Jean-Claude Trichet: The current state of the European economy and the ECB's monetary policy concept

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the International Financial Forum, Paris, 9 July 2004.

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Mesdames et Messieurs, ladies and gentlemen,

Présent aujourd'hui à Paris, je souhaiterais remercier le Président Mestrallet et les équipes d'Europlace pour la tenue de ce Forum Financier, témoignant une nouvelle fois du dynamisme de la place de Paris tant en France qu'à l'étranger. J'ai pu moi-même le constater à plusieurs reprises, notamment lors des Journés d'Europlace à New York.

I am very honoured to have been invited here on the occasion of the International Financial Forum. I would like today to talk about two topics of obvious importance for the ECB. First, I will make some remarks on the current state of the euro area economy. Second, I will make some more general remarks on the monetary policy concept of the ECB.

The current state of the euro area economy

Overall, the latest data releases confirm that the economic recovery in the euro area is continuing. Quarterly real GDP growth in the first quarter of this year was 0.6%, slightly higher than what had been expected earlier this year. For the second quarter of this year, the latest indicators of output and expenditure, as well as the most recent survey data, remain consistent with ongoing growth in real activity, with the working assumption of a gradual recovery.

Looking ahead, we remain confident that the recovery of economic activity will continue. Indeed, the conditions for a broadening and strengthening of the recovery are in place. Starting with external developments, economic growth outside the euro area remains strong and this should promote euro area exports. As regards domestic developments, investment should benefit from the positive external environment and the favourable financing conditions within the euro area. As corporate restructuring gathers pace and business efficiency advances, improved profitability should underpin business investment. As regards private consumption, its recovery should proceed in parallel with increases in real disposable income and the gradual strengthening of employment growth.

This picture of the euro area economy is broadly in line with all available forecasts from international and private organisations. In addition, it is worth stressing that financing conditions in the euro area are very favourable, supporting the ongoing gradual economic recovery in the euro area.

I should note that this scenario of an ongoing and further progressing economic recovery is subject to some risks - in both directions. On the upside, euro area economic growth in the first quarter of this year was stronger than anticipated and this momentum may strengthen shorter-term dynamics. Ongoing robust growth in the global economy could also lead to stronger than expected activity in the euro area. On the downside, although oil prices have declined somewhat recently, they remain at high levels and may dampen growth, mainly through their impact on the euro area's terms of trade. Considering longer horizons, concerns also remain with regard to the persistence of global imbalances.

Turning to price developments, when assessing risks to price stability at the current juncture it is essential to distinguish between short-term developments and the medium-term trend. Over the short term, oil prices continue to exert upward pressure on the general price level. According to Eurostat's flash estimate, annual HICP inflation was 2.4% in June, following 2.5% in May. Although oil prices have fallen over the last few weeks, markets expect them to remain high for some time to come. If this were to occur, inflation rates would most likely remain above 2% for longer than was expected this year and, possibly, in the first half of next year.

Looking beyond the short term, however, the main scenario for medium-term inflation remains consistent with price stability. This scenario is based on the assumption that wages will continue to develop moderately at a time when unemployment is still high. However, there are some upside risks to this scenario. The strength of global economic growth may continue to exert upward pressure on commodity prices, including oil prices. Moreover, on the domestic side, indirect taxes and administered prices have been subject to rather strong increases in the recent past and their future evolution is uncertain at this point in time, since such information usually becomes available only later in the year. In addition, measures of long-term inflation expectations derived from financial market indicators remain relatively high. While such measures always need to be interpreted with caution, their development calls for particular vigilance.

Against this background, the potential risk of second-round effects via wage and pricing behaviour needs to be monitored closely. In this respect, I should stress again the important contribution that social partners can make to facilitating the maintenance of price stability by focusing on the medium-term outlook for price developments. Certain upside risks to price stability are also indicated by the monetary analysis. Although annual M3 growth rates have fallen over recent months, there remains substantially more liquidity in the euro area than is needed to finance non-inflationary growth. While a significant part of the excess liquidity has accumulated as a result of past portfolio shifts, low interest rates have also fuelled the build-up of liquid assets. The low level of interest rates also supports credit growth. The stock of excess liquidity, if it persists, may pose an upside risk to price stability over the medium term. The monetary analysis therefore supports the case for continued vigilance with regard to the materialisation of upside risks to price stability.

All in all, we are confident that the outlook remains in line with price stability over the medium term. We therefore left the ECB interest rates unchanged at our last Governing Council meeting. We remain vigilant as regards all developments which could affect risks to price stability. Confidence and vigilance is the best summary I can offer of our present attitude.

Let me also mention that we all have our own, important responsibilities - on both sides of the Atlantic. Here in the euro area we of course take our decisions on the basis of our responsibilities and depending on our own analysis of the situation. Europe is Europe and the United States is the United States. They had good reasons to increase rates and we had good reasons to keep rates unchanged.

Let me also make a few remarks on fiscal policies in the euro area. At present the institutional framework of public finances in Europe is at a critical juncture. If we are to safeguard the soundness of public finances over the long run we cannot afford to weaken the existing institutional framework. In this respect, we observe current discussions on reforms of the Stability and Growth Pact very closely. In our view, there are no reasons to change the letter of the Pact, although we do not deny that its implementation could be improved further, in particular as regards the analysis of structural fiscal balances.

The current economic recovery offers the opportunity to put public finances on a sounder track. Credible and resolute fiscal consolidation efforts are essential for strengthening confidence in the short term and therefore economic growth prospects in the medium term. I refer here to the neo-Ricardian effects of fiscal consolidation, as opposed to the well-known Keynesian effects.

The ECB's monetary policy concept

I would now like to turn to the second part of my remarks, the monetary policy concept of the ECB. Devising a monetary policy for the Eurosystem at the outset of Stage Three of EMU was one of the challenges we were confronted with in the process of creating a new and common currency for the people of Europe. The monetary policy strategy of the ECB was announced in October 1998. We aimed to build on the wisdom and the wealth of experience with the conduct of monetary policy that had been accumulated in the preceding decades by central banks and academic institutions in industrialised countries, in particular those forming the euro area, to devise the best possible monetary policy for the new currency.

Transparency of the ECB's monetary policy

One of the principles that has transformed the practice of central banking in recent decades is its pursuit of a high level of transparency in all aspects of monetary policy. This includes the setting of clear benchmarks for accountability, the announcement of unambiguous objectives to the public, and the timely release of relevant information and the contents of monetary policy deliberations.

The ECB has played a leading role in this general trend. It has in fact set standards of transparency in the practice of monetary policy. We were the first large central bank, and remain the only one, to hold press conferences in which we give the public a detailed account of the Governing Council's monetary policy diagnosis immediately after our monthly monetary policy meetings, in real time. The introductory statement opening our press conference consists of an extended summary of the deliberations of the Governing Council in which the situation is assessed and our diagnosis expressed. Moreover, the press conference allows a transparent interaction with participants and, through them, with the full body of observers, savers and investors. In addition, the ECB's Monthly Bulletin provides the public with the full set of assessments and data underlying policy decisions only a few days after they are taken.

The ECB is one of most transparent central banks in the world and has helped to define "the state of the art" of central banking in this domain. The only area in which we prefer to remain cautious is in revealing the voting behaviour of individual members of the Governing Council. We have reasons for that.

First, we want to communicate clearly to the public that the entity which decides is not a personality or a group of personalities but a college, a united team which benefits fully from the collegial wisdom.

Second, we do not want in any respect to take the risk of giving credit to the idea that the ECB is a place of confrontation between various national interests, represented by various nationalities and various national central bank governors. The Maastricht Treaty asks all of us to decide in the interest of the euro area as a whole and to forget about reasoning on the basis of a national vision. Our present concept is fully in line with this very important Treaty instruction. Let us not forget that, from this standpoint, we are in a very different situation to that of the United States or the United Kingdom. There is no central bank governor in the United States or the United Kingdom equivalent to the Governing Council. The United States is not made up of twelve sovereign states sharing the same currency.

Third, we publish our diagnosis in real time and we provide a press conference so that all the arguments that have led us to our decision are known in full by the public.

Finally, empirical works - in particular by Artus and Wyplosz - have shown that we have been highly predictable in our decisions - even more than some other very influential central banks. This demonstrates that our present concept does not in any respect undermine predictability, which is one of the major ultimate goals of transparency.

Let me now focus on some elements of our monetary policy concept. To start with, I would like to stress something which is essential in order to understand all that we have done over the past five years: we were asked to deliver a new single currency that would be at least as good as each and every national currency. It was a solemn promise made to 306 million fellow citizens of Europe. It was the necessary fundamental feature of a smooth transition to the euro. Had this promise not been met, quite a number of people in Europe would have seen their market interest rates rise at the moment of transition, and they would have rejected it. So it was undoubtedly necessary. But, at the same time, it was also extraordinarily demanding. It was extraordinarily demanding because it called for the euro, from day one, to be as credible, as confidence-inspiring and as good a store of value as the best national currencies were before the introduction of the euro. And this had to be attained, not only on a short-term basis, but also on a five-year, ten-year, thirty-year basis…

We succeeded in delivering, to the benefit both of the euro and of 306 million fellow citizens, the best yield curve available in the euro area before the euro was introduced. This extraordinary success, which most observers, economists and market participants were not predicting a few months before the transition, can be attributed to the credibility of the ECB and the Eurosystem, and their decision-making processes, as well as to the pertinence of the monetary policy concept devised by the ECB before the introduction of the euro.

When judging our monetary policy concept one should never forget that it has passed the most extraordinary test that one could imagine: that of the introduction of a new currency without any past record, from day one, at the highest level of medium and long-term credibility and at the lowest level of medium and long-term market interest rates.

It is my belief that each particular feature of our monetary policy concept was a necessary condition for the success of the transition and that, all together, they created the necessary conditions for that remarkable success. This is true, in particular, of two crucial elements of our monetary policy concept: the focus on price stability as the primary objective of monetary policy and the need to provide the public with a clear framework for the assessment and communication of the risks to price stability.

The objective of price stability

The basis for our strategy is the ECB's mandate that the primary objective of monetary policy should be to maintain price stability. This mandate, which mirrors the mandates of a very large majority of the EU national central banks before 1999, is enshrined in the Maastricht Treaty, which was signed by all governments of the European Union and ratified by all the parliaments. It has been mentioned in the appropriate place in the Constitution just approved at the end of the term of the Irish Presidency.

Price stability enhances the efficiency of the market system in allocating resources. It is associated, in particular, with lower uncertainty and risk premia in financial markets. This facilitates financial transactions and ultimately implies lower medium and long-term interest rates, fostering investment. Maintaining price stability is the contribution of monetary policy to sustainable growth and job creation. Price stability also makes an important contribution to attaining social cohesion.

The ECB's definition of price stability

In order to make the Treaty mandate operational, and to enhance the transparency of the policy framework and thereby the accountability of its monetary policy, the Governing Council of the ECB has provided a quantitative definition of price stability. Price stability has been defined as a year-on-year increase of below 2% in the Harmonised Index of Consumer Prices (HICP) for the euro area as a whole. By referring to increases in the HICP it was made clear that deflation is excluded from the definition of price stability.

The May 2003 clarification: "HICP inflation below but close to 2%"

At the same time, we felt the need to convey even more clearly to the public that the Governing Council does not view all positive inflation rates of below 2% as equally desirable. On 8 May 2003 we made it clear that, in order to fulfil its price stability objective, the Governing Council aims to maintain HICP inflation below but close to 2% over the medium term. This was fully in line with our past practice and with medium-term market expectations. Thus, the announcement did not change inflation expectations.

The main argument for maintaining a low positive rate of inflation is that it helps to reduce to very low levels the probability that nominal interest rates will approach their lower bound of zero. Obviously, the likelihood of nominal interest rates hitting the zero lower bound in the euro area is rather remote. This notwithstanding, introducing a preventive margin for inflation rates is advisable, not least since available evidence indicates that even a relatively small safety margin for inflation rates above zero is sufficient to largely eliminate concerns that the zero lower bound for nominal interest rates will become binding.

There are other arguments for aiming at positive rates of inflation, such as the possibility of measurement bias in the price index and the inflation differentials in the euro area. Overall, our assessment is that aiming at inflation below but close to 2% over the medium term strengthens the public's confidence that deflation need not be a concern.

The anchoring of long-term inflation expectations

In the light of past experience, it is clear that the announcement of the quantitative definition of price stability, in combination with the medium-term orientation of policy, has been an extremely valuable element of the ECB's strategy. With its quantitative definition, the ECB has made a very significant contribution to the firm anchoring of inflation expectations. Notably, it has provided a benchmark for inflation expectations, which in turn has considerably facilitated the conduct of monetary policy. Indeed, as long as longer-term inflation expectations are firmly anchored, chances are high that the setting of wages and prices will be guided primarily by the ECB's objective rather than by past developments. This significantly reduces the likelihood of temporary increases in inflation triggering harmful second-round increases in wages and prices, events which were fairly frequent in previous decades.

For these reasons, the ECB has from the start carefully monitored and continuously communicated the developments in euro area inflation expectations. Experience indicates that the volatility of indicators of long-term inflation expectations, especially those based on survey data, has always remained relatively limited, at levels comparable to those in the best performing industrialised countries in this respect. Notably, survey-based indicators of inflation expectations have always remained fairly close to 1.8% and, most of the time, within the range of 1.7 to 1.9%, thus at levels fully in line with the ECB's definition of price stability. However, as I have already mentioned, indicators of long-term inflation expectations based on financial market data have edged up slightly in the course of this year. This is a source of concern for the ECB. I assure you that the Governing Council is particularly vigilant about the development of these indicators.

The framework for assessing and communicating the risks to price stability

Another important aspect related to the recent transformation in monetary policy concerns the ability of the central bank to present and explain to the public at large the analytical framework used by policy-makers to continuously assess the flow of data, reach policy decisions and communicate them to the public. In this respect, the ECB's framework emphasises two important principles: the medium-term orientation of monetary policy for achieving price stability and the principle of robustness of the analysis, which underlie its assessment of the risks to price stability.

The medium-term orientation of monetary policy

Ever since the announcement of its strategy in 1998 the ECB has made it clear that price stability is to be maintained over the medium term. I emphasised before that it is crucial in monetary policy to look through" short-term volatility in prices, which is typically outside the control of central banks. The medium-term orientation of the ECB's monetary policy strategy clarifies that the time horizon over which price stability has to be re-established needs to be tailored to the prevailing circumstances in the economy. This horizon would depend on factors such as whether the shocks are temporary or permanent, on whether they emerged on the supply or the demand side, on whether the origin of the shocks is domestic or external or on whether they have a bearing on the performance or even the fragility of the financial system. By adapting the appropriate monetary policy horizon to the nature of the shock, the ECB makes an important contribution to avoiding unnecessary volatility in output growth.

The focus on the medium term in the ECB's monetary policy strategy embodies a commitment to avoid overly activist and ambitious attempts to fine-tune inflation outcomes. It also helps to reinforce the credible anchoring of our definition of price stability in the medium and long-term expectations of economic agents and markets.

Robustness of the framework

The appropriateness of a monetary policy strategy cannot be evaluated by means of just one particular model or class of models. Rather, a good candidate strategy needs to perform well across a variety of empirically plausible models, and it has to allow for the judgement of policy-making bodies.

The ECB's analyses and economic perspectives of the risks to price stability are founded on a two-pillar framework. The two-pillar approach permits us to convey to the public the notion of a diversified analysis and it ensures robust decision-making based on different analytical perspectives. These two perspectives are referred to as "economic analysis" and "monetary analysis".

The economic analysis focuses mainly on the assessment of current economic and financial developments, their likely future dynamics, and any implied short to medium-term risks to price stability.

To fully assess the economic situation and the outlook for price stability, the Governing Council must be able to call on a variety of tools and models. However, judgement is also needed, particularly in assessing the likelihood of certain hypothetical scenarios eventually materialising. The ECB cannot and does not rely on a single model or a single set of equations. The Eurosystem staff macroeconomic projections constitute one important input into the monetary policy decision as a way of organising a large amount of information and helping to create a consistent picture of possible future developments. However, the numbers which come out of economic forecasts cannot by themselves encompass or even reflect all the complexities, conditioning factors, nuances and the multidimensional nature of a comprehensive assessment of the risks to price stability on which monetary policy decisions need to be based.

In this respect, attempts to base monetary policy decisions solely on inflation forecast numbers would involve significant limitations. Notably, they would entail the inefficient use of information, since every forecast, or any other index of indicators, is based on one possible scenario and one combination of assumptions. In the end, monetary policy requires judgement on the part of the policy-maker to assess not only the plausibility of all possible scenarios, but also the nature of the shocks and the best policy reaction in order to deal with this uncertain environment. Just focusing on one or a few forecast numbers would make it difficult for policy-makers to transmit the complexity of monetary policy deliberations to the public in a precise and transparent manner.

To this end, the ECB decided from the outset to single out money from the set of selected key indicators that it would monitor and study closely. To mark the fact that, in the medium and long run, inflation is indeed a monetary phenomenon, the Governing Council announced a reference value for the growth of a broad monetary aggregate which is compatible with sustainable, non-inflationary economic growth.

These decisions were made in recognition of the fact that monetary growth and inflation are closely related in the medium to long run. Indeed, assigning money an important role underpins the medium and long-term orientation of the strategy. It helps policy-makers to see beyond the transient impact of the various shocks affecting the economy and to implement an adequate gradual course for the conduct of monetary policy. A central bank simply cannot ignore the fact that, ultimately, inflation is always a monetary phenomenon.

To sum up, the ECB's framework strives to convey to the public the full complexity surrounding the monetary policy process. It aims to provide an honest account of all the relevant factors considered in monetary policy deliberations, forestalling any mechanistic description of monetary policy.

Using a single framework for both external communication and internal analysis guarantees consistency. As already mentioned, empirical studies show that the ECB has been, in the eyes of the market, at least as predictable in its monetary policy decisions as most other central banks in the industrialised world, if not even more so.

The emphasis on the robustness of the framework favours its stability over time. All this facilitates the public's understanding of how monetary policy is conducted, fostering the process of transmission of monetary policy decisions to the economy and ultimately facilitating the achievement of price stability.

Let me conclude. It may be useful to describe EMU as a long-distance race, with several rounds. So far, a number of rounds have already been completed, always successfully, leaving us with valuable assets, notably the high level of credibility of the ECB for attaining price stability, and highly and increasingly integrated financial markets in which long term rates of bonds have converged not to the average of the pre-Stage Three figures but to the best previous benchmarks. Yet we are not complacent. Ahead lie further rounds: major challenges in restructuring markets and industries, enhancing fiscal sustainability, and fostering technological advancement and the enlargement of the euro area. Speaking of enlargement, which will be the topic of the following session, I would like to stress the great opportunity it offers for the European economy as a whole. Fears and doubts have been expressed. I recall that the same fears and doubts were expressed back in 1986, at the time when Spain and Portugal joined the European Union. Today, nobody would dispute the positive impact their accession had on the European economy.

Beyond the enlargement of the European Union will come the enlargement of the euro area. Joining the euro area is a very important step, as it is an irreversible decision. This requires careful preparation. Every country will be assessed on its own merits and its own particular situation, on the basis of a strict analysis of the convergence criteria. Moreover, economic and monetary convergence will need to be sustainable, which means that it can be maintained over the long term. On this basis, the new Member States and Europe as a whole will fully reap all the economic benefits we can expect from the enlargement.

I thank you for your attention. Je vous remercie de votre attention.