Jean-Claude Trichet: The monetary policy of the ECB during the financial crisis

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the University of Montreal, Montreal, 6 June 2011.

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Prime Minister,

Rector of the University of Montreal,

Chancellor,

President of the Board of Governors,

Secretary-General of the University of Montreal,

It is a great honour and pleasure to be awarded this honorary doctorate. The University of Montreal has a global reputation for excellence. And I particularly appreciate the kindness of your introduction, even if it seems to me to be too flattering…

I intend to share with you my thoughts on the decisions taken by the European Central Bank in the period we have been experiencing since August 2007. This period started, as you know, several weeks after the Montreal conference of June 2007 which I had the pleasure to attend.

Just a comment to journalists here: I should say that I'm in the one-week period preceding the meeting of the Governing Council during which no indication must be given about future decisions. Please don't draw any conclusions on what I'm about to say in terms of future monetary policy decisions.

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As you know, the main task of the ECB is to ensure price stability in the euro area. The heads of state or government in Europe enshrined this mission in the European Union treaties in 1992. Pursuant to this mandate, the Governing Council's objective is to keep inflation rates below, but close to, 2% over the medium term.

The ECB has accomplished its mission over the past 12 years. During this period, the average annual inflation rate stood at 1.97% in the euro area.

It is important to grasp the significance of this achievement. Over these 12 years, the ECB has faced many challenges in pursuing its objective of price stability: the bursting of the dot-com bubble, the shock wave of 11 September 2001, the volatility of commodity prices and, of course, the worst financial crisis the world has known since the Second World War.

I would like to discuss today in particular our response to the crisis and the reform programmes of financial regulation and economic governance in which the euro area and the European Union as a whole are engaged.

I. The measures taken by the ECB in response to the crisis

During the crisis, together with other central banks around the world, the ECB has had to operate in an uncertain environment.

It should be noted that we have been vigilant from the very first day. When the problems started to appear in the financial markets, on 9 August 2007, we were the first central bank to react, taking action very quickly.

In parallel, dysfunctioning financial markets have threatened to compromise our ability to guide the outlook for price stability by using our conventional instrument – interest rates. Faced with this situation, over the years that followed, we have implemented a number of unconventional measures to ensure that our decisions on interest rates are transmitted to the whole economy, despite the problems observed in the financial sector and capital markets. In particular, it was to allow banks – regardless of the level of the key interest rate – to continue to lend to households and businesses.

From the outset of the crisis we have established the principle of strict separation between our unconventional and our conventional measures, that is to say, our policy rate of interest. Our interest rates are fixed so that we can ensure price stability over the medium term. The implementation of unconventional measures depends on the functioning of the monetary policy transmission mechanism and must respond to the degree of dysfunctioning or disruption of monetary and financial markets and market segments.

As the crisis called for rapid and unprecedented action, we never lost sight of our main objective, namely to maintain price stability over the medium term for the benefit of the 331 million citizens of the euro area. All – I stress that word – all monetary policy decisions we have taken over the last 12½ years were aimed at complying with this commitment.

Let me elaborate on this point. As you know, in normal times, central banks mainly influence the economy and inflation by using the instrument for setting short-term interest rates.

In practice, the identification, at an early stage, of the risks to price stability is a delicate task. To see it through, the ECB bases itself on a monetary policy strategy supported by several sources of information. The economic analysis we undertake enables us to synthesise information on short-term inflationary pressures from a large number of economic indicators. Thanks to the monetary analysis that we also carry out, we can cross-check this information with that concerning medium-term inflationary pressures drawn from the monetary and financial indicators. These are the two “pillars” of our monetary policy which indicate to us the necessary steps in respect of the interest rate to ensure price stability over the medium term.

The decisions we have taken in response to political pressures have demonstrated our independence. We refused to lower interest rates in early 2004 when Germany, France and Italy in particular asked us to do so. We did not hesitate to raise interest rates in December 2005. At that time, ten governments in the euro area out of 12 and many international observers asked the ECB to leave its key rates unchanged.

International financial institutions, in particular, highlighted the risks that the tightening of monetary policy – after a prolonged period of accommodative monetary policy – could pose to the recovery. Despite these warnings, we conducted our monetary tightening, and international financial institutions have agreed that we were right to make that decision.

After the crisis escalated in mid-September 2008, while inflationary pressures subsided, we decided, in full accordance with our mandate, to reduce our key interest rate. We cut it rapidly, from 4.25% in October 2008 to 1% in May 2009.

We lowered the key interest rate at a pace and a level unprecedented in the recent history of the euro area countries.

With the benefit of hindsight, the decisions we took during the crisis were effective. They have in particular helped to preserve a very solid anchoring of inflation expectations over the past four years. Our determination to maintain price stability over the medium term has enabled us to prevent both the risk of inflation and of deflation from materialising.

With the recovery now more firmly established, we have seen in recent months upside risks to the outlook for price stability over the medium term. Again, the sharp increase in oil and other commodities has had a major impact on overall inflation. In these circumstances, the central bank must prevent increases in the prices of raw materials from being incorporated into the long-term inflation expectations, which could trigger second-round effects on wages and prices.

It is against this background that the Governing Council decided in April to raise interest rates. I stressed in reporting this decision it had been taken unanimously. The action of the Governing Council is motivated by a common goal.

That decision in April confirmed that the separation principle is strictly applied and that our non-conventional measures do not restrict in any way our ability to toughen the monetary policy stance when facing inflationary pressures. Thus, when the Governing Council decided in March and April that it was time to raise interest rates, in parallel, at the same time, it decided to keep, in the second quarter, the provision of unlimited fixed-rate liquidity for a period of three months.

Let me remind you of what I said earlier: nothing of what I have just said can or should be interpreted in terms of future decisions of the Governing Council next Thursday.

II. The economic and financial reforms brought about by the crisis

The tensions we face in Europe today are not a crisis of the euro. They do not indicate a crisis in the monetary union. The single currency has kept its promise to provide price stability in the euro area.

The current crisis stems rather from insufficient monitoring of economic policies in some Member States. Today, it's not the monetary pillar of Economic and Monetary Union that is at stake, but the economic pillar. If we refer to the acronym of that union, EMU, we can say that the concerns relate to the "E" rather than "M" in the EMU.

In the rest of my remarks I'll consider what is being done now in Europe to strengthen the economic pillar of EMU.

The main cause of the crisis has been the negligence of financial risk. It has necessitated the implementation of a programme of comprehensive reforms for virtually every aspect of the global financial system. We have to control the forces that led the system to think only about itself and put an end to this situation so that the system serves the real economy. And we have to ensure that the financial system contributes to sustainable economic growth.

At this point, we have drawn up a set of more stringent banking regulations, providing capital to absorb more losses, improving coverage and reducing the risk of excessive borrowing. The countercyclical capital buffers are designed to reduce pro-cyclicality.

The supervision of financial institutions, financial markets and market infrastructure is increasing, while the organisational structure of financial oversight is being overhauled.

But much remains to be done. The most important aspect concerns the implementation of these reforms. In addition, the issue of financial institutions of systemic importance still has to be settled, and should strengthen the oversight of financial markets. We cannot allow ourselves to suffer from a lack of transparency and the excessive influence of dominant players and oligopolistic market structures.

The new European System of Financial Supervision (ESFS) represents an important step forward. The three new authorities created for the European banking sector, insurance and occupational pensions, and capital markets allow closer monitoring of the interrelationships and impact of contagion in the financial system of the European Union. Finally, the European Systemic Risk Board (ESRB) is developing the tools necessary to warn and, if appropriate, make recommendations on measures to cope with potential sources of systemic risk.

If negligence of financial risk is the main cause of the crisis, the macroeconomic risk – and the many channels through which this risk interacts with fragile budgetary structures – is causing the budget problems which some countries in the euro area are facing today. These considerations bring me to the issue of reforming economic governance.

The euro is unique among international currencies. It is the major currency that is not issued by a sovereign state, but by a union of states. Monetary policy is inherently indivisible in a monetary union, and for the euro area, it is conducted at European level. In contrast, fiscal policies and other macroeconomic policies continue to be largely the responsibility of national governments and reflect national political preferences.

Our economic governance framework has so far not managed to guarantee the implementation of sound policies in all Member States. The Treaty makes clear that Member States have pledged to pursue economic policies aimed at furthering the objectives of the Union, one of which is a stable single currency. It's an obligation which they have not yet fully discharged.

The European Union is about to set up monitoring mechanisms, specifically targeting the imbalances and differences in competitiveness within the euro area. This should have been done long ago. Since 2005, within the Eurogroup, and then publicly, shortly thereafter, the ECB has warned against the considerable risks arising from these differences, which would be the subject of corrective action.

If fully implemented – which of course is absolutely essential – macroeconomic surveillance will ensure a smoother functioning of EMU. It will require Member States to take measures to counter the emergence of macroeconomic imbalances at an early stage, before they weigh down on the macroeconomic outlook and assume a systemic dimension.

From 1997, even before the creation of EMU, the euro area governments had adopted the Stability and Growth Pact to prevent a debt crisis. As you know, the Pact requires EU countries to limit their budget deficit and national debt to 3% and 60% of GDP.

But in 2005, Member States decided to reform the Pact. At the request of Germany, France and Italy in particular, a greater freedom of action and greater flexibility was introduced into the monitoring procedures, to the detriment of the effectiveness of the Pact, a move which has weakened it considerably.

I then expressed, on behalf of the Governing Council, the serious concerns of the ECB regarding the negative impact of these reforms on the functioning of EMU.

It is important that Member States have recognised their error and intend to strengthen the Pact. The focus on fiscal sustainability and reducing public debt levels, supported by more effective sanctions, is a step in the right direction.

That said, the Governing Council of the ECB is concerned that, although they are going in the right direction, the economic governance reforms being discussed are not ambitious enough to correct the structural weaknesses of fiscal governance and, more broadly, macroeconomic governance, of the euro area. We believe that we can immediately go further in the "secondary legislation" with the current Treaty. It is particularly suited to enhance the automaticity of the application of sanction mechanisms. Countries in the euro area that violate our common rules should be accountable for their policies, and freedom of action and flexibility in this field should be reduced as much as possible. This implies a reduction of the margin of manoeuvre to terminate or suspend proceedings and the introduction of stricter deadlines.

In this context, we advocate a strengthening of sanctions to encourage countries to abide by the rules. This would require, first, a wider range of financial and non-financial measures and, second, reduced freedom of action to reduce or suspend them. Such strengthening would improve efficiency and create the right incentives.

Meanwhile, more ambitious demands in terms of economic policy would be more in line with the reality prevailing in the euro area. Ambitious benchmarks should be the basis when establishing the level of the excessive deficit and setting the adjustment path leading to a sound fiscal position. It is very important that macroeconomic surveillance clearly focuses on the countries with the greatest vulnerabilities.

The anchoring of these new rules at national level would strongly inscribe them in national legislation. A binding commitment on the part of Member States to implement sound domestic fiscal frameworks is essential to ensure national “ownership”. Finally, in our opinion, it would be appropriate to further improve the production of fiscal statistics.

All these issues are being discussed in the trialogue between the Commission, European Council and Parliament. The Governing Council of the ECB is confident that Parliament will push the Council further towards strengthening economic surveillance.

III. Conclusion

Let me conclude. The crisis has posed significant challenges for the euro area. But we have reacted to them. The European Central Bank has been an anchor of stability in a turbulent period. Price stability has been ensured. All countries in the euro area – without exception – have benefited from it.

We must not forget either that the euro area as a whole has made significant progress over the past 12 years. The economic dynamics of the euro area is the same order of magnitude as those registered in the United States. In both economic regions, per capita income has risen on average by about 1% annually. In the euro area, job creation has been stronger than in the US. Over the past 12 years, more than 14 million jobs have been created in the euro area.

I can assure you that the European Central Bank will continue to contribute to the smooth functioning of monetary union by continuing to be the anchor of stability and confidence that is so necessary.

Rector of the University, Secretary-General, let me thank you again for the great honour of being awarded this honorary doctorate from the University of Montreal.