Jean-Claude Trichet: Macroeconomic policies, imbalances and the need to avoid going back to the status quo ante

Address by Mr Jean-Claude Trichet, President of the European Central Bank, at the Annual Joint Parliamentary Meeting, European Parliament, Brussels, 16 February 2009.

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Monsieur le Président du Parlement européen,
Monsieur le Président du Sénat de la République Tchèque,
Monsieur le Président de la Chambre des Députés de la République Tchèque,
Mesdames et Messieurs les parlementaires européens et les parlementaires nationaux,

Je me réjouis beaucoup de participer à cette réunion interparlementaire à Bruxelles. Alors que nous ne sommes qu'à la mi-février, c'est déjà ma troisième rencontre cette année avec le Parlement européen. Cela montre encore une fois à quel point le dialogue entre la Banque Centrale Européenne et le parlement est étroit.

Auch heute steht unser Austausch im Zeichen der außergewöhnlichen wirtschaftlichen Lage. Die Weltwirtschaft erfährt einen starken konjunkturellen Abschwung. Dieser hat mittlerweile auch die EU erfasst. Regierungen, Parlamente und Zentralbanken haben rasch und entschlossen reagiert. Ich möchte heute auf einen Aspekt hinweisen, der mir besonders wichtig erscheint; nämlich, dass wir bei all unserer Entschlossenheit nicht die notwendige mittelfristige Orientierung unserer Entscheidungen aus den Augen verlieren. Diesen Aspekt möchte ich Ihnen erläutern.

Our primary and most immediate task as policy-makers is to help resolve this crisis, in cooperation with the private sector. We need to address the fundamental causes underlying the crisis: in the international financial system, in the international setting of macroeconomic policies and in the international financial architecture. And yet, we also need to make sure that our decisions today do not lay the ground for similar disorder in the future. We can only do so – and this is my main proposition today – if we design policies in such a way that we do not go back to the status quo ante and instead firmly enshrine in our policies the appropriate focus on ensuring stability over the medium term.

I would like to explain what I mean by this.

The global economy was – and, to a significant extent, still is – imbalanced. It is imbalanced in three domains: in its financial system, in its macroeconomic configurations, and in the governance of the financial architecture. The present crisis does not just offer us an opportunity to rebalance, it provides an obligation to rebalance these three intertwined domains of the global economy. These are the key challenges we must not fail to address, no matter how difficult the related work agenda.

The root causes of the crisis

Let me outline where I see these challenges more specifically, starting from the root cause of the crisis.

Clearly, the root cause of the crisis was a massive underestimation of risk in the financial sectors of virtually all advanced economies. Risks were blurred owing to financial innovation that had produced highly intransparent financial products. These allowed for a generalised deterioration in lending standards. The drop in virtually all credit spreads and the asset price booms were particularly important in spurring households and firms to increase consumption or accumulate debt at a rapid pace. Much of this boom was based on the erroneous assumptions that house prices and asset prices would continue to increase indefinitely, and that macroeconomic cycles had been eliminated. In 2007 market participants began to notice that these assumptions were unrealistic. Asset and house prices fell, financial institutions were caught with excessive leverage, and households and firms quickly became over-indebted.

As a second factor, we need to recognise that economic policies also played an important role. Macroeconomic policies in several economies were not sufficiently focused on medium-term stability and sustainability, which would have helped prevent macroeconomic imbalances from accumulating. This was mainly due to the erroneous belief that in a globalised economy, it would be optimal for some countries to borrow from the rest of the world, or accumulate claims on other countries, indefinitely. This belief was initially encouraged by years of rapid global growth. But ultimately it proved mistaken. The financial crisis led investors to shun risk. They became less willing to allow households, firms and entire economies to accumulate debt.

As a third factor, we have observed clear imbalances in global governance. Still at the current juncture we must be aware of the shortcomings in the international financial architecture. Here, it is not necessarily the analysis that was the problem: the rising risks in the global financial system were identified in the process of international cooperation. The IMF coordinated a multilateral consultation in 2006-07 to address global imbalances. The G7 and the G20 regularly flagged concerns related to imbalances in their communiqués. Policy recommendations were developed, but not appropriately enforced during this period. Also, the dangers of a sharp and abrupt correction were not generally perceived as grave and quasi-immediate. I have to say that in this respect it is in the constituency of central banks that we can find the clearest public statements on the need for the private sector to prepare for a very serious market correction. This was the sentiment of the Global Economy Meeting of Central Banks Governors in Basel as early as 2006 and the beginning of 2007. And the Bank for International Settlements itself in its own research had been the most lucid of the international institutions.

The course of action to be undertaken

Looking ahead, what actions should be undertaken to redress imbalances in the global financial system, in macroeconomic policies and in international governance?

For the financial system, there is a need for more stringent regulation. Such regulation needs to prevent a recurrence of the excesses witnessed in financial markets and must impose a much more stability-oriented perspective. The Financial Stability Forum has already identified the key avenues for reform. These include three policy areas where change is particularly warranted, in my view:

- first, introducing incentives and rules to prevent the financial sector from focussing excessively on short-term returns;
- second, improving transparency as regards risks to the financial system, as well as regarding institutions, instruments and markets that are currently unregulated or insufficiently regulated; and
- third, eliminating, wherever possible, the elements that amplify the tendency of the financial system to accumulate excessive risks and leverage in good times, and to shed risks hastily in bad times – i.e. dampening pro-cyclical tendencies.

I have dwelled upon these three issues on other occasions. These points are also reflected in the G7 communiqué issued last Saturday, and I will not elaborate on them further.

What I would like to emphasise today is the overall setting of macroeconomic policies looking ahead. While it is imperative, in the short term, that the current situation be stabilised, we should not lose sight of the need to maintain a medium-term orientation, to anchor expectations, and to stabilise economic conditions both domestically and globally.

Looking at the immediate future, monetary and fiscal measures have been and are being implemented swiftly and on a large scale. Indeed, the ECB was one of the first authorities to react through appropriate monitoring of the money market when the first signs of turmoil emerged in the summer of 2007. As regards monetary policy, our guiding principle has been and continues to be to ensure price stability in the euro area in the medium term, in line with our definition: below 2%, but close to 2%. This solid anchoring of price stability is the best contribution we can make to safeguarding the overall stability of the euro area.

At the global level, it is equally important that policies do not steer the global economy back to the global imbalances experienced in the status quo ante, since this was the starting point of the current problems. It is of the utmost importance that policy-makers do not merely focus on short-term solutions and instead adopt a longer-term perspective, with the objective of ensuring a sustained recovery. Wise policy actions therefore include two central elements:

- first, credible exit strategies must be planned and promptly implemented once macroeconomic measures have had their desired effects; and
- second, policies must aim not only to stimulate domestic demand over the short run, but also to foster longer-term structural adjustments.

Needless to say, these elements are fully valid also for Europe. Stability-oriented policies have become, if I may say so, a European trademark. The current crisis underscores the not only the value but the necessity of such stability-oriented policies. We should be proud of this European trademark and not abandon it at the current juncture.

As regards the global financial architecture, international organisations and fora should play an important role in convincing countries to adopt stability-oriented policies and ensure necessary corrective measures where required. And international institutions should, in turn, also adapt. Let me stress that the central banking community has adapted in a decisive manner, through unprecedented international cooperation, with global cooperation by central banks mirroring the globalisation of finance.

In particular, the connection between macroeconomic and financial stability needs to be more comprehensively addressed than has been the case thus far. This implies that we need to have an even better understanding of the link between macroeconomic and financial surveillance. Closer collaboration between global institutions such as the International Monetary Fund and the informal grouping that is the Financial Stability Forum would be helpful.

In addition, the IMF needs to improve its surveillance, including financial surveillance, especially as regards systemically important countries. We have for a long time concentrated on the surveillance of developing and emerging economies, while industrial economies considered themselves to be largely immune to international advice. The crisis provides the painful lesson that industrial economies also need surveillance – indeed, rigorous surveillance. All international institutions and fora should reflect on how to strengthen their surveillance and its effectiveness in fostering policy adjustment.

This is clearly a long and difficult agenda, and we may still not have all the answers yet. But Europe can play a leading role. We need to continue pursuing stability-oriented policies with a medium to long-term orientation within Europe. And we can foster international cooperation with the aim of having such policies pursued also at the global level and thereby prevent a return to the status quo ante. Again, the current crisis is an obligation to correct the fundamental causes of persisting imbalances, in the global financial system as well as in the setting of macroeconomic policies. The focus on sustainability and medium-term stability is a useful guidepost in this context.

Thank you for your attention.