# Jean-Claude Trichet: Testimony before the Committee on Economic and Monetary Affairs of the European Parliament

Testimony by Mr Jean-Claude Trichet, President of the European Central Bank, before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 21 June 2006.

* * *

*Madame la Présidente, Mesdames et Messieurs les membres de la Commission des affaires économiques et monétaires, je me réjouis de paraître devant votre Commission aujourd'hui et de poursuivre ainsi notre dialogue régulier. Comme vous le savez, nos rencontres trimestrielles sont très importantes pour la Banque centrale européenne. Je commencerai mon intervention par une évaluation de la situation économique et monétaire.*

*Anschließend möchte ich einige Ausführungen zum Beitrag der Geldpolitik zu wirtschaftlicher Wohlfahrt und Stabilität machen. Hiermit möchte ich nochmals die Grundprinzipien der Geldpolitik der EZB erläutern.*

## Economic and monetary issues

At the time of my last appearance before the European Parliament in February, I described how the available data at that time were in line with an assessment of a re-acceleration in economic growth in the euro area in the first months of 2006 and with a broadening of the expansion of economic activity. In addition, the cross-checking of our economic and monetary analyses underlined the prevalence of upside risks to price stability over the medium to longer term. I will now present to you our current assessment of how the economy and the outlook for price stability have evolved since February.

Starting with the economic analysis, the main indicators that have become available since the start of 2006 are positive, providing further evidence that the economy is evolving broadly in line with the scenario for economic developments that emerged at the end of 2005. According to Eurostat's first estimate, real GDP in the euro area grew in the first quarter of 2006 by 0.6% on a quarter-on-quarter basis. This compares with 0.3% in the last quarter of 2005, with domestic demand, including private consumption, making a significant contribution to higher real GDP growth. Our previous expectation of a re-acceleration of real GDP growth in the first months of 2006 has thus materialised, confirming our assessment that economic growth is broadening and gradually becoming more sustained. This assessment is further confirmed by available information on economic activity in the second quarter, notably by the main confidence surveys and indicator-based estimates, all of which continue to provide encouraging signals on the evolution of the economic outlook.

Looking further ahead, the conditions and economic fundamentals are in place for growth in the euro area to remain close to its trend potential rate on a sustained basis. Economic growth in the euro area's main trading partners remains strong, providing support for euro area exports. Investment is expected to grow robustly, benefiting from favourable financing conditions, corporate balance sheet restructuring, and gains in earnings and business efficiency. Furthermore, we expect consumption growth to further strengthen gradually over time, in line with developments in real disposable income, as the labour market situation, and in particular employment growth, gradually improves.

This outlook for economic developments is also reflected in the June 2006 Eurosystem staff macroeconomic projections, which foresee average annual real GDP growth between 1.8% and 2.4% in 2006, and between 1.3% and 2.3% in 2007. These projections for growth in 2006 are broadly unchanged from the ECB staff projections of March 2006. For 2007 the latest projections are slightly lower, mainly reflecting the recent rise in oil prices. The most recent forecasts by international organisations and private sector institutions also confirm a broadly similar picture.

In the view of the ECB's Governing Council, risks to the outlook for economic growth provided by these projections are broadly balanced over the shorter term, while over the longer term downside risks relate mainly to potential further oil price rises, a disorderly unwinding of global imbalances and protectionism.

Turning to price developments, according to Eurostat's flash estimate, annual HICP inflation increased further in May, to reach 2.5% from 2.4% in April, largely as a consequence of higher energy price developments. In the remainder of 2006 and in 2007, inflation rates are likely to remain elevated, with the precise levels depending mainly on future energy price developments. Meanwhile, the moderate evolution of labour costs in the euro area is expected to continue, notably reflecting ongoing global competitive pressures, particularly in the manufacturing sector. However, the indirect effects of past oil price increases are expected to have an upward effect on inflation in 2007, as already signalled inter alia by recently observed strong increases in industrial producer prices, which grew at an annual rate of 5.4% in April. The announced changes in indirect taxes will also have a bearing on inflation next year.

This outlook for inflation is also reflected in the June 2006 Eurosystem staff projections, which foresee annual HICP inflation in a range between 2.1% and 2.5% in 2006, and between 1.6% and 2.8% in 2007. Compared with the March 2006 ECB staff projections, these ranges embody a slightly higher baseline profile for HICP inflation in 2006, largely reflecting the assumption of higher oil prices.

This outlook for price developments remains subject to upside risks including further increases in oil prices, a stronger pass-through of past oil price rises to consumer prices than currently anticipated, additional increases in administered prices and indirect taxes, and – more fundamentally – stronger than expected wage developments due to second-round effects of past oil price increases.

Turning to developments in monetary aggregates and credit, liquidity in the euro area remains ample by all reasonable measures. The annual growth rate of M3 increased to 8.8% in April 2006, from 8.5% in March 2006, supported by the robust expansion of its most liquid components. Credit growth has also remained very strong, with the annual rate of growth of loans to the private sector standing at double-digit levels.

The rapid rate of monetary growth continues to be driven mainly by the expansion of its most liquid components. Thus, the latest developments confirm that the stimulative impact of the low level of interest rates remains the dominant factor behind the current high trend rate of monetary expansion, which signals inflationary risks over the medium to longer term. The further acceleration of monetary and credit growth in this environment of already ample liquidity points to increased upside risks to price stability at longer horizons. Monetary developments therefore require careful monitoring, in particular in the context of continued strong dynamics in housing markets.

To sum up, annual HICP inflation rates are projected to remain elevated in 2006 and 2007, mainly as a consequence of upward pressures from high oil prices and indirect taxes. Risks to this outlook for inflation remain on the upside. Against the backdrop of strong monetary and credit growth and the ample liquidity situation, the cross-checking of the outcome of the economic analysis with that of the monetary analysis confirms that upside risks to price stability over the medium to longer term prevail.

On 8 June 2006 the ECB's Governing Council increased the key ECB interest rates by 25 basis points, thus further adjusting its monetary policy stance after the interest rate increases in December 2005 and March 2006. By means of its timely further action, the Governing Council is helping to keep medium and long-term inflation expectations at levels which are in line with price stability, thereby making an ongoing contribution to sustainable economic growth and job creation in the euro area. Notwithstanding the increase in key ECB interest rates on 8 June, our monetary policy in the euro area remains accommodative. It is essential to ensure that inflation expectations in the euro area remain firmly anchored at levels in line with price stability. The firm anchoring of inflation expectations has permitted inter alia to maintain since the creation of the euro a low level of risk premia across the whole maturity spectrum, and to prevent costly wage-price spirals in the context of considerably higher oil prices. It is essential that this important asset of the euro area economy is preserved.

## The contribution of monetary policy to economic welfare and stability

Having explained the more specific and current reasons for the ECB's recent monetary policy moves, let me now put them in a broader perspective. As you know, the Treaty states that, without prejudice to the primary objective of price stability, the Eurosystem shall support the general economic policies in the Community, aiming at a high level of employment and sustainable and non-inflationary growth.

It is sometimes argued that the ECB's overriding focus on price stability implies that we do not pay sufficient attention to this latter part of our mandate; in other words, that in our policy we do not attach sufficient importance to growth, employment and the welfare of European citizens. I would like to explain to you that these assumptions are misguided: price stability, and economic growth and employment, rather than being substitutes, are complements in a relationship which makes price stability a necessary condition for sustainable growth and job creation.

### *The contribution of monetary policy to economic welfare and stability*

Price stability contributes to economic welfare and sustainable growth in many ways. An immediate way in which price stability contributes to welfare is by protecting the purchasing power of money, both for consumers and for savers. By protecting purchasing power, monetary policy also makes an important contribution to social cohesion, as the weakest groups of society are generally the least able to protect their savings against inflation. Moreover, inflation has the effect of transferring wealth from savers to debtors, as savers face a loss in the value of their assets, whereas the real value of debts diminishes as a result of inflation. Maintaining price stability prevents such arbitrary and unjust redistributions of wealth and income brought about by inflation.

Price stability also contributes to a better economic performance. Inflation undermines the proper functioning of markets, as the information deriving from price developments becomes blurred. Stable prices, on the other hand, enable markets to better allocate resources to their most efficient use, which enhances growth and employment. Very importantly, an environment of stable prices also reduces risk premia in medium- and long-term interest rates, as investors will not demand a high inflation risk premium to compensate them for the loss in purchasing power. This reduces real medium- and long-term market interest rates and increases the incentives to invest.

All these arguments show that price stability provides a substantial contribution to economic growth and social welfare. Yet, against the backdrop of relatively low growth rates in Europe, it is sometimes asked whether we could not achieve higher growth rates by accepting a somewhat higher rate of inflation. History has clearly shown, however, that growth and employment cannot be increased by inflating the economy by means of a loose monetary policy. This means that in the long run an increase in the quantity of money will only lead to an increase in prices, whilst leaving the levels of growth and employment unchanged. This implies that, in the long run, monetary policy can only influence the level of prices. The levels of real income and employment are ultimately determined by real factors. These include technological progress and productivity growth, the growth of the labour force and all structural aspects of the economy, such as the flexibility of goods and labour markets, tax policies and the quality of education, which are all outside the realm of monetary policy. By maintaining price stability, monetary policy is providing the conditions for such real factors to work better.

The strong consensus among academics and policy-makers on the basic principles that I have outlined has not always existed. Forty years ago, there was a widespread view that monetary policy could durably raise the growth rate of the economy and that it could achieve permanently lower rates of unemployment by accepting higher inflation. This view was proven wrong by reality. The inflationary policies adopted in the 1970s to counter the effects of the oil price shocks did not succeed in reducing unemployment. On the contrary, these policies in fact only led to persistently higher inflation. In addition, these policies also caused large fluctuations in real activity.

By contrast, the recent oil price increases have had a limited effect on inflation and also on output and unemployment. This has been the case because of the high credibility of the ECB in safeguarding price stability. Because of this high credibility, inflation expectations are now well-anchored. Since the public has remained convinced that inflation will remain low in the long run, the energy price increases have not generated significant second-round effects on wages and prices. As a result, monetary policy has been able to maintain a more accommodative stance. This stance has been decisive in counteracting the negative effects of the oil price increases on the real economy.

### *Price stability is the goal of monetary policies around the globe*

Today, the insight that price stability is the primary goal for monetary policy has also been translated into the mandates of central banks of advanced economies and also of a very large number of emerging economies. For instance, it is the case in the UK, it is the case in Japan, it is the case in Canada, in Australia and New Zealand. Price stability is the goal of modern monetary policy around the world.

This also holds true for the US Fed. The mandate of the Fed is sometimes contrasted with that of the ECB, because it comprises not only a goal of price stability but also the goals of maximum employment and moderate long-term interest rates. Although the Fed's mandate does not establish a hierarchy among these goals, the Fed has made clear on a number of occasions that it considers price stability as a necessary condition for and the best contribution of monetary policy to achieving the highest level of welfare and sustainable economic growth. The track record of the Fed in controlling inflation over the past decades speaks for itself. The successive Chairmen of the Fed have made clear that the Fed considers price stability not only as a goal but also as a means for the Fed policy to achieve its other statutory goals. This is very much in line with our own framework and thinking.

### Conclusion

To sum up, it is an error to think that a choice needs to be made between price stability on the one hand, and sustainable economic growth and welfare on the other. Price stability is both a precondition for and a means to enhance durable economic growth and welfare.

That being said, we should all be aware that, if price stability is a necessary condition, it is not a sufficient condition per se for sustainable economic growth and job creation. As I have pointed out before, the growth potential of the euro area economy is ultimately determined by its structural features. That is the reason why the ECB calls so often upon policy-makers to embark resolutely on the structural reforms of the Lisbon Strategy and on the full completion of the internal market. Both would elevate the ‘speed limit’ of the EU and the euro area economy.

I am now ready to answer your questions.