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Insight INVESTMENT

GLOBAL MACRO RESEARCH

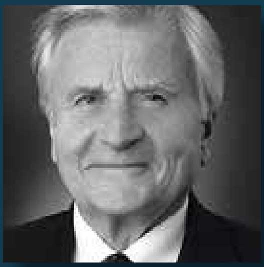
AN INTERVIEW WITH FORMER ECB PRESIDENT JEAN-CLAUDE TRICHET

MAY 2022

GLOBAL MACRO RESEARCH

BNY MELLON | INVESTMENT MANAGEMENT

JEAN-CLAUDE TRICHET



Honorary Chairman of the Board of Directors at Bruegel Institute, European Chairman of the Trilateral Commission and Honorary Chairman of the Group of Thirty

He currently chairs the Eminent Persons Group, advising on the establishment of the International Sustainability Standards Board. Jean-Claude was Bruegel's chairman from 2012 to 2020 and was a member of the Eminent Persons Group on Global Financial Governance (EPG), set up in 2017 by the G20 Finance Ministers and Governors. Jean-Claude was President of the European Central Bank from 2003 to 2011 and Chair of the European Systemic Risk Board from 2010 to 2011. Beforehand he was Governor of the Banque de France (1993-2003) and Under-Secretary at the French Treasury (1987-93). He was Chairman of the Paris Club (1985-93), Chairman of the European Monetary Committee (1992-93), Chairman of the Group of Ten Central Bank Governors, and President of the Global Economy Meeting in Basel (2002-11). He was named 'Person of the Year' by the Financial Times in 2007 and was ranked the fifth most powerful person in the world by Newsweek in 2008.

ADRIAN GREY

Global Chief Investment Officer, Member of the Insight Board and Executive Management Committee

Adrian joined Insight in April 2003 as Head of European Fixed Income following the acquisition of Rothschild Asset Management Limited (RAM). In September 2003, he was appointed Deputy Head of Fixed Income and in 2005 became Head of Fixed Income. Adrian joined the Executive Management Committee in October 2012 and in 2016, he became Chief Investment Officer – Active Management. In September 2018, Adrian took on his current role as Global Chief Investment Officer responsible for the oversight of the firm's investment management teams. Before joining Insight, he was a Director in the Fixed Income Team at RAM focusing on European research and global portfolios. Prior to joining RAM in 1994, he spent four years working in bond sales for UBS Phillips & Drew and three years managing international bond portfolios at ARCA, Milan. He has a BA honours degree in Economics and Politics from Warwick University and an MA in International Economics and International Relations from Johns Hopkins University in the US.

The world stands at a pivotal moment – inflation is soaring, and the US Federal Reserve (Fed) has embarked on what is expected to be the most aggressive tightening cycle in decades. With the outlook for global interest rates rapidly evolving, Insight's Global Chief Investment Officer, Adrian Grey, speaks to former President of the European Central Bank (ECB), Jean-Claude Trichet. A veteran central banker, Mr Trichet was the last ECB president to raise interest rates in 2011 and has more recently been working on new global sustainability disclosure standards.

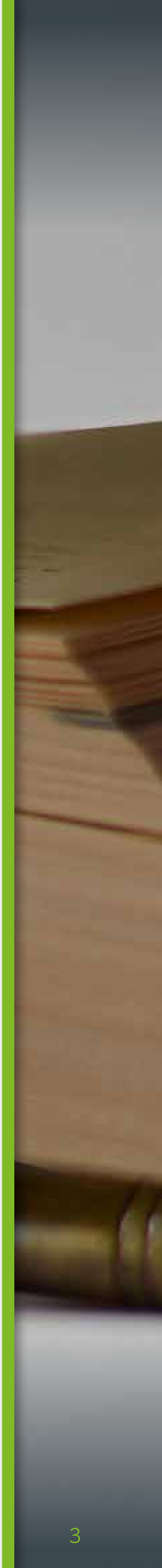
INTERNATIONAL STANDARDS ON SUSTAINABILITY-RELATED DISCLOSURES

Adrian Grey: Before we discuss monetary policy, could you tell us more about your most recent role, as head of the advisory group on setting up a global board for sustainability-related company disclosures?

Jean-Claude Trichet: I was asked by the IFRS[1] Foundation whether I could chair an international group to help them navigate how to create a new global standard-setting board for sustainability-related disclosures. We put together this 'eminent persons' group, which included Sheila Bair, former chair of the US Federal Deposit Insurance Corporation; Guillermo Ortiz, former governor of the Bank of Mexico; Min Zhu, former deputy managing director of the IMF; and Nandan Nilekani, founder and chair of Infosys.

When I was asked to help on this initiative, I was at first quite sceptical. The idea that we could help set up a global consensus to create a new international body with global reach and the ambition to redefine a number of sustainable standards at a global level seemed like a dream. But at the UN Climate Change Conference in Glasgow, the dream became a reality. A consensus was reached, and the new International Sustainability Standards Board, or ISSB, was announced. The hard work is only just starting. A draft of the general requirements for the disclosure of sustainability-related information has been published, and the global business and financial community have been asked for their comments, with the deadline the end of July this year[2].

I am still cautious, and we will see how things develop, but I believe the setting up of this new board is very important event.



[1] IFRS: International Financial Reporting Standards.
[2] To read the draft and submit comments see: https://www.ifrs.org/projects/work-plan/general-sustainability-related-disclosures/exposure-draft-and-comment-letters/

AN INCREDIBLE ACCUMULATION OF DEBT LEAVES THE WORLD VULNERABLE TO HIGHER RATES

Adrian Grey: You have vast experience as governor of the Bank of France and then president of the ECB, and you've had to make major monetary policy decisions through a range of economic cycles. What are your thoughts on where we stand today?

Jean-Claude Trichet: Unfortunately, I think we are in a particularly vulnerable economic and financial environment at this present moment. The last 15 years have been very difficult for the world. Central banks were forced to act boldly to deal with the subprime crisis in the US, which then became the Lehman Brothers crisis. When I was at the ECB, at the time of the subprime crisis we were forced to give €95bn to European money markets on 9 August 2007, a huge sum at the time. But this decision was made in just three hours, as we were observing that the market had simply ceased to exist, with no buyers and no sellers. Yields were skyrocketing and we had to regain control of the situation. Then after Lehman Brothers, I had to cope with the European sovereign risk crisis in 2010 and 2011. More recently, central banks faced the COVID crisis, which was even worse than the Lehman Brothers crisis in its potential for global destabilisation.

But it is perhaps what happened in between those two crises that was most important. During this time there was a real threat that deflation could materialise, so central banks kept monetary policy at exceptionally accommodative levels. At the same time many governments in the advanced nations also ran exceptionally accommodative fiscal policies.

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Unfortunately, I think we are in a particularly vulnerable economic and financial environment at this present moment

Billions and billions of dollars of debt piled up during this period, both public and private. We saw an incredible accumulation of tradeable securities purchases by major central banks, and the valuations of a range of assets, from equities to real estate, have reached levels that are historically high.

I think what governments and central banks did was right – it was what they had to do! This was not a benevolent action to please markets or to help governments. It was done to avoid the catastrophe that deflation would have brought.

But it is now, in such a vulnerable situation, that we are expecting a dramatic change in monetary policy. It was a mistake to trust economists explaining that low interest rates will be here forever: central banks will do their job. It is essential that there is trust in the ability of central banks to maintain long-term price stability and central banks will do what is necessary to ensure that is the case. Headline inflation may continue to pick up, but in my opinion central banks will now progressively work to regain control of medium-term inflation expectations. But core inflation is presently quite high, especially in the US, so this will not be easy.

At the same time, we are facing a dramatic change in global investment linked to the energy transition. There is a need to invest massively in the green transition and to replace huge amounts of obsolete investment, which will require higher real interest rates to draw in global capital. It is likely that the evolution of real and nominal interest rates to more elevated levels on a sustained basis will change the nature of global finance in the years ahead.

THE ROLE OF CENTRAL BANKS AND THE RUSH TO CONTAIN INFLATION

Adrian Grey: With the Federal Reserve having increased interest rates by 50 basis points – the first time since May 2000 that they have moved by 50 rather than 25 basis points – and the Bank of England raising rates, is the ECB acting too slowly?

Jean-Claude Trichet: I think both the ECB and the Federal Reserve have acted too slowly. At the end of last year in the US, the Federal Reserve still believed that there was little risk to the preservation of price stability, but clearly now the full Federal Open Market Committee has changed its view. With core inflation so high, at 6.5%[3], stabilising inflation expectations is very challenging, and time is now of the essence for the Federal

Reserve to prove to economic and market participants that second-round effects[4] can be moderated.

In the eurozone things are a little different, but still going in the same direction. Core inflation is higher than the ECB's long-term target, but much lower than in the US (3.5% versus 6.5%)[5]. The ECB has established a close link in their forward guidance between the purchase of tradable securities and increasing interest rates. Interest rates will not be raised until the purchase of securities has come to a close, but with core inflation well above the ECBs target and interest rates at -0.5% it is an anomaly to not be raising rates right now. The Governing Council of the ECB will soon need to navigate a change in forward guidance – that is absolutely necessary at this present time. But there is not quite the same pressure on the ECB as on the Federal Reserve.

The Bank of England is also in a more difficult situation given the level of inflation in the UK.

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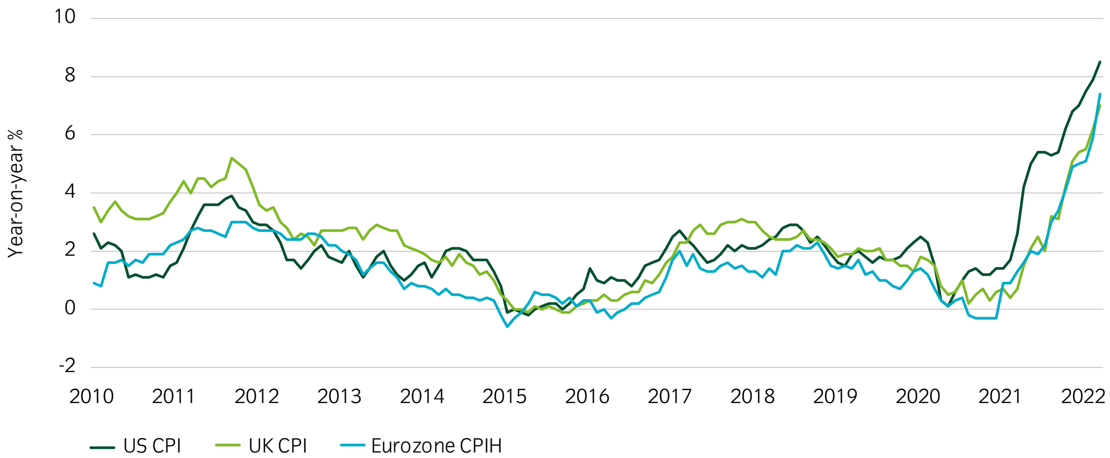
The Governing Council of the ECB will soon need to navigate a change in forward guidance – that is absolutely necessary

Figure 1: Around the world, inflation has accelerated to multi-decade highs[6]



[3] Source: Bloomberg. Data as at 31 March 2022. [4] Second-round effects refer to periods of high inflation that lead to workers asking for large wage increases, which then force firms to increase prices further and ultimately creates an inflationary spiral. [5] Source: Bloomberg. Data as at 31 March 2022. [6] Source: Insight and Bloomberg. Data as at 31 March 2022.

Adrian Grey: Do you think there is a risk that central bank independence may become compromised given the difficult decisions they will be required to make?

Jean-Claude Trichet: No, I think central banks have proven that even during very difficult circumstances they are able to fulfil their responsibilities. In the eurozone, ECB independence is especially clear as it is guaranteed by treaty and there are 19 different underlying countries and governments.

Central banks need to be independent as they need to be able to make bold decisions. If we look back at my own time as president of the ECB, there were many decisions that were made that would have been impossible for governments to make. No government could have provided liquidity to the financial system on such a scale and no government would have agreed to purchase Greek, Irish or Portuguese government bonds in 2010. If we look at the US, when the US Treasury tried to assist the Federal Reserve by providing massive help to banks, it was first rejected by Congress – and this only changed after dramatic falls in US equity markets. Governments are aware of the need for central banks to be able to make immediate and bold decisions, so the positives of independence need to be judged in both directions: avoiding complacent short term political decisions on one hand and being bold enough in extremely difficult times on the other hand.

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Central banks need to be independent as they need to be able to make bold decisions

There is also a connection between central banks and the social fabric of a country. Although governments may sometimes want central banks to be accommodative for political reasons, the people themselves will be demanding the central bank be responsible when inflation starts to move upwards.

That said, with inflation accelerating now, it is a difficult time for central bank credibility, but ultimately part of ensuring that credibility is independence, which is now more important than ever.

Adrian Grey: Given that inflation is primarily being driven by supply rather than demand, is raising interest rates the correct policy response?

Jean-Claude Trichet: To raise interest rates to combat today's headline inflation would make no sense, but this is about medium term inflation and second-round effects. If central banks are complacent and wait to raise interest rates then they appear immobile and second-round effects can occur very quickly; 8.5% inflation can rapidly become 14% inflation, as Paul Volker found during his time. When inflation is at such level's things can accelerate and the decisions that need to be made become even more dramatic. You have to take the appropriate decision at the appropriate time. Being ahead of the curve is not always necessary but being behind the curve will be punished by markets, and then all economic players have to pay the price for that.

Raising interest rates may have unexpected consequences in the short term, but higher interest rates are an important tool to signal that central banks are taking things seriously, and the critical issue is that longer-term inflation expectations are solidly anchored. A hump in inflation caused by sharp increases in commodity prices won't last forever. Once there is a peak, then the arithmetic computations of inflation mean that after one year the impact from those price rises will drop out. As long as people trust that price stability will remain in the longer-term then second-round effects can be avoided.

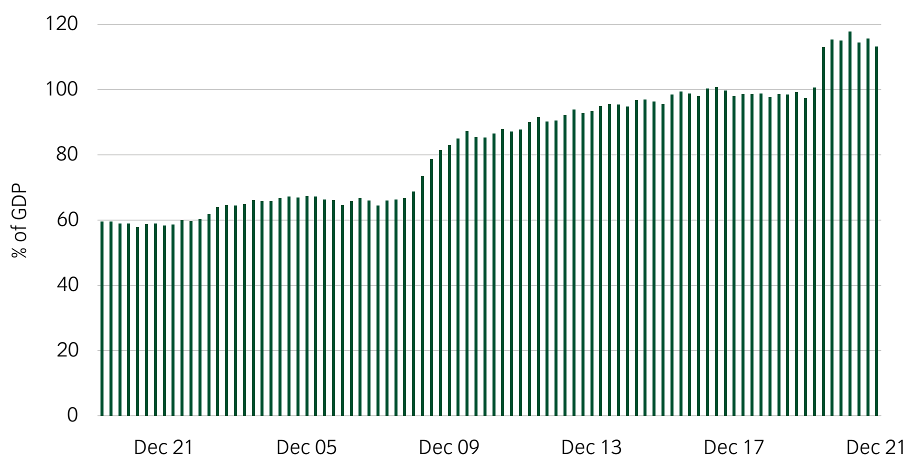
Adrian Grey: Looking beyond monetary policy and to broader central bank remits, President Lagarde has publicly spoken about the role the ECB may play in the implementation of the Paris Agreement. What can the ECB do to help governments reach their net zero targets?

Jean-Claude Trichet: The Bank of England was actually one of the first central banks to start to incorporate the environmental consequences of their actions into their policy decisions, and now we have a group of more than 70 to 80 central banks thinking along similar lines. In many ways, central banks are just like us as individuals: they are all wondering how they can make a contribution to the green transition. Central banks are also role models to an extent, so will be looking to send a broader message via their actions.

In the case of the ECB, the treaty under which the ECB was established says that the bank's primary target is price stability, but if price stability is maintained then the bank must act to support the policies of the European Union in general. That can include many things, including environmental goals.

Of course, we're no longer in a situation where price stability is easily maintained, so the bank's primary goal will become the priority. But if in the future they are required to purchase tradable securities once again, then it seems likely that they will consider issues such as ESG factors. At the same time, it is legitimate to consider ESG when considering the eligibility of the collateral that is taken in return for providing liquidity to markets. I'm sure that they will also be thinking of other ways that they can contribute in the longer term, and that over time a consensus will emerge among central banks on what they can do.

Figure 2: Debt to GDP is above 100% in France[7]



[7] Source: Insight and Bloomberg. Data as at 31 March 2022.

THE FUTURE OF THE EUROPEAN UNION

Adrian Grey: Macron has just been returned as president of France. He will have a certain amount of political capital, as he looks to spend that, what are his priorities likely to be? Do you expect him to win a majority in Parliament in the June elections?

Jean-Claude Trichet: The second election of Macron is remarkable. There has been a lot of noise around the election, with some saying that he is only supported by a fraction of the people, but with 58.5% of the vote, this is the third-best result for a president since the beginning of the French Republic. At 44 years old, Macron is still younger at the start of his second term than any other president has been at the start of their first, including Giscard d'Estaing.

I would say that there is a 75% chance that he will go on to win a majority in Parliament, and a 25% chance that he will face a more complicated situation where he has to manage a coalition to achieve his goals. But the important thing is that he remains totally pragmatic and is absolutely convinced that structural reforms are essential for France. Macron achieved a lot during his first term, but was ultimately blocked by the yellow vests, so he wasn't able to achieve everything. I believe he will now continue this into his second term, with a lot of bold, but likely unpopular, reforms. This is absolutely necessary, as in France there are many areas which still need to be actively reformed.

I'm more doubtful that he will address France's deficit and the accumulated public debt that is outstanding. I'm not sure that he believes he has a mandate for this, and he may consider it a price to be paid to keep the peace with the left. Saying that, with French presidents limited to two terms in office he can't stand for re-election again, so he may choose to be extremely bold and put the whole house of France in order. I hope so. We shall see.

Adrian Grey: Looking at the broader political landscape, post-Brexit the Franco-German relationship seems more important than ever to the future of Europe. Do you agree?

Jean-Claude Trichet: In all previous periods – solving crises, creating new treaties, the creation of the European stability mechanism, the fiscal compact, the banking union – required a meeting of minds between Germany and France. That doesn't mean that Germany and France have the key for everything, but it does mean that if they put their relationship to the service of the rest of the eurozone then there is the capacity to reach a consensus. The configuration of the new German government is very pro-European in comparison to what could have been, and President Macron is clearly waving the European flag. So, I'm confident that we will continue to see advances. One of the most important decisions will be around the issue of joint European Union bonds. Will this be a one-off as a response to the pandemic, or a policy that can be continued?

Personally, I also believe that there should be a minister of the economy for the euro area. The present structure is not sufficiently clear as the Eurogroup[8] is chaired by a minister of finance from a particular country rather than someone representing a single eurozone-wide economy and single currency.

[8] A collective term for meetings of the finance ministers of countries using the euro as their official currency.

Adrian Grey: We touched on the energy transition at the start. Who should pay for this transition? Is the growth and stability pact to much of a constraint at a fiscal level given the significant cost of the transition?

Jean-Claude Trichet: One thing is clear; we can’t ask God for the additional investment we need to finance the transition, and to a large extent it will require a significant reallocation of resources. Historically we’ve seen a number of advanced economies running large current account and fiscal deficits, which are funded by the rest of the world. That is not normal, and with huge investment needed across both the developed and developing world, it is likely to prove increasingly difficult to sustain.

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Decisions taken a long time ago are now having a dramatic impact

With regard to the growth and stability pact, it does seem likely that this will need to change to adapt to the needs of the future, but it shouldn’t be abandoned. Until there is a full political federation in the eurozone there has to be a way to monitor national policies, both fiscal and macro, to ensure that they are being enacted in a responsible way, compatible with the sharing of the same currency.

Adrian Grey: In terms of energy security, France is obviously a forerunner on nuclear energy, but Germany has serious problems with its overreliance on Russia – do you see any way to resolve this divergence in energy security between member states?

Jean-Claude Trichet: Decisions taken a long time ago are now having a dramatic impact. I think France was right to maintain its nuclear power plants, a policy that has its roots in the first oil shock. It’s also interesting that Macron’s decision to embark on the construction of six new plants didn’t seem to hamper his election campaign. In Germany it is difficult to see a change in strategy given the role of the Greens in the coalition. They trust that solar energy and other forms of renewable energy will suffice to do the job – we will see. What would be welcome is a joint strategy across the eurozone. This seems overdue now given the collective policies vis à vis Russia. This wouldn’t necessarily force any single state to change direction, but collegial decisions on energy strategy would hopefully produce a more sustainable future. The high prices we are seeing today are the price of erratic national policies in the past.

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Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

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