Jean-Claude Trichet: European economy - current state and prospects

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the Annual Dinner 2004 of Financial Services Ireland (FSI), Dublin, 23 September 2004.

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I am very honoured to have been invited here today. I would like to thank you, Mr Chairman, and the Executive Board of Financial Services Ireland for your invitation, and for giving me this opportunity to share my views on the state of the European economy and the prospects for the future. I will like first to discuss the current economic and financial situation in the euro area and prospects for the future, and then I will focus on some of the conditions which need to be in place to ensure sustainable growth, including the role of fiscal policy.

Current economic situation and future prospects

Let me start by describing the current economic and financial situation. The latest data releases confirm that the economic recovery in the euro area is continuing. Real GDP grew by 0.5% quarter on quarter in the second quarter of this year, having recorded a 0.6% increase in the first quarter. Moreover, the latest indicators of output and demand remain consistent with ongoing growth in real activity.

Looking ahead, the conditions for a continuation and broadening of the recovery remain in place. Economic growth outside the euro area continues to be robust, and should continue to support euro area export growth. On the domestic side, investment should benefit from the positive global environment and the very favourable financing conditions. Improvements in corporate efficiency and higher profits are also supporting business investment. Moreover, private consumption should continue its gradual recovery, broadly in line with growth in real disposable income which, with the usual lag, should be further underpinned by an increase in employment growth later on.

Against this background, the economic recovery in the euro area is expected to continue and to become more broadly based over the coming quarters, leading to a somewhat stronger upswing in the course of 2005.

I should note that this scenario of an ongoing and further progressing economic recovery is, as always, subject to some risks - in both directions. On the upside, the ongoing momentum of the recovery may again imply more positive developments for economic growth in the coming quarters. On the downside, there are still concerns about continuing economic imbalances in other parts of the world. These imbalances could affect the sustainability of the economic recovery.

Another downside risk to the growth projections relates to oil prices. If these were to remain higher than currently expected by markets, this would dampen both foreign and domestic demand.

In assessing the real risks stemming from the oil prices, one should nevertheless take into account that, when expressed in euro, the recent rise in oil prices has been significantly smaller than during previous oil shocks, for example, in 1973, 1979 and 2000 when oil price increases had a major impact on the world economy. In addition, in real terms, oil prices are significantly below the peaks they have reached in the past. Moreover, when compared with the 1970s and 1980s, the oil intensity of production in the euro area and elsewhere has fallen significantly. In 2001, the energy intensity of the euro area, measured as energy consumption in tonnes of oil equivalent, in relation to real GDP, decreased by around 50%, compared with its peak recovered in 1973. That being said, I will echo here the calls for oil producers to be as responsible as required by the situation in the present juncture of the global economy.

Turning to price developments, the recent oil price developments have had a visible direct impact on euro area inflation. The annual HICP inflation in August was 2.3%, unchanged from July. On the basis of current market expectations for oil prices, it appears unlikely that annual inflation rates will return to levels below 2% in the remainder of this year, and in the very beginning of next year.

Looking ahead, however, there are no indications at present of stronger underlying inflationary pressures building up domestically. Recent wage developments have been moderate, and this trend is expected to continue for some time to come in view of the continued high level of unemployment in the euro area. If this is the case, and provided that one-off shocks to prices from other sources such as those seen in 2004 are not repeated, annual inflation rates should drop below 2% in 2005.

However, there are several upward risks to the projections for inflation. Concerns relate in particular to oil price developments, which may continue to have a visible impact on inflation. Oil price rises also imply the risk of second-round effects emerging in wage and price-setting, a risk which intensifies when the economic upswing strengthens. A further upward risk relates to the future evolution of indirect taxes and administered prices, as very little specific information is currently available about these in 2005 and beyond.

All in all, while the available indicators are consistent with price stability being maintained over the medium-term, a number of upside risks need to be monitored closely. Cross-checking this with our regular monetary analysis indicates that there is substantially more liquidity in the euro area than is needed to finance non-inflationary growth. This also supports the case for strong vigilance with regard to the materialisation of risks to price stability.

Having given you an overview of the current state of the euro area economy, and some prospects for the near future, I would like now to address some of the conditions that need to be in place to ensure sustainable growth.

Conditions for sustainable growth

The key to the achievement and maintenance of strong growth in Europe requires a perspective that extends beyond shorter-term cyclical developments. There is an urgent need to promote growth-orientated economics strategies, including the stimulation of productivity and employment rates, within a framework of sound fiscal and macroeconomic policies. It is widely recognised that the accelerated implementation of structural reform, framed within the Lisbon agenda, is the key to making the EU economies more competitive and dynamic. Structural reforms that are designed to increase the flexibility of markets, open the path to achieving higher sustainable growth, increasing employment, promoting innovation and securing the sustainability of social security systems in the EU.

Tackling structural problems in European labour markets is essential to this process. Particularly difficult challenges for Europe include reducing the high level of structural unemployment, including youth unemployment, and increasing the relatively low level of labour market participation, particularly of older workers, that persist in European labour markets. Overall, there is quite a distance to bridge before Europe reaches one of the key goals that has been set in the Lisbon agenda, namely an employment rate of 70%.

Some countries have started to undertake the needed reform their social security systems to reduce the disincentives to work currently created within many European labour markets. Unemployment schemes have been amended and early retirement incentives have been reduced. But more progress of this type is necessary to attract more people into the labour market, particularly as Europe’s population becomes older in the face of demographic change. Here the remarkable experiences of Ireland provide a strongly positive example. Ireland’s economic success can be linked to the successful transformation of its labour market into a plentiful supply of competitively priced and quality labour resources. Its experiences demonstrate that policies to increase the flexibility of labour markets can bring with them the opportunity for long term positive effects on growth performance.

Stronger product market competition is also a central instrument for boosting growth in Europe. EU countries, including Ireland, have made significant progress in product market reforms during the 1990s, having positive effects on the integration and level of competition in goods markets, but barriers to competition and innovation in Europe remain, which urgently need to be tackled. Ireland’s experiences have again shown that the further reduction of these barriers in the internal Market, in particular in services and network industries, are essential to promote effective competition across Europe. The further reduction of red-tape in order to enhance productivity, job creation and the better use of information technologies is another priority. Attention should also be paid to the share of EU Internal Market legislation not yet implemented in national laws.

Finally much progress has been achieved in capital market reforms, not least due to the introduction of the euro. Whilst in most countries financial markets function well, there is still some market segregation. The completion of the Financial Services action plan is needed to promote pan-European competition and to further consolidate and restructure the financial sector. A recent study, for example, found that the overall level of EU-wide real GDP may increase by more than 1% over a decade as a result of further integration, and that employment would also benefit. The further integration of national capital markets towards a truly European financial market could also make a more important contribution to safeguarding against country-specific shocks. Another of Ireland's successes - as a premier host country for foreign investment - suggests that further efforts should also be made to promote foreign investment in the financial markets of the euro area, in order to attract additional capital and promote a greater transfer of technology.

Let me explain why we, at the ECB, keep stressing the importance of implementing structural reform. Confidence among European citizens is vital for a stronger economic recovery and sustained growth. Successful structural reform that credibly reduces disincentives to work, invest and innovate could have significant confidence effects, even in the short run. The impetus from determined structural reforms in capital, labour and product markets would set in motion a virtuous circle of increasing confidence: the more credible the reforms are, the more confidence they will create, and the more confidence is created, the sooner positive results will be visible.

To conclude on structural reforms, I think the key issue now is to put promised reforms into practice - to bridge the gap between strategy and implementation in Europe - to identify the best policy practices and make structural reform happen. We have a consensus on the "road map". The issue today is to improve "navigation", to streamline the decision making process and the effective delivery of the reforms. Convincing the people of Europe that our countries will be better off thanks to these reforms is absolutely key. It was clear that implementing effectively the necessary reforms would be a real challenge and this challenge requires that we win the heart and the trust of the people of Europe.

Fiscal policy

Implementing structural reforms to raise potential growth is a major challenge facing European governments. But it is not the only one. Achieving sustainable, non-inflationary growth also requires a strong commitment to fiscal discipline.

In any economy, in the absence of fiscal discipline, price stability can only be maintained at a higher cost in terms of interest rates, and thereby growth and employment. By contrast, sound public finances facilitate the task of the central bank by strengthening the conditions for price stability, leading to a better ex post policy mix with more favourable financing conditions and thereby contributing to higher, non-inflationary growth. But it is all the more important in a monetary union, without a federal budget at the area-wide level. A credible and reliable framework ensuring fiscal discipline at the level of the monetary union is a key component for the consistency and the cohesion of this union. Sound fiscal policies are necessary to avoid the negative spill over effects in terms of interest rate increases that could be caused by one country or a group of countries running large budget deficits. Reaching a safe budgetary position in good times is necessary to ensure that fiscal policy has room to cope with asymmetric shocks, which can no longer be addressed by monetary policy. Not least for these reasons, it is a matter of concern to the ECB that a number of Member States are struggling to live up to their commitment to fiscal discipline.

In view of recent difficulties, the Commission has tabled some proposals and a discussion has been launched to consider how to strengthen and clarify the implementation of the Stability and Growth Pact. Of course the ECB itself is not a party to the Pact and decisions in this area are the responsibility of governments not central banks. But since fiscal policies matter for monetary policy, we central bankers are affected and we consider it appropriate to give our advice.

We can find common ground between some of the Commission's proposals and our own thinking, namely, as regards the preventive arm of the Pact. We agree that the implementation of the Stability and Growth Pact should be improved. We agree that ownership and incentives for compliance need to be enhanced. And we agree that implementing the Pact in a way that best reflects its economic rationale should help to achieve this end.

At the same time, we are wary of excessive complexity or of relaxation of the rules. In particular the so-called "corrective arm" of the Pact must fully preserve the nominal anchor of 3%. The Stability and Growth Pact requires simple and transparent rules in order to facilitate effective monitoring; to provide an effective deterrence against unsound policies; and at the end of the day, to provide an anchor for long-term expectations, which results from the clarity, simplicity and credibility of the framework. In this respect, we stick to our assessment that the wording of the Treaty and of the regulations of the Stability and Growth Pact is appropriate in its current form and should not be changed.

Let me add one further word regarding the current discussions on the Stability and Growth Pact. Some proponents of reform - not all - argue that there is a need to focus more on growth, as if there was a contradiction between fiscal soundness and growth and job creation. On the contrary, economic theory and empirical observations support the idea that wise fiscal policies are fostering sustainable growth and job creation. There is no better example of this than here in Ireland where, in the second half of the 1980s, a vigorous fiscal consolidation was accompanied by an acceleration of economic activity. Indeed, the experience of Ireland suggests that, when needed, a credible and well designed fiscal consolidation can support economic growth not only in a medium and long term perspective but also in the short-run.

Conclusion

Ladies and Gentlemen, let me conclude with two remarks which could be summed up in two words : Confidence and Conviction.

Confidence first. We all know that the euro area has a considerable potential, which will progressively materialize in the period to come. The present gradual recovery is underway and conditions are there for it to be progressively more broadly based. In the present juncture confidence is of the essence. The degree of confidence in all economic constituencies, households, savers, entrepreneurs and investors is a key factor to foster growth and job creation. A Central Bank is an anchor of confidence. We, in the ECB and in the Eurosystem, are doing all what is necessary to preserve and consolidate confidence: confidence in our currency, confidence in our capacity to deliver price stability, confidence in the stability of our monetary and financial environment.

And then Conviction. We, in the ECB and the Eurosystem, are convinced that fully enhancing and expressing the growth potential of the euro area calls for reforms to be implemented. We support governments and Parliaments that have embarked on such structural reforms. I know that these reforms are neither easy to decide nor easy to put in place once decided. They need a great deal of courage and determination, particularly when the general public is not yet fully convinced that they are necessary. The sentiment of the public at large is decisive in any democracy. This is why I think that appropriate pedagogy and tireless explanations are more important than ever to convince our fellow citizens of Europe that reforms are paying off and that everyone would be better off, thanks to these reforms. We are part of this large, public explanation endeavour. The ultimate conviction of the people of Europe, of our fellow citizens, is of the essence. And Dublin is the best capital in Europe to stress this point, so visible and tangible are here the level of prosperity and the quantity of jobs that reforms can help delivering.

I thank you for your attention.