Benoît Cœuré: Restoring trust in the Economic and Monetary Union

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Forum Eco Libération ESCP "Reprendre confiance en (l')Europe", panel discussion: "L'Euro méfiance, c'est fini?", Paris, 1 December 2012.

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It is a great pleasure to participate in this panel that touches on a topic very close to our hearts at the ECB: trust in our common currency, the euro.[1]

In any society, the monetary contract fundamentally rests on trust, and I will borrow the explanation from my co-panellist, Michel Aglietta: "Money involves trust because it is a debt between society as a whole and each of its members."[2] Remember that credit comes from *credere* and *fiduciary* comes from *fidere*, both verbs meaning to trust in Latin.

As for trust in a central bank, well, that is secured and reaffirmed by permanent assessment of the central bank's performance against its mandate and strategy. Such an assessment has become very complicated as a result of the global financial crisis. Communication about the intentions and policy actions of a central bank has long been focused on its decisions on the level of the short-term interest rate and, in the case of some central banks, on the likely direction of that rate. But in a deep financial crisis this channel of policy interventions and communication becomes less significant. Compared with standard practices, non-standard instruments of policy are arcane tools which are difficult to describe and interpret.

Today I will try to illustrate how the ECB has fulfilled its mandate in an environment in which our traditional instruments have been tested to their limits. As you know, this situation led us – and many other major central banks – to vastly expand our toolkit of policy initiatives. Communication and the accountability of policies involving non-standard measures need to be intensified during a crisis such as the current one. In this vein, I will explain how to interpret the latest decision to conduct outright monetary transactions (OMTs) in secondary markets for sovereign bonds. I will conclude with some remarks on the democratic accountability of the central bank in these testing conditions.

Mandate and strategy of the central bank

A central bank receives legitimacy when it is assigned a clear mandate by the people in its jurisdiction. A mandate is a simple statement of duty. The Treaty on the Functioning of the European Union, for example, assigns the ECB the pursuit of a "primary objective of price stability over the medium term". This formulation establishes – at nothing less than international Treaty level – a hierarchy of priorities. First, the ECB has to ensure that price stability is accomplished over the medium term. Price stability is, by the way, the most important contribution that monetary policy can make to achieving high levels of economic activity and employment. Then, and provided that precedence is respected, the ECB can support the economic policies of the EU on a broader scale. The legal formulation of the Treaty is an abstract determination of priorities. To define the objective precisely and establish a relationship between the objective and the policy – consistently conducted and communicated – a strategy is needed.

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[1] I wish to thank Tobias Linzert, Stefano Nardelli, Massimo Rostagno and Arthur Saint-Guilhem for their contribution to this speech. I remain solely responsible for the opinions contained herein.

[2] Michel Aglietta: "Money: a matter of credit and trust", Journées internationales d'économie monétaire et bancaire, Lyon, 6–7 juin 2002.

The strategy of the ECB makes the Treaty mandate more precise in three respects. First, it provides a quantitative definition of "price stability" by indicating a range for year-on-year changes in the harmonised index of consumer prices which the ECB considers consistent with conditions of stable prices. That does not necessarily mean zero inflation. The price stability range that the ECB considers equivalent to "stable prices" covers positive inflation rates lower than 2%.

Second, the strategy identifies, within that range, inflation levels which the Governing Council of the ECB aims for, in its monthly policy decision. We aim at inflation rates that are below, but close to, 2%. In the identification of its policy orientation, the ECB bears in mind that an inflation rate too close to zero restrains the conduct of policy in deep recessions and it also filters out a host of factors that distort the measurement of the policy-relevant drift in prices.[3]

Third, the strategy describes and structures a host of economic and monetary variables which can signal risks to price stability before they materialise. This set includes important monetary and financial variables which influence the way monetary policy intentions are transmitted to price-setting decisions in the medium term.

As I said, the strategy turns the Treaty assignment into an action plan which, if I may borrow from performance management jargon, I would call S.M.A.R.T. — Specific, Measurable, Attainable, Relevant and Timely.

Let me focus on the "M" and "A". The action plan is measurable, and we can assess the ECB's progress towards that goal by looking at its record. Prices since the start of the euro have indeed been stable and in line with our definition. The average inflation rate over the past 13 years has been slightly higher than 2%.[4] The goal was *attainable* and it was attained.

Monetary policy and lack of trust in the integrity of the euro area

Over the summer the price of bonds issued by some governments in the euro area fell on concerns that investors' claims could be discharged by the issuer in a currency other than the euro, the currency of denomination.

The prospect of a disintegrating monetary union is harmful for both weak and strong member countries. Weak economies experience a currency run, which in the single financial space of a monetary union translates into two phenomena: loss of value for any liability issued by domestic borrowers – including the sovereign – and a depleting deposit base for domestic banks. Here, the scramble for liquidity and the flight from bank liabilities act as a powerful shock on domestic money demand. This is a money demand shock of the worst possible kind, one which shrinks the money multiplier and puts downward pressures on domestic consumer prices. At the same time, countries perceived as safe havens are the target of significant capital inflows, which mainly take place via cross-border bank transfers. In these receiving countries, the monetary base expands. But in order to induce local depositors to hold the excess cash which they are receiving, the expected return on all the competing assets has to fall. This means that the prices of a wide range of securities and of real capital are bid up on impact. Asset price inflation looms.

What is the role of the central bank which finds itself in the middle of these panic transactions?

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[3] Monetary policy should offset the genuine drift in the nominal scale of the economy, which measures the progressive loss of purchasing power of the currency. It should not resist increases in prices that reflect the rising quality of the goods and services included in the consumer basket, or equilibrium adjustments in the price level of economies in a catching-up phase, the so-called "Balassa-Samuelson effect".

[4] Annual rate of change of HICP (overall index, monthly data, and source: Eurostat). The average is 2.06% between January 1999 and October 2012.

Integrity and financial cohesion are, jointly, an absolute pre-condition for the Treaty objective of price stability to be and to remain a *measurable* objective for which the ECB can be held accountable, and in that sense, they are undoubtedly part of its mandate. The mere prospect of a reversible currency area – for all or some of its members – makes the geographical domain for measurement undefined. In addition, and worse, it debases the unit of account function of the euro, not only for a subset of members, but for all of them.

Furthermore, the stability of the financial system is a pre-condition for the strategy of the ECB to remain a meaningful guide for action. If price discovery in financial markets is perturbed, the chain of asset price changes which monetary policy depends upon to transmit its impulse to the economy becomes dysfunctional and unpredictable. As a consequence, the single objective of price stability becomes un *attainable*.

It is against this background that in the summer the ECB took two decisions. First, to restore the conditions for our S.M.A.R.T. strategy to be applicable as a concrete guide for monetary policy. Second, to combat the cause of the disease, not its symptoms, but within the precise confines of our mandate. According to our diagnosis, the cause was the pricing of a catastrophic event – exit from the euro – into governments' debt valuations. The symptom was – once more – an acute liquidity crisis for banks.

The framework of the outright monetary transactions (OMTs) is now well known. Here, I'll limit my remarks to one specific aspect of this new policy initiative, which we announced in early August. It's the fact that this initiative is entirely in the tradition of our non-standard monetary policy instruments. Let me explain.

Broadly speaking, there are two approaches to non-standard monetary policy. The first one can be referred to as "quantitative easing". It focuses on the importance of portfolio balance channels in the transmission mechanism. In essence, it aims to inject further stimulus in a situation in which the policy rate is constrained by its lower bound.[5]

Under the second approach to non-standard policies, a central bank does not aim to withdraw duration risk from the economy. It relies on the market-functioning channel and aims to reduce the spread between the yield paid by risky securities or standard loan contracts and risk-free securities with the same maturity. It does not necessarily aim to inject additional stimulus in lower-bound conditions, but to repair a breakdown in asset pricing and in the functioning of the credit market.

So far, the ECB has consistently adopted the second approach to non-standard policies. In the early phase of the crisis, we re-absorbed the liquidity risk and the market counterparty risk that banks were facing in interbank transactions. In keeping with this second approach, the aim was to repair the functioning of the market, not to add stimulus in a situation in which the policy rate was still positive.

OMTs, as their name suggests, will operate through outright transactions, not lending operations. But, in essence, they have the same purpose as the non-standard measures we adopted in 2008 and 2009: to price out a type of catastrophic risk premium that investors demand in conditions of market paralysis. It was break *down* risk in the early stage of the crisis, the risk that the payments system would seize up completely. It is break- *up* risk now.

5 The policy intervention works by reducing the supply of long-duration securities considered as risk-free and increasing the supply of zero-duration reserves. To the extent that private investors do not view these assets as perfect substitutes, in order for private investors to be willing to make those portfolio adjustments, the expected return on the long-duration securities has to fall. With less duration risk to hold in the aggregate, the market should require a lower premium to hold that risk. To the extent that the pricing of long-dated risk-free securities provides a floor for the pricing of any other types of long-dated securities, this operation is expansionary as it lowers the whole yield structure.

There is another parallel between our early liquidity operations with banks and OMTs. In providing liquidity to our banking counterparties, we cannot and do not want to subsidise banks that are failing. Our liquidity support is not and should not be equity support. Likewise, in pricing out the break-up risk in sovereign debt securities, we cannot and do not want to subsidise governments. Our interventions can only take place in the secondary market: they are not fiscal transfers and adequate safeguards are attached so that they do not become so.

While banks are subject to solvency regulations, governments – because of sovereign immunity – are not. So, we need a supranational structure which guarantees that government solvency – fiscal sustainability and macroeconomic viability – is in place and sufficiently constrains national policies. This is why we need programme conditionality and multilateral surveillance as a precondition to initiate OMTs. Without successful policy reforms, there will be no OMTs.

On the issue of possible inflation risks stemming from OMTs, let me assure you that, from a pure liquidity perspective, OMTs will not inject one euro more into the economy. All possible purchases will be fully sterilised through the absorption of the additional liquidity elsewhere.

How should the ECB be held accountable?

Before I conclude, let me briefly turn to the issue of accountability, which – as I said in my introduction – is essential to secure and reaffirm trust in the central bank. For the ECB, accountability to the people of Europe is not only a matter of good accountability practices. It is important for the central bank of a currency union to reach out to the whole euro area, to people in all parts of Europe and to spread trust in our currency, our institution and our policies.

As I mentioned, the ECB is accountable to the people of the European Union and – as that Union is a representative democracy – to the European Parliament, which is the only European institution elected by popular vote. Our President regularly visits Parliament to report on and explain the ECB's policies. The Governors of the national central banks in the Eurosystem have similar hearings before their national parliaments.

In addition, we have a continuous dialogue with all relevant institutions involved in the European political process, such as the European Commission, and we have regular exchanges with the finance ministries of the euro area Member States. We also regularly report on and publish our monetary policy decisions. This panel today is one such occasion. Especially in times of crisis, when policies become less conventional and more complex, it is all the more important to carefully explain our decisions. We do this, but – I also realise – we could do better: we have to steadily adapt our communication channels and satisfy the increased demand for clear and timely information in the unconventional times we are passing through. It is also clear to us that any additional task entrusted to the ECB (such as banking supervision, currently under discussion) must be matched by additional reporting and accountability channels.

Looking ahead: completing the architecture of EMU

Let me conclude. The euro deserves trust – and trust in the euro as a currency depends on trust in the euro as a project. The ECB, with the legitimacy provided by the fulfilment of its mandate, will do everything within this mandate to ensure price stability in the euro area and therefore trust in the euro as a currency. But trust in the euro as a project relies on a more complex framework and structures.

In a recent article,[6] the German philosopher Jürgen Habermas and his co-authors argue that a rallying cry of the American War of Independence – "No taxation without representation" – has a new and unexpected resonance in today's Europe. Once we create scope in the euro area for policies that result in redistributive effects across national boundaries – they write – European legislators who represent the people must be able to decide and vote on these policies. I tend to sympathise with this view.

European leaders have a great opportunity to rectify the now apparent failings of EMU's institutional structures. In particular, the financial market architecture must be at the centre of our discussions on the future of EMU.

The intellectual foundation of the monetary union is Robert Mundell's insight that exchange rate stability, financial integration and national monetary policies are incompatible objectives: a concept that has been called "Mundell's trilemma", or the "impossible trinity". We now find ourselves bound by a concept that Dirk Schoenmaker has called the "financial trilemma":[7] namely, that pursuing simultaneously financial stability, financial integration and national financial policies is unfeasible. Any two of the three assignments can be combined, but not all three. In this crisis, financial integration in the euro area but national responsibility for financial policies has resulted in financial instability. We can solve this trilemma either by going back to financial markets delimited by national borders or by passing financial and crisis management policies to the euro area level. The latter is the only viable solution. It is the most conducive to economic growth, as it will help European companies and households reap the benefits of a single financial market based on a deep pool of savings.

Some institutional reforms have already been undertaken. They represent a great step forward. We have made national fiscal policies more responsible under the Fiscal Compact, and subject to stronger surveillance. We have created a permanent solidarity framework – the European Stability Mechanism. It can provide financial assistance to Member States in difficulty, thereby reducing threats to financial stability in the euro area as a whole.

But we need continuous efforts, particularly in the area of financial policies. The "Four Presidents" of the EU were mandated to provide a vision for Europe. In the context of our discussion today, I would say that they were tasked with identifying and outlining *the minimum conditions to ensure the full viability of the euro area* – which are the same as the minimum conditions to ensure continued trust in the euro.

Four pillars have been identified: a banking union with a single supervision and common resolution framework; a fiscal union to prevent and correct unsustainable fiscal paths; an economic union that can guarantee sufficient competitiveness to sustain high employment; and a political union that can deeply engage euro area citizens.

As I discussed accountability, let me say a word on the last pillar, political union. I think that the general issue here is to clarify who does what, to establish a network of responsibilities. The notion that the euro is a currency without a state is in my view misguided. The euro is a currency with a state – but it's a state whose branches of government are not yet clearly defined. The ECB is part of the construction of Economic and Monetary Union, with a very clear but very limited mandate. The other parts – I am thinking in particular of the delineation between the Commission and the Council – still require clarification. The proposal put forward by Jean-Claude Trichet of a "euro area Treasury" would be an important step in that direction. The ECB is independent and fully accountable, but it needs clearly identifiable and fully empowered interlocutors.

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[6] Peter Bofinger, Jürgen Habermas and Julian Nida-Rümelin: "Einspruch gegen die Fassadendemokratie", Frankfurter Allgemeine Zeitung, 3 August 2012.

[7] Dirk Schoenmaker (2011): "The Financial Trilemma", Economic Letters 111 (2011) 57–59.

We all have in mind Robert Schumann's prediction that "*Europe will be built through concrete achievements which first create a de facto solidarity*". Now that the euro area crisis has created de facto solidarity, there is a need for concrete achievements to complete EMU. This, together with the individual commitment of each government to restore balanced growth and employment, is a necessary condition for lasting stability.

I thank you for your attention.