Jean-Claude Trichet: Overview of recent euro area developments and the effects of globalisation on prices and real estate

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the meeting of the Management Board of the CDU, Wiesbaden, 5 January 2008.

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It is a great pleasure for me to be invited as a guest speaker here today.

Let me briefly sketch out the main topics I want to address. First, I will present to you our views on the current economic situation in the euro area. Then, I will explain the ECB's liquidity operations following the tensions in the money markets since August last year as well as our views on the stability of the euro area financial system. To conclude, I will say a word upon the effects of globalisation on price developments and on developments in the real estate sector.

Economic and monetary developments

Let me first say that we are presently in the purdah period, namely within a week before the next decision meeting of the Governing Council. Nothing in what I will say should be interpreted in terms of our future decision next Thursday. I will stick to explaining what has been our diagnosis and judgment on the occasion of our last meeting.

All recent incoming information had fully confirmed our view that, in a context of vigorous money and credit growth and sound economic fundamentals in the euro area, the risks to price stability over the medium term are clearly on the upside, as I said, on behalf of the Governing Council, after our meeting on Thursday, 6 December 2007. The recent substantial increase in oil and food prices, together with unfavourable base effects from energy prices, owing to the marked decline in oil prices a year ago, are having a strong upward impact on inflation in the current context. Looking ahead, the inflation rate is expected to remain significantly above 2% in the near future, and it is likely to moderate only gradually in the course of 2008. Hence the period of temporarily high inflation rates would be somewhat more protracted than previously expected.

Looking further ahead, the December 2007 Eurosystem staff macroeconomic projections foresee annual HICP inflation to be between 2.0% and 2.2% in 2007, to then rise to between 2.0% and 3.0% in 2008, before moderating to a range of 1.2% and 2.4% in 2009. Compared with the September 2007 staff projections, the ranges for 2007 and 2008 have shifted upwards. These staff projections are based on two key assumptions. The first is that recent oil and food price dynamics and their impact on HICP inflation will not have broadly-based second-round effects on wage-setting behaviour. The second key assumption is that growth in profit margins will moderate over the projection horizon. These two assumptions imply, in the context of the staff projections, a continuation of overall contained domestic cost pressures, which contributes to the moderation in inflation projected in 2009.

It has been the view of the Governing Council that the risks to this medium-term outlook for price developments are fully confirmed to lie on the upside, mainly relating to possible further rises in oil and agricultural prices, and increases in administered prices and indirect taxes beyond those foreseen thus far. In addition, against the background of sound economic fundamentals, stronger than currently expected wage dynamics may emerge, while an increase in pricing power in market segments with low competition could materialise.

As regards economic activity, incoming information had confirmed the sustained nature of economic expansion in the euro area, with real GDP growing by 0.7% quarter-on-quarter in the third quarter, while indicating some moderation in the fourth quarter. Overall, the

economic fundamentals in the euro area remain sound. Looking ahead, Eurosystem staff projects annual real GDP growth to lie between 2.4% to 2.8% in 2007, between 1.5% and 2.5% in 2008, and between 1.6% and 2.6% in 2009. In comparison with the September 2007 ECB staff projections, the range projected for real GDP growth in 2008 has been revised slightly downwards, whereas for 2007 the new range lies within the upper part of the previous one.

This scenario is based on the expectation that the global economy will remain resilient, with the slowdown of economic growth in the United States partly offset by the continued strength of emerging market economies. However, in view of the potential impact of ongoing financial market volatility and re-pricing of risk on the real economy, this assessment remains surrounded by a high level of uncertainty. And in the Governing Council's view, the risks surrounding this outlook for economic growth lie on the downside.

The monetary analysis had confirmed the prevailing upside risks to price stability at medium to longer-term horizons. On the basis of latest available data, covering the period to the end of November 2007, the underlying money and credit expansion remains vigourous, even taking temporary factors into account, such as the flattening of the yield curve, the financial market turmoil and specific transactions associated with the restructuring of certain banking groups. Therefore, monetary and credit developments continue to require very careful monitoring, not least with a view to better understand the response of the private sector to increased financial market volatility.

Thus far, there has been little evidence that the financial market turbulence since early August 2007 had strongly influenced the dynamics of broad money and credit aggregates. Indeed, the expansion of loans to households and non-financial corporations has remained robust, which may suggest that the supply of credit has not been impaired. To develop a more complete view of the impact of financial market developments on bank balance sheets, financing conditions and money and credit growth, further analysis will be required.

The ECB's Governing Council stands ready to counter upside risks to price stability, in line with its mandate. Against this background, on 6 December 2007 we decided to leave the key ECB interest rates unchanged. The Governing Council will monitor very closely all developments. In particular, as I said on behalf of the Governing Council after our last meeting, for the recent increase in inflation to remain temporary, it is essential that the price and wage-setting behaviour remains unaffected by current inflation rates, so as to avoid the emergence of second-round effects. By acting in a firm and timely manner on the basis of its assessment, the Governing Council will ensure that such second-round effects and risks to price stability over the medium term do not materialise. To firmly anchor inflation expectations in line with price stability is even more important at times of financial market volatility and increased uncertainty. In this respect, the Governing Council has decided to continue to pay great attention to financial market developments.

Liquidity operations

Ladies and gentlemen, once the Governing Council has defined the monetary policy stance necessary for maintaining price stability in the medium term, in line with its mandate as defined by the Treaty, the ECB has the responsibility to also ensure the smooth functioning of the segment of the money market that we influence. I should like to underline – once again – that these two responsibilities are clearly distinct and should not be mixed.

Since early August last year, tensions have been observed in money markets and during the last months banks expressed particular concerns about their liquidity needs over the year-end. The year-end period is traditionally a period of scarce liquidity, as market activity is subdued and banks are preparing their year-end balance sheets.

In its open market operations, the ECB therefore pursued its endeavour to contribute to the smooth functioning of the euro money market. In early August, we responded to the sudden

upward pressures on the overnight interest rate by lending significant amounts of liquidity through overnight fine-tuning operations. We also carried out, and later renewed, two supplementary longer-term refinancing operations in order to reduce banks' concerns over their longer-term funding during a period when the longer-term repo and deposit markets turned illiquid. In the main refinancing operations the ECB has allotted larger amounts of liquidity than under normal circumstances with an aim to limit the volatility of very short term rates around the ECB's minimum bid rate. These large amounts of liquidity have always been absorbed later on during the maintenance period, so that the ECB has only provided banks with the liquidity needed for the fulfilment of their reserve requirements on average over the maintenance periods. Let me also underline that we only provide such operations against solid collateral, as always.

Just before Christmas we lengthened the maturity of the second last main refinancing operation from one to two weeks, thus facilitating the coverage of the year-end liquidity needs of banks. For this specific operation, we announced that we would satisfy all bids received at 4.21 percent or above, the 4.21 percent level being the weighted average rate of the previous main refinancing operation one week before. This action, combined with our liquidity-absorbing operations until 4 January, contributed to a smooth end of the year in the euro area by keeping short-term interest rates close to the ECB's minimum bid rate.

Overall, the ECB's actions permitted to maintain very short-term rates close to the ECB's policy rate. The tensions, which have been observed in the longer term money market rates in euro, are due in particular to the persistence of uncertainties surrounding the financial health and liquidity needs of financial institutions as well as the impact of the ongoing global financial market correction, with a general re-appreciation of risks. These tensions have receded whilst remaining significant. By reducing the volatility of the very short-term rates around the key policy rate of the ECB and by containing pressures in the interbank term money market, the ECB's liquidity operations have contributed to a better resilience of the European financial system without – of course – eliminating the causes of the tensions, originating outside the money market.

During this tumultuous period, the Eurosystem remained, as usual, in close contact with other major central banks. In this context, on 12 December the ECB, the Federal Reserve, the Bank of England, the Bank of Canada and the Swiss National Bank announced measures designed to address elevated pressures in short-term funding markets. In particular, the ECB participated in joint action with the Federal Reserve and the Swiss national Bank. The ECB provided a total of 20 billion US dollar in two auctions to Eurosystem counterparties against ECB-eligible collateral.

Through its own actions as well as the joint efforts with other central banks, the Eurosystem as well as the community of central banks have shown their capacity to cope with a number of challenges that euro and global money markets are currently facing. More than ever, in these periods of tensions, lucidity in the diagnosis, rapidity in the decision, and absence of complacency are of the essence. This total absence of complacency is particularly necessary as regards financial stability.

Financial stability

I would now like to share with you our assessment of the financial stability situation, as described in the recent Financial Stability Review. I will discuss briefly the role of financial institutions and supervisory authorities in coping with the present financial market correction.

With financial systems undergoing a process of de-leveraging and re-intermediation, uncertainty surrounding the financial stability outlook for the euro area has heightened and may persist until it becomes clear how the potential balance sheet effects of the turbulence will be spread across individual financial institutions. Clarity is also needed concerning liquidity commitments to off-balance sheet vehicles, and the magnitude of assets that may be

re-intermediated back onto the balance sheets of euro area financial institutions. The process of improving clarity, which started when Q3 2007 financial statements became available, will be advanced further when institutions publish their annual audited accounts for 2007 as a whole.

Given the uncertainties, the adjustment process in the financial system in the coming period may be challenging, and we have to be prepared to the materialisation of risks at any time. That being said, there are mitigating factors, including a broadly favourable economic outlook, the largely sound balance sheets of households and firms, and the generally sound capital positions of core financial firms. This should not, however, provide any grounds for complacency given the heightened uncertainties. In a fluid environment where financial system conditions may unexpectedly change, prudence is of the essence both for policymakers and financial institutions.

Concerning the role of financial institutions and supervisory authorities in coping with the financial turmoil, I would submit three observations. First, given the underlying factors of the financial stress, and in order to re-establish confidence within the financial system, it is crucial to promote a widespread consistent valuation of complex structured products as well as an adequate disclosure by banks of all their exposures, in particular related to the US sub-prime mortgage sector. Second, I would welcome the efforts of the supervisory community, namely through the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors, in keeping each other abreast of developments and in considering jointly possible measures to contain the potential effects of the turmoil. Third, I would underline the importance in stress situations, like the current one, of effective and smooth cooperation and exchange of information between the supervisory authorities and central banks.

As to the policy lessons to be learned in order to avoid the recurrence of similar disruptions in the future, I would say that, while it is still too early to draw definitive conclusions, there is a common understanding on the key issues requiring further analysis. In this respect, let me recall a few topics. First, the need for the financial industry to provide significantly more public information about securitisation, credit risk transfer and complex structured products. Transparency appears to be of the essence in order to restore trust and confidence. Second, the need for rating agencies to review their methodologies for complex structured products and to address very seriously potential conflicts of interest. Third, the need for investors to review their investment behaviour excessively reliant on ratings. Fourth, the need for supervisors to implement the new capital framework under Basel II as rapidly and effectively as possible and to reflect on possible improvements of the framework, including the enhancements of the supervisory regime for liquidity risk. In this context, I should mention that the ECB with the assistance of the Banking Supervision Committee is carrying out work on banks' stress-testing and contingency funding plans.

On all the issues mentioned above, work is already under way at both the international and European level. The ECB is strongly supportive of the work of the Financial Stability Forum, as well as of the European initiatives discussed in the ECOFIN Council. In this context, I would like to once again stress the importance of effective cooperation in any policy actions to be taken at the international level.

The impact of globalisation on price developments

Ladies and gentlemen, let me turn to the impact of globalisation on price developments. As a preface, let me say that while globalisation could influence aggregate prices in several ways, such impacts are limited to the short term given that inflation is ultimately a monetary phenomenon.

The direct, and perhaps most visible effect of globalisation for consumers, is its implication for relative prices. On the one hand, globalisation has dampened increases in euro area

import prices of manufactured goods given a rising share of imports from lower-cost countries such as China and the new EU Member States. On the other hand, rising demand associated with globalisation has contributed to the significant increases observed in world energy and other commodity prices. Although such relative price shocks do not necessarily affect inflation, prolonged short term impacts of sizeable relative price shocks could result, for instance, from adjustment frictions in the economy. Empirical studies for the euro area have tended to suggest a small dampening influence of trade openness on prices in the early part of this decade, though globalisation's contribution to recent movements in commodity prices – particularly energy and food – has had a significant offsetting upward impact on prices. This warrants close monitoring, in particular given the risks of second round effects. In case of food related commodities, it also underlines the importance of efficient supply side adjustment in agricultural commodity markets.

A separate but nonetheless potentially equally important channel through which globalisation can affect inflation involves the indirect price impact of increased competitive pressures, with two main aspects. First, in principle it could contribute to compressing firms' price-cost mark-ups as competitive forces resulting from trade openness would depress profit mark-ups of domestic firms competing with international firms. In practice, however, such effects have been hard to identify and, indeed, aggregate profitability has remained high. Second, in principle competition associated with globalisation could alter the responsiveness of prices to costs or measures of economic slack, or imply a greater role for foreign conditions in the inflation process. In practice, it would appear that such responsiveness has not increased over the last decade, while empirical evidence supporting a growing role of global measures of economic slack in the inflation process of the euro area and other advanced economies has been limited.

On balance, not only is the net effect of globalisation on euro area prices difficult to accurately gauge, but it may also be changing through time. For this reason, the ECB continues to actively monitor possible ongoing changes in the inflation process. At the same time, efficient adjustment can be best facilitated by focusing on price stability and continuing to solidly anchor inflation expectations in the face of considerable relative price shocks.

Developments in the real estate sector

Let me conclude with some remarks on residential property prices. As with other asset prices, residential property prices are closely monitored by the ECB in terms of our economic analysis. Within this context, while we take the euro area real estate sector into account in assessing risks to price stability, we certainly do not target house prices, or for that matter, any other asset prices. We do monitor asset prices closely because of the potentially high costs for price stability and for the economy as a whole that are associated with strong appreciations and rapid reversals in asset prices. Also, our monetary analysis covers the monitoring of money and credit which often reflect the evolution of prices and house purchases. In this sense, a strategy which on top of our economic analysis regularly assesses money and credit developments has an important benefit on the monitoring side in that it can contribute to identifying and limiting the emergence of unsustainable developments in asset prices.

In terms of recent developments in the euro area real estate sector, the latest available data on house prices appears to support the notion of a cooling in euro area housing market developments after a prolonged period of unusually high growth rates in many euro area countries. That said house price growth generally remains relatively elevated in the euro area on average when seen in historical perspective – notwithstanding considerable heterogeneity in underlying country developments. The outlook for the euro area as a whole – I insist, for the euro area as a whole – remains that of a relatively soft landing. Within this context, a continued moderation of residential investment would also be likely.

I thank you for your attention.