John Hurley: Monetary policy and prospects for the European economy

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to the luncheon meeting of EU Heads of Missions at the French Embassy, Dublin, 9 March 2006.

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Introduction

I welcome the opportunity to talk to you today and thank Ambassador Grasset for inviting me. High level gatherings such as this, where we have an opportunity to exchange views freely on important European issues, are invaluable and I look forward to hearing your views later. In my brief address, I will touch on the following issues: the experience in relation to economic growth and inflation developments in the euro area, the recent decisions of the Governing Council in relation to interest rates, some of the risks the euro area economy faces going forward and developments in EU countries outside of the euro area.

Economic developments

I would like to begin by talking about euro area economic performance and prospects. After many years of disappointment, during which economic recovery proved weak and hesitant, the signs are becoming more encouraging. Economic activity in the euro area is improving and the growth outlook, while still far from vigorous, is more favourable than it has been for some time. Why did economic recovery previously disappoint and why has it now apparently picked up? These are questions which I will now turn to address and, in doing so, shed some light on some of the factors which have shaped the monetary policy environment in recent years.

Looking back, the euro area has been slow to participate in the global economic recovery that has, more or less, been ongoing since the middle of 2003. Until recently, the recovery in activity in the euro area, following the protracted period of slow growth between mid-2001 to mid-2003, has been relatively weak compared with the experience of recovery periods in past decades. Up until now, euro area growth ebbed and flowed and the recovery did not evolve in the smooth and sustained fashion that would be usual for this stage of the economic cycle.

A number of factors account for the sluggish nature of the recovery until recently. First, unlike earlier episodes, the current recovery evolved against a background of sharply rising energy prices and a significant appreciation of the euro. While the impact of rising oil prices on activity has been more muted than has typically been the case in the past, higher oil prices have heightened uncertainty and acted as something of a headwind against a recovery that has lacked any great momentum. A second problem has been the disappointing performance of consumer spending. There is no doubt that there has been much to hold consumption back. Employment and wage growth have been modest. High and volatile oil prices have had a dampening influence. In addition, savings levels have remained high, reflecting concerns, not only in relation to labour markets, but also about longer-term prospects for health-care and pension systems. Thirdly, until recently, the corporate sector in the euro area has been engaged in a period of balance sheet restructuring, in response to the sharp rise in corporate debt which occurred as part of the late 1990s dotcom boom. A further problem has been the existence of significant structural rigidities in euro area labour and product markets, which are seen by many as holding back growth in the euro area economy.

Not surprisingly, given this background, economic recovery in the euro area was slow to take off in recent years. The problem was that the normal sequence of recovery, which tends to run, first, from a pick up in export growth, then to a recovery in investment and, finally, on to a strengthening of consumer spending, was not operating. While the external engine was firing strongly, the domestic engine was not. More recently, however, developments have become more encouraging. Following four quarters of moderate growth between mid-2004 and mid-2005, there are signs that euro area growth is gathering some momentum. While quarterly growth rates were somewhat volatile in the second-half of last year, looking through these short-term fluctuations, the evidence suggests that economic activity is improving. Of course, external trade continues to provide significant impetus to growth in the euro area. However, there are now also some signs of an improvement in domestic demand. Business confidence has strengthened significantly since last Summer, contributing to a welcome recovery in investment. The improvement in investment reflects not only the favourable external stimulus, but also the impact of improved business balance sheets and efficiencies, as well as rising profitability. However, progress remains slow in relation to consumer spending – the main element of domestic demand. While consumer confidence has picked up in recent months, consumer spending growth remains subdued, though there are one or two signs of improvement.

Looking ahead, the view of the Governing Council is that the conditions remain in place for ongoing economic expansion in the euro area. A favourable external environment should continue to provide support for exports. Investment should also benefit from what are still very favourable financing conditions, improved business balance sheets and gains in corporate earnings. On the consumer side, spending is likely to grow more gradually and broadly in line with developments in incomes. The recent ECB staff macroeconomic projections point to a somewhat improved growth outlook for this year and next as compared to the past two years. Taking mid-points of the ranges, the projections foresee economic growth of around 2 per cent in both 2006 and 2007, as compared with 1.4 per cent last year. While it has taken time, slowly the euro area economy is returning towards its trend growth rate.

Inflation developments

Having spoken about activity developments, I will now turn to talk about inflation developments and prospects, before moving on to talk about monetary policy. The headline rate of inflation (HICP) in the euro area has remained just above 2 per cent in recent years, mainly as a result of the strong increases in energy prices and, to a lesser extent, rises in administered prices and taxes. However, underlying domestic inflationary pressures have been relatively subdued and, overall, the pass-through of past oil price increases to consumer prices has been limited. The subdued growth in domestic demand in recent years helps explain the limited ability of producers to pass-on increases in input costs to consumers. Another important factor in this respect has been moderate wage growth, which, in turn, has reflected the subdued nature of labour markets. It was against this background that the Governing Council was able to keep interest rates unchanged at historically low levels for two and one-half years between June 2003 and December 2005.

Maintaining price stability – monetary policy decisions

Why then, you might ask, given this background, has the Governing Council twice raised interest rates in the past three months? The answer lies in the gradual upward creep of inflation risks. In the course of 2005, inflation projections were progressively revised upwards, mainly, though not exclusively, reflecting stronger than expected increases in oil prices. Reflecting this, as the year progressed, upside risks to the maintenance of medium-term price stability were viewed to be gradually increasing. This assessment was reinforced by the evidence of the monetary analysis, which pointed to strong monetary growth, ample liquidity and rapid expansion of credit – especially consumer credit, notably for housing. By the end of 2005, the evidence from both the economic and monetary perspectives was that an adjustment of the very accommodative stance of the ECB's monetary policy was warranted. Therefore, on 1 December last, the Governing Council decided to increase interest by 25 basis points. With risks to the outlook for inflation remaining on the upside in the early months of 2006 and the latest staff projections suggesting that, at unchanged interest rates, HICP inflation would probably remain above 2 per cent both this year and next, a further increase in interest rates was recently deemed to be warranted.

With respect to these two decisions, I would strongly emphasise a few points. In raising interest rates, on each occasion, the Governing Council was responding to the risks to price stability as it perceived them. As President Trichet has stated emphatically, the Governing Council has not taken any 'ex ante' decision to engage mechanically in a series of interest rate increases. I would emphasise that the Governing Council does not pre-commit unconditionally to any future action. Our approach is to consider the most up-to-date information and analysis of the economic and monetary situation and prospects and to act accordingly. I would also emphasise that the Governing Council stands ready to do whatever is necessary to ensure the maintenance of price stability and will act to anchor medium to long-term inflation expectations. The smooth reaction to the recent interest rate increases suggests that markets understand our underlying rationale.

Ongoing risks

I would like to turn now and make a few brief remarks on the main risks to the outlook for growth and inflation which lie ahead. I will begin with oil prices. Not only do high and volatile oil prices threaten to slow growth, they also raise the risk of higher inflation and it is essential to ensure that second-round effects on wage and price-setting behaviour are avoided. In the longer term, it is difficult to say how the price of oil might evolve. However, recent oil price strength would appear to reflect the combination of strong demand, lack of spare production capacity and uncertainties surrounding supply. This makes it likely that higher oil prices will persist for some time yet and there is an ongoing risk that oil prices could rise further and potentially combine with other negative factors to cause more protracted problems for the global and euro area economies.

Oil prices are not the only external factor complicating the outlook. There are also the risks posed by widening global current account imbalances, which show no signs of abating. The seemingly ever-increasing US current deficit implies the potential for significant volatility in foreign exchange markets and this continues to be one of the most important downside risks to growth.

There are also risks from within. In particular, reflecting the stimulative effect of low interest rates on the monetary aggregates, we have seen persistently strong growth in money and credit. This points to potential risks to price stability in the medium to long-term. We are mindful of these risks and we will continue to monitor these developments closely.

Another internal issue is fiscal policy. While we have gone through a difficult period, we now have a revised Stability and Growth Pact with a better economic rationale, but with a degree of flexibility that could be misused. With economic growth and prospects improving, countries with excessive deficits need to use the “good times” to make progress towards sound public finances (i.e. maintaining or attaining budgetary positions close to balance or in surplus) by setting sound consolidation plans. These consolidation efforts will be more effective if they are part of a comprehensive reform programme, which includes setting out concrete measures needed to prepare for the long-term fiscal challenges.

Developments outside the euro area

Finally, I would like to say a few words about developments in non-euro area EU countries. Enlargement of the European Union was a truly historic event and all the more so having occurred so smoothly. The economies of the new member states have benefited greatly from accession and continue to converge towards the rest of the EU at an impressive pace. Crucially, this is being driven by strong growth in productivity, a reflection of extensive structural reforms. This supports strong growth in exports, underpins capital inflows and allows wages to increase quite robustly without giving rise to inflationary pressures. As a result, inflation rates have generally declined or remained moderate, even after long periods of sustained economic growth and sharp increases in oil prices, though inflationary pressures have become evident in a couple of cases. Central banks in the new member states deserve a good deal of credit for managing inflation expectations effectively but this should not disguise the difficulties that they face, as overheating is an ever-present threat. Fiscal policies, on the other hand, could do more in some instances to stem domestic economic pressures, notwithstanding the need to modernise public infrastructure. Current account deficits are generally high but I would see this largely as a reflection of the convergence process. In a few cases, however, some moderation in import demand would be welcome.

The main exchange rate developments have been the entry of seven currencies into ERM II over the past two years. A high degree of exchange rate stability has been achieved, with all currencies trading either close to or at their central rates against the euro. This has facilitated the convergence process by allowing interest rates to decline while, at the same time, helping to anchor inflation expectations. Furthermore, it has been proven that inflation targeting can be fully consistent with membership of ERM II once economies are sufficiently flexible and policies are largely supportive. There are a couple of instances, however, where inflation rates have risen sharply. I would reiterate the importance of fiscal policy in this regard and point out in particular the fiscal stance should not add to demand pressures when the economy is already growing rapidly. Otherwise, the twin objectives of exchange rate stability and price stability could come into conflict.

The new EU member states have made considerable strides along the path towards membership of the euro area and it is clear that the euro area will expand sooner rather than later. I would not like to comment on the likely outcome of convergence examinations in advance of upcoming Convergence

Reports from the European Central Bank and the European Commission. However, it is worth reiterating that the Eurosystem is committed to according each country equal treatment with those that have gone before. At the same time, there is no single path towards euro adoption and each country has to be assessed on a case-by-case basis. Assuming that the criteria are satisfied and the conditions met, I look forward to the expansion of the euro area, not least to maximise the benefits of the single European market for all EU citizens.

Concluding remarks

In conclusion, for both the euro area and the EU, we live in challenging and changing times. However, there are also many opportunities; these must be exploited to the fullest extent, in order to further the living standards of all citizens. In the euro area, for the first time in a long time, we appear to be seeing a sustainable economic recovery emerging. This is a very welcome development and we in the Governing Council will ensure that the recovery takes place in an environment of price stability. In the wider EU, the process of monetary integration is set to continue. As a euro area country, I can assure you that we will be glad to see new members joining when they are ready to do so and have met the conditions for membership.

Thank you for your attention.