Jean-Claude Trichet: Reflections on the European Economic and Monetary Union

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Evangelische Akademie Tutzing, Tutzing, Bavaria, 13 November 2010.

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Ladies and Gentlemen,

I would like to thank the organisers for inviting me to speak here today.

This is a crucial time for the European economy and for the global economy. Vital debates about the state of and interactions between the world's major economies have been taking place at the G20 meetings of Ministers and Governors a few weeks ago and at the G20 summit in Seoul yesterday. Within Europe, there is a particularly vital debate about the framework of governance for Economic and Monetary Union.

Both debates touch on the importance in these challenging times for the design of appropriate policies. Throughout the global crisis, we have all striven to avoid a repeat of the economic policy disasters of the 1930s – and to foster a close cooperation between policy-makers around the world. Working together towards a common goal must continue to guide our actions. Today, I would like to put some of the key issues into a broader context.

First, I will focus on the experience of economic and monetary union in Europe. Second, I will briefly describe the origins and impact of the financial crisis and outline how the European Central Bank (ECB) has responded to the crisis. And finally, I will touch on the current economic situation and conclude with the key challenges that lie ahead of us in achieving an effective economic governance policy in Europe.

Price stability in the euro area

Let me begin with price developments. The quality of a currency is reflected in its value. As you know, this is what in German is called *Geldwertstabilität*. There is one single benchmark to measure such stability within an economy and that is the degree of price stability or, expressed the other way around, the rate of inflation.

As the guardian of price stability for the euro area, the ECB has set itself a very clear numerical benchmark to measure the degree of price stability. It has defined price stability to be an annual rate of inflation of consumer prices in the euro area of below, but close to 2%, over the medium term – that is, over an average of several years.

We now have almost 12 years of experience with the euro – enough time to judge whether the ECB has been successful in delivering its mandate. Over these 12 years, the average annual inflation rate in the euro area has been 1.97%. We have achieved price stability in the euro area over what has already been quite a long horizon. It is the best result of any of the larger countries in the euro area for at least 50 years.

The conditions for achieving price stability have not always been easy. In 1999, we began with a completely new institution – the ECB –, a new currency – the euro – and a new framework for monetary policy-making. Over the years we had to cope with highly volatile developments in many components of the consumption basket – including oil prices of up to $145 per barrel – considerable variations in exchange rates, and the burst of the internet bubble, to name but a few. Hence, the track record, with 12 years of price stability, is worth to take note of.

For Germany, the inflation rate has been even lower than the average in the euro area over the past 12 years: 1.5% per year on average from 1999 to September 2010. By comparison, the average 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%.

If the strength of a currency is measured by the degree at which it preserves purchasing power, the euro is stronger than the most stable currency that preceded its inception. Not *stark wie die D-Mark* but *stärker als die D-Mark* is the right characterisation of the euro in a historical context.

The second element that is important for the solidity of a currency is its external value. The reason is simple: a significant and persistent depreciation over time will ultimately lead to higher import prices and hence inflation. Therefore, abstracting from the large swings that foreign exchange markets are known for at times, over a longer period the exchange rate is an important ingredient in shaping domestic inflation outcomes.

In 1999, the euro was introduced at an exchange rate of 1.18 vis-à-vis the US dollar. You know what is its value today. It needs no further commentary.

But the euro is more than this. It is the uniting monetary element of no fewer than 16 countries that together form a monetary and economic area of 330 million citizens. It has contributed to a further integration of Europe's economies and I do not forget that as soon as 1 January next year we will be 17 countries and more than 330 million fellow citizens.

Challenges for Economic and Monetary Union

But as its name indicates, our Economic and Monetary union rests on two pillars: an economic pillar and a monetary pillar. The fundamental concepts of the monetary pillar are the full independence of the ECB and its crystal clear mandate to pursue price stability in the euro area.

The fundamental concepts of the economic pillar can be summarised as follows: first, the need to determine macroeconomic policies in line with the rules governing the participation in a monetary union that is based on price stability; and second, the need to set fiscal policies in line with the requirements as laid out in the Stability and Growth pact.

I have already described the contribution of the monetary pillar. Unfortunately, the contribution of the economic pillar is at times much less flattering. Much of the problems we face today see their origins in insufficient discipline of fiscal policy makers and an inappropriate setting of macroeconomic policies.

For several years, fiscal policies in many countries have not been in line with the letter and the spirit of the Stability and Growth pact. The pact calls for balanced budgets over the cycle, maximum deficits of 3% and a debt level of below 60%. When a few years ago it became clear that fiscal policies would not be able to meet the rules of the Stability and Growth pact, it was not policies that were changed but the pact.

In 2004 and 2005, several heads of states and governments were actively trying to dismantle the Stability and Growth pact. One of the countries in the lead of these endeavours was Germany. It was supported by France as well as other countries. It was a very fierce battle at the time, and the ECB voiced publicly its grave concerns.

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

By the same token, fiscal and structural policies – including appropriate supervisory policies (today we would say macroprudential policies) – need to keep domestic demand and credit growth in line with rates of sustainable growth and price stability. Otherwise, booms and busts are the inevitable consequence.

Both areas, fiscal and macroeconomic policies, are monitored by the peers, supported mainly by the Commission. The Eurogroup and Ecofin meetings of finance ministers are the fora for such peer monitoring. Of course, effective monitoring requires adherence by members to the policy framework, it requires peer pressure and consequences to deal with deviant behaviour and it requires reliable statistics.

It is in these areas that the biggest deficiencies have been revealed. Fiscal policy conduct has quite often not been in line with the pact, macroeconomic policies have been too loose and peer pressure has been too weak. These problems were visible well before the financial crisis, but the crisis has of course aggravated them, and massively so.

I will come back to how we deal with these problems in a moment. But first let me turn directly to the crisis and say a few words about its origins and developments, and how the ECB has responded to it.

The financial crisis: origins, development and policy responses

Robert Merton – one of the architects of modern financial theory – once said that: "Any virtue can readily become a vice if taken to excess, and just so with innovations".[1] There is unlikely to be a more compelling proof of this dictum than the developments in financial innovation that led up to the crisis that started in 2007 and became most acute in the autumn of 2008.

Historically, the financial industry has been at the forefront of economic progress because of its ability to offer funding to those who take on economic risk. Without credit, the innovation, production and trade of the real economy are severely constrained.

But in the recent past the focus of finance has gradually shifted. From helping the real economy manage economic risk, the focus of finance has quietly moved toward the *creation* of financial risk. Financial risk is different from economic risk. It is deliberate exposure to expected asset price changes.

Building exposure to changes in the value of an asset is not bad per se. But we have to distinguish between arbitrage and directional positioning. Arbitrage is an essential market force. Indirectly, it supports production and trade.

Directional positioning, instead, can amplify and even create gaps in asset prices. It does so by acting on expectations of future price changes. Unlike in the case of arbitrage, these price gaps are notional – indeed, "speculative". They are often large only because they are not suitably discounted for risk.

When on 15 September 2008, Lehman Brothers filed for bankruptcy, the turmoil that had started a year earlier turned into an avalanche. In times of financial panic, banks and other financial intermediaries shed risky and illiquid investments and rush to liquidity. In the process, banks' intermediation is reduced, and loans to companies are curtailed. If the process is allowed to unfold in a disorderly manner, it can create severe damage for borrowers and for the broader economy.

The ECB was among the first central banks in the world to recognise the severity of the situation as early as August 2007, when the turmoil began. It took actions well before a number of other central banks – to be precise: on the very first day the turmoil erupted.

As the failure of Lehman precipitated the acute phase of the crisis, the ECB acted decisively, taking several measures to protect against a disorderly correction in credit and liquidity conditions for the euro area. We put banks in a position to maintain their crucial role in the financing of the real economy. Fears of a "Kreditklemme" have not materialised. At the same

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[1] See Merton (1992).

time, we could start to phase out some of these measures and reduce the amount and duration of liquidity provision.

A few months ago, in May 2010, the ECB decided on bold measures again. It was for similar reasons. Increasing market concerns about the sustainability of public finances led to a paralysis in the secondary market for government paper. Once more, private financial intermediation was threatened.

With the rapid increase in secured interbank lending in the euro area over the past years, the impact on money markets of developments in government bond markets has grown substantially. Government bonds have traditionally been an important element in the transmission process because they serve as a benchmark, or floor, for the pricing of other financial contracts and fixed-income securities.

In recent years they have also emerged as a prime source of collateral in interbank lending. As a result abrupt changes in the value or availability of these securities can imply a sharp deterioration in banks' funding conditions – with adverse effects on both the supply of bank loans to the real economy and their prices.

Therefore, we had to determine further non-standard measures, including interventions in debt markets. All our non-standard measures help restoring a more normal monetary policy transmission mechanism which is necessary to fulfil our primary mandate of accomplishing price stability in the medium term. It is not to be confused with "quantitative easing" policies that aim to reduce longer-term interest rates by expanding the monetary base. In fact, all Eurosystem purchases of debt securities are fully sterilised by conducting liquidity-absorbing operations. All our non-standard measures are temporary in nature.

That being said we urge all governments to step up consolidation. There is a clear need to strengthen public confidence in the capacity of governments to return to sustainable public finances and thus support sustainable growth over the medium term. To this end, it is essential that countries pursue credible multi-year consolidation plans and fully implement the planned consolidation measures. Any positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected economic environment, should be exploited to make faster progress with fiscal consolidation.

Europe's economy: the current situation and the challenges ahead

Let me come to the third and final part of my remarks and turn to the latest developments in the euro area economy.

Looking ahead, our quantitative definition of price stability and our medium-term orientation significantly reduce the likelihood of either deflation or inflation scares. The firm anchoring of inflation expectations – throughout a time of crisis – meant that we could maintain the rate on our refinancing operations at positive levels without having any materialisation of a deflationary risk or inflationary expectations.

Indeed, recent data releases and survey evidence confirm our view that expected price developments will remain moderate over the policy-relevant medium-term horizon. At the same time, the positive underlying momentum of the economic recovery in the euro area remains in place. In line with previous expectations, this implies continuing real GDP growth in the second half of this year.

The global recovery is expected to proceed, and this should imply a continued positive impact on the demand for euro area exports. Private sector domestic demand should also contribute to growth, supported by the accommodative monetary policy stance and the measures adopted to restore the functioning of the financial system.

But complacency would be inappropriate. The European leaders recognise that our economic model is in need of a considerable strengthening. At their meeting in October, the Heads of State or Government agreed on the reform of the system of economic governance.

The proposals put forward by President Van Rompuy represent a strengthening of the existing framework for fiscal and macroeconomic surveillance. But as I have said before, the Governing Council of the ECB considers that they do not represent the quantum leap in the economic governance that is needed to be fully commensurate with the monetary union we have created.

One key area is surveillance of fiscal policies to prevent excessive deficits and unsustainable public debt. In our view we need shorter deadlines under excessive deficit procedures so that corrective policy action is taken in good time. We need quasi-automaticity in the application of sanctions, based on clearly defined criteria and with less discretion over outcomes. And we need ambitious targets for the reduction of public debt towards the 60% of GDP ceiling.

The second key area is broader surveillance of macroeconomic policies in the euro area. We need a new system of mutual surveillance in the euro area, concentrating firmly on euro area countries experiencing sustained losses of competitiveness and large current account deficits as these countries face the greatest sustainability challenges. It should be determined by transparent and effective trigger mechanisms and specify clearly the sanctions in case of breach. And we need full transparency. The assessments of macroeconomic imbalances and recommendations for corrective action should be given broad publicity at all stages of the surveillance process.

The effectiveness of these enhancements to the governance framework will in part be determined by the quality and independence of the economic analysis that underpins them. Without reliable statistical data we cannot be certain that the governance framework will provide the quantum leap forward that is necessary. It is therefore extremely important that the Commission services charged with conducting macroeconomic and fiscal surveillance for the euro area be sufficiently independent, ideally supported by a body of “wise persons” providing external assessments.

Conclusion

Let me conclude. The past 12 years have been very challenging, demanding and eventful years. The ECB has lived up to its responsibility and delivered what we promised to deliver: a stable currency, as credible and confidence-inspiring as the best previous currencies. The euro has also been a force of stability in what is now a more than three year period of economic and financial instability.

As is the case in all major advanced economies which all, without exception, have to put under sharp review their previous surveillance framework and economic models, changes are needed in the euro area framework. Not the kind of changes towards more unilateral action, with dangers of lack of cooperation, but changes towards greater cooperation, greater cohesion through a strengthened framework of economic governance. To sum up, more European unity, more responsible European unity. We must keep our sense of direction.

We are now at a stage where we need to remain bold and enact those reforms that we envisaged when the crisis was at its deepest. It was then that we witnessed the clearest manifestation of risks and our judgement was sharpest. It would be a big mistake if, with gradually improving conditions, we fell back into accepting the status quo. I therefore call on all parties to remain as bold in their reforms as they were when we were in the eye of the storm.

Thank you for your attention.