The Stamp Memorial lecture

The euro, its central bank and economic governance

Jean-Claude Trichet
President of the ECB

London School of Economics and Political Science
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Ladies and Gentlemen,

It is a great honour for me to speak here at the London School of Economics and Political Science today.

The euro and its central bank, the ECB, are unique. The European single currency is the only major currency not issued by a single sovereign state, but by a union of sovereign states.

Indeed, the European Treaties specify a clear division of responsibilities between European-level policy-making and national policy-making. For countries that have adopted the euro as their currency, this implies that, on the one hand, monetary policy is inherently indivisible, and in the euro area it is thus conducted at the supranational level by the ECB. On the other hand, fiscal policies remain largely the competence of national governments.

In this lecture I would like to explore how the unique institutional framework of Economic and Monetary Union (EMU) in Europe has fared over the past 12 years and particularly during the global financial crisis.

As you will be aware, the primary objective of the European System of Central Banks is to maintain price stability in the euro area. In the first part of my lecture I will show how the ECB achieved this primary objective before, during and after the crisis. I will also try to convince you that the economic performance of the euro area as a whole has been quite remarkable over the past twelve and a half years.

At the same time, we have to recognise that several individual countries in the euro area are facing significant challenges and that experiences during the crisis in different parts of the euro area have been quite diverse. In the second part of my lecture, I will address the issue of economic diversity in the euro area and show that the euro area shares this characteristic with the United States – an economy and a currency area that is a natural reference point taking into account its size.

Finally, the crisis has exposed weaknesses in the economic governance framework of EMU that need to be addressed urgently. I will close my lecture with some comments about what these reforms of the economic governance framework should look like from the perspective of the ECB.

The ECB's primary objective: Price stability in the euro area before and after the crisis

I can say today that the ECB has fulfilled its primary objective to the letter. As you know, the ECB aims at inflation rates of below, but close to, 2% over the medium term. Annual inflation over the first 12 years of EMU has been 1.97% on average. A precision landing.

More generally, the degree of price stability has been greater, over the past 12 years, in the euro area as a whole than in the individual euro area countries over the previous 50 years.

This is no small achievement. The ECB has faced many challenges in pursuing its objective: the bursting of the dot-com bubble, the shock wave of 11 September 2001, the volatility of commodity prices and, of course, the worst financial crisis the world has known since the Second World War.

During the crisis, together with other central banks around the world, the ECB has had to operate in an uncertain environment. Allow me to explain our monetary policy response to the crisis in more detail.

Crucially, we were alert from the very first day. We were one of the first central banks to react, when the financial markets became abruptly turbulent, in August 2007, taking action swiftly.

Dysfunctional financial markets threatened to compromise our ability to guide the outlook for price stability by using only our conventional instrument – interest rates. Faced with this situation, over the years that followed, we have implemented a number of unconventional measures to ensure that our decisions on interest rates are transmitted to the whole economy, despite the problems observed in the financial sector and capital markets. In particular, the major task was to allow banks – regardless of the level of the key interest rate which was designed to deliver price stability – to continue to lend to households and businesses.

[See figure on non-standard measures]

It is important to understand that we maintained a principle of strict separation between our conventional measures and our unconventional measures. Our interest rates are set so that we can ensure price stability over the medium term. The implementation of unconventional measures depends on the functioning of the monetary policy transmission mechanism and is intended to repair disruptions of monetary and financial markets and of specific market segments that might impede the overall transmission.

As the crisis called for rapid and unprecedented action, we did not lose sight of our main objective, namely to maintain price stability over the medium term for the benefit of the 331 million citizens of the euro area. All – I stress that word – all monetary policy decisions we have taken over the last 12½ years were aimed at fulfilling this commitment.

Let me elaborate on this point. As you know, in normal times, central banks mainly influence the economy and inflation by using the instrument for setting short-term interest rates.

In practice, the identification, at an early stage, of the risks to price stability is a delicate task. To see it through, the ECB bases itself on a monetary policy strategy supported by several sources of information. The economic analysis we undertake enables us to synthesise information on short-term inflationary pressures from a large number of economic indicators. Thanks to the monetary analysis that we also undertake, we can cross-check this information with medium-term inflationary pressures drawn from the monetary and financial indicators. These are the two "pillars" of our monetary policy, which indicate to us the necessary steps in respect of the interest rate to ensure price stability over the medium term.

The measures we have taken, sometimes in the face of political pressures have demonstrated our determination to stick to our mandate in full independence. We refused to lower interest rates in early 2004 when Germany, France and Italy in particular asked us to do so. And we did not hesitate to raise interest rates in December 2005, a time when 10 governments out of 12 in the euro area, plus many international observers, asked the ECB to leave its key rates unchanged.

International financial institutions, in particular, highlighted the risks that the tightening of monetary policy – after a prolonged period of accommodative monetary policy – could pose to the recovery. Despite these warnings, we conducted our monetary tightening, and international financial institutions, with the benefit of hindsight, have agreed that we were right to make that decision.

After the crisis escalated in mid-September 2008, while inflationary pressures subsided, we decided, in full accordance with our mandate, to reduce our key interest rate. We cut it rapidly, from 4.25% in October 2008 to 1% in May 2009.

We lowered the key interest rate at a pace and to a level unprecedented in the recent history of the euro area countries.

[See figure on monetary policy decisions]

With the benefit of hindsight, the decisions we took during the crisis were, I think, vindicated. They have in particular helped to preserve a very solid anchoring of inflation expectations over the past four years. Our determination to maintain price stability over the medium term has enabled us to prevent both the risk of inflation and of deflation from materialising.

With the recovery now more firmly established, we have seen in recent months upside risks to the outlook for price stability over the medium term. Again, the sharp increase in oil and other commodities has had a major impact on overall inflation. In these circumstances, the central bank must prevent increases in the prices of raw materials from being incorporated into the long-term inflation expectations, which could trigger second-round effects on wages and prices.

It is against this background that the Governing Council decided in April to raise interest rates. I stressed, in reporting this decision, that it had been taken unanimously. The action of the Governing Council is motivated by a common goal.

That decision in April confirmed that the separation principle is strictly applied and that our non-conventional measures do not restrict in any way our ability to toughen the monetary policy stance when facing inflationary pressures. Thus, when the Governing Council decided in April that it was time to raise interest rates, in parallel, at the same time, it decided to keep, in the second quarter, the provision of unlimited fixed-rate liquidity for a period of three months.

Contributing to economic performance

Price stability is the best contribution that central banks can make to sustainable economic growth and job creation. I think there is widespread agreement on this among central bankers and academic researchers.

In the short run, however, some academic research suggests that there might be a significant trade-off between low inflation volatility and low output volatility. If prices are stable, economic adjustment has to occur through the real economy channel. It may therefore be difficult to achieve these two goals at the same time.

The chart shows that the euro area scores relatively well on both dimensions. This is puzzling, given that the euro area has quite rigid product and labour markets, at least compared with the United States. The higher degree of price and wage rigidity in the euro area would suggest that output volatility should be significantly larger in the euro area than in the more flexible US economy.

[See macro volatility chart]

This would be particularly true during a period when the economy is subject to supply-side shocks, which are simultaneously exerting inflationary and recessionary influences. Yet surprisingly, and despite the negative supply-side shocks that had been hitting the euro area economy over the years up to 2007, the data suggested that both inflation volatility and output volatility in the euro area were lower than elsewhere.

Output volatility in the euro area is much higher when the crisis is included in the sample. But, remarkably, the euro area still scores well on both dimensions compared with other advanced countries.

How can we explain this puzzle? How can nominal rigidities plus supply-side pressures not produce bad or worse macroeconomic outcomes?

I believe that the strong anchoring of inflation expectations in the euro area is the key to understanding this good economic performance of the euro area.

[See the two charts on inflation expectations in the euro area and the US]

Inflation expectations have remained solidly anchored in line with our definition of price stability throughout the crisis. In particular, there was no materialisation of a deflation risk. This has enormously facilitated our task, especially during the period of economic freefall in the winter of 2008/09.

Other indicators corroborate the finding that at the aggregate level the real economy of the euro has proved relatively dynamic in comparison with the US: real output per capita has grown at a similar pace in the euro area as in the United States.

[See chart on GDP per capita growth in the euro area and the US]

Employment growth in the euro area has also been strong over the past 12 years. More than 14 million jobs have been created since the introduction of the euro, compared with 8 million in the United States.

This is not to suggest that there is time for complacency. Unemployment at 9.9% of the labour force remains much too high, and structural reforms are of the essence to make the euro area economy much more flexible and to elevate its growth potential.

Finally, public finances in the euro area as a whole are relatively sound. As elsewhere, the financial crisis has left its mark on government deficit and debt in the euro area. Yet, the fiscal deficit in the euro area on aggregate for this year is estimated at less than one half of that in the United States and Japan.

One may argue, however that this bird’s eye view is misleading. One common belief is that the US economy is more homogeneous than the economy of the euro area. In other words, aggregate economic data may hide very significant differences in the variance in economic performance across regions within a monetary union.

Economic diversity in the euro area and the United States

Looking more closely at the regional dispersion across US regions and euro area economies show that, contrary to what is generally perceived, the dispersion of many of the key indicators is similar.

Let us take a look at the inflation indicator. The dispersion of HICP inflation in euro area countries remained broadly stable since the late 1990s, at a level similar to the 14 US Metropolitan Statistical Areas. During the crisis we saw a temporary increase in inflation dispersion in the euro area. As you can see, this has been reversed over the past 12 months.

[See figure on dispersion of annual inflation]

The picture is similar for the dispersion of GDP growth. Before the crisis the dispersion of growth rates was around 2%, in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns overall. [1]

[See figure on dispersion of real GDP growth]

Let us go one step further and investigate the sources of this growth dispersion in the US and euro area economies. This reveals parallels even in the root causes of dispersion in economic performance. Both currency areas comprise regions that experienced a significant boom and bust cycle over the past decade. Both also contain regions that are facing significant structural challenges of a more long-term nature.

Nevada, Arizona, Florida and California in the United States, for example, experienced increases in house prices that outpaced the national average by a wide margin. Steep house price increases and the related strong performance of real estate, construction and financial services probably contributed to above average growth in these states.

Some other US states, particularly the former manufacturing powerhouses in the "Great Lakes" region, saw a long episode of below average growth at the same time. Below average performance of the region – and particularly weaker growth rates in the states of Michigan and Ohio – are related to strong reliance on manufacturing. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP, with implications for areas with a high concentration of companies in manufacturing industries other than information and communications technology.

The sharp fall in house prices in Florida and the south-western US states turned boom into bust. These states experienced the harshest recession among the US states. But GDP growth in the "Great Lakes" region, which was below average before the crisis, also remained below average during the crisis.

Some euro area countries experienced asymmetric boom-and-bust cycles similar to those just described in the United States. Several euro area countries had higher than average growth in the pre-crisis years, while a few have experienced growth below the euro area average for the past decade due to structural issues that could have been tackled with more determination.

The effect of the crisis on the different euro area economies follows a similar pattern to those of comparable US states. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. More specifically, Ireland and Greece, in particular, remained in recession in 2010.

Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis.

Just a few years ago, Germany was – entirely wrongly – labelled the “sick man of Europe”. Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

The relatively low growth rates in some countries are linked to a deterioration of competitiveness, driven, for example, by persistent above average unit labour costs.

Ahead of EMU, unit labour costs converged in the euro area. What is more – disregarding the most recent countries to join the euro area – dispersion both ahead of the crisis and during the crisis was very similar in the euro area and the United States.

[See figure on dispersion of ULC]

At the same time, it is worth noting that both currency areas include regions with persistently above or below average growth of unit labour costs. Again leaving aside the most recent countries to join the euro area, here, Greece, Portugal and Ireland, in particular, have lost competitiveness vis-à-vis their main trading partners in the euro area. Germany, in contrast, has been able to lower relative unit labour costs over the same period.

[See fan chart on dispersion of ULC in EA]

Similar persistent losses and gains in competitiveness are also observed in the United States. Some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states, on the other hand, have been gaining competitiveness vis-à-vis the national average over the past decade.

[See fan chart on dispersion of ULC in the US]

In summary, these results suggest that those who are questioning the viability of the euro area as a single currency area on the grounds of economic heterogeneity are misguided. Over the past 12 years, this has been broadly similar in the euro area and the United States.

This should, however, be no reason for any complacency in the euro area.

As the crisis has taught us, persistent losses in competitiveness on the part of individual members in a currency union lead to a build-up of external and internal imbalances. When these unravel, the cost for the affected economies can be very large. They can also have spillover effects on other members of the currency union.

In any union, an economic governance framework is needed to prevent developments in an individual member state endangering the smooth functioning of the union. But for EMU, the economic governance framework devised in the 1990s has not been implemented and, in any case, has proved too weak during the crisis. The crisis has exposed a clear need for strong reform. As I speak today the reform debate is still in progress, and in the last part of my lecture, I would like to talk briefly about the present reform of economic governance in the euro area.

Economic governance in the euro area

The existing economic governance framework has been incorrectly implemented and, more importantly, has proved to be insufficiently binding while lacking appropriate comprehensiveness.

Today’s reform of the governance framework has to take the current constitutional framework. We have to accept this situation as a given, at least for the foreseeable future, even if I am convinced that we have already to reflect upon further steps for economic governance in the longer term. Today, we have to empower the institutional arrangements that are already in place to the point at which they can really and durably inspire confidence.

The requirements for a very significant reinforcement of the fiscal surveillance of the Stability and Growth Pact and for the creation of a new surveillance of competitive indicators and macroeconomic policy have been discussed widely and in much detail.

As you may know, the ECB takes the strong view that there is the need for more speed and automaticity in the sanctioning mechanism, particularly in the Stability and Growth Pact, but also in the broader macroeconomic policy surveillance framework. The experience of the past months has vividly demonstrated the importance of a timely correction of internal and external imbalances.

Beyond faster and more automatic sanctions, the enforcement tools also need to be more effective. The macroeconomic surveillance framework, in particular, needs to provide clear incentives by imposing financial sanctions at an early stage. This also means that there should be no room for discretion in the implementation of the surveillance framework.

At the same time, requirements for fiscal and other macroeconomic policies should be more ambitious. To ensure that none of the euro area countries are left behind, they have to bring national policies in line with membership of a currency union.

The implementation of sound fiscal and macroeconomic policies is best ensured if these are solidly anchored at the national level. An effective way of achieving this is to implement strong national budgetary frameworks in the euro area Member States.

[See figure on governance reforms]

Another important area of reform, at the global level, is the reform of financial governance.

I have to say that on financial reform we have made relatively rapid progress at the global and European levels. As you know, we have drawn up a set of more stringent banking regulations, more ambitious capital requirements to absorb losses, improving coverage and reducing the risk of excessive borrowing. The countercyclical capital buffers are designed to reduce pro-cyclicality.

At the same time, the supervision of financial institutions, financial markets and market infrastructure has been tightened, and the organisational structure of financial oversight has been overhauled. The European Systemic Risk Board (ESRB), which I chair together with Mervyn King, and the European Supervisory Authorities (ESAs) – the three new authorities created for the European banking sector, insurance and occupational pensions, and capital markets – have taken up their work at the beginning of this year. The ESRB is in the process of developing the tools necessary to warn and, if appropriate, make recommendations as regards systemic risk. And the ESAs will allow closer monitoring of the interrelationships within the EU's financial system.

But much remains to be done. Most importantly, we need to ensure the full implementation of the envisioned reforms. In addition, key areas where work is still in progress – not only at the European, but also at global level – include: the treatment of systemically important financial institutions; the mechanism of bank crisis management and resolution; oversight of the shadow banking system; and – very importantly – the further regulation and oversight of financial markets and their functioning.

[See figure on financial reforms]

Conclusion

Let me conclude. Europe's European Union on the one hand and European Economic and Monetary Union on the other hand have always had their critics. For example, as regards EMU, some have argued that a single currency was inappropriate for a continent that is economically more heterogeneous than the United States. And some have claimed that the ECB would not be able to set appropriate interest rates for the euro area to maintain price stability and contribute a positive economic outlook.

The evidence I have presented here proves these sceptical views not confirmed. The euro area as a whole has witnessed an unprecedented degree of price stability since its inception more than 12 years ago, including during the crisis. This achievement has been accompanied by economic performance in terms of growth per capita and job creation that compares positively with other large advanced economies.

It is also remarkable that there is convincing evidence that the euro area and the United States have similar features in terms of diversity of the economies that are part of these vast continents: member countries on this side of the Atlantic and the States on the other side.

This is documented, in particular, as regards asymmetric inflation, asymmetric growth developments and even in terms of somewhat persistent asymmetric gains and losses of competitiveness.

As I have said, none of this should make us complacent. The sovereign debt crises in three smaller euro area countries underline the urgency of a far-reaching overhaul of the fiscal and macroeconomic surveillance institutions in Europe. Here the governments of the Member States are called on to create the institutions that are commensurate with full economic and monetary union.

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[1] The 2010 data for US regions are provisional estimates published by the Bureau of Economic Analysis on 7 June 2011.