Jean-Claude Trichet: How to better protect the euro area against financial instability – Interview in *La Stampa*

Interview with Mr Jean-Claude Trichet, President of the European Central Bank, in *La Stampa*, Italy, conducted by Mr Stefano Lepri, 14 October 2010.

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Mr President, is the crisis of the euro over?

I interpret your question as applying more to financial stability in the euro area than to the euro itself. I do not think there has been a crisis. The euro is the single currency of 330 million people and enjoys a high degree of confidence among investors and savers because it has delivered price stability remarkably well over the last 11½ years. What we had was a situation in which a number of countries had not respected the Stability and Growth Pact. These countries have now engaged in policies of fiscal retrenchment that were overdue. They have to implement vigorously these policies which are decisive for the preservation and consolidation of financial stability in Europe.

But, from now on, the rules must be strengthened.

It was necessary to fully respect the letter and the spirit of the Stability and Growth Pact. We have made that point constantly over the last years. On top of that, the Governing Council of the ECB – with Mario Draghi, the Governor of the Banca d'Italia – calls for a "quantum leap" – a very, very significant improvement – as regards fiscal surveillance inside the euro area. We must also engage in surveillance of monopolies and, in particular, of relative competitiveness and of current account imbalances. To that end, we must exploit the possibility of secondary legislation under the current Treaties to the maximum extent possible.

Even by imposing automatic sanctions? France, Italy and some other countries would prefer not to.

For us, the proposals of the European Commission move in the right direction. But more ambitious reforms are needed. With the benefit of hindsight we know now that it is very important to engage in quasi-automatic sanctions, and with an accelerated procedure, with the countries that break the rules. If we want the euro area to better protect itself against financial instability, room for discretion in applying the rules must be reduced. Sanctions must be possible in the early stages of macroeconomic surveillance.

If this is not a common, it is a collective economic policy. But is it necessary to add a new rule on debt levels? In Italy some are afraid a swift debt reduction – 2.75 points each year in our case, under the current Commission proposals – would be too heavy for the country.

There is already a debt rule in the Maastricht Treaty! And experience demonstrates that it is necessary to enforce it, because excessive debt might trigger instability. A simple calculation shows that, assuming an inflation rate of below 2%, but close to 2%, as in the ECB's definition of price stability, and a reasonable average yearly real GDP growth rate – for instance, slightly over 1% – a balanced budget – which is the "normal" position according to the Stability and Growth Pact – might reduce the debt outstanding as a proportion of GDP by more than 3% each year for a debt level of around 120% of GDP. By the way, the IMF also says a reduction of public debt in a number of advanced economies is urgent.

A balanced budget is the objective of the Stability Pact, but some euro area countries have never even come close. And the IMF, while recommending debt consolidation, admits it will be very painful in the early years.

We must take fully into account the confidence channel. When a country moves in the direction of fiscal soundness, this is not only good for growth from a medium and long-term perspective, but it might also be beneficial for growth in the short term. Because it enhances confidence in segments of the economy that had lost some of their confidence, and that is good for consumption, investment and job creation. People would not engage in more consumption, entrepreneurs would not invest actively, and savers would not be forthcoming if fiscal stability was impaired or threatened.

Other choices could be painful. The Bundesbank President, Axel Weber, some days ago hinted that a rise in interest rates could not be as far away as markets seem to think.

As you know, I never comment on remarks made by fellow members of the Governing Council. What is important, of course, is that there is only one single currency; there is one Governing Council, only one monetary policy decision, and one President, who is also the *porte-parole* of the Governing Council.

At the last ECB press conference, I said very clearly that current interest rates are appropriate. The needle in our compass is price stability – annual inflation of less than 2% but close to 2% – and on this we have a very, very remarkable track record: a yearly average price increase of 1.97% in the 11½ years that the ECB has been in charge of monetary policy. And thanks to this credibility, inflation expectations are extremely well-anchored for the next five and ten years in line with our definition of price stability."

Would you say yourself that the non-standard measure of buying government bonds on the secondary market – designed to support euro area countries in trouble – did not work and so has to be scrapped very soon, as one of your colleagues says?

No! This is not the position of the Governing Council, with an overwhelming majority. This non-standard measure, like all other such measures, was designed to help restore a more normal functioning of our monetary policy transmission mechanism. And we are withdrawing all the liquidity, euro for euro, that is supplied through this programme.

As regards euro area countries in trouble, what is the position of the ECB on what happens when, three years from its inception, the EFSF expires? Can a permanent resolution mechanism be put in its place?

We have said clearly that considerably strengthened fiscal and competitiveness surveillance, as we are calling for, is the appropriate instrument with which to minimise the risk of recurrent fiscal crisis. However, if the risk of debt crisis were to become relevant despite the previous measures, a crisis management framework could be useful. It would have to rely upon very strong policy conditionality and reinforce incentives for pre-emptive fiscal and macroeconomic adjustment.

Some economists think that a too long period of low interest rates can endanger financial stability. It seems that new financial bubbles are growing in the emerging markets. Some politicians, such as Italy's Treasury minister Giulio Tremonti, say speculation is rife again, as strong as ever.

The remarks of Giulio Tremonti are always stimulating. As regards the ECB, we have demonstrated in the past that we are very keen not to embark on policies that would foster volatility and financial instability. The euro area countries can count on the ECB to deliver price stability and to solidly anchor inflation expectations, a necessary condition for financial stability, even if it is not a sufficient condition. I am sure this preoccupation is shared by all the central banks in the world. It is striking to see the extent to which confidence in central banks and in their capacity to deliver stability is important in our democracies. Central banks are, by construction, devoted to stability, they are medium and long term-oriented and they are independent. I think these are some of the reasons why the new systemic risk boards are close to them on both sides of the Atlantic.

In other words, you trust Ben Bernanke will not risk a heavy depreciation of the dollar?

On exchange rates I will say that excess volatility and disorderly movements in exchange rates always have adverse implications for economic and financial stability. And I consider it very important that the US authorities also recently confirmed their long-standing position that a strong dollar vis-à-vis the other major floating currencies is in the interests of the United States.

But cooperation in the G20 is at a very low point. The United States will perhaps create even more liquidity; China refuses a substantial appreciation of the yuan. Between the selfish policies of the two great powers of today, Europe risks the euro becoming too strong.

I responded already on the United States. On the emerging economy currencies, I would say that at the Toronto summit emerging economies agreed to undertake reforms to enhance exchange rate flexibility. It is the case for all of them, including for China, which has confirmed the will to engage in such reforms, as it signalled last June.