# Jean-Claude Trichet: Economic and monetary issues and euro area enlargement

Testimony by Jean-Claude Trichet, President of the European Central Bank, before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 20 February 2006.

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## Economic and monetary issues

At the time of my last appearance before the European Parliament in November, I described how the latest available data at that time confirmed our working assumption of a gradual normalisation in the real side of the economy, including a strengthening and broadening in the expansion of economic activity in the euro area. I also noted that, over the past year, the euro area economy has exhibited a notable degree of resilience to marked increases in oil prices.

Let me now update you on our assessment of how the data have evolved over the past quarter, starting with price developments. In December 2005, the Eurosystem staff inflation projections were again revised upwards, on account of further upside surprises in oil prices and the announcement of increases in administered prices and indirect taxes in some countries. As a result, upside risks to medium-term price stability were assessed to have increased, according to our economic analysis. This assessment was confirmed by the monetary analysis in a context of strong monetary growth, ample liquidity and robust expansion of credit. 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 rate by 25 basis points, after two and a half years of maintaining this rate at the same historically very low level of 2 %.

The information which has become available since our decision to moderately raise interest rates supports the assessment that an adjustment of our very accommodative monetary policy stance was indeed warranted.

Starting with **economic activity**, according to Eurostat’s flash estimate, real GDP growth in the euro area in the fourth quarter of 2005 was 0.3% quarter on quarter. Although this is significantly lower than the 0.6% recorded in the previous quarter, this figure however mainly reflects the significant volatility in real GDP growth rates on a quarter-on-quarter basis. Looking through the short-term volatility to medium-term trends, our assessment continues to reflect a progressive strengthening of economic activity, supported in particular, by stronger investment, which should be followed by a gradual strengthening of consumption growth. Looking ahead, the conditions remain in place for continued sustained economic expansion. The external environment remains favourable, providing support for euro area exports. Investment is expected to remain strong, benefiting from an extended period of very favourable financing conditions, balance sheet restructuring and accumulated and ongoing gains in earnings and business efficiency. Consumption growth should also strengthen over time, in line with developments in real disposable income, as the labour market situation gradually improves. However, the outlook for economic activity remains subject to downward risks relating, in particular, to high and volatile oil prices and concerns about global imbalances.

Turning to **price developments**, annual HICP inflation declined somewhat towards the end of 2005, standing at 2.2% in December, down from 2.3% in November and 2.5% in October. In the coming months, annual inflation rates may again be somewhat higher amid renewed increases in energy prices and some base effects, as Eurostat’s flash estimate of 2.4% for HICP inflation in January 2006 would appear to confirm. Looking further ahead, indirect effects of past oil price rises on other components of the price index may gradually materialise, and already announced changes to administered prices and indirect taxes are expected to have an upward impact on HICP inflation. Meanwhile, wage dynamics have remained moderate over recent quarters and our working assumption is that they will remain contained, partly as a result of global competitive pressures. Risks to this outlook for price developments remain on the upside and include further rises in oil prices, a stronger pass-through of oil prices into consumer prices than currently envisaged, additional increases in administered prices and indirect taxes, and – more fundamentally – potential second-round effects on wage and price-setting behaviour. It is therefore essential that the social partners continue to meet their responsibilities also in the context of a more favourable economic environment.

In relation to the **monetary analysis**, the annual growth rate of M3 remains robust, even though it has moderated somewhat in recent months. 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. However, the trend rate of monetary expansion remains strong, reflecting the stimulative impact of the prevailing low level of interest rates. Overall, 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. Cross-checking the monetary analysis with the economic analysis therefore supports the case for vigilance to ensure that the risks to price stability over the medium to longer term do not materialise.

The preservation of a solid anchoring of **inflation expectations** for the euro area as a whole at levels in line with price stability, as reflected in available surveys and indicators, has contributed to a sustained decline in risk premia across the whole maturity spectrum since the creation of the euro, thereby leading to lower levels of both short and long-term interest rates. The ECB's high level of credibility and its stability-oriented policy have contributed to the very favourable financing conditions observed over the past few years for investors. They have also preserved the purchasing power of consumers, which is of greatest importance for all people and especially those with low incomes. It is essential that this important asset of the euro area economy is preserved. The Governing Council will exercise vigilance so as to continue ensuring the solid anchoring of medium to long-term inflation expectations at levels in line with price stability. Such vigilance is indeed warranted, taking into account the present upside risks to the outlook for price developments and the historically low level of both nominal and real short term interest rates.

As regards **fiscal policy,** recent information points to somewhat better than expected outcomes for 2005 in a number of countries and for the euro area as a whole. Looking ahead, the targets presented in the latest round of stability programme updates are consistent with a moderate fiscal consolidation, although in some countries imbalances would still persist for a number of years. 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. Adjustment efforts should be based on credible, fully specified measures as part of a comprehensive consolidation programme. Moreover, windfall gains from higher than expected growth or other factors should be allocated to speeding up deficit reduction. This would help to prevent a repeat of past experiences, when complacency in good times contributed to persistent budgetary disequilibria.

With respect to **structural reforms,** these remain an essential ingredient for improving competitiveness and growth performance in the euro area. Let me also add that, given the services sector's increasingly important role, the need to ensure a fully integrated internal market for services in the EU has rightly been at the forefront of the European policy agenda. Structural reforms aimed at increasing competition in both EU and international services markets would allow firms to benefit from economies of scale and should be expected to increase economic efficiency. This would support both a higher level and stronger growth rate of labour productivity in the services sector, promote a more dynamic economy and create more jobs. Moreover, a higher level of competition in the services market should have a dampening impact on prices and would contribute to the reduction of price stickiness in some areas of the services sector. Overall, opening up the services sector to new entrants would tend to foster more efficient and flexible services markets, facilitate adjustment processes and increase the resilience of the euro area to economic shocks. This would support economic growth and employment in the longer run.

## Euro area enlargement

I would now like to say a few words on the issue of euro area **enlargement**. Of the ten new Member States that joined the EU in May 2004, three entered the Exchange Rate Mechanism II (ERM II) in late June 2004, and another four countries joined the mechanism in 2005. All seven of these countries have expressed an interest in adopting the euro in the coming years.

Participation in ERM II is a necessary pre-condition for adopting the euro. Indeed, participation in a system of fixed exchange rates can be seen as a crucial test for living under conditions which are close to those that exist under the single currency.

The enlargement of the euro area is a process which follows clearly defined procedures and rules. It is of the utmost importance that countries adopting the euro have demonstrated that they have sufficiently converged towards the euro area for this convergence to be sustainable. As you know, the necessary conditions for this are set out clearly in the Treaty.

Later this year, in the autumn, the ECB and the European Commission will again publish their regular Convergence Reports, as required by the Treaty. As on previous occasions, these Reports will examine the readiness of countries with a derogation to adopt the euro and will therefore cover the ten new Member States and Sweden.

In the Reports, each country will be examined according to its individual performance. To examine the state of economic convergence, the ECB makes use of a common framework of analysis, which builds on principles set out in previous reports in order to ensure continuity and equal treatment. No additional criteria for the adoption of the euro by the new Member States will be introduced; while, at the same time, there will be no relaxation of the criteria laid down in the Treaty.

Following the publication of the Convergence Reports, consultation of the European Parliament and a discussion among the EU Heads of State and Government, the ECOFIN Council will decide, on the basis of a Commission proposal, which Member States fulfil the necessary conditions to adopt the euro.

In case of compliance with the convergence criteria, more practical arrangements will then be set in motion, relating, for example, to the integration of the national central banks into the Eurosystem and to the cash-changeover procedures. The fact that already today the NCBs of all the EU Member States participate actively in committees and other meetings within the framework of the European System of Central Banks will facilitate this process.

I cannot, and will not, pre-empt the analysis of the forthcoming Convergence Reports. Let me stress, however, that once one economy fulfils all the convergence criteria set out in the Treaty in a sustainable manner, I have no doubt its participation in the euro area will be highly beneficial for all parties.

I thank you for your attention.