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, 26 March 2008.

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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 régulier. Je commencerai mon intervention par une évaluation de la situation économique et monétaire, en expliquant les raisons sous-jacentes à nos récentes décisions de taux. Ensuite, je vous donnerai de plus amples explications sur la distinction opérée par la BCE entre la définition de notre politique monétaire d'une part, et la preservation du bon fonctionnement du marche monetaire d'autre part. Zum Abschluss möchte ich einige vorläufige Schlussfolgerungen für die Regulierung, Aufsicht und Stabilität der Finanzmärkte ziehen.

Economic and monetary developments

Since my previous appearance before the European Parliament in mid December, inflation has remained at relatively high levels of above 3%. The incoming information has confirmed our assessment of prevailing upside risks to price stability over the medium term, in a context of continued vigorous money and credit growth. Strong upward pressure on inflation in the short term mainly stems from the recent increases in energy and food prices. Looking ahead, the inflation rate is expected to remain significantly above 2% for most of the year. Hence the period of relatively high inflation rates will be more protracted than previously expected.

The March 2008 ECB staff macroeconomic projections foresee HICP inflation to range between 2.6% and 3.2% in 2008, and between 1.5% and 2.7% in 2009. These projected ranges have shifted upwards, mainly as a result of higher food and energy prices. I should stress that the staff projections are based on a number of purely technical assumptions which are unrelated to policy intentions, such as the use of market expectations in the assumptions for short-term interest rates.

In the view of the Governing Council, risks to the medium-term outlook for inflation are on the upside. These risks include further rises in oil and agricultural prices. Furthermore, taking into account high capacity utilisation and tight labour market conditions, wage growth may be stronger than currently expected, as well as the pricing power of firms, notably in market segments with low competition. Moreover, administered prices and indirect taxes may increase beyond what is foreseen.

At this juncture, it is therefore imperative that all parties concerned meet their responsibilities and that second-round effects on price and wage-setting stemming from current inflation rates are prevented. To that end, schemes in which nominal wages are indexed to consumer prices must be avoided. This is key to preserving price stability in the medium term and thereby the purchasing power of all euro area citizens.

Turning to economic activity, in the fourth quarter of 2007, real GDP grew by 0.4% quarter-on-quarter, following a rise of 0.8% in the third quarter. Incoming information confirms the picture of moderating growth. Looking forward, ongoing growth is expected. The euro area economy has sound fundamentals and does not suffer from major imbalances. Investment growth – while dampened by the global slowdown – should provide ongoing support. At the same time, employment and labour force participation have increased significantly and unemployment rates have fallen to levels not seen for 25 years. Accordingly, consumption growth should continue to contribute to economic expansion.

This assessment is reflected in the latest ECB staff projections, which foresee annual real GDP growth in the range of 1.3% to 2.1% in 2008 and of 1.3% and 2.3% in 2009. These ranges have been revised downwards, reflecting weaker global demand, stronger pressure from commodity prices and less favourable financing conditions than foreseen in December.

In the view of the Governing Council, uncertainty about the prospects for economic growth remains unusually high. Downside risks relate to a potentially broader than currently expected impact of financial market developments. Further downside risks stem from the scope for additional increases in commodity prices, protectionist pressures and the possibility of disorderly developments owing to global imbalances.

The monetary analysis confirms the prevailing upside risks to price stability at medium to longer-term horizons. On the basis of data available up to January, the underlying money and credit expansion remains strong, even taking temporary factors into account, such as the relatively flat yield curve. There is little evidence that the financial market turbulence since August 2007 strongly influenced the overall dynamics of broad money and credit aggregates. Bank loans to the domestic private sector have grown at annual rates around 11% for the past two years. While the growth of household borrowing has moderated over recent months, loan growth to non-financial corporations remains very strong.

In line with its mandate, the ECB's Governing Council remains strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term. Against this background, on 6 March, we decided to leave the key ECB interest rates unchanged. The current monetary policy stance will contribute to achieving our price stability objective. Indeed, the firm anchoring of medium to longer-term inflation expectations is of the highest priority. The Governing Council will continue to monitor very closely all developments.

The separation of the tasks of determining the monetary policy stance on the one hand and the preservation of the proper functioning of the money markets on the other hand

Let me now address the issue of the separation between the determination of the monetary policy stance on the one hand and its actual implementation on the other hand, meant as keeping short-term rates close to the level chosen by the Governing Council. In accordance with the Treaty provisions, the primary objective of the ECB is to maintain price stability in the euro area. To that end, the Governing Council determines, on the basis of its economic and monetary analyses, the appropriate monetary policy stance by setting the key ECB interest rates at the level that ensures the maintenance of price stability over the medium term. In view of safeguarding its credibility and firmly anchoring long-term inflation expectations, it is crucial that the Governing Council sets the appropriate monetary policy stance on the basis of no other considerations than the delivery of price stability in the medium term.

Once the appropriate level of the key ECB interest rates has been set, the Executive Board of the ECB implements monetary policy so that the level of the key interest rates decided by the Governing Council actually prevails in the money market. For this purpose, the ECB steers, primarily by means of open market operations, the liquidity which is lent to euro area credit institutions against adequate and sound collateral and for a given and short period of time. By so doing the ECB also fosters a smooth functioning of the euro area money market.

The steering of liquidity has been an important element of the Eurosystem's framework for monetary policy implementation since the launch of the euro. By these means, market participants get clear and loud the signal about the orientation of the monetary policy stance and this fosters the predictability and credibility of the Governing Council's monetary policy decisions. The fact that these decisions are firmly based on the objective of price stability and the concomitant fact that the steering of liquidity is in turn dependent on these decisions, but in no way influences them ensures that price stability is maintained over the medium term. This also ensures that the liquidity provision aimed at promoting the smooth functioning and resilience of money markets is also fully in line with the primary objective of price stability.

Particularly after the onset of financial tensions in August 2007, the principle, that the steering of liquidity is subservient to the monetary policy stance and does not affect it, appeared of the essence.

In this period of acute turbulences, the ECB has succeeded in containing deviations of very short-term interest rates from the official interest rate set by the Governing Council. As a result, the ECB has ensured a continued effective implementation of monetary policy in line with the stance, thereby also contributing to safeguarding overall financial stability.

Since the last Hearing in December, tensions have continued. During this period, the Eurosystem remained, as usual, in close contact with other major central banks. In this context, on 11 March the Governing Council of the ECB decided, in conjunction with the Federal Reserve to offer US dollar funding to Eurosystem counterparties as it did in December 2007 and in January 2008. Through the operations currently being undertaken, liquidity for an overall amount of up to USD 30 billion is provided. The Swiss National Bank is following an analogous course of action.

Overall, given its flexible design, the Eurosystem's operational framework with its broad range of instruments has thus far proved to be resilient and effective. Even in the course of the ongoing financial turmoil, there has been no need to adjust or extend the existing framework, e.g. by introducing innovative instruments or a broader range of collateral.

Recent developments regarding financial stability and supervision

I would now like to share with you the ECB's assessment of the current financial stability situation. I will also touch briefly upon the possible policy measures which are being prepared at the European and international level in response to the financial turmoil.

With the global financial system undergoing a process of de-leveraging, the euro area financial stability outlook continues to be clouded by considerable uncertainty. Since my last hearing before your Committee, it has been argued that the total valuation and income losses facing the global financial system are clearer. Yet considerable uncertainty still remains about the reliability of total cost estimates and about how the costs will eventually be spread. There is also uncertainty about the possibility of feedback effects onto the financial system, including questions about what the ultimate impact on the intermediation of credit – both through financial institutions and markets – will be. Moreover, until conditions in the US housing market show signs of improvement, the possibility of continuing tensions in structured credit markets cannot be excluded.

In the period ahead, large euro area banks are likely to face pressure on their revenues on account of lower activity levels in the structured credit markets as well as from a general retrenchment from risk-taking across many business lines. At the same time, the banks are facing increased funding costs. Consistent with this, a number of financial market indicators – including bank equity prices and credit default swap spreads – have generally been reflecting expectations of weaker profitability as well as concerns about credit and counterparty risks. On the positive side, several years of strengthening profitability had by mid-2007 left the euro area banking sector in a strong financial position to face the possibility of a credit cycle downturn.

All in all, given the heightened uncertainties, and in an environment where balance sheet conditions could unexpectedly change, vigilance is more than ever of the essence. Financial institutions will need to step up their efforts to effectively manage the risks that may lie ahead. From the central banks' perspective, restoring confidence among economic agents and market participants is crucial in the current environment of great uncertainty and high market volatility. One very important contribution the ECB makes to preserving confidence is to continue firmly anchoring medium to long term inflation expectations for the euro area while at the same time ensuring the smooth functioning of the short-term money market.

At the current juncture, priority has been given to comprehensively draw lessons and formulate policy responses to address the challenges raised by the financial market turbulence. The key areas have been identified and since my last hearing before you, work has been progressing intensively both internationally and in the EU. The Financial Stability Forum and the ECOFIN have developed preliminary assessments warranting further policy action. In that context, let me mention some areas I see as requiring timely responses:

First, with regard to improving disclosure and valuations of structured finance products, financial institutions are called upon to promptly and fully disclose on- and off-balance sheet risk exposures. Moreover, guidance is warranted by auditors and supervisors with the aim of enhancing the clarity and robustness of structured product valuations, particularly in relation to illiquid assets.

Second, credit rating agencies, whilst eliminating conflicts of interest, should take measures to expand the scope of information provided to investors – thus facilitating their exercise of due diligence, while improving governance and rating methodologies. If their endeavours will not prove to be adequate, public policy action would need to be considered.

Third, supervisors should ensure that banks retain adequate capital and liquidity buffers. In this context, work is underway to refine certain aspects of the capital adequacy framework, especially in relation to the treatment of securitisation and off-balance sheet exposures. Moreover, further supervisory guidance needs to be developed for liquidity risk, incorporating the lessons from the turmoil and focusing on liquidity stress-testing and contingency funding plans.

These are three examples of areas where very important progress should be made. More generally, I would call for a further significant change of culture at the national, European and global level. I would sum up this cultural change with two words: transparency and anti-cyclicality. "Transparency" because enhanced public information on financial instruments, on markets and on institutions is not only necessary to permit market participants to take optimal economic decisions, but is also the only way we have of avoiding contagion, herd-behaviour and, therefore, the propagation of turbulences in times of difficulty. And "anti-cyclicality" because a large number of rules, regulations and procedures have a tendency to foster behaviour that is largely procyclical, amplifying the booms as well the busts in the cycle. We must look at all parts of global finance with a view to diminishing progressively their pro-cyclical components, which implies, in particular but certainly not exclusively, eliminating to the greatest possible extent asymmetry in the treatment of booms and busts and, where necessary, extending as far as possible the time-horizon adopted by all the institutions concerned.

I am now at your disposal for questions.