John Hurley: The monetary and financial environment in the euro area

Speech by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to the ACI Ireland, Dublin, 11 April 2005.

* * *

Introduction

First, let me say how pleased I am to have the opportunity to speak to you tonight. The ACI plays an important role in bringing together participants in financial markets and in actively promoting the education and professional development of its members.

I would like to begin tonight by talking about euro area monetary policy and the factors which are shaping the current environment. I will then talk briefly about monetary policy implementation. Finally, I will devote some time to the important topic of financial integration in Europe.

The economic background

Beginning with monetary policy, a key feature of both the euro area and global economies in recent years has been the unusually high degree of economic and financial uncertainty which has accompanied economic recovery. As a result, particularly in the euro area, growth has ebbed and flowed and the recovery has not evolved in the smooth and sustained fashion that would be normal for this stage of the economic cycle.

While the recovery of economic activity in the euro area which started in 2003, continued in 2004, it was a year of two quite different halves. Relatively strong growth in the first-half of 2004 was followed by a slowdown in activity in the second-half. This reflected both the impact of higher oil prices and exchange rate developments. Thus, while growth of 1.8 per cent was recorded in 2004, the highest rate since 2000, the euro area economy lost some momentum during the second-half of the year.

While a somewhat similar pattern was also observed in the wider international economy, the global growth performance has been a good deal more impressive than that of the euro area over the past 18 months. Last year the global economy grew by 5 per cent, its fastest rate of growth in almost three decades; this was two and one-half times the rate of growth of the euro area. Driven by the strength of economic activity in the US and Asia, the global economy grew rapidly in the four quarters to mid-2004. The strength of global growth during this period was supported by favourable financial conditions and stimulative macroeconomic policies in many countries. In the US, growth acquired considerable momentum from the sizeable fiscal and monetary policy stimulus which had been put in place earlier. In addition, supportive wealth effects from equity and housing markets also helped propel growth. The improvement in the global economic environment during this time was not solely confined to the US. Growth accelerated sharply in China and East Asia, where it was supported by the strong rebound in global trade flows and a revival in domestic demand.

Since the middle of 2004, global growth momentum has slowed somewhat, though this has not been uniform. For most countries, with the exception of the US, growth moderated in the second-half of 2004, as the dampening impact of the rise in oil prices was felt. By and large, however, the slowdown has been modest and, so far, the global economy has weathered the earlier rises in oil prices reasonably well.

The pick-up in growth in the euro area between mid-2003 and mid-2004, while much less vigorous than in the other major regions, benefited significantly from the strength of global growth. Over this period, the recovery was largely driven by export growth, with the contribution of final domestic demand being relatively modest. However, there were significant differences across countries. Domestic demand grew strongly in France and Spain, while remaining weak in Germany and Italy. In the aggregate, euro area domestic demand growth failed to generate much momentum. This reflected slow wage and employment growth and also continuing uncertainty regarding the implementation of structural reforms, which dampened confidence and held back consumption. The moderation of growth in the second-half of 2004 was largely the result of a marked decline in the external contribution, which was only partially compensated for by higher domestic demand. Slower global growth and the lagged impact on competitiveness of the ongoing appreciation of the euro undercut export growth, while rising oil prices also took their toll. As a result, growth in the second-half of 2004 was a good deal weaker than in the first-half.

Inflation developments

Mainly reflecting the modest nature of the economic recovery, inflationary pressures have remained subdued in the euro area. HICP inflation averaged 2.1 per cent in 2004, unchanged from 2003. While higher oil prices and further increases in indirect taxes and administered prices exerted upward pressure on inflation, this was offset by ongoing exchange rate appreciation and sluggish domestic demand.

Despite the large rise in energy prices there have been no signs of 'second round effects'. There has been very little evidence of pass through from higher input prices to final goods, while the continued softness of labour markets has meant that wage growth has been moderate. Against this background, inflation and inflationary pressures have been relatively subdued and inflation expectations have remained benign. In this environment, the Governing Council has kept interest rates unchanged at the exceptionally low levels prevailing since June 2003. Thus, euro area interest rates remain at levels equivalent to post-World War II lows.

The current euro area monetary policy environment The current monetary policy environment is complex, clouded with a number of domestic and international uncertainties. The euro area recovery has clearly lagged that of most of the other major economies, and the future strengthening of growth still remains a gradually emerging prospect rather than a current reality. While inflation and inflation expectations remain well grounded and we don't see any immediate threats, there are some upside risks to the maintenance of price stability in the medium-term. The uncertainties surrounding the outlook relate in particular to the future evolution of euro area domestic demand, particularly consumer spending, the risks stemming from higher oil prices, the potential for volatility in foreign exchange markets and the potential impact of high levels of liquidity. Framing monetary policy in such an environment is challenging.

With regard to the economic outlook, the central scenario remains for moderate growth to gradually unfold, though the pace and timing of any pick-up is subject to much uncertainty. The normal sequence of recovery tends to run, first, from a pick-up in export growth, then to a recovery in investment and, finally, on to a strengthening of consumer spending. The recovery in export growth was largely seen in the period between mid-2003 and mid-2004. More recently, we have seen some small improvement in investment spending, though it remains sub-par when compared to earlier cycles. This would appear to reflect the fact that strong profit growth has been used more to restructure balance sheets than to boost investment. The main disappointment, however, has been the performance of consumer spending. There is no doubt that there has been much to hold consumption back. Employment and wage growth have been modest. Persistently high and volatile oil prices have had a dampening influence. In addition, the level of saving has remained high, reflecting ongoing concerns, not only in relation to labour markets, but also about longer-term prospects for health-care and pension systems.

Nevertheless, there are a number of positive factors. Real short-term and long-term interest rates are very low, making financing conditions favourable. The recovery in corporate profits should eventually stimulate both higher investment growth and a recovery in employment, which should underpin domestic demand. In addition, the continued strength of the global economy should help offset some of the drag resulting from the strengthening of the euro.

More recently, the signals with regard to the outlook for growth have been mixed. While data for January was generally favourable, data since then has been less supportive. Confidence surveys and activity data have generally weakened again, against the background of the renewed sharp rise in oil prices. This is not encouraging and does not suggest that growth is likely to strengthen in the near term. However, more information from both surveys and hard data is required before firm conclusions can be drawn.

This most recent episode is the latest instance in which high and volatile oil prices have raised risks. Not only do high and rising oil prices threaten to slow growth, they also raise the risk of higher inflation, and it is essential to ensure that second-round effects on wage and price-setting behaviour are avoided. The impact of higher oil prices on growth and inflation will depend on the scale of oil price increases, its persistence, the economy's dependence on oil and second round effects on inflation. There is much uncertainty about the scale of the impact on growth and inflation and estimates vary widely. On balance, the evidence tends to suggest that the effects of oil price shocks have become milder over time. Indeed, with regard to the inflationary impact of rising oil prices, it is notable that euro area inflation has been broadly stable in recent years. For example, despite a more than two and one-half fold increase in oil prices from around $20 per barrel in early 2002, the headline rate of inflation has remained in a fairly narrow range - 1.6 to 2.5 per cent - over the same period, while the core rate of inflation has remained close to 2 per cent for most of the time, until recently when it has fallen. With regard to economic activity, while the impact of oil prices has become more muted over time, it nevertheless remains significant. All major economic downturns over the past three decades have been associated with oil price shocks, though not all oil price shocks have led to downturns. Furthermore, a new and somewhat worrying feature of current oil markets relates to the rise in long-term futures prices, suggesting that higher oil prices may be here for some time.

Oil prices are not the only external factor complicating the outlook. There are also the risks posed by widening global current account imbalances, which show no signs of abating. At the same time, movements in exchange rates have come to be linked with the evolution of imbalances. Given the relative fixity of some Asian currencies vis-à-vis the US dollar, from time to time, this has led to sharp upward movements in the value of the euro. The strengthening of the exchange rate has acted to slow activity and the potential for further volatility in foreign exchange markets remains an important downside risk to growth. The position of the Governing Council on the issue of the exchange rate is very clear - sharp upward moves are unwelcome and undesirable for economic growth.

There are also risks from within. In particular, reflecting the stimulative effect of low interest rates on the monetary aggregates, we have seen persistently strong growth in money and credit. This points to potential risks to price stability in the medium to long-term. We are mindful of these risks but we are also mindful that, as yet, there is no evidence that strong growth in liquidity is affecting the general level of spending.

At some point in time, it will be necessary to begin to remove the accommodative stance of monetary policy. For the moment, however, the view of the Governing Council is that interest rates are at a level which is consistent with the maintenance of price stability. While there are risks to the outlook for both growth and inflation, the central scenario is still for ongoing moderate growth with underlying inflationary pressures remaining contained. In taking interest rate decisions it is always a question of weighing up opposing factors and reaching a decision consistent with the medium-term goal of price stability. I can assure you that the Governing Council remains vigilant and will continue to watch developments closely in coming months.

Monetary policy implementation

Turning now to implementation, the Central Bank has played and continues to play a full part in the Eurosystem's monetary policy implementation process. At the operational level, Central Bank staff carry out the Eurosystem's regular money market management operations with Dublin based banks. Reflecting the importance of Dublin as an international financial centre, the banking system in Ireland has a disproportionately high share of Eurosystem operations; for example, the normal level of outstanding lending by the Bank is in excess of EUR18 billion.

At a strategic level, the Bank has had a full input into the evolution of the monetary policy framework, both when the Eurosystem operational framework was being designed and when it was amended, most recently in March 2004. The revisions of last year came into effect following a public consultation, in which Irish institutions were among the most prominent in the number and comprehensiveness of their responses. The new arrangements involved a change in the timing of the reserve maintenance period and shortening the maturity of the Main Refinancing Operations from two weeks to one week. The intention of these two revisions was to eliminate the effects of expectations of interest rate changes on bidding behaviour. The ECB also enhanced its communications with market participants and increased transparency by publishing a benchmark allotment for each Main Refinancing Operation. The benchmark allotment is the amount that allows for neutral liquidity conditions and the market can now compare the actual allotment with this benchmark amount.

The implementation of the recent changes went smoothly and counterparties quickly adapted their bidding behaviour to the increased allotment amounts in the weekly operations. A favourable outcome has been an overall stabilisation of the spread between the overnight rate and the minimum bid rate during the reserve maintenance period. Another, almost inevitable, consequence of the changes has been the increased incidence of liquidity imbalances at the end of the reserve maintenance period, which has been reflected in increased volatility in the overnight rate on the last day of the period. The ECB has responded with more frequent fine-tuning operations and it recently consulted with market participants, via its Money Market Contact Group, on other possible approaches that might help to reduce volatility.

The Eurosystem institutional set-up, involving centralised decision-making on monetary policy issues and decentralised implementation of policy presents special challenges in the area of communication. Such arrangements demand that the Eurosystem keeps in touch with local market participants and opinion. I would like to outline a few examples of how this achieved. Local market views are collected by the Bank and provided to the ECB on a daily basis. Together with the views of the rest of the euro-area market, these play a part in the ECB's management of the euro-area money market. We in the Bank also conduct annual money market surveys and periodic bond market studies, which feed into wider euro-area market studies and these in turn are published by the ECB. Another communication forum is the Dublin Markets Contact Group. This group of banks, representative of the local market, meets under the auspices of the Bank's Financial Market Department. We use this forum to provide feedback from similar groups established at Eurosystem level while local issues that arise in the Dublin market are fed back to the ECB. At a more informal level, communication is facilitated by frequent contact between Bank staff and market participants and I would encourage you to contact the Central Bank with your views on any notable market developments.

The variety and type of assets acceptable as eligible collateral in Eurosystem credit operations is also currently under review by the Eurosystem. Following a public consultation process the Governing Council decided, in May of last year, to replace the current two-tier collateral system with a single list of collateral. This move, which will take place on a gradual basis, aims to reduce the diversity of the assets currently eligible as Tier-Two, thereby enhancing the transparency of the overall collateral framework. The first step towards establishing the Single List comes into force at the end of May and involves the inclusion of euro-denominated assets from issuers in major markets outside the European Economic Area (for example, euro bonds of US issuers) and the phasing out over time of some Tier-Two collateral, for example equities. As a second step, the Governing Council has approved, in principle, the inclusion in the Single List of bank loans from all euro-area countries and mortgage-backed promissory notes which were specially developed for Irish market conditions. I am particularly pleased at the retention of mortgage-backed promissory notes as this represents a positive result of a great deal of work undertaken by the Bank's representatives at Eurosystem level.

In terms of market functioning, we particularly welcome the ACI initiative that is aimed at integrating the short-term securities markets across the euro-area. Supported by the ECB, this should soon see the issuance of short-term securities under the imprimatur of the ACI STEP committee. Along with a small number of other euro-area national central banks, the Bank will contribute to the process of granting the STEP label, in our case for assets originating in Ireland and in some other jurisdictions.

EU financial integration

Turning now to EU Financial integration. The EU policy framework for achieving greater financial integration is through regulation, supervision and financial infrastructure. In relation to regulation and supervision, while the single market was established in 1992, it was only in 1999, with the drafting of the Financial Services Action Plan (FSAP) , that a concerted effort was made to break down the barriers to the provision of pan-European financial services. The Plan has led to the adoption of almost 42 Community measures which cover banking, securities, asset management, insurance and pensions, clearing and settlement and many other cross-cutting issues. The impact of the FSAP on financial markets will, however, take time to manifest itself fully, and the focus now is on consistent enforcement and implementation across the Union.

There are a several reasons why the Bank, and the SCAB, want to see more integrated EURO financial markets. These include better and more efficient allocation of risk and capital, the smooth operation of the monetary policy transmission mechanism and of payment systems, and greater overall financial stability.

The financial system plays a fundamental role in the transmission of monetary policy, and integrated European financial markets facilitate the implementation of the euro area's monetary policy. This is particularly relevant in the wholesale money and bond markets in which the EBB and the Bank, through the SCAB, are involved. Financial market integration should also contribute to greater financial stability, since a larger and more diversified financial system is better able to absorb economic shocks.

A robust framework for securities clearing and settlement - the plumbing of the financial system - is also needed. This infrastructure lies at the core of all financial markets and is indispensable for their proper functioning. There are a number of private and public-sector initiatives under way to promote the integration, efficiency, and security of the European securities infrastructure. One such important initiative is the development of the "Standards for Securities Clearing and Settlement in the European Union". These standards have been drawn up jointly by the SCAB and the Committee of European Securities Regulators (CESAR).

In the context of financial integration, the TARGET system that commenced operations on the first day of Monetary Union was a major initiative and it has proved to be very successful. It was created by interconnecting the then-15 national real-time gross settlement (RAGS) systems and the EBB payment mechanism.

TARGET was created to provide a safe, efficient and reliable mechanism for the settlement of cross-border large value payments in euro and to serve the needs of Euro system monetary policy. The system settles payments in real time with immediate finality in central bank money, thus eliminating settlement risk between participants. It is uniquely wide in its coverage, with almost 1,100 direct participants and more than 48,000 banks - including branches and subsidiaries - accessible through the system. Last year, an average of more than 267,000 payments with a value of EUR1.7 trillion were transferred through TARGET per business day. This makes TARGET - alongside the Fed wire system in the United States - one of the two largest wholesale payment systems in the world.

In December 2004, the Governing Council of the EBB approved the building of a TARGET Single Shared Platform to replace the current decentralised structure. This new system will achieve a higher level of efficiency and improved security, through a harmonised structure based on a single technical platform. It will also provide a harmonised service level ensuring a level playing field for banks across Europe. This will be supported by a single price structure for domestic and cross-border payments. TARGET will offer new functionalities that will enable banks to achieve better integration of their euro liquidity management. The existing business relationship and contacts between National Central Banks and their banking communities will continue on the same basis as at present. Work on the building of the new system is currently underway and it is scheduled to commence operations in January 2007.

Concluding remarks

In conclusion, a well-integrated financial system is essential to the smooth and effective implementation of monetary policy. While the technical and operational challenges to implementing a single monetary policy across twelve countries have been considerable, these have been successfully met. The Euro system approach has been to ensure that the financial infrastructure, and, in particular, the payment, clearing and settlement systems have operated in an efficient and integrated fashion. The dynamic and changing nature of markets means that these systems are continuing to be enhanced, with functionalities being improved to meet evolving needs.

As regards monetary policy, the current environment is complex, with a number of uncertainties, in particular, high oil prices, still persisting. There are risks to the outlook for both growth and inflation; however, the central scenario is still for ongoing moderate growth with underlying inflationary pressures remaining contained. The Governing Council remains vigilant and we will continue to watch developments closely in coming months.