Jean-Claude Trichet: Hearing before the Economic and Monetary Affairs Committee of the European Parliament

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 11 June 2007.

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Madame la Présidente, Mesdames et Messieurs les membres de la Commission Economique et Monétaire, je me réjouis d'apparaître devant votre commission aujourd'hui et de poursuivre notre dialogue fructueux. Comme toujours, je commencerai mon intervention par une évaluation de la situation économique et monétaire.

Anschließend möchte ich auf zwei Themen näher eingehen: erstens, auf den EU-Rahmen für die Regulierung, Aufsicht und Stabilität der Finanzmärkte sowie die Role des Eurosystems; und zweitens auf die Unternehmensfinanzierung in der Eurozone, ein Thema das im Strukturbericht der EZB behandelt wird, den ich heute dem Europäischen Parlament presentieren möchte.

Economic and monetary issues

Since my previous appearance before the European Parliament in March, incoming information has confirmed our view that economic growth in the euro area continues to expand at a pace significantly stronger than expected a year ago. Regarding price developments, upside risks to price stability prevail over the medium to longer term, as identified by both our economic and monetary analyses. Thus, in order to ensure that longer-term inflation expectations remain solidly anchored at levels consistent with price stability, on 6 June the Governing Council of the ECB decided to raise the key ECB interest rates by 25 basis points. After this decision, given the positive economic environment in the euro area, our monetary policy is still on the accommodative side, with overall financing conditions favourable, money and credit growth vigorous, and liquidity in the euro area ample. Let me explain the Governing Council’s assessment underlying its decision.

Starting with the economic analysis, real GDP grew by 0.6% quarter-on-quarter in the first quarter of 2007 and thus again somewhat stronger than previously expected. Looking ahead, conditions are in place for the euro area economy to continue to grow at solid rates. Euro area exports continue to profit from robust and broad-based growth in the world economy. Domestic demand in the euro area is expected to maintain its relatively strong momentum, as employment growth continues to strengthen, supporting real disposable income. Investment should remain dynamic, benefiting from financing conditions which remain favourable. This positive outlook is reflected in the latest macroeconomic projections of Eurosystem staff who foresee average annual real GDP growth in a range between 2.3% and 2.9% in 2007 and between 1.8% and 2.8% in 2008.

In the Governing Council’s view, the risks to this favourable medium-term outlook for growth are broadly balanced over the shorter term, while the balance of risks remain on the downside at medium to longer horizons. These relate mainly to external factors, notably potential protectionist pressures, possible further oil price rises, global imbalances and potential shifts in financial market sentiment.

Turning to price developments, annual HICP inflation was, according to Eurostat’s flash estimate, 1.9% in May, unchanged from April but somewhat higher than expected a few months ago, in particular owing to increasing oil prices over recent months. Looking ahead, the short-term profile of annual inflation rates continues to be determined largely by current and past energy price developments, as last year’s volatility in energy prices leads to significant base effects. Against this background, the Eurosystem staff projections foresee average annual HICP inflation of between 1.8% and 2.2% in 2007, slightly revised upwards compared with the March projections, and of between 1.4% and 2.6% in 2008.

In the Governing Council’s view, risks to the outlook for price stability remain on the upside over the medium term. Notably, these risks are on the domestic side. They relate mainly to emerging capacity constraints and, closely related, stronger than expected wage dynamics, which would pose significant upside risks to price stability. In addition, pricing power in market segments with low competition may increase in such an environment. It is therefore crucial that all parties concerned meet their responsibilities. Wage agreements in particular should be sufficiently differentiated to take adequately into account price competitiveness positions, the still high level of unemployment in many economies and sector-specific productivity developments.

Cross-checking with the monetary analysis confirms the prevalence of upside risks to price stability at medium to longer horizons, given the continued strong underlying rate of monetary expansion in a context of already ample liquidity. While, from a medium-term perspective, there are several indications that higher short-term interest rates are now influencing monetary dynamics, they have not, as yet, fully translated into a significant dampening of the overall strength of the underlying rate of monetary and credit expansion.

Overall, the Governing Council will monitor closely all developments in order to ensure that risks to price stability over the medium term do not materialise. Consequently, acting in a firm and timely manner to ensure price stability in the medium term remains warranted.

Fiscal developments in euro area countries in 2006 turned out to be significantly better than anticipated and the latest available forecasts suggest a further reduction in the government deficit-to -GDP ratio of the euro area over the period 2007-08. However, this reflects more cyclical improvements in the context of a favourable macroeconomic outlook rather than structural progress. The current economic “good times” should be used to rapidly redress the remaining budgetary imbalances in euro area countries as well as to accelerate the adjustment towards their medium-term objectives of sound budget positions with a focus on expenditure restraint. As agreed by the euro area finance ministers at the Eurogroup meeting in Berlin on 20 April, taking advantage of the favourable cyclical conditions would enable most euro area members to achieve their medium-term objectives in 2008 or 2009, and all of them are committed to achieve their MTO in 2010 at the latest. This is particular important with a view to reducing the still high government debt ratios and preparing for the fiscal challenges arising from population ageing.

Allow me to stress on this occasion that in the Governing Council’s view it is crucial for the smooth functioning of EMU that all countries comply with the rules and provisions of the Stability and Growth Pact, given that the Stability and Growth Pact is an indispensable part of the institutional setting.

As regards structural reforms, the Governing Council fully supports any efforts that enhance competition, increase productivity and foster economic flexibility, thus promoting higher sustainable real GDP growth and employment. Exploiting the complementary nature of reforms would increase their benefits in terms of long-term economic dynamism and price stability. Higher productivity growth will allow increases in real wages without negatively affecting employment, thereby supporting the income growth of the euro area workforce.

In fact, as a reflection of undertaken reform efforts so far and as a result of continued wage moderation in some countries, the euro area employment has increased by more than 12 million people since the start of Stage Three of EMU in 1999, which compares very favourably with the somewhat more than two million increase in the eight years before 1999. According to the latest Spring Forecast by the European Commission, prospects are for another 3.8 million employed persons in the euro area in the period 2007-08.

Financial regulation, supervision and stability

Let me now turn to an issue you have asked me to discuss today, which is the framework for financial regulation, supervision and stability and the way in which it can cope with the challenges stemming from increasing financial integration.

Starting with financial regulation and supervision, the Lamfalussy framework was introduced with the purpose of speeding up the process of adopting Community legislation and making its implementation more consistent at the national level in line with the needs of the single financial market. As such the Lamfalussy framework represents in itself an important institutional innovation and therefore we have always shared the stance that it should be exploited to the maximum possible extent before considering any far-reaching institutional changes.

This entails in practice that all four levels of the approach should work at their best and, when this is not the case, appropriate measures should be taken. It is therefore important – as it has been the case so far – to monitor systematically the concrete implementation of the framework to identify areas for possible enhancement. While at the beginning, the monitoring activity concentrated on the regulatory part of the approach (notably the Level 1 and 2), the focus has rightly turned more recently to the supervisory level (i.e. the Level 3). One of the main challenges concerning the Level 3 activity is to ensure that the deliberations taken by the supervisory committees concerning co-operation and convergence are applied consistently in practice.

In this respect, the concrete implementation of the recommendations contained in the Report on Financial Supervision prepared by the Financial Services Committee and endorsed by the ECOFIN Council on 5 May 2006 represents certainly an important milestone. More generally, the forthcoming review of the Lamfalussy process represents an important occasion for further reflections about the efficiency and effectiveness of the current EU supervisory setting. In this context, an important objective of the review should be the identification of concrete measures to further strengthen the supervisory role of the Level 3 Committees.

Turning to the framework for financial stability, the ECB supports in general the current discussions at the EU level to enhance the arrangements for handling financial crises, never forgetting that a crucial responsibility must remain with the private sector itself. It is important indeed that all competent authorities for financial stability, namely central banks, supervisory authorities and ministries of finance are well prepared and have a common understanding of how to manage potential financial crises with a cross-border dimension, whilst avoiding any moral hazard.

In this respect, we should not neglect that significant progress has already been achieved to enhance financial crisis arrangements through the work of relevant forums, including the Economic and Financial Committee, the Financial Services Committee, the ESCB Banking Supervision Committee and the Committee of European Banking Supervisors. The 2005 MoU on co-operation and exchange of information in crisis situations is a clear and relevant example in this respect. I see the current discussions as focusing on crisis resolution and their outcome should be, in my view, in line with three main principles.

First, the principle of flexibility. The arrangements on crisis management and resolution should be flexible enough to keep pace with market developments and to handle the specific features of the actual crisis. Second, the principle of consistency. There should be coherence between the framework for crisis prevention – which is based for the most part on prudential supervision – and the framework for crisis management and resolution. This implies acknowledging the current institutional distribution of responsibilities between home-country and host-country authorities also in a crisis situation. Third, the principle of the primacy of private sector solutions as regards crisis resolution. Again, the arrangements should avoid any kind of moral hazard that could provide the wrong incentives for risk-taking by the financial industry.

Concerning the specific role of the Eurosystem, the system has arrangements and procedures in place for the effective performance of its functions in crisis situations as well as for the provision of emergency liquidity assistance by the national central banks. These arrangements are periodically reviewed and tested also through the conduct of simulation exercises. The most recent exercise took place in May 2006. These simulations allow to maintain a high degree of preparedness of the system. The outcome of these reviews so far has shown that the Eurosystem is well equipped to cope with a financial crisis situation with an area-wide dimension.

Corporate finance in the euro area

Finally, I would like to use this opportunity to present to the Committee the ECB's Structural Issues Report, which this year deals with "Corporate Finance in the euro area".

The aim of the report is to analyse the main features of the functioning of the market for corporate finance in the euro area, including the specifics of the national markets and the conditions applicable to the borrowers. Given the great interest in the issue of small and medium-sized enterprises (SMEs) access to finance, the report also analyses how financing patterns differ across large, medium and small enterprises. Finally, the report discusses the recent trends observed in the corporate finance landscape of the euro area over the past few years and how they have influenced the availability of external finance for firms.

Let me briefly summarise some of the results contained in the report:

First, firms' financial structures are relatively homogeneous across euro area countries. Still, even after taking into account the average firm size and sectoral composition across countries, some cross-country differences remain which may be explained by the remaining differences among legal and institutional frameworks.

Second, regarding SMEs, the report indicates that several of the differences in the financial position of firms according to size which had been identified in previous studies are driven mainly by the relative weights of SMEs and large firms in the various sectors, and also to some extent by the relative weights of SMEs in the various countries.

At the same time, the report also highlights that some differences across size classes remain regarding the reliance on bonds and the share of financial to total assets – which is lower for SMEs – and in terms of the reliance on bank loans and cash – which is higher for SMEs. The latter may point to the need of keeping liquid balances to finance future projects. Small and medium-sized firms tended also to be in a somewhat weaker financial situation as indicated, for example, by their higher indebtedness.

Finally, concerning the role of financial intermediaries in providing finance to firms, a two-tiered process has been identified. Firstly, bank lending has become even more prominent in the last two or three years. Secondly, the link between the banking sector and the markets has been strengthened significantly, with commercial banks shifting from acting as traditional financial intermediaries to functioning as credit risk originators and sellers as a result of securitisation processes and the increasing use of credit derivatives.

From the point of view of monetary policy, four main conclusions can be drawn.

First, the growing importance of structured finance and increased competition between banks and other financial intermediaries may provide corporations with easier and cheaper access to external finance.

Second, as credit granted is evaluated on a more mark-to-market basis and the banking sector becomes more and more competitive, the speed of transmission of monetary impulses to bank interest rates is expected, ceteris paribus, to quicken.

Third, it is likely that credit risk will be less concentrated on banks, thereby making them less vulnerable in the event of shocks, whilst it remains to be fully understood if and where credit risks are again concentrating on some particular sub-sectors in the non-bank constituencies.

And fourth, we must be aware of the fact that episodes of mispricing of credit risk will necessarily be followed by adjustments. It depends on all the parties concerned that such adjustment be smooth and orderly and not abrupt and sharp, which in the second case would be adverse for the global economy

I am now at your disposal for questions.