Jean-Claude Trichet: Interview in *Politis*

Interview with Mr Jean-Claude Trichet, President of the European Central Bank, in *Politis*, Cyprus, conducted by Mr Demetris Georghiades and published on 29 October 2010.

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Politis: The framework and rules of how the EU and the euro zone work were designed at a time when the economies of member states were more or less on a similar level. Do we need to re-design them? For example you have on one hand matured economies like Germany and on the other hand Romania and Bulgaria that need to invest heavily to improve their infrastructure. Is it "fair" to ask for both to obey the same fiscal deficit rules?

Trichet: No, I don't think that there are major differences between countries from that standpoint. Sound fiscal policies are a necessary condition for sustainable medium and long term growth and job creation. A solid anchoring of fiscal soundness is also essential for the prosperity of future generations, our children and grandchildren. An excessive level of fiscal imbalances puts countries in a situation of vulnerability, where they can be hit by a sharp decline of confidence among firms, households and investors.

Politis: Cyprus prior to the crisis had had a double digit current account deficit (almost reached 18% in 2008). Even during the recession it records a current account deficit of 7–8%. Should this be a major source of concern for Cyprus? Do you think that this might be one of the amendments required to be made in the Stability and Growth Pact – the Maastricht Treaty, adding into the criteria one for the current account deficits?

Trichet: The current account is an important summary indicator of economic developments in a country, with a deficit indicating that the domestic savings are insufficient to finance domestic investments. Large and persistent deficits signal clearly structural underlying domestic imbalances. It also exposes a country to shifts in the availability and conditions of capital inflows and thus creates vulnerability. Therefore it is important to ensure that foreign capital is used to profitable investment, which will bring returns that can be used to repay the country's debt. Current account deficits can also signal losses in international competitiveness of an economy, related in particular to excessive increases of costs including unit labour costs. The experience of many countries highlights the risks associated with such competitiveness losses.

One has to fully understand that in a single currency area which ensures price stability in line with the definition given by the ECB – annual inflation less than two, but close to two percent – it is imperative for each economy belonging to this area to ensure that national increases of wages, of unit labour costs and of prices are broadly in line with the euro area average. This is essential. Otherwise the economy will lose competitiveness, year after year, and will trigger low growth and low employment. This is also true for Cyprus.

Politis: For the Cyprus economy, several organisations (IMF, European Commission etc) list as major threats its big government sector, its current account deficit and the projection for its mid term pension and health costs. With the exception of the first (current fiscal deficit) for the others, the European Commission can only issue warnings. Is the ECB's assessment on the same lines?

Trichet: At the time when Cyprus joined the euro area it featured a relatively sound fiscal position. Now the situation is different: the rapid aging of the population (one of the fastest across EU countries) and the deficit generated via increases in the public wage bill and social transfers pose very serious structural problems. These have to be addressed by means of a strong fiscal consolidation strategy and an important pension reform to ensure the long-term sustainability of the pension system. As you see, the ECB fully shares the diagnosis of the European Commission and of the IMF.

Politis: In your keynote address at the EUROFI Financial Forum 2010 you described the Basel III reform package as a cornerstone intended to put the global financial system on a sounder footing. Some academics call the whole Basel framework an excuse for mainly big banks and countries that do not want really to take the drastic and effective reform measures needed. Can the EU citizens be assured that the new framework (not just Basel III) will prevent a financial crisis of a similar of what we experienced two years ago?

Trichet: On Basel concretely: the agreement reached has two great achievements. First, the end results are tough standards. The required common equity has been increased from 2% to 7%; this is an increase by a factor of 3.5. (For some institutions, having 1% capital, it's 7 times bigger). Second, the agreement is global. It encompasses industrial economies as well as emerging economies.

Overall, I consider that our agreement strikes the right balance between the objective of a very significant strengthening of the resilience of the financial sector while not endangering the progressive consolidation of the recovery, thanks to an appropriate transition period. Also to be noted is that these standards are global minimum standards: national regulators or supervisors can set tougher standards if they deem that appropriate.

On your last point I will say that it is imperative that we make as sure as possible that a new crisis of that dimension would not erupt again. We could avoid a great depression only because governments, in all advanced economies, provided the financial sector with considerable public support. This in my view will not be repeated because our democracies will not mobilize such an amount of tax payers' financial risk taking twice. This is why it is absolutely essential that we make the whole financial system much more resilient, including through the Basel III agreement.

Politis: Some still insist that the banking problems still exist. We have seen Ireland just recently injecting capital into one of its major banks. Are you confident about the soundness of euro zone banks?

Trichet: As you know, a comprehensive stress test exercise, covering 91 EU banks, was finalized in late July. The ECB welcomed this exercise, which was prepared and conducted by the Committee of European Banking Supervisors (CEBS) and national supervisory authorities, in close cooperation with the ECB. This stress-testing exercise was comprehensive and rigorous, and the results confirmed the resilience of EU and euro area banking systems as a whole to severe economic and financial shocks. The stress test has also significantly enhanced transparency regarding the current financial conditions and risk exposures of the 91 institutions that participated in the exercise.

We also welcome the commitment made by national authorities with regard to the provision of support facilities for banks where private sector means are insufficient. Sound balance sheets, effective risk management and transparent, robust business models are key to strengthening banks' resilience to shocks and to ensuring adequate access to finance, thereby laying the foundations for sustainable growth, job creation and financial stability.

Politis: Will the break up of banks into investment banks and traditional banks make the ECB's and other regulators task easier? Will this be beneficial for the whole economy in general?

Trichet: The proposals aiming at affecting the structure of the financial sector, by limiting the scope of activities an institution can undertake, are important contributions to the debate on how to best regulate the banking sector. However, as regard the specific European framework, I believe that introducing a separation between investment and commercial banking would raise a number of complex issues. First, it would be in contradiction with the established model of universal banking, which has historically served well the needs of the European productive sector. Second, it could hinder the smooth provision of financial services in the European Union, thus hampering the objective of further financial integration in the Single Market. Third, in some cases, it might trigger unintended consequences such as

the migration of riskier activities to less regulated and less capitalized areas of the financial system. Hence, the functional separation does not seem the most promising way forward in the European context. Rather, we should focus our efforts on enhancing and enlarging the perimeter of both supervision and, when warranted, regulations to a wider range of potentially riskier activities and institutions.

Politis: It is apparent that the global tendency now is for a more uniform regulatory framework. On a European level we even see steps to move towards euro rather than national regulators. But countries still insist on their own models. In Cyprus we even have two supervising authorities for the banking sector. One for Commercial Banks and one for the Cooperatives. What is the ECB's position on this?

Trichet: The ECB considers that it is up to the member states to decide upon the national supervisory model they wish to adopt whilst fully respecting the necessary level playing field. It is also necessary that the cooperation and coordination between the national authorities, at the level of the EU as a whole, will be exemplary. The new European Supervisory Authorities, recently created and operational as soon as next year, must be fully effective. And the European Systemic Risk Board – which will have the responsibility to identify the systemic risks at the level of the European Union – will be operational next January.

Politis: You visited Cyprus on the occasion of the 6th Euro-Mediterranean seminar, where Eurosystem central banks meet their Mediterranean counterparts. What are the aims and expectations of such a seminar?

Trichet: This forum is one of the major contact points between the Eurosystem and the Mediterranean central banks. After we had initiated it, we were happy to see that the colleague central banks were very keen to participate in a forum which accommodates an open discussion on issues related to central banking. Our major stake, which we all share, is maintaining price stability over the medium and long term. This common stake creates an element of proximity. We are united in purpose, even though we may apply different specific policy measures targeted to our economies.