Jean-Claude Trichet: Recovery, reform and renewal – Europe's economic challenge

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference "The ECB and Its Watchers" XII, Frankfurt am Main, 9 July 2010.

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Ladies and Gentlemen,

It is a pleasure to be with you in this 12th edition of the ECB Watchers' Conference. Today, I would like to consider where we are in the financial crisis and the economic recovery; to describe the emerging contours of the post-crisis order both in Europe and the wider world; and to reflect on what has been achieved by the global policy response to the crisis and what remains to be done.

1. Where do we currently stand in the crisis?

We are now almost three years into the crisis. The development of the crisis was marked by a progressive collapse of confidence: a seizing up of markets, dramatic financial events impacting the global financial system, a sharp decline in trade and a freefall in economic activity in the industrial world. We can all feel relief that the collective international efforts to avert catastrophe in the winter of 2008/09 have been successful.

But events over the past few months have made clear that it is still too early to declare the crisis over. And, just as they have done throughout the crisis, governments and central banks in Europe and around the globe continue to respond to shifting economic and financial circumstances with swift, decisive and effective action.

In early May 2010, the gravity of the situation was such that public authorities in Europe had to step in, with unprecedented actions in terms of quantity and quality, to restore a sense of direction and renew confidence.

Over the past three years much has been achieved; but much remains to be done. Restoring confidence and a clear sense of direction does not mean going back to business as usual – the crisis has shown that we need to make fundamental changes to the way we manage our financial systems, our public budgets and the interactions between the national and international institutions that oversee the world economy.

There is a very strong unity of purpose among the world's policy-makers: to eliminate the fragilities of the global financial system and the global economy in order to achieve strong, balanced and sustainable economic growth.

We are now at a stage in which we have to finalise new rules and regulations that will help to make our economies more resilient in the future. This means that we are now in the time of implementation of decisions already taken and in the ultimate preparation of the new rules and regulations. It is a very important phase and it requires our full attention.

I see three areas at the core of efforts that will contribute to shaping the contours of the post-crisis order:

First, institutions. As the Nobel laureate Douglass North said 20 years ago, "Institutions exist to reduce uncertainty in the world." That message remains true today. We need strong institutions with clear responsibilities and which offer a framework for dialogue and formal agreement.

This is all the more important at the global level. The scope of international cooperation is broadening significantly as our economies become increasingly connected. This is reflected in current efforts to strengthen the mandates and governance structures of existing international institutions. At the same time, existing informal fora are being adjusted and new fora developed.

Examples are manifold. The G-20 has emerged as the prime group for global economic governance. The Global Economy Meeting of central bankers acts as the main forum for central bank cooperation. And the Financial Stability Board now represents all systemically important emerging market economies, and its mandate has been enhanced to strengthen the international financial architecture. These are encouraging developments and we must continue to pursue this path.

The second area at the core of our efforts concerns reforms of the financial sector. This is also an area where further progress is needed. The extent of the financial crisis leaves no doubt that tighter regulations and supervision are required to overhaul the financial system. We know that the crisis originated mainly in institutions that had moved away from traditional banking and which increasingly relied on non-interest sources of income and non-deposit-funding.

Reforms should be designed in a way that internalises the social responsibility that financial institutions bear for savers and society as a whole. How can this be achieved? The answer can be summed up in four dimensions: more transparency, better regulation, less pro-cyclicality and less short-termism:

1. More transparency is needed to ensure that financial market participants return to their prime mission of assessing the quality of investment. Securitisation lessened lenders' incentives for prudent screening and steady monitoring. Risk could be bundled, sliced and re-bundled for further sale. Risk management became difficult because information was unavailable to investors, buried in financial structures that were not transparent. Reform must ensure that sellers of securitised products disclose all information about the underlying loan structures so that both investors and rating agencies can correctly price the risks embedded in these products.
2. Better – that is, more effective – regulation will ensure that no financial product and no financial market participant can escape the eyes of supervising authorities. Many financial players with high leverage have gone unchecked by our regulatory system. Better regulation will expose the risks inherent in the financial system and make the system more stable. Needless to say, highly leveraged institutions should be part and parcel of this process.
3. Less pro-cyclicality of the financial system will reduce market volatility. Regulation should attempt to limit the risks that banks assume by imposing higher, countercyclical capital requirements, thus limiting leverage. Financial institutions will be asked to raise the quality and quantity of their capital base to ensure they have adequate buffers against future market disruptions.
4. Less short termism: the promise of significant returns in the short term was often linked to a misjudgement of underlying risk. At the level of individual institutions, compensation schemes must be adjusted to avoid encouraging excessive risk-taking on the basis of relatively small amounts of capital. Instead, the incentive structure should encourage profitability over the medium to longer term. At the same time, on Wednesday, the European Parliament approved significant curbs on bank bonuses as part of wider efforts to reform the financial sector. EU finance ministers are set to endorse the law next Tuesday with the curbs taking effect from the start of next year. At the level of the financial system as a whole, we need to improve decisively the prevention of build-up of risks, including systemic risk. Macro-prudential oversight will help to prevent the building up of imbalances.

The third area of work concerns fiscal consolidation. This affects all industrial economies. Governments must send a clear message to markets – a message of determination and commitment to sound macroeconomic policies. There is no doubt that bold government actions including large capital injections in support of the financial sector helped to cushion the impact of the financial crisis. These measures were courageous and important in avoiding an even worse economic downturn.

But many countries in the industrial world have reached the limits of fiscal expansion. Rising debt levels and large fiscal deficits have raised concerns among financial market participants about the longer-term sustainability of public finances.

Just like consumers and countries, governments cannot live beyond their means forever. Fiscal authorities need to look beyond the current cyclical upturn. There is no alternative to that. Let me remind you of an often forgotten remark by John Maynard Keynes from 1937, in the aftermath of the Great Depression, when he said: "Just as it was advisable for the government to incur debt during the slump, so for the same reasons it is now advisable that they should incline to the opposite policy".[1]

Fiscal consolidation and growth are not mutually exclusive. I disagree with the view that reducing public expenditures will hinder economic growth. On the contrary, prudent fiscal management provides the basis for balanced and sustainable growth. Stability-orientated fiscal policies will foster confidence among households, entrepreneurs and investors, which will ultimately increase our welfare by creating new jobs.

2. How should we address European modalities of today's global challenges?

I have outlined three key areas for efforts to shape the contours of the post-crisis world – reform of the institutions of global governance, reform of the financial system and reform of public finances.

These are global challenges affecting in particular the industrial economies. I would now like to explain how Europe specifically is responding to these challenges. An ambitious agenda lies before the continent. It is not only a visionary agenda: it has to be pursued with determination right now. We have to demonstrate the same spirit with which the European Union was progressively developed over the past half-century: setting objectives, agreeing deadlines and mobilising the necessary political will within Parliaments.

Europe's governments are committed to pursue fiscal consolidation. Those within the euro area have formally declared that they will take "all measures needed to meet fiscal targets this year and the years ahead in line with excessive deficit procedures" (Euro area heads of state or government declaration of 7 May 2010). Some of them have made precise additional commitments to accelerate fiscal consolidation and ensure the sustainability of their public finances.

Fiscal consolidation is being put in place at the same time as we strengthen the resilience of the European banking sector. Publication of the detailed results of a harmonised pan-European stress test is an important step in the right direction. These tests will increase transparency and enhance investors' confidence in Europe's banking sector. They will also contribute to restoring the important intermediation role of the interbank market in channelling funds within Europe.

3. Where next?

So where do we go from here? As I have indicated, collectively as European and global policy-makers, we need to ensure economic recovery and renewed confidence, while reducing fiscal deficits and remaking the financial system into one that supports the real economy. This needs to be our clear sense of direction.

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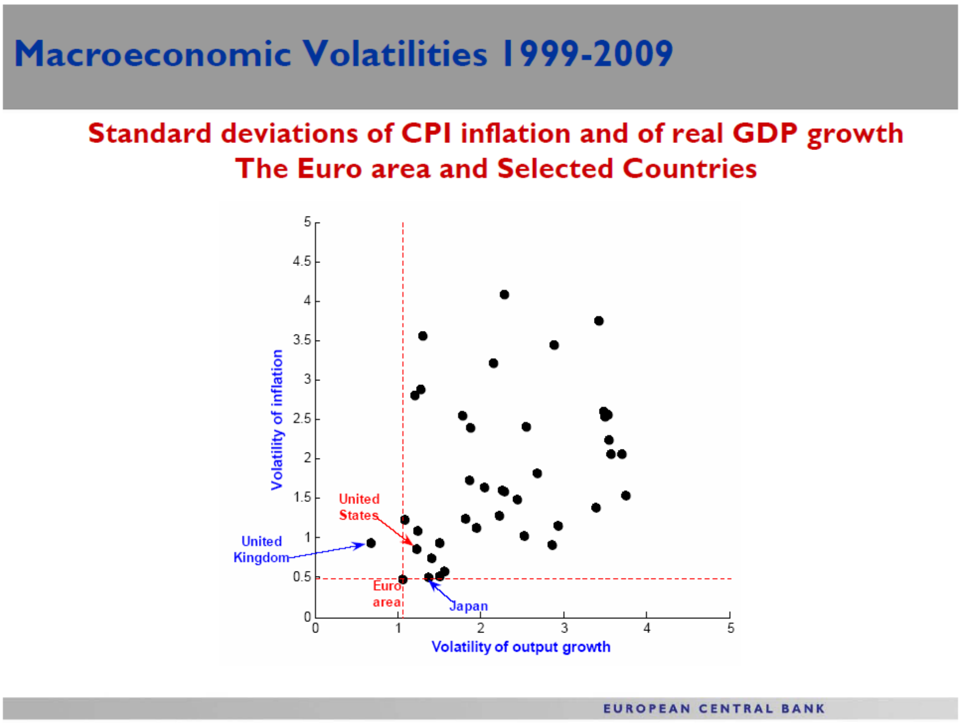
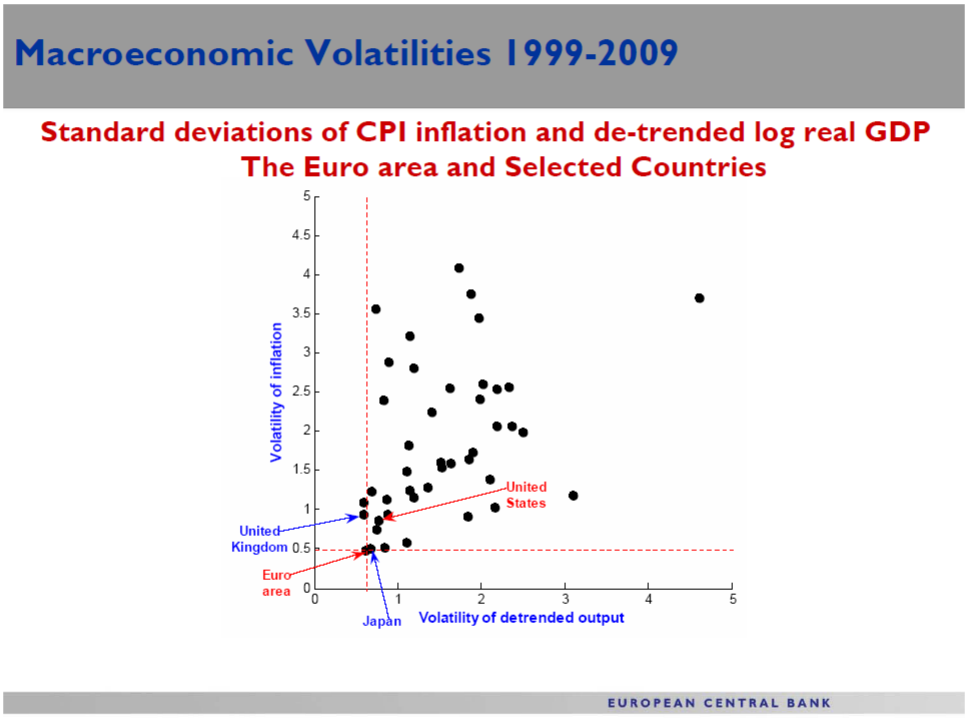
[1] *Keynes (1937), "How to avoid a slump", Article in The Times, 12 January 1937.*

Sound public finances and a stronger and more resilient banking sector will strengthen the fundamentals of the European economy. Already prior to the crisis, the euro area was among the least volatile economies in the world. Volatility of both inflation and output growth were significantly lower than in other industrial countries and inflationary expectations remained remarkably stable.



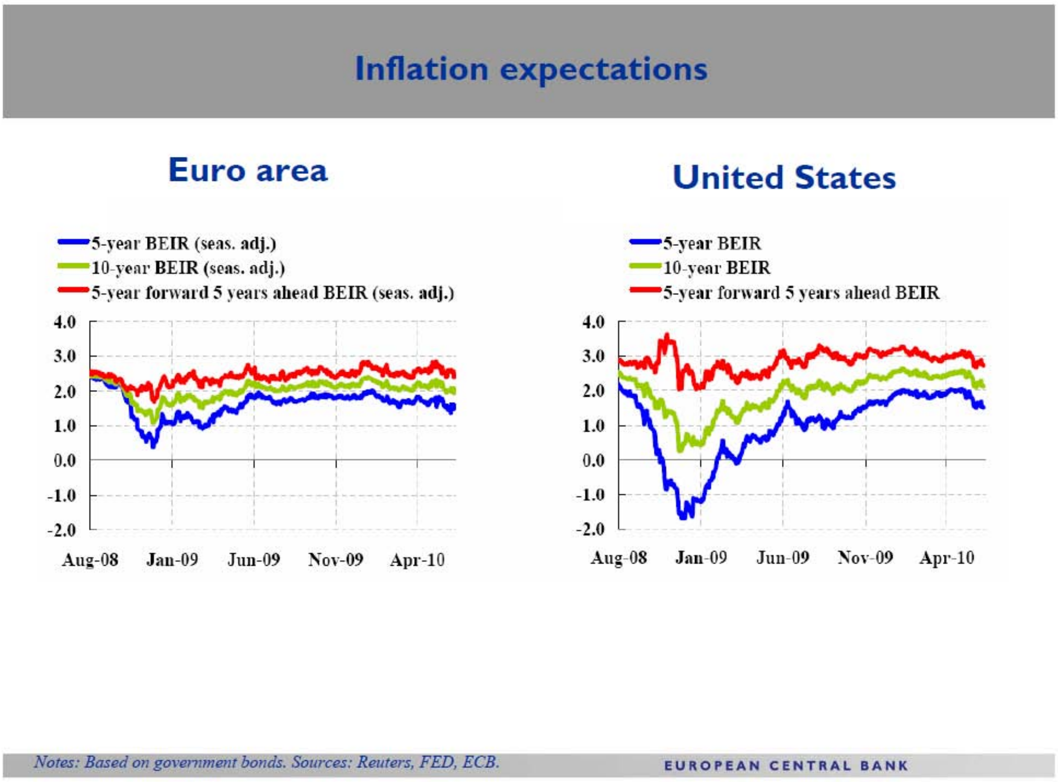


Once enacted and implemented fully, the new measures of fiscal consolidation and financial reform will help foster these sound fundamentals and turn the current cyclical upturn into sustained growth.

The latest signs that we are receiving from the economy are encouraging. Exports are recovering at a steady pace. Industrial production is rising and employment is stabilising. This fundamentally distinguishes the current situation from the situation that we faced last year.

But as I have said, the crisis is not yet over. For the ECB's role as the guardian of the euro, this means, first of all, to remain faithful to its primary mandate of delivering price stability in the medium term, in line with its definition.

In the exceptional financial market circumstances that we are experiencing since 2007 we have decided some non-standard measures to help restoring a more appropriate market functioning and a better transmission of our monetary policy. But our monetary policy stance has always been to deliver price stability and be credible in this delivery with a solid anchoring of inflation expectations. The Securities Markets Programme is fully in line with this approach. The Governing Council is constantly and carefully monitoring all developments and stands ready to do all that is necessary to maintain price stability.



Later today, Jürgen Stark will present the outcome of our enhanced monetary analysis that enlarges our toolkit to pursue this aim.

Beyond our role as guardians of the euro, we also have to deliver on our responsibilities as part of European and global economic governance. In this context, I would like to touch on the work programme of the Van Rompuy Task Force, which was established by the European Council in March 2010 and in which I am participating. Vítor Constâncio and Lorenzo Bini Smaghi will go into greater detail, and I will highlight a few elements of the task ahead.

First, national fiscal reforms – to which I alluded before – need to find an anchor and a collective guarantee in renewed and strengthened institutions for multilateral budgetary surveillance. National fiscal frameworks will receive a blueprint of good practice, which will ensure that commitments to fiscal prudence are internalised first and foremost in the national Parliaments. A new code for statistical reporting will support the legislatures in enforcing their fiscal plans. This will be the first line of defence against the accumulation of fiscal imbalances.

We will have a second line of defence at the level of the EU27, and in particular within the euro area. Here, a more stringent implementation of rules and procedures to check and correct excessive deficits and debts will be essential, among other things by increasing the automaticity and speed of procedural steps. Ultimately, the process needs also to comprise non-pecuniary forms of deterrence. In the most severe cases of persistent non-compliance, a limitation or suspension of voting rights should be considered.

The second area of institutional reform tackles one further aspect of the crisis: the fact that seemingly sound public budgets can sometimes reflect an overheated economy. When rising asset prices boost revenues from financial and housing market transactions, the budget looks sound; but when asset prices fall, the budget can go into profound distress.

So for all its critical importance, reinforced fiscal surveillance is not enough. We need reinforced macroeconomic surveillance. There is one indicator that can reveal underlying weaknesses as they are forming: losses of competitiveness. Within a monetary union, the relative competitiveness of economies measures the sustainability of national price and cost developments, the compatibility of national nominal trends with those that are likely and appropriate for the union as a whole.

The third area of institutional reform will be a crisis management framework. This framework has to respect strict conditionality and minimise moral hazard. It is an issue that has not yet been addressed in the task force itself.

We have a great deal of work to do on these three issues in the months ahead, and I am confident that when bold reforms in these areas are undertaken, we will have achieved the necessary quantum leap in euro area governance.

Thank you for your attention.