a newly created single currency area comprising 16 countries and 330 million citizens. In addition, the ECB has been successful with its reliable policies in anchoring future inflation expectations in line with the definition of price stability. This is another of its achievements. Citizens and financial market agents consider the ECB’s stability target to be a credible one, and continued to do so even during the difficult conditions of the financial crisis.

Fixing a quantitative definition of price stability was a key factor that contributed to the solid anchoring of inflation expectations. The definition was useful both in times of increased inflationary pressure – not least in the first half of 2008 when oil prices were high – and in times when risks of deflationary developments were being discussed by the markets – as occurred during the peak of the financial crisis in autumn 2008.

The current financial crisis represents a break not experienced in the world economy since World War II. The challenges posed by the crisis are immense, and in many areas we are still at the beginning of implementing the unavoidable and necessary changes. It is now clear to all actors that, in a globalised world, mistakes at the individual level – for example, unsustainable business models of certain large banks – can very quickly amplify into developments at the aggregate level that lead to dangerous imbalances across the entire system. This holds all the more if there are already marked imbalances within the system at the outset, such as in the current accounts of important economies. It was thanks only to the extremely speedy, comprehensive and well-coordinated monetary and fiscal policy interventions that, in autumn 2008, panic on the markets was held at bay and that a widespread stabilisation was subsequently achieved. In Europe, in particular, the crisis management proved to be effective. This should not be forgotten when drawing all the necessary lessons from the crisis, not only globally, but also at the European level and within the individual Member States of the euro area.

At the international level – within the G20 and supported, in particular, by the Financial Stability Board – there is agreement that the global financial system must be made much more resilient and less susceptible to risk. In the EU, cooperation between national supervisory authorities will be improved through the creation of a European system for financial supervision. In addition, a European Systemic Risk Board (ESRB) is being established, which will issue early warnings and recommendations in order to prevent risks from arising that threaten the financial system as a whole. The ECB will provide the Secretariat to the ESRB and give analytical and organisational support.

The crisis is forcing us to undertake careful analysis to identify where mistakes were made, and to correct them, even in the face of resistance from the political domain. At the same time, however, we should also identify what has proved itself to be of worth and what should be maintained as is. At the macroeconomic level, as I have already said at another occasion, there is one conclusion that should certainly *not* be drawn from the financial crisis, namely that higher rates of inflation should be targeted in future. There are no discernible macroeconomic benefits that would compensate for the obvious costs of increased inflation – higher risk premia and higher long-term interest rates, to name just two. And we should never forget that low inflation preserves the purchasing power of our most vulnerable and poorer fellow citizens. The financial crisis has not brought about any change in this fundamental assessment: contrary to the fears of some critics, the non-conventional monetary policy measures taken by the ECB had exactly the desired effect, even in an environment of temporarily negative inflation rates, so that they can now – given the normalisation of the outlook for inflation and the prospect of a general market recovery – be phased-out, step by step. The ECB will uphold its definition of price stability.

One characteristic of the ECB and the national central banks of the Eurosystem is that their activities are oriented towards the long term. In an environment generally characterised by short-term horizons, the ECB's long-term approach differentiates it from what occurs in both general politics and the private financial sector.

It is not surprising that political behaviour in democracies is strongly dependent on election cycles. In the field of fiscal policy in particular, this might encourage short-term action focused on election dates, resulting in a tendency to engage in deficit spending and growing government debt. As emphasised in the political economy literature, this short-term approach is, in fact, built into the political process itself, which demands that political actors are re-legitimised by means of elections at regular intervals. However, short-termism can and should be corrected through fiscal rules that work towards the sustainability of public finances. Examples of this include the Stability and Growth Pact and the recently agreed, and much to be welcomed, "debt brake" built into German law.

Activity in the private sector is often governed by the quest for short-term profits. Seeking profits is legitimate and an important motivation in a market economy, but an excessive gearing towards the short-term is problematic. Too strong a focus on the short term was one of the major errors made by the financial sector. It was intensified by, among other things, reward systems that created false incentives. The reforms currently being discussed are therefore rightly aimed at combating excessive short-termism in the financial sector, as well as other false incentives. Goethe's statement to Eckermann in 1830 has again become particularly meaningful: "The most important issue is to learn self-restraint. If I wanted to let myself go without any restraint, I could well destroy myself and my environment". We have strongly admonished actors in the financial sector to exercise their responsibility to demonstrate self-restraint. Profits should not be used to pay disproportionate bonuses, but rather to strengthen balance sheets, in order to safeguard the supply of credit.

The activities of the ECB and the national central banks of the Eurosystem are not subject to any election cycle. In fact, the opposite is true: the long-term focus of their activities is explicitly safeguarded by a wide-ranging institutional arrangement that ensures the full independence of the ECB and the national central banks of the Eurosystem from political and any other influence, at both the European and the national level.

Central bank independence is the result of a long learning process as old as paper money itself. On account of particularly difficult experiences in its past, the Federal Republic of Germany was one of the very first European countries to have an independent central bank. I myself was the first governor of the fully independent French central bank more than sixteen years ago. The model of an independent central bank, which proved to be a successful one, was then "Europeanised" and became the norm for the ECB and the Eurosystem.

Today, it is a well-documented viewpoint in economics that independent central banks are in a better position to guarantee low and stable inflation rates than central banks that are subject to political influence. Empirical evidence for this dates back, in particular, to the works of Cukierman (1992), and Alesina and Summers (1993). Although this finding may not surprise many monetary policy-makers, it is, in fact, only through the modern analysis of the time inconsistency problem of monetary policy that it has been clearly underpinned in economic theory. Fundamental theoretical papers on this topic include those of Kydland and Prescott (1977) and of Barro and Gordon (1983). These studies argue that, in the short term, there is the temptation for monetary policy to exploit a seemingly existing trade-off between employment and inflation through expansionary policy measures. In the long run, however, there is no such trade-off because, given the adjustment of inflation expectations, these measures would be systematically anticipated and would thus be rendered completely ineffective. The outcome would simply be higher inflation without any benefits to employment or growth.

The ECB's mandate and its independent status are laid down in the European treaties. These treaties were ratified by democratically elected parliaments in all Member States and, in some countries, by referenda. The core elements of the Monetary Union – namely price stability as the primary objective of monetary policy and an independent central bank – have remained unchanged in each of the treaty revisions since first laid down in the Maastricht Treaty in 1992. Accordingly, they were reconfirmed and re-legitimised through the ratification of the Lisbon Treaty by now 27 EU Member States. The members of the ECB's decision-making bodies are appointed by democratically elected politicians. In addition, provisions are in place in order to ensure the personal independence of individual monetary policy-makers. For example, the term of office for members of the Executive Board of the ECB is limited to eight years, and is non-renewable. Together, the treaty-enshrined foundations of the Monetary Union combine the ECB's independence with clear, democratic legitimation.

Price stability is in the acknowledged, very best long-term interests of the people. Stable prices benefit society as a whole, rather than serving individual interests. Price stability guarantees the purchasing power of income and the value of savings. It prevents arbitrary redistribution and fosters employment and growth. Only when prices are stable is the price mechanism – the key tool for managing supply and demand in a market economy – transparent and efficient. These findings also have a strong tradition within German economic science. Walter Eucken (1952), one of the spiritual fathers of what is known as "Ordnungspolitik" and the social market economy, rightly described price stability – as he put it at the time, the "primacy of foreign exchange policy" – as one of the constitutive principles of a competitive order. He envisioned a "monetary constitution with a stabiliser for monetary value" that would avoid both inflation and deflation, and would function "as automatically as possible".

The EU's monetary constitution reflects a consensus on stability among economists that has developed in Europe over many decades. With its constitutionally guaranteed independence, the ECB acts as a stabiliser of the value of money. There is no completely automatic guarantee of a stable value of money, but the clear commitment to the primary objective of maintaining price stability acts as a compass in all decisions relating to European monetary policy.

In democracies, certain tensions between independent central banks on the one hand and governments as well as economic and financial pressure groups on the other hand, do arise from time to time. Given agents' varying time horizons, these tensions are part of the nature of the issue at hand. The Deutsche Bundesbank and its predecessor, the Bank deutscher Länder, were repeatedly subject to criticism. An early example thereof is the well-known speech by Adenauer in 1956, when he branded an increase in interest rates as a "guillotine for the man of the street". The ECB itself cannot claim to have been lacking advice from the political sphere. It joins a long tradition of independent central banks in this respect. Several euro area governments criticised the ECB when it decided not to decrease interest rates in 2004 and to raise them at end of 2005. With the benefit of hindsight nobody would now question that the decisions of the time were appropriate. The exemplary nature of the cases cited is also revealed by the fact that criticism almost always arises in response to restrictive monetary policy measures. Expansionary measures, by contrast, are virtually never criticised. This, too, reflects the differences in the time horizons envisaged by independent central banks, on the one hand, and executive branches as well as pressure groups on the other.

Looking ahead, the financial crisis has created considerable challenges for monetary and fiscal policy. From the very outset, the monetary policy measures taken by the Eurosystem during the financial crisis were specifically designed in such a way that they could be phased out relatively easily and gradually once the environment improved. The goal of maintaining price stability never changed, and meanwhile the unwinding of these measures has started.

The situation in the field of fiscal policy is more complicated. Budget deficits in many countries across the globe have grown substantially on account of the crisis, although the euro area (in terms of the average deficit across Member States) did not by any means take the lead in this regard. Growing debt levels not only bring with them a potential for greater conflict between fiscal and monetary policy, but first and foremost, place a burden on the sustainability of public finances in the affected countries. It is, therefore, in the interests of each and every country to return to sound public finances as quickly as possible.

In the current circumstances, where Europe faces pivotal decisions, it is more important than ever to recognise that a prosperous union requires determined action by all. Regarding all further decisions on the way ahead, the most important issue is that Europe's policy-makers take and live up to their responsibility. This should hold not only for the European institutions – the European Parliament, the Commission and the ECB. It is also absolutely crucial that the governments themselves exert all their responsibilities of control and surveillance of the peers within the Eurogroup and the Council. I am confident that Europe will find a way to achieve this. Over the past 60 years, Europe has time and again succeeded in emerging from crises stronger than before. As I emphasised yesterday in the plenary session of the European Parliament, monetary union in Europe is far more than a monetary arrangement. It is a union of shared destiny. In order to surmount the consequences of the financial crisis, all public and private decision-makers must live up to their responsibility in their respective fields. For the ECB, this means continuing to fulfil its mandate – of maintaining price stability – in a fully independent and inflexible manner, for the future as it has done in the past. It will remain a bastion of stability and confidence, and is, therefore, on the side of the citizens. And, by guaranteeing price stability, it will do its clearly defined part to protect the long-term interests and future prospects of us all.