Jean-Claude Trichet: Hearing before the Economic and Monetary Affairs Committee of the European Parliament

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at a hearing before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 21 March 2007.

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Madame la Présidente, Mesdames et Messieurs les membres de la Commission Economique et Monétaire, c'est avec un intérêt chaque fois renouvelé que je parais, tous les trimestres, devant votre Commission afin de poursuivre le dialogue de la Banque Centrale avec le Parlement. La Banque Centrale Européenne est, vous le savez, très attachée à cet exercice qui contribue à rendre notre action transparente vis-à-vis du citoyen européen. Je commencerai mon intervention par une évaluation de la situation économique et monétaire. Anschließend werde ich auf die Unterschiede, die bei den geldpolitischen Transmissionskanälen in den USA und dem Euroraum bestehen, sowie ihre praktischen Auswirkungen eingehen. Zum Abschluss möchte ich die Bedeutung von Preisstabilität aus sozialpolitischer Perspektive erläutern.

Economic and monetary issues

Since my previous appearance before the European Parliament in December last year, newly available information has served to confirm our assessment that economic growth in the euro area continues to expand robustly. In addition, the cross-checking of our economic and monetary analyses have underlined the existence of upside risks to price stability over the medium to longer term. Accordingly, on 8 March the Governing Council of the ECB decided to increase key ECB interest rates by 25 basis points. Our decision to increase key ECB interest rates in March contributes to ensuring that medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability, which is a prerequisite for monetary policy to make an ongoing contribution towards supporting sustainable economic growth and job creation in the euro area. Let me explain the assessment underlying this decision and the outlook for the economy and risks to price stability.

Starting with the economic analysis, according to Eurostat's first estimate, the quarter-on-quarter growth rate of real GDP in the euro area for the fourth quarter of 2006 was 0.9%, which was above previous expectations. Both domestic demand and exports made significant contributions to this growth, confirming the sustained and broad-based nature of the current expansion. The information on economic activity from various confidence surveys and indicator-based estimates supports the assessment that economic growth has continued into 2007.

Looking ahead, conditions remain in place for the euro area economy to grow solidly. Global economic growth has become more balanced across regions and, while moderating somewhat, remains robust, providing support for euro area exports. Domestic demand is expected to maintain its relatively strong momentum. Investment is expected to remain dynamic, benefiting from an extended period of very favourable financing conditions, balance sheet restructuring, accumulated and ongoing strong earnings, and gains in business efficiency. Consumption should also strengthen further over time in line with developments in real disposable income as employment conditions continue to improve. This outlook for economic developments is also reflected in the new ECB staff macroeconomic projections which foresee average annual real GDP growth in a range between 2.1% and 2.9% in 2007 and between 1.9% and 2.9% in 2008.

In the Governing Council's view, the risks surrounding the favourable outlook for economic growth are broadly balanced over the shorter term. At longer horizons, risks lie mainly on the downside, relating to the possibility of a renewed increase in oil prices, fears of a rise in protectionist pressures and concerns about possible disorderly developments owing to global imbalances.

Turning to the price developments, annual HICP inflation was 1.8% in February 2007, unchanged from January 2007. The lower annual HICP inflation rates since the summer of 2006 have been predominantly due to lower energy prices. Looking ahead, last year's volatility in energy prices will lead to significant base effects, affecting the profile of annual inflation rates this year. Accordingly and on the basis of the current level of oil prices and oil price futures, annual inflation rates are likely to fall during the spring and summer before rising again towards the end of the year and hovering again at around 2%. The new ECB staff macroeconomic projections point to annual HICP inflation averaging between 1.5% and 2.1% in 2007 and between 1.4% and 2.6% in 2008.

At the policy-relevant medium-term horizon, the outlook for price developments remains, in the Governing Council's view, subject to upside risks. These stem from the possibility of renewed oil price increases and additional increases in administered prices and indirect taxes beyond those announced and decided thus far. More fundamentally, stronger than currently expected wage developments would pose significant upward risks to price stability, particularly in view of the favourable momentum of real GDP growth. It is therefore crucial that the social partners continue to meet their responsibilities and that wage agreements take into account present relative price competitiveness positions, the still high level of unemployment in many countries as well as productivity developments. The Governing Council will monitor the upcoming wage negotiations in the euro area countries very carefully.

Turning to the monetary analysis, this confirms the prevailing upside risks to price stability at medium to longer horizons. Annual M3 growth was unchanged at 9.8% in January, remaining at the highest rate observed since the introduction of the euro. At 10.6%, the annual growth rate of loans to the private sector also remained strong in January. This reflects the continuation of the upward trend in the growth of borrowing by non-financial corporations seen since mid-2004. Meanwhile, the growth of household borrowing has shown some further signs of moderation in recent months, albeit remaining at still high rates.

Taking the appropriate medium to longer-term perspective, the latest developments confirm the continuation of a persistent upward trend in the underlying rate of monetary expansion. Furthermore, following several years of robust monetary growth, the liquidity situation in the euro area is ample by all plausible measures. The robust expansion of money and credit in an environment of ample liquidity points to upside risks to price stability over the medium to longer term. Monetary developments therefore continue to require very careful monitoring, particularly against the background of a solid expansion in economic activity and continued strong property market developments in many parts of the euro area.

To sum up, in assessing price trends it is important to look through any short term volatility in inflation rates. At the policy-relevant horizon of the medium term, risks to price stability remain on the upside, relating in particular to stronger than currently expected wage developments in a context of robust ongoing growth in employment and economic activity. Given the vigorous monetary and credit growth in an environment of already ample liquidity, a cross-check of the outcome of the economic analysis with that of the monetary analysis supports the assessment that upside risks to price stability prevail over the medium to longer term.

Monetary policy transmission in the euro area and the US

In my remarks today I would also like to discuss differences and similarities in the transmission of monetary policy in the euro area and the US.

Optimal monetary-policy actions depend on the nature of the shocks hitting the economy, the present and future expected economic environment and, importantly, on the transmission mechanisms of monetary policy actions. These elements have a precise bearing on comparative exercises highlighting parallels and differences between monetary policies in different currency areas. For example, in order to compare the monetary policy decisions of the Federal Reserve and the European Central Bank, we must analyse, among other things, the structure of the economies in which they are operating, because economic structures and institutions determine the functioning of the monetary policy transmission mechanisms and, therefore, indirectly influence the design of policy.

Is the monetary transmission mechanism in the United States significantly different from that of the euro area? Applied economics has approached this question from two different angles: statistical and structural analysis.

Statistical analysis has studied the business cycle properties of aggregate data, such as GDP and inflation for the US and the euro area. By applying a battery of statistical tests, this approach seeks to assess whether macroeconomic time series display similar or different dynamic patterns over the cycle in the two areas. A related approach has applied statistical techniques to identify the way in which a monetary policy innovation propagates through the economy.

But statistical analysis is imperfect because it is difficult to see – based solely on aggregate data statistics – whether a difference in statistical patterns originates in shocks or in economic structures, and what feature of the economic structures and institutions is responsible for what particular aspect of the transmission of monetary policy impulses.

Structural analysis has concentrated – more fundamentally – on two related aspects. First, it has constructed measures of price and wage rigidity: these have been expressed by the frequency of price and wage adjustments. In economies with more rigid goods and labour markets – where, for example, labour practices and contractual institutions hamper a prompt transmission of shocks to wages – the macroeconomic adjustment to shocks takes longer to run its course and, more importantly, falls disproportionately on production and employment.

Second, structural analysis has provided evidence of the sensitivity of inflation expectations to past inflation developments. The relevance of inflation expectations to the transmission mechanism is more subtle but central. An inflationary shock tends to be more persistent if wage and price rigidities are greater, unless inflation expectations are found to be insensitive to the inflation history and more solidly anchored around the objective of the central bank. Again, this has important implications for monetary transmission. A shock to inflation is faster to dissipate – even if prices and wages are relatively more rigid – if inflation expectations are more firmly anchored.

Now, while the statistical approach has generally failed to spot significant differences across the two areas, structural analysis comes to two main conclusions. The first is that, in the euro area, prices are distinctly less flexible than in the United States.[1]

Second, an inflationary shock dissipates quickly in the euro area despite rigidities, and inflation has a tendency to return to its long-run norm reasonably quickly. Survey-based measures of inflation expectations, for example, suggest that the ECB's influence on expectations seems to have become much stronger since the establishment of the euro.[2]

What are the implications for policy? I will mention two of them, both stemming from the notion that the appropriateness of policy cannot be judged in abstract terms: policy needs to be carefully calibrated to the underlying economic structure.[3] First, in a relatively rigid economy, the adjustment falls primarily on quantities. So, a central bank is generally well-advised to avoid volatile policy paths, which in those conditions can transmit unwelcome volatility to the economy and often necessitate corrective, countervailing action further down the road. Second, inflation expectations that look more forward – to the central bank's intentions – than backward – to inflation history – call for more persistence in the policy direction. Again, a central bank that moves its policy rate around in response to each twist and turn in the data would under these circumstances have only a limited impact on the economy. When the inflation process is as forward-looking as it is in the euro area, policy shifts that lack persistence have little impact on longer-term interest rates, on expectations and – ultimately – on macroeconomic and pricing decisions.

Counterfactual policy evaluation is difficult to conduct and necessarily conditional on a long list of technical assumptions. Nonetheless, recently conducted counterfactual policy-evaluation exercises suggest that since 2001 – and compared with the flexible economy par excellence, the US – our policy interventions had a greater stabilizing effect on the economy. In tune with the structural conditions

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[1] The Eurosystem has made important contributions to the analysis of price rigidities in the euro area. A summary of a very extensive research project conducted jointly by the ECB and the national central banks is provided in Altissimo, F., M Ehrmann. And F. Smets (2006), "Inflation Persistence and Price Setting in the Euro Area: A Summary of the Inflation Persistence Network Evidence" ECB Occasional Paper 46, Frankfurt am Main: European Central Bank. The paper reports that the average duration of CPI price spells in the euro area is 4.3 quarters. By comparison, M. Bils and P. Klenow, in "Some evidence on the importance of sticky prices", Journal of Political Economy 112, 2005, calculate that the average duration of CPI prices in the United States is 2.2 quarters. Other Phillips curve-based analyses broadly confirm these results. For the euro area, see J. Gali, M. Gertler and D. Lopez-Salido, "European inflation dynamics", European Economic Review 45(7), 2001, and J. Gali, M. Gertler and D. Lopez-Salido, "Erratum", European Economic Review 47(4), 2003.

[2] The consumer survey on inflation expectations compiled by the European Commission is a good barometer of the sensitivity of short-term inflation expectations to recent inflation dynamics. Results are presented in terms of the difference between the percentage of respondents who believe prices will increase and the percentage of respondents who believe that they will decrease or stabilise. Prior to the euro cash changeover there was a close relationship between this qualitative indicator and actual inflation developments, with a correlation coefficient near to 1. However, since the cash changeover, the correlation between the two series has dropped to 0.4.

[3] Christiano, J., R. Motto and M. Rostagno (2007), "Shocks, Structures or Policies? The Euro Area and the US after 2001" (forthcoming in the Journal of Economic Dynamics and Control) argue along these lines on the basis of a structural estimated model of the euro area and the US.

prevailing in the euro area, the overall degree of accommodation delivered by the ECB was more ample, albeit back-loaded, because it was more persistent.[4]

Of course, keeping our interest rate at an unprecedented low level for two years and a half would not have been part of a feasible policy, without consistent signs that expectations were well-anchored and the inflationary shocks that were hitting the economy at the time of the downturn were being quickly reabsorbed.[5]

Social benefits of price stability

Let me now turn to my last point today in which I would like to emphasise the critical role of our quantitative definition of price stability in orienting expectations. I have mentioned how persistent conditions of price stability can change the transmission channels in ways that can partly alleviate structural shortcomings of the economy. In the euro area, notwithstanding structural rigidities that impede price and wage adjustments – rigidities that cannot be corrected by a central bank – well-anchored inflation expectations partly compensate for and make the transmission mechanism less inefficient than it would be otherwise.

But welfare analysis has also drawn attention to other, and perhaps even more fundamental, channels through which price stability can enhance growth prospects and contribute to the living standards of citizens.

First, in a market economy, the price system plays a key role in the efficient allocation of resources to alternative uses. Price pressures in a specific market can signal profitable investment opportunities to firms. Price stability improves the quality of the signals that prices convey to both households and firms, which can then easily recognise changes in the relative prices of different goods, allowing them to make well-informed consumption and investment decisions. By contrast, in an inflationary environment, prices only provide blurred signals: price increases in a specific market can either indicate strong demand and investment opportunities or simply reflect a general increase in the price level. By helping market forces to guide resources to those uses in which they can be used most productively, price stability contributes to sustainable increases in productivity and employment, and ultimately higher standards of living.

Second, price stability contributes to lower levels of both nominal and real interest rates. Inflation erodes the real value of nominal claims and, in an inflationary environment, lenders typically require an inflation risk premium to compensate them for the inflation risks associated with their investments. By contrast, creditors do not require such a risk premium when price stability is ensured. By reducing inflation risk premia, price stability results in lower levels of real interest rates, thereby making more investment projects profitable. By supporting investment, lower interest rates contribute to higher levels of employment and economic growth.

Third, it is well known that inflation acts like a tax on holdings of cash. Inflation increases the price of the transaction services of money. While this certainly is not a palpable economic phenomenon in the euro area today, a handful of hyperinflation episodes in economic history still makes this so-called "inflation tax" one of the most widely known examples of the undesirable consequences of inflation. By setting the "inflation tax" to negligible levels, price stability minimises transaction costs in the economy as a whole. This benefits all citizens on a daily basis, and even more so those who are not in a position to protect themselves against inflation.

Finally, inflation brings about an arbitrary redistribution of income and wealth. The more vulnerable groups in society typically suffer the most from inflation. They have a relatively higher share of their savings invested in cash and savings accounts, the real value of which is easily eroded by inflation. Their limited access to financial markets leave them with little room to evade the "inflation tax". In this respect, pensioners who have to live on their pension entitlements and savings accumulated during their working life constitute a group that is particularly vulnerable to inflation. Price stability ensures that the real value of both pension entitlements and savings is maintained.

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4 The counterfactual is conducted in Christiano, et al (2007), op. cit.

5 See in particular the following speeches (published on the ECB website): J.-C. Trichet, "Monetary policy and credible alertness" (Jackson Hole, 27 August 2005) and "Activism and alertness in monetary policy" (Madrid, 8 June 2006).

Today, the level of inflation in the euro area is below the threshold of our definition of price stability, of "less than 2%, close to 2%", while medium and long-term inflationary expectations in the euro area are solidly anchored. Against this background, the social benefits of price stability are often taken for granted. I should therefore like to stress here that the undesirable social and economic consequences of inflation, namely inefficient allocation of resources, high levels of interest rates, the regressive inflation tax, arbitrary redistribution of income and wealth to the detriment of the most vulnerable, and, last but not least, economic instability, lower growth and lower job creation, are the benchmarks against which one has to assess the social benefits of price stability. This is why a credible commitment to maintaining price stability is so important for the living standards of European citizens. And why our fellow citizens, according to all surveys, are so profoundly attached to price stability.

I thank you for your attention.