Jean-Claude Trichet: A stability-oriented monetary policy as a necessary condition for long term growth

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the UNICE Competitiveness Day, Brussels, 9 December 2004.

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Ladies and gentlemen,

It is a pleasure for me today to address such a distinguished audience, which best represents the European entrepreneurial capacity and dynamism. Today I would like to discuss first the general role of policy institutions in a developed market economy. I shall then dwell more specifically on how the conduct of monetary and fiscal policy in the euro area contributes to foster high and sustainable output growth and job creation. Finally, I shall stress the importance of structural reforms in labour and product markets in ensuring that our economy is endowed with the degree of flexibility that is needed for firms and workers to be able to withstand successfully the challenges that the contemporaneous, highly interrelated world economy poses to us.

The determinants of sustainable long term growth

The determination of the factors that increase the individuals' standard of living is the main issue that scholars have analysed since economics was born as a modern science more than 250 years ago. The evolution of the economic theory has greatly furthered and deepened our understanding of this issue. Nevertheless, one core conclusion remains today as important as it was in the late eighteenth century: the amount of goods and services produced in any given economy grows at its highest possible rate when the rules of market economies are applied.

We have learned that this prescription cannot possibly be translated into a pure laissez-faire doctrine, because when the production and the exchange of goods and services is carried out without a proper legal and institutional framework the potential of the economy would not be fully exploited. For this reason, societies need to equip themselves with the right framework, which enhances the collective welfare by clearly defining and ensuring property rights and ensuring the efficient supply of public goods. This means in particular that economic policy must ensure that individuals have the necessary incentive to earn their income by working and producing goods and services which other individuals need. It also means that enterprises must take their decisions on the basis of market signals without relying on subsidies or being protected from competition. This will foster the accumulation of human and physical capital and a high level of employment, which are the determinants of long term growth. To fulfil this objective, economic policy must create and maintain a "stable" macroeconomic environment, ensure an appropriate level of flexibility of the economic system and provide incentives to work and invest in both physical and human capital in order to maximise employment and output growth.

In Europe and more particularly in the euro area, the stability of the macroeconomic framework and the flexibility of the economic structures are two guiding principles of economic policy that are enshrined into the Treaty and the Lisbon Agenda, respectively. How can these principles be best applied in practice?

The role of a stability oriented monetary policy

Let me start by illustrating the role that the ECB's monetary policy plays in fostering long term output growth in the euro area. The EU Treaty establishes the maintenance of price stability as the primary objective of the ECB. This objective refers to the general price level in the euro area and the ECB has made it clear that it aims at keeping inflation (as measured by the Harmonised Index of Consumer Prices) below and close to 2% over the medium term. The ECB does all what is necessary to be credible in the delivery of price stability - in line with its definition - over time, including in the medium and long term. By credibly maintaining price stability, the ECB brings about a decisive contribution to long run output growth, and it does this through several channels.

First, price stability ensures the transparency of the relative price mechanism, thus enhancing the efficiency of resources allocation. In an environment of price stability economic agents can more easily discern the change in the relative value of each single good and service produced as well as that of labour and capital. In a situation of increasing inflation, instead, resources could be wrongly allocated to the production of goods and services whose relative demand has not increased. Furthermore, households may have difficulties in discerning the relative price of goods and services thus choosing a consumption bundle that turns out to be suboptimal.

Preserving price stability also contributes to fostering private consumption. Lower inflation supports private consumption via its positive impact on the real value of households' income and wealth.

Another important channel through which price stability fosters economic growth consists in the reduction of borrowing costs for individuals and firms. As we all know, inflation erodes the purchasing power of the nominal return on long term loan contracts or bonds. In case of high and uncertain inflation, savers or those who lend their liquid funds would then require a higher rate of return from borrowers, in order to compensate for the higher risks related to the uncertainty about future inflation. This inflation risk premium implies that in an economy with high inflation, less investment projects with a rather high rate of return will be profitable. In such circumstances, capital accumulation will be lower than it could have been in a situation of price stability and the output growth rate is consequently reduced.

Financial market developments during the past few years are indeed a testimony to the success of the ECB's stability oriented monetary policy in securing low and stable long-term inflation expectations and thereby low interest rates in the euro area. Over the period between 1995 and 1999, the latter is the year when the euro replaced the national currencies of eleven EU member states and the ECB started to run a single monetary policy, long-term inflation expectations, as measured by Consensus Economic Forecasts, swiftly converged towards the "below 2 per cent level", which is the ECB's definition of price stability, from levels much higher still in the mid-1990s. Such a high degree of credibility was reflected in the developments of euro area long term interest rates, which by the beginning of 1999 had declined to around 4%, which was the level prevailing for the most credible and stable currencies, thus resulting for a number of countries and economies in a decline of around 9 percentage points since the beginning of 1995.

Since 1999 the ECB's stability-oriented monetary policy and, overall, the ECB credibility in delivering price stability has been remarkably successful and has contributed to maintain financing costs - from the short term to the long term up to 30 years - at historically low levels. Inflation expectations have remained at low levels and have not been significantly affected by short-term developments in actual euro area headline inflation. Furthermore, in the period since the start of the single monetary policy, the fluctuation of key macroeconomic variables has declined significantly. In comparison with the average level of the first half of the nineties, the volatility of long-term inflation expectations (as measured by the Consensus Economic Forecast) has declined by more than one half. From a longer term perspective, when compared with the average levels recorded in the 1980s and the first half of the nineties the observed volatility of inflation and long term interest rates declined by around three quarters. Furthermore, over this latter period the decline in the volatility of both real GDP and employment figures by more than one quarter should also be associated with the contribution of successful stability-oriented macro-economic policies in the euro area.

The ECB manages monetary policy in a systematic and transparent manner so that private agents are in the best possible conditions to gauge the likely evolution of interest rates in response to economic developments. First of all, the ECB is very clear about its monetary policy strategy. In addition, the ECB informs the public through the monthly press conference held just after the first Governing Council meeting of the month where the economic and monetary diagnosis of the ECB and the decisions taken by the Governing Council are displayed and explained almost in real time. The ECB has been a pioneer in this domain and has been followed by other central banks keen on increasing the transparency of their actions and decisions. This transparency is one further element contributing to macroeconomic stability and long-term growth. In an environment where the predictability of interest rates movements and their likely relation with key macroeconomic developments is relatively high, firms can better manage their balance sheets. This reduces both their vulnerability to economic shocks and their risk management costs and creates the condition for better decisions as regards domestic and foreign investment.

Finally, I would like to stress the importance of maintaining price stability in enhancing the functioning of the labour market and contributing to sound nominal wage developments and competitive unit labour costs, which fosters firms' competitiveness, growth and job creation. In a credible regime of low inflation workers do not ask for extra-wage increases to compensate for inflation risk and firms and trade unions know ex-ante that firms will not be able to pass higher wages on to consumer prices. This helps to avoid excessive nominal increases, thus enhancing the ability of firms to efficiently manage their production costs and create new jobs. At the current juncture, it is important that there are no second round effects on wage and price settings arising from the recent increase in oil prices. Such effects have not been observed till now. All economic agents know without any doubt that we are very vigilant in this respect; and we trust that it is this vigilance and our credibility that are decisively contributing to prevent second round effects.

The role of a stability oriented fiscal policy

Of great importance for the maintenance of macroeconomic stability and long term growth are sound public finances. The Stability and Growth Pact, which complements and further specifies the EU Treaty, provides a set of rules for the national fiscal authorities with the aim to ensuring fiscal soundness, by avoiding excessive deficits and safeguarding government finances, as defined by the attainment in the medium-term of budgetary positions "close to balance or in surplus". Far from being a straightjacket on national policymakers, these rules derive from the experience accumulated in past decades showing that increased debt ratios - as well as the implicit debt associated with social security systems in ageing societies - cast a permanent shadow over long term output growth and constantly limit the scope for fiscal policy to act as a stabilising instrument.

Although its implementation has been far from satisfactory, we should see that the Stability and Growth Pact brought about significant improvements in the fiscal performance of the EU over the years. In other major economies outside Europe fiscal deficits reached very high levels in the recent economic slowdown, and the ratio of debt to GDP in these countries is now on a very worrisome path. In contrast, the euro area public finances weathered the economy cyclical downturn with aggregate deficit to GDP ratios remaining between 2% and 3% and with debt to GDP ratios only moderately rising. While this is less than what the ECB - as well as the Council and the Commission - had hoped for, it is a significant achievement for Europe where in the early 1990s average deficit to GDP ratios of above 5% were still recorded. The euro area is now in a better starting position, in terms of macro-economic policies, compared to a number of major economies to emerge from the phase of economic slowdown. These achievements are from time to time forgotten in the ongoing debate on the Stability and Growth Pact, and they demonstrate how important it is for Europe not to weaken this Pact.

As the ECB has repeatedly clarified on several occasions, it is important that the Stability and the Growth Pact and the excessive deficit procedure remain key cornerstones of the Economic Union. Let us never forget that we cannot have a Monetary Union (MU) without and Economic Union (EU), to make a coherent and economically rational EMU. This implies that both the Pact and the excessive deficit procedure are respected in their current form. Their implementation could be improved, in particular as regards the preventive arm of the Pact, ie the implementation of those rules aiming at avoiding that excessive deficits arise in the first place.

Experience shows that if financial markets are uncertain about the future soundness of fiscal policy, at some stage long term interest rates are likely to increase. This tends to exert a negative impact on private investment and physical capital formation. Ultimately, unsound fiscal policies reduce production, output suffers a permanent loss and consumption possibilities are diminished in the long run. To be sure, being in a monetary union, like the euro area, does not shield countries that are expected to follow an unsustainable fiscal course from sooner or later being forced to pay higher credit risk premia on their government bonds relative to more disciplined countries in the union. The Treaty explicitly prohibits that individual governments, which run policies that are not sustainable, can be bailed-out by other governments or by the ECB.

In recent years budgetary developments in the euro area have not been fully satisfactory and there is growing concern among market participants and observers that consensus on the importance of fiscal discipline is weakening in the euro area. While fiscal accounts in the euro area have been affected by the sluggish economic growth experienced in the past two or three years, it is undeniable that, in general, the resilience of fiscal deficits in the euro area is mainly due to high - and, sometimes, very high - structural public expenditure, which, by definition, are not dependent of the cyclical developments.

It is of crucial importance that euro area member states take advantage of the ongoing recovery and focus on the pursuit of balanced budgets or surpluses in the medium term. Such a policy would contribute to ensuring that the conditions for long-term growth in the euro area are strengthened and to meeting the challenges arising from an ageing population. Empirical evidence supports the conclusion that comprehensive fiscal consolidation programmes, if appropriately designed and credible, can have favourable effects on confidence, investment conditions and thereby on output growth even in the short term. Notably, if fiscal reform is based on the consolidation of public expenditure rather than on an increase in taxation, the adjustment in fiscal accounts would tend to support both private consumption and investment - because the current and expected after tax disposable income of household and firms increases.

Comprehensive and credible expenditure-based fiscal stabilisation programmes would in particular have positive supply effects as well. A number of empirical studies suggest that there are two main reasons why this can be the case. First, lower expected deficits reduce long term market interest rates, which creates more opportunities to invest and increase the productive potential of the economy. Second, following the reduction in labour taxation that is possible when public expenditure is reduced, the expectation of higher after-tax income induces higher labour supply and mitigates wage increases, thus boosting the country’s international competitiveness and job creation.

The role of structural reforms

A stability oriented macroeconomic policy framework is not sufficient to ensure that high long-term growth is achieved. When private agents take their decisions over consumption, saving and investment, they should also not have impediments in the form of unnecessary and excessive regulations. A sound monetary and fiscal policy framework has to be complemented by structural policies that make the economy more flexible and dynamic.

Since March 2000, when the European Council launched the Lisbon agenda, European national governments, parliaments and social partners have become increasingly aware of the importance of implementing a substantial, courageous and far-reaching agenda of structural reforms. The ECB, from its side, fully endorses the Lisbon agenda and shares its objectives. We also agree with the main conclusion of the High Level Group chaired by Wim Kok that - in preparation of the mid-term review of the Lisbon Strategy - has stressed the advantages of sharpening the focus on the key issues in order to revamp the structural reform process in Europe.

Indeed, in the last decade, euro area countries have made some tangible progress with their structural reform programs. Competition in product markets due to, for example, a lower level of state aid and de-regulatory measures has increased, especially in network industries. This resulted in significant downward price effects in some sectors like telecommunication.

The ECB is supporting strongly governments that are courageously embarking on reforms and does not underestimate the difficulty to implement them. In particular it has proven to be more difficult than previously expected for European governments and social partners to implement labour market reforms that could strengthen the positive employment trends recorded in the EU in the second half of the 1990s.

Breaking the reform deadlock is of the utmost importance, also in light of growing role played by new economies in the international market place that exposes European firms to new and challenging competitive pressures. It is not my intention today to provide suggestions to government, parliaments and social partners about specific policy actions, but it is clear to me that in the area of labour market reform, increasing flexibility and suppleness with a view to maximize job creation and to augment the capacity of outsiders, like unskilled youth, to enter the job market is of the essence.

In another domain there is a number of countries where the lengthening of retirement age, allowing workers to work longer hours per week and the reduction of non-wage costs of labour - like labour income taxation and social security contributions - are necessary to increase labour supply and demand, thus raising the productive capacity of the economy. Recent events involving a number of important euro area companies demonstrate that social partners are aware of the collective benefits induced by a better management of resource utilisation, as workers and employers could agree on measures that would preserve competitiveness and consolidate jobs.

Moreover, other measures facilitating workers reallocation, reducing both employment traps - due to generous unemployment subsidies and high marginal income taxes - and costs related to adjustments in the labour force are often useful to increase the resilience of the economy to unforeseen shocks. A more flexible economy will make it easier for the corporate sector to maintain competitiveness without large cuts in employment.

Finally, a more flexible cost structure will increase the expected rate of return from private investment in both physical capital and research and education of the labour force. Hence, both the productivity and the quality of the labour force employed will increase, thereby setting the stage for virtuous dynamics that lead to higher output growth.

Conclusion

All policymakers are called to play their role in making the euro area a more dynamic economy. By maintaining price stability, and by being credible in delivering it over the medium and long term, the ECB makes its own indispensable contribution to foster growth in the euro area. The rate of potential economic growth very much depends also on the other policy actors. It requires fiscal policy to be sound and sustainable, and it requires reforms ensuring that the structure of the economy is flexible and supple enough to augment the growth potential of Europe and to allow economic agents to respond smoothly to economic shocks.

In a very rapidly changing environment, where new technological advances, not only in the IT area, are extremely powerful and seem to be comparable only with the start of the industrial revolution, where creativity and conceptual innovations are flourishing in all economic sectors, particularly in the global financial system, and where economic globalisation is rapidly transforming the very structure of the world economy, the euro area and its 306 million fellow citizens are called to adapt in order to take advantage of the opportunities offered by this new world and to respond to new challenges.

A lot has been done in Europe over the last 20 years: the combination of the bold single market endeavour starting in the mid eighties and of the single currency starting at the end of the nineties are perhaps the most striking historical set of structural reforms at the level of a continent in peace time. We have proved we were able to move and to restructure. We still have a lot to do as Wim Kok is wisely and strongly recommending.

In this respect, permit me a last remark: at the moment I am speaking most of the reforms that are necessary at the level of our continent have been implemented with success in some European economies, generally on the basis of a bi-partisan consensus and with a large accord of the entrepreneurs and of the unions. Benchmarking in each particular domain of structural reforms the entire euro area and the European Union on the best European performers might well be the most powerful tool to make the necessary progress. Let’s just do it!

I thank you for your attention.