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

Introductory statement by Mr Jean-Claude Trichet, President of the European Central Bank, Brussels, 16 February 2004.

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In my testimony today I will first comment on recent economic and monetary developments. I will then make a few remarks about the benefits that have been brought to us by the euro in its first five years of existence.

Economic and monetary developments

When we last met in December, economic indicators and financial market developments were already supporting our view that a gradual economic recovery had started in the euro area in the second half of 2003. The evidence that has since become available has made us more confident that the recovery did indeed begin in the second half of 2003 and has strengthened our expectation of an upswing in economic activity.

An upturn in economic activity is well under way at the global level. This view was shared by all participants at the recent G7 meeting in Florida. The robust real GDP growth in the economies of the euro area's major trading partners over the past few months can be expected to support foreign demand for euro area goods and services. Looking ahead, the external environment of the euro area should continue to develop favourably, and the broadly-based global economic recovery should gain further momentum. External developments should thus support the continued recovery in the euro area.

We expect this economic recovery in the euro area to proceed gradually. After real GDP growth picked up in the third quarter of 2003, survey evidence on business confidence and the Eurostat flash estimate for real GDP growth in the fourth quarter point to a continuation of the recovery around the turn of the year. While domestic demand remained subdued in 2003, the conditions for some improvement are now in place. Investment activity should profit not only from strengthening global demand, but also from companies' earlier efforts to enhance productivity and profitability, from the historically low levels of interest rates and from the favourable financing conditions prevailing in the euro area. Growth in euro area private consumption is also expected to progressively recover, benefiting from price stability and supported by the growth of real household disposable income. The scenario of a gradual economic recovery in the euro area is reflected in all available forecasts from official and private sources and seems to be in line with developments in financial markets.

Over the shorter term, risks to the main scenario of a gradual euro area recovery remain balanced. Nevertheless, over longer horizons, some uncertainty related to the sustainability of economic growth remains, given the persistent imbalances in some regions of the world. Against this background, there is a broad international consensus, expressed in particular in the last G7 statement, that these imbalances are a challenge that calls for the implementation of structural reforms that raise the growth potential of our economies, elevate labour productivity growth and increase employment, and of sound fiscal policies over the medium term. Let me also mention that we all agreed to state in the G7 communiqué that exchange rates should reflect economic fundamentals and that excess volatility and disorderly movements in exchange rates are undesirable for economic growth.

With regard to price developments, annual euro area HICP inflation was 2.0% in December and is estimated by Eurostat to have remained at this level in January. Rises in food and oil prices and, in particular, significant increases in indirect taxes and administered prices have prevented a decline in the inflation rate to lower levels. Looking forward, inflation should fall below 2% in the course of this year and remain in line with the ECB's definition of price stability thereafter, namely below 2% and close to 2%. In view of the expected gradual nature of the recovery, wage developments should remain moderate. Nonetheless, given the conditional nature of any forward-looking evaluation, it is of course important to bear in mind all elements of risk to the outlook for price stability. Furthermore, inflation expectations need to be monitored closely.

Turning to the monetary analysis, annual M3 growth has continued to moderate only slowly over recent months. The shift of portfolios away from monetary assets towards longer-term financial assets outside M3 that started during the summer of 2003 has been rather gradual. The low level of interest rates is contributing to the continued strong growth of very liquid assets and may explain the slow pace of portfolio adjustment. At the same time, the increased growth of loans to the private sector reflects the effects of both low interest rates and an improvement in the economic environment.

The strong monetary growth observed over the past few years, means that there is significantly more liquidity available in the euro area than needed to finance non-inflationary growth. Whether the accumulated excess liquidity will translate into inflationary pressures over the medium term depends on the extent to which past portfolio shifts are reversed and on the future strength of economic growth. Should excess liquidity persist, it could lead to inflationary pressures over the medium and long term.

In summary, the economic analysis continues to indicate that the outlook for price developments over the medium term is in line with price stability. Cross-checking with the monetary analysis does not alter this picture. Against this background, the Governing Council judged at its last meeting on 5 February that the current stance of monetary policy in the euro area remained appropriate. Of course, we will continue to monitor carefully all developments that could affect the assessment of risks to price stability over the medium term.

With regard to fiscal policies, there are several important issues that warrant close attention. First, the implementation of fiscal policies should be in line with the commitments made by governments last year. In this connection, a thorough assessment of the new stability programmes of the Member States is currently under way. Sound public finances are needed to support a stable macroeconomic framework, which in turn enhances confidence and promotes investment, growth and employment in the euro area.

Second, as regards the institutional framework for fiscal policy, the Governing Council shares the concerns of the European Commission regarding the conclusions of the ECOFIN Council in November last year. The Commission is the guardian of the Treaty and the ECB respects the Commission’s decision to seek legal clarity on the implementation of the Stability and Growth Pact. The ECB does not see a need to change the Treaty and it considers the Stability and Growth Pact appropriate in its current form. The Governing Council is in agreement with the Commission that the implementation of the Stability and Growth Pact could be further improved, in particular in terms of the analysis of structural imbalances and the strengthening of incentives for sound fiscal policies during good economic times. The clarity and enforceability of the fiscal framework should be enhanced.

A sound monetary policy, a healthy fiscal policy and a stable macroeconomic framework are necessary to pave the way for sustainable growth in the euro area. But this alone is not sufficient. The euro area needs to boost employment, foster labour productivity and make the best use of technological and scientific progress. These challenges require structural reforms in the fiscal domain, in the management of social welfare and pensions as well as in financial, product and labour markets. The required measures have been identified and the Lisbon agenda has set the appropriate direction for the euro area. Important progress has already been made in many euro area countries. It is of the utmost importance that the implementation of structural reforms be speeded up, notably in labour and product markets, where the responsibility lies with governments, parliaments and social partners. This would, over longer horizons, significantly improve the euro area’s growth potential and increase the economic welfare of all its citizens. It would also enhance the confidence of economic agents over shorter horizons. All parties involved must strive to convince the public at large that everybody would benefit from such reforms - in terms of growth, more and better jobs, and higher incomes.

The euro after five years

It is now five years since the start of Stage Three of Economic and Monetary Union and two years since the introduction of the euro banknotes and coins, and I would like to make a few remarks on the benefits the single currency has had for our economies and our citizens.

First of all, I am proud to say that, in accordance with the mandate set out in the Maastricht Treaty, the ECB has, despite substantial adverse price shocks, successfully kept inflation and inflation expectations at low levels by historical standards. The single monetary policy and its clear focus on the maintenance of price stability have helped to anchor inflation expectations in the euro area over the medium and long term. This has facilitated a reduction of inflation uncertainty and the associated risk premia. As a result, market interest rates have remained historically low and our citizens, our companies and the euro area as a whole now enjoy financing conditions which are very favourable by historical standards. This is a key factor for growth and job creation.

We should not forget that prior to the euro, there were significant differences in long-term interest rate levels across countries. It was a remarkable achievement that the creation of a credible Monetary Union allowed market interest rates to converge towards the levels of the legacy currencies inspiring the maximum level of confidence and therefore having the lowest market interest rates, and not just to the average level. This very significantly improved the financing conditions in a large part of the euro area which previously had much higher market interest rates, and this is a success of the euro which is often underestimated.

Second, let me remind you that by adopting the single currency, euro area countries also eliminated their exposure to intra-euro area exchange rate volatility and risks. Prior to the introduction of the euro, intra-euro area exchange rate developments were very significant sources of uncertainty for trade and investment. This uncertainty was in turn priced into high-risk premia on interest rate markets. These phenomena hampered investment, job creation and growth all over what is now the euro area.

Moreover, the macroeconomic implications of exchange rate developments vis-à-vis non-European currencies are now much less significant than they were prior to the introduction of the euro. This is a very significant structural change, which has improved the conditions for investment and trade in the euro area.

All things being equal, this much more stable environment facilitates decisions by producers, investors and consumers. It increases the confidence of economic agents and is therefore favourable to growth and job creation. Had the single currency not existed, the various crises that have occurred at the global level over recent years would have translated into major turbulence for our economies.

My third comment relates to the very powerful impact the euro has had on the creation of the Single Market. The euro has led companies to see the euro area as a whole as the relevant domestic market for their business, rather than their own national markets as in the past. In this respect, the single currency has undoubtedly been a catalyst for the progressive reshaping of the European productive sector, which are in turn creating a more efficient and vibrant economy.

Low medium and long-term market interest rates, better protection against external risks and shocks, and the strengthening of the European productive sector are all important benefits for the citizens of the euro area. It is always difficult to compare what you have with what you would have, had the euro had not been established five years ago. The present benefits are extremely substantial, a fact which is unfortunately not very often stressed.

Let me summarise the advantages for the citizens of the euro area, which would not exist without the euro:

- the credible medium and long-term protection of their purchasing power throughout the euro area;
- the credible medium and long-term preservation of their savings throughout the euro area;
- favourable financing of their medium and long-term investment, in particular in housing, throughout the euro area;
- a total elimination of adverse effects on households from intra-European crises such as those observed in 1992 and 1993; and finally
- a more efficient and resilient productive sector, which is particularly important in a global environment of renewed healthy competition, both within the industrialised world and between industrialised countries and emerging economies and economies in transition.

Let me add one final remark. I know that some of our fellow citizens have the feeling that euro area inflation has been, and perhaps continues to be, above the levels of CPI inflation computed by national institutions and by Eurostat. I want to tell them that the figures published are not underestimating inflation. But I also want to tell them that the Governing Council of the ECB is fully aware of their fears. I want to assure them of our determination to preserve price stability in the euro area not only this year and next year, but on a medium and long-term basis. I also want to tell them that we are doing all we can to encourage competition, which is the law of market economies and fosters best value for money for all consumers. We are vigilant and we are confident. I know the European households are vigilant, which is good. I encourage them also to be confident: their purchasing power will be protected in the years to come, thanks in particular to the vigilance of the Governing Council of the ECB. From that standpoint, perhaps it is time to be more confident, and for households to consume and to invest more, which in turn would be good for growth and job creation.