Jürgen Stark: Economic recovery and exit strategies

Speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the debate on “The post-crisis strategy for growth and jobs” and “Modernisation of the global financial architecture” between the Committee on Economic and Monetary Affairs of the European Parliament and national parliaments, Brussels, 16 March 2010.

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Ladies and gentlemen,

Economic situation and outlook

In autumn 2008, the world entered the worst financial crisis and the most severe economic downturn since the end of the Second World War. Since spring 2009, financial market conditions have improved. Economic growth has resumed in most countries, albeit very moderately in many advanced economies. These improvements have largely resulted from massive support measures taken by governments and central banks.

Likewise, we have recently seen further improvements in the outlook for the global economy. However, uncertainty is still high, as both fiscal stimuli and the inventory cycle, which are currently supporting growth in many countries, are transitory and as there remain risks to the financial sector.

In the euro area, recent information indicates that recovery is still on track. The global recovery that is underway and the positive impact of the policy responses to the financial crisis are the main drivers behind this development. However, ongoing balance sheet adjustments in the private sector, which are necessary, are likely to weigh on growth, just as low capacity utilisation will weigh on investment. In the same vein, weak prospects for the labour market will dampen consumption growth.

Therefore, the euro area economy is expected to grow at an only moderate and most probably uneven pace in 2010. This is in line with the latest projections by ECB staff *[who predict real GDP growth of between 0.4 and 1.2% for this year and between 0.5 and 2.5% for next year]*. The Governing Council views the risks to this outlook as broadly balanced.

As regards price developments, inflation and inflationary pressures have remained low over recent months. Inflation stood at 0.9% in February. The outlook for inflation is in line with price stability and the risks to this outlook remain broadly balanced. More specifically, we expect inflation to stay at around 1% in the near term, and to remain subdued over the policy-relevant horizon, largely on account of the abundance of idle resources and the moderate recovery. This is in line with the projections by ECB staff.

Our monetary analysis confirms the assessment of low inflationary pressures over the medium term, with money and credit growth remaining weak.

All in all, inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

Monetary policy – exit from non-standard measures

Let me now turn to monetary policy. As you know, we have taken bold action in response to the crisis. Given subdued inflationary pressures in the context of a severe economic downturn, the ECB lowered its key interest rates sharply. From October 2008 to May 2009, i.e. within a period of only seven months, we brought the main refinancing rate down by 325 basis points to 1%, a record low level not seen in the recent history of euro area countries. Overall, the Governing Council views the current low level of its key interest rates as appropriate.

To foster financing conditions and facilitate the transmission of lower key ECB interest rates to money market and bank lending rates, the Governing Council also introduced a number of non-standard measures. Notably, the Eurosystem provided unlimited liquidity to banks at a fixed interest rate and at maturities of up to one year. It also provided liquidity in foreign currencies, extended the list of eligible collateral and purchased covered bonds outright. Together, our non-standard measures have helped to improve financing conditions, especially in the money market, thus contributing to a better flow of credit to households and firms than would otherwise have been the case.

However, it is important to ensure that the non-standard measures do not remain in place for longer than is necessary, as this would entail the danger of significantly distorting money market participants' perceptions of actual liquidity risk and their related behaviour. Therefore, in view of the improvements in financial market conditions seen since last spring, we decided in December to begin a gradual phasing-out of some of our non-standard measures.

In particular, we conducted the last 12-month operations in December and decided that the six-month operation coming up in two weeks will be the last. In addition, on 4 March, we decided to return to variable rate tenders in the regular three-month operations towards the end of April.

The Eurosystem will also continue its enhanced credit approach and provide liquidity support to the euro area banking system at very favourable conditions in its shorter-term refinancing operations (that mature after one week and after approximately one month). We decided to do this for as long as necessary and at least until mid-October this year.

These decisions help facilitate the provision of credit to the euro area economy. At the same time, the Governing Council will continue, in the context of its medium-term monetary policy strategy, to implement the gradual phasing-out of any extraordinary liquidity measures that are no longer needed, taking due account of economic and financial market conditions.

Such a medium-term orientation is essential in order to fulfil the ECB's mandate of maintaining price stability in the euro area.

Thus, phasing-out some of the non-standard measures to avoid risks to price stability at a later stage is fully in line with the ECB's price stability mandate under the current circumstances. At the same time, the ECB will avoid too early an exit from its non-standard measures, as this would risk hurting the normalisation of financial markets and the recovery.

Of course, we do not know today what post-crisis normality would look like. Nor do we yet know the design of the "final" post-crisis operational framework. However, when talking about the end-point of the phasing-out, the operational framework that prevailed prior to the start of the financial turmoil in August 2007 might provide a good benchmark. Should we fully revert to this, only a very few policy parameters remain – in particular, the tender procedures to be applied in the main refinancing operations and the operations with a duration of one maintenance period, which is approximately one month (a return to variable rate tenders).

The monetary policy framework

Recently, some voices have argued that central banks should act as risk managers by organising their working framework with a view to avoiding events that may lead to deflation. It has been further argued that, in such a working framework, central banks should relax their targets and aim for significantly higher inflation rates. In this vein the question has been raised as to whether it would not be appropriate to have a permanently higher inflation target of 4%, as this would leave more room for monetary policy to react to large, adverse shocks.

I strongly oppose this notion. Any relaxing of central banks' mandates in this direction would be a serious mistake. Let me explain why.

Certainly, it may be tempting for governments to suggest higher inflation in order to monetise the dramatic build-up of public debt. However, calling on central banks to raise inflation rates permanently takes the focus away from the overriding problem, which is that, at present, unsustainable fiscal policies represent a threat to macroeconomic stability in nearly all advanced economies. If, on top of the financial uncertainties and concerns about public debt, the general public were to lose trust in the purchasing power of money, the consequences could be grave.

Also, higher inflation increases distortions from taxes. It increases inflation variability and, hence, uncertainty for investors. This implies higher long-term real interest rates, as investors would want compensation for the increased uncertainty. Thus, a permanent increase in inflation curtails, rather than stimulates, long-term growth. Empirical evidence confirms this negative relationship.

Using monetary policy to manage macroeconomic risk would avoid policy restrictions when benign shocks reduce inflation, as was the case when China and other low-cost economies started to increase their market shares some years ago, thus fostering asset price booms, excessive risk-taking and financial imbalances. When the asset price boom finally turns into a bust, such a policy would lead central banks to overreact to the negative shocks.

So, financial stability is undermined in two ways: first, by a pro-cyclical monetary response to benign disinflation in good times; second, by moral hazard in financial markets, stemming from the expectation that the central bank will protect the markets from "tail events" in bad times, thus encouraging too much risk-taking. This would certainly also set wrong incentives for fiscal policy-makers.

Fiscal policy

This brings me to fiscal policy issues. The crisis began as a financial crisis and evolved into an economic crisis. There is now a clear risk that we will enter a third wave, a sovereign debt crisis in most advanced economies. Many euro area countries are faced with large budget deficits and sharply rising public debt levels. While it was right to also take extraordinary fiscal policy measures to avoid a 1930s-style depression, a timely exit from the fiscal stimuli is now crucial in the context of ongoing economic recovery. Any undue delay will have serious negative side-effects on confidence and economic welfare.

Let me remind you that unsustainable fiscal policies complicate the task of monetary policy, as they might lead to higher inflation expectations and higher uncertainty about the inflation outlook in the medium term. As a result, upward pressure on long-term interest rates might lead to a crowding out of private investment, which would, in turn, be detrimental to potential growth and contribute to adverse spill-over effects. High debt ratios reduce the room for governments to counter a new downturn by letting automatic stabilisers operate or even adopting discretionary stimulus measures. Indeed, with fiscal sustainability under pressure, fiscal multipliers can turn negative and a fiscal expansion can induce higher precautionary saving and, consequently, an economic contraction. This underlines the importance of reducing debt levels, and of having effective tools to counter serious downturns in the future.

As a result of the budgetary loosening in the context of the economic and financial crisis, many euro area countries will need to engage in ambitious fiscal consolidation to put their debt levels back on a declining path towards the Maastricht reference value of 60% of GDP. Simulation results suggest that even with average annual consolidation efforts of 0.5% of GDP, returning to the pre-crisis euro area debt ratio would take around two decades.

Therefore, to safeguard government solvency and sustainable fiscal positions in the euro area countries, governments must give fiscal consolidation top priority, taking the ongoing recovery of the economy into account, and bring their deficit ratios to below 3% of GDP, in line with the recommendations by the Ecofin Council. Consolidation efforts will have to last for several years in many countries. In Europe, the Stability and Growth Pact provides the appropriate framework for the coordination of the necessary consolidation policies. It is now crucial that all governments strictly adhere to their commitments under the Pact. Supporting national fiscal frameworks should be strengthened wherever necessary.

The situation in Greece shows how important it is to strictly apply credible fiscal rules. A lesson to be learnt from the recent events is to strengthen the fiscal rules in the euro area and to enforce their application.

Need for structural reform

Healthy economic growth could alleviate fiscal strains to some extent, by reducing the size of existing debt relative to the size of the economy and by improving the annual budgets. This underlines the importance of increasing our economies' growth potential. The starting point, however, is not the best. Most estimates suggest that the turmoil lowered both the level and the growth rate of the euro area's potential output. It is therefore crucial to accelerate structural reforms that will reinforce sustainable growth and job creation. Policies that enhance competition and innovation are urgently needed to speed up restructuring and investment, and to create new business opportunities. Increased labour market flexibility is required to create employment and restore competitiveness. Restructuring of the banking sector, aimed at sound balance sheets, better risk management and increased transparency, is also of the essence.

Concluding remarks

Let me conclude.

The global economy shows signs of an ongoing improvement. In the euro area, we are also on the road to recovery, albeit at a moderate pace. Uncertainties remain high.

As regards our monetary policy stance, we still view the current level of the ECB's key interest rates as appropriate, given continued low inflationary pressures and our current assessment of the risks to price stability over the medium term.

At the same time, improvements in financial markets since spring 2009 have justified a gradual phasing-out of non-standard measures. These decisions help to avoid distortions associated with the maintenance of our non-standard measures for longer than they are needed.

This does not mean that the crisis is over. There is no room for complacency. We cannot rule out setbacks. New challenges may arise. Greece is a case in point.

Thus, central banks need to provide an anchor of stability and confidence. Any attempt to weaken or even lift this anchor would be a step in the wrong direction.

Thank you for your attention.