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, before the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 10 September 2008.

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Madame la Présidente, Mesdames et Messieurs les membres de la Commission Economique et Monétaire, je me réjouis de ce troisième échange de vues avec votre commission au cours de cette année. Je commencerai mon intervention par une évaluation de la situation économique et monétaire, en expliquant les raisons sous-jacentes à nos récentes décisions de taux. Je me pencherai ensuite sur les développements sur les marchés financiers en vous donnant de plus amples informations sur les opérations de politique monétaire que la BCE a menées face aux tensions demeurant sur le marché monétaire. Des Weiteren freue ich mich das von Ihnen aufgeworfene Thema der Interdependenz zwischen den Vereinigten Staaten von Amerika und der Eurozone zu erörtern. Zudem möchte ich näher auf die Entwicklung der Wettbewerbsfähigkeit innerhalb der Eurozone eingehen. Abschließend erfolgt ein Inflationsausblick auch im Hinblick auf Ihre Frage, ob eine Phase höherer Preissteigerungsraten vor uns liegen könnte.

Economic and monetary developments

Since my previous appearance before the European Parliament on 9 July when I presented the ECB’s Annual Report for 2007, annual inflation rates have remained at high levels well above those consistent with price stability. This is mainly the result of both the direct and indirect effects of past surges in international energy and food prices. In addition, upside risks to price stability over the medium term have continued to prevail in a context where the underlying pace of monetary expansion continues to be strong. Looking ahead, inflation in the euro area is likely to remain high for quite some time, moderating only gradually during the course of 2009.

According to the latest ECB staff projections the average annual inflation rate is foreseen between 3.4% and 3.6% in 2008 and between 2.3% and 2.9% in 2009.

It is the Governing Council’s view that the risks to this outlook are on the upside. In particular, there is a very strong concern in the Governing Council that higher energy and food prices may lead to the emergence of broad-based second-round effects in price and wage setting, which in turn could add significantly to inflationary pressures. All parties concerned are called upon to contribute to avoiding broad-based second-round effects, as this is essential to ensure that longer-term inflation expectations remain firmly anchored in line with price stability. In this context, the Governing Council is concerned about the existence of nominal wage indexation schemes, as they involve the risk of triggering an inflationary wage-price spiral. The Governing Council calls for these schemes to be abolished.

Turning to economic activity, in the second quarter of 2008, real GDP contracted by 0.2% quarter on quarter. This reflects partly an expected technical reaction to the strong quarterly growth of 0.7% in the first quarter. It also reflects dampening effects from global and domestic factors, including high commodity prices and weaker investment growth in the euro area. The current episode of weak economic growth is expected to be followed by a gradual recovery. In particular, if persistent, the fall in oil prices from their peak in July will help strengthen real disposable income, with the level of employment remaining high and the unemployment rate low by historical standards. Moreover, euro area activity should be supported by relatively resilient world growth, benefiting mainly from sustained growth in emerging economies.

According to the latest ECB staff projections the average annual real GDP growth is foreseen in a range between 1.1% and 1.7% in 2008 and between 0.6% and 1.8% in 2009.

In the view of the Governing Council, uncertainty surrounding growth prospects is particularly high at the current juncture, with downside risks mainly relating to renewed increases in energy and food prices and a potentially more negative impact of financial market developments than currently foreseen.

The monetary analysis confirms the prevailing upside risks to price stability at medium to longer horizons. While money and credit growth are now showing some signs of moderation, the still strong underlying pace points to continued upside risks to price stability over the medium term. In addition, available data suggest that the ongoing financial tensions have, as yet, not significantly affected the availability of bank credit.

In accordance with its mandate, the Governing Council is resolute in its determination to keep medium and long-term inflation expectations firmly anchored in line with price stability. This will preserve purchasing power in the medium term and support sustainable economic growth and employment. It is against this background that the Governing Council on 4 September decided to leave the key ECB interest rates unchanged. On the basis of its assessment, the Governing Council believes that the current monetary policy stance will contribute to achieving the objective of price stability over the medium term. Indeed, the Governing Council will continue to monitor very closely all developments.

Financial stability situation and overview of the ECB's recent monetary policy operations

Let me now turn to the developments as regards financial stability. Recent developments suggest that the balance of risks in the ECB financial stability assessment remains tilted towards the downside. This is because the persistent, although moderating, decline in US house prices is leading to a rise in loan delinquencies and losses, and commensurate further declines in mortgage backed securities prices. Also in the euro area, economic growth has slowed down and credit risks could have increased in some housing markets and related corporate sector loans. At the same time, however, there is little evidence to suggest that the availability of bank credit in the euro area, as a whole, has been until now significantly affected by the financial market tensions.

That said, as we already emphasised, the persistence of the financial market tensions may have made the financial system more vulnerable to the crystallisation of other pre-existing risks. These include the possibility of a more broad-based turn in the global credit cycle, disorderly developments owing to global imbalances, and the financial stability implications of volatile energy prices.

More generally, the outlook for euro area and global financial stability will increasingly depend on the interaction between macroeconomic developments and the financial system, and on how banks respond to a challenging operating environment. The financial market correction could be gradually changing its nature and scope and evolve into a more traditional credit-cycle downturn. In such circumstances, it is more likely that the adjustment process will not abate as key participants in the financial system continue their efforts to strengthen their liquidity and capital positions. In an environment where balance sheet conditions change unexpectedly, there is no room for complacency.

In the last three months, the ECB continued to apply three measures it had used so far since the start of the financial market turbulences, with a view to further steering very short term money market rates close to the minimum bid rate and also to alleviate tensions in the euro money market.

First, the ECB continued to frontload the supply of liquidity over the reserve maintenance periods. This was achieved by increasing the allotment amounts in main refinancing operations (MROs) at the beginning of the maintenance period while reducing them towards the end of the maintenance period so that the average supply of liquidity remained unchanged over the entire maintenance period.

Second, the ECB maintained the increased share of longer-term refinancing operations vis-à-vis the share of main refinancing operations, which it had gradually built up since the start of the turbulences. Moreover, on 4 September, the ECB decided to renew the supplementary three and six month longer-term refinancing operations that will mature before the end of the year. This will allow the euro area banks to better plan their liquidity management over the turn of the year.

Third, the ECB continued to conduct USD term auction facilities (TAF) in cooperation with the US Fed and other central banks. Accordingly, it provided US dollar liquidity to euro area banks, secured with Eurosystem eligible collateral. This measure was adjusted in the period under review. Indeed, in August 2008, an 84-day TAF was introduced to supplement the already existent 28-day TAF, however without thereby increasing the total outstanding amount of TAF operations.

The Eurosystem's collateral framework has proven robust and efficient over the years, and during the recent episode of financial market turbulence. In particular, the acceptance of a wide range of collateral contributes to the resilience of euro area financial markets.

While fully preserving this feature, the ECB has – following its biennial review – incorporated some technical refinements in its risk control framework for Eurosystem credit operations. These technical refinements, which were published on 4 September 2008, reflect, inter alia, improvements in the methodological framework, the assessment of market and liquidity risk characteristics of eligible assets, the actual use of eligible assets by counterparties and new developments in financial instruments. All of these refinements will enter into force on 1 February 2009.

In concrete, these measures include the application of new valuation haircuts for asset-backed securities (ABS) and uncovered bank bonds and the application of a haircut add-on for ABS without a market price. Furthermore, the existing "close link rules" for the use of eligible assets were refined. As regards the credit assessment of eligible assets, the Eurosystem introduced rating disclosure standards applicable to rating agencies. Finally, it was recalled that the Eurosystem has the right and obligation to react to practices that lead to an inadequate risk protection for the Eurosystem.

The overall impact of the new haircuts for unsecured bank bonds and ABS on the availability of collateral is not expected to impair the ability of banks to participate in Eurosystem credit operations.

US-euro area interdependence

Let me now address the issue of interdependence between monetary policy conduct on both sides of the Atlantic. In considering such interdependence, it should be clear from the outset that both the ECB and the US Federal Reserve conduct monetary policy with a view to achieving the domestic objectives that have been assigned to them.

The single monetary policy was given the task of maintaining price stability in the euro area and was assigned to the ECB as an independent, supranational institution. I would like to stress that public pronouncements made by the US Federal Reserve are pointing out as we do ourselves that the delivery of price stability over the medium term is the best contribution that monetary policy can make to sustainable economic growth, job creation and prosperity.

The Governing Council of the ECB – as the Open Market Committee does on the other side of the Atlantic – takes decisions independently, on the basis of its monetary policy strategy, taking into account the structural features of its economy and the nature and amplitude of the economic shocks it has to cope with, and after careful assessment of the risks to price stability in its economy.

Of course, it is important for a stability-oriented monetary policy to analyse developments in external prices, in international trade and financial flows as well as the spillovers of policy actions around the globe. Central Banks have to take into account the multiple channels through which the major economies of the world are in close relationship, thus constituting a global economy. In that sense, it is very important for central banks to ensure that they exchange pertinent information.

As I already mentioned before, central bank staff and Governors of industrialised countries as well as of emerging countries meet every two months under the auspices of the Bank for International Settlements in Basel. Presently, I happen to be the Chairman of the Global Economy Meeting and I can tell you that this meeting in particular is important for all central banks. In a very frank and direct fashion and with a high degree of mutual confidence we compare notes, exchange all necessary information so as to be duly enlightened on the analysis and diagnosis that other central banks are making of their own domestic economies and on their perception of the global issues.

Against the backdrop of the serious market correction recorded since summer 2007, monetary authorities on both sides of the Atlantic have been cooperating to help ensuring a smoother functioning of inter-bank markets and help alleviating liquidity drying up in some market segments.

Intra-euro area competitiveness developments

Persistent inflation and wage growth differentials may occur in a monetary union, determined by catching-up processes and/or by sustainable trend differentials in potential growth across countries. However, if induced by structural inefficiencies, misaligned national policies including wage-setting policies or overly optimistic expectations, such differentials may be worrisome and may have important adverse implications for cost competitiveness of individual countries in the euro area. As national monetary and exchange rate policies are no longer available options within the euro area, it is important to ensure that the remaining mechanisms of adjustment to shocks function properly and that the build-up of imbalances is avoided.

Rigidities in price and wage-setting mechanisms or ongoing excessive price and wage developments may delay the necessary adjustments of relative prices to economic shocks and give rise to a prolonged period of relatively high inflation in some countries. This, in turn, could contribute to losses in price and cost competitiveness and an accumulation of internal imbalances within the euro area, which could also dampen output and employment. When looking at unit labour costs, it is also noticeable that a number of euro area countries which experienced significant increases in unit labour costs since their entry into the euro area, also show relatively high current account deficits.

National authorities have an important responsibility to contribute to moderate price and unit labour costs developments. It should in particular be avoided that public wage-setting contributes to strong overall unit labour costs growth. As high unit labour costs growth may also reflect an overheating of the economy, the avoidance of a pro-cyclical fiscal stance is particularly important. Furthermore, a key issue is the capacity of goods and labour markets to adjust. Therefore, wage agreements in particular should generally reflect the competitiveness position, and need to take into account the still high level of unemployment in many economies as well as the sector specific productivity developments. Finally, the efficient and smooth functioning of economic adjustments within the euro area requires the completion of the Single Market and thus greater domestic and cross-border competition.

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Let me conclude by briefly addressing the Committee's concern over whether we are experiencing a new and lasting upward shift in inflation. The central bank is precisely there to prevent such a lasting shift and to deliver price stability over the medium term. On the basis of the assessment of the Governing Council the current monetary policy stance will contribute to achieving this objective. The Governing Council remains resolute in its determination to keep inflation expectations solidly anchored in line with price stability. At the same time, upside risks to price stability over the medium term, in particular those stemming from second-round effects in price and wage setting, prevail. In this context, in order to avoid that the current high inflation rates become entrenched in expectations, it is of the essence that all relevant parties – price setters and social partners – meet their responsibilities. As emphasised, it is also important that indexation schemes are abolished. This would strengthen the resilience of growth and employment creation of the euro area economy with regard to the current adverse developments we have to confront.