

## **Jean-Claude Trichet: Interview with Le Figaro, Frankfurter Allgemeine Zeitung, Irish Times and Jornal de Negócios**

Interview with Mr Jean-Claude Trichet, President of the European Central Bank, by Jean Pierre Robin (Le Figaro), Benedikt Fehr (Frankfurter Allgemeine Zeitung), Paul Tansey (Irish Times) and Rui Jorge (Jornal de Negócios), conducted on 11 July 2008 and published on 18 July 2008.

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### **1. Could you outline how you see the euro economy evolving over the short run and the implications for euro interest rates?**

I always said – on behalf of the Governing Council with all our colleagues, Vítor Constâncio, John Hurley, Christian Noyer and Axel Weber – that in order to have clear indications on what the euro area economy has been doing in the last months, we should take together the first and second quarter of 2008. Whilst the first quarter was very dynamic, due to particular circumstances including the weather and its impact on construction in Germany for instance, the second quarter is likely to be weak. Our base line scenario is that we will have a trough in the profile of growth in the euro area in the second and third quarters of this year and, following this, a progressive return to ongoing moderate growth. I have also said clearly that the risks for growth were on the downside. Amongst these risks are the influence of the ongoing very significant financial market correction, the possible further increases in, oil and commodity prices and the possible unwinding of global financial imbalances. As regards interest rates, I have nothing to add or to withdraw from what I said before on behalf of the Governing Council – that we trust that our decision to raise our key interest rate from 4.0% to 4.25% will contribute to achieving price stability in the medium term in line with our definition. I also mentioned that we had no further indication for our future interest rates, that we are never pre-committed and that we will do in the future what is appropriate to deliver price stability in the medium-term and to be credible in doing so, since this is essential to anchoring inflation expectations.

### **2. Central Banks, including the ECB, have been responsible for a lot of monetary growth in the recent past. To what extent are central banks to blame for the present inflation, in the euro area and elsewhere?**

In the euro area we have certainly not been loose or lax! I trust that the ECB did well and took the right decisions in the past. Let me give you an example: you know that when we decided to increase rate in December 2005 (editors note: after almost two and a half years at 2.0%), we were advised by the IMF not to increase rates; we were advised by the OECD not to increase rates; we were advised by a number of other eloquent voices not to increase rates. We did it nonetheless, because our monetary analysis in particular strongly suggested that we should. Today nobody suggests that we were wrong in our analysis and in our decision, on the contrary.

### **3. Inflation in the United States is now around 4%. Would you say that the risks to price stability are now greater in the euro area than in the US?**

I certainly will not judge the policies that are pursued by other central banks. We all have our own responsibilities in our economies and we have to face different challenges: the shocks are not of the same nature and the same amplitude; the economies themselves exhibit different structural features, including as regards their degree of flexibility. Those different challenges are explaining why interest rates are different from country to country. Do you know that interest rates in Britain as well as in Australia, New Zealand, Sweden and Norway for example are higher than in the euro area? I trust that all central banks are doing what is necessary to counter inflationary pressures and to be credible in the delivery of price stability over time. To deliver price stability in the medium term is necessary for five reasons: first, it is

what the European democracies have asked us to do when they created the ECB; second, it is what our fellow citizens are asking us to do in the present circumstances; third, it is particularly necessary for the most vulnerable and the poorest segment of society; fourth, it is a necessary precondition for sustainable growth and job creation and fifth it is particularly important to solidly anchor inflation expectations in a period of financial market tensions and volatility.

#### **4. Why did the recent statement by the Governing Council lay so much emphasis on the need to suppress second-round effects in order to quell inflationary expectations?**

Indeed, our message is that we should avoid second-round effects. We cannot change today the prices of oil and commodities. But we must avoid that prices that depend on us – for instance prices of services or the wages and salaries – would augment abnormally as if the present abnormal level of inflation would last. We are there to tell households as well as enterprises, all social partners, that we will maintain price stability – less than 2%, close to 2% – in the medium term and that they have to take that into account when they are fixing their own prices.

#### **5. What do you mean by second-round effects?**

I mean all the price increases that would be wrongly based on the hypothesis that the inflation would remain as high as it is today in the years to come. Today price setters and social partners must take into account that we will be back to price stability – in line with our definition – say over 18 months.

#### **6. In what way can ECB interest rate policy curb inflationary expectations? What are the instruments?**

The economists will tell you that the Central Banks are ensuring price stability through different channels of transmission of their monetary policy decisions: the interest rate channel, the credit channel, the risk taking channel...I will stress particularly the decisive importance of the credibility of the central bank. If the Central Bank is credible in its handling of monetary policy, then our fellow citizens as well as the corporate businesses will have confidence that they can count on price stability in the years to come. The ECB is a credible anchor of stability and confidence for 320 million citizens of the euro area. We are strongly determined to preserve and reinforce confidence: it is our most precious asset. And it is good for all, households, enterprises and governments: market interest rates on a five years, ten years, twenty years basis are lower because the ECB is credible and inspires confidence. Some governments are borrowing on a fifty years basis at an interest rate significantly inferior to 5%: this is only possible because the ECB inspires confidence.

#### **7. Core inflation in the euro area is now about 1.7%, so why should we be so worried about inflation?**

First, core inflation is higher than that and secondly, we do not consider core inflation as a good predictor of future inflation. But let me give you an example of why we see signs that justify our concerns. Unit Labour Costs are an important indicator of future inflation, because they are a major cost in the euro area economy. In recent years, we have had an increase rate in Unit Labour Costs of 1.0% in 2005; 0.9% in 2006; 1.5% in 2007; and 2.4% in the first quarter of the present year. When you try to disentangle the factors behind this development, about half of the increase is attributable to increases in wages and salaries and the other half is due to a reduction of labour productivity. The overall result is that we have observed in the last two years a significant rise of unit labour costs.

#### **8. Are second-round effects then already at work in the euro area?**

The recent rise in unit labour costs is an indication that we have to take into account. So there are risks that we had to counter. I wouldn't say at all that second-round effects are a generalised phenomenon at present but we see signs that we have to take seriously. From that standpoint I am concerned about the schemes in which nominal wages are indexed to

consumer prices. They involve the risk of a wage-price spiral, very detrimental to employment.

**9. Is there a risk of euro area inflation exceeding 5%? Is a sharp economic slowdown preferable to an inflationary spiral?**

We are not pursuing two goals; we are pursuing one goal, which is price stability in the medium-term. And price stability is a pre-condition to sustainable growth and employment creation. There is no contradiction between price stability and sustainable growth. Since the euro was established in 1999, it has delivered both. In its first nine years, annual inflation in the euro area averaged 2.1% and over these nine years, the euro area has created 15.7 million jobs, almost three times more than in the previous nine years before the euro and one million more jobs than were created in the United States over the same period. The unemployment rate in the euro area last year was the lowest in 25 years. There is no contradiction between price stability and growth: price stability is a prerequisite for sustainable job creation.

**10. Has the ECB any other responsibility other than price stability?**

We have a primary objective, which is to maintain price stability. It is a precondition to contribute to the achievements of the objectives of the European Union.

**11. In order to achieve price stability, would the ECB raise interest rates consistently to break inflationary expectations?**

I have already said what I had to say on this.

**12. At present, inflation in the euro area is well above your target. Is the ECB to blame for this? Could we have avoided this surge in inflation?**

We are responsible for price stability in the euro area over the medium-term. We have been able to achieve this objective since the euro's inception. We know the sentiment of our fellow citizens. The latest surveys suggest that inflation is now the major economic concern of European citizens. They know of course that the Bank is not responsible for the increase in the cost of oil, commodities or food. Our 320 million fellow citizens can count on us to deliver price stability over the medium term, and we think particularly about the poorest and most vulnerable that can do the least to protect themselves from rising inflation.

**13. Should the ECB be concerned with asset price inflation as well as consumer price inflation in its determination of price stability?**

This is a very important question for all central banks. To sum up the sentiment of our own institution, we do not think that it would be possible or advisable to have a definition of price stability that would include in a single indicator not only consumer prices but also asset prices. That being said, through the "wealth" effect asset prices have an influence on demand and therefore on future consumer prices. So asset prices are indirectly taken into account in the decisions of central banks. On top of that, in the case of the ECB, you know that our monetary policy framework is based on two pillars: an economic pillar and a monetary pillar. When we analyse the monetary situation we look also with great attention to credit growth which might feed asset inflation.

**14. Over the past year, the expansion of credit to non-financial corporates within the euro area has been very high, while in the case of households, credit growth has been very low. Is this a reflection of the "credit crunch" in Europe?**

There has been a big difference in the credit expansion rates for non-financial corporates on one hand and households on the other. Over the past twelve months, the growth in credit to non-financial households has reached 14.2%, which is an impressive multiple of nominal GDP growth. On the other hand credit extended to households has progressively slowed down since we increased interest rates in December 2005. It is also true that we are told by

banks, through our bank surveys, that they are tightening their bank lending standards. We will monitor these evolutions closely in the months ahead.

**15. Can you explain the 14% growth in credit to non-financial corporates?**

We are working on that. What is sure is that there is still a very dynamic growth in the overall financing of the productive sector which is not offset by a diminution of stocks and bonds issuance.

**16. What is your feeling about the capital adequacy and the solvency of the euro banking system at present?**

I think that the process of accounting and of recapitalisation is a process that is taking place both in Europe, the euro area and the USA. At the present moment, all the information we have suggests that recapitalisation of banks in the euro area is in line with the amount of losses displayed. That being said, we have to be constantly alert. There is no room at all for complacency.

**17. Is the worst behind us in this credit crisis?**

My assessment is that we are experiencing, since the month of August last year an ongoing very significant market correction with episodes of turbulence, episodes of a high level of volatility and of hectic market behaviour. Again, it is an ongoing process.

**18. Are conditions today comparable to the oil shock of the 1970s?**

The situation is not identical. The structure of the global economy has changed with the increasing influence of emerging economies. There have been major breakthroughs in science and technology. Much progress has been made in energy saving technologies. But, that being said, I trust that there are also important similarities. Today as in 1973-1974, there is a major transfer of resources from oil consumers to oil producers. Trying to deny that there is such a transfer of resources to oil producers is and would be a major mistake. Because there are only two ways to isolate the households from this real transfer which is unavoidable: either you ask the enterprises to pay for it and you weaken considerably the productive sector; or you ask the budget to pay for it and you weaken dramatically the situation of public finances; or you do both! But, this has been – on the occasion of the first oil shock – and would be so in the present circumstances a recipe for high spiralling inflation, high unemployment and stagnation. We must take into account the lessons from the past.

**19. How do you protect productive sectors in the face of such external shocks?**

As I said, avoid second-round effects.

**20. Is it the role of the ECB to prevent a recurrence of the stagflation of the 1970s?**

We have a very clear mandate: achieving price stability in the medium-term. It is totally in line with the lessons of the first and second oil shocks of 1973 and 1980.

**21. One of the challenges the ECB has to deal with is that the cycles in the euro-countries are different. What can be said to those countries like Ireland, Spain and Portugal who are in a difficult position now and for which the rate hikes are painful?**

The ECB has to care for the superior interest of the euro area. My message to the fellow citizens is that they share a common destiny with an entire continent as populated as the United States of America. When we look at the differences in growth between states and countries in the US and in Europe, we have approximately the same level of differences. A large vast continental economy has necessarily to give breathing space to its components. And our monetary policy must be optimal at the level of the whole euro area; exactly like the Fed would not look what is in the interest of Missouri, California or Texas. That being said, there are numerous aspects of economic policies which are under the responsibility of the countries themselves: in particular the fiscal policies, the structural policies and the surveillance of the evolution of unit labour costs.

**22. Portugal, for instance, has quite a low level of inflation. When the rate rises, people look at the ECB, but should they be looking at what their governments have done in the past in order to put them in a better position to cope with the difficulties that arise from the single monetary policy?**

Firstly, in anchoring solidly inflationary expectations the ECB is preserving a financial environment which is favourable for sustainable growth and job creation. Because all medium and long term market rates are lower, all things being equal, if inflation expectations are in line with our definition: less than 2% but close to 2%. Secondly, as I said governments, parliaments and social partners have important responsibilities also because a lot of policies are within the competence of national authorities.

**23. You intend to go to Peking after the Olympic Games. What will be the message to China?**

We will see with our Chinese partners, for whom I have great esteem, whether we meet in China or in Europe. As regards our message it is well formulated: as we said in the communiqué of the last G-7 meeting, we appreciate the rise of the Yuan but we consider that an acceleration of the appreciation will be in the interest of all parties concerned.

**24. To what extent does the appreciation of the real euro exchange rate and the future impact on euro area growth cause you disquiet?**

I have said publicly that it is very important in my eyes that the President of the United States, the Secretary of the Treasury and the Chairman of the Federal Reserve have said that a strong dollar is in the interest of the United States of America.

**25. The difference between the interest rates in Europe and the US makes it more difficult to have a strong dollar compared to the euro. Would you expect some help in that?**

I have nothing to add to what I just said.

**26. The European economy is hurting because the Chinese constantly intervene in the currency market in order to promote their export. Shouldn't the ECB intervene itself and try to push the euro down?**

In my eyes, the acceleration of the appreciation of the Yuan would be in the interest of the Chinese partners themselves, because it will help to diminish inflationary tensions in China. It would also be part of a rebalancing between domestic consumption and exports, which are an important element in the strategy of China, and it would be part of the modernisation of the policy instruments available in the Chinese economy. But we have also always said that this is the responsibility of the Chinese authorities. We will continue to discuss with our partners, respecting their own responsibilities and explaining our own positions.

**27. How worried are you by the performance and the behaviour of hedge funds and their destabilising effects on the financial markets?**

Firstly, I think it was very important that we could have an agreement at the level of the international community on the 67 recommendations of the Financial Stability Forum. Work is also being done by the private sector itself and I trust that it is always important to ask the professionals themselves and the industry to reflect on best practices, to work out codes of conduct and set up benchmark principles. This is work in progress in particular for highly leveraged institutions and hedge funds. We will see if this work is satisfactory from the stand point of financial stability. Should this not be the case, then there is always the possibility to involve the public authorities. In any case transparency is of the essence.

**28. Is it clear to you that we can no longer live in a world with such a huge shadow banking system?**

We have to draw all the lessons and not single out a particular element but rather try to be as systematic as possible. It is clear that the "originate and distribute" model has to be reviewed

to be compatible with financial stability. A very important part of the Basel's committee work is precisely to see how to improve the behaviour of commercial banks. In any case, much more transparency of the institutions, the instruments and of the market will be necessary. That is not only because when pertinent information is available, the economic agents can make better decisions and engineer a better allocation of capital – but also because transparency is an important protection against “herd behaviour” and the propagation of any crisis. One of the lessons we learned from the Asian Crisis ten years ago was the strong need to improve transparency in the emerging economies as regards in particular their reserve assets and their monetary and fiscal policies. In the financial markets of the industrialised world we have exactly the same lessons to be learned.

**29. How healthy is the banking system in Europe? Some argue that some banks, namely the Spanish ones, are too addicted to the ECB's lending and collateral policy, a signal of little health?**

Since the very beginning of the market turmoil we had a framework which proved to be more adapted to the unforeseen new environment that was associated with the financial turbulences. Our framework appeared as an interesting example for other central banks that had to change their own framework. We are permanently examining and applying our rules with great care. If it would be useful to refine elements in our scheme, as we did in the past, two and four years ago, we would do it.

**30. So you don't think the banks are too dependent on your instruments?**

We have a framework that has proved to serve us well and we are caring continuously for it to be correctly applied.

**31. Do you think the Irish no to the Lisbon Treaty has any impact on the euro area or on the ECB's behaviour?**

As the President of the ECB, I would like to say that the Lisbon Treaty does not affect the EMU framework and therefore the present difficulty of ratification does not affect in any respect our work. We have a very clear policy objective – price stability in the medium term – and a very inspiring road map: achieving the integration of the single market with a single currency and progressively enlarging the euro area according to the criteria of the Treaty of Maastricht. As a citizen, I hope very much, and I am confident, that we will find a way to overcome the current difficulties.

**32. You shelved plans for the ECB headquarters. Your budget was 500 million euro, but the promoter wanted 1,2 billion. What are the plans ahead: will you increase the budget – and who decides that – will you start a new plan or stay in the current premises?**

We are responsible for public money. The Governing Council is the body which decides on the proposal made by the Executive Board. We are examining the situation in view of optimizing the present situation without altering our cost estimates.

**33. Would you be surprised and accept it if the political leaders decided to change the ECB's mandate to a dual one, with price stability and growth?**

That is a highly theoretical question. We have a primary mandate enshrined in a Treaty which has been negotiated, signed and ratified – either by Parliaments or by the people – by 27 exemplary democracies, 25 without an opting-out clause. This is the mandate that was given to us by our fellow citizens! The people of Europe gave us this mandate because they rightly trust that price stability is a prerequisite for sustainable growth and job creation so that there is no contradiction but complementarity between the two.

**34. Given that mandate, do you think all the political leaders are helping you by explaining exactly your mission to their fellow citizens? Would you expect more help from some leaders?**

We are fifteen countries today in the euro area and sixteen as soon as next year. One very important message for our 320 million fellow citizens is: "We share a destiny in common!" I see more and more political leaders and opinion leaders aware of the necessity of this message.

**35. What answer do you have to pressures for instance from Mr. Sarkozy or Mr. Berlusconi?**

Let me make three remarks. First, the ECB is fiercely independent. And the Treaty says, very explicitly that governments shall not try to influence the Governing Council of the ECB. This independence is key to our credibility, which is in turn essential for confidence in Europe. And confidence is our most precious asset, as I said.

Second, the most vulnerable and poorest of my fellow citizens have the biggest stake in price stability which is now the main concern of all according to the surveys.

Third, as regards the organisation of the relationship with authorities, whether government or Parliament, we have probably the best organised and the most frequent relationships that exist at the global level. This is not sufficiently known. I invite the president of the Eurogroup Jean-Claude Juncker and the Commissioner Joaquin Almunia to all our meetings twice a month. I am invited to all Eurogroup meetings once every month. That makes occasions of contacts three times a month. As regards the Parliament, I am invited five times a year and members of the Executive Board are invited on other issues as well. On top of these official hearings I participate in a number of informal gatherings with members of European Parliament. I attach great importance to these relationships with the European Parliament.