

Jean-Claude Trichet: Presentation of the ECB's Annual Report 2006 to the European Parliament

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, to the European Parliament, Strasbourg, 11 July 2007.

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Monsieur le Président, Mesdames et messieurs les députés,

J'ai l'honneur de vous présenter aujourd'hui le Rapport annuel de la BCE pour l'année 2006. Le Rapport annuel constitue un des outils principaux de la BCE pour rendre compte aux citoyens de l'Europe et à ses représentants élus – le Parlement européen – de sa politique monétaire et de ses activités dans les autres domaines de sa compétence.

Ich werde Ihnen zunächst einen kurzen Überblick über die wirtschaftlichen und geldpolitischen Entwicklungen im Jahr 2006 geben und die geldpolitischen Maßnahmen der EZB erläutern. Danach möchte ich einige Anmerkungen zur Finanzmarktstabilität sowie zum Thema Zahlungsverkehrssysteme machen.

Economic and monetary issues

In 2006 the ECB's monetary policy continued to anchor medium and long-term inflation expectations at levels consistent with price stability. This reflected the credibility of the ECB in conducting its monetary policy, in full compliance with its primary objective of maintaining price stability over the medium term. The solid anchoring of longer-term inflation expectations is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area, in line with Article 105 (1) of the EC Treaty.

In 2006 the euro area economy expanded at the highest growth rate since 2000. Notwithstanding the impact of high and volatile oil prices, real GDP rose by 2.9% in 2006, compared with 1.5% in 2005. The economic recovery gradually broadened in the course of 2006, and the nature of the economic expansion became increasingly self sustaining, with domestic demand acting as the main driver. Despite some moderation, the ongoing strong momentum in economic growth continued in the first quarter of 2007. The euro area continued to benefit from the robust ongoing expansion of the world economy, while substantial gains in corporate profits and an extended period of very favourable financing conditions supported investment growth and employment. Consumption growth observed a gradual recovery, in line with improving conditions in the labour market.

The latest data and survey releases have remained broadly positive, supporting the view that economic activity in the euro area in the second quarter of 2007 continued to expand at solid rates. Looking ahead, the medium-term outlook for economic activity remains favourable and the conditions are in place for the euro area economy to continue to grow at a sustained rate. As regards the external environment, global economic growth remains robust, while domestic demand in the euro area is also expected to maintain its relatively strong momentum.

The risks surrounding this favourable medium-term outlook for economic growth are broadly balanced over the shorter term. At medium to longer horizons, risks remain on the downside, owing mainly to external factors.

Regarding price developments, average annual HICP inflation in 2006 was 2.2%, unchanged compared with the previous year. This was slightly above the ECB's aim to keep inflation over the medium term below, but close to, 2%. Although this outcome mainly reflects increases in oil and commodity prices, and although inflation has been slightly below 2% in the first half of 2007, there is no room for complacency.

The outlook for price stability over the medium term remains subject to upside risks. As capacity utilisation in the euro area economy is high and labour markets are gradually improving, constraints are emerging which could lead in particular to stronger than expected wage developments. In addition, pricing power in market segments with low competition may increase in such an environment. The Governing Council stresses the importance of avoiding wage developments that would eventually lead to inflationary pressures and harm the purchasing power of all euro area citizens. In addition, upside risks to price stability arise from increases in administered prices and indirect taxes beyond those anticipated thus far and the potentially pro-cyclical stance of fiscal policy in some countries. Finally, on the external side, upside risks stem from the possibility of further unexpected oil price rises.

The Governing Council's assessment that upside risks to price stability prevailed has been confirmed throughout the period from the start of 2006 to mid 2007 by cross-checking with the monetary analysis. The marked dynamism of monetary and credit growth in 2006 reflected a continuation of the persistent upward trend in the underlying rate of monetary expansion in the euro area that has been observed since mid-2004, adding further to liquidity accumulation. Also in 2007, the underlying rate of monetary expansion remains strong, as reflected in the continued rapid growth of M3 as well as the still high level of credit growth. Following several years of robust monetary growth and the continued vigour of the ongoing expansion in money and credit, liquidity in the euro area remains ample. In this environment, there are clear indications of upside risks to price stability at medium to longer-term horizons. Therefore, monetary developments continue to require very careful monitoring, particularly against the background of the expansion in economic activity and still strong property market developments.

To address the upside risks to price stability identified by the ECB's economic and monetary analyses, the Governing Council has adjusted the monetary policy stance gradually in eight steps since the end of 2005. As a result, the minimum bid rate in the main refinancing operations of the Eurosystem rose from 2.00% in December 2005 to 4.00% in June 2007. After the adjustments in the key interest rates, the ECB's monetary policy remains still on the accommodative side, with overall financing conditions favourable, money and credit growth vigorous, and liquidity in the euro area ample. Looking forward, firm and timely action continues to be warranted to ensure price stability over the medium term. The Governing Council will continue to monitor closely all developments in order to ensure that risks to price stability over the medium term do not materialise.

Fiscal policies

As regards fiscal policies, the ECB shares the view expressed in the draft resolution that fiscal consolidation is key and all the more necessary in good times in order to achieve long-term growth. In a benign environment, budget balances in 2006 were generally better than expected. It is imperative that forthcoming budget plans build on this favourable outcome, assigning higher than expected revenues to deficit reduction and speeding up progress towards the achievement of medium-term budgetary objectives. The ECB is concerned about recent developments which point to a relaxation of fiscal targets in some countries, the aforementioned risk of pro-cyclical policies and a repetition of past policy mistakes. It is imperative that all governments comply with the provisions of the Stability and Growth Pact on fiscal consolidation and that all the countries concerned honour the commitments made at the Eurogroup meeting in Berlin on 20 April 2007. As agreed in Berlin, taking advantage of the favourable cyclical conditions would enable most euro area countries to achieve their medium-term objectives in 2008 or 2009, and all of them should aim for 2010 at the latest. These pledges should be reflected in the 2008 budget plans so as to avoid repeating governments' past failure to adjust fiscal balances in economic "good times". The Governing Council also welcomes the emphasis placed by the ECOFIN Council on measures to improve the quality and efficiency of public finances.

Economic differentials in the euro area and structural policies

Turning to structural policies, the draft resolution adopted by the ECON Committee refers several times to economic divergences in the euro area. I should like to stress first that, overall, inflation differences among euro area countries have fallen and are currently relatively limited by historical standards. The magnitude of current inflation and output differentials is similar to that observed across regions or states within the United States. These differentials can be considered normal to the extent that they reflect catching-up phenomena or country-specific shocks. However, inflation differentials tend to be rather persistent in the euro area, and they reflect in part persistent differences in unit labour cost developments. In addition, the variation of output growth across some euro area countries can largely be attributed to differences in potential output growth rather than in business cycles. In a number of cases, this may reflect existing rigidities in product and labour markets and a lack of competition, leading to sluggish adjustment processes and a restrained growth potential. It is very important to monitor the accumulated competitiveness losses in some of the euro area countries. A more comprehensive analysis of the sources and implications of these differentials, as requested in your draft resolution, has already been provided in our Monthly Bulletin of April this year.

A single currency means a single monetary policy and a single exchange rate vis-à-vis other currencies. It is therefore all the more important to ensure that all the national mechanisms of adjustment to shocks function perfectly. The efficient and smooth functioning of economic adjustments within the euro area requires the removal of institutional barriers to flexible wage and price-setting mechanisms as well as the completion of the Single Market and thus greater cross-border competition. Indeed, well-designed structural reforms implemented by national governments are crucial to improve the functioning of product, labour and financial markets and to reinforce competitiveness. Increased market competition and a reduction of cross-border barriers are beneficial for consumers since they lead to lower prices, higher real wages and a greater choice of products. They are also beneficial for firms since they lead to higher efficiency, greater dynamism and an enhanced capacity to cope with economic shocks and to face the challenges and opportunities posed by globalisation. Free and undistorted competition fosters long-term economic growth and job creation and facilitates the maintenance of price stability in the euro area. The completion of the Single Market must therefore be a priority for all of us, in particular as regards further financial market integration, the pursuit of effective competition in the energy market and the implementation of the Services Directive.

Financial stability

Mister President, honourable members of the European Parliament, let me now address some financial stability issues, in particular the ECB's view on hedge funds and leverage buyouts, both of which continue to remain at the forefront of financial market activity.

The ECB acknowledges the positive role that hedge funds play by contributing to enhancing the efficiency and liquidity of financial markets. We should be aware, however, that hedge funds can represent also a source of risk to the stability of the financial system. This can take place through two main channels, notably the possible effects on investors and counterparties, primarily banks, and the potential impact on financial markets and particularly derivative markets. Concerning the latter, it is not fully clear what could be the impact of hedge funds' behaviour on the liquidity of financial markets in a stress situation.

Against this background, the report issued in May 2007 by the Financial Stability Forum on High-leveraged institutions is welcome. The report concluded that, while the so-called indirect regulation of hedge funds through their regulated counterparties, foremost banks, remains the most adequate approach for containing potential risks to financial stability, the effectiveness of this approach cannot be taken for granted and needs to be monitored regularly. Therefore, the report contains a number of recommendations addressed to

supervisors, hedge funds' counterparties and investors, and the hedge fund industry itself, which I fully share. As for the role to be played by the industry, more than ever I will support the proposal that the hedge fund sector would strive for best practices and that industry-led benchmarks would be a suitable tool to pursue this objective. In this vein, the recent initiative undertaken by the industry to set up a working group to review best practices is a very welcome development and I look forward to the result of such work.

My second point concerns private equity and leveraged buyout (LBO) activity. This activity has been booming in Europe – also as a consequence of abundant market liquidity – and has seen an increasing involvement of banks. In a recent study on large banks' involvement in the LBO market in the EU, which was conducted by the Banking Supervision Committee and published by the ECB, banks' debt exposures were assessed as being manageable with respect to their capital buffers. However, the study identified so-called warehousing risk as a significant risk to which banks are becoming exposed through LBO-related activities. This risk arises from the material amounts of LBO debt that underwriting banks take on, with the aim of distributing it into the market shortly after the transactions are completed. The efficacy of these risk distribution processes strongly rely on the effectiveness of syndication processes and the degree of liquidity in credit risk transfer (CRT) markets. I consider that the warehousing risks faced by banks start to increase.

Payment systems

My final remarks concern the integration of payment systems in Europe. I noted with satisfaction the positive assessment you made in the draft resolution about the Single Euro Payments Area and the Target 2 project. The Eurosystem will continue to play its role in this regard.

As for the Target2-securities (T2S) project, the draft resolution shares the Eurosystem's assessment that this project might have the potential to foster the integration, the efficiency and the safety of the clearing and settlement infrastructure in Europe. At the same time, the draft resolution notes that an appropriate governance structure is of the essence. As for the latter point, we have always wished to have a strong involvement of the markets in the T2S project. We have put in place a governance model for the development phase which seeks to involve all stakeholders through the creation of an Advisory Group on T2S where markets players are well represented. The "Advisory Group" – which reports directly to the ECB Executive Board and Governing Council – is composed for about two thirds by market participants and only one third by central bankers. Hence, strong interaction between the ECB and the markets takes place on a continuous basis.

On 26 April 2007, the ECB Governing Council launched an official public consultation on the principles and proposals underlying the T2S Project. The 2-month public consultation launched by the ECB is now finalised, and the market feedback is very useful. We received quite a high number of comments. A first preliminary assessment of these comments shows that their feedback is generally rather positive. Out of 67 proposals, we have obtained a total of 3200 remarks from 56 institutions. 67% of these 3200 remarks indicated full agreement to the proposals, while only 6% indicated full disagreement. All the feedback received has been published (unless the respondent explicitly requested not to do so) and is being carefully considered.

The governance of T2S is of special importance for us and thus an important element of our work programme. My colleague, Mrs Tumpel-Gugerell and Mr Godeffroy, Director-General Payment Systems and Market Infrastructure, have made presentations before the Parliament this year to present the case for T2S and inform on the governance for T2S. The governance arrangements for the next phases of the project will be discussed in the coming months and the EP will be kept fully informed.

I thank you very much for your attention.