Jean-Claude Trichet: Monetary policy and economic prospects in the euro area

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Institute of Economic Affairs conference on “The state of the economy: overcoming key challenges to sustainable economic growth”, London, 6 February 2006.

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Ladies and gentlemen,

I would like to start by thanking the Institute of Economic Affairs for inviting me to speak at this 23rd annual conference. The annual conference of the Institute is a well established forum for discussing key policy issues of a global dimension. I appreciate this opportunity to discuss, in this forum, recent developments in the euro area economy and its prospects for the future.

Talking about the state of the economy and economic prospects is demanding. Not least, it requires being able to articulate sound forecasts of future developments – which as you all know very well – is a particularly daunting task. Nevertheless, as central bankers, we are required to be forward-looking and to regularly assess future economic prospects. When making these assessments, however, we are forced to rely on data and information that are available in real time. In this sense, steering monetary policy is, in many respects, like driving a car: without only looking at the immediate part of the road, but also having also to anticipate the direction ahead relying on the images provided by the rear view mirror.

I will organise my remarks as follows. I will first review what can be seen in the rear-view mirror, namely the evolution of the euro area economy in the recent past. I will then discuss the analysis underlying the latest policy decisions of the ECB’s Governing Council and the broad direction for policy ahead of us.

What have been the major recent trends in the euro area economy?

Over the last few years, the euro area has witnessed a gradual recovery in economic activity. The recovery started in the second half of 2003 and has now led to ongoing trend growth rates that seem to be close to our present estimates of the potential growth rate of the euro area economy.

Several factors are behind the relatively gradual pace of this recovery , including oil price increases, the restructuring and reshaping of the productive sector triggered by global competition, and a possible decline in potential output growth.

First, taking a longer-term perspective, there is some evidence that, underlying the moderate growth rates over the last few years, there may have been a decline in trend potential output growth in the euro area, particularly when comparisons are drawn with most of the 1980s and 1990s. The trend potential output growth rate seems to have moved closer to the lower bound of the previously estimated range of 2.0-2.5%. The sustained decline in euro area labour productivity growth has been identified as the main factor explaining lower potential output growth. Euro area labour productivity growth (measured per hour worked) was 2.4% in the euro area from 1981 to 1990. However, during the period 1996-2004, productivity fell to 1.3%. Decomposing trend labour productivity growth, in turn, shows that this decline reflects both lower growth in total factor productivity and less capital deepening.

There is a wide consensus that the still significant structural rigidities in the euro area factor and product markets are likely to explain the lacklustre evolution in these components of potential output growth and, consequently, the relatively modest euro area growth rates in the recent past. While there is some evidence that euro area product and labour markets may have become somewhat more flexible over time, there is also a wide consensus that further structural reforms are needed to improve euro area labour productivity growth relative to other economic areas. In this context, a number of specific European policy initiatives and recommendations to promote productivity growth in the euro area have been put forward by expert groups. The issue at stake, now, is how to implement these reforms. This is a rather fundamental issue to which I will return at the end of my talk.

Another factor accounting for the moderate growth for most of the recent past relates to the downward impact on economic activity of the sequence of strong increases in energy prices over the last few years. However, a notable feature of the recent recovery is that the euro area economy has shown resilience to exceptionally strong and continued increases in oil and other energy commodity prices. While oil price increases since 2004 have obviously had a visible dampening impact on euro area growth, the recent impact appears to have been more muted compared to previous episodes of significant oil price increases, particularly those in the mid and late 1970s.

Various developments may have contributed to the increased resilience of the euro area economy to oil price increases. First, there has been a continued decline in oil dependency over the past few decades, due to sectoral shifts and the substitution of oil by other energy sources. The oil intensity of the euro area, as measured by oil consumption in relation to GDP, has roughly halved since the early 1970s. Oil consumption (in tonnes) relative to real GDP (in millions of euro, at 1995 prices) has fallen from 160 in 1973 to 80 in 2001. A second factor that may have contributed to resilience to oil price shocks is an improvement in product and labour market flexibility over time, thus facilitating the reallocation of resources and lessening the impact of oil price increases on economic activity. For instance, wage indexation appears to be less widespread at present than in the 1970s. Last, but not least, the increased effectiveness of monetary policy in firmly anchoring inflation expectations for the euro area as a whole has contributed to enhancing resilience, as the solid anchoring of expectations is a necessary condition for preventing oil price increases from leading to the emergence of second-round effects in wage and price setting.

Turning to more recent developments in economic activity in the euro area, over the last few quarters more positive fundamentals have gradually come to influence both economic growth developments and market sentiment. From the external side, global demand has seen a protracted expansion that has consistently supported euro area exports. Domestically, financing conditions have remained very favourable for an extended period of time, which has, in particular, allowed firms to engage in balance sheet restructuring, to achieve efficiency gains and to improve earnings. The medium, long and very long-term, nominal and real interest rates have been low for a protracted period and still remain at historically low levels, thanks, in particular, to the firm anchoring of inflation expectations. Against this background, the expansion of economic activity in the euro area has strengthened and broadened since the second quarter of 2005, reflecting, in particular, stronger investment. The improvement in investment growth has been particularly marked: quarter-on-quarter gross fixed capital formation growth increased to 0.9% in the second quarter of 2005 and to 1.3 % in the third quarter, compared with only 0.1% in the first quarter. Taken together, the second and third quarters of 2005 posted a GDP growth of 1% (0.4 % + 0.6 %), half of it due to the sole contribution of capital formation (0.5 %).

As regards price trends over the last few years, headline HICP inflation rates in the euro area have remained elevated, at rates just above 2%, mainly as a result of the strong increases in energy prices and, to a lesser extent, rises in administered prices and indirect taxes. However, when seen from a historical perspective, a further notable achievement of the euro area economy during the recent period relates also to the relatively moderate impact of oil price increases up to now on underlying domestic inflationary trends and, in particular, on wage developments. Even in the case of headline inflation trends, the upward impact of oil price increases has remained relatively moderate when compared to increases in oil prices of a similar size in previous episodes. Overall, the pass-through of past oil price increases to consumer prices appears to have been rather limited. Obviously, the only gradual increase in final demand in the course of 2005 partly explains the limited ability of producers to pass on increases in input costs to consumers. Pass-throughs may also have been dampened by longer lasting factors, such as increased external competition. Indeed, the annual rates of change in prices of many manufactured goods, such as household high-tech equipment and textiles, have declined. In the case of many manufactured goods, these more subdued prices may be related to the competition pressure exerted by the rise in exports from China and may therefore persist for some time to come. In this context it would have been particularly inappropriate for us in the ECB's Governing Council to base our assessment of the outlook for prices or our policy decisions on measures of underlying inflation that exclude some price items, such as energy, from the headline price index and, at the same time, retains other items, such as internationally traded manufactured goods. Indeed, the broad assessment of the outlook for price stability over the medium term was always the compass that guided our policy.

Let me say a word on the evolution of monetary aggregates. Monetary dynamics started to strengthen in the euro area in mid-2004 and gained further momentum in 2005. The strengthening in monetary growth observed since mid-2004 has been associated with an increase in the growth of loans to the private sector and has been driven by the rapid growth of the more liquid components of M3. It is, thus, likely reflecting fundamental factors, in particular the low level of interest rates. Overall, strong monetary growth during 2005 contributed further to the already ample liquidity situation in the euro area.

The ECB's latest monetary policy decisions put into perspective

Let me now turn to considerations relating to the ECB's latest monetary policy decisions.

In the course of 2005, inflation projections were progressively revised upwards, mainly - but not only - reflecting further upside surprises in oil prices. As a result, as the year progressed, upside risks to medium-term price stability were analysed and assessed to be progressively increasing, according to our economic analysis. This assessment was confirmed by the analysis in the context of strong monetary growth, ample liquidity and rapid expansion of credit. That is the reason why I expressed, in the name of the Governing Council of the ECB, at the beginning of October 2005, the need for increased vigilance with respect to upside risks to price stability over the medium to longer term. By the end of 2005, the regular cross-checking of the economic and monetary analyses indicated that an adjustment of the very accommodative stance of the ECB's monetary policy was warranted to address these risks. Therefore, on 1 December 2005 the Governing Council decided to increase the key ECB interest rates by 25 basis points, after two and a half years of maintaining these rates at historically low levels.

At the time of the December decision, we communicated to the public that the Governing Council had not taken an "ex ante" decision to engage mechanically in a series of interest rate increases at each of our meetings. Let me elaborate on this statement. The ECB does not embark on a particular multi-monthly pre-commitment on interest rates or on the path of future policy interest rates. As the Governing Council has decided to regularly consider the most up-to-date information, such an unconditional commitment would limit the ability of the Governing Council to react to changes in the economic situation and therefore hamper our credibility and our capacity to preserve the solid anchoring of inflation expectations. This is, in particular, the reason why we refused to promise to maintain interest rates at 2 % for a "considerable period of time": "ex post", the interest rates remained at that level for a long period but observers and market participants knew that we could move at any time throughout the period, had the need arisen. We continuously analyse the facts and figures and remain pragmatic in ensuring price stability over the medium term as our guiding principle. This also means that we are ready to act at any time, should new information point to changes in our assessment of risks to price stability. The experience shows that markets have, indeed, understood well this principle.

What are the economic and monetary prospects for the euro area?

As I explained during my last press conference on 2 February, after the Governing Council meeting, the data and indicators that have become available since we decided to increase interest rates moderately on 1 December have further confirmed our working assumptions concerning the outlook for economic activity and price developments in the euro area.

As concerns economic activity, recent data continues to support the broad growth scenario embodied in the December 2005 Eurosystem staff projections. This continues to form our working assumption regarding the outlook for growth in the euro area. On the basis of the indicators and survey data, it appears that the tendency in economic activity to strengthen and broaden since the second and third quarters of 2005 has so far been broadly confirmed. I am not speaking of successive indicators and figures which can be volatile, but of the trend. Looking ahead, the conditions remain in place for economic growth to continue to materialise around current estimates of potential growth. The external environment is buoyant, providing support for euro area exports. Investment is expected to continue to pick up, benefiting from an extended period of very favourable financing conditions, some balance sheet restructuring, and accumulated and ongoing gains in earnings and business efficiency. Consumption growth is also expected to strengthen progressively, in line with developments in real disposable income as the labour market situation improves. This broad scenario for economic activity is also confirmed by available forecasts.

Downside risks to this outlook for economic growth certainly remain and relate, in particular, to external euro area developments, such as high and volatile oil prices and concerns about global imbalances.

Inflation moderated somewhat over the last months of 2005, although it remains at levels above the 2% ceiling of the ECB's definition of price stability. Over the short term, annual inflation rates may remain elevated, reflecting, in particular, past developments in energy prices and also some base effects. Meanwhile, wage dynamics have remained moderate over recent quarters and are assumed to remain so for the time being, reflecting, in particular, global competitive pressure.

This scenario for price developments remains surrounded by upside risks, which relate to the possibility of further rises in oil prices, a stronger pass-through of oil prices into consumer price index and additional increases in administered prices and indirect taxes. More fundamentally, upside risks to inflation also relate to potential second-round effects of past increases in inflation on wage and price-setting behaviour.

When looking at current monetary developments, the annual growth rate of M3 remained at elevated levels, even though it moderated further at the end of 2005. This moderation can be explained in part by an apparent resumption of the unwinding of past portfolio shifts, which exerts a dampening effect on headline M3 growth. The underlying rate of monetary expansion remains strong, reflecting the stimulative impact of the prevailing low level of interest rates. In particular, growth in the most liquid components of M3 remained very robust and the annual growth in loans to the private sector continued to strengthen. Mortgage borrowing is particularly strong, implying a need to monitor housing market developments closely. More generally, strong monetary and credit growth in a context of already ample liquidity in the euro area points to risks to price stability over the medium to longer term.

Against this background, we will exercise vigilance so as to ensure the solid anchoring of long-term inflation expectations at levels in line with price stability. Such vigilance is also warranted, given the historically low levels of both nominal and real interest rates across the whole maturity spectrum and the overall accommodative stance of monetary policy.

The main challenges for the euro area economy

Let me conclude with a few remarks on the longer-term prospects for the euro area. Over the last few quarters, the outlook for the euro area economy has improved and the economy has shown signs of increased resilience. The recent enlargement of the European Union is already helping to boost trade and support growth both in the euro area and in the new EU Member States. The ongoing recovery has strengthened and broadened and is expected to remain sustained. Yet, there is no room for complacency. While monetary policy has made its important contribution, helping to maintain long-term inflation expectations firmly anchored, a good monetary policy is a necessary condition for sustainable growth and job creation, but it is not a sufficient condition. To elevate the growth potential and pave the way for sustainable growth, we also need sound fiscal policies and an appropriate improvement in the competitive edge within the euro area, fostered by bold structural reforms.

First, in relation to public finances, there is a need for substantial fiscal consolidation in the euro area. Macroeconomic stability hinges significantly on the sustainability of public finances, which in turn are susceptible to the challenges posed by demographic developments. Compliance with the EU fiscal framework and the strict application of the rules are critical because this contributes to the sustainability of public finances in EMU. With the improvements in economic growth, determined fiscal consolidation is now even more important. In particular, countries with excessive deficits must take this opportunity to reduce their fiscal imbalances in a decisive and sustainable manner. This would strongly support the European fiscal framework as established by the Stability and Growth Pact. Delaying consolidation would be both inappropriate in the short term and risky in the longer term.

A second key element for sustainable growth in the euro area relates to the implementation of reforms that can improve the competitiveness of the euro area.

I have already elaborated on the sustained decline in euro area labour productivity growth and its consequences for potential output growth. In this context, competitiveness is also of crucial importance to the various components of euro area economy. Domestic cost developments, as captured by unit labour costs, play a key role in determining competitiveness. Unit labour costs, which correspond to the ratio of compensation per employee over labour productivity, reflect wage developments in comparison to productivity dynamics. One of the findings of recent research is that our single currency area is more flexible than previously thought in terms of the speed of adjustments in relative cost-competitiveness between various euro area countries. Sustained lower that average unit labour cost developments in a number of euro area countries are permitting, more rapidly than commonly thought, a previous lack of competitiveness to be made up, which is good. On the other hand, sustained and stronger than average unit labour cost developments in certain other euro area countries could worsen the competitiveness situation for these countries vis-à-vis the euro area as a whole. Preserving competitiveness by controlling domestic costs is essential for promoting economic activity and employment. This requires lucidity and appropriate responses by all parties concerned. For companies, it is essential to carefully monitor competitiveness indicators, notably unit labour costs, on a routine basis. Moreover, when deciding on how to compensate productive factors, and in particular employees, the social partners involved need to internalise the repercussions of wage settlements on the competitiveness of the firm and the sector as a whole. Indeed, experience shows that in countries where social partners have taken into account the implications of their wage settlement decisions on competitiveness, export shares have been more resilient and job creation more dynamic.

In sum, structural reforms are an essential ingredient to improve competitiveness and enhance output growth. Reforms in product and labour markets would help to reduce price and quantity distortions and thus encourage better allocation of resources, improving the efficiency of investment decisions as well as increasing productivity and real GDP growth.

Let me be somewhat more specific about the areas in labour and product markets where I think that further progress is most urgently needed. Structural reforms are crucial in the areas of employment protection legislation and wage-setting mechanisms, including wage indexation. A sufficient degree of wage differentiation is important to ensure that wage adjustments closely reflect regional and sectoral productivity differences. At the same time, labour market policies should go hand in hand with structural reforms resulting in enhanced competition in goods and services markets. There are significant productivity gains to be had in Europe by removing the considerable barriers to competition that still remain at the national and EU levels. Further efforts should therefore be made to reduce firms' entry costs, such as the administrative burden on start-ups and – more generally – to reduce red tape. Ensuring an institutional environment that encourages business creation and expansion should therefore be among our priorities, together with supporting innovation and the diffusion of technological progress.

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Let me stress, in conclusion, the importance of the ongoing process of structural reforms in the euro area. I see three main reasons for this process to be speeded up in the present European and global environment.

First, we have to elevate the level of our growth potential. This calls, in particular, for a flexible economy capable of taking full advantage of scientific and technological developments and, particularly, of the IT revolution as regards productivity. We are bound to catch up, progressively, with the levels of labour productivity growth reached by the most successful industrial economies, including the United States, since the mid 1990s.

Second, in a world of intensifying global trade, of very rapid development of emerging economies, and of the creation of a global financial system, we must make our economy more flexible so that it is capable of adapting rapidly to the major economic changes that globalisation is fostering. Flexibility is the recipe for taking full advantage of the constellation of Ricardian comparative advantages the world currently offers.

Third, a world of remarkable chances and unseen opportunities is also a world of risks. We must do all that we can to prevent those risks from materialising. But if and when they materialize, it is of the essence to cope with them, control the damage and overcome the crisis as effectively as possible. The resilience of the economy, reinforced by its flexibility, is, in these circumstances, a crucial feature.

For these three reasons, flexibility fostered by bold structural reforms is of the essence in the current global economy. Another way of presenting it would be to say that in today's world, marked by technological revolution and economic globalisation, the opportunity cost of not being flexible has considerably augmented.

I thank you for your attention.