Jean-Claude Trichet: Interview with the Financial Times

Interview with Mr Jean-Claude Trichet, President of the European Central Bank, conducted by Mr Lionel Barber, FT Editor, and Mr Ralph Atkins, FT Frankfurt Bureau Chief, on 10 December 2008 in Frankfurt, published on 15 December 2008.

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FT: Mr Trichet, this has been the Eurozone's first real crisis. How do you think the authorities have coped?

Mr Trichet: I'm not sure it is really the Eurozone's first crisis, because you remember we also had the bursting of the internet bubble, and we had to cope with the oil and the commodity price shock. Moreover, we also had other sets of difficulties here and there, including when we were told in 2004 by some large countries that we had to unravel the Stability and Growth Pact. So I would say we had to face up to a series of circumstances that were certainly not easy. But it remains true, of course, not only for us but for all the authorities in the world – central banks, executive branches and perhaps also parliaments – that we now have to cope with a truly exceptional situation. In that sense I would say that we are all being tested. In a way the ECB is being no more or less tested than the Federal Reserve, because these exceptional circumstances are calling for exceptional decisions and responses by a large number of central banks. But to the extent that we are only ten years old, this test is of course particularly important for a young institution.

FT: What was the most difficult moment for you at the ECB in terms of crisis management?

Trichet: I would certainly say that these were the first hours at the outset of the financial turmoil. The Executive Board had to make a diagnosis of the situation in a very short time span, assess what kind of problem we had to deal with, and take decisions almost instantaneously.

FT: …this is July/August 2007, yes….

Trichet: This was on 9 August 2007. We had a very important decision to take, which was in a way the first important decision that central banks had to take in order to confront these exceptional circumstances. I remember I was keen on thinking, "This is a grave situation that calls for appropriate responses". And then we had a great number of important decisions to take in the subsequent months, which were largely "firsts", in terms of supplying liquidity at fixed rates and even in terms of expanding our collateral framework which, from the outset, was already a very comprehensive collateral framework. It has been a big challenge. One of our challenges is that we had to take decisions very rapidly at the level of the Governing Council. And we again proved that, thanks to teleconferencing, in one hour and a half or two hours we could make a full judgment and take a decision. We had to test the capacity to have such teleconferences at very short notice, in order to be sure that we could confront any new situation. We had a large number of teleconferences with the Governing Council. You see there…[points to telephones on table]

If the situation were to demand now that we had in one hour and a half a teleconference with the Governing Council, we will then indeed have a teleconference in one hour and a half. The full continent would be there. That's very impressive, because this would mean all members of the Governing Council from Ljubljana to Helsinki and from Lisbon to Dublin.

FT: And as you say, an exceptional crisis, a global crisis. How much worse would it have been without the euro?

Trichet: It is very difficult to reconstruct history with new assumptions. But my memory of what we experienced together in the old days is certainly that we would have had a situation which would have been very difficult, because on top of all of these global challenges that are without precedent, we would have had to cope with the intra-European tensions, the equivalent of the intra-ERM 1 tensions, and that would have been demanding. There is no doubt from that standpoint that the enormous challenges we had at the level of the euro area as a whole were, very fortunately, not the result of intra-euro-area tensions, and that is something which is important.

FT: And that would have put the single market at risk?

Trichet: And that would have put the single market at risk, sure. Not only have the central banks had to cope with exceptional situations. Governments were called upon to take action in various forms, and the fact that Europe is a union of sovereign states means that a lot of decisions implying taxpayers' money or risks to taxpayers are taken at the level of governments and parliaments. Hence there is a constant need to ensure that we maintain the single market and its level playing-field, and that we do not re-nationalise segments of the market. This is a big challenge at the level of the institutional framework of Europe, but it has been done well so far.

FT: In the past, some warned that the first test for the euro would also perhaps put intolerable strains on the currency union, and some academics even suggested it would fall apart. This has not happened, but are you worried about some member states in the currency union that are facing greater challenges, say, than others?

Trichet: Europe's institutional framework is solid, and it has proved its solidity. The euro itself has functioned, by and large, as a protection against these intense international challenges. On the other hand it is clear that each economy has to be run as properly as possible. We are in a market system that punishes those who behave improperly. That is the reason why we ourselves are telling all members of the euro area to respect the Stability and Growth Pact. It is the legal framework that we have as a *quid pro quo* for the fact that we do not have a federal budget and a federal government. And it is economically based on solid ground. Consider the spreads for the refinancing of the various government's treasuries: they are taking into account the various fiscal policies. Consider the Ricardian effects, the level of confidence or the lack of confidence that you observe in the various constituencies of economic agents, particularly at the level of households: they suggest that there are certain situations where if you do not behave properly you might lose more in terms of confidence than what you are supposed to gain through the additional spending. We also say regularly to the various members of the euro area that they must be aware of the unit labour cost evolution, of the relative competitiveness of the various economies inside the euro area, and inside the single market of the 27 EU members. This is something which is also very important.

FT: But of course the Stability and Growth Pact, thanks to the French government, 1997, is still very constricting.

Trichet: It is supposed to function so as to prevent the various fiscal policies from loosening during the positive part of the business cycle in order to provide appropriate room for manoeuvre when we are in the downbeat episode of the business cycle.

FT: You mean the exceptional circumstances clause?

Trichet: In any case you are supposed to be close to balance or much better in surplus when you are in the…

FT: … upswing…

Trichet: … yes, affluent episode of the business cycle, so that you have at least 3% of GDP of room for manoeuvre to cope with the difficulty when the business cycle reverses. But on top of that there has been this mention of exceptional circumstances, which has been added to the Stability and Growth Pact. The Pact has been designed to cope with all episodes of the business cycle I was mentioning, and that is the reason why we ourselves say that the room for manoeuvre that is embedded in the Pact exists and can be utilised.

FT: Do you think Germany is utilising it to the extent it should?

Trichet: Every nation has its own Ricardian effects and its own assessment of the situation. I do not want to comment on any particular country, because my duty is to look at the continent of 320 million fellow citizens as a whole. But I fully accept that there are differences in the capacity of households in various cultures to accept a deterioration of their situation, and again, the Ricardian channel tells us that one might lose more by loss of confidence than one might gain by additional spending. Every nation has to assess its own situation. We are a union of sovereign states, so you have to take into account the sovereign decision-making process at the level of each nation. The process requires the approval of parliaments. In some cases you might have decisions that are taken very expeditiously because the democratic institutions are functioning very rapidly. In other cases you have to accept that it takes longer to take decisions that would be fully in line with the effective functioning of the democracies concerned. But I do not judge any country.

FT: But what role do you believe, then, should a fiscal stimulus play in mitigating the effects of this crisis and moving us towards a recovery?

Trichet: I believe that the existing room for manoeuvre according to the Stability and Growth Pact rules can be fully utilised. And there is a great coherence between the provisions of the Stability and Growth Pact on the one hand, and what – at least speaking for the euro area – an attentive economic analysis would recommend on the other. Again we have to be mindful of the spreads on the various treasuries, and of the fact that the market is aware of the room for manoeuvre of the various countries. We also have to be mindful of the Ricardian effects which are very important. When you look at the level of savings as a proportion of household revenue in the various countries, you see to what extent some of them are already largely taking into account the expectation that tomorrow you'll have to face up to additional taxation and additional financing needs for public funds.

FT: In the US, what is really striking about Europeans is that some of them understand that this crisis is so exceptional that in a way you may have to put aside the rules. These are exceptional circumstances. But on the other hand there are other Europeans who just feel that we've used so much effort and political will to put together and agree on those rules that whatever we do, we mustn't abandon them. Now, where do you come down on these two sides of the equation?

Trichet: Incidentally, we had an exceptional relationship with the other side of the Atlantic in a large number of areas, including the supply of dollar liquidity. We have had a lot of "premiers" in terms of our own decisions, and "premiers" in terms of the close cooperation and very confident cooperation with other central banks. This is something which is important.

But I'm cautious. I take the Stability and Growth Pact as it is, with its provision for exceptional circumstances. But it would be a mistake not to take into account fully the situation of the various economies. We have an exceptional situation, but understanding where exactly the limits are of the fiscal room for manoeuvre also depends on the culture. I see some cultures where people are very anxious that in the medium and long run the fiscal situation would be unsustainable, others that are reasoning short term. The "discount rate" which is implicit in the various cultures is not the same. We have to also take that into account.

We don't have a federal government. We don't have a federal budget. If we unravel the Stability and Growth Pact we won't rebuild it afterwards. It would have been unravelled. And what would I say then to American friends telling me, "you put the cart before the horse – you don't have a federal budget or a federal government – but you have a single currency"? I understand that from the outside our setup might seem a little surprising, but taking everything into account, the credibility of the euro area, the fact that there has been a *quid pro quo* at the birth of the euro area in terms of the institutional framework, our setup is very solid.

And don't forget that there is also something which is not negligible. The role of automatic stabilisers is also important, and I urge the members of the euro area to display to which degree the worsening fiscal balances represent the functioning of automatic stabilisers. If I compare the euro area – but I think this would also be true for Europe as a whole – with the US, we have public spending as a proportion of GDP that is significantly higher than in the US. We have a social safety net and social protection in general which is more comprehensive than in the US, and hence the role of automatic stabilisers is significantly more important. It represents a much larger part of GDP. An order of magnitude could be that for the same decrease of GDP, you would have perhaps twice as much influence of automatic stabilisers as a percentage of GDP in the euro area as compared with the US. A large level of public spending as a proportion of GDP is not something that we necessarily have to be very proud of, but it is some kind of "amortiser" in periods that are very difficult.

FT: In Britain you're looking at a potential 8 per cent budget deficit next year of GDP, and in America the word is for the next fiscal boost, name a number and go higher. And the doctrine of overwhelming force, the Powell doctrine, will be used to throw everything at this problem. Now, do you see risks in that approach, or are you sympathetic?

Trichet: If I stick to my own understanding of the difficulties we face, I would say we are certainly paying a price for the absence during a long period of time of appropriate balances in the various economies the world over. I'm not mentioning one economy or another in particular, because I think that we have had a phenomenon in the industrialised world which is very complex and which has manifested itself not only in the US but also in a significant number of industrialised economies including the European economies, where you see a permanent tendency to have domestic imbalances between savings and investment, with the mirror image of large external imbalances. I think we have to be aware of that. It seems to me that what we are told presently is – and again it is a message for all industrialised countries in my understanding – that it is not a normal position, that it is a dangerous position to be domestically and externally significantly in imbalance. Reflecting on what you call the "overwhelming force"… I don't know. I have no memory of colleagues on the other side of the Atlantic telling me that as if there were no limit … All colleagues trust that there are limits, in any case. I would echo that and I would say that there are always limits. There are limits as regards the structural features and the permanent features of the functioning of the various economies. And if you think that you have no limits, then you are taught that there are limits by the Ricardian effects, by the financial markets themselves.

FT: If you look to the medium term, how do we get to achieve a better balance? How do we avoid, if you like, another wave of volatility based around unrealistic asset prices, or an asset bubble?

Trichet: Let us look at the time of the bursting of the internet bubble. There was a degree of excessive pessimism, if I can analyse the real situation after the internet bubble burst. I do not exclude that in terms of macroeconomic policies that were…

FT: …in other words that we assumed things were really bad after the bubble burst, and therefore we erred maybe on the monetary side, perhaps….

Trichet: I am not criticising anybody, and I know to what pressure the ECB was resisting at the time. I was appointed at the end of 2003. As early as the beginning of 2004 three Heads of State and Government of large countries were calling publicly on the ECB to decrease interest rates. I suppose with the benefit of hindsight it would appear extraordinary, taking into account what happened afterwards, but it is documented. Central banks are permanently asymmetrically called on to privilege more the short term to the detriment of the medium and long term and this by all sensitivities, all constituencies whether private or public … We were made independent precisely because our democracies rely on us to reason also medium to long term, and to avoid being exclusively trapped in short-term considerations. In my own experience, this is both a national and international experience in the euro area: I know practically of no constituency which would call on us to increase rates at any time!

I experienced all the consequences in the 1980s of the second oil shock and the defaults of sovereign states, which were the mark of the 1980s. We had a very negative consequence of these dramatic oil shocks and commodity price shocks that we had to cope with in the 2000s, because there has been, on top of the savings glut, an additional pot of forced savings that were accumulated at the level of the global economy by the oil and commodity producers. That created an additional element of capital chasing investment and hunting for yields. You then had a very low level of spread, a very low level of volatility and a very low level of risk premia, which contributed to create an asset bubble, asset price inflation.

FT: Are there measures that you could take or policies that you should adopt in order to avoid another wave of volatility?

Trichet: I would say that it is impossible in market economies to avoid fluctuations. We have to accept that we have ups and downs. What is an overwhelming duty is to eliminate, as completely as possible, all the in-built elements in global finance that are amplifying the booms and the busts. Such pro-cyclical elements are everywhere. They are in the behaviour of the various private entities themselves. We have to draw the appropriate lessons from that, including in terms of risk management. We have to reflect on accounting rules. Now we have to see exactly how accounting rules could best reflect the reality of the situation, and how they would avoid augmenting booms and busts as has been the case. We have to reflect in the Basel Committee on prudential rules for banks and also for insurance companies. As regards market rules in general they might have been, all taken into account, too geared towards short-termism and too pro-cyclical.

All of these are the avenues that we see in front of us when we meet in the context of the Financial Stability Forum, the G20, the IFMC, G7, G8 or the G10 grouping of Central Bank Governors. I think we very much agree on the appropriate avenues. I used to sum them up by saying that we first have to improve transparency dramatically for financial instruments, for markets and for institutions. We second have to combat pro-cyclicality everywhere in the global financial system, we third have to combat short-termism and we fourth have to very significantly improve risk management in the private sector in general. Moreover, we have to improve surveillance, at a global level, of the economies that are systematically important. It is not only China, the US and Europe, but it is also the other members of the G20, because they are systematically important. If everything is settled as regards the financial system, and if we really go without any taboos in the directions that are presently suggested we can succeed. This includes the 67 measures suggested by the Financial Stability Forum that have been accepted by the international community. But on the other hand, if we maintain the possibility of the global economy having big imbalances that would pile up for years, we know that there will be recurrent corrections which will be equivalent to the earthquake that you have when continents are moving, which at some point leads to a collision. We have to prevent that too. We do not speak too much about that, but it is extremely important.

FT: Have the politicians lagged behind the financial markets? Certainly, the technocrats, the central banks understood… The politics has lacked, hasn't it?

Trichet: I would not say that. The Central Banks have indeed been instrumental in organising what I would call a line of defense against the “systemic liquidity risk”. The executive branches have taken the decision to organise a line of defense against the “systemic solvency risk” that was threatening national, continental and global finance. We had asked ourselves for such decisions to be taken. But I certainly will not underestimate the difficulty of the tasks of governments to put taxpayers’ money and risk at stake for the guarantees and the recapitalisation that were necessary. In the euro area, in the UK, in the US, it called for courageous decisions.

FT: Are there limits to the effectiveness of monetary policy because of the situation we're in, and if so, should the reaction of central bankers be to do more or less in such circumstances? And then what is the role that should be played by exceptional measures that you have at your disposal, the quantitative easing debate essentially?

Trichet: First of all, we made the point clearly that there was a clear separation between monetary policy stance, which was designed to deliver price stability in the medium term in line with our definition, and our interventions in the money market aiming at permitting a smooth functioning of this market at the level of the short term interest rates that we had decided. And we have continued to look at inflation expectations with extreme care during the entire period. And I was very satisfied, I have to say, that we had regained control of inflation expectations before the event of mid September, because it permitted us to decrease rates and to accompany the alleviation of inflationary pressure without hesitation. We participated in the collegial decrease of rates which we had organised with the other major central banks in the world. So that is a very important first point.

Second point, as regards the present situation, we consider that the decisions we have taken were exactly what was necessary. Taking into account the alleviation of inflationary pressures, we have to be very mindful of the spreads that we are still observing in the money market. I said at my last press conference on 4 December, you remember, we have to concentrate on obtaining from the interest rates effectively practised the intended consequences. The transmission channel is not functioning as usual, but it is functioning. There is no doubt that the decisions that we are taking have an impact, but it's made more complicated, more complex by the present situation, in particular by the fact that we do not have a money market which functions normally. We do all we can, in particular through our supply of liquidity, for this money market to function as well as possible. But we observe these challenges at a global level on both sides of the Atlantic; it is a phenomenon that we are all observing and that we all are trying to counter. It is certainly not easy to eliminate, otherwise we wouldn't see the same phenomenon in the US and in Europe, but at least we are progressively attenuating the problem.

FT: You said last week that you have an opportunity next week to view the operational framework, liquidity regime. You seem to contain a hint that maybe changes might be planned. Can you tell us about that without…? I don't expect you to tell us what you decide, but what would the aim be? Would it be perhaps to apply more whip on banks to encourage…?

Trichet: I can say nothing at this stage.

FT: What about buying debt, though; buying government debt? Would you consider such a move at the ECB?

Trichet: Again, I have said that experience has demonstrated that we had to prepare for unexpected exceptional situations, and I would say that I would not eliminate anything ex ante, and equally I will not pre-commit to anything ex ante. We'll always look at the situation on the basis of our own analysis, taking everything into account. Today, we will certainly not consider that it will be appropriate at all.

You were speaking of quantitative measures. There is a measure of quantity, which is impressive today – I'm speaking of both sides of the Atlantic, and both sides of the Channel – which is the size of the balance sheet of the central bank. This is explained by the fact that we are supplying liquidity on an unlimited basis and that we have allowed collateral in a way which is more forthcoming. And this is true for all central banks. But for us, our weekly balance sheet in comparison with that of one year ago has increased by around 55 % [from around 1.3 trillion to 2 trillion euro]. Of course, this increase does not imply an increase in net liquidity, because a significant part of the liquidity we provide comes back in the central bank through the deposit facility.

FT: That's less than the Fed.

Trichet: Yes, true. For the ECB part of it comes also from the fact that we have the counterparts of the dollar that we are supplying ourselves, and a counterpart of the dollar is our own collateral. The central banks are in a situation where they are playing a much more quantitative role than they used to play, and it is true for all of us.

FT: Should there be more centralised supervision within the Eurozone, and should the ECB take responsibility? Is the ECB willing to take that responsibility if the politicians so desire?

Trichet: As you know, we have always been in favour of a very close relationship between the central bank and the banking surveillance authorities. We said that long, long before any new problems, any new difficulties. We had a Governing Council position close to the start of the ECB, which we made public. So on that point, there is no ambiguity at all. We are also strongly thinking that better coordination for big cross-border institutions is absolutely necessary; even if we could cope with all the issues at stake in the present circumstances, we should not forget that. It's clear that we can improve the present framework and we have to improve it. Some avenues have already been suggested by Ecofin. There has already been a consensus on appropriate Memoranda of Understanding. But going further in this direction also seems important. At this stage, I have to say, I do not have a full-fledged Governing Council position. We are still reflecting, and we will see what will be the position of the Governing Council. But I understand that the European Parliament has carried out several works which have been done within the suggestion that the ECB would play a particular role in this domain for the coordination of surveillance for cross-border institutions – a little bit like in the US. The Federal Reserve has a position which concentrates very much on the big cross-border institutions. And I see also suggestions coming from the private sector, coming from the industry, that we could play a more important role in this domain. As President of the ECB's Governing Council, I would say again, I have no position of the Governing Council, but I think it's flattering for the Governing Council that we are called to reflect on that, by both parliament and perhaps the high-level group that has been set up by the Commission and where you have a number of eminent personalities. We will see.

A little bit of philosophy again. We cannot afford to put in the future the concept of the market economy at risk as we did. I have known myself a world where you had an east and a west, a north and a south. In this matrix, we were only one square out of four where you could say they are in favour of market economies. The others were devising other ideas, which failed, and it's very good that they failed. However, the trust which was put in the resilience of the market economy is at stake now. I think we were, again, quite lucid on this. I have permanently with me the first page of the Financial Times warning of it, it was January 2007, in Davos, where I was providing the sentiment of my colleagues, as it has arisen from the governors' meeting in Basel on the fact that market participants had to prepare for a significant correction because risks were underassessed and underestimated in global finance. But the fragility, not only of global finance but of the global economy itself, is something that we should reflect on. You know, there are some key intermediate inputs that are produced in only three factories in the world. This is not reliable. We have this just-in-time system, with minimum inventories, which in case of a shock might make the full body of the real economy more immediately vulnerable. In the financial system we have eliminated a number of cushions and shock-absorbers that we had here and there. This morning, I was telling our staff, that this is as if we had been keen on eliminating a number of air bags from the [global finance] "car". So now that we have an accident, we are surprised to see that we have a lot of scars. The scars of the current crisis on the global financial system are significant. All investment banks in New York have either been purchased, or gone under, or changed by their legal framework. That is saying something. A new concept of resilience for the market economy is of the essence.