Lucas Papademos: The economic outlook, financial market developments and prospects

Address by Mr Lucas Papademos, Vice-President of the European Central Bank, at the Conferencia Buenos Aires 2008, organised by the Americas Society and the Council of the Americas, Buenos Aires, 27 August 2008.

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Excellencies, Ladies and Gentlemen,

It is a great pleasure for me to participate in the Conference Buenos Aires 2008. I would like to thank the Americas Society and the Council of the Americas for inviting me to speak at this panel discussion on "World Economic Opportunities, Risks and Prospects". In my remarks, I would like to present you our current assessment, mainly – but not exclusively – from a European perspective, of the economic outlook and to address a number of issues pertaining to financial market developments and prospects.

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At the current juncture, the performance of the global economy is being strongly influenced by the simultaneous effects of two substantial and persistent shocks: (1) the significant increase in the price of oil and the prices of other commodities, including many food products, and (2) the turmoil in the financial markets of advanced economies which erupted more than a year ago.

The magnitude and duration of these two shocks are adversely affecting both the current economic situation and the outlook for the global economy. In the advanced industrial economies, the large rise in oil and other commodity prices – crude oil prices have tripled since 2000, and an index of food prices has doubled since the beginning of 2005 – have had a negative impact on aggregate demand and especially on aggregate supply and have resulted in a sharp and protracted increase in inflation. The financial market turbulence has led to a tightening of credit standards, an increase in financing costs and a deceleration of credit growth – though the severity of its impact on credit markets differs across countries. Moreover, the financial turmoil has adversely affected the profitability and the capital and liquidity positions of many financial institutions worldwide and in some cases it has caused severe distress or even the collapse of a number of banks.

As a result of these developments, advanced industrial economies are experiencing the uncomfortable combination of weakening economic growth and increasing inflationary pressure. In addition, the macroeconomic outlook is surrounded by exceptionally high uncertainty, with risks to economic growth on the downside and risks to inflation clearly on the upside.

The effects of the commodity price shock and of the financial turmoil on the emerging market economies bear similarities, but also differences from their effects on advanced economies. Economic growth in some emerging or developing economies has also moderated somewhat but in most cases it remains fairly robust supported by domestic demand and the increased income of commodity exporting countries. On the inflation front, however, developments have been universally unfavourable. Average inflation in emerging (and developing economies) accelerated to 8.0% in the first half of this year from an average annual rate of 4.5% in 2006. Moreover, the economic and social impact of higher inflation is especially acute in those economies as food accounts for over 30% of the consumption basket of households, compared to less than 20% in Europe or in the US.

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Let me now focus on the economic and financial situation in Europe and, in particular, in the euro area economy of the 15 EU countries – to become 16 next year – that use the euro as their currency. As a result of the direct and indirect effects of the two shocks I referred to, economic growth in the euro area has moderated significantly this year, and indeed real GDP declined slightly by 0.2% in the second quarter. Part of this decline can be attributed to a technical reaction to the strong growth (of 0.7%) recorded in the first quarter. Nevertheless, economic activity is expected to remain subdued in the coming months and to gradually recover in the fourth quarter of this year and in the course of 2009. However, it is likely that the annual average rate of growth next year will be lower than previously expected.

Over the medium term, economic growth in the euro area should be underpinned by its sound fundamentals and the absence of major imbalances. Moreover, the implementation of reforms planned in a number of euro area countries should help raise productivity and potential output growth. However, the uncertainty surrounding the likely path of euro area economic activity in the coming quarters is unusually high and the risks to growth are on the downside. Among these risks, the potential impact of the financial market turmoil on the real economy could turn out to be larger and broader than currently expected. In addition, unanticipated increases in energy and other commodity prices cannot be excluded, despite the recent drop in prices, especially if demand from emerging economies remains strong.

Despite the significant weakening of real GDP growth in mid-2008, inflation in the euro area has remained stubbornly high and well above the level that would be consistent with the ECB's definition of price stability (an inflation rate of below but close to 2%). In July 2008, annual inflation reached 4.0%, having steadily risen from 2.1% in September 2007. This is largely due to the direct and indirect effects of past sharp increases in energy and food prices globally. There are some indications, however, that domestic inflationary pressures are intensifying as labour cost growth has been increasing in the recent quarters.

Looking forward, given the current futures prices for oil and other commodities, the annual inflation rate in the euro area is likely to remain significantly above the level consistent with price stability for a considerable period of time before declining only gradually in the course of 2009. With regard to the outlook for price developments, the main and serious concern is that a protracted period of high inflation, even if it is largely due to the direct and indirect effects of previous commodity price increases, has the potential to adversely affect price and wage-setting behaviour and short to medium-term inflation expectations, thereby inducing a wage-price spiral via broadly-based second-round effects. The likelihood of such an undesirable scenario should be avoided. For if it materialises, it will adversely and perversely affect growth and the purchasing power of households. Moreover, it will require a stronger degree of monetary tightening in order to achieve price stability in a sustained manner. This concern is further heightened by other upside risks to price stability. As I previously noted, notwithstanding the recent sharp decline in oil prices, the possibility of renewed increases cannot be excluded. In addition, despite some signs of moderation of growth in broad money and credit aggregates, the continued vigorous underlying pace of monetary expansion over the past few years confirms the existence of upside risks to price stability over a medium to longer term horizon.

In order to address these upside risks and achieve price stability in the euro area over the medium-term, in accordance with the ECB's mandate, the Governing Council raised the key ECB interest rates by 25 basis points in July. The Council decided to keep the interest rates unchanged at its August meeting. We believe that the current stance of monetary policy will contribute to achieving our overriding objective of price stability and to maintaining medium and longer-term inflation expectations firmly anchored to this objective. Looking forward, we will continue to monitor very closely all relevant developments and we will do what is necessary to ensure that price stability will be maintained over the medium term.

It is evident from price developments in many countries that rising and persisting inflationary pressure is becoming a global phenomenon. Although from the perspective of individual

countries or economic areas, the recent surge in inflation is mainly due to “external shocks” affecting oil and other commodity prices, in a global context these shocks are internal and reflect, to a considerable degree, aggregate demand pressures, particularly stemming from the growing demand for commodities by emerging and developing economies which account for the largest share of global demand growth for commodities. This in turn reflects the continuing strong growth in emerging market economies –which in some cases is driven by an expansion of aggregate demand that outstrips the growth in aggregate supply and is supported by accommodative monetary policies. The global inflation risk is that the indirect and potential second-round effects of external commodity price shocks on domestic prices and wages in individual countries can, if accommodated, help sustain inflationary pressure in these countries and elsewhere. It is, therefore, necessary to address the surge in global inflation by concerted efforts, especially by the monetary authorities in economies experiencing strong but unsustainable growth.

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Let me now conclude by elaborating on recent developments in financial markets and assessing their implications for the economic and financial stability outlook. As I previously stressed, some of the risks surrounding the economic outlook, globally and in Europe, stem from the ongoing financial turmoil, which has caused sizeable losses for banks in several advanced industrial economies and has resulted in increased financing costs and tighter credit market conditions. In fact, recent developments in the global financial markets point to a renewed intensification of the financial turbulence that commenced more than a year ago.

More specifically, tensions in the global term money markets are persisting despite several measures taken by central banks to improve the access of their counterparty financial institutions to funds so as to alleviate funding liquidity pressures. The spreads between the three-month deposit and the overnight index swap (OIS) rates have broadly stabilised, but at rather high levels ranging between 60 and 80 basis points in all major markets, including the euro area, the US and the UK. At the 12-month maturity, however, euro area money market spreads recently increased and exceeded 90 basis points. Before the turmoil erupted, these same spreads typically stood at around 5 basis points. These protracted pressures in the term money markets continue to have a considerable negative impact on the financing costs of those financial institutions which cover a large part of their funding needs in the short-term wholesale money market.

In the markets for asset-backed securities and structured credit products, where activity was booming and liquidity was abundant until August last year, new publicly-placed issuance has virtually dried up, except for the simpler securitised instruments backed by high-quality collateral. Moreover, the value of many of the outstanding complex structured products, including some of those backed by high-quality assets, has fallen in recent months. In the corporate credit markets, spreads in the below-investment grade segment have recently widened to the highest levels since the beginning of the turmoil. In addition, the cost of buying protection against the risk of default by some of the major financial institutions (as reflected in corporate credit default swaps spreads) has increased again, reaching levels comparable to those seen in late March, before the Bear Stearns rescue. In equity markets, the stock prices of non-financial firms have also declined sharply since early May, while (implied) stock market volatility rose to a peak in July and has remained high. These developments reflect market expectations of a deteriorating corporate earnings outlook, increased financing costs and high and volatile commodity prices.

Overall, a number of developments, both external to and within the euro area, suggest that the uncertainty surrounding the euro area financial stability outlook has increased. This assessment reflects to a considerable extent the continuing decline in US house prices, which is leading to a sharp rise in loan delinquencies and losses, and associated further declines in the prices of mortgage backed securities. In the euro area, credit risks have risen, stemming from developments in some housing markets as well as in those non-financial

corporate sectors which are more exposed to residential construction activity. At the same time, however, there is little evidence so far to suggest that the availability of bank credit in the euro area as a whole has been significantly affected by these developments and, more generally, by the financial turmoil. In particular, the expansion of credit to the non-financial corporate sector remains strong, though moderating.

The persistence of the financial turmoil may also make the financial system more vulnerable to the crystallisation of other risks that have been previously identified by the ECB and other central banks and institutions. These include the possibility of a more broad-based turn in the global credit cycle, a disorderly unwinding of global imbalances and the financial stability implications of persistently elevated energy prices. It seems that large euro area banks have so far weathered the financial storm somewhat better than their global peers. Nevertheless, the investment losses suffered by some banks could make these institutions more vulnerable to a sharper deterioration in the credit cycle.

All in all, the outlook for both global and euro area financial stability remains highly uncertain. A lot will depend on the interaction between macroeconomic developments and the financial system and on how banks respond to an operating environment that presents various challenges, including some new ones. The financial turmoil could be gradually broadening in scope and evolve into a more traditional credit-cycle downturn. In such circumstances, it is likely that the adjustment process will remain protracted as key participants in the financial system continue their efforts to strengthen their liquidity and capital positions. In an environment where balance sheet conditions can change unexpectedly, there is obviously no room for complacency. Vigilance remains of the essence for market participants and policy makers.

Thank you for your attention.