

Mr Noyer gives a review of the economic situation in the euro area

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the conference of the International Finance Futures snc (IFF), Paris, on 8 March 2000.

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Introduction

Ladies and gentlemen, it is a pleasure for me to speak here at this conference. The topic of my speech is “la conjoncture dans la zone euro” and this may warrant some explanation, given that this conference traditionally focuses on the cyclical outlook for the French economy. Some, but hopefully not too many of you may simply see this as confirming their suspicion that central bankers like to surprise financial market participants. Let me assure you that this is not our intention, and there are good reasons indeed why, as a European central banker, my focus should naturally be on developments in the euro area as a whole, rather than on those in individual Member States. And, while I will also briefly go into the cyclical outlook for France, this will be largely with the outlook for the euro area as a whole in mind. Before I turn to this discussion and the policy challenges associated with it, please allow me to review the case for this area-wide perspective.

The primary objective of the Eurosystem is to maintain price stability in the euro area. This implies that the single monetary policy can only be based on developments in the euro area as a whole. Given this view, decisions are made with due consideration of all information that is available and relevant with a view to maintaining price stability in the medium term. This requirement is reflected in the two-pillar strategy of the Eurosystem, which comprises an assessment of monetary developments against a reference value for growth of M3 and a broadly based assessment of the outlook for price developments.

Economic analysis for the euro area as a whole critically hinges on the availability of appropriate data. In addition to requirements in terms of sufficiency, quality and timeliness, area-wide data also need to be harmonised to the highest degree possible. The latter requirement is clearly met regarding the data on, for instance, monetary aggregates and consumer prices, as measured by the HICP. Moreover, the changeover to the new European System of Accounts (ESA 95), which began in the course of last year, meant a further improvement in this respect and should be seen as representative of the ongoing efforts to develop a wholly satisfactory basis for the single monetary policy. It is true that in some areas further progress is still needed and, overall, it still holds that there is relative dearth of area-wide data compared with the availability of data in individual Member States. In addition, when assessing developments in the euro area as a whole, the possibility has to be considered that economic relationships which are taken to prevail at the level of the individual countries may look different at the area-wide level. But this cannot be taken as implying that a single monetary policy is not feasible or that there is an alternative to its focus on developments in the area as a whole. Rather, these intricacies should be seen as re-emphasising the case for the strategy which has been chosen by the Eurosystem and which reflects these particular circumstances.

Cyclical outlook for the euro area ...

With this in mind, let me now turn to the economic outlook for the euro area. There is by now sufficient evidence to say that the euro area is enjoying a strong upturn in growth, as had indeed also been predicted by the vast majority of international organisations and private institutions in the autumn of last year. The headline figure for this upturn is clearly the rate of growth of real GDP in the third quarter of 1999, which was well up from what had been recorded for the first two quarters of the year.

No estimate for real GDP is yet available for the final quarter of last year, but on the basis of available indicators growth should have continued to be strong.

Taken together, the year 1999 has been characterised by a rather swift and strong rebound from the slowdown in growth in the course of 1998 and early 1999 following the crises in Asia and Russia. Indeed, when reviewing the magnitude of the disturbances in the external environment as they appeared at the time, the likely outcome of 2% for euro area growth in 1999 as a whole is not bad at all. Judging from the currently available evidence, there seems to be a broad consensus in the forecasting community that the prospects for a strengthening of growth in the years 2000 and 2001 are favourable. On average, the latest forecasts point to real GDP growth of about 3% in the euro area in each of these years. It should be noted, however, that most of the currently available forecasts were made in the autumn of last year and that some of their underlying assumptions and initial conditions may thus no longer fully reflect current perceptions. For example, the IMF has since revised its projections for world growth upwards and such a scenario could well provide for somewhat larger impulses on euro area export growth than have been incorporated so far. Similarly, the quasi-technical assumptions for variables such as exchange rates, interest rates and certain commodity prices, which forecasts tend to be built on, might need to be revised in order to bring them into line with the latest developments. Rather than precisely forecasting numbers, my explanations should therefore be seen as relating to the general picture of the outlook which is likely to be much more stable.

The favourable outlook for euro area growth is essentially based on the prospect that the initial impulses from external demand and the sustained domestic demand within the euro area reinforce each other in a beneficial way in the current upturn. This is exemplified by the fact that, together with the brightening picture on the external side of the economy, there has been a strong rebound in industrial confidence. Following steady increases up to the first months of this year, most of the previous decline in industrial confidence has now largely been reversed. The cyclical pattern of consumer confidence was fairly subdued and confidence remained at a level close to its all-time high throughout 1999. Continued employment growth and further reductions in unemployment should help to sustain it at this high level. Taken together, the prospects for a strengthening of domestic demand growth appear to be good. In this context, it is worth pointing to a key feature of the euro area economy, namely that its degree of openness, and thus its dependency on foreign demand, is much lower than that of individual Member States. Developments in the world economy will nevertheless remain important, in particular through their repercussions via financial markets, and need to be monitored carefully. But if conditions for growth are right from the domestic side, the euro area economy should, in principle, be fairly resistant to potential shocks to foreign demand.

Let me now turn to developments in prices. Looking back, the average rate of increase in consumer prices in 1999 was just over 1%, the same as it had been in 1998. And most of the forecasts currently available from private and international institutions, while projecting a somewhat faster rise in 2000 and 2001, expect inflation to remain below 2% on average. So, is there any reason to worry? The bulk of these forecasts was made in the autumn of last year and is subject to the caveat of the potentially outdated forecasting assumptions already mentioned earlier. In a number of cases, these forecasts also incorporate the assumption of rising short-term interest rates in 2000. Prices are now rising faster and further than was expected earlier. In the course of the second half of last year, inflation moved up by almost one percentage point to reach 1.7% in December. And expectations of higher inflation rates in the first months of this year have just been confirmed by a rise to 2.0% in January. This continued upward movement essentially reflects the increase in oil prices, but - increasingly - also the impact that the lower exchange rate of the euro has on import prices in general. While these effects can be expected to unwind sooner or later, they have been more protracted and more fervent than expected earlier and, through their very duration and magnitude, they clearly heighten the risk for second round effects.

At this point, let me say something about interest rates. About one month ago, the Governing Council of the ECB decided to raise the interest rate on the main refinancing operations by 25 basis points. I would like to stress that this was not a direct consequence of the favourable prospects for euro area activity growth which I just described. As has been emphasised repeatedly, the ECB is not concerned about higher growth as such, but that this higher growth be non-inflationary. In this respect, the

interest rate decision of 3 February should have been a reassuring one. On the one hand, the rate increase did not mean that the ECB had put the brakes on. Rather, when looking at the high rates of monetary and credit growth and the fact that the levels of both nominal and real interest rates remained relatively low in a longer-term perspective, the appropriate picture would have been that of throttling back. The economic upturn in the euro area is now well under way and its momentum should not be hurt by an adjustment of the monetary policy stance. On the other hand, the interest rate move provided a clear signal to market participants, social partners and policymakers that the ECB was determined to counter inflationary dangers in a timely fashion and that the prospects for price stability in the euro area remained good.

In the run-up to this interest rate decision, a number of risks to price stability in the medium term came more clearly to the fore, indicated by both of the two pillars of the monetary policy strategy. First, monetary growth has remained consistently above the reference value and the uneven growth pattern at the turn of the year 1999/2000, with lower growth in January, should be seen against the background of a base effect. It is worth re-emphasising that there are no mechanistic reactions to deviations of monetary growth from its reference value, but, together with the continuing strong expansion of credit to the private sector, liquidity conditions in the euro area remained generous. As regards the second pillar, the outlook for future price developments has become less favourable. In particular, the danger has increased that the temporary upward pressures on consumer prices from the external side of the economy, from higher oil prices and a lower exchange rate, may feed into more lasting price pressures from the domestic side. In this respect, the interest rate increase has not, for instance, eliminated the need in the upcoming wage bargaining rounds to ensure that wage settlements do not give rise to second round effects. It should instead have given additional assurance to wage negotiators to keep wage increases in line with price stability.

... and the policy challenges lying ahead

What we currently observe in the euro area is a noticeable upturn in growth accompanied by price stability, and the challenge is to set the scene for this to turn into a prolonged period of non-inflationary growth. Monetary policy can best contribute to long-term growth of output and employment by pursuing its primary objective of safeguarding price stability and by counteracting risks in a forward-looking manner. This has been confirmed by several studies - within and outside the ECB. However, it would mean an overburdening of monetary policy if the responsibility for non-inflationary growth and for the single currency were left to that policy field alone.

So what can other policy areas do in support of these joint responsibilities? Ongoing efforts are required from macroeconomic and general economic policies as well as from wage negotiators to raise the productive potential of the euro area. In particular, further progress in structural reforms of labour and product markets is needed to eliminate or at least significantly reduce existing rigidities. There is now a broad consensus that the larger part of the still very high unemployment is of a structural nature. It is true that estimates of structural unemployment are subject to considerable uncertainty, but the dimension of the problem is certainly large enough to warrant decisive action. And there is no time to lose. The change to a post-industrial economy with different work profiles and job requirements is already under way. There is also the prospect of rising participation rates as demand for part-time employment increases. In order to ensure employability of the work force at all levels of productivity, structural reforms of labour markets are urgently needed. However, the full benefits of such reforms can only be reaped if supported by appropriate wage policies. The participants in the wage negotiation process thus have the dual responsibility of keeping wage increases consistent with both price stability and continued employment growth.

Some deregulation and liberalisation of previously sheltered sectors has already taken place in recent years, but there remains significant scope for further action along these lines. The favourable impact of such measures in terms of lower price increases have, for instance, become clear in the telecommunications and energy sectors and should be encouragement enough to step up efforts in other sectors as well.

As regards fiscal policies, the current cyclical upturn provides a good opportunity to intensify the necessary consolidation of public finances. It has to be acknowledged that public deficits have come down in recent years and that budgetary objectives for 1999 seem to have been met by all euro area countries. However, it has also to be borne in mind that the recent reduction of deficits has been greatly helped by the relatively low levels of interest rates achieved in the run-up to Monetary Union. And in a number of Member States the budgetary situation is still far from reaching the targets specified in the Stability and Growth Pact, which are for budgets close to balance or in surplus. The additional room for manoeuvre offered by such positions is urgently needed. First, sufficient safety margins are necessary to cope with the adverse shocks which will not cease to occur in a Monetary Union. Second, they are necessary to increase the scope for reforms of tax and expenditure systems which are conducive to long-term growth, and to start on the necessary reforms of social security systems. It appears that a number of updated stability programs, which have recently been sent to the European Commission for examination, do not yet sufficiently incorporate such objectives.

With all the appropriate policies in place, the momentum of non-inflationary growth could eventually be stronger than is currently expected. Such a prospect would have made a nice ending to a discussion on the outlook for the euro area. However, the question which currently appears to occupy European policymakers is whether Europe is about to convert into a so-called "New Economy" and whether it could be expected to mirror the strong performance of the US economy in terms of high growth and subdued inflation. At this juncture, the concept of the New Economy is still somewhat unclear, essentially combining a range of rather diverse factors which have in common that they potentially raise the speed at which the economy can grow before inflation starts to accelerate. In this respect, while certainly not "new" as a prescription, decisive action on the part of policymakers to pursue structural reforms and sound economic policies would certainly be part of this concept. The extent to which the potential gains of factors such as information technology can be reaped, is likely to depend on whether appropriate market structures and sound economic policies are in place.

To date, there has been a difference between the US economy and the euro area. This is most apparent with respect to the different growth performance, which is also reflected in recent developments of the euro. To the extent that exchange rates are a reflection of cyclical divergence between countries or economic regions, it is worth pointing out that the current external value of the euro vis-à-vis the US dollar is not so much an expression of bad performance or unfavourable prospects of the euro area. Rather, it reflects the exceptionally good performance achieved by the US economy. However, the growth differential vis-à-vis the United States is likely to narrow rapidly as the upturn in the euro area continues [and some re-balancing of the exchange rate can hence be expected. At the same time, in the longer-term, the exchange rate reflects more than just cyclical differences. Of greater importance for the upward potential of the euro will therefore be that monetary policy is committed to securing price stability. In addition, and this also ties up with the requirements for something like a New Economy to emerge, it is necessary that convincing further progress be made in the individual Member States regarding the structural reform of labour and product markets.]

Differences in economic performance across Member States ...

The single currency reflects a large number of factors, both at the area-wide and at the national level, and is therefore a joint responsibility of all Member States and of all policy areas. In this respect, differences in growth and inflation between Member States will continue to occur also with a single monetary policy, just as they have been normal between regions in the individual countries. Monetary Union is no universal shield against shocks and does not prevent these shocks from affecting countries differently, depending on their economic structures and policy responses. At the same time, monetary policy can no longer be geared towards the divergent developments in individual countries and it is clear that, if this divergence is considered to reflect unwarranted cyclical or structural conditions, this is primarily a question of the country in question and of national economic policies. But we should not forget that some divergence is quite normal. For instance, with countries still in a process of catching-up in terms of productivity and living standards, there will be some natural and even warranted divergence in growth and inflation in the course of this process.

While the single monetary policy is determined by developments in the euro area as a whole, looking also at the performance in the individual Member States is necessary to gain a better understanding of area-wide developments.

... and the outlook for the French economy

With this in mind, let me now say something about the outlook for the French economy - and to point out that it is indeed favourable. The cyclical developments in France combine moderate inflation, below the euro area average, and strong economic growth, above the euro area average. Towards the end of the decade, France has thus contributed to a great extent to stabilising the prospects of the euro area economy. In particular last year, and in contrast with other large economies of the area, the French economy has proved resilient in terms of activity and stable in terms of prices. Looking at the headline figures for 1999, an estimated 3.2% real GDP growth for the fourth quarter and a 0.6% annual average increase in consumer prices, the conclusion can be drawn that economic agents in France have so far successfully adapted to the new euro-wide macroeconomic context associated with the single monetary policy.

With a view to the near future, available indicators and forecasts suggest similarly favourable prospects for France as for the euro area as a whole. According to recent results from industrial and consumer surveys, both entrepreneurs and households remain confident about their short-term prospects. The optimism of the latter is best reflected in the historically high level of consumer confidence and stems partly from the on-going improvement of the situation on the labour market. Household consumption, which has been resilient in 1999 despite the temporary economic slowdown, is therefore expected to continue to grow rapidly this year. As far as enterprises are concerned, business confidence is in line with the historically high levels reached in 1998 and entrepreneurs have kept on signalling well-filled order books. With capacity utilisation rates some 2 percentage points above their long-term average, the overall positive environment can be expected to contribute to dynamic investment expenditure. This would be reinforced by other major determinants for investment. Irrespective of the positive influence of monetary policy on financing conditions, companies' financial positions can indeed be expected to remain healthy, while re-payment difficulties would continue to ease.

Not surprisingly in this context, there is a broad consensus among forecasters on a scenario of rapid economic growth in France, with inflation remaining within the definition of price stability for the two years ahead. So far, the consensus forecast predicts that real GDP could increase by some 3.4% in 2000 and by 3.0% in 2001, while consumer prices will grow by 1.2% in both years, although more recent forecasts indicate that prices could rise more rapidly. It is also widely expected that growth will be sustained by both domestic and external demand and will result in continued employment growth and further reductions in unemployment.

This is a bright picture and we should wish that it all comes true, not only in 2000 and 2001, but also beyond. But, although this scenario for the coming years is a likely one, it is important to bear in mind that it is subject to uncertainties. Some of them, like the event of an unexpected external shock, cannot be eliminated. But others fall within national responsibility. Proper economic policies and/or an adequate consensus among economic agents can in some cases be key factors in ensuring that crucial pending issues are faced in a way compatible with sustained and non-inflationary growth.

Among the pending issues for the future of the French economy, the implementation and financing of the 35-hour working week is certainly an important one. But other uncertainties also call for attention. I would like to stress the importance of maintaining the credibility of fiscal consolidation. In this regard, avoiding any relaxation of the fiscal stance, as well as reducing the risk of any deficit slippage in the event of an unexpected growth slowdown are certainly key elements. Moreover, with a view to external competitiveness, an explicit commitment on the part of the social partners to maintain wage developments in line with productivity increases is an important factor.

More generally, France faces the same fundamental challenge as the other European economies. It can be summarised in the following short question: "How can one develop an internal dynamic for

sustainable long-term growth?” This is a crucial challenge if one wants to significantly reduce unemployment. And, at the same time, in an increasingly integrated world economy, one wishes the euro area economy not to be too vulnerable to every external slowdown. By committing themselves to fostering low inflation and sounder public finances, public authorities, both French and European, have been working for years to develop the necessary background environment for such a domestic dynamic. The relative resilience of the French economy, despite the recent temporary slowdown, could be a sign of a successful policy mix in this regard.

Earlier in my speech I spoke about the “New Economy”, an appealing expression which is also being used more and more when referring to the good performance of the French economy in the recent past. However, for its true emergence, two important elements are required. First is the commitment to maintain an environment with moderate developments in production costs and to pursue sound public finances. Second is the need to continue and step-up the process of structural reforms. That is the only way to foster employability of the labour force and to encourage entrepreneurship, leading to appropriate choices in terms of product specialisation and ultimately, high economic growth coupled with macroeconomic stability.