Jean-Claude Trichet: Current challenges for the ECB - sustainable non-inflationary growth and financial stability

Speech by Mr Jean-Claude Trichet, President of the ECB, at a conference sponsored by Christa Randzio-Plath, the Bundesbank Hamburg office and the Chamber of Commerce, Hamburg, 13 May 2004.

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I am very honoured to have been invited here today. I would like to thank the Hamburg branch of the Bundesbank, the Chamber of Commerce and Madam Christa Randzio-Plath for their invitation. Today, I would like to talk about two main challenges inherent to the mandate, role and functions of the ECB. The first one concerns the ECB's role of providing a sustainable non-inflationary growth environment. The second relates to the ECB's contribution to financial stability in the euro area.

Let me turn first to the challenge of a sustainable non-inflationary growth environment.

Sustainable non-inflationary growth

The monetary strategy of the ECB: how it can contribute to sustainable non-inflationary growth

Let me start by elaborating on the contribution that the ECB's monetary policy can make towards a high level of sustainable non-inflationary growth. Any deliberations in this field must necessarily start from the wide consensus which has been reached in the past few decades on two fundamental principles that should guide monetary policy.

The first principle lays down exactly what monetary policy can and cannot do. It relates to the well-established fact that monetary policy impulses have only temporary real effects in the short term. In the long run, monetary policy can only influence the price level.

The objective of price stability

However, monetary policy can make a fundamental contribution to a high level of sustainable growth. It relates to the second principle I was referring to above. This second principle recognises the fundamental role of price stability as a prerequisite for sustainable growth and the creation of employment. Why is that so? The reasons are manifold.

- First, price stability enhances the efficiency of the market system in allocating resources by making it easier for economic agents to optimise their decisions. Symmetrically, price stability also prevents the considerable and arbitrary redistribution of wealth and income that arises in inflationary as well as deflationary environments, where prices change unpredictably.
- Second, price stability preserves and bolsters consumers' purchasing power and confidence, thus supporting consumption.
- Third, price stability conducts to lower uncertainty and minimised risk premia in financial markets, thereby implying lower medium and long term market interest rates, which stimulates investment and growth.
- Fourth, ensuring the price stability objective provides markets with an indispensable nominal anchor for adjusting wages in line with productivity growth, thereby helping to preserve the competitiveness of the euro area economy and the stability of the currency.

The above-mentioned principles are enshrined in the EU Treaty, which has assigned to the Eurosystem - i.e. the ECB and the national central banks of the euro area - the primary objective of maintaining price stability.

In the context of its monetary policy strategy, the ECB has made the Treaty's mandate operational by providing an explicit quantitative definition of price stability: a year-on-year increase in the HICP for the euro area of below 2%. In reviewing its monetary strategy one year ago, the ECB has clarified that it will aim at maintaining inflation rates below, but close to, 2% over the medium term. This public announcement is a fundamental element of our monetary policy concept. It is good for transparency and accountability: the public can judge whether and how we are achieving our own goals according to this yardstick. It is good for medium and long-term credibility: inflationary expectations can be more firmly anchored.

The medium-term orientation of the ECB's monetary policy

The ECB's monetary policy strategy also makes clear that price stability is to be maintained over the medium term. This is a crucial element of our policy. First and foremost, it means that the central bank eschews over-ambitious attempts to steer price developments over short horizons and with a high degree of precision.

Second, the medium-term orientation gives the ECB the possibility to respond in the most appropriate manner to different economic shocks, according to their origin, size and nature. In particular, the time horizon over which price stability has to be re-established would depend on whether the shocks are temporary or permanent, whether they emerged on the supply or the demand side, on their domestic or external origin, their potential for becoming entrenched in pricing decisions and on their implications for the fragility of the financial system. In all events, the central bank has to preserve its credibility, ensuring that expectations remain consistent with its declared policy objective.

A sound analytical framework

Maintaining price stability in a new, ever-changing and complex environment like the euro area economy is a continuous challenge. In such circumstances, we focus on the need for robustness and completeness of the analytical framework to assess the risks to price stability. Our approach is based on two pillars: the economic analysis and the monetary analysis. The economic analysis takes into account a broad set of economic and financial indicators to assess the short to medium-term price trends. The monetary analysis permits a cross checking of the economic analysis by drawing on the longer-term close link between the money stock and the price level from a medium to long-term perspective. In this way we trust that the ECB's monetary policy takes into account in real time all relevant information.

Overall, I have no doubt that the ECB's approach to monetary policy will ensure that price stability will be maintained on a lasting basis in the euro area, in this way providing a crucial contribution to economic growth. Let me now explain to you how, by doing this, we have contributed and continue to contribute to a sustainable non-inflationary growth path.

How we have contributed and continue to contribute to sustainable non-inflationary growth

The "magnetic north" of our compass is the maintenance of price stability over the medium term. Since 1999, the medium to long-term inflation expectations, extracted either from the ECB Survey of Professional Forecasters or from surveys conducted by private institutions such as Consensus Economics, have remained in line with our objective of price stability, fluctuating within a narrow band around 1.8%-1.9%.

It is true that actual inflation has several times risen above the ceiling of 2% since 1999. But this occurred in a difficult environment with many adverse price shocks. However, this has not jeopardised our achievement in anchoring medium to long-term inflation expectations.

Moreover, anchoring long term inflation expectations at moderate levels has allowed to maintain short-term, medium-term and long-term market interest rates at low levels, thereby offering very favourable financing conditions to consumers, investors and companies. This low level of market interest rates is the result of the high level of credibility that the ECB and the euro immediately inherited from the national central banks and from the most stable national currencies that existed before 1999; contrary to what some observers were forecasting, the euro was not build as an average of the former national currencies, displaying a yield curve that would be the average of the yield curves prevailing in the countries deemed to join the euro area; the euro inherited immediately the yield curve of the most stable currencies, thus offering to 12 countries and 300 millions citizens the low levels of market interest rates that prevailed in a few countries only ;this is a major success of the euro that unfortunately is often underestimated.

The past success in anchoring euro area inflation expectations over the medium term should guide and inspire our current and future actions. In this respect, let me describe briefly the current and short-term economic outlook for the euro area as we saw it in the last Governing Council meeting in Helsinki.

As regards the current outlook for prices, some short-term fluctuations will push inflation rates up over the coming months, on account of less favourable base effects and increases in indirect taxes. However, beyond the short term, we expect price developments to remain in line with price stability. In particular, wage developments should remain moderate. The latest data on wage growth in the fourth quarter of 2003 lend support to this view.

What about the outlook for economic activity? At the current juncture, we expect a continued, though modest, further recovery in real GDP growth in the euro area over the short term. The conditions remain in place for the recovery to continue into 2005 and strengthen over time. This outlook reflects a number of factors:

- First, global economic growth continues to be robust and world trade has strengthened.
- Second, on the domestic side, investment should be helped by favourable financing conditions, an improvement in corporate earnings and spillover effects from global demand trends.
- Third, as regards private consumption, growth in real disposable income should lead to increased spending, in particular because households do not face significant financial constraints. Over time, consumer spending should also be progressively supported by an improvement in labour market conditions.

However, although a sound monetary policy is a necessary condition for long term sustainable growth, it is not sufficient and it needs to be complemented by other factors. Actually, the main challenge is to raise the potential growth rate of the euro area economy.

Looking back over the last ten years, it is clear that the euro area has suffered a growth deficit when compared, for example, with the US. Since the mid-1990s euro area real GDP has grown at an average rate of around 2% per annum, whereas growth in the US has been almost one and half percentage points higher. Why is this? In principle, such medium to longer-term differences can be due to different growth rates in population, labour utilisation and labour productivity.

On the productivity side, we all know that we should view comparisons across countries with some caution. Despite this, the general finding is that average productivity growth in the euro area since the mid-1990s has been lower than before, while in the US it has clearly been higher. The main reason for this difference in productivity performance are developments in total factor productivity, a catch-all for improvements in technology, organisation and factor input quality. With the necessary structural reforms, productivity developments in the euro area could eventually follow those in the US. This leads me to my third point: I would like to stress the crucial role that future structural reforms will have to play in achieving higher and sustainable non-inflationary growth.

The need for structural reforms

Progress in this field has been uneven across countries, but significant, and such an effort should be recognised explicitly. However, there is still a long way to go. We all have committed to make the European Union “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”. Furthermore, we have set specific deadlines for the targets to be met. And that is why further reforms have to be adopted and effectively implemented.

Besides promoting higher sustainable growth, structural reforms are aiming at increasing the ability of the economic system to rapidly adjust to changing macroeconomic conditions. That has become even more important since the start of Economic and Monetary Union, given that euro area countries can no longer use monetary and exchange rate policies to mitigate the effects of adverse shocks.

The decision on the specific structural reform measures to be taken, their design and actual implementation is left to the individual countries. While getting closer to one another, EU Member States still differ in many respects: in terms of economic structure, economic development and institutional setting. Leaving it up to the national actors to decide on their reforms is the natural consequence of such differences. However, structural reforms should take the EU consensus on policy priorities and objectives as their clear and common reference point.

Let me mention some of the objectives at the top of the reform lists where I think progress is most needed.

As far as the labour market is concerned, moderation in wage agreements is essential, not only in order to contain risks to price stability but also to foster employment growth and to enhance competitiveness. Wage bargaining outcomes should allow for appropriate wage developments in the overall economy, as well as a sufficient degree of wage differentiation to reflect more strongly regional and sectoral productivity differences. But inflationary pressures could also result from matching inefficiencies in the labour market leading to wage increases in excess of labour productivity growth. That reminds us that a wide range of policies should aim at increasing the efficiency of matching potential workers to job vacancies; namely, investment in education, in training and life-long learning. Particularly important in this respect are all the structural measures that could facilitate employment of the young unskilled workers in countries where youth unemployment is abnormally high.

Let me also say a few words on product market reforms. There are important productivity gains to be reaped in the euro area countries by removing the barriers to competition that still remain at national and at EU level. That requires further progress with regulatory reforms at national level in order to intensify domestic competition and the full EU-wide integration of markets in order to foster cross-border competition within the enlarged EU. Furthermore, we need to ensure an institutional environment that is more encouraging to business start-ups, innovation and the diffusion of technological progress.

Again, let me stress that adopting effective structural reforms is not an easy task, it needs much determination and constant explanation on the part of governments, parliaments and social partners, in order to convince the citizens that structural reforms are good for growth and job creation. They are most definitely needed - along with monetary and fiscal policy - as an essential ingredient to ensure higher long-term growth, prosperity and job creation in the euro area. This is why the ECB is backing these reforms, why it is part of the European consensus on their necessity and why we try to contribute to their good understanding by our fellow citizens.

The importance of fiscal discipline

As I just said, fiscal discipline is another crucial element in enhancing sustainable non-inflationary growth. Sound public finances create a macroeconomic environment in which uncertainty about long-term macroeconomic developments is reduced. This encourages economic agents to increase long term investment and therefore it is favourable to growth.

Fiscal discipline will also enhance confidence in general amongst entrepreneurs and households. Greater confidence in sound economic policies may have a positive effect on the economy via higher private consumption and investment, even now. One particular challenge when it comes to fiscal discipline is the effect that ageing populations will have on government spending in the decades ahead. Concerns about unsustainable public finances due to high deficits and debts, and unsustainable social security systems, may lead consumers to save more, in anticipation of future tax increases.

Sound public finance and sustainable non inflationary growth are mutually reinforcing and are creating a virtuous circle : growth in turn reinforces public finance.

In Europe, the relevant fiscal rules are those of the Maastricht Treaty and the Stability and Growth Pact. They require the avoidance of excessive deficits, for which a reference value of 3% of GDP for the overall public finance applies. Beyond that, it has been agreed in the Stability and Growth Pact to maintain fiscal positions close-to-balance or in surplus in the medium term. These requirements provide a framework to preserve budgetary discipline and sustainable public finances, while also allowing for the smoothing effect of automatic stabilisers.

In the view of the Governing Council, the current rules, as included in the Maastricht Treaty and in the European secondary legislation, are appropriate. No changes to the present wording are needed. But the implementation could and should be improved. Areas where solid improvements could be made include in particular a better analysis of structural imbalances and means to strengthen the incentives for sound fiscal policies during periods of strong economic growth.

Financial stability

Let me turn now to the very important issue of financial stability. The development of both the role of central banks in financial stability and thinking about appropriate responses to financial imbalances, such as excessive movements in asset prices, is one of the key challenges that central banks face today.

The activities of central banks striving to strengthen financial stability are related - on the one hand - to the monetary policy function, aimed at preserving price stability and thereby contributing to sustainable growth in the long term. On the other hand - central banks' macro-oriented financial stability functions also relate to micro-level prudential supervision as both are geared towards safeguarding financial stability.

In broad terms, the financial system matters for growth as it can produce an efficient allocation of resources from savers to productive investors. Stable financial markets and a stable financial system also dilute risk by spreading it across a large pool of economic agents thereby reducing the costs of economic failure.

Another reason why financial stability matters for growth relates to the real economic costs of financial instability. In fact, both the direct resolution costs of financial crisis to governments and the broader costs to the welfare of the economy can represent large losses in output.

Financial sector information in monetary policy-making

Let me start by considering the ways in which financial stability is very closely related to price stability and monetary policy-making.

First of all, financial stability is a precondition for ensuring that monetary policy is efficiently and effectively carried out. The success of monetary policy in delivering price stability relies on the effectiveness of monetary policy transmission. Central banks have direct control over short-term interest rates only. Monetary policy decisions affect prices through various channels - acting directly on the expectations of economic agents as well as influencing, inter alia, banking credit conditions, the exchange rate and other asset prices. It is quite obvious that a correct and orderly transmission of monetary policy to the economy requires a sound and stable financial system. Financial instability may distort the transmission of monetary policy and ultimately reduce its effectiveness in maintaining monetary stability and contributing to long term sustainable growth.

The second crucial aspect is that conditions in financial markets in general, and financial stability considerations in particular, always need to be part of the overall assessment of economic conditions and the analysis of risks to price stability. This is an analytically challenging and very information-demanding exercise, in which central bankers have to be involved.

In this respect, a number of historical episodes have shown that financial instability can pose very difficult challenges to monetary policy. A much-debated specific case is the possible emergence of large misalignments in financial prices or asset price bubbles, a well-known symptom of imbalances in the financial system. Episodes of large "booms and busts" in asset prices are dangerous and may result in self-reinforcing spirals that are a significant threat not only to the stability of the financial sector but, more generally, to macroeconomic stability. Monetary policy cannot avoid taking into account these threats.

In practice, it is extremely difficult to identify asset price bubbles in real-time. Even after the fact, there can be debate on whether a bubble really existed or whether expectations had been misguided.

I should add that it appears very useful to look at developments in credit and monetary variables, which often in the past signalled the build-up of dangerous financial imbalances in the economy. As you know, the Eurosystem assigns a specific role to the monetary aggregates within the framework of its two pillars approach of its monetary strategy. Credit being one of the counterpart of M3, it is therefore carefully followed, which is important from the perspective of monitoring the preconditions for the build-up of the financial imbalances.

Having said that, what should be the response of monetary policy to the possible emergence of financial instability? The above considerations lead me to the following remarks.

First, the possibility of financial crises - and the potential high costs associated with them - strengthens the case for central banks to extend the horizon of their monetary policy beyond the short-term. All potential consequences of asset prices booms and busts need to be analysed, which may require looking far ahead into the future. The ECB has taken these considerations into account by adopting a medium-term orientation in its monetary policy strategy.

Secondly and crucially, in dealing with financial instability, a central bank should never lose sight of its ultimate objective of maintaining price stability over the medium-term. In this respect, there should be no doubts that the costs associated with financial instability reinforce the importance of price stability.

Financial stability as an independent goal

I just described how financial stability contributes to the maintenance of price stability. Symmetrically, price instability is also unambiguously harmful for financial stability. By blurring signals from relative price changes, inflation often leads to distortions in the allocation of resources. Equally, the likelihood of misperceptions about future profit possibilities can be increased by inflation. This results in sub-optimal investment decisions being taken and possibly over-optimistic credit risk assessments. Hence, price stability - which is the primary objective of monetary policy - can be regarded as the bedrock on which financial stability is built.

However, I cannot close the case here. Historical evidence does not support the idea that an environment of stable prices will inevitably ensure financial stability. Another way of stating this is that price stability would seem to be a necessary, but not a sufficient condition for ensuring financial stability. This leads to the fact that central banks need to focus on financial instability also on its own right.

Looking at the historical evidence, financial distress has occurred both in industrial countries and emerging market economies where price instability was not an issue. This has been apparent in the period since the extensive liberalisation of the financial industry, which started in the early 1980s. The examples are many, but to name a few, the financial crises in the Nordic countries, in Japan, in East Asia or in Mexico, all took place in circumstances where inflation was not a threat. Also, the stock market bubble of the late 1990s, in which stock prices across the globe rose to unrealistic levels - particularly in new technology sectors - shows that asset prices can deviate from their fundamental determinants even when prices of consumer goods and services are stable.

There are also other examples at the level of institutions. Some individual failures of financial institutions or elements of financial system infrastructure with concerns of wider consequences have also occurred in an environment of stable prices. Financial stability problems stemming from such individual events can be milder, but they can be obviously unrelated to macro-economic conditions.

Finally, let me remind you that the interest of central banks in financial stability matters is not a new phenomenon. Actually, financial stability was one of the original tasks of central banks due to the combination of the central bank monopoly on issuing “final” money and the participation of commercial banks in the money-creation process. Between the 1930s and 1980s, heavy regulation was a characteristic of financial systems. In such an environment, the issue of financial instability was less pressing, so that the financial stability objective did not attract significant attention from central banks. Even though it commanded less attention in certain periods in the past, this aspect of central banking is now being strengthened around the globe not least because of financial liberalisation.

Conflict between price stability and financial stability?

A potential conflict between price stability and financial stability is often claimed to exist, simply because these are two goals for a single institution, with only one major instrument at its disposal - the monetary policy. Such a conflict would emerge if there were circumstances in which the monetary policy stance - as reflected in short-term interest rates - which is aimed at maintaining price stability, harmed the stability of the financial system. It would also emerge if there were circumstances in which the price stability objective prevented the central bank from dealing appropriately with financial instability.

A very forceful argument supporting the view that such a conflict is unlikely to occur in the medium term is that the absence of stable prices is a major threat to financial stability, as I already noted. Nevertheless, there have been times when price and financial stability objectives have appeared to be in conflict, and other possible situations have been envisaged in the academic literature. However, when the central bank focuses on long-term price stability, addressing financial stability issues would likely contribute to achieving both objectives and no conflict should really exist.

It should also be noted - when talking about the possible conflict - that besides the interest rate "weapon" central banks have some other tools at their disposal to maintain financial stability. These include payment systems tools, such as standards for risk limitation, or communication tools. Ultimately, the crisis management measures of emergency liquidity support together with the co-ordination of private sector solutions can be used by a central bank to contribute to financial stability, even if it does not have supervisory responsibilities.

EU framework for financial stability and the role of the Eurosystem

I have hopefully made clear the close interest of central banks on financial stability and the case for addressing it explicitly by central banks. I would like to give some information on how the financial stability function is being developed in the ECB and the Eurosystem.

The Eurosystem has the task of contributing "to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Article 105(5) of the Treaty). It is also entrusted with an advisory role in the financial rule-making process. The Eurosystem fulfils these tasks by way of decisions taken by the Governing Council of the ECB. The actual tasks of the ECB and the Eurosystem in the financial stability field comprise both crisis prevention and crisis management. The Banking Supervision Committee (BSC) - which is constituted by central banks and banking supervisors of the now 25 EU members - assists the Eurosystem in performing its tasks in the financial stability area.

Let me describe our activities in the two areas of prevention and crisis management in more detail.

We are currently making many efforts to develop our financial stability monitoring. This work involves the assessment of sources of risk and vulnerabilities in the financial system and of the capacity of the financial system to absorb shocks from the euro-area or EU-wide perspectives.

There is ample evidence that substantial integration was achieved in the euro area wholesale markets. For instance, since the launch of the euro, bid-ask spreads in the euro money market have not signalled any market segmentation by country. However, the effects of integration on the stability of the financial system are not straightforward. The common wholesale market in euro is better able to absorb small shocks than before, but at the same time, in a more integrated financial system, systemic shocks can be transmitted more quickly and disturbances can now spread more easily across borders. This is one of the main reasons why we need to have a strong area-wide perspective on financial stability. Common shocks can be much more significant than before and contagion risks may be greater in the euro area than in the Single Market as a whole, due to common systemic components such as the wholesale money market and payment system.

In line with these developments, the ECB and the BSC aim at delivering a broad assessment of relevant developments for euro area and EU financial stability. This work draws upon supervisory information.

The core of the work is the overall assessment of the current conditions of the main components of the euro area financial system. This assessment includes in the first instance the banking sector analysis, which continues to represent the main component for financial stability, given the financial structure of the euro area. The BSC in particular contributes to the monitoring and evaluation of banking stability on the basis of quantitative (based on macro-prudential indicators) and qualitative assessment by national authorities. The assessment also extends to the analysis of other financial institutions, as well as the money market and the payment and settlement systems. The assessment builds on an extensive analysis of developments in the international and European economic and financial market environment, as well as in the financial condition of the household and corporate sectors. The outcome of the evaluation is delivered to the Governing Council for its discussion and judgement and also contributes to the European debate on financial stability, mainly in the context of the Economic and Financial Committee.

As you may know, one of the main task of the Eurosystem is to ensure the smooth functioning of payment systems, which is key to preserving financial stability. The most important way of reducing the risk of a disruption of the payment circuit has been the establishment of the single and safe RTGS system, TARGET, which links together the national RTGS systems of the EU countries. The launch of TARGET II - now in pre-project phase - will further improve the robustness and resilience of the system, as well as its efficiency. Moreover, financial stability concerns increasingly also relate to securities clearing and settlement, especially due to the ongoing domestic and also cross-border consolidation in this area. The ESCB and the Committee of European Securities Regulators are currently designing safety standards for security settlement systems.

Finally, in case a major crisis involving one or several credit institutions would occur, I would simply recall that the exceptional liquidity allocation function has to be exercised by the national central bank concerned, under the control of the Governing Council of the ECB in case where there is a large or a cross-border liquidity problem. Moreover, a memorandum of understanding was signed between EU central banks and supervisory authorities in March 2003 in order to ensure that effective co-operation across central banks and banking supervisory authorities would arise in a cross-border crisis.

Conclusion

Ladies and gentlemen, let me briefly conclude. I have just discussed two of the challenges that the ECB faces, but there are of course many other challenges. Maybe one of the most important ones, with the Europe-wide celebratory fireworks of 30 April still fresh in our minds, is the EU enlargement and the future entry of our new Member States into the euro area. This represents challenges, but it will also bring major opportunities for our European economy; if one remembers the concerns expressed when Spain and Portugal joined the European Union in 1986, and if one considers all the benefits that this integration brought to Europe as a whole, there is certainly room for hope and high expectations with this new enlargement.

Ladies and gentlemen, I thank you for your attention.